

March 16, 2015

TO: State Directors
Rural Development

ATTN: Multi-Family Housing Program Directors, Coordinators,
Specialists, State Architects, and Construction Analysts

FROM: Tony Hernandez /s/ ***Tony Hernandez***
Administrator
Housing and Community Facilities Programs

SUBJECT: Guidance on the Capital Needs Assessment (CNA) Process

Introduction

This 2013 Unnumbered Letter (UL) provides updated clarification and guidance on the Rural Development Capital Needs Assessment (CNA) process. This document is comprised of ten main sections: 1) References to CNA in [7 CFR Part 3560](#) and the RD MFH Handbooks; 2) [Contract Addendum](#); 3) [Requirements and Statement of Work for a CNA](#); 4) [The CNA Review Process](#); 5) Definitions; 6) [Guidance for the Multi-Family Housing \(MFH\) Property Owner Regarding Contracting for a CNA](#); 7) Revising a CNA; 8) [Updating a CNA](#); 9) [Incorporating a Property's Rehabilitation into a CNA](#); and 10) [Repair and Replacement Schedule](#). There are also ten attachments to this UL identified as Attachments [A](#), [B](#), [C](#), [D](#), [E](#), [F](#), [G](#), [H](#), [I](#), [J](#) and [two Subattachments A-1 and B-1](#). This entire Unnumbered Letter should be made available to RD MFH property owners, applicants and CNA Providers who are or are planning to submit transactions using the MPR or any other RD RRH or FLH program loan making or servicing authorities.

EXPIRATION DATE:
January 31, 2016

FILING INSTRUCTIONS:
Housing Programs

Purpose of the UL

The need for a CNA report arises from numerous property transactions and is intended to record the specific physical conditions of each MFH property that is an asset of Rural Development. A properly documented report will become the basis for the establishing of a reserve account that is assigned to address the financing for the physical replacement and repair concerns that are projected to occur for the full duration of the CNA cycle. The report shall include specific physical property items, systems and components that are not feasibly covered by the yearly maintenance funds. Although, the listed CNA items can differ from property to property, the overall intent and goal is to assure that the property is covered financially, in its' entirety, for all maintenance, repairs and replacements necessary for suitable living/working conditions for all occupants/visitors of the property.

By following the guidance of this UL there is a higher probability of acceptance of the application and a higher probability of successful performance of the property during the CNA cycle. Accuracy of the report and timeliness of the review process are critical to the CNA process providing a benefit to the property.

1. References to CNA in 7 C.F.R. Part 3560 and the RD MFH Handbooks

References to a Capital Needs Assessment (CNA) can be found in 7 C.F.R. Part 3560, HB-1-3560, HB-2-3560, and HB-3-3560; and 7 C.F.R. Part 3565 and HB-1-3565. (See [Attachment A, References to Capital Needs Assessment \(CNA\) in 7 CFR Part 3560 and Handbooks](#).) These references include information describing when a CNA is required, suggested uses of a CNA, general requirements for a CNA, sources of funding for a CNA, and situations in which a CNA may be performed by Rural Development (RD) or other third party provider.

2. Contract Addendum

Rural Development uses a Contract Addendum to supplement the basic CNA agreement or "contract" between the Owner and CNA Provider with additional details and conditions. It can be found in [Attachment B, Addendum to Capital Needs Assessment Contract](#) and must accompany all contracts executed between the Owner and CNA Provider for CNAs used in RD transactions. If any conflicts arise between the "Contract" or "Contract Addendum", the "Contract Addendum" will supersede.

The Contract Addendum identifies the responsibilities and requirements for both the property owner and the CNA Provider. To assure proper completion of the contract documents the following key provisions must be completed:

a. The Contract Addendum will include the contract base amount for the CNA Provider's cost for services on page B-2, and provisions for additional services to establish the total price for the CNA.

b. Item I(e) requires an itemized listing for any additional anticipated services and their unit costs including future updates and revisions that may be required before the CNA is accepted by RD *Note: Any cost for updating a CNA must be included, in the "additional services" subpart, of the original CNA contract.*

- c. The selection criteria boxes in II a, identify the type of CNA being provided.
- d. In III (a), the preferred language for the blank on "report format" is: "USDA RD CNA Template, current RD version, in Microsoft Excel format". This format will import directly into the underwriting template for loan underwriting purposes.

3. Requirements and Statement of Work for a CNA

Minimum requirements for a CNA acceptable to RD can be found in Attachment C, Capital Needs Assessment Statement of Work. This is supplemented by *Fannie Mae, Appendix D, Reference Effective Useful Life (EUL) Table, Instructions for the Property Evaluator, and Attachment J, Guidance on the Rehabilitation of MFH Properties*. To resolve any inconsistency in the two documents, Attachment C, the CNA SOW will in all cases prevail over the Attachment D, Fannie Mae, Appendix D, Reference Effective Useful Life (EUL) Table, Instructions for the Property Evaluator. Fannie Mae defines the "term" as "term of the mortgage and two years beyond". For USDA, the "term" will be 20 years, as defined in the CNA SOW.

Attachment C includes the required qualifications for the CNA Provider, the required scope of work for a CNA assignment, and general distribution and review instructions to the CNA Provider. CNA Providers must be able to report the current physical condition of the property and should **not** base their findings on the financial condition of either the property or the Owner.

Attachment D is a three-part document Rural Development uses as reference to the CNA process throughout the RD revitalization and demonstration program efforts. The three key components of this Attachment are: 1) guidance to the property evaluator; 2) expected useful life tables; and 3) a set of forms. It includes general instructions used in completing CNA reports, specific instructions on how to use the expected useful life tables and a set of applicable forms including the Terms of Reference form; Systems and Conditions forms; and Evaluator's Summary forms.

An acceptable CNA will appropriately address each of the following supplemental concerns within the report and narrative:

- a. Attachment E, Accessibility Laws and Requirements, outlines the federal accessibility laws, regulations, and standards that apply to Section 515 and Section 514/516 Multi-Family Housing properties. The CNA Provider should use Attachment E as a guide in assessing how the property meets the requirements for accessibility to persons with disabilities. The CNA report should include any actions and estimated costs necessary to correct deficiencies in order for the property to comply with applicable federal, state, and local laws and requirements on accessibility. The report should also include an opinion based on the adequacy of a current, approved transition plan for the property or advisory that one was not presented for review.

- b. [Attachment F, Existing Property Accessibility Checklist](#), contains general information in a checklist format that indicates a sample of the requirements for compliance that should be verified by the CNA Provider. For example, a transition plan that does not address all of the deficiencies listed in Attachment F, or is outdated, is not adequate. Attachment F should be used to indicate accessibility compliance corrections necessary to the property. It is the responsibility of the Provider to inspect and verify whether all accessibility features are compliant. The checklist is intended as a general guide and NOT intended to cover every aspect of accessibility (which may vary depending on site location). The Uniform Federal Accessibility Standards (UFAS) paragraph references are **bolded** and guideline language *italicized*. This Attachment provides relevant information extracted from the UFAS and paraphrased but is not necessarily quoted verbatim.
- c. [Attachment G, Accessibility Requirements for Rural Development Financed Existing Multi-Family Housing \(Supplemental Questions & Answers\)](#), provides “Frequently Asked Questions” on accessibility for RD MFH Program involving the existing MFH properties, which may be helpful to the CNA Provider.
- d. Attachment J, [Attachment J, Guidance on the Rehabilitation of MFH Properties](#) provides guidance on the rehabilitation of Rural Development Multi-Family Housing (MFH) properties using the Section 515 Rural Rental Housing and Section 514/516 Farm Labor Housing programs. It provides the primary guidance on the standards and requirements for projects using only Agency funding to complete the repairs or rehab. When financing sources include “third party” sources there may be other or additional construction requirements and conditions which will need to be discussed and mutually accepted by all parties involved. With projects using any third party (non-RD) financing the principles of Attachment J should be applied to the extent necessary to assure the Agency's security interest is adequately addressed.

4. The CNA Review Process

A CNA used by Rural Development will be reviewed by the designated RD CNA Reviewer serving the area. The CNA Reviewer will be an architect, construction analyst, appraiser, or other staff member with education, training, and experience in construction, rehabilitation, and repair of Multi-Family Housing (MFH) properties, especially as it relates to repair, replacement and maintenance costs throughout the term covered by the CNA.

A CNA report must be obtained by the property owner from a third party CNA Provider that has no identity of interest with the owner, management agent, buyer or any other principle or affiliate defined in 7 [C.F.R. Part 3560, §3560.11](#). The property owner will contract with the CNA Provider and is therefore the client of the provider. However, the owner should consult with

Rural Development before contracting with a CNA Provider to review Guidance for the MFH Property Owner Regarding Contracting for a CNA shown in this letter as Item 6, and the Addendum to Capital Needs Assessment Contract (Attachment B). The RD CNA Reviewer will evaluate a proposed agreement or engagement letter between the Owner and a CNA Provider using Attachment H, Capital Needs Assessment Guidance to the Reviewer, prior to reviewing any CNA report. Unacceptable CNA proposals, contracts or reports will be returned to the applicant for appropriate corrections before they will be used for any underwriting determinations.

The CNA Reviewer will also review the cost of the CNA contract. The proposed fee for the CNA must be approved as an eligible housing project expense under 7 C.F.R. 3560.103 (c) for the agreement to be acceptable and paid using project funds. If the CNA is funded by the property's reserve account, a minimum of two bids is required if the CNA service contract amount is estimated to exceed \$3,500, in accordance with HB-2-3560, Chapter 4, section 4.17-B. If the contract is funded by another source, or will be under \$3,500, a single bid is acceptable. (However, the Agency recommends multiple bids in all cases. There is no Agency requirement to select the "low bidder" and the owner may select a CNA Provider based on qualifications, as well as price after reviewing references and past work.)

If the proposed agreement is acceptable, the reviewer will advise the appropriate Rural Development servicing official, who will in turn, inform the owner. If the proposed agreement is unacceptable, the reviewer advises the owner and the CNA Provider in writing and identifies actions necessary to make the proposed CNA submission acceptable to Rural Development. Upon receipt of a satisfactory agreement, the RD CNA Reviewer should advise the appropriate Rural Development servicing or underwriting official to accept the proposal.

The CNA Reviewer will review a preliminary CNA report delivered to Rural Development by the CNA Provider using Attachment H, Capital Needs Assessment Guidance to the Reviewer, (including the checklist provided) and Attachment I, Sample Capital Needs Assessment Review Report, to write the preliminary CNA review report. The preliminary CNA report will be delivered to the Rural Development loan and servicing official(s) to jointly discuss the findings and reviewer's conclusions. If necessary, the loan official will then notify the owner in writing of any revisions that are necessary to make the CNA report acceptable to Rural Development. The CNA Reviewer will review the final corrected CNA report to verify that the report is acceptable to Rural Development before delivering the final CNA review report to the loan official for a subsequent joint discussion to verify the report complies with the CNA requirements. Any difference of opinions exist regarding the findings at this time must be mutually addressed by RD staff before the final CNA review report is delivered to the owner. To confirm this discussion between the CNA Reviewer and loan official, **the final CNA review report must be signed by both the CNA Reviewer and the loan official.**

During the CNA review process, the CNA Reviewer and the underwriter must consult with the field office most familiar with the property for their input and knowledge of the property. Upon signature by the RD CNA Reviewer and Loan Underwriter this report becomes the “accepted” CNA indicating the actual condition of the property at the time of the CNA inspection – a “snapshot” in time – and will be marked “Current Property Condition” for indefinite retention in the borrower case file.

5. Definitions

The following definitions are provided to clarify terms used in conjunction with the CNA process:

As-is CNA: This type of CNA is prepared for an existing MFH property and reports the physical condition of the property based on that moment in time. This CNA can be useful for many program purposes other than the MPR, such as, an ownership transfer, pre-payment incentive and evaluating or resizing the reserve account. The As-is report will include all major repairs and likely some minor repairs that are typically associated with the major work; each major component, system, equipment item, etc. inside and outside; building(s); property; access and amenities in their present condition . A schedule of those items showing the anticipated repair or replacement time frame and the appropriate, associated hard costs for the ensuing 20-year term of the CNA serves as the basis or starting point in evaluating the underwriting that will be necessary to determine the feasibility and future viability of the property to continue serving the needs of eligible tenants. The As-is CNA is an important tool when a property rehabilitation is anticipated. A well document As-is report will provide an excellent assessment tool when the agency reviews the rehabilitation scope of work.

“Post Rehab” CNA: This type of CNA is done for an existing MFH property as well, but considers any planned rehab or major repairs proposed for the property transaction. It builds on the findings of the accepted As-is CNA and is typically prepared for a project that will be funded for a major rehabilitation. The Post Rehab CNA is adjusted to reflect the work intended to be performed during the rehabilitation. The assessment must be developed from the rehabilitation project plans and any construction contract documents to reflect the full extent of the planned rehab.

Life Cycle Cost Analysis: When a CNA is required prior to beginning the construction of a new project, then a more suitable process is known as a Life Cycle Cost Analysis (LCCA). An Architect or Engineer is the best qualified person(s) to prepare this report. A LCCA is an expanded version of a CNA and is defined at 7 C.F.R. Section 3560.11. The LCCA will determine the initial purchase cost, the operation and maintenance cost, the “estimated useful life”, and the replacement cost of an item selected for the project. The LCCA provides the owner with the CNA information on repair or replacement costs and timeframes over a 20-year period.

It also provides information that will assist with a more informed component selection and can provide the owner with a more complete financial plan based on the predictive maintenance needs associated with those components. If the newly constructed project has already been completed without any previous CNA requirement, either an “As-is” CNA or LCCA can be provided to assist in establish the required reserve needs analysis necessary for establishing program mandated reserve deposits.

Consolidation: In some circumstances, Rural Development may permit two or more adjoining properties to be consolidated as defined in 7 CFR 3560, §3560.410 when it is in the best interests of the government. The property owner should consult with the RD loan official before engaging the CNA Provider in any case where the CNA intends to encompass more than a single (one) existing RD property to determine if a consolidated CNA may be acceptable for RD underwriting. Rural Development requires that individual properties be identified by name or address so the condition reported is specific to a unit, building or property.

Any proposed consolidation of properties or merging of ownership interests in any form, must comply with the specific program authorities and requirements as specified in the respective program regulations and guidance before engaging the CNA provider CNAs, as well as 504 Self Evaluation/Transition Plans or other accessibility assessments, should be performed independently for each legal entity receiving federal funds

A CNA Provider should be fully aware of the intended use for the CNA because it can impact the calculations necessary to perform adequate accessibility assessments and can impact the acceptability of the report by RD. Unacceptable reports will not be used for any RD underwriting purposes even though they may otherwise be acceptable to the owner or another third party lender or participant in the transaction being proposed.

Note: All CNA's will be required to include all line items relevant to a property when a CNA is performed. Line items exceeding an EUL of greater than 20 years may or may not include a cost at the discretion of the CNA provider, Owner, or Agency Representative.

6. Guidance for the MFH Property Owner Regarding Contracting for a CNA

Rural Development Offices in each State Office maintains a directory of CNA Providers, and can forward that information to the MFH property owner upon request at the time a CNA is being proposed. However, the property owner is not required to use a CNA Provider from the RD State directory. Note: Rural Development in no way guarantees the performance of the CNA Providers listed in their respective directories.

Property owners are advised to request an information package from several CNA Providers and to evaluate the information before selecting a provider. At a minimum, the information package should include a list of qualifications, a list of references, a client list, and a sample CNA report

but the Owner may request any additional information they feel necessary to evaluate potential candidates and select a suitable provider for this service. Consideration for the type of CNA required should be part of the owner's selection criteria and inserted into the contract language as well. The necessary skill set to perform the As-is versus the Post Rehab or New Construction CNA versions, needs to be considered carefully. Knowledge of the accessibility laws and standards and the ability to read and understand plans and specifications could also be among the critical skill elements to consider.

[Attachment B, Contract Addendum](#) should be submitted to Rural Development with the contract, and signed by Owner and CNA Provider. The proposed agreement with the property owner and CNA Provider must meet Rural Development's qualification requirements for both the provider and the CNA scope of work, as specified in [Attachment C, Capital Needs Assessment Statement of Work](#). Rural Development should review the proposed agreement between the owner and the CNA provider, and concur only if all of the RD requirements and conditions are met. (See the previous section 4 of this UL, [The CNA Review Process](#).)

7. Revising a CNA (applies to RD actions)

During transaction underwriting and analysis, presentation of the information contained in the "accepted" CNA may need to be revised by Rural Development to address financing and other programmatic issues. The Loan Underwriter and the CNA Reviewer will work together to determine if revisions are necessary to meet the financial and physical needs of the property and established RD underwriting or servicing standards and principals. These may involve shifting individual repair line items reported in the CNA, moving work from year to year, or other adjustments that will improve cash flow. The revised CNA will be maintained by Rural Development as supporting documentation of the loan underwriting, and used in the future as the anticipated schedule of replacements, establish reserve funding schedules, and operating budget preparation and analysis.

The initial CNA, prepared by the CNA Provider, will be maintained as an independent third party record of the current condition of the property at the beginning of the twenty-year cycle. Original CNAs will be maintained in the case file, clearly marked as either "Current Property Condition" ("As-is"), "Post Rehab Condition", "Revised Underwriting / Replacement Schedule", as applicable. Note: The CNA Provider is not the appropriate party to "revise" a CNA which has already been approved by the Owner and Provider, and concurred in by the Agency. The CNA Provider's independent opinion was the basis of the "As is" or "Post Rehab" CNA. The CNA developed for underwriting may **only** be revised by Rural Development staff during the underwriting process or as part of a post-closing servicing action.

8. Updating a CNA (applies to "As-is" and "Post-Rehab")

A completed CNA more than a year old at the time of Rural Development review and approval of the CNA must be "updated" prior to Rural Development approval. Likewise, if at the time of

Underwriting the CNA is more than a year old (but less than two years old), it must be updated before the transaction may be approved.

To update a CNA, the CNA Provider should review property changes (repairs, improvements, or failures) that have occurred since the date of the original with the owner, review costs and quantities, and submit a updated CNA for approval. However, if the site visit for the CNA occurred more than two years prior to the loan Underwriting, the CNA Provider should perform a new site visit to verify the current project condition.

Once the CNA has been updated, the CNA Provider will include a statement noting “This is an updated CNA of the earlier CNA dated ____” at the beginning of the CNA’s Narrative section. The CNA Provider should reprint the CNA with a new date for the updated CNA, and provide a new electronic copy to the owner and Rural Development.

Please note: it is in the Owner’s best interest to furnish the CNA Provider with the most current and up-to-date property information for a more comprehensive and thorough CNA report. RD recommends that the Owner conduct a pre-inspection meeting with the Owner, Property Manager, maintenance persons familiar with the property, CNA Provider, and Agency Representatives at the site. This meeting will allow a forum to discuss specific details about the property that may not be readily apparent to all parties involved during the review process, as well as making some physical observations on-site. Certain issues that may not be evident to the CNA Provider due to certain weather conditions at the time of review should also be discussed and included in the report. Additionally, other issues that may need to be addressed include environmental hazards, structural defects, as well as complex accessibility issues.

This pre-inspection meeting also allows the CNA Provider to discuss with the Owner total number of units to be inspected, as well as identifying any specific units that will be inspected in detail. The minimum number of units required for inspection by the Agency for an acceptable CNA is 50%. However, inspecting a larger number of units generally provides more accurate information to identify the specific line items to be addressed over the “term” being covered by the CNA report. Owners are encouraged to negotiate with the CNA Provider to achieve inspection of all units whenever possible. The ultimate goal for the Owner and CNA Provider, as well as the Agency, is to produce the most accurate “baseline or snapshot” of current physical property conditions for use as a tool in projecting future reserve account needs.

9. Incorporating a Property’s Rehabilitation into a CNA

A CNA provides a repair schedule for the property in its present condition, indicating repairs and replacements necessary for a property to function properly and efficiently over a span of 20 years. It is not an estimate of existing rehabilitation needs, or an estimate of rehabilitation costs. If any rehabilitation of a MFH development is planned as part of the proposed transaction, the rehabilitation repair list (also called a “Scope of Work”) should be developed outside of the

CNA. This rehabilitation repair list may be developed by the owner, a project architect, or an outside party (such as the CNA Provider, when qualified) hired by the owner. A copy of the rehabilitation repair list or Scope of Work should then be provided to the CNA Provider.

With this information, the CNA Provider, if requested by the owner and approved by Rural Development, shall prepare a “Post Rehab” CNA indicating what repairs are planned for the property in the coming 20 years based on conditions after the rehabilitation is completed. Items to be replaced during rehabilitation, such as appliances, that will need to be replaced again during the 20 years will be included in the “Post Rehab” CNA. Items, such as a new roof, that will not need replacement during the coming 20 years will also need to be included in the “Post Rehab” CNA- if the EUL is more than 20 years it is optional to include a cost for a particular line item. The line item should not be removed from the CNA, but no data input will be necessary until an updated CNA is required. Appropriate comments should be included in the CNA report to acknowledge the scope of work or rehabilitation repairs that were considered.

The Owner should not use repair line item costs taken from the CNA to develop the rehabilitation cost estimates for the rehabilitation loan as these costs will not be accurate. The repair costs in a CNA are based on “probable market costs” for the property to have selected items replaced. Typically, these market costs include the labor, materials, overhead and profit. For example, for CNA purposes, it’s the probable market cost to send a repairman out, remove an appliance, and put a new one in its place. No other “soft costs” are included. For rehabilitation cost estimates, the Owner typically intends to hire a general contractor to oversee and supervise the rehabilitation work, which is then considered a “soft cost”. The cost of rehabilitation includes the costs for that general contractor, his general requirements, the cost of a project architect (if one is used), tenant relocation (if needed), interim financing (if used), which are also considered soft costs attributed to the rehabilitation costs for the project. A CNA cannot be used to accurately establish cost data for a rehabilitation project as most CNA activities do not include “soft costs”.

10. Repair and Replacement Schedule

A CNA is not a formal repair and replacement schedule, and cannot be used for an exact replacement schedule. A CNA is an estimate of the anticipated replacement needs for a property over time and its associated replacement costs. If all of the refrigerators are being replaced in a rehabilitation project, and have an Estimated Useful Life (EUL) of 15 years, all refrigerators should not be replaced in year 15. If good quality equipment is purchased initially, they might last longer. If a refrigerator needs replacement in year 13, the tenant will not be forced to wait two years for a replacement refrigerator. The goal of a CNA is not to set the replacement times, but to estimate having funds available to replace equipment as it is needed. Hopefully, materials will be well maintained and last longer than estimated in the CNA. However, the CNA cannot be used to mandate replacement times for the identified building components.

Training Tool

Program Support Staff in the National Office developed a Power Point presentation that can be used to train staff, CNA Providers, or owners/managers on the CNA process. This presentation is posted to the Internet on <http://www.rurdev.usda.gov/rhs/mfh/MPR/MPRHome.htm>. Please contact William Downs (202-720-1499) wiliam.downs@wdc.usda.gov, Meghan Walsh (202-205-9590) meghan@walsh@wdc.usda.gov or Michel Mitias (800-548-0071, x142) michel.mitias@wdc.usda.gov if you have questions on the presentation.

Handbook Updates

A Procedure Notice incorporating this guidance into the appropriate RD Handbooks is planned. Handbook procedures regarding the CNA process will be revised over time as Rural Development continues to improve the process for using the CNA in underwriting and servicing. Any suggestions, comments, or questions on the current RD underwriting CNA guidelines should be directed to Carlton Jarratt, Senior Loan Specialist with the Office of Rental Housing Preservation at 804-287-1524 carlton.jarratt@wdc.usda.gov.

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