U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

OFFICE OF HOUSING

Special Attention of:
Multifamily Regional Center Directors
Multifamily Satellite Office Directors
Multifamily Asset Management Division Directors
Multifamily Account Executives
Multifamily Owners and Management Agents

Notice: 2023-03

Issued: 3/29/2023

Expires: This Notice remains in effect until amended, superseded, or rescinded

SUBJECT: Capital Needs Assessment (CNA) eTool for Asset Management

I. Purpose

This Notice provides guidance from the Office of Multifamily Housing to lenders/servicers, third-party needs assessors, property owners, and Department of Housing and Urban Development (HUD) staff on the policy for submission and review of Capital Needs Assessments (CNA) required for 10-year updates for Federal Housing Administration (FHA) insured properties, Rental Assistance Demonstration (RAD) Conversions, and several eligible asset management milestones. After 90 days from the date of publication of this notice, use of the CNA eTool is required for all CNA submissions, with a limited number of exceptions identified here within.

II. Applicability

This notice applies to all FHA-insured properties that have a 10-year CNA update requirement[1] Additionally, this notice applies to CNAs required for RAD Conversions, Housing Assistant Payment contract assignment (HAP Assignment) requests where HUD has requested a CNA, and other eligible asset management milestones, such as Budget Based Rent Increase (BBRI) for 202/811 Project Rental Assistance Contracts (PRAC), Partial Payment of Claims (PPC), or Transfer of Physical Assets (TPA). The CNA eTool is required for all submissions except as indicated otherwise in this Housing Notice. The CNA eTool is not required for non-insured properties that have thirty (30) units or less. FHA-insured properties, regardless of size, are subject to the requirements in this notice.

III. Background

CNAs describe the physical elements of a property and characterize the conditions and expected durability of those elements. The CNA projects the necessity and cost of future capital repairs and replacements for the property using estimated useful life calculations. The CNA eTool, which automates CNAs, was jointly developed by the

[1] See Risk Mitigation Notice (ML 2010-21, HN 2010-11, July 6, 2010 Section III.D.11)

U.S. Department of Housing and Urban Development (HUD) and the U.S. Department of Agriculture (USDA) to align agency and industry practice for the preparation and standardization of required capital needs assessments. The CNA eTool enumerates immediate repairs and estimates required initial and annual deposits to the Reserve for Replacement (RfR) while allowing for appropriate assumptions concerning variables such as inflation, interest on reserve balances, and minimum required balances or contingency allowances.

The CNA eTool helps generate reports that can be used to:

1) Identify and describe physical deficiencies of the property;
2) Identify and describe immediate/short-term repair needs;
3) Estimate long-term capital replacement costs; and
4) Support a financing plan to source identified repairs and capital needs.

HUD launched the CNA eTool in December 2016 with an original implementation date of November 1, 2017, for mandatory use in conducting CNAs for FHA Multifamily mortgage insurance applications, including 10-year CNA updates. This implementation date was delayed, however, for 10-year update CNAs for FHA-insured Multifamily Properties and other eligible asset management milestones, such as BBRI, PPC, and TPA, until the launch of the updated CNA eTool Version 3.0. This delay was due to technological limitations of previous version of the tool.[2] CNA eTool Version 3.0 was deployed on November 9, 2020, which allowed HUD to begin the process of training and distributing guidance for use of the tool in advance of lifting the suspension for eligible programs. This notice shall replace previous guidance on implementation of the CNA eTool for asset management.

IV. Process

For 10-year updates, the lender is required to hire a third-party needs assessor to conduct the CNA at the property. For those properties that do not have a servicing lender, the owner must hire a third-party needs assessor to conduct the CNA who will fulfill the role of lender in consulting with the owner and use the CNA eTool to submit to HUD. Upon completion of the CNA, the lender must review the CNA and notify the owner of any immediate repair needs, potential issues, and the new calculated RfR deposits. The owner and lender must work together to address and resolve any issues noted in the CNA. Once these issues are resolved, the lender should submit the final CNA to HUD through the CNA eTool.

The submitted CNA will be assigned to a HUD Account Executive (AE) for review and adjudication. The AE can consult with a Construction Analyst (CA) if the CNA contains information that requires additional expertise to complete their review. The AE

[2] HUD's August 3, 2018 Memorandum temporarily suspended the CNA eTool requirements for PRACS and HUD's July 18, 2019 memo extended the temporary suspension to 10-year updates and PPCs/Loan Modifications.

will receive a notification about the assignment from their supervisor or through the Asset Management Processing System (AMPS) and should begin the review processes promptly after being assigned a submission to review. During the review, the AE will verify that the correct number of units were inspected, analyze all business flags, financial factors, and repair schedules, such as RfR deposits, critical and non-critical repairs, attachments, and other system generated reports.[3] A key step in this process is that the AE should edit and comment on warning flags listed in the CNA eTool user interface. At the end of the review the AE will either return the CNA to the lender, issue conditional approval, or approve the CNA within the system.

V. CNA Costs and Decisions

A. Cost of CNA eTool Reports

Every 10 years from the date of final endorsement or other events triggering a CNA, one shall be performed on the Property by the lender at owner's expense. This cost may be treated as an eligible project operating expense, or it may be paid out of the RfR escrow as an eligible project operating expense, or as an eligible cost of financing for refinance applications.

In cases of TPAs or HAP Assignments, the purchaser is typically responsible for the CNA's cost. This report is being used as a due diligence tool to assess the physical needs of the property and the RfR deposit amount should be captured in the CNA eTool Initial and Annual Deposits.

In 2011, HUD and FHA lenders collaborated to modify HUD's policy regarding RfR funding. Prior to the 2011 MAP Guide revision, HUD required the RfR to cover 35 years of anticipated capital needs. This method sometimes resulted in unreasonably high or low RfR balances in some of the years within the 35-year period. To address the issue, HUD reduced the RfR estimate period from the mortgage term of 35 years to 20 years. Additionally, HUD established five (5) percent of the average annual reserve expenditure as the minimum yearly contribution to the RfR fund and restated accessibility compliance and remediation requirements to emphasize these issues. During underwriting, HUD requires initial and annual deposits cover all projected expenditures by establishing the minimum balance amounts to be met in years 1-10. While reserve balances are allowed to fall below the minimum or even go negative in years 11-20 (provided the deficit does not exceed 50 percent of the property's cumulative equity) this change was made with the understanding that the RfR would be reevaluated in year 11 and if it is underfunded at that time either monthly deposits must increase, or a one-time deposit must be made to address the property's capital needs.

This reevaluation, facilitated by the required CNA, must result in a plan for

[3] For more information about CNA requirements see the 2020 Multifamily Accelerated Processing (MAP) Guide Appendix A.5.7 Capital Needs Assessments.

the RfR balance to maintain the minimum balance requirements established in underwriting. If a minimum balance requirement was not established during underwriting, then the minimum balance will be $1,000.00 per unit. HUD encourages lenders to notify owners of this future RfR evaluation requirement (i.e., 10-year update CNA) prior to closing. Additionally, despite permitting lower RfR balances in underwriting, HUD requires lenders and owners to adequately plan for repair and maintenance needs that will occur in years 11-20. This plan might include higher initial and monthly deposits to ensure the borrower has sufficient funds to cover critical and non-critical repairs. This is especially important for subsidized or income-restricted properties which have only a limited opportunity to increase revenue or secure additional capital funds.

B. CNA Reviews and Decisions

The CNA submitter should work together with the property owner to complete and submit the most accurate report possible. Prior to the CNA submission to HUD, the submitter must share the report and recommendations with the property owner, and both parties should review and discuss the recommended capital repairs. If there is a dispute regarding a repair, the submitter can use the "Repair Replace Decision" form within the CNA eTool to modify a needs assessor's recommendation.

Additionally, if the submitter is proposing an increase to the monthly deposit in the RfR fund, the submitter must provide financial analysis which demonstrates that the property will generate adequate revenue to meet the proposed increase. If a one-time deposit of additional funds will be used to fund the additional needs, the submitter must identify the source of funds and indicate whether those funds encumber the property.

HUD staff will review each submitted CNA. The AE will analyze the list of critical and non-critical repairs. Critical repairs and replacements are those that affect life, safety, and accessibility. Non-critical repairs and replacements are those that are necessary and desirable for the current maintenance and operation of the property, or repairs that are needed to maintain or improve the marketability of the property.

Additionally, the AE will analyze the new RfR schedule and determine if the property can sustain the recommended contribution amount. The AE will review the Annual Financial Statement (AFS), surplus cash, and other financial factors of the property and determine if the RfR schedule is feasible. The AE may request additional financial information from the property, such as monthly accounting reports. If the AE determines the proposed contribution amount are not achievable or put the property at financial risk, the CNA review should be elevated to the Branch Chief or Division Director level for additional review. The HUD team will then work with the submitter who will need to make adjustments to the CNA, pursue other options for generating funds, or reject the CNA if no solution can be reached.

C. Conditional Approval

If the RfR account balance is insufficient to fund all the required repairs identified in the CNA submittal, or if the property cannot afford the suggested increase to the RfR deposits, the CNA may be conditionally approved subject to a plan to bring the property in to compliance. Properties that receive conditional approval shall be required to have a Capital Action Plan (CAP) which shall be documented in the Multifamily Housing Action Plans section of iREMS. The CAP will be developed through a collaboration between the owner and AE to prioritize the necessary repairs to ensure a reasonable completion schedule is agreed upon and implemented.

If the property has a Real Estate Assessment Center's (REAC) physical inspection score of 60 or greater, all non-critical repairs will need to be completed within three years from the date of the conditional approval date. If the property has a REAC physical inspection score of 59 or below the non-critical repairs will need to be completed within one year from the date of the conditional approval. Critical repairs are still required to be completed on the most expeditious possible schedule or within 90 days from the date of the conditional approval, regardless of the property's REAC score.

When a property is conditionally approved due to insufficient funds to complete the repairs identified in the 10-year update or because it cannot afford the suggested RfR increase, the AE will document in the notes section of the CNA eTool, "CONDITIONAL APPROVAL" and then provide the reasons the property's CNA is conditionally approved. Since there is not currently a conditional approval option in the CNA eTool, the status will remain in the "Awaiting Decision" status. The CNA will remain in the queue and the submitter will be notified by the AE that once sufficient funds are identified and secured then the CNA will be approved within the system.

VI. Transfer of Physical Assets

TPA transactions require a physical inspection of the property. The inspection report must be prepared by a professional, licensed Multifamily architect or engineer and it must address the cost of any required repairs and an analysis of the RfR needs.

While the CNA eTool is recommended to fulfill this physical inspection requirement in all cases, it is only required for properties that consistently have an underfund RfR account, have two consecutives under 60 REAC scores, or are considered troubled or potentially troubled assets. If none of the above criteria apply, the property may submit a CNA conducted in the last three years and the most recent REAC inspection report in lieu of an inspection report.

VII. CNA and the Reserve for Replacement Account

A. Prioritizing Reserve for Replacement Accounts

Notwithstanding any other agreements or capital funding sources, property owners should use their RfR account to pay for necessary repairs and replacements listed in the CNA or unanticipated necessary repairs if required. The Office of Production establishes a minimum balance at underwriting as a means of planning for an adequate reserve. This minimum balance is not a limit on disbursements when repairs and replacement needs occur. The AE can authorize withdrawals that place the RfR balance below the established minimum threshold; however, going below minimum RfR balance will require a review of the financial and physical status of the property. As such, it is strongly recommended that owners/agents communicate with their AE prior to completing repairs and replacements, particularly when reimbursement for the cost of such work will reduce fund balances below established minimum thresholds.

B. Approved Uses of the Reserve for Replacement Escrow

Unless otherwise approved by HUD staff, all draws from the RfR account must be used to repair or replace an item listed in the CNA. The CNA is intended to provide the categories and kinds of repairs and replacement projected; however, it does not necessarily mandate the timing of such repairs and replacements. HUD recognizes that not all capital expenditures can be predicted in advance and disbursements will be permitted for emergencies, unforeseen needs, and in special circumstances. Regardless of whether a repair or replacement is identified on the CNA, withdrawals from the RfR account must be specifically approved by the assigned HUD staff or under delegated HUD authority.[4]

C. Capital Action Plan Development

When RfR escrows are not expected to adequately meet all the future needs of a property, action must be taken by the property owner to remedy the shortfall. In most cases, other capital options are available and should be explored when a property needs extensive critical and non-critical repairs, and the RfR is insufficient to cover those repairs. Depending on the property condition and extent of the shortfall in reserve funds, these options include:

1. Residual Receipts Accounts
2. Secondary financing
3. Owner contributions
4. Rent increases
5. General operating reserves

[4] See Chapter 4 of Handbook 4350.1 Rev 2.

6. Loans and grants from other governmental agencies or private foundations
7. Other approved capital options

The property owner, in consultation with the HUD field office, should develop a CAP that utilizes one or more of the above options to replenish the RfR account for the property. Once the CAP is agreed upon, the AE will monitor the property performance and condition to ensure that the owner complies with the CAP.

D. Increasing or Decreasing the Reserve for Replacement Escrow

Regulatory Agreements designate the authority to adjust RfR contributions solely to HUD. Submitters are to discuss with HUD any concerns they have regarding the RfR contributions of a subject property, however submitters are not permitted to require the owner to make a lump sum RfR contribution or increase the monthly contribution without written approval from HUD. HUD will review requests for adjustments to RfR contributions but will delay any increases if implementation would substantially increase the property's risk of default.

If there are any questions regarding this notice, please contact Daniel Clark at Daniel.J.Clark@hud.gov.

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