

## FAQ-PCNA GUIDANCE – ML 2012-25 & HN 2012-27

### 1. Intrusive examinations:

#### QUESTION:

*Our PCNA providers propose the following procedure in order to comply with the new requirements.*

*For properties 30 years old that need the Intrusive testing and examination: The PCNA provider will ask the borrower/property manager to have the subcontractors which have worked on the subject property to report, in a letter format explaining the following, Trade Experience, (trade qualifications), relationship to the property to vouch for historic trends in repairs, preventive and other, component in question status, method of testing or examination used and if they are common to the trade, components estimated age, condition, RUL, and professional opinion for repairing, replacing or future servicing. The letters will be addressed to the borrower and included in the PCNA.*

*Please let me know if this approach ... meets the intent of the new guidelines.*

#### RESPONSE:

This is not what we had in mind and does not fully address the requirements.

First, it should be noted that the needs assessor may need to contact existing maintenance and systems contractors as a matter of course, even for properties not yet 30 years old and should use independent judgment with respect the information provided by such contractors in light of the needs assessor's own field observations and other written maintenance records.

Second, the need for intrusive examination of elements of a structure(s) is a recommendation by the needs assessor based on his observations and the age of the property and its components. Generally, if a component is 30 years old and has not been replaced or renovated and is not a well maintained and uniquely durable product (e.g. a slate, clay tile, or metal roof, or commercial grade windows), then we want sufficient information to confirm the actual condition and RUL of the component. If the component is susceptible of replacement and will need to be replaced within the estimate period then funds should be reserved to replace it. If the component is not susceptible of replacement and lacks a reasonable remedy, then the lender should take care to assure that the term of the mortgage is adjusted to account for the reduced RUL of this component. If a needs assessor does not have the specific expertise to evaluate the component, then the needs assessor should retain a qualified expert for the specific purpose of conducting the intrusive examination per ML 2012-25.

Third, it is our intent that the CNA report and any subordinate reports, tests or examinations be conducted based on the practice of independent third party research and opinion. It is the lender's job to assure the integrity and the accuracy of the CNA and any supporting documentation. While in some situations, use of some of the mortgagor's contactors may be appropriate and acceptable, this should not be assumed, particularly in light of the existing financial, contract and possible warranty relationships of the mortgagor with their contractors. In all cases, we want intrusive examinations conducted by experts under written obligation to the needs assessor, compensated by the needs assessor and responsible to the needs assessor...or the lender as the case may be.

Finally, we do not expect that intrusive examinations typically will involve removal of parts for laboratory tests or forensic examination typically associated with judicial proceedings or arbitration. "Intrusive" is used to emphasize the distinction between a walk-through inspection unaided by tools, lights, ladders or instruments as described in ASTM E 2018-08 and the expected use of these kinds of aids by experienced inspectors or tradesmen retained for their knowledge about specific systems or components.

## **2. Estimate Period-length**

### **QUESTION:**

*Page 7 of the notice, Item B speaks to R4R schedules. My question is regarding the term of the analysis. I am interpreting the notice different than others in my office. I believe that it says the analysis will be "the lesser of 20 years or the remaining life of the mortgage plus 2 years" actually means that the analysis will be 22 years on a new PCNA, or if it were done on an existing project as its "10-year" analysis, it would be the remaining term of the mortgage plus two years.*

*While we all agree on the term for the "10-year" analysis, the question comes on a new PCNA. Is the term really 20 years or is it 20 years plus 2 years, for a total of 22 years?*

### **RESPONSE:**

The estimate period is 20 years. Occasionally a 10 year update CNA, or very rarely a refinancing, likely a 223(a)(7), might involve a remaining term of 18 years or less, which with the added two years might be less than 20 years, in which event the remaining term plus 2 would be the estimate period, even though less than 20 years. The estimate period will never be more than 20 years.

## **3. Minimum Balance-Inflation Adjustment**

### **QUESTION:**

*How is the 5% minimum balance actually calculated and adjusted for inflation?*

**RESPONSE:**

The minimum balance is 5% of the total cost of the schedule of major repairs and replacements for the estimate period. The actual calculation is 5% times the uninflated total cost which results in a product which would be the minimum balance for the first year in the estimate period. This same product is then adjusted for inflation in each subsequent year by the same inflation adjustment factor used to estimate the inflated costs of repairs and replacements. Here is an example:

Uninflated total costs for the estimate period = \$1 m.

$5\% \times \$1\text{m} = \$50,000$

\$50,000 is the minimum balance for year 1.

Inflation adjustment is estimated to be 2% per annum

$\$50,000 \times 102\% = \$51,000$

\$51,000 is the minimum balance for year 2.

$\$51,000 \times 102\% = \$52,020$ , the minimum balance for year 3. And so on.

The minimum balance should not be calculated using 5% x the total inflated costs for the estimate period and the product used as a constant figure for all 20 years since this will overstate the minimum balance in each of the initial 19 years.

**4. Insurable Value**

**QUESTION:**

*For an existing property (223(f) or 223(a)(7) how is insurable value estimated for the HUD Form 92329?*

**RESPONSE:**

To clarify existing instructions, the correct amount for each structure listed on the 2329 is "replacement cost-as new." The best HUD reference source for the topic of casualty insurance is the Asset Management Handbook 4350.1 Chapter 21. Our instructions for existing properties on the 2329 originate in the old FHA "forms handbook," (item 6, existing properties). (The "forms handbook" instructions are correct for new construction/sub rehab projects because 221(d)(4) is a cost based program but inappropriate for existing properties.) The current instruction for existing properties is, in summary, to subtract land value from the appraised value and allocate the difference among structures. But market value is not material to casualty insurance risk. If a building is damaged or destroyed the claim that HUD-FHA wants payable is a claim for the actual current cost of repairing or replacing the damaged building, notwithstanding its market value. It is important that each building have an appropriate replacement cost since

casualty insurers and adjusters think in terms of individual structures not projects or properties. The purpose of the 2329 is to size the potential claim for each structure in a project, not necessarily to fix the aggregate or total face value of a casualty insurance policy. Prior to closing it is the lender's responsibility to assure and to demonstrate that the actual terms, conditions and values of the casualty policy(ies) operate to provide 100% coverage of a partial claim (e.g. destruction of 1 or several buildings out of many) arising from a single casualty event up to the replacement cost (insurable value) of the respective buildings with an overall policy face value or cap not less than the mortgage amount.

If the premium for casualty insurance based on replacement cost (as new) for each structure is prohibitive for a particular property, HUD will consider waivers provided the risk of less than 100% coverage of partial claims is addressed and the aggregate coverage is not less than the mortgage amount.

## 5. Table of Contents

### **QUESTION:**

*Must the PCNA provider follow the Table of Contents exactly as shown in Appendix 6?*

### **RESPONSE:**

In time our objective is to have all PCNA reports organized consistent with the standard table of contents, but we recognize that many providers have fixed templates embedded in software or systems making a change in their format more difficult and time consuming than meets the eye. Moreover, within reason, there is no one order for a table of contents which has demonstrated merit over similar alternatives covering all the same subject matter. Nonetheless, ease and speed of review both for lenders and for HUD argue in favor of standardization. In addition the Department, along with other agencies, is pursuing development of a CNA E-Tool which likely will eliminate the need for paper reports (although the tool will be able to produce them) and will necessarily result in standardization. This effort will engage the participation of the industry. So, within a period of years, further elaboration and standardization of PCNA contents and format is likely and that standardization likely will be based on the ASTM E 2018-08 recommended table of contents, as is Appendix 6 of the PCNA ML/HN. Accordingly, substantial, but not exact conformance to the Appendix 6 table of contents is acceptable.

Have more questions? Contact David Wilderman, HUD HQ, Division of Technical Support, 202-402-2803 or [david.b.wilderman@hud.gov](mailto:david.b.wilderman@hud.gov)