NATIONAL PRIVATE LENDERS ASSOCIATION

UNDERWRITING STANDARDS

For One-to-Four Single Family Residential Transition Loans (Rehab and New Construction)

info@nplaonline.com
www.nplaonline.com

National Private Lenders Association

LETTER FROM THE NPLA BEST PRACTICES COMMITTEE

The National Private Lenders Association's Best Practices Committee has put together the following framework to provide the association and its members with best practice underwriting standards for making private loans to borrowers.

These underwriting standards are not exhaustive, nor are they intended to direct the credit decisions of NPLA members. Rather, they have been established to ensure that NPLA members are informed on sound private lending underwriting standards for the good of the industry and our borrower community. The stability of our members in their assessment of financial risk and their extension of credit to qualified borrowers is paramount to our industry's long-term success and viability.

The guidelines below are also situational, as there are frequent tradeoffs between various credit factors, and strength in one area can often allow for less concern in another area.

The guidelines are organized in the following sections:

1. *Collateral Valuation*
2. *Borrower Evaluation*
3. *Project Review*
4. *Pre-Closing Requirements*

If you have suggestions for term additions or edits, please contact info@nplaonline.com.

Jonathan Hornik, Esq., NPLA Executive Director
Amy Kame, NPLA Managing Director

TABLE OF CONTENTS

The guidelines are organized in the folllowing sections.

If you have suggestions for term additions or edits, please contact info@nplaonline.com.

COLLATERAL VALUATION

In most private lending situations, real estate collateral is the primary security for the loan. Therefore, the collateral valuation is critical to success. A compliant valuation does not automatically guarantee that the valuation is correct or accurate. Many valuation products, even traditional appraisals, can be vulnerable to a significant amount of subjectivity which, if left unchecked, can result in a material misrepresentation of current or potential value, leading to financial losses. It is, therefore, essential to develop practices to ensure that the lender is confident that the loan is being underwritten with the most accurate representation of property value, both current as-is value and, when applicable, the as-completed / After Repair Value ("ARV").

Valuation Approaches/Products

There are various products to verify collateral asset value, including external reports such as full appraisals, alternative valuations, hybrid products, and BPOs, as well as internal valuations performed by the lender. Because many external reports allow for a large degree of freedom and subjectivity, it is usually recommended to develop a protocol for internal checks, QC review, and/or outside supplemental valuations when necessary to ensure that subjectivity has not been abused and that the valuation is an accurate representation of the subject property, with all its characteristics and potential flaws.

The project's type, size, and complexity should be considered when selecting your valuation product(s) for a loan.

Subject Property Valuation Inspections

Private lending benefits from latitude and freedom in setting business practices. For property inspections, each lender should develop protocols that can often be influenced by its business model, geographic footprint, risk appetite, LTV levels, loan products, etc.
Determine whether to require that an independent party inspect the subject property or whether alternative options, including borrower photos or guided self-inspections, are acceptable. For alternative inspection options, will the lender allow it across the board, only for select, repeat borrowers, or based on project criteria such as low LTV, low rehab, small loan size, or other factors?

Valuation Methodology and Review

The valuation should be established by recent market comparables of like-kind properties in the closest proximity to the subject property that is possible and reflective of similar conditions for both current and proposed for the subject property.

The following is a list of important factors to include and/or consider during your valuation and/or valuation review process:

Topic	Best Practices
Condition & Quality	Review the selected comps and all listing photos to verify that the condition and quality of the comps reflect the current condition of the property.
Impairments	Determine if the subject property has / should have been flagged due to potential impairments to value, e.g., arterial streets, vintage, architectural quality, non-conformance, easements, ingress/egress, and adjacent properties as a detriment. If yes: • Are these impairments adequately reflected in the valuation? • Were the selected comps also impaired similarly? If not, does the value appear to adjust for the impairment adequately? • Will the impairment be resolved or mitigated after the proposed renovation?
Enhancements	Determine if the subject property has / should have been flagged due to unique enhancements to value, e.g., waterfront, “deep water” access, view/ hillside/premium lot, and architectural superiority. If yes: • Are these enhancements adequately reflected in the valuation? • Did the selected comps also reflect similar enhancements? If not, does the value appear to adjust for the enhancements adequately?
Comp Selection (“As Is Value”)	• Compare the characteristics of the comps versus the subject property to ensure that like-kind properties are utilized. • Consider additional factors such as architectural style & neighborhood. • Identify the sale date and whether the market may have shifted since.

Topic	Best Practices
Value Adjustments	• Review the adjustments, if any, applied to the selected comps. Do these adjustments appear reasonable? • Pay attention to comps with superior elements, including condition and quality, which may not have been adjusted downward by enough.
Renovation Loans – Target ARV	• Analyze the budget and all its line items to identify the proposed ARV condition (not every renovation = a complete remodel) • Ensure the comps selected accurately reflect this proposed ARV condition and are not in superior condition to the proposed budget.
"Comp Fishing"	Determine if the selected comps may have been intentionally chosen to manufacture a desired value or ARV. Do this by identifying and analyzing which comps were omitted from the analysis. This step is critical to ensuring accuracy: • Identify a resource to assess the complete list of nearby recent sales. • Determine if comps with closer proximity were overlooked or omitted. • Determine if comps that sold more recently and/or appear to have as good or greater level of similarity to the subject property were omitted. • Determine if the selected comps represent the area's highest/higher sales prices. Do they appear to be outliers in any way? • Do you see any flags or concerns that the comps utilized may not accurately reflect value in the immediate area, subject street, or neighborhood?
Neighborhood Strength	• Does the valuation provide metrics besides light, subjective text regarding neighborhood market strength? • Does this neighborhood's strength give you confidence in the current and potential property values? Should values be adjusted up or down?

Topic	Best Practices
Conformance	• Determine if the subject property generally conforms with the neighborhood size, standards, and character. • If a renovation or new construction is proposed, determine if the finished product will generally conform. • If not conforming to any degree, determine what impact this might have on property resale value (see "Impairments" above)
Internal vs. External	• Checks and balances: How many eyes are placed on the value conclusion? • Develop internal processes to review and confirm opinions of value. • Develop internal processes to catch red flags and issues of concern.

BORROWER EVALUATION

Evaluate the borrower and their experience using a variety of components:

a) Credit Report

A borrower's credit score indicates a borrower's reputation and track record for repaying debts. Credit reports are generated by three (3) credit bureaus: Experian, Equifax, and TransUnion. These reports contain detailed information about the borrowing history of an applicant as well as their repayment performance. The credit score is used by 90% of the top U.S. lending institutions as they assess and underwrite the risk associated with their lending decisions. Review this credit report to determine if the borrower has a history of defaults or foreclosures.

b) Background Check

Trust but verify. A background report is another important measure lenders should take when deciding to loan to a borrower. The background report will not provide you with the same information a credit report or income tax return provides. Still, it will confirm that you are making a loan to a qualified and truthful applicant. The background report will also further demonstrate the borrower's character or the lack thereof.

c) Internet Search

An internet search on the borrower(s) and borrowing entity can be fruitful in providing information about the borrower. Additional data resources, often fee-based, can also be available to collect local market, title, or other information.

d) Borrower Liquidity

This will typically be verified with recent bank statements, typically within the last 30 days. Direct availability of unencumbered cash and short-term assets can provide a significant cushion against loan default by a borrower. It's essential to recognize that funds held in accounts for separate LLCs or beneficiaries that do not match the borrowing entity should not be included in a liquidity assessment unless legal documents can demonstrate the unencumbered nature as free to direct to the borrowing entity as needed.

e) Borrower Experience

A schedule of real estate and successful projects, both active and exited, can demonstrate a borrower's experience and skill level based on the quality of the records provided. Conducting online research for the stated properties to validate and verify the track record can be helpful.

f) Judgments or History of Legal Action

Recent and/or past history of legal action can be an important flag and/or factor to consider when evaluating a borrower. This can be performed at both the borrower level and the borrowing entity (or similar/affiliated entities).

g) Income Verification

This is not particularly common within the private lending sector. However, it can provide additional support in cases of need.

PROJECT REVIEW

For Renovation and/or New Construction loans, evaluating the project, complexity, feasibility, and other factors is crucial.

a) Project/Market Fit

- Is the proposed project consistent with the characteristics of the neighborhood?
- Is there depth of demand for the finished product (no white elephants), infill locations are preferred, rural loans are materially higher risk?

b) Budget Review

Private lenders should review a line-item rehab budget against the overall project to analyze the integrity of the rehab and confirm sufficient work can be done to ensure a successful project.

- Is the budget sufficient to complete the project? If not, there are feasibility concerns.
- Is the budget TOO LARGE to complete the project? If so, there are fraud concerns.
- Are the budget line items appropriate? Does the budget appear to be "front-loading" costs into certain line items while diminishing others?
- Are the budget line items appropriate – are there any line items indicating payments to the borrower, developer fees, overhead reimbursement, etc.?
- Is the contingency amount appropriate for the project's size and complexity?

c) Ground-Up Construction & Complex Projects

For ground-up construction or larger/more complex rehab projects, private lenders often add several additional process steps:

- Use a 3rd party provider to complete a budget feasibility analysis on each construction project as a checkpoint to understand if the budget is sufficient to build the project through to completion.
- Use a 3rd party for funds control management.
- Use 3rd party providers to run a detailed builder background report to verify that the builder is appropriately licensed, authorized to work in the state, has the applicable experience they are claiming, and has a clean background free from lawsuits and troubled projects.

d) Repair Timeline

- Requesting the borrower's anticipated repair timeline can be beneficial before approving a rehab loan. This accountability measure will ensure that the borrower and lender have the tools to monitor progress while the borrower executes on the project plan described in the loan application.
- Ensure that the loan term is long enough to cover the renovation plus sufficient time to sell or refinance the property upon completion.

e) Borrower Profitability

Are the margins on the project high enough to make it worthwhile for the borrower? Projects with thinner margins have a higher risk of default and also a lower likelihood of repeat borrower business. In addition, projects with higher margins make it easier for lenders to replace the borrower in the event of default.

f) Permits and Entitlements

Per local laws, does the borrower possess the right to build/renovate the proposed project on the subject site? If not, it is prudent to lend off the As-Is Market Value only until such entitlements and permits are obtained.

PRE-CLOSING REQUIREMENTS

a) Title

Obtain a clear title and applicable lender's title insurance policy. Ensuring a clear title and establishing a mortgage position is critical to enforcing collections on the loan. Here are components that are important to evaluate:

- Title insurance – obtain a lender's policy, which will require clear title.
- Review vesting of property ownership at the borrower level
- Borrower authority to enter into a contract after review of legal entity organization documents.
  - EIN and Operating agreement of the entity
  - Good standing of the borrower entity
  - Marital consent if lending to an individual in a joint property state
- Property Tax History - Review tax history and confirm no taxes are owed.
- HOA – Is the property part of an HOA? If yes, are the HOA dues paid on the property? Verifying this typically requires a phone call. Review the HOA's financial status, including financials if applicable, and confirm that the proposed project does not violate any HOA rules.

b) Property & Casualty Insurance

Private lenders should ensure that property and casualty insurance is in place on every property before making a loan. Here are some common pitfalls and/or critical factors when ordering/evaluating insurance.

- Types – Many traditional residential policies are meant for conventional homeowners only and carry exclusions for investment properties, mainly vacant properties. Make sure that the policy will not have such exclusions to the coverage. Usually, this means a commercial property policy with Builder's Risk Coverage AND Commercial general liability or premises liability coverage.
- Coverage – Usually, the property is insured for full replacement rather than as-is value. Flood coverage should be in place for situations where the structure is in a flood zone. The deductible should generally be no greater than 5% of the coverage.
- Certificate of Insurance – should be obtained, the named insured should be the borrowing entity, and the loss payee or mortgagee clause should be in favor of the lender. If the borrower carries a master portfolio policy, obtain a certification that the property has been added to the policy.
- Insurer Rating – Prefer AM Best A –VII or better or Demotech A or better.
- Term – the length of the insurance policy should match the loan tenor, up to a year.

c) Loan Documents

The preparation of accurate loan documents, including the actual security instrument, promissory note, draw agreement, disclosures, and affidavits, will vary by state. Private lenders must be well informed of the changing legal landscape in each state to ensure they are using documents that address current legal requirements and protections. Fortunately, several industry software providers and legal providers have up-to-date legal documents available for lenders to deploy.