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REPORT

APARTMENT FINANCE

Many conventional sources of financing for apartment development projects are no longer available due to ongoing constraints on liquidity. But the Federal Housing Administration has available a federally backed mechanism that private multi-family housing developers can access. In this article, the author maps out the statutory provisions for the FHA financing alternative and explains specific guidelines developers must follow. Given the unusual conditions in the markets for conventional project financing, the author argues developers should consider the FHA mechanism and not be worried about the possibility of encountering excessive red tape.

In Era of Tight Money, FHA Mortgage Insurance Is an Apartment Financing Option

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In this troubled economic climate Federal Housing Administration (FHA) mortgage insurance remains a viable financing option for owners and prospective developers of apartment projects. Under Section 221(d)(4) of the National Housing Act, as amended (the Act), developers can obtain construction/permanent financing for market rate apartments and under Section 223(f) of the Act developers can acquire or refinance existing market rate apartment developments.

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FHA mortgage financing is viable because the lenders that originate these loans issue mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA). The following is a summary of some of the key provisions of FHA insured financings.

Application Process. Developers must work with FHA-approved lenders to obtain FHA-insured loans. FHA-insured loans for apartments are processed through Department of Housing and Urban Development (HUD) state field offices. For a new construction project, a borrower must first submit a preliminary application to the HUD field office. Upon receipt of an ''invitation to submit,'' the borrower can submit an application for a firm commitment. The HUD field offices have 45 days to issue an ''invitation to submit.'' Thereafter, the borrower has 120 days to prepare and submit its application for a firm commitment and upon submission of the application for a firm commitment, the HUD field office has 45 days to review the application. There is no application fee payable to HUD at the invitation stage, however, the developer will need to fund an appraisal, market study, and environmental report. There is no preliminary invitation stage for 223(f) acquisitions or refinancings. The application fee for the firm commitment application for 221(d)(4) and 223(f) financings is $3.00 per $1,000 of the loan amount.

Determination of Loan Amount. The loan amount for a to-be-constructed project is the lowest of:

a. The amount requested.

b. Statutory limits. HUD has established cost limits per bedroom unit size. In the Richmond, Va., area, for example, for a project with elevators the limits are as follows:

- 0 BR - $111,337
- 1 BR - $127,634
- 2 BR - $155,200
- 3 BR - $200,777
- 4 BR or more - $220,394

c. Ninety percent of replacement cost. Replacement cost is the sum of hard and soft costs and HUD's valuation of the property.

d. Debt Service Ratio. This is calculated as the sum of the mortgage interest rate, mortgage insurance premium (0.45 percent), and initial curtail rate (a value set by HUD to calculate how much principal is paid), divided into 90 percent of net income.

The loan amount for an acquisition or refinance is the lowest of:

a. The amount requested.

b. Statutory limits. The statutory limits in the Richmond area for a walk-up complex are:

- 0 BR - $103,569
- 1 BR - $114,725
- 2 BR - $137,033
- 3 BR - $168,905
- 4 BR or more - $191,217

c. 85 percent of Replacement Cost.

d. Debt Service Ratio. The same formula as above except that the percentage of net income to be used is 85 percent.

The Replacement Cost factor is the most desirable factor under either structure because of its high leverage.

The Term of the Loan. New construction loans under Section 221(d)(4) are 40 years plus the construction period. Section 223(f) loans have a term of 35 years. Both loans are fully amortizing. It is worth noting that new construction loans include line items for interest, taxes, insurance, and mortgage insurance premium during the construction period in the calculation of replacement costs.

Nonrecourse. Both Section 221(d)(4) and Section 223(f) loans have limited recourse provisions as follows:

a. For funds or property of the project coming into their hands which, by the provisions of the Regulatory Agreement between the Secretary of HUD and the owner (the Regulatory Agreement), they are not entitled to retain; and

b. For their own acts and deeds or acts and deeds of others that they have authorized in violation of the provisions of the Regulatory Agreement.

Builder and Sponsor Profit Risk Allowance. Where there is an identity of interest between the owner and the general contractor, HUD will include in the replacement cost determination a line item called Builder and Sponsor Profit Risk Allowance (BSPRA). BSPRA is equal to 10 percent of the sum of hard and soft costs (excluding land valuation). BSPRA is a non-cash item that artificially inflates the replacement cost but can be used to offset the owner's equity requirement. An example of BSPRA follows:

Hard Costs	$14,762,542
Carrying Charges	1,588,633
Legal, Organization, and Audit fee	171,500
BSPRA	*1,652,268*
Total Development Cost	$18,174,943
Warranted Price of Land	3,060,000
Total Replacement Cost	$21,234,943
Loan amount based on 90 percent of replacement cost	$19,111,400
Owner's Equity	*2,127,543*
Owner's Equity after subtracting BSPRA	$471,275

When BSPRA is used, there is no builder's profit allowed in the construction contract. It is designed for developers who are their own builders.

Cost Certification/Supplemental Cost Certification. With new construction financing under Section 221(d)(4), an owner must certify the actual costs of construction and, if the costs are less than originally contemplated, the loan amount will be reduced. When there is an identity of interest between the owner and the general contractor, the general contractor must also certify its actual costs and may not be paid more than its actual cost of construction.

In addition to accounting for the actual cost of construction, an owner must account for net income during construction. More specifically, the measurement period commences with the cut-off date for cost certifying hard and soft costs and ends three months prior to the commencement of amortization of the loan. Amortization of the loan commences four months after the construction period.

Assurance of Completion. With new construction financings, the general contractor must furnish ''assurance of completion,'' which may be in the form of 100 percent performance and payment bonds or a letter of credit. The amount of the letter of credit is 15 percent of the upset price in the construction contract or 25 percent of the upset price in the construction contract if the building is greater than four stories.

   ISSN 1944-9453

Davis-Bacon Wage Rates. The Department of Labor promulgates Davis-Bacon wage rates that reflect regional factors for federally financed or subsidized transactions. The general contractor and its subcontractors must pay the Davis-Bacon wage rates and must submit to HUD evidence of payment. In metropolitan areas the promulgated rates should not increase the cost of construction but they may do so in rural areas.

Distributions and Annual Audits. The Regulatory Agreement limits distributions of net income to no more frequently than semi-annually. The Regulatory Agreement requires the submission of annual certified public accountant prepared audits.

Nursing Homes and Assisted Living Facilities. FHA mortgage insurance is also available under Section 232 of the Act for nursing homes and assisted living facilities. Most of the above provisions are applicable to Section 232 financings, except that HUD has centralized the processing of applications and the time frames stated above are not being met due to the limited staff.

Conclusion. With limited financing sources available for new construction, acquisitions, and refinancing, developers should not summarily dismiss FHA insured financings because of the perceived red tape associated with governmental programs. The loans are long-term, fixed-rate and fully amortizing thereby eliminating a refinancing risk. The 221(d)(4) and 223(f) programs are market rate programs with no subsidies or requirements to seek approval for rent increases or to lease units to low/moderate income tenants.
