BedfordLending

Multifamily New Construction Escrows Overview

Introduction

HUD requires non-mortgageable escrows in HUD new construction and substantial rehabilitation transactions.

Working Capital Escrow
Held By: Lender

The working capital escrow requirement for new construction transactions is 4% of the mortgage amount, half of which is a construction contingency for cost overruns and approved change orders.

The working capital escrow requirement for substantial rehabilitation projects is 2% of the mortgage amount. A waiver of the 2% Working Capital Escrow requirement for substantial rehabilitation transactions with Section 8 rental assistance covering 90% or more of the units (with or without LIHTC restrictions), may be granted when the Lender is able to demonstrate there will be enough income generated by the project during the rehabilitation period to cover items typically funded by the Working Capital Escrow.

For LIHTC projects with a funded working capital reserve held by the partnership (even though controlled by the syndicator or investor and not by HUD or the Lender), the funded reserve will be credited towards the increased construction reserve requirement, although the Lender-controlled account must still meet the 2% working capital escrow requirement.

It is the responsibility of the Borrower to advise the Lender how it plans to fund the escrow: either by cash, a letter of credit, excess mortgage proceeds, or excess land equity, if any. Using form HUD-92412-M, Escrow Agreement for Working Capital, the Lender will deposit said funds in an account insured or guaranteed by a federal agency.

The deposit is used to:

1. Defray the cost of initial marketing and rent-up including sales and advertising, model furnishing, and equipment and supplies essential to initial rent-up, etc.
2. Cover project expenses that are not covered by project income or the Initial Operating Deficit Escrow in the first operating year. The project expenses include real estate taxes, permanent property insurance premiums, mortgage insurance premium, ground rents and assessments.
3. Cover shortfalls in interest, taxes, property insurance premiums, mortgage insurance premiums, ground rents and assessments during construction after funds available under the Building Loan Agreement are exhausted.
4. Fund necessary change orders and construction cost overruns not caused by the contractor from the 2% new construction contingency portion of the working capital escrow.

Control and Release of Escrow

The Lender controls disbursements from the escrow and, in conducting its due diligence during initial occupancy, is required to fully document all expenditures from the escrow. In reviewing a Borrower's request to release a partial amount of escrow, the Lender should consider the following:

1. Borrower's request for the release of such escrow funds must be by letter to the Lender, rather than on form HUD-92403.
2. None of the escrow can be used to defray any of the hard costs of construction applicable to the Total for All Improvements, Section G of form HUD-92264.
3. As portions of a project are ready for occupancy, a partial disbursement may be permitted for reasonable opening expenses. However, the Lender must not exhaust the escrow prior to project completion but should retain a reasonable amount to offset funding needs through the remainder of the construction period and thereafter.
4. The HUD Office may direct that the deposit be used to cover any shortfall in interest, taxes, property insurance mortgage insurance premiums, ground rent and assessments.

Final Release of the Working Capital Escrow

At final endorsement (construction completion), any remaining balance of the new construction contingency portion of the escrow (2%) may be used to fund any latent defects assurance or escrow for delayed construction items or if these needs are otherwise met, refunded to the Borrower.

Subject to HUD approval, the Lender may release any unused balance in the working capital portion of the escrow (remaining 2%) to the Borrower if the project is not in default and when the operations of the project have demonstrated to the Regional Production Director's satisfaction that the project has achieved 6 consecutive months of sustaining occupancy.

Sustaining occupancy is a level or percentage of occupancy of tenant units by rent paying tenants consistent with signed leases such that the monthly rents paid are sufficient to pay all operating expenses for the month (actual or prorated annual costs as applicable) plus monthly debt service composed of principal, interest, and MIP. Any subordinate debt requiring current payment must be included in the sum of debt service. This is equivalent to a debt service coverage ratio (DSCR) of 1.0, a ratio also referred to as "breakeven." When this level of occupancy is sustained for a period of consecutive months, it is referred to as "sustaining occupancy". The standard number of months for achieving sustaining occupancy in HUD new construction and/or substantial rehabilitation projects is 6 months. HUD may vary the number of months of sustaining occupancy required to address specific project risk for individual cases or cases with identified risk conditions.

Initial Operating Deficit
Held By: Lender

The purpose of the operating deficit escrow is to provide funding for operating expenses, non-capitalized property taxes, insurance and interest and principal payments when income is insufficient during the initial lease up period. This escrow is not mortgageable and the unused portion must be returned to the Borrower.

The Borrower must advise the Lender how it plans to fund the escrow, by cash, a letter of credit, excess mortgage proceeds, or excess land equity, if any. The Lender will deposit said funds in an account insured or guaranteed by a federal agency.

For all new construction and for substantial rehabilitation projects in which there will be significant resident displacement resulting in negative cash flow during the rehabilitation period, the operating deficit escrow will be the greater of:

1. What the appraisal and underwriting analysis determines to be appropriate; or
2. 3% of the mortgage amount; or
3. 4 months debt service (Principal & Interest and Mortgage Insurance Premium) if the property is a garden apartment, or 6 months debt service (Principal & Interest and Mortgage Insurance Premium) if the property is an elevator building where a single Certificate of Occupancy will be issued before any of the units or any of the entire floors can be rented.

The amount of the operating deficit escrow for substantial rehabilitation projects with at least 90% Project-Based Rental Assistance shall be based only upon the conclusions of the appraisal and underwriting analysis and need not be the higher of 3% of the mortgage amount or 4 months of debt service.

For LIHTC projects with a funded operating deficit reserve held by the partnership (even if controlled by the investor and not by HUD or the Lender), the funded reserve will be credited towards the increased reserve requirements of 3% of the mortgage amount or 4 months of debt service, although the Lender-controlled account must still meet what the appraisal and underwriting analysis determines to be an appropriate operating deficit amount.

Commitment, marketing fees, and discounts must be paid out-of-pocket by the Sponsor/Borrower and may not be paid from the operating deficit escrow.

For tax-exempt or taxable bond financing, cost of issuance must be paid out-of-pocket by the Sponsor/Borrower and may not be paid from the operating deficit escrow.

The operating deficit escrow may be used to pay relocation expense that was not included in MAP Lender’s estimated replacement cost on form HUD-92264-A.

Control and Release of Escrow

HUD will consider Lender’s request using form HUD-92464M, Request for Approval of Advance of Escrow, for all initial operating deficit draws during lease-up. The Lender’s request must be accompanied by:

- A review and analysis of the monthly accounting reports detailing progress on lease up as compared to the lease up projections used in underwriting, and

- An updated calculation of the sufficiency of the escrow. This analysis and calculation are particularly important if the project is experiencing substantial variations from its lease up projections.

Final Release of the Initial Operating Deficit Escrow

Unused amounts will be released upon the Lender's request when the project has demonstrated to the Regional Production Director's satisfaction that the project has achieved six consecutive months of sustaining occupancy. Sustaining occupancy is a level or percentage of occupancy of tenant units by rent paying tenants consistent with signed leases such that the monthly rents paid are sufficient to pay all operating expenses for the month (actual or prorated annual costs as applicable) plus monthly debt service composed of principal, interest, and MIP. Any subordinate debt requiring current payment must be included in the sum of debt service. This is equivalent to a debt service coverage ratio (DSCR) of 1.0, a ratio also referred to as "breakeven." When this level of occupancy is sustained for a period of consecutive months, it is referred to as "sustaining occupancy". The standard number of months for achieving sustaining occupancy in HUD new construction and/or substantial rehabilitation projects is 6 months. HUD may vary the number of months of sustaining occupancy required to address specific project risk for individual cases or cases with identified risk conditions.

For garden-style apartment projects consisting of separate buildings, each of which is leased up separately, HUD will consider partial releases of the operating deficit escrow as individual buildings achieve 6 consecutive months of sustaining occupancy.

Cash-Out Escrow from Land/Building Equity.

If land, or the "as is" property value for a substantial rehabilitation project, is contributed to meet the Borrower's equity requirement, any cash-out from the excess land value above what is required at initial endorsement must be deferred until the project is complete and has demonstrated to the satisfaction of the Regional Office that it has achieved 6 consecutive months of break-even occupancy (or 12 months break-even occupancy for transactions meeting Large Loan parameters).

The Borrower may apply any excess land value to fund the operating deficit, the working capital escrow (including the construction contingency escrow) or other (i.e. non-mortgageable) cash requirements at initial endorsement. After all escrows and cash requirements are established at initial endorsement, any balance shall be escrowed with the Lender until the project has achieved the occupancy thresholds described above. After these minimum thresholds have been met, the balance of the escrow may be released to the Borrower.

Replacement Reserve
Held By: Lender

An Initial Deposit to the Replacement Reserve (if applicable) is funded at closing and monthly deposits are subsequently made from project operating income to pay for the eventual replacement of short-lived or capitalized physical assets.

A Capital Needs Assessment (CNA) for all insured projects is required every 10 years which may adjust ongoing reserve requirements as the loan matures.

Ongoing Escrowed Items
Held By: Lender

Taxes, insurance and mortgage insurance premium will be escrowed monthly.