Developing a Cooperative through FHA Financing

A model that works for Individuals, developers and the community
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Basic Cooperative Concept
Basic Cooperative Qualities

• A Cooperative is a unique form of home ownership in that a non-profit cooperative corporation holds title to the dwelling units and directly assumes the mortgage, tax and other obligations necessary to finance and operate the development.

• Members support the corporation through occupancy agreements, eliminating need each member to be an individual mortgagor.
Basic Cooperative Qualities (cont.)

• Each member pays his proportionate share of the annual cost to operate the corporation and debt service on the blanket mortgage for the property.

• Each member is entitled to their proportionate share of real estate taxes and interest of the corporation for their personal income taxes.

• Members have the right to vote on how the corporation conducts its business and participate on the board of the cooperative.
Cooperative Legal Documents

Articles of corporation and By-laws of the cooperative corporation are approved by the corporation commission in the state of incorporation. This will lay out how members relate to the corporation and how board members will be elected or removed by majority vote of the membership. Typical Cooperative documents are included on the following slide.
Cooperative Legal Documents

• Articles of Incorporation
• By-Laws
• Membership Certificate – a certificate, or share, showing evidence of ownership in the cooperative corporation.
• Subscription Agreement – document used to sell memberships in the cooperative.
• Occupancy Agreement – contract between member and corporation that spells out rights and obligations of the members. This basically gives the member the right to occupy a unit.
• Cooperative Agency Agreement
• Management Agreement
• Information Bulletin – disclosures are required similar to other investment opportunities.
Transfer of Membership

• Membership transfer is regulated by the by laws.
• Cooperative typically has the right to sell the member’s share.
• If co-op waives right, member responsible
• Typically shares of Insured projects usually sold by Cooperative.
  – Cooperative compiles waiting list
  – New member must be approved by cooperative.
  – Member entitled to appreciation of share price.
Share Price Appreciation

- Model Form of Bylaws sets appreciation as the amount of principal pay-down. In addition, improvement to the unit may increase basis in share price.
- There are two different types of cooperatives as it relates to appreciation, which is dependent on the particular “mission” of the cooperative:
  - **Limited Equity Cooperatives** – Many cooperatives that would like maintain affordability limit the amount of appreciation in share prices between 1% and 3% annually.
  - **Market Rate Cooperatives** – These types of cooperatives allow share prices to be determined by the market. A share price is valued by what one is willing to pay for it in an arms-length transaction.
Cooperative Development Structures
Cooperative Development Structures

There are a variety of ways to structure a new cooperative:

- **Pre-sale, Management approach** – This approach is typically initiated by a developer forming a cooperative corporation and pre-selling shares to members. Once memberships are sold and development is complete, control is turned over to the membership. Can be used for new construction or rehabilitation.

- **Investor-Sponsor approach** – An investor or sponsor develops a property, rents units, and then sells memberships to potential owners. Once enough memberships are sold, a separate cooperative corporation is formed the property is sold to the cooperative.
Cooperative Development Structures (cont)

- **Non-Profit Sponsor approach** – A non-profit sponsor develops a property, rents units, and then sells memberships to potential owners. Once enough memberships are sold, a separate cooperative corporation is formed the property is sold to the cooperative. If property does not convert, it remains a rental.

- **Conversion Approach** – Involves the formation of Cooperative corporation for the purpose of acquiring an existing rental property and selling memberships to residents. Can be a similar structure as a pre-sale approach.
Cooperative Development Structures (cont.)

A pre-sale management type of cooperative differs substantially from the investor and non-profit sponsored cooperatives. For a pre-sale, management approach, title is held by a cooperative corporation and it becomes a management style cooperative from the inception. The cooperative operates with a provisional board of directors, typically members of the developer but may include future residents and other development professionals.

Due to the advantages of a pre-sold cooperative from a risk standpoint, there is greater flexibility on loan terms, especially the amount of leverage available. Given this benefit, the pre-sale management approach is the most popular and advantageous way to structure a new cooperative development.
Cooperative Financial Structures
Cooperative Financial Structures

• Cooperatives can be structured in unlimited ways from a property type and financial perspective:
  – Market rate Cooperatives
  – Limited Equity Cooperatives
  – Senior Cooperatives
  – Mobile Home Cooperatives
  – Low down payment Cooperatives
  – High down payment Cooperatives
  – Variable down payment Cooperatives
Financing for Cooperatives
Financing for Cooperatives – All sources

Financing for cooperatives can come from a variety of sources, although construction financing typically is only available from FHA. All sources will have the following factors and requirements:

• Loan limits based on specific criteria of each lender including loan to cost, Debt Service Coverage Ration, loan to value, and Statutory Limits in some cases.

• Loan Term Limits – All lenders have different thresholds concerning loan terms and amortization.

• Market Acceptance – Lenders will need to understand that the cooperative model is acceptable in the marketplace either through the historical record or a pre-sale requirement.
Financing for Cooperatives – All sources (cont.)

• Cooperative Legal Documents – All legal documents of the cooperative including By-Laws, Articles of Incorporation, Membership Certificates, and occupancy agreements will need to be in a form acceptable to the Lender.

• For existing properties or conversion, the lender will review existing property conditions. In addition, they will examine the occupancy history and operating of history or the property.

• For new developments, the lender will review the experience level of the developer, architect, contractor, management agent and other related parties to insure there is sufficient experience on the team to complete the project.

• Lenders will ensure developer has sufficient financial capacity to complete the project.
Available Financing for Cooperatives

- **FHA Section 213 Cooperatives** – this program allows for financing of new cooperatives and conversions. Often this is the only source for construction financing for coops. Provides the longest terms, maximum leverage, lowest fixed rates of all programs, but can be more costly than other types of financing. In addition, there is institutional over-site from the U.S. Department of Housing and Urban Development.
Available Financing for Cooperatives

- National Cooperative Bank Financing programs
  NCB has programs that provide permanent financing and refinancing with repair funds for cooperatives. Loans can range in terms of 5 to 30 years.
Available Financing for Cooperatives

- **Fannie Mae** – Fannie Mae provides financing for existing cooperatives. Loan terms are typically 10 to 30 years. Loans may be used for rehabilitation of the property.

- **Bank Financing** – Most banks will not provide financing for cooperatives as they are unfamiliar with the ownership structures. In communities where coops are common, banks may provide financing, but typically at shorter terms and higher rates.
Pre-sale Management Approach with FHA 213 Financing
Pre-sale Management Approach with FHA 213 – General Characteristics

• Processed under Section 213 of the National Housing Act. This provides financing for elderly or family housing, new construction or conversion with rehabilitation.

• Co-operative formed before construction or rehabilitation.

• Sponsor/development service agent (DSA) acts to develop property, pre-sell memberships, and is in control of the provisional board.

• Loan term of construction period plus 40 years.
Pre-sale Management Approach with FHA 213 – General Characteristics

• Interest rates are fixed at closing for the full term of the mortgage.

• Valuation, downpayment and carrying charge amounts are usually allocated by sq. ft.

• Typical unit mix of newer co-ops:
  – 20-30% 1 BR’s
  – 50-60% 2 BR’s
  – 10-20% 2+Den/3 BR’s
Pre-sale Management Approach with FHA 213 – General Characteristics

• Provisional Board of Directors until first annual meeting of members
  – Within 1 year and 3 months of Certificate of Occupancy/Final Endorsement
  – Usually individuals from sponsor/Development service agent but also may include future residents

• Board of Directors (after provisional)
  – Members/occupants of units
  – Staggered, eventually 3 year terms

• Training is available for board members through various organizations including the National Association of Housing Cooperatives.
Pre-sale Management Approach with FHA 213 – Financial Characteristics

• The total development costs for a new cooperative include all acquisition costs, construction costs, financing costs, other soft costs, marketing costs and developer profit. Development costs covered by:
  – Downpayments: Can be as low as 3%, but typically range from 5% to 40% depending on the needs and development plan of the DSA and residents.
  – FHA Insured mortgage can be as high as 97% of development cost, but typically ranges from 60% to 95%.
Pre-sale Management Approach with FHA 213 – Financial Characteristics

• Carrying charges: covers on-going expenses/debt service
• 100% of income after expenses & reserves used for debt service.
• Maximum loan subject to Statutory Limits by unit type published in the Federal Register for Section 213.
• Not eligible for accelerated processing.
• General Operating Reserve: begins at 3% of total carrying charges. Controlled by mortgagor.
Pre-sale Management Approach with FHA 213 – Financial Characteristics

• Lender will require a certain level of shares be pre-sold prior to closing. Typically is 90% of units, but can be as low as 50% depending on specific market conditions and the financial capacity and willingness of the DSA to guarantee cash flow from unsold shares.

• Sponsor/DSA must guarantee cash flow
  – Sponsor/DSA must agree to pay the monthly carrying charges on any remaining unsold memberships for a maximum of 3 years or until sold.
Pre-sale Management Approach with FHA 213 – Financial Characteristics

- HUD will review all initial membership purchasers, review includes an examination of members:
  - Credit Reports
  - Personal Financial Statements (FHA 3232A)
  - Verification of employment/Income
  - Verification of deposit

Following initial sales, the cooperative will review new members.
Pros and Cons under Pre-sale Approach with FHA 213 Financing
Pros and cons for Cooperative Members

Pros

• Long-term, fixed-rate, non-recourse.
• Built-in mechanisms to protect the consumer.
• FHA allows for maximum leverage possible appealing to a broad level of income groups.
• Institutional oversight and discipline: audits, reserves, property inspections.
• Distributive Shares - MIP has been refunded.
Pros and cons for Cooperative Members

**Pros**

• Provides the benefits of home ownership relating to personal income taxes.
• Creates quality housing that can be affordable to all income levels.
• Establishes a community atmosphere that provides support and a sense of “home” to the members.
• Contributes to community economic health
• Provides same tax benefits as other types of home ownership.
Pros and cons for Cooperative Members

Cons

• Some co-op members uncomfortable under co-op oversight
• Some members or their beneficiaries may prefer unrestricted equity returns
• Lock-outs on mortgage prepayment
• Difficulties may arise from differences of opinion between board members and residents over management of the cooperative.
Pros and Cons for Sponsors & Developers

Pros:

• Nonrecourse
• Not rate-sensitive
• Equity funded by buyers, and non-mortgageable costs can be paid from equity.
• Profit margin built in to total development cost – Developer’s Fee
• Appeals to a diverse market
• Simple operating program
• On going Management Fees from property management.
Pros and Cons for Sponsors & Developers

Cons:
• Pre-sale requirement
• Typically must collect full down payment prior to construction
• Must guarantee cash flow for unsold shares for a maximum of 3 years.
• Can be difficult to market depending on acceptance in the area and educating potential residents.
• Sometimes difficult to build sufficient profit into the transaction to make it competitive with other types of housing development.
Pros and Cons for Lender and HUD

Pros:
• Significant pre-sale requirement before closing
• Very favorable default experience - good track-record
• Resident creditworthiness reviewed as part of approval
• Is not subject to credit-subsidy limits

Cons:
• Co-op members call HUD when they have a problem with the developer
Difficulties with Developing and Managing Cooperatives
Difficulties with Developing and Managing Cooperatives

- **Selling memberships requires education** – membership in cooperative is a unique form of home ownership and typically requires that the developer provide education on the benefits and drawbacks to potential members.

- **Market Acceptance** – Certain markets readily accept housing cooperatives making them easier to sell. However, if it is not a typical form of home ownership, gaining market acceptance can be difficult.

- **Pre-sale requirement** – Under the most typical development model, financing only becomes available after a certain level of pre-sales are completed. This will require a fairly significant investment from the developer of time and money to market the property.
Difficulties with Developing and Managing Cooperatives

• **Equity comes from Pre-sales** – The difference from the total development cost and the blanket mortgage, equity, comes from the members and/or the developer. This requires that funds be collected prior to construction start, unless the developer is funding equity, which can present difficulties in marketing memberships.

• **Ongoing management decisions** – Since members of a cooperative have a significant say in the ongoing management of the property, differing opinions and experience levels among members can cause significant tension and decision making delays. Ongoing education is key. It can not be stressed enough the importance of identifying significant issues and addressing them appropriately.
About Love Funding

Love Funding is a fully-approved HUD LEAN and MAP lender serving clients across the country from its headquarters in Washington D.C. and offices in Boston, Chicago, Cleveland, Dallas, Denver, Kansas City, Knoxville, New York, Palm Beach, Tampa and St. Louis.

The company offers refinance, construction and acquisition financing programs for multifamily, senior housing and healthcare facilities, including hospitals.

Love Funding is one of the Love Companies, a St. Louis-based investment holding company with origins dating back to 1875.
About Love Funding

Love Funding has substantial experience funding all types of multifamily, senior housing and healthcare loans. In addition, we have significant affordable housing financing experience. Last year, Love Funding arranged over $300 million in multifamily financing in addition to $100 million in affordable housing financing throughout the United States and Puerto Rico.

As a leading lender in multifamily finance, Love Funding’s FHA MAP underwriting expertise simplifies the application process and reduces the time needed to obtain funding. An experienced Love Funding originator can guide you through all of the options and advise on the merits of each.
As senior director, Hugh Jeffers is responsible for originating new business around the country. He is located in Pittsburgh, PA. Prior to joining Love Funding in August 2013, Mr. Jeffers was senior vice president with Bellwether Enterprise responsible for originating FHA, Fannie Mae and Freddie Mac multifamily and healthcare loans. Before his time at Bellwether Enterprise, Mr. Jeffers was director of FHA financing at Oppenheimer Multifamily Housing and Healthcare Finance, where he was responsible for FHA originations. Mr. Jeffers also spent time at Arbor Commercial Mortgage in New York as the screening director for FHA originations for the entire company. Prior to that, he was manager of the affordable housing group and the FHA multifamily lending operation of NCB Development Corporation in Washington, DC. He has over 15 years of multifamily and healthcare origination and underwriting experience. He has developed a particular expertise in affordable and senior housing. He is a board member of the National Association of Housing Cooperatives. Mr. Jeffers holds a bachelor’s degree from Lafayette College in Easton, PA, where he was a double major in Economics and Art. He holds a master’s degree from New York University, Stern School of Business.