

Focus on  
**AFFORDABLE HOUSING FINANCE**  
*White Paper I*

**Refinancing Section 202  
Affordable Senior Housing**

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Lancaster Pollard  
Mortgage Company



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Lancaster Pollard helps affordable housing, senior living and health care organizations expand and improve their services by providing financial advice and financing solutions. It offers a full range of investment banking, financial advisory, mortgage banking and investment advisory services. The firm is the country's leading underwriter of Section 202 refinance loans, according to HUD data from fiscal year 2006 through the first half of 2007, as of publication. As such, Lancaster Pollard has successfully navigated the various issues, questions and challenges arising in the course of the refinance process.

Headquartered in Columbus, Ohio, Lancaster Pollard consists of three affiliated companies and has regional offices in Atlanta, Austin, Denver and Kansas City. **Lancaster Pollard & Co.** underwrites taxable and tax-exempt bonds and is a registered broker/dealer with the Securities and Exchange Commission (SEC) and a member in good standing of the National Association of Securities Dealers (NASD), Municipal Securities Rulemaking Board (MSRB) and Securities Investor Protection Corporation (SIPC). **Lancaster Pollard Mortgage Company** underwrites and services mortgage loans insured or guaranteed by governmental agencies, including the Federal Housing Administration (FHA), Government National Mortgage Association (GNMA) and United States Department of Agriculture (USDA) and is a U.S. Department of Housing and Urban Development (HUD)-approved Multifamily Accelerated Process (MAP) lender. **Lancaster Pollard Investment Advisory Group**, an SEC-registered investment advisor, helps nonprofit organizations create the financial means to last the life of their missions by managing total financial risk rather than just investment-associated risk.

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The members of the American Association of Homes and Services for the Aging ([www.aahsa.org](http://www.aahsa.org)) help millions of individuals and their families every day through mission-driven, not-for-profit organizations dedicated to providing the services that people need, when they need them, in the place they call home. Our 5,700 member organizations, many of which have served their communities for generations, offer the continuum of aging services: adult day services, home health, community services, senior housing, assisted living residences, continuing care retirement communities and nursing homes. AAHSA's commitment is to create the future of aging services through quality people can trust.



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**Focus on Affordable Housing Finance:  
Refinancing Section 202 Affordable Senior Housing  
White Paper I**

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# Refinancing Section 202 Affordable Senior Housing

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Providing adequate affordable housing for an aging population is one of the nation's great social challenges, and the unmet demand is projected to worsen in coming decades. The loss of existing inventory due to market-rate conversion or physical deterioration will only exacerbate the problem; replacement cost is considerably higher than preservation cost. To prevent further widening of the supply-demand imbalance, not only must new units be created, but existing properties must be preserved to serve a growing population that lacks the option of aging into beachfront retirement.

Authorized by the National Housing Act of 1959 and administered by the Department of Housing and Urban Development (HUD), the Section 202 direct loan program has been a key component of the federal government's efforts to develop affordable senior housing. Over the years, the Section 202 program has transformed from its initial incarnation as a low-interest-rate loan program without rental assistance, to a prevailing-rate loan program with project-based Section 8 rental subsidy (1974 to 1990), to its current state as a rent-subsidized capital advance program. Until recently, properties built under the Section 202 program faced regulations that restricted the viability of refinancing as a method of injecting capital into an aging property.

After six years of legislative and regulatory effort, HUD gave Section 202 property owners the practical ability to refinance their mortgage loans with the November 2004 issue of Housing Notice 04-21. These regulatory changes made refinancing a real and practical opportunity, which has created understandable excitement within the affordable housing sector. Owners who have taken advantage of the opportunity have realized tremendous benefits. Refinancing can provide new money for facility improvements, increase replacement reserves and improve cash flow from operations, effectively extending the physical and economic lives of affordable senior housing properties. Refinancing also can be used to combine properties to create administrative efficiencies. More than 400 Sec. 202 properties have been successfully refinanced in the two years since Notice 04-21 was issued, and an estimated 600 more are in various stages of processing.

Owners contemplating a refinance can face what can seem to be an overwhelming number of choices within an unfamiliar decision process. HUD's guidelines allow Section 202 property owners to refinance using a variety of options. These include Federal Housing Administration-insured mortgage loans, conventional loans, tax-exempt bonds and Low-Income Housing Tax Credits (LIHTCs). The option or combination of options an owner chooses depends on many factors specific to the property itself, the surrounding marketplace and the organization's goals. Fortunately, the large volume of loans closed to date has established a high level of predictability regarding the benefits, costs and procedures associated with a refinance. This paper reviews the key financing options and provides a brief look at the analytical process used to determine which path is best for a property.

**Part I:  
Evolution of the Section 202  
Direct Loan Program**

Since its inception, the Section 202 program has supported the creation of approximately 6,200 housing facilities for low-income elderly people, accounting for about 250,000 residential units.

Under the program's original phase, the federal government lent money at below-market interest rates to fund the construction and rehabilitation of rental housing. Qualified nonprofit entities were typically able to borrow at an interest rate of 3 percent. These low debt payments made it possible for owners to operate their properties on less income, which made charging lower rents feasible.

From the late 1970s until the early 1990s, Section 202 loans were made at the prevailing interest rate, and properties were given Section 8 project-based rental assistance to facilitate rental to the broadest range of income-qualified tenants, including those with extremely low incomes. This assistance typically covered all of the units in the property. At the same time, HUD provided many of the earlier, lower-interest-rate Section 202 properties with at least partial Section 8 project-based rental assistance.

The current phase of the Section 202 program is in the form of a capital advance; HUD provides eligible owners grants that require no repayment so long as the property remains affordable. The projects are also provided with a Project Rental Assistance Contract (PRAC), a form of rental subsidy for tenants.

The program's success in creating new affordable housing continues, but the current new construction rate of approximately 4,400 units annually is significantly lower than the historic rate because of relatively stagnant federal funding levels and rising costs of new development. One of the benefits afforded to Section 202 projects was the ability to set rents at levels necessary to support reasonable operating expenses, even if that level rose above market rate. Tenants pay only a percentage of their income toward rent, and the fed-

eral government makes up the difference between what a tenant pays and what a property charges. As facilities age, maintenance costs rise and additional services may be added to better serve aging tenants. This often results in the growth of budget-based rents to well above the median market rents of unsubsidized facilities.

The Section 202 program peaked in the 1980s when an estimated 3,200 new properties – more than 150,000 units – were developed. The facilities created during this period were financed with 40-year direct federal loans using the prevailing interest rates of the times, often over 9 percent. The latest chapter in the evolution of the Section 202 program has focused on the rehabilitation and revitalization of these properties.

Many affordable senior living communities built during this period now face considerable challenges in terms of upkeep and modernization. In addition, with the aging of the resident population, the focus on accessibility and adaptability to resident needs has greatly increased. The average person in the United States lived until approximately 71 in 1960, when the Section 202 program started; life expectancy in 2010 is projected by the U.S. Census to be 78.5.

At the very least, many of the properties built in the 1980s are in need of basic cosmetic refurbishment to enhance marketability and improve resident quality of life. Even those properties that are well maintained face a combination of aging building systems that have become inefficient and an increasingly frail resident population in need of expanded support services.

But prior to November 2004, refinancing a Section 202 direct loan was not possible for most property owners. HUD had expressly prohibited the refinance of 202 properties until it issued Notice 99-6 in April 1999, which offered guidance on the process of refinancing but stated that Section 8 rents would be reduced by debt service savings. The possible reduction of Section 8 rents was further reinforced by language contained in Notice 00-26 issued in December 2000. The loss of exemption from the Mark to Market program and the possible reduction of above market rents



to the comparable market rent would have been financially fatal to most facilities. As such, only properties in extremely high-market-rent areas such as coastal areas and major metropolitan growth areas could refinance.

**American Home Ownership and Economic Opportunity Act**

The shortcomings of HUD Notice 99-6 spurred a congressional lobbying effort that resulted in the passage of the American Home Ownership and Economic Opportunity Act of 2000. This legislation mandated that HUD address the deficiencies of 99-6 and the subsequent notice 00-26 and provided the framework for prepayment and refinancing of 202 properties, eventually leading to the release of two additional HUD notices over the next four years.

**Notice 02-16**

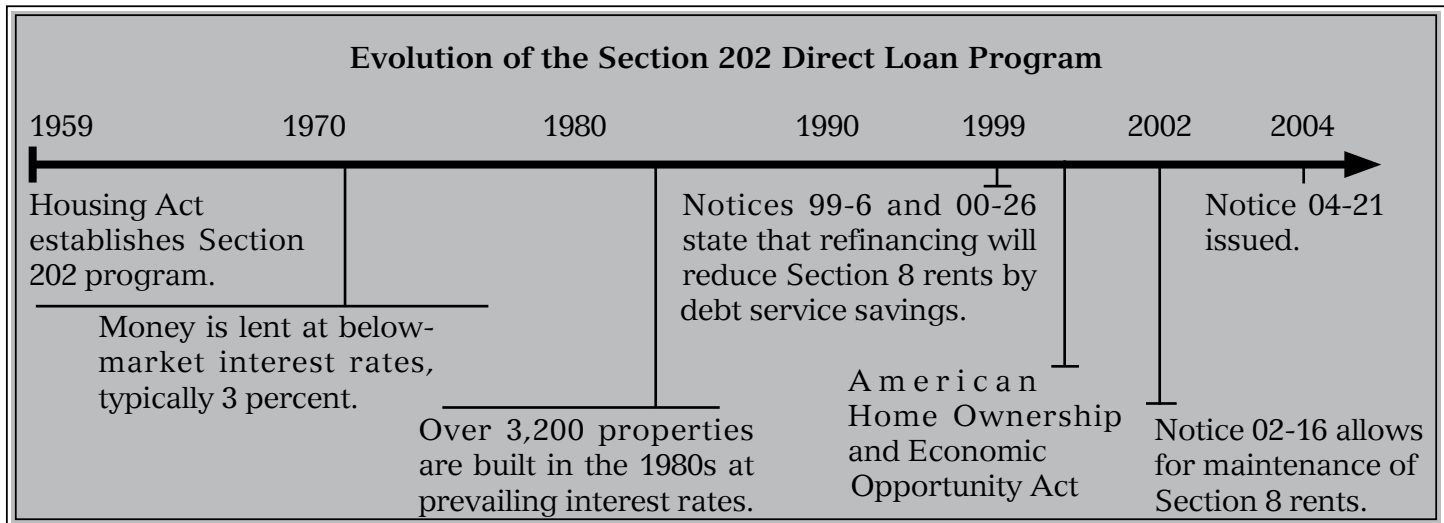
Housing Notice 02-16 outlined a specific process to request permission from HUD to prepay and refinance a Section 202 loan and stated that if this process were followed, the property would be able to retain its status as an “exception” project and maintain its current rents. Request for prepayment carries with it the obligation of the borrower to continue operating the project as low-income senior housing for the life of the original loan term, no matter what changes may occur within the market or to Section 8 subsidies. Prepayment requests, and therefore continued low-income operation, are mandatory for 202 refinances, with the exception of many properties built between

approximately 1978 and 1982, where the option to prepay was specifically embedded in the mortgage note. These properties need only submit a 30-day notice of intent to prepay; however, Notice 02-16 states that even if a property is not required to request prepayment permission, choosing to do so will still permit it to remain exempt from mark-to-market rent reductions.

Notice 02-16 was a key change in protecting property operations. Unfortunately, it also required that projects refinancing with FHA mortgage insurance (the preferred mechanism in most cases, for reasons discussed in Part II) use the area’s comparable market rent, rather than the property’s typically higher contract rent, to determine the size of the new loan. This position conflicted with language contained in the American Home Ownership and Economic Opportunity Act that stated HUD could assume a continual renewal of the Section 8 contract over the life of the loan for underwriting purposes. It eliminated nearly all properties’ practical ability to refinance because a loan underwritten under such terms would not provide sufficient funds to justify the transaction cost.

**Notice 04-21**

After six years of legislative and regulatory effort by the nonprofit community and advocacy groups, HUD gave Section 202 property owners the practical ability to refinance their mortgage loans with the Nov. 12, 2004, issuance of Housing Notice 04-21. The notice revised underwriting guidelines for HUD loan programs for Section 202



properties, allowing lenders to use Section 8 contract rents to determine the mortgage amount. Notice 04-21 also favorably modified other underwriting requirements of Section 223(f), the primary refinance program. It increased the loan-to-value ratio for refinance transactions from 85 percent to 90 percent, decreased the debt service coverage requirement from 1.17x to 1.11x, and created more favorable guidelines for determining appraised value. The notice also provided an added bonus: Owners can now be compensated for the time and expense of the refinance process by including a developer’s fee in the loan amount. Combined with the rent protection of Notice 02-16, these factors support substantially higher mortgage amounts and allow owners of Section 202 properties to enjoy more flexibility and success in preserving these properties.

Further revisions in 2005 changed HUD regulations to allow qualifying Section 202 properties to use Replacement Reserves to fund up-front FHA insurance application costs, eliminating a barrier that had prevented some owners without adequate cash balances from undertaking much-needed refinances and new capital infusions into their properties.

**Evolution in Action: The Meadows**

At the time of Notice 04-21, Lancaster Pollard was working with the Columbus, Ohio, HUD office to structure a refinance for The Meadows, the affordable housing component of Cincinnati’s Maple Knoll Village retirement campus. Built in 1980 using a Section 202 direct loan, The Meadows faced mounting maintenance costs and critical building updates. Deteriorating brickwork threatened to cause extensive water damage, fire safety systems needed upgrades, and the property needed access to gas service to fuel new water heaters. The building’s prognosis was not good, and The Meadows required a funding solution that would ensure it remained economically viable to continue providing safe, comfortable and affordable housing.

Refinancing The Meadows would not have improved its situation under HUD’s previous underwriting guidelines, particularly the require-

ment that properties refinance under the lower of contract or market rents. Contract rents at the 150-unit complex exceeded market rents. Without new guidelines, The Meadows did not qualify to borrow enough to pay off its original mortgage, let alone renovate. It would have had to contribute more than \$2.8 million in equity to refinance and meet its repair needs.

The Meadows’ situation highlighted several of the programmatic underwriting adjustments that were eventually made by Notice 04-21. It offered a real-life example of the positive implications of the notice on the preservation of similar properties nationwide. The American Association of Homes and Services for the Aging, along with the 202 refinance working group of the Mortgage Bankers Association, chaired by Lancaster Pollard, recommended the notice changes as early as the fall of 2003.

The regulatory revisions were issued as The Meadows was working to fund its refinance. Using contract rents, the property accessed a \$5.25 million loan insured by the FHA Section 223(f) mortgage insurance program. The new lower interest rate and extended term of the refinance provided more than \$1 million for immediate and future building improvements. The refinance also provided The Meadows a \$65,227 developer’s fee as payment for its work on the transaction. As the first application of the provision of Notice 04-21, The Meadows set an example for more than 4,000 affordable senior complexes nationwide.

**Effects of HUD Revisions on The Meadows**

	Before Notice 04-21	After Notice 04-21
FHA-Insured Mortgage Loan	\$2,091,000	\$5,251,500
Sponsor’s Equity	\$2,854,500	-
Development Fee	-	\$65,227
Initial Deposit to Replacement Reserve	-	\$583,500
<b>Total Accessible Capital</b>	<b>\$ 4,945,500</b>	<b>\$5,251,500</b>



## Part II: Financing Options

Section 202 direct loans can be refinanced using several options, including a variety of government and private sources. Each method's appropriateness will vary depending on the internal and external characteristics unique to each property, which will drive the economics and desired outcome.

The fact that so many financing options not only exist, but must be considered alongside various refinance regulations and each organization's unique goals, can make a decision seem daunting. Part III uses actual case studies to illustrate the thought processes and outcomes of three 202 loan refinances, which combined the following financing options and tools to create their solutions.

Potential borrowers should consider that while refinancing can provide repair funds, reduce debt service payments and consolidate projects, there may be situations in which it is not a cost-effective choice. Reasons for not refinancing would include an existing interest rate that cannot be sufficiently reduced to justify the cost to refinance, a small loan (under \$1 million) that cannot be pooled with other properties to reduce closing costs, and properties whose mortgage term and restrictions may be ending soon (in the next five to seven years) where ownership contemplates a divestiture or change in property use.

### FHA-Insured Mortgage Loans

The Federal Housing Administration (FHA), a division of HUD, provides insurance on mortgage loans to multifamily and health care facilities under various programs known by the section of the National Housing Act that created them<sup>1</sup>. This insurance protects the lender against losses on the loan, allowing the lender to accept -- and the borrower to pay -- a lower interest rate. The HUD programs also allow for the use of a long repayment term — in some cases up to 40 years.

1) FHA-insured loan programs are administered by HUD, often resulting in their description as HUD loans or HUD loan programs. These names are interchangeable and represent the same programs.

This can benefit the project by allowing for increased borrowing for repairs, or higher annual savings due to lower debt service payments. HUD loans also are an attractive option because they are "non-recourse," meaning they do not require a guarantee from the project's nonprofit parent organization (if applicable). HUD loans also are transferable to another qualified entity should a divestiture decision be made after closing.

For refinancing 202 properties, HUD programs can be even more beneficial and, in many cases, essential to achieving the desired outcome. HUD is the only creditor willing to underwrite new loans with Section 8 contract rents that are in excess of market rents. Some 202 owners also take comfort in having HUD retain the credit risk in the event of loan default, since HUD controls the revenue stream through the Section 8 payments (the theory being that HUD would not negatively alter this stream to create a mortgage loan default since it would suffer losses as the mortgage loan insurer). Finally, HUD allows the borrower to receive a developer fee equal to 15 percent of the total repairs and improvements made to the property, which is built into the new loan amount. There are no restrictions placed on this fee, and it can be paid to the owner, management agent and/or sponsor.

HUD loans are administered similarly to the current 202 direct loans, so Section 202 properties should be familiar with the process and with reporting and asset management requirements. HUD charges an annual fee for its mortgage insurance, ranging from 0.45 percent to 0.80 percent depending on the program utilized and whether LIHTCs are being used as an additional source of funding. There are two FHA mortgage insurance programs available to Section 202 owners interested in refinancing: FHA Section 223(f) and FHA Section 221(d)<sup>2</sup>.

FHA-insured loans can be funded at either taxable or tax-exempt interest rates, the latter being accomplished through the sale of tax-exempt revenue bonds, which are discussed below.

2) The Section 231 program also is technically an option; however, it will remain practically unavailable until certain programmatic changes are made.



### FHA Section 223(f)

The FHA Section 223(f) program is available for the refinance or acquisition of a multifamily housing property where “moderate” repairs and improvements will be made, generally defined as a scope of work that will not exceed \$12,000 to \$15,000 per unit. The exact amount of work allowed under this program is determined by HUD-published regional guidelines, but most areas of the country fall within this range. The Section 223(f) loan has a fixed interest rate and can have a term of as long as 35 years. The annual mortgage insurance premium payable to HUD is currently 0.45 percent of the unpaid principal balance of the loan.

In a refinance scenario, the loan amount can cover 100 percent of the total cost to refinance, so long as this does not exceed 90 percent of the value of the facility. Section 223(f) is the most heavily utilized program for Section 202 refinances because it is relatively quick, less complex, and financing can be arranged to include all associated costs within the loan itself, alleviating an organization’s need to contribute cash that it likely does not have. The program also typically provides for a fairly sizable amount of repairs, which generally can cover most of the property’s physical needs.

In an “arms-length” acquisition scenario, a Section 223(f) loan can cover up to 85 percent of the cost to acquire the property, which necessitates a cash contribution that must be met by the sponsoring entity, often by equity received from the sale of LIHTCs.

Refinancing with a Section 223(f) loan is a one-step application process and takes approximately six months from initiation to loan closing. HUD and the lender will require an Appraisal, a Capital Needs Assessment and a Phase I Environmental Report. Because this program is intended for moderate improvements, there is no formal construction period; however, all designated repairs must be completed within 12 months of closing.

HUD expects the borrower to manage the bidding, hiring and oversight of subcontractors conducting the facility improvements. It often does not allow loan proceeds to be used to pay for the services of a general contractor, although this position is viewed differently by local HUD field offices depending on the scope of work. If the scope of work warrants the use of a general contractor (building additions, major renovation, etc.), it is important that the owner and its mortgage lender discuss this early in preparing the application so that the most appropriate strategy can be developed.

### FHA Section 221(d)

The FHA Section 221(d) program is used for the refinance or acquisition of a multifamily housing property when the project involves a “substantial” amount of rehabilitation. A project becomes a “substantial rehabilitation” when the hard costs for repairs and improvements on a per-unit basis exceed a region-specific amount, calculated by multiplying the regional percentage by \$6,500. This generally amounts to hard cost repairs of at least \$12,000 to \$15,000 per unit.

The Section 221(d) loan features a fixed interest rate and has a term of up to 40 years following the construction period. This program requires the use of an architect and general contractor. The contractor must pay federally-set Davis-Bacon “prevailing wages<sup>3</sup>” under this program, and must obtain a performance and payment bond. It is strongly recommended that the borrower enlist an architect and contractor experienced with HUD requirements.

3) Generally, lower “residential” prevailing wages may be used for projects whose building height does not exceed four stories. More costly “commercial” prevailing wages must be used for all buildings of five or more stories.



The Section 221(d) program has an initial construction period, during which the borrower pays only interest on the loan. These interest-only payments are built into the loan amount as construction period interest, alleviating the borrower of any debt payments from operating cash flow during this period. If the borrower generates “income” during this period, it is important that these monies be reserved or used for HUD-approved uses, since the final loan amount may be reduced by this “income.”

The loan application is a two-stage process, but can be combined into a single stage with HUD approval. Generally, the timeframe from initiating to closing a 221(d) loan is nine months. HUD and the lender will require an Appraisal, a Market Study, a Phase I Environmental Report, an Architectural Review Analysis and a Cost Review Analysis of the proposed facility improvements.

The 221(d) program has two sub-programs. The 221(d)(3) program is available only to nonprofit owners. Under this program, the loan amount is based on the cash flow generated by the property and can be up to 100 percent of the costs of the project, subject to a debt service coverage test of approximately 1.05x. This program provides significant financial leverage with little room for operational error, which has resulted in a high number of defaults, prompting HUD to increase the annual mortgage insurance premium to 0.80 percent of the unpaid principal balance of the loan to help mitigate losses. This higher mortgage insurance fee offsets some of the favorable underwriting benefits of the 221(d)(3) program.

The 221(d)(4) program is available to for-profit and nonprofit owners. A 221(d)(4) loan amount is based on the cash flow generated by the property and can be up to 90 percent of the total cost of improvements subject to a debt service coverage test of approximately 1.10x. This provides slightly less leverage than the 221(d)(3) program and requires

an equity contribution equal to at least 10 percent of the cost of improvements. Few Section 202 properties have the cash necessary to meet this requirement on their own, but additional funding sources such as grants or other governmental loans can be utilized to fill this gap.

One of the most common types of incremental funding for an affordable housing property is the Low-Income Housing Tax Credit (LIHTC), which typically generates equity well above amounts needed to fill this gap. The annual mortgage insurance premium for the 221(d)(4) program is 0.45 percent based upon the outstanding principal balance of the loan.

*Woodmere Senior Housing had kept its 126 units comfortable for 26 years, but old windows brought in winter air, and other repairs were necessary. Woodmere’s replacement reserve was adequate for routine maintenance, but not for such major goals. Its \$5.3 million refinance funded \$855,765 in immediate repairs and provided a developer fee of \$128,365. Residents will receive new kitchens and energy-efficient, easy-to-open windows.*

Generally, the 221(d) programs are utilized when the project is truly in need of a significant amount of improvements. Typically, this entails improvements that involve a substantial amount of demolition, necessitate the temporary relocation of residents, or will render all or a portion of the property uninhabitable for a period of time.

### FHA Section 542(c)

HUD collaborates with state and local housing finance agencies through its Section 542(c) risk-sharing program. Housing agencies that issue bonds for multifamily housing loans can use Section 542(c) as a credit enhancement to make the bonds investment-grade. The housing agencies elect to share from 10 percent to 90 percent of the loss on a loan with HUD.

Generally, these programs will have characteristics similar to the above-mentioned FHA programs; one major exception, however, is that states must underwrite to the lesser of market or contract rents, which can make risk-sharing less attractive in lower-rent areas. Additionally, each housing finance agency that utilizes this program has established its own requirements, terms and fees, and not all states participate.

### Tax-Exempt Bonds

HUD requires that an owner of a Section 202 property be an eligible nonprofit entity<sup>4</sup>, a status that makes the property eligible to utilize 501(c)(3) tax-exempt bonds as a means of project funding. Tax-exempt bonds have the advantage of a lower interest rate, allowing for either additional borrowing or additional cash flow, both of which provide an ongoing benefit to the organization. Tax-exempt bonds, however, have higher up-front costs than taxable financing options. This tends to reduce, and may eliminate, their economic benefit for smaller projects of under approximately \$6 million.

Tax-exempt bonds also are utilized in conjunction with 4 percent LIHTCs, which require their use. These bonds are known as “Private Activity” bonds and, unlike 501(c)(3) bonds, their availability is controlled by the state in which the facility is located. Similar to LIHTCs, Private Activity bonds are available in a set amount depending on the state’s population. Many states do not use their total Private Activity bond allocations each year and there is little or no competition. Some active issuers such as California and several other states, however, routinely meet their issuance limits, making their 4 percent LIHTCs and Private Activity bonds highly competitive.

Tax-exempt bonds also may be used when consolidating multiple projects where the aggregate loan approaches or exceeds \$6 million. Both 501(c)(3) and Private Activity bonds can be credit-enhanced by FHA insurance programs, which may further reduce the interest rate. Tax-exempt bonds can be structured and sold without the enhancement of

4) HUD allows for-profit ownership of a 202 property if the controlling entity (i.e. general partner or managing member) is a qualified nonprofit. In certain instances, 202 properties have been sold to for-profit entities that do not meet this requirement, which can be done if the 202 loan explicitly grants an option to prepay and the owner elects to prepay outside of Notice 02-16.

FHA insurance, but the feasibility of this option typically depends on the strength of the property’s rental market, whether the Section 8 rents are below or above market rents, and other credit attributes of the organization.

### Conventional Financing

Conventional financing includes options such as bank loans, conduit financing, and loans placed with Government Sponsored Enterprises (FNMA, FHLMC). Due to the wide variety of lenders and programs, terms and conditions can vary more than those of FHA mortgage insurance or tax-exempt bonds. One of the primary reasons to look to this option would be to avoid some of the restrictions that typically accompany FHA

financing. Conventional financing will generally have a shorter repayment term than FHA-insured loans — generally 25 or 30 years. Unlike the FHA programs or tax-exempt bonds, which require a fixed interest rate, conventional financing can utilize a fixed or floating rate, providing increased

flexibility and a potentially lower interest cost. However, conventional financing can be problematic for projects with above-market Section 8 rents (which, in reality, applies to most Section 202 properties) because a conventional lender may not have the ability to use the above-market rent revenue in determining the loan amount. Hence, conventional options will almost always offer a lower borrowing potential than FHA programs.

### Low-Income Housing Tax Credits

The low-income housing tax credit (LIHTC) program was created to encourage private investment in the purchase, construction and rehabilitation of low-income housing projects. It has become one of the most important federal initiatives supporting affordable housing for low- and moderate-income seniors and families. The program allows state housing finance agencies to allocate an average of approximately \$5 billion in annual tax credits to eligible projects. The program can

*Two Virginia 202s combined their properties through a refinance. The \$5.98 million refinance of newly-created Scott Hill Apartments provides \$376,000 for repairs and saves over \$117,000 in annual debt service. Renovations were especially critical to certain units that faced potential rent cuts. The property is now positioned to keep operating even if this revenue change occurs.*



be implemented in coordination with FHA/HUD mortgage insurance programs, Private Activity tax-exempt bond financings, HOME funds, other state and local loan programs, and conventional financing.

LIHTCs provide for-profit affordable housing owners a dollar-for-dollar reduction of federal income tax liability over a 10-year period for renting housing units to low-income individuals or families. Section 202 properties, which are nonprofit entities, can also utilize the tax credit program with a bit of creative reorganization. This typically involves the property being “sold” to a for-profit partnership created to own the property and receive the tax credits, while the nonprofit maintains day-to-day oversight of operations as the controlling general partner or managing member. Private investors are sought to provide equity for development costs in exchange for the opportunity to “own” the project and receive the tax benefits. LIHTCs can be immensely beneficial to Section 202 properties by increasing equity for the project, often raising much more capital for improvements than the refinance alone.

Two types of LIHTCs are available: 9 percent (competitive) and 4 percent (non-competitive). States allocate credits based on criteria outlined in their Qualified Allocation Plans, usually a scoring system evaluating such factors as the units’ affordability, developer/applicant experience, local government support, property design features and location in “difficult to develop” areas or “qualified census tracts.”

The LIHTC process is a complex endeavor that will add myriad additional participants and fees. Post-closing, the property manager will have additional responsibilities for LIHTC compliance and monitoring. Owners of 202 properties considering LIHTCs should also closely evaluate existing tenant incomes, since income limits for LIHTC units may be more restrictive than those that currently exist under the Section 8 contract<sup>5</sup>.

5) Section 8 contracts allow incomes at or below 56 percent of the area median income for one tenant or 64 percent for a “family of two;” LIHTC requirements cannot exceed 42 percent for a single tenant or 48 percent for a “family of two.”

### Key Determinants of Funding Strategy

The four primary approaches to funding, in order of the amount of subsidy each provides, are i) 9 percent LIHTCs with taxable debt, ii) 4 percent LIHTCs combined with tax-exempt private activity bonds, iii) 501(c)(3) tax-exempt bonds, and iv) taxable FHA-insured<sup>6</sup> or conventional financing.

The greater the subsidy, the more new capital can be infused into the 202 project. Unfortunately, the amount a subsidy provides is inversely related to its availability. As discussed, 9 percent LIHTCs are a limited resource; competition for them by seasoned developers is considerable. Depending on the state in which a project is located, private activity bonds also can be competitive. The issuance of 501(c)(3) bonds is essentially unrestricted for affordable housing purposes, but produces only marginal funding benefits over taxable funding mechanisms, and the cost of issuing the bonds, in particular if the new debt is less than \$6 million, may offset much of their interest rate advantage. Projects seeking the higher forms of subsidy should be prepared for longer funding time frames and increased complexity both during the financing and after the process is complete. For projects whose needs cannot be met with taxable funding mechanisms alone, however, higher subsidy programs should be pursued to avoid the “short-term fix.” At a minimum, 202



6) FHA-insured mortgage loans can be used as the source of debt funding or as credit enhancement for bonds in all four funding scenarios.

owners should seek to address the needs of their property for the next ten years with the refinance, at which time a subsequent capital infusion may be possible.

### Part III:

#### Selection Criteria and the Decision-Making Process: How to Look at Refinancing a 202

#### Pulling it All Together

These myriad programs can be combined in a variety of ways to create a workable 202 refinance plan, and property owners and their financial advisers must perform a thorough evaluation of goals, costs, timing, eligibility and availability to determine which mechanisms may be most appropriate given the property's characteristics and ownership's objectives. Determining funding strategy begins with an assessment of key decision drivers. Some of these considerations can compete with or contradict others, but by reviewing them in this prioritized order, organizations can better identify the most appropriate refinance options.

#### Know Who You Are

Critically evaluate the existing property from a physical and a financial perspective before even thinking about financing options. The ultimate questions are, what does the property need in order to adequately serve residents for the next 15 to 20 years, and what resources does it have (or lack) that could aid in the refinance process? Consider:

- *Physical plant: Has the property been well maintained? Do any building systems require upgrades or replacement? Review the results of any Property Capital Needs Assessments, which will not only identify existing items of repair and potential life safety issues, but also improvements likely to be necessary over the next five to 10 years as short-lived building components expire.*

Based on their experience in operating the property and serving residents in the market, ownership or management also should identify building improvements that are necessary to enhance marketability, functionality, energy efficiency and resident well-being. It is important to bear in mind the market a property serves, recognizing that certain features and amenities often highlighted in upscale senior living communities are simply not economically feasible in moderate- and low-income rental markets. The amount of new capital needed for preservation, determined through a combination of a Capital Needs Assessment and ownership's evaluation of necessary quality of life and marketability improvements, impacts which financial program or programs are most appropriate for a refinance.

*Fellowship Manor's replacement reserve was under-funded. It wanted to upgrade but did not want to make piecemeal changes, which it saw as unfair to residents. The week of its silver anniversary, the property celebrated with cake and the announcement of new kitchens and bathrooms. The renovations are the first major improvements since the property opened. They were made possible by a \$2.97 million refinance that provided \$422,000 for immediate repairs.*

- *Ability to serve the local market: Are units configured appropriately, particularly regarding the number of studio or two-bedroom units? Is vacancy a concern, and what are the level and characteristics of local competition? It is important to understand the current housing*

supply in the area and future market needs. Evaluate what services and amenities will be necessary for the property to remain an attractive housing option for senior residents.

- *Financial condition: Does the property have adequate Replacement Reserve funds to meet existing and future capital needs? Are Residual Receipts available to augment other financing sources? Are rents sufficient to cover all expenses? Does the property anticipate any significant expense increases (e.g., insurance, taxes, utilities)?*

- *Existing mortgage note's prepayment features: If the existing 202 mortgage note provides the explicit option to prepay the loan, more options may be available to the 202 owner, especially if market rents equal or exceed the Section 8 contract rents. Owners whose existing loan notes are silent on prepayment provisions will be required to follow the guidelines of HUD Notice 02-16, including the*



execution of a new Use Agreement with a term equal to the maturity of the existing debt.

A realistic property analysis will begin to determine eligibility for and the appropriateness of various financing options. For example, a well-maintained community with high occupancy levels and a moderate reserve balance may find that adding LIHTCs to a transaction would add more complexity than value. Instead, the property could realize the benefits of a lower interest rate, upgrade priority building systems and provide an additional contribution to the reserves through the FHA Section 223(f) program alone, or potentially a conventional funding program.

In contrast, a property with significant improvement needs that exceed the “substantial rehabilitation” threshold may look to a construction lending program such as FHA Section 221(d). Incorporating LIHTCs into this structure could be considered depending on the amount of work planned and the need for funds beyond that which can be realized through the refinance effort alone.

### Contract versus Market Rents

Budget-based Section 8 rental assistance contracts allow 202 properties to remain somewhat independent of local rental market conditions. It is important, however, to understand the relationship between the Section 8 rents received and the area market rent. Section 8 rents have increased at a faster rate than market rents in most of the country, and most Section 202 properties have above-market rents. This is generally not an issue, since HUD has allowed projects to continue renewing rents under the budget-based option and will continue to do so if prepayment occurs under the guidelines of Notice 02-16; however, it can dictate the financing options available to a property.

Evaluate any difference between subsidized contract rents and comparable market rents: If existing rental assistance is provided, and at levels that are believed to be below comparable market rents, the project may be eligible to receive a mark-up of rents prior to the refinance that could support increased borrowing. Contract rents that are



at or below market rental levels open up much greater funding possibilities outside of the FHA programs. Section 8 renewal risk is mitigated, since technically the property would have greater revenue potential outside the Section 8 program. Further, if the option to prepay is available in the existing 202 mortgage note, prepayment outside of the guidelines of Notice 02-16 (avoiding a new use agreement) is viable, since the loss of exemption from the Mark-to-Market program is irrelevant.

Alternatively, if contract rents are in excess of market, the potential for their reduction poses a credit risk. In this situation, following the prepayment guidelines of Notice 02-16, even if the option to prepay is specifically granted in the mortgage note, is a must to preserve the exemption from the Mark-to-Market program. FHA mortgage insurance may also be more prudent than other sources to make certain HUD interests are “properly aligned,” maintaining credit risk in the event of loan default with the same entity that controls the Section 8 rental subsidy.

HUD mortgage insurance programs permit the use of above-market rents when calculating how much a property can afford to borrow: This was the key change in Notice 04-21 that made refinancing a viable option. But many conventional lenders view the above-market rents as a potential risk. They often compensate for this perceived risk either by collecting an extra reserve at closing (designed to protect the project for six to 12 months if rents were decreased to market), or by

ignoring any revenue received beyond the area market rent figure in calculating the maximum loan amount. This reduces the amount of debt a project can support and the benefit the project can receive.

### **Availability of State and Local Resources**

Review any state regulations, particularly those governing LIHTCs and tax-exempt bonds. Each state allocates LIHTCs according to ever-changing priorities, which can dictate whether competitive 9 percent LIHTCs are an option or unlikely. It can also determine if Private Activity tax-exempt bonds would be available, and the timing and process necessary to request an allocation.

### **Consider Short- and Long-Term Goals**

Senior housing is provided by both large national companies and by small, single-entity ownership. Their overall goal of providing safe and affordable housing may be the same, but their management and development capabilities can vary greatly, which may influence the complexity of transaction that should be pursued.

If an organization has multiple properties, has adequate “management capital,” and is committed to providing affordable housing into the future, then it may be practical to undertake a more complex financing structure with a goal of maximizing the benefit to the property and the return to the owner. LIHTCs, for example, likely will provide for the largest amount of rehabilitation funds, and likely will include the largest developer’s fee paid to the borrower. They also involve the most complexity, liability and risk. Managing a LIHTC property requires significant training and certification, a responsibility that could require a smaller property to give up management control to an outside entity, and give up all but nominal ownership of the property to the related for-profit entity using the tax credits. This is sometimes, but not always, necessary to save a very deteriorated project; smaller properties may prefer a less complex financing structure that still meets the property’s financial needs.

### **Conclusion**

Over its forty-seven year life, the Section 202 program has been widely recognized, both politically and socially, as a highly successful government program serving the housing needs of many of the poorest and most frail elderly. Although the current program funds very few new units, the inventory of properties built during the 1970s and ‘80s represents a valuable housing resource, the replacement cost of which would be considerable and the loss of which would worsen a growing housing shortage. The tools are now available to infuse new capital into these 202 properties, and with these tools come the opportunities to improve building aesthetics, increase energy efficiency, enhance life safety and improve adaptability, among others. The physical and economic lives of 202 properties are being extended, but more importantly, residents’ lives are being favorably impacted by the upgrades to their homes.

The favorable legislative and regulatory changes enacted by HUD, a relatively low interest rate environment, and the availability of other affordable housing resources has created an ideal environment to maximize the benefits of a refinance. Ownership and/or management should evaluate the physical and financial needs of their property, along with the goals of their organization, to determine if a refinance is appropriate for them. Consultation with a knowledgeable and experienced banker or advisor will likely facilitate this process.

While demand for affordable housing is only anticipated to increase, remaining competitive and financially viable in the future will require reinvestment and adaptation to meet the needs of a new generation, one expected to live longer than any before it. Refinancing a Section 202 direct loan can provide the financial stability to continue serving aging low-income residents for decades to come, and can provide funds to upgrade or add the amenities that this new generation has come to expect.

# Case Studies

**Trinity Manor: FHA Section 223(f) combined with 4 percent LIHTCs and Tax-Exempt Bonds**

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Location: Middletown, Ohio

Objective: Complete major repairs and strengthen replacement reserve

Sources of Funding:

- \$3.49 million tax-exempt bonds insured by the FHA Section 223(f) program
- \$1,173,024 in 4 percent LIHTC equity

Key Benefits:

- Initial Deposit to Replacement Reserve: \$376,199
- Repairs: \$959,334
- Annual Debt Service Savings: \$45,000

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Trinity Manor is a 90-unit, nonprofit affordable elderly housing facility associated with National Church Residences (NCR). It was constructed in 1979 through the Section 202 program.

Trinity Manor had benefited greatly over the years from NCR's keen oversight and favorable reputation. But as an aging facility in need of increasing maintenance, it had begun depleting its replacement reserves faster than new funds could be deposited. In addition, there were a number of repairs and improvements – including the replacement of the existing fire safety system – that, if implemented, would greatly enhance the residents' overall quality of life.

Trinity Manor needed to be able to provide for these significant near-term capital improvements and adjust the annual deposit to the replacement reserve to a level at which all future needs of the facility could be met with sufficient funds.

The project was developed during a period when Section 202 programs did not require HUD's permission to prepay their loans, and it could have considered non-HUD financial structures. However, because the Section 8 rents at the property were significantly higher than the comparable market rent, there was no incentive to utilizing financing outside of HUD insurance since HUD is the only creditor that will recognize the higher Section 8 rents for underwriting purposes.

The owner of the facility, NCR, is a sophisticated participant in the affordable housing industry and

comfortable with the complexities and requirements of the tax credit program. The property's small units, lack of amenities and other attributes, however, would not have made it highly competitive for 9% tax credits. As such, the development team looked to a combination of 4% LIHTCs and tax-exempt bonds backed by FHA insurance under Section 223(f).

The new FHA-insured loan paid off the existing Section 202 mortgage note, lowering the original interest rate by more than two percentage points and reducing subsequent debt service payments by more than \$45,000 annually. In addition, tax credit equity of over \$1 million was generated to cover additional work on the property. The resulting repairs and improvements (nearly \$15,000 per unit) include new plumbing fixtures and kitchen appliances, replacement air conditioning units, new windows and doors, and other energy efficiency, safety and comfort upgrades. These improvements will not only enhance the living environment for the residents, but will help reduce the facility's overall maintenance and utility expenses, thereby mitigating future rent increases.

The equity provided by the LIHTCs combined with a significant reduction in debt service allowed Trinity Manor to make a hefty initial deposit of more than \$376,000 to its replacement reserve. This financing structure also paves the way for increased annual deposits to the replacement reserve, ensuring that Trinity Manor's residents will enjoy a well-maintained, comfortable and safe living environment into the foreseeable future.



Meadowview Village: FHA Section 221(d)(4) combined with 9 percent LIHTCs

Location: Mt. Sterling, Ohio

Objective: Reduce debt service and convert studio units into one-bedrooms

Sources of Funding

- FHA/GNMA Mortgage \$1,590,300
- Limited Partner Equity \$2,187,000
- HDAP Loan \$550,000
- Existing Rep. Reserve \$160,941

Key Benefits

- Initial Deposit to Replacement Reserve: \$60,000
- Repairs: \$1,071,742
- Annual Debt Service Savings: \$40,000

Meadowview Village Apartments is a 40-unit affordable elderly housing facility located in Mt. Sterling, Ohio. It was constructed through the Section 202 Direct Loan Program in 1984, and all of its units receive budget-based Section 8 rental assistance.

Unfortunately, Meadowview Village had been paying a high interest rate of 9.25% for more than 20 years. This created a weighty debt service commitment, and the limited replacement reserves left little room for funding modest, let alone substantial, improvements. Meadowview needed a lower interest rate to save on debt service, and it needed significant equity to upgrade its interior and convert unmarketable studio units into one-bedrooms.

Similarly to other Midwestern projects, the Section 8 rents had far surpassed the market rents in the area, limiting funding options outside of HUD.

Because of the substantial nature of the intended facility improvements, and the high rent levels, the optimum financing structure for Meadowview Village was achieved through a combination of FHA Mortgage Insurance under Section 221(d)(4) and 9 percent Low-Income Housing Tax Credits (LIHTC). This structure provided the facility with long-term, non-recourse debt, along with a significant amount of equity to achieve the much-needed enhancements. A Housing Development Assistance Program (HDAP) loan and existing reserves completed the funding structure.

Key among Meadowview Village’s aims was to

convert its 10 unpopular studio efficiency units into standard one-bedroom models. With over \$28,000 per unit in repair funds generated by the refinance, Meadowview was also able to update all kitchens. Common area improvements, new windows and many energy efficiency, safety and comfort upgrades are some of the benefits to current and future residents. Property upgrades include new parking, repairs to exterior siding, a reconfigured entry that offers residents better shelter and landscaping improvements.

The financing made available \$1.9 million for rehabilitation, and Meadowview Village’s new lower interest rate and reduced debt service allowed for approximately \$40,000 in annual savings.

**Lewinsville Retirement Residence: Refinancing Without HUD**

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Location: McLean, VA

Objective: Increase financial flexibility and subsidize a meal program

Sources of Funding

- Unenhanced, tax-exempt, 501(c)(3) fixed-rate bonds

Key Benefits

- Released facility equity
- Released restricted Replacement Reserves

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Lewinsville Retirement Residence was one of the few Section 202 properties that operated at well below market rents. Located in an affluent suburb of Washington, D.C., it had a long history of generating very stable and predictable cash flow for debt service, and it had built up a strong reserve for replacement to keep the property well maintained. A proactive board, experienced management and an active local community further bolstered the facility's stability.

But like many properties built in the 1980s, Lewinsville was paying a higher interest rate than what is currently available. More importantly, the restrictions imposed by HUD on the use of Section 8 revenue and the replacement reserve balance limited Lewinsville's flexibility to implement new, forward-thinking resident services. With several years remaining in the term of a \$4 million loan balance, and with new programming planned for the near future, refinancing was an option to free capital from these restrictions to further the property's mission.

Lewinsville Retirement Residence's goals included subsidizing an existing meal program for its residents. A refinance using HUD programs was not an ideal solution for Lewinsville because HUD would not allow funds to be put toward this purpose. The property's goal of increased financial flexibility would not have been met.

Lewinsville Retirement Residence's original loan was issued during a period of the Section 202 program when properties were not required to request

permission to prepay their loans. It therefore was not required to enter into a new Use Agreement, which would have created an operating risk because the property would be mandated to continue as affordable housing for the length of the loan term even if Section 8 subsidies were no longer available. While HUD is comfortable with this risk, outside investors generally are not, which would have made non-HUD financing less likely. The lack of any need to request prepayment permission, combined with the facility's below-market rents and location in a prime real estate market, made non-HUD financing options realistic. Section 8 contract regulations also were a key consideration in Lewinsville's refinancing, and understanding the program iteration under which a property was constructed is key to understanding its options for refinancing and reinvestment.

Lancaster Pollard underwrote unenhanced, fixed-rate bonds issued through the Fairfax County Economic Development Authority to refinance the property. The bond offering provided an all-in interest rate 2 percentage points lower than Lewinsville's original Section 202 loan and comparable to HUD-insured financing. The lower interest rate allows Lewinsville Retirement Residence to realize savings that can be put toward the meal program or other property initiatives. Lewinsville Retirement Residence also lifted restrictions on \$1 million the property had in an existing reserve for replacement, and the property now has additional financial flexibility to develop its resident-focused initiatives.



## Frequently Asked Questions

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**Q: Will the refinanced property retain its Section 8 and remain exempt from Mark-to-Market?**

**A: YES.** Congress and HUD created protections that allow a property to retain its Section 8 contract and ability to use budget-based or Operating Cost Adjustment Factor (OCAF) rent increases. As long as the proper steps are followed, including a new use agreement, the refinance will not jeopardize the rental assistance contract or its exemption from Mark-to-Market upon contract renewal.

**Q: Will refinancing my Sec. 202 property provide capital for facility improvements?**

**A: YES.** The lower interest rate achievable through refinance will support a larger loan amount, creating new money for repairs, improvements and other permitted enhancements. For simple refinance projects, this typically ranges from \$4,000 to \$12,000 per unit. Well-maintained projects can use the refinance to replenish replacement reserves and ensure adequate funds in the future. Properties needing a greater infusion of capital can combine the refinance with Low Income Housing Tax Credits (LIHTCs) to fund improvements from \$15,000 to \$40,000 per unit, though this involves an additional complexity and operating oversight.

**Q: Will refinancing produce debt service savings?**

**A: YES.** One of Notice 04-21's requirements is that each Section 202 refinance result in reduced debt service. While the new loan amount will be increased to fund necessary repairs and closing costs, the interest rate will be sufficiently reduced to lower monthly debt service payments. Property owners have utilized the resultant savings to fund ongoing capital improvements and initiate projects such as adding service coordinators and activity directors, setting up computer labs, and providing transportation services. Properties with few improvement needs and strong reserves are able to maximize debt service savings and greatly expand resident services through the refinance.

**Q: What is the timing for a refinance?**

**A:** Timing varies depending on the refinance's complexity. Well-maintained properties with only moderate, immediate repair and improvement needs (less than about \$13,000 per unit) can utilize the HUD Section 223(f) program, which normally can be completed in five to seven months. Properties with more extensive capital needs would utilize the HUD Section 221(d)(4) program, and likely would incorporate Low Income Housing Tax Credits (LIHTCs). This process generally takes eight to 12 months. For this reason, creating a well-thought-out scope of repairs and improvements is one of the most important first steps in evaluating a refinance.

**Q: Can a developer fee be paid as part of the refinance?**

**A: YES.** HUD allows the payment of a developer fee equal to 15 percent of the total cost of property repairs and improvements. These funds are available to the owner and/or management company with no restrictions on their use. Typically, these funds are held with the money set aside for repairs to protect against cost overruns and to meet a HUD-required temporary escrow. Once all work is complete, the developer fee is released.

**Q: Can the refinance be used to consolidate projects?**

**A: YES.** Properties in close proximity can be consolidated into a single project in conjunction with the refinance. Consolidation can streamline administrative efforts, reduce financial audit cost, and reduce costs associated with the application and closing of the new loan. This is most easily accomplished where properties are adjoining or nearby, but it has also been achieved for projects dispersed over larger areas.

**Q: How are underwriting and application costs covered?**

**A:** HUD created a process by which excess replacement reserves of up to \$20,000 can be used to pay for third-party costs (capital needs assessment, appraisal, survey and environmental report) associated with application to HUD. In addition, all other costs incurred in the normal course of refinancing are eligible to be reimbursed at the time of closing.

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