

Issue Date: February 21, 1997
Audit Related Memorandum
97-NY-112-0802

MEMORANDUM FOR: Nicolas P. Retsinas, Assistant Secretary for
Housing, Federal Housing Commissioner, H

FROM: A. Paul Kane, District Inspector General for Audit, 2AGA

SUBJECT: Riverside South Apartments Project No. 012-32269

The Developer for Riverside South Apartments requested that the Federal Housing Administration (FHA) provide mortgage insurance on a \$356 million loan. The proceeds would be used to develop 1,663 residential units and a recreational park and pier on the Upper West Side of New York City, New York. Out of the 1,663 residential units, 333 (20 percent) will be available to low-and-moderate income people. The U. S. Department of Housing and Urban Development (HUD) New York Field Office reviewed the application and accepted it for processing. Because of the amount of the loan and other unique aspects, in October 1996, the New York Field Office consulted with Headquarter's Office of Multifamily Housing Development to assist with the review. Once Headquarters forwards their suggestions to the New York Field Office, the process will continue and a conditional commitment could be issued.

Because of local community and Congressional interest, the Office of Inspector General (OIG) reviewed the application and the corresponding documentation developed by the New York Field Office.

We concluded that the FHA should not bear the risk of insuring the proposed mortgage. Our reasons are threefold. First, out of the 1,663 residential units to be developed only 333 of the units will represent low-and-moderate income housing. In essence, for each one million dollars of insuring authority devoted to this development, one unit of low-and-moderate income housing will be produced. Second, immediately following the endorsement of the mortgage, the park and pier, nearly one-fourth of the security for the mortgage, will be given to the City of New York. Consequently, in the event of default, a potential significant loss to the FHA insurance fund is a practical certainty. Third there is a real question as to whether Congress authorized FHA to insure the park and pier.

As mentioned, we do not believe that FHA should bear the risk of insuring the proposed mortgage. Nonetheless, the issues identified in this review, specifically the issue pertaining to site not attributable

to dwelling use, is applicable to all requests for multifamily mortgage insurance. Accordingly, we made appropriate recommendations.

Within 60 days please give us, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you have any questions, please call me or William H. Rooney, Assistant District Inspector General for Audit, at (212) 264-8000, extension 3976.

Background

In April 1995, American Property Financing, Inc. (Mortgagee) submitted an application for mortgage insurance to FHA for a \$356 million loan pursuant to Section 220 of the Housing Act. Hudson Waterfront Associates 1, L.P., (Developer) desires to construct a mixed use development to be built on the former Penn Central rail yards, Upper West Side, New York City along the Hudson River.

The Developer is a limited partnership and plans to construct 5,700 units involving various phases of construction along the Upper West Side of New York City. For the Riverside South Apartments phase, the Developer requested FHA insurance to construct 1,663 apartments in four buildings and 20 percent of the units (333 units) will be designated for low-and-moderate income people. The Riverside South Apartments' site has 542,850 square feet of which 352,300 square feet pertain to a recreational park and a recreational pier (313,400 square feet for the park and 38,900 square feet for the pier).

To qualify for Section 220 mortgage insurance, a development must be in a geographic area that is eligible. The Code of Federal Regulations contains categories of geographic areas in which a development must be located. One category is that the mortgage property must be in an area in which concentrated housing, physical development, and public service activities are being or will be carried out in a coordinated manner, pursuant to a locally developed strategy for neighborhood improvement, conservation or preservation.

In February 1995, the New York City Department of Housing Preservation and Development designated the geographic location in which the development is located as an eligible area, and in June 1995, HUD accepted this designation. The designation of the geographic area and HUD's acceptance is currently being challenged by local community groups in the United States District Court and hearings are expected to start in February 1997.

This memorandum will not address the Section 220 eligibility issue because it should be resolved by the courts.

Procedures used by HUD to calculate the maximum insurable mortgage amount need to be clarified.

For multifamily mortgages, one of the criteria used to determine the maximum insurable mortgage amounts, is the criteria known as the limitations per family unit. For this criteria the maximum insurable mortgage amount is the sum of the following three components: (1) the statutory allowable amount per units; (2) development costs not attributable to dwelling units, and (3) site costs not attributable to dwelling use.

Regarding the first component, Congress placed statutory limits on the amount of the mortgage that is allowed based on the number of bedrooms per unit. For the second component, HUD placed a 15 percent cap on the amount of mortgage allowed for development costs not attributable to dwelling use. An example of the second component would be costs to construct parking and recreational facilities.

However, regarding the third component, a limit does not exist for the amount of mortgage allowed for site costs not attributable to dwelling use. An example, of this third component would be the value of the land pertaining to the parking and recreational facilities that were constructed as part of the second component.

For this development (Riverside South Apartments) 352,300 square feet, or 65 percent of the site, pertains to a recreational park and pier. Therefore, the third component of the formula to compute the maximum insurable mortgage amount (site not attributable to dwelling use) for the Riverside South Apartments amounts to approximately \$73 million. HUD Handbook, Multifamily Underwriting Forms Catalog pages 28-29 describes the procedures for calculating the site not attributable costs, but it does not place a limit on the maximum amount of insurance pertaining to site costs. We believe without a limit on the site not attributable costs, there is in effect, no limit to the maximum insurable amount.

Regarding the second component of the formula (dwelling costs not attributable to dwelling use), if HUD limits the amount of land to be included in its calculations, the second component also would be reduced. For example, if HUD excluded the park and pier, the construction costs associated with the park and pier (dwelling costs not attributable to dwelling use) would be reduced by \$11 million.

In short, the costs pertaining to the park and pier account for approximately \$84 million of the \$356 million mortgage. Also, it is interesting to note that the park is partially in front of one of the four Riverside South Apartment buildings and primarily in front of three other buildings that are not included as part of Riverside South Apartments (Attachment 1).

Finally, we believe that HUD must provide better guidance to its Field Offices pertaining to items considered as dwelling costs not attributable to dwelling use. HUD Handbook 4450.1, Cost Estimation for Project Mortgage Insurance, pages 4-2 through 4-4 gives examples of such items. However, when we read the Handbook, we interpret the examples to be items that financially benefit the project. We are not sure whether a park and pier would be consistent with the examples.

The title for the park and pier will be conveyed to the City of New York.

In 1992, Penn Yards Associates reached an agreement with the City of New York by which certain areas along the Upper West Side of New York City would be developed into a recreational area. Once developed, the title for this area would be conveyed to the City of New York and Penn Yards Associates would maintain this area. This agreement included statements that said in effect that if the property was sold, the agreement would be binding upon the successors.

The Developer for Riverside South Apartments acquired the property from Penn Yards Associates in 1994. In short, 352,300 square footage of the total 542,850 square footage would be given to the City of New York, once construction is completed. Not only is it questionable as to whether the maintenance of a park and pier is a reasonable and necessary operating expense of Riverside South Apartments, but if the Developer defaults on the insured mortgage, it is possible that HUD would have to maintain a recreational park and pier that is not owned by HUD, but owned by the City of New

York. The Developer estimates the annual park maintenance budget for the Riverside South Apartments at \$120,000.

Questionable if Congress authorized items such as the park and pier to be insured.

There is a very real question concerning whether Congress authorized FHA to insure the park and pier. When adding subsection (d)(3)(B)(iv) to Section 220 of the National Housing Act, Congress noted that it was intended to permit FHA to "insure projects which would be predominantly for housing but which could include stores and office space." See House Rep. 89-365. Congress did not mention or suggest that the amendment could be used to justify the insurance of a mortgage where 352,300 square footage will be used for a park and pier. Further, Congress limited the applicability of subsection (d)(3)(B)(iv) to "cases where it can be shown to be economically feasible and necessary to the economic success of the initial housing projects in the urban renewal area." Id. As opposed to being necessary to the economic success of the venture, the proposal contemplates that the park and pier will be a liability in the amount of \$120,000 annually.

Conclusions

We do not believe that FHA should bear the risk of insuring the proposed mortgage for three reasons. First, the mortgage is huge in relation to the low-and-moderate income housing being created. Out of the 1,663 units to be developed only 20 percent (333) of the units will represent low-and-moderate income housing. In other words, for each one million dollars in insuring authority devoted to this venture, one unit of low-and-moderate income housing will be produced. Second, immediately following the endorsement of the project's mortgage for insurance, nearly one-fourth of the security for the mortgage, is going to be released. Consequently, in the event of a default, a multi-million dollar (perhaps \$84 million) loss to the FHA insurance fund is a practical certainty. Third, there is a very real question as to whether congress authorized FHA to insure the park and the pier.

Recommendations

In addition to Riverside South Apartments the issues identified in this review also pertain to HUD's processing of all requests for multifamily mortgage insurance. Therefore, we recommend that HUD: (1) not bear the risk of insuring the proposed mortgage for Riverside South Apartments; (2) immediately place a cap on the site costs not attributable to dwelling use; and (3) provide better guidance to its Field Offices in identifying dwelling costs not attributable to dwelling use.

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