The Working Capital and IOD Escrows on a *221(d)(4)*

The Two Non-Mortgageable Escrows You Bring to a Ground-Up Closing

Every 221(d)(4) carries two escrows that sit outside the mortgage: a working capital escrow and an initial operating deficit escrow. Sponsors coming from the conventional construction world expect a contingency line inside the loan and an interest reserve funded from loan proceeds. HUD handles both differently, and the difference lands as cash — or a letter of credit — the borrower brings at initial closing on top of the equity already in the deal. This paper covers what each escrow is, how we size them, and when the money comes back.

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At a high level, these are two escrows the borrower funds at closing on top of project equity: one to carry construction cost overruns and the soft costs of opening the building, and one to cover operating shortfalls until the project leases up and can support its own debt service.

Both are funded at initial closing with cash or a letter of credit, and the lender controls and approves every disbursement, with HUD's written approval. These escrows are how a borrower ensures their new project has the cushion to absorb a construction overrun and to carry itself through lease-up before it can stand on its own income — since HUD does not consider contingency or operating deficit a

mortgageable cost. In the article below, we cover what each one is, how the lender determines their sizes, and how any unused portions are returned to the borrower.

A quick note: everything here is written for a 221(d)(4) new construction loan. The concepts carry over to a 221(d)(4) substantial rehabilitation, but several of the numbers change, and we have noted the rehab figures where they matter.

01
THE WORKING CAPITAL ESCROW

The Working Capital Escrow: *What It Is*

A key to understanding the working capital escrow is knowing that HUD does not treat contingency the way a bank does when it comes to what is mortgageable and what is not (a mortgageable cost being one that counts toward the loan-to-cost basis). In conventional construction financing, banks often carry the hard cost contingency and soft cost contingency as mortgageable development line items that can increase the loan amount. HUD does not consider those contingency line items mortgageable, because the costs going into a HUD deal are nailed down through the A&E cost review and the cost certification process at a level a conventional loan never reaches, so HUD does not need to lend against a padded contingency. But HUD also understands that even with the development team pinning down costs before construction, things happen and costs can rise. That is what the working capital escrow is for. It covers the costs of finishing and opening the building that the mortgage did not contemplate — for example, cost overruns and approved change orders, the accruals of taxes, insurance, and construction period interest above what was capitalized in the mortgage if construction runs long, and the soft costs of putting the project into operation, such as marketing, model furnishing, and the supplies needed for initial rent-up. It is HUD's version of a hard cost and soft cost contingency, just held outside the mortgage amount. It is the borrower's money, held by the lender in a controlled account, and the unused balance comes back.

For new construction the escrow is 4% of the mortgage amount, and HUD splits that 4% into two halves with different jobs. 2% is set aside specifically as a construction contingency for cost overruns and approved change orders (analogous to a hard cost contingency). The other 2% covers the excess soft costs and the cost of putting the project into operation (analogous to a soft cost contingency). For substantial rehabilitation the working capital escrow is 2% of the mortgage amount, and a formal hard cost contingency is permitted inside the construction costs themselves.

Because this is not a mortgageable cost, the borrower has to fund it with equity — but HUD allows that to be cash, an irrevocable letter of credit, or, where the deal has them, excess mortgage proceeds or excess land equity. It is funded in full at initial closing and then drawn against as needed. Anything left in the contingency at the end of the job is refunded to the developer at Final Endorsement (described in full at the end of the article).

02

THE IOD ESCROW

The Initial Operating Deficit: *The Greater of Three Numbers*

The Initial Operating Deficit (IOD) funds the gap between what the project earns and what it owes during lease-up — operating expenses, non-capitalized taxes and insurance, and the new debt service — until the NOI is enough to cover the mortgage. A new building generates almost no income on the day it opens but carries operating expenses and owes a full debt service payment, so the IOD is designed to carry that shortfall until enough units are leased to close it. Like the working capital escrow, HUD treats the IOD as a non-mortgageable cost, so it is funded entirely with equity — cash, a letter of credit, or excess mortgage proceeds if available.

On all new construction, and on substantial rehabilitation where resident displacement drives negative cash flow during the rehab period, HUD sizes the operating deficit escrow as the **greater of** three amounts:

- What the appraisal and underwriting analysis determine to be appropriate based on lease-up projections;
- 3% of the mortgage amount; or
- 4 months of debt service — principal, interest, and MIP — if the property is a garden apartment, or 6 months of debt service if it is an elevator building where a single Certificate of Occupancy is issued before any units or floors can be rented.

The first test, the appraisal and underwriting amount, is a month-by-month cash flow estimate that accounts for when buildings come online, when P&I starts, the reduced operating expenses during lease-up, and the appraiser's and market study's monthly absorption estimates. From those monthly cash flows, the underwriter sums the cumulative cash flow loss and arrives at the amount of cash needed to cover that total loss.

The third test is the four-to-six-month debt service floor, and the garden-versus-elevator distinction is there because a garden project can lease buildings as each one finishes, so income starts arriving while the rest of the site is still under construction. An elevator building with a single Certificate of Occupancy cannot rent a single unit until the whole building is done, which lengthens the period the project runs at a loss — hence six months of debt service instead of four. On a large loan above $75 million, HUD raises this test to a 12-month debt service floor, on the logic that bigger projects carry longer lease-ups.

The second test, 3% of the mortgage amount, is simply a backstop HUD set, and many deals actually underwrite right to it. Which of the three criteria governs depends on interest rates, the development budget, and the lease-up projections.

Releasing the Escrows — *Two Different Clocks*

The escrows are, ideally, not all spent during construction and lease-up — and to the extent they are not, the borrower gets the unused balance back. When that balance is released depends on a few different triggers, and the working capital escrow itself releases in two pieces (corresponding to the two halves of the escrow). Each release runs through the lender, subject to HUD approval.

Working capital. Any unused balance in the construction contingency portion — the 2% set aside for overruns and change orders — is refunded at Final Endorsement, or applied to a latent-defects escrow or delayed-construction items if those needs exist. The remaining working capital is released at the later of two dates: 12 months after Final Endorsement, or the point at which the project has demonstrated six consecutive months of sustaining occupancy.

Initial operating deficit. The unused IOD balance is released after the project shows six consecutive months of sustaining occupancy. There is no 12-month floor on the IOD the way there is on the working capital balance. Sustaining occupancy is a 1.0 debt service coverage ratio — break-even — measured on all sources of project income, including ancillary income.

During lease-up, the borrower does not have to wait for full release to use the IOD for its intended purpose. The lender can request draws against it using form HUD-92464M, Request for Approval of Advance of Escrow, supported by a comparison of actual lease-up against the underwritten projections and an updated check that the remaining escrow is still sufficient. For garden-style projects made up of separate buildings that lease up individually, HUD will consider partial IOD releases as each building hits its own six months of sustaining occupancy.

> **FROM THE UNDERWRITING DESK**
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> Brian underwrote 221(d)(4) deals before moving to origination, and the most common misconception on the sponsor side is treating these escrows as money that disappears. Hopefully it does not. Both escrows are the borrower's money, held in a controlled account, and the unused balances come back. The thing worth planning for is timing: the IOD can release months before the working capital balance, because the working capital balance carries the 12-month-after-Final-Endorsement floor. If the project stabilizes quickly, the IOD comes home first.

	WORKING CAPITAL ESCROW	INITIAL OPERATING DEFICIT (IOD)
Purpose	Cost overruns, change orders, excess soft costs, cost of putting the project into operation	Cover operating and debt service shortfalls during lease-up before the project reaches break-even occupancy
Amount	4% of the mortgage (2% contingency + 2% other)	Greater of UW amount, 3% of mortgage, or 4–6 months debt service
Mortgageable?	No	No

	WORKING CAPITAL ESCROW	INITIAL OPERATING DEFICIT (IOD)
Funding	Cash or letter of credit at initial closing	Cash or letter of credit at initial closing
Governing HUD Form	HUD-92412M	HUD-92476a-M
Release of Unused Funds	Contingency portion at Final Endorsement (FE); balance at later of 12 mo. after FE or 6 mo. sustaining occupancy	6 consecutive months of sustaining occupancy

04

COMMON QUESTIONS

Frequently Asked Questions: *221(d)(4) Escrows*

Are the 221(d)(4) working capital and IOD escrows mortgageable?

No. Both are non-mortgageable. They belong in the development budget but never enter the replacement cost basis the loan is sized against. The borrower funds both at initial closing with cash or a letter of credit, and the unused portions are returned.

How much is the working capital escrow on a 221(d)(4)?

For new construction it is 4% of the mortgage amount — 2% as a construction contingency for cost overruns and change orders, and 2% for excess soft costs and putting the project into operation. For substantial rehabilitation it is 2%.

How is the initial operating deficit (IOD) escrow calculated?

It is the greater of three numbers: the amount the appraisal and underwriting determine is appropriate, 3% of the mortgage amount, or 4 months of debt service (P&I plus MIP) for a garden apartment / 6 months for an elevator building. The appraisal and underwriting amount is a month-by-month cash flow estimate that sums the cumulative loss through lease-up.

Can the escrows be funded with a letter of credit?

Yes. Both can be funded with cash or an unconditional, irrevocable letter of credit at initial closing, and where available they can be funded from excess mortgage proceeds or excess land equity.

When are the working capital and IOD escrows refunded?

Any unused construction contingency is refunded at Final Endorsement. The remaining working capital releases at the later of 12 months after Final Endorsement or six consecutive months of sustaining occupancy. The IOD releases after six consecutive months of sustaining occupancy — a 1.0 DSCR on all project income.

Wim Roach & Brian Lorenz

HUD/FHA Multifamily Origination

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