Friends Don't Let Friends Buy Condos

HUD Relaxes the Underwriting Standards for FHA Insured Condominium Mortgages

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Working professionals in the various industries which serve condominium associations have long had a saying they have kept more or less to themselves, "*Friends don't let friends buy condos*". Now, more than ever, one must consider the possibility this may actually be seriously good advice!

After a valiant attempt to raise the reserve funding standards among condominium associations, the Department of Housing and Urban Development has finally succumbed to political pressure with the November 6, 2009 announcement they are suspending the minimum percent funded reserve requirements necessary for a condominium association to qualify for FHA mortgage insurance programs.

Prior to the November 6th announcement HUD had attempted to institute a very reasonable underwriting requirement; that in order to be approved for FHA mortgage insurance a condominium association must provide a current reserve study which indicated the association's reserve fund was at least 60% funded at the time approval was granted. Quite predictably this toughening of the underwriting criteria led to a great deal of turmoil among condominium owners and their associations as they scrambled to try and figure out a way to meet the more stringent funding requirements after years of mismanaged reserve planning and systematic under-funding of reserves.

The industry, in a thinly veiled attempt to save face, has tried to blame the situation on the current economic downturn and specifically the massive collapse of the U.S. housing market. However, the real culprit is nothing more or less than irresponsible fiscal governance and management of countless condominium associations throughout the country. To confirm this statement as fact, simply consider the case of any well governed community which has maintained a responsible level of reserve funding prior to 2008 and you are likely to find a community which has no trouble meeting the 60% minimum funding requirement.

Although the November 6 announcement – in the form of *Mortgage Letter 2009-46 A* – describes the move as "a temporary directive to address the current housing market conditions", it remains to be seen how strong the opposition to reform will become after December 31, 2010 when the supposed "temporary" measures are scheduled to expire. If the current climate is any indicator it is very likely the same groups who aggressively lobbied Congress to force HUD into making these changes, will again exert their influence in an effort to stymie reform a year from now.

Community Associations Institute Chimes In - Among the groups who supported this return to fiscal irresponsibility, and who publicly acknowledged their Congressional lobbying efforts, was the Community Associations Institute (CAI); who made no bones about their opposition to HUD's initial attempt to demand a higher level of fiscal responsibility on the part of condominium associations seeking FHA mortgage insurance approval.

CAI's position should come as no surprise to anyone familiar with the community management industry in general, and CAI in particular, as there has been a longstanding reluctance on the part of the industry to embrace regulatory oversight of fiscal governance among all types of homeowner associations; particularly as it applies to the long range planning process which is typically associated with reserve funding.

CAI as the defacto industry spokesman and leading policy-making organization has, over the last four decades, failed to address the issue of reserve planning and funding on a level consistent with its relative importance to successful community management and governance. In supporting this most recent effort to compel HUD to revise its condominium underwriting guidelines, whether it be on a temporary basis or permanently, CAI has publicly aligned the organization with those who oppose reforms which are long overdue.

Another Win/Win Situation for the Lenders - Among those who may not have been as open and transparent in their lobbying efforts, but whom reportedly were among the most vocal in their opposition to the more strict HUD underwriting requirements, were mortgage bankers and real estate lenders.

Sources behind the scenes have told this author that the mortgage industry lobbying effort was perhaps the most aggressive among all groups who worked to bring about the "temporary" changes described in the November 6th Lender Letter.

In the case of CAI it is easy to see why they might oppose the type of fiscal reforms being demanded by HUD, as they were clearly not in the interest of existing condominium associations with poorly managed reserve funding plans – many of which are the principal market for CAI's management company constituency. With respect to mortgage lenders one might ask why they would oppose HUD's efforts to raise the standard of fiscal responsibility among the collective pool of potential condominium borrowers.

The answer emerges with a simple risk analysis when viewed from the perspective of these lenders. In their view it is beneficial to have relatively liberal underwriting standards for loan products such as the FHA mortgage guarantee programs which are administered by HUD. By ensuring that FHA underwriting requirements for condominium loans are easy to meet, the lending industry can then use the FHA loan program as a sort of "high risk pool", by placing loans which their own underwriting process has determined are of a high risk nature, into the FHA mortgage program.

Because lenders have learned that making mortgage loans on condominiums with poorly funded reserves represents a higher level of risk, they are eager to mitigate this risk by placing such loans with a government insured mortgage program. This allows the lender to continue earning the fees associated with loan origination and servicing; and in the case of mortgages which do not end up in default, they will reap the benefits of yet another profitable mortgage loan. Thus allowing the federal government to absorb the risk associated with these higher risk loan prospects in the case of borrowers who do default on their obligations.

On a certain level one must admire the maneuvering of the lenders as a brilliant self-serving lobbying effort; and in the case of CAI it is not hard to understand why they would favor a return to the failed policies of the past when those policies do, in fact, make it easier for the organization's various constituencies to manage in these tough economic times. However, for prospective buyers and long term residents of the typically underfunded condominium association, these revisions to the condominium underwriting process, whether temporary or not, do not serve their interests.

The new "temporary" reserve funding requirement which HUD is now demanding for FHA mortgage approval is the old industry fall-back position that the current approved operating budget must include a line item for reserve funding which is equal to 10% of the total annual budget expenditures for the association.

HUD readily acknowledges that the 10% figure is an arbitrary number which may or not represent a sufficient level of reserve funding. Because there is no longer a requirement the association provide a current reserve study to confirm what the appropriate level of funding *should* be, prospective buyers have no way of determining whether the association they are considering buying into is adequately funded or not.

While this may bring a sigh of relief to some owners, especially those who have decided it may be time to attempt a cut and run strategy, or those who are desperate to refinance their way out of a toxic adjustable rate mortgage; over time this policy will do little good in terms of guaranteeing the financial health of the community in which they live. While it can certainly be argued that 10% is better than nothing, this random approach to reserve funding does not represent a sound long term approach to reserve funding.

Caveat Emptor - For prospective buyers of condominiums the situation should be viewed as a serious red flag, or as the old saying goes caveat emptor! (Buyer beware) Anyone considering a condominium purchase should take their pre-purchase due diligence all the more seriously, in light of the new underwriting guidelines and the current market conditions, as it is very much the case that purchasing a condominium in a poorly funded association, in a declining real estate market, is a potentially risky proposition indeed!

Even though you may think you have found a screaming deal on that $200,000 condo you can pick up for $120,000, if you are suddenly slapped with a $40,000 or $50,000 special assessment because the association has never funded its reserves, you could find yourself in a real bind; especially if you simply don't *have* the money to pay the special assessment. In the current market it is very unlikely you would be able to borrow the money, and if you were to attempt to sell your screaming deal, prospective buyers would avoid your association like a plague once it becomes public knowledge that the owners are facing a huge special assessment.

Similar to being in a sinking boat without a bucket, this is not a situation you want to find yourself in, especially if you have the power to avoid it. What *can* you do to avoid the pitfalls associated with condominium ownership? In conducting your pre-purchase due diligence prospective buyers should consider each of the following points carefully before making a decision to purchase any condominium:

- Ask for a copy of the association's most recent reserve study; if the seller is unable to produce one it is a good indicator the association doesn't have one. In most states with anything approaching credible real estate disclosure laws sellers are required to provide you with a copy of the complete reserve study if you ask for it. However, under the laws of your state it may be that it is up to the buyer to ask for any such documentation and in the absence of a request from the borrower for specific documents the seller may not be obligated to provide them voluntarily;

- Ask for a verification of the current reserve fund balance at the time of purchase; if the current reserve fund balance isn't consistent with what the reserve study funding projections suggest the current balance should be, then the association isn't funding its reserves according to the plan;

- Ask what the current delinquency rate is on association dues and whether dues are collected monthly verses quarterly or annually. HUD also has maximum delinquency rates allowed when underwriting an FHA mortgage application, which at the present time stands at 15%. Any association with a high percentage of delinquent assessments is problematic and it is a virtual certainty the solvent owners within these communities will end up stuck with the financial burden created by such circumstances. Associations that do not collect assessments on a monthly basis could be in worse shape than they appear because they may not know for 3 to 6 months (or more) to what extent their owners are unable to pay their association dues;

- Ask what the concentration of FHA mortgage loans within the association is at the time of purchase. HUD sets maximum percentages allowed for the number of units within an association which may be encumbered with an FHA insured mortgage. At the present time this standard has also been eased with the current maximum now at 30%. As time passes the higher the concentration of FHA insured mortgages within a given community, the more likely this is an indicator of the poor overall fiscal condition of the association; especially if the temporary guidelines announced on November 6th are extended beyond 2010.

  Over the long term the concern is that associations which represent poor financial risks to potential mortgage lenders will end up relying on HUD and the FHA mortgage insurance program as the lender of last resort when they find that conventional lenders are not willing to underwrite mortgages on the condominiums within their communities. Hence high concentrations of FHA mortgages may very likely be a confirmation of the poor fiscal condition of the association; particularly several years down the road as we emerge from the housing crisis and properties begin to again change hands with more frequency;

- Ask how many units within the association are vacant due to foreclosure or because they are still owned by the developer. If you are considering the purchase of a condominium in a development which is new and has not been completely sold out by the developer it is imperative to find out how many such units exist.

  The concern is that if the developer ends up in receivership (not an uncommon occurrence these days) the association's anticipated assessment revenue from these units may be lost forever or certainly delays may occur in the transfer of such funds to the association. It is also often the case that developers defer or simply do not pay reserve contributions on unsold units during the sales period. If the developer then ends up insolvent these funds are rarely recovered and the association ends up suffering in the long run. Vacant units, due to foreclosure, pose similar problems to the association in terms of its current cash flow. If you end up buying into an association with an inordinately high level of foreclosures, vacancies or delinquent assessments you may be required to pay for any funding shortfalls out of your own pocket if you are, in fact, one of the solvent owners within the community.

- Ask what percentage of units are currently owned by absentee owners and whether the association has a written policy regarding the maximum number of units which may be occupied by non-owners (typically renters, although it could be children or other family members of absentee owners). A high percentage of absentee owners are generally a red flag, except in areas such as Florida where many condominiums are owned by part-time residents who occupy the unit only during the winter months. In any case, an association which does not have a firm written policy limiting the maximum number of rentals within the community is generally not an optimum investment.

- Ask whether the association has been approved for FHA mortgage insurance prior to December 7, 2009. If so, and the approval was granted within the last eighteen months, then the association is probably among the better bets as a prospective investment;

In considering these points prospective buyers will be performing a level of due diligence which is consistent with responsible investment practices and will minimize their chance of making a bad purchase. Given the illiquid nature of real estate in general, and the increased likelihood that real estate investments will become even more illiquid as mortgage qualifying standards are increased across the board, it is imperative to do your homework before you buy. Condominium owners who find themselves stuck with a unit in an association that has a history of poor fiscal management and little, if anything, in the way of a long term financial plan may find they are in for a long period of expensive and stressful ownership.

As the economy begins to move forward and the housing market recovery begins to take shape, common interest communities are going to find market conditions to be very different from anything they have experienced in the past. Buyers will be much more discerning in their purchasing decisions if only because the mortgage lenders are going to demand a higher level of fiduciary responsibility on the part of the homeowners associations into which they choose to invest their mortgage dollars.

Associations that do not have a sound long term financial plan and cannot demonstrate a track record of responsible financial conduct will be classified as higher risk lending prospects due to the unsustainable nature of such practices. As an owner you do not want to find yourself stuck with an unmarketable home in one of these communities.

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