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Federal Housing Administrations new condo guidance were issued June 30th

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An initial review of the new Federal Housing Administration's (FHA) Condominium Project Guidelines shows some progress on issues critical to Community Associations Institute (CAI) members, but raises a host of new challenges for condominium associations. The new guidance was issued to provide greater clarity and flexibility to the condominium approval process for FHA mortgages, a process which CAI has criticized for adopting unrealistic criteria and not engaging key stakeholders in the development of program guidelines. The new guidance does offer some good news for condominium associations on some problematic areas of FHA's original guidance. At the same time new provisions in the guidance open a host of new and troubling issues for condominium associations and the companies that support them.

The Good News

The good news is that FHA has responded to CAI's recommendations on issues related to assessment delinquencies, commercial space, affordable housing and rental restrictions. FHA will also be allowing Housing and Urban Development (HUD) Home Ownership Centers (HOCs) greater flexibility in approving projects that do not meet specific requirements under the guidelines. These changes include:

*Assessment Delinquencies: Under the new guidance associations who do not meet the 15% of units, 30 days delinquent in assessments threshold will still be able to qualify for FHA approval. Taking CAI's recommendations, an association which does not meet the 15% threshold can apply for an exemption by meeting the following:

- * Having no more than 20 percent of units in arrears more than 30 days;
- * Provide a report showing the past 6 months of assessments;
- * Provide a showing of current reserve fund balances and operating results that show excess available funds in the amount of the outstanding delinquencies;
- * Provide a showing that the association has budgeted for delinquencies;
- * Provide a reserve study less than 24 months old demonstrating the association can meet replacement needs; and
- * Provide evidence of collection efforts including legal action, payment plans, or other similar efforts.

Prior to the adoption of this new provision, associations with delinquencies greater than 15% of units were disqualified from the FHA process. The added flexibility is welcome. However, there is one important caveat: assessment delinquency calculations must now include Real Estate Owned (REO) (e.g. bank owned) properties. This inclusion may outweigh any benefits created by the added flexibility.

Commercial Space

The guidance also provides some flexibility on the current requirement that any condominium project

have no more than 25% commercial -space in order to qualify for FHA financing. The provisions in the new guidance will allow for an exemption for condominium associations to be up to 35% commercial-space. To qualify for an exemption that condominium project must:

- * Be 100% completed for at least one year;
- * Have no more than 35% of the project space can be commercial; and
- * Have transferred control of the project to unit owners.

Investor Ownership/

Affordable Housing

The FHA requirement that no more than 10% of units can be owned by any individual or entity remains little changed in the new guidance. FHA does clarify that if the owner of multiple units in a condominium association lives in one of the units, then it may be excluded from the calculation of the ownership percentage. FHA does provide a larger exemption on an issue CAI raised regarding affordable housing. Specifically, in many jurisdictions, condominium associations are required to have an affordable housing component. In many cases the units are owned and managed by a single entity, typically a government agency or a nonprofit housing organization. If such units accounted for 10% or more of the association, FHA would disqualify the association from FHA financing. The new guidance excludes affordable housing (as defined by federal regulation 24 CFR 203.41) from the investor ownership calculation.

Rental Restrictions

FHA guidance requires that a condominium association have a minimum owner occupancy rate of 50% of units. Ironically, based on the 2009 FHA guidance, FHA would disqualify any condominium association that had a rental restriction in place. In 2011, based on pressure from CAI members, FHA issued a temporary waiver allowing rental restrictions which met certain requirements. The new guidance makes that waiver permanent. FHA will allow rental restrictions if they meet one or more of the following criteria:

- * All leases must be in writing and subject to the declaration and by-laws of the condominium project.
- * The condominium association may request and receive a copy of the sublease or rental agreement.
- * The condominium association may request the name(s) of all tenants including the tenants' family members who will occupy the unit.
- * Unit owners are prohibited from leasing their units for an initial term of less than 30 days.
- * The condominium association may establish a maximum allowable lease term (e.g. six months, twelve months, etc.).
- * The condominium association may establish a maximum number of rental units within the project; however, the percentage of rental units may not exceed the current FHA condominium project owner-occupancy requirement.
- * The condominium association may not require that a prospective tenant be approved by the condominium association and/or its agent(s), including but not limited to meeting creditworthiness standards.

The Challenges

Mortgagee Letter 2011-22 provides greater detail on the FHA approval process, while in some areas this creates greater clarity, in others it creates new, and possibly grave challenges for CAI members. These problematic areas include:

*Delegation of Authority to HOCs: While the new FHA guidelines provide some flexibility on FHA requirements, under the new guidance, determinations on exemptions will be left up to HUD regional HOCs. Over the past two years, CAI has observed varying degrees of consistency among the HOCs in applying existing criteria; some HOCs have even 'created' their own standards. This delegation, without proper oversight, will likely lead to greater inconsistency in the approval process with identically situated condominium associations receiving divergent approval decisions.

Delinquency Criteria

Calculation

Prior to the issuance of the new criteria the FHA did not include bank-owned (or REO) properties in the calculation of delinquency criteria. Under the new guidance, all bank-owned properties must be included in determining the percentage of units delinquent. The challenge for condominium associations is two-fold. First, it is not always clear who the owner of a foreclosed property is and it often takes months if not longer before that information is known to the association. Second, data collected by CAI members show that in the case of bank-owned properties less than one in four make any effort to pay assessments.

Certification of Application

The new FHA guidance will require that the association, management company or attorney sign a certification that the association is in compliance with all state and local condominium laws, and all FHA approval requirements. The signatory will also have to attest that all information is true and correct and that the signer has no knowledge of any condition that would cause a unit owner to become delinquent or know of any "substantial disputes concerning unit owners, rights, privileges or obligations." These attestations are subject to federal criminal penalties including up to \$1 million in fines and 30 years in prison.

Deed Restrictions

FHA notes that it will not approve condominium projects in condominium associations where deed restrictions may affect the ability of a buyer to freely transfer the property. Specifically, FHA notes that any provision in any kind of legal instrument that would cause a conveyance by the borrower to:

- * Be void, or voidable by a third party.
- * Be the basis of contractual liability of the borrower.
- * Terminate, or subject to termination, the borrower's interest in the property.
- * Be subject to the consent of a third party.
- * Be subject to limits on the amount of sales proceeds a borrower a borrower can retain.
- * Be grounds for accelerating the insured mortgage.
- * Be grounds for increasing the interest rate of the insured mortgage.

According to FHA if the conveyance could cause any of these things to occur, the property is considered to be subject to legal restrictions on conveyance and is usually ineligible for FHA mortgage insurance.

The issue here is two-fold. First, taking these criteria on their face, technically, no association would meet these requirements. The second bullet point would disqualify any deed restriction that would "be the basis of contractual liability of the borrower." It is unclear what the FHA means here, but since all deed restrictions impose contractual (or at the very least contract-like) obligations on buyers to pay assessments, adhere to rules, etc., this language as written is problematic.

More critical is bullet point number five which would disqualify any association with a deed restriction

that would make the buyer "subject to limits on the amount of sales proceeds a borrower can retain." Read in the broadest context, CAI believes that the FHA is taking a position that it will not fund condominium associations with deed-based transfer fees. In other words, FHA is taking a position that is in direct opposition to the decision made by the Federal Housing Finance Agency that deed-based transfer fees payable to community associations are not a restraint on alienation. CAI data shows that 49% of all community associations levy a deed-based transfer fee. This provision alone would disqualify millions of condominium units.

Mandated Fidelity Insurance for Managers/Associations

FHA will require that all condominium associations with more than 20 units carry and obtain fidelity insurance for all officers, directors and employees of the association and all other persons handling or responsible for funds to the association; the coverage must be equal to 3 months aggregate assessments on all units, plus reserves unless state law mandates a maximum dollar amount.

FHA also will require the association to mandate that any management company be required to maintain fidelity coverage for its employees with the association listed as the obligee in amounts equal to 3 months of aggregate assessments on all units plus reserves. While it is likely that most condominium associations and management companies, as a matter of business practice, carry such policies, CAI has concerns that such a requirement, due to its financial impact, may be beyond the authority of FHA to require by fiat. The fact that FHA is attempting to impose this requirement, which will have a cost impact on associations, without public input or notice may be in violation of principles of administrative law. CAI is examining the legal issues related to this mandate.

Conclusion: In writing about the entire set of federal mortgage challenges CAI members are facing, staff made the prediction that things might get worse before they get better.

Unfortunately it appears that this prediction is proving to be true. While CAI was successful in having FHA address our member concerns with the current guidance, the new guidance creates potential issues that, in scope, may be far worse than the problems which it resolves. The certification provisions, inclusion of REO properties in delinquency and the potential issues related to transfer fees and community manager insurance mandates do not move the program in a direction that will meet the demands of the market, nor do they speak directly to issue directly related to underwriting. CAI supports efforts to ensure that FHA or other mortgage programs remain solvent and are based on sound underwriting criteria. However, CAI also believes that it is the obligation of federal agencies to seek public input and provide prior notice and comment to changes to any federal program with substantial financial impact on the marketplace. Visit www.caionline.org for more information.