

FANNIE MAE, THE BENCHMARK IN QUALIFYING COOPERATIVE AND CONDOMINIUM LOANS

Unit owners who are attempting to sell their apartments may find that their prospective purchasers are encountering difficulty in obtaining a mortgage if their property is not approved by or eligible for sale to Fannie Mae. When these unit owners have difficulty selling their apartments, they turn to the Board who then in turn find they must obtain a crash course in the Fannie Mae guidelines. These guidelines are published in Fannie Mae's "Selling Guide" which is prepared for Lenders. To understand why these issues have arisen, it is important to understand that Fannie Mae and Freddie Mac originate 90% of the end loans obtained by unit owners. Freddie Mac's guidelines are more difficult to meet; however Fannie Mae buys substantially more loans. Therefore, Fannie Mae has become the benchmark that most properties need to be concerned with. These rules have also been adopted for Jumbo Loans; those in excess of the level Fannie Mae or Freddie Mac will consider buying. The Lenders have discovered that these rules work for lenders in helping to limit their risk for loans that they themselves will hold.

Fannie Mae is stringent and some prospective sellers interpret this to mean that they are not interested in Cooperatives and Condominiums. In reality, it is simply that Fannie Mae is seeking a reasonable return on their investment and assurance that their capital investment is protected. In the past several years, Fannie Mae has been having bad experiences with Condominiums in various markets such as California, Nevada, Arizona and Florida.

This article is designed to help Board members be as prepared as possible by providing them with a basic understanding of the regulations that they may encounter.

Fannie Mae provides a selling guide that presently has over 1,200 pages, and in some cases, it offers minimal consideration of the realities of the local Cooperatives and Condominiums markets. Fannie Mae's Selling Guide has been available for many years, but it has become more widely used in the past few years since it became available online at efanniemae.com.

Fannie Mae typically relies on the lenders to perform the reviews for Cooperatives and Condominiums. This is defined in a contract between Fannie and the individual lender. Based on this review, if a project does not meet the guidelines, the lender can seek waivers of the guidelines if there are compen-

sating factors. During 2007, Fannie Mae determined that they could simply rely on the representations and warrants from the lenders and announced that their project standards office would be shut down by year-end. This decision was reversed in late 2007 but as a result the entire Project Standards office needed to be re-staffed in 2008.

Additionally, lenders were historically allowed to utilize a limited review program to have properties approved. Fannie Mae regulations are adapting to the recent environment and as a result the option of utilizing the limited review has been curtailed. It may seem that Fannie Mae is simply getting much more serious about applying the rules however they are also requiring lending banks to repurchase loans that don't meet the requirements shown in the Selling Guide. As a result, lenders are following the Selling Guide quite carefully.

Unfortunately there are concerns with the Selling Guide. The Selling Guide is changed without any public consideration, without published proposals or news releases, and without a period for public comments. Updates simply appear on the website without any prior notice that changes are being considered.

In the New York metropolitan area there are aspects of the Selling Guide that seem to affect Condominium properties. Remember however, that Lenders can apply for a waiver to allow a property to qualify.

Projects where a single entity (individual, investor group, partnership or corporation) owns more than 10% of the total units

Accounting disclosure regulations require the property's accountant to disclose when there is ownership greater than 10%. As the selling guide has evolved, this aspect has caused properties that previously qualified to no longer be qualified unless they are able to obtain a waiver.

There is a separate approval process for properties in their initial marketing period. As the real estate market takes its time in recovering and foreclosures continue to occur, this approval is a tricky one. Fannie Mae will indicate that the Sponsor needs to sell units. However, with purchase prices down, the Sponsor often will reply that they require the cash flow from rental of the units in order to survive the downturn. This is an eligibility issue that likely will not go away in the near future.

Projects where more than 20% of the total space is used for non-residential purposes and projects in which the developer/sponsor has ownership interest/rights other than in relation to unsold units

Generally in this market, the Sponsor or Developer maintains ownership of non-residential space, as it is valuable for commercial operations. However, some Sponsors have established “sweetheart” lease deals as part of their conversion of the property. These sweetheart deals may create issues in the approval process. In very rare cases, the Condominium may have substantial common area with retail leases. The rent from the commercial tenants supplements the common charges from residents. In both these cases, Fannie Mae focuses on the concentration of revenue source and the risk of vacancy. This can cause rejection of the request for approval.

In absence of a Useful Life Study, 10% of monthly carrying charges to must be designated for reserves.

Our firm has always encouraged long-term planning for our clients’ financial well-being. Financial statement disclosure requirements call for either disclosure of the results of a Useful Life Study or that the Useful Life Study has not been undertaken. Most attorneys do not recommend that a Useful Life Study be undertaken. One further concern is that the level of reserve funds that such a Useful Life Study would indicate are needed would be substantially greater than those maintained by most properties.

From a long-term financial perspective, it is a quite beneficial to consider designating 10% of monthly carrying charges as reserves. However, how does a Board propose a 10% increase in this economic environment? While our firm encourages every property to maintain annual funding for reserves, it seems that some lenders will not accept anything less than 10% funding, and in addition are imposing their own requirements in addition to those found in the selling guide. We have heard anecdotal evidence that some lenders are continuing to require a 10% reserve contribution even where the Useful Life Study has been completed and the expected cost of future repairs and replacements is fully funded.

Projects with more than 15% of units more than thirty days in arrears

This aspect of the selling guide seems to predominantly affect Condominium conversions. Regardless of whether the initially proposed common charges were adequate or not, the economic environment has taken its toll. In order to avoid rejection under the guidelines, once “underwater” unit owners stop paying their common charges, newer Condominiums need to take immediate action to resolve such delinquencies.

Projects where the association is named as a “party” to pending litigation or where the Developer/Sponsor is named as a party relating to issues of safety, habitability, structural soundness, or functional use

Condominiums, who are considering pursuing Sponsors and

Developers for issues related to the adequacy of construction of the property, are forced to face the possibility that doing so could cause difficulties in obtaining mortgages for prospective purchasers.

Unfortunately, Cooperatives and Condominiums can also be subject to frivolous lawsuits from unit owners or other parties. These not only cost a substantial amount to defend against, but they now can also affect the ability of the purchasers to obtain financing. It is unfortunate that selfish, litigious individuals have the possibility of forcing properties to settle claims so that the property can remain qualified for purchasers to obtain financing.

Requirement to maintain fidelity insurance for an amount equal to at least three months common charges, as well as the funding for coverage of insurance deductibles in the annual budget.

In reality the level of Fidelity insurance that is required can be even higher. The coverage must rise to the potential amount of funds being handled if proper internal controls are not maintained. The internal control issue usually only affects self-managed properties, as they can lack adequate segregation of duties. However, we have also found that some of the smaller property managers have issues with adequate segregation of duties.

Properties with tax or assessment abatements, which will terminate partially or fully within three years

For the New York Cooperative market, this is more of an underwriting issue. As long as the Board has a plan to assure unit owners can pay for the increase in maintenance when the abatement expires, there should be no issue. However, for those newer Condominiums with real estate tax abatements that will expire, the question is whether the number of unit owners who will have difficulty paying their substantially increased real estate taxes will cause additional unit owners to be in arrears on their common charges.

Properties with fifty or more units, where documents don’t require an annual audited financial statement within 120 days

As most offering plans approved by the New York Attorney General include this provision, this should only affect very early conversions.

Each of the previously mentioned aspects of the selling guide also affects Cooperative properties in the New York Metropolitan area.

The 20% non-residential usage issue is a hold over from the Tax Law, which allowed Cooperative Shareholders to take a deduction on their individual tax returns of mortgage interest, and real estate taxes that the property also deducts on the Cooperative’s tax return. This law, known as the “80/20 rule”, was changed in 2007.

The issue of revenue concentration is a result of the change

in the 80/20 rule. Properties can now receive much higher fair market rents from commercial tenants without jeopardizing the ability of the shareholders to deduct the interest and real estate taxes. With the change in this Tax Law, certain properties are supplementing shareholder maintenance with over 50% of their expenses being covered by rents received from commercial tenants. As a result of this subsidy of shareholder maintenance, boards must exercise due care in approving shareholders. The concern is that should the commercial tenant leave, shareholder maintenance charges may need to be increased until a new commercial tenant can be found to cover what was previously subsidized. Additionally, lower monthly carrying charges tend to increase sales prices.

There are two risks that Fannie Mae is concerned with. First, if the commercial tenant leaves, do the current shareholders have the ability to pay the additional monthly carrying charges that will be needed, and second, if the maintenance charges are increased, will that lower the sales prices and value of the units? In either case, these selling guide aspects are prevalent in the New York cooperative market and affect numerous properties.

The good news is that a Cooperative is only required to demonstrate adequate reserves that meet currently accepted industry levels in lieu of 10% of monthly carrying charges being designated for reserves. Further, allowing up to 15% of units to be in arrears before a property becomes unqualified is actually a more lenient position, as the allowed percentage previously was closer to 10%.

It is unfortunate that only the Lender submitting the loan for approval of financing for a purchase can apply for a waiver. Our clients who find that their properties are ineligible and there is time pressure to assure that a commitment letter for a prospective does not expire continually contact us. The best strategy of avoiding the need for the Lenders to request a waiver is a proactive approach by the Board and Property Manager who can work with the local Lenders active in your market. By sharing information timely, such as financial statements, offering plan amendments, updates on insurance and future budgets, you are in a position to determine the status of your property. Speaking directly to the Project Approval Team may also allow for the possibility of determining any initial eligibility issues and potential options for the Board to consider in attempting resolving these issues.

We cannot stress the importance of speaking with the right person at the Lender. It is imperative that the person is knowledgeable and has vast experience in this area. Further, you may need to rely on their advice in the interest of getting your property qualified. Some Lenders are familiar with these issues and know them well, however, beware of those who solely want to close on a specific loan and may not be willing to do the work necessary to help the property become qualified. Demand an experienced individual who knows the best

path to getting your property itself on the approved list, not just the specific unit with the loan in question.

Encountering situations where there is great time pressure can be avoided by evaluating your property's situation well before an urgent situation arises. First, and perhaps most importantly, don't take the Lender's questionnaire lightly. Evaluate each question and assure that your response is both proper and adequate. Also, encourage sellers to not wait until the closing is near to resolve the qualification issue. With the constantly changing environment, the moment a questionnaire arrives; consideration should be given to potential changes that will affect your property. From the point where an owner initially shows the unit, the Board or Property Manager should be prepared with a list of Lenders who are active and providing financing for units in the property. Relying on prospective purchasers or their mortgage broker to determine which Lenders should be approached may only cause heartache for you and your fellow unit owners. Consider providing information on Lenders who are providing financing for your property to prospective sellers so that it may be shared with purchasers during their initial viewing of an apartment.

Although it appears that each Lender maintains their own list of eligible properties, a Lender will encounter projects that require special consideration on a project-by-project basis. Initially, the Lender needs to contact the Fannie Mae Project Standards Team and input data in the Condo Project Manager (CPM). This is a tool available on the Fannie Mae website to help Lenders determine if a project will meet Fannie Mae eligibility requirements. Lenders must document the loan file with the CPM decision. In order to request waiver through Fannie Mae's CVAS (Credit Variance Administration System), the Lender must pay a \$200 fee. Some Sponsors and Developers have previously utilized the Project Eligibility Review Service (PERS) from Fannie Mae to determine the eligibility of a project. The cost of a PERS is \$30 per unit plus and \$1,200 base fee per property to obtain the evaluation. Unfortunately, there is no obligation for Fannie Mae to approve the project based upon the review.

At some point, hopefully the Cooperative and Condominium community will be able to find a better solution to allow properties to take responsibility for resolving eligibility issues and possibly for requesting waivers as well. In the meantime, there is a wealth of information regarding available financing for your unit owners. There is information as well for the Lenders to evaluate your property's situation. The key to success is an investment in understanding and communication to assure that your Board does not receive that frantic call when an important mortgage commitment is about to expire. At that point you have limited options to resolve the situation. ◆