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New FHA Regulations Will Impact Financing of Condominium Units

By: Leslie Brown and Kimberley O'Halloran-Cordray

Effective December 7, 2009, the Federal Housing Administration (FHA) will have new standards for insuring mortgage loans involving condominium units. In light of the fact that these new standards will potentially affect condominium associations in significant ways, we believe Boards and managers should become generally familiar with them.

The availability of FHA approved financing has always played a big role in the condominium market. In short, an FHA approved loan reduces a lot of the risk to the lender. If the borrower defaults on a FHA-approved loan, FHA protects the lender against the financial losses.

In light of an increase in mortgage defaults and related foreclosures, FHA has adopted new rules, all of which are designed to "tighten up" the eligibility for approved loans.

- 51% of the units must be owner-occupied or sold to owners who intend to occupy the units (i.e., not purchased for investment purposes).
- No more than 25% of the property's total floor area can be used for commercial purposes.
- FHA will not insure more than 30% of the units in any one development.
- No more than 15% of total units in the condominium can be 30 days or more past due on the payment of assessments.

- Mortgagees must review the association's budget. The budget must include allocations/line items to ensure sufficient funds are available to maintain and preserve all amenities and features, provide for the funding of reserves in an account representing at least 10% of the budget, and provide adequate insurance. If associations do not meet these 3 criteria, the mortgagee may request a reserve study which must be no more than 12 months old.

FHA's requirements are distinct from the new requirements announced by Fannie Mae on December 16, 2008, but there are similarities. Like FHA, Fannie Mae announced its new requirements in order to improve the types of mortgage-based notes it will now purchase on the secondary market. In order to meet Fannie Mae's new requirements, condominiums must now satisfy the following:

- 51% of the units must be owner-occupied at the time the loan is originated for units that are being purchased or refinanced for investment purposes (bank-owned units are considered to be "owner-occupied"). In other words, if the unit is purchased as a primary residence, there is no owner-occupancy requirement.
- The condominium must have master insurance covering 100% of the insurable

replacement cost of the project improvements, including units.

- Unit owners must obtain a “walls-in” coverage policy (HO-6 policy) unless the master insurance provides the same interior coverage.
- No more than 15% of total units in the condominium can be 30 days or more past due on the payment of assessments.

Likewise, Freddie Mac has regulations in place for loans it purchases on the secondary market as well. For condominium unit mortgages, Freddie Mac requires the following:

- Maximum loan amount of \$417,000 for most of the nation and \$729,750 in high-cost areas.
- In established condominium projects, there is no owner-occupancy requirement if the unit is used as a primary residence or secondary home.
- In established condominiums, if the unit is an investment property, at least 51% of the total units must be conveyed to purchasers (other than the developer) and used as a primary or secondary residence (similar to Fannie Mae’s requirement).
- In new condominiums (when less than 90% of the units have been conveyed by the developer), at least 51% of the units must be used as primary or secondary residences.

The adoption of these new regulations by FHA and Fannie Mae, and the existence of Freddie

Mac’s requirements, have added another layer of regulation to the condominium market which can only make financing of mortgages more difficult.

Of particular concern to Boards of Directors are regulations relating to owner-occupancy. While Fannie, Freddie and FHA do not share the same restrictions regarding owner-occupancy, the FHA requirements are now the most stringent since, effective December 7, 2009, FHA will require that no more than 50% of the units in the condominium be rented. Hence, condominium associations with high rental ratios face potentially serious challenges that might severely affect the ability of current owners to sell or refinance their units.

More than ever before, Boards of condominium associations are reviewing whether to propose leasing restrictions for their membership, many of which require careful administration and amendments to the legal documents that require membership approval. Because the regulations are changing rapidly, you should contact your association counsel about this process before starting.

Furthermore, while delinquencies have always been an area of concern for condominium associations, this issue will only increase in magnitude, as these new regulations jeopardize the ability of parties to obtain mortgage loans if more than 15% of the units in their condominium are in arrears.

From time to time, Boards will also hear that a mortgage lender had to reject a loan application because the condominium association’s master insurance policy did not comply with Fannie

Mae's requirements. Boards would be well-advised to ask their insurance agent for a written certification of compliance with these new regulations.

Perhaps the most onerous of all of FHA's new requirements concerns the regulation requiring an annual reserve study. As most property managers know, the legal standard is to obtain a study once every 5 years. In the event an association does not comply with FHA's budget requirements, the Association will have to obtain a reserve study annually, which will entail more expenses that Boards will have to include in annual budgets, regardless of whether the annual study is only supplemental to the full study conducted every 5 years.

In closing, the ramifications of the new FHA and Fannie Mae requirements have not yet been fully realized. As we mentioned above, FHA's regulations do not even become effective until next month; however, we anticipate that these new regulations, if strictly enforced, will have a potentially significant impact on the condominium market.

If your association is contemplating changes to the Association documents to address these new requirements, please contact your association counsel for legal guidance when you first start discussing solutions to address these new regulations.

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