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The New FHA Requirements for Condominium Mortgages

Alphabet Soup

The various acronyms involved in the mortgage crisis can be bewildering. Here are the key players:

HUD	U.S. Department of Housing and Urban Development
FHA	Federal Housing Administration
FNMA	Federal National Mortgage Association aka "Fannie Mae"
FHMLC	Federal Home Mortgage Loan Corporation aka "Freddie Mac"
GNMA	Government National Mortgage Association aka "Ginnie Mae"

Of these, we need only focus on HUD and FHA to comprehend the new requirements for condominium mortgages. FNMA and FHLMLC are government sponsored entities that were designed to keep the flow of money moving through the mortgage system; they buy up mortgages issued by lenders who then get cash or securities to use to make more mortgage loans. Both are in deep trouble, scandal ridden and now under U.S. government conservatorship. GNMA can be ignored since it guarantees *government* issued mortgages.

Roles of the FHA and HUD

The FHA was formed back in 1934. It is intended to create a national home financing system and it does this by insuring mortgages issued by private lenders. The insurance is only available if the mortgage meets the FHA's requirements. The lender pays a fee and gets insured against the risk of the borrower defaulting. These FHA approved mortgages now make up a substantial and growing share (>30%) of all new mortgages being issued in these trying times. In 1965 FHA became part of HUD, hence the overlapping bureaucratic red tape, name and regulation.

FHA Mortgage Approvals for Condominiums

Historically, FHA has issued “spot approvals” for condominium mortgages on a deal by deal basis. That arrangement ended in February 2010. In its place are two new types of approvals, complete with their own acronyms; HRAP and DELRAP. (Since the documentation requirements are similar for both, we shall ignore their differences and full names for the moment.) The key difference from past practice is that each condominium *project* must get FHA certification before any more FHA insured mortgages can be issued.

The FHA’s new requirements are intended to protect it from the increasing rate of condominium mortgage defaults and foreclosures. Unfortunately, these requirements are quite restrictive, somewhat unrealistic and will entail substantial expense to the associations seeking certification.

Site Condominiums Exempt

The new FHA requirements do not apply to site condominiums so long as the homes, garages and other structures are totally detached. In June 2011, the FHA further defined “site condominiums” to mean fully detached units in which the co-owner owns the entire structure as well as the air space around, the co-owner is responsible for all insurance and maintenance costs of the structure and any assessments are for amenities outside the footprint of the individual site. **Please note that under this limited definition, many sites that are self-proclaimed “site condominiums” do not meet the FHA definition.**

Paraphrased and Condensed Eligibility Requirements

1. Project must exist in full compliance with all applicable laws and regulations.

This will be a problem for many associations owing to illegal text in documents and text that is not acceptable to HUD. The second most common problem will likely be failure to timely file annual reports resulting in dissolution, a problem that can be easily remedied if encountered.

2. Condo hotels, timeshares, condo houseboats, projects not primarily residential and those with more than one dwelling per condominium unit are all ineligible.

Again, not likely to be a problem given the rarity of these forms of condominiums.

3. Environmental review requirements will apply in special circumstances only. Any of the following which apply could delay or defeat a certification application. As you can see, a rational person could easily question why at least some of these factors have any bearing whatsoever on the likelihood of a mortgage going into default!

- *Project located in a special flood hazard.*
- *Noise issues where project is within 1000 feet of a highway, freeway, “heavily traveled road”, 300 feet of a railroad, one mile of an airport or five miles of a military airfield.*
- *Project has unobstructed view or is within 2000 feet of any facility handling or storing explosives or fire prone materials. (How is that for ambiguous?!)*
- *Project located within 3000 feet of landfill or site on EPA superfund list and certain others.*
- *Project located within a wetland.*
- *Project on National Register of Historic Places or is within a listed historic district.*
- *Any other condition that could adversely affect the health or safety of project residents. (Another breathtakingly broad and ambiguous statement!)*

4. Project must have at least two units.

The Michigan Condominium Act definition of “project” requires at least two units so this requirement will not pose any problems.

5. Hazard, liability, fidelity and if applicable, flood insurance are required.

A significant number of projects include land and/or improvements within flood zones; those which have not been purchasing flood insurance will have to do so to satisfy this requirement. Most will also need to increase the coverage carried for fidelity bond/employee dishonesty.

6. Projects with first right of refusal restrictions are not eligible.

HUD Mortgagee Letter 2009-46 B allows them unless their wording violates the Fair Housing Act. The HUD Handbook requirements simply prohibit them. Old (pre-1990) project documents often included restrictions in the Condominium Bylaws that required selling co-owners to first offer their units to the association. Very few associations ever attempted enforcement but many left the text in place. It would be best to simply amend and delete these restrictions if they appear.

7. No more than 25% of the total floor space can be used for commercial purposes, but an exception can be made for those between 25% and 35% on a case-by-case basis.

Not a problem for the great majority of condominiums, but mixed use projects will have to verify compliance.

8. No more than ten units can be owned by any one investor.

Here we begin to encounter more likely problems. Ironically, many conversion projects have reverted back to their apartment roots as investors bought up the units. We will determine if this is a problem for your project.

9. No more than 15% of the units can be delinquent by more than 60 days.

A disastrous requirement that will make large numbers of Michigan condominium projects ineligible for FHA loans. In good economic times the delinquency percentage is usually under 5%. Unfortunately there are now many projects over the 15% cap. Many would find this 15% cap extremely ironic since it is widely held that the federal government’s incompetent meddling with the lending industry caused the collapse of our economy which in turn has driven up the delinquency rates! However, rate refers only to units delinquent in the amount of more than 2 months of assessments and does not take into consideration late fees or other administrative fees.

10. At least 50% of the total number of units must have been sold.

Obviously no problem for established projects; not so for new and incomplete projects.

11. At least 50% of the units must be owner occupied.

This will be a problem for some associations, particularly those which are new conversion projects and those old conversion projects that are reverting back to quasi apartment projects owing to

investor activity. Also for projects under development in which the developer got “caught” with an unsold inventory of units. There are exceptions for units that are under contract to be sold.

12. Special restrictions apply to phased (expandable) projects.

Sometimes a problem for established projects where the developer is long gone and definitely an issue for projects under development that have been caught by the real estate market collapse.

13. Generally speaking, there is a cap of 30% of the total number of units that can have FHA mortgage insurance.

This cap pretty well mirrors the percentage of new loans that are FHA backed; over time many associations will become ineligible. Another seemingly absurd requirement.

14. The Association’s budget must be “adequate”.

Now we get into an issue that will probably affect the majority of associations’ ability to become certified. Most boards of directors strive to minimize their budgets to keep monthly assessments “competitive”. That means operating on a shoestring that fails to properly fund reserves, keep up with routine maintenance, anticipate surprise expenses or make any allowance whatsoever for bad debt (co-owner delinquencies). Nevertheless, this is one of the most rational of the FHA requirements.

15. The budget must provide funding of reserves in an account representing 10% or more of the budget.

The wording of this requirement could have been clearer. At present it can be interpreted as being consistent with the Michigan Condominium Act’s reserve fund requirement. One can also argue the requirement means 10% of the current revenue must go into reserves.

16. The budget must provide funding of insurance premiums and deductibles.

Most all budgets properly fund insurance premiums except when large premium increases unexpectedly occur. However, few associations specifically label any of their reserves for funding insurance deductibles and few specifically mention them in the line itemized budget. Both problems can be easily remedied.

17. A reserve study not more than one year old may possibly be required.

HUD issued an edict on June 12-09 (Mortgagee Letter 2009-19) which mandated that associations have a reserve study that is less than one year old. That was superseded by Mortgagee letter 2009-46 B which requires reserve studies if requirements 14, 15 and/or 16 above are not satisfied. HUD requirements notwithstanding, every association should have a reserve study that is annually reviewed. However, a large proportion (probably well over 50%) have never done their own study or commissioned a qualified professional to perform one. The party making the application to become FHA certified is subject to extremely severe criminal sanctions for making any false statements in the application. That will mean that a formal study will have to be commissioned. Consequently, every association seeking certification will be scrambling to have reserve studies done. There are very few companies that provide these studies and they generally charge \$2,500 to \$6,000 depending on project size and characteristics. Once performed, these studies will very often necessitate budget increases to adequately fund the true amount of the association’s long neglected reserve needs. Boards which choose to ignore such recommendations will be hard pressed to justify

their decisions and will render their associations ineligible for FHA backed loans. This creates the potential for a personal liability nightmare.

18. There are numerous, detailed insurance requirements.

One likely area of concern will be the new requirement of fidelity bond/insurance. FHA requires that this coverage be at least equal to three months aggregate assessments plus reserve funds. Most associations are not now carrying enough of this inexpensive coverage. The newest Mortgagee Letter 2012-18 (issued September 13, 2012) requires that association which have management companies must either show that the management company maintains a separate policy of its own which lists the specific association, the association's policy must specifically list the property management company as an additionally insured party, or the insurance must be accompanied by a "covered employee" endorsement that states the management company is covered by the association's insurance policy. These policies typically already state that any employee or agent is covered, but HUD would like to see the company specifically listed.

19. All project documents must meet HUD regulations plus state and federal law requirements.

Every document package I have reviewed in the past 33 years has text that will have to be amended to meet this requirement. We frequently encounter restrictions that violate both state and federal laws particularly with respect to restrictions based on familial status, those contrary to the FCC satellite dish rules, restrictions that violate the rights of persons with disabilities, etc. HUD's requirements will also necessitate amendments and create a few conundrums since some of its requirements are contrary to Michigan law!

What Should the Board Do?

A very good question indeed! Since FHA backed mortgages make up so much of the market, it would be wise for every board to carefully consider attempting certification. For some the choice will be simple since their project will simply not subject to the new requirements (site condominiums) or their project cannot pass the eligibility tests (projects exceeding any of the caps listed above, particularly the 15% delinquency cap).

Whatever decision the board makes, it is imperative that the rationale be memorialized in the official minutes of the board's meeting. The minutes must reflect *who* voted and *how* each director voted on the issue; Michigan law protects dissenting directors from liabilities arising out of the action taken by the directors who voted to approve the action taken. Legal counsel should also be consulted if for no other reason than to determine if the Articles of Incorporation include the proper statutory language shielding directors from personal liability for good faith actions.

Consultation with legal counsel, professional management, insurance agent and the association's certified public accountant are highly recommended. The membership should also be made aware of the issue and the board's decision whether or not certification will be attempted.

Government regulation has now suddenly and massively intruded into the World of Condominium. The freedom of every American to pursue the dream of home ownership has become further subject to the views and edicts of unelected bureaucrats, far removed from the realities of condominium administration. Everyone who owns a condominium may be affected and needs to take notice and carefully consider how they shall respond.