Condominium Financing:
FHA Rule Change Controversy

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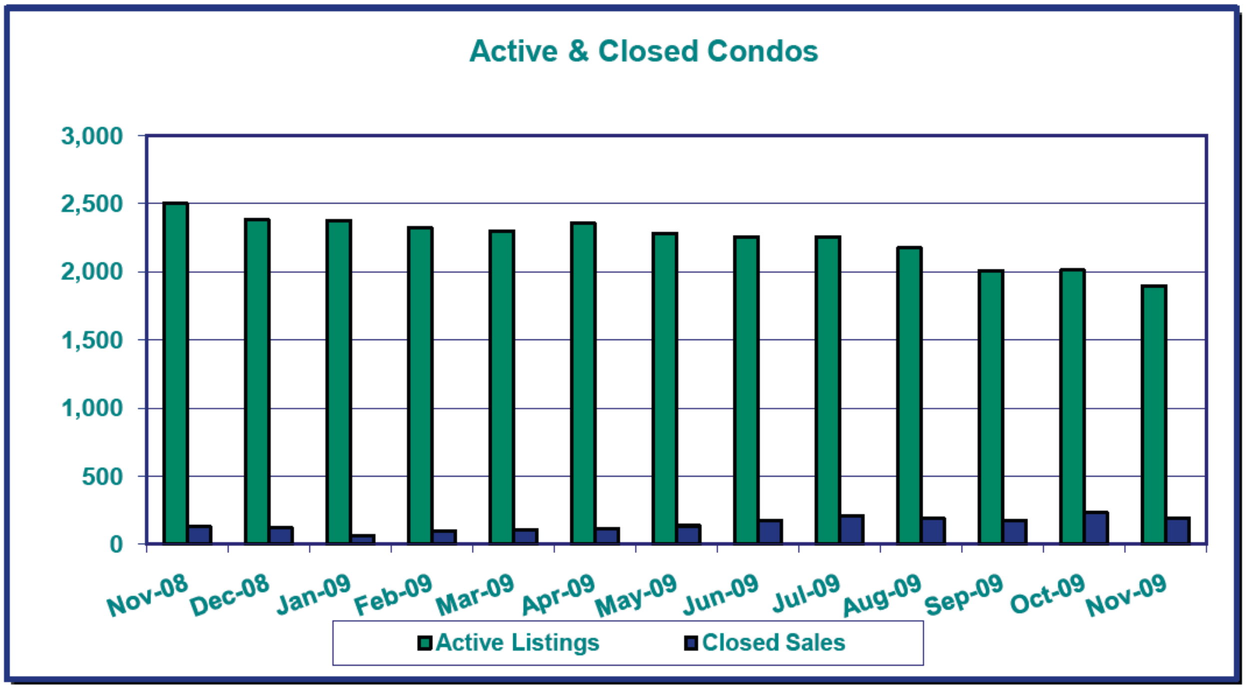


Source: RMLS

Condominium developers built more condominiums than the market could absorb from 2006 - 2009. They built from scratch, developing small and large projects from duplexes to hundreds of units, and they bought apartments, renovated and replatted them so they could be sold as condominiums. While the going was good, they sold thousands of them. Then the real estate bubble burst, the financial sector froze beginning the Great Recession and the developers, investors and their bankers were stuck with a huge inventory of empty condominiums, which they need to unload.

Due to the high number of condominiums in the marketplace and the low interest rates, this should be an optimal time to buy a condominium. But this year Fannie Mae, (Federal National Mortgage Association (FNMA)), Freddie Mac (Federal Home Loan Mortgage Corporation (FHLMC)) and the FHA, Federal Housing Administration (FHA), have decided to tighten up their standards and reduce their risks and exposure to the condominium market.

Fannie Mae and Freddie Mac are typically the organizations that supply a secondary market to banks. Banks and others originate mortgages and then turn around and sell their mortgage loans to one of these markets. They typically require 25% down payments if you want to buy a condominium.

An FHA loan is a federal assistance mortgage loan insured by the FHA. Federally qualified lenders may issue the loan. [1] FHA does not make loans directly. Rather, it insures loans made by private lenders. Each lender sets its own rates and terms, FHA allows first time homebuyers to put down as little as 3% and receive up to 6% towards closing costs.

According to the Mortgage Bankers Association, foreclosures on prime mortgages and home loans insured by the FHA rose to 30-year highs in the third quarter of 2009, driven by the biggest job losses since the Great Depression. One out of every six FHA mortgages was late by at least one payment and 3.32% were in foreclosure, the highest for both since at least 1979. The estimated value of FHA reserves had dropped to $3.6 billion, or about 0.5% of the $685 billion in loans the FHA has insured. As a result, the FHA has taken steps to reduce its exposure to defaults, particularly in the weak condominium market.

On the 2nd of November 2009, FHA drafted new rules[2] for condominium financing, explained below. They experienced a significant backlash from the development and condominium ownership community as the rules would have made it very difficult to finance the sale and resale of condominiums.

In response to the political and business pressures, the FHA decision makers agreed to a temporary reprieve. They issued an updated Mortgagee Letter Number 2009-46A[3] to open up a temporary window from December 7, 2009 through December 31, 2010. This letter was designed to help existing condominium owners cope with the economy and have a funding source available to sell condominiums.

A summary of the rules and their changes is as follows:

New Rules versus Temporary Rules

1) Due to noise concerns FHA insurance will be unavailable for properties that are:

    a. 1,000 feet from a highway, freeway or heavily traveled road;
    b. 3,000 feet from a railroad;
    c. one mile from an airport; or
    d. five miles from a military airport.

[1] http://www.fhainfo.com/condos.htm
[2] Mortgagee Letter 2009-19
[3] http://docs.google.com/viewer?a=v&q=cache:FceBAPzurksJ:www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-46aml.pdf+Mortgagee+Letter+Number+200946A&hl=en&gl=us&sig=AHIEtbSYz1cEUe3wbgk9K5WxPF1rrFk93w

2) FHA financing will not be available to properties located within 2,000 feet of any facility handling or storing explosive or fire prone materials, such as:
    a) Gas station;
    b) Fireworks sales or manufacturing operation;
    c) Facility that stores or uses flammable or explosive chemicals.

3) FHA loans are not available if a property is located within 3,000 feet of a:
    a) Dump,
    b) Landfill, or
    c) Superfund site (such as the Willamette River in Portland, Oregon)

4) Not more than 25% of the property's total floor area can be used from commercial purposes.

5) No more than 10% of the units can be owned by one investor.
6) No more than 30% of the units may be encumbered with FHA insurance.

7) No more than 15% of the total units can be more than 30 days past due on their association fees.

8) For newly constructed units, at least 50% of the total units must be sold prior to any endorsement of any mortgage.

9) At least 50% of the units must be sold to owners who will be occupying their units.

10) Projects in designated wetlands and flood zones will not qualify.

11) Properties listed on the National Register of Historic Places will be difficult to finance.

12) Projects consisting of four or more units will not be allowed to have more than 30% of the total units encumbered with FHA insurance.

13) A current reserve study must be performed to assure that adequate funds are available for funding capital expenses and maintenance. A reserve study can be no more than 12 months old.

14) These rules also include the requirement for an affirmative action housing plan, for new construction and conversions over five units. This plan requires that the racial, socioeconomic and ethnic composition of the condominium residents closely mirror that of the neighboring areas.

The above rules have been amended by temporary rules as outlined in the Mortgagee letter: [4]

1. FHA concentration may be increased from 50% to 100% if the project is:
   a. 100% complete and construction has been completed for at least one year.
   b. 100% of the units have been sold and no entity owns more than 10% of the units in the project.
   c. The property budget provides for the funding of replacement reserves for capital expenditures and deferred maintenance in an account representing at least 10% of the budget.
   d. Control of the homeowners association has been transferred to the owners; and
   e. The owner-occupancy (vs. rentals) is at least 50%.

   Vacant or tenant-occupied real estate owned (REO), including properties that are bank owned, may be excluded from the calculation of the required owner- occupancy percentage, both from the numerator and the denominator.
2. New construction and conversions are not eligible for these exceptions.
3. The presale requirement in new construction is reduced to 30%, compared with 70% for loans from conventional lenders.

FHA Rule Change Impact:

The Short run

For the next year, this keeps open the flow of loan guarantees available to buyers and sellers of condominiums, keeping this part of the economy moving and enabling partially competed projects to sell out and fill up.

The Long run

Buyers: In 2011, once the amended rules expire, the number of buyers without much cash to make a down payment will shrink considerably the number of properties that will be available for purchase. On the other hand as long as buyers have cash enough to pay at least 20% down payment, these rules will probably not affect them.

Condominium Owners: A condominium owner who wants to sell will be faced with a shrinking pool of buyers. If the owner's property is located on a major arterial road or in a downtown area, close to a river or a lake, FHA financing will likely not be available.

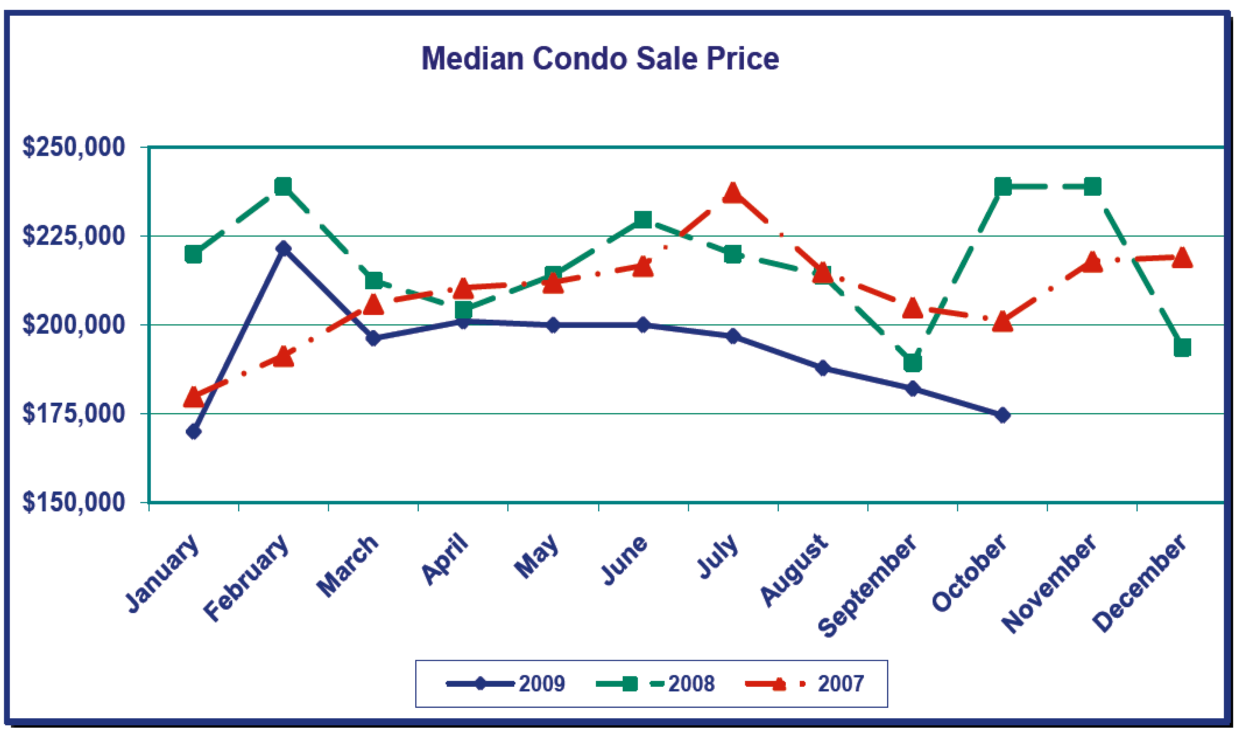
[4] Details can be found at: http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-46aml.pdf; http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-46bml.pdf.
Mortgagee Letter 2009-46A provides temporary guidance for FHA's condo policy, while Mortgagee Letter 2009-46B replaces Mortgagee Letter 2009-19.

<u>Condominium Associations</u>: Boards of Directors will be faced with the task of meeting these requirements if they can to preserve their position with FHA (as an FHA approved property) and get financing in place for at least 30% of their owners.

For the time being, we will see some form of status quo, with the exception of the lack of FHA financing for the development and construction of new condominiums. In the long run, buyers may be less able or unable to purchase condominiums. Once the real estate market stabilizes and home prices start to increase, many homes will be priced out of reach for first-time homebuyers, and condominiums will continue to be hard to finance. At this point, the FHA might review their rules again since the market will have stabilized and their risks reduced, but it will likely take three years or more before this may happen.

Apartment owners and multifamily developers will benefit from these rule changes since more first-time home buyers will not be able to afford buying homes, cannot get financing for condominiums and will be forced to stay renters until they can raise enough money for the significant down payments they will need to buy a home.

For 2010, the condominium market may not be significantly affected by the rule changes. It remains to be seen how the FHA will respond in the long run. [5]



Source: RMLS

[5] Please note the letter changes are short term and tweaks to the FHA policies. Most policies drafted earlier are being kept in place. For the most current information please go to the FHA website.