

Lending to Community Associations *An Update*

••A review of community associations as a lending opportunity is timely right now, given the massive change in this industry, the meltdown in the real estate market, and the nation's worst financial crisis since the Great Depression. This article updates a piece originally published by RMA in March 1999.

BY ALAN SEILHAMMER

THE COMMUNITY ASSOCIATION industry continues to expand and mature, offering several variations on the traditional covenant-controlled community. An important change in the past 10 years has been the pervasiveness of commercial condominiums. Condo-hotels have spread in many recreational parts of the country and have even developed their own professional trade association.¹ Mixed-use projects, combining residential and commercial properties, have sprung up and share elements common to condominium associations. Timeshares are moving from interval owner-

ship with a real estate interest to "club member" ownership defined by point systems. Meanwhile, the legal structure of condominiums has spread to nontraditional uses, including storage facilities, boat slips, and cruise ships.

A previous article from RMA ("Lending to Condominium Associations," *Journal of Lending and Credit Risk Management*, March 1999) articulated a view of the industry's creditworthiness in the lending environment of that time. To that point, no loan losses had been experienced. However, as lending subsequently became more widespread



and competitive, institutions with only limited knowledge of the industry approached the market with more enthusiasm than any actual underwriting skill and legal guidance. Consequently, some banks have lost money as a result of borrower fraud. Banks have been sued by unit owners who claimed that the financing provided was an inappropriate obligation of the association.

The current recession has caused banks to enter into forbearance agreements with community associations for lack of cash flow or to take actions that place associations into receivership. In any case, the bloom is off the rose with respect to the community association industry being considered a near riskless lending environment. It is still a safe industry, but to approach it with a sense of credit risk invincibility is irresponsible. Financial institutions need to engage in the basic underwriting rule of knowing their customer, and that means starting with a top-to-bottom credit and legal analysis. As noted in the 1999 article, underwriting the legal risk is almost more important than the credit risk.

A Difficult Financial Environment

One of the more misguided moves by lenders has been to provide funds to community associations for operating expenses. An association should always have a budget sufficient for predictable operating expenses, along with net excess to support unexpected budget variations or a reserve fund available to handle the unexpected.

Spikes in energy costs or busted snowplow budgets are not legitimate financing purposes. The community is a group of homeowners that is responsible for the proper management of all the buildings and land. Just as an owner of a single-family home needs to service home energy and snowplowing costs from cash flow or savings, so should an association, which is really just like a small municipality. Supporting an association with financing as a reward for poor fiscal responsibility only reinforces the culture of poor planning. If an association's financial condition is so limited that it needs to borrow for such needs, it is not creditworthy.

The March 1999 article cited, as an important underwriting concern, the strength and reliability of the association's cash flow—a valid and critical indicator of the industry's inherent safety. However, implicit in that article is the need for a normally functioning financial system. As of this writing, the global financial system is severely impaired and, based on the various media—print, Internet, and broadcast—the outside date for reaching bottom would seem to be the end of 2009.

What a reeling financial system means for the community association industry is, primarily, a higher degree of difficulty in removing a nonpaying owner of a unit and replacing that person with someone who will pay. The

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very idea of being able to replace an owner at some market-clearing price for the unit is currently not possible in many regions of the country. Even during a normal recession, economic distress is more intense in some regions than others. There will always be less affected regions, classes, or business sectors that are operating at close to normal levels or perhaps even thriving.

At this time, for many individuals, the ability to obtain financing to acquire a unit has broken down. Investors, both domestic and foreign, are unwilling to purchase deeply discounted properties from cash reserves because of uncertainty that values have hit bottom. As a result, community associations have a lack of buyers and, even worse, a governmental system that is advocating constraints on the foreclosure system. Additionally, there is little access to credit.

Most states do not have a super-lien for any amount of association dues. The association cannot effectively “foreclose out” the nonpaying unit owner because the collapse of property values has left the association with little or no equity. In the current real estate market, the association cannot take over the unit and pay out the first mortgage holder with the hope of reselling the unit and therefore recovering the foreclosure costs and delinquent assessments. Even units owned by banks as a result of foreclosure are not paying association dues.

As the federal and state governments struggle to stem the tidal wave of foreclosures in an effort to stabilize the contracting and deleveraging economy, community associations are stuck with unit owners who are not paying association fees, who cannot be removed, and who effectively have become squatters. Meanwhile, the financing institutions themselves cannot process the foreclosures through the system with an appropriate rate of speed.

The result has been a perfect storm of systemic distress that has threatened the near invulnerability of associations to lose any degree of their cash flow. Historically, it

has been unusual for an association to have a bad-debt reserve included in its annual budget. Now that item is a basic part of the budget.

An added complication occurs when the cash flow of the association is constrained, irregular, or disrupted.

Such an occurrence puts at risk the association's ability to make loan payments. Of course, it would take all of these dramatic events coming together at once before the strength and reliability of the association's cash flow would come under stress.

Critical for lenders to understand is that when a loan to a community association goes into default, there are few options available.

Address the Legal Matters First

Subsequent to March 1999 and prior to December 2007, the month in which the current recession officially started, only one known bank loan to a community association had gone into default. The community was located in Miami. Up until this time, lenders to the industry had never experienced a loan default, but the recovery system worked perfectly. The bank sued on the note, and the association was placed in receivership. The receiver, working unilaterally under the authority of the court, restored financial well-being to the association and the bank was repaid. Currently, many banks in Florida are working through the same process or are entering into forbearance agreements with associations until such time as they can restore their cash flow.

If a community association goes into default on a loan, it will likely have happened because financially distressed unit owners have stopped paying their association fees, which essentially dries up the association's cash flow. Critical for lenders to understand is that when a loan to a community association goes into default, there are few options available. The primary workout skill needed is patience. In a general sense, there is nothing to sell off to recover cash. The financial institution will not be able to grab a greater share of the association's income stream for rapid payout. A lump-sum special assessment is unlikely to be court approved or even successful because the unit owners were under financial stress in the first place. The workout of the loan will come from the eventual replacement of nonpaying unit owners with paying owners—which will occur only when a market-clearing price for the units is achieved. The only caveat to this certainty is if the property's condition is questionable. That is, the property for some reason risks becoming uninhabitable.

In lending to community associations, the most important first step is to address the legal matters related to the association. As mentioned in the March 1999 article, the loan documents must be able to withstand the scrutiny of a courtroom challenge. More than any potential cash flow problem for the industry, the greater credit risk is the loss that would result from an inappropriate or incomplete loan documents package. An example would be if a bank is made party to a unit owner's lawsuit against his association's board.

The community association industry is a litigious one.² In an actual case, a unit owner sought to have a special assessment overturned and the loan set aside. The bank was made party to the suit under the premise that the bank knew or should have known that the special assessment was inappropriate. Fortunately, the association and the bank prevailed against what was clearly a frivolous suit. However, the lesson learned was to have a strong indemnification agreement included in the loan documents, given that \$30,000 in legal fees was expended to protect the bank's interests and ultimately had to be recovered from the borrower. Obviously, this case had a relationship-destroying effect.

Protecting the Financial Institution

The financial institution needs to recognize that it is not dealing with a consumer or a business entity. The borrower is a quasi-government. It has a voting citizenry and elected board. There is a unique set of state statutes governing its activities. There are governing documents known as *bylaws and formation declarations* (CC&Rs).

Of primary importance to a sound loan transaction is the opinion of the borrower's counsel. That opinion needs to be written as an assertion that the attorney alone has performed the investigation and is providing assurances. An opinion stating that the attorney is relying on the assurances of the association board or those of the property manager is no more valid than if the bank itself had obtained the opinion assurances from the manager or board.

Keep in mind that the board members themselves are not professional board members, and they are unlikely to be skilled in legal matters. Typically, they are volunteers who are successful in some outside profession and have come together to assist in their community's governance. Property managers have various ranges of skills, but no professional legal responsibility to a loan obligation. An error or inaccuracy by a property manager or board member does not help the bank recover a loss. On the other hand, an attorney has an errors and omissions insurance policy and is subject to oversight by the state bar association.

The bank needs, at a minimum, the following explicit statements:

1. The association is in good standing with the local governance/regulatory authorities.
2. The person or persons signing the documents are empowered agents authorized to execute the documents.
3. The association has accurately and legally elicited the votes needed to allow the association to enter into the loan transaction.
4. The association has the ability to pledge all aspects of its assessment income as collateral for the loan.

The last item is usually the most difficult assurance to obtain. If it is not obtained, the bank may have a valid loan but one that is probably unsecured.

Another part of the legal process is to understand whether the item approved by the unit owners is appropriate. For instance, in Hawaii, borrowing for replacement of reserve funds cannot occur. In several other states, repairs cannot be paid for through a special assessment, but maintenance can be. So it is important to understand the validity of the special assessment, which may be the primary part of the cash flow for the loan's repayment.

Meanwhile, the records of associations are frequently incomplete or inaccurate. The governance documents often have errors or contradictions. It is not unusual for the legal name of the association to be called into question. It may be different across the governance documents, including the articles of incorporation, the bylaws, and the declaration document. For the loan documents to be accurate and to satisfy the requirements of the PATRIOT Act, a validated, single name needs to be obtained and recognized. In addition, it is not unheard of for an association to have no clear indication of the number of units in the community. Often, when a developer fails financially at some stage in the project's build-out, the legal development of the community's records (CC&Rs) becomes a mass of confusion.

Not obtaining a borrower's counsel opinion or not having it properly structured is the largest area of credit risk. The risk point increases with the regular turnover of board members and unit owners. The board and unit owners of today may feel blessed that they obtained a loan for roof replacement. But the board and unit owners of tomorrow may feel that the special assessment supporting the loan—or the loan itself—was inappropriate. It is not unusual two years into a loan for newly elected board members to call the bank and express surprise at having just learned of the existence of a loan to the association. It is also not unusual for that new board to be hostile toward anything done by the previous board. Too often, a new board might start off by challenging the loan's validity.

A Question of Commitment

In lending to community associations, a point on the plus side is the positive motivation instilled by home ownership. When homeowners are experiencing personal finan-

cial stress, they typically will do whatever they can to save their home. Accordingly, unit owners have motivation to pay their association dues, supporting the strength of the budget.

As lending to a covenant-controlled entity moves further from the concept of home ownership, however, the risk of default by unit owners rises. This concern about owners "walking away" from their units increases as the property's value falls. It becomes a question of commitment. Owners are less committed to a property whose value has diminished. They are less committed to a second home than to a primary home. They are less committed to a property in which they have no valid equity. They are less committed to a property held for investment as opposed to a primary residence. They are less committed to a lot held in a motor home cooperative than to the motor home itself.

Even in a healthy economy, a financial institution increases its exposure to credit risk as the protection afforded to home ownership dissipates or as the property's intrinsic value becomes less important to the owner. A \$15,000 timeshare interval is rationally less valuable than having the cash flow to send a child to college. Further, as a per-unit special assessment becomes a substantial portion of the property's market value, an owner may begin to question the cost of home ownership. In a number of coastal communities, for example, per-unit special assessments can easily reach \$20,000 to \$50,000 for deferred maintenance. Maintaining the structural elements of a high-rise building are documented to be as much as \$250,000 per unit as a one-time special assessment.

Deterioration of Common Elements

The very act of providing a loan to a community association at all is something that shouldn't have to occur. Proper financial management of an association dictates that the unit owners' monthly assessment must include a small portion of funds that are set aside as reserves in the association's coffers. This reserve is calculated according to a special reserves study, which is updated regularly.

Each day, a unit owner uses up some minor portion of the common elements—such as the clubhouse, recreation facilities, parking areas, and grounds. The varied life cycles of these common elements mean that the community faces an almost constant state of deterioration. In effect, a person who has ownership of a unit for three years should have been made to pay for the estimated cost to replace the roof (and all other common elements) over those three years,

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because that owner experienced the benefit and value of a roof in good condition during that period. Otherwise, the unit owner in place at that moment 30 years later when

Quality of cash flow remains king in community association lending.

the roof's useful life expires has the unfortunate luck of having to pay for the roof's replacement. In keeping with that concept, a loan provided to an association should not be intended to replace an expired common element, nor should a loan term be considered in the context of the life cycle of the common element being replaced. The loan funding is to replace the reserves that have not been accumulated appropriately. Because all the common elements of the association are in a constant state of deterioration, those responsible for structuring the debt should keep the loan term as short as possible.

The association needs to recover its cash flow that has been diverted away by the debt servicing requirement for the inevitable replacement of future common elements. In all likelihood, the association is not building reserves to address those other common-element expirations. If the debt service is not eliminated when the other common elements expire, the unit owners are now subject to added special assessments on top of the existing debt service special assessments. The result is financial stress.

The financial institution needs to recover the loan proceeds for the sake of its own safety. Thus, the loan term needs to be in balance with the cash impact that will occur over the life of the loan for the replacement of the future expiring common elements. In other words, the loan needs to be paid off before the next major—and as yet unfunded—capital maintenance project.

In structuring the amortization of loan payments over the past 10 years, the association financing industry has moved away from shorter terms as the unit owners have expressed a desire for lower loan payments. However, the loan term should not be dictated by the current unit owners' lack of discipline to have an adequate budget or the failure of previous unit owners to allow for the accumulation of reserves. As we have learned from the currently deleveraging economy, the higher the level of debt, the greater the risk to the debtor and consequently the creditor.

A Loan Structure to Avoid

Financing is a tool to achieve a specific goal; it should not be a crutch to support a lack of discipline or a breakdown in fiscal responsibility. A particular problem is the evolution of balloon-payment loan structures. Consider, for example, a 25-year payment amortization structure that is due in full after 10 years. The sole purpose of this

structure is to let current unit owners escape making appropriate loan payments and to defer the debt to future owners. Such a structure works against the idea of getting the association out of debt as soon as possible so that it can recapture its cash flow and finance future common-element needs.

A curious position has been taken with regard to cooperatives.³ Because co-ops have a real estate interest, balloon-payment structures have become typical along with a second mortgage that is a renewable interest-only line of credit. To their detriment, financial institutions have felt comfortable with this structure because of the availability of a real estate lien position as collateral—a collateral concept that does not exist in all other community association legal structures.

The problem comes from the financing purpose failing to match the loan term. There is no valid exit strategy. The rudimentary basis of lending is that the financing should be for a purpose; it should not be based on comfort that collateral exists.

The original underlying mortgage may have come from any number of original purposes. As this debt provides “no value in use” to the association, it is a burden that must be lifted as soon as possible. Establishing a balloon-payment structure is doubly damaging because future upgrades to common elements are likely not reserved for by the association. The ill-conceived plan may be to seek further financing for future needs.

In the worst case, debt is piled upon debt as further common-element replacements are financed. The continued justification is an increase in the value of real estate. However, there comes a time when the cash flow demands of the ever-increasing debt load drive up the association budget to a point that makes additional financing impossible. Eventually, the new debt requested to support newly expiring common elements will, when heaped upon the existing debt, be greater than the value of the real estate collateral available. The unit owners will be left with a situation of cash flow strain due to the association debt plus the inability to repair common elements without enacting substantial lump-sum special assessments.

With debt that is ever increasing under the manner described, the failure of the cooperatives' financing model is as predictable as the failure of the subprime mortgage financing model. The math simply does not work over more than one life-cycle improvement of the full set of common elements. It is based on a house of cards—effectively, a Ponzi scheme. The new investor throwing more cash into the scam is the financial institution that refinances the existing balloon mortgage plus the common-elements upgrade based on the false premise of ever-increasing real estate values.

Do Your Homework

Quality of cash flow remains king in community association lending. Knowing your borrower is the key to safety. The starting point is in getting to know the demographics of the population. The more socially and economically diverse the population, the better.

A concentration of ownership is a risk point. If there is only one owner holding a block of units and he or she stops paying, that level of cash flow can be gone for as long as it takes to foreclose and obtain new assessment-paying owners. Another risk is a large percentage of investor-owners, who would be more inclined to walk away from their units in a period of economic decline.

Be aware of the existing business-cycle stages for the region and the nation. Is there an industry concentration in the property's area? The tech bubble of the 1990s devastated real estate values in the Silicon Valley area. The collapse of Wall Street in 2008-09 has crushed the real estate market of Fairfield County, Connecticut. Michigan, suffering from the auto industry's woes, has the fourth highest level of mortgage foreclosures.

Simply getting a list of the unit owners with their unit number and their mailing address reveals a lot of information. Are any of those units bank-owned? Supporting that list is a current aging of the assessments due. A tip in tracking such data is to ask for any supplemental reporting. It is very typical for a community association manager to track special assessments and the regular common assessments separately.

Monitoring the Project

Project monitoring can be a challenge for traditional tangible-asset lenders to grasp, but, again, it goes back to the very key point that financing is not for the project at hand. The financing is to replace reserves that should have accumulated so the association could self-fund the project—a project that self-interested owners would have monitored closely with the goal of improving their homes and a self-interested board would have administered with the goal of carrying out its fiduciary responsibility.

Another point—and a unique one—is that the project creates no value. Restoring common elements does not create a tangible asset with a resulting value. This type of expenditure is equivalent to a homeowner renovating a kitchen. There is pleasure derived from using the kitchen, and there may be improved operating efficiency. But there is no appreciable change in the value of the home. The point for community association lenders is that monitoring the project does not protect the bank's collateral position, as it would in a construction project.

A further point is that it “almost” doesn't matter that the association performs the proposed project at all. The financial institution's loan is not at risk because the col-

lateral is the assignment of assessment income and the budget has been increased based on properly approved steps as confirmed in the opinion of the borrower's counsel. When all these points are taken together, there is almost no value in monitoring the progress of a project. An equivalent concept is municipal bond financing of a new school. The bondholders have no interest in whether the school is built. They are interested only in the quality of the tax roll.

In many cases, lenders to community associations simply provide the loan proceeds in a lump sum and have no interest in the project. In other cases, the financing goes out as an open line that the association draws on as needed—a structure that is, in effect, a giant home equity line of credit. Both of these practices have merit. However, as well intentioned as the association board may be, it is important to remember that its volunteer members may be largely unskilled in matters of finance. Therefore, it is prudent for the financial institution to assume some involvement, particularly in understanding the full range of cost potential related to a project. The bank should be comfortable that the board has obtained bids on a project and that the scope of work is thoroughly understood by all parties concerned. Naturally, the level of involvement should be determined by the complexity of the project at hand. If it is a simple replacement project such as re-shingling a standard pitched roof, there is little cause for concern. But if the project is the restoration of rotted walls, that means extensive investigation and testing will be required to gauge the extent of the repair needed.

The industry of community associations has, at its core, a “logic system” largely looking to perform projects on the cheap. It is very common for an association to seek financing for a project only up to a certain level of money. The dollar level selected may have no bearing at all on the true cost of the project. The financial institution would be well served to know the full and accurate cost of the project and to pass that information on to the community. Often, associations with projects that have hidden costs find themselves facing crisis levels of repairs once the project is started and the hidden damage is revealed. It is not unusual for per-unit structural improvement costs to be nearly as much as the market value of the unit. This is not an expenditure level that any unit owner—or the association—could likely support and presents the potential for a loan default.

Often, associations with projects that have hidden costs find themselves facing crisis levels of repairs once the project is started and the hidden damage is revealed.

Once the cost is known and the budget has been increased to support the financing provided, there is little need for the financial institution to monitor a project. There is, however, an alternative view of project monitoring. If the association did not use the loan funds for the intended project, then the expired common element in question has still not been improved. Say, for example, the loan was to be used for replacing a leaking roof but the funds were spent on repairing a swimming pool. The roof is still leaking. And now the association will have to source new money to replace the roof. This could cause a financial strain on the unit owners.

There is also a legal question here. If the association voted for the loan funds to repair the roof and a subsequent board instead used the funds for a new perimeter fence, the purpose of the special assessment has been violated, which could cause unit owners to bring a lawsuit against the association for misallocating funds. An easy way to avoid these potential problems is to simply have the association submit copies of invoices to support the advance of funds. A minor check to ensure that the funds are going to the approved project can keep the project on track and reassure the bank that work on the project is actually being done.

In nearly all jurisdictions, there is no need for mechanic's lien waivers. Mechanic's liens are against real estate, and community associations (excluding cooperatives) have no real estate interest. The buildings are indivisible interests of the unit owners. Again, a feature of community associations is that there are buildings constructed on land, but no real-estate-related legal concepts apply.

Conclusion

Community associations remain among the safest lending opportunities, but they are not without risk. A proper

lending process requires a full understanding of the project being undertaken. The legal requirements of the association must be verified and validated in a thorough legal opinion that will survive an ongoing progression of board members and unit owners. The debt must be structured in such a way that it will expire by way of properly considered amortization.

Lenders must also be mindful that the association is a continuously deteriorating physical structure. The life cycles of the common elements need to be understood so that debt can be extinguished in time for the association's cash flow to be redirected in support of the next restoration project. ❖

The opinions and concepts presented in this article do not reflect the opinions and concepts of Mutual of Omaha Bank. The article is exclusively reflective of the knowledge, opinions, and experiences of the author.



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Notes

1. For more information, see www.nacho.us, the Web site of the National Association of Condo Hotel Owners.
2. See the online monthly publication "Community Associations Network," available at www.communityassociations.net. Most of the articles are about misappropriation of funds by managers and/or board members and unit owners' lawsuits against their associations.
3. A cooperative, or co-op, is a legal entity that owns the real estate aspect of the property. Each shareholder in the legal entity is granted the right to occupy one housing unit subject to an occupancy agreement, which specifies the co-op's rules. Many of the apartments in New York City that are owned rather than rented are co-ops.

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