HUD Underwriting Requirements
For FHA Condominium Mortgages

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Author's Note: *Since this article first appeared we have received numerous inquiries from individuals and businesses seeking clarification of various details relating to the new HUD underwriting guidelines. As is typical in such situations a considerable amount of incorrect information has also been circulated by misinformed sources who do not have their facts correct. As a public service we have revisited this topic with representatives of the HUD field office in Santa Ana, CA which has jurisdiction over the Western United States. Policies which are set by this office regulate mortgage activity of the agency throughout the western region, which includes the states of Oregon and Washington.*

The article which follows is an update of an article which was written earlier in 2009. The policies which are discussed have been in effect since the latter half of 2008. Special thanks to Mr. Tom Wilke of the U.S. Department of Housing and Urban Development, Santa Ana Homeownership Center in Santa Ana, CA, for his assistance in preparing this article.

Due to the declining housing market, recent turmoil in the credit markets and residential mortgage industry, the Department of Housing and Urban Development - better known to most of you as HUD - has enacted new lending requirements for certain types of federally insured mortgage loan programs.

One such rule change with far-reaching implications for condominium associations and community management companies, is the new underwriting requirement making it mandatory for all *existing* condominium associations to maintain minimum percent funded levels in their reserve account in order to qualify for FHA insured mortgages. An *existing* association is defined by HUD as any condominium association which is not under the control of the original declarant.

Newly constructed condominium developments are subjected to different underwriting requirements than those required for existing associations; as are condominium conversions which are still under the control of the original declarant. *Control* of the association is said to exist until such time as the declarant conducts a turnover meeting which officially relinquishes decision-making control of the association's affairs to a board of directors comprised of homeowners within the community.

Existing Associations: When determining if an existing association's reserve fund meets the minimum funding requirements, HUD underwriters require a *current* reserve study containing a funding projection which clearly indicates the percent funded level is 60% or more at the time of approval. Once a particular association is approved for FHA lending guarantees there is no requirement that they re-qualify at a future date. However, that does not mean once you are approved by HUD you can forget about your reserve funding program. Even after an association has received HUD approval for FHA loans subsequent loan applications must include an updated reserve study as part of the document package submitted to underwriters. If the underwriters see evidence the reserves are not being funded as planned, or the percent funding amount has fallen to unacceptable levels, it could trigger the need for a new reserve study.

Not only must the reserve study provide a funding plan which indicates the reserves are 60% funded at the time approval is granted, but the association's reserve account must be current in terms of the contributions which are required to maintain the funding levels indicated in the reserve study. Reserve contributions which are scheduled in the reserve study must be made on a monthly basis.

For example if the reserve study indicates the beginning balance in the reserve fund as of the first day of the current budget cycle was $100,000.00, and an annual contribution of $60,000.00 is scheduled for the current year; then the association must be making a monthly contribution of $5,000.00 to the reserve account. So, in a situation where approval was sought on July 1st of the current year, the reserve fund balance would need $130,000.00 in order to gain approval for FHA insured mortgages. ($5,000 x 6 = $30,000 + $100,000 = $130,000)

Letters from the association's accountant; bank statements showing the amount of money on deposit at the time of approval; personal assurances from the Board of Directors, and other equally informal documentation are not adequate to gain approval of the loan.

The reserve funds must be sequestered in a separate account which is not commingled with the association's operating fund account, maintenance account or any other accounts maintained by the association. The reserve fund account must be earmarked with an account name which clearly identifies it as the reserve account. The existence of the account and the account balance will be verified by the HUD underwriters as part of the FHA approval process.

At the present time HUD does not have any limit as to the maximum level of assessment delinquencies among the owners within the community. However, the scheduled reserve contribution which is required by the current reserve study must be maintained regardless of the level of delinquencies.

Using the aforementioned example, if the association is scheduled to make a $5,000 per month reserve contribution, but is experiencing a 20% delinquency rate on the payment of monthly assessments from its members, the $5,000 contribution will still need to be made every month in spite of the fact that only 80% of the owner's are paying their HOA assessments on time.

In many situations, especially among smaller communities, such a situation is likely to result in the inability of the association to make the scheduled reserve contribution on a timely basis; effectively making it impossible for them to qualify for FHA guaranteed mortgage financing if they are experiencing a significant level of delinquencies.

Declarant Controlled Conversions: Converted condominium properties in which existing buildings have been converted from some other type of use to that of a condominium, and which are still under the control of original declarant, are faced with even more stringent funding requirements than those which existing associations are subjected to. Declarant controlled conversions must meet all of the previously described requirements except that the percent funded level must be 100% rather than 60% at the time approval is granted.

<u>There is no one year time limit or other time constraint on this requirement.</u> Meaning that, if a development is over one year old and is still under the control of the original declarant at the time they seek FHA approval, the 100% requirement will apply. At no time does a declarant controlled conversion become an existing association until such time as the control of the association is turned over from the declarant to an owner controlled board of directors.

Reserve contributions due from the declarant for unsold units which are still owned by the declarant, cannot be deferred beyond the one month time horizon required for all reserve contributions. Hence, if the declarant still owns one hundred units in a 150 unit development, and the per unit reserve contribution works out to be $50 per month, the declarant must make a monthly contribution to the reserve account of $5,000 ($50 x 100 units = $5,000). Many developers will attempt to defer the contributions until each individual unit sells, or until the time of turnover; this practice is *not* allowed under the new HUD guidelines.

New Construction Condominiums: New condominium developments are treated somewhat differently than existing and converted condominium associations. *New* developments are said to be those which are newly constructed and are being sold by the developer to the *first* owner who will ever occupy the dwelling.

New developments are not required to maintain a specific percent funded level in their reserve account. What *is* required in order to gain approval for FHA loan guarantees is a current approved operating budget which includes a provision for a reserve transfer. The transfer must be adequate relative to the size of the association, its reserve funding obligations, etc.

While this may seem somewhat ambiguous what is important to understand is that the underwriters are looking at the budget and the reserve funding obligations of the association to develop a sense of whether there is a prudent plan for long range replacement funding in place.

Site Condominiums: HUD defines a site condominium as a development which is organized under a condominium regime, and is platted as a condominium even though the individual homes within the community are free-standing, single family residences. More common in some regions than others, this type of development is becoming more commonplace for a variety of reasons related to land use and development regulations.

In such situations, if the condominium association is *not* responsible for maintaining the exterior of the individual homes within the community, then the reserve funding requirements previously outlined may not apply.

We say *may not apply* because at the present time such communities are treated as traditional condominiums with respect to the HUD underwriting guidelines. HUD is expected to release new underwriting requirements for site condominiums within the next few weeks which would allow mortgages on homes within these communities to be funded under the FHA 203b loan program, rather than the condominium loan program. By the time this article goes to press this change may well have taken place.

Site condominiums, in which the association does maintain the exterior of the homes, are likely to continue being treated as traditional condominiums with the same underwriting requirements as previously discussed.

When *New* Becomes *Existing*: At the point where a new or conversion condominium is turned over to the control of the unit owners it becomes an "existing" condominium under the HUD guidelines. From this point forward the underwriting requirements for existing associations will apply; although there is no provision in the HUD underwriting process for re-qualifying any condominium association after it is initially approved for FHA lending guarantees.

However, the underwriting process does require lenders to provide an updated reserve study when a new loan application is submitted, and the updated study is evaluated, to determine if the association's funding plan is still consistent with the objectives HUD is trying to achieve with these guidelines. If the current reserve funding plan does not reflect a percent funded level at, or very near the 60% threshold, HUD will approve the loan in question, but will then require a new reserve study before any future applications will be approved.

In California, Oregon, Washington and the handful of other states which require condominium associations to prepare a reserve study, the issue is moot; however, the vast majority of states have no such statutory requirement for reserve studies, which places the burden on each association to voluntarily conduct a reserve study and fund the reserve account.

Market Impact & A Paradigm Shift: In view of the current mortgage market instability and recent increase in the number of FHA loan applications from prospective homebuyers, the new HUD underwriting requirements suggest a number of important changes may be warranted by many condominium associations and their management companies.

Any association which can expect prospective buyers to require FHA guaranteed mortgage loans in order to purchase condominiums within the community, should consider the following implications which are a direct result of the HUD funding requirements:

- A formal reserve study is *required* to gain loan approval, irrespective of whether the association is under any statutory requirement to perform a reserve study; assuming the association has never been approved by HUD for FHA insured mortgages.

- A minimum percent funded level of 60% is required for the year in which the association is initially approved for FHA condominium mortgages. Even though the 60% funded level is well below the ideal of 100%, it is typically higher than the levels maintained by many associations. This situation could easily result in many under-funded associations having to seed the current reserves with money raised through a special assessment, or be unable to secure FHA guaranteed mortgages on the condominiums within their community.

- Although HUD does not require an association to re-qualify after the initial approval, ongoing FHA lending activity can be expected to require the reserves to *remain* funded at, or very near the 60% threshold from year to year. Therefore, responsible governance suggests that all associations should anticipate it being necessary to maintain a 60% percent funded level at all times.

- Given the relatively high funding threshold, associations should seek to obtain the most thorough, comprehensive and accurate study possible. Hastily prepared, low cost reserve studies generally lead to poor results; if only because the preparer isn't paid enough to spend the amount of time warranted performing a thorough, accurate analysis. In such a situation the association could easily end up paying more than is necessary to maintain adequately funded reserves.

- Associations should be equally leery of reserve study providers who offer to magically transform the percent funded levels by extending the remaining life estimates or under-estimating the replacement cost of major reserve components. Percent funded levels are a comparison of cash reserves with the accumulated depreciation of association assets which are the subject of the reserve study. Through manipulation of these numbers it is possible to paint just about any picture one chooses, whether it represents a credible funding projection or not. Remember, statistics can be interpreted in different ways to support just about any point of view the statistician desires.

- Failure to plan ahead by obtaining a competent reserve study and addressing the adequacy of the association's reserves could be viewed as a breach of the fiduciary duty of the Board of Directors. Professional managers are also well advised to encourage their association clients not to ignore the importance of this subject. All it will take is one or two failed sales as a result of condominiums within the association not being eligible for FHA financing, before managers and board members alike are certain to hear from disgruntled owners.

In addition to the HUD underwriting guidelines which apply to FHA insured mortgages, conventional mortgage underwriting guidelines are also beginning to reflect a heightened level of concern for adequate reserves and responsible financial planning on the part of homeowner's associations in general and specifically in the case of condominium associations.

The time is fast approaching when it will no longer be an option to simply ignore the need for responsible long range financial planning which includes an adequate level of reserve contributions. To meet the ongoing major repair and restoration costs which all associations face sooner or later, reserves are a necessity, not a luxury.

Even though the need for reserves has traditionally been treated as a discretionary form of savings - a fact which is reflected in the condominium statutes in the vast majority of states to this day – we have reached a tipping point in the evolution of common interest developments beyond which the future will be very bleak for those communities who continue to ignore the importance of reserves and long range planning.

T.A.N.S.T.A.A.F.L: The era of the "free lunch" is over. With property values declining in many areas and with real estate unlikely to appreciate in the future at anywhere near the rates Americans have grown accustomed to, many homeowner's will be hard pressed to afford huge lump sum special assessments when an association finds itself with a major shortfall in its reserve fund.

Communities in which the buildings are twenty years of age or older are particularly vulnerable as the dreaded thirty year time horizon begins to close in on them. Thirty years is generally considered to be the point when most major building systems and components will have substantially reached the end of their useful life.

Associations which are not prepared to make major financial expenditures at or beyond thirty years of age may never be able to raise the money they need to pay for repair and restoration of major community assets, if they have failed to develop a long range reserve funding plan.

With disclosure laws being changed in many states to now require sellers of real estate to disclose details about the financial status of their association to prospective buyers; it will become increasingly difficult to simply walk away from a financially deficient association by selling your home and moving on.

Like the old saying goes, *"there ain't no such thing as a free lunch"*…there never was and there never will be.