Loan Structures & Long Term Budget Short Falls

By Alan D. Seilhammer

In my profession, I have the joy of traveling the entire country and experiencing community associations of all types, sizes and shapes. Community associations are amazingly diverse. Depending on regions and specific locations, communities range from 50 to 125 units or 1,000 to 50,000 units. A high-rise or a sprawling resort. Each of these communities have a particular nature. I find this to be the most fascinating. I like to refer to it as a corporate culture. In effect, at some point along the way, people within the community began gravitating to a particular way of managing their affairs. Rules of behavior, communication and tolerance. Some communities are just down right fun places. Some of the disposition is caused by demographics such as the community being made up of retirees, yuppies, families, etc.

Financing for community association capital maintenance needs has gone from being rarely available to easily accessible. Financial institutions that are truly skilled in serving this unique industry are particularly flexible to the differing needs of each community. Not only does each have a unique culture but the projects all need to be approached in a tailor made fashion to suit what they desire to have accomplished. The financing available is low cost because the transactions are acknowledged to be of low risk and the associations often provide the institutions with deposits that allow for buying down the interest rate or loan fees.

The one aspect that permeates the vast majority of all communities is the handling of financial affairs. A very important responsibility is broken in most communities. I know this to be true by virtue of years of experience as a lender financing communities throughout the country and involvement with the Community Associations Institute, as well as interacting with professional reserve study professionals who say most associations are typically not more than 20% funded. That is, reserve studies indicate that a certain level of reserves are needed to support expired common elements but only 20% of that specified funding level has actually been accumulated.

The reason is also very consistent. No one wants to spend any money. A culture of “keep monthly association fees minimal” exists almost universally. Now, I am not a spendthrift, but I have witnessed nothing but adverse affects to the ostrich head in the sand mentality. The reality is simply this. A community association regardless of size is a very complicated miniature town. The buildings and infrastructure are a sophisticated system of structural materials that is constantly in a state of deterioration and its components are becoming obsolete.

Because of the desire to keep the annual budget low for the sheer sake of it, there is typically a huge cost impact put upon the unit owners when a project needs to be addressed. Because of the under funding issue, the cost has typically been accomplished via large special assessments. The availability of obtaining an association loan has smoothed the impact.

However, there is a growing desire by Boards to further lower the impact of the monthly loan payment on unit owners. Boards are requesting loan structures with long amortization schedules to keep the payment low but the loan has a balloon payment at some point. A thoroughly dangerous concept. Consider that if a loan is provided on a 30 year amortization with a balloon payment in 10 years, the original principal balance of the loan will largely still exist but the unit owners calling the property home 10 years from now will bear the burden of dealing with the amount due. In addition, further common elements have worn out and require more financing or special assessment. This creates a never ending cycle of new debt being piled onto old debt or on top of a special assessment.

It is all based on an unfortunate societal trend in America of enjoying a better life-style today at the expense of future prosperity. A concept reflected in growing credit card debt, the growing national debt and home equity being accessed to acquire consumer goods.

The concept of Bonds has also come into the picture for associations. A Bond is just another word for Loan. Their use has been very limited in the community association industry because of the high transaction costs. For the annual percentage yield (APY) to become comparable to a traditional loan, the Bond amount typically has to be several million dollars. The unique aspect of the Bond is that it is a private debt placement with an investor. Consequently, there are State, Federal, Securities and Tax laws governing the instrument which invokes the need for a sophisticated Investment Banker and qualified legal counsel. The enticement of a Bond can be that there is a longer payback period such as 20 to 30 years. But, this is the equivalent problem of there being a balloon payment. Unit owners in the distant future are paying for the common element that was replaced decades ago while at the same time additional common elements need to be replaced. Or even worse, the common element that was financed for replacement has worn out and needs to be replaced again while the Bond is still outstanding. Having a debt pay back over 20 plus years also results in a lot more over all interest cost to the association regardless of the seduction of having lower payments. A monthly debt payment over 20 years could be 33% less than a 10 year loan but the summed interest cost would be over 200% more. A critical challenge with a Bond structure is the very basic nature of associations to prepay the loans. Since the instrument has been placed with an investor that is expecting a particular yield, prepayments are unlikely to be accepted.

The repayment structure of a Bond is no different than what can be obtained from a bank knowledgeable of community associations. Graduated annual debt payments blended with annual budget increases. Even a long term amortization with the caveat that there be a supporting sinking fund. A sinking fund is a regularly funded accumulation of cash set aside to retire the debt at maturity.

There are a lot of options available to fund the renovation projects of community associations. However, there are three unequivocal truths:

1. There is only one place that the cash comes from: the unit owner.
2. The project will never get cheaper.
3. The project will not go away.

So, you can pay now, you can pay later but you are without a doubt going to pay.

Alan D. Seilhammer is Senior Vice President and HOA Lending Manager for Community Association Banc, which is a Platinum Premium Partner of the Chapter and an exhibitor at the Trade Show.