Lending to... Condominium Associations

by Alan D. Seilhammer

Lending to a condominium association is not unlike lending to a municipality. No loan losses from condominium associations have been recorded by those banks with the most lending experience—in Florida and California. Further, there are cross-selling opportunities. Nevertheless, there are special considerations when lending to a condominium association, which are discussed in this article.

Common Interest Realty Associations (CIRA) are legal entities formed from the organization of real estate property owners generally as non-profit nonstock corporations. The purpose of the organization is to serve the collective needs of the real property owners by providing services and maintaining the common ownership elements (COE). The predominant form of CIRA is condominiums, which emerged in the 1960s. This concept evolved into other forms of CIRA structures, including cooperatives, homeowner associations, and time shares.

Starting as residential communities, common ownership methods have been applied to professional offices, retail/industrial complexes, and resorts. An estimated 42 million Americans live in some form of CIRA and CIRA comprises 15% of U.S. housing. There are approximately 205,000 community associations today, with estimated annual growth of 6,000 to 8,000.

This industry represents an estimated $1.7 trillion in resale values and $18 billion in reserve balances. The points made in this article relate to residential communities. The concepts presented are transferable to other areas of CIRA but require additional considerations.

CIRAs are largely under the governance of the individual states. Most states have adopted the model legislation drafted by the National Conference of Commissioners of Uniform State Laws known as the Uniform Condominium Act. The sole basis of existence for the CIRA is management service to the unit owners and responsibility for the COE to the benefit of the unit owners. The CIRA generally is operated by a volunteer board of unit owners. Board members have a fiduciary responsibility for the management of the association's affairs and, consequently, are exposed to certain aspects

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of personal liability.

Sources of Revenue

The ability to lend successfully to condominium associations, a particularly profitable market for financial institutions, has been proven. Specifically, California and Florida have 40% of the nation's condominiums and the local banking institutions have several years of experience providing financing. However, lending can be a smaller part of a whole package of cross-selling opportunities.

Deposit accounts. Of special interest is the potential deposit base. Condominium associations have operating accounts to support their daily activity. They also accumulate pools of money as reserves to maintain all of the common ownership elements that require upgrading or replacement at different points in time. A well-conceived reserve plan matches the funds accumulation to the timing of addressing respective common elements. Because of the board's fiduciary responsibility, these reserves are typically invested in principal-safe instruments—most often, FDIC-insured certificates of deposits. However, mutual fund products that are structured for principal protection also are appropriate.

Property management companies. The most effective way to attract the deposits of condominium associations is through their property management company, which is particularly attracted to lock box services that help minimize back office staff. A management company services anywhere from five associations to hundreds. In geographic areas that have a concentration of condominium associations, it is not unusual for a bank to have an autonomous department servicing just this industry. However, the developing online banking methods may make geographic concentrations irrelevant.

The condominium services product line can be a distinct profit center. Condominium associations and their property managers have unique needs for the administration of their funds. To attract the deposits, the bank needs to develop a group of appropriate products, price them competitively, if not higher than average, and have an infrastructure available that can address their unique needs. The tangential products can be the full range of consumer services, including residential mortgages, deposit accounts, auto loans, and retirement accounts.

THE CONDOMINIUM ASSOCIATION INDUSTRY OFFERS A UNIQUELY SAFE ENVIRONMENT FOR LENDING BASED ON ITS PERFORMANCE AND THE CONSERVATIVE MOTIVATIONS IT OPERATES UPON.

Default-less Lending

Lending to condominium associations appears to be a particularly safe market. If the research is accurate, nationally there has never been a defaulted loan between a bank and condominium association when the developer is not involved.

Lending to this market is not new and, as indicated earlier, Florida and California lenders have the most extensive background. Local banks have assisted associations within the community and a small group of national lenders is developing. To do it well, a particular lending officer or group needs to be the specialist. The broadly skilled jack-of-all-trades commercial lender will not be effective in this market.

Lending Considerations

Legal issues are separate and distinct and the credit underwriting considerations are unique in lending to condominium associations. However, the issues are not complicated and the lending methodology is not more extensive. It simply entails an entirely different set of steps and considerations.

Adjusting perceptions. The first step for preparing to lend in this market is removing prejudice and misconceptions. Bankers have lost a tremendous amount of money in the condominium real estate market. Developer loans have gone bad. Mortgages on units have been foreclosed at a loss due to stagnant or declining values. Consequently, upon hearing the word "condominium," lenders grow wary.

However, the motivations, needs, and environment of the condominium association are not real estate-centered. To better appreciate the logic at work, this is analogous to lending to municipalities. Condominium associations are mini-municipalities with a quasi-taxing

authority, and the elected administering board serves at the will of the citizenry. To add another dimension, these are people's homes, with all the emotional attachment that homeownership brings. When their financial condition goes into decline, people are likely to fight hardest to prevent losing their homes. This is an important point in appreciating the strength of condominium association cash flow.

Another misconception is that these are unsecured loans. If the respective state's statutes allow for the assignment of *the association's right to assess*, there is collateral and it may be strong (depending on the statutes). As will be more fully explained later, condominium associations are cash flow entities. They do not have much in tangible assets. However, the continuity of that cash flow is the collateral's strength. Unlike tangible assets, the value does not change with market conditions—it is not mobile and it does not dissipate. There is an argument that a properly transacted assignment of the association's right to assess is a more reliable source of repayment than a tangible asset (other than cash).

Getting started. At the outset of lending to condominium associations, the lender must keep in mind that every issue is specialized in this industry and requires bank counsel with a specialty in the area. The lender is not looking for an attorney experienced with developing condominium documents for condominium developers or an attorney that does primarily collection work for associations. Attempting to train a bank's traditional counsel in this environment is a short-sighted mistake. The legal issues are too complicated for a generalist and the laws in this segment continually change. Legal safety comes with finding a practiced attorney that is plugged into the network of information that will keep him or her up to date. That person will help educate you on the legal issues in a particular state's condominium associations.

Condominium associations are solely creations of law and so the lender must become intimate with those issues of law. They do not have a tangible existence like a person, office building, or automobile. Tangible entities first gained material existence, which caused laws for their governance. With condominium associations, first came the law of their governance and then their intangible existence. The quality of the loan will not rest on the underwriting performed. It must have the certainty of withstanding courtroom challenge in order to be a forever performing asset. The closing table is the lender's first point of risk.

Funding opportunities. The items that can be funded are diverse. The unifying issue is that the funding be project-specific. Open-ended availability to financing as in credit lines are inappropriate to the nature of condominium associations. The typical funding items are such projects as roof replacement, conversion to vinyl siding, driveway resurfacing, and central mechanical system upgrades. A more unique matter is buying out a land lease. The debt service level is likely to match the lease payment but the loan will have a much shorter maturity. The collateral will still be the assignment of assessments. The former leased land or other real estate-like item will cease to exist independently as it becomes a common ownership element. Associations have sought funding for expanding recreational facilities and purchasing adjacent land as a buffer or for easement control.

Underwriting concerns. The underwriting issues are concentrated on matters surrounding the quality of cash flow, both existing and proposed. The condominium association has an authority spelled out in its Declaration and By-Laws, allowing for the levy and collection of assessments and special assessments and further augmented by state statutes that may provide the association with foreclosure rights.

This quasi-taxing authority is potent and reliable. Consider the following example to illustrate the importance of continuity of this cash flow. A unit owner having purchased a condominium unit for $5,000 at foreclosure sale in a complex of $100,000 units is subject to the same $150 monthly assessment as the rest of the community. If a bank acquires a unit in foreclosure or state/federal agency comes into ownership, it also is subject to the $150 monthly assessment. Regardless of who has title or the cost of obtaining the unit, the association is entitled to be paid monthly.

This form of lending should not be attempted if the developer is in any way involved with the condominium association in question. If the developer is involved, it is necessary to follow the bank's loan policy and underwriting standards for commercial real estate lending.

Another potential concern is the ratio of investor-owned units. As this ratio climbs, it is not unusual for the dynamics of the community to be weakened. Investors do not have the same sense of concern in the

complex as homeowners. The investor is in the complex for the opportunity to earn a positive cash flow from the unit owned or it is a second home that is possibly intended for recreation. Consequently, investors are not motivated to build reserves, perform routine maintenance, or have required projects done in a quality manner versus a low-cost manner. The tenants that they bring also lack a sense of ownership concerns. As the ratio of investors increases, their relative control increases. This becomes obvious as they gain board seats and measures for maintenance and upgrades are defeated. This is not an exclusive observation, but it can become an observable distinction after a complex has more than 30% investors.

In conjunction with the developer and investor concern, a lender must determine if there is a concentration of unit ownership. This is readily available information from the association, which does monthly billing to unit owners for assessments due. Investors use their cash flow for other matters. Regardless of whether the units held in the subject complex represent a positive cash flow to the owner, the investor has motivation to divert those funds to troubled areas of his total portfolio. Concentrations of ownership in a complex may, therefore, disrupt the continuity of cash flow to the association.

Funding issues—income. On the income side, an issue that could disrupt the cash flow is the possibility of natural disasters. If wind, flood, or fire displaces a large part of the citizenry, they are individually going to be financially strapped until the complex is rebuilt. There is insurance available that maintains assessment income in such circumstances and most associations have it as a standard rider on their policy.

Lending to a small condominium complex presents another problem. If the association is only 10 units and two units are not paying at all or on time, the cash flow is significantly disrupted. It is possible that a strong economic shock to a local community could create cash flow problems, but this is a lesser concern. Remember that an empty unit once selling for $100,000 in a good economy that is now more marketable at $5,000 is still subject to the same $150 monthly assessment. At some market clearing price level, a prospective unit owner will step forward. Otherwise, cash flow continues even if the bank owns the unit or the FDIC takes over the bank.

A final issue that could disrupt the continuity of cash flow on the income side concerns pollution. Some condominiums are conversions from former manufacturing plants of some industry. There are cases in which the local government has threatened condemnation and evacuation unless remediation is immediately performed. This matter obviously also may affect the expense side of the association's cash flow. However, units being suddenly defined as inhabitable has a more definitive and rigorous impact. In the same vein, the lender must pay attention to the existence of underground storage tanks, the quality and source of the water supply, and the sewer waste disposal system.

WITH CONDOMINIUM ASSOCIATIONS, FIRST CAME THE LAW OF THEIR GOVERNANCE AND THEN THEIR INTANGIBLE EXISTENCE. THE QUALITY OF THE LOAN WILL NOT REST ON THE UNDERWRITING PERFORMED. IT MUST HAVE THE CERTAINTY OF WITHSTANDING COURTROOM CHALLENGE IN ORDER TO BE A FOREVER PERFORMING ASSET.

Funding issues—expense. The operating expense budget is a fairly consistent figure, excluding capital maintenance. The unit owner citizenry is typically active enough to be sure that funds are frugally administered. The motivations of ownership pride, property values and fairness generally cause the complex to have routine maintenance performed. Capital maintenance projects are those intermittent upgrade or replacement activities of the common elements. During the project period, the statement of income and expense may show a deficit. It is these during periods when reserves are drawn on that an association is self funding. This is the arena available for commercial lending.

The bank can provide funds for project-specific requests. The lender does not want to provide a revolving line of credit to an association. The nature of an association's existence does not suggest such a need unless a risk issue discussed earlier exacerbates a cash

flow problem or general mismanagement does not permit the annual budget to support the association's needs. In either case, these are reasons to stay clear. The association should be accumulating funds to self fund its capital improvements based on knowledge of the common element's life cycle.

For a whole host of reasons, this accumulation of funds may be insufficient. As an example, suppose the association makes a loan request. The following shopping list are those items needed to open all the windows to knowledge for ascertaining whether and how to provide financing. This material will assist in determining the stability of governance, the plans for continual maintenance and the stability of the cash flow.

1. The Association's CPA prepared *fiscal* year-end financial statements for the past three years.
2. a. A copy of the current fiscal year's budget with year to date actual results.
   b. A copy of the coming fiscal year's budget if it has been constructed and ratified (if applicable).
   c. Itemized current list of assessments receivables showing the obligor's name, unit number and amount due.
   d. Current list of accounts payable.
3. A copy of the By-Laws and Declarations.
4. A copy of any engineer's study on the common elements and resulting capital reserve plan.
5. A copy of the current table for per unit assessments, the percentage ownership of each unit and each unit owner's name with mailing address.
6. As of "to date":
   a. Number of foreclosures in process.
   b. Number of units delinquent on assessments and amount itemized by name.
   c. Number of units held by absentee owners.
   d. Number of units bank or government owned.
7. Describe the lawsuits brought by or brought against the association (excluding foreclosures).
8. Describe the complex: number of units, number of buildings, acreage, heating system (if oil, location of tanks).
9. a. Description of the project and how it is to be funded.
   b. Copy of the accepted contractor's bid (or proposal) and applicable engineer's report on the project.
10. Sales history: prices of units sold in 1998, currently and asking price of units for sale. Number of units for sale.
11. Copy of insurance information showing types of coverage and levels of coverage for buildings and personal property, general liability, umbrella coverage, Directors' & Officers', workers' compensation, and evidence of the manager's fidelity bond.
12. Copy of the past twelve months of Board meeting minutes.
13. Names, addresses and phone number of the current Association Board members. Plus, the length of time and number of terms that each has served.

This information is typically readily available because it essentially already exists as result of the association's self administration. With smaller complexes, reports indicated in item 4 may not be available. In addition to this information, the lender must obtain external information. This mini-municipality is subject to the governance of the host city or county. The lender should contact the local building inspector, zoning enforcement officer, and health department. A simple phone call will determine if the complex is subject to any action by the respective government. These concerns can affect cash flow.

The lender should visit the complex and take pictures. If this is not a complex that presents ownership pride, it will confirm the financial concerns noted in the material provided: high delinquencies, overactive mortgage foreclosures, inadequate reserve levels, and so forth. The local board of realtors may have a multiple listing service (MLS) that can be tapped for statistics. The MLS may provide an indication of the number of units for sale, units recently sold, and the monthly assessment of local competing condominium associations. While this is not a real estate-based loan, awareness of the market for these units, the price trends, and overall market may provide signals about the complex being considered. In particular, the comparative level of local market assessments may be an indicator of how high the subject association's assessment can be pushed to support the debt servicing requirement.

Stability of the community is important. The lender should determine whether the property management company, CPA, or attorney is often replaced. Information can be gained by reading the board minutes. The lender should find benign comments about shrubs, cats, and landscaper contracts. Unfortunately, there often are comments about efforts to oust the board, charges levied against the treasurer for misappro-

priated funds, and denial of unsupported insurance claims.

Insurance is an important aspect of financing risk. Since failure of a loan will likely be from the widespread disruption of the continuity of cash flow, it is most likely that a natural disaster is going to be the cause. Associations have a master policy that covers the entire complex. The lender needs to understand the policy and determine if it is satisfactory. It is inappropriate to attempt to be made a loss payee, and most insurance companies will not allow it. The lender does not need to be the additional payee on reimbursement checks for every claim that the association has—and there are many. The lender does need to know that the board has acquired a policy that provides adequate coverage for restoration of the complex, theft of assets, and continuity of the assessment income.

Loan Term and Structure

Structuring the loan is contradictory to much of the logical concepts for all other types of lending. It is appropriate to fund the entire cost of an individual project. The issue of having immediate equity into the asset funded does not exist. To fund 80% of a contractor's bulldozer purchase or 70% of an office building development causes the bank to have an immediate equity cushion in the event of default. The borrower having commitment to the project by injecting funds is not a pure concept with a condominium association. In practicality, with their monthly assessments, unit owners are always funding a reserve balance, the routine and capital maintenance of their complex.

Secondly, the unit owners' down payment when buying the unit creates commitment. The monthly assessment follows the unit and not the owner. Again, the lender should keep in mind that the obligated unit owner is the current owner, foreclosing bank or future unit owner. Having the unit owners provide a deposit into the project has merit, but the issues are different from funding acquisition or development of a directly owned tangible asset. The area of concern with this matter is whether there is broad-based support for the project and a majority vote supported it with the external funding. Satisfaction with the level of support will confirm the continuity of cash flow—the whole focus of concern.

The loan term should be as short as possible without overstressing the unit owner's ability to support the monthly assessment. In all likelihood, the debt service is going to result in an increase in the assessment level. The loan term should not match the life cycle of the common element upgrade being funded. The relationship of importance is not funding the common element but the effect on the association's cash flow over time. The common elements are in different stages of deterioration. Each will need to be addressed at individual points in time and overlapping of upgrades may cause cash flow strain. The lender must know the association's plan to maintain the common elements. Consider an example in which the lender is funding the roof replacement with a 10-year loan that increases the monthly assessments by 15% and places that assessment level a bit above average in the market. Within five years, the decks will need to be replaced and reserves are minimal. The central air conditioning system is currently on its last leg and windows will need to be replaced in seven years. The overlapping expense of these projects may strain the unit owner's abilities to support the necessary projects. It is conceptually best for all parties to make the loan for five years and increase the monthly assessments 30% for debt servicing support. It is even more prudent to apply a loan covenant that requires some degree of positive net increase in reserves for the life of the loan. If an untimely and significant expense (a common occurrence) develops, access to reserves protects the bank's debt servicing need. The lender is forcing the board's good management.

A typical loan structure would be a nonrevolving credit line during the construction period with a rate floating at some spread over prime. At the end of the construction period, the loan would set to amortize with a level P&I payment. This is a better payment plan for the association that operates on the basis of a fixed annual budget. The rate should be fixed for some time increments during the term, such as every 30 months of a 60-month loan. Again, this is a budgeting need of associations. Funding fees are a typical pricing mechanism. Prepayment penalties cannot exist in these loans. By virtue of the buying and selling of units with in the complex, it is routine that the association is presented with the outstanding balance of a unit's pro rata share of the special assessment levied for the project. The association is then motivated to apply this prepayment to the loan balance.

The collateral is the assignment of the association's assessment rights or to all future income. There is a recent

legal perspective that the assignment should be an "absolute assignment." This method effectively has the bank holding the assessment right in trust for the association. The benefit to the bank may be that in a bankruptcy filing the assessment right is no longer an association asset and subject to control of the bankruptcy court. In the event of a default, do not operate on the basis of obtaining a lump sum reimbursement. This is a cash flow entity without an asset basis. Therefore, the lender is looking for reinstatement of timely loan payments. The court is likely to determine a portion of the monthly common charges must go to the operation of the complex for basic operational needs: lawn mowing, insurance payments, utility expenses, etc. It is not practical to encumber the association's reserve accounts for collateral support. These funds are needed by the complex for unanticipated and expected needs. Personal guarantees are not available since the officers are a volunteer group in office at the moment with no economic interest in the complex other than their individual unit. There is some interest in placing a lien on the common elements. However, this is basically an ineffective repayment source. Foreclosure of hallways, elevator shafts and parking lots may leave the lender with more liability than benefit.

A significant point of concern is the increased assessment level. The association has been operating at a certain budgeted level. The project may allow for some routine expense to drop from the budget, but the net effect is likely to be an increase. There is no rule of thumb for the appropriate assessment level or maximum palatable increase. It is a judgment supported by conditions of the local market, demographics of that community, and good sense.

An association's balance sheet has minimal assets. Consequently, the loan provided will put the association into an immediate negative net worth position. The renovations funded are not capitalized, so there is no offsetting asset. This is a topical matter of the American Institute of Certified Public Accountants more than it is a practical concern. Once again, the issue of concern is the quality of the continuity of cash flow now and in the future versus a statement of position. Proper underwriting concentrates on who the unit owners are—investors versus homeowners, ownership concentration, the trend of foreclosure activity, the delinquency of assessments, and the policy for handling delinquency. The receivable balance detail needs to be reviewed closely. There may be a small number of units that owe the association a large amount because of complex foreclosure issues. This condition is of less concern than a large portion of unit owners being 30 and 60 days late. It is more important to be concerned with the number of units routinely delinquent than the total amount of receivable dollars outstanding at different points in time.

Financing commercial condominiums has the same range of underwriting issues. However, they have a couple added dimensions of risk. The units are not as ordinary as residential units and their vacancy may have a greater impact on the association's continuity of cash flow. The owners of the business operating in the unit have more interest in that business than the association. Consequently, even though literally an owner occupant, the owner has similar motivations as the residential investor owner. Prudence may suggest some underwriting of unit owners and even the extreme step of having them as co-borrowers with the association.

Summary

Servicing the condominium association industry should be an area actively pursued. The industry offers a uniquely safe environment for lending based on its performance and the conservative motivations it operates upon. The mix of deposit potential, cross selling and lending opportunities offer a profitable market. ❐

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