FHA Issues Revised Guidance in Condominium Loan Approvals

On Friday, November 6, 2009, the Federal Housing Administration (FHA) issued two documents related to FHA mortgage insurance requirements for condominium associations. These two documents: HUD Mortgagee Letter 2009-46A and Mortgagee Letter 2009-46B provide an overview of the FHA-proposed transitional criteria and successor criteria for condominium association requirements for FHA mortgage insurance.

These letters replace earlier proposals issued by FHA that triggered a strong response from affected industries. CAI provided FHA with its feedback on the earlier drafts of the criteria. The new transitional criteria and the successor criteria found in these documents demonstrate a positive movement by FHA in areas in which CAI provided comments, but will continue to pose a challenge for condominium associations.

One Step Forward, but More Issues to Address:

In response to the condominium regulations initially proposed by FHA, the flexibility and revisions found in the temporary guidance should be seen as a positive step in our efforts to help shape FHA's current and future direction. We can accomplish this by providing expertise from CAI homeowner volunteers, managers, management companies, and business partners. In our letter to FHA on October 23, 2009, CAI provided an outline of concerns and recommendations in the following areas:

- Presale requirements
- Developer turnover
- Certificates of occupancy
- Reserve study requirements
- FHA concentration limits
- Commercial area percentages
- A 15 percent, 30-day delinquency rate for assessments
- Project recertification

CAI also encouraged the FHA to consider delaying the implementation of any new requirements by at least 120 days to allow for further dialogue. In the final analysis, FHA moved in a positive direction on our expressed concerns related to presales, reserve studies, concentration limits, and a more gradual approach to migrating to a new regulatory regime. This positive development is balanced against the larger concerns related to delinquencies, commercial area, and accurate data collection to meet these new requirements. CAI plans to continue our dialogue with CAI members and with FHA on both the temporary guidelines and the successor guidelines.

This document is an analysis of both the temporary guidance and the successor guidance. For an analysis of what this means for your condominium association, please see FHA Condo FAQ.

Temporary Guidance for Condominium Policy:

FHA will continue the existing spot loan approval process through February 1, 2010. The Temporary guidance is effective for all FHA case number assignments between December 7, 2009, and December 31, 2010. The FHA is implementing this transition approach to address the challenging market conditions.

Eligible Projects - Eligible projects are declared condominium projects that exist in full compliance with appropriate state law. Condominium hotels, timeshares, houseboat projects, multi-dwelling unit condominiums, and projects not deemed to be residential are not eligible for FHA insurance under the current regulations.

Spot Approvals - Under the Temporary Guidance, the FHA Spot Approval process will continue through February 1, 2010, rather than ending on November 2, 2009, as originally proposed.

Approval Process - Under the regulations found in the Mortgagee Letter 2000-46, FHA would eliminate the current spot approval process on February 1, 2010, and require all condominium approval projects to be approved through either a HUD Review and Approval Process (HRAP) or the Direct Endorsement Lender Review and Approval Process (DELRAP). The approval process will be applicable to condominium projects that are proposed, under construction, or currently in place. It will also apply to conversion projects.

General Requirements

Site condominiums: A Site Condominium is a totally detached condominium with no shared structural elements. Site condominiums do not require approval under the condominium project approval process. Modular homes will also be treated as site condominiums for approval purposes. Manufactured Housing Condominium Projects (MHCP) are not considered site condominiums and must be approved under the HRAP process.

Environmental Requirements

Environmental reviews are not required by lenders who use the HRAP process when:

- The condominium plat has been approved, phases delineated, and has been recorded

- The construction of the projects major infrastructure, facilities, and buildings has progressed to a point that precludes any major changes.

Environmental reviews will not be required for DELRAP approvals unless an appraiser identifies an environmental condition, or the developer is aware of an existing condition through remarks provided in the HUD Builder's Certification Form, the appraisal, or other known documentation. If so, a lender must determine that certain conditions (enumerated in Section IV of the Mortgagee Letter) are met.

Eligibility Requirements - All condominium project approvals must meet the following requirements:

- Projects must consist of two or more units.
- Projects must be covered by hazard and liability insurance and flood and fidelity insurance where applicable.
- Right of first refusal is permitted, provided it does not violate the Fair Housing Act regulations found in 24 CFR Part 100.
- No more than 25 percent of the total floor area can be used for commercial purposes. The commercial portion must also be of a "nature that is homogenous with residential use."
- No more than 10 percent of the units may be owned by one investor. This limitation also applies to developers/builders that subsequently rent out vacant and unsold units. For projects with 10 or fewer units, no single entity can own more than one unit.
- Delinquent Homeowners Association Dues [Assessments]: No more than 15 percent of the total units can be in arrears (more than 30 days past due) of their condominium association fee payments.
- At least 30 percent of the total units must be sold prior to endorsement of a mortgage in on any unit. After December 31, 2010, the pre-sale requirement will increase to 50 percent. *(See Presale section below)*
- At least 50 percent of the units of a project must be owner-occupied or sold to owners who intend to occupy the units. For proposed, under construction or projects in their initial marketing phase, FHA will allow a minimum owner occupancy amount equal to 50 percent of the number of presold units. *(Through December 31, 2010, or otherwise provided by FHA, bank-owned properties, vacant, or tenant-occupied real estate-owned properties are excluded from this calculation.)*

Pre-Sales - FHA has added flexibility to the pre-sale requirement, requiring 30 percent presales for the duration of the temporary guidance period. The FHA will require presale documentation that includes:

- Copies of the sales agreements and evidence of a lender willingness to issue a loan.
- Evidence that units have closed or are occupied.
- Information from a developer that lists all of the units already sold, under contract, or closed that is accompanied by a signed certification from the developer.
- The presale requirement will increase to 50 percent at the end of the temporary period December 31, 2010.

Legal Phasing

FHA will permit legal phasing for condominium processing. FHA will not accept market phasing in lieu of legal phasing.

<u>Phasing in Vertical Buildings</u>:

- Floors may be phased in groups of no less than five floors.
- Temporary certificate of occupancy has been obtained (at minimum) and all common areas and amenities have been completed.
- A third-party completion bond has been obtained.
- Calculating Owner Occupancy and FHA Concentrations in Phased Developments.

<u>Multi-phased developments</u>:

- Owner-occupancy percentage is calculated on the first declared phase and cumulatively on subsequent phases if ownership of the condominium project is the same.
- If multi-phasing includes separate owners per each phase, each phase is calculated individually.
- In single-phase condominium project approval request, all units are used in the denominator when calculating the 50 percent owner-occupancy percentage.

Concentration Limits (**Temporary) -** During the transition period of December 7, 2009, to December 31, 2010, FHA will increase its temporary concentration limits (the percentage of units that it will insure in a project) to 50 percent.

FHA will also consider increasing concentrations up to 100 percent if a condominium project meets additional criteria that include:

- The project is 100 percent complete and construction has been completed for at least one year.
- 100 percent of the units have been sold and no entity owns more than 10 percent of the units in the project.
- The projects budget provides for the funding of replacement reserves for capital expenditures and deferred maintenance in an account representing at least 10 percent for the budget.
- Control of the association has been transferred to the owners.
- The owner-occupancy ratio is at least 50 percent. *(Bank-owned properties, vacant, or tenant-occupied real estate-owned properties are excluded from this calculation.)*

Concentration Limits (**Successor)** – Beginning on January 1, 2011, or earlier by FHA action, FHA concentrations will revert to the following:

- In projects of 3 or fewer units, FHA will insure no more than 1 unit.

- In projects consisting of 4 or more units, FHA will have no more than 30 percent of the total units encumbered with FHA insurance.

- Calculating the level of FHA concentration in a project declared with legal phases will follow the same methodology as the owner-occupancy requirements.

Budget Review - Mortgagees must review all homeowner's association budgets (actual budgets for existing projects and projected budgets for new projects) for all project approvals.

The review must determine that the budget is adequate and:

- Includes allocations/line items to ensure sufficient funding for upkeep of amenities and features unique to the project.

- Provides for the funding of replacement reserves for capital expenditures and deferred maintenance amounting to at least 10 percent of the budget.

- Provides adequate funding for insurance coverage and deductibles (as required under the insurance requirements section).

If the documents do not meet these standards, the mortgagee may request a reserve study to assess the stability of the project. The reserve study cannot be more than 12 months old. In reviewing the reserve study, consideration must be given to items that have been replaced after the time that the reserve study was completed.

Insurance Requirements- Condominium projects must be covered by hazard, flood, liability, and other insurance as required by state or local laws, or acceptable to FHA under the following criteria:

- Hazard Insurance: The Condo Association is required to maintain a master or blanket property insurance equal to 100 percent of current replacement costs exclusive of land, foundation, excavation, or other normal exclusions. If the association does not maintain 100 percent coverage, unit owner gap coverage does not satisfy meeting this requirement.

- HO-6 Coverage: In cases in which the master policy does not include interior unit coverage, the borrower must obtain a "walls in" coverage policy (H0-6).

- Liability Insurance: The association is required to maintain comprehensive general liability insurance covering all common elements, commercial space owned and leased by the owner's association, and public ways of the condominium project.

- Fidelity Bond/Fidelity Insurance: New or established projects with more than 20 units are required to carry fidelity bonds/insurance for all officers, directors, and employees of the association, and all other persons handling or responsible for funds administered by the association in an amount equal to three months aggregate assessments on all units plus reserve funds.

- Flood Insurance: Insurance coverage equal to the replacement cost of the project less land costs or up to the National Flood Insurance Program standard of $250,000 per unit, whichever is less. If insuring a residential building, the maximum building coverage is $250,000 times the number of units in the building. The association, not the borrower, is responsible for maintaining adequate flood insurance under the NFIP when the building is located in a Special Flood Hazard Area.

- Determining Need for Flood Insurance: If the property is located in a 100-year flood plain, flood insurance is required. If the project is not located in a 100-year flood plain, it is not subject to the flood insurance requirement if documentation is provided (documentation that includes either a final Letter of Map Amendment or a final Letter of Map Revision).

Condominium Conversions – Condominium conversions are defined as projects that involve changing the title of an existing structure (usually under one title) to property that is separated into units that may be held individually. Under the new regulations:

- The one-year waiting period required for conversions is eliminated.

- For FHA-insured mortgages on a unit and an undivided interest in common elements on a project undergoing remodeling or rehabilitation, the entire project must be 100 percent built before a mortgage may be endorsed. Weather delays to completion of common elements may allow for escrow.

- Conversions or non-residential property or rental properties will be treated as new construction.

New Construction Pre-Approval Process and Inspection Requirements

Processing for new condominiums is now permitted, consistent with the process found in Mortgagee Letter 2001-27.

In cases in which a local jurisdiction issues a building permit or certificate of occupancy and performs a minimum of three inspections, FHA will not require an Early Start Letter or a HUD approved 10-year warranty plan.

For jurisdictions that do not issue a building permit prior to construction and a certificate of occupancy upon completion of construction, a condominium that is one year old or less must have either an Early Start Letter or be covered by a HUD-approved 10-year warranty plan to be eligible for high-ratio mortgage insurance.

FHA will require retention of the following documents for new construction approvals:

- Builder's Certification of Plans, Specifications and Site, Form HUD-92541

- Builder's Warranty, form HUD-92544

- Building Permit (or its equivalent)

- Final Certificate of Occupancy (or its Equivalent)

  <u>Temporary/Conditional Certificates of Occupancy:</u> FHA will accept temporary or conditional certificates of occupancy for new or converted projects when:

  - All common areas and amenities are completed.

  - The certificate of occupancy clearly indicates the unit is habitable and eligible for occupancy.

  - The jurisdiction issuing the temporary/conditional certificate has in place a standard protocol for the issuance of permanent certificates.

Recertification of Project Approvals

Projects that received FHA approval prior to October 1, 2008, will be required to recertify on or before December 7, 2009.

Projects approved between October 1, 2008, and December 7, 2009, will follow the recertification requirements defined as:

> Recertification: Condominium projects will expire within two years from the date of placement on the list of approved condominiums. Further participation in the program after this two-year period has expired will require recertification to determine that the project is still in compliance with the HUD's Owner-Occupancy requirement, and that no conditions currently exist that would present an unacceptable risk to FHA. Items that must be given consideration are:

- Pending special assessments
- Pending legal action against the condominium association or its officers or directors
- Adequate hazard, liability insurance, and when applicable, flood insurance coverage

Next Steps

CAI will keep you updated in the coming weeks as additional information becomes available. Updates will be posted to the "Heads-Up" page on CAI's Web site. CAI members with questions should call Andrew Fortin, Vice President of Government and Public Affairs, at 703-548-8600, or by e-mail at g&pa@caionline.org, with the subject line "FHA Condo Regs."

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