

New York Law Journal

Real Estate Law & Practice

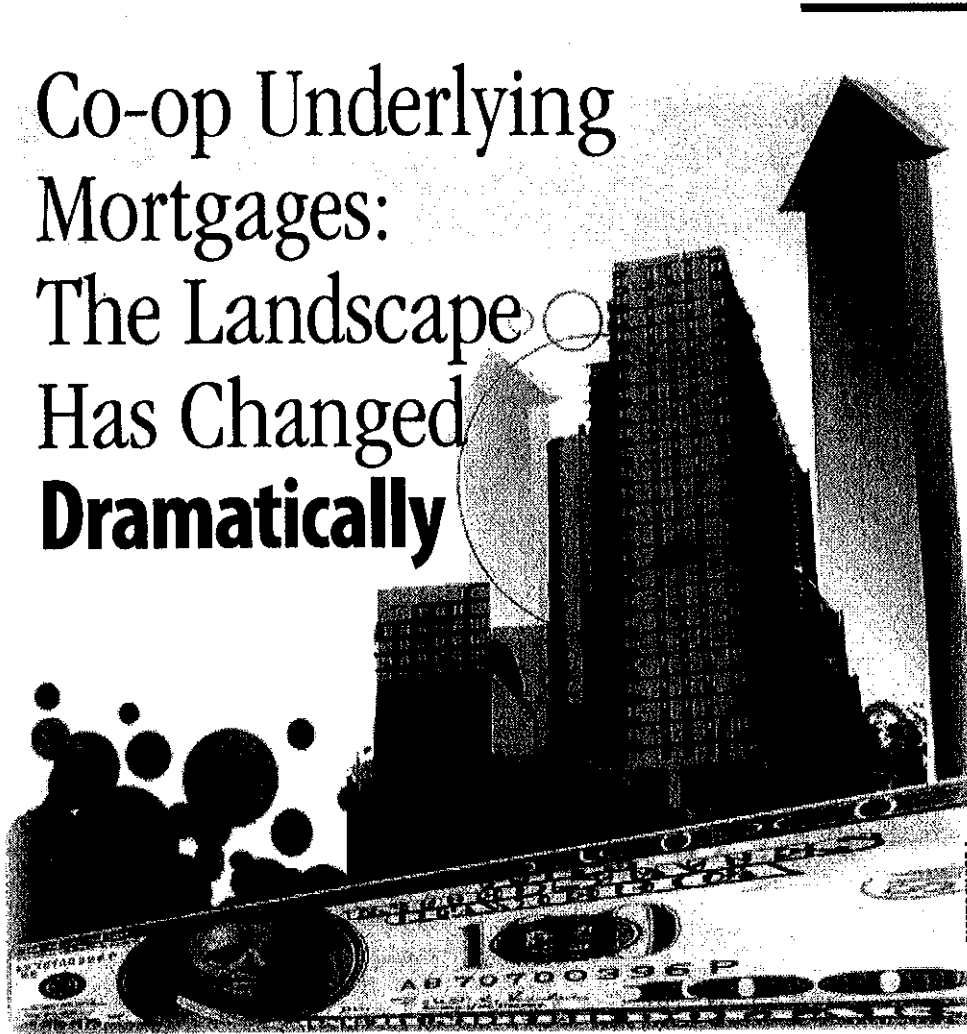
WWW.NYLJ.COM

An ALM Publication

©2010 ALM

MONDAY, MARCH 15, 2010

Co-op Underlying Mortgages: The Landscape Has Changed Dramatically



Therefore, on the maturity date, there is a large balloon payment which must be made. Thus, most cooperatives find themselves stuck on the refinancing carousel, always having to refinance, and never paying off the mortgage. In fact, the new mortgage is typically larger, as the co-op often uses the proceeds not only to pay off the old loan, but also to pay for closing costs, and future capital improvements.

The alternative to a newer (and often larger) mortgage? Pay off the entire loan by assessing the shareholders. But this is rarely ever done, as this would truly be a financial catastrophe for the average co-op shareholder.

Just how large the problem is can be appreciated by reviewing a few numbers.

In the five counties of New York City alone, there are approximately 5,700 cooperatives (consisting of approximately half a million apartments), and of these, approximately 95 percent of all cooperatives have an underlying loan. The amount of underlying debt per apartment varies wildly, with some co-ops having but a few thousand dollars per apartment, to a number that have \$40,000 to \$50,000 of debt per apartment. Therefore, the amount of underlying co-op loans in New York City is probably in excess of \$6 billion.

The Way It Used to Be

In the "good old days" (i.e., before our current crisis), a co-op had various sources of money when it was time to refinance its underlying mortgage (i.e., when its balloon mortgage came due).

One source was always the normal, down the block bank. Bank of New York and Dime Savings, to name a few, always seemed to be in the mix.

There were special situations, depending on the circumstances, when other lenders might be available, such as The Community Preservation Corporation (CPC), a national organization sponsored by 70 prominent banks and insurance companies to encourage and assist affordable housing. Then, of course, there was National Cooperative Bank (NCB).

NCB is a federally chartered savings bank that originates a substantial number of loans for housing cooperatives nationwide. In 2009, NCB reported that it had made \$341 million of co-op underlying loans in New York.

The great advantage to an NCB loan was that under normal circumstances, it would be exempt

BY CHRISTIAN DAGLIERI
AND ANDREW P. BRUCKER

THE FINANCIAL CRISIS in which the United States now finds itself has had many far-reaching ramifications. Besides the loss of jobs throughout America, the retirement funds and personal investment portfolios of nearly every single American have taken a devastating hit. Another result of this crisis is that the credit market has changed drastically.

With fewer and fewer people buying and selling properties, especially their homes, one might believe that lenders would be clamoring for a borrower's business. This, naturally, should result in lower rates and an easier process (as the lenders compete for the business).

While rates are certainly low at the present time, lenders are more careful, the process has gotten more complicated and cumbersome, and loans are sometimes just impossible to obtain. This is most evident in the field of cooperative housing, where a cooperative corporation's underlying loan typically matures in seven to 10 years (although debt service is based upon a longer amortization table, usually 30 years).¹

CHRISTIAN DAGLIERI is an associate, and ANDREW P. BRUCKER is a founding partner, with Schechter & Brucker.

from New York City's mortgage recording tax (which is typically 2.8 percent of the mortgage). Often, though NCB's rate might have been a little higher, co-op boards chose it for this upfront, immediate benefit, and thus NCB was a very popular choice of co-ops looking to refinance.

Prior to our current crisis, regardless of which bank or any lending institution made the loan, the loan may have been kept in the lender's own portfolio of loans, sold to Fannie Mae or Freddie Mac, or sold to Wall Street (the so-called "securitized loans" we heard so much about). Packaging loans on Wall Street and selling pieces to investors was at one time quite popular.

The cooperative corporation borrowing money, however, did not care what happened to the loan. Where the mortgage ended up was of little concern to the co-op corporation, as long as it got its money.

And Then Things Changed

Then, suddenly, in what seemed to be but a few months, the co-op mortgage landscape changed.

With the financial crisis hitting, and banks either in trouble or so cautious that they were almost frozen in their ability to process and make loans, there was a big shift in co-op lending. Suddenly, there seemed to be only one type of lender: those lending institutions that made mortgage loans and then immediately sold the paper to Freddie and Fannie.

Certainly there were other lenders, but the alternative was a loan that was substantially higher in rate. The banks, on their loans, raised rates based upon perceived risk, uncertainty in the market, etc.

Fannie and Freddie, on the other hand, were created for a higher social purpose by the federal government (to assist homeowners), and therefore kept rates much lower. Since the loans were assigned to Fannie Mae and Freddie Mac, those lenders that worked with Fannie Mae and Freddie Mac were not at risk, since after a week it was no longer the lenders' loan.

Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are leaders in the lending industry by owning or guaranteeing approximately half of the U.S. \$12 trillion mortgage market.

Fannie and Freddie are government-sponsored enterprises that are chartered by Congress with a mission to provide liquidity, stability and affordability to the U.S. housing and mortgage markets. They are leaders in the secondary

mortgage market, as many lenders rely on Fannie Mae (or Freddie Mac) to purchase the loans they originate in order to make new loans.

But not every lender can sell its mortgages to Fannie or Freddie. The lender must first apply, and must qualify as a so-called "DUS lender" (Delegated Underwriting and Servicing). Once the lender has established its relationship, it also must adhere to requirements Fannie Mae (or Freddie Mac, depending on which one the lender has the relationship with) has issued for loans it will purchase, or risk that an originated loan will be rejected for purchase.²

These requirements are in turn passed on to the individual borrowers and their team of professionals.

The years of local banks giving, and then holding onto, mortgages to cooperatives seem to be gone. Today, Freddie Mac and Fannie Mae are an indispensable partner to banks, and with that, Fannie and Freddie seem to be making the rules.

With respect to cooperative corporation loans, Freddie Mac requirements seem relatively simple, but that is only due to the fact that Freddie Mac relies heavily on its multifamily rules.³ Fannie Mae has many more (and stricter) requirements specifically for underlying mortgages (in addition to its multi-family rules) for what it deems to be an acceptable loan for purchase.

The landscape of the world of co-op borrowing has changed dramatically as Freddie and Fannie have essentially become the preferred lender for co-op underlying loans (based on their lower rates).⁴ This situation now obviously exists due to the bad loans that were made by lenders all over the country.

The cautious rules and requirements, always a trademark of Freddie and Fannie, were created to protect themselves from defaults. But even these cautious rules are changing, due to the increasing fear of defaults. The following is a brief summary of some of the current requirements and some of the recent changes in regard to Fannie Mae loans.

Changes in 'DUS' Guide

In 2009 Fannie Mae updated its DUS Guide⁵ (Guide) for acceptable loans on cooperative

properties for the first time in nearly 10 years.

One notable change to the Guide affects the Fannie Mae requirement regarding potential maintenance fee increases. Under the prior Guide, if a loan would potentially result in an increase to the tenant-shareholders of 8 percent of their maintenance fee, the transaction would be deemed unacceptable to Fannie Mae, as determined on a case-by-case basis.⁶ The update to the Guide has removed the phrase "case-by-case basis," thereby removing Fannie Mae's discretion and creating an absolute rule.

Similarly, under the old Guide, Fannie Mae required lenders to review and analyze any investor⁷ owning 10 percent or more of the units in the building. Fannie Mae could consider waiving this requirement on a case-by-case basis, which discretion was removed in the new Guide.

Fannie Mae's removal of the ability of the borrower to request a waiver of the requirement of furnishing these financial statements may be a result of the worsening economic conditions. Any investor having a significant presence in the building is a potential risk to the corporation, and a default in the investor's obligations to the corporation may result in a default and subsequent foreclosure of the loan should the other owners (i.e., the resident shareholders) be unable to support the debt service.

Fannie Mae requires a potential cooperative corporation borrower to have a sound fiscal history: good credit history and no history of delinquent payments. Although there is no definition or even guidance as to what the word "good" means in this context, the prior Guide requirement noted a minimum number of documents necessary to complete this review.⁸

The new Guide, however, has eliminated the list of minimum required documents and leaves the analysis to the lender. Now that the burden of determining risk has been shifted to the DUS lenders, they are being more careful than previously. This, in turn, results in the lender putting an onerous burden on the borrower to provide additional financial information to ensure its analysis will be deemed acceptable by Fannie Mae.

Since its loans are non-recourse to borrower, Fannie Mae must be assured that the collateral for its mortgage is well maintained and not neglected, and continues to produce sufficient income. Fannie Mae or any lender would consider a borrower with a good credit score and no negative payment history a responsible borrower who would most likely maintain the building.

Ownership Requirements

Additionally, Fannie Mae has streamlined its ownership requirements.

Previously a loan with a loan to value ratio (LTV) of 65 percent or less would have required that tenant-shareholders (as opposed to sponsors or investors) own a minimum of 60 percent of all units in the cooperative.

A possible loan with an LTV of more than 65 percent, but not more than 80 percent, would have required that a minimum of 90 percent of all units in the cooperative be owned by tenant-shareholders.

Fannie Mae has since revised this language to indicate that prior approval is required in the event that a "sponsor" owns more than 40 percent of the units, regardless of the size of the loan. It is interesting to note that the language has been changed to reflect sponsor ownership instead of tenant-shareholder units.

Although a subtle change, it may reflect a possible concern Fannie Mae has with buildings that have a large sponsor presence. Fannie Mae may want its lenders to closely scrutinize such buildings and encourage more loans to buildings where the sponsor has sold more units.

If, for example, the sponsor has financial issues and owns a significant portion of the shares, the sponsor's financial troubles could result in a refusal to make maintenance payments, and this in turn could have a devastating effect on the cooperative corporation.

Another Notable Change

Another notable change to the Guide is the requirement that lenders submit specific information in a memo to Fannie Mae regarding the transaction's approval.

The lender must obtain a one-year history of unit sales prices in the cooperative by unit type, review historical operating reserve and maintenance charge arrears and also obtain maintenance charge comparables. The lender must then conclude whether or not the cooperative is operating within typical market ranges.

Although an obvious burden to the lenders, it is also a potential significant burden to the borrowers, the managing agents, brokers and attorneys, resulting in the due diligence period taking much longer than it once did. The borrowers must compile all of this information for the lender without knowing if the loan has even been approved.

There is little doubt that there have been major changes in the world of underlying mortgages. The

years of local banks giving, and then holding onto, mortgages to cooperatives seem to be gone.

Today, Freddie Mac and Fannie Mae are an indispensable partner to banks, and with that, Fannie and Freddie seem to be making the rules. However of late, Fannie Mae and Freddie Mac seem to have changed their philosophy in buying the loans from participating banks. Rather than checklists and specific requirements, it seems as if they have put the onus on the lenders to do their best in order to assure the creditworthiness of the borrowers.

Each lender, in turn, is working harder than ever to assure itself that the loans are safe and the cooperative corporation (i.e., the borrower) is credit worthy. The reason is that the DUS lender, under certain circumstances, may be required to repurchase the loan from Fannie Mae. The DUS Guide provides that not only will the repurchase require that the lender pay to Fannie Mae the balance of the loan, but will also have to pay a prepayment penalty when it repurchases the loan.

The result of all this to cooperatives is that as long as Freddie Mac and Fannie Mae are heavily involved, interest rates will hopefully continue to be low (as Freddie and Fannie continue to fulfill the federal government's desire to help homeowners).

It also means that cooperative borrows must be flexible, as requirements may change not only from DUS lender to DUS lender, but may also change as the market changes and the federal government, Fannie Mae and Freddie Mac monitor the country's financial health.

.....●.....

1. The alternative to a balloon amortizing loan is either an interest only loan, or a fully amortizing loan (i.e., a loan that is fully paid off, including interest, when the term of the loan expires). Most underlying mortgages are neither of these types of loans.

2. There are 26 Freddie lenders and 26 Fannie lenders. Of these, only seven have both licenses.

3. A cooperative loan must comply with its standard multifamily mortgage eligibility requirements in addition to: (a) the proprietary lease stipulating that it is subordinate to the underlying mortgage, (b) no restrictions on the rights of the lender being contained in the cooperative corporation's constituent documents, (c) sales of shares complying with federal and state laws, and (d) the corporation having the power to act against a shareholder for nonpayment of maintenance charges.

4. Even NCB has now begun to sell its mortgages to Fannie Mae. So rather than being an alternative, NCB has joined the other DUS lenders.

5. The Fannie Mae DUS Guide is the Fannie Mae Multifamily Delegated Underwriting and Servicing Guide. This Guide provides lenders intending to sell their loans to Fannie Mae with underwriting and performance requirements for the property, borrower and loan in order for Fannie Mae to consider purchasing the loan.

6. The potential loan would still need to meet all other requirements of the Guide.

7. Fannie Mae does not distinguish, and in fact includes, the cooperative's developer/sponsor as an investor to be reviewed.

8. Minimum required documents included credit reports, two years of federal income tax returns, verification of significant deposits and noncash assets, verification of bank and trade references, and the cooperative corporation's loan payment record for the prior two years.