

**FHA Project Approval Update:
The Pros, the Cons and the Current Requirements**

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As we move into the last quarter of 2011, the housing market remains depressed and industry experts warn of yet another wave of mortgage foreclosures. Times are tough and both sellers and buyers are looking for the best means to complete the purchase transaction. Associations are concerned that unit sales at low “desperation” pricing will depress market values for the entire condominium.

Some industry professionals believe that FHA (that is, Federal Housing Administration) insured financing is now involved in about 30 to 40 percent of financed residential home purchases. The impact of lenders’ stricter requirements to qualify for conventional mortgages cannot be ignored. It is simply more difficult to obtain a conventional (20% down) mortgage in the current lending market. In turn, a greater number of people are without financing and unable to purchase, thereby reducing the pool of prospective buyers; indeed, proponents of condominium FHA certification claim that not having your condominium project approved for FHA insured financing reduces the potential pool of buyers by approximately 30 to 40 percent, which is significant in today’s market. In any event, condominium association boards of managers/directors are increasingly faced with the decision of whether to seek FHA project approval for their association.

Pros and Cons

Historically, FHA insured financing has been saddled with a negative image, and has even been associated with “Section 8” low income housing. The concern has been that buyers purchasing with FHA insured financing have lower credit scores, make a smaller down payment (which could be gift money), may not have any of their own money invested in the property, and do not have the means to meet the continued (and possibly increasing) financial burden of property ownership. As it relates to condominiums, the fear is that owners who purchased with FHA insured financing will not be able to pay their assessments, thereby adversely impacting the financial stability of the community and placing additional financial burden on other owners. There has also been concern that condominium units secured by FHA insured mortgages will adversely affect the fair market value of all units within the building, and possibly within the neighborhood (i.e. comparable properties).

On the other hand, proponents contend that the negative stigma on FHA insured financing is antiquated and possibly even unlawfully discriminatory under federal and state fair housing laws. In fact, along with the general lending industry, the U.S. Department of Housing and Urban Development (“HUD”) has tightened up its requirements to qualify for FHA insured financing. Although FHA insured financing does allow for a smaller down payment, the purchasers must still meet other qualifying requirements to ensure that they can afford the purchased property.

Therefore, the fear that buyers purchasing with FHA insured financing will not be able to meet their financial obligations is arguably unfounded.

Proponents also contend that FHA project approval will have a positive impact on fair market values. A larger pool of prospective buyers means a potentially greater demand for a given property. A greater demand means greater competition. Greater competition leads to an increase in the purchase prices for which properties are sold, due to purchasers trying to out-bid each other. As a result, the fair market value rises generally. Thus, according to its proponents, FHA certification is a key to a larger pool of prospective buyers and higher unit values.

Some condominium projects may not be eligible for FHA project approval for a variety of reasons. In this situation, it does not matter whether the association's board or the unit owners in general desire to pursue FHA project approval. If the association realistically cannot obtain project approval, then it does not make sense for the association to incur the time and expense associated with the approval process.

Current Requirement Highlights

On June 30, 2011, HUD issued new, more comprehensive guidelines for the FHA condominium project approval process in the Condominium Project Approval and Processing Guide (the "Guide"). While the eligibility requirements issued in 2009 largely remain in place, the most significant changes relate to additional required information and documentation and the allowing for some discretion on the part of HUD for some requirements.

As a reminder, the FHA does not lend or provide financing to purchasers directly; rather, the FHA insures or guarantees mortgage loans obtained through private banks and lending institutions. Such mortgages are commonly referred to as "FHA insured mortgages" or "FHA insured financing." With regard to condominiums, "FHA approval" or "FHA certification" means that the FHA has determined that a given condominium project meets certain requirements so that individual units within that project are eligible for FHA insured financing.

HUD Review and Approval Process ("HRAP") and Direct Endorsement Lender Review and Approval Process ("DELRAP") are currently the only two methods for condominiums to obtain project approval. "Spot loans" (meaning only one unit, as opposed to the entire condominium project, being approved) are not available. The DELRAP process is done only through qualified lenders; whereas, the HRAP process allows the condominium to apply directly to HUD.

FHA condominium project approval applies only to condominiums, not to non-condominium common interest community associations or cooperatives. The condominium project, provided it has been declared a condominium, can be detached, semi-detached, a row house, a walk-up, mid-rise, or high-rise.

The Guide sets forth requirements for different eligible construction types, including proposed or under construction, existing less than 12 months, existing more than 12 months, and condominium conversions. This article will focus on and highlight the more significant

requirements applicable to existing projects that are more than 12 months old and under the HRAP process.

Generally, HUD focuses on the association's financial stability. Among other things, the association must submit information and documentation pertaining to the budget, reserves, unit owner delinquencies, special assessments, and pending litigation. HUD is looking for any indication of adverse impact on the association's financial health. HUD also has requirements for hazard, liability, flood, fidelity, and other insurance coverage.

The following is an overview of HUD's general requirements:

- Copies of the recorded condominium documents are required to be submitted to HUD, including but not limited to declaration, bylaws, plat of survey, and all amendments. Articles of incorporation must also be provided.
- The condominium instruments, as well as any other legal instrument, cannot place "legal restrictions on conveyance", as stated in 24 CFR 203.41 (including a lease). "Legal restrictions on conveyance" is broadly defined to include provisions that would cause a conveyance to:
 - Be void or voidable by a third party;
 - Be the basis of contractual liability of the borrower;
 - Terminate, or subject to termination, the borrower's interest in the property;
 - Be subject to the consent of a third party;
 - Be subject to limits on the amount of sales proceeds a borrower can retain;
 - Be grounds for accelerating the insured mortgage;
 - Be grounds for increasing the interest rate of the insured mortgage.
- The condominium instruments may contain leasing restrictions, provided such restrictions meet one or more of the following criteria:
 - All leases must be in writing and subject to the declaration and by-laws of the condominium project;
 - The condominium association may request and receive a copy of the sublease or rental agreement;
 - The condominium association may request the names(s) of all tenants including the tenants' family members who will occupy the unit;
 - Unit owners are prohibited from leasing their units for an initial term of less than 30 days;
 - The condominium association may establish a maximum allowable lease term, e.g. six months, twelve months, etc.
 - The condominium association may establish a maximum number of rental units within the project; however, the percentage of rental units may not exceed the current FHA condominium project owner-occupancy requirement (which is 50%);
 - The condominium association may not require that a prospective tenant be approved by the condominium association and/or its agent(s), including but not limited to meeting creditworthiness standards.

- The condominium instruments may contain right of first refusal provisions, provided that such provisions do not violate discriminatory conduct prohibitions under the Fair Housing Act regulations.
- The commercial/non-residential space located in a project cannot be more than 25% of the property's total floor area (including commercial/non-residential space located within the building, but not considered a unit in the association). Such space must be "homogenous" (which term HUD does not expressly define, but likely means "compatible") with residential use and cannot have any adverse conditions to the occupants of the residential space.
- Not more than 10 percent of the total number of units may be owned by one investor/entity.
- At least 50% of the total number of units must be owner-occupied.
- Not more than 50% of the total number of units can be secured by FHA-insured mortgages.
- Not more than 15% of the total units can be more than 30 days delinquent in payment of assessments (late fees and other administrative expenses are not included). An exception may be requested and granted, provided that the following requirements are met:
 - The association provides a report for the past 6 months that reflects the history of unpaid assessments;
 - The association's current reserve fund balance and current operating results (documented by the association's Balance Sheet and Income/Expense financial statements dated less than 90 days at the time of submission) evidences excess available funds in the amount of the outstanding arrearage;
 - A review of the association's financial statements and verification of the reserve account balance reveals that the association has sufficiently accounted for bad debt and arrearages;
 - A current reserve study that is no greater than 24 months old supports the sufficiency of the current association assessments to meet the project component replacement needs;
 - The association provides evidence of action to collect the unpaid arrearages, including legal action, execution of payment plans, or other similar efforts;
 - Any exception to these requirements terminates with the expiration of the current condominium project approval.
- HUD requires submission of the following documents:
 - Current year budget
 - Current balance sheet less than 90 days old (at the time of submission)
 - Actual income and expense statement
- The condominium budget must:
 - include allocations/line items to ensure sufficient funds are available to maintain and preserve all amenities and features unique to the condominium project; and
 - provide for funding of replacement reserves for capital expenditures and deferred maintenance in an account (amount?) representing at least 10% of the budget; and
 - provide adequate funding for insurance coverage and deductibles.

- A reserve study not more than 24 months old may be requested if the above described budget standards are not met.
- Flood insurance or a Letter of Map Amendment (LOMA) or Letter of Map Revision (LOMR) in lieu of flood insurance.
- If there is a special assessment, the following information must be provided:
 - The purpose of the assessment;
 - Whether it affects marketability of the units;
 - Whether other special assessments have been required (if yes, an explanation of purpose and timing of such other special assessments is required);
 - Timing for payment of special assessment (payment up-front, payment over time, etc.);
 - How the overall financial stability of project is impacted by the special assessment;
 - What impact the special assessment will have on future value and marketability;
 - And any other item that may evidence a negative impact on the project.
- If there is any pending litigation (other than routine foreclosure actions), the attorney representing the association must provide a signed and dated explanation addressing:
 - The reason(s) for the pending litigation;
 - The anticipated settlement/judgment date, if any;
 - Whether there is sufficient insurance coverage to pay out a settlement/judgment without affecting the financial stability of the project, if applicable;
 - Whether the legal action could impact the future solvency of the association (if so, how);
 - Whether the unit owners' ability to transfer title could be affected (if so, how);
 - Whether the action could impact the unit owners' rights;
 - And any other item that may evidence a negative impact on the project.
- A Project Certification must be submitted on the submitting entity's letterhead and signed and dated by the submitter or a representative of the association, stating and certifying that:
 - He/she has reviewed the project and it meets all State and local condominium laws and all FHA condominium approval requirements thereto applicable to the review of condominiums;
 - To the best of his or her knowledge and belief, the information and statements contained in the application are true and correct; and
 - He/she has no knowledge of circumstances or conditions that might have an adverse effect on the project or cause a mortgage secured by a unit in the project to become delinquent (including but not limited to: defects in construction; substantial disputes or dissatisfaction among unit owners about the operation of the project or the owner's association; and disputes concerning unit owner's right, privileges, and obligations).
 - He/she understands and agrees that he/she is under a continuing obligation to inform HUD if any material information compiled for the review and acceptance of this project is no longer true and correct.
- An attorney's certification is not required, but may be advisable.

If an association is considering FHA approval, it should first evaluate whether the association conforms to the guideline operational requirements. In the event of non-conformance in some areas, the association would have to take action to conform to the guideline requirements. For example, if the unit owner delinquency rate exceeds the FHA requirement limit, the association must institute collection actions to reduce the delinquency rate. However, in some cases, bringing the association into conformance could be cost prohibitive or may simply not be feasible; for example, if the association is involved in construction defect litigation with the developer, it is almost certain the association will be denied certification.

Conclusion

Whether an association should seek FHA approval depends upon a variety of factors, including but not limited to: (1) whether the association believes that it would have a positive impact on property value and the financial stability of the association; (2) whether the association does or could meet all approval requirements; and (3) whether it is financially or practically feasible to address areas of non-conformance. If the answer to the foregoing questions is “yes”, the association can pursue certification through a variety of service providers (including this law firm).

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