

A man with a beard and mustache, wearing a dark suit, white shirt, and dark tie, looks upwards with a confused expression. The background is dark grey with numerous white question marks scattered throughout. A large green question mark is positioned above the man's head. To the left of the man, a large green speech bubble contains the text "DAZED AND CONFUSED:" in white, bold, sans-serif font.

DAZED AND CONFUSED:

Attempting To Make Sense of FHA's New Condominium Project Approval and Processing Guidelines

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On June 30, 2011, the Federal Housing Administration (FHA) issued its long-anticipated Condominium Project Approval and Processing Guidelines for condominiums seeking approval for FHA-insured mortgages. These guidelines, issued as part of Mortgagee Letter 2011-22, were intended to provide a single source of information as well as to consolidate, update and clarify the FHA's previous policies and procedures for condominium project approval. Instead, however, many of the new requirements introduced for the first time in these guidelines have created further confusion and elicited serious concerns from association boards, community managers, attorneys and lenders alike.

What Is FHA Mortgage Insurance?

In order to understand the new guidelines, it is important to understand what FHA mortgage insurance is (and is not). The FHA does not make or guarantee mortgage loans; rather, the FHA insures mortgage loans, and FHA mortgage insurance protects lenders against some or most losses on a mortgage if the borrower defaults.¹ FHA-insured loans play a critical role in the housing and mortgage markets today, in part because they are simpler to obtain than conventional mortgages and typically require less than a twenty percent down payment.² And while FHA approval is not legally mandated, an association that is FHA-approved provides potential home buyers with an additional financing option and, at least in theory, makes the association more marketable.³

Traditionally, FHA-insured mortgages played only a small role in the condominium market, accounting for approximately five percent of all condominium mortgages in 2007. However, in part due to the mortgage and foreclosure crisis, from 2008 to 2010 the number of FHA-insured mortgages skyrocketed to between 30 and 40 percent of all mortgages.⁴ And in 2011 alone, FHA insured its highest dollar volume ever – \$236 billion, including 770,000 new purchase loans, 585,000 for families who became homeowners for the first time.⁵

In response to this dramatic increase in FHA-insured loans, the FHA took a closer look at its condominium approval process and began implementing a new protocol in 2009, which did away with traditional spot approvals for mortgage loans, limited

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approvals to two-year terms and tightened lending criteria. However, even with this belt-tightening, the FHA estimates that losses on loans insured through the first quarter of fiscal year 2009 are expected to reach \$26 billion⁶, which was one of several reasons for the adoption of the new guidelines in June 2011.

Condominium Project Approval and Processing Guidelines

In some areas, these new guidelines do provide greater clarity and flexibility for the entire condominium approval process, allowing each Housing and Urban Development (HUD) Home Ownership Centers (HOC) greater flexibility in approving applications and projects that do not meet all of the requirements. Unfortunately, many of these new provisions also create troubling issues for condominium associations seeking FHA approval. A few of the most problematic areas include:

Certification of Compliance

One entirely new requirement in the guidelines, and probably the most troublesome, concerns a certification that must be executed by an association or its representative that confirms the association is in compliance with all state and local condominium laws and all FHA approval requirements. The signatory will also have to attest that he or she knows of no “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.” Included among these potential adverse conditions are construction defects or “substantial disputes or dissatisfaction among unit owners about the operation of the project [or the association], and disputes concerning unit owners’ rights, privileges and obligations.” Moreover, these attestations are subject to a “continuing obligation” on the part of the signatory and potential criminal penalties including up to *\$1 million in fines and 30 years in prison.*

Needless to say, the penalties are significant enough to cause serious trepidation even if anyone was contemplating signing such a vague and undefined certification that calls for a legal opinion. Specifically, it would be near impossible for anyone to know or predict what “adverse circumstances” might affect an association’s financial stability or what constitutes a “substantial dispute” among unit owners. And among other issues, the “continuing obligation” provision

could theoretically subject board members or managers to penalties even though they no longer serve on the board, live in the community or work with the association.

Deed-Based Transfer Fees

The new guidelines also disallow approval of projects where certain deed-based transfer fees or restrictions may affect the ability of a buyer to freely transfer the property. Although not specifically addressed in the new guidelines, the FHA has informally announced that any condominium association with a deed-based transfer fee, including a working capital or capital contribution fee, would be disqualified from access to FHA-insured mortgages.⁷

The inclusion of this prohibition, especially as it pertains to working capital and capital contribution fees, is perplexing, especially considering that this issue was recently addressed by the Federal Housing Finance Agency (FHFA). Specifically, FHFA found that such transfer fees add value to the properties where collected and have been an important source of funds for communities for over 40 years.⁸ Why FHA would unilaterally decide to take action contrary to other federal agencies and, more importantly, to effectively deny approval to close to half of all condominium associations in the country is confounding.

Special Assessments and Litigation

The guidelines require that the association provide information and documentation regarding any special assessments or litigation (other than collection or foreclosure actions) together with an opinion as to the potential effect of the assessment or litigation on the unit owners. Moreover, the FHA has suggested that it will not approve any association with pending construction defect litigation until the defect claims have been resolved and the repairs completed. The guidelines also seem to demand that the association tell the future, asking for prognostication as to any pending or *anticipated* litigation (and the expected outcome of such litigation that may not even be pending yet) as well as the *future* value and marketability of the units.⁹ Possibly more troublesome is the fact that the FHA appears to be viewing all assessments and litigation as negative indicators, when such an assumption is not always the case.

Insurance and Fidelity Bonds

The guidelines call for the association be covered by hazard, liability, flood and other insurance at levels as required by state or local condominium laws. In addition, the guidelines inexplicably require both the association and its management company

obtain separate fidelity bonds to cover board members and employees. The uproar over this requirement was immediate, and CAI took action to identify for the FHA that the proposed management company fidelity bond was duplicative, costly and difficult, if not impossible, to obtain. The FHA has since backed off this pronouncement and advised that it will allow associations to obtain a fidelity bond that both names and covers the management company rather than require a separate fidelity bond.

And these are just a few of the many problematic issues with the new guidelines.

Yet, the new guidelines *do* provide greater clarity and flexibility in some areas. Specifically, the new rules allow HOCs to grant exemptions for associations that do not meet certain delinquency requirements (so long as there are no more than 20 percent of units in arrears). Also, HOCs can authorize exemptions for associations that contain up to 35 percent commercial-space or exceed the requirement for investor-owned units. Further, the new guidelines allow for certain flexibility in associations with affordable housing and with rental restrictions (although certain problematic restrictions regarding rentals are still applicable).

Overall, the effect of all of these new

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requirements on the FHA approval process is just beginning to be felt across the country. Many associations that received FHA approval or that were recertified under the previous guidelines have now had their certifications expire with little hope of recertification. The FHA indicated that out of the approximately 25,000 condominium projects nationwide that expired between December 2010 and September 2011, only 2,100 – approximately eight percent – have been approved or recertified.¹⁰

However, the news is not all bleak. CAI continues its attempts to negotiate changes in the new guidelines, specifically those requirements dealing with transfer fees, the assessment delinquency criteria, and the certification of compliance. In addition, many members of Congress have expressed their concerns with the guidelines and called on the FHA to reconsider these new policies.¹¹ Further, FHA officials have announced that they intend to issue a new mortgage letter by the end of 2011, which should address at least some of these concerns.

So by the time you are reading this article, the guidelines may have changed yet again. But until then, the current state of FHA condominium project approvals remains in flux, leaving everyone – association boards, community managers, lenders and attorneys – in a continued state of confusion. ■

(Endnotes)

- 1 CAI Mortgage Matters, “CAI FAQ – FHA Condominium Guidelines,” at <http://www.caionline.org/govt/news/Political%20HeadsUp%20Public%20Document%20Library/FHA%20FAQ%202011-22.pdf>
- 2 Id.
- 3 Id.
- 4 Id.
- 5 Carol Galante, Acting Assistant Secretary for Housing, “Report to Congress” (November 21, 2011), at http://portal.hud.gov/hudportal/documents/huddoc?id=fhacomcgnov2111_final.pdf
- 6 Id.
- 7 CAI Mortgage Matters, “CAI Cautions FHA on Transfer Fees, Calls for Waiver” (October 14, 2011), at <http://www.caionline.org/govt/MortgageMatters/blog/Lists/Posts/Post.aspx?ID=26>
- 8 Id.
- 9 See endnote 1.
- 10 Kenneth R. Harney, “FHA Rules for Condo Purchases are Causing Major Headaches for Buyers and Sellers,” *The Washington Post*, published October 21, 2011.
- 11 CAI Mortgage Matters, “Key Congressmen Express Concern with FHA Criteria, Process” (November 8, 2011), at <http://www.caionline.org/govt/news/Political%20HeadsUp%20Public%20Document%20Library/Key%20Congressmen%20Express%20Concern%20with%20FHA%20Criteria.pdf>

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