Ten Things You Should Know About Condominium Association Lending

by Larry Jones

Congratulations! As the president of your condominium association, you have identified a key capital improvement that will have a significant positive impact on the property values in your community. You have negotiated the political landscape of board and member approval for the improvement, and you have even collaborated with your treasurer—an experienced CPA—to document the fact that your association would be best served by financing the improvement with an association loan.

An association loan…what do you need to know about an association loan? Well, here are the basics, as well as many of the nuances, in a brief but enjoyable piece we will call:

TEN THINGS YOU NEED TO KNOW ABOUT CONDOMINIUM ASSOCIATION LENDING

1. An association loan is typically secured by a pledge of the association's assessment and lien rights.

In most cases, an association will not be able to provide real property as collateral for a loan. As such, these loans are typically secured by a pledge of the association's assessment and lien rights. To provide further security, most banks will require that an association establish their primary deposit relationship with them as a condition of the loan.

2. Your lender will consider the delinquency rate in your condominium association.

The rate of delinquencies in assessment payments will be a primary factor in a lender's decision on extending credit to your condominium association. The reason this is such an important factor is that any association loan will likely be repaid using the proceeds of ongoing assessment payments. A high delinquency rate calls into question the association's ability to meet its obligation to repay the loan. Lenders differ on their criteria, but most will look for a delinquency rate of less than seven percent of total units.

3. Your lender will consider the increase in assessments required to cover loan repayment.

It should come as no surprise that a large increase in a monthly payment will cause more financial stress and a higher delinquency rate than a smaller increase. This is true both in terms of actual dollars and percentages. A $75 per month increase in assessments will present much more of a challenge in an association where the previous amount was $100 per month versus one where the amount had been $1,000.

In either case, the "allowable" rate of increase in normally budgeted assessments may very well be controlled by the condominium documents governing the association. For this reason, a lender will typically ask you to provide your condominium documents as part of the underwriting process for an association loan.

At the very least, a lender will require you to provide an identifiable source of repayment for the loan—one which includes principal, interest, and some provision for a percentage of the unit owners going into delinquency or default on their assessments. This repayment source can be a budgeted line-item funded by the normal assessments. If, however, the condominium documents will not allow a budget increase of the size required for the loan repayment, your lender will want to see evidence of an approved special assessment to repay the loan.

4. Your lender may require an "opinion letter" from your association's attorney.

We mentioned above the fact that a lender may ask to examine your condominium documents as part of the underwriting procedure. If the condominium documents, in the opinion of the underwriter, present any ambiguity about the association's ability to enter into a lending agreement, your lender will most likely request an "opinion letter" from your association's attorney. This is a letter where the association's attorney states in writing that it is their (the attorney's) opinion that the association is duly authorized to enter into a lending agreement and that the terms the lender is proposing are in accordance with the authorization granted by the condominium documents.

5. Your lender will consider the percentage of units in your condominium complex that are investor-owned.

Again, this criteria is all about the likelihood of a successful repayment of the loan. A complex with a high percentage of "investor-owned" units presents more of a risk to a lender than does a complex with a high percentage of owner-occupied units. A person who has purchased a unit as an investment does not have the same vested interest in the property as a person who has purchased a unit as a primary, or even a secondary residence. There are certainly other criteria that play into the underwriting decision, but most lenders will initially look for an investor-owned percentage of 20 percent or less.

6. Your lender will consider the relative cost of the improvement project on a "per-unit" basis to the market value of the individual units.

We have previously discussed the issue of a loan where the repayment amount is relatively large when compared to the current ongoing assessments. This in itself presents the opportunity for a financial hardship on the part of the individual unit owners. However, even in cases where there would

be no undue financial stress placed on the current owners, the lender would still want to be sure that the proposed project makes financial sense from a property value and resale perspective.

In short, the proposed project should not "price the property out of the market." If a condominium complex is in an area where comparable units are valued at $250,000, a lender is not going to want to finance a project that would cost an average of $200,000 per unit on the perception that the property values will rise accordingly. Proceeding with a project such as this would likely lead to a scenario where unit owners are not able to obtain a resale price that will sufficiently repay them for their share of the improvements. Furthermore, the increased assessments—either normal or special assessments—needed to repay such a loan would likewise prove to be "above market" when compared to surrounding properties.

Difficulties in resale put the revenue stream for repayment (the ongoing assessments) at risk. Any time units go unsold, there can be a higher rate of delinquencies and defaults on the stream of assessment revenue.

7. Your lender will consider the number of units in your complex.

The fewer units in a complex, the more the impact of each assessment, delinquency, or default. For this reason, lenders will look more carefully at the other criteria when deciding on lending to a complex with a relatively low number of units.

8. Your lender will want to conservatively match the length of the repayment schedule to the life of the capital improvement project.

A lender will typically be conservative with regard to the repayment schedule in relationship to the useful life of the project. In almost no circumstance would a lender agree to a repayment schedule that is longer than the useful life of the improvements financed. In most cases, the repayment schedule will be somewhat less than the useful life of the improvements. For example, a loan for an improvement with a useful life of seven years would most likely have a repayment schedule of three to five years.

9. Your lender will recommend a fixed interest rate for an association loan.

The most consistent thing about condominium associations is that they are always changing. There will be new board members each year, new owners as time goes by, and new economic conditions on an increasingly frequent basis. All of this speaks to the fact that any loan your association enters into should have a fixed rate. No one likes to see increases in yearly assessments, and they are all the more difficult to accept as time passes and unit owners are less connected with the board members and association members who made the lending decision several years ago.

10. Your lender will require detailed information about the proposed project, including project management and approval.

Your lender will very likely request detailed information about the proposed improvement project. This could include meeting minutes from board meetings where the project was discussed and approved, bids from contractors, design plans, and inspection reports showing the need for the proposed improvements.

Additionally, your lender will want to know who is going to oversee the project as it is completed. If you intend to have a board member conduct the ongoing inspections and work approvals, the lender will want to have a statement as to the qualifications of that board member. Last but not least, the lender could ask for ongoing inspection reports or similar reports as the work proceeds, with a written acceptance of the project when it is completed.

As stated earlier, this is not an exhaustive list of the factors involved in association lending, but it certainly hits the highlights. The bottom line is that, depending on your situation, an association loan could offer a great deal of benefit to your condominium association. If that is the case, the information presented here will hopefully prove useful as you move forward in the lending process.

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In the June issue of FLCAJ, *the article "Valuable Tools for Effective Management" on page 52 listed incorrect company information at the end of the article. The article should have read: For more information, please visit Cornerstone Specialty Services at **www.cornerstonespecialtyservices.com**. We would like to offer our sincerest apologies to Cornerstone Specialty Services and Clara Rose for our mistake.*