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FHA Condominium Certifications: The Requirements and Prohibitions



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Introduction

The Federal Housing Administration (“FHA”) is a government-owned insurance company that insures home loans for buyers who cannot afford a conventional down payment or prefer to use their available funds in other ways. In other words, a FHA backed loan allows a home buyer to purchase the home with a smaller down payment than other types of loans and, oftentimes, at a lower interest rate. FHA backed loans permit buyers to put down as little as 3.5% as opposed to the typically required 20%. Lower down payments tend to attract many first-time home buyers.

Until February 2010, FHA provided “spot approvals” (i.e. approvals for individual units in condominium associations), but now FHA requires the entire condominium project to be “certified” before FHA loans to purchase units in such project are authorized. No single condominium unit will be eligible for FHA financing unless the entire condominium project has been certified.

Being FHA certified means a condominium community meets the minimum guidelines established by FHA. Meeting these guidelines according to FHA will reduce risk of default on home loans which it insures, making such loans safer for banks and for the FHA. FHA certification may be obtained through two methods: (1) “HRAP” (the HUD review process), or (2) “DELRAP” (the direct endorsement lender review and approval process). The HRAP process is generally used by associations seeking to have their communities certified.

What does all of this mean for condominium communities? It means unless a condominium association is FHA certified no unit within the community may be purchased using an FHA backed loan, which in turn means a smaller pool of purchasers, potentially less sales, and lower property values. This leaves many boards of directors scrambling to figure out how, and whether, they can get their condominium communities certified.

Is there a duty on the part of condominium boards to ensure their communities are certified? Currently, arguments are being made on both sides of the issue and there are no court cases to guide us. On the one hand, boards have a duty to act in the best interests of their communities and to preserve and protect property values. Arguably, if a board does not, at least, attempt to get its community certified, one might argue such failure is a breach of that duty. There has even been a situation in which an owner in a condominium community accused the board of discrimination based on the board’s refusal to obtain FHA certification.

On the other hand, there is currently no legal requirement (in Colorado or federally) for boards to ensure certification of condominium communities. Thus, one may also argue that certification of a condominium community goes beyond the basic fiduciary duty of boards. However, until there is case law on this issue, we will continue to have conflicting opinions.

The purpose of this article is to discuss the various FHA requirements for certification to allow boards and managers to determine whether their communities can be certified as is, or whether changes are needed first. Please keep in mind, however, FHA certification requirements have been known to change overnight without warning. Therefore, the requirements set forth in this article are those in affect as of July 1, 2013.

Project Eligibility

A. Eligible Projects

It is important to note only condominium communities are eligible for FHA certification. PUD's (such as townhomes and single family communities) cannot obtain FHA certification. To be eligible for FHA certification, condominium projects must consist of two or more units, be fully completed (100% built out), and over one year old.

In the case of a phased condominium project, the initial phase must be completed and over one year old. This includes completion of all buildings, if more than one, within the initial phase and the issuance of a certificate of occupancy for all buildings in that phase that has been in existence for over one year.

With respect to all condominium projects, each project must be declared to exist in full compliance with applicable state law requirements of the jurisdiction in which the condominium project is located and with all other applicable laws and regulations.

B. Ineligible Projects

Certain condominium-like projects are excluded from FHA certification on the basis that the FHA views such projects as a financial risk. These ineligible projects include the following:

1. Condominium Hotels or "Condotels" (i.e. short-term guests—typically less than 30 days);
2. Timeshares or segmented ownership projects;
3. Houseboat projects;
4. Multi-dwelling unit condominiums (i.e. more than one dwelling per condominium unit);
5. Projects where units are not being used primarily for residential purposes (such as business parks);
6. Projects where more than 25% of total space is used for nonresidential purposes (i.e. live-work units where 25%, or more, of the project, or unit square footage, is used for nonresidential purposes);
7. Projects located within designated coastal barriers of the Atlantic Ocean, Gulf of Mexico, or the Great Lakes;
8. Assisted living facilities; and
9. Projects where the developer continues to own common area or amenities after transfer of control to owners of the association.

Based on the above, projects that fit within any of the above categories may not be FHA certified. The biggest concern to condominium communities is being categorized as a Condominium Hotel, which happens when associations have provisions in their declarations allowing rentals for less than a 30 day term. This problem will be discussed in more detail further on in the article.

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Certified Representations

When applying for FHA certification, a condominium community must make certain “certified” representations. These certified representations must be submitted on company letterhead and must be signed by an association representative, or its authorized representative (i.e. management company, project consultant, or attorney).

The following certified statements must be made by the signing party with respect to all FHA certification applications:

1. The project meets all current FHA condominium approval requirements;
2. To the best of his or her knowledge and belief, the information and statements contained in the application are true and correct;
3. The submitter 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:
 - a. Defects in construction;
 - b. Substantial disputes or dissatisfaction among unit owners about the operation the project of the owner’s association;
 - c. Disputes concerning unit owner’s rights, privileges, and obligations.

The submitter must also acknowledge and agree 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.

When a condominium association retains legal counsel to obtain certification for the community, legal counsel typically signs the representations. However, in situations where condominium associations are attempting to obtain certification without the assistance of legal counsel, the condominium community will still need to obtain an attorney letter confirming that the association meets the FHA standards. Once the legal opinion is received, the representations will need to be signed a board member, preferably the board president.

In the event the signor of the FHA certification application makes a knowingly false representation, the maximum penalties the government may impose include a \$1 million fine and 30 years imprisonment. For this reason, most board members have become quite gun-shy when it comes to signing these representations and prefer it be handled by legal counsel. However, there even law firms that believe the risk is too high and will not provide FHA certification services.

FHA Certification Requirements

In addition to being eligible for FHA certification, a condominium project must also prove it complies with the certification requirements established by the FHA. Each requirement is discussed separately below.

A. Concentration of Loans

As a general rule, no more than 50% of the total units in a condominium project may be encumbered by FHA insured loans for the community to obtain FHA certification. However, in a condominium project with three or less units, no more than one unit may be encumbered with an FHA insured loan.

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Notwithstanding the above, the acceptable FHA insurance concentration level may be increased up to 100% if the condominium project meets all of the basic condominium standards, as set forth in this article, plus the following criteria:

1. The project is 100% complete and construction has been completed for at least one year, as evidenced by issuance of the final or temporary/conditional certificate of occupancy for the last unit conveyed;
2. 100% of the units have been sold and no entity or individual owns more than 10% of the units in the project (for projects with fewer than 10 units, single entity/individual may own no more than one unit);
3. The project's budget provides for funding of replacement reserves for capital expenditures and deferred maintenance in an amount representing at least 10% of the budget;
4. Control of the condominium association has transferred to the owners (with the developer not owning any common elements); and
5. The owner-occupancy ratio is at least 50% (discussed in more detail later).

The above exception terminates with the expiration of the community's current project approval and is not available for new construction or Gut-Rehabilitation conversions.

B. Commercial Limitations

A condominium community cannot have more than 25% of the total floor area in the project or individual unit used for commercial purposes. It is important to note the area need not actually be used for commercial purposes, but only have the ability to be used in such a manner to disqualify an otherwise eligible condominium project for certification. Therefore, if a condominium association's declaration authorizes any portion of a community to be used for commercial purposes (i.e. for non-residential purposes), it may be necessary to amend the community's declaration before moving forward with the certification process.

In addition to the restriction concerning commercial space, FHA also requires the commercial portion of the project be of a nature that is "homogenous" with residential use and free of adverse conditions to the occupants of the individual condominium units.

In addition to the above, condominium projects (who have met the 25% limit or received an exception as discussed further in this section) must also meet the following requirements:

1. Approved via HRAP;
2. Condominium declaration must state the work (non-residential) space per unit cannot exceed 25% of the unit's total floor area;
3. The non-residential work space may not exceed 25% of the project's total floor area; and
4. The work non-residential use must be subordinate to the unit's residential use and character.

Exceptions may be requested on a case-by-case basis and FHA could hypothetically approve as much as 35% of the total floor area for commercial space. In order to qualify for such exception, a condominium community must comply with the following requirements:

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1. Requests must be submitted as part of the approval, re-approval, or recertification process as an HRAP application;
2. Project must not be under construction, less than one year old, or newly converted;
3. Project must be 100% complete for at least one year.
4. Non-residential/commercial space use cannot exceed 35% of the property's total floor area;
5. Control of the association must have been transferred to the owners.

If an association is not provided with an exception, it will not meet the criteria for FHA certification unless it can figure out a way to not only lower the commercial use space to less than 25%, but also eliminate the possibility that additional space in the community could ever be used for commercial space.

C. Occupancy Restrictions--Rentals

A condominium community must also meet FHA set occupancy restrictions, which pertain to the number of owner occupied units in the community. Specifically, FHA requires at least 50% of the total units in a project be owner occupied or sold to owners who intend to occupy the units.

What does it mean for a unit to be "owner occupied"? It means the person(s) whose name(s) are on the title utilize that unit as their primary residence. There are several factors that are used to determine if a residence is truly primary, these factors include but are not limited to: the address listed on the individual's driver's license, address used when filing income taxes, and the mailing address used by such individual for billing purposes. Therefore, an owner who lives out-of-state, for example, but returns to the condominium for only a few weeks out of the year, would not be considered a "primary resident" of the condominium unit.

FHA permits condominium declarations to restrict owners' abilities to lease their units if the restrictions comply with, or mirror, the following criteria:

1. Leases must be in writing and subject to the declaration and by-laws of the condominium project;
2. Condominium association may request and receive a copy of the sublease or rental agreement;
3. Condominium association may request the name(s) of all tenants including the tenant's family members who will occupy the unit;
4. Unit owners are prohibited from leasing their units for an initial term of less than 30 days;
5. Condominium association may establish a maximum allowable lease term, e.g. six months, twelve months, etc.;
6. 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 (i.e. currently 50%); and

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7. 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.

As mentioned earlier in this article, one of the more problematic provisions encountered in declarations is one that prohibits rentals of less than 30 days unless otherwise approved by the board. This provision has been used in many instances as a reason for denial of certification on the basis that the board of directors still has authority to allow leases that are less than 30 days and therefore the possibility of having the project become hotel-like still exists.

In addition to the above, there have also been rejections based on verbiage in declarations prohibiting leases less than 30 days, but carving out exceptions for first mortgage holders in the event the unit is foreclosed upon.

These types of provisions have required associations to consult with their attorneys to amend their declarations and remove such provisions before they could re-apply for certification and become FHA certified.

D. Assessment/Delinquency Requirements

Until August 31, 2014, no more than 15% of the total units in a project can be more than **60 days** past due with the payment of assessments (does NOT include late fees or administration charges). All units must be included in the delinquency ratio regardless of ownership. No exceptions will be permitted.

After August 31, 2014, no more than 15% of the total units in a project may be more than **30 days** past due with the payment of assessments (does NOT include late fees or administration charges). All units must be included in the delinquency ratio regardless of ownership. It may be possible to request an exception to the 15% delinquency cap (after August 31, 2014) and raise the cap up to 20%. Such requests will be evaluated on case-by-case basis. FHA will likely require the following documentation prior to evaluating the request:

1. Report for past 6 months that reflects history of unpaid assessments.
2. The association current reserve fund balance and balance sheet/financial statements evidence excess available funds in the amount of the outstanding arrearage;
3. Association financial statements demonstrate the association has sufficiently accounted for bad debt and arrearages;
4. A current reserve study that is no greater than 24 months old supports the sufficiency of the current association assessments to meet project component replacement needs; and
5. Association must provide evidence of actions to collect unpaid arrearages.

If an exception is granted, such exception will terminate with the expiration of the certification period and the association will need to apply for another exception during its recertification attempt.

Before seeking an exception to the budget requirement, however, a board should consider whether it would make sense to write off any of the outstanding balances. For example, if an association is only a couple of percentage points over the maximum, writing off one or two delinquent accounts could bring it under the required threshold allow for FHA certification without the need of seeking an exception. What types of accounts are appropriate for write offs? Examples would be accounts

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where the delinquent amount is minimal or accounts that consist exclusively of late fees and interest.

E. Insurance Requirements

With respect to the specific requirements for maintenance of insurance policies by condominium associations, FHA requires associations to carry all of the following:

1. Hazard-Replacement cost coverage (100% current replacement cost of condominium exclusive of land, foundation, excavation, and other typical exclusions);
2. Liability Coverage on common elements;
3. Fidelity Insurance for new and established condominium projects with 20 or more units in an amount equal to three times the monthly aggregate of dues plus everything in the reserve accounts. Please note, if community engages a management company, it must provide proof of fidelity insurance coverage or bond for the management company naming association as obligee in amount not less than estimated maximum funds in custody of the association or management company, and in no event shall the amount of coverage be less than a sum equal to 3 months aggregate assessments plus reserve funds;
4. Flood (when applicable); and
5. Owners are required to obtain HO-6 policies if the master or blanket policies do not include interior unit coverage including replacement of interior improvements and betterment coverage (i.e. an "all in" policy).

In situations where a condominium association does not carry an "all in" policy covering the condominium units and improvements therein, the association will be required to show that owners in the community are carrying appropriate insurance covering the components that are not insured by the association.

F. Budget

The existing budget of a condominium community must be determined to be adequate before FHA certification is approved. The budget must be determined to accomplish the following:

1. Include allocations/line items to ensure sufficient funds are available to maintain and preserve all amenities and features unique to the condominium project;
2. Provide for the funding of replacement reserves for capital expenditures and deferred maintenance in an account representing at least 10% of the budget; and
3. Provide adequate funding for insurance coverage and deductibles.

In cases where the budget documents do not meet these standards, a reserve study (no older than 24 months) may be requested to assess the financial stability of the project.

G. Investor Limitations

Until August 31, 2014, no more than 50% of the units may be owned by one investor/entity (single or multiple owner entities) – including all rented and leased units owned by a developer/builder. Non-profit owned units and eligible governmental housing programs are included in these calculations and are subject to the 50% ownership limitation.

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After August 31, 2014, no more than 10% of the units may be owned by one investor/entity (single or multiple owner entities) – including all rented and leased units owned by a developer/builder. For projects with 10 or fewer units, no single investor/entity may own more than one unit.

For clarification purposes, please note the following:

1. If an individual unit is owner occupied (even though it is one of many owned by the same owner), the unit not considered investor owned;
2. Unoccupied and unsold units owned by a developer are not considered investor owned;
3. Non-profit owned units and eligible governmental housing programs are not subject to the 10% ownership limitation; and
4. Units in projects subject to legally mandated rental regulations are not subject to investor requirements.

H. Affordable Housing

Condominium projects containing affordable housing programs operated through governmental agencies and/or eligible nonprofits are eligible for FHA approval if the government or eligible nonprofit program restriction meets the exceptions defined in 24 CFR 203.41(c) and (d), or the recorded condominium declarations contain the affordable housing program requirements, including defining the specific units that are covered under the program. If no such provision exists, the declaration must be amended to reflect the specific units.

I. Special Assessments

Although special assessments will not prevent a condominium association from being FHA certified, it is challenging. Project submittals with current special assessments must contain a signed and dated explanation of the special assessment from the builder, developer, sponsor, association, or management company providing the following information:

1. Purpose of the assessment;
2. Impact of assessment on the marketability of any units;
3. History of other special assessments in the past and explanation;
4. Due date of assessment;
5. Impact of overall financial stability of the project by the assessment; and
6. Impact of assessment on the future value and marketability of the property.

If the provided explanation is deemed appropriate and adequately demonstrates the community is a viable and “healthy” project, FHA certification may be granted.

J. Pending Litigation

As with special assessments, communities involved in litigation may also still receive FHA certification if they can provide the community remains viable and healthy. Project submittals for communities that are involved in litigation (does not include routine foreclosures), must include a

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signed and dated explanation regarding pending litigation from the attorney representing the builder, developer, sponsor, association or management company addressing the following:

1. Reason for pending litigation;
2. Anticipated settlement/judgment date, if any;
3. Indication whether there is sufficient insurance coverage to pay out a settlement/judgment without affecting financial stability of the project;
4. Impact of action on future solvency of the association;
5. Ability for owners to transfer title affected; and
6. Impact on owners' rights.

Depending on the nature and stage of the litigation, an association may sometimes be forced to wait until conclusion of the litigation before it can receive FHA certification.

K. Duty to Supplement

After submission of the FHA certification packet and even after FHA certification is granted, a condominium community continues to have a duty to provide supplemental disclosures of any new conditions, if known, that would affect its right to be FHA certified.

Hypothetically, this could mean if a certified condominium community exceeded the FHA limit of non-owner occupied units (i.e. rentals) midway through its certification period, it would have a duty to disclose this to HUD, which would likely result in the certification being removed from such community.

For this reason, it is imperative that condominium communities continue to strive for compliance with all FHA certification requirements, even if such communities have already been certified.

Recertification Requirements

Project certifications are good for two-year periods after which they expire. If a condominium community wishes to be certified again, it must apply for recertification. The recertification process is essentially the same as the certification process because it requires the association to re-establish all of the FHA requirements from scratch; as such requirements pertain to the prior two years.

Recertification packets may be submitted by mortgagees, builders, developers, associations, management companies, or an attorney or project consultant who submits on behalf of one the above parties.

Conclusion

There's no doubt about it, FHA certifications benefit condominium communities by increasing the buying pool, which in turn drives up sale prices, unit sales, and increases values of units in the community. There are two ways to obtain certification: (1) the DELRAP process or (2) HRAP process. Regardless of the method utilized, however, the criterion for certification remains the same and the scrutiny of the process is unchanged.

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Therefore, prior to applying for FHA certification, take a look at your community's governing documents, finances, and rental situation to ensure your condominium community is on the right track to becoming certified.

HindmanSanchez provides both FHA certification and recertification services for condominium associations. If you are interested in this service please contact us at 303.432.9999.