RESEARCH INSTITUTE for HOUSING AMERICA
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Washington, DC 20006-3438
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Changing Perspectives on Community Association Mortgage Underwriting and Credit Analysis

INSTITUTE REPORT NO. 01-02

RESEARCH INSTITUTE FOR HOUSING AMERICA

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- expands the markets for housing and mortgage credit, particularly for underserved populations and communities; and
- assesses the costs and benefits of homeownership.

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CHANGING PERSPECTIVES ON COMMUNITY ASSOCIATION MORTGAGE UNDERWRITING AND CREDIT ANALYSIS

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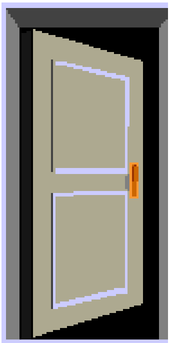
Institute Report No. 01-02

November 2001

RESEARCH INSTITUTE for HOUSING AMERICA

ISSN – 1530-0102

Published by:
The Research Institute for Housing America
1919 Pennsylvania Avenue, NW
Washington, DC 20006-3438



THE INSTITUTE PERSPECTIVE

This Institute Report raises some important issues that do not typically receive much attention. In the ever-changing world of mortgage origination and servicing, great strides have been made in improving the efficiency of the lending process for mortgages on both single-family and multifamily properties. As Mr. Treese, Mr. Diamond, and Professor Rosenberry point out, one area has been largely left behind—the role of community associations.

Community associations come in several forms: cooperatives, condominiums, and planned communities. All have the common attribute that they have the power to conduct business and governance functions of the community. Moreover, they all have lien powers to collect the funds necessary to conduct that business and to require that residents conform to community rules. As the authors point out, the typical community association deals with an increasing functionality. The economic investment that homeowners have made in the units under the community association's umbrella is often highly dependent on how well the community association executes these functions.

The Institute Report is designed to fulfill two functions. The role of community associations in housing and mortgage markets is not well understood. Thus, the report lays out the basics of what community associations are and what they do. Particularly interesting is the trend for such entities to be assigned responsibilities for services that typically have been provided by local governments. This and other factors have led, according to the authors, to a rapid increase in the number of homes that are now part of one of the three forms of community association.

The growth in the number and scope of community associations has real implications for mortgage lenders. This is the second issue addressed by the report. The liens that they have on the homes in their community may be exercised, directly affecting the status of the first mortgage on the homes. In addition, increasing assessments or physical deterioration of the community infrastructure resulting from the actions of a poorly run association would be of vital interest to the holders of the mortgages on the individual units in the community. A community association can increase the risks of delinquency and default, either by putting an undue financial burden on the homeowners or by adversely affecting the value of the homes in the community.

The report concludes by addressing the issue of how information systems for community associations can better serve the lending community and borrowers alike. Progress on this front would mean lower transaction costs in terms of both time and money. It also would allow for more efficient and equitable pricing of loans by providing the information necessary for accurate risk-based loan pricing appropriate for mortgages on homes in either a poorly run or well-managed community association.

While many think of community associations as restrictive and favoring high-income homeowners, the authors maintain that this view is too narrow. As the report points out, a more efficient market in mortgage lending to homes in community associations will facilitate the achievement of some of today's key policy goals. The community association structure is uniquely suited to high-density and mixed-income real estate developments—key elements of both policies targeted toward smart growth and expanding homeownership to low-income and minority communities.

James L. Freund
Director of Research
Research Institute for Housing America

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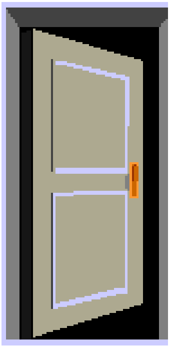


I. INTRODUCTION

The Rise of Community Associations

In the United States, community associations or common interest communities—planned communities, cooperatives, and condominiums—developed over the past 150 years. As with many other concepts borrowed from Europe, associations evolved into something uniquely American. In order of historical appearance, the three basic types are as follows:

- *Planned communities* were sporadically developed beginning in the 1820s, received more systematic treatment with J.C. Nichols and the creation of the Country Club district in Kansas City, and came into their own a decade after the Urban Land Institute published *The Homes Association Handbook* (Technical Bulletin No. 50), in 1964. Planned communities have tended to serve market-rate homebuyers.

- *Cooperatives* were first centered in New York City in the 1880s and were spawned by immigrant affinity groups and organized labor to provide affordable housing for garment workers and others. Cooperatives have tended to serve lower- and moderate-income homebuyers and families. Later, in the 1920s, luxury cooperatives were developed in New York City and spread to other major urban centers such as Chicago and Washington, DC.

- *Condominiums* were created by nominal common law efforts in the 1950s, but they received a significant boost in 1961 with the passage of National Housing Act Sections 234(c) and 234(d) which extended mortgage insurance to project development and unit sales. Condominiums have tended to serve the first-time homebuyer market, empty-nesters, and others seeking "carefree living."

Most associations are developed entirely or predominantly for residential purposes, although some may contain nonresidential uses, typically commercial activities. At times, planned communities are structured to contain subassociations comprised of any or all of the three basic types of community associations. If these planned communities are large enough (usually 1,000 lots/homes or more), they are generally called *master planned communities or large-scale associations* because of their size and complexity.

Homes within planned communities and condominiums are real property interests and, therefore, are eligible for long-term amortized mortgages. Homes within housing cooperatives usually are personal property interests and, therefore, have not been eligible for traditional home mortgage financing. This latter fact probably has inhibited cooperative housing development, with the exception of the New York market where historical forces have overcome mortgage lender reluctance.[1]

Defining Characteristics of Community Associations

All three forms of ownership share three basic characteristics:

- *Mandatory membership:* All owners must belong to the association.
- *Mutually binding governing documents:* The owners, the association, and its board of directors are obligated to each other to perform certain functions and refrain from certain activities.
- *Lien-based assessments:* All owners must pay fees (assessments) to the association for the operation of common property with collection enforceable through lien rights on their ownership interest. Cooperatives have a lien right on the stock or membership interest when the proprietary lease is signed. For condominiums and planned communities, the trend is for the lien right to exist from the time the governing documents are recorded in the land records. Actual enforcement for cooperatives is usually through housing court and eviction; for the other two types of community associations, enforcement generally follows typical real estate foreclosure practices.

Although community associations can be unincorporated, in most states they are incorporated as nonstock not-for-profit corporations. Variations exist, however, as in New York, where general business laws are followed. All associations are obligated to file IRS tax form 1120H or 1120 annually. Some associations are tax exempt under either Section 501(c)(4), 501(c)(7), or 501(c)(12)(A) of the Internal Revenue Code, but this is a very small minority.[2] (See appendix 1 for a comparison of the number of community associations to other types of organizations in the United States.)

A major difference between the three basic types of community associations lies in the ownership and/or operation of the common areas (or common elements). In a condominium, the common elements (everything other than the units) are held by the unit owners as tenants-in-common with each owner having an undivided percentage interest. In a cooperative, a corporation owns both the units and the common areas, and the unit owner (or cooperator) secures the benefits of ownership through a special proprietary lease or occupancy agreement with accompanying stock ownership or membership in the corporation. In a planned community, a corporation owns the common area, and the lot owner (homeowner) is required—by a recorded declaration—to belong to the association.[3]

The owners in all three types of community associations enjoy the pass-through benefits of being able to deduct mortgage interest and real estate taxes on their personal federal income tax returns. In cooperatives, the amount paid by the corporation for blanket real estate and blanket property taxes is allocated to the cooperator based on ownership shares or membership interest in the corporation. The monthly fee (or assessment) paid by the owner to the community association is usually not tax deductible.

A major difference between the three basic types of community associations lies in the ownership and/or operation of the common areas.

There is a trend, however, toward *municipal services equalization* legislation, whereby the community association may receive local government refunds if the association assessment pays for items that are also considered to be expenses paid for by real estate taxes. For instance, the community association assessment may pay for trash collection, and the property taxes collected from each unit owner may also pay for trash collection.[4] In a number of municipalities, the local government will reimburse the community association the amount the municipality would otherwise have paid for trash collection, but not necessarily what the community association paid for such collection.

Although the creation of condominium associations is authorized by a specific state enabling statute, planned communities and cooperatives are usually created by combining conventional real estate transactions with general nonstock nonprofit statutes. Each type of community association is under the formal control of a volunteer board of directors, elected from among the owners and almost always serving without compensation. Under most modern community association governing documents, the members of the board need not actually reside in the association, but they do have to own a unit or a share in the corporation.

Both the owners and renters in the community association are bound by the governing documents, but only owners have the obligation to pay assessments and the right to vote and participate in governance.

The manner in which ownership interests, voting rights, and assessment obligations are allocated varies as set forth in the association's governing documents.

Growth and Impact of Community Associations

Data published by the Community Associations Institute (CAI) shows that by 1970 there were approximately 700,000 homes in 10,000 community associations. Today, the comparable figures are thought to be over 230,000 associations with upward of 18 million homes.[5] Further, some association industry experts believe that 85 to 90 percent of *all new for-sale housing* is located in one of the three basic types of community associations. Somewhere between 40 and 60 percent of community associations are contract-managed by specialized community association management companies, while the other 40 to 60 percent are self-managed either solely by volunteers or with association-hired staff. (See appendices 2 and 3 for tables that present data on the recent growth of community associations.[6])

Given the fundamental reasons for the rapid growth of community associations, discussed later in this report, there is every reason to believe that this growth will not only continue, but will accelerate.

The financial and related metrics for the year 2000 connected with association life and operations are estimated to be equally important:[7]

- Over 1.1 million volunteers are estimated to be serving on the boards of directors with over 250,000 participating as committee members. There are 222,500 annual association meetings with democratically conducted elections and another nearly 2.2 million board of directors meetings during the year in which owners debate and shape their housing community's future. To assist the board, there are over 1.4 million committee meetings during each fiscal year.
- These boards supervise the collection of over $32 billion in annual assessments and maintain investment accounts of another $35 bil-

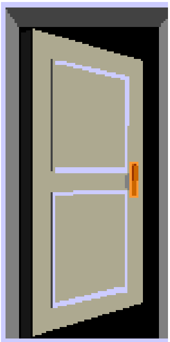
lion for the long-term maintenance and replacement of commonly held property.

- Associations provide shelter for nearly 50 million individuals in homes that have an estimated resale value of almost $2 trillion.
- These owners spend another $25 billion on internal home improvements and an estimated $85 billion on mortgage interest and real estate taxes.

Purpose of the Institute Report

This Institute Report discusses the important effects of community associations on lender collateral in home mortgage credit risk analysis. The importance of such underwriting is amplified by the growth in the percentage of homes located in community associations. First, the report examines the reasons behind the growth of community associations, including a discussion of the risks of making loans secured by homes in a community association. Second, the report examines key problems of underwriting and processing such mortgages. Finally, some ideas are presented on how loans secured by homes in community associations could be underwritten more effectively, more efficiently, and more cost effectively.

This Institute Report discusses the important effects of community associations on lender collateral in home mortgage credit risk analysis.



II. REASONS FOR THE CONTINUED GROWTH OF COMMUNITY ASSOCIATIONS

Although there are numerous historical reasons for the growth of community associations, four contemporary forces drive the explosive growth of community associations today: a revealed preference for collective management of community operations, public policies that stress privatization of formerly public functions, favorable demographics, and public policies favoring the expansion of homeownership opportunities.

The Value of Collective Management

Traditionally, the governing restrictions for single-family housing have been adopted and administered by public bodies. The rapid growth of community associations suggests that more homeowners also value the additional restrictions that community association living provides.[8] Specifically, Americans have accepted private controls embodied in community association governance in return for recreational amenities, clubhouses, and social activities. Moreover, residents of community associations seem to view private covenants, rules, and architectural controls as valuable tools to protect and enhance the value of their single largest investment: their home.

Privatization of Public Functions

Because of rising demand for services and limited economic resources, many jurisdictions now require builders and developers to create community associations to absorb certain aspects of the fiscal burden of new development.

Community associations are required to assume many responsibilities that traditionally belonged to local and state governments. In a recent survey, more than 50 percent of responding associations furnished street lighting, cleaning, snow removal, garbage collection, and other services.[9] In effect, the development jurisdiction delegates (or privatizes) these functions by requiring that developers of residential properties create community associations to fulfill such tasks.

Favorable Demographics

Condominiums and cooperatives traditionally have been entry points into homeownership. Almost from their inception in the 1960s, condominiums have played a key role in serving the lower end of the housing market, especially for first-time buyers. This was especially true of early condominium conversions in many urban areas. More recently, the natural increase in younger households, the growth of nontraditional families, the increase in singles, and the affordability crisis that high single-family house prices have caused in many areas have driven many households toward condominium ownership. In some urban areas such as New York City, cooperatives historically have served as a key ownership vehicle for lower- and moderate-income families.

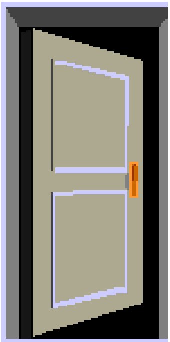
Expanding Homeownership Opportunity

Community associations have often played a key role in policies to expand the reach of homeownership. Cooperatives have been a popular vehicle for reaching out to lower- and moderate-income households for two reasons. First, cooperatives have had special state and federal mortgage and related subsidy programs that help lower housing costs. Second, it has been easier administratively to provide subsidies on a single blanket mortgage in a 100-unit cooperative than it has been to provide such subsidies on 100 separate mortgages in a condominium or planned community. Many private developers and community development corporations, however, have turned to using condominiums and planned communities in expanding the reach of homeownership to lower- and moderate-income families.

Community associations have often played a key role in policies to expand the reach of homeownership.

In some jurisdictions, developers of community associations are required, for inclusionary zoning purposes, to include lower- and moderate-income housing in their market-rate community association developments. The density structure of most community association housing, whether achieved by zoning variances or simple vertical construction, makes it a natural vehicle for policies that seek to minimize urban sprawl.[10]

The community association framework also works well in managing conflicts and functions in a dense housing environment as well as in dealing with potential problems arising from mixed-income and multicultural housing projects.[11]



III. THE EMERGENCE OF COMMUNITY ASSOCIATION UNDERWRITING

Mortgage Lending to Homes in Community Associations

By the mid-1970s, as the number of community associations increased, real estate developers and their attorneys became increasingly innovative in creating associations. At the same time, various practical problems surfaced that made it clear that the legal, governance, and financial infrastructure in which associations were developed and operated was inadequate. The National Conference of Commissioners on Uniform State Laws launched a concerted effort to develop uniform real property acts for each of the three types of community associations. Congress enacted a new section of the Internal Revenue Code (IRC Section 528) to deal with association taxation, and the American Institute of Certified Public Accountants adopted a special audit guide for community associations. Many states, such as California, Texas, Virginia, and Florida, made comprehensive revisions to their community association statutes. The lending community, however, was slow to make changes in its underwriting policies and procedures to accommodate these developments.

The Federal Housing Administration (FHA) and the Veterans Administration (VA, now the Department of Veterans Affairs) did address the issues involved in lending to homes within a community association by requiring the use of form documents for condominiums in the early 1960s and for planned communities in the early 1970s. FHA Form 1400[12] and VA Form 2600[13] were prescriptive in that they required certain language and a certain legal structure. These forms were almost universally copied and widely used for community association documentation (even to the warning that the documents were forms and should be modified for individual projects).

The two government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac also developed guidelines for lending to both planned communities and condominiums.[14] Their procedures, as articulated in their respective seller/servicer guides, differentitated between new projects controlled by the developer and existing projects controlled by the homeowners. Their guidelines, however, were basically a list of prohibited practices that might disqualify loans within a project for financing. For example, their guidelines contained a 70 percent presale requirement for new projects, a limit of 20 percent on the number of investor-owned (rental) units, a prohibition on rights of first refusal, as well as detailed insurance requirements and restrictions on developer control and on certain association actions.

By the 1980s, FHA/VA and GSE practices had evolved into a de facto national standard (with fringe variations) for the documentation of community associations. As part of flexible risk management, even portfolio lenders used these guidelines in case they might later sell their loans to the GSEs. Planned communities were proliferating, however, and originating lenders complained about the delay in processing project approvals. In response, Fannie Mae and Freddie Mac began to modify their underwriting. A new category, *de minimus* planned unit development (PUD), was created where the community association had little or no common area and nominal assessments. No approval was required for *de minimus* PUDs. Freddie Mac abandoned in-depth project reviews by its staff, instead requiring both representations and warranties as to compliance from originating lenders and opinion letters, usually from the developer's attorney, regarding the documents. Fannie Mae began limiting project reviews by its staff to more complex projects, also relying on lenders and attorneys to ensure compliance with its guidelines.

The FHA/VA and GSE guidelines . . . have been extremely useful in supporting the creation of community associations.

In contrast, FHA and VA standards changed little over the years. Then, late in the 1990s, VA modified its review processes. It began to accept attorney opinion letters regarding compliance with its guidelines. FHA project review was frequently circumvented by obtaining VA project approval and using it for FHA qualification.[15] Today, VA no longer reviews projects developed as planned communities.

Taking Stock of Underwriting of Home Loans on Properties in Community Associations

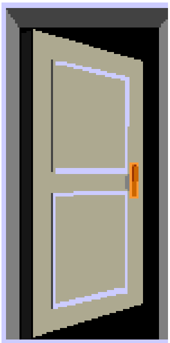
The FHA/VA and GSE guidelines are focused on prescriptive or functional requirements (that is, long lists of "do's" and "don'ts"). As such, they have been extremely useful in supporting the creation of community associations and in meeting the needs of construction lenders, title insurers, and the home mortgage markets. Agency guidelines have not, however, addressed association governance or operational issues, nor have they kept up with accelerating changes in development practices.

Such problems have not gone unnoticed. In 1994, CAI convened a task force to re-evaluate the guidelines and procedures.[16]

The task force analyzed the GSE and FHA/VA guidelines and paid particular attention to the obligations imposed on originating lenders in order to obtain community association project or individual loan approval. Subsequent to the task force's report, the GSEs and VA made selected changes; FHA had other priorities at the time and did not adopt any of the recommendations.[17]

> ***Community association underwriting standards and risk analysis have been virtually untouched by academics, the business community, policymakers, and financial regulators.***

Even the CAI task force, however, addressed only a limited set of lending issues regarding loans secured by homes within community associations. The area of underwriting standards and risk analysis has been virtually untouched by academics, the business community, policymakers, and financial regulators. The remainder of this report reviews the additional underwriting considerations in lending on a home that is part of a community association and how information might be collected to aid in controlling and pricing the risks involved.



IV. RISKS INVOLVED IN COMMUNITY ASSOCIATION-BASED MORTGAGES

Traditionally, lenders have not focused on community association underwriting issues because loan losses were acceptable, and homes in community associations were not yet a significant percentage of their total loan portfolio. The expansive growth of community associations has meant that a larger and larger percentage of loan portfolios and underwriting efforts involve mortgages on homes where at least a portion of the value is dependent on a community association. Even though the association may have a secondary lien position, a community association can cause a homeowner to default on his or her first mortgage if it exercises that lien. Actions of the association may cause the homeowner to go into default on the first mortgage or to be otherwise financially stressed. Just as the rationale for community associations is that they will provide services that enhance the value of the properties they serve, poorly run community associations will have deleterious effects on the homeowners and their property.

Traditionally, lenders have not focused on community association underwriting issues because loan losses were acceptable.

This will have derivative effects on lenders holding the mortgages on a home in such an association. First, rising homeowner assessments can impair the ability of the homeowner to meet mortgage payments. Second, deterioration in the physical plant of a community association or increasing assessments to prevent such deterioration both can have adverse effects on the property values of homes and reduce their value as collateral.

The Unique Risks Associated with Community Associations

The homeowner's interest can be foreclosed by association-induced defaults even if the borrower is current with mortgage payments. At a minimum, this will precipitate foreclosure of the mortgage on the home, imposing unwanted expenses on the lender that has to reinvest the funds. At worst, the value of the collateral may deteriorate during the dispute and endanger the principal on the loan. The primary cause of either of these problems results from increasing assessment burdens and disputes. Even if the assessment dispute simply involves a fine for late payment, then a small dollar issue (compared to the mortgage payment) can escalate to significant sums and may result in a lien and eventual foreclosure proceedings, assessment acceleration or, in a cooperative, eviction. In nearly all U.S. jurisdictions, the courts in a long series of cases have indicated an unwillingness to tolerate nonpayment (the equivalent of a rent strike) even if the board of directors is accused of poor management.[18]

Another source of problems that may cause association-induced financial stress for the homeowner stems from governance disputes. Such disputes arise from lifestyle complaints and governance problems. Lifestyle complaints usually involve a failure to comply with stated community association rules and regulations. As in the case of assessment disputes, these governance disputes can lead to fines, penalties, and attorney fees. Most associations have procedures for the collection of assessments and the imposition of fines and penalties arising from these types of disputes. These fines and penalties, however, may become increasingly severe as the debt remains unpaid. Despite these procedures, the filing of a lien against the owner's home remains the primary method of not only securing the debt, but of securing the disputing homeowner's attention.

In either case, and despite the lender's ability to request notice, the lender may or may not be notified of these disputes. Even if notified, the lender has few tools by which to intercede. In the case of governance disputes, the lender may never be aware of what is taking place until the fines, penalties, and attorney fees have moved the association toward some type of more formal legal action—and perhaps not even then. The increasing division of mortgage origination from mortgage servicing exacerbates this situation.

Sources of Operational Risks

An alternative, and potentially serious, source of risk for lenders secured by homes within a community association is the economic strain that problematic delivery of association services and operations can put on borrow-

A potentially serious source of risk for lenders secured by homes within a community association is the economic strain that problematic delivery of association services and operations can put on borrowers that may endanger the payment of their individual mortgage.

ers that may endanger the payment of their individual mortgage. The core risk centers on the "commercial" nature of the process. In reality, a group of single-family homes with a common area is little different than a multifamily rental housing project. The underwriting process for multifamily loans is a fairly intensive one, having little in common with the underwriting of a normal single-family loan. Multifamily underwriting analyzes three issues: the capability of the management to operate the project, the risks of the underlying cash flow stream supporting the mortgage, and the physical and financial nature of the collateral project.

Management of the day-to-day operations of the community association is a crucial element in the successful physical and financial outcome of an association.

The core services of a 100-unit community association (whether single-family detached or attached) are quite similar to a multifamily rental property. Thus, loans dependent upon the governance of a community association might be expected to be underwritten in much the same manner. The key elements of such underwriting would involve an assessment of financial soundness, the physical condition of the property, and the effectiveness of management operations (whether by volunteers or professionals). In point of fact, the risks probably are magnified in the case of community associations.

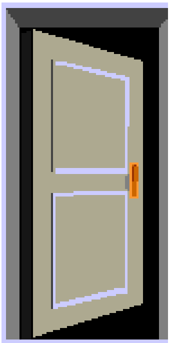
The leadership of the association is the ultimate manager of the process. These volunteers may not have the same focus, incentives, or financial acumen as a Real Estate Investment Trust, professional management company, or corporation that owns a comparable multifamily rental unit. Management of the day-to-day operations of the community association is a crucial element in the successful physical and financial outcome of an association. As in multifamily underwriting, the preferred course is to have professional management. Finally, physical issues are important, including the associated financial planning required to reserve enough funds to meet major replacement expenses when they are needed.

Recent Developments and Credit Risks

In addition to the normal risks inherent in community association lending, the age of many community association projects makes the credit risk of underwriting related home loans an even more timely issue. Many are 20 to 30 years old and at the beginning of a cycle of needed renovation. In particular, many rental projects were converted to ownership status in the late 1970s to the early 1990s; some of those buildings were 25 to 30 years old at the time of conversion. Even if a given homeowner were able to pay for the necessary repairs to his or her own home, repairs to the common area constitute an additional burden if reserves are not adequate to meet these expenses. Typically, the board of directors will have control over the timing and financing of such expenditures. Experience has shown that such decisions may, or may not, be made in a timely manner.

Two other recent trends are likely to add to the risks facing association operations and the lenders that finance the homes within them. First, to the extent that community associations are being used to facilitate high-density and mixed-income development, one would expect a higher level of physical and financial challenges in governance and fiscal management. On the one hand, expenses are likely to be higher with more density and lower-income tenants. On the other hand, the ability to pay for assessment increases and issues of equity in raising funds are likely to be more contentious.

Second, to the extent that community associations are taking over municipal functions, risk is probably magnified. Keeping a busy street in repair is not necessarily the same as keeping a pool clean.



V. NEW STRATEGIES FOR COMMUNITY ASSOCIATION MORTGAGE LENDING

Where We Stand Now

Current underwriting practices for mortgage loans secured by homes within a community association are the product of an uncoordinated collection of rules promulgated by the GSEs and FHA/VA. These rules have not been updated in many cases in some time, are largely prescriptive in nature, and—most importantly—are not focused on performance issues.

Moreover, the current practice involves high costs and time delays in processing loans. Under the current system, all of the underwriting information and documentation for any given community association is collected anew each time an originator makes a loan that is sold to, insured by, or guaranteed by the GSEs, FHA, or VA (or kept in portfolio). The system has no memory.

Further, this lack of memory makes it difficult to rank community association underwriting information and documentation in life cycle terms. For instance, some community association information (such as governing documents) has a long duration, while other information (such as the budget) has an annual cycle.[19]

A final consideration in the current ad hoc underwriting system is one common to situations in markets in which information is not efficiently obtained. That is, the originator of the loans will have superior knowledge of the efficiency and financial condition of the community association in which a home is located. This could well lead to an adverse selection problem in which the mortgage originator may keep the less risky loans in portfolio and sell the others in the secondary market. This could be a major problem for the GSEs and FHA/VA in the case of home loans in which the secondary market is so important.

Moving Toward a More Modern System

Modern lenders deal with risk in two ways: by prescribing rules on the terms and conditions of the loans to prohibit risky practices, and by evaluating the risks involved in the practices it accepts and pricing the loans accordingly. For example, if a lender on a multifamily property allows only loans with underlying income flows to loan payment burdens with debt service coverage ratios of 1.3 or above, a 1.4 ratio loan will receive a less favorable rating than a 2.0 coverage loan.

In addition, unknown or unquantifiable risks often add to the "price" of the loan. The same theory holds for single-family loans (where the riskiness of a loan can now be given a numerical score).

The prescriptive rules that have evolved for mortgage lending for homes in community associations discussed above do set prescriptive boundaries on practices of community associations that affect loan quality. Moreover, years of business experience help lenders decide how to price loans based on their view of riskiness. With the growth in the percentage of loans secured by homes in community associations, however, it is time for the next step. For most other types of loans, sophisticated lenders systematically collect data on loan and collateral characteristics and on loan performance. These data are then used in statistical models to pinpoint the sources of risk relating to community associations. In that way, careful and efficient lenders will be rewarded with lower default rates and higher profits. The key to applying this framework to mortgage loans on homes within community associations is to build an information base to support such a performance-based analysis of how well (or poorly) associations function.

The key . . . is to build an information base to support a performance-based analysis of how well (or poorly) associations function.

The Specifics of an Effective Underwriting System

To design and implement a system that collects the necessary data to identify lending- related risks, one must first document what the association does that could affect loan performance. To a large extent, these functions can be subsumed under the categories of business operations, governance effectiveness, and community services. Some of these functions can have a direct impact on loan performance because they affect the levels of assessments and quality of community assets. Other factors may have an indirect impact by affecting both property values and the willingness of residents to make sound long-run financial decisions.

Table 1
Community Association Underwriting: Delivering Services from a Performance Perspective

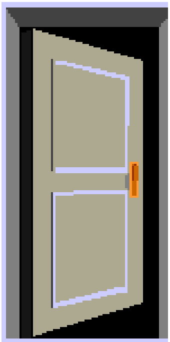
Business Services	Governance Services	Community Services
Management Competency	*Compliance Management*	*Communications Management*
Professional association management company	Date of last governing document revisions	Number of newsletters per year
Years of experience and designations	Number of legal actions per year	Annual report
Adequacy of professional insurance coverage	Fines as a percent of revenue	Resident forum
	Ratio of architectural review approvals/ denials	Tenant communication
Asset Quality and Management	*Board of Directors Management*	*Community Management*
Community asset inventory: rental units, vacant units, average turnover rate, etc.	Number of board meetings per year	Dispute resolution policy
Age and quality of physical plant	Number of new board members per year	Rules orientation
Adherence to maintenance schedule	Annual plan	Resident orientation
Maintenance ratios	Training new members	
Financial Management		
Average collection cost		
Average percent delinquent		
Professional reserve study		
Adequate reserve ratios		
Number of collection actions per year		
Bad debt write-offs		

Table 1 documents the types of information that could be collected to provide the basis for performance-based underwriting and pricing systems for home loans in community associations. With respect to business services, an association should be evaluated in at least three areas: management competency, physical asset management of common property, and financial management. Key issues include the presence and quality of professional management services, the nature of the community as a housing market, and the quality and care of common assets. Governance issues include the quality of the governance structure and the level of contentiousness regarding compliance issues. Finally, the community functions might look at some key quality-of-life measures.

An association should be evaluated in at least three areas: management competency, physical asset management of common property, and financial management.

Collecting these data should not necessarily be difficult or expensive. Most of the information is readily available to each community association. The availability of the Internet and the creation of powerful, but moderately priced, information technology and database systems should help to alleviate some of these challenges in the same way that they have helped alleviate similar problems in the individual home mortgage application process.

Some key steps that are necessary to move forward are already under way. First, information must be standardized. An extensible markup language and extensible business reporting language are being tailored by CAI, in conjunction with the American Institute of Certified Public Accountants, for community association business, governance, and community services information reporting. This will lay the groundwork for community association information compatibility and transmission similar to the efforts under way by the Mortgage Industry Standards Maintenance Organization. Second, a centralized community association database should be assembled, organized, and maintained.



VI. SUMMARY AND CONCLUSION

Despite the rapid growth in community associations in housing markets, the state of the art of underwriting mortgage loans on homes within such communities lags behind both traditional single-family or multifamily mortgage lending practice.

This report has developed the framework in which improvements could be made. It involves focusing on the creation of performance-based measures of the delivery of community association housing services and on collection of the proper data to support the appropriate analysis. Accomplishing these two tasks would have direct benefit for all concerned.

For borrowers, it would mean loans could be processed in a timelier fashion and rates could be set in a more accurate and equitable manner. Those lenders that understand community association practices will have an advantage in the future. With some changes to current underwriting procedures, thoughtful lenders can not only more efficiently mitigate risk (or price for it) but also obtain a long-run competitive advantage over other lenders that do not fully understand such lending. Finally, for community associations, improved underwriting would provide a free market mechanism for maintaining operational discipline and an incentive for efficient operations.

An important extra benefit of improved community association underwriting is that it will facilitate the use of this form of homeownership in some of the key policy initiatives currently under way. First and foremost, community associations are uniquely suited to "smart growth" initiatives—they are predicated on density, they require attractive design for marketability, and they are organized to meet the fiscal sustainability necessary to support the privatization of infrastructure and municipal service obligations. Second, as new policies aimed at raising lower- and moderate-income homeownership rates are formulated, community associations are a natural vehicle for achieving that goal.

ACKNOWLEDGEMENTS

The authors would like to thank Barbara Byrd Keenan, CAE, President, and Kris Cook, Senior Vice President, of the Community Associations Institute and Douglas Kleine, CAE, Executive Director of the National Association of Housing Cooperatives, for their assistance in preparing this report. The views expressed and errors committed, however, are solely those of the authors.

NOTES

1. Congress chartered the National Cooperative Bank in 1978 to provide a capital source for housing cooperatives and other non-agricultural cooperatives. Housing cooperatives developed under Federal Housing Administration Section 213 have had the best performance of any U.S. Department of Housing and Urban Development multifamily loans. Similarly, the Fannie Mae share loan program for cooperatives usually has a lower default rate than the Fannie Mae single-family mortgage programs.

2. A more complete description of the similarities and differences between the three basic types of associations can be found in Treese (1999a). A comprehensive discussion of financial and tax issues in the operation of community associations can be found in Porter and Nelson (2000) and Rutledge et al. (1999). The National Conference of Commissioners on Uniform State Laws has promulgated several uniform real property acts dealing with associations. The most comprehensive is the Uniform Common Interest Ownership Act. These acts, in some form or another, have been adopted by about one-third of the states.

3. Some states provide for variations. In California, the unit owners in a planned community can own the common areas as tenants-in-common. Also in California, cooperatives can be created as real property interests. Similarly, the Uniform Common Interest Ownership Act permits cooperatives to be developed as either real or personal property interests.

4. New Jersey has the most comprehensive statewide municipal services act that addresses this type of double taxation. See Kennedy and Lambert (2000).

5. A more detailed chronology of the growth of community associations can be seen in Treese (1999a). Both the U.S. Census and the American Housing Survey (AHS) count units in condominium associations and units in cooperative associations, but do not count units in planned communities; neither the Census nor the AHS counts the number of associations. Estimates of the number of units and of the number of associations that contain those units are derived from federal and state tax returns, certain state estimates, and private surveys of industry practitioners. Currently, of the 231,000 community associations (using 2001 estimates), approximately 5 to 7 percent are cooperatives, 35 to 40 percent are condominiums, and the balance are planned communities.

6. The statistics for community association growth were compiled by Treese from numerous sources including the U.S. Census, American Housing Surveys, related federal government publications, tax returns, state documentation, and association industry practitioners.

7. The community association metrics have been compiled by Treese from a variety of sources. See Treese (1999a).

8. The two most recent surveys of homeowner satisfaction were conducted by the CAI Research Foundation. The first is available in book form from CAI (Heisler and Klein 1996); the second is a Gallup Organization-commissioned survey available online at http://www.caionline.org. Both studies indicate high levels of satisfaction with association living.

9. See Heisler and Klein (1996).

10. See Treese (1999b).

11. The moderately priced dwelling units of the Housing Opportunities Commission of Montgomery County, Maryland, are a good example of this type of mixed-income housing being used within standard community associations.

12. See HUD Handbook 4150.1, Rev. 1, Chapter 11.

13. See 38 CFR 36.4350.

14. The current guidelines are in FannieMae's *Seller's Guide*, chapter 3 (Type C Condominium) and chapter 4 (Type E and Type F PUDs), and Freddie Mac's *Seller's Guide*, chapter 42 (Condominiums) and chapter 43 (PUDs).

15. See 38 CFR 36.4356 through 38 CFR 36.436.

16. CAI is a trade association that gathers information on the community association industry and has developed and administers the most prevalent management and homeowner education programs. CAI also developed and conducts the most widely used board of directors education program. Together with a sister association, the National Board of Community Association Managers, CAI administers and maintains the primary association management designations. The National Association of Housing Cooperatives administers a designation program for managers specializing in housing cooperatives and conducts leadership education for boards of housing cooperatives (see http://www.coophousing.org).

17. The CAI task force was led by Robert M. Diamond and Clifford J. Treese. Diamond and Deborah Raines, both of Reed Smith Hazel & Thomas, P.C., Falls Church, Virginia, produced the privately published two-volume *Report on Agency Guidelines.*

18. See *Agassiz West Condominium Association v. Solum*, 527 N.W.2d 244 (N.D. Sup.Ct. 1995); *Park Place Estates Homeowners Association, Inc., v. Naber*, 29 Cal. App. 4th 427, 35 Cal. Rptr. 2d 51 (1994); and *Rea v. Breakers Association, Inc.*, 674 So. 2d 496 (Miss. 1996).

19. Nearly every state has some type of disclosure requirement for the first sale or the resale of a home within a community association, especially if it is within a condominium. See Article 4 of the Uniform Common Interest Ownership Act for an example. Lenders, in turn, often use some form of the Uniform Project Questionnaire, otherwise known as Fannie Mae Form 100. In addition to disclosing information, most purchasers are entitled to receive copies of the governing documents (declaration, bylaws, articles of incorporation), budget, common area insurance certificate, rules and regulations, most recent financials and/or audit, and most recent reserve study. All of this information (including the documents) can accumulate to 150 to 300 pages. Generally, if the buyer does not receive all of the mandated information prior to closing, then the buyer has a right of rescission.

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APPENDIX 1. COMPARING COMMUNITY ASSOCIATIONS TO OTHER ENTITIES

Category	Total Entities	% of Total	% of All Entities
Private nonprofit organizations[a]			
Tax-exempt organizations registered with IRS as 501(c)(3)	734,000	47.66	
Social welfare organizations, 501(c)(4)	140,000	9.09	
Other reporting tax-exempt organizations	400,000	25.97	
Religious congregations not reporting	266,000	17.27	
Total	1,540,000	100.00	6.04
Governmental units[b]			
U.S.	1		
States	50		
Local			
County	3,043	3.48	
Municipal	19,372	22.15	
Township & town	16,629	19.01	
School district	13,726	15.70	
Special district	34,683	39.66	
Total	87,504	100.00	0.34
Businesses[b]			
Corporations	4,710,000	19.92	
Partnerships	1,759,000	7.44	
Nonfarm proprietorships	17,176,000	72.64	
Total	23,645,000	100.00	92.81
Community associations[a]	205,000	100.00	0.80
TOTAL	**25,477,504**		**100.00**

[a]As of 1998.

[b]As of 1997.

Sources: U.S. Bureau of the Census (2000), and The Urban Institute Center on Nonprofits & Philanthropy.

APPENDIX 2. GROWTH OF COMMUNITY ASSOCIATIONS, 1970–98

	1970	1975	% Change 1970–75	1980	% Change 1975–80	1985	% Change 1980–85
Type of CA units							
Condominium	85,000	1,252,000	1,372.9	2,541,000	103.0	2,566,700	1.0
Cooperative	351,000	439,000	25.1	482,000	9.8	506,000	5.0
Planned community	265,000	340,000	28.3	613,000	80.3	2,162,300	252.7
Total	701,000	2,031,000	189.7	3,636,000	79.0	5,235,000	44.0
Total housing units	69,778,000	78,821,000	13.0	87,739,000	11.3	97,333,000	10.9
CA units as % of all housing units	1.0	2.6	156.5	4.1	60.8	5.4	29.8
Total occupied housing units	63,640,000	71,925,000	13.0	79,638,000	10.7	87,887,000	10.4
CA units as % of all occupied housing units	1.1	2.8	156.4	4.6	61.7	6.0	30.5
% of units in each type of CA							
Condominium	12.1	61.6		69.9		49.0	
Cooperative	50.1	21.6		13.3		9.7	
Planned community	37.8	16.7		16.9		41.3	
Total	100.0	100.0		100.0		100.0	
Total CAs	10,000	20,000	100.0	36,000	80.0	55,000	52.8

APPENDIX 2. GROWTH OF COMMUNITY ASSOCIATIONS, 1970–98 (continued)

	1990	% Change 1980–90	1995	% Change 1990–95	1998	% Change 1995–98
Type of CA units						
Condominium	4,848,000	88.9	4,962,000	2.4	5,079,000	2.4
Cooperative	824,000	62.8	772,000	-6.3	749,000	-3.0
Planned community	5,967,000	176.0	7,911,000	32.6	10,563,000	33.5
Total	11,639,000	122.3	13,645,000	17.2	16,391,000	20.1
Total housing units	106,283,000	9.2	112,655,000	6.0	117,282,000	4.1
CA units as % of all housing units	11.0	50.9	12.1	12.1		14.0
Total occupied housing units	94,224,000	7.2	99,985,000	6.1	103,534,000	3.5
CA units as % of all occupied housing units	12.4	107.4	13.6	13.6		15.8
% of units in each type of CA						
Condominium	41.7		36.4		31.0	
Cooperative	7.1		5.7		4.6	
Planned community	51.3		58.0		64.4	
Total	100.0		100.0		100.0	
Total CAs	130,000	136.4	171,000	31.5	205,000	19.9

Sources: Simmons (2000) and Treese (1999).

APPENDIX 3. SUPPLEMENTARY GROWTH PROJECTIONS OF COMMUNITY ASSOCIATIONS, 1999–2004

	1999	% Change 1998–99	2000	% Change 1999–2000	2001(E)	% Change 2000–01
Total CA units	17,120,000	4.5	17,000,000	4.0	18,480,000	3.8
Total housing units	119,044,000	1.5	119,629,000	0.5	122,320,653	2.3
CA units as % of all housing units	14.4	-6.8	14.9	3.5	15.1	1.5
Total occupied housing units	104,928,000	1.3	105,721,000	0.8	108,099,723	2.3
CA units as % of all occupied housing units	16.3	3.2	16.8	3.2	17.1	1.5
Total CAs	214,000	4.5	222,500	4.0	231,000	3.8

	2002(E)	% Change 2001–02	2003(E)	% Change 2002–03	2004(E)	% Change 2003–04
Total CA units	19,200,000	3.9	19,920,000	3.8	20,800,000	4.4
Total housing units	125,072,867	2.3	127,887,007	2.3	130,764,464	2.3
CA units as % of all housing units	15.4	1.6	15.6	1.5	15.9	15.9
Total occupied housing units	110,531,966	2.2	113,018,935	2.3	115,550,560	2.2
CA units as % of all occupied housing units	17.4	1.6	17.6	1.5	18.0	2.1
Total CAs	240,000	3.9	249,000	3.8	260,000	4.4

Note: Columns marked with an (E) contain data that are projected values based on recent growth trends.

Sources: Simmons (2000) and Treese (1999).