



NEW FHA RESERVE REQUIREMENT

QUESTION: Regarding the FHA 60% reserve funding requirement; just what does the 60% mean?

ANSWER: As reported last week, starting November 1 the FHA will not insure loans in condo developments where the association's reserves are less than 60% of the funding levels called for in the association's most recent reserve study. The 60% reserve requirement is not a national standard, it was issued by the Santa Ana HUD/FHA office. Since the Santa Ana office serves the Western region, their rule controls all loan guarantees in California.

Reserve Requirements. In addition to requiring 60% reserve funding for existing condominium associations, the Santa Ana office obligates condo conversions to 100% reserve funding. Below describes how the new requirements work.

Existing Condos. If an association's roof costs \$100,000 to replace in 20 years, then \$5,000 must be set aside annually for the next 20 years. Assume the roof is now 10 years old; to be fully funded, the association must have \$50,000 in its reserve account for the roofs. To meet the Santa Ana requirement, the association needs at least 60% of the \$50,000, i.e., \$30,000 cash on hand for the roofs. To arrive at the total cash for all reserve items, the same calculation is applied to each item in the reserve study. If all components taken together total \$1 million as of today's date, then the association must have 60% of \$1 million in the bank, which means \$600,000.

Condo Conversions. If the development is a condo conversion, the association needs 100% of the reserve study's fully funded requirement. In the roof example above, condo conversions need the entire \$50,000 in roof reserves to qualify for FHA loan guarantees. Keep in mind that roofs are only one component. If all components taken together total \$1 million, then the association must have \$1 million in its reserves to qualify.

Bona Fide Reserve Study. An obvious way to meet the FHA requirement is to doctor the reserve study to reduce the \$1 million funding requirement to whatever amount is currently in your reserves. That would be a very bad idea. Directors would face potential liability for fraud (not covered by insurance) and breach of fiduciary duties. In addition, the FHA requires that associations use a bona fide site visit reserve study for their calculations. Bona fide means "made in good faith without fraud or deceit."

Thank you to Robert Nordlund of Association Reserves, Inc. and Clifford Treese of Association Information Services for their input on this question.

COMMENT: It's understandable the FHA would not want to guarantee loans in weak associations. Unfortunately, the Obama Administration's timing is terribly short-sighted. The new requirement is being imposed when the housing market is already distressed and associations are suffering record foreclosures. FHA insured loans are vital to the housing market because they enable buyers with modest incomes to purchase homes. On November 1 when the new regulations go into effect, tens of thousands of condominiums in California will become virtually unsalable. This will further depress the housing market and drive more condominiums into foreclosure. Not a smart move.

- Adrian Adams