Understanding the Federal Housing Administration's (FHA) New Reserve Requirements

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Due to new HUD rules, condominium developments must now have FHA approval in order for buyers to obtain FHA loans or for current owners to refinance into FHA loans. Therefore, those who choose not to have their communities FHA approved are in essence limiting the pool of potential home buyers. To get the FHA stamp of approval, the association must understand the new reserve requirements.

In November 2009, the FHA issued Mortgagee Letter 2009-46 B entitled, "The Condominium Approval Process for Single Family Housing" to all approved mortgagees and FHA roster appraisers. In this letter there are certain guidelines that must be met in order for FHA mortgages to be approved. Section 11 entitled "Budget Review" relates to the new FHA reserve requirements and states that mortgagees must review the actual or projected budgets for all established and planned projects. This review must determine that the budget is "adequate" and:

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

The only FHA definition of "adequate" is that 10% of the budget be set aside for maintenance and reserves. Should the budget documents not meet these standards, the document explains that, "the mortgagee may request a reserve study to assess the financial stability of the project." This reserve study cannot be more than 12 months old and must take into consideration items that have been replaced after the time that the reserve study was completed.

In lieu of the actual budget documents, the mortgagee may rely on Fannie Mae for their Analysis of Annual Income and Expenses Operating Budget using Form 1073a. The form must be executed by a representative of the seller/servicer, owners association or management agent. Much like a reserve study, this form collects similar maintenance schedule and budgetary information.

Definition of Adequate:

Throughout the Mortgagee Letter the term "adequate" is used as a standard, but no place within the document clearly defines what adequate means. In the first section under budget review, it states that "the review must determine that the budget is adequate." The beginning paragraph indicates that review for adequacy should be performed by the mortgagees, but the list of terms explaining the standard also use the undefined term. For instance, one of the criteria of an adequate budget is that it provides adequate funding for insurance coverage. What percentage or amount of insurance is not detailed and readers are once again left to create their own definition of "adequate." This lack of clarity could cause applicants problems during the approval process.

10% for Reserve Replacements

There are also a number of issues that can be raised by the 10% definition of "adequate." The FHA letter indicates that the funds for both capital expenditures and deferred maintenance should be included in one account representing 10% of the budget. It is very important that the Association discuss this with their accountant since there are accounting reasons why both deferred maintenance and replacement reserves should not be co-mingled within one account, but that they should be separated, for tax purposes, into a deferred maintenance and capital reserve and fund account.

In addition, there is no indication as to how 10% became the standard. Who decided, how and why is 10% the magic number which provides "adequate" funding of the reserves and deferred maintenance. It must be recognized that two associations side by side may have significant differences in their amenities but the same budget size. Therefore to use a 10% standard figure for both of these associations could significantly under–fund or over-fund their reserves. For this reason, the most appropriate way to establish the actual reserve requirements is with a professionally prepared reserve study.

Recommendation

Although the FHA does not require community associations to have a current reserve study, an adequate budget must be established in order to receive loan approval. An association could try to show that its budget accounts for ongoing common area maintenance, future reserve replacements and community insurance costs, but a professionally prepared reserve study will undoubtedly fulfill the budget review requirements of FHA qualification. In light of the FHA's technical and ambiguous budget requirements, an updated reserve study is recommended for associations looking to comply with the new regulations.

While at this point the dust has yet to settle with regard to how the FHA requirements are going to affect the need for an association to have a reserve study performed, having a professionally prepared reserve study is recommended for the financial and physical well being of all communities. A reserve study represents the components of the specific association and reflects their actual condition, replacement costs and estimated remaining lives. It acts as a road map for planning the community's budget, meeting all legal, fiduciary and professional requirements, minimizing the need for special assessments and enhancing property resale values. As a financial planning tool, a reserve study also helps associations evaluate which is the best funding plan for them in order to maintain adequate reserves while at the same time not over-funding their reserves.

There is no question that even if the association doesn't fund a reserve schedule, that will not stop a roof or any of the other common elements of the association from aging and requiring replacement if the funds are no longer available.

References: U.S. Department of Housing and Urban Development, Washington, DC, *Mortgagee Letter 2009-46 B*, p. 6.

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