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Association of Condominium, Townhouse, and Homeowners Associations

ACTHANEWS

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North Expo—Oct. 12, Wheeling

HOW MANY LOAN SHARKS DOES IT TAKE TO...

By: Brook Silvestri, CMCA

By this point, I imagine that you have heard about community associations borrowing money for common element repairs. You probably have the section of your governing documents memorized that allows your association to pledge assets as security on this type of debt. So we know that they *can* borrow. But the question remains as to how, practically, they *do* borrow. What is it that the shark tank full of lenders will ask when reviewing a credit request? Let's arm you with that information before you face the lenders.

While methodologies differ among experienced lenders in this arena, their philosophy is consistent. Most associations do not have a great deal of hard assets to secure financing, so the lender is looking for a solid cash flow stream to use as collateral. They will perfect a lien on that cash flow stream by filing a form with the Secretary of State as part of the loan documentation. Most lenders don't play well in the sandbox with other lenders. That means that only one lender can have a priority lien on those assessments. So in the vast majority of cases, an association will borrow from only one lender at a time. If there is an existing loan on the balance sheet and the association is looking for more debt, it needs to discuss that with the current lender or be prepared to refinance the existing debt with a new loan as part of the new financing that they seek.

So if cash flow is paramount, how do lenders determine what good cash flow looks like? They will first examine the delinquency report normally prepared by the managing agent from its accounting software. There are a series of ratios that lenders run during an underwriting process and this delinquency ratio is the king. Some lenders calculate it based on the number of units that are past due and some base it on dollars. Regardless of the method, they want to see a modest delinquency usually not higher than 5% to 10%. This

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TIP OF THE MONTH

From a Management Perspective

- Managers are not the enemy. We take directions from a) our contract, b) the Board of Directors and c) the Law.
- Please avoid calling at 9:01 a.m. on Monday and expect a call back by 9:05 a.m. Monday. We need time to get our phone calls off voice mail before we start the day.
- It is the Manager's job to take your concerns to the Board, not decide for the Board.
- Despite what some people think, screaming at a Manager will not get anything done faster.
- Contrary to popular belief, one owner of one property does not pay my salary.
- When you call into management with a concern, please provide a great deal of information so that we can send the correct vendor to handle the problem.
- The Board of Directors cannot give you something that the Declaration and Bylaws of the property does not entitle you to.
- All Managers must now be licensed. That means we cannot provide a legal opinion to you, because that is not our license, we cannot give you insurance advice, because that is not what we are licensed in. But if you go to the correct professional you will get an answer.
- Managers do not provide homeowners recommendations to use particular vendors. The reason is simple—in today's litigious society, no good deed goes unpunished.
- As an owner in your association your responsibility is to come to meetings. As a Board member, your responsibility is to make decisions for the good of the entire community. As a Manager, we need to bring information to the Board so the Board can make informed decisions.

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basically means that the association is collecting 95 cents out of every dollar that it budgeted in assessment income. If that is happening, they likely have the capacity to repay the proposed debt. They will have a hard time arranging financing if the association collects less than that.

Next in the series of underwriting ratios are an income diversity measurement and an overall pro-forma change in assessments. They sound complicated, but in reality the lender simply wants to know 1) how many owners are in the association in order to diversify the cash flow stream? and 2) how much will assessments go up to cover the payments on the proposed loan? Obviously, the greater the number of units there are, the more diverse the cash flow stream is. For example, if one owner in a ten unit building loses his job, that represents roughly 10% of the cash flow of the association. If the same thing happens in a 100 unit building, the impact is only 1%. It is generally pretty tough for associations with less than 20 units to get financing for this reason. The increase in assessments going forward to cover the loan payments is also important, especially where statute allows the general ownership to potentially veto an annual year over year increase greater than or equal to a certain amount. Lenders will take into account the absolute dollar value of assessments when calculating this ratio and make reasonable conclusions about it. In a recent deal, we calculated a 50% increase, but the dollars were going from $40 to $60. An extra $20 is probably not a giant financial burden for any owner. A jump from $400 to $600, on the other hand, could clearly be a much bigger issue and will give the lender pause.

Every lender that I know will perform some level of reserves analysis in conjunction with the cash flow ratios above. Now, banks are famous for providing umbrellas when the sun is shining and taking them back as soon as it starts to rain. So I hear all the time that if the association had the money in reserves, it would not need to borrow. The lender's intent in measuring reserves is more to see how the board is addressing its fiduciary duties to the association than in examining its net worth. Contributing funds on a regular basis to the reserve, year in and year out, is a good idea and shows financial wisdom on a board's part. Buying lottery tickets and planning to put the winnings in the reserve is not. Lenders will likely look at the association's reserve study (yes, get one) and try to figure out how many dollars of repairs the association will face during the proposed loan life, outside of the potential loan, and how the association can pay for those. So, if we are looking at a five year loan and the association has $1,000,000 of repairs in the next five years as identified in the study, they intend on financing $700,000, and have $100,000 in cash today, how will they pay for the other $200,000? If their reserve contribution is at least $40,000 on average annually ($1,000,000 repairs - $700,000 loan - $100,000 cash = $200,000 / 5 years), that is a great answer. If not, they will need another plan and will probably need to document that for the lender. It would not surprise me if that plan showed up as a financial covenant in the credit agreement too.

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One of the last ratios is one that is based on unit value. I call it "equity bleed" and it is not used by all lenders and is sometimes not even included in the underwriting criteria, but it sure is good to know. It measures the amount of proposed debt, on a per unit basis, compared to the average unit value and tells the lender and owners how much home equity, on average, is being diluted, or bled, by taking on this loan. Historically, when we see this ratio exceed 10%, owners revolt....not universally, but regularly. Again, absolute dollars play a role here and in an area where values are artificially low, one must examine the dollar change in addition to the ratio. This ratio is most effective when a special assessment will be used to repay the loan. If we pretend then, that units are worth $250,000 in a 120 unit building and the association plans to take out a $1,500,000 loan, the equity bleed ratio is 5% ($1,500,000 / 120 units / $250,000). In this fictitious scenario, as long as unit values don't fall below $150,000 on average, the association and its owners will probably be just fine with this debt.

I have been financing common interest communities for a long time and would highly recommend to an association contemplating financing a project that it runs these ratios early in the process. It will certainly help their discussion with a lender later and can identify issues that require attention before actually approaching the bank.

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LEGISLATIVE CORNER

The Illinois General Assembly adjourned May 31 and will not reconvene until the fall (unless a special session on pension reform is called by the Governor). In terms of issues affecting community associations, below are bills which passed both Houses and await the Gubernatorial action. All of the bills below were supported by ACTHA.

- *HB 595 Amends the Community Association Manager Licensing Act. Makes various changes but most importantly eliminates any fee on associations for administration or enforcement of the law.*
- *HB 1773 Amends the Common Interest Community Act to allow for three (currently four) annual board meetings and makes changes to the insurance section*
- *HB 2374 Amends the Common Interest Community Act to provide that a board member's immediate family includes siblings.*
- *HB 2527 Provides that before a residential co-op can be dissolved, there must be an open meeting and vote of the membership*
- *HB 3390 Allows a board to install solar and wind energy devices on common elements and on limited common elements with the consent of the owner.*
- *SB 1606 Amends the Condo Property Act to allow for 3/4ths of owners to approve changes to the governing documents as opposed to 100% of all owners as some documents may require.*

ACTHA was successful in opposing a bill that while extending from 6 to 9 months the ability of associations to collect common expenses in a foreclosure action, also eliminated the ability for associations to collect anything but assessments—no collection of special assessments, late fees, or attorney fees.

Most disappointing was the failure to pass a bill to make moot the Appellate Court's decision to allow owners to withhold assessments if they feel the board is not maintaining common elements. This decision will be heard by the Illinois Supreme Court.

Finally, ACTHA will host a seminar on recent legal and legislative issues impacting associations at the North Expo on Sat., October 12.

ACTHA
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Question of the Month

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Q. We are a self-managed condo. We recently learned that the Treasurer lost the checkbook and decided to look in the account. The President learned that the Treasurer is the only signatory on the account. As a result, the bank will not give us any information. We also learned the Treasurer has not filed any taxes for the last three years. What should we do?

A. There are many issues here that need to be addressed. In regards to obtaining the association's account information, the Board needs to give the bank proof. Every bank has different requirements of what they accept, but the Board can give the bank a copy of the minutes of when the Board members were elected along with identification. They should also give the bank a copy of the Articles of Incorporation. In addition, they can go to the Secretary of State's website to see if the association is in good standing (by filing their current year annual report). If the report has not been filed, they need to file their report or get the association reinstated if they have not been in good standing for a period of time. The annual report or website will list the officer(s), which can also be given to the bank as identification. Once the association has obtained their bank statements and information, they need to make sure that they have dual signatures on their bank accounts. The board also must understand that they are responsible for the financial information of the association, so they need to get more involved in reviewing and understanding the financial information of the association. It should not just be one board member (like the Treasurer) responsible for the financial information. Finally, there should be certain internal controls in place.

Regarding the income tax returns, the association should get the current year's income tax return filed immediately and then update the past two years records so they can prepare those income tax returns.