

The Coupon Mortgage: A Luxury Construction Lender's End Run

by Steven C. Cronig, J.D., LL.M. and Jesse M. Keenan, J.D., LL.M.

The impact of the market failure that has befallen the residential real estate market during the past two years is well-known and self-evident, even if the underlying causes and remedies remain in controversy. Whether the market failure was caused by “predatory lenders,” whose only interest was in “churning product” to generate fees; “speculative developers,” who saw endless demand; “greedy securitizers,” who built a financial house of cards using over-leveraged derivative insurance contracts; “clueless speculators,” who thought the market values of real estate could only increase; or “hapless regulators,” who were under-funded and held in thrall to the industries they oversaw – the bottom line is that there is plenty of blame to go around. As a result of this market failure, primary and secondary market liquidity has slowed to a trickle, significantly reducing institutional and consumer credit for the first time since the late 1940s.

Recent additional regulatory restraints have had a significant negative impact upon the developers of high-density condominiums and their construction lenders. The U.S. Department of Housing and Urban Development (HUD) serves as the chief regulator of the largest single component of the secondary residential debt market, including Government Sponsored Entities (GSEs) and the Federal Housing Administration (FHA). HUD has implemented various policies which, in the aggregate, were intended to limit the U.S. Treasury's exposure to speculative condominium development.¹ By limiting access to government-backed end-user financing, the imposition of these project eligibility requirements has severely limited the pool of potential purchasers in newly constructed condominium projects. This especially is true in Florida where additional state-specific regulations have been imposed.²

Using the FHA requirements as an example, a new condominium project must meet the following onerous qualifications: (i) at least 80% of the FHA-insured loans in a project must be owner-occupied as a principal or secondary residence; and, (ii) at least 50% of all of the units in a project, whether FHA insured or not, must be owner-occupied as a principal or secondary residence.³ The requirements for FHA “spot loans” (non-project-based approval) are even narrower. Ultimately, such loans are expected to be phased out altogether in favor of a project-based registration system.⁴ While these restrictions, historically, have not been relevant to the luxury market, because product pricing far exceeds conventional loan limits, they are becoming increasingly relevant to struggling luxury developers and their lenders. For potential end purchasers of units in large- and medium-sized luxury residential condominium projects, the availability of end-user GSE-backed financing cannot be counted upon, regardless of the amount of cash the purchaser is willing to put down. The result is that, by product type, luxury condominiums now make up the largest single class of unsold real property.

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¹ Freddie Mac, 42.1 *General Condominium Project Requirements*, Single Family Seller/Service Guide, July 7, 2009; Freddie Mac, *HVCC, Relief Finance and Condominiums*, Bulletin 2009-7 (March 31, 2009); Fannie Mae, *Project Eligibility Review Service and Changes to Condominium and Cooperative Project Policies*, Announcement 08-34, December 16, 2008; see also, Dawn Watopka, *Fannie, Freddie Guidelines Slow Down Sales in Florida*, WALL STREET JOURNAL, February 18, 2009.

² Fannie Mae, Ann. 08-34, at 4.

³ 24 C.F.R. § 234.26 (HUD, FHA).

⁴ 24 C.F.R. § 206.51; see generally, U.S. Dep't of Housing and Urban Development, *Single Family Loan Production-Condominium Units in Non-FHA Approved Projects*, Mortgagee Letter 96-41, August 1, 2006.

At present, the sales velocity of condominium units is measured almost exclusively by the primary auction market for foreclosed properties and by the participation of cash purchasers. Even purchasers who are able to put significant equity into a unit face informal market blacklist underwriting which discriminates against “broken condominiums.” Saddled with un-saleable condo projects and limited end-user financing opportunities, developers’ construction loans nevertheless will continue to accrue interest and penalties, while ad valorem taxes and project maintenance costs will collectively squeeze out any remaining developer equity. Considering the costs associated with currently defaulted sales, taxes and association operating costs, many condominium associations’ slide into financial calamity seems destined to accelerate.

Under many states’ laws, developers of newly constructed condominium projects customarily retain control of the condominium association until a majority of the units are sold; and, as a trade-off for this control, the developer guarantees payment of all association budgeted expenses during that period of control.⁵ As developers fall into the current financial abyss, they frequently fail to adequately fund condominium association operating budgets, leading to cutbacks or termination of maintenance of the projects. This leads to accelerated asset deterioration. In associations where control has been turned over to end purchasers, the high mortgage default rates have caused a “Catch-22” spiral wherein both defaulting unit owners and REO lenders are failing to pay maintenance fees, resulting in further neglect of maintenance, failure to fund capital reserves, and radical declines in the market value of units—often far in excess of those caused by general market conditions.

When a developer is still in control of an association, the minority owners and their lenders have few options since the developer is not going to file liens against its own units. Even when an owner-controlled association goes to the trouble of foreclosing liens against end purchaser units, under Florida law and the law of most states, the lien is mostly junior to the interests of the unit’s first mortgagee.⁶ Meanwhile, mortgagees forestall filing foreclosures, even of long-overdue defaulted condominium loans, knowing that once the foreclosure is completed, they will become liable for ongoing taxes and condominium fees at sale of the unit.

At the same time, a construction lender is faced with the choice of either: (i) carry a non-performing asset on its books, hoping for more advantageous accounting treatment from Congress; (ii) declare the developer to be in default under its construction loan, or mini-perm, resulting in protracted and expensive litigation including potential lender liability claims; or, (iii) declare the developer to be in default and immediately take the keys to the project. In the second and third instances, the lender ends up owning a large number of condominium units that steadily decline in value and accrue property taxes and condominium maintenance fees. Further, any lender who takes title to a block of condominium units in one project may end up with the liabilities of a “successor developer” under many states’ condominium laws.⁷

Left adrift by the capital markets, it is clear that developers, lenders and condominium associations, jointly, must find a solution. The solution identified herein is an alternative to bypass the capital market constraints by using private workout settlements, which convert non-performing commercial assets into performing residential assets. This proposed solution provides the developer and the lender an early horizon exit strategy. This(i) avoids foreclosure, default conveyance, or bankruptcy; (ii) results in bringing financial stability to the condominium association, thus stabilizing property values; and (iii) provides a “bridge” to future GSE qualification of the project and, in the long run, takes the project into the mainstream market. The agreement requires all three parties to realize that an across the

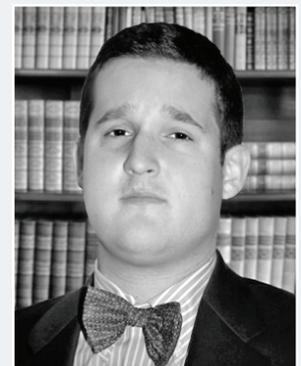
⁵ For example, F.S.A. § 718.301. (Florida); O.C.G.A. § 44-3-101 (Georgia).

⁶ F.S. § 718.116(1)(b)(Florida); O.C.G.A. § 44-3-109(a)(2)(Georgia).

⁷ F.A.C. 61B-15.007, *Developer, Defined* (Florida Division of Condominiums, Timeshares and Mobile Homes).

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board reduction in price points and principal balances is an absolute. Only in this way can the parties stabilize the project.

The Coupon Mortgage Structure

Customary construction loan financing documentation provides for disbursements throughout the construction period. Following disbursements, the loan is either converted to a mini-permanent loan (a “mini-perm” loan), or replaced by a permanent “takeout” loan pursuant to a pre-existing tri-party agreement with specific benchmarks for participation. In either case, the loan documents provide for release of each unit from the mortgage lien as the units are sold, upon the payment of a specified release price.

The coupon mortgage structure, essentially, is a privately-negotiated workout settlement that would include developer, lender(s), and condominium association. The construction loan is modified to break the loan into individual loans for each condominium unit. Each loan is freely assumable one time only⁸ upon fulfillment of straightforward and independently ascertainable conditions precedent, or underwriting criteria, negotiated by the developer and lender. From a broader perspective, the lender is converting the loan’s asset class from a non-performing “scratch n’ dent” construction loan to a “shiny new” performing residential loan. Creating a legal division between performing and non-performing pieces of the same loan is a preferred workout strategy by regulators, because it functionally parcels and minimizes risk.⁹ While each lender will have different requirements for coupon mortgage assumptions, we recommend that the underwriting conditions be as few and as independently verifiable as possible.

The purchaser is, in effect, “buying” the right to assume the coupon mortgage. She is avoiding the need to pay “all cash,” notwithstanding the lack of available lending options and, at the same time, qualifying herself as credit-worthy. This model is premised on the assumption that the lender and developer will reduce principal balances across the product spectrum, including reductions in price for existing contracts that have not yet closed. Likewise, this model ultimately depends on the purchaser’s substantial down payment, usually at least thirty percent.

With the coupon mortgage workout, the lender makes its own determination about the borrower’s credit scores, debt-to-income ratios, and other underwriting criteria that can allow for private secondary market acquisitions of the assumed coupon mortgage loans. It is another question whether the secondary market is a junk market or a prime arbitrage market. Lenders should attempt to comply with FHA guidelines for mortgage insurance and other private insurance underwriting criteria so coupon mortgage loans may be sold at a later time when the project comes into compliance with GSE guidelines. This may occur through reevaluation by a GSE-designated underwriter or GSE regulatory change.

As condominium units are sold, the remaining un-assumed coupon mortgage loans are administered in bulk pursuant to the terms of the loan modification agreement. While some lenders might hesitate to place qualification/underwriting duties into the hands of developers, the critical difference in this situation seems to be the free assumability of individual coupon mortgage loans and the easy verifiability of the underwriting conditions. The purchaser is either making a down payment or she is not; her credit score qualifies her or it does not; title is taken individually or it is not. In any event, the lender can require approval and supervision of origination activities, closing statements, and credit reports, which independently verify fulfillment of the assumption conditions. Ultimately, the lender could provide qualified on-site originators to ensure compliance with state and federal

⁸ Thus, the loan is similar in nature to a one-time “coupon” payment.

⁹ Federal Reserve Board, et. al, *Joint Policy Statement on Prudent Commercial Real Estate Loan Workouts*, Section D. Classification and Accrual Treatment of Restructured Loans with a Partial Charge-off, 9 (2009).

origination regulations. However, the developer's sales team likely would do the bulk of the ground work. Since the coupon mortgage structure bypasses conventional mortgage products funded by the secondary market, the issue of FHA, Fannie Mae and Freddie Mac ("GSE") qualification should not arise, provided the lender is prepared to hold the loans on a long term basis or has a pre-arranged secondary market purchaser for the coupon mortgage loan pool. Of course, any secondary market activity would have to comply with applicable securities regulations.

Upon entering into a contract for the sale of a unit, the developer provides proof to the lender of fulfillment of the ascertainable conditions. Upon closing of a unit sale, the borrower signs standardized loan documents, which constitute a modification of the construction loan terms applicable to the developer, and which allow for individual resale or securitization of the coupon mortgage loan, if desired. The coupon mortgage loan documents also provide for the usual advance escrow deposits for annual property taxes and, in a departure designed to stabilize the project itself, an advance escrow for condominium maintenance fees. While these are not customary provisions, they allow the condominium association to return to financial stability and ensure that the project is properly maintained and saleable and the collateral preserved for developer and lender.

The advantages for the three parties involved are clear. The developer can sell units without the need for traditional residential mortgage lenders, and reduces the likelihood of a developer default and loss of the project. As with traditional loans, once sales recommence and the outstanding principal balance of the construction loan is paid, the developer even stands a chance of making a profit on the project. The lender gets to move the loan from delinquent status to current status on its books, eliminating the need for additional capital reserves. At the same time, this effects a significant principal reduction on the outstanding defaulted loan, and, over time, spreads the loan risk from one huge borrower to many smaller borrowers. The condominium association avoids the financial ruin that occurs when a developer stops funding a project and a lender refuses to pay maintenance fees. This process secures stable or increasing property values for all parties involved.

If the GSE rules are relaxed in the future or if sales in the project later qualify the project for GSE project eligibility, the coupon mortgage loan documents should already be expected to conform to the GSE documentation criteria, which likely will allow the lender to phase out the coupon mortgage structure as prime market funds become available. The variations in cash flow which result from the conversion of the construction loan into multiple residential mortgage loans also could be hedged within asset liability swaps (ALS) market, to permit compliance with asset liability management protocols. The reductions of loan principal associated with the sale of condominium units also should provide a significant present-value boost to the lender's balance sheet as funds can be invested and re-lent outside the context of the troubled project. Historic statistical data demonstrate that borrowers who invest sizeable down payments, as would be applicable here, have significantly lower default rates than borrowers with little or no actual investment in the property.¹⁰

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Additional Settlement Considerations

In negotiating the workout settlement which will result in the implementation of the coupon mortgage structure, developers and lenders address fundamental background considerations. While these background considerations will not directly affect potential purchasers of condominium units, they will determine whether the workout settlement ultimately will succeed or fail. These workout issues include:

¹⁰ Kelly Austin, 'Skin in the Game': Zero Down Payment Mortgage Default, 19 JOURNAL OF HOUSING RESEARCH 2, 75 (2008).

1. To what extent the sales prices for the unsold units are to be adjusted to take current market conditions into account; and, if adjusted, how will the difference be allocated between the developer and the lender. If the lender agrees to take an up-front principal reduction, some arrangement similar to “shared appreciation” may allow the lender partially to recoup such a concession. The lender’s decision ultimately may depend upon the number of unclosed presales which remain in place as of the time of the coupon mortgage workout settlement.
2. Where the lender is the lead lender in a participation which requires participant approval, the lender will be responsible for compliance with the terms of its participation agreement and, if required by the participation agreement, obtaining the approval of the coupon mortgage workout settlement with its participant lenders. The same would be true for special services, at least in terms of managing the decision process during the workout.
3. Whether the lender agrees to allow interim distributions of some portion of each unit’s sales proceeds to the developer as an incentive to drive sales efforts. This would be especially relevant where an outside sales agent is being used.
4. In condominium projects where developer warranties and guaranties have not expired, contract safeguards should be implemented to prevent the possibility of developer liabilities being imposed on the lender.
5. Determination of what loan and closing fees may be charged to end purchasers in connection with assumption of each coupon mortgage loan and by whom.
6. Whether there will be deadlines for the sale of particular numbers of units, and what happens if those deadlines are not met. As with all workout settlements, special attention must be given to ensure that the lender is not viewed as a joint-venture partner of the developer.
7. Whether the lender will subordinate the mortgage lien to the lien for unpaid condominium maintenance fees. If the coupon mortgage documentation includes an escrow for payment of these fees, this issue would not arise. If no such escrow is provided, the lender should recognize that the financial stability of the condominium association is an essential aspect of the continued viability of all of its collateral.

Voluntary conformance with GSE underwriting criteria also increases the probable salability of the coupon mortgage loans in the private mortgage market. If the lender does not contemplate any future sales to GSEs, it may wish to decrease the length of the coupon mortgage loan’s maturity dates, notwithstanding current public demand for the stability of the long fixed rate product. Ultimately, however, the lender will be able to structure the coupon mortgage loans according to market demand and without regard to the restrictive underwriting standards in the GSE market.

At some point in time, the sales velocity at the project may be expected to fulfill the GSE project eligibility requirements, allowing for qualification of the project. The workout settlement should stipulate that the developer will qualify the project at the earliest opportunity. This would allow for lower-end unit purchasers to finance a larger portion of their equity, speeding the time when the need for coupon mortgage loans requiring a greater down payment would be eliminated.

As market prices continue to drop, luxury units will begin to fall within conventional loan limits and will no longer require “jumbo” loans. . An irony is that most high-end

luxury towers were forced by planning boards to include smaller more “affordable” units as a condition of project approval. Now, it is precisely these affordable units which may be the key to these projects’ survival. Projects which have achieved some sort of GSE project approval have benefited from a greater velocity of sales. The coupon mortgage strategy offers the following valuable benefit. As sales in the project increase due to coupon mortgage sales, a new round of comparable sales data and appraisals reflect increased occupancy and stable pricing. This makes the project more attractive to GSEs and conventional mortgage lenders. Eventually, even existing GSE thresholds may be met. As previously mentioned, there is a current policy against qualifying large condominium projects which the government views, apparently per se, as speculative. However, frequently, there are exceptions to the rules. HUD, in particular, has been very open to innovative concepts.

Depending upon the ownership structure of particular construction loans and the authority given to services and trustees, one particular accounting issue should be addressed. Special or master services may be required to map out a transaction blueprint for converting the existing construction loan from a commercial to a residential asset class. At present, there is some ambiguity among banking regulators for greater capital allocations to housing debt. Presumably, a restructuring of a defaulted construction loan, pursuant to a settlement workout, would be treated more favorably than a de novo residential project application. This is premised on the concept that a pool of one hundred residential loans with a twenty percent default rate is more attractive in present value terms than a non-performing construction loan. In recent public and private statements, the Treasury has committed to making residential financing more available to the public, despite halting their purchasing of residential mortgage debt. Successful implementation of a coupon mortgage restructuring could result in qualification of a project for participation in a government-supported debt relief program.

Summary

Developers, lenders and condominium associations all suffer from the shortage of secondary mortgage funding for condominium unit purchasers, especially in the luxury market. As long as a significant principal reduction on the outstanding balance occurs with the closing of each coupon mortgage, each closing moves the lender and the developer into an increasingly better position. The damage to a lender’s balance sheet from any individual unit’s default is much more easily contained than a default on the whole construction loan. “Loans to one borrower” limits also progressively improve as coupon mortgage loans are closed. Implementation of the coupon mortgage workout settlement allows developers to resume sales of their inventory, lenders to recognize significant principal reductions and regulatory accounting advantages, and condominium associations to regain solvency.

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