All Roads Still Lead to Financing

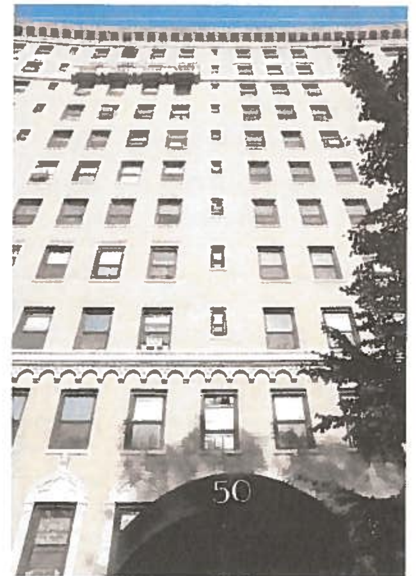
WITH THE ECONOMY CRATERING AND THE MARKET GOING SOUTH, WHAT LESSONS CAN BE LEARNED FROM PAST LOAN STRATEGIES?

PHOTOS BY CAROL J. OTT

BY TOM SOTER

Hampton Court, Queens

300 Clinton Avenue, Brooklyn



50 Plaza Street East, Brooklyn

Underlying Talk

BY PATRICK NILAND

Hampton Court was a cooperative in trouble. The reserve funds were critically low – at $250,000, they were $100,000 below the minimum required by the mortgage-holder, the National Cooperative Bank (NCB). To replenish the funds, the board was forced, reluctantly, to impose a monthly ten percent assessment on the owners. In addition, operating costs were going through the roof: everything from staff overtime to use of outside contractors had ballooned, while the co-op itself – after borrowing and spending heavily to perform long-neglected capital repairs and maintenance – was desperately cash-strapped. To top if off, a new untested slate of directors had just been elected.

Hampton Court has not been alone in facing its challenges. There was the Brooklyn co-op with the mysterious leak, the source of which escaped detection by the hapless board. And then there was a four-unit co-op, also in Brooklyn, which – although it only has three shareholders – still had trouble agreeing on whether it should do patchwork or spend the big bucks on needed capital repairs.

The common thread: each property needed money. And a lot of it.

Small or large, keeping a property afloat during increasingly perilous times is a challenge that often leads a co-op to one solution: the refinancing of its underlying mortgage. But before making the deal and getting that urgently needed infusion of cash, there are strategic reasons behind the decision. Here are three stories, three boards, and three strategies.

AS THE CREDIT CRISIS DEEPENED over the last several weeks, a growing number of co-op shareholders have phoned me, anxious that their building might somehow be affected. Most of these callers fell into two groups. The first lives in buildings with underlying mortgages that are about to mature. These folks fear that their building will not be able to get a new loan, forcing their board to levy a huge assessment to pay off their existing underlying mortgage. The second group lives in buildings with either Fannie Mae or Freddie Mac loans. Since the government has "taken over" these two institutions, they worry that the government will "call" their loan, likewise forcing their shareholders to pay off their pro rata share of their building's underlying mortgage. Given the recent headlines predicting a draconian economic future, I certainly can empathize with these board members. However, no one should panic. Neither of the above scenarios will occur. Moreover, the underlying mortgage market is very much alive – if not entirely well.

First, this crisis *will* pass. The transition may not be pretty. It may take longer than we'd like. Certain ways of doing business may be modified or eliminated. But the markets will survive. And so will every co-op, whether it be a high-rise doorman building in Manhattan, a low-rise walk-up in one of the other boroughs, or a garden apartment complex in Westchester or Long Island. I can say this with the confidence that comes from 30-plus years of working in the financial industry and 20-plus years of arranging underlying mortgages. In that time, I have seen three severe market contractions. Each time, the market returned to "normal" after the necessary "adjustments" were completed. I have absolutely no doubt that the system will heal itself this time as well. Therefore, if your building does not have a pressing need for new funding at this time, sit back and wait out the storm. If, however, you do need to refinance now, do not despair. You will get a new loan.

It is helpful to remember that the epicenter of this crisis sits some distance from the underlying mortgage market, in the so-called "sub-prime" sector of the single-family residential mortgage market. That is where greedy, unscrupulous, and/or stupid loan originators processed applications from unqualified, greedy, and/or dishonest borrowers. As long as housing prices continued to rise, everyone looked the other way – including the appraisers, the lenders, Fannie Mae, Freddie Mac, the underwriting agencies, and Wall Street firms, all of whom earned hefty fees from the explosion in loan volume. However, once the housing bubble burst, no one could escape the consequences. So, while our market is not on the fault line, we will feel the after-shocks.

Fortunately, the vast majority of lenders that were offering underlying mortgage loans before this crisis erupted are still open and looking for new business. Those that were affected – Bear Stearns, Lehman Brothers, AIG, Merrill Lynch, and Wachovia – had little or no involvement in the underlying mortgage market. Both Fannie Mae and Freddie Mac played important roles as buyers of underlying mortgage loans in the secondary market, so their failure would have been a major blow. However, the financial markets assumed that these "government-sponsored enterprises (GSEs) would be rescued by the federal government if they ever got into trouble. Some still debate how weak Fannie and Freddie actually were before the government stepped in, but that's an academic discussion. Since the markets *thought* they were in trouble, they *were* in trouble. So, the government was forced to act, essentially nationalizing both institutions.

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In many ways, that's a good turn of events for those of us in the underlying mortgage world. First, both Fannie and Freddie are still around to buy underlying mortgage loans from lenders. Second, underlying mortgage loans have not generated and will not generate any of the headaches that defaulting sub-prime loans have caused and will continue to cause. Therefore, I fully expect continued support from both Fannie and Freddie for the underlying mortgage market.

That said, you should be prepared for some changes from the old lending environment. The biggest change that you will encounter is the run-up in spreads – the margin that lenders add to some index (usually the U.S. Treasury security with the same maturity as the new loan you are seeking). Over the last year or so, spreads have doubled and, in some cases, tripled from previous levels. So, while treasury rates have been falling fairly steadily, new loan rates have not declined by much because spreads have risen so dramatically. I would expect these higher spreads (190 basis points or more – that's 1.9 percent and up) to prevail until the current financial crisis subsides. However, even with these higher spreads, co-ops currently are closing new underlying mortgages with interest rates in the 5.90 to 6.50 percent range, depending on loan term. From a historical perspective, those are pretty good rates!

The second change that you will face is "change" itself, i.e., the extreme volatility of today's financial markets. Unfortunately, this condition is unlikely to diminish anytime soon. In fact, a recent economic report from Goldman Sachs notes an *optimistic* timeline of two years of mild recession and "painfully slow" economic growth. Until some semblance of market stability returns, most lenders will remain reluctant to lock the interest rate on any new loan until all underwriting issues have been addressed, all third-party reports (appraisal, engineering, and environmental) have been received, all title and survey problems are resolved, and a closing is scheduled or pending. In addition, don't be surprised if the spread quoted in your offer letter or application changes by the time your commitment is issued, and even between then and when you actually lock in your new rate. All legend to the contrary, this is not a case of lenders "playing games." It is the direct result of a very tumultuous financial market.

You also should expect lenders to be more demanding of information about your building's financial and physical condition. Issues that formerly were overlooked or given cursory attention now will get thorough evaluation. Be prepared with full explanations of deferred property maintenance, excessive shareholder arrears, serious or extensive litigation, or any other significant problem, as well as the steps you are taking to remedy them. Depending on the severity of any of these issues, you might confront a higher interest rate on your new loan and/or significant escrows withheld at closing to assure the lender that the problems will be addressed in the very near future. In short, all lenders are being much more careful about each loan they make, much more attentive to the underlying collateral, and much more critical of their borrower's ability to meet their obligations in both good times and bad.

As a consequence of these very difficult times, it is even more important for a co-op board to prepare thoroughly *before* starting the refinancing process. That preparation includes the involvement of all of the co-op's professional advisors (managing agent, accountant, and attorney). Refinancing a co-op's underlying mortgage always has been one of the most, if not the most, significant decisions that a board will make during its tenure. It will affect not just the monthly maintenance but also the market value of every shareholder's apartment. Mistakes during any refinancing can be very costly; but missteps in a market as volatile and unsettled as the current one can be disastrous. So, as I said earlier, don't despair – but do take *very* special care. **H**

Trust But Verify

A 315-unit complex of four elegant buildings with a central courtyard located in Kew Gardens, Queens, Hampton Court was built in 1937 as a tony rental property. It went co-op exactly 50 years later, with little fanfare and great hopes. Unbeknownst to the newly minted board directors, however, the sponsor was playing games with their money. Funds that were earmarked for capital repairs and maintenance were instead being applied to another property, then under construction. When the sponsor sunk in the aftermath of the Wall Street crash of 1989, he took the extra money with him, and the co-op spent the next decade struggling to keep ahead of the game. The board then made long-deferred capital repairs a priority. Although those were costly, the co-op was being hurt more by high daily operating expenses and a dwindling reserve fund. By 2005, recalls Steve Greenbaum, director of management at Mark Greenberg Real Estate, the complex's manager, "they were in really dire financial straits. Their J-51 had expired so their taxes were going to rise. They already had a monthly assessment and maintenance increase, and their reserve funds were at a critical low."

Then a new slate of directors was elected in 2005 with a mandate to get the financial house in order. "The new board wanted to get a handle on expenses," says Greenbaum. "They were very active and aggressive."

They questioned everything – and found black holes into which the co-op's money had been disappearing. The superintendent was working on outside jobs and subcontracting his duties to others, who would charge the complex. Building supplies were running at $25,000 over average prices. The staff members were demanding overtime for tasks that the board thought were within their job descriptions. And the site manager was letting it all go on.

After the board complained to Greenbaum, he brought in a new site manager, whom he personally supervised, and the seven-person board researched supply costs, sought out energy-saving measures, and contacted the Realty Advisory Board and the union to get a handle on how to handle the staff issues.

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Michael Soccio, President, Hampton Court, Queens

micro-managing," recalls Michael Soccio, the current president. "We just wanted to figure how to bring costs down and bring us onto a more level playing field with other co-ops on the market."

Indeed: Soccio says the directors were especially worried about their co-op's relatively high maintenance and low reserves and how that would affect their resales and standing with the lender (the bank required $350,000 in reserves, $100,000 more than they had on hand). "It wasn't appealing to buyers; we wanted to eliminate the ten percent assessment that was in place just to build up reserves, and we wanted to have a cushion in case something did happen."

Greenbaum suggested that they consider refinancing. "You can always make money in a refinancing," he says. The trick is to know how much to request. Although Soccio, a nurse, had no professional financial experience, he became "very hands-on in the process," Greenbaum recalls. When the manager – working with Ed Pecker, the co-op's accountant, and Steve Geller, a mortgage broker at Meridian – found opportunities, he would bring them back to the board for review.

But Soccio says the board, burned by its previous experiences with the sponsor, manager, super, and staff members, questioned everything.

The six-month process ended with the co-op obtaining a $1.25 million loan from North Fork Bank (now Capital One), which was placed in short-term CDs. Greenbaum says the successful conclusion of the deal gave the board the confidence to propose (and actually get approved) a flip tax in 2007. Soccio reports that the transfer fee has netted the complex between $80,000 and $100,000, which has swelled the reserves to $1.6 million. "Our strong financial picture makes us more attractive in a down market," says the president.

Soccio adds that the success of the flip tax is directly linked to the board's strategy employed in the refinancing process: use your professionals but also educate yourself. "We let them get us proposals," says Soccio, "but we then researched them ourselves. Call me skeptical, but I'm not going to just take what my managing company gives me. You've got to work with them, trust them, but you've got to verify it yourself. If you don't research, you won't really know."

Getting Along

The four-unit cooperative at 300 Clinton Avenue in Brooklyn, near Fort Greene, sits in another borough – and seemingly in another world – from the massive Hampton Court. Unlike its larger cousin in Queens, the two-member board had no manager to rely on yet it, too, had capital repair problems. Four stories high, the red brick, Queen Anne-style building is a former one-family home built in the 1890s. As such, it has its share of façade and structural problems.

"It hasn't been maintained in a long, long time," says board president John Velez, a computer systems consultant who moved in a year and a half ago, shortly after the other new owner, film editor Elise Spiegel, had arrived. A renter and a couple that had lived there for 20 years occupied the remaining two apartments.

The building, in a landmarked district, faced two distinct financial challenges that made getting along crucial: its underlying mortgage was coming due and the Landmarks Preservation Commission required the co-op make expensive repairs on the façade and stoop of the building.

The board encountered resistance from its lone non-board shareholder, who was opposed to large expenditures. "We didn't agree on the amount for a long time," Velez

recalls. The neighborhood was gentrifying and the newcomers wanted to spend money to improve things. "In the last ten years, the whole neighborhood's changed dramatically," says Velez, who paid nearly $500,000 for his apartment. The long-time residents presumably paid much less; Velez says his unit had sold for only $90,000 ten years before. The two camps' differing histories led to differing views on how to spend the corporate treasury. It was, in fact, the co-op world in microcosm, a "petri dish" example of how co-op directors and their constituents can (or cannot) get along.

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John Velez, President, 300 Clinton Avenue, Brooklyn

"We thought we could work with him, so we brought him on the board," says Velez. "But then he tried to [stop the process] by refusing to sign an NCB document for the refi. Luckily, our lawyer found a way to get around that. There were a lot of other things that happened. He just took a dislike to us. It was a disaster."

Beyond that, the board knew little if anything about refinancing. "I had never been in a co-op before," admits Velez. The two directors, on the recommendation of a residential broker, sent them to Patrick Niland, president of First Funding, a mortgage broker, "who guided us through the process and offered us options." The final refinancing was for $425,000 with a $75,000 line of credit.

After it was over, Velez felt he had learned one lesson: if you're small, you can probably do it yourself, although he admits it would have taken more research. "If we had been smart, we would have just called NCB and had them walk us through the options. Of course, if we hadn't gone with Pat we wouldn't have known that NCB was an option."

Niland sees it differently, naturally, noting that it wasn't just a question of making a phone call. There were circumstances to explain to a potential lender. "The most unusual thing about the building was its size," he notes. "Many lenders would say it really isn't a co-op because it's got only three owners; it's legally a co-op, of course, but it's seen by lenders more like a rental. So, there was a lot of discussion as to was it really a co-op, and would it continue to operate as a co-op? I talked to maybe four lenders; had it been four units, owner-occupied, smaller loan, adequate reserve account, building in good condition, no planned work just refinancing, four owners and all agreed, [it would have been an easier deal to make]. This was a little different. There was a story here to be told. The story was that it was a co-op. And that needs explaining."

Quality-of-Life Concerns

Ben Perez is no slouch at dealing with building systems – his job as an infrastructure urban planner at a large engineering firm has brought him into contact with engineers, construction work, and the like – but in his seven years as president of the 12-story 50 Plaza Street East, he had never encountered a more frustrating mystery than The Leak. The board members tried one solution. It still leaked. They tried another. No luck.

Finally, in 2007, Perez and the board of the 49-unit cooperative off Brooklyn's Grand Army Plaza realized that patches wouldn't help: what was needed was a major waterproofing job involving repairing and/or replacing steel girders, terra cotta façade designs, and balconies. "It was sort of a fussy job," Perez says. And it also needed a large infusion of cash.

"We finally did get to the bottom of what was going on and I said, 'We're going to pay one way or another.' It became very clear to me that we needed to do the work and solve the problems or it was going to degenerate and cost us way more in the future," Perez notes.

The entire seven-person board then spent many hours debating two questions: Does the co-op pay a prepayment penalty on the existing underlying mortgage and get out

of it before its 20-year expiration date? Or does it take out a second mortgage and raise people's maintenance to pay for that? They examined their goals – to give the owners a better quality of life (meaning more money in their pockets and a leak-free, structurally sound building) and a greater resale value on their units – and that led to the answer. "We're a very beautiful, 1927, neo-Byzantine, prewar, elevator, doorman building," says Perez. "We had to look at the value we'd be adding, to see if it would be a good return for the money."

"This board was struggling with competing ideas," notes Patrick Niland, of First Funding, who was referred to the board by its accountant. "One idea was not to raise maintenance and the other was to raise enough money to do the capital improvements they felt needed to be done. Those were irreconcilable ideas in the sense there was a lot of work to do. But they couldn't afford all of it. They were looking for a way to maximize the work they had to do and minimize the negative effects of increasing maintenance. And I think we came pretty close."

One faction on the board didn't want to see the building go deeper into debt on a long-term basis, feeling it would be unfair to saddle future owners with a loan from which the current residents got the immediate benefit. "We agreed it wouldn't be right," explains Perez.

Nonetheless, notes Niland, "since interest rates were low, they wanted to lock in the rates for as long as they could." They did take out a 15-year loan, but the concession they made to the group on the board that didn't want long-term debt was a more rapid amortization.

"This [kind of choice] happens a lot on buildings that keep refinancing; over time, they build up significant debt loads for the building," Niland continues. "The argument to counter that is yes, but overall value is going up. What happens if it doesn't? And is it fair to owners down the line? There were some pretty astute people on the board who said, 'To maintain the fiscal integrity of the building we need to have more amortization to get rid of this debt.' I was quite impressed with their thinking. They clearly had done their homework. They were struggling to make the best deal; they locked in the rate at 15 years, borrowed as much money as they could but had a shorter amortization period than the traditional 25 years. They really wanted to get the debt down more quickly. They actually thought long-term."

The directors spent a lot of time talking, asking questions of Niland, each other, and of Robert Alper, vice president at Advanced Management Services, their manager. "Bob had spent some time researching this before we went with Pat," says Craig Winer, a board member who worked closely with Perez. "So he helped us evaluate our options and gave us a second source to see what was out there."

The co-op paid a prepayment penalty of just under $500,000, and then took out a new loan of $3.45 million, with a $500,000 credit line from NCB.

"This was a very involved board that took their responsibilities very seriously," observes Niland. "Many don't do that. They want to get the lowest payment they can get. This board really cares about tomorrow." **H**

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