A MORTGAGE PRIMER

By Patrick Niland

The basics of refinancing an underlying mortgage.

To paraphrase Sy Syms, "an educated board member is a lender's best borrower!"

That concept underlies all of the articles I have written about co-op financing. Since my last article ("Dial 'M' for Mortgage"), however, much has changed in the mortgage market. Therefore, a review might be helpful. Another reason for a review is the fact that refinancing an underlying mortgage is the most important decision that a board member will make. This one decision will affect not only the monthly maintenance of every shareholder but also the market value of every apartment in the building. It is a decision that warrants thorough planning, careful analysis, and diligent execution by every member of the board's professional team.

Note the word "team." No board should attempt a refinancing on its own. It is absolutely essential that the board involve every one of its professional advisors in this critical decision from the very beginning. And speaking of "beginning," I really should start this article there.

First, some terminology. What most people refer to as a "mortgage" is more correctly called a "mortgage loan," i.e., a loan which uses some form of real estate as collateral. The borrower promises to repay this loan according to the lender's terms in a document called a "note" (sometimes called a "promissory" note). The lender secures its right to take possession of the collateral should the borrower default (i.e., not pay) in a document called a "mortgage." The lender and borrower sign both the note and the mortgage at the "closing," a meeting during which all relevant documents are executed and money changes hands.

An *underlying* mortgage is a loan to a cooperative apartment corporation which uses its property as collateral. This type of loan is called an "underlying" mortgage because it lies under (i.e., comes ahead of) any personal (or "end") loans which individual co-op shareholders might have taken out to "purchase" their apartments. To be technically correct, I should mention that no co-op shareholder actually owns their *apartment.* All of a building's apartments (as well as the grounds, garage, pool, and any other improvement which might exist on the property) are owned by the cooperative apartment corporation which, in turn, leases the apartments to its shareholders. Individuals can pay "all cash" for their shares, or they make a down payment in cash and get a personal loan for the balance of their new apartment's share price. Such personal loans are called "end" or "share" loans and are secured by a lien against the shares of stock which have been allocated to the borrower's apartment.

While some co-ops do not have an underlying mortgage, the vast majority do. There are several reasons for this. The early co-ops were built with borrowed money, and that debt was passed on to the apartment corporation once the project was ready for occupancy. During the conversion wave of the 70's and 80's, many property owners became "sponsors," wrote "offering plans," formed "cooperative apartment corporations," and sold shares to their tenants ("insiders") and others ("outsiders"). In these "conversions," the sponsors sold shares in the new apartment corporation for cash, but they also sold their *building* by transferring their existing debt to the apartment corporation. Some sponsors were able to squeeze even more profit from their building by “wrapping” their existing loan before transferring it to the apartment corporation.

Today, most co-ops still have an underlying mortgage because they can’t afford to pay it off. Even co-ops which *can* afford to pay off their underlying mortgage often don’t, due to the tax benefit their shareholders get from their pro rata shares of the co-op’s monthly interest payments. Whichever situation applies, a co-op is almost always better off with a *reasonable* amount of underlying debt than no debt at all. What’s a reasonable amount of debt? Well, it depends on many factors.

Some lenders look at the percentage of maintenance represented by debt service. Others calculate the amount of underlying debt per unit and compare it to the average sales price per unit. Still others estimate the total effect that a particular co-op’s underlying debt has on its unit maintenance as compared to prevailing market rents in that co-op’s neighborhood. There are no hard-and-fast rules but, if your co-op’s debt is less than $15,000 per unit, you probably don’t have a problem. Conversely, if it is more than $30,000 per unit, you just *might* have a problem.

There are several steps your co-op can take if it has too much debt. First, be sure that your loan includes amortization, i.e., the systemized repayment of a small portion of your loan’s outstanding balance in each monthly payment. If your current loan is “interest only,” make sure that you include some amortization in your next loan. In the meantime, the board could levy an assessment to reduce the co-op’s debt to a more manageable level. Some lenders will allow partial prepayments but, unfortunately, such prepayments almost always incur prepayment penalties. However, *even with a penalty*, prepaying a portion of your co-op’s underlying debt might be an excellent way to get your co-op’s financial picture back into focus.

More aggressive (or desperate) boards can request that their existing lender reduce the outstanding principal (“take a haircut” in industry jargon), or decrease their interest rate so more of each monthly payment can be used to pay down principal, or suspend interest altogether (an interest “holiday” or moratorium) until the outstanding principal is reduced to a more reasonable level. Such concessions are very difficult to negotiate, but some co-ops may have no other choice.

Most co-ops will have to refinance their underlying mortgage eventually. When that day finally comes, it really pays to do it right. To be successful, just follow these seven steps:

1. **Become an expert on your building.** Before calling a single lender or mortgage broker, review all of your co-op’s important records and assemble all of the information on the Mortgage Refinancing Checklist (see inset).

2. **Make up your mind.** Don’t let a lender or mortgage broker decide what kind of loan you “want.” Get input from all of the co-op’s professional advisors about the co-op’s physical and financial needs. Use that advice as a basis for deciding what type and size of loan you want.

3. **Get market wise.** Familiarize yourself with general economic trends, read the financial press, consult with the co-op's accountant and other financial advisors. Unless you have a "feel" for the market, how will you know whether a particular loan offer is a good deal?

4. **Lean on your team.** Don't go it alone. Take full advantage of the skill and experience of your managing agent, attorney, accountant, and other professional advisors. A good mortgage broker can be an invaluable addition to your professional team as well.

5. **Pick a captain for your ship.** You can (and should) involve as many shareholders as possible in your refinancing discussions. However, only one person should contact the outside world, i.e., all communications to and from lenders and/or mortgage brokers should pass through this one person. This will prevent inaccurate or unauthorized information from contaminating your application.

6. **Stay focused.** A well-run refinancing should be completed within ninety days. This schedule assumes quick response to lender questions and fast turnaround from the co-op's attorney. During a refinancing, time really is money.

7. **Remember your manners.** In today's busy world everyone is under a lot of pressure. Screaming and yelling will not make anything happen faster. However, a friendly "please" just might.