AT THE MORTGAGE MART

By Patrick Niland

SORTING OUT THE CHOICES IN UNDERLYING FINANCING

The market for refinancing your co-op's underlying mortgage is broad, varied, and filled with peril. Loans that are available may not be right for you, and ones that are right might not be available. Others that appear attractive might hurl your building into financial oblivion. When shopping for an underlying mortgage, then, know what you can get and what will best serve your needs.

WHAT YOU CAN GET

Before you even enter the mortgage mart, consider a well-established principle of finance: borrow short-term for short-term needs an long-term for planned "capital" items. Cooperatives should fund their operations completely from shareholders' maintenance charges, increasing them annually to keep pace with inflation. Money for purchasing the building (as done at the closing of conversion), major capital improvements, the reserve fund, and other such items should be financed through longer-term debt.

When they borrow, however, co-ops are limited to securing "commercial" loans – the same type taken by General Motors, IBM, and any other corporation or business. These come in six varieties: short-term; medium-term; long-term; variable rate; credit lines and seconds; and hybrids.

- *Short-term (three to five years).* The most common form of cooperative financing is the five-year "balloon" loan from a local savings bank. In such deals, the building makes small monthly payments – either interest only or interest and a small portion of amortization – until the final one, which "balloons" to equal all or almost all of the amount initially borrowed. To pay this off, the co-op will probably have to take a new balloon loan.

Many of these loans contain a renewal option: in the last 60 to 90 days, you can extend the loan, typically by five years, with the same terms and conditions but at a different interest rate. Generally, the formula used for such adjustments to the rate is spelled out in the original commitment letter. Some lenders even offer a second renewal for a total loan term of 15 years. The loan amount continues to amortize with each renewal.

By exercising renewals, you can avoid most, if not all, new-loan closing costs, including appraisals, inspections, lawyers, and mortgage recording taxes. Some lenders charge a "rollover" fee of up to one percent of the amount borrowed; others do it for free.

Short-term loans are ideal for older buildings in poor condition and those undergoing a series of major capital improvements. They can establish a program of taking short-term loans to pay for projects as they come up, rather than locking into a long-term one that prohibits or charges a

significant penalty for prepayment. Those with tighter improvement schedules might consider the three-year deals offered by some lenders. Be careful, however: such a brief lifespan can play havoc with your budget. If you do not renew, refinancing costs elsewhere can add up. If you do renew, be prepared for the possibility of higher rates.

- *Medium-term (7 to 10 years).* Provided primarily by insurance companies, these are recommended for newer co-ops and older ones in good physical condition with large preventive maintenance and replacement reserves. Medium-term loans offer lower payments – the terms are generally "interest-only" and the interest rates are lower, by as much as one percent, because of the reduced risk. In most cases, there are also no origination or commitment fees.

Yet these are only available to so-called "better properties;" co-ops that are less than 80 to 85 percent owner-occupied and are borrowing less than $1 million need not apply. Why? All lenders look at mortgages as investments in a co-op's "business" of operating an apartment building, which serves as collateral. They determine this using the "loan-to-value" (LTV) ratio – the strength of the borrower and the quality and value of the collateral in relation to the loan amount. All lenders are particularly interested in reducing their risk by maintaining low LTV ratios, and this is particularly true of insurance companies.

- *Long-term (15 to 30 years).* If the American Dream is a home of one's own, then realizing that dream means paying off the mortgage. For a co-op, that translates into securing a long-term, self-liquidating underlying loan. Unfortunately, there are two hefty obstacles. First, few co-ops are able to keep them for their 30-year terms, typically having to refinance because of a change in spending habits, a failure to raise maintenance in step with inflation, or a sudden need for more money. Second, these loans are very difficult, if not impossible, to obtain. Approval depends on governmental or agency guidelines, which are often interpreted by someone unfamiliar with the local market.

If you cannot get one, the next best thing is to maintain a reasonable and constant level of debt while preserving shareholders' tax deductions. You can do this by structuring short- or medium-term loans with enough amortization to cover the next round of refinancing. And if it refinances through conventional sources (banks and insurance companies), the co-op has more control over the timing and the cost of the entire process.

- *Credit lines and seconds.* If you don't need a large infusion of cash for ongoing projects, and if the terms of your current loan make prepayment economically foolish or prohibitively expensive, consider a second mortgage loan or an equity credit line.

Second mortgages are best when the co-op needs money quickly for a specific project. While the interest rate may be as much as two percentage points higher than a first mortgage, it is fixed and the closing costs are lower – particularly if you get the secondary loan from your primary lender.

If your co-op's needs are in flux or spread intermittently over several years, an equity credit line may be the answer. You can draw on the line up to a maximum amount whenever you need

the money and repay when you can, all the while paying interest only on what you have taken out – like a credit card.

As good as credit lines sound, they present three serious problems. First, closing costs can be staggering. All of the fees for establishing the account are calculated on the maximum amount made *available* regardless of whether to co-op has taken out *any* money. Second, almost all lines charge a variable interest rate. That's not a danger when rates are stable, but if they begin to fluctuate, financial planning becomes a crapshoot. Third, and most dangerous, credit lines can be seductive. If the board gets into the habit of drawing on its line, perhaps to avoid maintenance increases, the mounting debt and interest could cripple the building.

- *Variable-rate.* These short-term loans are a big risk – their interest rates adjust monthly, quarterly, bi-annually, or annually. They can be very appealing when rates are low, but the market can change quickly. The board should think carefully before gambling like this with people's homes.

- *Hybrids.* Creative lenders, trying to capture more of the market, are always coming up with new variations. Many combine aspects of two or more of any of the above five commercial-loan varieties – and they may be just the ticket. Because new hybrids appear continually, co-ops should talk to as many lenders as possible. In the final analysis, if the board knows what it needs, a product probably exists.