CALM IN THE FACE OF CHANGE

By Patrick Niland

As the credit crisis deepened over the last several weeks, a growing number of co-op shareholders have phoned, anxious that their building might somehow be affected. Most of these callers fell into two groups. The first group 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 understand why these board members are so concerned. 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 outer boroughs, or a garden apartment complex in Westchester or Long Island. I can say this with confidence that comes from thirty-plus years of working in the financial industry and twenty-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 because our global financial markets are so intertwined. So, while New York area cooperatives are not on the fault line, any building seeking new financing 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. Despite buy-outs, mergers, and other consolidations, there still remain more than twenty lenders with active underlying mortgage programs. AIG, Bear Stearns, Countrywide, Lehman Brothers, and Merrill Lynch had little or no involvement in the underlying mortgage market.

Both Fannie Mae and Freddie Mac long had 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 always had assumed that these "government-sponsored enterprises (GSEs) would be rescued by the federal government if they ever got into trouble. And that, in fact, is exactly what happened. 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, to preserve these critical funding sources for the essential housing segment of our economy.

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 did not ever, do not now, and will not generate any of the headaches that defaulting sub-prime loans have caused. Co-op underlying mortgage loans remain one of the safest investments that a lender can make, with default ratios so low as to be insignificant to any lending decision. Therefore, I fully expect continued strong support from both Fannie and Freddie for the underlying mortgage market.

That said, you should be prepared for some substantial 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 1.90% 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% range, depending on loan term. From an 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, loan terms will be notably tighter than in the past and 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 resolved, and a closing 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 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 disturbing and difficult times, it is even more important for a co-op board to prepare thoroughly *before* starting the refinancing process. That preparation must include 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 the most important decision 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.