A CRASH COURSE ON CREDIT LINES

By Patrick Niland

Current wisdom argues that every new underlying mortgage should come with a credit line. That's a little like saying that every new car should come with a spare tire. As anyone who has had to change a flat recently knows, spare tires are not what most of us think of as "tires". In their cost-cutting and mileage-boosting fervor, most automobile manufacturers now include as a spare something that looks more like a bicycle training wheel than a car tire. The point is that most credit lines, while helpful in an emergency, are not what most people expect – and are never a good long-term solution to many problems. More on that later. First some basics.

What Are They?

A credit line is a lot like the overdraft provision on your checking account. In other words, it's a flexible lending arrangement with a bank under which the borrower can draw down funds as needed, up to a predetermined maximum. Interest is charged only on the amount actually borrowed, and usually is billed monthly. Interest rates are floating, and are determined by adding a margin or spread to a popular index like the prime rate (now 8.50%) or LIBOR (the London Inter-Bank Offer Rate - a sort of "offshore" prime rate - now about 5.65%). Spreads generally range from 1.00% over prime to 2.00% over LIBOR. Some lenders charge a fee of up to two points (plus additional legal and other costs) to establish a credit line, but most charge nothing. A few lenders charge a monthly "non-use" fee on the amount *not* borrowed, but most do not.

How They Work

The maximum term currently available for credit lines is ten years, but most lenders say they will renew them after that. None of the lenders will *guarantee* a renewal, but chances are pretty good that you'll be able to get one as long as the lender is still around in ten years. Most credit lines are "interest only", although a few include a modest amount of amortization (repayment of principal).

A little-known fact about some credit lines is something I call the "window of availability". Some lenders will provide a credit line "facility" for a period of ten years, but the borrower may draw down funds during a shorter period of time. For example, one prominent credit line lender allows draw-downs only during the first five years of the line. At the end of the fifth year, the outstanding balance is frozen and subsequent payments include interest *plus* amortization (usually on a 25-year schedule) during the remaining five years. Another lender's credit lines remain open for only five years *after* the first draw down. Few lenders allow unrestricted access for the entire ten-year period. Even fewer allow truly "revolving" credit lines in which the borrower can draw down and repay funds at will.

Credit lines can be *secured* or *unsecured*. When a credit line is secured, it is recorded as a second mortgage against the borrower's property. Recording triggers the mortgage tax, which can run from 1.00% of the credit line amount in Long Island and most of Westchester to 2.75% on lines over $500,000 in the five boroughs of New York City. That expense can be avoided by getting an *unsecured* credit line.

With an unsecured credit line, no mortgage or other lien is recorded against the borrower's property. Therefore, the borrower saves the recording tax and the lender assumes the incremental repayment risk. Not all lenders provide unsecured credit lines, so it pays to shop around. Another issue to consider is the tax treatment of an *unsecured* credit line. Some accountants feel that interest paid on an unsecured line is *not* deductible for tax purposes and, therefore, cannot be passed through to shareholders like regular (secured) underlying mortgage interest. Be sure to consult your accountant before making a final decision.

In today's market, virtually all credit lines are created as an accessory to a new underlying mortgage. Very few lenders will offer a credit line separately from a new mortgage. However, if the cooperative is an existing customer of the lender, or if the co-op's current underlying mortgage has less than three years remaining, some lenders might consider providing a credit line as a stand-alone product. However, in virtually every such case, the lender also will require the right of first refusal on the next refinancing of the co-op's existing underlying mortgage.

Do You Need One?

As I said at the start, the current thinking on credit lines is virtually unanimous; namely, every new mortgage should come with one. I do not subscribe fully to this idea, just as I don't agree wholeheartedly that every checking account should have overdraft privileges. Like overdrafts and credit cards, co-op credit lines are very seductive and potentially dangerous. There is constant temptation to dip into a credit line to pay for some problem best dealt with in a more permanent or fiscally-responsible way.

To decide whether your co-op really needs a credit line, you should determine the probability of a truly unexpected need for capital. Depending on the age and condition of your building, such an occurrence might be highly unlikely. That is certainly true for those co-ops whose boards prudently budget an amount for "contingencies and unforeseens" and maintain a proper reserve account (most accountants recommend two to four months of maintenance). Having a credit line available just to test your resistance to its temptations is foolish. Too many co-ops fall into the habit of bleeding their reserve account to subsidize maintenance charges because they still have a credit line for any emergencies. The problem with this line of thinking is that such co-ops soon exhaust their reserves and then raid the credit line to avoid the political heat of raising maintenance to its proper level. No board should allow any significant component of their co-op's operating budget to be funded with variable rate debt.

Alternatives

But some of you will ask "If I don't have a credit line, what will I do when my boiler blows up?" There is no question that credit lines provide ready access to capital for emergencies such as these. There is no last-minute application or rushed loan processing to delay the receipt of funds. The board treasurer can write a check immediately to handle the problem. However, for those co-ops that keep adequate reserves and properly maintain their property, similar flexibility can be provided by including in the first mortgage documents the right to add a second mortgage at any time during the life of the loan.

Many lenders now provide second mortgages to well-managed co-ops at very attractive rates. The advantage of a second mortgage provision over a credit line is that funds availability doesn't expire after five or ten years. It remains in place for the entire term of your loan, whether you have a 5-year term loan or a 30-year self-liquidating mortgage. Since the need for additional funds most often arises during the later years of a co-op's mortgage, the firm, up-front guarantee of secondary financing often is more reassuring than a vague, unwritten promise of a credit line renewal.

So, what's my recommendation? On balance, I think credit lines are a valuable tool that most board treasurers should have in their toolbox. But, like most tools, they should be used with much care and only for the appropriate tasks.