THE DEADLY DOZEN – Part II

By Patrick Niland

Don't fall victim to these mistakes when refinancing your co-op's underlying mortgage.

Anyone who closed a new underlying mortgage loan in late 1998 probably is smiling from ear to ear. That's because interest rates fell to a 31-year low back then, and that sparked a wave of refinancings that is just now beginning to slow down as rates creep back up. Many boards recognized this historic opportunity and locked in rock-bottom rates for long terms. Some co-ops even scooped up additional funds for capital improvements by keeping their old monthly payment to pay for a new larger loan at a much lower interest rate.

Unfortunately, not all boards took full advantage of this wonderful opportunity. Some rushed blindly after what they thought was the lowest interest rate and forgot other crucial terms. Others hoped for rates to fall even lower and "missed the boat" entirely. Still others grabbed loans that they now discover don't quite meet their needs. All of these boards should have spent more time planning their refinancing and should have involved all of their professional advisors right from the start of their refinancing effort. This is a very important lesson for the future. For now, however, they are stuck with their costly error. Don't you make the same mistake!

In the last issue, we discussed the first five mistakes commonly made by boards who are refinancing their co-op's underlying mortgage:

(1) *Starting too early.*
(2) *Waiting too long.*
(3) *Not borrowing enough.*
(4) *Borrowing too much.*
(5) *Interest rate myopia.*

In this issue, we warn you about the other eight members of the "deadly dozen".

(6) *No amortization.* Ignoring amortization is a dangerous trap that snares many a co-op. It is very easy to understand why "interest only" loans are so popular. Since their new monthly payment includes nothing more than interest on the outstanding balance without <u>any</u> principal repayment, a board often can borrow more money without a maintenance increase. This temptation is <u>very</u> strong, but the quiet by-product of such loans is their tendency to continually increase the co-op's total debt. This happens because very few boards have the discipline to set aside enough money to cover the closing costs for their next refinancing. Therefore, they end up increasing their debt just to cover closing costs. More often than not, the board also has drained its building's reserves over the years to avoid raising maintenance charges. It must then borrow even more money to replenish the reserve fund. To avoid this trap, <u>always</u> include amortization among the terms of your new loan.

(7) *No secondary financing.* Murphy's Law plays special havoc in co-ops. An unusually cold winter pushes up heating oil prices, overshooting the co-op's energy budget by 30%. Or a city inspector requires immediate sidewalk replacement to eliminate trip hazards caused by winter ice heaving. Or heavy spring rains draw attention to an unexpected need for roof repair. Or a routine pressure test reveals the need to replace an underground storage tank, which also causes a repaving of the co-op's parking lot. Where will this money come from? From the reserve fund, right? That may be what reserves are for, but what will the co-op do for reserves after making these repairs? That's why you always should include a credit line or the unconditional right to add at least some secondary financing as part of any refinancing. That way your co-op can make its needed repairs and still have reserves.

(8) *Too many cooks in the kitchen.* Remember the "finance committee" from mistake #1? Some boards have members competing against each other for the lowest rate. With everyone out "shopping", conflicts and mix-ups are bound to occur. If two people contact the same lender, especially if they give different information, the loan officer doesn't know whom to believe. It's easier – and safer – for the loan officer to decline your application and move on to the next one.

To prevent this from happening, boards should appoint one person as liaison with the outside world. Involve as many people as you want in the decision process, but funnel all information to and from lenders through just one person.

(9) *Forgetting notice requirements.* Most lenders require that you give them some advance warning that you are planning to repay their loan. Depending on the lender, this notice may be as short as thirty or as long as ninety days. This requirement may not seem like much until you combine it with a commitment that requires a loan closing in thirty days. Many a co-op neglects to check the notice terms on their existing loan until they have scheduled the closing for their new loan. Only then do they discover that they have a problem. Some lenders are understanding and will accept shorter notice or extend your commitment, while others might bend their rules for a fee. When interest rates are falling, such accommodations are more likely. However, many lenders insist on the required notice. Postponing a closing to satisfy your existing lender could "unlock" the interest rate on your new loan – a very expensive mistake if rates are rising. So, make sure your attorney checks your existing loan's notice requirements before you sign any loan application.

(10) *Lost documents.* Getting your attorney involved early in the refinancing process has many benefits. In addition to checking notice requirements, your attorney should make sure that all of your existing loan documents are available. You'll need them if you want to assign your old mortgage to the new lender to save on the mortgage recording tax.

(11) *Hidden title problems.* Your attorney also should do a preliminary title search to make sure that there are no significant problems that could derail your refinancing. Doing this early gives you plenty of time to fix whatever problems you do find or change the terms of your new loan to accommodate them.

(12) *Ignoring prepayment previsions.* Most borrowers assume that they will carry their new loan to maturity. However, only a very small percentage actually do. That means that most borrowers will pay a prepayment penalty at some point in the future. Despite this fact, very few borrowers give more than cursory attention to their new loan's prepayment terms. This is very foolish because and inopportune loan prepayment can be very expensive. So, careful consideration of prepayment terms in light of the cooperative's current physical condition and long-term financial plan should be an important part of any refinancing effort.

(13) *(That's right…a baker's dozen!) Environmental issues.* Many cooperatives view a lender's concern over environmental issues as unreasonable. But, in today's legal world, such concerns are legitimate. Even if they weren't, the lender would be within rights to ask for whatever they wanted before lending their money. So it pays to anticipate such issues rather than hide them. Get your managing agent and engineer involved up front to assess your environmental risks from such items as asbestos pipe insulation, underground oil storage tanks, lead paint, etc. Prepare reports and get estimates to remedy any problem. Fix anything you can before you apply for a loan. For example, if you have a buried oil tank that hasn't been pressure-tested in the last year, get it tested. If it passes, great! If it fails, at least you know you've got a problem before you're under pressure to close a new loan.