PLAY IT AS IT LAYS

By Patrick Niland

HERE ARE SOME IDEAS TO HELP YOU AVOID GAMBLING AWAY YOUR CO-OP'S FINANCIAL STABILITY WHILE REFINANCING

Watch the monte hustlers and their marks on Times Square and you see a scenario repeated. The dealer shuffling cards on a cardboard box draws crowds to his transient game, some of whom catch a scent of easy money.

The more adventurous think they can beat the hustle without knowing how to play. They're the ones who plunk down the greenbacks.

Then, just when they're certain where their card will turn up, the monte dealer flips them over and, voila, the mark's card turns up in a different spot. The dealer pockets the cash and, if the cops show, splits.

Mortgage refinancing is far from a street corner hustle—for one thing, the stakes are much greater, and for another, banks are not trying to cheat you. But in these days of the lowest interest rates in decades, there can be a clear resemblance between the marks at the monte box and co-op directors seeking a new loan—they both catch a whiff of what smells like easy money. You might be able to save some cash, perhaps stave off maintenance increases, resolve problems in your building, or merely strengthen your co-op's financial foundation.

However, there is one other key way in which mortgage refinancing resembles playing monte with the sharpies. Unless you are very careful and fully prepared, the game will wind up costing you dearly.

So, before you dive into the market, there are some important things to consider. Most important is to understand what a cooperative is—a corporation, just like IBM or General Motors. In other words, it's a business. And the business of the cooperative corporation is running an apartment building. Like the board of directors of GM, the co-op board bears a fiduciary responsibility to maximize the value of its stock.

Remember: refinancing requires preparation and long-term financial planning. Without these, the new mortgage—even at today's lower rates—could wind up costing far more than your existing loan. A careless board that refinances without doing its homework could jeopardize its shareholders' financial future.

First, use the building's hired professional help--the managing agent, accountant, and outside mortgage brokers. If you do not, you might end up making any of these five common mistakes.

NO THANKS, JUST BROWSING

(1) *They look too early.* Often boards start shopping for a new loan too early, too much in advance of when they actually expect to need it. In the classic case, the board of directors appoints a multi-member "finance committee" to "research the market" and report back to the full board on what loans are available for their building. Committee members get out the phone book and each calls a few banks. During the next several months, they collect quotes from each of the lenders on their lists. Often, someone also calls a broker or two they've heard of to get a few more quotes. All of these are then neatly arranged on a spreadsheet for review by the full board. Invariably, the directors are most attracted to quote "A" but would like to incorporate some of the more favorable terms from quotes "C" and "F".

Hence, the finance committee is directed to recontact its lenders for updates based on this new set of parameters. This cycle may be repeated several times before the board settles on what it wants. Unfortunately, by that time the various quotes solicited over the previous several months are now invalid—the market has moved on. More importantly, all of the finance committee members' "shopping" has contaminated the market for their building. Loan officers, contacted repeatedly by committee members or wild-card brokers, long ago concluded that this co-op is *just shopping* and not serious. To be labeled a shopper is the kiss of death from a loan officer.

WE WANT THE LOAN AND WE WANT IT NOW

(2) *They look too late.* Many co-op directors wait until the last three months of their existing loan term before they begin looking for a new loan. In some cases, the existing loan has a sub-market interest rate that the board would like to keep for as long as possible. That is certainly understandable. However, by waiting so long, the board is forfeiting much of its negotiating power with lenders. A loan officer will often be less competitive in his pricing if he thinks that board members are desperate for a new loan. Therefore, boards should begin the refinancing process six to nine months before the maturity date of their existing loan.

HOW MUCH IS TOO MUCH?

(3) *They borrow too much.* Many cooperatives now in deep trouble got that way because they borrowed too much in past refinancings. Other co-ops are saddled with the high debt left behind by their sponsor. It is essential that board members carefully assess their building's needs and not borrow extra money for frivolous expenditures—no matter how low today's rates may seem.

SINKING FUND OR BUST

(4) *They overlook amortization.* Overlooking amortization is a dangerous trap that catches many co-ops. Interest-only loans are popular since their entire monthly payment is (deductible) interest. While this leads to lower monthly mortgage payments and helps the board hold the line on maintenance increases, it fails to provide for principal repayment. The somewhat hidden and sinister byproduct of such loans is their tendency to increase the total debt on the building.

In most cases, the board makes its monthly mortgage payment but neglects to budget for future refinancing costs. Consequently, when the loan matures, the board must increase the size of its new loan just to cover closing costs. More often than not, the board also has drained its building's reserve fund over the years to avoid raising maintenance charges. It must then borrow even more money to replenish the reserves. To avoid this trap, always include amortization among the terms of your new loan. Further, raise maintenance charges to keep pace with inflation and other budgetary increases. Save your reserve fund for its intended purpose: emergencies. Draining it to hold down maintenance charges is like using your IRA to buy groceries. It's dumb.

WHEN IT ISN'T ENOUGH

(5) They don't borrow enough. This is by far the most costly mistake that a board can make. Most board members think that their new loan's interest rate is the most important factor. They will shop endlessly to save an eighth of a percent. This obsession with rate blinds them to other issues whose costs will dwarf whatever savings they might achieve from a lower interest rate.

If you lower the interest rate on a $1 million loan by an eighth of a point, you will save the co-op about $1,250 per year in interest, or roughly $6,000 over the life of the typical five-year co-op mortgage. While certainly worthwhile, that pales beside the $20,000 to $40,000 cost of refinancing such a loan (not to mention the 10,000 to $50,000—or more—penalty associated with prepaying the loan before its due date).

ON THE POSITIVE SIDE

So how does a board determine the right amount to borrow? That's where the cooperative corporation's chief operations officer and chief financial officer—the building's managing agent and accountant—come into play. The accountant should assess the cooperative's financial assets, examine past financial statements, and then create various five-year projections based on different scenarios for inflation, real estate tax increases, and other elements. These different cases will help quantify the risk associated with different loans the board might choose.

Meanwhile, the managing agent and a professional engineer should evaluate the cooperative's physical assets, forecasting those building components that might require maintenance, overhaul, or replacement during the life of the new loan. To ignore this area is downright suicidal. You wouldn't ignore a cancer in your body. So don't ignore the current and future health of your building.

THE FIVE-YEAR PLAN

Now the hardest work begins: developing and implementing a workable five-year plan that can spell the difference between financial security and financial ruin. This is not over dramatized. Well-run cooperatives have greater access to the financial markets, more marketable apartments, and happier residents. Cooperatives that operate from “hand to mouth” eventually deteriorate to “down in the mouth.”

To do this properly, board members need to communicate with, and trust the skills and experience of, their managing agents, accountants, and other professionals. (If they don’t feel they can do this, they’ve hired the wrong people.) Managing agents need to take a more proactive approach to their buildings. (If the board won’t let them do the job they were hired to do, then they’ve accepted the wrong account.) And accountants need to tell it both like it is and like it will be. Most board members don’t have the expertise to make alternative future projections. But they must see such forecasts to understand the risks involved and make the right decisions. (If the board wants something sugarcoated, send them a candy bar.)

Ultimately, the board and co-op president, the chief executive officer of the co-op as it were, has to study the long-term plan and other research to see how mortgage refinancing alters the mix. If the decision is to refinance, then be sure to schedule the shopping trips appropriately. Have all your information together so your expeditions have some focus—don'’ get yourself tagged as “shoppers” by the lenders. Armed with reams of financial information about your building, you should be able to discern—with the help of your accountant—how much money to borrow. And don’t forget that amortization.

If nothing else, all this work will achieve one goal: money will never have that easy smell to it again—which, of course, is just as it should be if your building is to survive and prosper.