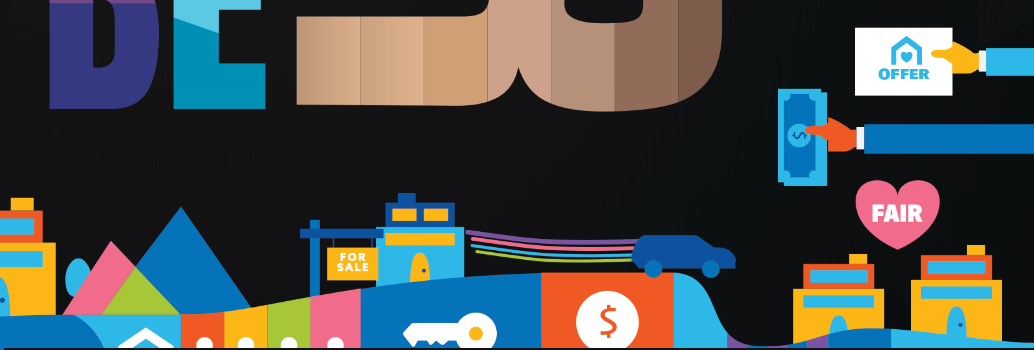
OC REALTOR®

MAY | JUNE 2021

THINK SELL BE FAIR



IN THE INTEREST OF FAIRNESS

Although we once naively believed fairness would be the inevitable result of our having declared that all are created equal, experience has shown us otherwise. Often uncomfortable with diversity, we need to address our implicit biases before we can consistently encourage equality, equity, and inclusion. Featured in the May/June issue of OC REALTOR© are articles intended to aid this process.

on pages 24–31

MEET THE CANDIDATES FOR YOUR BOARD OF DIRECTORS

on pages 16–19

HOA DEAL KILLERS

Because properties within Homeowners' Associations (HOAs) make up a significant portion of the available housing stock in Orange County, transactions involving an HOA are becoming more common.

By Scott Clements

Because the number of Homeowners' Associations (HOAs) in Orange County numbered more than 2,600 in 2020, properties within HOAs make up a significant portion of the available local housing stock. As a result, transactions involving an HOA are becoming more common. Unique issues are involved when buying or selling property located in a common interest development. Outlined below are some issues to be aware of when representing clients who are selling or are considering purchasing in an HOA.

Mortgage Financing

Obtaining mortgages for units within a condominium project may involve more than the credit worthiness of the buyers and the appraised value of the unit. Whether the mortgage is from a private lender or from a lender approved by the Federal Housing Administration (FHA), the HOA itself must demonstrate fiscal soundness. Because the FHA is the largest insurer of mortgages for entry-level housing, the inability of an HOA to qualify for FHA financing can severely limit mortgage options.

Delinquencies

The maximum delinquency rate allowed under FHA guidelines is 15 percent; therefore, HOAs with assessment collection issues and high delinquency rates will be excluded from loan products involving federally insured mortgages. Although some private lenders allow delinquency rates above 15 percent, the added risk the lender absorbs will be reflected in the rates and terms of these loans, making them more expensive than traditional products. REALTORS® are encouraged to have prospective sellers obtain a copy of the HOA's most recent financial statement (unit owners are entitled to this information, accessible within ten business days, per California Civil Code Section 5210) and review the delinquency report. If it is high, encourage the seller to work with the HOA in reducing the delinquency rate to an acceptable level.

High Rental Rates

Units within HOAs with high rental rates—that is, more than of 65 percent of the units rented—

> "HOAs with high rental rates are known to have more maintenance and financial issues than communities in which a high percentage of the units are owner-occupied."

would be disqualified from FHA-insured loans. Many private lenders impose similar rental restrictions. Non-owner-occupied units tend to resist assessment increases to maintain the facilities; therefore, HOAs with high rental rates are known to have more maintenance and financial issues than communities in which a high percentage of the units are owner-occupied. Lenders know this and respond accordingly.

Poorly Funded Reserves

Reserve funding is carefully reviewed in the underwriting process. A poorly funded HOA is more likely to impose special assessments and dramatically increase the regular assessments on its members. The impact of these assessments can sometimes inhibit the mortgage holder's ability to fulfill his or her obligations to the home loan. Foreclosing on a unit with little equity in a poorly funded HOA is an undesirable option for the lender because possession of the unit would obligate the lender to assume the financial responsibilities accompanying it. It can be challenging to find financing for units in poorly funded communities.

For FHA-insured loans, the minimum reserve contribution rate—that is, the amount of money placed into the reserve fund from the operating income—is 10 percent. HOAs contributing less would need to increase their contribution rate for units within to qualify for federally backed mortgages. In addition, most FHA lenders have interpreted the requirement to include a minimum 10 percent funded level. Some private lenders require a funded level of more than 10 percent.

Federally insured loans will require a reserve study conducted within the past twenty-four months so that the lender can review the funding needs. Without a current reserve study, the lender—and potential buyers—cannot gauge the soundness of the HOA's finances. Will there be a special assessment? If so, how much might it be? When will it be due? Could there be more than one special assessment? How much are regular assessments expected to increase in the next ten years? Without a current reserve study, nobody knows the answers to these questions. California law requires that all HOAs provide a reserve study, among other financial documents, to their members annually. REALTORS® are encouraged to ensure that complete financial information is included in all transactions within an HOA.

Assessment History

A history of special assessments, spikes in regular assessments, or assessments that are unjustifiably low are red flags for lenders. They indicate a lack of planning and prudence. Well-managed associations have sufficient reserves and, therefore, have no need to collect special assessments from the members for routine repairs and replacements. Operating cost increases are generally consistent with inflation; therefore, HOAs should be capable of planning for small regular increases to the assessments to avoid large year-over-year spikes. Reserve studies include replacement and expenditure schedules which illustrate the anticipated future expenses. Statutory reporting requires that budgeted-versus-actual expense comparisons be displayed in financial reports. An HOA collecting insufficient funds to cover both the operating expenses and future capital expenditures may be rejected because of anticipated future special assessments.

Use Restrictions

Conditions, Covenants and Restrictions (CC&Rs) and other governing documents, such as operating rules and regulations, can be long and detailed. Learning of restrictions after escrow can lead to dissatisfaction and potential liability. Use restrictions that often get overlooked in the transaction process include those that govern parking, keeping pets, operating a home business, renting out the unit, and changing the size or appearance of the unit.

Parking

Many communities prohibit overnight parking of commercial vehicles outside an individual closed garage. Others prohibit any vehicle from parking overnight outside an individual closed garage. Most limit parking of recreational vehicles or trailers to specific timeframes and locations. Multi-unit properties typically prohibit unit household members from using designated visitor parking areas and may limit the number of spaces or the hours that visitor parking is allowed. In car-centric Southern California, where many people use their vehicle in their work, these are important issues for home purchasers to consider.

Keeping Pets

Many associations limit the number or type of pets that can be housed. They often establish weight limits, such as fifty pounds, which are intended to keep out larger, more dangerous, types of canines. Personally, I have never encountered a dangerous English Bulldog, nor seen an adult one that weighed less than fifty pounds. But rules are rules. People with multiple pets, large dogs, and overfed cats should be aware of these rules and limitations. In addition, the keeping of many species of exotic pets may be restricted or prohibited. Prospective purchasers who want to raise livestock, primates, or reptiles should do so outside an HOA.

Operating a Home Business

Most HOAs have limitations or exclusions on operating commercial businesses from individual units, and those that do allow commercial activity typically impose conditions and restrictions on those rights. These restrictions may include prohibitions and limits on the numbers of customers, employees, or service providers that can visit a unit. And they often prohibit any manufacturing or assembly of products within a unit or any shipping of products from a unit. If potential purchasers have, or are interested in opening, a home-based business, they should read the HOA governing documents carefully before buying.

Renting Out the Unit

Many HOAs have rental restrictions. The laws and regulations for short-term rentals, such as AirBnB, continue to evolve. Some associations prohibit rentals of any type. This is common in active adult communities. Others may specify minimum terms of rentals, such as six months or one year. Associations may also impose fees to offset the costs of accommodating rental units. It is important to note that unit owners are still responsible for the unit and the activity of its occupants. If renters damage the common area, the unit owner could be held liable for the repair expenses. If renters' actions result in fines levied by the HOA, the unit owner will be held financially responsible. If rental usage is desired, it would be prudent to recommend that the information be reviewed by a competent real estate attorney.

Changing the Appearance or Size of the Unit

Changing the appearance of a unit or expanding its features is usually subject to architectural review. Although this provision is intended to ensure the consistent look and aesthetic appeal of the community, it may also limit improvements or changes to the property. An owner's ability to install pools, decks, and out-buildings is typically limited in the governing documents. Changes to driveways, walkways, and landscaping may also be restricted. Many associations have limitations on the types of materials that may be used, and color options are often restricted to a list of preapproved tones.

All operating documents—including those that spell out the rules, regulations, and limitations—must be distributed annually (California Civil Code Section 5300) and be made available for review by members within ten days of request (California Civil Code Section 5205). It is important that clients are aware of these limitations to ensure that their expectations are consistent with HOA policies.

Because each HOA is unique, REALTORS® are encouraged to assist in procuring information about the association in which clients are considering a purchase to ensure that they have copies of all the relevant documents they need to make an informed purchase decision.

Scott Clements is chief executive officer of Reserve Studies, Inc. He serves on the Education Committee for Community Associations Institute Orange County Regional Chapter. A popular author and speaker about common interest development, Scott was recognized as 2010 Educator of the Year.