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ASSOCIATIONS INSTITUTE

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U.S. Department of the Treasury
1500 Pennsylvania Ave, NW
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The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave
Washington DC 20551

The Honorable Shaun Donovan
Secretary
U.S. Department of Housing and Urban Development
451 Seventh Street, SW
Washington DC 20410

Mr. John G. Walsh
Acting Comptroller of the Currency
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Washington DC 20219

The Honorable Mary Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington DC 20549

Mr. Edward DeMarco
Acting Director
Federal Housing Finance Agency
1700 G Street, NW
Washington DC 20552

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington DC 20429

Ladies and Gentlemen:

On behalf of Community Associations Institute (CAI)[1], I am pleased to submit the following discussion and recommendations as you continue to study and develop proposed regulations as required by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2009 (DFA). CAI's members are keenly interested in the development of the regulatory definition of "qualified residential mortgage" and the process by which this definition and other exemptions to the risk retention requirements of Section 941 will be derived.

[1] CAI is the only national organization dedicated to fostering competent, well-governed community associations that are home to approximately one in every five American households. For nearly 40 years, CAI has been the leader in providing education and resources to the volunteer homeowners who govern community associations and the professionals who support them. CAI's 30,000 members include community association volunteer leaders, professional managers, community management firms, and other professionals and companies that provide products and services to community associations.

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Community Associations' Access to the Housing Finance System and the Financial Crisis

Community associations[2] have long been the housing option of choice for millions of American families with more than 60 million American households currently located in a community association[3]. These homeowners choose to live in a community association for any number of reasons, but chief among them are a desire for a strong community identity, to protect the value of their home, to enjoy amenities that may not otherwise be available, to mutually share some of the expense of property maintenance, and to provide a decent home and suitable living environment. While community associations have been in existence for more than 150 years, the community association model of homeownership has become more popular and widespread in the past several decades.

Role of Federal Agencies in Supporting Standardization of Community Association Governance
As the community association model of housing developed, the housing finance system, led in large part by the U.S. Department of Housing and Urban Development (HUD), began to offer mortgage insurance for condominium project mortgages and for condominium unit mortgages in the early 1960s. These program offerings began the process of standardizing financial management and operational requirements for community associations as HUD published model governing documents for community associations. Later, toward the end of the 1960s and during the early 1970s, HUD, via the Federal Housing Administration (FHA), worked with the Urban Land Institute, the Department of Veterans Affairs (VA) and the National Association of Homebuilders to create Community Associations Institute (CAI)—recognizing that none of the existing housing organizations were able to provide continuous and credible information about best practices in the development, management and governance of community associations.

The government sponsored enterprises or GSEs (Fannie Mae, Freddie Mac and the Federal Home Loan Bank System) followed HUD's leadership, developing programs to serve the community association market. State legislatures provided a strong legal foundation, as well, by devising and implementing statutory frameworks for community associations. Taken together, actions by FHA, the GSEs and state governments have encouraged the standardization of association development, management and governance, all of which are significant benefits to the residents of community associations.

While the residents of community associations clearly benefited from healthy associations and increased access to mortgage credit, over time, the program standards of the individual agencies became less harmonious. This situation created confusion in the community association housing market as associations were required to meet different program criteria to ensure that mortgage financing would be available to residents. In 1994, CAI requested the GSEs, FHA and VA form a working group to facilitate a harmonization of program criteria.

The interagency working group met periodically over the course of two years seeking to eliminate individual program requirements that were no longer necessary given market developments and to achieve standardization through program reciprocity where possible. In some circumstances, a statutory directive focused the agencies on different sectors of the housing market, and these differences prevented the publication of a unified set of recommendations among the agencies. The process did, however, produce tangible and positive results for the residents of community associations by allowing these homeowners to more easily connect with the housing finance system and live in well-governed and prudently managed communities.

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[2] All community associations have three defining characteristics: (1) membership is mandatory and automatic for all owners; (2) certain documents bind all owners to be governed by the community association; and (3) mandatory lien-based assessments are levied on each owner in order to operate and maintain the community association. There are three basic types of community associations: condominiums, cooperatives and planned communities.
[3] 2009 CAI National Survey

The basis for the movement to standardize criteria for community association programs is the fact that residents of community associations have a mutual interest in the performance of the association. The fiscal condition of a community association has always had a direct bearing on the value of property in the association and the ability of the association to deliver the benefits that residents expect. While community associations may vary in scale, the basic requirements to maintain adequate reserves, prepare a realistic annual budget, obtain important insurance coverage, govern in a responsible manner, and levy and collect appropriate assessments are all similar, regardless of whether the community is a condominium, cooperative or planned community.

CAI's goal was, and is, to build a "partnership in community" among the many parties involved in making the community association model of homeownership successful, which includes the GSEs, FHA and VA. In many cases, CAI's effort to coordinate community association programs at the GSEs, FHA and VA led to stronger community associations. This has protected the value of the real property, securing mortgages purchased, insured or guaranteed by these agencies.

How the Financial Crisis Impacted Residents of Community Associations

As the financial crisis developed in 2008, it became apparent that lax mortgage underwriting and securitization standards, so pervasive from 2005 through 2007, exposed the entire financial system to substantial losses. Similar to other homeowners across the country, some residents of community associations purchased homes during this period with exotic mortgage products, which they could not have reasonably been expected to repay. As household budgets became severely constrained, many troubled borrowers in community associations ceased paying association assessments and, shortly thereafter, ceased making mortgage payments. In some cases, homeowners simply walked away from their homes, mortgages and associations.

The common bond between homeowners living in community associations caused the housing crisis to have a unique impact if the association was faced with a significant foreclosure rate. It is well documented that a foreclosure lowers property values for most neighboring homes, compounding any financial distress these homeowners may be experiencing. For residents of community associations, the impact of widespread foreclosures was magnified as a high number of homeowners ceased paying the assessments required to fund association operations. In many community associations, the association is responsible for waste removal expenses, maintenance of community infrastructure, utility services and insurance premiums. When an association has a sudden reduction in income and is forced to use emergency reserve funds to cover ongoing expenses, the only available means to recapitalize these funds are through assessment increases, special assessments or a combination of the two. As these costs are borne by residents of the association, homeowners who are otherwise in a healthy financial condition can be subjected to significantly higher housing costs, thereby increasing the number of financially distressed owners in the association. To further aggravate this situation, many associations have taken on the expense of maintaining vacated homes and adjacent common areas for security and fire safety reasons, while mortgage lenders have intentionally delayed unpreventable foreclosures and failed to take title of properties to avoid paying association assessments.

As reported in CAI's September 2010 Association Impact Survey[4], the impact of the crisis was broad and profound for community associations. Approximately 54 percent of responding community associations described the impact of the housing and financial crisis as serious or severe. Vacant homes due to foreclosure, abandoned properties and other factors increased with more than 25 percent of communities reporting vacancy rates of greater than 6 percent. Most telling are data regarding association assessment delinquencies. In 2005, community associations across the country reported low rates of assessment delinquencies—95 percent of associations reported delinquency rates of less than 10 percent with 81 percent reporting delinquency rates of less than 5 percent. In 2010, approximately 35 percent of

[4] Community Associations Institute: September 2010 Association Impact Survey

associations reported a delinquency rate of less than 5 percent; 32 percent of associations reported a delinquency rate of 6 to 10 percent; and 32 percent reported a delinquency rate of more than 20 percent.

Association boards, comprised of homeowners elected from the community, have responded to the crisis through a variety of means. The most commonly reported means of managing the crisis have been postponing planned capital improvement projects; laying-off staff and/or reducing work hours; reducing contributions to or borrowing from emergency reserve accounts; and, levying special assessments or increasing regular assessments. The economic impact of these actions is significant. In 2009, residents of community associations assessed themselves more than $41 billion for the purpose of funding association operations. Additionally, association boards maintain investment accounts of more than $35 billion for the long-term maintenance and replacement of commonly held property.[5] The contraction of operations forced on community associations by the housing and financial crisis has not only impacted the residents of those associations, but also the economies of the cities and towns in which they are located.

Community Associations Support Return to Prudential Underwriting Standards

CAI strongly supports new public policies demanding that mortgage originators and securitizers adhere to more strict credit underwriting standards for borrowers. CAI has supported the efforts of both the federal financial regulators and the Congress to require that mortgage originators verify a borrower's ability to repay a mortgage at the fully-indexed rate and to prohibit loans with predatory characteristics. Further, CAI strongly supported regulatory and congressional efforts to require that originators qualify borrowers on the basis of all monthly payments required to keep a mortgage current. The DFA contains specific language requiring that association assessments, which are lien-based and mandatory for all homeowners in the association, be included in the calculation of a borrower's mandatory monthly mortgage obligations.

The return to prudential management and operation standards in the nation's federally-insured financial institutions and non-bank lenders, as well as the imposition of new regulatory discipline on secondary mortgage market actors, is welcomed by CAI. A renewed focus on the fundamental business of banking—taking deposits, underwriting and making loans, and earning a reasonable return on the interest rate spread of these activities—will ensure that mortgage financing is available to creditworthy individuals and families, and that they are prepared for the financial burden necessary to maintain homeownership. Congress clearly intended to require that mortgage originators and securitizers employ fundamentally sound and historically valid loan underwriting standards as a means to avert a future housing crisis of this magnitude.

Regrettably, there have been recent instances in which federal agencies have not acted in a manner consistent with the new congressional mandate to enforce sound and historically verifiable underwriting standards for mortgages, and these actions have harmed the housing market. The FHA has implemented economically harmful and significant changes to its condominium insurance program without providing notice and opportunity for public comment. Additionally, the Federal Housing Finance Agency (FHFA) has sought to restrict the use of certain private transfer fee covenants in community associations and has proposed guidance directing the GSEs not to purchase or otherwise support any mortgage where the underlying property may be encumbered by a private transfer fee. CAI believes these actions go beyond the pale of prudential regulation, and CAI believes that rather than protecting the interests of homeowners these agencies are causing homeowners economic harm.

FHA Condominium Program Guidelines

On June 12, 2009, FHA released Mortgagee Letter (ML) 2009-19[6] announcing economically significant changes to the process by which condominium associations are certified to participate in FHA insurance programs. The announcement was not preceded by a notice in the *Federal Register* and, therefore, was not subject to prior notice or public comment. ML 2009-19 does not explain or justify how the new

[5] 2009 CAI National Survey
[6] ML 2009-19

program guidelines protect borrowers or the associations they live in, nor did FHA offer any examination of compliance costs or the economic impact of the guidelines on condominium residents or associations. FHA followed ML 2009-19 with the release of ML 2009-46A and 46B[7] on November 2, 2009, which made further changes to the agency's condominium program, again, without providing notice to the public in the *Federal Register*.

The changes executed to FHA's condominium program guidelines have a material effect on the economic interests of many groups such as homeowners and their volunteer board members, attorneys, managers, insurers, planners, and developers. Yet, there is no evidence of outreach by FHA to communicate the need for such sweeping policy changes or to provide justification for the specific policy changes being implemented. Given the inclusive and deliberative process that FHA has used in the past to improve its condominium program guidelines, the agency's failure to seek public input is uncharacteristic of its public reputation. Put simply, FHA failed to follow the statutory requirement of Section 941 of the DFA that will guide your collective efforts to define the term "qualified residential mortgage."
The DFA provides guidance and direction to the agencies involved in the joint rule-making to define "qualified residential mortgage," stating that the agencies shall take "*...into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default ...*"[8] FHA offers no empirical data demonstrating its unilaterally imposed condominium program guidelines are based on an evaluation of historical loan performance data and, therefore, fails to meet the rule-making standard set in Section 941. CAI urges your agencies to use a more inclusive and comprehensive approach to this rulemaking and reject a closed process that hinders rather than facilitates public input.

In addition to failing to meet the data-driven, empirically verifiable standard applied to the agencies in the formulation of a joint definition of "qualified residential mortgage," FHA has implemented its new condominium guidelines without adopting a new regulatory framework that could then be available in HUD Handbooks as are the other FHA programs. The Housing and Economic Recovery Act of 2008 moved the statutory authority for FHA's condominium program from Section 234(c) of the National Housing Act to Section 203(b) of the Act.[9] FHA has yet to engage in rulemaking to transfer regulatory authority from Section 234(c) to Section 203(b). While these legislative and regulatory changes were implemented as long as two years ago, FHA has made no effort to update its regulations or relevant HUD Handbooks, which provide specific guidance to homeowners and industry partners on the administration of FHA's condominium program. This has exposed many homeowners and community associations to legal uncertainty and constantly changing program requirements that are implemented differently across the country.

FHFA's Proposed Guidance on Private Transfer Fees
On August 16, 2010, FHFA published proposed guidance in *the Federal Register* directing that the GSEs not purchase, invest in securities or accept as collateral for advances any mortgage or security where the real property securing the mortgage or security is encumbered by a private transfer fee covenant.[10] The proposed guidance, as published, would have a devastating impact on millions of homeowners living in community associations across the nation by denying up to an estimated 11 million households access to the secondary mortgage market through the GSEs.[11] Given the breadth of impact, it is not surprising that more than 2,600 individual comments (an overwhelming majority in opposition) were submitted to FHFA in response to its proposal.

CAI's members commend FHFA for publishing the proposed guidance to the GSEs in the *Federal Register* even though no statutory requirement to do so existed. Yet, given the number of and the content of comments the agency received from the public, it appears the agency may not have clearly understood

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[7] ML 2009-46A; ML2009-46B
[8] P.L. 111-203: Section 941(b)(e)(4)(B)—*Qualified Residential Mortgage*
[9] P.L. 110-289: Section 2117—*Insurance of Condominiums*
[10] FHFA No. 2010-N-11: *Guidance on Private Transfer Fee Covenants*
[11] *For the Common Good: Use of Community Transfer Fees by Community Associations*: September 27, 2010.

the impact its proposed guidance would have on the housing market. Further, in its proposed guidance, FHFA arrived at certain conclusions, yet failed to provide or make available the data used to support its conclusions. By failing to employ a data-driven, empirically verifiable process in developing its proposed guidance, FHFA failed to meet the statutory standard to be used in the joint rule-making process to define "qualified residential mortgage."

The Response to the Housing and Financial Crisis Should Address Causal Factors
CAI's members have been greatly disturbed by the actions of FHA with regard to the agency's condominium program and FHFA's proposal to restrict access to credit for any property encumbered by a transfer fee (regardless of whether or not the fee provides a direct benefit to the property). These policies seem to target community associations as a contributing factor to the housing and financial crisis. CAI's membership strongly rejects this notion.

Community associations are organized under state law and are comprised of individual homeowners bound together by private contract. Association boards are populated by volunteers from among these homeowners through fair and open elections governed by state law. These volunteers serve their neighbors by managing association operations, enforcing association rules, and ensuring compliance with federal and state law. This can be a tough assignment, but it is one that 2 million homeowners take on each year.[12]

CAI is not aware of any published or credible study identifying a causal link between community associations, and the lax mortgage underwriting standards and secondary market operations or the excessive leverage in the financial system that precipitated the housing and financial crisis. Association boards do not set loan underwriting requirements for homeowners nor do associations select the lenders that owners must use. Homeowners living in community associations did not cause the crisis; rather, many of these homeowners experienced significant economic loss due to poor business decisions of originators and secondary mortgage market actors. This is why CAI strongly believes the federal financial regulators should focus efforts on restoring sound underwriting practices in the mortgage finance industry and the secondary mortgage market rather than attempting to regulate the private contractual obligations between homeowners living in community associations.

Recommendations on Definition of "Qualified Residential Mortgage"
Residents of community associations understand the need for, and strongly support, improved underwriting standards for the mortgage lending industry and the secondary mortgage market. CAI strongly supports the return to sound mortgage lending and securitization practices. As mentioned earlier, CAI also has a long history of supporting and working with housing-related federal agencies and federal financial regulators to ensure that community associations are financially stable and well-managed. With this background and recent experience in mind, CAI respectfully offers the following recommendations for your consideration.

The qualified residential mortgage definition must recognize the presence of community associations in the nation's housing stock, respecting the decision of homeowners that choose the community association housing model and the local governments that support it as the most effective means of land planning and ensuring sustainable housing that does not require public financial support.

- Section 941 is concerned with aligning the interests of originators and the secondary markets with those of the borrower by focusing on borrower qualification and the borrower satisfying the ability to repay standard.
- Regulators should avoid conditioning the extension of credit to qualified borrowers meeting all requirements of the ability to repay standard solely on the basis of a common ownership element of the real property securing the mortgage.

[12] 2009 CAI National Survey

- Housing-related government agencies and individual lenders should retain the responsibility to determine whether or not to extend credit to qualified borrowers for the purchase of a home in a community association on the basis of their own statutory and risk requirements.
- A qualified residential mortgage standard that promotes sustainable mortgage lending to creditworthy borrowers will allow qualified consumers to purchase housing of their choice and promote healthy, vibrant, and sustainable neighborhoods and community associations.

The qualified residential mortgage definition should not restrict access to mortgage credit and/or the secondary mortgage markets for residents of community associations.

- CAI urges you to carefully consider the legal basis for the structure and governance of community associations in recorded covenants, as well as state and common property law when constructing the definition of qualified residential mortgage.
- Given that more than 300,000 individual community associations exist across the nation, CAI encourages a careful and deliberate analysis of common legally valid concepts in recorded covenants and state and common property law for any element of the qualified residential mortgage definition that may affect the management and operation of community associations.
- As residents of community associations are governed by private contractual obligations duly authorized by state law and/or conventional real estate transaction, the federal government has limited authority to interfere with the terms of these contracts.
- Any criteria included in the definition of qualified residential mortgage that compels community associations to amend existing and enforceable contractual obligations will have a significantly negative effect on millions of American homeowners by restricting their access to mortgage credit.
- CAI notes that in correspondence to your respective agencies on the development of the qualified residential mortgage definition, the Mortgage Bankers Association states:

> *The potential impact on the availability of credit stemming from the QRM risk retention exemption cannot be overestimated. The design of the QRM and the "Qualified Mortgage" (QM) under the "ability to repay" provisions of Title XIV of the DFA will largely govern who can and cannot achieve homeownership for years to come. Few loans to ordinary customers are likely to be made outside the QRM construct; the loans that are made will be costlier and likely to be made only to more affluent customers.*[13]

- As loans not satisfying the qualified residential mortgage definition will be severely limited, CAI is concerned that unanticipated consequences of any underwriting criteria specifically applied to community associations will devastate millions of American households by rendering their largest asset unmarketable.

Strict adherence to the statutory directive that the definition of qualified residential mortgage be based on empirical data that is verifiable, subject to public review and scrutiny, and is historically-demonstrated to have a significant correlation to reduced borrower default.

- CAI urges that the qualified residential mortgage definition be developed through strict adherence to the statutory directive that underwriting criteria be clearly demonstrated by verifiable and testable data to reduce the likelihood of borrower default.

[13] Letter from the Mortgage Bankers Association to Financial Regulators Developing Qualified Residential Mortgage Definition: November 9, 2010.

- Data driven standards that are testable and, therefore, verifiable will ensure only those underwriting criteria shown to reduce the likelihood of borrower default will define the qualified residential mortgage basket of loans.
- CAI urges that data sets and tests demonstrating the efficacy of individual underwriting requirements for the qualified residential mortgage basket of loans be published in the *Federal Register* and available for public review.
- To ensure the efficacy and relevancy of the underwriting criteria and to provide opportunity to address unintended market impacts, CAI urges the rule defining qualified residential mortgage establish a regular periodic review of the definition.

To ensure transparency in the development and application of the qualified residential mortgage definition, the Department of Housing and Urban Development should publish the historical and actual performance data used to support its underwriting criteria for all single family FHA insurance programs.

- The statutory exemption granted FHA insured loans from the risk retention requirements of Section 941 of DFA confer upon FHA programs qualified residential mortgage status.
- Given the substantial concern that this statutory exemption will lead to increased usage of FHA programs and the likely adoption of FHA underwriting criteria by a substantial portion of the mortgage finance industry, markets and consumers will benefit from additional transparency and disclosure of the justification for FHA program underwriting criteria.
- CAI believes FHA's newly developed condominium program guidelines offer a case study on the need for additional transparency and disclosure in FHA operations.
- To date, FHA has imposed the following restrictions on its condominium program that have eliminated access to FHA programs for many condominium owners:
    - Rental restrictions:
        - Condominiums may not have less than 50 percent of units owner-occupied.
        - FHA has prevented condominiums from adopting policies to restrict the percentage of leased-units to less than 50 percent of total units in order to comply with FHA guidelines.
    - Delinquency rates:
        - FHA will not insure loans in a condominium where 15 percent of association assessments are more than 30 days in arrears.
        - FHA includes REO properties that are delinquent on assessments in its calculation, despite the fact that the delinquency rate criteria disqualifies many of its own REO from borrowers seeking FHA financing.
    - Commercial space limitations:
        - FHA restricts to 25 percent the amount of space used for commercial purposes in mixed-use developments.
        - This policy is in direct conflict with other federal programs, many sponsored by HUD, to encourage more environmentally-friendly housing in locations convenient to employment, healthcare facilities, transportation hubs and other services.
- CAI urges additional transparency and disclosure for FHA program guidelines to ensure that further revisions in its single family programs comply with the standards applied to all other underwriting criteria required for the qualified residential mortgage exemption.
- Additional transparency in FHA's single family programs will ensure that residents of community associations will be protected from any unintended consequences of changes to FHA programs that may affect their eligibility for FHA-insured mortgages and/or refinancing based not on their creditworthiness, but on a regulatory determination regarding their association's governance and operations.

To ensure consumer choice and attract private capital to the mortgage market, the qualified residential mortgage definition should be as broad as the statute permits.

- To guard against overutilization of FHA due to its statutory exemption from DFA Section 941 risk retention requirements, CAI urges that the definition of qualified residential mortgage be broader than FHA's traditional market.
- Given the limitations of Section 941 on the scope of the qualified residential mortgage definition placed on regulators, CAI believes it appropriate for the standard to be as broad as the statute allows.
- CAI believes an overly restrictive qualified residential mortgage definition will limit consumer choice and ensure that public resources rather than private capital will support the housing finance system as the mortgage finance industry will have a substantial incentive to mainly originate mortgages eligible for FHA insurance to ensure legal safe harbor.
- CAI urges that FHA program standards serve as a floor for the definition of qualified residential mortgage and that the "Qualified Mortgage" standard in Section 1412 of the DFA serve as the definition's ceiling.
- By taking as broad a definition as the statute will allow, the qualified residential mortgage exemption can be crafted to allow the GSEs (or their successors) and private firms to compete in the secondary market, providing efficiently priced and appropriately constructed mortgages to qualified borrowers.

CAI appreciates the difficult and sensitive work involved in crafting a definition of qualified residential mortgage that fulfills the intent of Congress and that promotes the return of private capital to our nation's housing finance system. The recent experiences of community associations discussed in this letter demonstrate the impact that seemingly narrow regulation can have on homeowners living in community associations if not carefully constructed. CAI's members are committed to the principle that qualified borrowers should have access to credit on fair terms so they are free to live in housing of their choice—an American aspiration that the housing and financial crisis has jeopardized. We look forward to working with you to attain this shared goal.

Sincerely,

Thomas M. Skiba

Thomas M. Skiba, CAE
Chief Executive Officer