



July 22, 2011

Mr. Cass R. Sunstein  
Administrator  
Office of Information and Regulatory Affairs  
Eisenhower Executive Office Building  
725 17<sup>th</sup> Street, NW  
Washington, DC 20503

Dear Mr. Sunstein:

On behalf of the Community Associations Institute<sup>1</sup> (CAI), I am writing to express concerns with recent regulatory guidance issued by the Federal Housing Administration (FHA) which is currently in review by your office. Specifically, our concerns involve new requirements imposed by FHA under Mortgagee Letter 2011-22 (ML-2011-22) issued on June 30, 2011. We believe that deficiencies in the process FHA staff used in developing such guidance resulted in provisions that do not comport with the requirements of Executive Order 12866 (EO 12866). We bring these issues to your attention and encourage you to take appropriate action, which includes directing FHA to revisit its guidance in light of the issues we are raising.

First, ML-2011-22 was issued as regulatory guidance and according to FHA was designed to provide a single source of information for the FHA condominium mortgage approval process. This included consolidating existing FHA guidance found in other Mortgagee Letters and to consolidate and clarify existing policy guidance for this program. The guidance meets the definition of "Regulation" found in EO 12866, Section 3(d) as it determines the qualifications for FHA insured condominium mortgages. Specifically, the guidance provided under ML-2011-22 is designed to describe the procedure or practice requirements of an agency. We also

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<sup>1</sup> 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.

<sup>1</sup> 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.

believe that the guidance falls under the category of significant regulatory action found in Section 3 (f)(1) as having a material effect on the economy of \$100 million or more. We note that FHA has submitted the Mortgagee Letter to the Office of Budget and Management for review.

As discussed in this letter, provisions found in ML-2011-22 violate the goals and provisions of EO 12866. As supported in our comments below, FHA has breached its obligations as found in the Statement of Regulatory Philosophy and Principles. Specifically, provisions of FHA's guidance demonstrate that in developing its requirements, FHA has failed to:

- Identify and assess available alternatives to direct regulation;
- Design its regulations in the most cost-effective manner to achieve its regulatory objectives;
- Harmonize federal regulatory actions with applicable state law;
- Tailor its regulations to impose the least burden on businesses and individuals; and
- Draft its regulations to be simple and easy to understand, with the goal of minimizing the potential for uncertainty.

As such we request that pursuant to your authority<sup>2</sup> to return the provisions of ML 2011-22 noted in this communication to FHA for further consideration and discussion with stakeholders. CAI believes that such action is prudent, would benefit consumers and would ensure FHA adheres to the spirit and intent of the requirements of regulatory action.

CAI believes that 3 provisions of ML 2011-22 violate the requirements in EO 12866, these provisions are: Fidelity Insurance Requirements, found in Section 2.1.9; Assessment Delinquency Criteria, found in Section 2.1.5; and Project Certification Requirements, found in Section 2.4. Further, CAI notes that Deed Restriction requirements imposed under Section 1.8.8 demonstrate that FHA failed to properly consult existing regulations.

### **Section 2.1.9: Fidelity Insurance Mandate**

Section 2.1.9 of the ML 2001-22 requires fidelity coverage for the theft of a community association's funds. That Section imposes 2 different requirements. Coverage for a theft committed by a board member of an association must be covered by fidelity insurance. Coverage for a theft committed by a management company hired by an association must be covered by a fidelity bond. Fidelity insurance and a fidelity bond are not synonymous. As drafted, FHA's regulatory guidance imposes an impractical standard that demonstrates that FHA did not identify and assess available alternatives to direct regulation, design its regulations in the most cost-effective manner, nor consult appropriate existing regulations or practices, related federal or state requirements.

A fidelity bond is a 3-party contract in which a bonding company guarantees to reimburse a party for any losses it suffers caused by the dishonest acts of another party. Each person that is bonded is named and has been scrutinized by a bond company for "character, capacity and credit."

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<sup>2</sup> Executive Order 12866, Section 6, (b)(3)

Unlike a fidelity bond, fidelity insurance is a policy of insurance. It is a 2-party contract just like any other policy of insurance involving the insurer and the insured. As the Guide shows, fidelity insurance is known as employee dishonesty insurance or crime insurance.

The need to protect an association from an unreimbursed loss of funds resulting from a dishonest act of a management company has been addressed by the community association industry. Fidelity bonds are not used in the community association industry to protect an association's funds. The protection is afforded by an association's employee dishonesty policy that extends coverage to a management company. The primary reason fidelity bonds are not used in the community association industry is the impracticality of naming and the cost of investigating each person within a management company that has access to association funds. Since bonds specifically identify the persons that are bonded, bonds do not automatically cover new employees.

Even if fidelity bonds were available for management companies, the specific coverage required by the Guide will be practically unattainable. The specific coverage issues created by the Guide are:

- The minimum amount of coverage required by the Guide fails to recognize the constant change in the amount of funds under the control of a management company. For example, an association that imposes assessments on an annual basis will have an ever-declining balance as a year progresses. Bonds are not variable; the premium, if a bond could be obtained, is based on the maximum potential loss. Such a premium would be based on an amount that will exist for less than 30 days.
- The Guide requires a management company to obtain a separate bond, in the minimum amount, for each of its association clients. A management company will not be able to afford the premiums. Bonds are not like an insurance policy that can name additional insureds on a single policy thereby reducing costs. Few associations will be able to afford the pass through of the cost of a bond.
- The Guide also requires a management company's bond to cover the total funds in the custody of the owner's association. That requires a management company's bond to cover funds that are not in the management company's custody or control. Bonds require the bonded person(s) to have custody and control of the covered money and securities.

Most associations do not allow a management company to have access to its reserve funds. Access is restricted to members of a board. The Guide requires all management company bonds to be in a sum that includes reserve funds, regardless of whether the company has access to those funds.

The Guide also requires a management company to carry a policy even if it would be covered by appropriate state law. In at least three states, Florida<sup>3</sup>, Virginia<sup>4</sup> and Maryland<sup>5</sup>, an association may purchase fidelity insurance to cover acts by agents of the association. Under the provisions found in Section 2.1.9, a management company would be required to obtain duplicate coverage. This imposes a costly and unnecessary burden on businesses and homeowners.

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<sup>3</sup> Fla Stat. 718.111(11)(h)

<sup>4</sup> Virginia Code Section 55-79.81(b)

<sup>5</sup> Ann. Code of Maryland, Real Property Article, Title 11, Section 11-1141.1 Fidelity Insurance (a)(2)(ii)

FHA's requirements also stand in stark contrast to the treatment of fidelity insurance issued by Freddie Mac. While Freddie Mac requires fidelity insurance as a condition for mortgage issuance in a condominium, its guidance<sup>6</sup> is a model on an appropriate and flexible approach more appropriate to the market place. It simply requires:

*The condominium owners association<sup>7</sup> must carry fidelity insurance covering losses resulting from dishonest or fraudulent acts committed by the association's directors, managers, trustees, employees or volunteers.*

The only way to achieve FHA's goal of avoiding an unreimbursed loss caused by a management agent's theft of association funds is to add the management company as an insured under the association's employee dishonesty policy. A management company can be included in the definition of an employee, just as members of a board of directors are considered employees for that coverage. Alternatively, a management company can be covered by a designated agent endorsement, ISO Form.

The guidance issued by FHA does not comport with state law, existing market regulations and imposes a costly and difficult requirement on condominium association management companies. It is evident in reading the provisions of Section 2.1.9 and referencing the insurance requirements of Freddie Mac and those imposed by states that FHA failed to perform required due diligence as required under EO 12866 Section 1, part (b) sections (3), (5), (9), and (11). FHA has clearly failed to assess appropriate alternatives to this requirement, failed to design regulations in the most cost-effective manner, failed to harmonize its requirements with existing state law and has failed to tailor the guidance to impose the least burden on effected entities. We encourage your office to return this Section of the guidance to FHA for further review in light of these issues.

### **Section 2.1.5: Assessment Delinquency Criteria**

Section 2.1.5 of ML 2011-22 revises allowable delinquency criteria for condominium associations participating in the FHA program. Specifically, FHA has retained the 30-day, 15-percent-of-unit delinquency standard; has expanded delinquencies to now include bank-owned properties; and allows for limited expectations beyond the 15-percent threshold if certain conditions are met.

First the requirement that no more than 15 percent of the total units can be more than 30 days in arrears on association assessments is an arbitrary number and does not adequately measure the financial health of the community. Increasingly, associations are budgeting for bad debt, thus even though 15 percent of the units may be delinquent, the association may still be able to meet its budget obligations to maintain its common property. Therefore, if an association maintains an allowance for delinquent assessments and the delinquencies do not exceed any budgeted bad-debt allowance, the delinquencies should have no impact on funding continued operations and routine maintenance.

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<sup>6</sup> See Appendix B: Freddie Mac Condominium Insurance Requirements

<sup>7</sup> CAI notes that Freddie Mac uses the appropriate term "Condominium Association" where as FHA incorrectly uses the term "Homeowners Association", throughout its guidance. This is further evidence that FHA has not engaged proper due diligence.

Additionally, a 30-day test for delinquencies fails to take into account time periods required under various state laws with respect to any notice and mandatory payment plans. The association must comply with these time periods as a precondition to its collection efforts<sup>8</sup>. In many cases, the association begins the process of tracking and seeking collection at or beyond the 30-day delinquency date, thus making a delinquency determination at such an early date difficult. Therefore, many associations will be unable to meet the 30-day delinquency window because of requirements of state law, not because of the financial condition of their community.

FHA will likely note in its defense, that this requirement is imposed by Fannie Mae on condominium associations. However, unlike Fannie Mae, which is a private entity, FHA has an obligation under requirements administered by the Office of Information and Regulatory Affairs (OIRA) to ensure its requirements comport with federal, state and local requirements. In the case at hand, FHA knew of existing state laws in conflict with the 30-day provision and chose to ignore them when issuing its guidance. This is not in harmony with FHA's obligation to ensure its regulations are the least burdensome, achievable and do not conflict with related state functions.

#### **Section 2.4: Project Certification Requirements**

Section 2.4 project eligibility requirements will mandate that the person submitting a project for approval attest, under criminal penalty, to 3 FHA imposed requirements. These include requirements that the condominium project complies with all state and local laws, the information contained in the submittal is true and correct, and requirement #3 which reads:

*The submitter has no knowledge of circumstances or conditions that might have an adverse effect on the project or cause a mortgage secured by a unit in the project to become delinquent (including, but not limited to: defects in construction; substantial disputes or dissatisfaction among the unit owners about the operation of the project of the owner's association; and disputes concerning unit owner's rights, privileges and obligations). The submitter understands and agrees that the submitter is under a continuing obligation to inform HUD if any material information compiled for the review and acceptance of this project is no longer true and correct.*

CAI believes it is appropriate that a person or entity submitting a project approval attest to the association's compliance with current law and the truthfulness of the information submitted. However, this Section also requires that the submitter agree to provide the United States Department of Housing and Urban Development (HUD) with information on an ongoing basis that does not comport with the transactional nature of FHA approval and the varying entities who may submit a project on an association's behalf. This attestation also requires the submitter to make, under criminal penalty, guarantees on the ability of a borrower to meet *future* mortgage obligations. As such, the obligations implemented in requirement #3 are too vague, too broad and impose punishments so severe that CAI believes few association board members, attorneys or project approval specialists will sign such a statement. Our concerns on this provision center

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<sup>8</sup> General Assembly of North Carolina Session 2011, Session Law 2011-362

on the issue of future condition of the borrower and the ongoing reporting requirement imposed by this Section. CAI believes that as drafted, part 3 of the project certification requirements violates the requirement found in EO 12866 Section 1, part (b) (11), which requires the agency to tailor regulations to impose the least burden on individuals or businesses, and section (12), which requires the agency to draft easy-to-understand rules that minimize the potential for uncertainty.

Association Boards Cannot Attest to Future Conditions: First, requirement #3 of the project certification requirements imposes an obligation that the submitter attests to current and future conditions on the property that may affect the borrower's ability to be current in their mortgage; specifically, defects in construction, substantial disputes or dissatisfaction among the unit owners about the operation of the project of the owner's association, and disputes concerning the unit owner's rights, privileges and obligations. This imposes a standard that is too vague, and too broad for any reasonable form of compliance. As drafted this Section not only requires the submitter to attest that they have no current knowledge of such conditions, but also requires them to attest that such current conditions will not have a future impact on the person holding an FHA mortgage. This is an impossible standard to meet and one that will lead to litigation.

Condominium associations are governed by residents elected by unit owners in periodic elections. CAI survey data demonstrates that condominium and residents of community associations have high satisfaction rates with the leadership provided by their elected boards, with 8 out of 10 residents expressing approval of how their community is governed and more than 9 out of 10 believing the board acts in the owners' best interests<sup>9</sup>. However, in any self-governed process, disputes are not uncommon. In fact, in any democratic process, debate and disagreement on policy are the lifeblood of a vibrant community in which members engage in defining their living arrangements from diverse viewpoints. As such disputes are not uncommon in a condominium association and are as much an indicia of a healthy community as a sign of distress. Disputes are nearly universally resolved by the board and rarely do such disputes rise to the level of litigation. While many special powers are granted to a member of a condominium board of directors by governing documents or state statutes, clairvoyance is not among them. A vast majority of condominium association disputes are resolved without litigation; however, there exists no clear process by which a board member or project submitter can reasonably certify that such disputes will not have a future affect on a borrower.

Ongoing Reporting Requirement Impractical for Submitter and HUD: Second, project certifications can be made by members of the condominium association board, attorneys, professional community association managers and businesses specializing in FHA project approvals. The standard imposed by FHA does not address that in most cases, as the project approval process is transactional in nature and does not lend itself to ongoing reporting by a homeowner volunteer or by a business or agent on an ongoing basis. As management companies, attorneys or project approval companies engage for project approvals, this requirement will radically change the transactional relationship and require that any firm engaged in project approvals be hired not only for the approval itself, but a 2-year monitoring requirement. This will needlessly increase the cost of obtaining FHA project approvals, which already can run as much as \$6,000 per association. Additionally, considering that FHA has to engage a contractor to assist

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<sup>9</sup> *What do Americans Say about their Community Associations?*, National research by Zogby International, 2009, Community Associations Institute.

in processing the volume of applications it receives, and the volume of the applications remains low to the total number of condominium associations, it is unlikely that FHA or HUD has the resources to process such materials.

The guidance issued by FHA in Section 2.4 is impractical, unclear and will lead to increased litigation or even criminal liability for individuals or businesses who cannot adequately predict, to FHA's satisfaction, the ability of a borrower to meet *future* mortgage payments. Not only does this provision set an impossible standard, it is self-evident that the best manner in which to assure that future mortgage payments are affordable is to impose standards on the borrower based on present, empirical data, and not to impose liability on third parties to the mortgage transaction for accuracy of predicting future events. On this provision FHA has clearly failed to assess appropriate alternatives to this requirement, failed to design regulations in the most cost-effective manner, failed to tailor the guidance to impose the least burden on effected entities and failed to draft requirements to minimize the potential of uncertainty. We encourage your office to return this section of the guidance to FHA for further review in light of these issues.

### **Section 1.8.8: Deed Restrictions**

Section 1.8.8 reiterates existing regulatory provisions under 24 CFR 203.41 that require FHA insured property to be free of restrictions that prevent the borrower from freely transferring their property. FHA's guidance notes that deed restrictions which would "be the basis of contractual liability of the borrower" shall be excluded from FHA approvals. CAI reads this section as FHA incorporating these provisions by reference. However, as drafted, the current guidance in this section misstates existing regulations on deed restrictions and does so in a manner which would exclude all condominium associations from FHA's condominium insurance program. Specifically, the second bullet point in this section notes that deed restrictions which would "be the basis of contractual liability of the borrower" as grounds for rejection.

As FHA should be aware, this is a material misstatement of the provision found in 24 CFR 203.41(ii) which actually reads:

*(ii) Be the basis of contractual liability of the mortgagor for breach of an agreement not to convey, including rights of first refusal, pre-emptive rights or options related to mortgagor efforts to convey;*

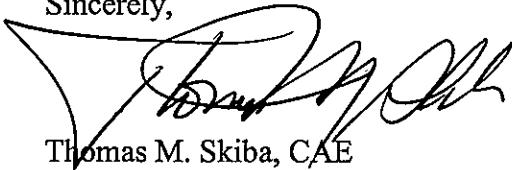
The clear intent of the regulations referenced by FHA is to exclude deed provisions that create a right of first refusal. As drafted by FHA, the guidance excludes any condominium association where the deed restrictions are the basis of contractual liability for the borrower. As all deed restrictions impose contractual liability on a purchaser and in fact serve as the basis upon which the entire legal structure of condominiums is based, FHA's current language will serve to exclude all condominium projects from the FHA program. We understand that in any regulatory process tension will exist between the industry being regulated and the agency charged with regulation. Rarely though does one encounter evidence of an agency's fundamental lack of understanding of the legal principles of the market being regulated. In the case at hand, CAI believes that this provision, while not technically violating provisions of EO 12866, supports the other issues raised by showing that FHA failed to undertake basic due diligence in preparing and

issuing this guidance. As FHA currently insures more than 30 percent of condominium loans, the impact of this guidance will be significant and will cause considerable and needless problems for buyers.

CAI supports the larger objectives of market stability and financial soundness in the FHA condominium program. We note that, despite sharing a common goal with FHA for accessible, affordable housing through the condominium program, that there may be divergent opinions in how to achieve such goals. However, we do not believe the issues raised in this letter are a matter of approach, but rather an issue of FHA's breach of its obligations of a regulatory agency as defined in EO 12866. It is clear from the guidance and the evidence presented that FHA has failed to undertake even the most basic due diligence. We believe that FHA's failures on this part appropriately fall under the jurisdiction of OIRA and we encourage you to take appropriate action to ensure the letter and the spirit of this Order are met.

If you have any questions regarding the issues raised in this letter, please contact Andrew S. Fortin, Esq., CAI's Vice President of Government and Public Affairs, at (703) 970-9224.

Sincerely,

A handwritten signature in black ink, appearing to read "Tom Skiba", written over a large, stylized, handwritten flourish that resembles a large, open letter 'T' or a similar symbol.

Thomas M. Skiba, CAE  
Chief Executive Officer