

Forty Years of Regulation

ORIGINS & OPTIONS AT MORTGAGE PAYOFF

By D. Friedrichs¹

In 1950, on the heels of an amendment² to the National Housing Act, a wealthy philanthropist joined with others to organize what he hoped would be a “General Motors for co-op housing”. Setting up both development and management companies, the Foundation of Cooperative Housing (FCH) went on to sponsor and manage some 45,000 units of low and moderate income co-op housing between 1952 and 1972, including the 350 townhouses that became Arrowwood Hills Co-op in Ann Arbor, Michigan.

Following the initial success of co-ops under the enabling legislation, FCH succeeded in getting other major amendments into the Federal Housing Code³ – both aimed at making mortgage rates more affordable in exchange for restrictions on the income of persons who apply for residence (that is, “membership” if the housing community being developed was a co-op).

For those who were motivated to help resolve the lack of “affordable”⁴ housing in Ann Arbor, the FCH program was very attractive. With its one hundred percent-of-cost financing on 40-year mortgage repayment terms (amortization), a sponsoring organization for Arrowwood Hills was formed in 1968 – and rapid development began of the 350 townhouses that were to open in 1970⁵.

For Arrowwood and each of the new co-op communities, the FCH attorneys prepared bylaws that “LIMITED” how the value of ownership would GROW as “owner equity” for individual member-residents over the 40-year term of the original mortgage.

This “Limited Equity” formula was a NEW system for allocating and transferring (at move-out) the value of ownership in co-op housing. Until FCH invented the Limited Equity mechanism, the valuation of memberships had been either FIXED price or OPEN market.

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² Section 213, providing housing cooperatives (and others) with 100 percent-of-cost federal mortgage insurance (without any income limits imposed on applicants for move-in to the “213” housing).

³ Section 221-D-3 and Section 236, the first being restricted to households making not more than 95% of Average Median Income (AMI) at move-in, the second to those making not more than 80% AMI.

⁴ “Affordable” means that a household spends no more than thirty percent (30%) of its monthly income on its housing costs, that is, mortgage, taxes, basic insurance and prescribed maintenance care (carrying costs). For example, if a household’s annual income were \$30,000 (at 50% of a “median” (AMI) of \$60,000, 30% of monthly would limit “affordability” to monthly housing costs of \$750 or less.

⁵ Also FCH-sponsored in A2 in these years were Colonial Square Co-op (427u); University Townhouses (604u); Forest Hills (306u) and Pinelake Village (128u). In Ypsilanti, Glen Oaks (42u) is the sole surviving FCH co-op.

Forecasting FCH's Limited Equity formulas⁶, what began as a move-in cost (of membership) equal only to a security deposit would become a MOVE-IN COST similar to a downpayment on a stand-alone home at the end of the 40-year mortgage. To the dismay of co-op experts at the time⁷, FCH was silent on the long-term impact of this gradual change in move-in cost (and the predicable need for future financing of this move-in or membership acquisition cost).

In terms of ongoing service to low income applicants, the major unknown of the Limited Equity system became "*how would the gradually increasing cost of membership be handled decades into the future*"? This question was never answered by FCH, its attorneys or the legislation they promulgated. Moreover, for a variety of reasons, the business plan of FCH proved unable to sustain itself⁸.

As the Nixon and subsequent GOP administrations took hold of the legislative process in the 1970's and 1980's, the development of co-op communities was further curtailed by a pendulum shift AWAY from the direct-loan approach to non-profit sponsors -- TO a system of private-sector syndications of absentee-investors (i.e., individuals willing to invest a small amount of equity in exchange for a depreciable asset, namely, new HUD or state-financed low-income housing.

Decades later, the pendulum for affordable housing development may be swinging back in favor of housing cooperatives as H.O.P.E.⁹ and "transition" programs FROM absentee-ownership are sought for a variety of reasons (including periodic exhaustion of tax-shelter depreciation). Afterall, home ownership is widely recognized as a key to motivating personal responsibility and improved care of one's living area and housing environment.

Co-op (user) ownership also motivates the providers and managers of the housing to emphasize service (to owners) and to encourage programs that support stronger neighborhood relationships and pride-in-community (through the combination of resources, even if limited).

As Regulatory Agreements with HUD expire, the challenge is both new co-op communities AND those like Arrowwood Hills to RE-PLAN their futures and decide, first, IF they wish to provide for the long-term MOVE-IN affordability of low income residents – and, if so, HOW to do so.

Let's look at the options.

⁶ Most of the FCH Bylaw formulas end their 40-year cycles (between years 2002 and 2012) with the sum of all membership values totaling to a specific percentage of the original cost of development and construction, i.e., 50%. This calculation of future value was simply an estimate of what the housing might be worth 40-years in the future. In reality, each co-op was its own unique case – with future housing values determined by its own unique market and location – and by the maintenance and management history of the community.

⁷ Among those expressing such concern were Fred and Virginia Thornthwaite, founding managers of Cooperative Services, Inc (CSI), an integrated, multi-tier cooperative developer, owner and manager originally based in Detroit.

⁸ The company's service arm was sold off to avoid outright failure; and the parent charitable organization was reconstituted with a focus on international work, continuing into the 21st century under the name "Cooperative Housing Foundation - CHF".

⁹ HUD's Home Ownership for People Everywhere crafted around 1990 and funded in a variety of formats since.

Realistically, the options are four¹⁰ – each explained herein. Of these four options, the last one presented represents a “hybrid” approach intended to help ensure both income diversity and service of households with low incomes (as one might think should be the objective in ALL community neighborhoods).

Choosing among these options is a “subjective” decision of anyone operating or forming a housing cooperative. For existing co-ops, the decision must be made by vote of the current member-owners – and implemented by adoption of a revised (or new) set of Bylaws. May your decision show good foresight and be based on good analysis of personal, financial, maintenance, legal and market information.

OPTION #1. CONTINUE (or MODIFY) THE LIMITED EQUITY FORMULA.

For an individual co-op, the advantages and disadvantages of the Limited Equity system of memberships valuation is best evaluated in the context of the co-op’s own history. Have membership sale and resale prices kept to the formula in the Bylaws? Have they remained “more or less” affordable to new move-ins? Have outgoing members realized some gain in the value of their equity, while living at the co-op (or at least not lost value)?

To elect to continue the Limited Equity system beyond HUD-payoff (i.e., the end of the Regulatory Authority), NO ACTION is really necessary. Your co-op’s existing bylaws, however, are the key. Look up the section(s) in your Bylaws that pertain to “Transfer of Membership” - and read for understanding. While similar in most FCH-sponsored bylaws (and commonly numbered Section #8), over the years Boards and memberships at many co-ops have exercised discretion -- and variations in costs of memberships (from Bylaw prescriptions) are commonplace. In these cases, understanding current costs of your memberships may require historical interpretations by past co-op leaders and managers.

If a DIFFERENT limited equity formula is desired after the end of HUD’s regulatory involvement (i.e., the mortgage payoff date), the membership of the co-op needs to agree to use the existing formula (*or another defined formula for annual increases*) as the co-op’s prescription for annual increases in “Transfer” (equity) Values. Such formulas for adding “limited” equity are implemented monthly by dividing the authorized annual amount by 12 – and changing to the new value as of the mid-point of each month. The agreed upon formula (change) must remain a part of the new, revised, Bylaws of the co-op.

¹⁰ There is, of course, a fifth (5th) option not discussed in this paper. This fifth option would be to resell the co-op (either to yourselves for re-structuring, e.g. as a condominium -- or to others). For the following reasons, most who study this fifth option of resale, however, conclude that the option is “counter-intuitive” to fiduciary duty and fiduciary responsibility: (1) high level of transaction costs to current members (engineering, survey, deed and transfer work and fees); (2) rise in taxation values for any who would be staying in residence (due to resale & change in form of ownership); (3) irreversibility and loss of control; (4) risks of major changes to housing operation and nature of community.

OPTION #2. CHANGE TO FIXED-PRICE MEMBERSHIPS.

Because it requires the least investment in owner equity (downpayment for move-in), persons on low income and especially those with fixed or subsidized incomes (including students, retirees, households requiring financial assistance for independent living) often prefer fixed-price memberships for their co-op housing.

Others prefer this formula for co-op housing ownership simply because it centralizes the housing equity (value) in the parent organization (the cooperative), rather than dividing it among individual members. (The co-op can then mortgage and refinance its property more readily, e.g., for major rehab needs.)

If fixing the price of membership for each type of townhouse is the democratic choice of your co-op members, the starting point for implementing a system of conversion to Fixed Price equity would be determining and setting the Transfer Values (prices) of the co-op's memberships. Besides being certain that the desired system works on financial and operational grounds, implementation would require both the establishment of Transfer Values (prices) for each membership – and the endorsement of the membership.

Setting these fixed prices – either by type of unit occupied or as “one-price” regardless of unit type -- would have several variables, all worthy of discussion if you prepare to recommend this option to your members.

These variables include: (a) whether or not the dollar amount of the membership is enough to protect the co-op against the possibility of neglect and abuse of the unit by the member-resident; (b) how inflation will effect the Fixed Price(s) of the membership over time (typically solved by a provision for periodic adjustments based on inflation, i.e., changes in Consumer Price Index (C.P.I.)); (c) whether the co-op will allow installment payments from the purchaser at time of move-in, in the event the Fixed Price(s) of membership is higher than an amount available to the target population?

Using an advisor to assist in discussing these variables as they pertain to your particular co-op, its membership and market, is recommended. Each community and location has different resources and different constraints. In turn, these circumstances influence what's available and necessary – for a Fixed rate housing co-op to be successful.

One of the long-term advantages of Fixed Price equity systems for a housing cooperative is the “leverage” that accrues to the parent co-op (or organization) as mortgage debt is paid down, increasing owner equity. Adding to this equity increase (as debt reduces) would be whatever increase there may be in the value of the co-op's land and buildings. Because the cooperative is the principal owner of the equity, reduction in debt and higher real estate values can LEVERAGE new investments by the co-op (into future rehab work or even new housing).¹¹

¹¹ This multi-site format for co-op development is sometimes referred to as “mutual housing”. Common in Europe and in campus-based student housing co-ops, others also use this model, including Cooperative Services, Inc. (CSI), the nationwide senior housing co-op organization founded in SE Michigan and mentioned in footnote #7, above.

OPTION #3. OPEN MARKET PRICING (of co-op memberships).

At the end of the regulatory relationship with HUD, *if* neither LIMITED nor FIXED equity-pricing plans are able to gain the favor of a majority of members -- the next option to consider is to allow the OPEN MARKET to price each membership (share). Called “Open Market” by some, and referred to as “Market Rate” (resales) by others, each member who decides to move sets their own asking price – and buyers offer the price they are willing to pay.

Under an Open Market system, buyers (and sellers) observe the transactions of others with similar housing and consult knowledgeable appraisers. Sales (transfers of ownership) then occur on a case-by-case basis, at whatever price is mutually agreed on. The Co-op, in turn, processes the applicant(s) for membership as a seller-approved buyer.

Just like mortgage financing, buyers of Open Market co-op memberships (“shares”) require financing for whatever percentage of the purchase price is paid as debt (rather than cash equity). This financing of co-op memberships (owner equity) is becoming more common and competitive in Michigan¹², as more former FCH-type co-ops pay off their HUD mortgages and enter existing open housing markets¹³. “Share loan” financing, itself, has been common in some parts of the country since the mid 20th century, e.g., New York City.

To change to Open Market resales (for new move-ins), the cooperative must modify its Bylaws – eliminating the Limited Equity provisions in the current bylaws and adopting Open Market transfers as authorized procedures. With this option, as with any other, good planning and consultation with an attorney knowledgeable about both co-ops and contemporary State law for community associations is important. The membership must then vote in the majority (of all shares) to adopt the Bylaws as updated.

By such a change, for each member, what had previously been CAPPED values (constrained by the Bylaws and HUD regulations enforcing the limited equity formula), would become “uncapped” values -- and the marketplace will determine sale and resale prices for the membership share. Where there has been substantial appreciation in real estate values, Open Market pricing can result in a “windfall” in member equity. Simultaneously, there can be a LOSS in marketability of the units – due to fewer buyers (and excluded buyers) at higher move-in prices. In turn, this has the potential to result loss-of-value (or the realization of less gain than some might anticipate).

Since most members will not be moving from the co-op, most may not even notice any change in the month-to-month functioning of the co-op. Because housing co-op shares are recognized by the IRS as real estate, however, the new appraised value of each resident’s membership can change the “balance sheet” of what individual households OWN (equity) and

¹² As of 2008, lenders offering membership share loans in Michigan included Share Loan Service Corporation of www.ncb.coop; Mackinaw Savings Bank in Farmington Hills 248-553-3555; some branches of Key Bank (e.g., Brighton 810-494-4888); Triad Mortgage 734-973-8800

¹³ In 2007, Colonial Square Co-op became an Open Market co-op, joining the likes of Geddes Lake Townhouses, The Village and others in Ann Arbor.

OWE (debt). Based on their co-op's Recognition Agreements (to local lenders), members will become eligible for Home Equity financing, if they wish to consider it.

Four factors are commonly cited as influencing Open Market prices (values) for co-op memberships: (1) the level of demand for townhouses in the community and neighborhood; (2) the general management and maintenance condition of the community (and specific unit) as compared to others; (3) the financial well-being and reserve funding of the community; and (4) the interest rates and loan terms available to buyers who consider moving in (i.e., for those buying a membership from a departing member).

The strength of the local economy is not something that the co-op can influence. Most other items can, however, be impacted by actions and efforts of the co-op's members, leaders and management. In turn, these "operating" items help everyone to understand what's important – and what factors can be worked on to help preserve and enhance ownership values.

***OPTION #4. HYBRID PLANS –
or MAKING ROOM IN EVERY COMMUNITY for LOW INCOME***

As a corporation, a cooperative can have super-human powers. After all, corporations can live forever – certainly beyond the lifetimes of individuals. As such, if goals are identified, creative ways of "structuring" ownership shares (memberships) at a housing co-op can achieve mission-specific goals.

For the purposes of fourth option in housing co-op structuring, the focus is placed on the goal of providing housing not only for households with moderate incomes – but also for those with low incomes. For most, low income is most commonly defined as "*below 50% of median*", although each person and market can be their own judge.

In any event, to provide "affordable" housing to those earning "Below 50% of AMI", not only do the month-to-month operating costs need to stay around (or below) thirty percent (30%) of monthly income – but the MOVE-IN downpayment fees (whether by deposit or investment) cannot exceed the savings (or savings rate) of the would-be resident.

From the standpoint of move-in cost, this affordability is most easily accomplished if membership share (equity) costs are low and "Fixed", as discussed in Option #2, Fixed Pricing. The key becomes making the Fixed Equity option possible as a distinct membership option – or, in corporate terms, a distinct type or process of ownership.

Fortunately, through use of the corporate powers of the cooperative, a secondary affordable housing "fund or foundation" can be created to make different processes possible for member-ownership within the community. Through such a "sister organization", some segment or percentage of total co-op memberships can be earmarked or targeted for fixed price resale ONLY (i.e., for households with certified incomes Below 50% of Median). Such "reserved" or targeted marketing can complement whatever other standard resale program a co-op might have.

Legal assistance is recommended for any cooperative wishing to provide for a specific percentage of low income memberships within their total number of shares, as federal tax laws are written in such a way as to make a sister organization (“fund or foundation”) the most appropriate vehicle for accomplishing such a goal¹⁴. This “fund or foundation”, established by (but distinct from) the existing co-op – could have as its Board of Trustees the board members or officers of the Cooperative, as well as others with a specific interest in the co-op’s affordable housing.

At the organizational level, several questions have to be answered and worked through to establish such a fund or foundation for fixed-equity share sales of a co-op community. These include the following: (1) what will the eligibility standards be for purchasers of the affordable units – and how will they be selected; (2) what price will be charged for the membership in the affordable units – and how will the selling (maximum transfer) price be set; (3) what will the details of the new entity be (name, tax status and board of directors) – and how will each be implemented; (4) what percentage of total memberships will the new entity be allowed to acquire and offer to eligible applicants – and will occupancy or ownership of multiple memberships be allowed?

Why go to the trouble of creating a secondary entity to preserve (or establish) fixed-price affordability for some segment of memberships? The rationale must come from the objectives, or mission of the community.

If the mission of the co-op community is to maintain income diversity and ensure service to low income residents, a distribution curve of incomes in the co-op’s LARGER community can be used to show what a “representative percentage” of low income households might be typical. Perhaps there will be agreement that targeting a similar percentage of total memberships as Fixed Price shares – thereby setting up a plan that can provide income diversity comparable to the co-op’s city at large.

Setting the dollar cost of the Fixed Price memberships in such a hybrid co-op structure is likely to require that prices not exceed the savings and savings rate of the target population as applicants prepare to move-in. For example, if the cost of a Fixed Equity membership were \$4,500 with a minimum of 20 percent down (\$900), the balance due at move-in would be \$3,600. If the *sister* fund or foundation were to allow installment terms of payment – and at least 3-years to repay -- the monthly fees to the co-op would only need to be \$100 LOWER per month than “affordable” (30% of household income) for the cost of the full Fixed Equity share to be repayable within the 36-months allowed, i.e., $\$900 + \$100 \times 36 = \$4500$

Some low income households may wish to invest in their housing by purchasing an Open Market membership when they move-in – rather than applying for a Fixed Equity membership.

¹⁴ Internal Revenue Code Sec 216 has a "one class of stock" test reflecting both the philosophical principal of co-op housing pioneers that "all members are equal" and a congressional concern that the Section 216 pass-through of tax benefits could lead to abuse or misuse of homeowner benefits. For tax purposes, however, attorneys consulted on this issue believe that creation of a second or sister organization, e.g., a “fund or foundation” with a written option to purchase and re-issue some memberships on a fixed-equity (price) basis, is capable of satisfying Section 216.

In such cases, the new buyer would have to obtain his or her own (open market) financing – and the availability of regular “open market” units would determine what would be available. Then, resale pricing at move-out would conform to conditions in the market (assuming that the balance of the memberships were, indeed, being transferred on the open market.

In contrast, the resale of a Fixed Equity membership -- back to the fund or foundation, as sister organization (for the preservation of affordable housing) -- would be constrained by rules to a “constant dollar” value – and conveyed to the next eligible low income household on the Waiting List. In this way, the fund or foundation serves in a “trust” capacity of sorts for whatever number of shares it purchases for, and transfers to, qualified low income households.

One interesting aspect of this Hybrid Option for perpetuating service to some measure of eligible low income households is that the option does NOT have to rely on public sector assistance, tax credit or perpetual subsidy. It is a private sector solution implemented by creative structuring of a private corporation’s documents and procedures (for sales).

As a self-governed entity, the cooperative can decide, plan and implement an affordable housing future by setting up a mechanism (fund or foundation) for including (or reserving) within its total number of memberships a representative percentage of shares for “Below 50% of Median” applicants. By so doing, it can clear a major hurdle en route to a broader goal of sustaining economic diversity in a housing community or neighborhood.

Examples are common of communities with high percentages of tax-credit rental units OR of public housing developments exclusively for low income. But, these communities often lack the dynamics of communities with income diversity – and cannot be expected to sustain themselves as well as more balanced and diverse co-op communities. The cost to the US Treasury is also higher in public housing and rental cases.

More examples of the private sector, hybrid co-op housing option for providing income diversity are needed and should be reported on. Such reporting may lead the way to stronger community associations and less segregation by income.

IN CONCLUSION

Regardless of the individual conditions at your co-op, this paper is written from the premise that any co-op considering changing its structure and bylaws will seek to make as sensible and self-perpetuating a revision as it can – while preserving and enhancing not only the value but the affordability of the property for its members.

Any change decided on should help the greatest number of members on three counts, namely: (1) preservation of value; (2) preservation of affordability, (3) and enhancement of long-term value (or savings) for all owner-occupants. In terms of measurable changes, the month-to-month savings realized through co-op homeownership and the security of long-term stability and/or appreciation in real property values are likely to be the most treasured.

With any decision to change or to set a co-op's structure for the end of HUD or any regulator's involvement, a new set of bylaws is required. As these new bylaws are drafted, remember to update all new documents to reflect any recent changes enacted in State Laws.

Select and work with an attorney who is recommended (and interviewed) for his or her work with community associations. For the actual decision-making, mobilize the leadership within your community and provide member feedback so that these leaders can make informed decisions.

Ultimately, the new set of bylaws will be the new life blood of the cooperative. May the systems of the next generation of US cooperatives outlast their predecessors – and chart a durable course for many decades to come.

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August 13, 2007