Underlying Mortgages: What Co-op Boards Should Know

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Over the past couple of years, the all-time low interest rates have resulted in a significant increase in the amount of co-op buildings that have refinanced their underlying mortgages. Due to the fact that a shareholder in a co-op only owns shares in the corporation which are appurtenant to a specific unit and not actual real property, co-op boards can take out a commercial mortgage on the land on which the building is situated.

This option is not available for condominium buildings due to the fact that condos are considered real property with each unit having a separate tax lot (which the bank files a lien directly on when extending a mortgage to an individual). Co-op buildings on the other hand have one block and lot for the entire building with each unit not having an individual lot.

Most underlying mortgages are for ten-year terms, have interest-only payments, contain hefty pre-payment penalties, require all violations against the building to be removed, require good-faith deposits which are only refundable if the loan closes and, unlike loans extended to individual shareholders, the mortgage recording tax is applicable to underlying mortgages.

Underlying mortgages are actually some of the safest loans a bank can possibly make. The loan to value ratio is always very low (i.e. 5%) and the bank essentially becomes the senior lien holder over the entire corporation. Historically, the default rates in New York City related to underlying mortgages are essentially non-existent.

The following points are the main factors that boards should be aware of in considering whether to refinance their underlying mortgage:

Term/Amortization
Most co-op boards decide to take out interest-only mortgages for ten-year terms. The main reason is that your average shareholder owns their unit for approximately seven years and chances are there will be significant turnaround in units prior to the mortgage maturing.

If the board were to make principal and interest payments, it would result in an increase in maintenance, which would devalue the property and hurt most current shareholders in the building. Only future shareholders and those current ones who plan on staying in the building for far longer than seven years would benefit from a reduction in principal. Once the underlying mortgage is paid off, maintenance generally decreases significantly.

However, most boards do not desire to ever pay off their underlying mortgage in its entirety and view the mortgage as a way to fund capital improvement projects or replenish the reserve fund.

Pre-Payment Penalties
All underlying mortgages contain pre-payment penalties. Typically they are structured by having a fixed percentage of the loan amount as a pre-payment or through a formula known as "yield-maintenance." If the pre-payment is based off of a fixed percentage, that percentage may vary depending on the year in which the mortgage is paid off or may be a fixed sum or the entire duration of the mortgage. If the penalty is based off of yield maintenance, then it is calculated on the difference between the co-op's interest rate and the treasury rate (reinvestment rate) at the time of pre-payment and pro-rated from pre-payment to maturity.

Typically, partial pre-payments are prohibited and sometimes a pre-payment penalty may not be applicable with the payment is made within a set time period prior to maturity (i.e. the last four months of the term of the mortgage). That is why when refinancing it is important to know your specific pre-payment calculation and if there are any times during the life of the mortgage where the sum varies or is not applicable.

Mortgage Recording Tax
Underlying mortgages are subject to the commercial mortgage recording tax rate of 2.8%. In order to avoid this tax or reduce the sum owed, the co-op's attorney should inquire if a consolidation, extension and modification agreement (CEMA) is an option.

In order to accomplish this, the co-op's current lender would have to agree to assign the remaining principal balance of the outstanding mortgage to the new lender. If the outstanding balance is an equivalent or higher sum than the new mortgage, then no tax is due. If the new loan amount is higher than the outstanding balance of the current loan, then the tax will only be due on the difference between the two. Most banks that partake in underlying mortgages are amenable to CEMAs and the savings can be significant for the borrower.

Underlying mortgages are quite complex and co-op boards who are not familiar with them should definitely consult with an attorney, mortgage broker and their management company to assess all of the factors necessary to determine if refinancing the mortgage is the best business decision for corporation.

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