Owning a Co-op

10 questions to ask before you buy

HSBC

So you want to own a Co-Op!

If you're a first-time homebuyer, this is probably one of the biggest financial decisions you have ever made. As rents escalate and private home prices reach new heights, a co-op apartment may be a great route to homeownership. Cooperative living can be a wonderful experience – a comfortable apartment decorated to your own tastes, few home maintenance responsibilities, known neighbors, and some possible tax benefits. Before you decide to buy, you should know how to tell the difference between a financially healthy cooperative and one that is over-financed or poorly managed.

This guide has been prepared to help you ask the right questions and make informed decisions. The information provided is of a general nature and may not be totally applicable to every cooperative or every potential buyer's individual situation. Also, it will not, and is not intended to, take the place of the type of advice that will be provided by a real estate attorney or a tax advisor on matters relating to the possible deductibility of interest, common charges or other expenses.

Here are some of the questions you may want to ask.

1. What is a Co-op?

When you buy a house or a condominium, you are getting real property. When you buy a co-op you are not actually purchasing the physical apartment. You're buying shares in the cooperative corporation which owns the building in which the apartment is located. You will own the number of shares allocated for that apartment based on its size and location. Instead of the deed you receive when you buy a house or a condo, with a co-op you get a stock certificate and a proprietary lease or occupancy agreement. The lease spells out the rights and obligations of the coop and the shareholder for the use and occupancy of the apartment. The shareholder becomes part owner of the building and has a proprietary lease on a specific apartment.

2. How is a Co-op mortgage different?

When you get a mortgage to buy a house or a condominium, the property is collateral for the mortgage. Since you're not buying real estate property when you buy a co-op, you are not getting a mortgage in the traditional meaning of the term. In effect, you are getting a loan to buy the shares and proprietary lease to live in the co-op unit. Your shares in the co-op and the proprietary lease are the collateral. They are not as valuable to the lender because they can't be sold or disposed of as easily as real estate. The co-op's board of directors may put conditions on the sale of its shares. It may also be difficult to sell the shares if the building is in poor financial or physical condition.

3. Tax benefits

As it is with any home or condo, real estate taxes and mortgage interest on primary residences are usually deductible on your federal income tax return. As a co-op owner, your share of the real estate taxes and interest on any underlying mortgage allocated to your shares may be deductible. The co-op corporation notifies shareholders of the dollar amounts of these allocations annually. See your tax advisor regarding tax deductibility of interest and real estate taxes.

4. Common Charges / Maintenance Fees

The common charges are the costs associated with the operation of the building, distinct from the costs of your apartment. These charges may include payments on the building's underlying mortgage, real estate taxes, water and sewer fees, fuel costs, utilities for the common areas, salaries for building employees, insurance and the other expenses of operating the building. These costs are apportioned to each shareholder as maintenance fees, usually payable to the corporation on a monthly basis. The corporation then pays the bills.

5. What you should know about unsold shares and sponsor-ownership

© HSBC Bank USA, N.A. 2015

When a structure is built as a cooperative or a converted rental, the builder or converter is known as the sponsor. Initially, the sponsor owns all of the shares in the cooperative. The sponsor then starts selling shares for apartments and the purchasers become shareholders. The sponsor continues to own all unsold shares. The more unsold shares the sponsor holds, the more control the sponsor has over the physical and financial management of the building. It is also possible that the sponsor pledged the unsold shares as collateral for the underlying mortgage, so that if the sponsor runs into financial difficulties the shares become the property of the lender and not the remaining shareholders. Majority ownership by the sponsor does not produce a true cooperative and may not be in the best interest of a purchaser. You should find out the status of the shares from the managing agent or the Co-op board. Ask questions like, how many shares are owned by the sponsor? How many of the apartments are owner occupied?

If the building started out as a co-op or was converted a long time ago, chances are that all or most of the apartments are owner occupied or occupied by tenants who moved in after the conversion period. Under these circumstances, shareholders' maintenance payments and tenant rents can be set to meet the financial obligations of the building.

If the building was originally a rental with rent controlled or rent stabilized tenants, some of these tenants may still be in residence. Although their apartments may be owned by the sponsor or other shareholders, co-op conversion laws generally permit rent regulated tenants to occupy the apartment for as long as they choose under the same terms and conditions of their original leases. Their rent increases are determined by city and state agencies. Under these circumstances, the shareholder of an apartment occupied by a rent regulated tenant is obligated to pay maintenance fees to the co-op even if the tenant's regulated rent does not meet the maintenance charge.

If you are considering buying into a building in which there are rent regulated tenants, you should know how many units are rent regulated and how the rents compare with the maintenance charges.

6. A Building's Financial Condition

When you become a shareholder, you share the assets and the liabilities of the whole building. For example, when you buy shares allocated to one 2-bedroom apartment in a 4-unit building with three other 2-bedroom apartments all with the same number of shares, you are buying ¼ of that building – 25% of its assets and 25% of its debt. If one of the other three shareholders defaults on the maintenance payments which help pay utilities, taxes, and the underlying mortgage on the building, you may have to increase your outlay before the legal status of the defaulting shareholder is resolved.

The same scenario can apply to larger co-ops, particularly if the sponsor owns a majority or even a significant number of shares. If the percentage of shares held by the sponsor is high, a default could jeopardize every shareholder.

That's why lenders look at the level of owner occupancy and the ratio between occupant and sponsor-held shares. Generally, a lender may not consider granting a loan to purchase a co-op in a building which is less than 80% owner-occupied or in which the sponsor still holds the majority of shares after a significant amount of time has passed since the conversion plan was approved. In New York City the number of units sold to owner occupants may be as low as 51%.

7. The Building's Underlying Mortgage

Before investing in a co-op, you should ask for the terms of the underlying mortgage. What is the amount of the mortgage? What is the term? Is it paid off in installments or is it a "balloon" mortgage, the entire principal becoming due at one time? What is that date?

© HSBC Bank USA, N.A. 2015 Member FDIC
Equal Housing Lender

As a shareholder, you pay your pro rata share of the underlying mortgage and interest in your monthly maintenance, and your annual federal tax deduction is related to the mortgage interest payment. If the mortgage on the building is long term and at a favorable rate of interest, then you and the lender to whom you have applied for a co-op loan can be more comfortable with your ability to make your loan and maintenance payments for the term of your co-op loan. Also, there is greater certainty that your maintenance payments will not increase and therefore you will probably be able to make your agreed co-op loan payments.

If the terms of the mortgage call for full payment in four or five years, the co-op's board of directors will have to secure new financing without assurance that they can get favorable rates or similar terms.

8. What is the Pro Rata Share?
As a shareholder you are not only responsible for the maintenance and co-op loan on your apartment, you also have a share of the assets and liabilities of the building.

The pro rata share is your apartment's share of the building's underlying mortgage. In most cases, that share is determined by dividing the amount of the underlying mortgage by the number of shares in the building and then multiplying the per share amount by the number of shares for your apartment. The lower of either the appraised value or purchase price then divides that number. As a general rule, a lender may not consider approving a loan where the unit's pro rata share exceeds 30% of the purchase price of the apartment. The reason for this is that the purchaser is assuming liability not only for the purchase price of the apartment shares but also for the additional pro rata share of the underlying mortgage. If the building is over financed, the pro rata share could exceed the appraised value of your apartment. If the co-op's financial condition deteriorates and there is a default on the underlying mortgage caused by non payment from other shareholders or the sponsor, you may be assessed additional charges to cover payments due on the underlying mortgage.

9. The Reserve Fund?
The reserve fund is a designated amount of money set aside and kept separate from the operating expenses of the building.

A co-op's annual operating budget should include adequate provisions for ongoing maintenance. However, major capital improvements or unexpected repairs or replacement of building systems may need to be funded from the building's reserve fund. If the fund is large enough there may be no need for increased maintenance fees, assessments, or new loans, if, for example, the heating system needs emergency repairs. If not, shareholders might have to absorb increased maintenance costs or pay the interest and principal on a loan covering such repairs. Some co-op boards pass on the expense to shareholders through assessments rather than maintenance fee increases. This can take the form of a one-time set amount or can be an addition to the monthly maintenance fee for a period of time or in any manner decided by the board.

In general, the lender looks for a reserve fund that is adequate to cover any major capital improvements. Typically a lender would like to see a reserve fund of at least $1,000 per unit with a minimum of $25,000 per building.

10. The Board and the Corporation Bylaws
The bylaws are the rules and guidelines under which the board of directors is elected and runs the corporation.

In a true co-op, where the sponsor is no longer the majority shareholder, the board of directors is made up of your neighbors – shareholders who function on a volunteer, part-time basis and, in all likelihood, have

© HSBC Bank USA, N.A. 2015

no training in building management or real estate financing. In most co-ops, once elected, boards have broad authority to approve or disapprove sales of stock, authorize expenditures, hire and fire staff and adjust maintenance charges as the need arises. The board can also change policy, rules, and regulations as long as the changes don't conflict with the bylaws or proprietary leases. They can determine issues such as: prohibitions on the ownership of pets and the right of a proprietary lessee to sublet an apartment. The co-op board can also change the terms of the sale of shares by requiring the seller to secure a waiver or pay a fee before a sale is approved.

The cooperative corporation's bylaws and the board which administers them can affect the quality and security of your investment. They set the rules for the physical and financial operation of the building in which you are a shareholder and of the home in which you reside.

In Summary.

These are the types of questions you should consider asking when shopping for a Co-op. You may want to ask to examine the minutes from recent board meetings to determine if any major problems were discussed - such as the need for a new roof or possible refinancing. Also, you can ask for several years of financial statements. You may want to check on the physical upkeep of the building. Are the public halls and compactor rooms clean? What is the condition of the windows? Are there cracks in the walls? Are the elevators working? Whether you're dealing with a real estate agent, the apartment owner or a managing agent, you should have your questions answered before you buy. It's possible that the managing agent can generate a computerized form providing the latest information on the building. The more information you have, the easier it is for you and your lender to make a sound decision on whether or not this will be a comfortable home and a wise investment.

Speed, service and support you can count on.

Count on the financial strength and backing of one of the world's leading financial institutions, plus the personal attention and service provided by experienced professionals. Join thousands of satisfied HSBC mortgage customers.

Applying for a Co-op loan is easy!

Visit a branch or call **1- 866-731-4722 to apply**. For more information, please visit our web site at us.hsbc.com and click on "Borrowing"

The information contained in this brochure is intended to be of a general nature and is not intended to be a complete or definitive discussion of matters relating to ownership of a cooperative apartment. In some instances, the information contained in this brochure may not apply to your situation or additional factors or circumstances may have to be considered. This brochure is not intended to provide legal, tax or any other specific advice.

You should seek the advice of a real estate attorney, tax counsel, and other appropriate professionals who can give you precise information relating to your situation and the most current analysis of legal and other issues relating to cooperative ownership.

Mortgage and home equity products are offered in the U.S. by HSBC Bank USA, N.A. Subject to credit approval. Borrowers must meet program qualifications. Programs are subject to change. Geographic and other restrictions may apply. Discounts can be cancelled or are subject to change at any time and cannot be combined with any other offer or discount.

Mortgage and home equity products are only available for property located in the United States.

© HSBC Bank USA, N.A. 2015

Member FDIC
Equal Housing Lender