CARIBBEAN BUSINESS
caribbeanbusiness.pr THURSDAY, MAY 3, 2012 WEEKLY $2.00

Condo meltdown

Puerto Rico's vertical housing faces serious downward spiral

By Alexander López
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Condo meltdown: Proceed with caution

New HUD condo regulations adversely affect lending; coming 40-year mortgages could spell more trouble down the road

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The oversupply of condominium apartment inventory traces back to a host of factors. Serious miscalculation of population levels by the Puerto Rico Planning Board over the past 10 years, strict U.S. Department of Housing & Urban Development (HUD) guidelines, a stagnant economy and a high level of distressed sales are all ingredients in the formation of a perfect storm that is putting downward value pressure on the condo market.

It all started like this: The development of a condo takes years of planning from conception to completion and sale. During the past decade, developers based demand for their projects on Planning Board data that clearly miscalculated the number of potential buyers that would be in the market. The Planning Board estimated that the population of Puerto Rico would grow by 213,836 between the 2000 U.S. Census and the census in 2010.

Instead, the population *decreased* by 82,821, or 2.2%, which represents a difference of 296,657 residents who, though projected to need housing, don't in fact need it because they no longer live on the island.

Puerto Rico's population continues to decline, losing another 19,100 people between the census in April 2010 and July 2011, according to estimates offered in December 2011 by the U.S. Census Bureau. That now brings the negative population deficit to 315,657.

Municipalities aggravated matters as well by raising impact fees and requiring more and more infrastructure improvements to be paid for by the developers. This led to significant increases in construction costs, which were then passed on to the asking price of the units.

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HUD crackdown on mortgages for condos

The final blow to end the era of prosperity in the condo market came in late 2009 when HUD issued two new guidelines for condominiums seeking approval for Federal Housing Administration (FHA) mortgages.

The guidelines establish a challenging set of requirements for condos to even become eligible for FHA financing. For preconstruction sales, at least 50% of the total units of the project must be sold before an FHA loan on a unit may be closed. At least 50% of the units at the project must be owner-occupied, and the FHA won't issue new loans on a project once 30% of the units at a project have FHA loans. In addition, no more than 15% of all units can be more than 30 days past due in the payment of Home Owners Association assessments.

These are just some of the onerous aspects of the new guidelines that have all but eliminated FHA borrowing as an alternative for many condos. In the past, a borrower could purchase a condo unit with about 5% of the down payment and closing costs through an FHA loan. Under the current guidelines, a borrower will be required to produce as much as 20% of the purchase price of the unit in addition to closing costs, which prices many potential buyers out of the market.

"It is unlikely we will be seeing many high-end condominium developments in the near future, since there are many years of inventory already constructed," said George Joyner, executive director of the Puerto Rico Housing Financing Authority (HFA). "Developments such as Gallery Plaza, Mont Blanc, Ciudadela and Capitolio Plaza have been completed for years and still have numerous unsold units."

A 'difficult operating environment' for banks

As first reported by CB Online, Moody's Investors Service announced April 10 it had placed Popular Inc., parent company of Puerto Rico's largest bank by assets and deposits, and the local subsidiaries of two major Spanish banks underwatch for potential downgrades. Moody's said the rating reviews of the three Puerto Rico banks are "driven by the island's difficult operating environment."

Moody's added that the weak operating environment, which is characterized by high unemployment and depressed real-estate values, continues to threaten banks' asset quality.

"The banks' problem assets remain extremely high and could lead to significant losses if the recession continues," Moody's said.

It is no surprise the credit rating agency is skeptical regarding banks' assets. The mortgage industry in Puerto Rico took a beating in the second half of the past decade, losing $1.1 billion from 2006 to 2010. In 2011, the industry experienced a net gain of a mere $12.8 million—a step in the right direction, but a long way from recovering its losses. (See graph on page 16)

As one might expect, then, local banks are currently in a precarious situation with their construction loan portfolios. Many of the high-rise condos financed by the banks remain empty, and although some developers are able to weather the storm, others have been forced to abandon multimillion-dollar projects. These projects, many of which are substantially completed, sit empty and idle on the books of the banks.

Many of these properties were inherited by the banks during the Federal Deposit Insurance Corp.-assisted bank consolidation; nonetheless, idle buildings still require maintenance and upkeep that continue to drain banks' and developers' resources.

In other jurisdictions, banks have resorted to liquidating these types of properties at pennies on the dollar to third-party investors who take over entire projects. Some of the properties are sold at fire-sale prices, while others are converted to other uses such as college dormitories or assisted-living facilities. The economic impact on real-estate values resulting from such practices is devastating, bringing values down across the board.

The cause of the mortgage-crisis-turned-meltdown in the U.S. was the abundance of subprime loans, many of which had adjustable rate mortgages and financed 100% or more of the sale price of properties. In many cases, when the interest rates on the loans were increased to normal rates, the borrowers could no longer afford to pay their loan. In other cases, when property values dropped below the outstanding debt on the mortgage, borrowers walked away from the property, allowing the banks to foreclose.

> A developer, who preferred to remain anonymous, said, "After the success of Millennium Condominium at the entrance to Old San Juan, a number of developers came to the conclusion that they knew 50 people who would also be interested in a high-end condo unit in the metropolitan area. Unfortunately, all these developers were thinking of the same 50 people."

In Puerto Rico, subprime loans were much less common and not the cause of the real-estate downfall. The declining economic climate, changes in FHA regulations for condos, drop in population and oversupply of housing inventory were the primary causes. Now, in an effort to transfer nonperforming loans—also known as toxic assets, such as unsold condos—off their books, banks are resorting to tactics similar to those that caused the mortgage debacle in the U.S.

Banks that have construction loans on many high-rise condos are now offering 40-year mortgages with developer buy-downs over the first few years of the loan. This means the developer subsidizes the interest on the loan in order to lower the monthly payment during the first few years to encourage buyers to purchase the units. However, as the monthly mortgage payment increases after the first few years, buyers may no longer be able to make their payments, leading to a new wave of foreclosures on the island, not unlike what happened in the U.S.

The Real Estate Board

The Board of Real Estate Agents, Brokers & Companies (JCVEBR by its Spanish initials), which oversees the practice of real estate in Puerto Rico, receives hundreds of thousands of dollars in revenue every year from the issuance and renewal of licenses. However, the manner in which the money is spent is unclear, and efforts to contact members of the board to clarify this matter were unsuccessful.

Under Section 38 of Law 10, the board is authorized to establish a fund to monitor brokers and salespersons, have arbitrations, respond to real-estate complaints, prepare and update tests, and respond to consumers in a timely manner.

"Instead, they have spent the past decade squabbling over to whom and how the licensing exam should be administered, and who should be licensed to operate real-estate schools," said real-estate broker Edna Maloy. "They should have used the funds to monitor real-estate trends, predict the bubble caused by overbuilding, relay the truth about certain types of financing and financing practices, and investigate the real-estate schools."

As distressed properties boost sales, property values drop

RealtyTrac, which publishes the largest database of foreclosed, auctioned and bank-owned homes in the U.S. and its territories for investors and homebuyers, found that preforeclosure sales, which are typically short sales, increased 33% in January compared with a year ago.

A short sale occurs when the lender allows a property to be sold for less than the amount owed on a mortgage and takes a loss. This usually occurs when the market drops and the property is worth less than the current mortgage. It is typically facilitated

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by a loss mitigator who negotiates the debt owed down to a level at which the property can be sold.

Banks had been reluctant to engage in short sales, often taking months to respond to offers from potential buyers. This frequently frustrated the potential buyer, leading them to walk away from the transaction. However, as of June 15, real-estate agents working with distressed homeowners whose loans are backed by Fannie Mae and Freddie Mac should expect to receive a decision on a short-sale offer within 30-60 days.

The Federal Housing Finance Agency (FHFA) has established a new uniform set of minimum response times that servicers must follow to facilitate more efficient short sales. The new guidelines require servicers to make a decision within 30 days of receiving an offer on the property. If more than 30 days are needed, servicers must provide the borrower with weekly status updates and come to a decision no more than 60 days from the date the offer was received.

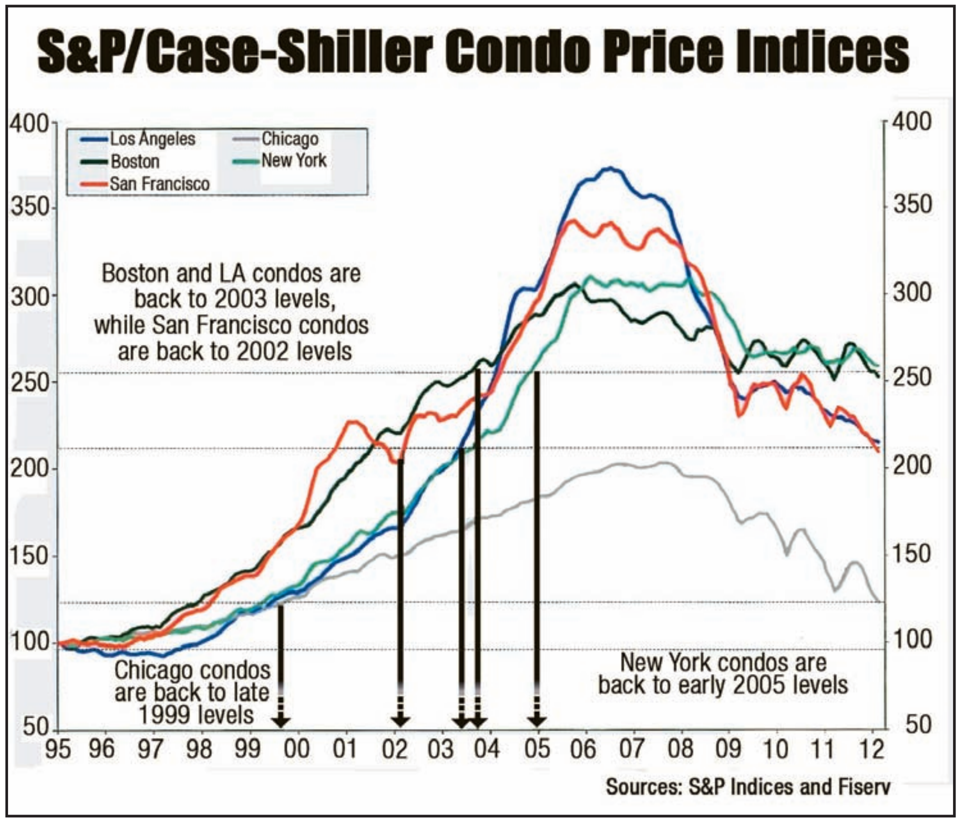
A recent RealtyTrac report indicates that the average price of a home sold via short sale in January was down 10% from January 2011. This, RealtyTrac stated, shows that lenders are more willing to approve more aggressively priced short sales. According to a Campbell Communications Survey, the total share of distressed properties in the U.S. housing market in March was 47.7%.

"With nearly half of the market being distressed, we're a long way from a return to a normal market," said Thomas Popik, research director at Campbell Communications.

ON THE U.S. MAINLAND

U.S.-based financial services company Standard & Poor's (S&P) publishes the Case-Shiller Home Price Index (CSHPI) every month. January 2012 data for the CSHPI were released late in March and indicate that condo prices in all five of the metro areas covered by the indexes have fallen. Prices have been declining in condos in Boston, Chicago, Los Angeles, New York and San Francisco for at least four months in a row.

Chicago posted the largest annual decline at -9.7% taking average condo prices back to their January 2000 levels, effectively erasing 12 years of any appreciation in value. Los Angeles condo prices have fallen 18 consecutive months; San Francisco's condo market has fallen nine consecutive months, and condo prices overall are hovering at about early 2002 levels.



The one market that has shown a dynamic rebound has been Miami. Four years ago, when the economy suffered the banking meltdown and all construction activity stopped, there were dozens of high-rise residential condominiums with about 20,000 units left unsold in Miami. Prices of the units dropped tremendously. Today, prices have moved up with increasing demand from buyers from Venezuela, Mexico and other Latin American countries. The unsold inventory is now down to about 2,000 units and going fast. None of the other markets are showing any signs of a sustained recovery.

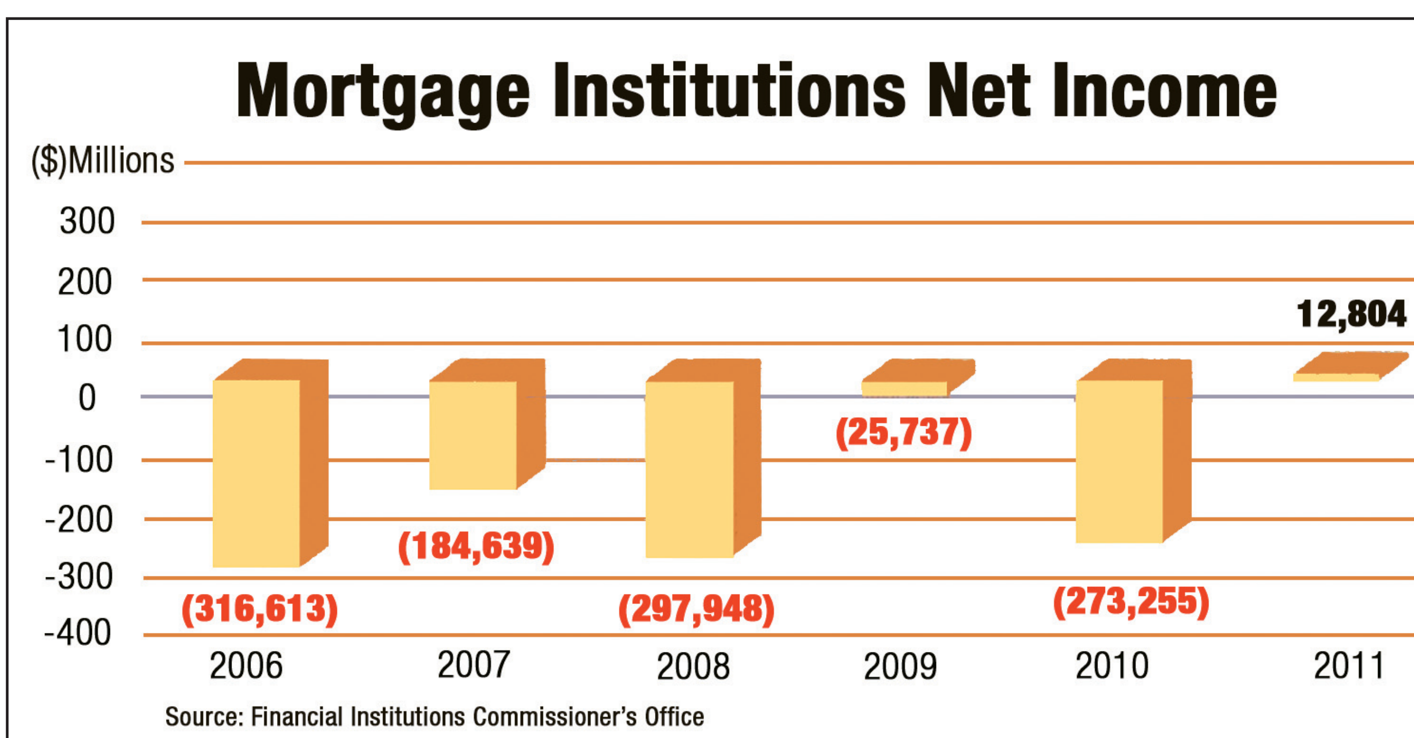
IN PUERTO RICO

Overall, sales of real estate in Puerto Rico have been in rapid decline over the past six years. The recession-turned-depression has seen the island's economy contract by 12%. Bank consolidation and stricter lending standards imposed by federal regulators have further aggravated the situation.

Carmenchi García, a longtime real-estate broker and author of *"El colapso de la vivienda: Historia y perspectiva futura* (2006-2011)" [The Collapse of Housing: History and Future Perspective (2006-2011)] objectively chronicles the events that led to the overall downfall in real estate in Puerto Rico and the U.S.

"According to the dictionary, a collapse is a sharp diminution or paralyzation of an activity; which in our case applies to the sale of properties. In 2005, according to Luis Abreu, there were a total of 20,647 housing sales in Puerto Rico versus 2010, when only 7,182 properties were sold, representing a marked diminution of 65% in the sale of properties in Puerto Rico," García wrote.

As a veteran of the industry, García realized that action must be taken to liquidate the inventory of unsold properties throughout the island. Her primary tactic was simple enough: Convince banks and developers that it was better to drastically reduce prices to attract buyers than to leave the properties sitting idle.



This worked in the complete sale of several developments that had been fully constructed yet sat idle for years. The Brighton Country

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Club townhouses in Dorado had languished on the market for years with a starting asking price of $458,000. A relocation unit sold in 2010 in the high $200,000s, and with property sales stagnant, the developer was eventually convinced to drop the asking price $138,000, to $335,000. This tactic, in combination with creative banking incentives, eventually led to the 100% sale of the development.

Acqualina, Acquamarina, Aquabella, Aquablue, Capitolio Plaza, Casa Maggiori, Cima de Torrimar, Ciudadela, Ciudadela Nordeste, Coliseum Tower, Cosmopolitan, Gallery Plaza, Hacienda las Ceibas, Luchetti, Maxim Tower, Ocean Blue Tower, Oceania 2029, Oceanica, Paseo San Juan, Quantum Metrocenter, The City, and The Lofts are just a sample of the newly constructed condos on the market that have yet to be completely sold by the developers or have been repossessed and now sit as potentially toxic assets on banks' balance sheets.

The labor participation rate dropped once again, to 39.9%, the lowest in the history of Puerto Rico. The broader economy is closely correlated to what happens in the real-estate market. The reduction in labor participation indicates fewer people working on the island and, in turn, fewer people capable of qualifying for a mortgage loan, or even considering buying a home or condo.

THE SOLUTION

There are no simple solutions to the crisis in the condo market, neither in Puerto Rico nor in the U.S. Banks, developers, property owners and the federal agencies that guaranteed these loans will all have to take an economic hit. Condo property values will continue to decline until they reach market equilibrium.

Some examples of recent price drops in high-rise condos are: The City, where developers reduced their starting price from $275,000 to $225,000; Aquablue, which lowered starting prices from $299,000 to $249,000; and Quantum Metrocenter, which reduced starting prices from the mid $400,000s to $344,000. In addition, these projects and many others are offering creative financing for qualified buyers to reduce monthly mortgage payments in the first few years of the loan.

It is unclear how much more condo prices will have to drop until they reach market equilibrium; however, with the decreased availability of qualified buyers due to the new HUD regulations, deteriorated economy and reduction in population, there is less aggregate demand, which will likely continue pushing prices down.

Moving forward, the HFA has taken steps to make financing available for the construction of affordable housing by creating a fund for these types of projects. Under the intricate structure of the fund, the Puerto Rico Community Development Fund, a subsidiary of the HFA, will use $17 million of the 2009 New Market Tax Credits funded by the U.S. Treasury.

As part of the transaction, Citi Community Capital, a department of Citigroup's (Citi) Municipal Securities Division, will provide $11.5 million and the HFA will contribute $33.5 million to create the Puerto Rico Revolving Loan Fund.

Later in 2011, the Economic Development & Commerce Department (DDEC by its Spanish initials) did its part to attract non-Puerto Rico residents to the island by promoting legislation that has created a local tax haven. Under the plan, a person who hasn't been a resident of the island for the past 15 years is now exempt from tax payments in Puerto Rico for all passive income generated from interest and dividends until 2036. These immigrating resident investors would need a place to live, and there are plenty of attractive options in Puerto Rico.

Attracting foreign buyers to residential-tourism projects will also play a key role in selling these projects. As previously reported in CARIBBEAN BUSINESS (Dec. 8, 2011), Puerto Rico offers some of the best conditions for owning real estate in the U.S. and the rest of the world. These include low transaction costs, easy accessibility (airlift) and low property taxes.

"I don't know of any jurisdiction that has this type of initiative," said DDEC Secretary José Pérez-Riera.

GOVERNMENT INCENTIVES

There are some additional financing

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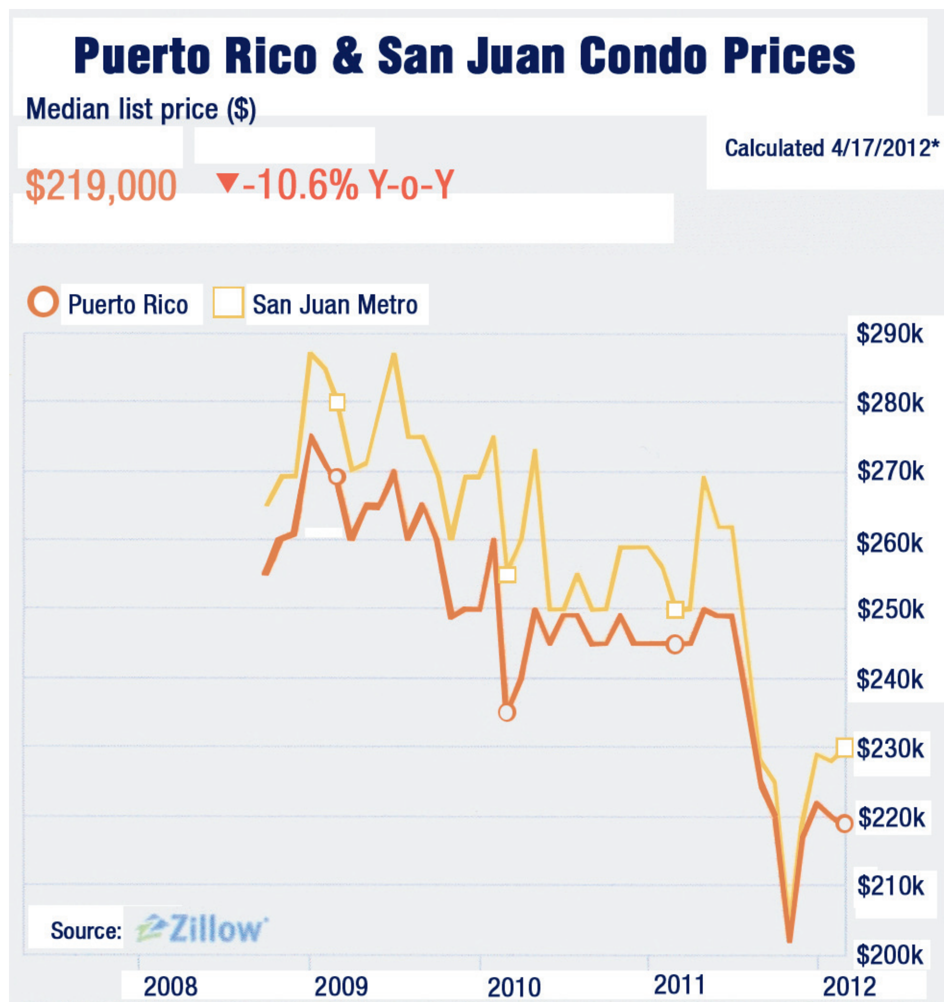
An emblematic representation of what is happening in Puerto Rico's high-rise residential condo market



Region	M-o-M	Q-o-Q	Y-o-Y	Mar 2012
Puerto Rico	▼-0.4%	▲0.9%	▼-10.6%	$219,000

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alternatives. The recently enacted housing incentives can contribute to the down payment and closing costs. Banks and developers are also creating packages that significantly reduce down payments; however, borrowers will typically pay higher interest rates, must have excellent credit scores and these nonconforming loans can't be sold on the secondary market, thereby reducing banks' liquidity for future lending.

In an effort to stimulate the housing market, the administration of Gov. Luis Fortuño in September 2010 launched a broad spectrum of incentives for the purchase of a home. Buyers pay nothing for stamps and internal revenue vouchers, which represent a significant chunk of closing costs. In addition, those selling an existing property during this period—the incentives were extended through the end of 2012—are exempt from paying additional stamps and vouchers to cancel their mortgage.

Owners of new property are exempt for five years from paying property taxes to the Municipal Revenue Collections Center. In addition, those acquiring a residential property (whether new or existing) or a commercial property worth up to $3 million, with a capital gain from such a sale, paid zero taxes on the capital gain. In the case of an existing home, they pay only 50% on the capital gain.

Housing Finance Authority Executive Director George Joyner

The program also increased from $1,000 to $5,000 the available credit taxpayers can claim against their capital-gain losses if the sale of their home was completed within the program's timeframe. The credit can be claimed annually until the loss is covered.

A related program, known as "Mi Seguro Hipotecario," is aimed at new and existing residential properties worth up to $300,000. Under this program, the mortgage bank can finance up to 105% of the home's sale price and the mortgage insurance would cover 17% of the risk, while the mortgage bank would assume the remaining risk of up to 88%. In addition, the "FHA Boricua" covers financing of up to 98% of the loan-to-value of a property up to $300,000.

Another related program offers a second mortgage loan of up to $25,000, on which the homeowner is waived from paying interest for 10 years.

In an attempt to stimulate the rental market, owners who made their property available for renters, whether new or existing, pay zero taxes for 10 years on the net rental income.

"The program is a great success," said the HFA's Joyner. "I have seen families who have been able to acquire a property with as little as $500 and, in many cases, it was their first home."

As announced by Fortuño during his budget address April 24, 28,000 home sales have taken place since the introduction of the housing incentives. A majority of the incentives are to be phased out by the end of the year and it is unclear what effect this may have on future home sales.

Incentives are important but the government must do more to help businesses thrive. Housing demand and real-estate prices will only recover when the broader economy recovers and job growth rebounds. ■

Puerto Rico's horizontal-property laws contrast with other jurisdictions

Another major contributor to the overbuilding in the local condo market can be attributed to the impact of horizontal-property laws in Puerto Rico versus other jurisdictions. Before a bank approves the construction loan for a project, the developer markets the project and initiates a preconstruction sale of units for interested buyers.

During the first half of the past decade, when prices were continuously rising, speculators entered the market and began optioning properties during the preconstruction stage of development, and then sold the options for substantial profits once the units were ready.

At some point in the development phase, most of the units in these now vacant buildings were optioned for purchase by qualified buyers. As the economy soured, people holding option contracts developed buyer's remorse and withdrew their options, leaving many developments empty after they were substantially completed. After 18 months, a developer is required to return a deposit on request if a property isn't ready for delivery.

In other jurisdictions throughout the U.S. and the rest of the world, an option contract is binding and if purchasers don't qualify for financing or wish to withdraw their option, they lose their deposit. If buyers knew they would lose their option deposit if they didn't consummate the purchase transaction, the speculative bubble that developed could have been avoided and many of these projects may have never been built.

Puerto Rico's real-estate laws also require a developer to pay for the maintenance of a project until more than half of the units have been transferred to the buyers. Under current market conditions, more than half the units in many projects have remained unsold for years, placing a burden on developers and forcing some out of business, leaving even more toxic assets (nonperforming loans) on the banks' balance sheets. ■