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**COMMENTS BY THE CENTER FOR REGULATORY EFFECTIVENESS ON
FHFA'S PROPOSED GUIDANCE FOR TRANSFER FEES**

I. Introduction

A private transfer fee covenant is attached to real property by a developer and requires that a fee be paid to a third party or trustee each time the land is sold. If the fee is not paid when the property is sold, then a lien is placed on the property. Traditionally, private transfer fees were used to fund community benefits. For example, private transfer fees have been widely used by homeowner associations, co-op buildings, and charitable organizations to fund environmental restoration projects and affordable housing developments.

However, recently the use of private transfer fees has transformed from a financing tool to fund community projects, to a purely private for-profit income stream for developers and real estate financing firms to provide for a temporal distribution of development costs.¹ Under this for-profit system, developers create private transfer fee covenants on newly developed properties. The covenant requires that each time the property is sold, the seller is required to pay a percentage (typically 1%) of the final sale price to the developer, and most times a licensing company. The developer can then sell the long-term revenue stream in exchange for immediate upfront capital. Moreover, in a developing scheme, private transfer fees will be bundled into

¹ For purposes of this paper, traditional private transfer fees used to benefit communities and charitable organizations will be referred to as “community transfer fees.” Private transfer fees that benefit third party investors and developers will be referred to as “capital recovery fees.”

securities and sold to investors.² Under this system, the investors receive the income stream of 1% of the sale price each time the encumbered property is sold. Because a home is estimated to sell eight to ten times in 99 years, it is estimated by one licensing company that the fee recovered over the life of the covenant will amount to eight to ten percent of the value of the home.³

Recognizing that the expanded use of private transfer fee covenants pose “serious risks to the stability and liquidity of the housing markets,” the Federal Housing Finance Agency (FHFA) proposed “Guidance on Private Transfer Fee Covenants” (FHFA’s Proposed Guidance).⁴ FHFA’s Proposed Guidance would prohibit the entities it regulates—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBanks)—from dealing in mortgages on properties encumbered by private transfer fee covenants.⁵ Although FHFA recognizes the distinction between community transfer fees and capital recovery fees, the proposed guidance treats both equally by prohibiting all private transfer fee covenants.⁶

FHFA received 2,639 comments on its proposed guidance for private transfer fee covenants. The purpose of the paper is to analyze two comments that present the core arguments surrounding the policy implications of private transfer fees. Section II analyzes the two comments submitted by Freehold Capital Partners. Freehold Capital Partners has been a leader

² Freehold Capital Partners, *Freehold Brochure*, page 12 available at http://freeholdcapitalpartners.com/forms/freehold_brochure.pdf.

³ Patton Boggs, *Freehold Capital Partners comment on FHFA proposed guidance concerning Private Transfer Fee Covenants*, page 3, October 15, 2010, available at http://www.fhfa.gov/webfiles/19294/2521_Patton_Boggs_LLC_on_behalf_of_Freehold_Capital_Partners.pdf [hereinafter *Freehold Capital Partners Comment I*].

⁴ 75 Fed. Reg. 499832, August 16, 2010 (“Fannie Mae and Freddie Mac should not purchase or invest in any mortgages encumbered by private transfer fee covenants or securities backed by such mortgages. The Banks should not purchase or invest in such mortgages or securities or hold them as collateral for advances”).

⁵ *Id.*

⁶ *Id.* at 499833 (“To the extent that private transfer fee covenants benefit unrelated third parties, one cannot claim that a service or value is rendered to the relevant property owner or community. Even where such fees are payable to a homeowners association, unlike more typical annual assessments they are likely to be unrelated to the value rendered”).

in promoting capital recovery fees. Freehold Capital Partners argue that private transfer fees are a beneficial financial tool to provide capital to developers. Moreover, Freehold contends that private transfer fees benefit consumers, because the fees reduce the cost of homes. Freehold Capital Partners is opposed to FHFA's Proposed Guidance in its entirety, and instead recommends a tailored disclosure regime of private transfer fees. Section III discusses the comment submitted by the Federal Home Loan Bank of New York (FHLBNY). FHLBNY is one of the entities regulated by FHFA that will be directly affected by the ban on private transfer fees. FHLBNY believes that FHFA should restrict the practice of capital recovery fees, but should not prohibit transfer fees used by co-ops and homeowner associations. Finally, section IV concludes the paper with recommendations by the Center for Regulatory Effectiveness (CRE).

II. Freehold Capital Partners Comment

The CRE submitted a draft of its paper to Freehold Capital Partners and FHLBNY for comments. Freehold Capital Partners provided a critical response to CRE's analysis (please see attached). CRE would like to posit the following questions regarding Freehold Capital Partner's response:

1. Freehold Capital Partners state that purchasing a home with a PTF carries a benefit to the consumer, even if it is small. Are Freehold Capital Partners' conclusions correct?
2. Are the assumptions set forth in Freehold Capital Partners analysis indicative of market conditions?
3. Are there additional costs associated with capital recovery fees?
4. Is there any data indicating that capital recovery fees increasingly depress the value of the home over time (in contrast to community PTFs, which fund improvements on the relevant property)?

5. Are current disclosure practices for “community-based transfer fees,” the same as “capital recovery fees?”
6. FHLBNY characterized capital recovery fees as “bad PTFS.” Are there additional problems associated with capital recovery fees in light of Freehold Capital Partners’ analysis?

Please consult Section II of the “CRE Draft Recommendations for Internal Review” for CRE’s Initial Analysis of the Freehold Capital Partners Program.

III. Federal Home Loan Bank of New York

The FHLBNY is one of the entities directly regulated by the proposed ban on private transfer fees by FHFA. FHLBNY submitted comments on October 15, 2010 to address its concerns with FHFA’s proposed guidance.⁷ FHLBNY argues that FHFA’s Proposed Guidance is overly broad. FHLBNY states that not all private transfer “are created equal...[and] that a distinction must be made between those ‘good’ [private transfer fees] that provide value in which they benefit the affected property homeowners association and community as opposed to those ‘bad’ [private transfer fees] which accrue value only to unrelated parties.”⁸ FHLBNY claims that co-op share loans, condominiums, and planned urban development projects should be excluded from the ban on private transfer fees. FHLBNY does support FHFA in prohibiting the purchase and collateral use of mortgage loans burdened by capital recovery fees.

a. Capital Recovery Fees Do Not Benefit the Relevant Property

⁷ Federal Home Loan Bank of New York, *Public comments on “Guidance on Private Transfer Fee Covenants,”* October 15, 2010 available at http://www.fhfa.gov/webfiles/19270/2497_FHLBank_of_New_York.pdf [hereinafter *FHLBNY’s Comments*].

⁸ *Id.* at 5.

The FHLBNY echoes FHFA’s concern over the negative impact of capital recovery fees.⁹ The FHLBNY finds, “Such fee covenants appear to only benefit either the developer by providing a lucrative and long lasting revenue stream, or the investors in securities backed by these revenue streams.”¹⁰ The FHLBNY further comments that “FHLBanks should not lend against mortgage collateral or purchase mortgage loans that are subject to” capital recovery fees.¹¹

While FHLBNY is correct that the capital recovery fees are not paid back to the community or property owner, the FHLBNY fails to address Freehold Capital Partners’ proposition that capital recovery fees do benefit the relevant property, because it provides developers with upfront capital to build infrastructure for the community at lower developing costs. In a tight credit market, capital recovery fees may provide consumers with the opportunity to purchase a home at low cost, which will increase demand and homeownership.

b. Exemptions for Private Transfer Fees on Co-ops and Homeowner Associations

The FHLBNY argues that “not all [private transfer fees] are created equal.” The FHLBNY urges FHFA “that a distinction must be made between those ‘good’ [private transfer fees] that provide value in which they benefit the affected property homeowners association and community as opposed to those ‘bad’ [private transfer fees] which accrue value only to unrelated parties.”¹² As such, FHLBNY believes that the “good” community private transfer fees should be exempt from the ban on private transfer fees.

⁹ *Id.* at 2.

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.* at 5.

The FHLBNY argues that 50% of New York City co-op buildings have private transfer fee covenants attached to the property.¹³ These transfer fees go directly to investments in the building to fund ongoing maintenance, modernization projects, and unexpected repairs to the buildings. Transfer fees have replaced the traditional income stream for co-ops of monthly maintenance fees. However, transfer fees are preferable to monthly maintenance fees, and actually increase the value of the co-op, because transfer fees provide adequate reserve funds. Without the large reserves provided by transfer fees, special assessments levied against shareholders are necessary to cover shortfall and unexpected repairs.¹⁴ Moreover, FHLBNY argues that because so many New York City co-op buildings have adopted private transfer fee covenants, a complete ban will result in disqualifying a currently eligible and actively used form of collateral that is pledged by FHLBNY members. Furthermore, applying the ban to co-ops will result in the disruption in liquidity and stability in the New York City co-op market.

c. Concerns With Community Private Transfer Fees

As FHLBNY proposes, transfer fee covenants are a better alternative to monthly maintenance fees because they provide large reserve funds. However, monthly maintenance fees could also provide adequate reserve fund by simply raising monthly maintenance fees to each shareholder. Thus, transfer fees are not a necessary financing tool for co-ops. Moreover, many of the risks associated with capital recovery fees also apply for community transfer fees.

First, similar to capital recovery fees, the person paying the community private transfer fee receives no direct benefit from the fee. The community private transfer fee is paid by the shareholder to the co-op only when the shareholder sells his or her share in the co-op. Thus, the selling shareholder does not realize the benefits of the fee that he pays. Arguably, every shareholder who benefits from the transfer fee paid by the selling shareholder, will at some point

¹³ *Id.* at 2.

¹⁴ *Id.*

also be a seller who has to pay the fee. However, the payer of the fee still does not benefit from the fee directly, which may carry some serious implications for current shareholders, particularly in the current depressed housing market. For example, the current income stream from private transfer fees is relatively low for co-ops, because with the sluggish housing market, housing prices are depressed and the volume of home sales is reduced. Thus, co-op boards have to raise monthly fees to account for the decline in income from private transfer fees. Accordingly, current shareholders are not benefitting as much from the transfer fees in the sluggish housing market and have to pay greater monthly maintenance fees. However, as the housing market begins to recover, housing prices will increase and selling shareholders will pay a proportionally greater transfer fee relative to the benefits he or she received from the fee during the struggling housing market.

Second, community transfer fees reduce liquidity in the co-op housing market. The transfer fees act as a restraint on the alienation of the property, because the fee is imposed each time the property is sold. FHLB NY states that transfer fees are advantageous over monthly maintenance fees, because they provide large adequate reserves. However, as a restraint on the alienation of the property, transfer fees deter the very thing that sustains them and the co-op reserve funds—the selling of property. As the housing market continues to struggle, all transfer fees encumber and devalue property unnecessarily. This further impedes the return to a robust housing market.

Finally, community private transfer fees suffer from the same problems with transparency as capital recovery fees. However, disclosure requirements that provide consumers with actual notice and knowledge of the private transfer can cure the lack of clarity surrounding private transfer fees.

IV. Recommendations by the Center for Regulatory Effectiveness

a. Decision Process

CRE reviewed the public comments submitted to the FHFA on its Proposed Guidance for Private Transfer Fees. CRE then identified critical issues raised by the public and sought comment on them through the establishment of an [Interactive Public Docket](#). The resultant analysis performed by CRE result in the following conclusions and recommendations:

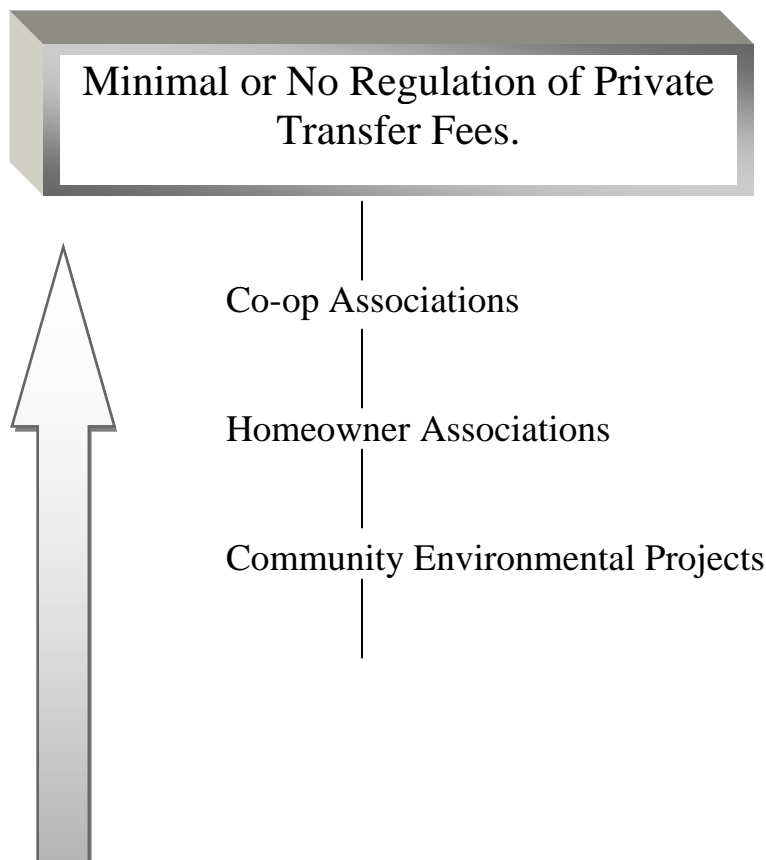
b. Controlling Public Comment: Federal Home Loan Bank—New York

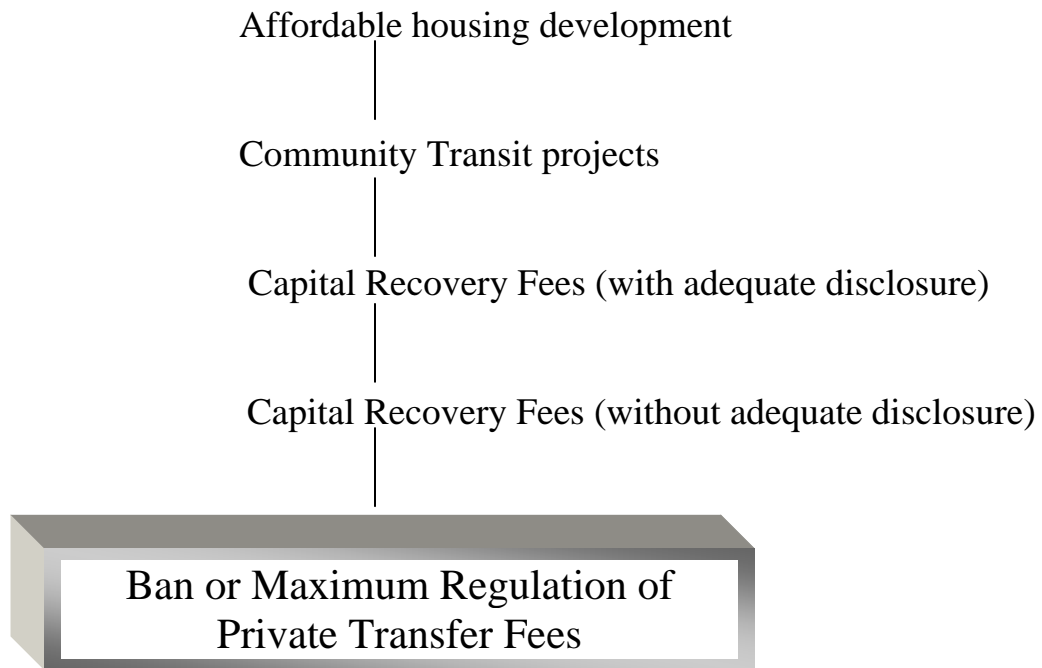
“As such, the FHLBNY (Federal Home Loan Bank--New York) believes that a distinction must be made between those ‘good’ [private transfer fee covenants] that provide value in which they benefit the affected property’s homeowners association and community as opposed to those ‘bad’ [private transfer covenants] which accrue value only to unrelated parties.”

c. Operating Principle

The more the benefits accrue to the property owners paying the Private Transfer Fee, the less the need for regulation to prohibit their use or to disclose their contents. Figure 4 below, illustrates the increasing level of the need for regulation to prohibit the use or disclosure of private transfer fees.

Figure 4





d. **Answers to Questions Raised by CRE**

1. If FHFA is going to regulate private transfer fees, it should be done by regulation, not by guidance.
2. If FHFA is going to regulate private transfer fees either by guidance or by rule, it should prepare a draft environmental impact statement for public comment addressing, at a minimum, the impact on the aforementioned beneficiary classes.
3. If a regulation is to be promulgated to prohibit the use of private transfer fees *prior* to the implementation of an adequate disclosure program for capital recovery fees, there is insufficient evidence to regulate all beneficiary classes.

If a regulation is to be promulgated to prohibit the use of private transfer fees *subsequent* to implementation of an adequate disclosure program for capital recovery fees, there is insufficient evidence to regulate all beneficiary classes, and a re-examination of the role

of capital recovery fees should be undertaken depending upon the effectiveness of the disclosure program.