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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 (PTF) 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 Freehold Capital Partners’ (Freehold) position that PTFs are beneficial to homeowners. Freehold is a leader in promoting capital recovery fees and argues that private transfer fees are a beneficial financial tool to provide capital to developers. Moreover, Freehold contends that private transfer fees

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 1*].

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”).

benefit consumers, because the fees reduce the cost of homes. Freehold opposes 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 with recommendations by the Center for Regulatory Effectiveness (CRE).

II. FREEHOLD'S COMMENTS

Freehold, a real estate financing firm and licensing company, has been an industry leader in promoting capital recovery fees. According to Freehold's chief operating officer, the firm has signed up more than 5,000 developers who are adding private transfer fee covenants to developments worth over \$600 Billion dollars.⁷ Freehold submitted two comments to the Federal Housing Finance Agency (FHFA) detailing their objections to FHFA's proposed guidance on private transfer fees.⁸ Freehold argue that private transfer fees benefit homeowners, because the fees provide a capital infusion for developers to finance their projects. The fees enable developers to spread infrastructure costs across the life of the property, thereby lowering the costs of the homes for property owners. CRE and Freehold have conducted independent analyses of the benefits of PTFs, arriving at different conclusions concerning the benefit of PTFs to consumers. The following discussion outlines the economic analyses that Freehold recently submitted to CRE concerning the value of PTFs to consumers.

⁷ *Id.* at 4; Janet Morrissey, *Resale Fees that Only Developers Could Love*, The New York Times, Sept. 11, 2010, at BU1, available at <http://www.nytimes.com/2010/09/12/business/12fees.html>.

⁸ Freehold Capital Partners two comments are available at http://www.fhfa.gov/webfiles/19294/2521_Patton_Boggs_LLC_on_behalf_of_Freehold_Capital_Partners.pdf and http://www.fhfa.gov/webfiles/19319/2546_Freehold_Capital_Partners.pdf.

a. Freehold's Economic Analysis Prepared for CRE

In addition to the comments submitted to FHFA, Freehold has presented CRE with a very detailed economic analysis of the impact of private transfer fees.⁹ The first analysis is based on the assumptions used by CRE in its Draft Recommendation.¹⁰ CRE's analysis assumed a 2% annual appreciation rate, a 1% private transfer fee, a 5% reduction in the initial price of the home reflecting the price transfer fee,¹¹ and a 5-year turnover. Based on these assumptions, CRE concluded that as a result of the cost of the PTF paid to investors and the lost appreciation on a property encumbered with a PTF, a PTF increased the cost of home ownership by nearly \$20,000 on a \$300,000 home. Freehold used CRE's assumptions to reach an opposite conclusion. Freehold concluded that PTFs decrease the cost of home ownership by 2.33%. Freehold included 9 additional assumptions into CRE's analysis to conclude that after 15 years the third homeowner of the encumbered property will benefit by approximately \$3,000 in savings.

In the second analysis, Freehold Capital Partner modified CRE's assumptions by using a 3% discount rate and a 10-year turnover.¹² Similar to the first analysis, Freehold concluded by finding that a property encumbered by a PTF would receive marginal benefits of 1.49%. CRE does not intend to dispute Freehold's many assumptions. However, given all of the assumptions, the resulting benefit is marginal. Moreover, if any of the assumptions are not realized, then the PTF could potentially come at a great cost to the consumer.

⁹ <http://www.thecre.com/tForum/?p=538>

¹⁰ Freehold Capital Partners, *Transfer Fee Impact Analysis Cost of Homeownership Assumptions 1*, http://www.thecre.com/tForum/wp-content/uploads/tdomf/538/Transfer%20Fee%20Impact%20Analysis_Cost%20of%20Homeownership_Assumptions%201.pdf

¹¹ *Freehold Capital Partners Comment 1*, at page 5 (“homebuyer receives a four to five percent reduction in the initial purchase price”).

¹² Freehold Capital Partners, *Fee Impact Analysis Cost of Homeownership Assumptions 2*, http://www.thecre.com/tForum/wp-content/uploads/2010/12/Transfer-Fee-Impact-Analysis_Cost-of-Homeownership_Assumptions-2.pdf

Finally, the third analysis from Freehold Capital Partner simply restates the conclusions from the first two analyses, but is presented in a manner to emphasize the potential benefits of a PTF.¹³

b. CRE's Analysis of Freehold's Position

Freehold fails to include the immediate costs of PTFs to consumers. PTFs cannot be financed and must be paid by the consumer at closing, thereby increasing the upfront out of pockets costs to consumers when purchasing a home. Although Freehold presents the cost of the PTF as insignificant relative to the full cost of homeownership, it is certainly not an inconsequential fee for consumer when it needs to be paid out of pocket and at the time of closing.

Furthermore, Freehold's analysis emphasizes the reduced opportunity cost for a home encumbered by a PTF. Freehold argues that the money saved by purchasing a home with a PTF can be used as an alternate investment with a return of 5%; thus, amplifying the effect of the savings of the PTF. However, this conclusion is misleading. Freehold's assumption that the homeowner can, and will, take the money saved from the PTF and use it directly as an alternate investment is erroneous. The money saved from purchasing a home encumbered by a PTF is not cash in hand for the consumer that can be invested. Instead, the money saved from PTF only reduces the mortgage amount and carrying costs for the consumer. Freehold has already calculated these initial savings into their analysis. Any reduced opportunity costs from purchasing a home with a PTF would come in the form of the reduced monthly mortgage payments and accordingly it would be extremely small.

¹³ Freehold Capital Partners, *Reference Transfer Fee Impact Analysis Cost of Homeownership Assumptions 1*, http://www.thecre.com/tForum/wp-content/uploads/2010/12/Reference_Transfer-Fee-Impact-Analysis_Cost-of-Homeownership_Assumptions-11.pdf

Finally, CRE does not intend to dispute Freehold's numerous assumptions in its analysis. However, even given all of the Freehold's assumptions, the benefit to the homeowner of a property with a PTF is very marginal. However, if Freehold's assumptions do not materialize, such as a 5% opportunity cost, then the PTF will certainly come at a great cost to the homeowner. Moreover, Freehold does not consider the increased difficulty a homeowner will have selling a property encumbered by a PTF. The stigma of holding a home encumbered by a PTF could result in additional costs to the consumer.

III. FEDERAL HOME LOAN BANK OF NEW YORK

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.¹⁴ FHLBNY argues that FHFA's Proposed Guidance is overly broad. FHLBNY states that not all PTFs "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."¹⁵ 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

¹⁴ 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*].

¹⁵ *Id.* at 5.

FHLBNY echoes FHFA’s concern over the negative impact of capital recovery fees.¹⁶ 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.”¹⁷ FHLBNY further comments that “FHLBanks should not lend against mortgage collateral or purchase mortgage loans that are subject to” capital recovery fees.¹⁸

While FHLBNY is correct that the capital recovery fees are not paid back to the community or property owner, FHLBNY fails to address Freehold’s 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

FHLBNY argues that “not all [private transfer fees] are created equal.” 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.”¹⁹ As such, FHLBNY believes that the “good” community private transfer fees should be exempt from the ban on private transfer fees.

FHLBNY argues that 50% of New York City co-op buildings have private transfer fee covenants attached to the property.²⁰ These transfer fees go directly to investments in the building to fund ongoing maintenance, modernization projects, and unexpected repairs to the

¹⁶ *Id.* at 2.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* at 5.

²⁰ *Id.* at 2.

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.²¹ 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 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

²¹ *Id.*

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. FHLBNY 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

CRE reviewed the public comments submitted to 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](#). CRE also

reviewed additional analysis presented by Freehold. The subsequent analysis performed by CRE results in the following conclusions and recommendations:

- **A distinction must be made between capital recovery fees and community private transfer fees.**

As the FHLB NY proposes, “a distinction must be made between the ‘good’ [private transfer fees] that provide value in which they benefit the affected property’s homeowners association and community as opposed to those “bad” [private transfer fees] which accrue value only to unrelated parties.”²² Capital recovery fees serve a different function and have a very different impact on property owners than community transfer fees do.

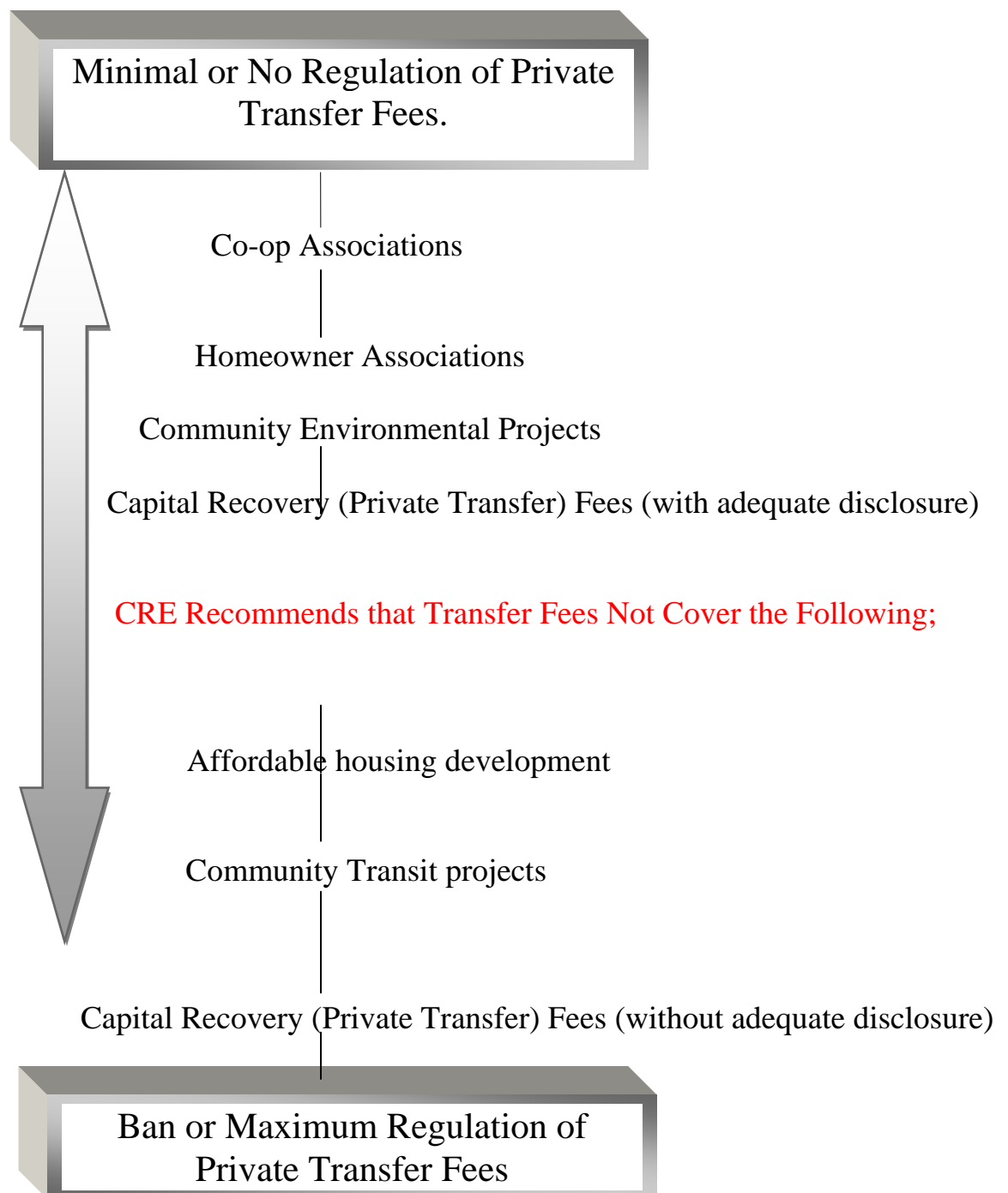
Community transfer fees are directed back into the relevant property for maintenance, repairs, and modernization efforts. Thus, community private transfer fees have a beneficial impact on the property owner and the relevant property. In contrast, capital recovery fees are not intended for purely community purposes, but instead are created as investment vehicles to provide an income stream for investors either directly or through securitized investment vehicles. While capital recovery fees may benefit the property owner by reducing initial the cost of the home, these benefits are less clear to the consumer in the absence of a national disclosure regime. FHFA must recognize the substantial difference between capital recovery fees and community transfer fees.

- **The level of regulation of private transfer fees should proportionally reflect the amount of benefits that flow directly to the property.**

As FHLB NY recognized, not all private transfer fees are created equal. As such, FHFA should not regulate all transfer fees equally. Accordingly, the more the private transfer fee directly benefits the relevant property or owner paying the fee, the less need there is to regulate or prohibit the use of transfer fees. There is insufficient evidence to prohibit private transfer fees that directly benefit the relevant property and community. These community private transfer

²² *Id.* at 5.

fees increase the value of the relevant property and directly benefit the homeowner. A broad sweeping prohibition of all private transfer fees would inappropriately disregard the benefits of community private transfer fees. In contrast, where the fee is paid to a third party and does not benefit the relevant property that it encumbers, there is greater need for regulation if such fees are not disclosed. The figure below represents the level of regulation that CRE believes is appropriate for each type of private transfer fee.



- **There should be national disclosure legislation.**

Private transfer fees currently lack transparency. Private transfer fees are a complex mechanism for homebuyers to understand. While it is true that private transfer fees may operate to the benefit of the consumer by allowing the consumer to negotiate down the buying price to reflect the encumbrance on the land, this cannot occur on the current operation of transfer fees where consumers are acting without actual notice and knowledge of the fees. There is a need for legislation implementing robust national disclosure requirements for properties encumbered by a private transfer fee covenant. If there is passage of national disclosure legislation, then FHFA should not ban any private transfer fees.

- **Transfer fees should not be utilized in the absence of local, state or federal legislation requiring the adequate disclosure of the fees.**

At this time, capital recovery (private transfer) fees are problematic, because of the lack of transparency and homeowner's lack of knowledge of the fees. Legislation creating national disclosure requirement may perhaps cure capital recovery fees of their lack of clarity. If consumers are aware of the existence and risks of capital recovery fees, they may be in a better position to negotiate down the price of the home to reflect the encumbrance on the land. At the same time consumers, after being fully informed of the magnitude of a fee, should not be precluded by a federal mandate of exercising their own discretion.

The benefits of capital recovery fees to homeowners still are uncertain. If the assumptions that Freehold claim do not materialize, then the capital recovery fees may potentially become at a great cost to the consumer. While consumers should have the choice to purchase a home with a capital recovery fee, because it may be in their economic interest to

purchase the home a reduced cost, the consumer must be aware of the risks and costs of the encumbrance. Without adequate disclosure requirements, any potential benefits of capital recovery fees are far outweighed by the cost and dangers of the fees.

■ **The Federal Government Should not Preclude a Fully Informed Consumer from Using a Capital Recovery Fee**

In those instances where a capital recovery reduces the initial price of house for whatever reason, eg., by spreading infrastructure costs over a period of time, and if the consumer is fully informed of the magnitude of the fees, than the Federal government should not preclude the consumer from acting in a manner which he or she believes to be in their self interest. However this conclusion is predicated on the fact that a public body, a duly elected group of individuals representing the best interest its citizenry, will establish detailed guidelines for the disclosure of transfer fees.

CRE Interactive Public Docket on Transfer Fees

The analyses set forth herein would not have been possible without the very significant input of stakeholders through the [CRE IPD](#) on Transfer Fees.

Conclusions

1. FHFA should not ban all transfer fees.
2. Community transfer fees could share some of the same shortcomings attributed to private transfer fees.
3. Unlimited use of transfer fees is detrimental to homeowners.
4. FHFA should not prohibit homeowners from paying capital recovery fees if such fees are adequately disclosed pursuant to the requirements mandated by a public body.