03/05/09

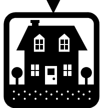
POLICY GUIDANCE ON NSP-SUPPORTED HOMEOWNERSHIP: AFFORDABILITY, FINANCIAL STRUCTURE, AND PROGRAM INCOME

PURPOSE:

This memorandum seeks to clarify issues that are separate but related in the Neighborhood Stabilization Program (NSP). These include initial affordability, continued affordability, financial structures, and program income. Providing definitions and examples should reduce potential confusion for grantees.

OVERVIEW

NSP funds are allocated to the grantee—a city, urban county, or state.



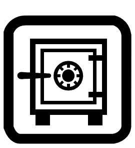
The grantee acquires foreclosed or abandoned homes directly, or through subrecipients or private parties. If necessary, the grantee can also arrange for rehabilitation to local standards.

A family with income that qualifies for NSP wishes to buy the home. The family applies for NSP assistance from the grantee. The home will be the family's principal place of residence.

The grantee reviews income documentation for the family and calculates an "affordable rent" (or mortgage payment) for the home. In many cases, this will require a subsidy in the form of a reduced sales price, downpayment assistance, and/or a second mortgage at favorable terms in order to make the transaction *initially affordable* for the family.

The amount of the subsidy to make the house affordable initially (above) becomes the basis for determining "*continued affordability*". Based on HOME Program or stricter standards, the grantee requires the house to remain affordable for 5, 10, 15, or more years. The grantee places a lien or covenant on the house to enforce this requirement.

When the family sells the house, the grantee determines whether the period of continued affordability is completed. If the affordability terms have been met, the family owes no more money and may sell the house free of NSP conditions. If the affordability terms have not been met, the grantee may recapture some or all of the subsidy funds or require that the house be resold to an income-eligible family.



If any funds are returned to the grantee at sale, these funds are considered Program Income to the NSP and must be used for NSP-eligible activities in accordance with CDBG Program Income procedures.

BACKGROUND:

Congress established the NSP to stabilize neighborhoods by addressing problems created by the abandonment and foreclosure of homes and residential properties.

NSP activities are carried out through five Eligible Uses:

A. Financing Mechanisms for foreclosed homes and residential properties;
B. Acquisition and rehabilitation to sell rent or redevelop abandoned or foreclosed homes and residential properties;
C. Establishment of land banks for foreclosed homes;
D. Demolition of blighted structures; and
E. Redevelopment of demolished or vacant properties.

Separate Policy Guidance on Eligible Uses describes the terms used under each eligible activity and under the 25 percent set-aside for low income housing. The terminology and applicability varies slightly between Eligible Uses, so grantees must exercise care. See "Guidance on Eligible Uses" at the URL below:
(http://www.hud.gov/offices/cpd/communitydevelopment/programs/neighborhoodspg/pdf/nsp_terminology.pdf)

The NSP Notice requires grantees to ensure affordability to LMMI by:

- Calculating "affordable rents" to ensure that purchasers and renters of NSP-assisted structures do not have problems making mortgage or rent payments. A common standard is that housing payments should not exceed 31% of adjusted family income;

and

- Adopting standards that ensure that the units will continue to remain affordable.

The NSP Notice allows grantees flexibility in meeting this standard, but says that grantees using the HOME program standards at 24 CFR 92.252 (for renters) and 92.254 (for owners) must meet the minimum compliance standards. These standards link the amount of funding to the length of time that the units must remain affordable and offer methods of ensuring affordability. HUD will allow grantees to impose more restrictive standards, but not less restrictive ones.

For rental properties, the standards are:

Rental housing activity	Minimum period of affordability in years
Rehabilitation or acquisition of existing housing per unit amount of HOME funds: Under $15,000	5
$15,000 to $40,000	10
Over $40,000 or rehabilitation involving refinancing	15
New construction or acquisition of newly constructed housing	20

For owner-occupied units, the standards are:

Homeownership assistance HOME amount per-unit	Minimum period of affordability in years
Under $15,000	5
$15,000 to $40,000	10
Over $40,000	15

INITIAL AFFORDABILITY:

NSP grant recipients also have options for meeting initial affordability through different Eligible Uses. Grantees may offer multiple types of homeownership assistance or utilize different subrecipients.

The following strategies can be applied using each of the five Eligible Uses:

A. Financing Mechanisms for purchase and redevelopment of foreclosed upon homes and residential properties may include soft-second mortgages, loan loss reserves, and shared equity loans. This use must involve some form of loan or credit enhancement and might include a pool of low interest loans for individuals who purchase and rehabilitate homes for use as their primary residence. Loan forgiveness is allowed, based on performance by the borrower according to terms set by the grantee. Such Financing Mechanisms are distinct from the type of subsidies used below in B or E.

B. In purchasing and rehabilitating homes and residential properties that have been foreclosed upon or abandoned, grantees can finance rehabilitation with loans or grants to make housing affordable, provide direct homeownership assistance, reduce the price of the home being sold, or offer downpayment assistance and other support. See last page for details on options under Homeownership Assistance allowed by law.

C. Land banking will not be discussed here, but properties that have been landbanked may use any of the strategies mentioned above under A or B when they are put back onto the market, then renovated and/or sold.

D. Demolition of blighted properties generally does not involve financing and is not discussed here.

E. Redevelopment of demolished or vacant properties could include many of the activities noted above in A and B, as well as new construction of housing for LMMI. These would include loans and grants for homeowners and rental housing providers, homeownership assistance, and other similar forms of assistance.

This homeownership guidance is based on the assumption that families receiving assistance occupy the home as their primary residence. Note that some of these forms of assistance may be combined, although in such cases, the more restrictive standards will apply. However, because of the different property types described in each eligible use, combinations are not always possible. For example, Eligible Use A, Financing Mechanisms, applies only to foreclosed upon homes and residential properties, not to abandoned homes.

CONTINUED AFFORDABILITY

Grantees must ensure that, regardless of the repayment terms, the home remains affordable for at least the minimum period shown on the charts above, generally five to fifteen years.

Options for Continued Affordability

The HOME regulations cited in the NSP Notice provide options for continued affordability including the following:

- ***Resale*** of the home to the grantee or to another income-eligible buyer;

- ***Recapture*** all or part of the initial subsidy, via full repayment of the loan, forgiveness of a portion of the principal, or equity-sharing. With recapture, the subsidy funds can be used for another home. Such recaptured funds become Program Income to the NSP Program;

- ***Presumed affordability*** of homes in affected neighborhoods. Using analysis of market conditions, the grantee may show that houses will continue to be affordable to LMMI purchasers with conventional mortgage financing. This allows the grantee to avoid requiring repayment of the initial housing subsidy.

To ensure continued affordability, grantees often structure financing terms to mirror the periods of affordability, but this is not required. More often, however, grantees impose financing requirements that tie the amount of subsidy to the term of affordability. If properties are sold before the period of affordability ends, the seller must reimburse the grantee for some or all of the initial subsidy. This revenue is Program Income and must be used by the grantee or approved subrecipient for other NSP-eligible uses. The hyperlink below provides related policy guidance on Program Income to determine how the funds are distributed after the calculation is made.

http://www.hud.gov/offices/cpd/communitydevelopment/programs/neighborhoodspg/docs/program_income_guidance.doc

Note that the affordability period is calculated differently under the resale and recapture provisions. For example, assume that $50,000 in NSP funds were used to purchase and rehabilitate a home and the purchaser repaid $30,000 to the grantee at the time of sale. $20,000 would remain as the direct subsidy to the owner (via grant, deferred loan, or other terms).

- Under the Resale Provisions, ALL $50,000 used in the project would become the amount used to calculate the period of affordability, in this case 15 years.

- Under the Recapture Provisions, only the $20,000 direct subsidy would count toward the affordability period calculation, resulting in a term of 10 years.

However, with all types of assistance, the NSP grantee cannot require the beneficiary (usually a homeowner) to repay more than the original amount of NSP assistance, nor can it recover any more than the amount of the net sales proceeds. This mirrors a similar requirement in the HOME Program.

HOMEOWNERSHIP ASSISTANCE EXAMPLES

The following pages come directly from a HOME Program handbook called Using HOME Funds for Homebuyer Programs: Structuring Recapture and Resale Provisions. These are suggestions, because grantees may develop their own programs. However, since the NSP Notice allows HOME to be used as a base for affordability issues, these tested models should be helpful. There are also excerpts about the presumption of affordability and about definitions of recapture and resale, as well as a chart of pros and cons of each, that may prove useful.

HUD is posting this entire handbook on the NSP website for more detailed reference. From this point until the last page on Homeownership Assistance, all material is from the HOME guidebook. The Program Income referred to in the HOME guide will, of course, become NSP Program Income in this program.

HOME definitions of recapture and resale.

RECAPTURE AND RESALE: DEFINED

During the affordability period, HOME regulations require either repayment of the HOME subsidy -- referred to as the **recapture option** -- or continued use of the property by another low-income buyer -- referred to as the **resale option** -- in the event of property transfer, or when the owner no longer occupies the unit as a primary residence.

- **Recapture option**: Under this option, the HOME subsidy must be returned to the HOME Program with certain exceptions. However, this option allows the seller to sell to any willing buyer at any price. Once the HOME funds are repaid, the property is no longer subject to any HOME restrictions. These funds may be used for any other HOME-eligible activity.

- **Resale option**: Using this option, an owner is obligated to resell the original home to another income-eligible homebuyer. This sale must be at a price that is affordable to the purchaser, although the owner is also allowed a fair return on the sale. Under HOME regulations, the PJ defines both the terms of affordability and fair return.

Note that the *affordability period is calculated differently under the resale and recapture provisions*. In a resale situation, ALL NSP funds that have been used in the project count toward the period of affordability. Under the recapture provisions, only the net amount of subsidy remaining in the transaction would count toward the affordability period calculation.

Grantees may wish to adopt similar provisions to bring buyers to areas with limited appreciation.

Making the Owner Whole: Repaying the Owner Before the PJ

HOME rules also permit distribution of net proceeds to the homeowner first, and then to the PJ. Some programs find this a particularly valuable way of stimulating participation in homeownership initiatives in very soft markets and challenging neighborhoods. Reluctant investors concerned about the ability to recoup funds invested for a down payment and/or improvements are comforted by the knowledge that when the home is sold, they are first in line (after the first mortgage holder) for repayment.

Deciding How to Handle Net Proceeds

Because different policies related to forgiveness and distribution of net proceeds have profound effects on both PJs and homeowners, it is essential to understand how the HOME subsidy subject to recapture is calculated, and how net proceeds from resale will be distributed before subsidies are provided. Key decisions required up-front include:

- whether the direct HOME subsidy will or will not be forgiven over time,
- how repayment will be calculated in the event net proceeds are insufficient to repay both the direct HOME subsidy and the owner, and
- how any excess net proceeds will be distributed.

The decisions about repayment of the direct HOME subsidy and the related distribution of net proceeds are best made at the time of program design. The policy should be articulated to potential purchasers prior to the sale and loan closing. The up-front decision with respect to recapture and distribution of net proceeds allows homebuyers to understand the extent to which their funds are at risk, and the opportunities being provided for return on their investment. PJs, on the other hand, will be able to estimate the extent to which some or all of their investments may be recouped if market conditions permit.

This method of ensuring continued affordability requires some analytical capabilities and can only work in areas with stable or declining property values. However, it can make the program more attractive to purchasers and result in less monitoring in the future.

RESALE ALTERNATIVE: PRESUMPTION OF AFFORDABILITY

PJs may develop a presumption of affordability for a particular neighborhood where HOME homeownership assistance is being provided. This resale alternative was developed in response to PJs who were investing HOME funds in construction financing, but were later repaid with the proceeds from primary conventional mortgages. These PJs were using HOME funds in the short term to effect large-scale rehabilitation and reinvestment in neighborhoods of modest, deteriorated housing. The PJs imposition of resale agreements as a detriment to marketing units in these modest neighborhoods and indicated that subsequent buyers would be income-eligible without the imposition of restrictions.

Properties in neighborhoods with modest housing values that are affordable to HOME-eligible applicants through conventional financing are not required to carry enforceable resale restrictions (for example, deed restrictions). The affordability of such homes must be demonstrated through a market analysis showing that, in relation to the larger housing market for the community, homes are modest in size, amenities and price, and are projected to remain so over the life of the affordability period. Further, if the PJ continues to provide homeownership assistance in the neighborhood over time, it must periodically update the market analysis to determine whether or not the presumption of affordability remains valid.

CDBG Direct Homeownership Assistance

From The Housing and Community Development Act Section 105 (a)

(24) provision of direct assistance to facilitate and expand homeownership among persons of low and moderate income (except that such assistance shall not be considered a public service for purposes of paragraph (8)) by using such assistance to--

(A) subsidize interest rates and mortgage principal amounts for low- and moderate-income homebuyers;

(B) finance the acquisition by low- and moderate-income homebuyers of housing that is occupied by the homebuyers;

(C) acquire guarantees for mortgage financing obtained by low- and moderate-income homebuyers from private lenders (except that amounts received under this chapter may not be used under this subparagraph to directly guarantee such mortgage financing and grantees under this chapter may not directly provide such guarantees);

(D) provide up to 50 percent of any downpayment required from low- or moderate-income homebuyer; or

(E) pay reasonable closing costs (normally associated with the purchase of a home) incurred by a low- or moderate-income homebuyer; and

Using Home Funds For Homebuyer Programs:

Structuring Recapture and Resale Provisions

May 1997

U.S. Department of Housing and Urban Development
Community Planning and Development
Office of Affordable Housing Programs

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The use of HOME Investment Partnerships Program funds to support homeownership opportunities is popular among participating jurisdictions (PJs) of all sizes and shapes. The appeal of the HOME Program is obvious: HOME offers PJs the flexibility to structure and customize programs and subsidies that best meet the needs of the community and the priorities of the PJ.

HOME permits many types of activities in the development and financing of homeownership opportunities: acquisition, acquisition and rehabilitation, and new construction. Also, PJs can choose among investments that include downpayment assistance, rehabilitation financing, and development subsidies.

Homeownership programs vary in design, depending on such factors as the primary goal of the program, the condition of the housing stock, the financial resources available, and the administrative capacity of the implementing organization. A few examples illustrate how widely programs may vary.

- Some are limited to first-time homebuyers, while others are open to any income-eligible household.
- Some are targeted to specific neighborhoods and types of structures, while others are open to eligible properties in any part of the community.
- Some are designed to stimulate major reinvestment in housing, while others target housing requiring minimum repairs to meet local standards.
- Some are part of larger public-private community partnerships, while others are focused investments of public funds.

While program designs may vary, all homebuyer programs share a common goal of maintaining a community's stock of affordable housing. These programs recognize that:

- Housing affordable for lower-income households often is in need of repairs.
- Lower-income buyers often cannot afford mortgage financing for the full amount of the purchase and rehabilitation of the property.
- HOME subsidies can make a purchase and rehabilitation program affordable and feasible.

With the recent HOME rule changes and the growing involvement of private lenders in many HOME programs, more localities are bringing their knowledge of finance and rehabilitation to HOME homebuyer programs. The trend is likely to continue as communities learn to work with the HOME program and its increasing regulatory flexibility.

This guidebook describes how the HOME Program can be used effectively to structure and operate a successful homebuyer program. It is a companion to the HOME model guidebook entitled **First-Time Homebuyers and the HOME Program**, published in March 1993 by HUD's Office of Affordable Housing Programs. This guide summarizes recent modifications to HOME rules and provides detailed information on implementing HOME's recapture and resale provisions for a typical homebuyer program.

Chapter One reviews key HOME Program rules related to homebuyer programs, and outlines recent legislative and regulatory changes affecting homeownership. **Chapter Two** discusses program design issues for homebuyer programs -- particularly the structure of recapture and resale options. **Chapters Three** and **Four**, respectively, explore the recapture and resale options in detail, and **Chapter Five** compares the advantages and disadvantages of the options. Two case studies, Stoneybrook and Farmington, explored in **Chapter Six**, provide a comprehensive look at how to structure homebuyer and property eligibility guidelines, financing packages, and recapture/resale agreements in these communities.

Chapter One

Basic Requirements

All types of HOME-assisted homebuyer programs -- acquisition, acquisition and rehabilitation, and new construction -- must meet basic eligibility requirements.

- **Form of ownership**: The homebuyer must obtain a fee simple title or a 99-year leasehold interest in a one- to four-unit dwelling, ownership in a condominium or cooperative unit, or an equivalent form of ownership approved by HUD.

- **Eligible property**: Eligible properties are one- to four-family residences, condominium or cooperative units, and manufactured homes.

- **Property value**: Properties must have an initial purchase price that does not exceed 95 percent of the median purchase price for that type of eligible property in that jurisdiction, as determined by HUD or documented by the jurisdiction. If rehabilitation is required, the estimated after-rehabilitation value must not exceed this limit.

- **Property standards**: Properties that are constructed or rehabilitated with HOME funds must meet all local codes, rehabilitation standards, and zoning or other ordinances. PJs that have no local codes must ensure that projects meet:

  - one of three model codes -- Uniform Building Code (ICBO), National Building Code (BOCA), Standard Building Code (SBCCI); or

  - the Council of American Building Officials (CABO) one- or two-family code; or

  - HUD's Minimum Property Standards (MPS).

  Newly constructed properties must meet CABO's Model Energy Code. For rehabilitated properties, HUD's cost-effective energy conservation and effectiveness standards may be used as a guide.

- **Residency and income eligibility**: The homebuyer must occupy the property as a principal residence. The homebuyer's household must qualify as low-income (80 percent or less of area median income) at the time of purchase.[1]

- **Recapture/resale provisions**: The HOME-assisted property is subject to recapture or resale provisions as described below. These provisions remain in place for the duration of the property's affordability period.

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[1] If more than six months elapses between income qualification and the date of purchase, the homebuyer's income must be re-verified.

RECAPTURE AND RESALE: DEFINED

During the affordability period, HOME regulations require either repayment of the HOME subsidy -- referred to as the **recapture option** -- or continued use of the property by another low-income buyer -- referred to as the **resale option** -- in the event of property transfer, or when the owner no longer occupies the unit as a primary residence.

- **Recapture option**: Under this option, the HOME subsidy must be returned to the HOME Program with certain exceptions. However, this option allows the seller to sell to any willing buyer at any price. Once the HOME funds are repaid, the property is no longer subject to any HOME restrictions. These funds may be used for any other HOME-eligible activity.

- **Resale option**: Using this option, an owner is obligated to resell the original home to another income-eligible homebuyer. This sale must be at a price that is affordable to the purchaser, although the owner is also allowed a fair return on the sale. Under HOME regulations, the PJ defines both the terms of affordability and fair return.

KEY CHANGES IN REGULATIONS

The use of HOME funds for homeownership has become increasingly flexible since the program's inception, as demonstrated by the following changes.

- **Elimination of the first-time homebuyer requirement**: Purchasers may now be any income-eligible household. Income-eligible households are those with incomes at or below 80 percent of the median income, adjusted for family size.

- **Revising maximum purchase values**: Properties purchased with HOME funds must have "modest" values -- that is, values at or below 95 percent of the median purchase price for units of that type in the community. For all communities except high cost areas, the applicable limit is established by the Federal Housing Administration's 203(b) Mortgage Insurance Program, or may be determined by the locality based on a study of recent sales.

- **Eliminating restrictions on homebuyer recapture proceeds**: If properties are sold during the affordability period, recaptured funds may now be used for any eligible HOME cost. Previous rules restricted re-use to homebuyer program activities.

- **Modifying the period of affordability**: Rather than a fixed 15-year period for rehabilitation and 20 years for new construction, the required affordability period for both rehabilitation and new construction is now five years for HOME subsidies of less than $15,000 per unit; ten years for per-unit subsidies of $15,000 to $40,000; and 15 years for subsidies greater than $40,000. Further, the requirement that properties receiving FHA-insured financing carry affordability terms equal to the length of the mortgage has been dropped. [For more information on the concept of "affordability," see Chapter 2.]

- **Resale option: presumption of affordability**: Under the resale option, continued affordability of homebuyer properties may be documented by a neighborhood market analysis of <u>both</u> properties <u>and</u> residents that demonstrates that housing is modestly priced and affordable, and will remain so for the next five to seven years. Such properties are presumed to be affordable and are not required to carry resale restrictions.

- **Clarifying the amount of HOME subsidy**: Under the recapture option described above, the affordability period is tied to the amount of HOME funds subject to recapture (i.e., the direct subsidy to the homebuyer). Construction subsidies, including those subsidies that exceed the market value of the home at the time the assistance is provided, are not subject to recapture and are not included in the affordability period calculation. In contrast, the resale option requires the affordability period to be based on the total of all HOME funds invested in the property.

- **Adding forgivable deferred payment loans as an eligible form of subsidy**. Under the recapture option, HOME subsidies may now be provided in the form of deferred payment loans that may be forgiven over time.

- **Changing the distribution of proceeds requirements**. Also under the recapture option, the PJ may choose to repay the homeowner's cash investment in the property before recapturing the HOME subsidy.

- **Adding loan guarantees as a financing tool**. HOME funds may now be used to guarantee financing provided by private lenders to eligible homebuyers.

The next chapter discusses the impact of local policy and program design considerations on the recapture/resale option selection decision.

Chapter Two

Structuring the Subsidy Package

A number of key issues affect the design of a successful homeownership program. Each of these should be addressed once the primary goal(s) have been set for the program. Program goals will vary by community, depending on local housing stock and market conditions, as well as population characteristics and housing needs. Typical goals include providing affordable homeownership opportunities for lower-income households, rehabilitation of deteriorating properties, stabilization of property values, and revitalization of neighborhoods. An appropriate design will be driven by whether the program's primary goal is providing assistance to homebuyers <u>without</u> regard to geography, or targeting assistance to make units within a particular neighborhood affordable to eligible homebuyers. Whether assistance is targeted to particular neighborhoods in an effort to retain long-term affordability may make a difference in the structure of a subsidy.

Once the primary goal has been identified, program staff must consider the various strategies for providing HOME subsidies. Decisions must be made about:

- the incomes of eligible homebuyers and what is affordable to them;
- the potential for equity accumulation, and how equity will be distributed upon resale;
- the appropriateness of offering to forgive HOME subsidies as an incentive to participate in the program; and
- the level of subsidy to be provided to households and/or properties, and whether subsequent subsidies will be offered to new homebuyers of previously assisted properties.

These issues must be examined in the context of both current and expected housing market conditions, as well as the community's political climate.

AFFORDABILITY AND ELIGIBILITY TO PARTICIPATE

While the HOME Program specifies maximum income for eligible homebuyer households, as well as the period over which a HOME-assisted property must remain "affordable," it leaves the definition of affordability to the PJ. The PJ's definition of affordability affects who will be eligible to participate in a program. It is also important to note that affordability must be defined not only for the household initially purchasing the home, but, if the resale option is used, for subsequent purchasers who buy during the period of affordability.

Typically, affordability is defined as some percentage of the homebuyer's household income. Many PJs assume that homebuyers can afford to spend 30 percent of their monthly income for housing expenses; others use a higher percentage (for example, 35 to 40 percent) if the homebuyer has previously demonstrated the willingness and ability to spend a significant amount of monthly income for housing (for example, a history of rental payments in the higher range).

How a PJ defines affordability has important consequences for the expenditure of HOME dollars. The lower the percentage of income used for housing expenses and the "hotter" or more expensive the real estate market, the higher the HOME subsidy required for the homebuyer to complete the purchase.

EQUITY ACCUMULATION AND SHARING

Homebuyers can realize equity in two ways -- through the repayment of mortgage principal and appreciation through increasing property values. Whether or not equity will accrue to a HOME-assisted property in the form of appreciation will depend on the strength of the local housing market over the period of affordability. In active, growing markets where the demand for housing units is high, values are likely to increase during the affordability period. Before HOME subsidies are provided, PJs need to consider whether appreciation is likely and, if so, whether the homebuyer, the PJ, or both, should benefit.

Equity sharing is one strategy that may be used in strong housing markets. With equity sharing, the PJ and the homebuyer agree up-front to share in any increase in the value of the property realized at sale. An equity sharing agreement may expire with the required affordability period, or be extended for a term deemed appropriate by the PJ. Further, the PJ may decide to use a longer affordability period than is required by the HOME Program. Both of these strategies can support the PJ's efforts to preserve affordable housing and encourage homeowners to view their home purchases as long-term investments in the community.

In strong markets where homebuyers are passive beneficiaries of market appreciation, PJs can profit from their investments of HOME subsidy. However, enabling homebuyers to capture a significant percentage of any equity accumulation will encourage them to maintain and invest in their properties over time by giving them one of the highly valued benefits of homeownership -- the opportunity to benefit financially from the growth of their community. (Typically, PJs that wish to share in the appreciated value of assisted properties are asking for 10 to 25 percent of equity realized from the sale of a HOME-assisted property.)

In soft markets where appreciation is uncertain, PJs may want to pass on to the homebuyer 100 percent of any equity accumulation, as a way to encourage initial and ongoing investment in the property. Maintenance and pride of ownership are particularly critical for transitional neighborhoods, especially where the primary program goal is neighborhood stabilization or revitalization, and where the PJ wants to ensure continued community building.

Further, in markets where depreciation is more likely than appreciation, it is important to protect homebuyers from some or all of the downside risk. To encourage homebuyer investment in such markets, the PJ must provide adequate incentives for participation. These might include retention of any market appreciation and, to the extent that proceeds are available upon resale, the guaranteed right to recover one's initial investment (specifically, down payment, closing costs and any improvements) in the property before repayment of any HOME funds.

FORGIVENESS

Under the revised HOME Program rules for the recapture option, PJs may forgive part or all of the HOME subsidy provided to the homebuyer. Forgiveness is usually tied to one or more conditions, such as: the length of time the homebuyer has owned and occupied the unit, the ratio of the HOME subsidy to the sum of the HOME subsidy <u>plus</u> the homebuyer's investment, or the balance of sale proceeds available to reimburse the PJ following repayment of the homebuyer's investment.

The decision to forgive, including how much and how quickly, should be made up front as part of the overall program design -- and <u>not</u> on a case-by-case basis. The decision should be based on the primary goals of the program and underlying market conditions. Programs that emphasize neighborhood revitalization and/or serve communities threatened by weak or declining values should consider forgiving HOME debt. In such areas, a forgivable loan may be the key to encouraging eligible households to contribute their own funds and resources to an otherwise risky investment. Forgiveness is also a useful tool for communities experiencing limited demand for homeownership for whatever reason (for example, if standard, inexpensive rental housing is readily available).

In contrast, in strong housing markets where property values may increase over time, it may not be necessary for PJs to forgive the HOME subsidy. Homebuyers reselling in such markets will easily recover their initial investment and repay the subsidy to the PJ. Depending on the agreement with the PJ, they may also receive part or all of any appreciation.

PJs that require full repayment of the HOME subsidy typically defer repayment until resale of the property. Some PJs do, however, require immediate amortization of the HOME subsidy, and some even charge interest. Holding an amortized loan can impact the amount of a homebuyer's HOME subsidy, since repaying the loan reduces the amount the homebuyer has available each month to repay principal and interest to a private lender. In these cases, the homebuyer will need a grant to make up the difference between what the he/she can repay and the cost of the home. Therefore, PJs that want some return on the subsidy "investment" should consider an alternative to interest-bearing loans, such as equity sharing.

LEVEL OF HOME SUBSIDY

Under HOME, PJs can provide subsidies directly and indirectly to benefit homebuyers. As an example of an indirect benefit, a PJ may subsidize development of new single-family homes to reduce the sales price to market levels, or use a loan guarantee to induce a lender to provide first mortgage financing. The same PJ could then choose to assist homebuyers directly by offering down payment and closing cost assistance. The appropriate level of HOME subsidy to support homebuyers depends on the goals of the program and the conditions in the housing market.

PJs must consider the incomes of the households they want to assist when determining the appropriate level of subsidy. Some PJs target very low-income households (for example, households at or below 50 or 60 percent of median income), understanding that these families will require substantial up-front subsidies to become homeowners. Others take the position that homeownership may not be appropriate for very low-income households and, in fact, may be a burden for them. These PJs believe that homeownership requires a higher minimum income, and limit their programs to households with incomes closer to 80 percent of median.

As noted above in the discussion about affordability, the lower the percentage of income available for housing expenses and the "hotter" the real estate market, the higher the HOME subsidy required to enable the homebuyer to afford homeownership. High HOME subsidies can trigger a host of policy and political issues, including:

- Fewer households can be assisted with the PJ's limited HOME dollars.
- Recovery of the subsidy may become politically desirable to prevent the possibility of windfall profits for homebuyers, and to assist additional families in the future.
- Homebuyers may be reluctant to accept large subsidies that must be repaid, either over time or upon resale.

The key to determining the right level of subsidy is to answer the question: "What is the minimum level of HOME money that must be contributed to make the development happen (or encourage an eligible homebuyer to agree to participate)?" PJs have two options for answering this question.

1. PJs might determine the answer on a case-by-case basis, effectively tailoring the subsidy amount to the circumstances of each property or homebuyer.

2. They may look at several typical projects or homebuyers to determine a standard level of assistance for all program participants, or may evaluate what is necessary to foster investment in a particular neighborhood.

There are pros and cons to both approaches. For example, tailoring the subsidy amount to each participant takes more staff time and can reward households with higher existing debt by providing larger subsidies than those for households who have prudently controlled their spending. On the other hand, standard subsidies likely will be insufficient for some otherwise eligible households, and excessive for others.

Under the resale option, PJs must also consider whether subsequent subsidies will be offered to new buyers of previously assisted properties, effectively extending the affordability period. An additional subsidy may be necessary to ensure that the homeowner selling the property receives a fair return, and that the property remains affordable to the new homebuyer.[2] Some PJs may want to offer additional subsidies for the very reason that the affordability period can be extended, thereby ensuring that the assisted property remains in the affordable housing stock for as long as possible.

STRUCTURING THE HOME SUBSIDY AND SELECTING A RECAPTURE OR RESALE MECHANISM

Once PJs have examined the issues that can impact the subsidy level, the next step is to create the most appropriate subsidy package to respond to the needs of low-income homebuyers and a community's housing market conditions. The goal of a well-structured subsidy package should be to maximize its appeal to potential applicants, while limiting the level of subsidy to what is really needed to make HOME-assisted properties affordable to the target population.

In summary, selection of an appropriate recapture or resale mechanism will depend on program goals and the decisions regarding the key considerations discussed in previous pages. The next two chapters explore in-depth program decisions related to the recapture and resale alternatives, recognizing that each option:

- has distinct advantages and disadvantages to both the buyer and the seller,
- offers opportunities to add special features to a homebuyer program that further target the use of HOME funds or achieve other program objectives,
- requires different financial analyses and calculations of investments and returns, and
- involves unique legal document preparation and contract provisions.

[2] Strategies for striking a balance between these two competing needs are provided in the HOME model guidebook entitled **First-Time Homebuyers and the HOME Program**, published in March 1993 by HUD's Office of Affordable Housing Programs.

Chapter Three

Structuring the Recapture Option

Once an owner has resided in a HOME-assisted property as a principal residence for the duration of the affordability period (described below), there are no restrictions on resale or transfer. However, if a homebuyer resells or transfers ownership of a HOME-assisted property during the affordability period, the homebuyer is required to either repay the HOME subsidy or sell the unit to another low-income buyer. This chapter describes the procedures for requiring the owner to repay the HOME subsidy -- known as the recapture option.

THE RECAPTURE OPTION

Under the recapture option, an owner who is subject to recapture is required to repay all or a portion of the HOME subsidy if the property is sold or transferred during the affordability period. The seller is allowed to sell the home to any willing buyer at any price as long as the HOME debt remaining on the property is repaid. If the sale of a HOME-assisted house during the affordability period results in repayment of some or all of the HOME subsidy, the PJ can use the proceeds for any HOME-eligible activity.

Successful design and implementation of the recapture option requires an understanding of four major issues:

- the affordability period,
- the amount of HOME subsidy subject to repayment,
- the use of recapture proceeds, and
- enforcement mechanisms.

DEFINING THE AFFORDABILITY PERIOD

The HOME regulations require affordability periods based upon the amount of HOME funds that are of direct benefit to the homebuyer, as described in the next section.

Figure 3-1

Minimum Length of Affordability

Direct HOME Subsidy	Length of Affordability
Less than $15,000	5 years
$15,000-$40,000	10 years
More than $40,000	15 years

CALCULATING THE HOME SUBSIDY SUBJECT TO REPAYMENT

HOME regulations require repayment of HOME funds that directly enabled a homebuyer to purchase an eligible property. (HOME subsidies that indirectly benefit a homebuyer, such as those discussed below, are not subject to recapture.) Funds that directly benefit a homebuyer include down payment assistance, reduction of the sales price of a property to below the appraised market value, and interest rate buy-downs.

Two sample transactions illustrate how HOME funds directly benefit a homebuyer. Assume that a PJ acquires two vacant single-family homes, each for $20,000, and invests an additional $15,000 to rehabilitate each house. The first home is then sold at its appraised value of $35,000. The purchaser borrows $31,500 from the bank, contributes $1,500 of her own funds, and receives a $2,000 HOME down payment to help buy the home. The $2,000 down payment is considered a HOME subsidy subject to recapture. The second home is sold with the same $2,000 down payment assistance -- but at the lower price of $30,000 to make it affordable to a very low-income family. That family contributes an additional down payment amount of $1,500 and borrows $26,500 from the bank. The HOME funds subject to recapture in the second transaction equal $7,000 ($2,000 down payment assistance and the $5,000 "write down" of the sales price).

Uses of HOME funds that do not directly benefit a homebuyer are not subject to recapture. A development, or construction, subsidy is the best example of an "indirect" subsidy that is not subject to recapture. Assume that the same PJ as in the examples above buys a third home for $20,000, but this time in a less desirable neighborhood than the first two purchases. The PJ invests the same $15,000 to rehabilitate the property. Rather than having a market value of $35,000 after rehabilitation, the appraiser determines that the value of this third property is only $30,000 due to the neighborhood's condition. After rehabilitation, the city places the property on the market for $30,000. The difference between the PJ's total investment ($35,000) and the sales price ($30,000) is $5,000. The $5,000 is considered a development subsidy -- the price the PJ must "invest" in order to make a deal financially feasible in the market place -- and is not subject to recapture from the homebuyer. The homebuyer contributes $1,500 and receives $2,000 in down payment assistance, which is subject to recapture.

Each of the above properties and the financial transaction associated with it is summarized in Figure 3-2 below:

Figure 3-2

Calculating HOME Funds Subject to Recapture

	Property A	Property B	Property C
Acquisition Price Paid by PJ	$20,000	$20,000	$20,000
Rehabilitation Cost	$15,000	$15,000	$15,000
Total Development Cost	$35,000	$35,000	$35,000
Appraised Value	$35,000	$35,000	$30,000
Sales Price	$35,000	$30,000	$30,000
SUBSIDIES:			
Development (Total Development Cost-Value)	$ 0	$ 0	$ 5,000
Below-market Sales Price (Value-Sales Price)	$ 0	$ 5,000	$ 0
Down Payment Assistance	$ 2,000	$ 2,000	$ 2,000
Total HOME Subsidy Subject to Recapture	$ 2,000	$ 7,000	$ 2,000
Mortgage Amount	$31,500	$26,500	$26,500

CALCULATING THE HOMEOWNER'S INVESTMENT AND COMBINED INVESTMENT

In addition to the PJ's investment of HOME funds, purchasers make their own investments in their homes that ultimately affect the recapture of HOME funds and the disposition of proceeds at the time of sale. Such investments include the purchaser's contribution to the down payment and improvements made to the property over time.

In the examples in Figure 3-2, assume that each homebuyer contributed $1,500 of his or her own funds as a down payment. Over the period they own the homes, two of the three owners make an additional $1,000 in improvements, while the third invests only $500. The combined HOME and homeowner investment for each of the properties is shown in Figure 3-3.

NET PROCEEDS

The amount of money available to repay the HOME subsidy at the time of sale is called "net proceeds." <u>Net proceeds</u> are defined by HUD as: <u>the sale price, minus loan repayments and closing costs</u>. Net proceeds may be equal to, less than, or greater than the combined amount of HOME subsidy subject to recapture and the homeowner's investment. The amount of net proceeds, therefore, affects how much of the HOME subsidy realistically can be repaid and how much of the homeowner's investment can be recovered.

If net proceeds are greater than the combined investment, funds are sufficient to repay both the PJ and homeowner. If the combined investment is greater than the net proceeds, funds are insufficient to repay both. Because it is impossible to anticipate with any assurance when a sale will occur, the market conditions at the time of sale, or the likely amount of net proceeds that will be generated, it is essential for PJs to set a policy at the time of loan closing that establishes how net proceeds will be distributed when a property is resold.

Figure 3-4 examines each of the three sample properties from Figure 3-2 in terms of what is likely to occur at the time of sale. What are the net proceeds for each of the sample properties, if

Figure 3-3

Combined HOME and Homeowner Investment

	Property A	Property B	Property C
Total HOME Subsidy Subject to Recapture*	$2,000	$7,000	$2,000
Homeowner's Investment			
Down payment	$1,500	$1,500	$1,500
Improvements	$1,000	$1,000	$ 500
Combined HOME/Homeowner Investment	$4,500	$9,500	$4,000

* From Figure 1.

each is resold for $2,000 more than the purchase price, and if $1,000 of the original loan principal has been repaid? Further, are the net proceeds sufficient to repay both the HOME and the homeowner's investment?

Figure 3-4

Calculating Net Proceeds

	Property A	Property B	Property C
Resale Price	$37,000	$32,000	$32,000
(Loan Repayments)	($30,500)	($25,500)	($25,500)
Closing Costs	($2,000)	($2,000)	($2,000)
Net Proceeds	$4,500	$4,500	$4,500
Combined Investments	$4,500	$9,500	$4,000
Surplus (Deficit)	$ 0	($5,000)	$ 500

At the time of sale, Owner A has sufficient net proceeds to both repay the HOME program and the owner's investment in the property. Owner B has insufficient proceeds to repay the HOME investment or to recoup his/her own contribution. The net proceeds from transaction C provide repayment for both the HOME program and the owner, with enough surplus funds for allocation to the HOME program, the owner, or both.

In the sale of properties A and C described above, both the owner and the HOME program at least recover their investments. In the sale of property B, however, neither the owner or the HOME program are so fortunate. The HOME program, however, anticipates the possibility of insufficient net proceeds, a not-uncommon problem in modest neighborhoods with limited market growth and low-income homebuyers. The next few pages discuss program design options that can mitigate the problems associated with insufficient proceeds, and balance the returns to the HOME program and the owner at the time of sale.

Forgiveness: Reducing the Direct HOME Subsidy to be Repaid

Much, if not all, of the potential problem of insufficient net proceeds can be eliminated if HOME programs elect to forgive all or a portion of the direct HOME subsidy provided to the buyer. The PJ has the flexibility to reduce the amount of direct HOME subsidy to be repaid based on the length of time the homebuyer has owned and occupied the property in relationship to the affordability period. The decision to forgive should be made at the program design stage in response to housing market conditions and the needs of potential purchasers -- not at the time of resale. Homebuyers should know at the time the HOME subsidy is provided whether it will be forgiven and, if so, over what period. As discussed in Chapter 2, forgiveness is most appropriate in neighborhoods where investment in homeownership is viewed as high-risk, or as a strategy for ensuring that homebuyers who sell during the affordability period receive some return on their investment.

In Property B above, the direct HOME subsidy subject to recapture was $7,000, but the net proceeds from the sale were only $4,500. The $7,000 HOME subsidy triggered a five-year affordability period (see Figure 3-1). If the HOME program had agreed at the time of loan closing to forgive one-fifth of the $7,000 each year for five years -- $1,400 per year -- and the owner of Property B sold the home in year two, two/fifths, or $2,800, of the HOME subsidy would be written off. The amount subject to recapture would then be reduced to $4,200 ($7,000 – $2,800 = $4,200). The net proceeds of $4,500 would be sufficient to repay the HOME subsidy or the homeowner, but not both in full. If the owner held on to the property for four years instead of just two, the proceeds would be sufficient to repay not only the HOME program, but the owner's investment as well. Figure 3-5 illustrates for Property B the relationship between net proceeds and the return of the PJ's and homeowner's investment with and without forgiveness of the HOME subsidy.

Figure 3-5

Effects of Forgiveness on Net Proceeds for Property B

	Sale in Year 3 Without Forgiveness	**Sale in Year 3 With 2-Year Forgiveness**	**Sale in Year 5 With 4-Year Forgiveness**
Resale Price	$32,000	$32,000	$32,000
(Loan Repayments)	($25,500)	($25,500)	($25,500)
(Closing Costs)	($2,000)	($2,000)	($2,000)
Net Proceeds	$4,500	$4,500	$4,500
Combined Investment	$9,500	$6,700	$3,900
Owner Investment	$2,500	$2,500	$2,500
HOME Subsidy	$7,000	$4,200*	$1,400*
Surplus (Deficit)	($5,000)	($2,200)	$ 600

**HOME Subsidy Subject to Recapture Before Forgiveness*		$7,000	$7,000
Forgiveness (1/5 per year = $1,400)		($2,800)	($5,600)
Amount of HOME Subsidy to be Repaid		$4,200	$1,400

Sharing Net Proceeds: Proportional Distribution

A proportional distribution of net proceeds permits both PJs and homeowners to share the net proceeds based upon the ratio of the PJ's subsidy to the homeowner's investment. If net proceeds are less than the combined investment, neither party will recover all that they contributed to a project, but both will receive a fair share of whatever proceeds are available at the time of sale. The formula for distributing net proceeds based upon a proportional allocation is as follows:

$$\frac{\text{HOME Subsidy}}{\text{HOME Subsidy + Homeowner Investment}} \times \text{Net Proceeds} = \text{HOME Recapture Amount}$$

$$\frac{\text{Homeowner Investment}}{\text{HOME Subsidy + Homeowner Investment}} \times \text{Net Proceeds} = \text{Homeowner Repayment}$$

Using Property B as an example, assume that the owner decides to sell in year three and that the PJ decided at the time of the original purchase not to forgive any of the direct HOME subsidy.

The PJ, however, agreed to permit a proportional allocation of the net proceeds at the time of resale. Figure 3-6 illustrates how the $4,500 in net proceeds would be distributed.

Figure 3-6

Proportional Allocation of Net Proceeds
Property B: Insufficient Net Proceeds

$$\frac{\$7{,}000}{\$7{,}000 + \$2{,}500} \times \$4{,}500 = \$3{,}316 \text{ PJ Recapture}$$

$$\frac{\$2{,}500}{\$7{,}000 + \$2{,}500} \times \$4{,}500 = \$1{,}184 \text{ Homeowner Repayment}$$

As illustrated in Figure 3-5, even when PJs permit the HOME subsidy to be forgiven, net proceeds may not be sufficient to repay both the HOME program and the owner. PJs may, therefore, elect to forgive the HOME subsidy and provide for proportional repayment of whatever net proceeds are available at the time of sale.

So far, proportional allocation of net proceeds have been discussed in the context of insufficient funds at the time of sale. However, PJs may want to allow proportional allocation of net proceeds even when the net proceeds are in excess of the combined investment. A good way to illustrate this point is to look at Property C (see Figure 3-7), where the combined investment was $4,000 ($2,000 HOME subsidy and $2,000 owner investment) and the net proceeds were $4,500. Using the proportional allocation, the net proceeds would be split as follows:

Figure 3-7

Proportional Allocation of Net Proceeds
Property C: Sufficient Net Proceeds

$$\frac{\$2{,}000}{\$2{,}000 + \$2{,}000} \times \$4{,}500 = \$2{,}250 \text{ PJ Recapture}$$

$$\frac{\$2{,}000}{\$2{,}000 + \$2{,}000} \times \$4{,}500 = \$2{,}250 \text{ Homeowner Repayment}$$

In this example, each party receives repayment of his/her full investment plus a proportional share of the remaining balance. The proportional return of investment encourages purchasers to participate (especially in difficult neighborhoods), shares the investment risk between the PJ and homebuyers, and provides fair returns to both parties at the time of sale.

Making the Owner Whole: Repaying the Owner Before the PJ

HOME rules also permit distribution of net proceeds to the homeowner first, and then to the PJ. Some programs find this a particularly valuable way of stimulating participation in homeownership initiatives in very soft markets and challenging neighborhoods. Reluctant investors concerned about the ability to recoup funds invested for a down payment and/or improvements are comforted by the knowledge that when the home is sold, they are first in line (after the first mortgage holder) for repayment.

Again, returning to Property B (see Figure 3-8), assume that the direct HOME subsidy is $7,000 and the owner's investment is $2,500. If the net proceeds are $4,500 and the PJ has agreed to repay the owner first at the time of a resale, the distribution of the net proceeds is as follows:

Figure 3-8

Repaying the Owner First
Property B: Insufficient Net Proceeds

Net Proceeds	$4,500
Homeowner Recapture	$2,500
Balance to HOME Program	$2,000
HOME Subsidy	$7,000
Net Loss to HOME Program	($5,000)

Using this allocation system, the homeowner's investment is protected first, and the PJ assumes the full risk of recovering its investment. In fact, the HOME program risk in this example is quite high, since the seller has little incentive to recover anything more than its costs. As structured, all proceeds in excess of the homeowner investment return to the PJ, leaving little incentive for the seller to maximize the sales price. To overcome this problem, programs that elect to repay the owner's investment first often agree to proportional allocations of any amounts of net proceeds exceeding the owner's return. This encourages the seller to seek the best price, since both the HOME program and the seller stand to enhance their returns as the net proceeds increase.

Deciding How to Handle Net Proceeds

Because different policies related to forgiveness and distribution of net proceeds have profound effects on both PJs and homeowners, it is essential to understand how the HOME subsidy subject to recapture is calculated, and how net proceeds from resale will be distributed <u>before</u> subsidies are provided. Key decisions required up-front include:

- whether the direct HOME subsidy will or will not be forgiven over time,
- how repayment will be calculated in the event net proceeds are insufficient to repay both the direct HOME subsidy and the owner, and
- how any excess net proceeds will be distributed.

The decisions about repayment of the direct HOME subsidy and the related distribution of net proceeds are best made at the time of program design. The policy should be articulated to potential purchasers prior to the sale and loan closing. The up-front decision with respect to recapture and distribution of net proceeds allows homebuyers to understand the extent to which their funds are at risk, and the opportunities being provided for return on their investment. PJs, on the other hand, will be able to estimate the extent to which some or all of their investments may be recouped if market conditions permit.

ENFORCING THE RECAPTURE OPTION

One purpose of HOME's repayment requirements is to deter homebuyers from selling a property in the near-term and making an unreasonable profit as a result of their subsidies. The PJ may use several legal vehicles to ensure compliance with the required restrictions. These include, among others, affidavits, purchase options, covenants, and deed restrictions. Mortgage instruments alone are not sufficient. The appropriate means to ensure compliance is determined by a variety of factors, including:

- the extent of control desired by the PJ,
- the form of conveyance and the obligations placed upon the homebuyer during the rehabilitation/initial occupancy period,
- the use of private financing and lender imposed conditions, and
- state or local laws governing real estate and mortgage financing.

Residency Requirements

HOME regulations require that the homebuyer maintain the HOME-assisted property as a principal residence during the affordability period. The residency requirement continues even if the provisions of lending, and any other locally imposed conditions, have been met. It is the PJ's responsibility to comply with these regulations throughout the affordability period.

An affidavit signed by the homebuyer at the time of purchase or financing is one simple and direct way to gain the homebuyer's commitment to this obligation. In addition, the PJ may wish to verify the homebuyer's occupancy periodically. Finally, this residency requirement should be recorded as a condition of financing and covenant within the loan agreement and mortgage or deed of trust.

Terms and Conditions of Financing

In most cases, a mortgage or deed of trust is used to pledge the property as full repayment of the HOME debt. In conjunction with this instrument, a promissory note is issued which defines the repayment of principal and interest. It is especially important that the loan agreement reflects the homebuyer's obligation under the mortgage and note to repay the HOME debt upon resale. Since most HOME assistance is likely to be subordinated to other debt, these terms must be approved by those lenders who have priority in receiving proceeds in the event of a sale or foreclosure.

The HOME regulations allow revocation of HOME's recapture and resale provisions if an ownership interest is terminated prematurely by foreclosure, transfer in lieu of foreclosure, or assignment of an FHA-insured mortgage to HUD. If an owner reassumes a redemptive interest in the property, the original affordability period resumes and continues until its term is expired or the property is resold.

Similar to an option to purchase upon resale, the PJ may use its pre-emptive rights to purchase a property in these situations to avoid financial loss or loss of affordability. The PJ must also include this option to purchase under these circumstances in the original loan agreement, deed of trust or mortgage instrument.

Figure 3-9 provides a summary of the resale requirements under the recapture option and how these provisions may be enforced. The next chapter looks at the second option -- resale.

Figure 3-9

Enforcing Resale Restrictions Under the Recapture Option

Requirement	Recapture Option	Enforcement Vehicle
Residency Status	Principal residence	Affidavit, lien*
Minimum Affordability Term	5 Years <$15,000 10 Years $15,000-$40,000 15 Years >$40,000	Lien
Repayment of HOME Subsidy	Recapture/forgiveness of HOME subsidy	Promissory note, lien
Return to Owner	No requirement	N/A
Sale Price at Resale	No requirement	N/A
Subsequent Buyer's Income	No requirement	N/A

* A recorded deed of trust or mortgage securing repayment of the HOME subsidy.

Chapter Four

Structuring the Resale Option

This chapter describes the second option available to PJs under the HOME regulations in the event a property is sold during the affordability period: <u>the resale option.</u>

THE RESALE OPTION

The objective of the resale option is to continue the affordability of a property in the event of resale. The PJ must ensure that the terms of resale are both affordable to the new buyer and fair to the seller. Finding this balance may be complicated by fluctuations in price, interest rates, and availability in uncertain housing markets. Many buyers may be reluctant to participate in a program that limits their return on resale, and many PJs may be reluctant to take on the responsibility of monitoring the necessary resale restrictions under this option. Yet, in situations that might benefit from such controls, the resale option offers PJs an attractive alternative to searching for affordable properties in the future for their homebuyer programs.

The resale option must be used whenever the PJ provides no direct subsidy to the homebuyer and there is nothing to recapture. For example, a PJ might choose to use HOME funds to develop market-priced housing for eligible homebuyers by subsidizing the difference between the market value of the homes and the total development costs. Since homebuyers would be paying "full price," in this case HOME funds would not be subject to recapture.

The final HOME rule offers PJs another way to meet the requirements of the resale option. PJs may use market analysis to develop a presumption of affordability for a particular neighborhood with modest housing values that are affordable to HOME-eligible applicants through conventional financing. This alternative is described in detail at the end of this chapter.

Successful design and implementation of the resale option requires an understanding of four major issues:

- the affordability period,
- the affordability calculation for resale,
- the definition of fair return, and
- enforcement mechanisms.

DEFINING THE AFFORDABILITY PERIOD

Under the resale option, the affordability period continues until its original expiration, regardless of whether the property is sold. The initial minimum affordability period is the same as that of the recapture option:

- five years for HOME subsidies of less than $15,000 per unit,
- ten years for per-unit investments of $15,000 to $40,000, and
- 15 years for investments greater than $40,000.

However, under the resale option, the period of affordability is determined by the total amount of HOME funds used to assist the property and the homebuyer, rather than by just the direct subsidy to the homebuyer, since the objective in choosing the resale option is to preserve a specific unit as an affordable housing resource. The total amount of HOME funds invested in the unit counts in determining the period of affordability. For example, if a PJ invests a $10,000 development subsidy in a HOME-assisted property and provides the homebuyer with $5,000 in downpayment assistance, the property's minimum affordability period is ten years.

If a home is sold during its affordability period and no additional HOME funds are contributed to the sale, the initial affordability period remains the same. However, if the PJ contributes additional HOME funds to this property as a result of resale, the original affordability period is terminated and a new period starts when the new HOME funds are invested. In the example above, adding $15,000 of HOME assistance to this property at resale would start a new ten year affordability period, regardless of when during the original affordability period it was sold.

DEFINING RESALE AFFORDABILITY

Maintaining affordability is a requirement of the resale option. Under this option, the PJ must define affordability in terms of the subsequent low-income purchaser's ability to buy the property. Affordability is generally measured as a percentage of the homebuyer's income that must be spent on the fixed costs of owning a house: principal, interest, property taxes, and insurance (PITI). For example, many PJs use somewhere between 28 and 33 percent as the maximum percentage of income that may be dedicated to PITI.

Each PJ is free to adopt its own definition of affordability. Since the PJ is responsible for establishing the maximum sales price for assisted properties, it is important to consider the actual income of the purchaser relative to actual housing costs to ensure that the property is truly affordable with the HOME subsidy that the PJ is providing.

DEFINING A FAIR RETURN

In a sale during the affordability period, the PJ must also ensure that the seller receives a fair return on investment. For the resale option, homeowner investment is defined as the sum of downpayment, capital improvement, and loan principal payments.

Like affordability, HUD also allows the PJ to define fair return and how it will be enforced. The PJ may allow the homeowner to retain all of the net earnings or share in this return. In most cases, the PJ should be willing and able to justify sharing a return with the homeowner. In some cases, such as a brief period of ownership or limited homeowner investment, the PJ may be justified in capturing the entire return.

If the return is to be shared or given to the owner, the PJ may base this calculation upon a formula, a simple percentage or fixed amount of the appreciation. The HOME model guidebook entitled **First-Time Homebuyers and the HOME Program**, published in March 1993 by HUD's Office of Affordable Housing Programs, provides a detailed description of these options, which include:

- allowing the seller to retain increases in value after repayment of all debts based upon the value of the property at the time of sale;
- tying the return to an economic index or formula that takes into account such factors as the original purchase price, the value of improvements, a cost-of-living factor, and mortgage terms;
- sharing equity as a fixed amount or percentage of the property's appreciation.

However, determining a fair return is more than a simple accounting procedure. The calculation must take into account more intrinsic matters of equity. If the PJ HOME subsidy is fairly small, as in the case of providing down payment and closing cost assistance, the fair course may be to recapture little or none of the homeowner's equity. In other cases where the HOME assistance is substantial, the PJ may feel entitled to a larger share.

Another perspective is consideration of the needs of both the seller and the subsequent homebuyer, given market conditions at the time of resale. Where markets are stable or have declined, the profit may be small, and the need to keep the subsidy in the property may be less. In this situation, the seller may be entitled to a greater share. On the other hand, rising markets, in which housing has become more expensive and less available, will require the PJ to balance the needs of both the buyer and the seller in setting an acceptable sales price. The following questions may assist the PJ in defining fair return.

- Are housing prices in the area expected to increase over the affordability period, making appropriate units increasingly unaffordable?
- Will housing be more or less available in the area over the affordability period? (Low vacancy rates typically indicate increasing housing prices.)
- Will the PJ permit the new homebuyer to assume all or a portion of the existing HOME subsidy?
- Will the original homebuyer participate in the HOME program if equity is shared or limited?

ENFORCING THE OPTION

Under the resale option, the primary purpose of the HOME resale restrictions is to secure and retain the affordable re-use of the property, while providing a fair return to the seller. Enforcement during the affordability period is especially important under this option, since the resale restrictions enable PJs to control the price of a HOME-assisted property and ensure that the subsequent purchaser is an eligible homebuyer. In the event of a sale during the affordability period where the purchaser assumes the existing financing and the PJ invests additional HOME funds to benefit the new purchaser, it is possible for the new affordability period to extend beyond the term of the underlying financing and its legal obligations. This possibility requires the PJ to place greater emphasis upon clearly defining the terms of affordability, fair return, and resale. A homebuyer's agreement and other legal documents are the mechanisms to define these terms. The agreement should state the covenants, conditions, and restrictions to be placed in the property deed and recorded according to local and state laws governing conveyance.

It is important for the PJ to maintain its ability to option the property, and to assume ownership or assign its right of ownership to another low-income family in the event of resale, foreclosure, or execution of a due-on-sale clause. Similarly, it is important to structure the original mortgage or deed of trust to allow assumption of the note and, if necessary, restructuring of the remaining debt.

Figure 4-1 provides a summary of the resale requirements under the resale option and how these provisions may be enforced. While there are more restrictions under resale than under recapture, the resale restrictions also provide a greater certainty of maintaining affordability.

Figure 4-1

Enforcing Resale Restrictions Under the Resale Option

Requirement	Resale Option	Enforcement Vehicle
Residency Status	Principal residence	Affidavit, deed restriction or land covenant, lien*
Minimum Affordability Term	5 Years <$15,000 10 Years $15,000-$40,000 15 Years >$40,000 (may be extended if additional HOME subsidy provided to subsequent buyer)	Deed restriction or covenant, lien
Repayment of HOME Subsidy	No requirement	N/A
Return to Owner	Fair return as defined by PJ	Deed restriction or land covenant, lien
Sale Price at Resale	No limit on sale price but must remain affordable to subsequent buyer	Deed restriction or land convent, sales contract
Subsequent Buyer's Income	80% of median	Verification, deed restriction or land covenant

* A recorded deed of trust or mortgage securing repayment of the HOME subsidy.

RESALE ALTERNATIVE: PRESUMPTION OF AFFORDABILITY

PJs may develop a presumption of affordability for a particular neighborhood where HOME homeownership assistance is being provided. This resale alternative was developed in response to PJs who were investing HOME funds in construction financing, but were later repaid with the proceeds from primary conventional mortgages. These PJs were using HOME funds in the short term to effect large-scale rehabilitation and reinvestment in neighborhoods of modest, deteriorated housing. The PJs imposition of resale agreements as a detriment to marketing units in these modest neighborhoods and indicated that subsequent buyers would be income-eligible without the imposition of restrictions.

Properties in neighborhoods with modest housing values that are affordable to HOME-eligible applicants through conventional financing are not required to carry enforceable resale restrictions (for example, deed restrictions). The affordability of such homes must be demonstrated through a market analysis showing that, in relation to the larger housing market for the community, homes are modest in size, amenities and price, and are projected to remain so over the life of the affordability period. Further, if the PJ continues to provide homeownership assistance in the neighborhood over time, it must periodically update the market analysis to determine whether or not the presumption of affordability remains valid.

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Chapter Five

Advantages and Disadvantages of the Recapture and Resale Options

The HOME Program's recapture and resale options can help ensure long-term housing affordability for lower-income households. Used wisely, these options can encourage and support homeownership for both the initial buyer and those who follow.

Selecting the appropriate option is important for several reasons:

- Recapture/resale restrictions may deter some homebuyers from participating.
- Local lenders may be reluctant to participate if restrictions are too limiting.
- The recapture of HOME funds can be an important source of program income.

Both options have distinct advantages as described below. The decision of which option to use is a matter of weighing the relative value of such factors as:

- trends in the marketplace,
- homeownership opportunities for lower-income households in the community,
- the homebuyer program's local objectives, and
- long-term interest in continuing a homebuyer program.

Regulations allow a PJ to determine which option to use, although the decision must be documented in the PJ's Consolidated Plan submission, which is approved by HUD. The PJ may retain the right to make this decision, or permit the homebuyer to determine which option will be used at the time assistance is provided or at resale. Allowing the homebuyer to decide introduces an element of uncertainty and complexity.

If the PJ chooses which option to use, the choice must be made at the time of initial sale to the homebuyer. Although using only one option is the simplest approach, there are times when a PJ may use both to accommodate differing market conditions. For example, the recapture approach, which is simple to market and requires minimal continuing public sector involvement, might be used community-wide. To supplement the community-wide program, the resale approach could be used in a specific neighborhood where escalating home prices make future home purchase by lower income households unlikely.

ADVANTAGES AND DISADVANTAGES OF THE RECAPTURE OPTION

In weighing the benefits of the recapture option, the PJ must carefully consider such factors as:

- balancing the benefits offered to both buyers and sellers,
- the anticipated cost of housing in the community and the HOME subsidies that will be required to make it affordable in the future, and

- the PJ's interest in continuing its homebuyer program over time.

The recapture option is generally the more flexible option. In uncertain situations such as changing housing markets, this flexibility allows a PJ to alter its reinvestment plan to target another neighborhood, or to direct its assistance to rental housing. If housing becomes less expensive or incomes rise faster than housing costs, the PJ may elect to decrease its subsidy to future homebuyers. Potential homebuyers who fear that it may be difficult to resell the house to a qualified low-income buyer may also appreciate the recapture option.

The recapture option is also by far the simplest of the two options to implement. The agreement with the homebuyer, and the instrument that secures it against the property, is the PJ's insurance that resale of the property will trigger the recapture of the HOME subsidy. The requirement that the property remain owner-occupied is the only element that may necessitate attention during the affordability period should the homebuyer move out and rent the property.

Finally, homebuyers and private lenders interested in providing financing for home purchases will find the recapture option easiest to understand. In addition, PJs can tailor the repayment requirements to the specific market conditions in their communities. For example, in a community with increasing real estate prices, the PJ can structure the recapture requirement so that, should there be additional sales proceeds following repayment of the HOME subsidy and the homebuyer's investment, the PJ would receive a percentage of those funds. The homebuyer and the PJ would both benefit from the increased value of the property at resale as a result of the initial investment of HOME funds.

As a disadvantage, the recapture option introduces greater uncertainty into the PJ's ability to assist homebuyers in the future, since housing may increase substantially in price during the affordability period or become less readily available for purchase in tight housing markets.

Another disadvantage is that some buyers considering a move before the end of the affordability period may be discouraged by the obligation to repay HOME assistance (with some exceptions), regardless of whether a profit is made upon resale. The repayment feature can make this option least attractive to buyers in declining markets, unless the PJ allows homeowners to recapture their investment prior to repayment of the HOME subsidy. Even then, the PJ cannot guarantee that the resale proceeds will be sufficient to repay the homebuyer's investment in full.

ADVANTAGES AND DISADVANTAGES OF THE RESALE OPTION

The resale option is a more certain way to guarantee that a particular property will remain as part of the stock of affordable housing, even during periods of rising housing prices and in gentrifying neighborhoods. The resale option is well suited to environments where controlling the price of housing is required to sustain long-term availability and affordability. It is likely to work best in those areas that are also part of a larger neighborhood revitalization effort and where there is an interest in preserving homeownership opportunities for lower-income residents in spite of rising home values. Because of its targeted nature, the resale option requires a clear understanding of local housing markets and how they are changing.

While the resale option benefits the subsequent low-income buyer by controlling the purchase price, it may be less profitable to the seller who is obliged to share a profit with the PJ or reduce the sales price paid for a property resold when housing prices are increasing. Its principal disadvantages are the constraints upon market forces when prices are rising, although this may work to the seller's advantage in a declining market supported by a PJ's fair return commitment.

For the PJ, the greatest difficulties come in crafting a balance in the fair return to the seller and a sales price affordable to the new buyer. Of course, the PJ can contribute additional HOME subsidy to the new buyer to write down the sales price or otherwise make the property affordable. The resale option's requirements also place greater responsibilities upon the PJ for monitoring and enforcement.

The resale option is also appropriate for neighborhoods where values are likely to remain stable and affordable over time. Under the "presumption of affordability" approach, properties are not required to carry resale restrictions in such neighborhoods if the PJ can document, through a market analysis, that housing values are modest and affordable to HOME-eligible applicants through conventional financing. This presumption of affordability is particularly effective when the PJ invests a development subsidy to build or rehabilitate a home to be sold at market value to a low-income family. Elimination of the resale restrictions will simplify marketing and should increase the pool of applicants, which may be especially helpful in neighborhood revitalization areas.

COMPARING THE TWO OPTIONS

The recapture option is most attractive to communities likely to experience continued availability of property and stable purchase prices. It is also attractive to those communities wishing to spread affordable housing opportunities geographically. These communities are most likely to benefit from the flexibility of reinvesting HOME funds in another property.

From the owner's perspective, this option also allows the greatest flexibility in resale, since new buyers do not have to be low-income, nor do sales prices have to be affordable. However, in the event of a declining market, the PJ could require the owner to repay a large portion of the HOME subsidy, even if no profit is derived from the sale.

The resale option is most beneficial to those communities committed to geographic targeting, and in neighborhoods where home prices are rising. These communities are most likely to benefit from retaining the affordability of specific houses in selected locations.

The resale option helps the most when used as part of a larger neighborhood revitalization effort or as a tool to assist specific household types or sizes. The resale option may also be structured to provide an owner with a larger return on investment than he or she could receive from a market sale in a declining market, thereby restoring buyer confidence and neighborhood stability.

While these resale requirements may discourage some buyers in heated markets, fair returns can be structured to attract eligible buyers without compromising affordability upon resale. Affordability may be easily passed on to another homebuyer, even in inflationary markets, by structuring the original homebuyer and financing agreements to include purchase options and rights of assumption. Further, PJs can use land trusts to control escalating values and limit the appreciation realized by homebuyers to the value of the property improvements. Land trusts enable homebuyers to realize some return on investment while PJs minimize the impact of land values on home prices.

Figure 5-1 summarizes some of the advantages and disadvantages of the recapture and resale options. A more complete comparison of these options is found in **First-Time Homebuyers and the HOME Program**, published by HUD's Office of Affordable Housing Programs. In addition, the following chapter presents two case studies illustrating how and why different communities used either the recapture or resale option.

Figure 5-1

Comparison of Recapture and Resale Options

Recapture Option

Market Trend	Advantages	Disadvantages
Stable/Declining Prices	Flexibility in selecting new homebuyers and locations of new properties	Depending on PJ's approach, buyers may not be attracted to program due to subsidy repayment
	For PJ, repayment discourages quick property turnover	Sale proceeds may be insufficient to repay subsidy and/or owner's investment
Stable/Rising Prices	Owner able to capture all or part of market return	PJ may confront limited supply of affordable housing in the future
	Incentive for owner to utilize equity to make repairs and property improvements	

Resale Option

Market Trend	Advantages	Disadvantages
Stable/Declining Prices	Owner may be guaranteed a return in a declining market to build confidence in investment and neighborhood	Commitment to house and area that may not remain appropriate for affordable housing
Stable/Rising Prices	Greater certainty that original home will remain affordable	Buyers may not be attracted to program which limits profit and restricts who can purchase property
	PJ and new buyer may share in profit	

Chapter Six

Case Studies

Stoneybrook and Farmington are different types of communities. In the following case histories, each was undertaking homeownership programs with HOME funds. Both worked with private lenders to provide down payment and rehabilitation assistance to low-income homebuyers. Because of differences in their housing markets and program objectives, Stoneybrook chose the recapture option, while Farmington selected the resale option.

STONEYBROOK: IMPLEMENTING THE RECAPTURE OPTION

PROGRAM ENVIRONMENT AND OBJECTIVES

Stoneybrook had few geographically defined neighborhoods. It had maintained an affordable housing stock and stable growth pattern even in periods of economic downturn. Residents supported and took pride in Stoneybrook's quality of life. However, deferred maintenance, declining housing prices, and an increased number of rental units in some older parts of the city had brought calls for increased support for homeownership opportunities to encourage investment.

City officials identified the following three program objectives based upon their understanding of HOME regulations, an analysis of community characteristics, and an assessment of housing needs and priorities:

1. stabilizing property values and housing conditions,

2. balancing the mix of owners and renters, and

3. helping renter households with stable or growing incomes to become homeowners.

All three of these objectives were intertwined; that is, by helping renters to become homeowners, the number of owner-occupied units would increase. Further, increased homeownership would help to stabilize, and perhaps improve, the marketability of available homes over time.

DEFINING THE PROGRAM

Since the affordable housing stock was disbursed throughout the community, Stoneybrook's objectives led to the design of a city-wide homebuyer program. Given the flexibility of the HOME regulations, the city decided to limit participation to first-time buyers, defined locally as someone who had never owned a home. To minimize the administrative burden and liability risk associated with holding and managing property associated with government acquisitions in some homebuyer programs, city officials also decided to structure a purchase-rehabilitation program under which homebuyers would purchase properties directly from private sellers, and the city would help manage the rehabilitation.

City officials believed that a city-wide program was likely to attract an unmanageable number of potential buyers. In an effort to target the homebuyer program, Stoneybrook elected to limit income eligibility to those households with acceptable credit ratings, and who earned less than 75 percent of Stoneybrook's $28,000 median income for a four-person household. Given the expected costs of homeownership, likely income for a participating family of four ranged from $16,000 to $21,000.

To assist younger families, who traditionally had been attracted to Stoneybrook's modestly priced homes, the city decided to use its HOME funds to provide first-time homebuyers with down payment and rehabilitation assistance. As a first concern, Stoneybrook wanted both to restore confidence in its older areas and to remedy the incipient decline that was occurring in a growing number of locations.

The median purchase price for Stoneybrook's existing single-family housing was $82,500. Under the HOME regulations, 95 percent of the median area purchase price would be $78,375 -- the maximum after-rehabilitation value of any property assisted with HOME funds. Numerous properties with asking prices in the range of $35,000 to $60,000 are typically available in the multiple listing service covering Stoneybrook. City rehabilitation staff drove by a sample of ten properties in this price range last month and predicted that all of them easily required $15,000 to $25,000 in repairs, and that most, if not all, would appraise for less than $78,375 after rehabilitation.

City officials anticipated that a significant percentage of assisted households would require down payment assistance in addition to a rehabilitation loan. Given Stoneybrook's limited resources and the desire to assist at least 30 homebuyers, the city further limited eligibility to properties requiring a maximum of $25,000 in rehabilitation. A $31,800 maximum HOME subsidy for a one-unit property would leave room for down payment assistance where necessary. It would also allow the city to contribute a development/construction subsidy to those homes whose after-rehabilitation values would not keep pace with the cost of necessary rehabilitation. While part of the city's total HOME assistance package, the development subsidy would not be subject to recapture and would not affect the applicable affordability period.

FINANCING

Stoneybrook's private lenders had actively promoted their own community reinvestment programs, but had only limited involvement with the city's housing initiatives. Several lenders who were especially committed to making loans in older areas of town were very interested in the new homebuyer program. In meeting with the city, three possible forms of HOME assistance were discussed:

- assistance for down payment and closing costs,
- interest rate buy-downs on private lender financing, and
- principal write-downs of purchase money mortgages.

Each type of assistance would be provided as either a deferred payment or deferred forgivable loan.

Lenders initially expressed concerns regarding the impact of rehabilitation on loan security, the complexity of monitoring the rehabilitation process, and how to ensure that the work would be done well, on-time, and within budget. The prospect of providing deferred-payment loans for the rehabilitation and any down payment assistance appealed to the city, which had limited capacity to underwrite or service loans. Also, since the city had experience administering a rehabilitation program, it seemed logical to allow the lender to finance the first mortgage for purchase, and for the city to provide subordinate financing for the rehabilitation.

With the maximum rehabilitation cost established at $25,000 and a goal of making the purchase affordable to households with incomes at 75 percent of median or below, the city agreed to provide the following:

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- down payment assistance in the form of a deferred forgivable loan of the lesser of $2,000 or 40 percent of the down payment;
- a deferred, non-interest-bearing second mortgage rehabilitation loan of up to $25,000 due on sale or transfer;
- a development/construction subsidy to address the costs of purchase and rehabilitation exceeding a property's after-rehabilitation fair market value;
- administration of applicant pre-qualification, the rehabilitation process, and the affordability term requirements for up to ten years, including the following specific tasks: applicant intake and referral to lenders, preparation of specifications and cost estimates for all rehabilitation work, and oversight of contractor selection and construction work; and
- homebuyer counseling both before and after purchase on a range of financial and property maintenance topics.

For its part, the lender agreed to:

- allow a down payment equal to five percent of the purchase price (as-is appraised value) of the property, provided the homebuyer contributed no less than three percent;
- provide a first mortgage of up to 95 percent of the projected after-rehabilitation value of the property;
- process loan applicants using the standard secondary market underwriting ratios (for example, a maximum of 30 percent of household income dedicated to principal, interest, taxes and insurance, and a maximum of 38 percent of income dedicated to all monthly debt payments); and
- first-mortgage terms including the waiver of origination fees, a fixed-market interest rate with a 30-year loan term, and financing of closing costs.

SELECTING HOMEBUYERS AND PROPERTIES

Although Stoneybrook's housing department had a successful history with homeowner rehabilitation programs, it had not been actively involved in homebuyer programs. Stoneybrook's city council decided to allow homebuyers to select the properties, since this approach would fit well with the city-wide program focus, minimize staff involvement in the property selection process, and support the city's affirmative marketing policy.

As a start, the housing department prepared an announcement of the program's funding availability and trained staff to initially screen applicants for income and first-time buyer eligibility. Applications were taken on a first-come basis. Those passing the initial eligibility screening were reviewed further to determine whether they would meet the program's underwriting standards for income, credit, and employment history. Qualifying applicants, who also attended ten hours of homebuyer training administered by a local nonprofit, were pre-qualified for down payment assistance and rehabilitation financing from the Stoneybrook housing department, and were then sent to a participating lender for first-mortgage funding.

Figure 6-1 outlines a typical transaction for Stoneybrook's homeownership program using the financing described above.

Figure 6-1

Stoneybrook HOME Total Development Cost

Purchase Price	$50,000	
Estimated Rehabilitation Cost	$20,000	
Total Purchase and Rehabilitation		**$70,000**
Closing Costs		**$ 2,000**
Total		**$72,000**
AMOUNT TO BE FINANCED		
Total Development Cost		**$72,000**
Development/Construction Subsidy		
Purchase and Rehabilitation	$70,000	
Value After Rehabilitation	$65,000	
Subsidy		**($7,000)**
Total		**$65,000**
FINANCING		
Down Payment: Buyer Contribution	$ 1,950	
City Forgivable Loan	$ 1,300	
Total		**$ 3,250**
<u>1st Mortgage</u>: Private Lender Financing (8.5% for 30 yrs.; up to 95% of after-rehab value, plus closing costs)		**$46,650**
<u>2nd Mortgage</u>: City Rehabilitation Loan (0% interest, due on sale/transfer)		**$15,100**
Total Project Financing		**$65,000**
LOAN TO VALUE RATIO (1st mortgage only)		
Mortgage Amount	$46,650	**74%**
Estimated After-rehabilitation Value	$63,000	
MONTHLY COST TO BUYER (PITI)		
1st Mortgage	$358.70	
2nd Mortgage	$ 0.00	
Taxes and Insurance	$110.00	
Total		**$468.70**
REQUIRED ANNUAL INCOME (PITI of 30% of Annual Income)		**$18,748**

Assuming that 30 percent of gross income is an affordable household contribution to housing costs (principal, interest, taxes, and insurance), this transaction would require an annual income of $18,748 -- within the city's targeted income range. In addition, a household with this income would meet the lender's underwriting standard limiting housing expense to 30 percent of monthly income. The lender's second underwriting ratio of total monthly debt payments to gross income would have to be reviewed as well before making a final affordability determination.

RECAPTURE RESTRICTIONS

Under the recapture option, Stoneybrook would be obligated to recapture its HOME subsidy if a homebuyer sold during the assisted home's affordability period. With an expected HOME subsidy of $15,000 to $27,000, the affordability period would run ten years in most, if not all, cases. The home probably would not appreciate significantly during the affordability period.

As part of the program design process, city staff decided to evaluate the impact on the average buyer of three recapture options for the second mortgage. While the city wanted repayment of its HOME subsidy, it also was concerned about the homeowner's investment. Given the conditions in the neighborhood and the likely changes in the value of housing, the Stoneybrook staff was concerned that homebuyers would not be willing to invest their own money if the city insisted on receiving repayment of all the HOME funds at the time of resale. Some program planners wanted a policy that would forgive the HOME investment each year during the period of affordability. Other staffers suggested a proportional distribution of the net proceeds. To evaluate the impact of these policies, the city decided to examine what would happen if the typical property was sold at the end of the fifth year, assuming no forgiveness, forgiveness over a ten-year period, and proportional distribution.

City staff estimated that the typical home described in the example could be resold in five years for $64,500, a slight increase from the original after-rehabilitation value of $63,000. The staff looked at three scenarios to examine the estimated repayment of the second mortgage to the HOME program, and the return to the homebuyer. In each of these scenarios, the down payment assistance of $1,300 was forgiven over the ten-year affordability period.

- <u>Scenario 1 -- No Forgiveness</u>: The HOME second mortgage would be due on sale if the sale occurs before year ten.

- <u>Scenario 2 -- Forgiveness</u>: The HOME second mortgage would be forgiven one-tenth for each of ten years and the balance would be due on sale.

- <u>Scenario 3 -- Proportional Return</u>: Net proceeds would be distributed proportionately to the HOME program and the owner at the time of sale.

As Figure 6-2 shows, in all three scenarios, any excess proceeds would be split equally between the PJ and the homeowner.

Figure 6-2

Three Scenarios for Second Mortgage Repayment

	Scenario 1 No Forgiveness	**Scenario 2 Forgiveness**	**Scenario 3 Proportional Return**
Homeowner Investment:			
Downpayment	$1,950	$1,950	$1,950
Improvements	$1,500	$1,500	$1,500
Subtotal	$3,450	$3,450	$3,450
HOME Program Subsidy:			
Downpayment	$1,300	$1,300	$1,300
Amount Forgiven	($ 650)	($ 650)	($ 650)
Balance	$ 650	$ 650	$ 650
<u>Second Mortgage</u>*	$15,100	$15,100	$15,100
Amount Forgiven	$ 0	($7,550)	$ 0
Balance	$15,100	$7,550	$15,100
HOME Subsidy Recapture Amount:	$15,750	$8,200	$15,750
Combined Total Investment	**$19,200**	**$11,650**	**$19,200**
Net Proceeds:			
Sale Price	$64,500	$64,500	$64,500
(Payout to Lender)	$44,546	$44,546	$44,546
(Closing Costs)	($2,000)	($2,000)	($2,000)
Net Proceeds	$17,954	$17,954	$17,954
Distribution of Net Proceeds:			
To HOME	$15,750	$8,200	$14,728 (82%)
To Homeowner	$ 2,204	$3,450	$ 3,232 (18%)
Excess Proceeds:	$ 0	$6,304**	$ 0
Total HOME Recapture:	**$15,750**	**$11,352**	**$14,728**

* *No interest, due on sale.*

** *Shared equally between the PJ and the homeowner.*

HOME program staff reviewed the above analysis and created a program design based on the second scenario: forgiveness of one-tenth of the HOME subsidy for each year of the affordability period that the homeowner occupies the property to provide an incentive for remaining in the property. They selected this option because it appeared to provide the best balance of returns to the owner and the HOME program. Each participant in the program receives a fair return and a chance to share in the appreciation of the property over time. This scenario provides an incentive to maintain ownership over time and yet offers a fair return to the original purchaser when a sale finally occurs.

SUMMARY

Stoneybrook used the recapture option to develop a workable purchase-rehabilitation program. The program design allowed the city to target the income groups and geographic areas to best fulfill its program objectives. Working with private lenders, Stoneybrook developed a partnership that met the needs of both lenders and homebuyers.

The recapture option provided sufficient flexibility in property selection to address city-wide housing needs. The resale option, with its affordability tied to the same house, would not have met this objective as easily. If home prices continued to increase, Stoneybrook could eventually change its recapture option, or discontinue forgiveness of the HOME subsidy.

FARMINGTON: IMPLEMENTING THE RESALE OPTION

PROGRAM ENVIRONMENT AND OBJECTIVES

Farmington's purchase-rehabilitation homebuyer program grew from the city's commitment to its well-defined older neighborhoods. These areas had an aging housing stock that remained attractive to younger buyers. Though some housing had declined in quality as older and absentee homeowners deferred maintenance, the overall market remained strong as more affluent families bought and repaired these homes. While older neighborhoods remained below the city's average, housing prices in most of these older neighborhoods were steadily increasing. The city's goal was to preserve the existing economic and cultural mix, while providing opportunities for less affluent households to become homeowners.

Since the first-time homebuyer requirement was eliminated from the HOME Program guidelines, the city decided to open its program to any low-income household interested in purchasing in any of three targeted older neighborhoods. These neighborhoods contained a mix of single- and multi-family properties. Single-family homes ranged in cost from well above the city average to well below. Most home prices where appreciating faster than incomes. As a result of speculation, some homes on the market in need of moderate repairs were priced unreasonably high.

Once the three target neighborhoods were selected, community leaders suggested that the city's housing department facilitate the process of acquisition and rehabilitation. Farmington's housing department has been actively involved in numerous federal housing rehabilitation programs and several local community reinvestment programs initiated by local lenders for first-time homebuyers. Program administrators felt confident that they could manage the new HOME Program as part of their ongoing commitment to affordable housing and targeted reinvestment.

The city agreed to acquire and rehabilitate properties in these targeted neighborhoods and to resell them to eligible buyers. It also agreed to make the homes affordable by providing a subsidy to qualifying buyers. With only limited resources, the city realized the need to strike a balance between serving the lowest income families possible and helping the largest number of households. Therefore, the city chose to purchase a variety of houses, and to provide down payment assistance and forgivable second mortgages to a wide range of buyers, in conjunction with the permanent financing offered by Farmington's private lenders.

DEFINING THE PROGRAM

After further deliberation with neighborhood leaders, city housing officials agreed that the purchase-rehabilitation program should acquire homes to serve households earning up to 80 percent of the area median. No lower income limit was set, but qualifying households were limited to purchasing homes requiring no more than 30 percent of their income for PITI payments.

Not wanting to limit its options in the selection of appropriately priced homes, the city set the program's maximum after-rehabilitation value for homes it purchased at HOME's maximum value. In Farmington, the price was $104,500, 95 percent of the median sales price for the jurisdiction. However, most home sales in the target area ranged from $75,000 - $90,000.

Each home acquired and rehabilitated for resale would be offered to eligible buyers on the basis of affordability and the purchase subsidy provided. Eligible households also would have to meet basic credit standards. To reach those earning below 60 percent of median income, the city agreed to provide these households one-half of their closing costs, and to work with the buyer and the lender to resolve any debt or credit problems.

Determining the Purchase Subsidy

Balancing its desire to assist very low-income households with the goal of serving as many households as possible, the city determined that it would provide a maximum subsidy of the lesser of 20 percent of the selling price or $15,000. This amount would be sufficient to allow a household earning 75 percent of the median income to purchase a home costing $86,500, the average sale price for the target area.

A check of recent home sales in Farmington determined that the average interest rate was 9 percent for 30-year fixed mortgages. Projecting a monthly average of $100 for taxes and insurance, the city calculated a required income of $31,840, or 88 percent of median income, to purchase a home costing $86,500 in the target area. Making this home affordable to a household earning 75 percent of median income would require a purchase subsidy of $15,000, based upon a housing expenditure of 30 percent of income as, follows in Figure 6-3:

Figure 6-3

Purchase Subsidy and Affordability

Annual Income (75% of $36,000 median)	$27,000
Available for Housing (30% of monthly income)	$675
Projected Taxes and Insurance	($100)
Available for Principal and Interest Payment	$575
Affordable Mortgage Amount (9% loan for 30 years)	$71,500
HOME Purchase Subsidy (0% Interest, Deferred Payment Forgivable Loan)	$15,000
Affordable Purchase Price with Subsidy	$86,500

Defining Qualifying Incomes and Purchase Prices

With an 80 percent-of-area-median upper income limit and a subsidy of up to the lesser of $15,000 or 20 percent of the sales price, HOME administrators were able to match each house they would purchase with a qualifying buyer. The matching process was based upon 30 percent of the buyer's income and prevailing interest rates. The following table illustrates the income required to afford variously priced housing using these assumptions.

Figure 6-4

Affordable Purchase Price Based Upon Qualifying Income and HOME Subsidy

Purchase Price*	Qualifying Income	Percent of Median Income
$92,000	$28,800	80%
$86,500	$27,000	75%
$75,300	$23,400	65%

* Assuming 9%, 30-year first mortgage, $100 in monthly taxes and insurance and $15,000 purchase subsidy.

With the $15,000 HOME subsidy, a buyer could purchase a home costing up to the maximum affordable purchase price (see Figure 6-4). If the purchase price of a particular home was less than the maximum affordable purchase price for a particular household, the subsidy would be reduced accordingly to maintain affordability at 30 percent of that buyer's income. As an example, if a household at 80 percent of median income purchased a home selling for $86,500, the purchase subsidy would be $9,500 rather than $15,000, based upon that household's income and ability to afford a $77,000 first mortgage, as follows in Figure 6-5:

Figure 6-5

Purchase Subsidies at Different Median Incomes

80% Median Income		75% Median Income	
Purchase Price	$86,500	Purchase Price	$86,500
Affordable Mortgage Amount (9%, 30-year)	($77,000)	Affordable Mortgage Amount (9%, 30-year)	($71,500)
Purchase Subsidy	$9,500	Purchase Subsidy	$15,000

SELECTING HOMEBUYERS AND PROPERTIES

After discussing the merits of the new homebuyer program with lenders, community leaders, and potential buyers, the city decided it would handle the match of qualified buyers and affordable housing in-house. The city's housing department established an intake process that placed qualified buyers on a waiting list according to the price they could afford to pay. As homes became available for sale at that or a lower price, each qualifying applicant would be offered the opportunity to purchase a suitable home, based upon their eligibility profile and the date of their application approval. The city would reserve the right to make the final selection from all qualifying applicants interested in each house offered for sale, based upon such factors as the household's income and debts, credit rating, and family size.

To further guarantee the original sale and ensure a continuing supply of affordable housing, the city agreed to repurchase any home originally sold to a qualifying buyer if, at the time of resale, the home remained unsold after 180 days on the market. This would help ensure that homes selected for the program were perceived as marketable, which was especially important given the city's commitment and exposure. In fact, the city considered numerous factors in selecting properties, including:

- acquisition and rehabilitation costs,
- property value after rehabilitation,
- property characteristics and environmental factors, and
- qualifying incomes necessary to purchase the home.

FINANCING

Farmington's housing department geared up to acquire the first five homes for purchase and rehabilitation under the city's new homebuyer program. Funds for acquisition and rehabilitation came from the city's annual HOME allocation. The city offered the homes for sale after rehabilitation at fair market value, based upon an appraisal and a maximum $15,000 HOME subsidy. The city also committed to funding one-half of the closing costs for households earning under 60 percent of the median income.

For their part, Farmington's lenders committed to offering 30-year first mortgages at prevailing mortgage rates with no mortgage insurance requirement. Since the city's HOME subsidy effectively reduced the loan-to-value ratio to approximately 80 percent, lenders did not require a down payment. Closing costs, including prepaid expenses, were capped at $2,500 and would be paid by the homebuyer. Both the city and lenders felt this to be an important contribution from the homebuyer, given the elimination of the down payment requirement. The lenders also agreed to allow subsequent qualified buyers to assume this mortgage during the remaining amortization period with no assumption fee.

The city's subsidy would be subordinated to the first mortgage loan as a ten-year, no-interest forgivable mortgage. Total debt would be due and payable upon resale or assignable to the new buyer during the affordability period. The entire debt would be forgiven at the end of the affordability period. Under HOME regulations, this debt would be also be forgiven in the event of foreclosure.

Figure 6-6 details a typical transaction for a house acquired and rehabilitated with no development subsidy, and then sold to a household earning 65 percent of median income at the maximum affordable purchase price.

Figure 6-6

Typical Transaction Without Development Subsidy

PURCHASE PRICE

City's Acquisition Price	$55,000	
Rehabilitation Cost	$20,300	
Total Acquisition and Rehabilitation		$75,300
Fair Market Value/Sale Price After Rehabilitation		**$75,300**

HOME SUBSIDY

Development Subsidy	($ 0)	
Purchase Subsidy	($15,000)	
Total HOME Subsidy		**$15,000**

HOMEBUYER INVESTMENT

Closing Costs	$2,000	
Total Homebuyer Investment		**$2,000**

FINANCING

1st Mortgage:	Private Lender Financing (80% LTV @ 9% for 30 yrs.)		**$60,300**
2nd Mortgage:	City Purchase Subsidy Loan (Forgivable, No-Interest, 15 yrs.)		**$15,000**
Total Project Financing			**$75,300**
MONTHLY COST TO BUYER (PITI) 1st Mortgage 2nd Mortgage Taxes and Insurance		$ 485.19 Deferred $ 100.00	
Total			**$ 585.19**
REQUIRED ANNUAL INCOME (PITI of 30% of Annual Income)			**$23,408**

RESALE RESTRICTIONS

In selecting the resale option, Farmington gave thoughtful attention to both affordability and fair return. This impacted design of the program documents relating to property selection, owner assistance, and resale. The program's homebuyer agreement became an important tool to communicate overall program requirements to the buyer and to declare the conditions of use and occupancy. The city treated these provisions as covenants running with the land and placed them into their deeds of conveyance. The program's second mortgage also reflected these restrictions on resale and return.

Fair Return

In providing a deferred payment forgivable loan, Farmington gave owners a strong incentive to keep their homes through the affordability period. With housing prices projected to keep rising, the resale option was considered critical to maintaining long-term affordability. While not wanting to encourage resale, Farmington also recognized its obligation to provide a fair return to an owner who decided to sell during the property's affordability period.

Since the HOME subsidy would provide an owner the opportunity to purchase a home otherwise unaffordable, the city felt that a fair return should be limited to the owner's contribution to closing costs, return of principal, and improvements made to the property, less any rehabilitation necessary to meet code standards at the time of resale. By agreeing to return virtually all of the owner's investment at resale, the city would essentially provide the owner high-quality housing at a lower cost than renting. In addition, the resale option required the city to make homes affordable for subsequent purchasers. The city also wanted to give owners a strong incentive to remain in occupancy during the affordability period. For these reasons, the city decided not to share any appreciation with owners selling during the affordability period. The city deemed this return to be fair to the owner.

Figure 6-7 describes the resale of the house described in Figure 6-6 during the home's ten-year affordability period. The owner had not made any improvements to the house, nor had any major code violations been found upon inspection by the city. The owner's original contribution to closing costs was $2,000, and return to principal totaled $1,000. The owner's total return was $3,000.

Figure 6-7

Calculating a Fair Return

Closing Costs	$2,000
Improvements	$ 0
Necessary Repairs	($ 0)
Principal Repayment	$1,000
Owner's Return	$3,000

Resale Price

To provide for a fair return while promoting affordability, the city established an allowable resale price during the affordability period. That price would be the lesser of the property's appraised fair market value at the time of resale or the repayment of outstanding debt plus the owner's return. The owner's return is defined as the return of the owner's closing costs, principal, and improvement costs, less any repairs required to meet code or HUD's Housing Quality Standards at the time of resale. In the example in Figure 6-8, the new appraised value of the property is $80,000. Since the debt repayment plus the owner's return is $77,300, the new sales price is set at $77,300.

Figure 6-8

Calculating the Resale Price

Market Value		**Debt Plus Return**	
Appraised Market Value at Resale	$80,000	Debt Repayment * *$59,300 Loan Balance ($60,300 - $1,000) $15,000 Deferred Loan*	*$74,30 0
		Owner's Return	$ 3,000
Total Resale Price	$80,000		$77,300

Distributing Resale Proceeds

The proceeds of sale are based upon the established resale price. Proceeds in the amount of the deferred loan, which would be assumed by the new buyer as described in Figure 6-9 below, would be applied to the owner's return or returned to the city's homebuyer program, depending upon the established resale price and the new buyer's income. After repayment of the remaining balance of the first mortgage, the owner's closing cost contribution, principal repayment, and property improvements (if any) would be disbursed.

Figure 6-9

Resale Proceeds

Resale Price	$77,300
Remaining First Mortgage Balance	$59,300
Deferred Loan Repayment (assumable)	$15,000
Repayment of Owner's Contribution	
Closing Costs	$ 2,000
Property Improvements Less Repairs	$ 0
Principal	$ 1,000
Total	$ 3,000
Total Proceeds	$77,300

Affordability

In creating its assistance package, Farmington based its initial calculation of affordability upon a $15,000 maximum subsidy. This subsidy was sufficient to allow a household earning 75 percent of the area median income to purchase a home costing the target area's average sale price. Households earning more or less were matched with more or less expensive houses according to their income and their required subsidy.

For purposes of resale, the city also chose to consider the income of each purchaser relative to actual housing costs (principal, interest, taxes, and insurance) and to ensure that each property remained affordable to the buyer, based upon an expenditure of no more than 30 percent of monthly income. Upon resale, the city would recalculate its contribution to the new buyer based upon the new sales price, and provide additional subsidies as required.

In the example in Figure 6-9, the new purchaser financing would be based initially upon a sales price to the new buyer of $77,300. This price could be altered by the city's contribution of additional HOME subsidies to the new buyer, depending upon the fair market value of the property at the time of resale and the new buyer's income.

In developing its HOME subsidy, the city structured its deferred payment loans so that they could be assumed by the new buyer either through a purchase option executed by the city or by direct sale to the new buyer. In cases where the city acquired a property that had remained on the market beyond 180 days, the city would re-issue the loan according to the financial needs of the new purchaser at the time of resale.

In the example in Figure 6-10, the owner of the house described above chose to sell during the affordability period. While the fair market value rose to $80,000, the resale price established by the city was $77,300. Interest rates had remained at 9 percent, and 30-year financing was still available.

Using this interest rate and attributing 30 percent of income to housing costs, the city determined that the new buyer of this home must earn $24,040 and receive the $15,000 subsidy to purchase the property at $77,300. This compares to the original income requirement of $23,400.

Figure 6-10

Maintaining Resale Affordability

Fair Market Value	$80,000
Purchase Price	$77,300
Purchase Subsidy	$15,000
Due from Buyer	$62,300
Monthly Cost to Buyer	
1st Mortgage	$ 501
Taxes and Insurance	$ 100
Deferred 2nd Mortgage	$ 0
Total	$ 601
Required Annual Income	$24,040

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SUMMARY

The demand and resulting price for housing in several of Farmington's neighborhoods had been escalating, making homeownership increasingly unaffordable for low-income households. Farmington's leaders felt comfortable targeting the city's homebuyer program geographically, while broadly defining homebuyer eligibility to include a diverse population of low-income owners and renters. The city's housing department was well equipped to deal with acquisition and rehabilitation, and lenders limited their fees in recognition of the relatively low risk of making their loans after rehabilitation had been completed.

While the city made a major commitment to meet the gap in affordability for low-income buyers through contributions to closing costs and development and purchase subsidies, its selection of the resale option provided an appropriate vehicle both to secure affordability for future buyers and to provide sellers with a fair return. The resale option, by controlling the sale prices of properties during the affordability period, would ensure that HOME-assisted properties remained within reach for low-income families into the future.