Fitting the Pieces Together:

Using Public and Private Financing Tools with HOME-Assisted Homebuyer Programs

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Foreword

A growing number of states and local jurisdictions have been using affordable housing funds to provide direct assistance to help low-income residents achieve the American dream: owning their own home. The many benefits of homeownership have long been recognized. In addition to the benefits to individual families, homeownership helps build stronger and more stable communities. Homebuyer programs are a relatively simple and cost-effective way to increase the housing choices of low-income Americans.

The U.S. Department of Housing and Urban Development supports the goal of homeownership for low-income residents. With funds provided by the HOME Investment Partnerships Program, states and local jurisdictions have the resources and flexibility they require to design homebuyer programs to meet their specific local housing needs. The American Dream Downpayment Assistance Initiative provides an additional funding source to help low-income households purchase their first home.

The most effective homebuyer programs operate in a full public/private partnership. Participating jurisdictions know the participants in the housing industry, understand their motivations and organizational needs, and tailor their involvement in ways that are mutually beneficial. This publication, *Fitting the Pieces Together: Using Public and Private Financing Tools with HOME-Assisted Homebuyer Programs*, provides a road map for HOME Program staff to understand the ins and outs of home purchase lending, and thereby gain the maximum benefit from this valuable resource.

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Introduction:

Joining Forces with Mortgage Lenders

Over the past ten years HOME participating jurisdictions (PJs) have devoted increasing portions of their HOME Program funds to homebuyer activities. This increasing emphasis on homeownership has been encouraged in part by research documenting the many benefits low-income families derive from owning their own homes. At the operational level, advances in the mortgage marketplace have facilitated the increase in HOME assistance for affordable homeownership. As lenders have developed tools to better understand the needs of low-income borrowers and evaluate risk, new lending products have been tested and the viability of the affordable homeownership market has been amply demonstrated. How should a PJ get started on re-designing a homebuyer program to synchronize it with the operations of the private mortgage market?

To build a successful partnership with private lenders requires understanding the clients to be served and their home buying needs. A PJ with an affordable homeownership program acts as a kind of broker, bringing together lenders who want business and families who need homes. The PJ has to define the target population the program is designed to assist, and then determine what form of HOME assistance will best serve the population's needs. The PJ needs to know what is keeping potential homebuyers from obtaining mortgages in the conventional market by answering the following questions:

- Are high prices the primary reason clients cannot afford a standard mortgage?
- Do clients have significant credit problems?
- Can these problems be addressed through counseling, and if so, what kind?
- Do potential buyers have a steady stream of income, but simply lack downpayment funds?
- Do potential buyers lack the knowledge to find an affordable home?
- What program delivery method will best meet these needs?

PJs with a clear understanding of the home buying hurdles faced by their target populations will have a good foundation for initiating conversations with potential lenders.

PJs should do their homework to determine which lenders can best help meet these affordable housing needs. PJs should remember that they are not shopping for just any lender, but are looking for a partner, an organization interested in accomplishing similar goals. PJs can quickly research local lenders and the loan products they offer. It may take a little longer to understand lenders' level of interest in serving disadvantaged people or communities. PJs might want to learn if the institution has participated in other homebuyer programs, either locally or nationally, or whether it has received favorable Community Reinvestment Act ratings. To discover signs of flexibility that could benefit low-income borrowers, PJs should evaluate how the lender does business, whether it services the loans it originates, and how it underwrites loans. In addition to identifying lending partners, the PJ needs to plan for homebuyer education and counseling by identifying what entities are available to provide these services, and what funding is available to pay for them.

After potential partners are identified, program design can begin. While HOME allows PJs a great deal of latitude to design programs to meet local needs, PJs need to be clear with their partners that certain regulatory requirements, as outlined in Chapter 2, are not negotiable, and certain monitoring responsibilities cannot be delegated. Likewise, PJs should keep in mind that lenders are risk-averse and profit-motivated. Knowing and articulating the business incentives for lenders to be involved in homebuyer programs will support an effective partnership. PJs should think about what aspects of their intended programs might appeal to potential lenders, and look for points they can "sell" to the lending institution. Is the institution a local organization that wants to expand its market, perhaps in communities that are underserved? Or is the lender a national organization that needs to strengthen its ties to a local community? PJs need to present lenders with the key advantage that HOME support brings to a program: the ability to expand markets while responsibly managing risk.

This guide will explore and explain these issues in the following five chapters:

Chapter 1 introduces the major resources for mortgage lending and explains the considerations of industry participants when they provide financing. Chapter 1 discusses related services PJs should be aware of, including homebuyer counseling programs, loan servicing, and the growth of the subprime lending industry. Predatory lending practices are also outlined in this chapter.

Chapter 2 reviews key regulatory issues involved in structuring HOME funds for homebuyer programs. It details eligible activities, income requirements, long-term affordability provisions, PJ monitoring responsibilities, and how those requirements might affect lender practices.

Chapter 3 explains the major elements of loan origination and underwriting and discusses how PJs can reduce costs or obtain better terms for eligible homebuyers. This chapter describes how lenders evaluate credit, collateral, and a borrower's ability to pay, and how origination fees and closing costs are structured. It also presents a variety of techniques PJs can use to provide loans, subsidies, and guarantees to reduce borrowers' costs.

Chapter 4 provides an overview of loan servicing practices, with a focus on how loan servicing techniques can meet the needs of low-income borrowers. This chapter discusses technological advancements that may make servicing more responsive to mortgage delinquencies, and addresses PJ responsibilities during the affordability period, including cases of foreclosure.

Chapter 5 concludes this publication with advice for building partnerships with lenders, including identifying characteristics to consider in assessing potential partners and leveraging the HOME Program's advantages to negotiate the best deals. This chapter discusses partners' roles, different ways to structure a homebuyer program, and how to partner with lenders to provide counseling. The chapter also contains information on homebuyer programs that may be unusual for private lenders, including land trusts and manufactured housing.

Chapter 1:

What HOME Staff Need to Know About Private and Public Financing of Homebuyer Housing

Chapter 1 describes private and public tools available to finance HOME-assisted homebuyer housing, with a focus on the practices, motivations, and institutions that matter most to quality design and administration of HOME programs.

Overview: Basic Roles of Primary and Secondary Mortgage Market Institutions

The mortgage lending process begins with a borrower, a house, and a lender or "loan originator." These are the elements of the primary mortgage market. Primary lenders fall into different categories, including banks, thrifts, and mortgage bankers, but their similarities outweigh their differences. It used to be that originating primary lenders typically held mortgages as long-term assets for their portfolios. They usually handled the collection of monthly mortgage payments and processed delinquencies and foreclosures, too.

In today's mortgage business, most originators act as middlemen, originating loans for sale to secondary market investors like the Federal National Mortgage Association (Fannie Mae), Government National Mortgage Association (Ginnie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). Secondary market investors specialize in attracting capital from a wide range of sources around the globe into the home mortgage market, which helps to reduce the cost of mortgage funds to the consumer. Lenders pay close attention to secondary market loan requirements even for loans they plan to keep as portfolio assets. Doing so preserves their ability to sell loans later on.

Loan collection or servicing is a major source of revenue for primary mortgage lenders, not simply a routine footnote to the lending process. The typical servicing fee of 0.37 percent of loan balance adds up to a sizeable, low-risk stream of revenue when applied to large volumes of mortgages. Lenders who sell loans may or may not sell servicing rights along with them.

What Do Primary Lenders Look For?

Regardless of whether loans will be retained or sold, the main responsibility of a primary mortgage lender is to originate loans carefully so they perform as expected. Because loan pricing (interest rate) is based on expected loan performance, the primary lender's diligence is the foundation of mortgage lending profitability. Primary lenders analyze borrowers' willingness and ability to repay. They also evaluate the market value of the home being pledged as collateral for the loan.

When primary lenders originate loans for sale to a secondary market investor, they act as agents for the investor. The secondary market institution that will fund and hold the loan specifies detailed standards for key loan characteristics like these:

- Quality of borrower's credit;
- Monthly payment-to-income ratio;
- Type of housing (condominium, town home, manufactured home); and
- Ratio of loan amount to documented home value (loan-to-value ratio).

Even when they sell loans, primary lenders retain some risks. Secondary investors audit the loans they purchase, searching for flaws or guideline deviations. Primary lenders may be required to buy back such loans. In addition, secondary investors monitor the timely payment performance of loans, lender-by-lender. The terms of future loan purchases may be better or worse depending on the primary lender's track record.

What Do Secondary Market Investors Look For?

Uniformity is all-important to the secondary mortgage market. A very wide range of loan types is accommodated, but each type is clearly defined. Standard documents are used. Standardization facilitates accurate performance prediction, and allows the use of statistical sampling to control loan quality even at huge volumes. Standardization transforms diverse mortgage loans from many geographic areas into commodities that are readily understandable, and therefore tradable in the broad capital markets where investors like insurance companies and pension funds shop for investments. Often the secondary market institution "bundles" individual loans into a mortgage-backed security, usually with a guarantee to the investor that payments will be timely. Securitization further enhances the attractiveness of investing in mortgages.

Credit enhancement is the industry's term for strengthening an individual mortgage borrower's application with additional financial backing, typically in the form of insurance that protects the lender in the event the borrower defaults. Secondary investors specify the level and type of enhancement they require in order to make individual mortgage loans acceptable for purchase. Credit enhancement is almost always required on loans with less than a 20 percent down payment. Insurance providers are financially strong third parties like private mortgage insurance companies or government entities like the U.S. Department of Housing and Urban Development's (HUD's) Federal Housing Administration (FHA) and the U.S. Department of Agriculture's (USDA's) Rural Housing Service. Credit enhancement helps to define and limit how much an investor could actually lose in case of default. By reducing investor uncertainty about possible losses, credit enhancement is another tool for turning diverse mortgage loans into easily understandable commodities.

What Do Loan Servicers Look For?

For loan servicers, scale is the key to profitability. To facilitate automated processing, servicers seek uniform pools of loans with clearly defined servicing requirements, late fees, and work-out guidelines. Servicers compare the size of the annual servicing fee to their estimated time for carrying out servicing responsibilities. They look for higher fees on higher risk loans that will demand more attention.

Major Private Financial Resources for Mortgage Lending

Although there are many distinct sets of participants in the private mortgage industry, there are relatively few operational differences in how they evaluate borrowers and originate and service mortgages. By understanding how the market is organized, PJs will know how to spot the distinctions that matter for effective program design.

Mortgage Bankers

Mortgage bankers specialize in originating loans for sale to investors. They do not raise funds with savings or checking accounts; instead, they borrow short-term funds to originate and then hold loans pending sale. Mortgage bankers fund more than half of mortgage loans annually.1

Mortgage bankers usually have no asset portfolios. They rely on two basic sources of revenue: loan origination fees and loan servicing fees. Origination fees are charged to borrowers for the service of taking applications, evaluating them, and funding loans. Servicing fees are built into the loan interest rate. Mortgage bankers may opt to collect loan payments themselves, earning fees gradually over time, or they may sell the servicing rights to another party and realize the value of the fees up-front.

The mortgage banking business model means that mortgage bankers and secondary market investors rely on one another. Mortgage bankers cultivate a wide range of investors or “outlets” for their mortgages, so they can originate and sell loans of virtually any size or type. Major outlets include Fannie Mae, Freddie Mac, and Ginnie Mae, as well as wholly private mortgage investors who purchase “non-conforming” loans that are too large or otherwise unsuitable for government-sponsored investors.

Mortgage bankers are major customers for the mortgage insurance and guaranty programs of the FHA and the Veterans Administration (VA). They originate more than 80 percent of all loans covered by these credit enhancement programs. FHA and VA loans account for 25 percent of all mortgage banker originations.2

To the consumer, a mortgage banking institution is usually indistinguishable from a bank or thrift. Most major mortgage banking companies are owned by commercial banks, bank holding companies, or financial services firms.3

Mortgage Brokers

Brokers are independent marketing agents for wholesale mortgage lenders, including mortgage bankers. Typically organized as small businesses, each of the nation’s 30,000 mortgage brokerage companies markets loans for many different lenders. Brokers assemble loan application files for evaluation. They played a role in 55 percent of all loan originations in 2000. Brokers earn fees paid by borrowers and/or lenders.

Mortgage brokers used to specialize in marketing for subprime lenders, who specialize in making loans to borrowers whose credit quality or backup documentation are insufficient to qualify for prime lending rates. Brokers have broadened their services to include prime quality loans, too.

Brokers fill a particular niche in the highly segmented and specialized business of mortgage lending. Their strength is retail presence and marketing. Brokers enable loan wholesalers of all sizes to gain market presence quickly, without setting up offices or mounting a marketing campaign of their own. Brokers can help consumers navigate the application process, understand alternative loan types, and shop for a good rate.

Consumer Problems

Some brokers have caused problems with misleading marketing techniques. It is difficult for consumers to know whether a given broker is a neutral agent, representing various loan sources impartially, or whether the broker receives higher fees from particular institutions. Given that the broker’s fee can sometimes vary according to the consumer’s choice of a lender, the smart consumer retains responsibility for comparison shopping.

So-called “yield spread premiums” are a controversial form of broker compensation. In this system, brokers get a higher fee when borrowers accept a higher interest rate—sometimes unknowingly. Even seemingly negligible variations in loan interest rates can add up to real money over the long term of a typical mortgage. Comparison shopping with attention to the exact terms of competing programs is the consumer’s best strategy.

Commercial Banks

Commercial banks originate about one mortgage out of four, and are indirectly responsible for substantially more through their mortgage banking subsidiaries. Banks maintain large portfolios of assets, ranging from bonds to commercial loans to mortgage loans. This business model (portfolio lending) gives them the flexibility to decide whether to hold mortgage loans themselves, or sell them to secondary investors. If they sell, then their operation is subject to the same principles followed by mortgage bankers. On the other hand, if they retain loans, banks have the option of deviating from the standardized guidelines of secondary market investors. Often they choose not to deviate from them, in order to retain the ability to sell portfolio loans in the future.

Some banks use portfolio lending to serve the needs of customers who might have difficulty qualifying for reasonably priced secondary market programs. For example, self-employed borrowers could benefit from a bank's portfolio lending program. So could some first-time buyers whose credit, employment, or choice of home might not fit secondary guidelines. Often banks emphasize adjustable-rate loans in their portfolio lending, because adjusting the borrower's interest rate eliminates the need to match long-term fixed-rate loans with long-term fixed-rate deposits.

Banks sometimes originate special affordable, fixed-rate loans for low-income homebuyers for their own portfolios. Special terms may include high loan-to-value ratios, acceptance of subprime credit, or elimination of credit enhancement expenses and approval hurdles. Even though such portfolio loans may not meet secondary market standards at the time of origination, they can often be sold after a few years of good payment performance, known as "seasoning."

Thrift Institutions

Thrift institutions include mutual savings banks and savings and loans. In the past, thrifts were the primary homeownership loan source. They used funds from savings accounts paying regulated interest rates to originate long-term, fixed-rate home mortgage loans for their own portfolios. As competition for savings increased with the advent of unregulated money market funds that paid higher rates, thrifts ran into trouble during the 1980s. The culmination was the collapse and restructuring of the entire thrift industry. Thrifts participate in the mortgage business along the same lines as commercial banks. They originate some adjustable rate loans for their own portfolios, although these have been relatively unpopular given the low level of fixed interest rates. Overall, thrift institutions originate about 20 percent of mortgage loans.

Credit Unions

Credit unions originate a very small percentage of total mortgage loans, although their market share is trending upward. Virtually all credit unions with more than $50 million in total assets offer mortgage loans. Terms are similar to those of other mortgage market lenders, with an emphasis on member service.

Finance Companies

Finance companies specialize in mortgage lending to borrowers with subprime credit. The purpose of subprime lending and its associated benefits and risks are discussed in more detail later in this chapter.

Community Development Finance Institutions

Community development finance institutions comprise a small group of lenders specializing in community development lending. Some, but not all, originate mortgage loans. Leading examples of community development banks include the South Shore Bank in Chicago and Self-Help Credit Union in North Carolina.

Development finance institutions may be organized as for-profit or nonprofit organizations. Both South Shore and Self-Help combine regulated finance institutions with other development organizations within the structure of a single holding company.

The U.S. Treasury Department administers the Community Development Finance Institutions Fund to support development finance institutions. Additional information about this fund can be found at http://www.cdfifund.gov/.

For HOME PJs, community development finance institutions offer the advantage of like-minded partners with the expertise to help structure innovative mortgage loan programs. Their trade group is the National Community Capital Association, and additional information is available from their website at www.communitycapital.org.

Mortgage Industry Trends

Despite their different origins and designations, the various types of mortgage lenders now do business in much the same way. Increasing concentration is predicted for the mortgage industry, with one forecast calling for 90 percent of mortgage loans to be originated by just 25 firms in 2008.4 Specialization will increase as well, as specific functions like origination and servicing are located in discrete business units. Financial services companies are playing larger roles in the mortgage market. They will gain further momentum due to banking reform legislation enacted in the late 1990s.

Legislation that Leverages Private Support of Affordable Housing Lending

Two pieces of Federal legislation are notable for their impact on encouraging private sector support of community development and affordable housing lending, the Community Reinvestment Act and the Home Mortgage Disclosure Act.

Community Reinvestment Act

Enacted in 1977, the Community Reinvestment Act (CRA) prohibits lenders from “redlining” parts of their market areas and broadly requires them to offer equal access to financial services throughout the communities in which they are chartered to do business. CRA has been a source of real clout for housing and community development advocates over the years, but CRA’s impact is constantly changing as Federal legislation and market trends transform the mortgage origination landscape.

CRA is enforced by a lender’s regulatory agency through scheduled and special examinations. Lender mergers or branch closings prompt these special examinations, and community groups frequently intervene when lenders petition for approval of such activities. Advocates try to assemble a persuasive case that lenders have not complied with CRA, or they explore how the proposed new configuration of the institution will impact low- and moderate-income people and neighborhoods. As a result, lenders sometimes make special commitments to lend for affordable housing and community development. Almost $400 billion has been committed through such agreements.

The rigor of CRA lender exams increased in the early 1990s, as lenders were scrutinized on new objective measures such as the number and percentage of loans, investments, and branches reaching low- and moderate-income communities. CRA is credited with having supported the expansion of major lenders into the low- and moderate-income market during this period.

During the1990s, lenders who were not subject to CRA originated an increasing share of mortgage loans. This has been especially true in the booming subprime mortgage market. The landmark Gramm-Leach-Bliley Act (1999) also exempted some key lending institutions from CRA, for example, mortgage company affiliates of banks. The legislation made a passing CRA grade a critical requirement for institutions wishing to merge with insurance companies and securities firms.

Ten years ago, as many as 10 percent of banks failed their CRA exams. Grades are higher today. Virtually all large banks and 98 percent of small banks now receive passing grades. For many institutions, compliance reviews have become less frequent. The small lenders that comprise about 80 percent of all banks and thrifts are now examined for CRA compliance every four or five years.

Home Mortgage Disclosure Act

The Home Mortgage Disclosure Act (HMDA) requires lenders to report loan data that helps establish whether financial institutions are serving the housing needs of their communities. The data can also reveal possible discriminatory lending patterns. Data includes the borrower's race, sex, income, and the basis for the lender's approval or denial of applications. The law applies to banks, savings associations, credit unions, and other mortgage lending institutions.

Using HMDA loan data, the Federal Financial Institutions Examination Council (FFIEC) creates reports on lending activities for each metropolitan area. These reports are made available to the public at www.ffiec.gov/hmda.

Major Public Financial Resources for Mortgage Lending

A number of public sector resources complement the private mortgage resources described earlier in this chapter. Public resources include both *mortgage products* such as mortgage insurance and *subsidy programs*.

Federal Mortgage Products

Perhaps the best known public mortgage products are the FHA's mortgage insurance programs. FHA insurance, including the 203(b) program for home purchase and the 203(k) program for purchase and rehabilitation, covers mortgage lender losses in the event of default. To use FHA insurance, borrowers work with a participating lender and pay an insurance premium, which can be financed through the mortgage. From the PJ's perspective, the key benefit of FHA programs is liberalized borrower qualification requirements, including reduced downpayments. There are no income limits, but HUD sets maximum mortgage amounts for various geographic areas. FHA mortgage limits are available on the HUD website at https://entp.hud.gov/idapp/html/hicostlook.cfm.

The USDA's Rural Housing Service (RHS) offers two mortgage products for low- and moderate-income borrowers in rural communities. The Section 502 Single Family Housing Loan Guarantee, much like FHA insurance, covers lender losses in the event of a default. No downpayment is required, and borrowers with annual household incomes up to 115 percent of the area median income are eligible. The maximum loan size is the same as for the FHA 203(b) program described above.

In the Section 502 Direct Housing Loan Program, RHS itself is the lender. Borrowers whose annual household incomes are below 80 percent of area median income are eligible, and are not required to make a downpayment. RHS offers slightly longer than average loan terms, typically 33 years, and subsidizes interest rates.

From the PJ's perspective, the key benefits of RHS programs are the no-downpayment option and the subsidized interest rates of the Direct Loan Program.

The U.S. Department of Veterans Affairs (VA) has a series of loan guaranty programs that provide benefits similar to those of FHA and the RHS guarantee.

> For more information on these Federal mortgage programs, visit the following websites:
>
> **FHA 203(b)**
> http://www.hud.gov/offices/hsg/sfh/ins/sfh203b.cfm
>
> **VA**
> http://www.homeloans.va.gov/
>
> **Rural Housing Service**
> http://www.rurdev.usda.gov/rhs/

The VA programs are available to veterans or qualified guardsmen. In most cases, no downpayment is required.

Mortgage Revenue Bonds and Mortgage Credit Certificates

In addition to state HOME funds, state and local housing finance agencies use mortgage revenue bonds (MRBs) and mortgage credit certificates (MCCs) to help first-time homebuyers.

Low-cost funds raised from tax-exempt mortgage bond investors are loaned to home buyers by private lenders, who then sell the loans to housing finance agencies. MRB loans are typically available for first-home purchases by households earning no more than 115 percent of median income, although agencies can choose to set a lower limit. From the PJ's perspective, MRB financing means an interest rate savings of about two percentage points below the market rate, and low downpayment requirements.

Housing finance agencies may also offer Mortgage Credit Certificates, which provide qualified first-time homebuyers with a Federal income tax credit that reduces net interest expense. MCCs help borrowers increase repayment capacity and qualify for a larger mortgage.

Local Resources

Many local governments have devoted locally generated resources to affordable homeownership. Examples include issuance of general obligation bonds, incentive zoning for higher density, rebates of permit and hookup fees, and on-going housing trust funds. Locally generated resources can be more flexible and accessible than state and Federal funds.

Federal Subsidy Resources

Many different subsidy resources can complement HOME assistance. Two of the more prominent Federal resources are HUD's Community Development Block Grants (CDBG) and the Federal Home Loan Bank System's Affordable Housing Program (AHP). The CDBG program is a block grant provided from HUD to states and localities. It can be used for a number of community development purposes including homebuyer closing costs, interest subsidy, and downpayment assistance. Assisted households must generally have incomes at or below 80 percent of the area median income. Affordable Housing Program funds provide an extremely flexible housing subsidy. Funds are awarded competitively through member banks of the Federal Home Loan Bank system. Borrower income may not exceed 80 percent of the area median income as determined by HUD, and successful applications frequently target lower income buyers.

These programs deliver subsidies that can dramatically increase affordability. When combining these sources with HOME funds, PJs will need to be sure their program design complies with the rules of both programs.

Secondary Market Institutions

Mainstream Secondary Market Institutions

As explained earlier in this chapter, lenders often sell mortgages to investors in what is called the secondary mortgage market. By far the two largest secondary market entities are the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, known universally as Fannie Mae and Freddie Mac. These publicly chartered but privately owned enterprises purchase mortgages from lenders and either hold them in portfolio, or bundle them into securities for resale to investors. A third government-sponsored enterprise, the Government National Mortgage Association (Ginnie Mae), acts as a guarantor for securities backed by loans insured or guaranteed by FHA, VA, or RHS.

From the PJ's perspective, the government-sponsored enterprises (GSEs) are important because of their gigantic scale (they financed over $564 billion in 1999), which allows them to set many of the standards that are generally accepted by the modern mortgage market. They also innovate a wide range of special programs for affordable housing, and hire expert staff that can serve as resources for PJ program design.

Alternative Secondary Market Institutions

In addition to the GSEs, there are many alternative secondary market investors. Some are private entities and some have a public purpose. One of the largest is the Community Advantage program, a collaboration between the Self-Help Credit Union, Fannie Mae, and the Ford Foundation. The Community Advantage Program has purchased 20,000 loans as of 2001. Other examples include Neighborhood Housing Services of America, which buys loans from the Neighborhood Housing Services Network; the Community Development Trust, a public purpose real estate investment trust (REIT) that purchases debt as one of its activities; and the Community Reinvestment Fund (CRF) which has purchased more than 1,200 development loans totaling more than $220 million. These secondary market alternatives are of interest to PJs because they generally can offer more liberal underwriting standards than those available from the GSEs.

How Can Primary and Secondary Lenders Benefit HOME-Assisted Borrowers?

In an effort to expand markets and sustain profitability, primary lenders have developed numerous flexible programs, many of which are suitable for borrowers in HOME-eligible income ranges. Publicly-chartered GSEs have been instrumental in supporting this expansion as a means to increase the nation's homeownership rate, particularly among minorities and immigrants.

For example, primary lenders have developed portfolio programs that can accept less-standardized loans and documentation than the secondary market requires. By holding loans in portfolio and retaining all of the credit risk, lenders are free to offer underwriting flexibility. Examples include accepting rent receipts in lieu of credit reports for applicants with limited credit histories, or accepting low credit scores. Once these loans are seasoned, they can be sold on the secondary market to investors like the Community Advantage program described above.

Primary lender portfolio programs are limited in scale by a finite supply of loan capital. In contrast, Fannie Mae and Freddie Mac are linked to national and global capital markets, meaning that their supply of mortgage capital is essentially unlimited. For primary lenders, the benefits of Fannie Mae and Freddie Mac are access to capital and the ability to transfer interest and repayment risk.

In exchange for the benefits they receive from their GSE status, Fannie Mae and Freddie Mac must achieve affordable lending goals set by the HUD Secretary. These include targets for lending to low- and moderate-income households. Motivated by these goals, as well as by a profit-motivated desire to expand the range of borrowers they can serve, Fannie Mae and Freddie Mac have developed a range of affordable loan products that PJs should be aware of. These affordable lending products permit higher house payment-to-income ratios, lower downpayments, flexible credit standards, and clear procedures for accommodating second mortgages from sources such as HOME funds. Both Fannie Mae and Freddie Mac support homebuyer education initiatives. Their regional and state office staff can structure targeted lending initiatives.

Subprime Lending

Interest rates on subprime loans are higher than the lowest or "prime" interest rates. Subprime loans are intended to serve borrowers who cannot qualify for the best rates, usually due to credit problems.

Responsible subprime lenders charge extra interest in proportion to the additional risk they assume. However, subprime lending is not always conducted responsibly. Severe abuses that have systematically victimized low-income borrowers have earned the label of "predatory" lending.

Subprime interest rates are typically three to four percentage points higher than conventional mortgage rates. Subprime loans typically charge higher processing fees too, and they are much more likely to include prepayment penalties than conventional prime interest rate loans.

The subprime market is concentrated in low-income and minority communities. Subprime loans are three times more likely to be made in low-income neighborhoods than in high-income areas, and they are five times more likely in African-American neighborhoods than in white neighborhoods.6 Even after controlling for income, African-American borrowers and people living in predominantly African-American neighborhoods are more likely to refinance their homes in the subprime market than are white borrowers, or borrowers living in white neighborhoods.

Recent Growth in the Subprime Lending Market

Subprime lending has grown explosively in the past decade as lending institutions have found ways to reach consumers who simply would not have been considered under conventional lending standards. Mortgage companies specializing in subprime loans increased their share of home purchase mortgages from one percent in 1993 to 13 percent in 2000. Banks have also become leading players in the subprime market.7 As of 2000, subprime lending accounted for six percent of all home purchase loans and 25 percent of refinancing loans.8

The vast majority of subprime lending (80 percent) is made for the purpose of refinancing. Subprime refinance increased by 890 percent between 1993 and 1998.9

Several factors have supported the rise of subprime lending. Rising levels of debt fueled consumer demand for a way to consolidate bills. Increased capital flows to the subprime credit market and successful marketing techniques drove loan volume.

Subprime Loan Performance

Research indicates that subprime mortgages are indeed riskier than conventional loans. Delinquencies in the subprime market averaged 13.5 percent, and loans in foreclosure averaged 2.6 percent during a recent 21-month period. Mortgage delinquency rates in the prime market averaged 2.8 percent, and fewer than one percent of loans were in foreclosure.10 Even when compared to FHA loans, which also carry a higher level of risk, the foreclosure rate for subprime loans is greater, nearly four times the FHA foreclosure rate.

The Impact of Foreclosure on Households and Neighborhoods

A home foreclosure is obviously a major setback for an individual household. When concentrated geographically, foreclosures can also have devastating impacts on neighborhoods. Because subprime lending is disproportionately concentrated in low-income and minority neighborhoods, these neighborhoods bear a higher risk of concentrated foreclosure. All too often the cycle of easy credit and foreclosure leads to clusters of abandoned homes, a downward spiral in property values, deferred maintenance, and eventually, blight.

Why Borrowers Choose Subprime Loans

A number of factors lead borrowers to subprime rather than conventional loans. The prime motivation is credit history. Irregular income or a shortage of up-front cash can also block a household's access to the prime market. Housing type is another factor. Although manufactured homes are a popular choice for low-and moderate- income households, conventional mortgage lenders and public finance programs are minor players, leaving this $15 billion market open for subprime lending specialists. A similar lack of competition from conventional sources at the neighborhood level can leave borrowers in minority or low-income areas with convenient subprime lending as their only loan option. Even where conventional institutions are present, lack of information about them and discomfort in dealing with them, can keep borrowers away.

Too many borrowers turn to the subprime market when they do not have to, sometimes in response to aggressive marketing. As a result, some well-qualified borrowers wind up paying high subprime interest rates and fees. Nearly 30 percent of subprime borrowers could have qualified for prime loan terms. Steering borrowers unnecessarily to subprime products is an abusive marketing practice.

Predatory Lending Practices

Subprime lending is not synonymous with predatory lending, although the two terms are often used interchangeably. When does subprime lending cross the line and become predatory? Predatory loans take advantage of a consumer's real or perceived lack of credit alternatives to charge excessive interest and fees, far beyond those needed to compensate for higher risk.

These are some key features of predatory lending:

- **Targeted Marketing Based on Characteristics Other Than Credit.** Marketing to a targeted audience is a common practice in most businesses. However, predatory lenders take this a step further, using market research on factors including race, age, and ethnicity to identify customers most vulnerable to abusive marketing. Predatory lenders often target elderly homeowners because they are more likely to have equity in their homes and have older homes in need of repair. This sets the stage for confusing marketing pitches. Loans often strip away equity with excessive up-front fees included in the financing.
- **Unreasonable and Unjustified Loan Terms.** While it is normal for higher-risk loans to be priced to protect a lender's profit margin, predatory loan marketers simply try to extract the maximum achievable rate. Excessive fees are charged and often financed for lump-sum insurance such as credit life,11 disability, unemployment, and health coverage. Loan prepayment penalties prevent the borrower from refinancing the high-rate loan. Others make repayment difficult or impossible, allowing the lender to foreclose on the property or to "rescue" the borrower with subsequent financing.
- **No-Benefit Refinancing.** Predatory lenders sometimes refinance loans such as zero-interest mortgages. In such transactions, only the lender benefits.
- **Asset-Based Lending.** Asset-based lending is the practice of originating loans on terms so lax that extremely high default rates are inevitable. Lenders benefit by selecting borrowers with substantial home equity collateral as targets for this tactic.
- **Fraudulent, Abusive, or Malicious Actions.** Fraudulent practices can range from high-pressured sales tactics to intentionally misrepresenting the loan's terms. As a result, homeowners may borrow more money than they need, or accept terms that block their ability to pay off the loan. A common abusive practice includes "flipping" loans, in which the loan originates at a standard rate but is repeatedly refinanced at higher rates with high up-front fees.12

Responsible subprime loans are priced based on the actual risk the borrower presents plus actual additional processing costs. For example, origination fees may justifiably be higher for subprime loans due to the additional effort required to underwrite them. However, when lenders exploit the opportunity to add surcharges because borrowers do not know they have alternatives, or in fact do not have alternatives, they cross the line into profiteering and predatory lending.

How HOME Can Deter Predatory Lending

Through mechanisms such as pre- and post-purchase homebuyer counseling, PJs can raise awareness of the dangers of predatory lending among low-income borrowers, who are the most likely targets.

The way HOME loans are structured can also help protect borrowers from predatory lending. Because most predatory loans are refinancings that target a homeowner's equity, PJ approval can be required in order to place a second or third lien on a HOME-assisted dwelling. PJs can also simply prohibit refinancing of low-interest rate HOME loans. With this approach PJs avoid the administrative burden of reviewing individual refinancing requests.

To fund general outreach and counseling efforts to deter predatory lending practices, PJs can use HOME administrative funds. However, if the outreach and counseling is targeted only to buyers or residents of HOME-assisted units, these costs can be funded from project soft costs.13

Buyer Education and Counseling

With their strong connections to nonprofit housing organizations, PJs are in a good position to broker the inclusion of buyer education and counseling in a homebuyer assistance program. Education and counseling programs for prospective and new homebuyers have become common features in affordable lending programs. The types of services available and the providers who deliver them are as varied as the local needs that they are intended to address. These services have long been recognized as an important means of guiding buyers through the complex and sometimes confusing process of buying a home. Today, education and counseling are increasingly available after a home purchase as well, to provide support and information that can prevent mortgage default.

Part of the appeal of education and counseling programs is the dual benefit they offer to buyers and lenders alike. Information and guidance are important for new homebuyers who may be unfamiliar with the buying process, lending practices and needs, and ownership responsibilities. But education and counseling are also valuable to help lenders reach out to new customers while minimizing risk, by ensuring that borrowers are prepared to own a home. Post-loan communication becomes even more important as subprime lending increases. Maintaining contact with borrowers over time can help them avoid pitfalls such as refinancing on predatory terms.

The following section outlines the major types of buyer education and counseling available, and who provides them. Recent findings on the effectiveness of education and counseling are also discussed.

What Are Homebuyer Education and Counseling?

Homebuyer education and counseling are two distinct activities, suitable for conveying different types of information.

Buyer education is a way to provide general information, often for buyers who do not need a great deal of assistance. It is typically taught from standardized curriculums designed for a range of audiences. Tools may include brochures, handbooks, or classroom-style presentations. Increasingly, homebuyer education is provided over the phone, although it loses effectiveness compared to in-person delivery. When used in pre-purchase situations, education covers topics such as understanding housing finance, selecting a real estate agent, evaluating a home's condition, negotiating a home purchase agreement, and avoiding mortgage default. Because of its general nature and its ability to reach a large number of people, education is usually less expensive to provide than one-to-one homebuyer counseling.

Homebuyer counseling may include education as a component, but it tends to be more tailored to the individual needs of participants. It is often provided in a one-on-one setting and takes place over a longer period of time, making it ideal for helping potential buyers address problems that require time and guidance to resolve. For example, improving credit history or establishing stable employment are challenges better suited to counseling support than classroom discussion. As counseling is usually the more intensive learning process of the two, it is also more expensive to provide.

Post-purchase education and counseling can also help to sustain homeownership over time. Key topics for post-purchase counseling are home maintenance, repair, and household budgeting. If borrowers fall behind on payments, default counseling is provided in conjunction with the loan servicing institution. Counseling may be required for obtaining payment deferral from the lender, known as "forbearance." Although intensive counseling can be expensive, lenders may find it more cost-effective than foreclosure.

Education and Counseling Providers

Many of the main participants in the financial industry have some level of involvement in providing counseling and education services. The following institutions are among the major providers and supporters.

- **Private Lenders.** Lenders are the most typical sponsors of homebuyer education services, usually in partnership with nonprofit organizations or other agencies that deliver them.
- **Nonprofit Organizations.** Nonprofits are major providers of both education and counseling, and are particularly prominent in providing pre-purchase counseling. Nonprofits also form partnerships with other organizations to deliver services, acting as a link between clients and lenders, and helping the lending industry reach underserved markets.
- **Government-Sponsored Secondary Mortgage Enterprises.** When government- sponsored enterprises purchase affordable mortgage products from lenders, they often require that borrowers receive some sort of education or counseling. They have traditionally provided workbooks and teaching materials.
- **Mortgage Insurance Companies.** Like lenders, mortgage insurance companies often form partnerships with other organizations to make education and counseling available.
- **Government Agencies.** HUD has provided funds to counseling agencies for several decades. HUD-approved agencies can provide a full range of education and counseling services to meet the needs of particular communities. Additionally, state-housing finance agencies and local governments often provide counseling, especially in areas lacking nonprofit capacity. A list of HUD-approved counseling agencies is available online at http://www.hud.gov/offices/hsg/sfh/hcc/hccprof14.cfm.

Measured Effectiveness—Why Education and Counseling Are Important

The near-universal presence of education and counseling programs in affordable lending programs suggests that they offer real benefits for borrowers and lenders. However, until recently there was little research to demonstrate that education and counseling actually reduce mortgage risk. A large-scale 2001 study by a government-sponsored mortgage enterprise evaluated the impact of pre-purchase counseling on mortgage delinquencies, and developed empirical evidence that counseling can reduce delinquencies. The study also detailed how different types of education and counseling vary in effectiveness.14

The research considered four education and counseling formats: classroom, home study, individual counseling, and telephone-delivered education. The study analyzed 90-day mortgage delinquency rates of borrowers over a period of 18

Table 1-1

Results of Hirad-Zorn Study of Homebuyer Counseling Effectiveness

- Individual counseling: 34 percent reduction in 90-day mortgage delinquency rates.
- Classroom counseling: 26 percent reduction in 90-day mortgage delinquency rates.
- Home study counseling: 21 percent reduction in 90-day mortgage delinquency rates.
- Telephone counseling: reduction not statistically significant.

months and found that, generally, borrowers who had received pre-purchase education and counseling had 19 percent lower delinquency rate than those who had not. While the study showed that the type of provider had no significant effect on mortgage delinquency rates, the training formats did have significantly varying effectiveness. Individual counseling had the greatest impact. Telephone counseling, which has rapidly increased in popularity in recent years, had no statistically significant imapct. Table 1-1 compares the formats' impact.

Education and counseling were believed to hold positive benefits long before research confirmed their effectiveness. These services have won broad support from government, lenders, mortgage insurers, and the secondary market because of their perceived value to buyers and lenders. They help new homebuyers understand the institutions they will deal with and develop trust and confidence in the buying process. They prepare buyers for the responsibility of owning a home and increase their financial literacy. For lenders, education and counseling services are a way to increase business by reaching out to non-traditional markets and to helping communities that are underserved. For all parties, education and counseling are important ways to prepare applicants to be "mortgage-ready" and minimize delinquencies and defaults.

Origination: Standard Principles and Practices

The guiding principle of loan origination is risk evaluation. Will the borrower have the ability and willingness to repay the loan as agreed? Will the home provide sufficient collateral if the lender has to foreclose? The process of evaluating loan risk is discussed in detail in Chapter 3. The loan origination process entails an evaluation of:

- Incom e documentation;
- Household budget analysis;
- Credit information; and
- Apprai sal.

The loan application, credit report, and the appraisal provide the information the lender needs to evaluate risk. At loan closing, information is updated and certified, and legal documents are executed to transfer ownership to the homebuyer, subject to the lender's mortgage interest.

Servicing: Standard Principles and Practices

PJs have a long-term interest in seeing that new homebuyers succeed. A comprehensive buyer assistance program should address loan collection processes just as carefully as qualification and loan origination.

Servicing Options and Functions

When a lending institution makes a loan it becomes an asset to the institution. Like all assets, it must be managed. Originating lenders have three main options: they can keep the loan in their own portfolio and continue to service it; sell the loan in the secondary market, but retain the servicing rights; or sell the entire loan, including the servicing rights.

Loan servicing includes the day-to-day functions of loan collection, including:

- Collecting monthly payments from borrowers;
- Forwarding proceeds to investors;
- Sending payment notices and year-end statements to borrowers and tax authorities;
- Administering escrow accounts to pay property taxes and hazard insurance;
- Reporting loan performance details to investors; and

- Intervening when payments are late.

How Servicing and Origination Functions Differ

In the past, the originating lender was likely to service a loan until payoff. But as the home mortgage industry has become more specialized, originating lenders increasingly turn loan servicing over to other entities, even for loans held in their own portfolio.

This trend results partly from the fundamental differences between origination and servicing functions. Origination is an analytical process that involves a number of third-parties, such as appraisers, title companies, and underwriters. Servicing, on the other hand, is normally a straightforward, repetitive process. Only when payments are delinquent or loans default does servicing vary from the routine.

Because servicing activities are predictable and standardized, servicing rights are relatively easy to price. Servicers achieve economies of scale by handling large numbers of loans. Although most common servicing functions are routine, some loans deviate. In cases of delinquency and default, servicing functions stretch to include working with borrowers to collect late payments, developing work-out plans to prevent defaults, or foreclosing. Foreclosure brings servicers the additional responsibilities of disposing of the property and filing the mortgage insurance claim. Because these functions are time-consuming, servicers are highly motivated to avoid foreclosure to reduce administrative costs that erode their slim profit margins.

End Notes

1 Market share data used throughout this chapter is based on the U.S. Department of Housing and Urban Development's *Survey of Mortgage Lending Activity, 1998.* This data is available online at www.huduser.org/periodicals/ushmc/spring98/nd_fh.html.

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3 La Cour-Little, Michael. "The Evolving Role of Technology in Mortgage Finance," *Journal of Housing Research*, Volume 11, Issue 2 (2000): 175.

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6 U.S. Department of Housing and Urban Development. *Unequal Burden: Income and Racial Disparities in Subprime Lending in America.* April 2000.

7 Immergluck, Dan. "Stark Differences: Explosion of the Subprime Industry and Racial Hypersegmentation," *Home Equity Lending:* 235. Available through HUD User at http://www.huduser.org/publications/pdf/brd/11Immer.pdf.

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11 Credit life insurance is sometimes offered to new borrowers. The lender is named as the beneficiary, and the coverage amount is the loan balance. As the loan is re-paid and the loan balance decreases, the coverage decreases. Premiums are typically held constant.

12 Carr, James H. and Lopa Kolluri. *Predatory Lending: An Overview.* Fannie Mae Foundation. 2001.

13 U.S. Department of Housing and Urban Development, Office of Affordable Housing Programs. *HOMEfires*, Volume 1, Number 1. June 1, 1997.

14 Hirad, Abdighani and Peter M. Zorn. *A Little Knowledge is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling.* Freddie Mac, May 2001.

Chapter 2:

Issues Critical to the HOME Program

Chapter 2 describes the requirements that apply to HOME-assisted homebuyer housing, with particular focus on income eligibility, long-term affordability, and property requirements. This chapter explores how lenders are likely to perceive these HOME requirements, and how the requirements might affect lender motivations and practices.

Overview of the HOME Requirements

HOME funds are an extremely flexible source of support for homebuyer programs. The key regulatory requirements for HOME-assisted homebuyer programs relate to:

- Eligible activities, costs, and forms of assistance;
- Eligible properties and forms of ownership;
- Income eligibility; and
- Long-term affordability.

Regardless of how, or with whom, a PJ forms its partnerships, it is the PJ that is accountable to HUD for ensuring that its HOME programs and activities comply with all applicable requirements.

This chapter reviews each of these key requirements and discusses how they are implemented in homebuyer programs. For detailed and up-to-date information on the HOME program, visit the HOME Program website at http://www.hud.gov/offices/cpd/affordable housing/programs/home/.

Regardless of the level or type of benefits provided, HOME PJs need to comply with all HOME Program requirements, and document their compliance in project files. Homebuyer activities can be implemented directly by the PJ, through state recipients, subrecipients, Community Housing Development Organizations (CHDOs), or contractors, and/or in conjunction with banks and private developers. Sometimes, these partnerships present opportunities for coordination or streamlining of activities, such as sharing of a single appraisal between the first mortgage lender and the PJ. Other times, the differing motivations and needs of the PJ and its partner(s) are reason for PJs to make independent assessments of information regarding properties and buyers. Understanding the rules and the needs of each of the partners in a transaction can help PJs make appropriate decisions in program design and operations. Regardless of how, or with whom, a PJ forms its partnerships, it is the PJ that is accountable to HUD for ensuring that its HOME programs and activities comply with all applicable requirements.

Eligible Homebuyer Assistance Activities

PJs can undertake many different HOME-eligible activities to support homebuyer programs.

- **Acquisition.** The PJ can help eligible homebuyers purchase standard, existing, or newly constructed affordable homes by providing downpayment or closing cost assistance, or by reducing the monthly carrying costs of a loan from a private lender. Direct assistance to homebuyers to acquire a house is an eligible CHDO set-aside activity when the CHDO also owns, develops, or sponsors the housing being acquired by the assisted homebuyer.

- **Acquisition and Rehabilitation.** The PJ can acquire and rehabilitate, or assist a developer to acquire and rehabilitate, substandard properties to be sold after rehabilitation to low-income purchasers. The PJ can also lend rehabilitation funds directly to buyers wishing to rehabilitate units after purchase.
- **Reconstruction.** The PJ can rebuild, on the same lot, housing that was standing on-site at the time of project commitment, or replace substandard manufactured housing with a new or standard unit. Reconstruction is considered "rehabilitation" for the purposes of complying with the HOME requirements.
- **New Construction.** The PJ can develop housing itself or may work directly with private and nonprofit developers, including CHDOs, to create new units.
- **Lease-purchase.** The PJ can support lease-purchase arrangements to assist households at the lower end of the income range by helping them accumulate downpayment funds while building ownership skills. Homebuyers must qualify as low-income when they execute the lease-purchase agreement, and they must take ownership within 36 months thereafter. If the original lease-purchaser cannot take ownership within that time, the PJ has 42 months from the execution of the original lease-purchase agreement to find another eligible homebuyer and transfer the property. If this deadline is not met, the property becomes a HOME rental property and the HOME rental rules apply.
- **Loan guarantee (single loan or pool of loans).** The PJ can invest HOME funds to guarantee loans made by lenders, and, if required, establish a loan guarantee account. The amount in a loan guarantee account must be based on a reasonable default rate, but under no circumstances may the amount on deposit exceed twenty percent of the total outstanding principal amount guaranteed.1

Factoring in community needs and local market conditions, PJs can structure homebuyer programs and provide assistance in a number of different ways. Following are some common forms of assistance in homebuyer programs:

- Downpayment and closing cost assistance work well to help households that have enough income to pay monthly housing costs, but need additional upfront capital.
- Loans or grants to homebuyers are a relatively easy way to reduce the buyer's monthly housing costs. HOME financing can close the gap between the sales price of the house and the amount of private mortgage the buyer can secure. Generally, loans are preferable to grants because they provide the PJ some program income upon repayment, which can be used for additional affordable housing activities.
- Interest rate buy-downs, by providing funds to the lender in order to lower the interest rate offered to the buyer, can effectively reduce monthly housing costs to a borrower who secures a loan from a private lender. However, this technique can become expensive for long-term loans.
- Development subsidies for newly constructed or rehabilitated housing are typically provided directly to the developer. The developer can then offer a home to a low-income homebuyer at a sales price that is lower than the cost of producing the housing. This is an important strategy in markets where development costs exceed the market value of the developed property. This assistance is generally provided as a grant or a deferred payment loan to the developer. If the property is sold at market value to the low-income buyer, the development subsidy is not considered assistance to the buyer. However, if no other HOME assistance is provided directly to the homebuyer, the resale option must be used to meet the HOME long-term affordability requirements.

Eligible Costs

Regardless of the PJ's chosen program design, the PJ must use HOME funds only for eligible costs for HOME-assisted units. Table 2-1 provides a summary of HOME-eligible costs.

Where the PJ is directly involved in construction or rehabilitation, contractor invoices, payment vouchers, and PJ on-site inspection records should provide a paper trail for documenting costs. When the PJ is simply providing downpayment assistance, a good practice is to obtain a copy of the HUD-1 (Good Faith Estimate of Settlement Costs) used at closing to detail all costs and sources of financing.

Allocating Costs in Multi-Unit Projects

HOME funds can only pay for the eligible costs of HOME-assisted units. Furthermore, there are limits on the amount of HOME subsidy that can be used for each assisted unit. For multi-unit housing projects with multiple-financing sources, HUD provides guidance on allocating costs to help PJs determine the maximum amount of HOME assistance and the number of HOME-assisted units in the project.

A multi-unit housing project can be treated as a single project if it is under common ownership, financing, and management (such as a homeownership subdivision project or owner-occupied two- to four-unit house). The method for allocating the HOME costs varies, depending on whether the residential units in the assisted project are comparable or not. The minimum number of units that must be designated as HOME-assisted units and the maximum amount of HOME funds that can be invested in a multi-unit project are determined by the cost allocation method used. PJs also have the option of designating all residential units in a multi-unit project as HOME-assisted or providing a lesser amount of HOME subsidy.

These options and issues are explored at length in HUD Notice CPD-98-2, *Allocating Costs and Identifying HOME-Assisted Units in Multifamily Housing,* available online at the HOME Program website at http://www.hud.gov/offices/cpd/affordablehousing/lawsandregs/notices/index.cfm. The following section summarizes these options.

Units that are Comparable

When all of the residential units in a multi-unit housing project are comparable in terms of bedroom size, square footage, and level of amenities (including appliances, fixtures, and

Table 2-1

Eligible Costs

Hard costs
Acquisition of land and structures;
Site preparation or improvement, including demolition;
On-site infrastructure costs;
Securing buildings; and
Construction materials and labor.

Soft costs
Financing fees, including origination fees;
Credit reports;
Title binders and insurance;
Surety fees;
Building permits;
Independent cost estimates;
Impact fees;
Recordation fees, transactions taxes;
Legal and accounting fees, including cost certification;
Appraisals;
Architectural/engineering fees, including specifications and job progress inspections;
Environmental investigations;
Builders' or developers' fees;
Affirmative marketing and marketing costs;
Homebuyer counseling provided to purchasers of HOME-assisted housing;
Management fees; and
Development costs incurred by the PJ that are directly related to a specific project, such as inspections, cost audits and loan processing.
Note: Back taxes and fees are not eligible.

Relocation costs
Replacement housing, moving costs and out-of-pocket expenses;
Advisory services; and
Staff and overhead related to relocation assistance and services.
Note: Relocation costs are eligible for all units in a project, not just the HOME-assisted units.

materials), the ratio of HOME-assisted units to the total number of units must be at least equal to the ratio of HOME funds to the total funds invested in the project for HOME-eligible acquisition and development costs. The actual costs of any ineligible items and non-residential space (such as commercial space) must be subtracted from the total acquisition and development costs before allocating the costs. The maximum amount of HOME funds that can be invested in the project is determined by calculating the percentage of HOME-assisted units in the project and applying that percentage to the total eligible project acquisition and development costs, *provided that* the maximum per unit subsidy limits are not exceeded, as discussed below.

For instance, a PJ invests HOME funds to pay for 25 percent of the HOME-eligible development costs of $3,500,000 for a sub-division project of 50 newly constructed units of for-sale housing. All units are comparable, there are no ineligible cost items or non-residential space and the project is under common ownership, management, and financing. Since the HOME funds are paying for 25 percent of the total eligible development costs, at least 25 percent of the units (13 units) must be designated HOME-assisted and sold to HOME-eligible buyers. Conversely, if the PJ has designated 25 percent of the units as HOME-assisted units, the maximum HOME investment cannot exceed 25 percent of the total eligible development costs, or $875,000. The PJ retains the right to designate a higher number of HOME-assisted units in the project, or to fund a lesser percentage of the total eligible development costs, if it so chooses.

Units that are Not Comparable

When all of the units in a multi-unit HOME-assisted project are not comparable, the PJ must identify the actual costs and allocate these costs on a unit-by-unit basis so that only the actual, eligible costs of acquiring and/or developing the specific HOME-assisted units are paid by the HOME Program.

Common costs

Costs for shared infrastructure systems, community space, and common facilities are allocated in the same manner as the housing unit costs.

Only eligible common costs may be financed by HOME. For example, a freestanding community center or a community swimming pool is not eligible for HOME assistance. Actual costs for ineligible common items must be subtracted from the total common costs before allocating the common costs to HOME. If a housing project includes ineligible non-residential space such as commercial space, the common costs attributable to this non-residential space must also be subtracted from the total common costs before allocating the common costs to HOME.

Only eligible *on-site* common costs are HOME-eligible. When a multi-unit housing development, such as a subdivision project, is under common ownership, financing, and development, it can be considered a single project site—even though the project will be subdivided and sold as individual units after completion. Therefore, the entire eligible common costs, such as the installation of roads, sewers, water mains, and electric lines within the boundaries of this subdivision project, may be included when allocating eligible costs to HOME.

When all housing units are comparable and will benefit equally from the common systems, space, or facilities, the eligible common costs can be included in the total acquisition and development costs that are prorated proportionally as described above. When all units are not comparable, but will benefit equally from the common systems, space, or facilities, the eligible common costs must be allocated to each HOME-assisted unit based on the total square footage of the HOME-assisted unit as a percentage of the total square footage of all units sharing the common system, space, or facility. When all units will not benefit equally from a common system, space, or facility (for example, more extensive landscaping will be provided for the non-assisted units), the costs for that system, space, or facility must be allocated on a unit-by-unit basis based on the actual acquisition and development costs of the eligible common cost.

Regardless of the method used to determine the amount of HOME assistance per unit, the per unit HOME subsidy cannot exceed the maximum per unit HOME subsidy limits, as discussed below.

Acquiring or Developing Two- to Four-Unit Properties

In addition to the cost allocation and unit designation issues discussed in the previous section, when the PJ provides HOME assistance for the new construction, rehabilitation, or acquisition of owner-occupied two- to four-unit properties, there are additional circumstances to consider in allocating costs. The PJ should consult with HUD for further guidance.

Allocating Buyer Education and Counseling Costs

Homebuyer counseling is an eligible cost under HOME, and can be charged as a project soft cost; an administrative cost; or, if provided by a CHDO, as a CHDO operating expense. The method for charging these costs depends on who receives the counseling, and who provides the counseling services. To charge counseling as a project soft cost, the household or individual counseled must become an owner of a HOME-assisted unit. For buyer education and counseling that is not targeted specifically to buyers of HOME-assisted units, the costs must be charged as an administrative cost, or as a CHDO operating expense when incurred by a CHDO. When a project owner provides the counseling services, the costs must be eligible as a project soft cost since only the PJ or its subrecipient can incur eligible administrative costs. For more information, see *HOMEfires* Vol. 1, No. 1, June 1, 1997, published by HUD's Office of Affordable Housing Programs. This document is available online at the HOME website at: http://www.hud.gov/offices/cpd/ affordablehousing/library/homefires/volumes/vol1no1.cfm.

Maximum and Minimum Per Unit Subsidy Limits

The amount of HOME assistance invested in a project must meet the minimum and maximum per unit subsidy limits established by the HOME Program, as follows:

- The minimum HOME assistance is $1,000 times the number of HOME-assisted units in the project.
- The maximum HOME assistance is an amount that cannot exceed the FHA 221(d)(3) mortgage limits for elevator-type projects that apply to the area in which the housing is located. The limits vary by bedroom size. The limits are available from HUD's Multifamily Office or Program Center. There is no comprehensive list of these limits for all jurisdictions.
- For multi-unit projects, the average HOME assistance for various unit sizes must be determined. When all HOME-assisted units are comparable based on square footage, bedroom size, and level of amenities, the average HOME assistance can be determined by dividing the total amount of the HOME assistance by the number of HOME-assisted units. However, when all HOME-assisted units are not comparable, the average HOME assistance must be determined for each unit. An acceptable method is to divide the unit's square footage by the total square footage for all HOME-assisted units to calculate a percentage and apply that percentage to the total HOME assistance. The resulting proportional HOME assistance for that unit size cannot exceed the FHA 221(d)(3) mortgage limit for the bedroom size that corresponds to that unit. However, the majority of PJs find that because HOME is used as gap financing, the average per unit HOME assistance for all assisted units (regardless of bedroom size) is lower than the lowest 221(d)(3) limits (for a O bedroom unit), thereby making a more detailed calculation unnecessary.

The PJ must combine both the HOME project development assistance and the direct homebuyer assistance when determining whether the project complies with the minimum and maximum per unit subsidy limits.

More information on per unit subsidy limits can be found at the HOME Program website, at: http://www.hud.gov/offices/cpd/affordablehousing/ programs/home/limits/subsidylimits.cfm.

The PJ cannot use more HOME funds, in combination with other governmental assistance, than is necessary to provide modest, affordable housing. When using more than one governmental source of funds, the PJ must perform a subsidy layering analysis to verify that this is the case. For additional information on conducting a subsidy layering review, see HUD Notice CPD-98-01, *Layering Guidance for HOME Participating Jurisdictions When Combining HOME Funds with Other Governmental Subsidies.* This Notice is available online at: http://www.hud.gov/ offices/cpd/affordablehousing/lawsandregs/notices/cpd9801.pdf.

Property and Ownership Requirements

There are a number of property-related requirements that must be met when using HOME funds for homebuyer assistance, including a principal residence requirement, maximum purchase price limits, forms of ownership, and property standards.

Principal Residence

Eligible properties must be the purchaser's *principal residence*. These might include a single-family property (one- to four- units), a condominium unit, a cooperative unit, or a manufactured home. The PJ may choose to enforce the principal residence requirement by a deed restriction or covenant running with the land. This requirement can also be incorporated into the loan documents and the written agreement between the purchaser and the PJ.

Maximum Purchase Price or After Rehabilitation Value

The maximum purchase price may not exceed 95 percent of the median purchase price of homes purchased in the area. In the case of a purchase-rehabilitation project, the value of the property after rehabilitation may not exceed 95 percent of the area median purchase price for that type of housing. The after-rehabilitation value estimate should be completed prior to the investment of HOME funds.

There are two options that PJs have for determining the 95 percent of the median purchase price limits. Most PJs opt to use the FHA Section 203(b) Mortgage Limits. These limits are available from the HUD Single Family Homeownership Center that serves that PJ. The limits are also made available online at the HOME Program website at: http://www.hud.gov/offices/cpd/affordablehousing/programs/home/limits/maxprice.cfm.

PJs also have the option of conducting a specialized market analysis that meets certain requirements established by HUD. The HUD Field Office must review the PJ's market analysis and conclusions. These requirements can be found in the HOME Final Rule at 24 CFR 92.254 (a)(2)(iii).

Eligible Forms of Ownership

Any of the following forms of ownership are allowable:

- Fee simple title to the property;
- A 99-year leasehold interest in the property;
- A 50-year leasehold interest in trust or restricted Indian lands;
- A 40-year leasehold interest, for insular areas;
- C ondominiums;
- Participation in a cooperative or mutual housing project that constitutes homeownership under state law;
- Community land trust;

- Lease-purchase;
- Manufactured housing; and
- An equivalent form of ownership approved by HUD.

Note that life estates are not an eligible form of homeownership.

When HOME funds are invested in a homeownership unit, the ownership interest must be subject only to the restrictions on resale required by the HOME Program (discussed below), mortgages, deeds of trust, or other liens or instruments securing debt on the property as approved by the PJ. Any other restrictions or encumbrances must not impair the marketable nature of title or the ownership interest.

When HOME funds are used to help purchase a manufactured home, the additional requirements apply. First, at project completion, the manufactured housing must be connected to permanent utility hook-ups. Second, the home must be located either on land that is owned by the unit owner, or on land for which the unit owner has a lease for a period equaling or exceeding the applicable period of affordability. See *Long-Term Affordability* below for more on affordability periods.

Property Standards

Depending on the type of property being assisted, different levels of property standards apply. The PJ or designated program administrator must inspect each assisted unit for compliance with the applicable standard.

- **Acquisition.** If no rehabilitation or construction is planned, the acquired housing must meet state and local housing quality standards and code requirements. If there are no such standards or codes, the property must meet Section 8 Housing Quality Standards.
- **Rehabilitation and New Construction.** Housing that is being constructed or rehabilitated with HOME funds must meet all applicable state or local codes, rehabilitation standards and ordinances, and zoning ordinances. If no state or local codes apply, PJs must use one of the national model codes.2 New construction must also meet the Model Energy Code.
- **Rehabilitation after Acquisition.** The housing must be free from all health and safety defects before occupancy, but no later than six months after the property ownership is transferred. Not later than two years after ownership transfer, the housing must meet all required property and rehabilitation standards.
- **Manufactured Housing.** Newly constructed manufactured housing units must comply with the National Manufactured Home Construction and Safety Standards found at 24 CFR 3280, and commonly known as the "HUD Code." In addition, PJs must ensure that manufactured units are installed as required by applicable state and local codes. In the absence of such codes, PJs must see that units are installed according to the manufacturer's specifications. Existing manufactured housing that is acquired, or acquired and rehabilitated, must meet local standards and codes established for manufactured housing.

The HOME Program requires a *property inspection* for every unit of housing assisted with HOME funds to determine that the property meets the applicable standards. The purpose of these standards and inspections is to ensure that assisted units are safe, decent, and sanitary premises for its occupants.

Most private lenders will require an appraisal to assess the value of the property. This cannot substitute for a property inspection by the PJ or the PJ's contractor to determine that the property meets applicable property standards and code requirements.

Private lenders, on the other hand, typically require an *appraisal* of the property, which generally includes a site visit, or limited inspection of the property. An inspection for appraisal purposes, however, is not the same as a property inspection. Appraisers assess and inspect the property for the purpose of determining its value only. Appraisers are not trained to evaluate a property for code compliance. Regardless of whether or not the lender conducts an appraisal, PJs must conduct a property inspection to ensure the property meets the appropriate codes or standards.

> Since the income determination processes for a private lender and a PJ have different purposes, it is critical that the PJ verify applicant income itself, and not rely on lender representation.

Homebuyer Eligibility

To be eligible for HOME assistance, a prospective purchaser's income must not exceed 80 percent of the median household income for the area, as adjusted by family size and established by HUD. HUD issues updated income limits annually which can be found at the HOME Program website at http://www.hud.gov/offices/cpd/affordablehousing/programs/home/limits/ income.

PJs may choose from three definitions of income to determine individual eligibility:

- Section 8 Program definition for annual gross income (for homeownership, the value of a principal residence may be excluded from assets);
- IRS definition of adjusted gross income as defined for reporting on IRS Form 1040; or
- Annual income as defined by the U.S. Census Long Form.

The PJ can use any one of these three definitions for its homebuyer programs. However, it should use the same definition consistently for all applicants of the same homebuyer program. The definition need not be the same income definition used for other HOME activities. To facilitate the income determination process, HUD provides online training and an "Income Calculator" online at http://www.hud.gov/offices/cpd/ affordablehousing/training/calculator/index.cfm.

Regardless of the income definition used, a PJ must review source documents such as wage statements, interest statements, and/or unemployment compensation statements to determine annual income. Eligibility determinations are based on anticipated income for the next twelve months. The previous year's tax return alone does not reflect next year's earnings, and it does not constitute adequate income source documentation.

The HOME regulation establishes the timing for qualifying HOME-assisted homebuyers as income-eligible. In the case of a contract to purchase existing housing, the homebuyer must be income-eligible at the time of purchase. In the case of a contract to purchase housing yet to be built, the potential homebuyer must be income-eligible when the contract is signed. In the case of a lease-purchase agreement, the potential homebuyer must be income-eligible when the lease-purchase agreement is signed. If more than six months elapse from the time the potential homebuyer is income-certified (e.g., a buyer was income-certified at program intake but needed more than six months to complete buyer education, find a property, and execute a sales contract), the program administrator must recertify income.

Lenders also determine a borrower's income, and verify it with source documentation. However, PJs and private lenders have different purposes for determining income eligibility, and therefore have different methodologies. The PJ's income determination is done for the purpose of determining whether or not a buyer meets the definition of low-income in order to establish eligibility for HOME assistance. The lender's income evaluation is done to determine if the buyer has sufficient income to carry the mortgage. While the incentive for HOME income qualification is to document that income is below a certain threshold, applications to lenders may seek to maximize income in order to qualify for a larger mortgage. It is a good business practice for PJs to obtain and review copies of lender application packages to be sure an applicant's information is consistently reported.

Long-Term Affordability

One of the purposes of the HOME Program is to increase the supply of affordable housing over time. PJs can choose to meet this goal either by restricting the resale of HOME-assisted properties to other low-income buyers ("resale option"), or by recapturing HOME funds to assist other buyers and/or properties ("recapture option").

Periods of Affordability

In order to ensure that property assisted with HOME funds remains affordable for some period of time, the HOME Program sets affordability periods that control the sale of the homeownership property to a subsequent owner. These periods are based on the amount of HOME assistance provided for the property, as follows:

- If the HOME assistance is less than $15,000, the affordability period is no less than five years.
- If the HOME assistance is between $15,000 and $40,000, the affordability period is no less than ten years.
- If the HOME assistance is greater than $40,000, the affordability period is no less than 15 years.

The method for determining the amount of "HOME assistance," for the purposes of determining the period of affordability, varies depending on whether the PJ chooses to use a recapture option or a resale option for controlling home sale during the affordability period.

The recapture option and the resale option respond to different market conditions. In its Consolidated Plan, the PJ must describe the recapture or resale guidelines it will use for each homebuyer program. The PJ may establish more than one type of option for the same program, provided the PJ advises the homebuyer about which option will be used before the HOME funds are committed. These provisions should be explained to homebuyers in simple terms, and included as part of the closing documents so that a homebuyer fully understands his/her obligations during the affordability period and how the recapture or resale provisions will be applied upon the sale of the property or when the property ceases to be the homebuyer's principal residence. Some PJs execute a separate written agreement with homebuyers to evidence that the homebuyer understands and agrees to the recapture or resale requirements.

For more information on selecting and structuring a resale or recapture option, see *Using HOME Funds for Homebuyer Programs: Structuring Resale and Recapture,* HUD-1674-CPD. To get a copy of this model program guide, see HUD's Office of Affordable Housing Programs online library at: http://www.hud.gov/offices/cpd/affordablehousing/library/modelguides/ index.cfm. Further guidance on resale and recapture provisions is provided in HUD's *HOMEfires Volume 4*, *Number 4*, October 2003 and *Volume 5, Number 5*, November 2003. These *HOMEfires* can also be downloaded from HUD's Office of Affordable Housing Programs online library at: http://www.hud.gov/offices/cpd/affordablehousing/library/homefires/index.cfm.

Recapture Option

Recapture is a mechanism for the PJ to recover all or a portion of the direct HOME assistance if the initial HOME-assisted buyer decides to sell the house during the affordability period. The recapture option is often the simplest for most PJs. When a recapture option is used, the homeowner is at liberty to sell the HOME-assisted property to any buyer, at any price the market will bear.

When a PJ uses a recapture option, the period of affordability is based on the amount of direct HOME assistance that enables the buyer to purchase the unit. This includes any HOME assistance that reduces the purchase price from fair market value to an affordable price, or otherwise directly subsidizes the purchase by the homebuyer (such as downpayment assistance, closing cost assistance, mortgage financing, or interest rate buy-downs). This does not include any “development subsidy” which is the amount of HOME assistance in excess of fair market value that is used to produce the unit.

If sale to a new owner occurs during the affordability period, the PJ can choose to:

- Recapture the entire amount of the direct HOME assistance, or, when HOME funds are loaned, any outstanding loan balance on a HOME loan.
- Forgive a portion of the direct HOME assistance based on the length of time the homebuyer has occupied the home, in relation to the period of affordability. For example, the PJ might forgive 50 percent of the assistance amount for an owner who sold the home halfway through the period of affordability.
- Share the net proceeds, when the proceeds are insufficient to repay the full amount of HOME assistance. Net proceeds are the sales price minus the repayment of any non-HOME loan balance and closing costs that were financed by the homeowner. Net proceeds may be divided proportionally based on the ratio of the HOME assistance to the sum of the homeowner’s investment (downpayment and any documented capital improvements financed by the homeowner) plus the HOME assistance, as follows:

$$\frac{\text{HOME Assistance}}{\text{HOME Assistance + Homeowner Investment}} \mathbf{\times\ Net\ Proceeds = HOME\ Recapture}$$

- Permit the repayment of the homeowner’s investment in full before any HOME funds are recaptured. The homeowner’s investment includes any downpayment and documented capital improvements financed by the homeowner. The HOME subsidy is then repaid only to the extent that net proceeds are available.

The PJ must deposit all recaptured HOME funds in the PJ’s HOME Investment Trust Fund account, unless the PJ permits a state recipient, subrecipient, or CHDO to retain recaptured funds in accordance with a written agreement. Recaptured funds must be used for HOME-eligible activities, in accordance with all HOME requirements. Recaptured funds are generally treated as program income, with the exception that ten percent of the recaptured funds may not be used for eligible administrative and planning costs since recaptured funds are a return of the original HOME investment (and the ten percent administrative funds have already been calculated on the original allocation).

For more information on this issue, see HUD Notice CPD-97-9, *HOME Program Income, Recaptured Funds, Repayments and CHDO Proceeds*, available online at: http://www.hud.gov/offices/cpd/affordablehousing/lawsandregs/notices/cpd9709.pdf.

Under the recapture option, once the recapture occurs, the long-term affordability period terminates and HOME requirements no longer apply to the property. The home can be sold to any homebuyer, regardless of income.

Resale Option

The resale option ensures that the HOME-assisted unit remains affordable over the entire period of affordability, even in the event of a subsequent sale. This option is often preferred by PJs in high cost or rapidly appreciating housing markets. Using this option, the PJ may either require the owner to sell to another eligible low-income homebuyer or establish a “presumption of affordability.” When the resale option is used, the period of affordability is based on the total amount of HOME funds used to assist the acquisition, development and purchase of the housing (i.e. the HOME investment).

- **Sale to an income-eligible homebuyer.** This option requires the following criteria to be met:
  - — The new purchaser must be low-income and occupy the property as the family's principal residence. (See discussion of Homebuyer Eligibility earlier in this chapter.)
  - — The sales price must be affordable to a reasonable range of low-income homebuyers, as defined by the PJ. Many PJs choose to establish the maximum sales price by calculating the maximum principal, interest, taxes, and insurance (PITI) that could be paid by a reasonable range of low-income households without exceeding 30 percent of gross income (a widely used standard of housing affordability).
  - — The original homebuyer, now the home seller, must receive a fair return on his or her investment, as defined by the PJ. The PJ should identify its method for determining a fair return in the written resale documents that apply to the property. The homeowner's investment includes any downpayment, loan principal payments, and capital improvements financed by the homeowner.

Once an affordable price that offers a fair return to the seller is established, a PJ may choose to require the repayment of all or a portion of the HOME grant or loan upon resale, should net proceeds from the sale allow this. This is most likely to occur in housing markets where prices are appreciating.

- **Presumption of affordability.** This option relies on the presumption that a specific neighborhood in its entirety is affordable and that it will continue to remain affordable for the foreseeable future, and therefore, any sale within that neighborhood will be affordable. In other words, market forces will ensure the continued affordability of HOME-assisted properties, and the PJ can presume the property will be sold at an affordable price to another low-income household. In order to rely on a presumption of affordability, the PJ must demonstrate that the neighborhood is, and is likely to remain affordable. To do this, the PJ must undertake a market analysis and document the affordability of the neighborhood in accordance with specialized procedures established by HUD and outlined in the HOME Final Rule at 24 CFR 92.254 (a)(5)(i)(B). The PJ's methodology and conclusions must be reviewed and approved by HUD. If the PJ continues to offer homeownership assistance for housing in the neighborhood, it must periodically update the market analysis to verify the original presumptions and continued affordability.

Under the resale option, if a new homebuyer receives HOME assistance to purchase a property that has previously been assisted with HOME funds, the PJ may terminate the original period of affordability. A new period of affordability may be established based on the amount of the direct HOME assistance provided to the new homebuyer, regardless of when during the period of affordability the property is sold. The PJ also has the option of retaining the original affordability period. If no new HOME assistance is provided, the new homebuyer must assume the remaining term of the original long-term affordability period.

The resale option must be used when HOME assistance is provided only as a development subsidy and there is no direct HOME assistance to the homebuyer. The development subsidy is the difference between the cost to develop housing and the fair market value. This type of subsidy is generally used in markets where the development costs exceed market value. Note that when the resale option is used, the affordability period is based on the total amount of HOME assistance invested in the housing and not on the amount of the development subsidy.

For example, the PJ provides $50,000 in HOME assistance as a construction loan to a developer. The appraised value after construction is $45,000 because of neighborhood and market conditions. The house is sold for the fair market value of $45,000. The $5,000 difference between the $45,000 sales price and the $50,000 construction loan represents a development subsidy provided to the developer. Since there is no direct assistance to the homebuyer in this instance, the resale option must be used. The affordability period is fifteen years based on the *total* amount of the HOME investment, or $50,000.

Sometimes HOME assistance is structured so that both a development subsidy and assistance to the homebuyer are provided. When this happens, the PJ has the option of imposing either resale or recapture requirements. If the resale option is used, the minimum affordability period must be based on the total amount of HOME funds invested in the acquisition and development of the property plus any additional HOME funds directly assisting the homebuyer (e.g. downpayment and closing cost assistance). If the recapture option is used, the minimum affordability period is based on the amount of HOME assistance that enabled the homebuyer to purchase the property, as described above under the *Recapture Option*. HUD's *HOMEfires Volume 5, Number 4* dated October 2003 provides more guidance. This *HOMEfires* can be downloaded from HUD's Office of Affordable Housing Programs online library at: http://www.hud.gov/offices/cpd/ affordablehousing/library/homefires/index.cfm.

Enforcing Resale and Recapture Provisions

To enforce both resale and recapture provisions, PJs must execute an appropriate written agreement with the homebuyer. In addition, in order to enforce the resale provisions (except when a "presumption of affordability" has been approved by HUD), the PJ must impose a deed restriction, covenant running with the land or similar mechanism approved by HUD. It is also a good business practice to use these mechanisms to enforce the recapture provisions as well. Most lenders and secondary market entities have loan products that accommodate these provisions, as long as they allow for the deed restriction or other restrictions to be lifted in the case of foreclosure. PJs can address lenders' concerns, as the HOME Program permits the affordability restrictions to terminate upon foreclosure. PJs should be aware, however, that in the event of a foreclosure, while a deed or other restriction is terminated for purposes of clearing title, the PJ's obligation to provide affordable housing for the period of affordability is not terminated. The PJ's failure to meet this obligation may result in the repayment of HOME funds. Chapter 4, Understanding Loan Servicing, describes what happens when a HOME-assisted property is foreclosed, and what steps a PJ can take to ensure continued affordability, rather than repay HOME funds.

Special Considerations for Two- to Four-Unit Properties

For owner-occupied two- to four-unit properties, the long-term affordability requirements depend on which units are designated HOME-assisted units. When both the homeowner's unit and one or more rental units are assisted, the PJ has the option of imposing resale or recapture provisions on all assisted units, including the rental units. If resale restrictions are used, the affordability requirements on all assisted units continue for the period of affordability. If recapture restrictions are used, the affordability requirements on the assisted rental units may be terminated at the discretion of the PJ, upon the recapture of the HOME investment. If only the rental units are assisted, then the housing is not HOME-assisted homebuyer housing and only the HOME rental requirements apply. The PJ should consult with HUD for more guidance on providing homebuyer assistance with HOME funds in owner-occupied two- to four-unit properties.

Written Agreements

A PJ must execute a written agreement before any HOME funds are committed or disbursed to any entity or recipient, including homebuyers. If a state recipient, subrecipient, or contractor is administering any, or all, of the HOME program on behalf of a PJ, it must also enter into a written agreement with the PJ, as well as any entity or recipient to whom it, in turn, disburses funds. The written agreement is an important enforcement tool. The PJ should work with local counsel to ensure that the written agreement is a legally enforceable document. The agreement should include provisions to compel compliance with HOME rules and other applicable Federal, state and local requirements and establish penalties for failure to comply. Written agreements can vary, depending on the role of the entity or recipient of HOME funds, and the scope of the activity or project undertaken. Every written agreement should concisely define the relationship of the PJ with the entity or recipient of HOME funds, and clearly state all the conditions under which HOME funds are being provided. These conditions include the principal residency requirement and the recapture or resale requirements that apply when the property is sold. The written agreement should identify any reporting and record-keeping requirements that must be met, as well as the corrective actions that the PJ will take if non-compliance occurs.

Record-keeping

Generally, the PJ and any entity administering HOME activities on its behalf, must establish and maintain records sufficient to document that program requirements are being met.

The following project records must be maintained, including:

- Description of each project;
- Location (with a map);
- Form of assistance;
- Number and identification of units or tenants, if any, associated with HOME;
- All sources and application of funds;
- Evidence of compliance with maximum and minimum subsidy limits, and evidence of a subsidy layering review, where applicable;
- Evidence of compliance with property standards and lead-based paint requirements;
- Evidence of income eligibility of assisted buyer, and tenant(s), if applicable;
- If refinancing is provided, evidence of compliance with established guidelines and/or requirements;
- Evidence of compliance with maximum property value limits;
- A copy of loan document(s);
- A copy of all documents that ensure the property remains affordable throughout the period of affordability, such as a deed restriction or covenant running with the land, and/or documents that convey the provisions of the PJ's resale and/or recapture requirements; and
- Evidence that such documents have been recorded.

In addition to the requirements imposed by the HOME Program that are discussed in this section, PJs are encouraged to establish their own requirements for record-keeping and reporting by their partners, to facilitate monitoring and compliance.

Table 2-3 provides a summary of the key homebuyer rules and provides guidance on how to document compliance.

Other Federal Requirements

In addition to the above requirements, the use of HOME funds for homebuyer activities often triggers other Federal regulations. Table 2-4 provides a summary of these other Federal requirements.

Table 2-3

Summary of Key Homebuyer Rules and How to Document Compliance

	Key Home Requirement	Documentation
Eligible Participants		
Owner Income	• Gross income ≤80% of median income based on the upcoming 12 months. • Income is defined by one of three options: Section 8 annual income; annual income under Census long form; or adjusted gross income under IRS Form 1040.	• Include completed application in project file. • Include source documentation (wage statements, interest statements) in project file.
Owner Occupancy	• Applicant must purchase property and maintain it as his/her **principal residence**.	• Applicant should sign a clause on the application form certifying that the property is the principal residence; include copy in project file.
Ownership of Property	• Applicant must obtain ownership of the property through: ⇒ Fee simple title; ⇒ 99-year leasehold interest (50 year leasehold on trust or restricted Indian land or 40 year interest for insular areas); or ⇒ Ownership/membership in a cooperative, condominium, or mutual housing project (if recognized by state law). ⇒ For manufactured housing, fee simple title or a leasehold interest in the land that equals or exceeds the applicable affordability period.	• Include title search documentation in project file. • Include copy of deed, leasehold interest, or other ownership document in project file.
Eligible Property		
Property Type	• Eligible property types include: ⇒ One-to-four-unit property; ⇒ Condominium unit; ⇒ Cooperative or mutual housing unit, if recognized by state law; and ⇒ Manufactured or mobile home.	• If 2-4 units, indicate status of non-owner-occupied units in the written agreement with the owner; include copy in project file. • If non-owner units were assisted with HOME funds, include written agreement with homeowner regarding rental requirements in project file; reference the property's rental monitoring file.
Property Location	• Property must be located within geographic area of the PJ.	• Include completed application in project file. • Application should show address.
HOME Minimum and Maximum Thresholds	• An average of a minimum of $1,000 in HOME funds must be invested in each assisted unit. • The maximum HOME assistance per unit as determined by HUD.	• Maintain records in project file demonstrating that the average per-unit HOME investment exceeded $1,000. • Maintain records indicating total HOME assistance did not exceed maximum provided by HUD in project file.

	Key Home Requirement	Documentation
Property Value	• Sales price must not exceed 95% of the area median purchase price. • If rehabilitating property, after rehabilitation value must not exceed 95% of the area median purchase price. ⇒ Use 203(b) limits; OR ⇒ Establish local limits and obtain HUD approval.	• If using local purchase price limits, document data used to determine limits as well as evidence of HUD approval; include in program files. • Document method for determining value; include in the project file. • Include copy of sales price or value estimate in project file.
Eligible Property (Continued)		
Property Standards	• If acquisition only, property must meet either local codes/standards or Section 8 Housing Quality Standards (HQS). • If rehabilitation, property must be free of safety and health hazards prior to occupancy or within 6 months of property transfer, whichever is sooner. • Also, if rehabilitation, property must meet local rehabilitation standards and applicable codes (local codes/standards or one of the nationally accepted codes) within 2 years of transfer. • New construction must meet local codes/standards or one of the nationally accepted codes and the Model Energy Code.	• Document local code or model code used; include in program files. • Maintain written rehabilitation standards; include in program files. • Include inspection report or certification by inspector in project file. • Keep inspection checklist and work write-up in project file. • Include checklist indicating compliance with Model Energy Code requirements for new construction projects in project file.
Eligible Activities	• Acquisition, acquisition and rehabilitation, and new construction.	• Document all expenditures; include in project file.
Long-Term Affordability		
Affordability Period Resale/Recapture	Property must be subject to either resale or recapture revisions for the period of affordability. • Resale: future sale of property must be to and affordable to low-income buyer, at an affordable price. • Recapture: portion or all of direct assistance to buyer must be recaptured at time of sale.	Resale: written agreement , mortgage and/or note and deed restriction, covenant or other enforcement mechanism restricting future sales; include copy in project file. Recapture: written agreement, mortgage or note showing formula by which funds will be recaptured and any enforcement mechanism; include copy in project file.

Table 2-4
Other Federal Requirements

Other Federal Requirements	Apply to Homebuyer Programs?	Special Issues/ Considerations	Regulatory Citations and References
Non-Discrimination and Equal Access Rules			
Fair Housing and Equal Opportunity	Yes.	PJs must affirmatively further fair housing. Particular attention should be paid to signs of discrimination in sale of properties.	• 24 CFR 92.202 • Title VI of Civil Rights Act of 1964 (42 U.S.C. 2000d et. seq.) • Fair Housing Act (42 U.S.C. 3601-3620) • Executive Order 11063 (amended by Executive Order 12259) • Age Discrimination Act of 1975, as amended (42 U.S.C. 6101) • 24 CFR 5.105(a)
Affirmative Marketing	Yes, for all projects of five or more HOME-assisted units.	PJ must adopt affirmative marketing requirements and procedures.	• 24 CFR 92.351
Handicapped Accessibility	Yes.	New projects must be designed and constructed in accordance with applicable standards. Rehabilitated properties may require modifications.	• Section 504 of the Rehabilitation Act of 1973 (implemented at 24 CFR Part 8) • For multifamily buildings only, 24 CFR 100.205 (implements the Fair Housing Act)
Employment and Contracting Rules			
Equal Opportunity Employment	Yes.	Contracts and subcontracts for more than $10,000 must include language prohibiting discrimination.	• Executive Order 11246 (implemented at 41 CFR Part 60)
Section 3 Economic Opportunity	Yes, if amount of assistance exceeds $200,000 OR contract or subcontract exceeds $100,000.	Include Section 3 clause in contracts and subcontracts.	• Section 3 of the Housing and Urban Development Act of 1968 (implemented at 24 CFR Part 135)
Minority/Women Business Enterprises	Yes.	PJ must develop procedures and include in all contracts and subcontracts.	• Executive Orders 11625, 12432 and 12138 • 24 CFR 92.351 • 24 CFR 85.36(e)

Other Federal Requirements	Apply to Homebuyer Programs?	Special Issues/ Considerations	Regulatory Citations and References
Davis-Bacon	Yes, if construction contract includes 12 or more units that are HOME-assisted.	If applicable, requirements apply to the whole project, not just the HOME-assisted units. Include language in contracts and subcontracts. Requirements do not apply to volunteers or sweat equity.	• 24 CFR 92.354 • Davis-Bacon Act (40 U.S.C. 276a - 276a-5) • 24 CFR Part 70 (volunteers) • Copeland Anti-Kickback Act (40 U.S.C. 276c) • Contract and Safety Standards Act (40 U.S.C. 327-332) • HUD Handbook 1344.1 Federal Labor Standards
Conflict of Interest	Yes.	PJs should ensure compliance in-house and when using subrecipients.	• 24 CFR 92.356 • 24 CFR 85.36 • 24 CFR 84.42
Debarred Contractors	Yes.	PJs should check HUD list of debarred contractors.	• 24 CFR Part 5
Environmental Requirements			
Environmental Reviews	Yes.	Categorically excluded projects are **not** subject to 58.5 (existing or under construction). Buildings to be constructed in the future require a compliance review.	• 24 CFR 92.352 • 24 CFR 58.35 (b)(5) • National Environmental Policy Act (NEPA) of 1969
Flood Insurance	Yes.	Must obtain flood insurance if located in a FEMA designated 100-year flood plain. Community must be participating in FEMA's flood insurance program.	• Section 202 of the Flood Disaster Protection Act of 1973 (42 U.S.C. 4106)
Lead-Based Paint	Yes for pre-1978 units.	Notices to purchasers and tenants. Visual assessment must be performed. Paint stabilization must be completed (if applicable). Safe work practices and clearance. Provisions included in all contracts and subcontracts.	• 24 CFR 92.355 • Lead Based Paint Poisoning Prevention Act of 1971 (42 U.S.C. 4821 et. seq.) • 24 CFR Part 35 • 982.401(j) (except paragraph 982.401(j)(1)(i))
Relocation	Yes.	Required notifications to tenants. Required language in offers and contracts for acquisition of property.	• 24 CFR 92.353 • Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970 (URA) (42 U.S.C. 4201-4655) • 49 CFR Part 24

Other Federal Requirements	Apply to Homebuyer Programs?	Special Issues/ Considerations	Regulatory Citations and References
			• 24 CFR Part 42 (subpart B) • Section 104(d) “Barney Frank Amendments”
Unqualified aliens	Yes.	Federal benefits to unqualified aliens is limited.	• Title IV of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (42 USC 601 et seq.)
Uniform Administrative Requirements			
Cost Principles	Yes.	Must follow uniform approach for determining allowable costs under Federal grants, and other agreements.	• For PJs and other governmental entities, OMB Circular A-87 • For nonprofit organizations, OMB Circular A-122
Other uniform administrative requirements	Yes, applies to programs administered by PJ, subrecipient, or state recipient.	Must follow uniform requirements for financial management, procurement, record-keeping, and close-out procedures.	• PJs and other governmental entities, certain provisions of 24 CFR Part 85 • For nonprofit organizations, certain provisions of 24 CFR Part 84

End Notes

1 Additional loan guarantee requirements can be found at 24 CFR 92.205(b)(2).

2 The national model codes used by the HOME Program are:

- Uniform Building Code (issued by CABO);
- National Building Code (issued by BOCA); and
- Standard (Southern) Building Code (issued by SBCCI).

Since the promulgation of the HOME regulation, the national model code-issuing agencies have merged to form the International Code Council (ICC). The model codes used for the HOME Program are no longer being updated; in their stead, the ICC has adopted the International Building Code. HUD will consider whether changes to the HOME regulations incorporating the International Building Code are appropriate.

3 See Footnote 2, above, for a discussion of the national model codes.

Chapter 3:

Understanding Loan Underwriting and Origination

Chapter 3 presents key concepts that ground loan underwriting practices and explores how lenders apply these concepts with standard documents, procedures, and information technology. The chapter highlights what the industry's norms suggest for HOME program design.

Loan Origination

The loan origination process determines whether the assisted borrower qualifies for mortgage credit. This section discusses how lenders weigh the different elements of mortgage risk. The key to profitable mortgage lending is pricing loans according to their risk of default. Default risk is tied to three things:

- Willingness to pay (evidenced by credit history);
- Ability to pay (income vs. expenses); and
- Collateral (downpayment amount, home value).

Each of these is reviewed carefully during the process of loan underwriting.

Evaluating Credit

Methods for determining a borrower's willingness to honor credit obligations have changed over the past ten years. In the past, mortgage lenders collected basic credit information and then decided for themselves whether there were too many unexplained late payments in a given period of time. To assist first-time homebuyers with little credit history of any kind, lenders would sometimes consider the timeliness of utility or rent payments.

During the 1990's, credit scores became the dominant way of assessing an applicant's willingness to pay. Credit scores predict the borrower's likelihood of default. The use of credit scores has grown rapidly over the past ten years as their contribution to lender profitability has become clear.

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A credit score is calculated by a mathematical equation that evaluates information from the borrower's credit report. Independent analytical firms developed the equations used to generate the scores by comparing actual performance of past loans with actual borrower credit records. The accuracy of credit scores has been verified using a similar approach, by scoring large portfolios of existing loans and then comparing score predictions to actual loan performance.

Credit scores are assigned to assess the probability of loan default. Scores can range from 300 to 850, worst to best. Approximately 75 percent of all scored borrowers have a credit score of 650 or better. There is no single score that serves as a cutoff for a borrower's eligibility for favorable interest rates because each lender determines how to use the score in combination with other factors in its evaluation of a borrower. Generally borrowers with credit scores of 650 or higher are typically able to qualify for favorable interest rates, if all other aspects of the loan application meet standard guidelines.

Credit scores are based solely on credit information, not employment, income, or other factors. Heaviest weight is given to the applicant's previous credit performance, and total indebtedness. Scores change monthly based on new information from credit bureaus.

Evaluating Collateral

Lenders need to know the true market value of the home they will accept as collateral. Appraisers rely heavily on the "comparable sales" method to determine market value of single-family residential properties. Recent sales of similar homes in nearby locations indicate what the subject property would be worth on the open market. Sale prices for comparable properties are adjusted to reflect specific differences from the subject property.

Because an appraisal is such a central part of the lending process, and because it necessarily involves a number of judgment calls by the appraiser, appraiser certification and qualification are hot topics for mortgage lenders, secondary market investors, and housing finance regulators. (Note, an appraisal does not replace the need for a home inspection to verify compliance with HOME property standards. This issue is discussed in more detail in Chapter 2.)

Just as information technology has transformed the lender's evaluation of borrower credit, automated appraisal is doing the same for collateral review. Large databases of comparable sales are compiled for a given market area. Statistical analysis and geographic information systems then process the data and estimate a value for the subject property. Automated appraisal is particularly well-suited for suburban markets where there are large numbers of relatively uniform properties. Its estimates are not as reliable in rural markets or diverse in-city locations.

The size of the borrower's downpayment is related to collateral evaluation. It represents the financial stake the borrower has invested in the property. Lenders have traditionally relied on downpayments as an incentive for borrowers to persevere during lean times and save their investment rather than default. The reliability of automated credit scoring has reduced lender reliance on collateral and downpayment. Special mortgage programs with 97 percent or even 100 percent loan-to-value ratios are now commonplace. These were almost unheard of 15 years ago.

However, a counter-trend could be in the making to restore some of the importance of downpayment and collateral. Recent research shows that borrowers had much higher default rates in markets where home prices were volatile than did borrowers with identical credit scores in stable real estate markets. This suggests that home value and downpayment are still critical parts of mortgage loan risk.

Evaluating Ability to Pay

Lenders review a household's income and expenses to understand an applicant's ability to pay the proposed loan payment. Two ratios are calculated. The first or "front-end" ratio compares the loan payment (which includes principal, interest, taxes, and insurance) to gross income. The second or "back-end" ratio compares the loan payment *plus* installment and revolving debt to gross income. Common rules-of-thumb say that households should spend no more than 28 to 33 percent of their income on housing, and no more than 36 to 38 percent on total debt. Special programs sometimes enable the ratios to rise substantially. For example, FHA loans permit higher ratios.

PJs that pre-screen potential borrowers may find that their assessment of borrower qualifications is more liberal than the one eventually applied by lenders. This can be especially true for lenders who are unfamiliar with typical household budget profiles in the particular market a HOME-financed program is designed to serve.

Automated Underwriting

The analysis of willingness to pay, ability to pay, and collateral is usually facilitated by loan underwriting software, and the resulting process is called "automated underwriting." The substitution of computer-assisted judgment for the human element has been estimated to save as much as $650 per loan. Still, even automated systems refer some loans for human judgment.

How Automated Underwriting and Credit Scoring Affects HOME Applicants

There is both good and bad news for low- and moderate- income homebuyers in the trend toward automated mortgage loan decisions. On the positive side, credit scores have been found not to correlate with borrower income. Confidence in sophisticated technology can enable lenders to push the envelope further on risk elements like borrower expense-to-income ratios.

On the down side, HOME-assisted buyers may be disproportionately affected by technical problems in the process used to develop credit scores. The very poor, the less educated, and those living in central cities may be under-represented in credit bureau data. This under-sampling could cause less valid credit scores for these groups of borrowers, according to some researchers.

PJs should counsel borrowers well in advance about the importance of their credit score, and applicants should be advised that even the act of applying for credit may reduce credit scores. Anyone can get a copy of his or her credit report and credit score online at www.myfico.com. There is a fee for this service.

Some HOME-assisted borrowers will need the benefit of a traditional application review. Elimination of automated underwriting and credit scoring is a selling point for some new mortgage programs for affordable ownership sponsored by major secondary market enterprises. PJs should ensure that partner lending institutions have skills in traditional, hands-on loan underwriting. Participation in affordable housing programs and active portfolio lending programs may be good indicators of such skills.

Fees for Loan Origination and Closing Costs

Lenders charge borrowers an origination fee (sometimes called a "transaction fee") to cover the costs of the transaction, including preparing documents, making credit checks, and analyzing the loan file. Fees can range from as little as 0.5 percent to as much as 2 percent, but they are typically between one to 1.25 percent of the loan amount. Borrowers who provide complete documentation and have solid credit may be able to negotiate a lower fee, especially with larger loan sizes. On the other hand, when lenders commit to make special, hands-on efforts to qualify borrowers, origination fees may be somewhat higher.

PJs may be able to negotiate lower origination fees for HOME-assisted borrowers. Some lenders might offer lower fees as a public-purpose concession. Other lenders might be willing to provide optimal terms if the PJ can reduce some of a lender's work to facilitate the transaction, such as pre-screening borrowers and collecting necessary documentation before meeting with the lender. Without such bargaining points, PJs may encounter lenders who argue for higher origination fees due to the smaller loans and more demanding underwriting requirements of some HOME borrowers.

Borrower costs typically range from two to five percent of the loan. Closing costs include home inspection, appraisal, advance payment of homeowner's insurance, property taxes, real estate transfer taxes, title insurance, escrow fees, and attorney's fees. Closing costs may range from $2,000 to $3,000, in addition to the loan origination fee and any points. Sellers also have closing costs. These include the real estate agent's commission, and in some areas, the attorney's fee, transfer taxes, and title insurance costs.

"Points" are cash payments up front that buy reductions in the loan interest rate. They are called points because they are expressed as percentage points of the loan amount. Comparison shopping is important, as lenders may not charge uniformly for rate reductions. For buyers who have the cash, and who plan to remain in the house for at least four years, paying points can save money in the long run by reducing interest costs, while also lightening the load the mortgage places on the family's monthly budget. However, for many HOME-assisted buyers, cash is short. For them, a higher interest rate is the price of completing home purchase sooner.

It may be possible to negotiate with sellers to get assistance with closing costs, including points. Lenders usually permit at least three points to be paid by the seller to the borrower at closing. Borrowers should expect to see such assistance reflected in a higher sale price, which in turn must always be justified by the appraisal.

Some lenders, especially subprime lenders, bundle insurance products into a loan closing. Credit life insurance is sometimes offered to new borrowers. This type of insurance is similar to term insurance in that it pays the mortgage if the borrower dies. Typically, the sole beneficiary of credit life insurance is the lender. The insurance coverage is reduced as the loan is re-paid; however, the premiums paid remain fixed throughout the life of the loan.

All of the costs that are likely to be incurred in the purchase of the home, including those discussed in this section, must be summarized and presented to the homebuyer as early in the loan origination process as possible. A standard form, the "Good Faith Estimate of Settlement Costs" (also known as the "HUD 1"), presents the complete estimate of cash requirements. It is required by law to be prepared and provided to the homebuyer so that he or she is aware of all the likely costs that will be incurred in the transaction.

Credit Enhancement

What Is Credit Enhancement?

Credit enhancement provides extra financial strength to fortify the overall quality or "credit" of a loan. In other words, credit enhancement increases the likelihood that the lender will eventually recover principal and interest. It is usually structured as mortgage default insurance, or simply, "mortgage insurance."

Mortgage insurance covers lenders in the event of loan default. It is typically required for loans having less than a 20 percent downpayment. The borrower pays the premiums. This typically adds about seven-tenths of one percent to the mortgage interest rate. Mortgage insurers have recently begun to adjust premiums based on borrower credit scores. Mortgage insurance is a significant expense, but without it borrowers must wait until they can accumulate a full 20 percent downpayment.

Private firms, as well as FHA and VA, provide mortgage insurance. Market share is 50 percent private; 37 percent FHA; and 13 percent VA. A few states also have mortgage insurance programs.

Private mortgage insurance (PMI) providers are rated for their financial strength. Mortgage insurance from recognized sources helps to transform an individual mortgage loan into an investment-quality asset. That, in turn, channels global capital to the U.S. home mortgage market, eliminating capital shortages and driving down interest rates.

From the borrower's point of view, credit enhancement is no cure-all. First, it costs money and reduces loan affordability. Secondly, not everyone qualifies for credit enhancement. Mortgage insurers must earn a profit by assuming risks that lenders will not take by themselves. That means they must be selective. Credit enhancement companies make their own evaluation of acceptable risk, in effect adding a second borrower qualification process—and it can be a tough one.

Private mortgage insurers are required by law to cancel insurance when a loan is paid down to 78 percent of original home value.

Using HOME-Assistance to Overcome Qualification Hurdles Responsibly

Potential low- and moderate-income borrowers may have trouble passing one or more of the three underwriting hurdles described earlier, credit, collateral, and ability to pay. The HOME regulation allows PJs a great deal of flexibility, enabling them to structure assistance to best fit the needs of the borrowers they are trying to serve. The type of HOME subsidy provided to the prospective purchaser depends on the type of underwriting hurdle(s) that the prospective borrower faces:

- Assisting with the homebuyer's downpayment and closing costs;
- Reducing the mortgage amount to reduce monthly payments; and/or
- Overcoming credit-related hurdles.

The subsidy choice depends on the characteristics and needs of potential borrowers, interests and requirements of participating lenders, and capabilities and resources of the PJ.

Downpayment and Closing Cost Assistance

For many potential homebuyers, the biggest barrier to homeownership is raising cash for downpayment and closing costs. While households may have a steady income that would support monthly payments, they do not have enough savings to cover the upfront costs of buying a home. The HUD 1 is very useful for evaluating the borrower's cash needs.

Downpayment and closing cost assistance is usually structured as a grant or a deferred payment loan. If downpayment/closing cost assistance is the only assistance the PJ provides, then a deferred payment loan, rather than a grant, may be advisable. If all the terms of the loan are met, the loan may be forgiven. A deferred payment loan is repaid (in whole or in part) at a stated point in the future, often in stages over time, or at the end of some specified period, such as the sale of the home, or upon violation of any conditions attached to the loan. A deferred payment loan provides a means of enforcing the principal residency and resale/recapture requirements of the HOME Program, and also potentially recycles HOME funds.

Gap Financing

Other potential homebuyers lack the income to cover the monthly cost of principal, interest, property taxes, and insurance (PITI). The difference between the loan amount their maximum affordable payment would cover, and the actual mortgage amount required, is called the "gap." HOME funds structured as "gap financing" can reduce monthly loan payments and eliminate the gap. Probably the most efficient way to reduce the size of a borrower's monthly payment is to provide the homebuyer with a grant, or more likely, a second loan on favorable terms, to reduce the first mortgage principal they must borrow. Another option, less common and usually more expensive, is an interest rate buy-down. With a rate buy-down, the PJ provides funds directly to the lender, who then reduces the interest rate on the borrower's loan.

PJs can structure gap financing in a number of ways. For example, HOME loans can be deferred payment, interest only, or fully amortizing at a low interest rate. Gap financing reduces the first mortgage lender's risk by reducing the loan-to-value (LTV) ratio. If the first mortgage LTV is reduced to 80 percent, the lender will not require mortgage insurance. This has the benefit of eliminating both the borrower's monthly premium and the need to qualify under mortgage insurance guidelines. In addition, gap financing can overcome "appraisal gaps" when the costs of purchasing and rehabilitating exceed a home's post-rehabilitation value.

When structuring gap financing, PJs will encounter the concept of "lien priority." A lien is a claim on the property, such as a mortgage. A lender with a first lien on the property (also known as "first position") has first claim on foreclosure sale proceeds, a lender with a second lien has second claim, and so on. If nothing remains after superior liens are paid, subordinate lien-holders must pursue other, more uncertain legal remedies to collect from the borrower. Generally, HOME gap financing is structured as a secondary loan to the privately financed loan. Often the HOME loan is structured as a "soft second," meaning that it is forgivable at some point in time.

Credit-Related Hurdles

For many potential homebuyers, credit-related hurdles can be the most difficult barrier to address. When lenders are unwilling to make loans due to the applicant's credit profile, PJs can pledge HOME funds to guarantee a single loan or a pool of loans. A loan guarantee is a written promise to pay the lender some percentage of the outstanding principal balance in the event the borrower defaults. HOME funds can be deposited into a guarantee account held by the lender. For example, for a group of mortgages totaling $2 million, $200,000 could be set aside to cover losses (10 percent). HOME regulations require that the amount placed in a loan guarantee account be based on a reasonable estimate of the loan default rate. HOME funds in the guarantee account may not exceed 20 percent of the total outstanding principal balance guaranteed. Note: compensating bank balances funded by HOME are ineligible for use as a loan guarantee.

PJs will need to negotiate the particulars of the guarantee with the first mortgage lender. Key questions to consider include:

- For what period will the guarantee remain in effect?
- How many defaults will it take to exhaust the fund?
- What criteria will be used for claim payment?

Because of the financial complexities involved, PJs should carefully review the HOME Program rules on loan guarantees found at 24 CFR 92.205(b)(2) and plan on obtaining experienced technical assistance when structuring a guarantee fund.

Education and counseling provide applicants with information, tools, and support to repair credit records. By providing financial support for homebuyer and credit education courses, PJs can ensure that applicants who are approved are truly ready for homeownership, and that credit counseling is available to those who are screened out due to poor credit.

Loan Closing

Loan closing is the legal process that transfers the home's title to the buyer, transfers loan funds and downpayment to the seller, and makes the home legally enforceable collateral for the lender. The closing usually occurs in the office of the lender's attorney. The buyer receives the deed to the property, and executes a mortgage note pledging to repay the loan with the home as collateral. The HUD 1 statement of settlement costs lists all payments and credits due from the buyer and the seller at closing.

At loan closing, HOME funding is also legally executed. Liens, deed restrictions, recapture agreements, repayment provisions, and any other formal agreements related to the HOME funds must be included in the loan closing documents. Upon completion of the closing, PJs should be sure all executed legal documents are publicly recorded. For most PJs, these documents will provide the primary, if not sole, legal mechanism for enforcing long term affordability restrictions. Without recording the documents, these enforcement tools will be ineffective. Further, given the importance of the loan closing process, PJs should establish a process for auditing loan closing files periodically to ensure quality control of these essential documents.

Loan closing is a good opportunity for PJs to reconfirm that borrowers understand their obligations, and, where applicable, are made aware of the availability of post-purchase counseling.

End Note

1 See myFICO, a consumer division of Fair Isaac Corporation. *Credit Scores—Credit Education.* Available at: http://www.myfico.com/myfico/CreditCentral/ScoringWorks.asp [Last updated 2004.]

Chapter 4:

Understanding Loan Servicing

Chapter 4 presents key concepts that ground loan servicing practices and explores how lenders apply these concepts with standard documents, procedures, and information technology. The chapter highlights the PJ's responsibilities and what the industry's norms suggest for HOME Program design.

Servicing's Place in the Lending Industry

Servicing a loan is usually a routine process of collecting payments—but not for the borrowers who get into financial trouble, cannot make timely payments, and stand to lose the home they have worked hard to buy. Given the high level of automation that characterizes loan servicing, the PJ's challenge is to have ongoing systems in place to break through the routine when necessary to maintain the homeowner's equity and credit standing.

As discussed in Chapter 1, loan servicing functions are increasingly separated from loan originations. Specialized servicing organizations may be responsible for hundreds of thousands of home mortgages scattered throughout the country. This means that departments and organizations with no connection to the parties who worked with the applicant to originate the loan typically perform loan servicing.

Effective and appropriate servicing of higher-risk loans will detect payment difficulties early and avert default. Government sponsored secondary market enterprises have issued benchmark guidelines for how to service affordable loans. They require that delinquency counseling be offered the first time a borrower is delinquent, and that early delinquency counseling be continuously available for seven years after loan origination. Counseling must be documented in a monthly status report on each delinquent borrower.

For PJs, the challenge is to get attentive servicing for low-income borrowers in a marketplace that strives for standardization. With good working relationships with both lenders and servicers, and some help from technological advancements, PJs can find ways to see that low-income borrowers get the attention they need.

Matching Servicing Routines to Borrower Risk Using Computer Models

Loan servicers who deal with thousands of mortgages see many delinquencies every month, but only a few ever reach the foreclosure stage. In the early stages it is hard to know which borrowers are simply a week late on their payments, and which ones are heading into greater trouble.

Once again, information technology plays a key role in the modern mortgage business. Computer software uses statistical models to predict delinquent borrowers' repayment behavior. The scores generated by the models give servicers a tool to determine which delinquencies are likely to persist, so they can intervene at the earliest stages. This helps servicers manage workloads by directing attention to borrowers most likely to benefit. If delinquency persists, software also identifies when servicers should begin loss-mitigation procedures. Foreclosure prevention strategies are suggested too.

Servicing software generates scores based on risk using factors like:

- Mortgage and property characteristics;
- Lo an-to-value ratio;
- Pay ment history;
- Current real estate market data; and
- Econom ic conditions.

What does technology-based servicing intervention mean for low-income borrowers? Before servicing software was developed, servicers had to rely on hunches to predict who could benefit from workout plans and avoid foreclosure. Proponents of servicing software say the old method made servicers less inclined to invest resources to help borrowers, since they had no reliable way of knowing whether their intervention would bring results. Ideally, technology can direct scarce counseling resources efficiently. Skeptics worry that predictive models may not account for the sacrifices that low-income homeowners may be willing to make to keep their homes.

Meeting Special Needs of HOME Borrowers

Servicers have a major stake in avoiding costly foreclosures, and they will work with borrowers to prevent it, either directly or behind the scenes. Affordable loans may require more attentive servicing than conventional loans. Low-income borrowers are at higher risk of financial crises that can impact their ability to make timely payments. Low-income borrowers may also have less experience with financial institutions, making them less confident about the system and less savvy about how the whole complex process works.

The most effective servicing for HOME-assisted borrowers is likely to result when servicers, lenders, counselors, and PJs work together to prevent mortgage defaults. Although the servicing organization may have the earliest knowledge of payment difficulties, it may not be in the best position to help. Financially troubled borrowers are generally best served by entities with which they have established a relationship. When servicers identify potential problems with a loan, a pre-established network of support for the borrower can be invaluable. PJs may choose to play coordinating or organizing roles in creating such support.

Lending programs can be designed so the originator remains responsible for working with the borrower if payments are missed. Alternatively, in the event that servicing rights are sold, sale documents can require that the originating lender or the PJ be notified of delinquencies. A partnering counseling agency might also be engaged as soon as a borrower falls behind, to work one-on-one with the borrower to get back on track.

Post-purchase counseling can provide HOME borrowers with an ongoing network of support, month-in and month-out, as loan payments are made. It gives borrowers somewhere to turn for advice if financial trouble arises, before the first payment is missed. If default becomes unavoidable for a HOME-assisted borrower, post-purchase services can help the borrower understand the options and determine the best course of action. One alternative to an inevitable foreclosure is a "deed in lieu of foreclosure." Often referred to simply as a "deed in lieu," it is a resolution of default in which the owner signs the property over to the lender, and in return the lender agrees not to pursue the balance of what is owed. A deed in lieu is an appropriate resolution when there is little equity in the property and the lender wants to avoid the time and expense of formal foreclosure proceedings. A deed in lieu typically has less negative impact on the borrower's credit rating than a traditional foreclosure. However, as discussed later in this chapter, the PJ may still be responsible for ensuring that the required long-term affordability requirements are met.

Guarding Against Predatory Lending

The post-purchase support mechanisms that can reduce defaults can also deliver continuing education about preserving home equity and rejecting predatory loan marketers. Some HOME borrowers live in older or urban neighborhoods that are particular targets for abusive lenders. Because housing in these neighborhoods typically requires more repair, borrowers are vulnerable to high-cost, equity-stripping home-improvement loans. It is important to remind HOME borrowers regularly about the dangers of predatory lending and how it can deplete the equity they have struggled to build. Borrowers should be alert to marketing pitches and loan features that signal caution, including:

- Door-to-door outreach, especially in conjunction with offers to finance home improvements;
- Offers of cash, since predatory lenders often market "cash-out" loans for debt;
- Loan flipping, or repeated refinancings with high up-front fees that are rolled into each transaction; and
- Balloon payments that require financing at a fixed date, subjecting the borrower to the risk of rising interest rates or the absence of any refinancing at all.

Post-purchase counseling can advise borrowers how to tap home equity prudently.

PJ Responsibilities During the Affordability Period

The PJ's primary responsibilities during the long-term affordability period are to ensure compliance with the applicable resale/recapture provisions if the property is sold and to track the timely payment of any HOME funded loan. It is also a good idea for the PJ to verify that the property remains the principal residence of the assisted homebuyer. These provisions are largely self-enforcing through the loan documents, deed restrictions and/or lien that accompany HOME assistance. A well-crafted written agreement is another important enforcement mechanism. The PJ should also consider using other tools for tracking program compliance during the long-term affordability period.

Monitoring Principal Residence Requirement

The homebuyer must reside in the HOME-assisted unit as his/her principal residence. Many PJs choose to enforce this requirement through loan documents, deed restrictions, written agreements, or other enforcement mechanisms. One of the following techniques can also help a PJ ensure that permanent residency is maintained:

- **Annual Certification of Residency.** Send a certification letter to the homebuyer via certified return receipt mail.
- **Insurance Policies.** Require homeowners to list the PJ as a loss payee on their homeowner's insurance for the duration of the affordability period. The insurance carrier will notify the PJ whenever a claim is made, the policy is renewed, or it expires. These notifications state whether the home is an owner-occupied or rental property.
- **Utility Bills.** Check periodically with local utility companies to determine the name and address of record.

Monitoring Repayments of HOME Assistance

For repayable HOME assistance, PJs or their collection agents must establish tracking systems to log payments and calculate the remaining HOME principal due. Substantial program income is at stake in programs using deferred payment or year-by-year forgivable loan structures. To protect this program income, PJs should ensure that loan documents and/or deed restrictions require repayment upon sale, or when the home ceases to be a principal residence, consistent with the written resale or recapture agreement.

Regardless of whether or not the PJ services debt, the PJ should arrange to be notified by the first mortgage lender in the event of payment problems. This not only helps build good relations with the lender for future collaboration, but also enables intervention by the PJ or affiliated partners to assist financially troubled borrowers. Notification also provides data on loan performance to help design future programs.

Monitoring Resale and Recapture Provisions

If a HOME-assisted borrower elects to sell during the affordability period, the PJ's written agreement establishing the resale or recapture provisions will guide who can buy the property, what funds must be repaid, and how long the affordability restrictions continue, as explained in Chapter 2. The deed restriction or other enforcement tool that is recorded by the PJ should ensure that the PJ is notified when a sale is pending. The techniques described above for monitoring the principal residency requirement are also useful in alerting the PJ when a sale has occurred.

PJ Responsibilities in the Event of Foreclosure

In the event of foreclosure, or transfer in lieu of foreclosure, the HOME rule allows the lender to take the property without the affordability restrictions. This permits a lender to get clear title to the property, in order to recoup its investment to the greatest extent possible. However, a foreclosure does not relieve the **PJ** of its responsibility to ensure that the HOME-assisted property remain affordable throughout the period of affordability, even after a foreclosure occurs. The implications for the PJ vary, depending on whether the PJ uses a resale or recapture agreement to preserve affordability, and depending on what recapture provisions are established. It is important that the PJ establish mechanisms so that it will be notified of pending foreclosures.

In the event that the owner of record1 before the foreclosure (or transfer in lieu of foreclosure) obtains an ownership interest in the project or property after foreclosure, the original affordability restrictions are revived.

Foreclosure of Property with Resale Restrictions

Under the resale option, a PJ commits to keeping a specific HOME-assisted property affordable for the duration of the affordability period through the sale of the property to a low-income family, or a family that is "presumed" to be low-income. If a lender forecloses on the property, the affordability restrictions may terminate. However, termination of the affordability restrictions does not satisfy the requirement that the property remain affordable for the long-term affordability period, as established by the resale agreement.

Unless the property is located in an area where there is a presumption of affordability (as described in Chapter 2), in order to meet its obligation to keep the unit affordable to a low-income buyer, the PJ must ensure that after foreclosure or transfer in lieu of foreclosure the subsequent buyer of the property is low-income. Since the lender takes ownership of the property upon foreclosure, the PJ will need to work with the lender to see that this happens. If the new buyer receives HOME assistance to purchase the property, a new period of affordability can be established based on the amount of the direct HOME assistance to the new homebuyer, or the original affordability period can be retained. If no new HOME assistance is provided, the new

Determining the Amount to be Repaid in the Event of Foreclosure

The following scenarios illustrate how to determine the repayment amount in the event of foreclosure:

1. A PJ provides $5,000 in downpayment assistance to a homebuyer. The assistance is forgiven on a pro-rata basis over the five-year affordability period. The property is foreclosed in the owner's third year of ownership. The PJ must repay $5,000 to its HOME Trust Fund account because none of the HOME funds have been repaid by the homeowner. If, after foreclosure, these funds are not available to the PJ as a subordinate lien holder, the PJ must use its own non-federal funds to repay the entire $5,000 to the HOME Trust Fund account.
2. If this same downpayment assistance is provided in #1, above, but it is structured as a loan, repayable in equal amounts over five years, the PJ must repay $2,000 to the HOME Trust Fund account since by the third year, the homeowner has already repaid $3,000 of the loan to the PJ (assuming the homeowner had made the required payments) as program income.
3. If the PJ also provided development assistance to this property in the form of a $10,000 grant to the developer, the PJ must repay an additional $10,000 to the HOME Trust Fund account since no repayments of the development assistance have been made by either the developer or the homeowner.

low-income homebuyer must be willing to assume the remaining term of the original long-term affordability period in order for the PJ to meet its obligation.

If the HOME-assisted housing fails to meet the affordability requirements for the full period of affordability, the PJ must repay the appropriate HOME Trust Fund account. The PJ is responsible for repaying the funds whether or not it is able to recover any portion of the HOME investment from the owner, project developer, state recipient, subrecipient, or community housing development organization (CHDO). The amount of HOME funds that must be repaid is based on the total amount of HOME funds invested in the project (development subsidy and direct homebuyer assistance), but varies, depending on the form of subsidy provided. If the HOME funds were provided in the form of an amortizing loan, the PJ must repay the outstanding principal balance (since a portion of the original loan has already been repaid to the PJ and reprogrammed as program income). If HOME funds were provided as a grant, or a non-amortizing or deferred payment loan, the amount of repayment is the full amount of HOME assistance invested in the property (since no payments on the loan have been made to the PJ).

When a PJ uses a resale provision, it is prudent for the PJ to take proactive steps to prevent foreclosure, given the PJ's potential liability in the event of foreclosure. When negotiating the original financing terms with the lender, PJs should consider ways to prevent foreclosure, and negotiate terms that give it pre-emptive rights to purchase the housing before foreclosure or transfer in lieu of foreclosure, such as a purchase option or the right of first refusal. The PJ might also negotiate a notification clause requiring the lender to notify the PJ when payments are late or missed, or at the first signs of risk of foreclosure. The PJ can intervene with these borrowers on behalf of the homeowner, particularly if the PJ offers a post-purchase counseling program. The PJ might also be able to work with the lender to develop a mutually satisfactory foreclosure workout plan. Since a foreclosure can be expensive for the lender, the lender may be open to negotiating favorable terms with the PJ.

Foreclosure of Property with Recapture Provision

When there is a foreclosure of a property with a recapture provision, the PJ or family may or may not have a recapture obligation, depending upon the type of recapture provision the PJ has chosen (see Chapter 2 for a discussion of the different options a PJ has when using a recapture provision).

Unlike homeownership housing that is subject to a resale restriction, when homeownership housing is subject to a recapture restriction, the terms of the recapture provisions determine the amount of HOME funds that must be repaid when a property is foreclosed:

- If the recapture agreement provides for shared net proceeds, the amount that must be repaid is the homeowner's required share of the net proceeds (if any) from the foreclosure sale. Net proceeds are the funds remaining after the first lien is satisfied. If there are no net proceeds, then there is no recapture obligation.
- If the recapture agreement requires the homebuyer to repay the entire amount of the HOME assistance, or an amount reduced pro-rata based on the time the homebuyer has owned and occupied the housing measured against the affordability period, the amount that must be repaid is the amount required by the recapture agreement. If the agreement requires the recapture of the full amount of the HOME assistance, the repayment obligation is the full amount, regardless of the amount of any net proceeds after foreclosure. If the agreement requires the recapture of a pro-rated amount of the original HOME assistance, then the repayment obligation is the pro-rated amount of the original HOME assistance, regardless of the amount of any net proceeds after foreclosure.
- If the PJ is unable to recapture the required amount of funds at foreclosure, the PJ must use its own funds to make up the difference.

PJs that are concerned about the possibility of repaying funds in the event of a foreclosure may wish to consider adopting recapture provisions that base the recapture amount on the net proceeds available from the sale of the property rather than on the entire amount of the HOME investment. If the written agreement bases the recapture amount on net proceeds and there are no net proceeds from the foreclosure, repayment is not required and HOME requirements are considered to be satisfied.

Failure To Comply With Home Requirements

If, during the long-term affordability period, the HOME-assisted property fails to comply with the applicable HOME requirements for reasons other than foreclosure (such as sale to a non-eligible homebuyer or the failure of the original homebuyer to occupy the property as his/her principal residence), the PJ must repay the entire outstanding balance of the HOME investment (development subsidy and direct assistance to the homebuyer), regardless of whether it is able to recapture any funds from the homeowner.

When Funds Must Be Repaid

Funds that must be repaid by the PJ to the HOME Trust Fund account because of the failure of the HOME-assisted property to comply with all of the HOME requirements for the entire affordability period (as a result of foreclosure or from other causes) must be repaid as follows:

- If the HOME funds were initially disbursed from the PJ's HOME Investment Trust Fund *Treasury* account, they must be repaid to the Treasury account.
- If the HOME funds were initially disbursed from the PJ's HOME Investment Trust Fund *local* account (i.e. program income or recaptured funds), they must be repaid to the local account.

HUD may waive the repayment requirement for good cause, although this is done infrequently. A PJ can show good cause by demonstrating to HUD that it has made a good faith effort to preserve the unit for affordable housing. Waivers might also be available in the event the foreclosure or non-compliance was the result of an extreme circumstance, such as the destruction of the property by a fire, or other disaster.

Note that once a PJ has recaptured HOME funds in accordance with a written recapture agreement, it has met its obligation to preserve affordable housing, and the property is no longer subject to any affordability requirements.

End Note

1 This would include the owner of record, or those with whom the former owner has or had family or business ties.

Chapter 5:

Maximizing the PJ's Relationship with Private and Public Lenders

Chapter 5 discusses how to create a win-win partnership with private and public lenders, keeping the lender's perspective of the HOME Program in mind. The chapter reviews the HOME Program's real and perceived advantages and disadvantages, and describes how PJs can recruit private and public lending partners. Armed with information from this chapter, PJs will be able to make sound finance-related decisions when choosing and assessing their program delivery systems and allocating administrative tasks. The chapter concludes by summarizing specific finance issues that PJs should consider when designing programs that might be familiar to HOME staff, but are unusual for private lenders.

Choosing a Delivery System

Homebuyer programs come in all shapes and sizes. The range includes downpayment assistance programs where PJs receive lender referrals of pre-approved buyers with sales contracts in hand, all the way to intensive, client-focused programs in which the PJ or a nonprofit partner work with buyers for months to prepare loan packages. Certain core components are common across the whole range.

Pre-Application

Pre-application has three purposes. It attracts potential homebuyers, pre-qualifies them to determine if they are likely to qualify for financing, and offers access to counseling services to strengthen loan applications and prepare for ownership.

- Marketing and Outreach. Especially for programs seeking to serve populations with little exposure to the home buying process, good marketing is essential. Marketing efforts should use multiple channels to produce a sizeable pool of inquiries. It may take 15 or more applications to generate one qualified loan package.

  For example, a nonprofit partner can attract applicants with print or radio ads, notices in paycheck envelopes, or fliers distributed by local schools and faith-based organizations. Local realtors who have been briefed about the program can refer clients. Participating lenders can include the program in their marketing materials. Loan officers can refer applicants who do not qualify for conventional loans.

- Pre-Qualification. After an individual has expressed interest, the next step is pre-qualification. Pre-qualification involves reviewing unverified information to make a preliminary, non-binding assessment of eligibility, and sometimes estimating the approximate level of HOME support that may be needed. The partner managing the pre-qualifying process should be able to quickly see whether an applicant is ready to apply for financing, needs to work on budgeting and credit counseling, or has long-term credit issues. The partner should have strategies in place for applicants in each category.

The application should include an applicant privacy release so information can be shared among partners.

- Counseling/Education. Many potential applicants may need to improve their credit before applying for a loan. As discussed later in this chapter, credit counseling and education programs can help potential applicants repair credit, accumulate savings, and develop sound family budgets and debt payment habits. Homeownership counseling can help prepare potential applicants for the responsibilities of homeownership.

Application

The formal application documents income so the PJ can determine HOME Program income eligibility and the lender can determine whether to provide financing. A wise idea is to have one entity coordinate the process and serve as the single point of the contact for the applicant.

In some programs, after determining that an applicant is HOME-eligible, the PJ will assemble an application for the participating lender. Packaging the application involves ensuring that paperwork is complete and meets both the PJ's and the lender's requirements. Consistent packaging of documents supports a smooth loan underwriting process.

Underwriting and Selection

Underwriting is the process by which the PJ and the participating lender review the completed loan application package and determine whether or not to approve the loan request. The result is a determination of how large a mortgage the first lender is willing to provide, if any, and how much HOME assistance and other gap financing will be needed.

Loan Closing

Loan closing takes place when the buyer and seller execute mortgage documents that complete the home purchase. Depending on local preferences and the type of assistance being provided, some PJs simply deliver a check and a copy of loan documents to the closing agent, while others send a representative to each closing.

PJs that provide downpayment or closing cost assistance often cover a fixed percentage of costs, with the balance coming from the borrower's own resources. Obtaining an advance copy of the Good Faith Estimate of Settlement Costs (discussed in Chapter 3) enables PJs to determine how much assistance is warranted, and ensures that checks can be cut in time for closing.

Post-Closing

Experienced managers of homebuyer programs know the job is not finished at loan closing. In cases where repayment of HOME assistance is required, the PJ or program administrator will need to establish loan-servicing procedures (see Chapter 4). Post-purchase counseling and early intervention during the first one or two years are critical to support good payment habits.

Defining Roles

An honest assessment of the institutional capacity and motivation of each partner involved is necessary when establishing responsibilities and processes for a homebuyer program. Such an assessment can help determine which partners will take on which of the responsibilities outlined above.

Different partners have different areas of expertise. Nonprofit organizations typically are strong in outreach, counseling, and pre-screening applicants. Generally, the program administrator, either the PJ or a nonprofit organization, will pre-screen prospective homebuyers, arrange for homebuyer counseling sessions, and possibly help with finding a home. An astute mortgage lender can match applicants with appropriate loan programs. The mortgage lender will generally assume loan processing and underwriting responsibilities, including credit checks, income and debt verifications, and appraisals. Secondary market investors often define the extent of underwriting flexibility, and local or regional staff of secondary market enterprises can play important roles in program design. Servicing lenders collect payments, escrow taxes and insurance, devise workout plans for delinquent borrowers, and institute foreclosure proceedings when necessary. The PJ's role will vary depending on staff resources and expertise available, but will always include a loan-by-loan review to verify compliance with key HOME requirements, such as the income eligibility of homebuyers.

The PJ's Responsibilities

> PJs must be specialists in HOME Program compliance and must monitor their partners to ensure that program requirements are met. Whatever the nature of its partnership with nonprofit organizations and lenders, ***the PJ retains accountability for HOME compliance***. See Chapter 2 for a discussion of the key HOME requirements for homebuyer programs.

The PJ is ultimately accountable to ensure that all the requirements of the HOME Program are met. If it has engaged with a partner, such as a state recipient, subrecipient, or contractor to administer all or a part of its homebuyer program, it must make sure that its partner is fully knowledgeable about the requirements. In addition to communicating these requirements to its partners verbally, PJs should communicate these requirements in writing. Ideally, the mandatory written agreement between the PJ and its partner will describe, in simple and understandable language, all the terms and conditions under which HOME funds are provided. Prudent PJs also include specific reporting and record-keeping requirements in their written documents to facilitate their efforts to document compliance with program rules.

Chapter 2 provides a summary of the key requirements that apply in the operation of a homebuyer program. These include:

1. Borrower income eligibility;
2. Property and ownership requirements;
3. Eligible activities and cost items;
4. Propert y standards;
5. Long-term affordability (resale and recapture);
6. Maximum purchase price;
7. Maximum and minimum per unit subsidy;
8. Written agreements; and
9. Record-keeping.

> **Remember, when a PJ uses a contractor to administer all or part of its HOME Program, that contractor must be procured in accordance with 24 CFR Part 85.36.**

Lender Relationship

> **Soft second mortgages, deed restrictions, non-traditional credit histories, and other common features of affordable homeownership programs can be problematic for lenders unfamiliar with this part of the market. Consider asking the participating lender to designate certain loan officers who will be trained in the HOME-assisted program. Lenders may also choose to focus loan availability in specific locations convenient to potential homebuyers.**

As part of its program design, the PJ must decide how to structure its relationship with the mortgage lender(s). Some PJs allow borrowers to choose any lender, while others establish standards for lender participation (transaction fees, origination points, etc.) and meet periodically with lenders to explain the program, including its procedures, forms, eligibility criteria and subsidies, as well as the lender's role in the process. In the most formal (and least common) lender relationship, a lender is selected competitively, in accordance with government procurement procedures. The partners negotiate and agree on underwriting and servicing criteria, loan terms, marketing, and terms of HOME assistance, and execute a lender agreement to confirm terms. If a lender or secondary market investor has established a special loan product for the HOME-assisted program, the agreement may include a lender commitment of funds to the program.

Assessing and Recruiting Lending Partners

Local vs. Regional or National Lenders

Locally-based lending institutions may respond to the opportunity to gain recognition in their own communities, although they might lack experience with specialized approaches to funding affordable housing. Major lenders are more likely to have dedicated affordable housing and community development staff. Sometimes these more sophisticated institutions give priority to programs in their home office cities.

Community development financial institutions (CDFIs) and development credit unions tailor their services to low- and moderate- income borrowers and generally have substantive expertise matching appropriate resources to individual households. However, there are relatively few CDFIs nationwide, and many operate on a relatively small scale. It may be necessary to supplement their financial or staff capacity with private lender resources.

Traditional credit unions may have strong ties to their membership group, typically an employer. This provides a useful basis for marketing and outreach when the PJ is interested in reaching the same group.

Marketing Reach

One of the key services a partner lender can provide is marketing. PJs can find out if the institution's network of offices serves its program area conveniently, and whether loan marketing staff would be willing to meet with applicants after-hours. PJs should look for lender partners with staff who are familiar with the specific customer groups the PJ especially wants to reach.

PJs may also want to inquire about the commission structure for loan marketers. Will the typically smaller mortgage loans of a HOME-assisted program yield a higher percentage commission? If not, expect marketers to have less interest in the PJ's program.

Of course, innovative marketing ideas are one of the clearest signals of an institution's commitment to getting the word out about affordable lending. For example, one major lender's marketing staff succeeded in penetrating previously unserved markets by paying church members to recruit new accounts from its tight-knit community.

Track Record

Lenders who have originated sizeable portfolios of specially underwritten affordable housing loans have experience in lending to those the HOME loans are designed to reach, and have demonstrated a commitment to this clientele. On the other hand, dramatic announcements of loan commitments do not always result in loan production. PJs are cautioned to check out any potential partner's actual track record.

The more background a potential partner has in the affordable lending business, the better. Whether it is an intended role or not, PJs should assume that lenders will counsel clients to some extent. Experienced lenders can direct potential HOME-assisted borrowers to the programs that make the most sense for their particular circumstances.

Checklist

To evaluate whether a new lender is well-versed in affordable housing lending, determine if the institution has participated in other types of affordable housing ventures, such as:

- Making Federal Home Loan Bank affordable housing programs available;
- Investing in low-income housing tax credit projects;
- Providing construction financing for affordable rentals;
- Having officers on boards of housing nonprofits;
- Originating loans for state housing finance agency programs;
- Providing FHA mortgage insurance or VA/RHS loan guarantee;
- Making mortgage loans for manufactured housing;
- Participating in portfolio or secondary mortgage market programs for affordable housing; or
- Providing funding, staff, or meeting space available to support buyer education.

HOME's Impact on Lender's Profitability

As PJs develop partnerships with mortgage lenders, it is important for the PJ to be able to understand the lenders' perspective. Good intentions and regulatory incentives for making HOME-assisted loans will leverage only so much. PJs must be prepared to articulate how their proposed program will affect the lender's bottom line, positively and negatively.

Unusual loans that do not conform to the standard pattern can disrupt the production process and cost lenders money. For example, HOME second mortgages must be reviewed to be sure they meet requirements of the lending institution and its secondary market partners. HOME-assisted applicants sometimes require traditional underwriting, which is more costly than standard automated underwriting. And in general, small mortgage loans take as much or more time to originate than large ones, yet the percentage-based origination fee structure means they yield less revenue to the lender.

Loan servicing may require more careful monitoring and follow-up for HOME-assisted borrowers. As with origination fees, servicing revenue is keyed to loan size, making HOME loans somewhat less profitable to service. On the plus side, to the extent that second mortgages whose balances are forgiven automatically over time add to borrower equity, they give borrowers an extra reason to make timely payments on the first mortgage. Defaults on such HOME-assisted loans may be lower than on standard loans, reducing lender costs.

PJs that are able to take steps to make the HOME-assisted loan program resemble a mini-production line, are able to talk the lender's language. Consider concentrating HOME loans with a smaller number of originating partners so they can generate an efficient scale of production. This benefits PJs because it enables lender partners to build expertise in HOME procedures. It simplifies the PJ's monitoring efforts, too.

What the HOME Program Offers Lenders: Using Your Leverage to Get the Best Deal

PJs have some meaningful benefits to offer participating lenders. If these are properly articulated, PJs may find they have some leverage when negotiating lending partnerships. All of the lender benefits derive from the central fact that *HOME assistance helps lenders make loans that they otherwise would not be able to approve.*

Lenders are constantly seeking ways to expand their market while managing risk. By reducing loan-to-value ratios, making monthly payments more affordable, or providing loan guarantees, HOME assistance can reduce lender risk in serving the low- and moderate-income market. HOME assistance means new borrowers who otherwise would never have done business with the lender. And once a family has borrowed for a mortgage, the lender has an opportunity to "cross-sell" other banking services, such as checking or savings accounts, to the new customer.

Lenders who participate in HOME-assisted homebuyer programs are also likely to receive credit towards Community Reinvestment Act (CRA) goals. The risk-absorbing benefits of HOME assistance help lenders balance their obligations to regulators under CRA with their obligations to be profitable and prudent.

Similarly, the Home Mortgage Disclosure Act (HMDA) tracks the location, income, race, and ethnicity of mortgage applicants, and makes all data available for public scrutiny.

Some lenders track their performance on these measures very actively in order not to be surprised by charges of "redlining." Likewise, housing advocates use special software to watch lender performance. In many markets, HOME-assisted borrowers are likely to improve lenders' HMDA statistics.

Participation in HOME-assisted homebuyer programs opens up new partnership possibilities for lenders. Lenders benefit from the outreach efforts of the program, which can amount to free advertising. They can refer unqualified applicants to pre- and post-purchase counseling partners instead of simply having to turn people away. In addition, the nonprofit or for-profit developer that becomes a partner with a bank on a small homebuyer project today could bring additional, and potentially larger deals to the lender in the future.

Negotiating Tips

Armed with the knowledge that their HOME assistance provides potentially attractive benefits to lenders, PJs can effectively negotiate lending partnerships if they bear in mind the following strategies:

- **Know the Lender.** Develop an understanding of the institution, its role in the community, the programs it offers, how decisions are made, and who makes the final decisions.
- **Obtain Commitment from the Top.** Start negotiations from the top, both within the PJ's own organization and the lending institution. Aim to negotiate a comprehensive program that will make loan-by-loan discussion unnecessary. Work out the details of the program after the general commitments have been made.
- **Address the Lender's Needs.** Understand the lender's goals and objectives and offer the agency's expertise where appropriate (for example, buyer education, post-purchase support for borrowers, nonprofit linkages).
- **Know What Is and Is Not Negotiable.** Lenders are by nature risk averse, and they must answer to regulators and secondary investors for the quality of their lending. Determine up front what options the lender will and will not discuss.
- **Do Not Overplay the Hand.** As discussed earlier in this chapter, HOME-assisted loans may not be as profitable to the lender as other loans. If the mortgage market is hot (e.g., the refinancing boom of the early 2000's), do not expect lenders to be as responsive.
- **Compromise.** The key to negotiating anything is compromise. Keep objectives at the forefront of all discussions and keep a flexible approach to meeting those objectives in order to make the program work for the PJ and for the lender.

What to Ask For

PJs can make the most out of a lending partnership if they carefully think through their negotiating goals. These goals will vary according to the resources available to the PJ, the target population for the program, overall market conditions, and the motivations of partner lenders. Some typical negotiating points include the following:

- **Use the Lender's Experience.** Lenders are in the business of evaluating risk and can provide valuable insight. The underwriting tools they have access to, such as automated underwriting models, provide a useful perspective on borrower risk. PJs should plan to leverage this expertise in the design of their programs.
- **Consider a "Top-Down" Approach.** Secondary market investors call the shots on much of a primary lender's origination activity. PJs may want to start with a local or regional office of a secondary market enterprise and then approach primary lenders with proposed terms that have already earned at least preliminary approval.
- **Agree On Underwriting Criteria.** A homebuyer program will operate much more efficiently if partners establish mutually acceptable underwriting criteria. If everyone knows what is "bankable," then time will not be wasted packaging and referring borrowers who are unlikely to receive loan approval. Factors to specify clearly include debt-to-income ratios, loan-to-value ratios, and credit benchmarks.
- **Make Sure Rates and Fees the Lender Proposes Are Competitive.** Lenders generate profits by charging origination fees, along with a combination of discount points and interest rates. In addition, many loan transaction costs are pass-through fees (such as appraisals, title reports, and credit checks). Subsidy dollars will be lower and the first mortgage more affordable if the lender can be convinced to waive or reduce fees and provide competitive interest rate loans. At a minimum, lenders should be able to offer a fee structure comparable to what is available to its borrowers who do not receive HOME assistance.
- **How Does CRA Fit?** PJs need to do some homework to understand whether CRA compliance is a key element of a prospective lender partner's business plan. This can vary depending on the institution's charter, where it is in the exam cycle, and on the institution's plans for mergers or branch closings. The National Community Reinvestment Coalition is a basic source of CRA information for advocates. Its website is www.ncrc.org.

Delivering and Funding Homebuyer Counseling

As discussed in Chapter 1, recent research demonstrates that individual and classroom homebuyer education and counseling (simply "counseling" hereafter) reduce the likelihood of mortgage default. The new research provides even stronger support for incorporating counseling into affordable housing programs. Taking account of what is known to work, the challenge for PJs is to design counseling services that meet their communities' needs and to work with partners to provide additional support and funding.

Designing Counseling Services

In developing counseling programs, there is an array of formats to consider, including pre-purchase, post-purchase, and comprehensive counseling services. The selected format should reflect both client needs and partnership resources available. For example, with a strong partnership of lenders, counseling providers, and a secondary market, PJs can develop a comprehensive (or "full service") lending program. Comprehensive lending provides buyers with counseling throughout the entire home buying process, and supports them as new homeowners. Neighborhood Reinvestment Corporation (NRC) is the most prominent advocate of this approach, which it labels Full-Cycle Lending.

The NRC Full-Cycle Lending Program is a comprehensive counseling program that includes the following elements:

- Pre-purchase education;
- Affordable financing with flexible loan products;
- Property services, such as home inspections;
- Post-purchase counseling; and
- Post-purchase assistance, for those struggling with mortgage payments.

More information on the NRC Full-Cycle Lending Program can be found at http://www.nw.org/network/nw/network/strategies/oldcampaign599/fullcycl.html.

One-on-one counseling sessions have been found to have the greatest impact on reducing mortgage delinquency rates. However, these sessions can be the most costly to provide. To reach a larger number of potential homebuyers, classroom counseling is a popular option. A variety of materials have been produced to support classroom delivery, which typically involves from 4 to 10 hours of instruction. Telephone counseling has been shown not to have any statistically significant effect on repayment behavior.

Exhibit 5-1

Designing Counseling to Meet Community Needs

The ideal type of counseling program for a PJ is tailored to address the assessed needs of the clients being served:

- How much do clients know about home buying, budgeting, and finance?
- How much help will participants require to repair credit?

Program design also depends on the partners involved:

- Does the PJ work with organizations that already have counseling curriculums or programs in place?
- Will these programs suit the PJ's clients?
- Will lenders work with the PJ to design or fund a program that fits the community's needs?

Counseling costs money, especially when delivered individually or in classroom settings. PJs need to consider efficiency in designing counseling programs. "One size fits all" is likely to be inappropriate unless the program is narrowly targeted.

- Can the counseling program be targeted to provide more intensive services to borrowers with the highest risk?
- Can the counseling requirement be waived for experienced homeowners, those with high credit scores, or rehabilitation loan applicants?

Because clients served by a HOME-assisted financing program will each have different needs, PJs can adopt a combination format that provides counseling of different intensity depending on a participant's level of knowledge and experience. In this way, costly one-on-one services can be made available to borrowers who need more help preparing for homeownership, and less intensive group counseling sessions can assist people who are more prepared to buy a home. Quality screening and assessment are key components of such an approach.

Lenders support counseling because of their stake in loan performance. PJs can build upon this basically favorable stance. They can point out specific benefits counseling can bring to the lender's business. For example, if the PJ's homebuyer program is focusing on stabilizing homeownership in a specific neighborhood, a local lender can be encouraged to provide or sponsor counseling as a way to get to know the market and possibly provide other financial services.

In presenting the benefits of counseling to a lender, or any potential partner, PJs should remember what they themselves bring to the partnership. PJs often have a unique understanding of the communities they serve. They also have connections with community leaders that are important to lending institutions.

As discussed in Chapter 2, HOME funds can be used to pay for homebuyer counseling as an administrative cost, or as a project soft cost when the homebuyer also receives direct HOME assistance.

Know the Providers

Lenders are only one of a group of counseling providers, all of whom act in different ways. Anticipating what various players typically bring to counseling programs helps PJs reach out to organizations who can best assist the target communities.

- **Government.** Counseling programs have historically received financial support from the government, primarily through HUD, which provides grants to HUD-approved housing counseling agencies. These grants are competitive, and the funds are not meant to cover all counseling program costs. HUD-approved agencies must offer counseling services in a one-on-one format.

In 2002, 12 national and regional intermediaries and 322 state and local housing counseling agencies received over $18 million in HUD funding. A list of HUD-sponsored housing counseling agencies is available online at: http://www.hud.gov/offices/hsg/ sfh/hcc/ hccprof14.cfm.

- **Nonprofi t organizations.** Nonprofit organizations have been the traditional providers of counseling services. Although other providers, including lenders, have increased their activities, nonprofit organizations continue to deliver a major share of buyer counseling. They often partner with other organizations for funding. Local nonprofit groups have strong community links that enable them to reach out to people in need of counseling.

  Many local nonprofit counseling providers operate under the umbrella of larger, national intermediary organizations. These intermediaries' scale gives them greater access to the funding and resources needed to develop curriculum and delivery systems. Some of the major organizations involved in counseling include ACORN, Neighborhood Reinvestment Corporation, and National Foundation for Consumer Credit (Consumer Credit Counseling).
- **Lenders.** As the party with the most to gain from successful counseling (after the borrower of course), lenders should logically be financial backers. To date, their financial support has been limited. PJs should not hesitate to seek funding support, and the recent research on counseling's impact on loan performance makes a compelling case.
- **Mortgage Insurance Companies.** Like lenders, mortgage insurers often partner with nonprofit organizations to deliver counseling services. They are also providing counseling over the Internet and on the phone. One company is partnering with the National Foundation for Consumer Credit on both pre-purchase and post-purchase counseling.
- **Secondary Market Enterprises.** Secondary market agencies have been leaders in supporting buyer education and counseling. Recently, one agency developed a model curriculum to reach borrowers with low literacy levels. They are partnering with nonprofit organizations to prepare them to train the new curriculum and provide grants to support the training.

Developing Lender Partners to Support Unusual Homebuyer Programs

PJs often need to push the envelope with creative finance programs. Even stalwart mortgage finance partners may balk at collaborating on loans that are new to them. Following are basic descriptions of a few programs that are not uncommon to PJs, but are less familiar to most traditional mortgage lenders. The mortgage lender's perspective and possible roles for HOME assistance are included.

Land Trusts

In a land trust, residents own the individual dwelling units, but the trust holds title to the land, which is leased to the homeowners. The land lease provides firm control over home resale prices, which are limited to ensure permanent affordability. Controls also limit approval to buyers based on income or other factors. The permanent affordability provided by land trusts means that HOME subsidy dollars have permanent impact.

Community land trusts are local nonprofit organizations that can operate as community housing development organizations (CHDOs) under the HOME Program. Land trusts that qualify as CHDOs are eligible for HOME set-aside funding and can get operating support through the PJ's allocation. Although HOME funds can assist land trusts in a variety of ways, including capacity development, technical assistance, and feasibility studies, HOME Program funds may not be used to acquire land for future development (also known as land banking).

HOME Program funding for land trusts is often leveraged with private financing, such as mortgages, and other government funding sources, including tax credits or state housing finance agency funds. In the public sector, Community Development Block Grant (CDBG) funds are one of the primary sources of land trust financing. Federal Home Loan Bank resources also help land trusts, as their mission of permanent affordability gives them a scoring advantage when competing for funding. In the private sector, financing may be more difficult.

A mortgage on a land trust home in the private market is non-standard, since the homeowner does not own the land. Mortgages with ground lease and resale restrictions are generally perceived as riskier in the private mortgage market. Mortgage institutions have concerns about limitations on their ability to realize collateral value in the event of foreclosure. The resale controls for most land trust housing gives mortgagors a limited market to sell the property.

Advocates of community land trusts argue that land trust homes actually carry less risk than conventional mortgages. Since the trust shares an interest in the successful repayment of the mortgage and has regular contact with the homeowner, it can notify lenders of payment difficulties and work with the homeowner to resolve them. Such provisions can be written into the ground lease. In the event of default, the trust has the option to purchase the home and continue payments to the lender. In effect, the lender has a backup borrower.

Secondary market agencies have facilitated the process of lending for community land trust dwellings. They have special programs that address key issues and allow primary lenders to sell land trust mortgages.

Housing Cooperatives

Housing cooperatives are resident-controlled nonprofit corporations that own housing units, typically in a single building or complex. The creation of cooperative housing is initially financed with a blanket mortgage through the commercial real estate division of a financial institution. The blanket mortgage is the obligation of the nonprofit cooperative corporation. The shares that residents hold in the nonprofit corporation entitle them to occupy a particular unit.

Resident shareowners may sell their shares at market value. Residents of limited equity cooperatives may sell only at specified, limited values designed to keep the project affordable over time. Share loans, not mortgages, finance the acquisition of cooperative shares/living units. Lenders active in the cooperative market provide share loans. Secondary market agencies have programs both for blanket loans and share loans. Cooperatives are eligible for HOME assistance. Depending on state or local law, a cooperative unit may be either homeownership or rental housing.

Condominiums

When buying a condominium unit, the purchaser acquires sole title to a dwelling unit and a proportionate interest in common areas and facilities such as greenspace or community buildings. Condominium projects present lenders and secondary market agencies with special risks due to the concentration of units and the importance of good management. Mortgage lenders will have a number of questions about proposed HOME-assisted condominium purchases, such as:

- Ratio of owner-occupied to renter-occupied units;
- How long owners have been in control of the condominium association;
- State of completion of units and common areas;
- Insurance coverage held by the association;
- The project's marketing track record; and
- Proportion of units already financed by the lender in the project.

Two- to Four-Unit Owner-Occupied Homes

Two- to four-unit properties account for almost nine percent of the nation's housing stock. Becoming a landlord by purchasing a two- to four-unit building and occupying one unit can be an effective way for buyers to earn extra income and surmount high housing costs.

Buying a two- to four-unit property is an ambitious step for buyers who might not have managed rental property before. Making this program idea work takes careful planning and partnership among the PJ, the lender, and buyer education providers. Note that rental income is added to the borrower's other income to determine HOME income eligibility. Chapter 2 describes additional technical HOME requirements for PJs that invest HOME funds in two- to four-unit properties.

Secondary market agencies have taken the initiative to design mortgage programs that make it easier for low- and moderate-income households to finance two- to four-unit properties. One such program allows originating lenders to add all rental income to the borrower's qualifying income. Combined with low downpayments and higher expense-to-income ratios, this expands buyers' purchasing power.

HOME funds and specialized education on managing a small rental property could complete the picture. Because of the specialized nature of loan underwriting and secondary market rules for a two- to four-unit property, PJs will need to be clear on program goals and shop carefully for lender partners willing to invest the effort. Follow-up support for buyers after purchase could be important too.

Manufactured Housing

Manufactured housing is the term reserved by Congress for homes built to the building code implemented in the Manufactured Home Construction and Safety Standards Act, which took effect in June 1976. (Note: "modular" housing is built to local building codes.)

Manufactured housing deserves close attention. It makes up approximately 18 percent of all affordable housing stock in the nation. Owners of manufactured homes comprise about five percentage points of the nation's homeownership rate. Many buyers and residents of manufactured housing meet HOME income guidelines.

Many of the manufactured housing finance practices are a holdover from the days when the manufactured housing units were considered vehicles or trailers. Manufactured home retailers provide one-stop shopping, including financing. Mortgage lenders and secondary market agencies have begun to participate in the market, but many buyers still pay interest rates three to five percentage points higher than site-built homebuyers. For older units, purchase financing is even more costly, or simply unavailable. Equity and rehabilitation loans are hard to find. Financing costs and associated marketing practices contribute to the widespread problem of manufactured home value depreciation.

The existing manufactured housing stock has something of a split personality. Units over 20 years old, many of them single-section units, are frequently of lower quality. Many are located on leased land, making financing more problematic. In contrast, a majority of new manufactured homes are double-section units placed on the owner's private land. Well-constructed newer units can be functionally equal to site-built homes. Quality still varies widely, and improper installation is a frequent source of problems. Compliance with the Manufactured Home Construction and Safety Standards, also known as the HUD code (24 CFR Part 3280), is evidenced by a metal tag affixed to the end of the home opposite the hitch.

HOME funds can fill some of the gaps in existing private-sector finance, while also introducing mainstream mortgage lenders to a large market sector in need of their products and services. Possible HOME-assisted initiatives:

- Partner with mortgage lenders on purchase financing for new and existing units. For the purchase of owner-occupied units on leased land, the lease period must be equal to or greater than the HOME affordability period.
- Provide replacement home financing assistance;
- Provide land purchase financing assistance;
- Provide buyer education for manufactured home consumers;
- Provide rehabilitation financing (Note: HOME regulations do not require a long-term lease when rehabilitating existing owner-occupied manufactured homes); or
- Partner with a CHDO to create model manufactured home subdivision designed for value appreciation.

Lease-Purchase

In lease-purchase programs, tenants lease a home for a period of time before purchasing it, and a portion of their rent payments during the lease period are credited to the home purchase down payment. Lease-purchase programs can be particularly effective for participants with poor or insufficient credit histories. During the lease period the potential homebuyer can build a payment history that supports mortgage qualification.

Circumstances can change greatly during the lease phase of a lease-purchase program. For example, interest rates can increase and put the purchase out of reach. The borrower's employment, family size, and marital status can also change during the period. HOME regulations stipulate that if, at the end of the 36-month period the household occupying the lease-purchase unit is ineligible or unable to purchase the unit, the PJ gets an additional six months to identify another homebuyer. In all cases, if a homebuyer does not purchase the unit by the end of the 42-month period, the unit must become a HOME rental unit. What this means in practical terms is that the PJ must either have a pool of eligible homebuyers available to step in and purchase units, or the PJ must reserve funds to subsidize the existing tenant.

Self-Help Housing

The basic concept of self-help housing programs is the use of "sweat equity," (homebuilding labor provided by the beneficiary), to help reduce the cost of the home. Probably the best-known practitioner of this concept is Habitat for Humanity, which uses homebuyer and volunteer labor to achieve dramatic cost reductions.

Two Federal resources are available specifically to promote self-help housing programs.

- **U.S. Department of Agriculture Rural Housing Service's (RHS) Section 523 Mutual-Self Help Housing Program.** This program funds nonprofit organizations that provide technical assistance to low- and very low-income households to build their own homes in a rural area. Funds may be used to pay salaries, rent, and office expenses of the nonprofit organization. Homes built by Mutual Self-Help grantees typically receive low interest long-term financing through RHS's Section 502 Loan Program.
- **HUD's SHOP Program.** This program funds nonprofit organizations to purchase home sites and develop or improve the infrastructure needed to set the stage for sweat equity and volunteer-based homeownership programs for low-income families.

Mutual Housing

Mutual housing has characteristics of both ownership and rental housing. Mutual housing is developed, owned, and managed by a nonprofit corporation known as a mutual housing association, whose board of directors is majority-controlled by residents and potential residents of the mutual housing facility. Other board members may include local government representatives, business leaders, and members of the larger community. The association's mission is to provide permanently affordable, resident-controlled housing. Mutual housing gives residents much more security of tenure than traditional rental housing. It also gives residents authority over how their housing is managed.

Mutual housing residents do not own their units, rather they own the corporation that owns the units. Residents have lifetime occupancy rights and they can pass those rights on to another family member. In addition to their monthly housing charge, residents typically pay a one-time membership fee, which is refundable when they leave their unit. In most states, resident membership in the association, combined with the rights granted by the occupancy agreement, constitutes a personal property ownership interest. The Neighborhood Reinvestment Corporation provides information and assistance for those interested in mutual housing. See http://www.nw.org/NWIS/Home FrameX.asp?searchfor=17&keywords=mutual~housing.

Conclusion

HOME funds can be the missing link for low- and moderate-income buyers searching for a way into homeownership. The flexibility of HOME allows PJs to structure programs that meet many different buyers' needs, but PJs cannot simply finance affordable homeownership by themselves. PJs must work within the larger context of a rapidly evolving mortgage finance marketplace. To design and implement successful programs, PJs need to know how the mortgage industry works, and what motivates its major participants.

Understanding some of the fine points of the mortgage market equips PJs to approach lenders as peers and working partners—and partnership is indeed the right word for a relationship where both sides have something to gain. A well-designed homebuyer program offers real benefits to both private and public sector lenders. The affordable mortgage market is a major way to expand mortgage business, and HOME funds offer a prudent path for moving beyond conventional underwriting boundaries. Access to buyer counseling and ongoing support for buyers after purchase are valuable assets PJs can bring to the table.

This guide has suggested how PJs can operate successfully as players in the world of mortgage financing. It has presented the monitoring and compliance requirements PJs must attend to directly, to avoid the pitfall of delegating too much. Using current information about industry practices for loan origination, credit evaluation, risk management, and loan servicing, astute PJs can negotiate terms to benefit low- and moderate-income borrowers.

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