CENTER FOR HOUSING POLICY

Cornerstone Partnership
Keeping Homes Affordable & Communities Strong

The Annie E. Casey Foundation

**Balancing Asset-Building Opportunities with the Ability to Preserve Affordability in a Homeownership Program**

by Ryan Sherriff[1]

There are many different goals that affordable homeownership programs may seek to achieve. Among them, there are several common goals that are often linked to balancing individual opportunities to build assets with community goals of ensuring long-term affordability and preserving the opportunities and assets that public investment helped to create. These include:

- Helping the program's participants to afford the costs of homeownership, both at initial purchase and during the span of their tenure
- Preserving or recycling public or private subsidies to serve a greater number of households
- Ensuring that the buying power of these subsidies is preserved in the face of rising home prices
- Helping individual families build wealth

A collaborative process of gathering practitioner and stakeholder input led by NCB Capital Impact's Cornerstone Partnership identified six voluntary principles for the development of local affordable homeownership programs. Included among these guidelines was the recommendation that, when designing an affordable homeownership program, each community should identify a locally appropriate balance between the goal of helping individual homeowners to build financial assets and the community's interest in maintaining long-term affordability. This white paper provides a summary and brief analysis of several approaches for achieving this balance.

The guidance provided in this paper is geared to programs that provide substantial amounts of assistance to help low- or moderate-income families become homeowners. It is not intended to be applied to programs that provide small amounts of down payment assistance that constitute less than five percent of a home's initial value.

**The Importance of Balancing Asset Building and Preservation of Affordability**

As many communities have learned the hard way, homes that they helped to make affordable – through a large initial grant or other assistance provided by a public agency or nonprofit organization – often become unaffordable when resold to the next family. Given the sizable subsidy needed to bring homeownership within reach of working families, communities have struggled with the question of how to ensure that the public's investment in homeownership will keep pace with the market. For this reason, many believe that it is prudent, appropriate, and increasingly necessary for public programs to

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adopt resale restrictions to ensure that limited public funds can provide lasting investments that make efficient use of government funds and serve one generation of homeowners after another.

For many working families, the chance to assume greater control of their living environment, stabilize their housing costs, and build equity through the pay-down of their mortgage principal is reason enough to buy a home. At the same time, the opportunity to build wealth is one of the key reasons for the continuing interest in homeownership among policymakers and prospective homebuyers alike. Individual asset building may not be the primary policy goal for a deeply subsidized homeownership program, but it is an appropriate goal and a motivating force behind many local homeownership programs.

Some advocates and policymakers believe that homeownership programs that impose resale restrictions offer homebuyers no real opportunity to build wealth. They see the choice as an "either-or" decision between two competing approaches: the standard homeownership model, which provides unfettered opportunities to build individual wealth; and limited-equity models, which preserve affordable housing resources to serve future buyers but do not offer meaningful asset-building opportunities.

New research shows that this dichotomy is false. In truth, policymakers do not have to choose between maintaining affordability and offering homeowners asset-building opportunities. Well-designed homeownership programs incorporating permanent affordability can generate significant assets for the homeowners. The challenge is to design programs that do a good job of balancing these two goals to achieve both lasting affordability and significant asset-building opportunities.

The Champlain Housing Trust (CHT) in the Burlington, Vermont, area provides a prime example of how a program can effectively balance affordability and asset building. A recent analysis of CHT's home resales showed that from 1984 to 2008, families who resold their land trust homes earned an average annualized return of over 25 percent on their initial investment of a down payment and/or closing costs, with some homeowners realizing almost $30,000 in equity. In addition, almost 70 percent of these families moved on to market-rate homeownership. At the same time, the program not only preserved, but even increased, affordability. Upon resale the average CHT home was affordable to a household earning 53.4 percent of the area median income, while at initial sale the average home was affordable to a household earning 56.6 percent of the AMI – a marked gain in affordability.[2]

A recent study released by The Urban Institute, sponsored by the Cornerstone Partnership, reported similar results for long-term affordable homeownership programs in King County, Washington; San Francisco; Davis, California; Duluth, Minnesota; Boulder, Colorado; and Atlanta.[3] The average annualized return on homeowners' initial investment across these seven programs ranged from around seven percent in Davis to almost 60 percent in the Seattle area. The average levels of affordability ranged from about 28 percent of area median income in Atlanta to just under 93 percent in San Francisco.

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[2] Rick Jacobus and John E. Davis, 2010. *The Asset Building Potential of Shared Equity Homeownership*. New America Foundation; John Emmeus Davis and Amy Demetrowitz, 2009. *Lands in Trust, Homes That Last*. Champlain Housing Trust.
[3] Kenneth Temkin, Brett Theodos and David Price, 2010. *Balancing Affordability and opportunity: An Evaluation of Affordable Homeownership Programs with Long-Term Affordability Controls*. The Urban Institute.

The programs covered by the Urban Institute evaluation represent several different types of approaches to long-term affordable homeownership – including community land trusts, deed-restricted homes and limited equity cooperatives – and employed different types of resale formulas. The discussion below reviews the pros and cons of several different types of resale formulas.

**Developing an Appropriate Affordability Approach to Meet a Community's Homeownership Goals**

There are a number of principles that communities will likely want to incorporate when designing their program and determining their approach to preserving affordability. These include:

- Long-term affordability is an important public policy objective that should not be sacrificed without a clear compensating public benefit and should only be reduced by the extent necessary to achieve those other goals.
- Every homeownership program should offer homeowners a real opportunity to build wealth – homeowner equity gain should not be limited more than necessary to sufficiently protect ongoing affordability.
- Without guaranteeing a minimum resale price, programs should avoid imposing price restrictions or equity sharing requirements that limit owners' outgoing equity to less than their initial investment in the home.

The Cornerstone Partnership recommends that communities first assess their affordable homeownership challenges in order to determine their specific goals. Communities then should assess the different approaches to designing affordable homeownership programs and select the approach that best meets their local conditions, needs and policy goals – particularly for achieving an equitable, acceptable, and sustainable balance between building individual assets and preserving affordability for lower-income families.

There are many different options for designing affordability restrictions. Below, we describe three common approaches to setting the resale price of publicly assisted, privately owned homes. These examples illustrate some of the choices involved in balancing asset-building and long-term affordability objectives:

- *Shared Appreciation/Appraisal-Based Resale Formula* – This model balances long-term affordability and asset building by allowing the assisted homebuyer to receive a certain share of home price appreciation, such as 25 percent, as measured by an appraisal at the time of sale. The balance stays in the home to keep it affordable for the next income-eligible buyer. The maximum resale price equals the original purchase price plus the seller's share of home price appreciation. Sellers may also receive a credit for eligible capital improvements made during their occupancy.

- *Area Median Income (AMI) Resale Formula* – In this model, the balance is achieved by allowing the homeowner to sell the home for the original purchase price plus an increment based on the change in area median income[4] (again, a credit is generally provided for eligible capital improvements). The aim is to ensure that a home that was initially made affordable to a family

[4] To the best of the authors' knowledge, the change in area median income is the most commonly used index. However, programs do use other indices, such as the change in the consumer price index.

at the target income level will stay affordable to families at roughly the same income level over time.

- *Affordable Housing Cost (AHC) Resale Formula* – This model limits the resale price to the exact level that will make the unit affordable to a buyer at the target income level at the time of sale. This resale price is calculated by working backward from current mortgage interest rates, current tax rates, estimated insurance premiums, and other basic housing costs, to determine the maximum amount an income-eligible buyer can afford to spend in buying the home.

Below, we describe these three models in more detail and analyze their relative performance in providing asset-building opportunities and preserving affordability.

## Asset-Building and Affordability Outcomes of Three Common Approaches

This section provides an overview of the three major approaches to setting the resale price and how each serves asset-building and affordability goals under different market conditions. Our goal in providing this information is to help inform discussion within a community on the most effective strategy for meeting the community's long-term affordable homeownership goals. Because the ultimate balance must be set by each individual community, this section should not be understood as advocating that any single approach be applied in all contexts.

In considering the wealth-potential creation of all of these models, it is important to keep in mind that a substantial amount of the wealth that homeowners accumulate over time comes from paying down the principal balance of their mortgage. All three of these approaches provide the same general opportunity to build wealth in that manner. They differ only in how they treat home price appreciation.

### *Shared Appreciation/Appraisal-Based Resale Formula*

Description

A "shared appreciation" or "appraisal-based" resale formula is based on the market value of the property. The value of the home is appraised upon resale and the homeowner shares a certain portion of any market price appreciation with the program that subsidized the initial home purchase. Several well-established programs, such as the Champlain Housing Trust, provide sellers with about 25 percent of any appreciation upon resale.[5] Using CHT's program as an example, if a buyer pays $180,000 for a home with a market value of $300,000, and then sells the home some years later for $400,000, the seller would receive $25,000 (25 percent) of the $100,000 in home value appreciation. The other $75,000 would remain invested in the home (along with the original $120,000 subsidy that the program provided to bring down the original sale price of the home), helping to keep the home's price affordable to the next purchaser.

[5] The Champlain Housing Trust allows the homeowner 25 percent of any appreciation in a land trust home upon resale, no matter what portion of the original purchase price the family pays. Although this may limit equity gains more than some other shared appreciation programs in which the share of appreciation is equal to the share of the purchase price they paid, it helps to ensure homes in the relatively expensive Burlington market remain affordable to lower-income families.

Under this approach, the homeowner is able to realize a specified share of home price appreciation, while the public share remains invested in the home, allowing it to be sold to another purchaser at an affordable price. Both the ongoing affordability and the level of wealth creation under an appraisal-based formula will depend greatly on the equity sharing percentage used and the performance of the local housing market.

<u>Analysis</u>

When home prices are rising slowly – that is, at about the same rate as incomes – the shared appreciation approach generally maintains affordability as well as the AMI and AHC approaches. However, depending on the exact amount of home price appreciation these approaches allow the homebuyer to retain on resale, the ability of this formula to maintain affordability over time may decline substantially when home prices rise much faster than incomes, which could lead to compromised affordability in "hot" markets.

From the asset-building perspective, the shared appreciation approach provides comparable equity gains to the AMI and AHC approaches when home prices rise slowly but offers greater and greater equity gains as prices start to rise faster than incomes. But in declining markets, homeowners in shared appreciation programs are more likely to have lower resale price limits than those in AMI and AHC programs. When home prices have declined (even modestly) while incomes have risen, a buyer in the AMI and AHC programs would receive a higher sales price (and thus build more equity) than a buyer in a shared appreciation program.

*Area Median Income (AMI) Resale Formula*

<u>Description</u>

Under this approach, a program calculates the maximum resale price based on the percentage change in the area median income (AMI). Thus, if the AMI rises at 3 percent per year, the maximum resale price will rise (relative to the initial purchase price) at 3 percent per year as well. Indexing to the median income ensures that the home price will only rise in proportion with people's general ability to pay. While an AMI index formula protects affordability over the long term, the exact affordability level at any point in time will fluctuate as mortgage interest rates rise and fall since interest rates greatly affect a family's buying power.

<u>Analysis</u>

The AMI approach effectively preserves affordability under most market conditions. The only case in which affordability may be compromised under the AMI formula is when interest rates rise. Although the price of a home purchased under this approach rises in line with incomes, any increase in interest rates will effectively decrease a family's buying power, likely making the home unaffordable to a family in the target income range. However, it should be noted that homeowners under the AMI model are less likely than homeowners under the AHC approach to experience a loss in equity upon resale when interest rates have risen.

The AMI approach offers predictable, and often significant, equity gains across various market conditions. Even when housing markets are in decline, this approach can offer significantly greater downside protection than most shared appreciation approaches.

For these reasons, the AMI formula tends to work very effectively in balancing asset building and affordability under multiple market conditions. Several local government and nonprofit affordable homeownership programs use the AMI resale formula. This approach can be particularly effective where home prices are rising significantly faster than incomes, such as in Washington, DC. The District of Columbia Inclusionary Zoning Affordable Housing Program has begun to implement a resale formula tied to changes in the metro area's median income. Their approach avoids significant fluctuations in resale prices from year to year, allowing lower-income homeowners more predictable asset-building opportunities.

*Affordable Housing Cost (AHC) Resale Formula*

<u>Description</u>

This approach involves limiting the resale price to the exact level that will make the unit affordable to a buyer at the target income level at the time of sale. This approach works backward from current tax rates, estimated insurance premiums, and other basic housing costs, to calculate the monthly amount a buyer can afford to spend on a mortgage payment. Then, given current interest rates, the program calculates the maximum loan amount that the payment will support. This loan amount plus a modest down payment produces the maximum "affordable" resale price. This is the only approach that is guaranteed to preserve affordability under all circumstances.

<u>Analysis</u>

The affordable housing cost (AHC) approach is the only formula that truly maintains the affordability of a home under any market conditions. Even when interest rates rise, the AHC approach ensures that the complete cost of owning a home is within reach of a family at a target income level. For this reason, it has an advantage over both the AMI and shared appreciation approaches in preserving affordability and any subsidies invested in the home.

The downside to the AHC formula is that it increases the risk of a homeowner facing a loss in equity when selling the home after interest rates have risen. Under these circumstances, it does not provide the same downside protection that the AMI formula affords. However, when interest rates remain stable, it essentially offers the same asset-building potential as the AMI approach and offers better downside protection than most shared appreciation approaches.

For those programs that want to focus on maintaining affordability, there are some modifications to the AHC approach that offer better downside protection to the seller in the face of rising interest rates, while maintaining affordability to the next buyer. For example, San Francisco's Below Market Rate (BMR) homeownership program implemented two effective changes. First, it combined the AHC and AMI approaches. It initially priced homes using the AHC formula, taking interest rates into account. The program then used the AMI formula to determine the maximum resale price, so that the seller would not experience an equity loss due to a spike in interest rates. Second, when setting the initial affordable price on the home with an AHC formula, it incorporated a 10-year average interest rate instead of the more volatile daily rate. This controlled for any major fluctuations in rates that may cause the initial price to be unnecessarily high or low.

**Final Note**

This document aims to provide communities and advocates with a general overview of how the three major approaches to long-term affordable homeownership function under different market conditions and how each serves asset-building and affordability goals. It is important to note that all three approaches can be adjusted to focus more strongly on either asset building or long-term affordability. These approaches can also be adapted to different market conditions, community characteristics and affordable housing policy goals. The ultimate approach a community decides to use should depend on locally determined policy choices, as well as its administrative capacity and structure and the availability of resources.

*For More Information*

The Center for Housing Policy – in collaboration with the Cornerstone Partnership and with financial support from the Annie E. Casey Foundation – maintains a suite of materials on shared equity homeownership. The suite of materials includes tutorials, reports and interactive tools to help aid communities in designing and implementing shared equity homeownership programs and other strategies to promote long-term affordability and help lower-income families build wealth through homeownership. To access the suite of materials, go to *www.nhc.org/housing/sharedequity*. The Cornerstone Partnership also has an extensive set of resources on long-term affordable homeownership and asst building available at *affordableownership.org*.