Policy Brief

Preservation of Affordable Homeownership: A Continuum of Strategies

By Rick Jacobus and Jeffrey Lubell

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INTRODUCTION[2]

In recognition of the significant benefits of homeownership for families and the communities in which they live, many cities, counties and states have adopted policies that seek to increase residents' access to affordable homeownership opportunities. This paper examines the range of different policy options that communities have adopted to reduce the cost of homeownership, with a particular focus on the *effectiveness of each option in preserving affordable homeownership opportunities over time*.

The focus of this review on the *preservation of affordable homeownership* grows out of the collective experience of numerous communities around the country with sharply rising home prices over the past five to ten years. As many communities have learned the hard way, homes that they helped make affordable through an initial downpayment grant or other assistance often have become unaffordable when sold to the next family. With the amount of subsidy needed to bring homeownership within reach of working families growing exponentially, communities have struggled with the question of how to ensure that the public's investments in homeownership

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[2] Portions of this paper are adapted from *Creating Permanently Affordable Homeownership* by Rick Jacobus and Amy Cohen. Forthcoming. In *California Affordable Housing*, Solano Press.

keep pace with the market. This review provides an overview of the range of mechanisms that local governments use to ensure that housing funds invested in affordable homeownership today are able to serve additional families into the future. In general, this is accomplished either through resale restrictions that preserve the affordability of specific assisted units or through deferred loans that allow the locality to capture a portion of home price appreciation at the time the assisted units are sold which can then be used to help subsequent buyers purchase homes of their choice.

The recent slowdown in home price appreciation in many of the nation's hottest housing markets provides communities with an important opportunity to take a step back and review their existing homeownership policies. While it is impossible to know with certainty what will happen to home prices in the future, the sharp run-ups of recent years have made clear the necessity of planning for every contingency – including the real possibility that rapid home price increases could erode the value of public homeownership investments over the long term.

BALANCING INDIVIDUAL ASSET ACCUMULATION AND LONG-TERM AFFORDABILITY

While state and local homeownership programs come in all shapes and sizes, the most common approach is to provide a public subsidy to make homeownership more affordable to working families and other moderate-income households. The subsidy might take the form of a loan or grant from city, county or state government directly to the homebuyer or a grant from one of these jurisdictions to a developer who then agrees to build homes for sale at an affordable price. In other cases, the "subsidy" is implicit rather than explicit; a good example is a local inclusionary housing program that requires developers of market-rate homes to sell a small percentage of the new homes at affordable prices. In each of these cases, a community makes it possible for working families to afford a home that they would not be able to purchase affordably without this subsidy.

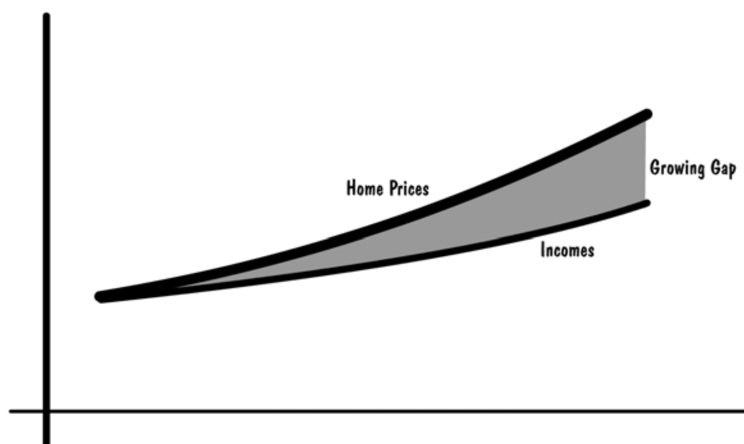

Figure 1: When home prices rise faster than incomes, the result is a growing affordability gap.

As shown in Figure 1, however, when home prices rise more rapidly than incomes – as has been the case in all of

the nation's hot housing markets over the past five to ten years – it becomes more and more expensive to help working families purchase homes. As the amount of subsidy required to help each family rises, these programs face an increasingly difficult set of policy decisions. Should the programs continue to make homeownership affordable to families at the same general income level, and if so, are they prepared to assist fewer and fewer families each year? Also, at what point does it become unfair to provide a windfall to a few lucky families who are selected to receive a subsidy when numerous other families are falling further and further behind in their quest for homeownership? Providing a $5,000 down payment assistance grant may be a small price to pay to help a family improve its economic position, but as the cost of the assistance rises – to $20,000, $50,000 or even $100,000 or more – the amount starts to seem like too much to give away to one family when there are so many others who will receive no help at all.

This is where the question of *preserving affordable homeownership opportunities* comes into play. Cities, counties and states are accustomed to commitments of affordability for up to fifty years or longer when they invest in affordable rental homes. Many programs designed to assist first-time homebuyers, however, have no provisions preventing the assisted family from selling the unit and realizing a windfall the day after the home is purchased. What naturally happens is that as the amount of per-household subsidy rises, programs become more concerned about preserving the value of public subsidies and turn from grants to loans and then to "shared equity" approaches such as shared appreciation loans or resale price restrictions designed to preserve the buying power of the public investment.

Such changes are often controversial. Critics of these preservation mechanisms charge that they are unfair because they do not allow assisted homeowners to experience the same amount of growth in individual assets as market-rate home purchasers experience. Advocates for these mechanisms argue that tight restrictions are needed to ensure that subsidized homes remain affordable over time to help other homebuyers in need of assistance.

While these debates can be contentious, the issue of whether, and if so, how to preserve the value of public investments in homeownership is crucial to the design of these programs and thorough discussion is appropriate. Unfortunately, the quality of the policy dialogue tends to suffer when both sides see the choice as an "either-or" decision between two competing approaches: one model that provides wealth creation for homeowners and the other that preserves affordable housing resources to serve future buyers.

In reality, there is enormous variety in local homeownership programs, which fall along a continuum between strategies that maximize individual wealth creation and strategies that maximize preservation of long-term affordability. Few of the policy options fall at one extreme or the other, however. Most options attempt to strike a balance between these two competing goals by offering homeowners real wealth-creation opportunities while still preserving the value of public funds so that they can serve other homebuyers in the future. Under these models, families build assets both by paying down the principal balance on their first mortgage and by sharing the benefits of home price appreciation with the jurisdiction providing the subsidy.

As this continuum shows, there are ample opportunities to preserve the value of public subsidy while simultaneously offering meaningful opportunities for individual asset accumulation. The question for policymakers should not be whether to provide opportunities for individual wealth creation or preservation of ongoing affordability, but rather how to strike an appropriate balance between these two goals.

A CONTINUUM OF STRATEGIES FOR PRESERVING AFFORDABLE HOMEOWNERSHIP

While there are literally dozens of different options for designing an affordable homeownership program, these diverse options may be divided into four main categories,[3] each of which treats the question of subsidy preservation in a different way. Figure 2 graphically illustrates the continuum between homeownership programs that emphasize individual asset building and those that emphasize long-term affordability. As points of reference, Figure 2 also shows where traditional homeownership and permanently affordable rental housing fall on the same continuum.

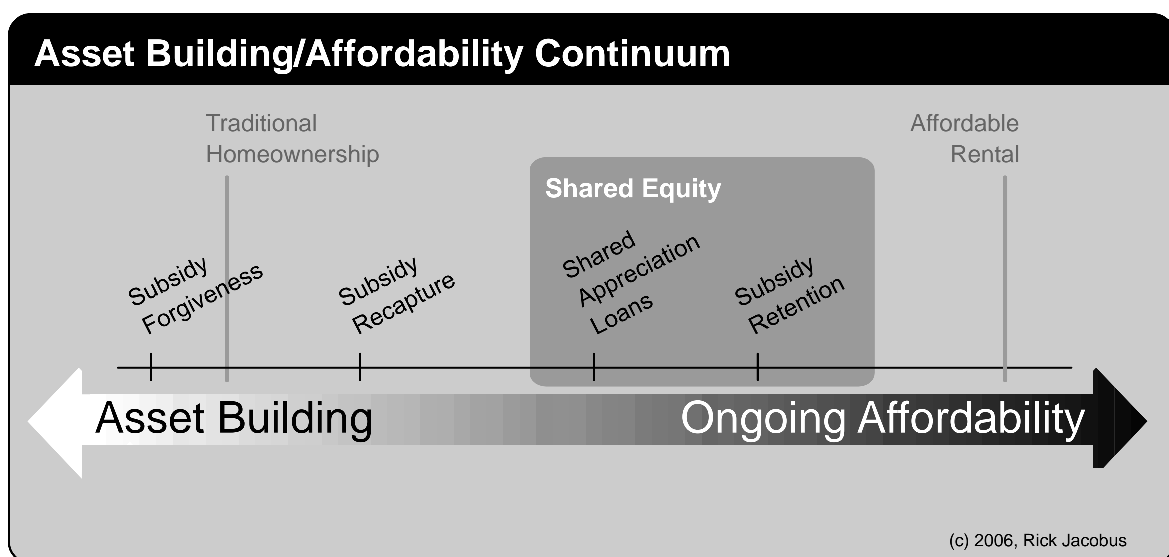

Figure 2: Asset building – affordability continuum

A. **Subsidy Forgiveness** programs provide one-time assistance to homebuyers with no expectation that these funds will be repaid to help serve future buyers. These programs include homebuyer grants as well as loans that are forgiven if families remain in the homes for a certain period of time (forgivable loans).

B. **Subsidy Recapture** programs allow buyers to temporarily use public funds but expect these resources to be returned so they are available to assist future buyers. The most common form of subsidy recapture is a "silent second" mortgage that is subordinate to a family's primary mortgage, but requires no payment of principal or interest until the family sells its home (or in some cases, refinances the first mortgage). Sometimes these loans are interest free; other times sellers are required to repay the funds along with deferred interest. In some cases the loans are only deferred for a limited period of time

[3] These categories are adapted from a typology developed by John Emmeus Davis. 2006. *Shared Equity Homeownership: The Changing Landscape of Resale-restricted, Owner Occupied Housing*. Newark, NJ: National Housing Institute. Davis uses the term "shared equity homeownership" to refer only to subsidy retention strategies – approaches that maintain affordability through resale price restrictions – while we include both subsidy retention and shared appreciation loans under the general heading "shared equity."

(e.g., five years) after which homeowners are expected to begin making regular payments.

C. **Shared Appreciation Loans** are second mortgages that require no payments until the home is sold (or, in some cases, the first mortgage is refinanced). At the time of sale, the family is required to repay the original principal plus a share of home price appreciation in lieu of interest. These loans exhibit characteristics of both subsidy recapture (above) and subsidy retention (below).[4]

D. **Subsidy Retention** programs provide a one-time investment of public funds to bring the sale price of specifically designated homes (often, though not always, new construction) down to a level that is affordable to buyers at the target income level, who are then required to resell the homes at affordable prices. These programs utilize one of several different pricing formulas to keep resale prices at affordable levels. Common subsidy retention strategies include deed-restricted homeownership, community land trusts, and limited equity cooperatives.[5]

Each general approach offers a different way of thinking about the rights and responsibilities of homeowners who benefit from government assistance. To illustrate the cross section of choices, this paper describes several specific program models and highlights some of the reasons that local communities turn to one approach over another. These models represent only a few of the dozens of common alternatives but comparing these options in detail should help policymakers to better understand the full range of choices.

In this paper, and in related materials being released at the same time by the Center for Housing Policy,[6] we refer to the third and fourth categories – shared appreciation loans and subsidy retention – as “shared equity homeownership” strategies. Under both approaches, the benefits of home price appreciation are shared between the public entity providing the subsidy and the individual homebuyer assisted with that subsidy. In the case of a shared appreciation loan, the public’s share is returned to the government entity making the subsidy in the form of a cash payment that can be used to help subsidize a subsequent homebuyer. In the case of a subsidy retention strategy, the public’s share of the equity stays with the home, reducing the

[4] This paper discusses only shared appreciation loans provided by public sector or nonprofit lenders. Private “shared equity mortgages” are somewhat common in England and have been proposed from time to time in the United States but are not included here because the equity that is shared is not available to be reinvested in the provision of affordable housing. For a recent proposal for privately financed shared equity mortgages in the US see: Andrew Caplin, James H. Carr, Fredrick Pollock, and Zhony Yi Tong. 2007. *Shared-Equity Mortgages, Housing Affordability, and Homeownership*. Washington, DC: Fannie Mae Foundation.

[5] These terms are discussed in more detail in the body of the paper.

[6] For more information on the Center’s suite of information resources on shared equity strategies, see www.nhc.org/housing/sharedequity.

cost to the next homebuyer. There are other important differences between the two approaches, some of which are discussed below, but for the moment, the important point is that they share the basic underlying characteristic of trying to preserve the value of the public's homeownership investment by sharing the equity attributable to home price appreciation.

The following sections provide an overview of each of these four different approaches.

A. Subsidy Forgiveness

Advantages	Disadvantages
• This approach maximizes individual asset-accumulation by homebuyers • Programs are relatively simple to administer • Grant programs are easier than more restrictive models to market to families	• New subsidy funds must be invested for each new homebuyer assisted • As home prices rise, the level of assistance required for each assisted family also rises • Large grants to individual families may become hard to justify and erode public support for the program

Many communities offer programs through which income-eligible homebuyers can receive small grants (or loans that are forgiven in the event that families remain in the home for a certain period of time) that help make homeownership more affordable. In many cases, these are "downpayment assistance" grants that are designed to help buyers who have enough income to afford the monthly mortgage costs but have not saved enough for a minimally adequate downpayment. In some communities, the grants are larger and are intended to help fill the gap between what a working family can afford and the cost of an entry-level home in the market. In some cases, the program may still be called "downpayment assistance" even though the amount of assistance is larger than the 5% to 10% of the purchase price that would be required for a minimal downpayment. A larger amount is necessary when home prices are so high that working families or other target households cannot afford monthly mortgage costs even after putting down a minimal downpayment.

Similarly, communities with inclusionary zoning programs sometimes require developers to sell homes for less than their market value but allow qualified buyers to resell these homes at market prices after a short period of time. Such programs forgive the subsidy implicit in the inclusionary units that might otherwise be retained to help future buyers.

Grants and forgivable loans offer a strong individual asset-building opportunity for participating homebuyers. In fact, they actually offer a greater opportunity to build equity than traditional homeownership because, in addition to earning equity based on the pay-down of the principal balance of a mortgage and any home price appreciation, the assisted homeowners also are allowed to keep the publicly funded grant.

The challenge that subsidy forgiveness programs face is that as housing prices rise, the amount of grant or forgivable loan funds required to assist each new family increases substantially. This process is illustrated in Figure 3. At a certain point, it becomes difficult to justify such a large "gift" of public funds to a single family. In addition, unlike the other models described below, each dollar invested in a grant program serves only one family. Funds that are granted to homebuyers today are not available to assist additional families in the future.

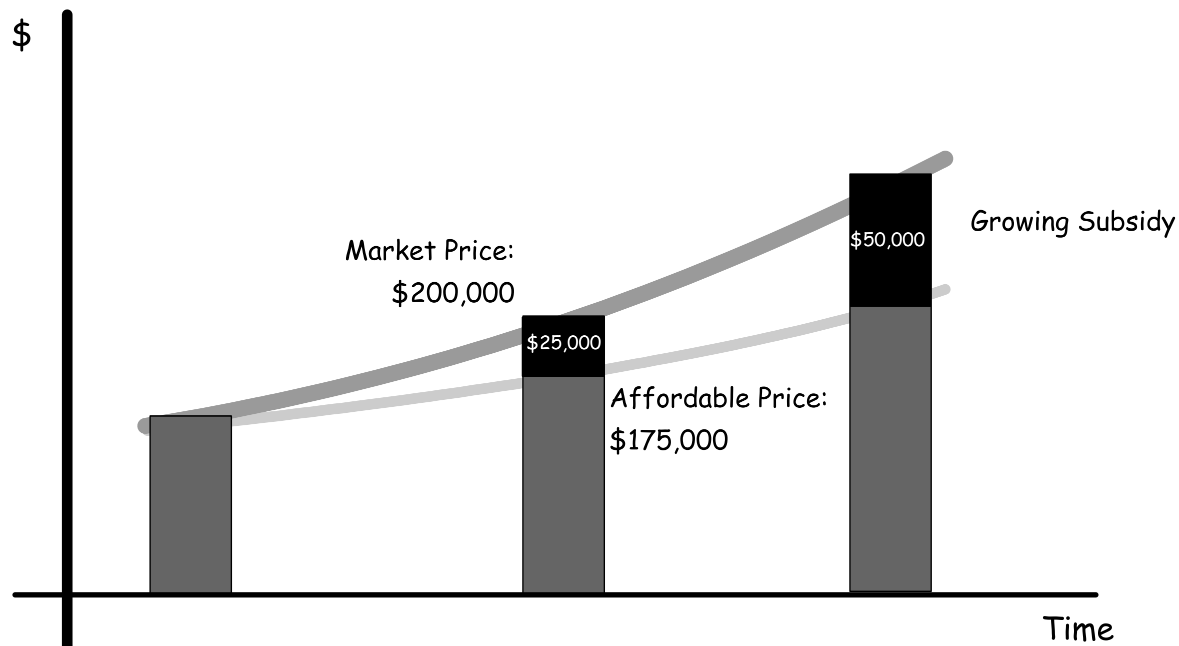

Figure 3: A growing affordability gap requires a growing level of subsidy.

If home prices rise faster than incomes, homes that were once affordable to working families quickly become less and less affordable, requiring greater and greater investments of subsidy to keep them affordable to families at the target income. Imagine a home that sold for $150,000 several years ago. In this community and at that time, a family in which both parents worked as teachers were able to afford this house without any government assistance.

Five years later, however, if home prices have risen significantly faster than teachers' salaries – certainly a plausible scenario in light of the home price spikes of recent years – another family with two teachers would not be able to afford the same home. Let's say the home sells for $200,000, but now teachers can only afford $175,000.[7] In this case, a $25,000 subsidy would be required to make that home affordable to a new family. Fast forward another five or ten

[7] This would be the case if house prices had risen by an average of 6% annually and salaries had risen by only 4%.

years and now the home is worth $250,000. If over the same period of time, salaries again have risen more slowly than home prices, a new family of two teachers might only be able to afford a $200,000 home. If the community wanted to make this same home affordable to the same type of buyer, it would need to invest new subsidy, only now the amount needed to bridge the gap would have risen to $50,000. Over time, if the housing affordability gap keeps growing, the need for subsidy will grow with it.

The Continuum of Subsidy Forgiveness Programs

Some grant programs have experienced problems when one or more buyers turn around and sell their homes soon after purchase in order to "cash out" the public subsidy. While most buyers are likely to stay in their homes for years, even a small number of buyers taking advantage of the program can undermine public support. If the goal is to stabilize a community or encourage long-term homeownership, the jurisdiction will often impose some minimum time period that a buyer must reside in the unit before they are allowed to keep the public grant funds. Many programs make these funds available not as grants but as loans to buyers that are repayable if the homeowner sells quickly, but forgiven if the owner stays longer; for example, a program might forgive 20% of the loan each year the family resides in the home.[8] Homebuyers with forgivable loans eventually receive the full amount as a grant but only if they stay in the home for some period of time. The period over which these loans are forgiven might be as short as three years or as long as twenty-five years. The longer the period of forgiveness, the more likely the program is to recapture some of the initial subsidy to assist future buyers.

Consider a grant or forgivable loan program when:

- Subsidy levels per buyer are low
- Maintaining affordability over time is not a major goal of the program
- Homebuyers need inducement to buy a difficult property or a property in a challenging location

[8] Forgivable loans also are used to help comply with federal requirements associated with the HOME Investment Partnerships Program – a major funding source for downpayment assistance – that requires communities to monitor homeownership assistance to ensure that it is used to assist eligible families for at least certain minimum periods of time.

B. Subsidy Recapture

Advantages	Disadvantages
• Recaptured funds can be used to help future homebuyers • Homeowners are not able to take scarce public funds with them when they move • Homeowners earn significant equity based on increases in the housing market • Recapture loans are relatively simple to administer	• As home prices increase, recaptured funds may not be sufficient to help future buyers • Without increases in annual funding, programs may end up serving fewer families • This approach does not ensure the continued availability of affordable homes in a particular neighborhood • Recapture programs require ongoing program administration to recapture funds and reinvest them in new units

One of the most common responses to concerns about gifting public funds to individual families is to establish recapture provisions that require families to repay the public subsidy when they sell their homes. Rather than simply giving public funds to one lucky buyer, the community is loaning the money temporarily to one beneficiary with the expectation that the same resources will be available to help another buyer in the future. When the subsidy is recycled, a one-time investment of public resources can serve more than one household.

Often, the subsidy is provided in the form of a "silent second" mortgage loan. It is silent in the sense that no monthly payments are required, but it is a loan in that a deed of trust or mortgage is recorded against the property, which requires eventual repayment of the subsidy. These loans can be interest free or can carry deferred interest that is due when the homeowner sells the home. Some silent second mortgages also require repayment when a family refinances its first mortgage.

Silent second mortgage programs allow communities to serve many more families than equivalently sized grants. For example, a program with a fixed annual budget of $500,000 could make twenty loans per year of $25,000 each. After a few years, as homeowners began to repay these loans, the repayment funds would be added to the budget for new loans, allowing the program to offer more than twenty $25,000 loans with the same annual budget.

As home prices increase over time, however, the size of the second mortgage needed to close the affordability gap for a similarly situated family may increase as well. As a result,

communities relying on a subsidy recapture approach will end up serving fewer families than they could have served if they had implemented policies to preserve the effective buying power of the public subsidy. A program with a $500,000 annual budget would only be able to help ten families per year if the average subsidy required were to rise to $50,000. Repayments of earlier $25,000 loans could help, but the program would be able to assist only one new family for every two who repaid their loan. As the required subsidy continued to rise, the number of families served each year would decline further. (Alternatively, to avoid serving fewer families, communities may have to increase their annual budget for homeownership assistance.) Subsidy recapture preserves the amount of the initial subsidy, but the value or "buying power" of that subsidy declines over time as home prices rise.

Figure 4 provides an illustration of this problem. Assume a program initially provides $50,000 to help a working family buy a $250,000 home and requires full repayment of the subsidy at the time of resale. Assume further that, seven years later, when the family decides to move, its home now sells for $375,000, (representing a 6% annual increase over seven years) making it easy for the family to repay the $50,000 loan. The local government could then reinvest that $50,000 to help another family.

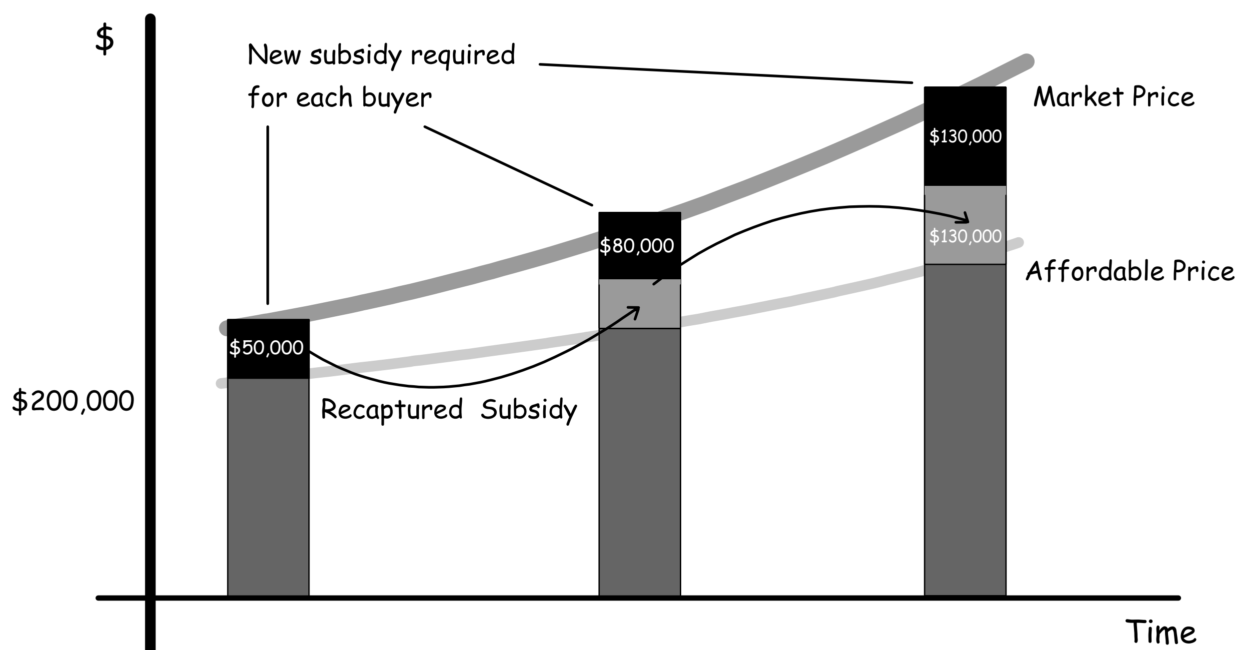

Figure 4: Reinvestment of recaptured subsidy still leaves a growing gap.

To the extent that home prices have risen faster than incomes, however, the $375,000 purchase price will be far beyond the means of working families. If incomes were to rise at only 3% annually over the same seven-year period, a new family in the same general economic circumstances would now be able to afford a house costing $245,000. To help that family buy a $375,000 house would require a subsidy of $130,000. Even with $50,000 in recaptured funds, the jurisdiction would need to make an additional $80,000 investment to maintain the same level of affordability. To the extent that home prices continue to outpace incomes, larger and larger amounts of subsidy will be required over time to keep the same types of homes affordable to the same kinds of families, even when the initial subsidy is recaptured in full.

The Continuum of Subsidy Recapture Programs

Subsidy recapture programs vary quite a bit in how they calculate the amount that homeowners owe at the time of sale. At one end of the continuum are programs that charge no interest and simply require repayment of the initial subsidy amount. These programs maintain the full dollar value of the initial subsidy, but the buying power of that money is diminished over time because they are not keeping up with inflation. Further along the continuum are programs that charge some modest interest. This interest is often deferred until sale of the home. Deferred interest programs allow homeowners to retain slightly less of the proceeds from the sale of assisted homes, thereby enabling the total pool of subsidy to at least keep up with general inflation.

Other variations within this category include (a) deferred loans where payments are deferred for a period of time – say five years – at which point ordinary monthly payments of principal and interest begin and (b) standard amortizing loans, without a deferral period, that carry below-market interest rates or fees.

Consider subsidy recapture approaches when:

- Subsidy amounts are modest
- The jurisdiction can afford to supplement recaptured funds with new subsidy with each resale
- Home prices are not expected to increase substantially
- The market area offers an ample and expanding supply of reasonably-priced homes where the recaptured subsidy can be re-invested

C. Shared Appreciation Loans

Advantages	Disadvantages
• Shared appreciation loans do a better job of preserving the buying power of public funds than subsidy forgiveness or recapture approaches • Sharing the benefits of home price appreciation corresponds to an intuitive sense of fairness, which suggests that the benefits of home price appreciation should be shared among all financial contributors to the home purchase • Unlike subsidy retention programs, shared appreciation loans do not tie subsidy to a single home forever, allowing future families a wider choice of homes	• Homeowners will receive less equity at sale than if they were not sharing appreciation with the community • In a rapidly rising home market, additional infusions of subsidy may still be needed to enable the next purchaser to afford a home of similar quality • Without increases in annual funding, programs may end up serving fewer families • Because homes are sold at full market value, this approach does not ensure the ongoing availability of affordable homes in a particular neighborhood • There is little to prevent a jurisdiction from reusing recaptured funds for a purpose other than affordable housing

Shared appreciation loan programs try to preserve not just the amount of public subsidy but the "buying power" of that subsidy. They do this by requiring that homeowners repay not only the initial subsidy, but also a share of any appreciation in the market value of the assisted home. By recapturing a portion of home price appreciation, this approach increases the amount of subsidy available to assist the next purchaser, reducing the likelihood of an affordability gap.

When home prices are rising quickly, however, the extra subsidy provided through the recapture of a share of appreciation still may not be enough to help a similar family buy a comparable home. This problem is illustrated in Figure 5.

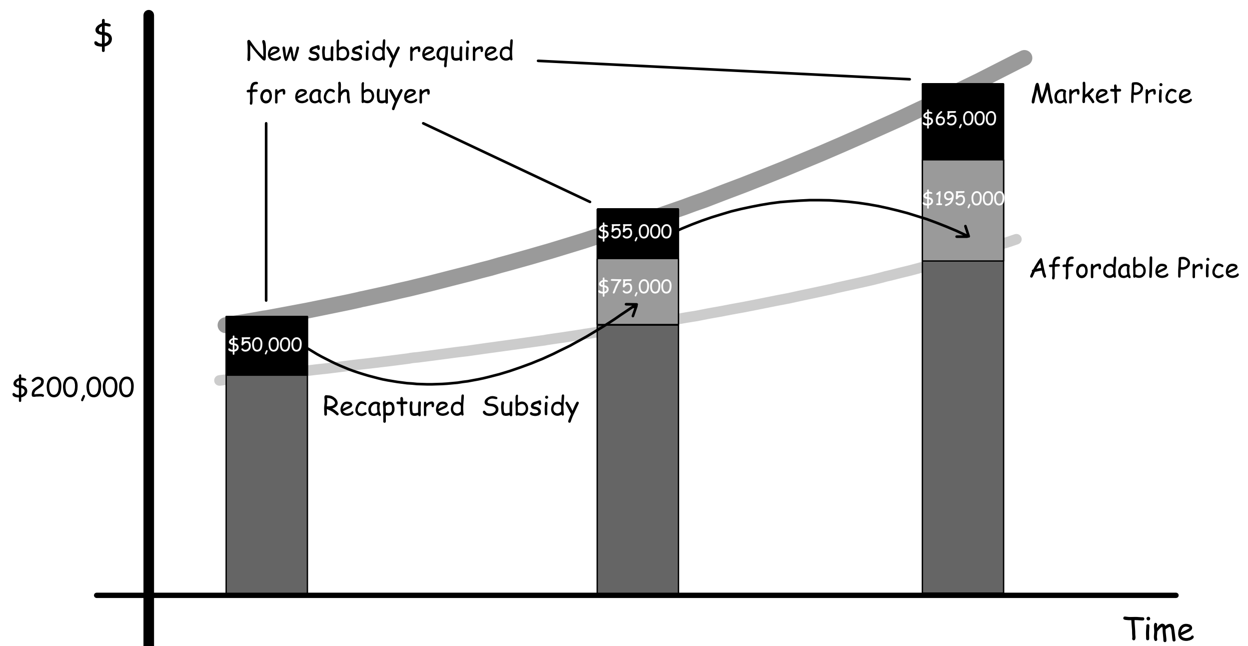

Figure 5: Under certain conditions, programs relying on shared appreciation loans may still require that new subsidy be invested each time a unit turns over.

One common approach to shared appreciation loans is to calculate the share of appreciation required to be paid on sale of the home based on the share of the original purchase price that was subsidized. For example, if a family received a $50,000 subsidy to buy a $250,000 home, the family would be required to give the community 20% ($50,000 divided by $250,000) of any home price appreciation at the time of sale, in addition to repaying the original $50,000. If home prices rise at an average rate of 6% annually, then the home will sell after seven years for $375,000. In this case there would be a total of $125,000 in appreciation and the homeowners would owe the community $25,000 (20% of $125,000) plus the original $50,000.

The repayment of subsidy plus a share of appreciation helps the community fill the gap for the next family, but by itself it may not be enough. If incomes rose by only 3% over that same period, a similar family would only be able to afford a $245,000 house, leaving an affordability gap of $130,000. Thus, despite the $75,000 in recaptured funds, the local government would still need to add $55,000 to help a new family buy this house or one like it. This is obviously much less than the $130,000 that would have been required if the subsidy had been provided in the form of a grant or a forgivable loan. Over time, however, even with shared appreciation, more and more subsidy may be required to keep a comparable home affordable to subsequent families at the same target income level.

The Continuum of Shared Appreciation Loans

Various shared appreciation programs establish the percentage of appreciation that is retained by the homeowner differently. Some programs simply offer all sellers a given percentage of appreciation (e.g., 40%) regardless of their purchase price or the amount of subsidy they initially received. Others tie the percentage to the homeowner's share of the initial purchase price. When units are created through inclusionary zoning programs and sold initially at below market prices, jurisdictions sometimes impose shared appreciation requirements tied to the homeowner's purchase price as a percentage of appraised value. So, for example, a homeowner who purchased his or her home with a 25% discount due to an inclusionary housing program would owe the jurisdiction 25% of any future appreciation upon sale.

Consider shared appreciation loans when:

- There is a concern that future increases in home prices could erode the value of the public subsidy, but the community is willing to take a chance that some additional subsidy may be needed to assist the next buyer
- Preserving family choice of where to live is more important than ensuring the ongoing affordability of homes in a specific neighborhood

D. Subsidy Retention

Advantages	Disadvantages
• A one-time subsidy investment creates a unit that remains affordable for one family after another without new subsidy • Homeowners earn significant equity due to debt retirement and increases in the permissible sales price • Preserves mixed-income character of neighborhoods experiencing rapid home price increases by ensuring ongoing affordability of assisted homes	• Long-term affordability requirements create long-term need for monitoring and administration • Homeowners typically receive less total equity than they would under other models

Instead of asking families to repay the public subsidy when they move, subsidy retention programs expect the initial subsidy to ***stay in place*** in a specific home when one family moves out and another moves in. Rather than subsidizing the *buyer*, subsidy retention programs subsidize the *unit,* ensuring that the specific home remains affordable to families at the target income range over the long-term. In exchange for government assistance in purchasing their homes, the buyers agree that, when they sell, they will sell at a price determined by a resale formula designed to keep the home affordable to other working families.

Subsidy retention programs achieve permanent affordability by specifying the price at which an assisted family can resell its house. The price restriction generally is enforced through a deed covenant, resale restriction agreement or community land trust ground lease. (See below for more details on these programs.) The maximum resale price is established by a formula that is contained in one of these legal documents.

By limiting the price at which homeowners can sell their homes, subsidy retention programs eliminate the need to provide new subsidy each time a family sells. This means that a single investment in a homeownership unit can serve one family after another over time without any new investment of public funds. Subsidy retention programs preserve the buying power of public subsidies, ensuring that rapid rises in home prices will not diminish the number of families who may be served.

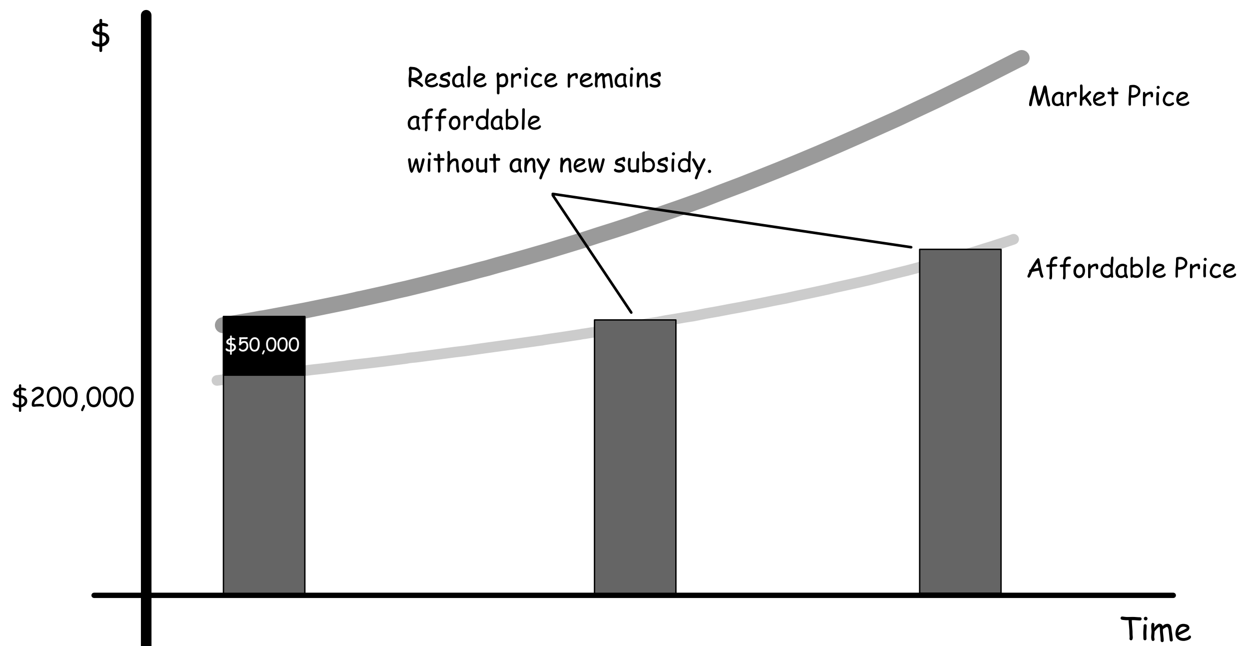

Figure 6: Subsidy retention programs allow a one-time subsidy to make a unit permanently affordable.

Subsidy retention is illustrated in Figure 6. Recall the family who could afford to pay only $200,000 for a home in a market where starter homes cost $250,000. In most of the models described above, the family would buy the home for $250,000 and receive a loan for the $50,000 in subsidy. In a subsidy retention program, by contrast, the subsidy would be invested once to buy down the price of the home to $200,000 – the level that a working family could afford. This family would purchase the home at that price without any second loan, but with an agreement specifying the price at which the home may be sold.[9]

Based on this agreement, when the family is ready to move, the home would be sold for an affordable price, rather than a market price. For example, rather than selling for $375,000 and requiring a $130,000 second loan to maintain affordability, the house might resell for only $245,000 – a price that would be affordable to working families without any new subsidy.

[9] Some jurisdictions will record a deed of trust or mortgage to make enforcement of the resale restriction easier, but in practice, the subsidy funds are never expected to be repaid.

Permanent Affordability vs. Family Choice

One key difference between subsidy retention, on the one hand, and subsidy recapture and shared appreciation loan programs on the other, is that under a subsidy retention strategy, the specific homes to which subsidies are attached will remain affordable in perpetuity. Subsidy retention programs aim to build a portfolio of homes that sell for affordable prices even if the prices of other homes in the same community rise substantially. Among other benefits, this can help ensure the preservation of mixed-income communities in the face of gentrification pressures. Subsidy retention also can help address the problems associated with the limited supply of starter homes in many communities, which can make reinvestment of funds recaptured through a shared appreciation loan challenging and, in some cases, result in affordable homes being clustered in the least desirable neighborhoods.

On the other hand, tying subsidy permanently to a set of specific units can be seen as a disadvantage as well. Shared appreciation loan programs can be structured to offer future buyers a greater choice of homes to purchase because funds are not tied up indefinitely in any specific home. While many subsidy recapture and shared appreciation loan programs invest recaptured funds only in new affordable developments, others are structured to allow homebuyers to choose existing homes in the market and use recycled subsidy funds to make those homes affordable. However, if the loan programs do not keep up with rising housing prices, the choices of future assisted families may be more limited.

In practice, subsidy retention programs tend to incorporate more restrictive formulas while shared appreciation loan programs tend to allow homeowners to retain a greater share of appreciation and as a result often recapture less than is necessary to replace affordable units that are sold. However, the question of whether subsidy is retained within a specific unit or recaptured as a cash payment can be considered independently from the specific formula that is used to determine the homeowner's share of appreciation. It would be possible, for example, for a shared appreciation loan to calculate the homeowner's share of appreciation based on changes in incomes rather than market prices. This approach, which is not common, would produce outcomes that are similar, from a financial standpoint, to the subsidy retention approaches discussed here.

One challenge to implementing such an approach is that the amount of subsidy returned to the jurisdiction might grow quite large and create a perception of unfairness on the part of buyers. This problem is not as acute when the subsidy is retained in the home, because the community's share of the equity simply stays in the home rather than being paid out in cash to the jurisdiction.

The Continuum of Subsidy Retention Programs

There are a number of different formulas that are commonly used to set the maximum resale price in subsidy retention programs. An **appraisal based resale formula** ties the "affordable" resale price to the change in the market value of the property – for example, the homeowner might be permitted to sell for a price equal to the original purchase price plus 25% of any increase in the appraised value. These formulas are similar to the shared appreciation loans described above, but rather than selling the home at the market price and splitting the appreciation, an appraisal-based resale formula requires the home to sell at the below-market price. Under this approach, the homeowner is able to take his or her share of home price appreciation, but 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 housing market. As with shared appreciation loans, however, when prices rise rapidly, even a conservative approach to sharing appreciation may allow prices to rise beyond the level at which they are affordable to future buyers without additional subsidy.

Another popular approach to resale pricing is to tie the price to an index such as the consumer price index or the Area Median Income (AMI). A formula based on an **Area Median Income index**, for example, specifies that the resale price shall be no more than the initial (affordable) purchase price plus an adjustment based on the annual change in the AMI published by HUD. Each year, as the AMI rises, the maximum resale prices rise at exactly the same rate. Because increases in the permissible sales price of the home are tied to increases in income rather than increases in the prices of market-rate homes, a new buyer with the same income profile should be able to purchase the home for this price without any need for additional public subsidy. If the resale price is limited so that it does not rise any faster than incomes, the same house can remain affordable to one working family after another without any new subsidy. Forever!

However, even indexing the maximum resale price to the median income is not enough to guarantee with 100% certainty that the same affordability level will be maintained at all times. When interest rates rise, new buyers will be able to borrow less money on the private market with the same monthly payment. A home that was initially affordable to families earning 80% of the area median income, with resale restrictions tied to changes in the AMI, would remain affordable to families at that same income level so long as interest rates remain unchanged. If

interest rates rise, however, the formula resale price might eventually be more than what buyers earning 80% of AMI could afford.

Some programs respond to this challenge by imposing resale price restrictions that work backward from what a family can afford, in the same way that we would calculate the price at the time of initially selling an affordable home. These programs use what is called an **affordable housing cost formula** (or mortgage-based formula), which specifies a target income (i.e., 80% of AMI) and a definition of affordability (i.e., 33% of monthly income for housing costs including mortgage, taxes and insurance). Then, at the time of sale, they calculate the maximum resale price by estimating the cost for taxes and insurance and subtracting that from an affordable share of the target family's income (i.e., 33% of 80% of AMI). They assume that what is left is the monthly mortgage payment and calculate how much debt that payment can support given the current market interest rate; finally, they add a small downpayment to that amount to determine the maximum resale price. This approach, and only this approach, guarantees that assisted homes will always remain perfectly affordable to the target income group without any need for additional subsidy.

Affordable housing cost formulas achieve this perfect affordability, however, by imposing considerable interest-rate risk on the assisted homeowner. When interest rates are falling, the permissible sales price will rise dramatically, offering homeowners greater-than-market-rate appreciation. But when interest rates rise, the maximum permissible sales price will decline sharply, which could lead homeowners to earn no equity or even face a loss when they sell – even if market home prices are going up! These programs protect affordability in the face of rising interest rates at the expense of wealth creation. Homeowners, even in a rising housing market, may not receive any equity when they sell their assisted homes.

Even within subsidy retention strategies, there are tradeoffs between strategies that emphasize ongoing affordability – for example, the affordable housing cost formula – and strategies that emphasize individual wealth creation, such as some appraisal-based resale formulas. The Area Median Income index approach represents a middle ground that both preserves ongoing affordability and provides significant, predictable wealth creation.

Consider subsidy retention strategies when:

- Subsidy amounts are high and there is a concern that home prices may increase faster than incomes
- Preservation of a stock of affordable units is a key goal, for example, to preserve affordable homes in a mixed-income setting
- Funds may not be available to re-subsidize assisted units at resale
- Limited future development opportunities may make it difficult to reinvest recaptured funds

Common Approaches to Subsidy Retention[10]

Deed-restricted Homeownership. Under this common approach, the subsidy is applied to reduce the purchase price to a level affordable to homeowners at the target income level. Then, restrictions are put into place requiring that the units be sold to buyers meeting certain qualifications – for example, incomes below 80% of AMI – at an affordable price as defined according to a formula set in the deed restriction or covenant. While these agreements are sometimes assumed to be self-enforcing, experience suggests they need to be actively monitored by an entity with an interest in maintaining ongoing affordability.

Limited Equity Cooperative. Under this approach – typically, but not exclusively, applied in the context of an apartment or other multifamily development – families purchase a "share" in the cooperative, rather than a standard property interest in the home. Members of the cooperative receive a right to occupy one unit, as well as a vote on matters of common interest. Cooperative members share responsibility for maintaining common areas and other areas of joint responsibility (e.g., maintaining the roof), as well as the admittance of new members. Share prices are set by formula (contained in the co-op's bylaws, subscription agreement and stock certificates), which can be used to implement one of the shared equity formulas described above.

One of the principal distinctions of this model is the concept of common ownership and shared decision making. Proponents of cooperatives also point to financial advantages stemming from economies of scale and the fact that the mortgage is held by the collaborative, rather than by individuals. There are roughly 400,000 to 500,000 limited or no-equity cooperative units in the country.

Community Land Trust. Under this approach, the land is owned by a community land trust (CLT) and then leased to families who purchase the homes that sit on CLT land. Because the family needs to purchase only the building and not the land, a CLT home is more affordable than a conventional home. The ground lease establishes the conditions under which ongoing affordability is maintained, with the CLT always having the right to repurchase the property at an affordable price established by a resale formula built into the ground lease.

One common approach to governing CLTs is to establish a board of directors consisting of an equal number of representatives of the following three groups: existing owners of homes on land leased from the CLT; residents from the surrounding community; and, public officials or other supporters of the CLT. There are approximately 200 Community Land Trusts active throughout the United States.

[10] This box is adapted from Jeffrey Lubell, "Increasing the Availability of Affordable Homes: An Analysis of High-Impact State and Local Solutions." Washington, DC: Center for Housing Policy and Homes for Working Families. For more information on the different approaches for implementing subsidy retention, see John Emmeus Davis. 2006. *Shared Equity Homeownership.* Available at http://www.nhi.org/pdf/SharedEquityHome.pdf.

COMPARING APPROACHES

Table 1 provides a simplified comparison of the performance of four of the program models described above. The table contrasts four alternatives for structuring a subsidy for a home with a market value of $250,000 in a market where a working family at the target income range could only afford to pay $200,000:

- A grant with no required recapture or repayment (subsidy forgiveness)
- A silent second mortgage where the funds are expected to be repaid at resale, without interest (subsidy recapture)
- A shared appreciation loan, in which the homeowner's share of home price appreciation equals the homeowner's share of the home price.
- A construction subsidy in which the resale price may not exceed the initial (affordable) purchase price plus an adjustment based on the annual change in the Area Median Income published by HUD (subsidy retention).

Bridging this affordability gap at the time of initial sale will take $50,000 in subsidy regardless of which model is selected. When the first owner sells, however, the subsidy strategies differ in how well they preserve the value of the public's investment and in how large a return the seller is able to realize on his/her own investment when reselling the home. The table shows the net equity that sellers would receive under each of these approaches if they were to sell after seven years. The table assumes that housing prices rise at 6% annually and incomes rise at only 3% annually. The table also presents the estimated sale price for several additional sales at seven-year intervals and the additional subsidy, if any, necessary to maintain affordability under each model at each resale.

The principal conclusions of this comparison are as follows:

- The initial homebuyer's net proceeds following the sale is greatest under the grant program and least under the AMI index approach. However, the AMI index still provides the family with an opportunity to walk away with assets of $56,000 after only seven years. Based on an investment of approximately $15,000 (3% down and 3% closing costs), this represents an annual return of 21%.
- Over a thirty-year period, a total public investment of $1.74 million would be needed to ensure the continued affordability of this one home if assistance is provided in the form of grants. The required public investment over the 30-year period is $820,000 for assistance provided in the form of silent second mortgages; $356,287 for assistance

provided through shared appreciation loans; and $50,000 if the assistance is provided through resale restrictions tied to the AMI index.

This comparison relies on a single set of assumptions about the economic future. For a more detailed comparison that evaluates the performance of alternative homeownership assistance models under a much wider range of economic scenarios, see www.nhc.org/housing/sharedequity.

Table 1: Performance Comparision

Initial Sale	1. Grant Program	2. Deferred Loan (No Interest)	3. Shared Appreciation Loan	4. AMI Index Resale Formula
Initial Market Value	$250,000	$250,000	$250,000	$250,000
Subsidy	50,000	50,000	50,000	50,000
Initial Sales Price	250,000	250,000	250,000	200,000
Resale in Year 7				
Sale Price	375,000	375,000	375,000	245,000
Repay First Mortgage	(174,051)	(174,051)	(174,051)	(174,051)
Repay Public Subsidy	0	(50,000)	(75,000)	0
Sales Costs (6%)	(22,500)	(22,500)	(22,500)	(14,700)
Seller's Net Proceeds	**178,000**	**128,000**	**103,000**	**56,000**
Affordable Price to Next Buyer	245,000	245,000	245,000	245,000
Recaptured Subsidy	0	50,000	75,000	0
Additional Subsidy Required	**130,000**	**80,000**	**55,000**	0
Total Subsidy for Next Buyer	130,000	130,000	130,000	0
Resale in Year 14				
Sale Price	565,000	565,000	565,000	303,000
Additional Subsidy Required	**262,000**	**132,000**	**66,133**	**-**
Resale in Year 21				
Sale Price	850,000	850,000	850,000	372,000
Additional Subsidy Required	**478,000**	**216,000**	**83,841**	0
Resale in Year 28				
Sale Price	1,278,000	1,278,000	1,278,000	458,000
Additional Subsidy Required	**820,000**	**342,000**	**101,313**	0
Total Subsidy Invested - Thirty-year period - Five Families	**$1,740,000**	**$820,000**	**$356,287**	**$50,000**

Assumes 6% annual home price inflation, 3% annual income inflation and stable interest rates.

CONCLUSION

In the traditional housing market, there are two primary housing options: rental housing and homeownership. In terms of wealth creation, there is an enormous difference between these two options. Rental housing offers no asset-building opportunity, while homeownership offers unfettered asset building (though also a risk of equity loss). When home prices rise rapidly, homeownership becomes a stronger wealth creation vehicle, but one that is available to fewer and fewer households. Affordable homeownership programs can offer an opportunity for wealth creation that falls in between these two extremes. At the same time, by ensuring that the public investment is preserved over the long-term, well-designed programs make that opportunity available to far more families. Rather than offering one or two families large windfalls at the public expense, these programs create a sustainable avenue for both affordable homeownership and individual wealth creation for families who cannot access traditional homeownership.

There is a natural tendency for communities to move along the continuum from grant and deferred loan programs toward more restrictive models as necessary subsidy levels increase. Subsidy forgiveness programs are common in communities where the affordability gap is small. In high cost, rapidly escalating markets, subsidy recapture and subsidy retention programs are more common. Where subsidy levels are higher as a percentage of the market housing cost, both local jurisdictions and homebuyers understand that access to large public subsidies will come with greater restrictions. Where homebuyers have other affordable housing options – where they can find affordable homes nearby or settle for slightly smaller units without public subsidy – they may conclude that significant limitations on their potential equity gains from home price appreciation are not worth the benefits.

When home prices increase faster than incomes, communities where only small subsidies are required today are likely to require larger subsidies tomorrow. Policymakers should make an effort to plan ahead and think about not only today's market conditions but tomorrow's. Well-designed programs can protect the value of public resources even in the face of rapidly rising housing prices while still offering assisted homebuyers the benefits of homeownership, including the opportunity to build significant wealth.