Development Seminar Series Workshop 4a: Homebuyer Project Budgeting & Financing

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under contract to NY DHCR/HTFC

Overview of the Seminar Series

- 6 workshops:
  - Introduction to Development – May
  - Project Selection – May
  - Project Design – June
  - Project Finance
    - Today: Homebuyer Budget & Finance
    - Tomorrow: Rental Budget & Finance
  - Project Implementation – September
  - Ongoing Management & Org Survival - October

Materials

- Reference manual
  - Supplemental discussions of institute topics
  - For review outside of class
- Each seminar, add:
  - Overheads for note-taking
  - Tools for project planning

Seminar 4a Topics

- Development project budgeting
- Project financing
- Mortgage financing
- Subsidizing the buyer
- Working with buyers in the current market
- Foreclosure prevention

Homebuyer Project Budgeting

Important Points About Budgets

- Budgets are projections (or estimates)
  - Be conservative; include contingencies
- Budgets must be thorough
  - Identify all anticipated costs
- Budgets are a moving target
  - Levels of detail added as planning proceeds
  - Adjusted for actual costs during implementation

Remember Cost Analysis Principles

- Key OMB Principles
  - Eligible (& allocable)
  - Necessary
  - Reasonable
  - Documentable
- Pre-award costs: + would have been allowable if incurred after award (2 CFR 225 Att B; Item 31 – old OMB A-87)

Homebuyer Project Budget Challenges

- Buyers might be unknown
  - Hard to precisely estimate buyer funds (mortgages & DPs)
  - Hard to determine the gap & appropriate amount of subsidy
- Delivery of units may need to be in stages/phases
  - Buyer readiness should determine schedule of delivery
  - Buyer pipeline is critical lead activity
  - Budget may have inflows (sales proceeds) while expenses still occurring on other units

Phases of Development Budget

2 phases:

- Phase I: Development
  - Construction loans used to build/rehab
  - Costs deferred to sale: sales costs, dev fees, other
- Phase II: Sales
  - Proceeds pay:
    - Sales/ closing costs
    - Private and public construction loans
    - Developer fee
  - Excess proceeds: profit, subsidy repayment

Homebuyer Dev. Budgets

<u>Development:</u>

Sources:

- Equity
- Construction loan
- Public capital advances

Uses:

- Acquisition
- Infrastructure/site improv.
- Construction (hard costs)
- Soft Costs

<u>Sales:</u>

Sources:

- Buyer $: DP+1st Mortgage
- Minus: sales costs
- Minus: constr. loan payoff

Net Proceeds:

- Developer fee
- Public loan payoff *

Profit/Loss

Acquisition Cost

- Should you carry cost or value on budget?
    - Acquisition cost + carry cost < fair market value
    - Acquisition cost > fair market value?
- Related party transactions – cost reasonableness
- Remember project selection guidance:
    - Budget for all acquisition costs: Price + closing costs + infrastructure + site improvements + env remediation + demolition + relocation
    - Location: if unsuitable for market housing…
        - Inaccessibility to services and transportation

Infrastructure/Site Improvements

- Reconnaissance/site survey:
  - What utilities service & access does the site have/need?
- Jurisdiction/utility companies:
  - Subdivision
  - What must installed/upgraded (at developer expense)?
  - Egress/parking issues
  - Connection fees (and deposits)?
- Architect/engineers:
  - Site survey, sizing of utilities, cost estimate
- While planning site, don’t forget curb appeal

Construction Costs

- Basis of bid/estimate, level of detail
    - Reasonableness: critical if not competitively bid
- Regulatory compliance:
    - Accessibility
    - LBP (pre-1978)
    - Labor standards?

Construction Costs, cont

- Adequacy of scope v. sustainability
  - Compliance period v. useful life of systems/structure
  - Cost of improvements v. energy/maintenance costs
  - Market competitiveness (level of finish)
  - Appliances?
- Contingency: how much?

Soft Costs

- Typical soft costs
  - Acquisition transaction costs
  - Financing costs
  - Interim holding: insurance, taxes, security, mgt, etc.
  - Buyer intake, counseling, buyer finance packaging
  - Marketing & sales
- Analysis
  - Completeness: <u>all</u> costs
  - Reasonableness: less than 30 % of budget
  - Timing of expenditures
    - Constr. financing or out of sales proceeds

Sales Costs

- Items paid at or after closing
  - Marketing
  - Counseling fee
  - Closing costs
  - Realty fee
  - Developer fee – next slide
- Paid out of net proceeds from sale? Or budgeted from development sources?

Developer Fee

- Fee ranges based on work & burden of developer
  - Key variables: site development, construction/rehab, sale risk, homebuyer assistance
- Ask for reasonable developer fee
  - If funders won't pay it, carry it as developer capital advance & look at net proceeds of sale
- Assume a portion (or all) of fee will be paid out of closing proceeds

Final Word on Development Costs

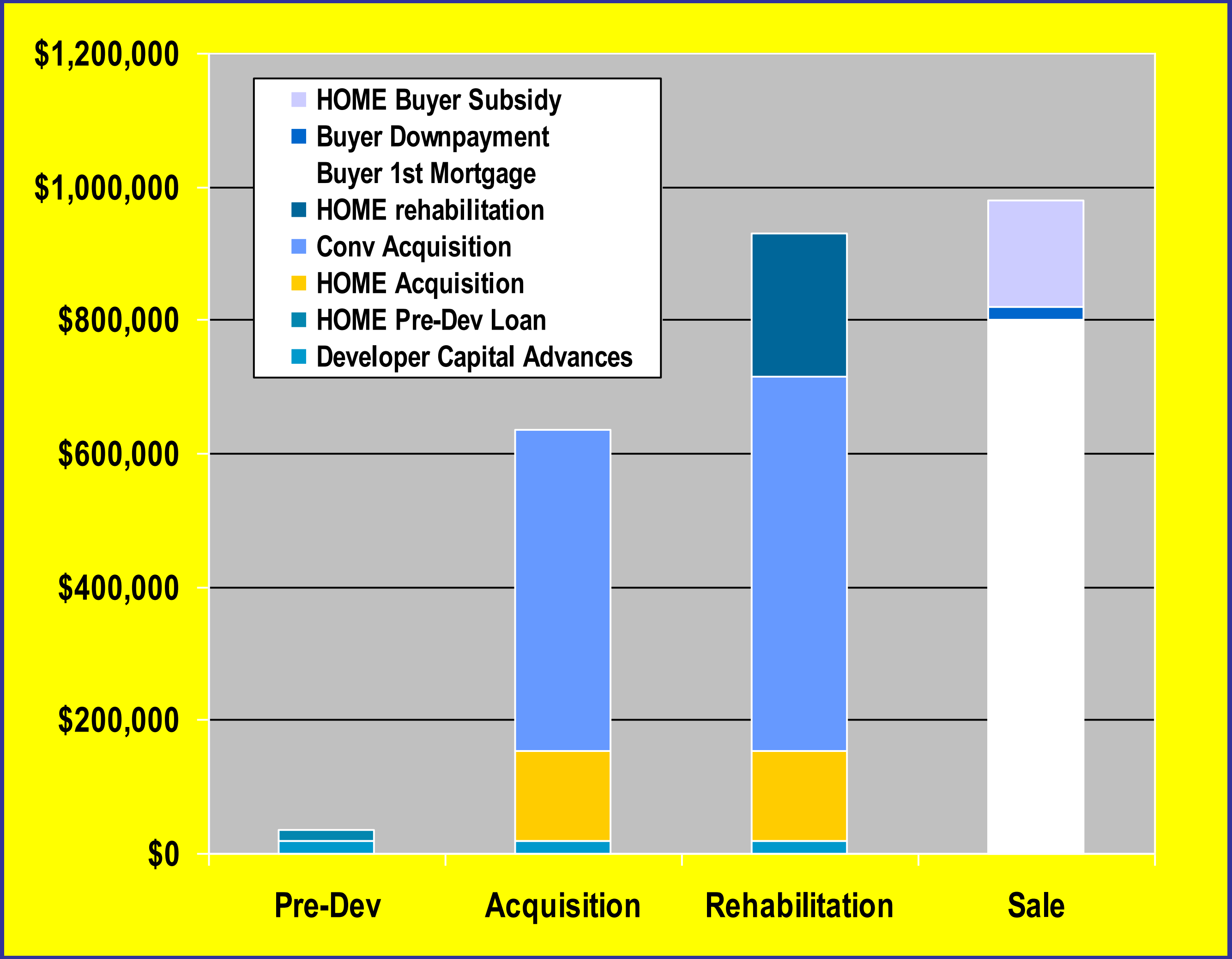
- Every project is unique; build cost estimate from scratch
- Don't overlook, ignore or understate costs
  - If you don't budget for them, you will eat those costs
- Remember: budget for contingencies, "fluff", high end of cost ranges

Project Financing

Stages of Project Financing

- Pre-development
- Acquisition
- Construction
- Buyer – the sales phase

Acquisition-Rehab-Resale Example



Pre-Development Financing

Pre-development Uses

- Site control
- Market analysis/appraisal
- Prel design/engineering
- Environmental assessment
- Legal

Pre-development Sources

- Equity/capital advances
- Pre-development loans (e.g., CHDO PDLs)

- Usually repayable (sometimes forgivable)
  - Rolled into construction loans
- May need environmental clearance

Acquisition Funding

- Developers may self-fund or take interim loan
- Interim financing:
  - Conventional loans: usually not more than 50% LTV
  - May be rolled into construction loan (if acquisition coordinated with construction start)
- Public loans for acquisition:
  - CDBG
  - HOME - requires development plan (expected to begin construction within 12 mos.)
  - If Federal, contingent on environmental review *

Construction Financing

- Pays for development costs till sale
  - Some costs deferred to permanent closing: perm fin costs, partial developer fee
- Sources
  - Equity
  - Construction loans
  - Public gap sources?
- May be a package deal
  - Construction loan & homebuyer loans
  - Or a buy-sell agreement between lenders

Construction Lenders

- Conventional lenders
  - Like to do constr lending: short-term, high interest rate
  - Underwriting & management structure in place
  - Risk mgt: bonding, insurance, letters of credit/ guarantees, structured draws & retainage, take-out loans
- Public agency construction-period lending
  - Requires underwriting & construction inspections
  - Can funder monitor construction & disburse $ on time?
  - Is constr. interest subsidy > cost of coordination?

Permanent Financing

- Buyer financing (1st mortgage) & downpayments
  - And rollover of HOME (and other subsidies into buyer subsidy mortgage – and HOME Development Subsidy if applicable)
- Takes out construction loans & pays for other development costs incurred at permanent closing

Phased Development

- Spread out development for:
  - Market absorption issues
  - Management of scale, budget & risk
- Affects size of construction Line of Credit (LOC)
  - Don’t need to cover all costs at once
  - May have some interim revenues from sales
- Need to analyze budget on a month-to-month basis
  - Schedule outflows based on production schedule
  - Schedule sales revenues available for next phase

Phased Development Budgeting

- Some costs front-end loaded: e.g., acquisition, infrastructure, design costs, site improvements, approvals, financing costs
- Construction costs based on # units/phase
- Net sales proceeds rolled into next phase
- Construction line of credit = Ph. 1 budget + overlaps (next phase costs) + shortfalls in net proceeds (dev/buyer subsidy left)

Final Word of Project Financing

- Consider needs at different phases: pre-development, acquisition, construction, sales
- Phasing development addresses market absorption and limits financial risk
    - But needs to be carefully planned and budgeted

Mortgage Financing

Buyers: The End Borrowers

- Homebuyers are the ultimate borrowers
  - Permanent funds come from them (1st mortgage & DP)
- We need to know what they can “bring to the table”
  - And ensure that they are bringing what they can
- But we may not know buyers at project financing
  - Need to package & underwrite based on typical buyers

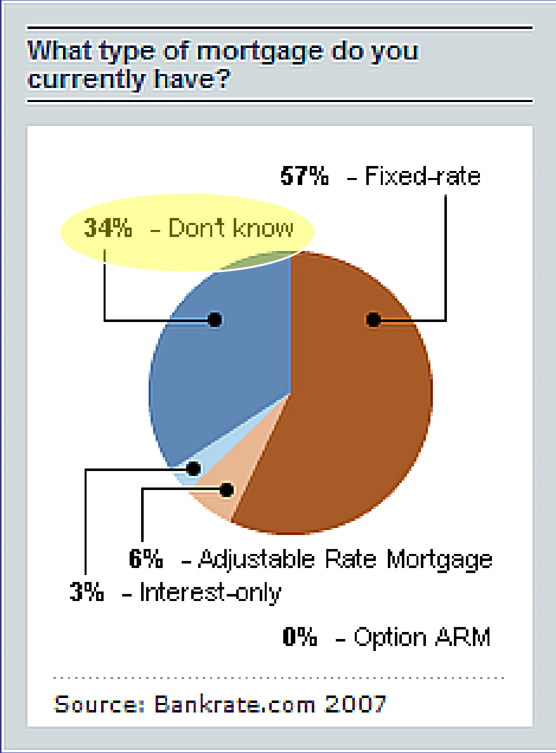
Loan Products

- Large number of products
  - Fixed Rate Mortgages (FRMs)
  - Adjustable Rate Mortgages (ARMs)
  - Combined or Hybrid Loans: Graduated Payment Mortgages (GPMs), Two-step Mortgages, Convertible ARMS
  - Exotic mortgages: Interest Only, Option ARMs (pick your payment)
    - Now less common
- But LI buyers really need fixed mortgages

Awareness of Mortgage Type

Q According to a 2007 Gfk Roper survey, what % of owners don't know what type of mortgage they have?

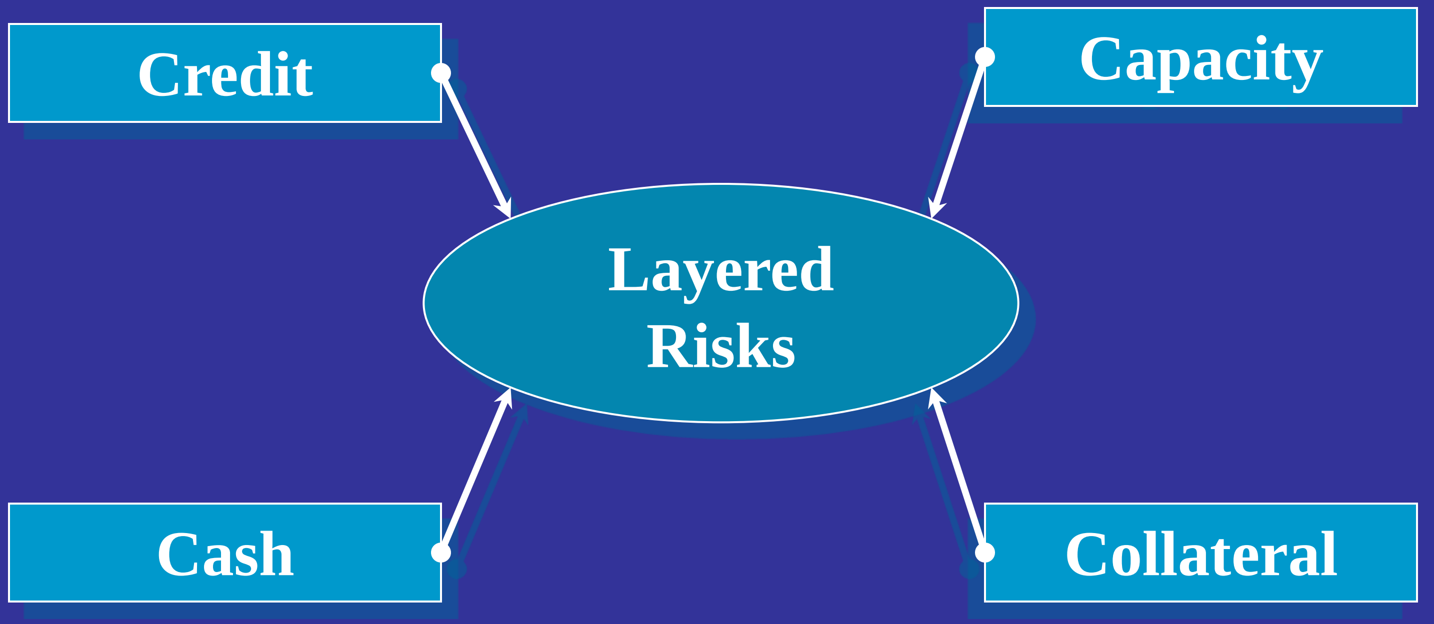
A



Why We Care About Mortgage Lending

- Availability: buyers can't buy if they can't get a mortgage
  - After period of excess lending, lending standards have gotten tougher
- We need to ensure affordable 1st mortgages
  - "Reasonable" public buyer subsidy
  - Sustainability (protecting the nghd & the public investment)
- Let's talk about the 4 C's of mortgage underwriting

The 4 C's of Credit



Mortgage Underwriting

Four "C's" of Underwriting	**Lender Metrics**
Credit	Credit score
Capacity	Front/back ratios
Capital	Downpayment
Collateral	LTV

Credit History

Will the homebuyer repay the debt?

- Past performance is the best predictor
  - But 1st time buyers don't have prior history; immigrants can't bring international credit history
- Credit reports & scores are major source of information
  - Enables automated approvals, but some LI buyers won't qualify
- Lenders have raised the bar on credit scores
- Developer challenges
  - Identify loan programs for lower scores and non-traditional credit?
  - Provided adequate lead outreach, education, counseling?

Credit Scores

- Statistical method of predicting likelihood of repayment
  - Only one of several pieces of information lenders use
- FICO score v. new VantageScore
- Credit scores based on (FICO):
  - Late payments, delinquencies, bankruptcies (35%)
  - Outstanding debt (30%)
  - Length of credit history (15%)
  - New applications/inquiries for credit (15%)
  - Types of credit in use (10%)

Capacity

Can the homebuyer repay the debt?

- Ratio Analysis
  - Housing expense to income ratio – front ratio
  - Total debt to income ratio – back ratio
  - Back end more important: increasing debt load of HHs
    - Freddie Mac does not consider front ratio
- Ratio concerns:
  - High ratios, especially with adjustable mortgages

Front End Ratio

- Housing Costs (PITI)   Gross Income
  - Principal + Interest, Taxes, Insurance
- Typical ranges of 25% to 33%
  - Higher ratio = qualify for larger loan but also higher monthly payment
  - Lower ratio = more affordable mortgage payments, but less purchasing power

Front Ratio Example

Gross income	$35,000	
Front ratio	x 28%	
	= $9,800	per year
	12	months
	= $817	max per month
	- $117	taxes/insurance
	= $700	max/month for principal & interest

At 6% for 30 years = $116,754 loan

Back End Ratio

- Total debt   gross income
- Total debt includes PITI plus:
  - Installment debt (e.g., car loan) and
  - Revolving debt (e.g. credit cards)
- Typical ratios are 36-41%
- Back ratio more likely to limit the amount a borrower can borrow, due to high levels of other debt many households have

Back Ratio Example

Gross income		$35,000	
Back ratio	x	38%	
	=	$13,300	per year
		12	months
	=	$1,108	max per month
	-	$117	tax/insurance
	-	$150	car payment
	-	$75	credit card payment
	=	$676	max to P & I

At 6% for 30 years = $112,751 loan

Calculating Mortgages

- To find mortgage amount or payment, 3 data items:
  - Interest rate (i): annual divided by 12
  - Term (n): in months
  - Either the mortgage amount (PV) or monthly payment (PMT) to find the other
- To calculate, use:
  - Mortgage calculator (e.g., HP-12C)
  - Microsoft Excel (PMT or PV function)
  - Online mortgage calculator (many sites)
  - Mortgage factor table

Cash (Capital)

- Does the homebuyer have sufficient cash for down payment and closing costs?
  - No longer the major barrier due to high LTV loans
  - But DP + Closing Costs can drain all cash
- Analyze:
  - Total buyer funds required for DP and closing costs
  - Standards for reserves/liquidity after closing
  - Level of improvements; likelihood of early capital needs

Fees & Closing Costs

- Points: origination fees affect APR
- Fees/closing costs:
  - Credit report
  - Appraisal
  - Title insurance
  - Legal, document prep & recording
- Pre-paids/escrows
- Mortgage insurance
- Counseling: teach buyers to inquire & compare
- Seek full and early disclosure
- Negotiate with participating lenders for fee concessions

Collateral

- Will the lender(s) have adequate security?
  - Likelihood of recovery in event of foreclosure
  - Higher owner equity reduces risk of default
- Value v. cost
  - Look at appraisal (1st mortgage likely required)
  - TLTV: Risk increased if TLTV > 100%
  - Even if “Development Subsidy”
    - Loss of public funds & intended use
  - Mortgage insurance unlikely to protect subsidy liens

Layering of Risk

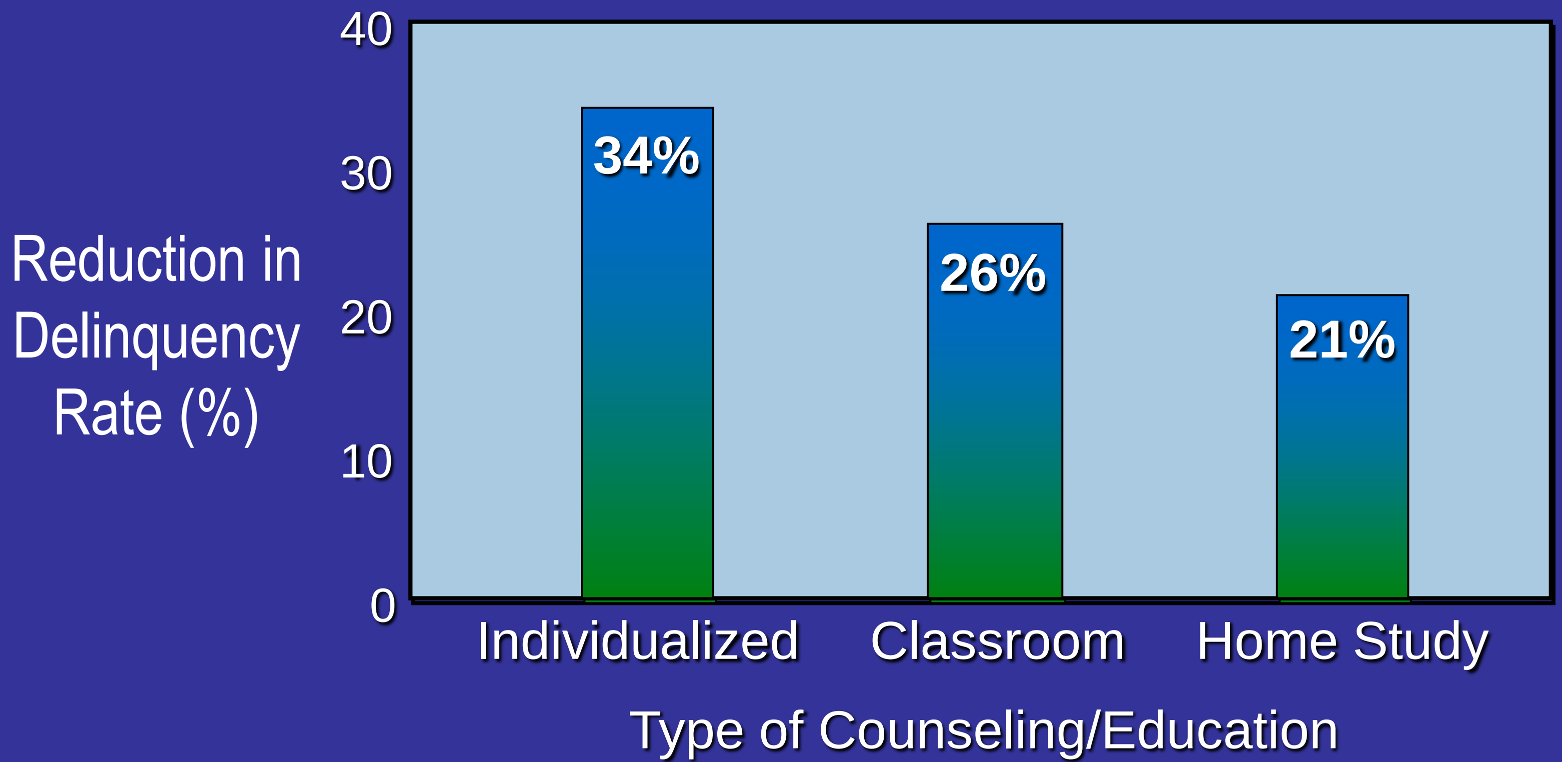
- Why automated underwriting is better
  - Objectivity
  - Synergy of risk factors
- Layering: the interaction of many small risk factors
  - Multiple small problems tend to be deceptive (appear to be insignificant)
  - May overwhelm borrower
- Pay attention to market & borrower risks as well as project risks, and consider interaction of risk factors

Sustainability Risk

- Can homebuyers can sustain ownership over compliance period/loan term?
  - Ability to manage mortgage/financial obligations
  - Ability to maintain: quality/useful life of structure, systems & finishes
  - Energy efficiency: control utility costs
  - Location/accessibility: transportation costs
  - Market viability: ability to sell & recover funds

The Effect of Counseling

The higher the "touch", the greater the impact.



Source: *A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling*, Freddie Mac, 2001.

Final Word on Mortgage Financing

- Don’t leave underwriting to the lenders
- Remember the layering of risk
- Sustainable ownership requires sustainable underwriting
- Counseling: the higher the touch, the greater the impact

Designing Buyer Subsidies

Appropriate Use of Public Subsidy

- Public purpose:
  - Community development – increase homeownership (stability); cover difference between cost & value
  - Affordability – make ownership affordable to Low Income
- Public $ in private hands
  - Need to underwrite to ensure effective & sustainable
  - Need to monitor for appropriate use
  - Need to recover funds if not

Two Gaps Requiring Public Subsidy

- Development budget gap
  - Difference between what the development costs are and what the developer can fund or borrow
  - Public assistance is called "**Development Subsidy**"
- Homebuyer affordability gap
  - Difference between what the buyer can afford and the cost of the property; or the amount of public subsidy needed to make ownership affordable
  - Public assistance is called "**Buyer Subsidy**"

Start with the Sales Price

- What is the fair sale price?
  - Total development cost
  - Fair market value
  - What the buyer can afford (buyer 1st mortgage + cash)
- What is fair to:
  - Buyer?
  - Taxpayer?
  - Future buyer?

Estimate Affordability Gap

- Determine maximum or optimal buyer mortgage
  - Fixed rate; use likely lender terms
  - Apply maximum PITI to avoid mortgage burden
  - Apply minimum PITI to prevent subsidizing excessive debt
- Determine affordability gap: fair market value minus affordable mortgage
  - Allow for range
- Determine desirable downpayment
  - More than cost of renting
  - Something they have to earn & can't afford to lose
  - Don't leave them penniless

Dev/Buyer Subsidy Example

- Acquisition + Rehab/soft costs = $140,000
- HOME funds provided nonprofit = $30,000
- Market value after rehab/sale = $120,000
- Buyer funds = $105,000 mortgage + $5,000 DP
- Devel. subsidy = $140,000 - $120,000 = $20,000
- Buyer Subsidy = $120,000 - $110,000 = $10,000
- Buyer's 2nd note/mortgage = $10,000

Developer Funds + DPA

- Same project as before:
  - TDC = $140,000
  - FMV = $120,000
  - HOME $ to nonprofit developer = $30,000
- But HOME DPA of $5,000 added at closing:
  - Buyer funds = $105,000 (DP + 1st)
  - HOME buyer subsidy = $10,000 + $5,000 = $15,000
  - Can be covered by one or two HOME notes/mortgages

Structure Buyer Subsidy

- Purchase gap
  - Soft second mortgage
  - 1st mortgage interest buy-down
  - Loan guarantees
- Downpayment/closing cost gap
  - Downpayment assistance
  - Closing cost assistance

Recapture Options

- Full recapture
- Declining balance recapture
- Shared appreciation
- Owner investment returned first

Resale Restriction If No Buyer Subsidy

- Project facts:
  - TDC = $140,000
  - FMV = $110,000
  - HOME $ to nonprofit developer = $30,000
  - No DPA
- House sold with resale restrictive covenant
  - $30,000 HOME note/mortgage for foreclosure/noncompliance

Trends in Buyer Subsidies

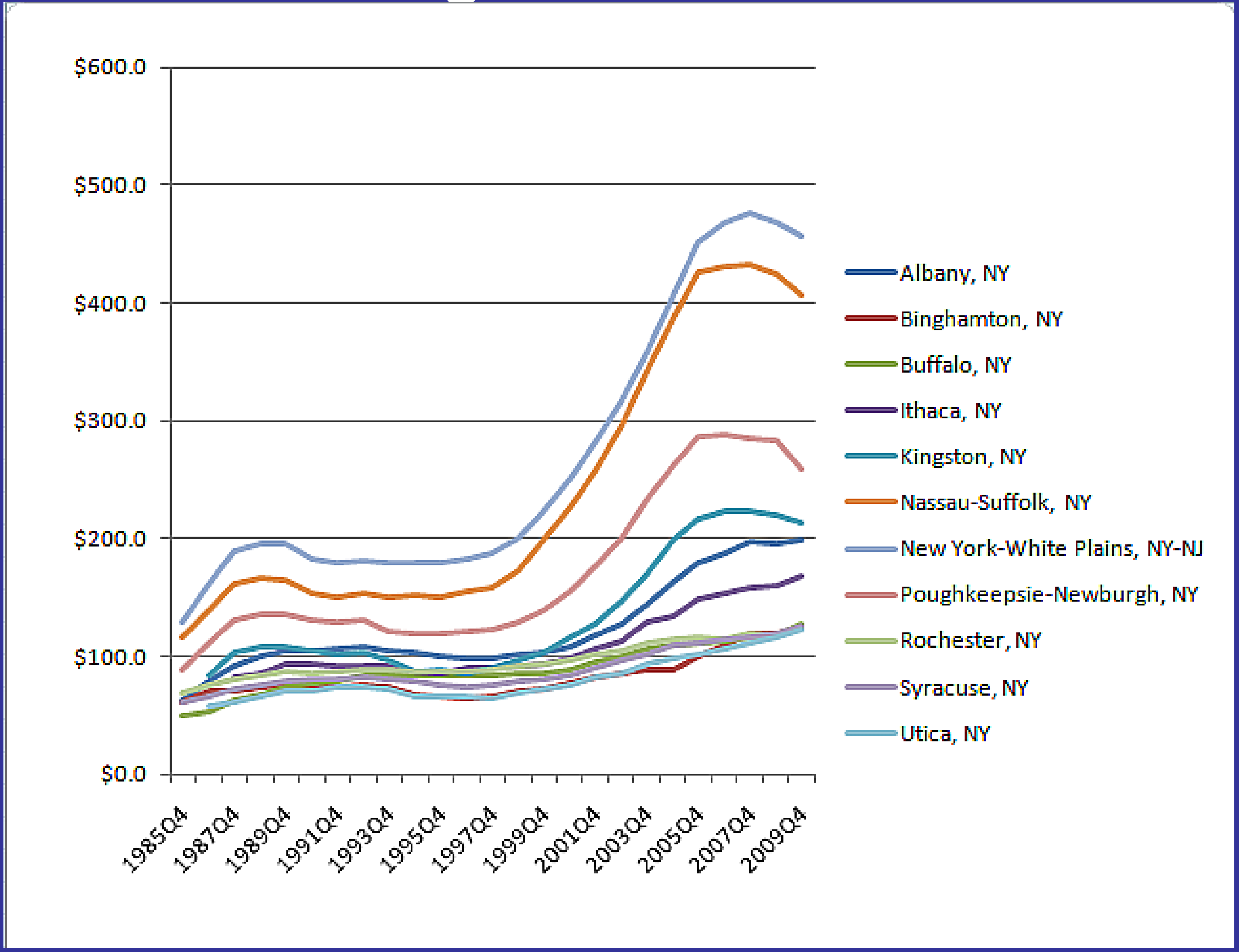
- Recapture method preferred (exc high cost areas)
  - Move away from declining balance toward full recapture
  - Equity sharing in up markets (instead of resale method)
  - Owner's equity returned 1st in flat markets
- Shift toward emphasis of program income
  - More extended local use periods (loan terms)
  - After minimum compliance period, no repayment or recaptured funds, it's all Program Income

Final Word on Buyer Subsidy

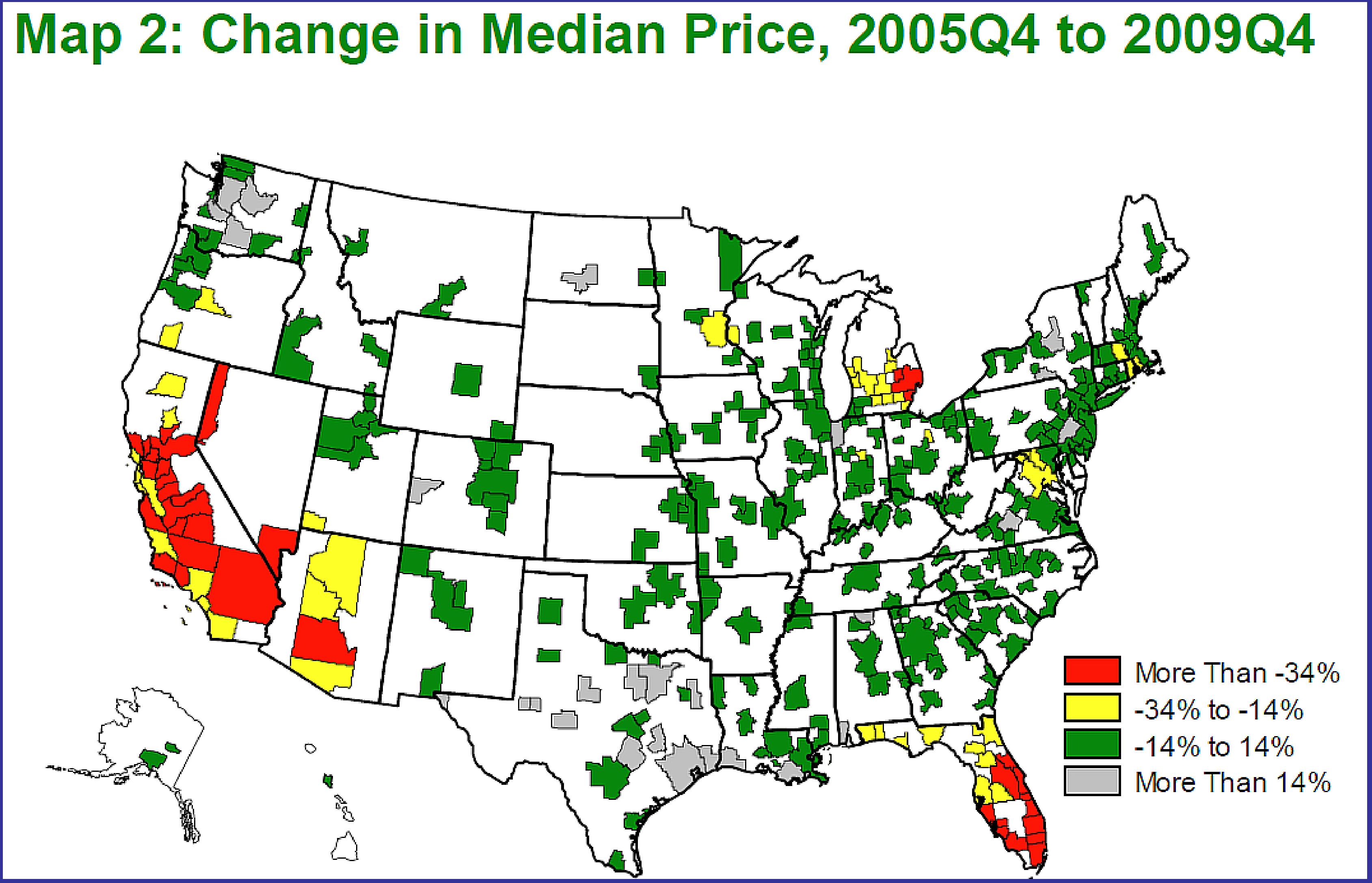
- Sell homes at market value
- Give the buyer the assistance needed to afford
- Give them a fair deal given market conditions
- But secure the buyer subsidy to protect the public investment

Homebuyer Projects in the Current Market

NY Price Changes – 25 Years



Price Changes From the Peak (2005)



What Happened?

- Housing became a fungible asset…not just a home
  - Consumers: primary investment asset & debt vehicle
  - Investors: another trade in/out commodity, market swings
  - Lenders: easy money induced more trading and price rises
- In NY
  - Upstate: economic downswing, so moderate increases
  - Downstate: greater rise and fall, but not like other states
- A new paradigm? Housing prices will fluctuate more with investment dynamic

Implications

- Recent buyers - over-leveraged & “upside down”
  - ARM & high LTV mortgagors extremely vulnerable
  - Refi products more limited & stricter appraisals
  - Bottom line: “Can’t Pay, Can’t Refi, Can’t Sell”
- New buyers – prospects for near-term appreciation?
- Bottom feeding?
- Collateral damage: increasing foreclosures & job losses might hurt everyone
  - 0.9% decline in value for foreclosed home w/in 1/8th mile

Risks in the Current Market

- Demand down: buyers sitting on sideline
  - Price uncertainty
  - Financing harder to get
  - Some investor bottom-feeding, but not to change trends
- Excessive supply
  - Upstate declining population & jobs
  - Foreclosures add to supply

Planning a Homebuyer Project?

- Narrower affordable income band: smaller target pool
  - As mortgage products narrow and underwriting becomes more conservative, what is happening to buyer pipelines?
- Buyer risk: buying in at top or on downward trend
  - How much equity do they have? How quickly will they be upside down?
  - What mortgage factors put them at risk?
- Declining prices & size of public subsidies
  - What is the TLTV? If declines continue?
- Current market information is essential
  - Watch trends: inventory, listing times, sales/listing price ratios

Foreclosure Prevention & Intervention

National Foreclosure Data (3/10)

- 4.63% of mortgages in foreclosure
- 1.23% entered foreclosure in quarter
- 10.06% 30+ days delinquent
    - 9.56% seriously delinqnquent (90+ days)
- Trends: subprime foreclosure starts down, but prime fixed & FHA increasing

Source: MBA

Actions to Prevent Foreclosure

- Avoid funding owner opportunities that are immediately “upside down”
- Provide housing with long useful life
- Maintain the post-purchase relationship
- Develop sensible resubordination/prepayment policies
- Monitor

Avoiding Upside Down

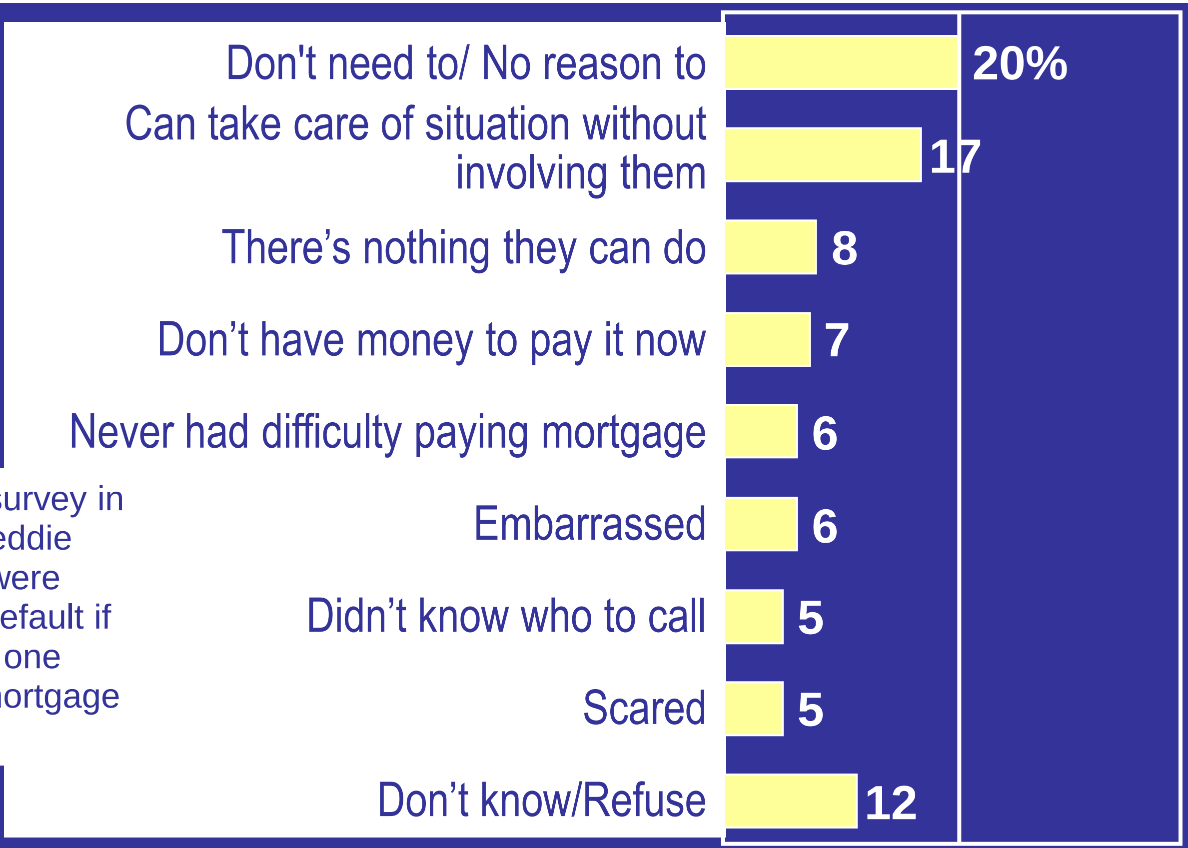
- Neighborhoods that show some stability
  - Balance between supply and demand
  - Location: access to jobs, shopping services
- Fair pricing
- Second mortgages that protect buyer equity
- NY: 6.3% upside down; 2.2% near upside down (average LTV only 49%) (source: Core Logic)
  - Versus 23.8%, 4.9%, & 70% nationwide

Sustainability

- Manageable mortgage
- Useful life: adequate improvements to avoid major repairs in first 5 – 10 years
- Energy efficiency: control utility costs
- Ability to maintain: quality of systems & finishes

Delinquent Owners Contact Lenders?

Delinquent owners: 25% claimed not contacted by lender; 31% never contacted lender; 11% claimed no problem



Source: Telephone survey in 8/05 by Roper for Freddie Mac. Respondents were considered to be in default if they were more than one month late on their mortgage payment.

Post-Purchase Counseling

- A relationship…not just an event
  - Newsletters, community events, etc.
- Topics:
  - Things they forget/didn’t hear pre-purchase
  - Managing/maintaining your home
  - Avoiding predatory lending
  - Responsible refinancing & resubordination
  - Where to turn if you get into trouble

Resubordination & Prepayment Policy

- Resubordination:
  - Refi with no takeout?
  - Equity takeout for:
    - Home improvements?
    - Economic emergency (e.g., job loss)
    - Medical emergencies?
    - Education?
    - Other debt?
    - Foreclosure prevention?

- Prepayment policy:
  - Will you prohibit?
  - Will you require pre-prepayment counseling?
  - Do you require full repayment if noncompliance

Loan Servicing/Management

- Even if not collecting amortization payments
- If local lenders, can they notify you of delinquencies
- If no mortgagee notice, adopt other methods:
  - Contact homebuyers
  - Local tax and water bill delinquencies

Prevention v. Intervention

- Prevention
  - Helping existing owner avoid foreclosure
  - Counselor involvement
  - Restructure public loan terms?
  - Other subsidies; resubordinate HOME?
  - Additional HOME funds not eligible
- Intervention
  - Getting control of property or new buyer
  - Repurchase rights
  - Repurchase funds
  - Entity to repurchase/convey
  - Active buyer pool
  - Additional HOME funds eligible (see next slide)

Repayment & Recaptured Funds

- Repayment:
  - If foreclosure & restrictions terminated, HOME $ must be repaid
  - Amount subject to repayment to US Treasury
    - If resale, all HOME $ repaid
    - If recapture, only balance of note/mortgage due
- Recaptured funds
  - Must be repaid to Participating Jurisdiction (PJ); can't be retained
- Other funds recovered: considered program income, subject to your agreement with the PJ

Wrap Up & Evaluation

The Big Picture

- Budgets: costs must be complete; leave margins
- Financing: month-to-month planning of project outflows & inflows
- Buyer financing: impose DP & 1st mortgage standards
- Buyer subsidy: market based mortgage approach with terms fair to buyers & taxpayers
- Think sustainability of ownership, including foreclosure prevention

Questions to Take Away

1. Are you tracking & adapting to local housing & mortgage markets?
2. Is the buyer pipeline “informing” your development planning?
3. Have you fully budgeted your project?
4. Have you structured for sustainability?
5. Do you need to increase your post-purchase monitoring and support?

- Final questions?
- Evaluation
- MLFranke@aol.com
- Enjoy your summer!

- Tomorrow: Rental project budgets & finance
- Next development seminar:

  5. Project Implementation
     - Albany: 9/14
     - New York City: 9/15
     - Syracuse: 9/22
     - Buffalo: 9/23