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HOME OWNERSHIP

Limiting Mortgage Assistance Provided to Owners With High-Income Growth

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The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives

As required by section 4005(i) of Public Law 100-647, we are reporting on the recapture provisions for qualified mortgage bond and mortgage credit certificate assistance. The report discusses how the recapture mechanism is likely to affect assisted home owners and whether it may be expected to limit the home ownership subsidy provided to households with rapid income growth. Also, the report discusses alternatives to the recapture mechanism that might limit the subsidy provided to those with rapid income growth. Chapters 3 and 4 contain several matters for consideration by the Congress.

We are sending copies of this report to the Senate and House committees responsible for tax and housing matters; the Secretary of the Treasury; the Secretary of Housing and Urban Development; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

This report was prepared under the direction of John M. Ols, Jr., Director, Housing and Community Development Issues, who may be reached at (202) 275-5525. Other major contributors to this report are listed in appendix IX.

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

The Congress enacted legislation in 1988 to recapture some or all of the subsidy from first-time home owners who receive qualified mortgage bond assistance. As stated in the conference report, the purpose of the recapture mechanism was to retrieve the subsidy from owners who experience rapid income increases after they purchased their assisted home and, as a result, did not need the subsidy to remain home owners. The Congress delayed the effective date of the recapture provisions until 1991 to enable GAO to report on whether the enacted provisions will accomplish the act's purpose and to identify alternative approaches.

Background

State and local government agencies assist first-time home buyers by using qualified mortgage bond proceeds (often called mortgage revenue bonds) to provide fixed-payment mortgage loans at below-market interest rates. These loans lower owners' monthly payments. Assisted buyers must meet income, home purchase price, and other eligibility standards.

The recapture provisions were imposed to recover some or all of the assistance if the owner's income increased beyond certain levels. Assisted owners pay the recapture amount as part of their federal income tax for the year in which the home is sold. The recapture amount is based on an assumed interest rate reduction of 1.25 percentage points per year during the first 5 years of ownership. It increases on a pro rata basis from $0 at the start of the first year to a maximum of 6.25 percent of the mortgage amount for a home sold after 5 years. The recapture amount is then phased out during years 6 to 10, after which no recapture amount is due. Also, the recapture amount may be reduced to $0 if the household's income has not increased by certain amounts, as determined through a complex income test. In any case, the recapture amount cannot exceed 50 percent of the gain on the sale.

Results in Brief

While the recapture provisions will recover some or all of the subsidy received by certain assisted home owners, it does not treat all owners with income increases equitably. For example, the 1.25 percentage point recapture rate may be larger than the interest-rate reduction owners received. Moreover, because the recapture amount is computed only after the subsidy is discontinued, some owners will continue to receive the assistance even after their income has risen to a level where they could make unassisted housing payments. Finally, assisted loans can be made to those who could afford market-rate conventional loans with comparable terms, and therefore do not need mortgage bond assistance.

Various ways exist to more closely tailor the amount recaptured to the interest-rate reduction received by the owner. A more fundamental change would be to discontinue the assistance when the owner could afford to remain an owner without the reduced-interest-rate loan. Finally, agencies could limit this assistance to those who could not initially afford a market-rate conventional loan with comparable terms.

GAO's Analysis

The recapture formula estimates whether assisted owners would still meet income eligibility standards when they sell their home. If income is less than the estimated eligibility standard, the recapture amount is reduced or eliminated. The income increases needed to pay any or the maximum recapture amount in any year depend on (1) median income in the area, (2) how the owner's income compares with the maximum income eligibility limits when the home was purchased, and (3) changes in household size.

GAO developed five hypothetical recapture situations. Under the most conservative one, income would have to increase by about 18 percent for the household to pay the full recapture amount in the first year, and an average of 11 percent per year if the home was sold after the second year. The income increases needed to pay the full recapture amount further decline from an average of 9 percent per year after year 3, to an average of 6 percent per year near the end of year 10. For the other cases, the income increases needed to pay the full recapture amount were almost always higher, and most were significantly higher than the most conservative case.

Recapture Not Tailored to Assistance Received

Many assisted owners will compute their recapture amount using a higher rate than the interest-rate reduction they receive. Others will use a lower rate. These situations occur because most assisted owners will have a mortgage interest reduction that is different from the recapture formula's assumed 1.25 percentage point reduction. For example, in a 1988 study, GAO found that one-quarter of the sampled buyers received interest rate reductions of three-quarters of a percentage point or less.[1]

[1] Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988).

For an $80,000 mortgage in which the owner received a 1-percent reduction in the mortgage interest rate, the owner could pay as much as $1,000 more in recapture than the benefit received.

Subsidy Continues Even When Income Increases Significantly

Because the recapture amount is phased out from years 6 through 10, owners with large increases in income and/or those who receive assistance the longest have their recapture amounts reduced and eventually eliminated. This reduction occurs even if owners could afford unassisted housing payments. Also, a recapture amount that is phased out may induce assisted owners to stay in their home longer to avoid or reduce the recapture. As a result, the subsidy period is extended even if the owner could afford unassisted housing payments.

Initially, Many Assisted Owners May Have Been Able to Afford Unassisted Housing Payments

Buyers can receive mortgage bond assistance even if they may have been able to afford housing payments on a market-rate loan of comparable terms without it. Using two standard mortgage qualification tests, GAO found that about half of the assisted households may have been able to afford the same home with a market-rate fixed-rate mortgage. Limiting assistance to only those who could not afford housing payments on a conventional loan of comparable terms would be a better use of mortgage bond funds.

Alternative to the Recapture Mechanism

An alternative to the recapture mechanism would be to increase an owner's monthly payment for principal and interest (up to the level determined by the market interest rate at the time the loan was made) when the owner's income has increased sufficiently to afford those payments. One advantage of this approach is that it halts assistance when it is no longer needed, rather than when the home is sold. However, this approach would require housing agencies or their agents to periodically reexamine owners' income and would make the program administration more complex and costly.

Matters for Congressional Consideration

The enacted recapture mechanism is preferable to no recapture mechanism at all because some or all of the assistance could be recovered from at least some of those who probably could have waited a short time and purchased a home without it. However, it is a relatively ineffective way to identify and recapture benefits from those who do not need continued assistance because the recapture requirements are triggered solely by an owner's decision to move.

If the Congress decides to change the recapture provisions, it could either (1) keep the current mechanism with some revision or (2) substitute a different approach.[2] Regarding the former, the Congress may wish to (1) tailor the recapture amount more closely to the interest-rate reduction received and (2) eliminate the phaseout after year five so that those owners who continue to benefit from the assistance have some or all of it recaptured. If the Congress decides to replace the recapture approach, it may wish to enact an alternative that ends assistance when owners can afford unassisted housing payments.

The proposals discussed above do not keep those buyers who could afford housing payments with a market-rate loan of comparable terms from initially receiving assistance. The Congress may wish to require that housing agencies initially limit assistance to buyers who could not otherwise obtain a market-rate loan with comparable terms without qualified mortgage bond assistance.

Agency Comments

The Association of Local Housing Finance Agencies, National Council of State Housing Agencies, and Department of the Treasury commented on a draft of this report. The Association and the Council disagreed with GAO's alternatives to the current recapture mechanism. They cited additional administrative complexity of these approaches with little, if any, perceived gain. GAO agrees that administrative requirements would increase somewhat. The added requirements should be weighed against better achieving the stated congressional goals for the recapture mechanism.

The Association and the Council also stated that an affordability test was not needed. Their disagreements center on their belief that current eligibility standards for income and home purchase price are sufficient and that GAO's analyses are flawed. GAO conducted an additional analysis and continues to believe that about half of the assisted buyers may have been able to otherwise afford a market-rate loan. Therefore, GAO continues to believe that a conventional affordability test is needed.

Treasury did not express support or opposition to GAO's proposals but emphasized the complexity and administrative effort needed to implement them.

[2] GAO's March 1988 report questioned the continued use of qualified mortgage bonds to assist first-time buyers. This report should not be considered as a change in that position.

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Related GAO Products

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Abbreviations

FmHA	Farmers Home Administration
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
MCC	Mortgage credit certificate
QMB	Qualified mortgage bond

Introduction

A popular form of assistance for first-time home buyers is a below-market interest rate mortgage loan financed through tax-exempt qualified mortgage bonds (QMB).[1] A related form of assistance is the mortgage credit certificate (MCC), which allows first-time buyers to take a credit on their federal income tax for a portion of mortgage interest paid. The Congress has restricted the eligibility of those receiving QMB loans and MCCs to prevent upper-income households from receiving them.

In 1988, the Congress further restricted home buyer eligibility requirements. It also imposed a tax that, under certain circumstances, will recapture some or all of the assistance provided. However, the Congress deferred the effective date of the recapture provisions for loans to those made on or after January 1, 1991, and required us to assess the mechanism and alternatives that would accomplish its purpose.

How QMB and MCC Programs Operate

The issuer of QMBs, usually a state or local government housing finance agency, issues these bonds when it believes that sufficient demand by home buyers exists for the resulting mortgage funds. Home buyers are attracted to QMB loans because the interest rates are lower than those available on conventional loans.[2] Typically, the agency issues bonds when it believes that the resulting QMB mortgage interest rates will be 1-1/2 to 2 percentage points below the conventional mortgage rate for fixed-rate loans. Depending on the movement of conventional mortgage interest rates between the time the bonds are issued and the time the loans are made, the spread may be higher or lower than the agency attempted to achieve.

The reduced payment from the below-market QMB loan benefits the buyer.[3] However, the effect of this benefit is somewhat reduced since buyers often pay one-time fees to the housing agency to help defray program costs that a borrower in the conventional market would not pay. The prospective home buyer executes a purchase contract on a home and applies for assisted financing through a mortgage lender acting for the housing agency. The lender makes the fixed-rate QMB loan after determining that the purchaser has not had an ownership interest in a

[1]These bonds are often called "mortgage revenue bonds."

[2]QMB funds may also be used for other kinds of loans, such as home improvement loans; however, home mortgage loans are by far the most prevalent form of assistance.

[3]We found the median reduction to be 1.44 percentage points from January 1983 to June 1987, or about $40 per month after taxes. See p. 38 of Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988).

principal residence for the 3 previous years ("first-time buyer"), meets income and home purchase price requirements, shows repayment ability at the below-market rate set by the housing agency, is a good credit risk, and meets other qualifying requirements.

MCCs, on the other hand, entitle buyers to take a credit against their federal income tax liability (i.e., a dollar-for-dollar reduction in tax liability) for a portion of their mortgage interest paid during the year.[4] The credit may be from 10 to 50 percent of the interest paid. In taking the credit, home owners must reduce the amount of the home mortgage interest deduction (i.e., a reduction from gross income) taken on their year-end income tax returns by the amount of the credit. If the home owner's federal income tax liability is less than the amount of the credit, the balance of the credit is lost to the owner in that year (a "nonrefundable" credit). However, the owner can carry forward any unused portion of the credit for 3 years.

Loans with MCCs are made through a participating mortgage lender at the market interest rate. The lender checks to make sure that the buyer can afford the home and qualifies the buyer for both the mortgage loan and the certificate. Lenders may or may not use the expected credit to qualify the buyer. Buyers also pay a fee to help defray the cost of the program.

Serving Lower-Income Households

The Mortgage Subsidy Bond Tax Act of 1980 imposed the first statutory restrictions on the ability of state and local governments to issue tax-exempt bonds for financing home mortgages. Generally, these restrictions limited (1) the dollar volume of bonds that could be issued; (2) those assisted to first-time buyers; and (3) the purchase price of the assisted home to no more than 90 percent of the area average. In drafting the 1980 act, the Congress, while expecting that lower-income households be the primary beneficiaries, largely allowed the bond issuers to determine the proportion of proceeds that would be used for lower-income households.

The Congress recognized that qualified mortgage bond programs operate in housing markets that differ considerably in affordability, and the

[4]QMBs are one type of so-called "private activity bonds." The Internal Revenue Code (the Code) limits the total amount of private activity bonds that can be issued each year. In lieu of issuing bonds, the agency may convert some or all of its unused bond issuance authority to authority to issue a certain volume of MCCs.

broad eligibility standards that it enacted gave state and local governments wide flexibility in structuring their programs. Through legislative changes in 1982 and 1986, this flexibility has remained, although the Congress has attempted to tighten eligibility requirements by adding a requirement that, generally, assisted buyers' household income cannot exceed 115 percent of area median income.

Tightened Eligibility Standards and a Subsidy Recapture

With the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647, Nov. 10, 1988), the Congress tightened eligibility requirements once again in response to evidence that the (1) program was serving a higher proportion of single-person households than the first-time home buyer market serves generally and (2) income and purchase price eligibility requirements did not reflect the significant differences in which first homes are affordable in different housing markets.[5] The act added a household size adjustment to the income eligibility standard. Under the act, household income for household sizes of one or two persons cannot exceed 100 percent of the area median income. The income eligibility standard for households of three or more persons remains at the 1986 level of 115 percent of area median income. In addition, on a formula basis, the income eligibility standards are adjusted upward or downward in areas of high or low housing costs, respectively.

The act also imposes a tax on assisted households that is designed to recapture all or a portion of the expected subsidy from some QMB- or MCC-assisted owners. The recapture tax was added because the Congress believed that

> "in those QMB- and MCC-assisted households where income has risen rapidly since acquisition, the special subsidy provided by the program was not necessary in order to become or remain a homeowner."[6]

[5]Miscellaneous Revenue Act of 1988, Report of the Committee on Ways and Means, House of Representatives, U.S. Congress. Report 100-795, July 26, 1988, pp. 434-6. See also (GAO/RCED-88-111, Mar. 28, 1988) and Home Ownership: Targeting Assistance to Buyers Through Qualified Mortgage Bonds (GAO/RCED-88-190BR, June 27, 1988).

[6]Technical and Miscellaneous Revenue Act of 1988, Conference Report to Accompany H.R. 4333. House of Representatives, U.S. Congress. Report 100-1104, Vol. II, Oct. 21, 1988, p. 85.

The House legislative report noted that while home ownership provides the owner both consumption benefits and investment benefits (through house price appreciation), the recapture mechanism was intended to return the consumption assistance received through the reduced-interest QMB loan or MCC tax credit. See Miscellaneous Revenue Act of 1988, p. 436.

While the revised eligibility provisions under the 1988 act became effective for bonds issued (and elections not to issue bonds in favor of MCCs) after December 31, 1988, the Congress delayed the effective date for the recapture provisions until January 1, 1991. In the interim, the act requires that we study the enacted recapture mechanism and alternatives to it.

Objectives, Scope, and Methodology

Section 4005(i) of the 1988 act requires that we report on the enacted provisions and any alternatives that would accomplish the purposes of the section. Accordingly, we studied the formula contained in the enacted legislation and alternatives in terms of how they would be likely to achieve the conference report's stated objective of identifying those with rapid income increases and recapturing the assistance provided by the QMB loan or MCC.[7] These alternatives include potential modifications to the legislated provisions and substitution of different approaches for achieving the Congress' goal. We also assessed whether the recapture mechanism or other legislative provisions would prevent those who could afford a market-rate loan from initially receiving a QMB loan or MCC.

To determine the recapture requirements for QMB loans and MCCs, we reviewed the pertinent sections of the Technical and Miscellaneous Revenue Act of 1988 and the legislative reports leading to it. The Internal Revenue Service, which has primary regulatory responsibility, told us that the Service plans to have taxpayer guidance completed by December 1990.

To determine how two major federal home ownership programs structure their recapture mechanisms, we reviewed laws, regulations, and program documents, and met with officials at the Department of Housing and Urban Development (HUD) for its section 235 program and the U.S. Department of Agriculture for the Farmers Home Administration's (FmHA) section 502 program.

We also obtained information on the extent that recapture mechanisms are used by state and local housing agencies and whether potential overlap with the federal recapture mechanism may exist. For state agency practices, we obtained a summary of a 1989 survey of member

[7]Our March 1988 report concluded that the QMB-financing mechanism is costly, serves mostly buyers who could afford homes otherwise, and does little to increase affordability for low- and moderate-income buyers (see (GAO/RCED-88-111, Mar. 28, 1988)). This report primarily limits its scope to recapture and related issues.

agencies performed by the National Council of State Housing Agencies. To learn about local agency recapture practices, we mailed a survey instrument or telephoned 128 local housing agencies that are members of the Association of Local Housing Finance Agencies.

We reviewed economic and housing literature related to possible alternative recapture mechanisms and topics related to the behaviors of first-time buyers. We performed our work between January and August 1989.

We sent a draft of this report to the Association of Local Housing Finance Agencies, National Council of State Housing Agencies, and Department of the Treasury for their review and comment. The Association and the Council disagreed with most aspects of our draft report. Treasury did not express support or opposition to GAO's proposals but suggested additional discussion about the complexity and administrative effort needed to implement the proposals. Their comments are reproduced in appendixes VI through VIII, respectively. Our evaluation of their comments is set out at the end of chapters 3 and 4 and appendixes VI through VIII. On the basis of those comments, we performed an additional test on the extent to which QMB loan recipients may have been able to purchase the same home with a market-rate loan (see ch. 3 and app. V).

Many Owners May Pay a Reduced Recapture Amount

The recapture provisions are a set of complex formulas that are applied when the owner disposes of the assisted home.[1] The provisions are designed to recoup the assisted owner's assumed interest rate reduction if the owner sells the home during the first 5 years of home ownership and if income has increased beyond established limits. After 5 years, the recapture amount is gradually phased out until, at the end of the tenth year, no recapture amount is due.

The increases in income needed to pay the maximum, or even any, recapture amount during this period vary by year and household situation. However, in the initial years the increases needed are substantial, suggesting that many assisted owners may pay a reduced recapture amount or, perhaps, none at all. And, those who sell their assisted home after 5 years will have the recapture amount phased out. Therefore, we would expect that many owners, including those whose income increased rapidly after they purchased the assisted home, will pay less in recapture than the benefit that they received.

Some state and local housing agencies impose forms of recapture that are independent of the federal recapture. However, the incidence of these recaptures is apparently limited. Therefore, few owners may be subject to multiple recaptures.

How the Recapture Amount Is Calculated

The recapture provisions impose a potential federal income tax liability on those whose income grows after they purchase the assisted home. The recapture amount is due for the tax year in which the assisted home is sold. The maximum recapture amount is 6.25 percent of the owner's original mortgage amount (from QMB loans or MCCs) if the home is sold 5 years after it is purchased. The recapture amount is reduced to reflect periods of time shorter or longer than 5 years (the holding period adjustment). In addition, adjustments for (1) gain on sale of the assisted home and (2) changes in household income may reduce or eliminate the amount.

Holding Period Adjustment

The recapture amount increases on a pro rata basis from $0 to 6.25 percent of the assisted mortgage amount over the first 5 years, according to the number of months from date of purchase until the home is sold, and similarly decreases evenly during years 6 to 10. For example, after 1

[1]Dispositions are generally sales, exchanges, or gifts. We refer to dispositions as "sales" throughout the report.

year the maximum recapture tax is 1.25 percent of the assisted loan amount (6.25 x 12/60 months); after 2 years the maximum tax is 2.5 percent of the assisted loan amount, and so on, up to 5 years.[2]

Gain-On-Sale Adjustment

The recapture amount cannot exceed 50 percent of the gain realized on the sale of the home. The gain is computed by subtracting the basis of the home (purchase price of the home plus cost of improvements and certain purchase costs) from the selling price, less certain selling expenses. For example, if the gain on the sale of the home was $5,000, the amount recaptured could not exceed $2,500.

Income Adjustment

The general nature of the income adjustment is to estimate, at time of sale, whether the assisted owner would still meet the income eligibility limits for a QMB loan or MCC at that time. If the assisted owner's household income at time of sale is higher than the estimated eligibility limits, then no reductions to the recapture amount (because of income) apply. If the owner's household income is less than the estimated eligibility limit, then the recapture amount is reduced to a lesser amount, as described below.

The income adjustment provides that the recapture amount is reduced by 2 percent for every $100 by which the assisted owner's income (adjusted gross income plus any tax-exempt interest) is less than the estimated income eligibility limit. The estimated income eligibility limit is the highest household income level that would have met the Code's income eligibility limit in the area where the buyer lived when the loan was made, plus $5,000. The highest household income level is determined after two adjustments.

The first adjustment is to reflect the mortgagor's family size on the date of sale. Generally, the income eligibility limit is 115 percent of area median income for households of three or more persons and 100 percent of area median income for households of one or two persons.[3] The second adjustment is to increase the highest household income level by 5

[2]Tax writers estimated that the typical after-tax benefit (reduction in mortgage interest rate) seen by assisted buyers was 1.25 percent per year. This estimate was based on a typical before-tax reduction in our March 1988 report. See p. 38 of Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988).

[3]If the seller's household size changes, say from a two-person household at time of purchase to a three-person household at time of sale, then the qualifying income dollar amount is based on the 115 percent standard, rather than the 100-percent eligibility standard, and vice versa.

percent (simple interest) for each full year the assisted loan is outstanding. The 5-percent increase is a proxy for the amount that income eligibility limits might increase each year.

The Code also contains several exceptions and special provisions to the computation. Table 2.1 summarizes the primary recapture requirements, and appendix I provides a detailed example of a recapture calculation.

Table 2.1: Summary of Recapture Requirements

Condition	Provision
To whom recapture applies	Buyers who receive QMB loans or MCCs starting January 1, 1991.
When recapture is due	The year in which the owner sells or otherwise disposes of the home.
How much is recaptured	The maximum amount is 6.25 percent of the assisted mortgage amount.
Reductions and to limitations	The recapture amount increases from $0 the maximum amount over the first 5 years of ownership, and then decreases to $0 after 10 years.
	The recapture amount cannot exceed 50 percent of the gain realized on sale.
	The recapture amount is reduced if household income is less than the estimated income eligibility standard, subject to household size and income change adjustments.
How recapture is paid	Recapture is part of the mortgagor's individual income tax liability.
Other provisions	The housing agency must inform the mortgagor of the potential recapture amount within 90 days of settlement.
	Home improvement loans are excepted from recapture.
	Other requirements, including limited exceptions to those subject to recapture, and refinancing were also enacted.

Source: Section 4005(g) of P.L. 100-647, IRC Stn. 143(m).

Combined Effect of Several Factors Determines the Recapture Amount Due

This section examines how the reductions and limitations affect the recapture amount due on the basis of a hypothetical example. The income test and the gain-on-sale test may reduce the recapture amount due for households that have relatively large increases in income during the first 3 to 4 years. After the fifth year, the holding period adjustment reduces and eventually eliminates the amount due for all assisted owners.

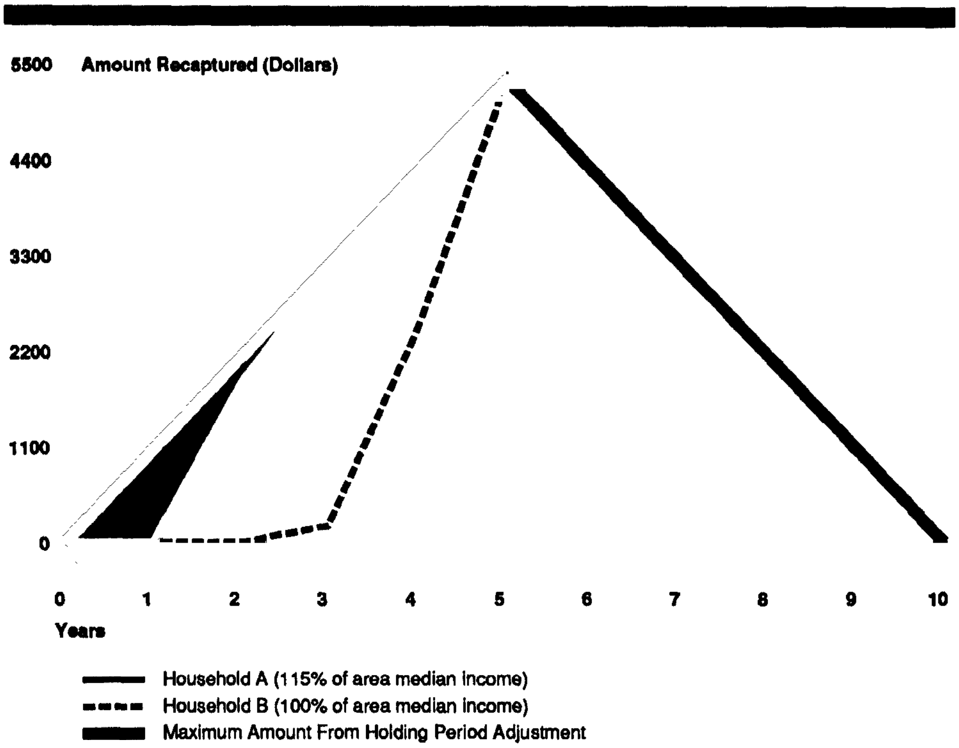
Figure 2.1 shows the maximum recapture amount that would be collected over a 10-year period and compares that amount with the amount that would be collected for two households that have relatively large increases in income. For this comparison, we constructed two hypothetical assisted households. Both households live in an area with a median income of $34,000. Both households purchase $94,500 homes and obtain assisted loans of $85,000.[4] Both households have three members and both experience relatively large annual increases in income of 10 percent annually.[5] Both households' homes have a 7-percent appreciation rate, which is about equal to the nationwide average for existing single-family homes for the 1979-88 period.[6]

[4]The numbers chosen are illustrative of recapture provisions only. Incomes and house prices vary widely across the nation. For this example, the area median income chosen is about equal to HUD's estimate of the expected 1989 nationwide household median income and its estimate of statewide household median income for Ohio, Washington, and Wyoming.

[5]These increases are larger than the 5-percent increase in the qualifying income dollar amount built into the recapture formula income test. They are also larger than the nationwide average increase in nominal income for all home owners over the last 10 years that we computed from Appendix Table I of the Joint Center for Housing Studies' The State of the Nation's Housing, 1989.

[6]National Association of Realtors' data show an average annual appreciation of 6.7 percent on the sale of existing homes nationwide from 1979-88. To compute the net gain, we assumed that selling expenses, such as realtors' commissions, transfer taxes, and other selling expenses, were 8 percent of the sales price.

Figure 2.1: Expected Recapture Amount for Hypothetical Households With Relatively Large Income Increases



Note: After the Household A and B lines intersect the maximum tax line, the amount due in this example is determined by the holding period adjustment. The recapture amount is based on an $85,000 assisted loan amount. For other details, see text.

The households differ only in their income at the time that they purchase their assisted homes. Household A has the maximum income to be eligible to participate, $39,100 (115 percent of the area median income) and Household B's income equals the area median, or $34,000.

As the thicker solid line in figure 2.1 shows, the recapture amount due before the income and gain-on-sale adjustments reaches its apex at the end of the fifth year and decreases symmetrically through the tenth year of ownership. This line also shows that, for a household that obtains an $85,000 loan, the maximum recapture amount rises from $0 when the home is purchased, to $5,313 at the end of year 5, and then declines at the same rate until the end of year 10, after which no amount is due.

Different Recapture Provisions Dominate Over Time

Figure 2.1 also shows the consolidated effects of the income and gain-on-sale tests and the holding period adjustment on Households A and B, both of which bought homes under identical terms and have relatively large annual increases in income (10 percent annually). Figure 2.1 shows that, because of the income and gain-on-sale tests, even those with 10-percent income increases and average gains on sale are likely to pay less than the maximum recapture amount if they sell their home before the end of the third year in the case of Household A and before the end of the fifth year, for Household B.[7] For example, Household A's income must rise by 18 percent in the first year to pay the full recapture amount.[8] Since we assumed a lesser increase of 10 percent, the income adjustment would reduce the recapture amount due. Also, since we assumed that selling expenses would be 8 percent of the sales price and the home appreciated 7 percent in the first year, no gain on sale would result in the first year, and, hence, no recapture amount would be due even if income had risen by 18 percent or more.

In addition, figure 2.1 shows that the recapture amount due depends on the difference between household income at the time of sale and the estimated income eligibility standard under the recapture formula. That is, for determining the recapture amount, an assisted owner's increase in income is measured against the maximum qualifying income. The lower the income of the household when buying the assisted home in relation to the income eligibility standard, the more income has to rise to be subject to the maximum or any recapture amount. Therefore, the income increase that Household B must have before it pays any or the maximum recapture amount is greater than that for Household A since (1) both are tested against the 115-percent eligibility amount of $39,100 and (2) Household B has a lower starting amount.[9]

Table 2.2 shows in dollar values the effect of the holding period, income, and gain-on-sale provisions in determining the recapture amount due for Households A and B. For most years, the holding period adjustment determines the recapture amount due.

[7]Two major federal home ownership programs, HUD's section 235 and FmHA's section 502 programs for low- and moderate-income buyers, have recapture provisions. Neither recapture provision makes an adjustment for changes in the assisted owner's income in calculating the recapture amount due. (See app. III.)

[8]($39,100 x 1.05) + $5,000 = $46,055, which is 18 percent greater than the $39,100 income eligibility limit.

[9]The results would have been the same if Household B was a one- or two-person household when it bought the assisted home and a three-person or larger household when it sold it since the qualifying income dollar amount is calculated on the basis of household size at sale.

Table 2.2: Dominant Recapture Provision Over Time for Households A and B

End of year	Maximum amount based on holding period adjustment	Household A: Amount due using all provisions	Household A: Dominant provision	Household B: Amount due using all provisions	Household B: Dominant provision
1	$1,063	$0	GOS	$0	GOS,INC
2	2,125	1,828	INC	0	INC
3	3,188	3,188	HPP	184	INC
4	4,250	4,250	HPP	2,430	INC
5	5,313	5,313	HPP	5,313	HPP
6	4,250	4,250	HPP	4,250	HPP
7	3,188	3,188	HPP	3,188	HPP
8	2,125	2,125	HPP	2,125	HPP
9	1,063	1,063	HPP	1,063	HPP
10	0	0	HPP	0	HPP

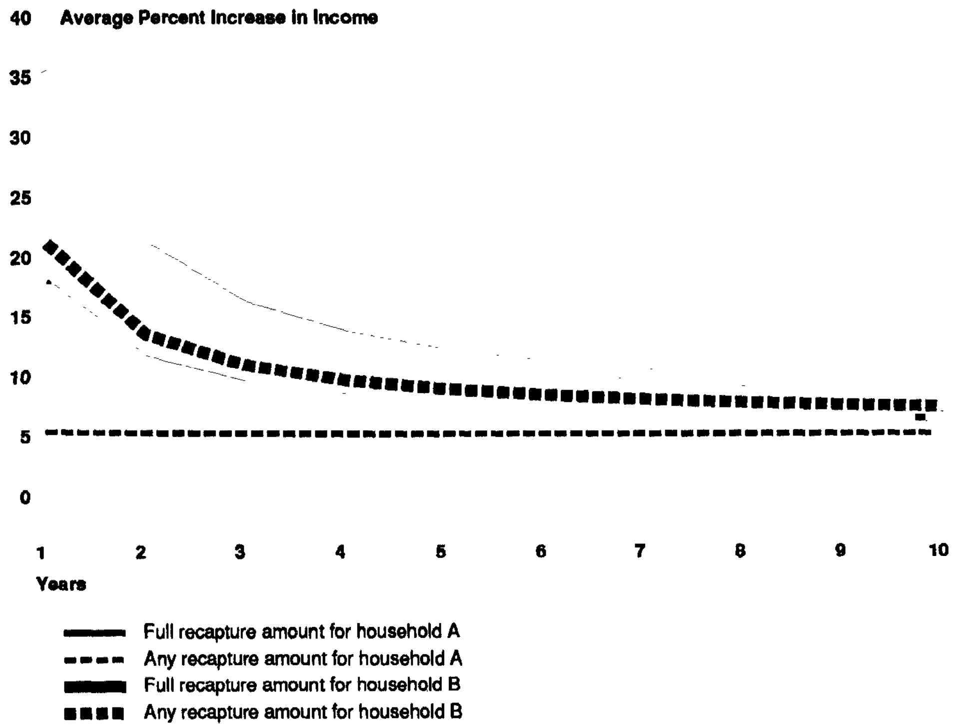
Legend
HPP = holding period provision
INC = income provision
GOS = gain-on-sale provision

After the fifth year, the holding period adjustment reduces the recapture amount to levels below the assumed benefit seen by the assisted owner. The act's legislative history does not indicate why this phaseout was enacted.

Income Increases Needed by Owners to Pay the Maximum or Any Recapture

Figure 2.2 shows the annual average percentage increases in income needed in any year to pay both the maximum recapture amount and any recapture amount. For Household A, the increase needed to pay the maximum recapture amount declines from 18 percent for a home sold at the end of the first year to just over 6 percent for a home sold before the end of the tenth year. The declining increases needed to pay the recapture amount are due to the declining influence over time of the $5,000 amount added to the adjusted qualifying income, since adjusted qualifying income is increased by 5 percent (simple) each year. If the $5,000 amount was eliminated from the formula, income increases needed to pay maximum recapture would be constant, that is, 5 percent in any year.

Figure 2.2: Average Annual Income Increases Needed for Households A and B to Pay the Maximum or Any Recapture Amount



Note: Assumes an area median income of $34,000. When it bought the assisted home, Household A's income was 115 percent of area median income, or $39,100. Household B's income matched the area median. See text for details.

For Household B, the annual income increase needed to pay the maximum recapture amount ranges from about 35 percent for a home sold after the first year to almost 9 percent for a home sold just before the end of year 10. The results for Household B are larger than for Household A because (1) Households A and B are both tested against the 115-percent eligibility amount of $39,100 and (2) Household B has a lower starting point than Household A. Of course, for both Households A and B, the recapture amount computed just before the end of year 10 will be negligible because of the holding period adjustment.

For Household A, the income increase needed to pay any recapture amount is slightly more than 5 percent per year. Again, the result is different for Household B with the average annual income increases needed to pay any recapture amount decreasing from 21 percent at the end of the first year to about 7 percent near the end of the tenth year.

But, the reasoning is the same as for the determination of income increases needed to pay the maximum recapture amount.

The results that we present here depend upon a number of factors. While the same general results will hold for several different assumptions, the dollar values derived depend on initial values, such as the area median income. The lower the initial income, the larger the percentage increase in income that must occur to pay the maximum recapture amount. Again, this is the result of the $5,000 constant.[10] See appendix II for an example of recapture amount calculations using lower area median income levels.

Many Assisted Owners Could Pay Less Than the Maximum Recapture Amount

In our March 1988 report, we found that 65 percent of the assisted buyers in our sample had incomes at or below area median income.[11] Also, as discussed above, those whose incomes at time of purchase were equal to the area median must have quite large income increases before they pay the maximum, and, in some cases, any recapture amount. Therefore, many assisted buyers will probably pay less than the maximum recapture amount. Figure 2.1 and table 2.2 showed how the recapture amount would be reduced by the income test for owners whose income was at 100 percent of the area median income level, rather than the maximum of 115 percent of area median income. Appendix II takes this analysis one step further by comparing income increases needed to pay the maximum or any recapture amount when the owner's income at time of purchase was 80, 100, and 115 percent of area median income, and it uses a lower area income.

[10]For example, assume median incomes of $24,000 for Area X and $34,000 for Area Y. Household income in Area X would have to rise by 21 percent to reach $29,000 (Area X median income plus $5,000) and by only 15 percent to reach $39,000 in Area Y (Area Y median income plus $5,000).

[11]Based on 135,000 loans made during the January 1983 through June 1987 period. See (GAO/RCED-88-111, Mar. 28, 1988), p. 81.

State and Local Recapture Mechanisms Are Apparently Limited

Several state and local governments impose some form of recapture on buyers whom they assist. However, these are limited, and any overlap that may exist between them and a recapture of QMB loan or MCC assistance is apparently quite small.

A 1989 survey by the National Council of State Housing Agencies of its national membership showed that eight states had some form of recapture mechanism as part of one or more of their home ownership programs. None of the eight members reported that it applies recapture to its QMB loans. Rather, the recapture mechanisms appear to be used only with special programs of limited duration or availability.

In 1989, we surveyed 128 members of the Association of Local Housing Finance Agencies for the same purpose. Because not all local housing agencies belong to the association, our survey may not cover all recapture approaches in use. Twenty of the responding agencies indicated that they employed a recapture or recapture-like mechanism.[12] In a number of cases, these mechanisms were limited to a single development or small set of properties rather than applying to the agencies' housing programs in general. In only a few cases did the respondents indicate that the recapture mechanisms were applied to QMB loans and/or MCCs, although survey results did not provide details on these situations.

Consequently, the home owner, in rare instances, may be subject to multiple recaptures. A multiple recapture could be avoided if state and local governments recaptured only the enhancements they add to the QMB loans or MCCs (such as closing cost or down payment assistance). Because the federal recapture provisions are effective for loans made starting January 1, 1991, none of the home owners currently receiving state or local assistance and subject to a state or local recapture provision will be affected by the federally enacted recapture provisions.

A description of the state and local recapture mechanisms identified by the two surveys, as well as descriptions of recapture of subsidies in HUD's and FmHA's home ownership programs, are contained in appendix III.

Summary

The recapture provisions are a complex set of formulas that impose a potential tax liability on assisted owners whose income grows after they

[12]About 91 percent of the 128 members surveyed responded. Also, one of the respondents was not an Association member, but returned our survey when another agency sent the questionnaire to it.

purchase the assisted home. Many of those who sell their homes during the first 5 years may have the recapture amount reduced from the maximum amount in any year because of the income test and the gain-on-sale test. During years 6 to 10, the legislated recapture formula reduces the amount to be recaptured and the recapture amount becomes $0 at the end of the tenth year.

Although some state and local agencies impose some form of recapture, the number of owners subject to state and local recapture is apparently quite limited. Therefore, few assisted owners may be subject to a multiple recapture when the QMB loan and MCC recapture provisions become effective starting January 1, 1991.

Changes to the Recapture Provisions to Promote More Equitable Treatment of Owners

The recapture provisions will identify and impose a potential recapture payment on certain households whose incomes increase after they purchased their assisted homes. However, several features treat assisted owners differently. For example, the recapture provisions can impose the same recapture amount on households that receive different amounts of assistance.

Further, the recapture provisions do not address two fundamental weaknesses in how QMB loan and MCC assistance is provided: (1) assistance can be provided to those who initially could afford market-rate housing payments without QMB loan or MCC assistance and (2) once obtained, the assistance is continued regardless of the owner's ability to support unassisted housing payments.

Several revisions could be made readily to the current recapture mechanism to treat assisted owners more similarly and to ensure that only those who cannot support unassisted housing payments, initially, receive assistance. However, discontinuing assistance when the owner could support unassisted housing payments would require a fundamental change in how assistance is delivered.

Increasing Equitable Treatment in the Recapture Provisions

Equitable treatment between taxpayers is one goal of tax policy. Two basic concepts of equity are the "benefits principle" and the "ability-to-pay principle." Under the benefits principle, equity is fostered when those (1) who benefit more pay more in taxes than those who benefit less and (2) with equal benefits are taxed at the same level, all else being equal. However, the recapture legislation contains provisions that treat differently situated assisted households similarly and similarly situated households differently. As a result, assisted owners may be treated inequitably.

Under the ability-to-pay principle, equity is fostered when those with greater financial resources are taxed more than those with fewer resources. As applied to the recapture provisions, the income adjustment provision is generally consistent with this principle, while the gain-on-sale provision is not.

Single Recapture Rate Not Fully Consistent With the Benefits Principle

The recapture formula is not fully consistent with the benefits principle since it uses a single rate that is equal to the presumed benefit, rather than the actual benefit received, as the basis for the recapture amount.[1] In one respect, this approach satisfies equity principles in that assisted owners who have larger loans are subject to a larger recapture amount than those with smaller loans, all else being equal.

However, this approach raises other equity considerations because many assisted owners will receive larger or smaller interest-rate reductions from QMB loans than the yearly after-tax 1.25 percentage point amount imbedded in the recapture provisions. For example, in March 1988 we reported that, while the median before-tax reduction was 1.44 percentage points, one-fourth of the assisted buyers we studied received reductions of about three-quarters of a percentage point or less from the conventional interest rate.[2] Similarly, the MCC credit may give a larger or smaller benefit than the after-tax surrogate 1.25 percentage point figure, because of either the nonrefundability of the credit or the credit rate the MCC bears (see ch. 1).

The results of the disparity between the uniform recapture rate and the actual benefit received, all else being equal, is quantified in table 3.1 for three levels of interest-rate reductions.[3] For example, an assisted owner with an $80,000 QMB loan would be liable for a maximum of $5,000 in recapture amount on the basis of the legislated formula, after 5 years. However, if the owner received an after-tax benefit of 1 percent, then the owner would pay $1,000 more in recapture amount than the benefit received. Similarly, an owner who received an after-tax benefit of 1.5 percentage points would pay $1,000 less in recapture amount than the benefit received.

[1]Home ownership typically conveys several benefits, such as increased equity as a result of house price appreciation. For this discussion, we use the term "benefits" to mean the interest-rate reduction from a QMB loan and the tax credit received from an MCC by the assisted owner.

[2]Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988), p. 38.

[3]This example serves as an illustration, only. Therefore, it does not consider the time value of money from the time the assistance is received to the payment of the recapture amount.

Table 3.1: Effect of Uniform Recapture Liability on Assisted Owners Receiving Different Interest Rate Reductions

Amount of assisted mortgage	Recapture amount[a]	Additional amount recaptured (not recaptured) based on an after-tax interest rate reduction of 1%	1.25%	1.5%
$40,000	$2,500	$500	$0	($500)
60,000	3,750	750	0	(750)
80,000	5,000	1,000	0	(1,000)

[a]Assumes the home is sold at the end of 5 years and no other reductions apply.

To increase equity of treatment between assisted owners, the recapture provisions could be changed to base the recapture amount on the assisted owner's monthly payment reduction. For example, the participating lender could document the before-tax monthly payment reduction due to the QMB loan at the time the loan is closed. This document could state the difference in monthly principal and interest payments between a comparable conventional loan and the QMB loan of the same size. At time of sale, the maximum amount to be recaptured would be the dollar amount of the reduction (say, $50 per month) times the number of months that the assisted loan is held. For a loan with a MCC, the assisted owner could tally the credits taken from prior years' tax returns and use that amount as the basis for the recapture amount. As with the current recapture provisions, the maximum recapture amount could be capped or phased out, if so desired.[4]

Moves for Other Than Housing Reasons Are Less Consistent With the Ability-To-Pay Principle

Households move for a variety of reasons, including the desire to live in a larger home or reside in another neighborhood. Here, the assisted owner's choice is purely voluntary. Other situations, such as moving for employment purposes, are also voluntary, but are not dictated by a change in housing choices. However, under the first situation, an assisted owner may be more likely to time the move to minimize the recapture amount (or accumulate the financial resources to pay it), all else being equal. This may not be the situation when the move is made for reasons other than housing choice.

From this standpoint, the recapture provisions may not be fully consistent with the ability-to-pay principle since households that move for other than housing reasons may not have set aside financial resources

[4]In commenting on a draft of this report, Treasury suggested that, in theory, the appropriate policy would be to recapture the benefit only for the years in which the assisted owner's income exceeded maximum qualifying income. Treasury also acknowledged that this would require constant monitoring of owners' incomes, which would increase administrative and compliance costs.

for the change in ownership. However, in this case the decision to move and pay a recapture amount is still voluntary. This situation is not easily remedied. It would not be equitable to forgive the recapture amount for a voluntary move. Alternatives that do not present this problem are presented in chapter 4.

Gain-On-Sale Provisions Are Not Always Consistent With the Ability-To-Pay Principle

The gain-on-sale provision fulfills a purpose because it leaves a portion of the home owner's gain on sale available for the purchase of a replacement home. However, the provision is not always consistent with the ability-to-pay principle when households with rapid income increases escape paying recapture because they live in areas of low or no housing price appreciation. Under law, the recapture amount cannot exceed 50 percent of the gain on the sale of the assisted home. In effect, this limitation leaves some of the equity buildup due to appreciation with the assisted owner, which then can be applied toward the purchase of a replacement home.[5] However, different areas of the country and different segments of a local housing market experience different rates of appreciation (see table 3.2 for examples). Equity considerations occur because the gain-on-sale provisions may reduce or eliminate the recapture amount for an assisted owner with a rapid increase in income if the home does not appreciate. Another household with similar income increases would pay a greater recapture amount if it had a greater gain on sale.

Table 3.2: Appreciation Rates of Existing Single-Family Homes for Selected Metropolitan Areas — 1981-88

	Median sales price (Percent appreciation from 1981)			
Metropolitan area	**1981**	**1984**	**1986**	**1988**
Washington, D.C.	$88,300	$93,000 (5.3)	$101,200 (14.6)	$132,500 (50.1)
Birmingham, Ala.	59,200	65,100 (10.0)	68,300 (15.4)	75,700 (27.9)
Milwaukee, Wis.	64,500	68,200 (5.7)	69,900 (8.4)	74,500 (15.5)
Oklahoma City, Okla.	54,100	63,900 (18.1)	63,000 (16.5)	56,200 (3.9)
Baton Rouge, La.	69,600	73,500 (5.6)	70,900 (1.9)	64,700 (−7.0)

Source: GAO analysis of National Association of Realtors data.

[5] HUD's section 235 and FmHA's section 502 home ownership programs also limit recapture amounts based on gain on sale (see app. III).

Similar assisted owners would pay different recapture amounts depending on whether their homes appreciated markedly or had low appreciation. In addition, two assisted owners in the same market area, one with high income growth and the other with lower income growth, could pay a small recapture amount in areas of low appreciation. This means that those who experience rapid increases in income (but who live in a market area with little or no appreciation) not only pay a reduced recapture amount, but may have less need for the appreciation equity if they choose to buy a replacement home in the same market area, in contrast with an assisted household in higher appreciation markets experiencing a smaller income growth.

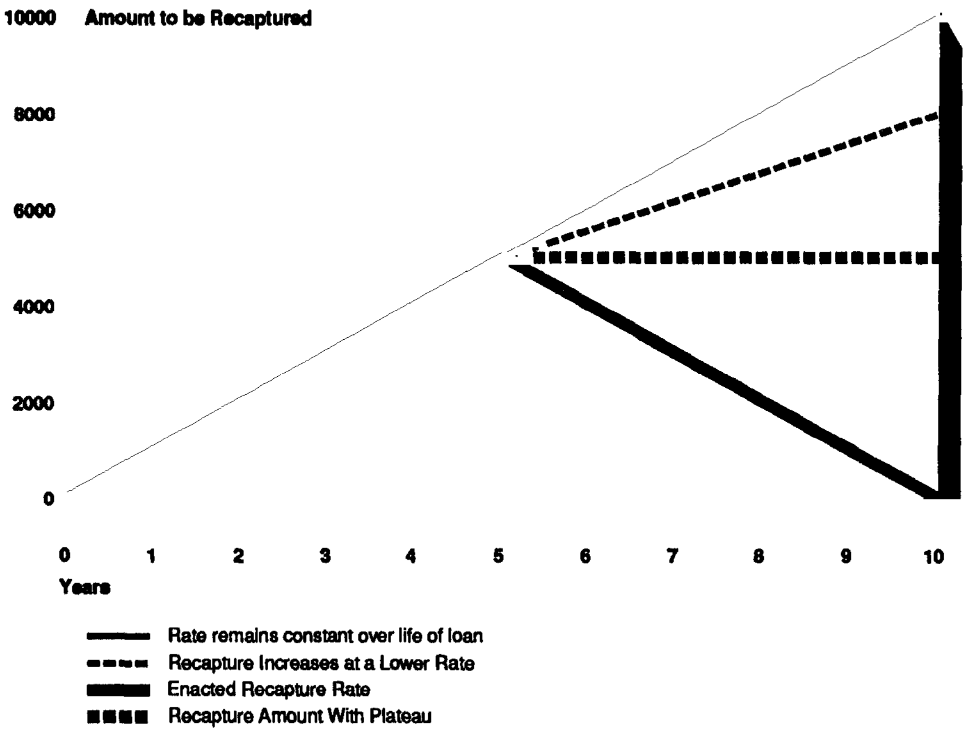
By allowing owners to retain some equity for a replacement house purchase, the gain-on-sale provision fulfills a purpose: it does not force these owners to return to renter status because of a large recapture amount. As such, the above equity considerations are not easily remedied. Alternatives to the current recapture provisions that do not create this equity consideration are discussed in the next chapter.

Phaseout Provisions Not Consistent With the Benefits Principle

Although the legislative history is silent on the intent of the phaseout of the recapture from years 6 to 10, it is an explicit part of the recapture formula. However, the phaseout is not consistent with the benefits principle since those who receive greater total benefits over time are subject to a lesser recapture amount than those who receive the same annual benefit, but over a shorter period. As shown in table 2.2, the phaseout overrides the income test. Thus, those owners who benefit the most from a lengthy subsidy period and/or who have large increases in income over this period have their recapture amount reduced and ultimately eliminated.

The recapture formula could be revised to increase equity of treatment between two groups of assisted owners who have rapid increases in income but, in one case, stay in the assisted home for 5 years or less, and, in the other, more than 5 years. Figure 3.1 shows three alternatives. First, the provisions could allow the recapture amount to increase (after 5 years and until the home was sold) at the enacted recapture rate. Second, the recapture amount could increase after a certain period (say, 5 years) but at a somewhat reduced rate. And third, the law could establish a plateau from which the recapture amount would neither increase nor decrease.

Figure 3.1: Alternatives to the Recapture Phaseout



Subsidy Allowed to Continue Despite Owners' Significant Income Increases

The recapture provisions are imposed after the assisted owner sells the home. This approach is consistent with the general framework of QMB loans and MCCs, where the continued need for the assistance is not periodically determined. It is also easier and less costly to administer since the amount is computed once, as opposed to periodic testing.

However, some owners' incomes will increase to the point that they do not need continued assistance to remain home owners. The current recapture provisions do not address this consideration. In this regard, the recapture provisions (1) test for the increases in income only after the assisted home owner has sold the assisted home; and (2) may cause the owner to stay in the home longer and thus extend the length of time the subsidy is provided.

Subsidy Continues Regardless of Household's Income Growth

Since the recapture mechanism tests for income growth only at sale, QMB and MCC subsidies continue as long as the assisted owner owns the home, or for the life of the mortgage. Thus, those who experience rapid increases in income can continue to receive the subsidy when the income increases make continued participation unnecessary. Further, unless prospective participants believe that they will be worse off financially with a QMB loan or MCC subject to recapture than with a comparable conventional loan, they are likely to participate in the program even when faced with a recapture amount.[6]

While the QMBs are outstanding, the government loses substantial revenue from foregone tax revenues.[7] Similarly, for MCCs, every dollar in tax credit taken is a dollar of tax revenue foregone. A different approach for testing whether income is sufficient to afford the home without continuing the subsidy would be one in which a home owner's income is periodically tested to determine continued need for assistance with housing payments. This approach is discussed in chapter 4.

Recapture May Extend Subsidy Duration for Some, But Not for Others

Another result of the recapture mechanism is that assisted owners may stay in their homes longer (or sell earlier) to minimize the recapture tax. Potential home buyers often do not know with certainty how long they will reside in a housing unit, whether it is subsidized or not. The potential recipient of a QMB loan or MCC with the current recapture mechanism has a relatively small probability of a very low subsidy if the recipient moves within 5 years and a larger probability of a greater subsidy if the recipient stays in the home longer.[8] As a result, the potential recipient is presented with a "no lose" situation, since the present value of the subsidy is greater than the expected present value of the recapture amount.

Even though the potential recapture amount increases during the first 5 years, we would not expect that the recapture amount would create an

[6]In more formal terms, home buyers would choose to participate if they believe that the net present value of their stream of benefits will be greater than zero. The net present benefit to the home buyer is the sum of the annual savings from the reduced interest rate mortgage over a conventional mortgage, less the anticipated recapture tax, and less additional costs borne by the borrower that the conventional buyer would not incur (participation fees), discounted to reflect the time value of money.

[7]Several studies have estimated that an annual federal tax expenditure of between $20 million to $30 million occurs for every $1 billion in QMBs issued, or between $150 million and $200 million in present value terms. See (GAO/RCED-88-111, Mar. 28, 1988), pp. 60-62.

[8]For a general discussion of economic behavior with risk and uncertainty present, see Milton Friedman, Price Theory, 2nd. ed. (Chicago: Aldine Publishing, 1976), pp. 80-84.

incentive for owners to move during that period because owners who expected the benefit from the QMB loan or MCC to be less than the recapture amount (in present value terms) would not be likely to participate in the program. Alternatively, a substantial recapture amount might be expected to motivate assisted owners to remain in their homes for more than 5 years to reduce or eliminate the amount due.[9] This situation could cause some households to receive the subsidy longer than they would have without the enacted recapture mechanism. The reduced mobility would increase federal tax expenditures.

Alternatives that do not have these effects on moving behavior are discussed in chapter 4. Additional considerations regarding the recapture provisions' expected effects on home owner participation are contained in appendix V.

A Prospective Affordability Test Is Needed

In establishing the recapture provisions, the Congress attempted to identify those assisted owners (1) whose incomes will increase rapidly so that they could have waited a short period and bought a home without assistance or (2) who no longer need the assistance to remain home owners. However, the recapture provisions do not attempt to identify a third group: those who do not need a QMB loan or MCC to afford the assisted home, but are eligible to receive it under Internal Revenue Code eligibility requirements. The Code does not require that QMB loan and MCC assistance be limited to buyers who cannot afford their first home without this assistance.

In March 1988, we reported that only 2 of the 25 agencies we contacted attempted to limit assistance to those who could not afford a similarly priced first home without a reduced-interest rate QMB loan. Using housing agency records for over 149,000 buyers who received QMB loans from 1983 through 1987, we estimated that 56 percent of the assisted buyers probably could have bought the same home at the same time with a conventional fixed-rate loan of the same size with comparable terms. The report indicated that even more probably could have afforded the same home at the same time if they had chosen a conventional adjustable-rate loan, which offers lower initial interest rates than

[9]For findings that indicate that two out of three first-time buyers remain in their housing units for over 5 years, see John Simonson, "Prospective First-Time Homebuyers: Salient Characteristics and Their Implications," National Association of Realtors (Feb. 1989), p. 32.

fixed-rate loans. We based this result on the prevailing industry housing-expense-to-income qualifying test in making these analyses.[10]

For this report we expanded our affordability test by adding the second standard qualifying test, the total-debt-expense-to-income test. This test measures whether total debt expense (housing expense and consumer installment payments, such as automobile loans) exceeds a certain percent of household income. At the time of our prior review, the 36 percent of income could typically be devoted to debt expense. Because this second test acts as an additional screen, it would be expected that some who probably would have qualified under the first test, might be screened out by the second test. That is, their added debt expense might make them an unacceptable mortgage credit risk.

For this report, we ran the total debt test on those who passed the housing expense test. We found that the total-debt-expense-to-income test had little effect on the proportion of assisted households that may have been able to afford the same price home at the same time with a market-rate, fixed-rate loan. The proportion of households that may have been able to afford the same home with a market-rate, fixed-rate loan decreased slightly, from 56 percent to 51 percent of the over 149,000 households we reviewed.[11] As such, we continue to believe that most assisted buyers may have been able to buy a home conventionally.

A conventional affordability test could better target QMB loans or MCC assistance to those who need assistance with housing payments to buy their first home. To determine whether buyers qualifying for QMB loans could afford the same house with a market-rate loan, the lender could run the same qualifying tests using mortgage interest payments at the market rate. If prospective buyers could afford a market-rate loan, then they would not be eligible for a bond-assisted loan. Lenders would continue to use the prospective borrower's credit and employment histories in the same way that they do for QMB loans and market-rate loans to determine the expected risk of the loan. For MCCs, the process would be similar. Since the buyer receives a market-rate loan, the lender would determine whether it would lend the same amount of money to the buyer if the MCC were not available.

[10] See (GAO/RCED-88-111, Mar. 28, 1988), pp. 32-34, 45, and 55-58. See also Home Ownership: Targeting Assistance to Buyers Through Qualified Mortgage Bonds (GAO/RCED-88-190BR, June 27, 1988), pp. 16-17. We recognize that some owners prefer fixed-rate over adjustable-rate loans to eliminate interest rate variations.

[11] To estimate consumer debt, we used data from a 1987 Federal Reserve System study. See app. V for a description of how we performed this analysis.

Conclusions

The legislated recapture formula is consistent with the general design of QMB and MCC assistance since the assistance is provided until the home is sold and the recapture is imposed only after the home is sold. Although the rationale for many of the provisions are not contained in the act's legislative history, the provisions are specific mathematical formulas set out in law. However, the effect of the provisions raises considerations of equitable treatment between assisted owners since the provisions treat differently situated households similarly and similarly situated households differently. These differences in treatment are reflected in the (1) uniform versus observed benefit rate, (2) gain-on-sale provision, and (3) phaseout of the recapture amount from years 6 to 10. In particular, the uniform (1.25 percentage point) recapture rate will recapture more benefit than some owners received and less than others received. Also, the phaseout of the recapture amount reduces and eliminates the recapture amount due even though the total benefit received by the owner increases each year.

Further, because the provisions are triggered only when the home is sold, the recapture provisions (1) allow the subsidy to continue when it is not needed to support housing payments, if the assisted owner decides not to move, and (2) may act as an incentive not to move as soon as may have occurred if the recapture was not present.

While the recapture provisions retrospectively attempt to identify owners who no longer need the assistance, no mechanism exists to prevent agencies from providing QMB loans and MCCs to those who do not need it to afford their first home. A conventional affordability test made at the time a prospective buyer applies for a QMB loan or MCC would better ensure that only those who need the assistance receive it.

The current recapture mechanism is preferable to none at all because some or all of the subsidy will be recaptured from at least some owners who probably could have waited a short time and bought a home without assistance due to rapid growth in household income. Overall, however, the current mechanism is a relatively ineffective way to identify and recapture benefits from those who do not continue to need assistance with housing payments because the recapture process is triggered solely by an assisted owner's decision to move. Without altering its basic form, the recapture provisions could be improved if the changes discussed in this chapter were made. Other improvements, such as continuation of the subsidy when it is no longer needed, would require more fundamental changes to the existing framework.

Alternatives to the recapture provisions may better achieve the purpose of denying the subsidy to those who no longer need it and increase equity of treatment between assisted owners, although at an increased administrative cost. These alternatives are the subject of chapter 4.

Matters for Consideration by the Congress

If the Congress desires to retain the existing recapture framework, it could improve equity of treatment between owners by providing that the recapture amount be based on the actual benefit received, rather than a uniform rate. For the QMB program, this could be accomplished by basing the rate of recapture on the actual before-tax housing payment reduction realized by the owner over the period of ownership. For the MCC program, the recapture could be based on the amount of the tax credit actually taken.

Also, if the Congress decides to retain the existing recapture framework and to have the recapture amount better reflect the total amount of benefit received from owners with rapid income growth, it may wish to eliminate the phaseout of the recapture amount after year 5. If, however, the Congress wishes to limit overall recapture liability, it could provide for a lesser recapture rate for years 6 and beyond, or cap the recapture amount at the amount determined after year 5, subject to other current adjustments.

Further, if the Congress wants to improve the targeting of those who initially receive QMB loans and MCCs, it could require that they be provided only to those who cannot obtain a market-rate loan with comparable terms.

Agency Comments

The Association of Local Housing Finance Agencies, National Council of State Housing Agencies, and Department of the Treasury provided comments on a draft of this report (see app. VI through VIII, respectively). The Association and the Council objected to basing the recapture rate on the actual interest rate reduction received by the assisted owner, rather than the uniform 1.25 percentage point amount. Both groups thought our proposal would needlessly encumber the program and that the single rate was easier to understand and administer. Treasury commented that our suggested approach was generally appropriate as a matter of fairness. However, as a matter of tax policy, Treasury suggested that the fairness objective would have to be balanced against associated administrative and compliance costs. We agree that a single rate is easier to administer. However, our concern is that the assisted owner not be placed in a position of potentially paying more in recapture than the benefit received.

We also do not believe that the administrative requirements for the assisted owner or lender would be as burdensome as suggested. While we did not quantify the added costs involved in tailoring the recapture formula more to the benefit received, we expect that the additional cost per home owner would be small. The additional effort would comprise two steps. First, the lender would determine the monthly principal and interest payment for a fixed-rate market-rate loan of comparable terms. Second, the lender would determine the difference between the housing payment for the market-rate loan and the QMB loan. The results of this one-time computation would be provided to the assisted owner and retained by the lender or the housing agency. In deciding whether to make this revision to law, the Congress must weigh the effort required in performing these calculations against the benefit of refining the recapture mechanism.

Similarly, the Association and the Council objected to our analysis of the effects of the recapture phaseout provision. The Association believed that our proposal would discourage owners from remaining in their home, apparently because the recapture would not be phased out. Our discussion points out that the enacted phase-out provision allows the recapture provision to be reduced to as far as $0 even though the household (1) continues to receive the benefit from a reduced interest loan for the life of the loan and (2) has income increases that meet or exceed those in the income test. From a standpoint of achieving the Congress' stated goals (as set out in the conference report), we believe it is appropriate to recapture at least some of the benefit from those who continue to receive it and meet income increase thresholds.

The Council said that the phaseout would have little effect on those with rapid increases in income because they (1) will move out as soon as they can afford to and (2) are better off selling earlier, rather than later, to take advantage of the provision that adds $5,000 to adjusted qualifying income.[12] The Council ignores the fact that the substantial transaction costs involved in selling a home creates significant disincentives to selling within the first few years of ownership. Treasury had no specific comments on our phaseout discussion.

[12] As discussed in ch. 2, in the first few years of ownership, the $5,000 amount adds significantly to the amount income must increase before the full recapture amount is due.

The Association and the Council strongly disagreed with our analysis of whether assisted owners probably could have afforded the same house without assistance. Both groups said that if the second standard mortgage qualifying test (total-debt-expense-to-income test) was applied, our results would have been substantially different. As a result, we performed that test and found little change in our results.

Finally, both the Association and the Council stated that an affordability test was not needed. In its comments, however, the Council stated that it agrees with the objective of discouraging those from getting a QMB loan when conventional financing is a reasonable alternative. Treasury also agreed that providing assistance to those who could otherwise afford a market-rate loan with comparable terms is not consistent with the goals of the QMB and MCC programs. On the basis of our affordability test in this report, we maintain that this sort of screening mechanism is needed as a way of demonstrating that potential first-time home buyers need QMB loans and MCCs to purchase their homes.

Alternatives That Would Better Identify and Deny Subsidy to Those With Rapid Income Growth

Chapter 3 discussed improvements that could be made within the framework of the enacted recapture provisions to provide more equitable treatment between sets of assisted owners who experienced rapid income growth. As chapter 3 also indicated, the recapture approach does not identify and suspend the subsidy to those with rising incomes because it is triggered only by the recipient's decision to move.

Mortgage loans that discontinue assistance because of pre-established affordability criteria (roll-over loans) and periodically increase housing payments as long as income increases (income-based variable payment mortgage loans) are income-driven alternatives to the current recapture approach. These alternatives improve equity of treatment between assisted owners and are not based on an assisted owner's decision to move. However, these approaches are most likely more complex and costly to administer than the recapture provisions.

Substituting a Roll-Over Approach for the Recapture Mechanism

A roll-over mortgage loan is a mechanism that continues or ends assistance on the basis of periodic examination of current income. If the owner's income rises to a point where the owner could afford a comparable market-rate loan, the owner is required to refinance the assisted loan with a market-rate mortgage loan. If income growth is insufficient for the owner to afford a market-rate loan, then assistance is continued with no change in monthly payment. The roll-over decision points could come at any time. Roll-over mortgages with 3- and 5-year intervals are common in the Canadian private mortgage market.[1] This approach differs from the recapture approach discussed in the preceding chapters in that the roll-over approach does not require that assistance be paid back.

Since a roll-over decision is driven by income growth, this approach is consistent with the ability-to-pay principle. Similarly, it does not create inequities cited in chapter 3, making it consistent with the benefits principle. A roll-over mortgage does not require a voluntary move to end assistance during the lifetime of the assisted mortgage and, therefore, more efficiently continues assistance to those who require assistance to meet monthly payments, while halting assistance to those who no longer need it. Recipients who do not experience the income growth required for the roll-over to occur are not discouraged from moving as much as if

[1]For a further discussion of the roll-over mechanism, see David Ling and Mark Smith, "Another Look at Mortgage Revenue Bonds," Journal of Policy Analysis and Management, Vol. 7, No. 3 (Spring 1988), pp. 562-4.

they were subject to a recapture. They lose the ongoing subsidy if they move, but they do not become subject to the recapture provisions.[2]

The current recapture provisions and roll-over loans introduce administrative costs and complexities. The recapture mechanism adds to reporting requirements by assisted owners and others and may increase general Internal Revenue Service costs to the extent that the Service audits recapture tax reporting (see app. IV). The use of roll-over loans is likely to incur costs since they require routine examinations that would probably be performed by the mortgage servicer acting for the housing agency.[3]

Refinancing and Other Costs of a Roll-Over Loan Could Be Avoided

A loan that "rolls over" to a market-rate loan requires determining what the market rate should be: either the prevailing rate for similar loans at the time the loan was made or the rate at the time the roll-over occurs. Also, converting to an unsubsidized conventional loan will entail refinancing costs, which are often substantial. Last, periodic examinations of income will require increased administrative activities by the mortgage servicers and increase the costs of the program.

The easiest method, administratively, for determining the market rate and refinancing costs for home owners with QMB loans is to require them to incur refinancing costs and find a market-rate mortgage in the current mortgage market. This method, however, subjects recipients to one certain and a possible second cost. First, refinancing charges can be substantial. Second, if mortgage interests rates in the private market have risen since the time of home acquisition, recipients could become worse off than if they had never participated since owners have to pay a higher mortgage interest rates than if they had never participated in the QMB program.

The FmHA section 502 home ownership program handles this situation by establishing a "market rate" when the household becomes a recipient. As the assisted household's income rises, housing payments increase up to the amount determined by the "market rate." However, since the loan

[2]Both the roll-over loan and the current recapture provisions treat assisted owners who have little or no income growth similarly. In the former, assistance is continued until the home is disposed of; in the latter, no recapture amount is imposed either during the life of the loan or when it is discontinued.

[3]Roll-over loans and a recapture could be combined but would entail higher governmental administrative costs and a greater home owner burden than if only one approach was used. The two combined, however, both limit the duration of assistance and impose a recapture amount on recipients with potentially the greatest ability to pay.

is not converted to a conventional loan, no refinancing costs are generated. A similar mechanism could be set in place for QMB loans to avoid interest-rate risk and refinancing costs.[4]

The MCC program does not create this tradeoff. The recipient already holds a private mortgage instrument made at market-rate interest. The MCC can be cancelled without triggering a change in the mortgage interest rate or incurring refinancing costs. Therefore, a roll-over mechanism would involve the ending of the mortgage credit rather than shifting to a new private mortgage instrument.[5]

Finally, periodic reexamination of income leads to increased administrative costs. These costs could be paid from participation fees, bond proceeds that might otherwise be used to make mortgages, or from other (non-QMB or MCC-related) sources available to some housing agencies. We did not attempt to quantify the likely cost increases that would result from the roll-over mechanism. However, a Mortgage Bankers Association of America official estimated that a lender's activities relating to roll-over recertification would add about one-eighth of a percentage point to the lender's servicing fee (or about $100 on an $80,000 mortgage loan). If roll-over approach replaces the recapture mechanism, the reexamination period could be set at a point, such as every 3 or 5 years rather than annually, to lessen the burden but still test for sustained income increases.

Shallow Subsidy Reduces Roll-Over Impact

While the roll-over approach halts the subsidy when it is no longer needed to afford housing payments on a comparable market-rate loan, the impact is small because the original subsidy is relatively small. As discussed earlier in this report and in our March 1988 report, QMB loans provide relatively shallow subsidies—typically a 1.44-percentage point reduction in the mortgage interest rate (or about $40 per month, after taxes).[6] In contrast, HUD and FmHA home ownership programs reduce mortgage interest rates to as low as 1 percent. Clearly, a roll-over mechanism that operated in a deep subsidy program would have a greater

[4]An income-averaging approach could be used so that increased payments do not result from temporary increases in household income.

[5]Although implementing this alternative would be much simpler for a MCC loan than for a QMB loan, QMBs form the overwhelming majority of the assistance provided. See Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988), pp. 11 and 88-90.

[6]See p. 38 of (GAO/RCED-88-111, Mar. 28, 1988).

potential impact than a similar roll-over for a QMB loan and MCC, which typically provide a much smaller amount of assistance.

Income-Based Variable Payment Loans as an Alternative to the Recapture Mechanism

A second income-based alternative to the recapture provisions is an income-based variable payment loan. In this type of loan, the owner's payments for principal, interest, taxes, and insurance are a fixed percentage of household income. As income increases, so do monthly payments. While the roll-over mortgage caps the mortgage interest rate at the market rate, the income-based variable payment loan allows the assisted owner's interest rate to rise above the market rate as income continues to grow. Mortgage payments increase as long as income does. For QMB loans, this mechanism would motivate recipients to leave the program when their monthly payments for principal and interest become greater than payments for an unsubsidized market-rate mortgage.

For variable-payment loans with MCCs, the MCC could be reissued at a decreased rate (say, a 10-percent credit rather than a 20-percent credit), as warranted by periodic review of income. A MCC reissued at a lower rate would decrease the subsidy amount and maintain housing payments as a percent of income.

The variable payment approach can lead to better targeting of benefits and is similar to the HUD section 235 and FmHA section 502 home ownership programs, except that QMB loans and MCCs provide shallower subsidies. (See app. III for descriptions of the HUD and FmHA programs.) As with the roll-over loan, the income-based variable payment loan is consistent with the ability-to-pay principle. Also, it tests for income growth periodically, rather than when the home is sold, and it does not rely on a voluntary move to halt the subsidy for recipients who no longer need it to afford housing payments. The income-based variable payment mortgage fulfills this objective indirectly by increasing mortgage payments to a level above that which the recipient with rapidly increasing income would pay in the private mortgage market.[7]

[7]The variable payment approach could be combined with a recapture mechanism as the HUD section 235 and FmHA section 502 programs do. Regardless of the possibly desirable equity outcomes, such a mechanism would entail administrative complexities and costs that are not part of the current recapture approach.

Increased Administrative Costs and Complexity

As with the roll-over loan, income-based variable payment loans will increase administrative cost and program complexity over the current recapture approach. As with the roll-over loan, a reexamination at 3- or 5-year intervals would be less costly than annual reexaminations. Overall, however, periodic income reexamination and adjustment of mortgage payments for variable payment loans would be more costly than for roll-over loans. These activities must be performed at each designated time interval (say, every 3 years) for each outstanding loan under the variable payment approach. However, under the roll-over approach, loans that had "rolled-over" would not be subject to further examinations and adjustments. It is possible that, over the life of the loans, the increased cost and effort to reexamine income and adjust variable payment loan payment schedules could make this approach unworkable. The final consideration of how the increased payments are treated by the loan servicer and the housing agency is similar to that of the roll-over loan.

Conclusions

The decision to substitute a roll-over loan for the existing recapture mechanism is not clear-cut. The roll-over mechanism presented in this chapter better achieves the objective, as stated in the conference report, of not providing subsidies to those who experience rapid income growth. On the other hand, the roll-over approach adds some administrative costs and complexity. However, the additional cost and effort that would be required could be lessened if the period for reevaluating need were set at 3- or 5-year intervals, rather than annually.

A variable payment loan, which is an income-based alternative to a roll-over loan, would also be more equitable than the present recapture mechanism because it would tie the amount of the subsidy directly to income growth. However, because it requires constant monitoring of changes in recipient income, it probably is not administratively feasible within the operations of the QMB and MCC programs.

Matter for Consideration by the Congress

If the Congress decides to replace the existing recapture approach with one that will terminate assistance to recipients who experience rapid income growth and, as a result, can afford housing payments on a market-rate loan of comparable terms, it may wish to enact a roll-over approach that does not require external refinancing.

Agency Comments

Both the Association of Local Housing Finance Agencies and the National Council of State Housing Agencies disagreed with adopting a roll-over type approach as an alternative to the existing recapture mechanism. Both cited our discussion of the added administrative burden and complexities in reexamining owners' incomes in this type of approach. Treasury did not state a position on whether a roll-over approach should be substituted for the recapture mechanism. However, it did suggest that our report should discuss the administrative and compliance costs associated with a roll-over approach.

Both our draft and this report recognize the additional burden and complexity of the roll-over approach and contain an estimate of the cost for periodic recertifications. The added burden and complexity is the tradeoff for better identifying those whose income is rising to the point where further assistance is not warranted. The existing recapture mechanism requires that the home be sold before that examination of income increases takes place. Under the roll-over approach, that examination would be done periodically.

Example of How to Compute the Recapture Amount

J, a single individual, purchases a home with a $55,000 QMB loan. At the time of purchase, the applicable income limit for a single person is $20,000. He marries S, and they have two children, E and M. They sell their QMB-assisted home 6 years and 2 months later and realize a gain of $12,000 on the sale of the home. In the year of sale, J and S's household income (adjusted gross income plus tax-exempt interest) is $32,000. Before adjustments, the maximum recapture amount would be $3,438 (0.0625 x $55,000).

However, because the home was held more than 5 years, the holding period adjustment reduces the recapture amount to $2,636 ((120-74)/60 x $3,438), where the adjustment is based on the number of months (74) out of the 10-year period (120 months). The recapture amount is further reduced because J and S's household income ($32,000) is $2,900 less than the estimated income eligibility limit of $34,900.[1] Since the recapture amount is reduced by 2 percent for every $100 that modified adjusted income exceeds J and S' household income, the recapture amount owed is $1,108. Since $1,108 is less than the amount determined by the holding period adjustment, the maximum recapture is $1,108.[2]

Since J and S realized a $12,000 gain on the sale of their home, the 50-percent gain-on-sale limitation did not further reduce the $1,108 recapture amount due. If the gain on sale had been $2,000 instead of $12,000, then the recapture amount would have been $1,000, which is the lesser of the computed amount of $1,108 or 50 percent of the gain on sale (0.5 x $2,000 = $1,000).[3]

[1]If $20,000 was the applicable income limit for a one-person household, $23,000 would be the applicable 3-or-more-person household limit ($20,000 x 115%). The $23,000 amount is increased by 5 percent per year for each of the 6 full years to $29,900 ($23,000 x 0.05 x 6 = $6,900 and $23,000 + $6,900 = $29,900) and $5,000 is added to this amount ($29,900 + $5,000 = $34,900).

[2]Multiply 2 percent for every $100 that household income ($32,000) is less than the estimated income eligibility limit of $34,900. Since ($34,900 - $32,000)/100 = 29, the reduction to the recapture amount is 0.02 x 29 x $2,636 = $1,528. The recapture amount due after this step is $2,636 - $1,528 = $1,108.

[3]We were also asked to determine the effect on the marginal tax rate resulting from the recapture provisions. Since the provisions do not require any modifications to the taxpayer's adjusted gross income, no tax bracket changes will occur.

Income Increases Needed to Pay the Recapture Amount for an Area With a $26,000 Median Income

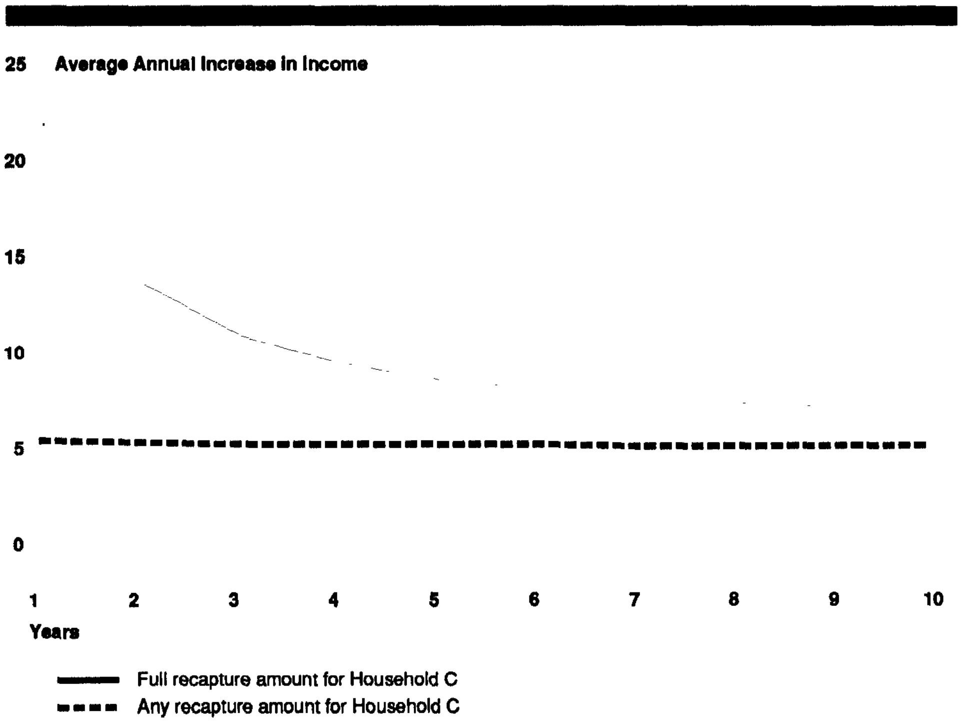
Chapter 2 provides examples of the recapture amount due for hypothetical households in an area in which the median income was $34,000. As discussed, the income test is sensitive to the median income level. In this appendix, we show how much income would have to increase to pay the recapture amount for three households in an area where median income is $26,000.[1]

In this example, we use three households, each with three or more members. The households differ only in their income at the time they purchase their assisted homes. Household C has the maximum income to be eligible to participate, $29,900 (115 percent of the area median income); Household D has an income at the area median, or $26,000; and Household E has an income of $20,800 (80 percent of the area median income).

Figures II.1, II.2, and II.3 show the average annual income increases needed to pay the recapture amount for Households C, D, and E, respectively. The increases needed for Households A and B in chapter 2, where our calculations were based on an area median income of $34,000, are smaller than the increases needed for Households C and D, respectively. Average annual income increases needed to pay the maximum recapture are higher the lower the area median income because of the $5,000 constant in the income test formula. The increases are higher because the $5,000 amount has a larger influence when the area median income is lower: a $5,000 increase from $26,000 to $31,000 is a 19-percent increase, and a $5,000 increase from $34,000 to $39,000 is a 15-percent increase.

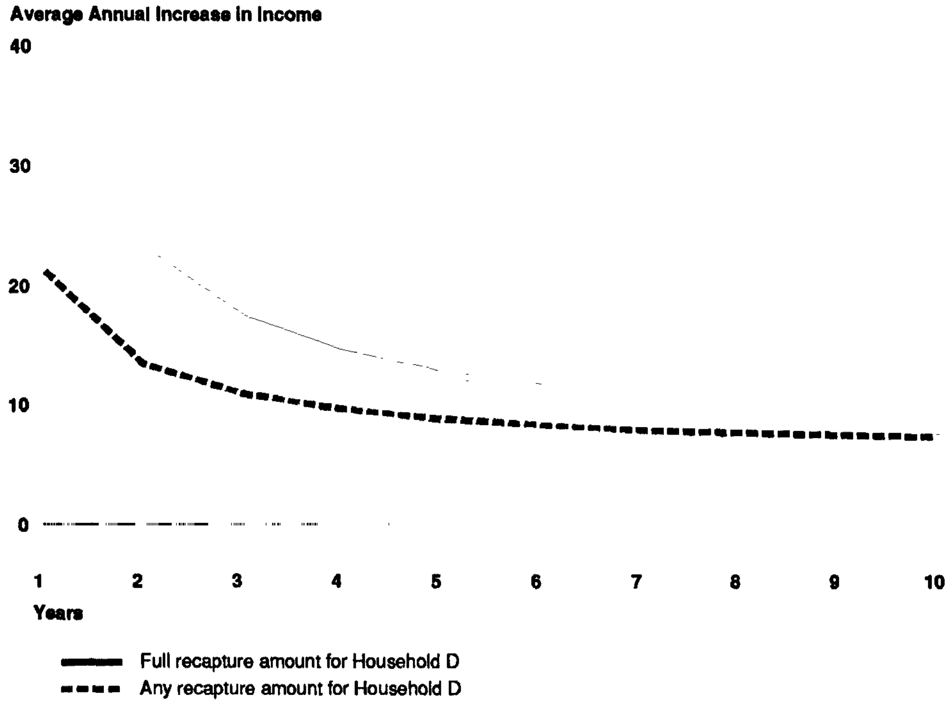
[1]For example, $26,000 is about equal to the estimated 1989 statewide median incomes for Alabama and Kentucky, according to HUD.

Figure II.1: Average Annual Increase in Income Needed to Pay the Recapture Amount for Household C



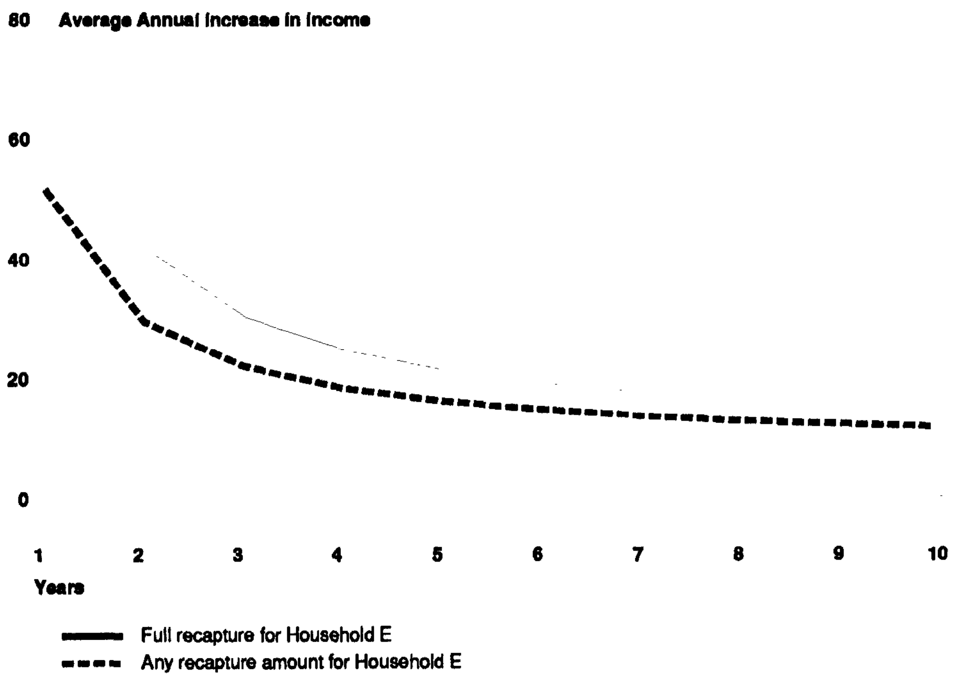
Note: Household C has an income at time of purchase of 115 percent of the area median and a household size of three or more. Area median income is $26,000.

Figure II.2: Average Annual Increase in Income Needed to Pay the Recapture Amount for Household D



Note: Household D has an income at time of purchase of 100 percent of the area median and a household size of three or more. Area median income is $26,000.

Figure II.3: Average Annual Increase in Income Needed to Pay the Recapture Amount for Household E



Note: Household E has an income at time of purchase of 80 percent of the area median and a household size of three or more. Area median income is $26,000.

Recapture Mechanisms in Federal, State, and Local Housing Programs

Certain federal, state, and local housing programs recapture some or all of the assistance they provide to home buyers or have recapture-like mechanisms. The recapture may be levied programwide or limited to a specific housing project. This appendix describes several housing programs with recapture or recapture-like mechanisms.

HUD Section 235 Program

The HUD section 235 home ownership assistance program provides for a mortgage interest reduction for lower-income families. Loans are made by commercial lenders at market interest rates. Eligible families pay at least 20 percent of their adjusted income toward monthly mortgage payments (or 28 percent, depending on which portion of the program the assisted household is participating in). The difference between the market-rate mortgage payment and the amount that subsidized owners are paying is made up by federal assistance payments (the "interest subsidy" or interest credit). The interest rate may be subsidized to a level as low as 1 percent. The commercial lender services the loan and reexamines the home owner's income annually, and the required home owner payment is increased or decreased accordingly.

Section 206(b)(1)(C) of the Housing and Community Development Act of 1980 (P.L. 96-399, Oct. 8, 1980) added a recapture provision for those home owners who dispose of their property or rent it for more than 1 year. Under the act, HUD recaptures the lesser of (1) the amount of interest subsidy actually received or (2) 50 percent of the net appreciation of the property.[1] The legislative history behind the act does not explain why the recapture was added or the problems it was intended to address. On disposition, the recapture due constitutes a lien on the property.

When the assisted owner proposes to dispose of the home, the mortgage lender notifies the local HUD field office of the total amount of assistance payments that HUD provided. The HUD field office then calculates the recapture amount due and the recapture amount must be paid to convey title.

[1] Net appreciation is defined as the increase in value over the original purchase price, less (1) reasonable costs of sale, (2) reasonable costs of home improvements, and (3) certain increases in the mortgage amount over the original balance.

FmHA Section 502 Program

FmHA's section 502 rural home ownership loan program provides low- and moderate-income households with home purchase loans. FmHA makes fixed-rate loans to eligible buyers at an interest rate approximately equal to the cost of long-term government borrowing at the time of loan origination. However, most borrowers receive a subsidy, called an interest credit, to reduce the loan's effective interest rate to as low as 1 percent, depending on borrowers' incomes when they receive the loans.

Section 502 participants initially pay at least 25 percent of their adjusted income for principal, interest, real estate taxes, and insurance. FmHA annually recalculates the borrower's required payment using the borrower's current income.

Section 506(a)(3) of the Housing and Community Development Amendments of 1978 (P.L. 95-557, Oct. 31, 1978) added a recapture provision to the section 502 program. The legislative history behind the act does not explain why the recapture was added or the problems it intended to address. The assisted owner must repay the lesser of (1) the amount of the subsidy received or (2) a percentage of the property's net appreciation, ranging from 9 to 78 percent (depending on the average interest rate paid by the owner over the life of the loan and the number of months that the mortgage was outstanding).[2] The mortgages or deeds of trust signed by those receiving the interest credit contain a provision making the amount of the subsidy a lien against the property.

State Housing Programs

In 1989, the National Council of State Housing Agencies surveyed its membership to determine the extent to which recapture mechanisms are used and how they are structured. The Council reported that eight of its members had some form of recapture mechanism as part of one or more of their home ownership programs. None of the eight applies recapture to its QMB programs. Rather, the Council reported, the recapture mechanisms appear to be used only with special programs of limited duration or availability.

The Council reported the predominant objective of the state recaptures was to recapture funds for future program use. Four states had a secondary objective of preventing speculation. Two states had a third

[2]Net appreciation is defined as market value of the home, less the amount of non-FmHA prior loans, unpaid balance of FmHA liens, sales expenses, principal paid at note rate, principal reduction attributed to subsidy, and original equity.

objective of removing the subsidy when borrowers were no longer eligible for it.

The Council's summary included a short description of the recapture provisions in seven states:[3]

- The amount recaptured is the amount of down payment and/or interest rate subsidy or a portion of the net appreciation of the property (Massachusetts, Minnesota, North Carolina).
- During a specified control period, 95 percent of the appreciation of the home sales price (net of capital improvements) is recaptured (New Jersey).
- If the assisted owner sells or transfers the house within the first 15 years, any proceeds in excess of the state's home ownership affordability index must be paid at a rate of 2 percent of the sales price or appraised value (Rhode Island).
- At time of sale, an owner receiving state-funded down payment assistance in conjunction with QMB loans must pay 20 percent of gained equity during years 1 to 5, 10 percent in years 6 to 10, 5 percent from years 11 to 20, and 2.5 percent from year 21 to loan maturity (New Hampshire).
- If a home is sold within 7 years, the assisted owner must pay (1) the interest rate differential between the (assisted) note rate and 8 percent and (2) on a sliding scale, a percentage of the original sales price. The recapture cannot exceed the gain realized on sale (Connecticut).

Local Housing Programs

We surveyed 128 local housing agencies that are members of the Association of Local Housing Finance Agencies. We (1) asked the agencies to tell us if they recaptured some or all of a subsidy they provided and (2) allowed the agencies to define what recapture might entail. Because there are other local housing agencies that do not belong to the Association, our survey was not meant to be statistically representative of local housing agency practices. Rather, the survey was meant to provide some insight into how some local agencies structure recapture mechanisms.

[3] Alaska, one of the eight states with recapture mechanisms, did not provide a program description.

Twenty of the agencies that returned our survey indicated that they employed a recapture mechanism.[4] These mechanisms took five forms, and three agencies use more than one technique. In a number of cases, the documents sent to us showed that the recapture was limited to a single development or small set of properties rather than being applied to the agencies' housing programs in general. Also, several of the recapture mechanisms were applied to non-QMB and -MCC programs. The following mechanisms are used:

- **Limitations on resale price** (eight agencies). The assisted owner agrees to resell the house at no more than the original purchase price plus the value of improvements, plus some or all of the percentage increase in the area's median income (or increase in the sales price for existing homes in the area) for the period that the home was owned.
- **Shared appreciation loans** (seven agencies). Most frequently, these loans were deferred payment second trusts. For example, when the assisted home is resold, the owner pays the agency the principal amount and the lesser of (1) 10 percent simple interest on the loan or (2) 50 percent of the net appreciation on the home. Several programs have provisions that reduce the proportion of appreciation taken the longer the assisted owner holds the assisted unit.
- **Equity appreciation loans** (five agencies). The loans are somewhat similar to shared appreciation loans, but the amount recaptured is based on the contribution made by the housing agency. For example, if the agency made a second trust loan that represented 15 percent of the total loan amount received by the assisted owner, then the amount to be recaptured at time of sale would be the outstanding principal balance and 15 percent of the appreciation of the property.
- **Roll-over loans** (two agencies). If periodic examination of the borrower's income shows that the subsidy is no longer needed, then the owner is required to refinance the loan or pay it off. Otherwise, the subsidy is extended.
- **An interest rate surcharge** (one agency). Assisted owners receive a subsidy that is repaid as a 5-percent (simple interest) loan. If the home is sold within the first 5 years to other than a low- or moderate-income buyer, a 5-percent surcharge is added (total of 10 percent). The surcharge declines to 4, 3, 2, 1 and 0 percent in years 6 to 10, respectively.

[4]About 91 percent of those surveyed responded, although not all operated home ownership programs. We did not consider the simple repayment of principal and interest to be a recapture mechanism, as indicated by several agencies. Also, one of the respondents was not an Association member, but returned our survey when another agency sent the questionnaire to it.

In addition, several agencies restricted resale of the assisted units to low- and moderate-income buyers. While this is not a recapture, per se, it may tend to keep resale prices somewhat lower than if the restriction were not in place, effectively limiting the gain on sale.

The local jurisdictions using the limitation on resale price were Fremont, San Mateo County, San Francisco, Santa Barbara, and Palo Alto, California; Boulder, Colorado; Montgomery County, Maryland; and Fairfax County, Virginia.

The jurisdictions using shared appreciation loans were Hayward, San Francisco, and two agencies within the city of Los Angeles, California; Baltimore and Montgomery County, Maryland; and Seattle, Washington. Those jurisdictions using equity appreciation recaptures were Sacramento, California; Minneapolis and St. Paul, Minnesota; Raleigh, North Carolina; and Portland, Oregon.

The localities using a roll-over provision were Anaheim, California, and Baltimore, Maryland. The city of Santa Ana, California, used the interest-rate surcharge mechanism.

Expected Recapture Effects on Program Participation and Tax Administration Matters

This appendix discusses whether the (1) imposition of a recapture mechanism will be likely to affect a household's decision to apply for the assistance, (2) assisted owner will have sufficient liquid assets to pay the recapture amount when due, and (3) IRS will be able to identify those who sold their assisted home and are subject to recapture.

No Expected Adverse Effect on Program Participation

Our earlier report and the example in table IV.1 indicate that the QMB program generates relatively small subsidy levels.[1] In the former, the participating population was found to be fairly typical of first-time home buyers. In the latter, the present value of the subsidy that is continued for 10 years is only $6,989. Even with relatively small subsidy levels, home buyers who do not have to change their housing choices to receive a subsidy would be expected to participate in the program because it would be in their financial interest. If a larger subsidy were provided through an MCC or other form, potential recipients who would line up to participate would be likely to include this group plus others who may be willing to make some adjustments in their housing choices to receive the (larger) subsidy.

Table IV.1: Example of Present Value of QMB Assistance With and Without Recapture Provisions

		Present value of subsidy at time of purchase	
Time in housing unit	Nominal subsidy	Without recapture	With recapture[a]
5 years	$5,542	$4,347	$1,048[b]
10 years	11,083	6,989	6,989[c]

Note: The example is based on an $85,000, 30-year, fixed-rate mortgage. The market and QMB mortgage interest rates are 10 percent and 8.5 percent, respectively. Present values are calculated by discounting with the 10-percent rate.

[a]Assumes no reductions due to income or gain-on-sale provisions.

[b]At time of sale, the recapture amount equals the amount collected at that time, or $5,313.

[c]After 10 years, no recapture is due.

We would expect that potential recipients who could afford and would choose home ownership will participate as long as the expected present

[1]Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988), pp. 37-38.

value of participation, net of recapture amounts and other program-specific costs, is positive.[2] Economic theory suggests that even the hypothetical recipient characterized in table IV.1 who would receive a subsidy stream net of recapture with a present value of about $1,000 would still probably participate in the program, as long as the recipient's housing choices did not have to be altered.

Ability to Pay Recapture With Income Tax Filing

While some assisted owners' recapture liability could be several hundred dollars or less, for others it might be several thousand dollars. The recapture amount would probably be paid anywhere from several months to over a year after the assisted home is sold. For those with substantial liability, the recapture amount might present payment problems unless owners set aside funds from the sale of the assisted home or have other financial assets to enable them to pay the recapture amount when due. Alternatives that do not present cash flow problems are discussed in chapter 4.

IRS' Ability to Identify Owners Subject to Recapture

The Internal Revenue Service needs to be able to identify assisted owners subject to recapture to ensure that they will pay the appropriate recapture amount. To accomplish this, the recapture provisions in the 1988 act require that the real estate broker must send an information return to the IRS stating whether or not the seller's financing was from a QMB loan or a loan with a MCC. The Code defines "broker" to include any person who acts as a middleman with respect to property and services. The American Land Title Association expressed concern that the broker, in many instances, may find it difficult to comply with the reporting requirements.[3] We contacted officials at three state housing agencies who tended to mirror the Association's concerns. These are as follows:

- The information submitted to brokers is often not substantial. They may not have the original loan commitment to determine whether the seller has a QMB loan or a MCC provided along with the conventional loan.

[2]This suggests that people make decisions using the best financial information available to them. However, the (1) smaller the subsidy, and (2) greater the uncertainty of the expected recapture amount, the more likely it will be for households not to participate.

[3]The Association is a trade association whose goal is to promote the safe and efficient transfer of ownership of real property. It represents about 2,300 abstractors and agents, title insurance companies, and associated members nationwide.

- Even if the seller's loan documents are available to the broker, the loan documents will not always contain the necessary information to determine whether the seller is subject to recapture.
- To the extent that a principal in the real estate transaction chooses to withhold information not necessary to the closing of the transaction, the broker will be unable to comply with the reporting requirement.

One approach to foster identification of assisted loans would be for mortgage lenders making loans for housing agencies to "flag" loan files, so that a notice that the owner is subject to recapture is provided to the broker. A second approach would be for housing agencies to add wording to their loan documents (or in amendments) that the loan is a QMB loan and the owner is subject to recapture. However, the second approach would not be effective for those settlements in which loan documents are not submitted. Also, both approaches require the voluntary cooperation of all state and local governments making these loans, since the act's reporting requirement does not require these actions.

A third approach would be for brokers to request that lenders identify whether the loan was a QMB loan or made with a MCC when it makes its request for information relevant to the transaction. However, if lenders (1) do not flag their files to identify loans as QMB loans or loans with MCCs and/or (2) choose not to comply with the broker's request, then the approach will not work.

Approach Used in Applying a Total-Debt-Expense-to-Income Test to Assisted Buyer Data Base

In our March 1988 report, we found that over half of the assisted buyers covered in our review probably could have purchased the same priced home with a conventional fixed-rate mortgage loan.[1] This result was based on a housing-expense-to-income qualifying test. For this report, we performed a second test, the total-debt-expense-to-income test, to determine the extent to which performing a second qualifying test to those who passed the first test affected our earlier finding. This standard determines whether total debt payments (housing expense and other debt, such as automobile loan payments) exceed 36 percent of income. For the "other debt" amount, we assumed that each of the assisted households that passed the housing-expense-to-income test had monthly "other debt" payments of $160. This amount is equal to the median dollar amount of installment payments for home owners in a survey conducted by the Survey Research Center of the University of Michigan.[2] The Center's survey data were based on statistical samples of households across the country.

The median $160 installment payment is for all home owners, rather than for first-time buyers alone. However, the Center's results for three reported measures (age of head of household, race, and income) suggest that the $160 median installment payment amount for all home owners is likely to be a fair approximation of the payment amount for QMB loan recipients. In this regard, our March 1988 report showed that QMB-assisted buyers were typically younger, white, and had a median income of $26,000 (see table V.1 below). In comparing the Center's reported monthly debt payments for those with similar age, race, and income range to QMB-assisted buyers, the monthly installment credit payment amounts cluster around the Center's $160 figure for all home owners. As such, we believe the Center's estimate is a reasonable approximation for use in our total-debt-to-income test.

[1]See pp. 30-35 of Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988).

[2]See Robert B. Avery, et. al., "Changes in Consumer Installment Debt: Evidence from the 1983 and 1986 Surveys of Consumer Finances," Federal Reserve Bulletin, vol. 73, no. 10, Oct. 1987, pp. 761-78.

Table V.1: Comparison of QMB-Assisted Buyers to Household Attributes in the Survey Research Center Survey

Household attribute	GAO's March 1988 report	Median installment payment in Survey Research Center results (monthly payments)
Median installment debt	(Not reported)	$160, for all home owners
Income	Median income was $26,000	$150, for all households with incomes of $20,000-$34,999[a]
Age of head of household	61 percent of assisted buyers were age 25-34	$173, for all households of age 25-34[a]
Race	82 percent of assisted buyers were white	$150, for all white households[a]

[a]Home owner and renter households.

Note: All dollar amounts are in 1986 dollars.

Sources: See text.

Use of the median value for debt payments implies that half of those in the Survey's results had consumer payments in excess of $160 per month. As such, a closer estimate of the extent to which consumer debt payments would affect our test results would be to apply the distribution of higher debt payment amounts to assisted owners in our data base. However, we did not have the Survey data from which to make such a distribution. Nor did we have a way to allocate higher debt payments to those in our data base.

Instead, we performed our debt test again to determine how the results would change if all assisted buyers had debt payments in excess of the $160 median value using three different amounts. We found that, if all buyers in our data base had consumer debt payments of $180 per month, the percentage of assisted owners passing this test decreased only slightly from 51 percent (if all assisted buyers had installment payments of $160 monthly) to 49 percent. Increasing the debt payments to $200 per month and $220 per month reduced the number of households passing the debt test to 45 percent and 41 percent, respectively. Since it is unlikely that all buyers had debt payments of this magnitude, we believe that our results are reasonable.

To determine the effect of this second test on the assisted owners, we applied it only to those owners who had a housing-expense-to-income ratio of 28 percent or less, using the same general procedure outlined in our March 1988 report.[3] If the assisted owner's (1) housing-expense-to-

[3]See pp. 79-80 of (GAO/RCED-88-111, Mar. 28, 1988).

income ratio was 28 percent or less and (2) total-debt-expense-to-income ratio was 36 percent or less, we then concluded that the assisted buyer may have been able to afford the same home at the same time with a conventional fixed-rate loan.

Housing agency files that we obtained for our March 1988 report sizable amounts of missing data and often required substantial effort to make them usable. As a result, we elected to use the Center's data rather than trying to obtain a complete data set for the total debt expense variable from housing agency files.

Comments From the Association of Local Housing Finance Agencies

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

alhfa ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES

1101 Connecticut Ave., N.W., Suite 700 • Washington, D.C. 20036 • 202/857-1197

May 30, 1990

Mr. John M. Ols, Jr.
Director, Housing and Community
Development Issues
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Ols:

This letter responds to your invitation to the Association of Local Housing Finance Agencies (ALHFA) to provide comments on GAO's draft report "Limiting Mortgage Assistance to Owners with Rapid Income Growth."

The report makes several findings:

- The current recapture mechanism does not treat equitably all owners with income increases;
- Some owners with large increases in income will continue to receive assistance after their incomes could support housing payments without it; and
- Bond-assisted loans are made to those who could afford market-rate conventional loans with comparable terms, the mortgage bond program imposes high costs on the Treasury, and the program benefits are relatively small.

"Program Not Needed"

See comment 1.

This last finding is a reiteration of that which GAO made in its 1988 report, "Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need." ALHFA challenged that finding then and does so again.

Conventional Underwriting Criteria

Apart from mentioning a 28-percent mortgage payment-to-income ratio, the GAO staff in 1988 did not enumerate any other criteria. It appears that on this basis alone, GAO

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concluded that fully 67 percent of assisted homebuyers could have purchased homes with unassisted conventional financing (56 percent with 30-year fixed-rate loans, and 11 percent with adjustable-rate loans). How did GAO qualify these assisted buyers for conventional mortgages? Did GAO use the different underwriting criteria applicable to adjustable-rate loans? Did GAO consider credit histories, employment histories, and other financial obligations? Did GAO calculate the standard second ratio that compares the mortgage payment and other regular monthly expenses with income? Did GAO actually determine that mortgage bankers would have extended the conventional mortgages to assisted buyers simply because they had a front ratio of 28 percent or below?

The conclusion reached by this dubious methodology is even more lacking in validity today because of the income limits imposed by the 1986 and 1988 Tax Acts.

ALHFA contends that this simplified qualifying procedure reflects the GAO's failure to perform reality testing on its conclusions. Based on our conversations with association members contacted by GAO for this report, we learned that the study amounted to an exercise in data gathering and manipulation, in other words a preoccupation with data files. Regretfully, it appears that the study group made little or no effort to learn the program content or context in the individual localities. ALHFA maintains that a methodology reliant entirely on numbers is inadequate and inappropriate for such program analysis.

Revenue Loss Estimates

The GAO staff reported in 1988 that they referred to work done by the Joint Tax Committee staff and "others" to estimate revenue losses from tax exemptions on the bonds. Who are the other sources? What are their assumptions and methodologies? What are their predispositions regarding bond-financed housing programs?

Interested parties often use these revenue loss estimates to comment on the relative efficiency of bond-financed programs in promoting homeownership. ALHFA contends that GAO's revenue loss discussion missed an important efficiency consideration. Housing finance agencies make carefully informed decisions to issue housing bonds at very specific times when they perceive a demand for affordable mortgage financing. In the absence of this demand, agencies do not issue bonds; they take action that results in federal revenue loss only in an economic environment that otherwise discourages homeownership opportunities for low- and moderate-income, first-time homebuyers.

In some instances, the economic environment in which agencies issued mortgage revenue bonds changes so that the affordability of assisted mortgages resemble that of conventional mortgages. This results from unexpected falling interest rates, over which housing finance agencies have no control. In this environment, first-time buyers tend to opt for the administratively-simpler conventional loans; the assisted loan funds do not move, the agency calls the bonds, and the federal revenue loss related to that issue ceases once the bonds are retired.

Federal revenue loss discussions should not ignore or underestimate the ability of housing finance agencies to make responsible economic decisions about issuing bonds; they do not compulsively or carelessly issue housing bonds. Likewise, such discussions should not ignore the fact that Congress and the President accepted revenue losses generated from this program as a tradeoff for the public gains also generated.

Benefit Estimates

ALHFA believes that the analysis in 1988 emphasized "statistical significance" at the expense of what is really "important." GAO must not lose sight of the fact that Congress created the MRB program for housing finance agencies to achieve public policy objectives and to create public benefits. Over the years, Congress has modified the program to further ensure this public purpose. ALHFA contends that GAO largely ignored this public character in its analysis, as revealed most vividly in the program benefit estimates.

It does not appear that GAO considered the intangible benefits of homeownership - improved self-esteem, self-worth, pride, and sense of responsibility and of the community; the benefits from achieving public policy objectives such as increasing homeownership rates, improving affordability, and expanding the housing stock; the community development impacts of the MRB program; or the value of rejuvenating residential neighborhoods in distressed areas.

GAO did not count the employment, income, and tax revenue benefits generated by new housing construction. GAO's data indicate that over 100,00 units of new construction occurred, creating approximately 176,000 jobs as estimated by the National Association of Homebuilders. It did not estimate the value of protecting low- and moderate-income first-time buyers from interest-rate risk inherent in the conventional market. GAO did not address the counter-cyclical benefits yielded by bond-financed homeownership programs. It even underestimated the buyers' direct economic benefit by focusing on monthly payment savings alone and ignoring the up-front benefits associated with the program. In fact, lenders are the first to observe that the downpayment and points are more critical factors than interest rates in determining affordability. The MRB program further enhances affordability by permitting these things to be financed in the loan.

Asserting that the MRB program yields only lower monthly mortgage costs - as implied in GAO's benefit estimate - grossly underestimates the economic, public policy, and personal benefits which our agencies have observed in their communities over the life of their bond-financed mortgage programs.

It should also be noted as ALHFA did in 1988 that the 1988 GAO study included findings which reflected favorably on MRB programs:

- Most assisted buyers were in the "25 to 29" age category and lived in a household comprised of two people; this suggests that single-family bond programs bring low- and moderate-income individuals into the housing market early in their adult years permitting them to enjoy homeownership benefits sooner than the conventional market permits;
- Forty percent of assisted buyers purchased new homes and 80 percent of bond issuers set aside some portion of bond proceeds for developers; this demonstrates that single-family bond programs add significantly to new housing construction and the nation's overall affordable housing stock, providing increased homeownership opportunities; and
- Assisted homebuyers purchased homes that cost 70 percent of the average purchase price and 80 percent of assisted buyers had incomes at or below 115 percent of the area median income; this suggests that housing finance agencies administered single-family programs before the 1986 Tax Act in a manner that generally complied with the Act's new income and price restrictions.

These findings suggest that housing finance agencies have largely succeeded in achieving the very fundamental objectives of the Mortgage Revenue Bond Program enunciated by Congress: to encourage homeownership among low- and moderate-income households by providing an incentive to purchase in the form of an affordable mortgage, and to expand homeownership opportunities for such households by expanding the affordable housing stock.

It is not surprising then that the MRB program enjoys widespread, bipartisan support within Congress. H.R. 1200, the bill to extend the sunset on authority to issue MRBs/MCCs, currently has 364 cosponsors while its companion, S.355, has 85 cosponsors. The GAO should recognize this fact and lay to rest its notion that the program is somehow not needed.

"Recapture Does Not Treat Equitably Those with Income Increases"

GAO states that, while the recapture provisions will recover some or all of the subsidy received by assisted homeowners, it does not treat equitably all owners with income increases. Some owners will receive benefit larger than the uniform 1.25-percent interest rate differential, while others will receive less benefit. In such cases the owner could pay more in recapture than the owner received in subsidy. GAO suggests that this situation could be overcome by basing the recapture amount on the monthly payment reduction.

See comment 2.

Of all the elements of the recapture mechanism, the 1.25-percent differential is perhaps the simplest, easy to understand by borrower and lender alike. The situation which GAO hypothesizes of a borrower receiving a subsidy of less than 1.25 (i.e., 1.00 percent) is not likely to occur. Housing finance agencies simply would not issue bonds when the spread between tax-exempt and conventional rates is this small. In instances where the subsidy was greater than 1.25 percent, the public purpose of assisting homebuyers through providing a meaningful subsidy would be achieved. Therefore, ALHFA does not believe any change in the 1.25-percent assumed subsidy differential is warranted. Requiring lenders to calculate the actual benefit against some measure of conventional interest rates would needlessly encumber the program.

GAO also asserts that the limitation of the recapture amount to no more than 50 percent of the gain-on-sale is inequitable "because those with rapid income increases may escape paying it if they live in areas with low or no housing price appreciation." The Report goes on to say "by allowing owners to retain some equity for a replacement house purchase, the gain-on-sale provision fulfills a purpose: it does not force the owners to return to renter status because of a large recapture amount." ALHFA could not agree more that denial of some share of the gain-on-sale to the owner could very well return such owner to renter status. This event would be completely contrary to the fundamental purpose of the MRB program: to stimulate homeownership. Permitting the owner to retain 50 percent of the home's appreciation does enable the owner to move up, thereby freeing up his/her more modestly priced home for potentially another first-time homebuyer.

That the gain-on-sale provisions treats those in high appreciation versus low/no appreciation housing markets differently is no reason to eliminate the gain-on-sale provision.

See comment 3.

GAO then asserts that the phaseout of the recapture from years 6 to 10 "... is not consistent with the benefits principle since those who receive greater total benefits over time are subject to a lesser recapture amount than those who receive the same annual benefit, but over a shorter period of time." GAO suggests the this situation could be remedied by reversing the recapture provision to allow the recapture amount after 5 years to increase at the full recapture rate until the home was sold, allow it to increase at a reduced rate, or establish a plateau from which the amount would neither increase nor decrease.

See comment 4.

GAO's discussion of the phaseout treats it as a negative effect: that persons assisted should be discouraged from remaining in their home. Recapture should have the opposite public policy objective as the phaseout has -- encouraging neighborhood stabilization through long-term homeownership.

"Subsidy Allowed to Continue Despite Obvious Significant Income Increases"

GAO states that, because recapture is imposed after the owner sells the house, it is easier and less costly to administer, since the amount is computed once, as opposed to periodic determination(s) of whether there is a continuing need for assistance. ALHFA agrees that it is easier and less costly to administer.

GAO goes on to say that some owners' income will increase to the point where they do not need continued assistance to remain homeowners. Again, ALHFA agrees with this statement. However, ALHFA sees one of two things happening in such a situation: one, the owner sells the home and pays off the MRB-financed loan. These proceeds are then used to retire the bonds, thereby saving the federal government money, or the proceeds are relent to a qualifying homebuyer; or, two, the owner remains in the home lending the stability of homeownership to the neighborhood. In either case a proper public purpose is served.

"A Prospective Affordability Test is Needed"

The Report again notes that GAO's 1988 study concluded that a majority of those assisted between 1983 and 1986 would have obtained fixed-rate conventional loans at the time they received MRB assistance. Even more could have qualified for adjustable-rate mortgages. GAO then asserts that to remedy this situation lenders would have to determine whether those applying for MRB loans could qualify for conventional loans. If they could, they would be denied the MRB assistance.

GAO admits in a footnote, as it did in 1988, that it reached its conclusion that most of those receiving MRB assistance could have qualified for a conventional loan, based solely on the industry housing-expense-to-income test. It readily concedes that it "... did not use other information used in the loan-making process, such as housing-expense-total-debt ratios, credit histories, and employment records," dismissing their importance by saying that the housing finance agencies computerized records did not contain it and that regardless it would not have changed the outcome. This statement is so incredible that it calls into question the validity of the 1988 report as well as this draft report. These additional factors are critical and are often the deciding factor in helping low- and moderate-income households who cannot qualify for conventional loans.

See comment 5.

Housing finance agencies use private lenders to originate loans and to work with borrowers to make loans. MRB-financed loans have more qualifying and administrative requirements than conventional loans with which both lenders and borrowers must comply. Given a choice between a conventional loan and a MRB-financed loan, we believe that the borrower who anticipates a near-future rise in income will choose the conventional loan to avoid the administrative and programmatic complexities associated with an MRB-financed loan. ALHFA contends that they have made this choice all along considering that, as GAO pointed out in the 1988 study, the average life of an MRB-assisted loan was 7 years. This relatively long tenure, coupled with the targeting restrictions enacted in 1986 and 1988, makes the MRB program one not for the "yuppie" as GAO would have us believe, but for owners who cannot qualify for a conventional loan. ALHFA concludes therefore that such an affordability test is unnecessary and would further complicate rather than simplify the program.

See comment 6.

"Alternatives to the Existing Recapture Mechanism"

GAO asserts that "the current recapture mechanism is preferable to none at all because some or all of the subsidy will be recaptured from at least some owners who probably could have waited a short time and bought a home without assistance due to rapid income growth." GAO suggests two alternatives: a roll-over loan where assistance is discontinued, after periodic reviews, based on preestablished affordability criteria, and income-based variable payment mortgage loans whereby housing payments are increased periodically as long as income increases.

In the former alternative, "if the owner's income rises to a point where the owner could afford a comparable market-rate loan, the owner is required to refinance the assisted loan with a market-rate loan. If income growth is insufficient for the owner to afford a market-rate loan, then assistance is continued."

GAO correctly states that a roll-over loan introduces costs and other complexities to the program for both borrowers and lenders. Borrowers must bear refinancing costs which might be substantial and more than the subsidy received. It will also increase administrative burdens for the lender by (re)certifying income and determining what the market rate should be. ALHFA finds no justification for Congress to choose this as a preferred alternative to the existing recapture mechanism.

See comment 7.

In the second alternative, the owner's payment for principal, interest, taxes, and insurance are a fixed percentage of household income. As income increases, so do monthly payments even to the point where the interest rate exceeds the conventional rate. At this point, according to GAO, there would be an incentive for the household to leave the program.

GAO again correctly asserts that this alternative "... will increase administrative cost and program complexity over the current recapture approach." It would even be more costly than the roll-over approach due to the continuing need to adjust loan payment schedules leading to increased costs. Here again ALHFA finds no justification for Congress to chose this alternative over the current recapture.

Moreover, such a requirement would conflict with normal mortgage underwriting practices whereby lenders assume some income growth over time on the part of the borrowers, thereby increasing the loan's security. If the payment-to-income ratio were held constant through an adjustment to the interest rate, lenders would compensate by imposing lower credit-to-income ratios thereby targeting away from lower-income to higher-income borrowers, which would not be a desirable public policy outcome.

See comment 8.

In summary, ALHFA finds no recommendation in the report which would make the recapture mechanism, or alternatives thereto, simpler or easier to administer. We find too that GAO's continued assertions that the program is not needed based on faulty and aged data are inaccurate, and a disservice to the program's congressional supporters, the local and state agencies which administer the program, and to the first-time homebuyers whom Congress has chosen to assist.

Sincerely,

John C. Murphy

John C. Murphy
Executive Director

The following are GAO's comments on the Association of Local Housing Finance Agencies' letter dated May 30, 1990.

GAO Comments

1. The first four pages of the Association's comments reiterate, mostly word-for-word, its 1988 comments disagreeing with most aspects of our March 1988 report. The comments largely relate to topics in our earlier report and not to those in this report. See pp. 94-106 of Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988) for the Association's comments and our responses.

2. The Association states that home owners are not likely to receive an (after-tax) subsidy of less than 1.25 percent because housing agencies will not issue bonds when the interest rate-spread between tax-exempt bonds and conventional mortgage rates is this small. The Association's comments ignore the fact that interest rates sometimes decline after the bonds are issued and before loans are made, thus reducing the interest rate differential the home owner can achieve. The 1982-87 period was one of generally declining interest rates. Our 1988 report estimated that one-quarter of the buyers in our 1988 study received interest rate reductions of three-quarters of a percentage point or less from the conventional interest rate.

Finally, the Association believes that tailoring the recapture amount more closely to the actual interest-rate reduction would needlessly encumber the program. We believe that the procedure we propose in chapter 3 would only minimally increase administrative requirements. The alternative is to decrease the attractiveness of the program to some prospective buyers who learn that the recapture mechanism may, in some instances, take away more than the subsidy they are likely to receive.

3. Neither GAO's draft report nor this final report recommended eliminating or changing the gain-on-sale provision.

4. The Association mischaracterizes our discussion. The enacted phase-out mechanism reduces the recapture amount for those who benefit the most (as measured by length of time in the assisted home) and who exceed the income test thresholds.

5. We added an analysis of housing agency loan files using a total debt-expense-to-income test in this final report. Mortgage lenders qualifying

prospective QMB loan and MCC recipients review credit histories and employment histories to ensure that the applicants are good credit risks. We did not need to do so again.

6. As discussed in appendix IV, a typical prospective buyer may find it financially worthwhile to obtain a QMB loan, no matter what the buyer's income expectations, even with the imposition of a potential recapture.

7. Our draft report outlined an approach that would not have required loans to be refinanced. The approach we suggested follows that of FmHA's section 502 program and avoids interest-rate risk on the part of the assisted buyer and the imposition of refinancing costs. The Association is incorrect in suggesting that our approach would require refinancing and the attendant costs to do so. However, we have reworded our discussion to further clarify this point.

8. Adjustable rate mortgages, which can result in increased monthly payments—even if income does not increase—are used widely in the conventional marketplace. Thus, the asserted conflict does not exist. Roll-over approaches are also used elsewhere. See appendix IV of this report for a description of HUD's section 235 and FmHA's section 502 home ownership programs and two local housing finance agencies that use a roll-over loan mechanism.

Comments From the National Council of State Housing Agencies

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

National Council of State Housing Agencies

June 5, 1990

Mr. John M. Ols, Jr.
Director, Housing and Community Development Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Ols:

Thank you for providing the National Council of State Housing Agencies (NCSHA) the opportunity to comment on the General Accounting Office's draft report, "Homeownership: Limiting Mortgage Assistance Provided to Owners With Rapid Income Growth." The enclosed comments are submitted to you on behalf of NCSHA's member State Housing Finance Agencies.

If you have any questions on our comments, please do not hesitate to call me. We look forward to your final report.

Sincerely,

John T. McEvoy
Executive Director

cc: James Ratzenberger
Dennis Fricke

enclosure

444 North Capitol Street, N.W., Suite 118, Washington, D.C. 20001 (202) 624-7710 fax (202) 624-7719

Comments on the General Accounting Office's Draft Report, "Homeownership: Limiting Mortgage Assistance Provided to Owners With Rapid Income Growth"
Submitted by the National Council of State Housing Agencies
June 1, 1990

The National Council of State Housing Agencies (NCSHA) is pleased to be able to submit these comments on behalf of our member Housing Finance Agencies (HFAs) on the General Accounting Office's (GAO's) report, "Homeownership: Limiting Mortgage Assistance Provided to Owners With Rapid Income Growth." That report comments upon the MRB recapture provision of the current Internal Revenue Code.

NCSHA considers that the MRB recapture provision represents a highly complex overreaction which burdens the entire MRB program to penalize a few theoretical homebuyers whose existence is documented only anecdotally at best. Because the recapture provision is expensive to administer, raises difficult issuer and lender liability questions, and may frighten eligible homebuyers away from buying their first home, we believe it should be repealed. If it is not repealed, we believe it urgently needs substantial simplification. These NCSHA comments are limited to the simplification issue, since they are a response to the GAO report on improving the existing recapture provision.

NCSHA is a national, not-for-profit organization created in 1970 to represent the interests of State HFAs in low and moderate income housing. HFAs in every state, the District of Columbia, Puerto Rico, and the Virgin Islands respond to low and moderate income housing needs through the financing, development, and preservation of affordable rental and ownership housing. HFAs collectively operate more than 350 affordable housing programs, which range from homeownership to homeless initiatives.

NCSHA members have helped more than 1,000,000 low and moderate income Americans buy their first home through Mortgage Revenue Bond (MRB) programs in every state. These HFAs issued approximately $6 billion in MRBs in 1989 under the private activity bond cap which strictly limits the overall volume of such bonds. In 19 states, these HFAs also administer Mortgage Credit Certificate (MCC) programs. Local government agencies also administer MRB and MCC programs in several parts of the country.

NCSHA's member HFAs have also financed over 500,000 units of rental housing for low and moderate income tenants through reduced interest rate mortgages financed by tax-exempt bonds. Since 1986, NCSHA members have financed 235,000 low income rental units with the Low-Income Housing Tax Credit for households with incomes at 60 percent or less of area median.

1

The MRB/MCC (MRB) program, which is scheduled to expire this year, is the only generally available federal mortgage payment assistance program in today's disheartening environment of climbing home prices and declining homeownership rates. An overwhelming 85 percent majority of the Congress -- 454 of the 535 House and Senate members, including 70 percent of the members of both tax-writing committees -- have co-sponsored legislation in this Congress to extend this time-honored, well-tested, and Congressionally limited program to make the national goal of homeownership attainable by lower income Americans.

The NCSHA and its member agencies hope that Congress will this year extend MRBs permanently to eliminate what has become a pointless and time-consuming review for both Congress and MRB issuers of a program which has been tightly targeted by Congress and has proved its value and popularity in the states. At the same time, we hope Congress will substantially simplify the program's recapture requirement, found in Section 143(m) of the Internal Revenue Code, which becomes effective for MRB loans made and MCCs issued after December 31, 1989. Without such a simplification, the cost of administering the MRB program will be significantly increased without any benefit to the federal government. Moreover, deserving, but unsophisticated, borrowers may be frightened away by the complexity of the recapture provision, and many MRB-assisted homebuyers will face the need to obtain professional assistance to file their tax returns when they sell their homes.

This response to the GAO report is divided into three parts:

- First, analysis of the goals and complexity of Section 143(m) of the Internal Revenue Code, the "MRB recapture" provision enacted in 1988, which is the subject of the GAO report.
- Second, a discussion of the unfounded bias against the MRB program displayed in the GAO report which undermines the credibility of its recapture recommendations.
- Third, an analysis of the GAO's recapture recommendations.

Section 143(m): The Recapture Provision

Existing provisions of the tax code limit MRB assistance to lower income purchasers who buy less than average priced homes. The price of an MRB-financed home cannot exceed 90 percent of the average area home purchase price. MRB borrower income may not exceed 115 percent (100 percent for families of fewer than three persons) of the higher of the area or statewide median gross incomes for the area in which the residence is located.

2

In practice, HFAs frequently set their MRB-assisted home prices and purchaser incomes well below the federal limits. In many areas, however, housing costs are high relative to incomes. In such areas, incomes even higher than the federal limits are frequently necessary to purchase even lower priced homes, so the MRB program limits inhibit use of MRBs in these markets.

Last year, conventionally financed home prices averaged 37 percent more than State HFA MRB-financed homes. Conventional borrowers' incomes averaged 44 percent above MRB borrowers' average incomes.

Congress enacted Section 143(m) of the Internal Revenue Code in 1988 to discourage buyers who expect their income to increase faster than a simple five percent per year above the MRB program limits from using MRB mortgages. When an MRB-assisted home is resold, Section 143(m) requires MRB-assisted owners to repay to the federal government some or all of any MRB benefit they obtained while they owned the home. The amount of recapture penalty MRB purchasers might owe under Section 143(m) depends upon how much their incomes have risen, their family size at the time of sale, the size of their mortgages, and the length of time they owned their home.

NCSHA believes that the recapture proposal represents a highly complex solution to a problem of minor proportions, if a problem exists at all. Thus, NCSHA believes that the recapture provision should be simply repealed.

NCSHA agrees with the objective of discouraging those from getting an MRB mortgage for whom conventional financing is a reasonable alternative. However, the Congress has made no finding beyond anecdotal evidence of significant and rapid income growth among MRB beneficiaries. Nor has NCSHA found evidence to support the perception that MRB beneficiaries experience significant and rapid income growth. In fact, occupational surveys conducted by several HFAs suggest that MRB borrowers are not upwardly mobile families whose salaries climb rapidly, but instead are teachers, firemen, factory workers, and service industry people whose salaries rise, if at all, only at approximately the rate of inflation.

We agree that recapture may be appropriate for those whose incomes rise outside the MRB eligibility range while occupying an MRB-assisted residence. The current provision, however, is like a cannon trained upon a gnat, in terms of the complexity imposed upon the entire MRB program, to "catch" a few buyers whose incomes may rise rapidly and who may exist more in anecdote than in reality. For these reasons, we are urging the Congress to consider simplifying current law without diminishing the intended effect of recapture and to avoid adding additional complexities to the law which meet no demonstrated need.

3

Section 143(m) involves a process of computation which contains up to 13 sometimes complicated mathematical computations to determine the recapture amount. A summary example of how Section 143(m) would work in an ordinary home sale consumes a single-space page of the GAO report, complete with two footnotes.

When the Congress enacted the recapture provision in 1988, it delayed the effective date in order to permit consideration of alternatives to attain its policy goal. As part of that review, Congress asked GAO to study the recapture provision's effectiveness and administrability. GAO has now rendered its report.

We commend GAO for acknowledging the complexity of the recapture mechanism in that report. However, we are disappointed that GAO offers no solution to this complexity, which will confound borrowers and lenders alike and discourage their participation in the program.

The GAO suggests no simplification of the current recapture provision. Instead, demonstrating the truth of the axiom "the perfect is the enemy of the good," the GAO report poses new recapture alternatives, the cost, inconvenience, and complexity of which dwarf those of the existing version of Section 143(m) without any assurance of improving its results. In fact, GAO's proposed revisions and alternatives to the current provision would further complicate its application and are completely unworkable. Each of the GAO suggestions would add additional layers of complexity to a provision whose intended purpose can be well served by a limited simplification of its existing provisions, without the introduction of still new complications.

Possible Recapture Simplification

The current recapture provision contains up to 13 mathematical calculations to determine the recapture amount. At least one simplification (described below) of Section 143(m) reaches virtually the same mathematical result as the current law, but reduces the required mathematical computations to a maximum of eight.

Under current law, recapture is assumed to be potentially payable by all MRB purchasers, but the amount is reduced potentially to zero by application of a set of complex calculations involving up to 13 separate computations. Under a possible simplification, no recapture would be owed unless income exceeded a certain threshold level in the year of sale. That Threshold Income would be determined by multiplying .05 times the number of years the home was owned and further multiplying that result by the maximum eligible income which would have been available to a family the size of the MRB seller at the time he or she purchased the home (maximum eligible income) and adding that product to the maximum eligible income.

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The current law provision calculates the maximum recapture amount by multiplying 6.25 percent times the amount of the MRB mortgage and multiplying that result by a "holding period percentage" which is derived through a two or three step calculation, depending on whether the home is sold in years one through five or in years six through ten. Under the simplification alternative, the maximum recapture amount would be determined by multiplying the original mortgage amount by .001 and multiplying that result by the number of months the home is owned up to 60. (The .001 is the result of dividing 1.25 by 12 months. Sixty months is the period during which current law recapture rises to its maximum possible amount.)

The simplification proposal differs significantly from current law in its application after year five. Current law increases the recapture amount by 1.25 percent per year to a maximum of 6.25 in year five, reduces the maximum amount by 1.25 percent per year in years six through ten and eliminates recapture after year ten. Like current law, the simplification proposal assesses the maximum recapture amount in year five, but that amount remains constant in years six and seven and recapture is eliminated in year eight. The reason for this change is that the targeted "yuppie" population will not remain in their homes beyond seven years, if they stay that long. In fact, MRB mortgage prepayment statistics indicate that the vast majority of MRB homeowners sell their homes between years five and seven. The Congress recognized this in the softening of the current recapture penalty in years five through ten. The simplification proposal just eliminates these additional and unnecessary computations.

Under current law, the actual amount of recapture is determined by adding $5000 to an income level determined in exactly the same fashion as in the simplified alternative and then reducing the total recapture amount otherwise payable by two percent for every $100 the owner's income is below this amount. Additionally, the recapture actually owed could not exceed one-half the MRB seller's net gain on the sale. Under the simplification proposal, no recapture would be owed if income did not rise over the Threshold Income. If the owner's income exceeded the threshold, recapture would equal the lowest of the following: (1) the maximum recapture amount, (2) 50 percent of the net gain on sale, or (3) .0002 times the amount of income over the threshold times the maximum recapture amount. The effect of both current law and the simplification is that for every $100 the seller's income is above the Threshold Income, the seller would pay 2 percent more of the maximum recapture amount, until it is $5,000 above the Threshold Income, at which point the seller would pay full recapture.

The actual operation of current law and the possible simplification are demonstrated in the example set out below.

The following description illustrates how current law and the proposed simplification would apply to the "Example of How to Compute the

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Recapture Amount" contained in Appendix I to the GAO Report (page 52). In the example, the MRB Mortgage is $55,000; the applicable income level for the seller's household is $23,000; the home is held 6 years and 2 months; the seller's income at time of sale is $32,000; and the gain on the sale is $12,000.

<u>Current Law</u> - Thirteen Steps to Determine Recapture

Maximum Recapture Equals: (one step)	$55,000 x .0625 = $3,438
Holding Period Adjustment: (three steps)	[(120-74)/60] x $3,438 = $2,636
Income Eligibility Limit: (four steps)	($23,000 x .05 x 6) + $23,000 + $5,000 = $34,900
Recapture Reduction: (four steps)	[($34,000 - $32,000)/100] x .02 x $2,636 = $1,528
Recapture Computation: (one step)	$2,636 - $1,528 = $1,108

Recapture equals lesser of the Recapture Computation ($1,108), the Holding Period Adjustment ($3,636), or one-half the gain on the house ($6,000).

<u>Simplification</u> - Three to Eight Steps (No Recapture below Threshold Income)

Threshold Income: (three steps)	($23,000 x .05 x 6) + $23,000 = $29,900
Maximum Recapture: (two steps)	$55,000 x .001 x 60 = $3,300
Adjusted Recapture: (three steps)	.0002 x ($32,000 - $29,900) x $3,300 = $1,386

Recapture equals lesser of Adjusted Recapture ($1,386), Maximum Recapture ($3,300), or one-half the gain on the house ($6,000).

In this example, the recapture under the simplification proposal ($1,386) actually exceeds the recapture under current law, because current law ($1,108) reduces the recapture amount for each year over five the house is held, whereas the simplification proposal does not.

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The Unfortunate Bias in the GAO Report

The GAO approach to the recapture issue not only overlooks simplification alternatives to existing law, but also reflects an unfounded and undocumented assertion that most MRB-assisted buyers need no assistance and, hence, should have to prove they cannot get credit elsewhere before they get an MRB loan.

The GAO has traditionally opposed the MRB program, which is the only federal homeownership mortgage assistance program generally available to lower income individuals and families. Today's MRB program is the product of a decade of Congressional refinement designed to tighten the MRB program as far as practicable to assure that MRB benefits are targeted to those who need them in order to qualify for homeownership at all.

Because the MRB program has been caught up with a number of other tax programs - popularly known as "the extenders" -- which have been continued from year to year during the 1980's for revenue accounting reasons, it has been reviewed about as often - five times - and amended to assure its cost-effectiveness - four times - as any tax provision ever considered. And a nearly unprecedented majority of the Congress - more than 80 percent of all Members in both Houses and 70 percent of each House's tax-writing committees - have co-sponsored legislation to continue the MRB program in its present form.

As a matter of fact, the MRB program is one of the least expensive of the "extenders" or many other provisions of the Internal Revenue Code. The Joint Tax Committee staff estimates that the MRB extension represents only about three percent of the aggregate cost of all 12 extenders.

In light of these refinements and overwhelming Congressional support, the Senate Finance Committee last year reported a permanent extension of the MRB program as part of its version of the 1989 Tax Act, notwithstanding the Gramm/Rudman Act, which has led Congress to provide only short-term extensions for other "extenders," in order to meet deficit reduction targets. That permanent MRB extension, however, along with most of the rest of the Finance Committee bill, was dropped in the subsequent maneuvering over the capital gains issue.

But just as Congress has consistently found the highly targeted, recapture-limited MRB program to be overwhelmingly worthwhile, some academic critics have persisted in comparing it to goals Congress does not share and ignoring the bulk of all the evidence which impeaches their criticism.

Regrettably, the GAO study of Section 143(m) partakes richly in this prejudice. It ignores the Congressional determination embodied in the MRB program to provide a limited chance for homeownership to lower income families. The GAO report is undermined by repeated reference to a previous

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See comment 1.

GAO report, "Homeownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those In Need," in which GAO criticized the MRB program. But this 1988 report was fatally flawed, because it was based on data the GAO gathered selectively and admitted was at best inconclusive and manipulated with invalidly hypothesized assumptions about the actual real world practice of making MRB mortgages.

Proceeding on this unfounded prejudgement that the MRB program is full of undeserving participants, the GAO unsurprisingly finds fault with the recapture mechanism Congress enacted in 1988 to discourage buyers from the program who expect an extraordinary income increase or to recover the benefit from others who receive such an increase unexpectedly while MRB owners. Surprising, however, is the additional complexity and further burden GAO asks the Congress to consider imposing on the MRB program for all buyers, without any convincing statement of need for such steps based on any serious examination of current or statistically valid MRB program data.

MRB Beneficiaries Could Not Afford Homeownership Without Help

We strongly object to GAO's repeated assertion throughout its report that a majority of MRB beneficiaries could have purchased the same house without help, using a conventional mortgage. We are dismayed that GAO continues to rely on a view first expressed in its dated 1988 report, which was based on incomplete and obsolete information, contained highly controversial conclusions, and became completely irrelevant after Congress further restricted MRB eligibility and enacted the recapture provision later that same year.

NCSHA successfully rebutted the conclusions of GAO's 1988 study in a 1988 Occasional Paper of Georgetown University's Center for Public Policy prepared by Dr. Margaret Wrightson and funded by NCSHA and in a 1988 report -- *A Referendum on the American Dream* -- prepared in cooperation with the Association of Local Housing Finance Agencies, the National Association of Realtors, and the National Association of Home Builders. The findings of these reports have been supported by data collected by NCSHA in the years since their release. GAO has never updated its 1988 report to reflect the MRB program tightening Congress enacted that year, acknowledged the thorough rebuttal provided by the Georgetown and NCSHA responses, or seriously addressed the inaccuracies those studies demonstrated in GAO's conclusions regarding MRBs.

See comment 2.

See comment 3.

We are aware of no credible evidence that MRB beneficiaries could, as GAO claims, buy a home without help. The 1988 GAO report containing these assertions was not based on a random or impartial selection of state program data, but instead, by GAO's own admission, was conducted with a skewed methodology. As the 1988 report stated on page 16 . . ."Because we selected housing agencies judgmentally, we cannot assert that our findings are representative of qualified mortgage bond activity nationwide."

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GAO's conclusions are contradicted by any impartial, statistically valid review of the same and comparable data. The Georgetown study used data from the same years as the GAO study, collected from an unbiased sampling of data from 17 HFAs. The Georgetown study included eight of the states GAO studied whose data was sufficient to permit a statistically valid review and an additional nine states selected to replace the states in the GAO study in which the data was inadequate to support a statistically valid review. These replacement states, if anything, tended to be "high cost areas," data from which would tend to support GAO's conclusions more strongly, if, indeed, those conclusions were correct.

See comment 4.

The Georgetown study found that MRB household income and purchase price limitations established by Congress in 1980 (and gradually made more stringent since) have been very effective in targeting MRB assistance to lower income homebuyers. It revealed that many states are serving even lower income people than mandated by the federal guidelines. It found that the incomes of the population served and the prices of the homes financed with MRBs are well below those represented by conventional, or even FHA or VA, sales. According to the Georgetown study, in 1987 (the last year studied by either GAO or Georgetown), the median income of an MRB recipient was $27,000, compared to the 47 percent higher $39,600 income of the conventional buyer. The average price of a MRB-assisted home was $62,000, compared to the 34 percent higher average conventional buyer purchase price of $82,900.

The gap between MRB and conventional borrower home purchase prices and income continued to widen in 1988 and 1989. According to data compiled by the NCSHA in its Annual Survey of the 58 State HFAs, the average purchase price of an MRB-assisted home was $52,597 in 1988 and $59,377 in 1989, compared to conventionally financed average first-time buyer prices of $94,400 in 1988 and $95,000 in 1989. The average income of an MRB borrower was $23,071 in 1988 and $25,019 in 1989, compared to conventional borrower incomes of $44,200 in 1988 and $45,000 in 1989.

See comment 5.

In addition, GAO's conclusions were based on underwriting assumptions which it invented and did not reflect actual market practice, such as the FHA underwriting standards used at that time which were commonplace in the MRB program. The underwriting ratio of permitted expenses-to-income GAO used in its study helped predetermine its conclusion that MRB recipients could have qualified for conventional loans. Standard underwriting ratios, on both conventional loans and adjustable rate mortgages, are stricter than those used by GAO. These standard ratios include a formula that penalizes the amount of the borrower's household debt in determining mortgage credit worthiness. This debt factor is often the toughest hurdle for first-time homebuyers to jump. Yet, GAO did not include it in its underwriting assumptions.

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See comment 6.

As an consequence of this bias, the GAO recommends requiring that potential MRB borrowers first obtain proof that they could not qualify for a conventional loan before receiving MRB assistance. NCSHA believes that such a requirement is unwarranted, as the existing law recapture provision is effectively designed to discourage participation in the MRB program by any potential buyers who are within the MRB income eligibility range and who may also qualify for a conventional loan. The threat of recapture will outweigh any possible MRB interest rate advantage for such buyers.

See comment 7.

To require lenders to essentially deny conventional credit to borrowers as a precondition for making an MRB loan, could potentially cause them to issue adverse actions against borrowers which may become part of the borrowers' credit histories and may leave lenders vulnerable to legal action. Even a lesser requirement of prequalifying borrowers for both MRB and conventional loans would impose additional administrative requirements on lenders, who already have little incentive to participate in the MRB program.

<u>GAO's Proposed Revisions and Alternatives Are Unworkable</u>

GAO suggests that the Congress either retain the current recapture mechanism with some modifications or replace it with one of two alternative approaches. The proposed modifications to the existing recapture provision would further complicate it and make its administration more difficult without furthering recapture's public policy objective. The alternatives GAO suggests are even more complex than the current law recapture provision and would impose insurmountable administrative and financial burdens on MRB borrowers and housing agencies alike, without measurably improving recapture efficiency.

<u>GAO's Proposed Revisions in Current Law</u>

GAO suggests that the current law recapture provision be modified to base the recapture amount on the actual interest rate benefit received by MRB borrowers compared to conventional rates. The 1.25 percent per year provided in current law is an approximation of that benefit. Under the GAO proposal, lenders would have to document the difference in monthly principal and interest payments between the MRB loan and a comparable conventional loan at the time the MRB loan is closed. When the MRB-assisted home was later sold, the amount of recapture would be the amount of that monthly savings times the number of months the loan was outstanding.

See comment 8.

We strongly object to this approach. First of all, it is unworkable since there is no single conventional rate to which MRB rates can be compared in most real estate markets. Rates vary from bank to bank on a daily basis. For example, the May 26 *Washington Post* survey of 19 lenders in the D.C. metropolitan area showed that these institutions offered as many as eight different effective interest rates with differences as great as 5/8 percent on

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a 30-year conforming conventional loan on a single day. Thus, two identically situated borrowers could be subject to significantly different recapture amounts if they borrowed from different banks on the same day or even the same bank on different days in the same week. This is an absurd result Congress should not allow.

It is important to note that the basis for this GAO suggestion is that the present recapture provision might take too much recapture from some MRB-assisted buyers, not too little. The GAO points out that the arbitrary 1.25 percent per year recapture formula of current law overstates the benefit actually received by many MRB borrowers.

See comment 9.

GAO's attempt to achieve mathematical perfection would, however, only further complicate an already exceedingly complex recapture formula. It would replace current law's standard calculation applicable to all MRB-assisted purchasers with documentation which would have to be individualized for each and every borrower and which would require further administrative and record keeping requirements of lenders.

See comment 10.

Moreover, GAO would fail to obtain the parity it seeks, for some MRB owners would be required to return every dollar of MRB benefit even if they legitimately qualified for the benefit for most of the time. For example, a borrower's income could remain well within the MRB eligibility range for the first three years of owning the home and then jump considerably in the fourth year due to a change in employment or the addition of a second household income. In the year of sale, the total interest rate benefit received over the life of the loan would be recaptured, even though the benefit was deserved in at least years one through three. GAO's solution to this problem -- suspending or adjusting the benefit as income rises over the life of the mortgage-- introduces a whole new set of complexities and administrative hurdles which are discussed further on.

GAO is also concerned that MRB owners who experience large income increases might remain in their homes for long periods in order to continue receiving a benefit which they do not deserve. In addition, some MRB owners may pay little or no recapture, because the recapture penalty is phased out under existing law during the second five years of ownership and eliminated after ten. GAO also argues that this phase-out will prompt owners to stay in their homes for longer periods than they would otherwise. They suggest that the recapture amount should either increase through year ten, increase through year ten at a reduced rate, or plateau in year five and remain constant through year ten.

See comment 11.

NCSHA believes that the so-called "yuppies," the upwardly mobile families with rapidly increasing incomes that recapture was designed to "catch," are unlikely to remain in their homes after they can afford to move. They will not stay long periods just to avoid paying recapture and, in fact, are better off selling in the early years to take advantage of the one-time

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$5,000 factor added to income under current law to compute the actual recapture total.

Finally, GAO suggests that the 50 percent of "gain-on-sale" recapture limitation will cause households in low-appreciation areas to pay less recapture than comparable households in high-appreciation areas. GAO at least concedes that this result is not easily remedied for the purpose of the limitation is to leave a portion of the home equity to be applied to the purchase of a replacement home. It does not recognize that the 50 percent limitation is essentially a protection for those living in the poorest neighborhoods that they may have something left to move on with after recapture is paid.

See comment 12.

We strongly advise the Congress to leave this protection in place. Recapture was never intended to prevent households from eventually moving up in the housing market and certainly was not designed to return owners in the poorest, least likely to appreciate neighborhoods, to renter status. Lower-income households' ability to move up is already strained under the current recapture requirement.

GAO Recommended Alternatives to the Existing Recapture Provision

The GAO suggests two possible alternatives to the current recapture provision: a "roll-over" loan approach and an income-based variable payment loan approach. The "roll-over loan" would discontinue MRB assistance when the owner's income rose by raising the interest rate on the loan to conventional rates in subsequent years. Under the income-based variable payment loan approach, housing payments would increase as a fixed percentage of income, if income rose.

Both approaches would require housing agencies or their lenders or servicers to establish a system for monitoring the income of every MRB borrower. Borrowers would be required to disclose their federal tax returns periodically. This process would be an extremely intensive, costly, and administratively complex task for servicers who must service hundreds of thousands of loans. Those servicers would have to make sure borrowers' tax returns are actually collected and reviewed, determine if the borrowers' incomes could support higher monthly payments, and when necessary, dispatch a new payment schedules to the borrowers.

See comment 13.

Another serious problem with these approaches is that increases in income are incorrectly presumed to mean increased "ability to pay." Increased tax withholdings, utility costs, property taxes and other household costs must be considered to avoid financially overburdening homeowners and potentially triggering a loan default. To take such increased costs properly into account, a lender would have to completely re-underwrite a homeowner's loan each and every time his or her income was reviewed. This would require substantial financial information from the homeowner

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and significant time and financial analysis from the lender. This is a task unprecedented in mortgage servicing.

Under the Section 8 Certificate program, income monitoring and verification is required, but the administering agency is paid a fee by the federal government to cover such costs. Moreover, unlike Section 8 where only the amount of tenant income is in question, the servicer under the GAO approach would be required to analyze the owner's income against the income which would be required to support a conventional housing payment. The substantial cost of administering such an MRB monitoring program would be passed on to all borrowers in the form of increased loan points or servicing fees.

See comment 14.

Neither approach is practically workable, and neither improves on the fairness or effectiveness of the current law provision. The GAO suggests testing income under either approach at three and five year intervals. Since existing law recapture peaks after five years and ends after ten, these approaches would provide less disincentive for purchasers who expect extraordinary income increases than current law does, since current law imposes a definite, unavoidable penalty for any sale within ten years. In contrast, the periodic income testing approach would not impose any penalty until the year income is tested, which might be years after the assisted buyer's income rose substantially, with no recapture of the benefit received in those prior years.

See comment 15.

Under the roll-over loan approach, as GAO acknowledges, borrowers could be required to refinance their loans, at potentially higher conventional rates than prevailed when they first took their MRB loan and, in any case, with the payment of points which might well exceed the value of any MRB subsidy received. Their inability to pay could force them out of their homes. This risk would be particularly acute when the income increase was only temporary. Establishing a market-rate at the time the borrower enters the MRB program and adjusting the original mortgage to that rate without refinancing when the borrower's income rises could overcome some of these risks. However, the difficulties involved in determining what the conventional rate is at any particular time which has already been discussed and the periodic need to examine income and all its associated costs and complexities would remain.

Under the variable payment loan approach, housing payments for principal, interest, taxes and insurance would be set at a fixed percentage of household income. As income increased, so would monthly payments. Unlike the roll-over loan which caps the interest rate at some predetermined rate, the variable payment loan allows the owner's effective interest rate to rise above the market as income continues to increase. Of course, the owner would have the option of refinancing when his or her payments exceeded payments on a conventional loan, but then would incur all of the associated costs of refinancing which might exceed the MRB

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benefit received and would face the risk of not being able to service the refinanced loan.

Both of these alternatives would impose recapture on all MRB borrowers whose incomes rise steadily and conservatively over the life of their mortgage and not just the "yuppie" population Congress intended to target with recapture.

See comment 16.

In conclusion, the current recapture provision must be substantially revised, so that it is simple, administrable, discloseable and does not adversely affect lower income borrowers. An alternative along the lines of the simplification proposal contained in these comments would achieve these goals. The revisions and alternatives GAO poses in its report would not accomplish these objectives, would in no way increase the effectiveness of recapture and in fact, would alter Congressional intent. These recommendations should be soundly rejected. The NCSHA is committed to working with the Congress to achieve a simplification of the current recapture provision which preserves Congressional intent.

See comment 17.

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The following are GAO's comments on the National Council of State Housing Agencies' letter dated June 5, 1990.

GAO Comments

1. We disagree with the Council's characterization of our report.[1] The Council's characterization of our report ignores other supporting analyses contained in the report that reached similar conclusions using different data sources and analytical techniques.

2. The studies cited by the Council do not offer an assessment of the extent to which owners could have purchased homes without QMB assistance. To our knowledge, this type of analysis has not been undertaken on a widespread basis elsewhere. We have conducted an additional analysis that further supports our earlier results. We continue to believe that many assisted owners may have been able to purchase their first homes without QMB loans.

As a piece of anecdotal evidence, a Rhode Island mortgage lender stated that its analyses of its loan files showed that at least 25 percent of approved QMB loan applicants would have been able to obtain an alternative mortgage from that lender.[2] Additionally, it believed that 20 percent of all Rhode Island participants could have purchased a home without a QMB loan. Since Rhode Island was not included in our review, we cannot specifically comment on the numbers derived. However, while their results are less striking than ours, they do show a significant portion of buyers served were not in need of the assistance they received.

3. We object to the Council's characterization that by "GAO's own admission, [its 1988 study] was conducted with a skewed methodology." We believe that the approach we used was appropriate to provide an estimate of conventional affordability. In addition, the home ownership test was one of several analyses contained in the report using different approaches and data sources. All reached the same conclusion.

[1]For the Council's prior comments in this vein, and our discussion, see pp. 107-111 of Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988).

[2]"Expiring Tax Provisions," Hearings Before the Subcommittee on Taxation and Debt Management of the Committee on Finance, United States Senate. S. Hrg. 100-1002, Mar. 28, 1988. Pp. 86-91.

The Council objects to our use of a judgmental sample of about 178,000 loan files.[3] The Council essentially argues that decisions about the effectiveness of the QMB program can only be answered by statistically reliable studies. If that is so, the studies cited by the Council do not meet that test. For example, in claiming statistical validity of the studies it supported, the Council substantially misrepresented the statistical nature of these studies. First, it claims that the study conducted by Dr. Wrightson was a "statistically valid review." However, disclaimers in that study specifically state that it was not and should not be taken as such.[4] Second, notably omitted from the Council's statement is any reference to local housing finance agency performance. Neither of the studies cited by the Council analyze local housing agency QMB loan performance. As such, these studies can hardly be considered to be statistically valid reviews of QMB loan activity.

Finally, many policy questions do not lend themselves to statistical analyses for a number of reasons, including the ones that hampered us from obtaining a statistical sample of buyers. In addition, even those analyses conducted under statistical procedures are often open to different interpretations. In the absence of iron-clad proof, which the Council suggests is the only basis from which to judge the merits of QMB loan activity, policy makers make their decisions by weighing the merits of available evidence.

4. Our 1988 report recognized the efforts of several housing agencies to target assistance more strictly than required by the Code. However, the question central to the affordability test is the extent to which QMB loans increase home ownership opportunities to first-time buyers. A finding that some agencies provide set stringent eligibility requirements does not address the question of whether the assisted owners could not have purchased their home without QMB loan assistance.

5. We added an analysis of housing agency loan files using a total debt-expense-to-income test to chapter 3 of this final report. Our results did not change markedly.

[3]These files represented home purchase loans made by 29 state and local housing agencies and in their automated files for the January 1983—June 1987 period. These were the latest data available at the time of our review. We did not perform a statistical sample of state and local housing agency loan activity because of the lack of a central data base from which to do so. Nonetheless, we believe that these loans represented about one-third of the loans made during that period.

[4]The "Referendum" paper also cited by the Council relies heavily on Dr. Wrightson's study.

6. We disagree. The recapture mechanism, either as enacted in law or proposed by the Council, tests for certain income increases after an assisted home is sold. As we discuss in appendix IV, the recapture formula would not be expected to induce buyers to decline to participate.

7. We see no basis for the Council's contention that affordability testing would subject lenders to lawsuits. If the applicant could afford a conventional loan of comparable terms, then the lender would be agreeable to making a loan to the applicant. If, as a result of the affordability test, the applicant could not afford the conventional loan, then the applicant would be offered a QMB loan (assuming the applicant met eligibility requirements and was a good credit risk). Therefore, applicants meeting either conventional or QMB loan-making requirements would not be denied credit because of the affordability test. If they are not denied credit, then a lawsuit would be groundless. Finally, if the applicant sued on the basis that he or she was denied the lower-interest rate QMB loan, the suit would likely be dismissed as long as the lender acted in good faith in that the lender was following affordability test requirements set out in law.

8. The terms that lenders offer are those at which they are willing to make loans. For that lender at that time, the stated rate for the prospective buyer is "the rate." That interest rates change over time or differ between lenders is the basis of our proposal. The QMB loan rate is fixed, while conventional interest rates change. In this environment, the enacted recapture formula will almost always recapture more or less than the assumed interest rate reduction.

9. We believe that the Council overstates the administrative burden involved. See chapter 3 for a discussion of the steps involved.

10. We would not support the Council's concept because we believe that it would be too difficult to administer. Rather, the approaches that we suggest form a middle ground between "real time" testing and the enacted version. Chapters 3 and 4 discuss what we believe are the benefits from the approaches we suggest, as well as the increased administrative effort, relative to the enacted version. In deciding whether to change the recapture formula, the Congress must weigh these expected benefits against the increased administrative effort.

11. The Council ignores the fact that substantial transaction costs in selling a home can substantially eliminate gains on sales in early years

creating a disincentive to sell within the first several years of ownership.

12. Neither our draft report nor this final report advocate eliminating the gain-on-sale provision. However, the gain-on-sale provision benefits all assisted owners, not just "those living in the poorest neighborhoods."

13. We disagree that additional underwriting would have to occur. See our discussion in chapter 4 which describes how assisted owners' loan payments could be increased administratively without underwriting or refinancing the loan. It is interesting to note that conventional fixed-rate loans are not underwritten again when home owner costs increase or if an owner's income remains flat or decreases. Similarly, conventional adjustable-rate loans that can result in higher housing payments when interest rates rise are not underwritten again, even if other costs increase and income remains stable or decreases.

14. The 3- or 5-year testing period is presented as a trade-off between examining income changes at the time of sale or doing so more frequently, say, annually.

15. The Council has misstated our suggestion. The roll-over approach that we discussed in our draft report does not involve refinancing of loans, including interest-rate risk, or the payment of refinancing costs. In fact, our suggestion specifically stops this from occurring. However, we have added further clarifying language. See also comment 8, above, for our view on determining a market interest rate when the loan is made.

16. The Council has misstated our approach. The roll-over approach tests for whether an assisted owner no longer needs the subsidy. Whether income increased "slowly and conservatively" or more quickly, we see no public purpose being served in continuing the assistance when those receiving QMB loan or MCC assistance could remain home owners without it. A roll-over approach satisfies that goal.

17. We disagree with the Council's assertion that our proposals alter congressional intent. The intent is quoted in chapter one of this report, and our analyses clearly fall within the language contained in the congressional conference statement.

Comments From the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF THE TREASURY
WASHINGTON

July 9, 1990

ASSISTANT SECRETARY

John M. Ols, Jr.
Director, Housing and
Community Development Issues
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Ols:

Thank you for providing the Department of the Treasury with the opportunity to comment on the draft GAO report, "Home Ownership: Limiting Mortgage Assistance Provided to Owners With Rapid Income Growth." The report evaluates the recapture provision of the Qualified Mortgage Bond (QMB) and Mortgage Credit Certificate (MCC) programs in terms of how effectively it limits the homeownership subsidy to households with rapid income growth. The recapture provision was enacted and the report mandated by the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647).

Background

The QMB program assists first-time homebuyers with below market interest rate loans financed with the proceeds of tax-exempt mortgage bonds issued by state and local housing agencies. The MCC program also assists first-time homebuyers by allowing them to claim a credit against their Federal income tax equal to between 10 and 50 percent of the mortgage interest paid during the year on a market rate loan. Those who claim a credit, however, must reduce their home mortgage interest deduction by the amount of the credit. Under both programs, homebuyers must meet income, purchase price, and other eligibility requirements. In the 1988 Act, Congress added a provision designed to recapture the subsidy provided by these programs from households that experienced rapid increases in income subsequent to their purchase of a home. This provision becomes effective on January 1, 1991.

An assisted homebuyer may become subject to recapture only in the year in which he disposes of his home, and only if his income in that year exceeds the maximum amount of income that would have allowed him to qualify for the assistance in that year. The recapture amount increases from zero to the full recapture amount on a pro rata basis as the homebuyer's income increases from the maximum qualifying income to the maximum qualifying income plus $5,000. During the first five years of the mortgage, the full recapture amount is equal to the product of 1.25 percent of the original mortgage amount and the number of years since the home was purchased. The full recapture amount decreases by 1.25 percent of the original mortgage amount for each year thereafter so that after year ten there is no recapture. In addition, the recapture amount is capped at 50 percent of the gain on disposition of the home. The recapture amount is added to federal income tax liability for the year in which the homebuyer disposes of his home.

The report concludes that the proposed recapture mechanism is preferable to no recapture mechanism, because it would recover at least some of the subsidy from those who would have delayed home purchases for a short time until they could have afforded an unassisted loan. The report recommends that Congress consider tailoring the recapture amount to the actual amount of assistance received and eliminating the phaseout of the recapture after year five. It also recommends that Congress consider limiting QMB and MCC program assistance to individuals who could not otherwise obtain a market rate loan with comparable terms. Finally, the report discusses two alternatives to recapture: a "roll-over" loan and an income-based variable payment loan.

Comments on GAO Recommendations

GAO Recommendation: With respect to the QMB program, Congress should consider basing the recapture rate on the actual difference between the market and below market interest rates at the time the home was purchased.

Comment: It is inappropriate as a matter of fairness to recapture an amount which exceeds the actual subsidy received by a homebuyer. The report cites a 1988 GAO report*/ which estimated that the actual median difference between the market and below-market interest rates received was 1.44 percent. This translates into an actual median after-tax benefit of 1.22 percent assuming the marginal income tax rate of the homebuyer is 15 percent. This is less than the after-tax benefit of 1.25 percent assumed under the current law recapture provision. While this difference would not be important if there were little variability in the actual subsidies, it appears that there is a substantial amount of variability. The report cites the 1988 GAO report which estimated that 25 percent of the assisted buyers received reductions of about three-quarters of a percentage point or less. The implication is that the recapture amount could exceed the actual subsidy by a significant amount in a significant number of cases.

*/ U.S. General Accounting Office, Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111), March 28, 1988, hereinafter referred to as the 1988 GAO Report.

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Equating the recapture amount with the actual benefit would generally be appropriate as a matter of fairness, but as a matter of tax policy, this objective would have to be balanced against the associated administrative and compliance costs. The report would be improved by the addition of a discussion of the magnitude of these costs in comparison with the potential recapture amount. The report might also indicate that the recapture amount may understate the benefit of below-market rate financing because of the assumption implicit in its calculation that the current value of the benefit received in any given year is constant. While the benefit of below-market rate financing in any given year may be 1.25 percent of the mortgage amount, it must be compounded at the prevailing interest rate over the subsequent years of the mortgage to obtain the true economic benefit. In addition, it would be helpful to clarify whether interest rates are before- or after-tax rates.

See comment 1.

See comment 2.

See comment 3.

GAO Recommendation: Congress should consider the following alternatives to the phaseout of recapture after year five: eliminate the phaseout; reduce the rate at which the recapture phases out; and cap the recapture amount at year five.

Comment: The report argues that because the recapture amount decreases after year five, the homebuyer has the opportunity to reduce or eliminate the recapture amount by choosing when he sells his home. A related concern, not addressed in the report, is that homebuyers whose income remains below the maximum qualifying income in the earlier years of the mortgage but whose income increases in the later years may be subject to the full recapture amount.

In theory, the appropriate policy would be to recapture the benefit only for the years in which a homebuyer's income exceeded the maximum qualifying income. This would require a continuous monitoring of a homebuyer's income which would increase administrative and compliance costs. The report might acknowledge this problem and discuss the administrative and compliance costs associated with recapturing the benefit only for the years in which the homebuyer's income exceeds the maximum qualifying income.

See comment 4.

GAO Recommendation: Congress should consider requiring that QMB loans and MCCs only be provided to those who could not otherwise obtain a market rate loan with comparable terms.

Comment: Providing assistance to those who could otherwise afford a market rate loan with comparable terms is not consistent with the goals of the QMB and MCC programs. The report cites the 1988 GAO report which estimated that over half of the assisted homebuyers could have obtained a market rate mortgage with comparable terms to purchase the same home. The report, however, does not explain how this recommendation would be implemented. The report might, for example, address how much tighter the income eligibility requirements would have to be to target the assistance to those Congress intended to benefit.

See comment 5.

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GAO Recommendation: Congress should consider "roll-over" loans as an alternative to the recapture mechanism.

Comment: A roll-over loan would require a homebuyer to refinance at a market rate if his income increased above the maximum qualifying income. This would require continuous monitoring of a homebuyer's income and would impose substantial administrative and compliance costs. In addition, if a homebuyer were forced to refinance, he would bear substantial refinancing costs. Moreover, if interest rates were to rise during the period in which he owned his home, then requiring a homebuyer to refinance at a higher rate could make him worse off than he would have been if he had originally financed his home with a market rate loan. These considerations suggest that the roll-over loan be pre-approved, so there would be minimal refinancing costs, and that the rate on the roll-over loan be capped at the market rate in existence when the homebuyer purchased his home. The report should discuss the administrative and compliance costs associated with continuously monitoring income, pre-approved refinancing costs for roll-over loans, and the costs associated with capping the refinancing rate at the market rate in existence when the individual originally purchased his home.

See comment 6.

GAO Recommendation: Congress should consider an income-based variable payment loan as an alternative to the recapture mechanism.

See comment 7.

Comment: An income-based variable payment loan would establish a homebuyer's mortgage payments at a fixed percent of his income. This alternative could allow the implicit rate to rise above the market rate that existed when the home was originally purchased. It also could allow the implicit rate to drop below the subsidized rate if the homebuyer were to experience a drop in income. The appropriate policy might be to allow the implicit interest rate to vary between the subsidized rate and the market rate that existed when the home was originally purchased. This alternative would impose additional administrative and compliance costs on the homebuyer and the administrative agency.

General Comments

The report might consider the alternative of having no recapture mechanism (if only for the purpose of exposition). Indeed, it is possible that the administrative and compliance costs associated with recapturing an amount which is close to the actual benefit may exceed the actual recapture amount. The report cites the 1988 GAO report which estimates that the after-tax value of the subsidy to the typical homebuyer is $40 a month. Assuming this is the potential recapture rate, the maximum possible recapture amount will increase on a pro rata basis to $2,400 at the end of year five and then will decrease to zero at the end of year ten. Unless the recapture phaseout is

See comment 8.

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eliminated, the amount by which the recapture amount exceeds the administrative and compliance costs may not be substantial, especially since the recapture amount is capped at 50 percent of the gain on disposition of the home.

See comment 9.

The QMB and MCC programs may also be inherently self-policing. This is in part due to the fact that there is a ceiling on the amount of QMBs and MCCs that a state or local housing agency may issue, which suggests that states have an incentive to insure that the subsidy goes to those for whom it was intended. It is also in part due to the fact that the eligibility requirements limit the pool of potential beneficiaries and the value of purchased housing. In general, beneficiaries must be first-time homebuyers with incomes that do not exceed 115 percent of the area median income, and assisted mortgages can be used only to purchase a home that costs less than 90 percent of the area average.

See comment 10. (Page reference in final report is p.16.)

The report should clarify whether income eligibility refers to the maximum amount of income that a homebuyer could have and still qualify for assistance or the amount of income that would subject a homebuyer to full recapture (see, for example, the first full paragraph on p. 19).

See comment 11.

Finally, the analysis of the percent by which income must increase in order to trigger recapture under different scenarios could also be clarified. Because recapture is triggered if income exceeds the maximum qualifying income in the year of disposition, the percent by which income must increase is obviously dependent on the amount of starting income. The hypothetical scenarios included in the report may only confuse this straightforward issue.

If you have any questions concerning these comments, please contact William Trautman of my staff at 566-2203.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

The following are GAO's comments on the Department of the Treasury's letter dated July 9, 1990.

GAO Comments

1. While we did not attempt to quantify the added costs involved in tailoring the recapture formula more to the benefit received, we expect that the additional cost per home owner would be small. The additional effort would entail computing the difference in monthly housing costs between the reduced interest-rate QMB loan and a market-rate loan of comparable terms. The results of this computation would be provided to the assisted owner and retained by the lender or the housing agency. The cost of this approach should be weighed against the benefits derived from it.

Regarding compliance, the seller's tax return could, at the Internal Revenue Service's discretion, identify the dollar amount of the monthly reduction, the number of months the home was held, and the product of these two amounts as the unreduced recapture amount. Should the Service decide to audit a taxpayer's return, it would request all pertinent documentation, as it does for other taxpayer audits.

2. Treasury's observation is correct if the only alternative to the QMB loan is an adjustable-rate mortgage that provides for annual adjustments. However, the fixed-rate, market-rate loan provides for a constant differential over the life of the loan.

3. This final report clarifies this point.

4. We added Treasury's comment to this final report.

5. We believe that the draft that we provided to Treasury and this final report outline how this approach could be implemented. Changes to income eligibility limits are not necessary to carry out the conventional affordability test described in this report.

6. Both the draft report provided to Treasury and this final report discuss that refinancing is not necessary under the approach we present. We have added language that further clarifies this point. Also discussed is the administrative cost trade-off between annual income reexaminations and less frequent reexaminations. Finally, both the draft report and this final report provide an estimate, based on similar activities, of the administrative cost of the roll-over approach.

7. Neither our draft report nor this final report recommend that the Congress substitute an income-based variable payment loan as an alternative to the recapture mechanism.

8. We did not consider the alternative of having no recapture requirement because the statutory study requirement was clear in its charge that we study recapture and other alternatives that would achieve the congressional objectives set out for it.

9. We agree that state and local agencies have an incentive to make loans to those who meet the first-time buyer, income, and home purchase price requirements. If these requirements were not met (and if the Service enforced these provisions), then the underlying bonds would lose their tax-exempt status. If a bond loses its tax-exempt status, it would become taxable. On future issues, investors would require higher interest rates because of the uncertainty over the tax-exempt status of the bonds. This discussion was included in our March 1988 report.[1] However, we do not believe that it is germane to this report.

10. We believe that the term "income eligibility limits" clearly identifies eligibility for QMB loans or MCCs.

11. We do not believe that the analysis is as straightforward as Treasury suggests. The starting income, the recapture formula's $5,000 constant, and the number of years before the home is sold all contribute to the different shapes and levels of the curves. This very point is illustrated by the charts in chapter 2 and appendix II.

[1] We reported in 1988 that the Service had no ongoing compliance review program for QMBs. See pp. 92-93 of Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988).

Major Contributors to This Report

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Related GAO Products

Home Ownership: Targeting Assistance to Buyers Through Qualified Mortgage Bonds (GAO/RCED-88-190BR, June 27, 1988).

"Role of Qualified Mortgage Bonds in Providing Home Ownership Opportunities," Testimony Before the Subcommittee on Taxation and Debt Management, Senate Committee on Finance (GAO/T-RCED-88-31, Mar. 28, 1988).

Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988).

"S-1598, The First Time Homebuyer Assistance Act of 1983," Testimony Before the Senate Committee on Finance, Sept. 13, 1983.

"The Costs and Benefits of Single-Family Mortgage Revenue Bonds," Testimony Before the House Committee on Ways and Means, June 15, 1983.

"The Costs and Benefits of Single-Family Mortgage Revenue Bonds," Testimony Before the Subcommittee on Taxation and Debt Management, Senate Committee on Finance, May 13, 1983.

The Costs and Benefits of Single-Family Mortgage Revenue Bonds: Preliminary Report (GAO/RCED-83-145, Apr. 18, 1983).

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