

AFFORDABILITY PRESERVATION PROJECT

Mortgage

How does the Model work?

Typically, affordable single-family housing involves a subsidy to the homeowner from the subsidy provider, either through a “below market” purchase price or a low- or no-interest loan. As home values increase, the initial beneficiary of the subsidy can receive a windfall when they sell the home and capture the appreciation (even after repayment of the subsidy). The appreciated price of the home may also take it out of reach of the targeted low- or moderate-income homeowner. The goal of preserving affordable single-family housing can, to some degree, be achieved by the use of mortgage controls. In addition, this model provides a means for the subsidy provider to recapture the loan or subsidy and generates cash flow for future subsidies or operating requirements.

The subsidy provider, which may be a non-profit corporation, would sell one of its homes to a low- or moderate-income person who meets the criteria that it has established. The subsidy provider can determine if it wishes to sell the house at a reduced price and/or provide a low- or no-interest loan. If a reduced price is offered, the “subsidy” can be recaptured either in the form of a promissory note for the amount of the subsidy (plus the amount of any accompanying loan) or in the mortgage through a provision to recapture the amount upon sale and/or to share in the appreciation upon sale through a predetermined formula. If a low- or no-interest loan is made, this form of “subsidy” would be recaptured in a promissory note for the amount of the loan secured by a mortgage. The amount and frequency of the principal payments under the note can be determined by the subsidy provider based upon the cash flow it would like to generate, keeping in mind the financial ability of the homeowner to make the required payments. Similarly, the subsidy provider can determine the term (amortization period) of the promissory note, which can be of any length of time, but generally would be long-term (e.g., 30 years or more), to increase the affordability of payments. It is expected that the promissory note would be due and payable upon the sale of the house in any event, unless the sale was to a permitted family member or income-qualified buyer. It is also expected that this mortgage would provide limited funding and be second (subordinate) to a purchase money mortgage.

The mortgage, in addition to serving to secure repayment of the subsidy or loan, could include a provision that the home be the principal residence of the mortgagor/buyer, a shared appreciation clause, a restriction allowing a sale or transfer only to a spouse or child or to an income-qualified buyer, a restriction limiting a sale to a maximum sale price, and/or a right of first purchase. Restricting sales to a maximum sale price is a useful tool to maintain affordability. The right of first purchase clause would also be a key to maintaining future affordability. It would require that the buyer, before going to market or selling to a third party, offer the home to the subsidy provider based on a predetermined formula (which could be similar or the same as that which is used in the Community Land Trust model). The subsidy provider must be given enough time to find a new low- or moderate-income buyer (who could take an assignment of the purchase option from the subsidy provider) or to acquire the funds needed to purchase the home itself and then find another buyer. Often times, local non-profit organizations that focus on affordable housing maintain “waiting lists” of people who would like subsidized housing. This reduces the amount of time the subsidy provider will need to find a new low- or moderate-income buyer.

Implications of the Model.

Using traditional legal documentation, mortgages are familiar and acceptable to buyers and first mortgage holders. However, the subsidy provider needs to be aware of Michigan and federal licensing and disclosure requirements. Regulation Z (sometimes known as Truth In Lending) and the Real Estate Settlement Procedures Act (RESPA) apply to consumer loans secured by residential real estate, subject to certain exemptions depending upon the nature of the lender and the number and dollar amounts of loans made during a year by the lender. Regulation Z, for example, would apply if the lender made more than 5 mortgage loans in a calendar year (or more than 25 consumer loans whether or not secured by a mortgage during a calendar year).

In addition, a non-profit corporation may be required under Michigan law to be licensed as a mortgage lender depending upon the number of loans it makes during a year. Under the Michigan Secondary Mortgage Loan Act, licensing is required for a lender that makes or negotiates more than 2 second mortgage loans or acts as a servicer for more than 10 second mortgage loans in a calendar year. If the subsidy provider makes or services more than 10 first position mortgage loans in a 12 month period (July 1 to June 30), then it will be subject to (and must be licensed under) the Mortgage Brokers, Lenders and Servicers Licensing Act. There is a process for a non-profit corporation meeting certain requirements to request a licensing exemption from the Michigan commission of financial services.

Also, the subsidy provider who chooses a mortgage term in excess of 30 years needs to be aware of MCL 565.382, which provides that a recorded mortgage which is not renewed is considered discharged 30 years after its due date or, if no due date is recited in the mortgage, 30 years after it is recorded. The federal tax treatment of forgiven interest or principal will either result in a reduction in the basis of the property or be treated as additional income.

Implications for Michigan property taxes.

This model presents no issues with respect to Michigan property taxes, except potentially with respect to a right of first purchase that is included in the mortgage. The homeowner may be able to obtain a reduced assessed value where the fair market value of the home is capped by a right of first purchase.

Impact on transferability and title.

A mortgage with a due on sale clause is a commonly used document and will not affect a property transfer, as it becomes payable at the time of the sale from the loan proceeds. However, if the mortgage includes restrictions as to eligible buyers and limits the maximum sale price, this is out of the ordinary and needs to be understood by the buyer. If the mortgage includes a right of first purchase, this will affect the buyer's ability to freely transfer the home, as the buyer must comply with the particular requirements imposed in the mortgage. It is the right of first purchase which may be unfamiliar to a buyer and needs to be clearly explained and understood by the buyer prior to purchasing the home. There are no issues with respect to obtaining either an owner's or lender's title insurance policy where a mortgage is involved. The subsidy provider's mortgage will almost certainly be subordinated to a third-party's financing.

Protection of third-party interests.

The parties involved in this model are the subsidy provider, the homeowner and the third-party financing source. The subsidy provider and the homeowner are protected by the promissory note and the mortgage, which outline their respective rights and duties. The enforceability of a note and mortgage, including foreclosure issues, is well established. A third-party financing source will be protected by requiring that it be in first place (typically through means of the subordination of the subsidy provider's mortgage). Being in a subordinate position, however, creates risk to the viability of the subsidy provider's mortgage. It must be in a position to either buy out the first lender position or to redeem the first lender's mortgage if the first lender forecloses. This would require it to have some readily available source of cash or financing. Often times, local non-profit organizations that focus on affordable housing maintain "waiting lists" of people who would like subsidized housing. This reduces the amount of time the subsidy provider will need to find a new low- or moderate-income buyer in the event it takes title after a foreclosure.

Implications for bankruptcy.

A bankruptcy court may not uphold specific terms of a mortgage, even though the subsidy provider remains a secured creditor. This could adversely impact the enforceability of a right of first purchase. As an alternative to a mortgage, the subsidy provider could use a land contract. The land contract combines the note and mortgage and is basically an installment sales contract. It is a commonly used document in Michigan and for almost all purposes is treated the same as a mortgage. One area of different treatment, though, is in bankruptcy. Because a land contract is considered an executory contract under Michigan law, it may be rejected in bankruptcy. However, in that case the land would then revert to the land contract holder (e.g. the subsidy provider).

Implications for third-party financing.

A mortgage in favor of a subsidy provider should not affect the ability to obtain third-party financing in most instances, since the third-party lender will simply require that its mortgage be superior to the subsidy provider's mortgage.

Enforcement mechanisms.

There is less need to monitor the property when using a mortgage versus other models, since, upon sale, a new lender will insist upon the subsidy provider's mortgage being paid off or subordinated. Also, mortgage foreclosure procedures are well defined. A subsidy provider may nonetheless choose to monitor various provisions of the mortgage, such as the buyer maintaining the home as his or her principal residence and maintenance and insurance requirements. The problem with a mortgage is that, once the home is sold, it disappears and must be replaced with another mortgage providing similar protections for affordability. Also, if the buyer has the money even prior to sale, he or she may want to pay the mortgage before it is due and thereby be free of its restrictions. The accompanying note attempts to prevent this by prohibiting prepayment. In addition, a second position mortgage is always subject to the risks of a default under the first mortgage and must be prepared to cure those defaults or to pay off the first mortgage in the event of a foreclosure by the first mortgagee. Finally, if a mortgagor ignores restrictions in a mortgage as to whom it may sell to (e.g., only to income-qualified buyers) and as to maximum sale price, the subsidy provider will only be left with its default remedies under the mortgage. Even though

the subsidy provider may foreclose the mortgage, the new owner (assuming it has available funds) can simply payoff the mortgage and be free of its restrictions to protect affordability.

Implications for scattered site development.

A mortgage is ideally suited for use either in a clustered home or scattered site setting.

This document is a product of the Community Legal Resources Affordability Preservation Project. Please check the CLR Affordability Preservation Project website for updates to this document:

www.clronline.org/app

This publication is intended to provide general information, and is not a substitute for legal advice. If you have additional questions about this issue, contact Community Legal Resources at 313/964-4130.

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