Repair and Replacement Reserves for Resale Restricted Housing: A How to Guide

Introduction

As the stock of resale restricted housing has aged, the organizations and governments responsible for overseeing resale transactions have improved their programs to ensure that they address the long term repair and replacement needs of major capital systems within those homes. Since the "market" does not automatically take care of this, and since the ability to negotiate condition for price is limited in resale restricted transactions, alternative safeguards are needed to ensure that these homes are adequately maintained over time and that the major capital systems are replaced as needed to maintain the integrity of the structure for the long haul.

This guide provides an overview of a variety of mechanisms that address these issues as well as a detailed outline of how to create a reserve for the repair and replacement of major capital systems within resale restricted housing.

Why Reserves?

Resale restricted housing was conceived to create a stock of affordable homeownership units that *remain* affordable in the long run. The idea is simple, a homebuyer purchase a home at a below-market price, and in exchange for that affordable price, that homebuyer agrees to limit the amount of appreciation they receive when they sell their home to another, low-income buyer. As time has tested this idea, it has become clear that if we are going to fix the price of this housing, we must take additional steps to ensure that this housing is adequately maintained.

Non-profit organizations and governments that produce and steward resale restricted housing use public resources to create that housing, and in doing so, commit to those public entities that the housing produced will remain affordable for a long, designated period of time. Given that, it is incumbent upon those programs to build safeguards to make sure that the buildings themselves remain standing and functional at least for the period of affordability.

Traditionally, the market is responsible for this oversight, and homeowners either reinvest in their homes over time, thereby maintaining the structure and its associated value, or they do not. If they do not reinvest over time, the market compensates with a substantially lower price at resale, allowing the next buyer the financial ability to make such an investment, or the home deteriorates to such as state that it is abandoned or demolished to make room for the next structure in its place. However, out of concerns for the affordability of housing over time, resale restricted housing does not typically allow this type of market correction.

In response to this concern, several different mechanisms have been created to help ensure that the housing stock is maintained for the duration of the affordability restrictions and beyond.

These mechanisms fall into a few broad categories – adjustments within the resale formula, additional investments at resale, and reserve funds. It is important to note that one, two or all three of these approaches may be implemented simultaneously as each has its strengths and challenges.

Resale Formula

At first glance, it often appears that the best and easiest way to address the issue of significant repairs and systems replacement is thru the resale formula and many formulas were initially designed to do just that. In addition to the appreciation offered by the resale formula, programs added clauses to their formula that allow homeowners to receive credit for various improvements. In order to minimize disputes, many formulas relied on appraisals to provide a "value" for these improvements, which would automatically adjust for depreciation etc. But these incentives failed to produce the desired result in part because an investment such as a new roof does not actually add any value to the appraised value of a home. Appraisals assume that the home has a functioning roof. The types of improvements that add appraised value tend to be limited to cosmetic improvements (new counter tops) or increases in square footage.

The next generation of capital improvements credits tried to do a better job of addressing this problem by calling out specifically the types of improvements/systems that were eligible for credit, and by tying the added value to something other than increases in appraised value. KulshanCLT in Bellingham, Washington, added such a clause to its resale formula. In an effort to provide incentives to homeowners to replace aging wiring, boilers and roofs, KulshanCLT's formula allows its homeowners to receive credit if and when they replace more than 50% of a capital system from a defined list of systems. Homeowners who are approved for such credits receive 100% of the cost of their capital system replacement at resale. This type of formula does a better job of incentivizing the types of capital investments necessary to maintain the integrity of a home over time, but it too has its shortcomings. Homeowners who do not have the resources to make the investment will still not be able to replace their systems, even with the promise of compensation down the road. And then there is the issue of depreciation. If someone replaces a system when they move in and proceeds to live in the house for the remaining useful life of that system, do they still get the full credit? What is the impact on affordability over time if many homebuyers take advantage of such a credit? Programs that have more conservative resale formulas have more room to offer such incentives but programs whose resale formulas are more generous may find such credits price their homes out of the range of affordability for low-income homebuyers.

Investments at Resale

Another option for replacing major capital systems is to reinvest at the time of resale. From time to time, resale restricted programs have found it necessary to step in and invest additional resources into their homes *between* owners. Like capital systems credits, this is only possible if the resale formula produces a price that is low enough to allow for additional investments at resale that do not render the home unaffordable to the next low-income buyer. But unlike the capital system credit, depreciation is less of an issue. However, in this scenario, repairs may be more expensive if they have been deferred. That being said, this approach is easy to implement in the absence of a more thoughtful program or plan.

Reserve Fund Considerations

In an effort to be proactive and plan for the long term sustainability of resale restricted housing, affordable housing programs have started to create and implement repair and replacement reserves. These programs function much like condo associations in that they collect fees from the owners and accrue those funds for future repairs and capital investments into the homes in the future. The specific goals of these funds vary, but generally speaking, they are intended to create a resource for programs and homeowners to use to ensure the long term viability of this housing stock.

There are a variety of ways to fund and manage repair and replacement reserves. The following sections will outline the various alternatives and weight the pros and cons of each.

Reserve Fund Goals

In order to design an effective reserve fund, it is important to clearly articulate the goals of the fund.

Housing Stock: The first step is to assess of the types and quality of the housing stock the fund will be designed to serve. Which of the follow best describes the portfolio?

- Older housing stock with significant, existing needs for investment?
- Housing stock of varying age and quality?
- Newly constructed, durable homes?
- Newly constructed homes but made from less durable materials?
- Condominiums with condo association fees? If so, do they have established/adequate reserve funds? Who controls them?

The answers to the questions above will influence the design of the reserve fund. Programs that are currently building quality, durable homes, will not likely need significant reserves for a long period of time. Conversely, programs that are composed of older, existing housing stock may have significant immediate needs for investments. Programs that have some of each may need to configure their reserve funds so they accrue at different rates for the different needs within their portfolio.

Existing Programs & Resources: The next step is to research and evaluate existing programs that are currently in place.

- Does the resale formula address any repair/replacement issues? Is it working?
- Is there room to reinvest at resale?

- Is there a revolving loan fund currently available to homeowners? If so, is it effective in meeting the needs and how long might it continue to be available?
- Is there an emergency repair currently available to homeowners? If so, is it effective in meeting the needs and how long might it continue to be available?

Purpose of the Fund: Once it is decided that the existing resources are not sufficient to address the needs of the portfolio of resale restricted housing for the long run, it is time to consider the intended purpose of such a fund. Is the fund intended solely to protect the long term integrity of the home? Is the fund intended to address health and safety issues? Or is it intended to improve the energy efficiency of the portfolio over time? Is the goal to provide a resource to homeowners to help protect them from large, unexpected expenses? The answers to these questions may be more evident after looking into several key sub-categories.

Types of Reserve Funds: There are two basic types of funds, emergency funds for use as needed in unusual circumstances and funds designed for regular, scheduled investments into the property.

Control of the Funds: Once that distinction has been made, the next decision has to do with who is responsible for the controlling what repairs are done and when. This too falls into two basic categories, funds that are directed for use by program staff and funds that are directed for use by the homeowners themselves, within defined parameters.

Targeted Building Components: Given the type, age and condition of the housing stock, what building components are the most important in terms of protecting the integrity of the home in the long run? The types and extent of building components targeted for repair and replacement reserves will vary greatly depending on the decisions made regarding the type of fund and who controls its use. If the fund is intended for emergency uses as directed by program staff, the guidelines may be quite flexible in terms of allowable investments. On the other hand, if the program is intended for regular, scheduled investments directed by the homeowners themselves, it is much more important to have a clearly defined, limited list of eligible components eligible for these capital investments.

Reserve Fund Options

In practice, there are three basic types of reserve funds, each of which as its own pros and cons. One is to create a resource for use by homeowners, similar to how a condo association might plan for the long term repair and replacement of major building components (homeowner directed). The other is to create a resource available to homeowners who otherwise lack such resources through some sort of loan program (emergency loan fund). And the third is to create a fund for use by the program to intervene (generally at resale) and do whatever is necessary to ensure the new buyer is buying a quality home (program directed). Which approach will best fit depends in part on the considerations outlined above, as well as the very practical implications of balancing the need for a resource with the affordability of the homes and the program's ability to administer whatever system it establishes.

The following tables outline each of the basic approaches, starting with a program that makes funds available to homeowners for use on a defined list of capital investments at defined intervals.

Homeowner Directed Reserve Funds	
Pros	**Cons**
✦ *Homeowners remain directly and solely responsible for carrying out long-term repair and replacement of major building components.* ✦ *Scheduled access to resources for repair and replacement encourages timely and regular repair and replacement which should save money in the long run.* ✦ *Since homeowners pay into the fund and then have scheduled access to the resources, they do not have to request "assistance" in order to pay for scheduled repair and replacement.* ✦ *There is an element of fairness since all homeowners that "consume" a portion of the house pay to replace it.*	✦ *Funds may not be sufficient to pay for intended repairs.* ✦ *Unrealistic expectations on the part of the homeowner about what the fund can pay for may create conflict.* ✦ *Cumbersome bookkeeping.* ✦ *Homeowner may not track the timing of necessary repairs (building life cycle issue).*
Emergency Loan Fund	
Pros	**Cons**
✦ *Pooled funds mean less money is required to support the fund (there is an expectation that it will only be used by some homeowners, not all).* ✦ *More like conventional homeownership in that homeowners are expected to have the resources to pay for all repairs themselves and the repair and replacement reserve is a resource for those who cannot.* ✦ *Easier to administer (because it is used less frequently).* ✦ *Allows for more flexibility in use since fewer*	✦ *Homeowners must ask for "assistance."* ✦ *There is a sense that the program is providing the money rather than the homeowners themselves.* ✦ *Higher risk that homes will generally suffer more deferred maintenance because resources are not available to all homeowners.* ✦ *Less bookkeeping on the front end (since funds are not assigned to specific properties), but potentially more bookkeeping in terms of tracking monthly loan payments, default etc.*

homeowners will need to access the fund.	
Program Directed Reserve Fund	
Pros	**Cons**
✦ *Pooled funds mean less money is required to support the fund (there is an expectation that this fund will be unnecessary for most homes).* ✦ *Easiest to administer (Since it is primarily used at resale, no homeowner interaction necessary. If it is used during the homeowner's tenure, it is more like the loan funds described above).* ✦ *Most like conventional homeownership – homeowners are on their own to find adequate resources to maintain their homes.* ✦ *Allows for more flexibility in use since funds will be invested in fewer homes and at the discretion of program staff.*	✦ *Least homeowner accountability of the 3 options.* ✦ *Least homeowner support of the 3 options.* ✦ *May end up more costly in the end if building deteriorates as a result of lack of maintenance.* ✦ *Higher risk that homes will generally suffer more deferred maintenance, even when emergency funds are not required at resale.*

Funding a Home Repair and Replacement Reserve

The next challenge is deciding how to fund a repair and replacement reserve. Once again, there are several basic approaches, each of which has its own pros and cons. Some programs fund their reserves via monthly fees paid by the homeowners themselves. Others charge a fee to either the buyer or seller at the time of sale.

Which approach will best meet the needs of the program depends, in part, on some very practical considerations. For instance, if the program already collects a monthly fee, it will not significantly increase the administrative burden to increase that fee to include a portion designated for the reserves. On the other hand, if the program does not already collect a monthly fee, adding such a fee may create significant time and expense.

Before looking in more detail at the various options for collecting a fee, it is valuable to consider the math. All three of these impact the affordability of this housing in some way. If homeowners pay a monthly fee to fund the reserve, that fee is included in their front end ratios for the purposes of underwriting and qualifying for a mortgage to purchase their home. If a buyer is purchasing a home with a 6%, 30-year fixed rate mortgage, a $50 monthly fee will reduce their borrowing power by approximately $8,300. In other words, that homebuyer can afford $8,300 less house because of the additional $50 monthly fee. So another way to approach this would be to fund the reserve up front by selling the house for $8,300 more. In both cases the buyers' monthly payment is the same and in both cases there will be money in the reserves. But the two approaches *feel* different.

The following table outlines the pros and cons of the three basic approaches to funding a reserve.

Homeowner Fee Existing owners pay a monthly fee that is put into the designated fund. The fee may be identified as a reserve fund that they will later be able to access or it may be part of a larger administrative fee that is not designated for each owner's use.	
Pros	**Cons**
✦ *Creates a steady stream of income to the fund and a steady increase in fund balance over time.* ✦ *Spreads the burden across all homeowners (including the first buyer).* ✦ *Different properties can be assessed different fees depending on the building components and corresponding repair and replacement needs of those properties.* ✦ *Funds begin accumulating before the first resale and therefore are available to original homeowners with longer tenure.* ✦ *Monthly housing costs are higher, but better reflect the true cost of homeownership.*	✦ *Cumbersome bookkeeping.* ✦ *Can make monthly fees appear too high.* ✦ *People tend to believe/feel monthly fees "belong" to the homeowner – which can create problems if their expectations are not met.* ✦ *Less flexibility re: use from the perspective of the program.* ✦ *Increases the subsidy needed up front because it reduces the borrowing power of the homebuyers.*

<table>
<tr><th colspan="2">Resale Fee – Paid by Buyer

A fee is added onto the formula price and is then paid by the buyer when they purchase the house.</th></tr>
<tr><th>Pros</th><th>Cons</th></tr>
<tr><td>✦ Fee is hidden.
✦ Funds may be more flexible (since there is a less direct tie between the fund and the homebuyer).</td><td>✦ Can be confusing – seller and buyer have different "prices."
✦ Reserve funds are often cut from initial budgets and when they are included, they increase the initial subsidy required. Financially, this has a similar impact as assessing a monthly fee but the lump sum reserve line in the budget is more likely to be cut.
✦ Unless it is included in the original development/acquisition budget, the fund is not available to the initial homebuyers, even those with significant tenure.
✦ It may prove to be impossible to add the fee on at resale if there is not room in terms of affordability.
✦ Many groups collect operating funds this way and may find it difficult to increase the % added to include reserve funds. Likewise, when programs fund both operating and reserves out of the same mechanism, there is a risk that operating needs will outweigh the need to proactively fund the reserves.
<u>Note: The programs contacted that fund their reserves out of buyer paid resale fees had in fact stopped funding reserves in favor of operating expenses.</u></td></tr>
</table>

Resale Fee – Paid by Seller A fee is paid by the seller at closing out of their limited appreciation.	
Pros	**Cons**
✦ *Funds may be more flexible (since there is no tie between the fund and the homebuyer).* ✦ *No impact on the amount of subsidy needed up front.*	✦ *Comes from seller's already limited equity.* ✦ *Many groups collect operating funds this way and may find it difficult to increase the % added to include reserve funds. Likewise, when programs fund both operating and reserves out of the same mechanism, there is a risk that operating needs will outweigh the need to proactively fund the reserves.* ✦ *Since it is funded out of seller's proceeds, it is not available to the original homebuyer, even those with significant tenure.*

Implementing a Home Repair and Replacement Reserve Program

Now that the program has decided on its goals and how to fund it, it is time to consider what it will take to implement such a program. Each of the three program types has a slightly different set of practical considerations for implementation.

Homeowner Directed

In an effort to minimize disputes and staff time necessary for oversight, homebuyer directed funds generally limit the allowable uses to a very short, specific list of building components. Similarly, programs may provide homeowners with a schedule of specific components that can be paid for out of the fund, each with its own line item dollar amount and expected life cycle. Not only does this help educate the homeowners about the expected work needed to maintain their home, it alerts them to potential financial shortfalls of the fund down the road.

Additional components of a homebuyer directed program might include:

1. Required documentation for reimbursement of expenses associated allowable repairs/replacement.
2. Approved contractor list, license requirements and warranty considerations.
3. Material choices, quality of product and work, etc.
4. Compensation for repairs completed by the homeowner themselves.
5. Potential process for appeals/uses beyond the approved list.

6. Homeowner statements of reserve fund status.

Emergency Loan Fund

Unlike homeowner directed funds, emergency loan funds are pooled funds available for periodic use. Some funds are designed as a loan of last resort while others are designed to be an on-going resource available to homeowners who need it in hopes that the resource will encourage timely repair/replacement.

Additional components of an emergency loan fund may include:

1. List of eligible uses or need based program.
2. Minimum or maximum loan amounts.
3. Deferred loans vs. payable loans.
4. Secured or unsecured.
5. Interest bearing or low-no interest.
6. Set terms or flexible based on payment ability and means testing.
7. Underwriting criteria.

Program Directed Fund

Program directed funds are generally the most flexible funds and therefore require the least amount of programmatic infrastructure. The risk, on the other hand, is that the fund is not actually funded or is redirected for other purposes when times are tight. However, it remains valuable to create a set of parameters within which staff can use the funds for their intended purpose.

Additional components of a program directed fund include:

1. Basic guidelines for use of the fund.
2. Limit to repairs/replacement or allow fund for use to improve affordability if necessary.
3. To what extent are the funds recovered when the home is sold?

The following section contains sample documents for both homeowner directed programs and emergency loan funds. At the time of this writing, there we no program directed funds that maintained written policies and procedures from which to create sample documents.

SAMPLE Home Repair and Replacement Reserve Fund -- Language & Policy for a Homeowner Directed Program (Monthly Fee)

The following language is intended for use in a deed restriction or ground lease when implementing a monthly fee to fund a reserve for use by homeowners in maintaining their homes.

A Monthly Home Repair and Replacement Reserve Fee, established at the commencement of this Deed Restriction/Lease is ________________ dollars ($).

1) ***Home Repair and Replacement Reserve Fee***: The parties acknowledge that the Homeowner is responsible for all maintenance and repair of the Home, as set forth in this Deed Restriction/Lease. As an additional assurance that all Homeowners are able to comply with their maintenance and repair obligations, the Program and the Homeowner agree that a Home Repair and Replacement Reserve Fee will be collected from the Homeowner as part of the Monthly Fee, and held as a reserve by the Program for the capital maintenance of specific portions of the Home.

2) ***Release of Funds***: Policies and procedures for the use of Home Repair and Replacement Reserves are specified in Exhibit F: HOME REPAIR AND REPLACEMENT RESERVES. The Program may reasonably withhold Home Repair and Replacement Reserve funds if the requested use is for purely aesthetic exterior alterations (such as a change in paint color when existing paint is still in good condition) or to repair items damaged by neglect.

3) ***Reserve Funds are Nonrefundable***: The Home Repair and Replacement Reserves are explicitly the property of the Program, but may only be used for the capital maintenance of the Property. The Homeowner acknowledges that the Home Repair and Replacement Reserves are intended for, and shall remain with the Home and not the Homeowner. In the event that the Home is sold or transferred by the Homeowner, the unused Home Repair and Replacement Reserves will be retained by the Program for the future capital repairs or replacements of the Home.

4) ***Costs in Excess of Reserves****:* Any capital costs that exceed the amount of available Home Repair and Replacement Reserves will be borne by the Homeowner.

5) ***Yearly Report upon Request***: No later than September 30th of each year, the Program will make available, upon the Homeowner's request, a detailed report of Home Repair and Replacement Reserve transactions for the prior fiscal year.

■ Exhibit F: Home Repair and Replacement Reserve Fee

Reserves collected through the Homeowner's monthly Home Repair and Replacement Reserve Fee are explicitly the property of the Program, but may only be used for the capital maintenance of the Property.

<u>Use of Reserve Funds:</u> The Home Repair and Replacement Reserves will be administered by the Program, and the Program will decide which capital repair or replacement costs are eligible for the use of the Reserves and shall specify those costs when the fund is established. Homeowner may request release of funds prior to completing the necessary repairs or replacements and the Program shall inform the Homeowner of the eligibility of the proposed expenses and the amount of funds available in the fund for use in such repairs. Upon satisfactory completion of the work and evidence of the expenses incurred, the Program shall release funds up to the amount quoted, at its sole discretion, if the requested use is found to be necessary and in accordance with the Reserve's intended use.

Specifically, the Home Repair and Replacement Reserves will be used for the repair and replacement of the following capital systems:

- The Roof
- The Exterior Siding and Trim (including paint)
- Other:____________________________

Homeowner remains solely responsible for the repair and replacement of the above listed capital components. System components will be replaced with products of comparable quality and features. During a system replacement, the Homeowner may opt to replace components with higher rather than comparable quality products. In this case, the Homeowner will pay the cost difference between the comparable quality and the higher quality product.

It is incumbent upon the Homeowner to notify the Program immediately of any deficiencies in the above capital systems. Damages resulting from failure to make prompt notice of deficiencies are the responsibility of the Homeowner.

<u>Exclusion of Items Covered by H/COA Dues:</u> In communities with homeowner or condominium owner associations, a portion of the above capital repair and/or replacement costs may be covered by the owner association dues. In this case, capital items that are specifically the responsibility of the owner association are explicitly excluded from coverage under the Home Repair and Replacement Reserves. The Homeowner's monthly Home Repair and Replacement Reserve Fee will be adjusted to reflect coverage of these items under the owner association dues.

TEMPLATE HOMEOWNER DIRECTED RESEVE FUND REQUEST FORM

Property address: ____

Homeowner name: ____

I would like to request the use of the Home Repair and Replacement Reserve Fund designated for the above listed property for the following repairs/maintenance: ____________________

____

____.

I have attached estimates or invoices for the work and certify that the estimates or invoices reflect only work that comply with the fund's intended use as outline in my Ground Lease/Deed Restriction.

Amount Requested: ____

Homeowner signature: ______________________________

Date: ______________________________

Program Administrator Use:

Eligible uses outlined in ground lease/deed restriction: ________________________________

____

Current fund balance:____

Funds available for requested repair:______________________________________

REQUEST APPROVED / DENIED (state reason):_____________________________________

AMOUNT APPROVED:____

Signature & Title: ____

Date: ____

MODEL Home Repair and Replacement Reserve – Language & Policy for a Loan Fund

The Program has established a loan fund for use by its Homeowners to pay for the ongoing repair and key component replacement needs of the Home. When funds are available, the Program shall make loans to its Homeowners under the following conditions:

1. The homeowner demonstrates that she or he has exhausted all other known avenues for obtaining funds;
2. The homeowner has sufficient equity in their home to repay the principal and anticipated interest on the loan;
3. The homeowner engages in financial counseling (with Program staff);
4. The homeowner is either current with their mortgage and all Program related fees, or through the process of this loan and financial counseling, will become current with a reasonable expectation that they will remain current;
5. The Program approves the requested repairs or replacement;
6. The homeowner demonstrates that she or he is able and committed to the following terms and conditions for the loan:
    a. The interest rate shall be a fixed rate equal to the current (Insert rate here) rate plus 1%;
    b. The work shall either be done by a licensed contractor (or the Program shall inspect the work, charging a fee for any time necessary);
    c. The homeowner shall sign a promissory note. For amounts greater than $5,000 Program staff shall file a subordinate deed of trust/mortgage to secure the note;
    d. Program staff may negotiate the terms of the promissory note, but at a minimum those terms shall include:
        1. Principal and interest are due in full upon sale, refinance or transfer of title.
        2. The note shall encourage monthly payments or regular payments to principal whenever financially viable.
        3. Staff shall provide a "Truth in Lending" statement that illustrates a comparison of the interest burden from making regular payments and not making payments.