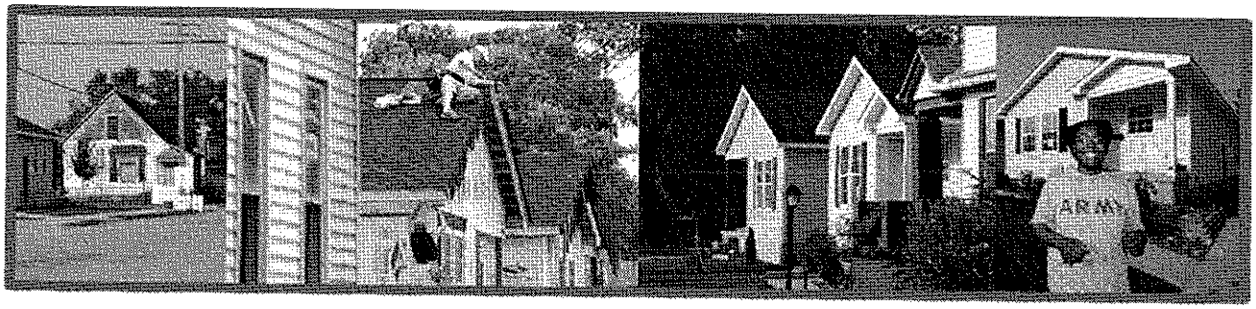

# HFHI's Overview and Guide to Affiliate Mortgage Leveraging Strategies

*(Mortgage Sale, Zero-Equivalent Mortgages, FlexCAP, Local Mortgage Backed Financing, and USDA 502 Loans)*

***March 2011***

## Overview

This guide is intended as a reference tool for Habitat for Humanity affiliates in the U.S. interested in mortgage leveraging programs. Effectively leveraging your affiliate's mortgage portfolio can accelerate your cash flow, increase your homebuilding capacity and improve your sustainability. This document explains the benefits and risks associated with mortgage leveraging generally, and provides an overview of several mortgage leveraging strategies, including examples and guidelines to ensure prudent and optimal use of an affiliate's mortgage portfolio.

### The Habitat Mortgage

*"If I were donating money to a not-for-profit and saw them piling up assets, I'd be wondering why they weren't using it for programs to feed the poor or educate students."*

- **Frank Kurre**, Managing Partner of Grant Thornton's nonprofit practice

Habitat affiliates in the U.S. collectively hold about 55,000 mortgages, with a book value of roughly $1.4 billion. For most affiliates, their mortgage portfolio is their largest and most important asset. However, unlike other mortgage lenders in the U.S., many Habitat affiliates hold their mortgages for the full term of the loan. As discussed in more detail below, since Habitat mortgages bear interest at 0%, they lose considerable value over time due to inflation. In order to promote the principles of good stewardship, HFHI encourages affiliates to explore methods of leveraging their mortgage portfolios. Leveraging may prove to be an effective means of helping the affiliate realize more of the value of its mortgages and, in turn, serve more families.

### Mortgage Leveraging Strategies for Habitat Affiliates

There are several ways for Habitat affiliates to leverage and accelerate their mortgage portfolios or to otherwise generate cash from house sales:

- participate in the FlexCAP Program administered by HFHI;
- obtain local mortgage-backed loans from or sell mortgages to a financial institution; or

- work with a third party lender who will originate the mortgages under an approved program such as USDA 502 or a "zero equivalent mortgage" program.

Despite their differences, all of these financing methods give affiliates ready cash to accelerate their building efforts. Each method is explained in more detail below.

## The Benefits of Leveraging Affiliate Mortgages

### Realizing the Value of Mortgages

When valuing a mortgage as an asset on an affiliate balance sheet in accordance with GAAP, affiliates are required to discount the mortgage to reflect the time value of money. This discount rate is provided by HFHI and historically has been set at around 8%. Because of this valuation method, affiliates often discover that their mortgage portfolio is worth less than half of the remaining balance of principal or "face value". For example, after application of an 8% discount rate, a mortgage with a face value of $100,000 and a remaining term of 20 years will be valued at roughly $50,000. The same mortgage will be valued at roughly $43,000 if the remaining term is 25 years. However, if an affiliate leverages its mortgages through FlexCAP or another local mortgage leveraging program, the affiliate can recover some of the value of its mortgage portfolio that would otherwise be lost. In other words, giving effect to the time value of money, affiliates that do not leverage the value of their mortgages will recapture less than 50% of the original face value of their mortgages, resulting in fewer funds to be applied towards their mission.

### Growing a Mortgage Portfolio

An affiliate which leverages its mortgages may have the opportunity to grow its mortgage portfolio at a faster pace. By using cash proceeds from mortgage leveraging programs for home building activities, an affiliate can accelerate house-building and, consequently, create more mortgages.

### Ability to Fund Growth-Related Initiatives

Many affiliates want to grow their mission by investing in large scale development, major land acquisition, or other strategies involving large upfront costs. Some affiliates have leveraged the value of their mortgage portfolios to fund that growth. Having an "upfront" infusion of cash has allowed these affiliates to increase their capacity to serve more families. Specific examples include:

- ***Building Infrastructure-*** Some affiliates have found it more challenging to raise funds for sewers and sidewalks than to raise funds for house construction, as many donors prefer to put their money into the direct costs of a house. The affiliate can use funds raised from leveraging mortgages to cover these development costs. This in turn allows the overall project to be finished more quickly, while still respecting donor intent.
- ***Purchasing Land-*** Many affiliates use cash from mortgage leveraging to purchase low cost land for large-scale multi-year development projects.

- ***Purchasing Foreclosed Properties/Vacant Lots-*** Upfront cash is beneficial for affiliates looking to acquire low-cost foreclosures and vacant lots. Upfront cash allows affiliates to take advantage of these time sensitive opportunities.

### Bridge Financing

Mortgage leveraging also allows affiliates to take advantage of reimbursable grants without depleting their cash flow for operations. Many affiliates have used mortgage leveraging as a bridge to grant- or donor-matched funding. The ability to convert a portion of their mortgage portfolio to cash has enabled these affiliates to take advantage of these types of opportunities, allowing them to serve more families.

Based on these considerations, one might assume that mortgage leveraging should be an essential part of every affiliate's development. However, mortgage leveraging is not right for every affiliate. Before entering into any mortgage leveraging program, your affiliate must carefully review the risks and requirements of any such program, or you may find the program to be more harmful than helpful. The following sections explain key considerations an affiliate should weigh before deciding whether or not to pursue a mortgage leveraging program.

## Key Considerations for All Mortgage Leveraging Strategies

### Don't Replace Traditional Fundraising with Mortgage Leveraging

*"The most important thing we and affiliates must learn is that fundraising is the only reason we can serve very low-income families. Affiliates who turn to debt and AAR (Accelerated Asset Recovery) programs to replace or reduce their fundraising efforts are eating their seed corn."*

-**Millard Fuller**, founder of Habitat for Humanity

Leveraging mortgages is not a substitute for traditional fundraising. If the two are not paired together, an affiliate can become too reliant on financing programs and lose existing and potential donors in the process. Not only are donors critical to Habitat from a fundraising standpoint, but relationships with donors may provide important support for Habitat in other areas, including advocacy, volunteer involvement and the leveraging of other resources in the community. Without cultivating these other resources, your portfolio will become over-leveraged and impact your affiliate's financial stability.

### Align Your Mortgage Leveraging Strategy with Your Growth Plan

Leveraging your mortgages will not create automatic growth. To create growth, your affiliate must have a clear plan of how and where it will spend its proceeds, replace the foregone cash flow, and leverage the value of those proceeds through fundraising. At its essence, mortgage leveraging is spending tomorrow's cash flow today. Therefore, the only sustainable way to use those funds is to create more assets to replace the ones being leveraged. Some affiliates have imposed internal requirements on themselves, such as every mortgage leveraged must yield one or more houses in the future.

### Avoid Leveraging Mortgages for Operational Expenses

Similar to the previous point, proceeds from mortgage leveraging transactions should not be spent on operating expenses. These expenses accelerate the draining of tomorrow's cash flow without replacing it with additional income streams. The focus for proceeds of mortgage leveraging transactions should be on expenses that translate into building capacity, such as covering the costs of expanded fundraising. As stated above, setting goals to expand your affiliate is a good way to do this. For example, rather than saying that your affiliate will use the funds to cover certain costs, set a goal that your affiliate will use the funds in a way that will result in production of a specified number of additional houses in the current year over the number of houses produced in the prior year.

### Continue to Serve Homeowners by Maintaining Rights to Intervene

As a Christian housing ministry, the affiliate's relationships with individual homeowners are its most important relationships. Affiliates must always retain the right to intervene in the event that a mortgage becomes delinquent. Affiliates should never allow their relationship with a funder to supersede or in any way interfere with the relationship they have established with a Habitat homeowner.

### Maintain a Sufficient Reserve

Affiliates must maintain either sufficient cash reserves or sufficient mortgage collateral reserves to repurchase or substitute for a mortgage in the event of a delinquency. Cash reserves should directly coincide with delinquency rates. For collateral reserves, HFHI recommends that an affiliate leverage ***no more than 60% of its performing mortgage portfolio***. In addition, HFHI strongly recommends that any affiliate considering a mortgage leveraging program have a policy approved by its Board of Directors regarding this reserve.

### Consider Affiliate Characteristics when Adopting a Mortgage Leveraging Strategy

Mortgage leveraging strategies may not be ideal for every affiliate. When adopting a mortgage leveraging strategy, affiliates should consider the following factors:

- Size of mortgage portfolio;
- Delinquency rate;
- Debt profile;
- Capacity and knowledge of staff who will have to support the program within the affiliate; and
- Adherence to the "Fund for Humanity Model", in which the cash flow from mortgages should be used to build more houses.

### Board's Financial Knowledge

Mortgage leveraging programs are complex transactions that require subject matter experts. Members of your Finance Committee should have experience with mortgage discounting, present value analysis, and leveraged finance. You will need accountants and lawyers to review the financial impact of each transaction and the legal documents. An affiliate's Executive Director or Director of Finance should also be familiar with the details of the transaction, and its impact on the staff's time. Finally, one or more spokespersons should be able to explain the transaction in simple terms to the general public and media. In the wake of the subprime mortgage crisis, these transactions can be misinterpreted. The affiliate should have the confidence and expertise to describe why mortgage leveraging is consistent with the principles of good stewardship and Habitat's mission.

**Substitution and Buyback Provisions**

If the option exists, affiliates should negotiate for the ability to provide substitute collateral for delinquent or otherwise unsuitable collateral, rather than being required in all cases to repurchase the delinquent or unsuitable collateral.

**Regulation**

As mortgage regulations become more restrictive, property values decline and government regulators increase their scrutiny of consumer lending, some affiliates may experience increased reluctance from financial institutions to engage in these transactions. Affiliates must make sure their sales, lending and servicing practices are in compliance with RESPA and other federal and state laws pertaining to real estate and mortgage transactions. Not only does this reduce risk for the affiliate, but it also increases confidence in the financial institutions that provide these programs to affiliates.

**Choosing the Right Partners**

Not all financial institutions are the correct fit for Habitat affiliates. HFHI recommends that affiliates use caution and exercise due diligence regarding the financial institution to which they sell or leverage their mortgages. Affiliates will probably find more trusted partners and better relationships with institutions such as local banks or state housing finance agencies, rather than other mortgage finance entities. While many banks and agencies are looking for socially conscious investments, your affiliate should treat every prospective relationship as an "arms-length" transaction. This will protect you in the rare case of a breakdown in the relationship.

**Too Much Ready Cash and Unsustainable Growth**

Some affiliates have in the past accelerated more cash than they were ready to deploy, or significantly expanded house production over a short period of time. As a result, they were unable to sustain their growth in later years. Growth can significantly increase the size of the staff and overhead. If the increased expenses cannot be covered by increased philanthropic giving, this may result in future downsizing. Prior to any mortgage leveraging, the affiliate should have an established business plan approved by its Finance Committee or Board of Directors.

As you have read in this section, there are a number of potential pitfalls to be aware of when reviewing a prospective mortgage leveraging program. Despite the risks, the majority of affiliates have successfully used these programs to expand their services. The following sections describe several types of programs, and outline the benefits and drawbacks of each.

## FlexCAP

### Program Overview

FlexCAP is a mortgage leveraging loan program administered by HFHI that accelerates the receipt of income from affiliates' mortgages. FlexCAP is the revised and improved version of HFHI's Accelerated Asset Recovery Program (AAR). HFHI borrows money from investors and re-loans these funds to affiliates at the lowest possible rate. As collateral for these loans, HFHI takes a security interest in promissory notes and mortgages in an affiliate's portfolio. After the loan is paid off, these notes and mortgages are returned to the affiliate.

One key difference between FlexCAP and other types of mortgage leveraging programs is the loan sizing. While most transactions size the deal based on the "face value" of the mortgages being leveraged, FlexCAP sizes the deal based on the total cash flow pledged during the 7 or 10 year term of the loan. The loan is sized by calculating the present value of the 7 or 10 years of cash flow on the pledged mortgages, using the interest rate on the loan as the discount rate. This means that cash flow from the mortgages pledged will fully cover the principal and interest payment on a FlexCAP loan. The pledged mortgages are held in a trust managed by Wells Fargo. If an individual mortgage needs to be replaced due to delinquency or prepayment, the affiliate can substitute another mortgage with the same or greater monthly payment.

A typical FlexCAP Loan term is outlined below:

| | |
|---|---|
| **Rate*** | 4.95% for 7 years and 5.5% for 10 years |
| **Terms** | 7 or 10 years |
| **Amortization** | Amortizing quarterly over the term of the loan |
| **Security** | Promissory notes and qualified mortgages |
| **Reserve** | One quarterly payment |
| **Servicing** | Affiliates continue to service the mortgages |
| **Prepayments** | Allowed after 1 year |
| **Mortgages** | No seasoning requirement |
| **Processing Fee**** | Sliding fee schedule - $1,000 - $8,000 per bundle of mortgages |

*Note:*Please note the final rates are subject to investor approval. **Please note that the fee structure has changed from a flat rate of $3,000 per bundle to the following sliding scale: loans under $100,000 = $1,000 fee; loans from $100,000-$400,000 = $3,000 fee; loans from $400,000-$750,000 = $5,000 fee; loans above $750,000 = $8,000 fee.*

### Sample Transactions

Below is a sample transaction based on a 25-year mortgage with monthly payments of $300. As described above, the loan is sized by taking the present value of 7 or 10 year cash flow from the pledged mortgages, using the interest rate as the discount rate. You can compare in the table below the upfront cash you will receive for a 7 or 10 year FlexCAP loan.

| | Pledge 4 Mortgages | Pledge 25 Mortgages |
|---|---|---|

| | | |
|---|---|---|
| 7-year Loan* | $80,700 | $504,000 |
| *Monthly Payment*** | *$1,142* | *$7,142* |
| 10-year Loan* | $104,900 | $655,900 |
| *Monthly Payment*** | *$1,142* | *$7,142* |

*Note: *Based on monthly cash flow of $300. **Assumes 7-year interest rate of 4.95% and 10-year interest rate of 5.5%.*

**Requirements for Participation in FlexCAP**

In order to participate in FlexCAP, affiliates must meet at a minimum the following requirements:

- Be in Good Standing with HFHI;
- Have at least 10 performing mortgages in their portfolio;
- Have at least $250,000 in Net Assets;
- Have Annual Audited Financial Statements; and
- No more than 60% of an affiliate's performing mortgages may be pledged or sold to HFHI or any other party.

**HFHI Recommendations for Participation in FlexCAP**

HFHI recommends FlexCAP to affiliates with the following characteristics:

✓ Low delinquency rates
✓ Low to moderate leverage
✓ Stable fundraising track record
✓ Strategic plan around growth
✓ Full-time staff

**Benefits and Drawbacks of FlexCAP**

| Benefits | Drawbacks |
|---|---|
| **Short-term Loan**<br>7 and 10 year loans available from HFHI, with the ability to prepay after one year. | **Loan Size**<br>Smaller initial loan amount when compared to options that leverage the full life of a loan. |
| **Ability to Re-leverage Mortgages**<br>Affiliates can re-leverage their mortgages after a FlexCAP loan expires and gain more cash flow. | **Funding Availability**<br>FlexCAP funding is only available twice per year as opposed to on-demand. |
| **Financing with a Trusted Partner**<br>HFHI is a partner you can trust. Helps avoid the risks that can be involved with banks and external investors that may be surprised by higher than expected delinquency rates. Often it is easier to implement than 3rd party mortgage leveraging options. | **Restricted Funding**<br>Usually, affiliates looking to use the funds for home-building related activities are prioritized. |
| **Ability to Replace Mortgages if Delinquent**<br>Collateral (instead of cash) substitution required in the case that a pledged mortgage becomes delinquent or is sold. | **Reporting Requirements**<br>FlexCAP requires semi-annual reports updating financial, collateral and social impact data. |

| | |
|---|---|
| **Affiliate Support**<br>Legal, financial and organizational consulting provided by HFHI experts during the due diligence process. Improves the professional expertise and financial processes of participating affiliates. | |

**Case Study**

***Habitat for Humanity of Lansing, Michigan*** will use its $180,200 FlexCAP loan to finance the acquisition and improvement of foreclosed and abandoned properties throughout the Greater Lansing area. The properties will be improved to Energy Star 5 standards and sold to low-income families that qualify for a Habitat mortgage. Through a grant from the City of Lansing, the Affiliate will receive reimbursement for costs incurred to acquire and rehab foreclosed and abandoned properties. These grants, however, are reimbursements of actual costs incurred and, as a result, the Affiliate will not receive the grant funds for a house until the renovation is complete and a certificate of occupancy has been issued. The FlexCAP funds will serve as bridge financing, enabling the Affiliate to maximize its participation in the city program by acquiring and rehabbing houses at a much faster pace than would otherwise be possible. The ready availability of FlexCAP loan proceeds will also ensure that the Affiliate is able to act quickly to secure and purchase available properties. Because the FlexCAP funds will be replenished by the City of Lansing's grants, the Affiliate will be able to continuously recycle these funds to acquire and improve more homes for its partner families. Without a FlexCAP loan, the Affiliate would not have sufficient funding to acquire existing houses at any scale, or to fund rehabilitation projects.

## Mortgage Sale Deals

**Mortgage Sale Overview**

Mortgage selling allows an affiliate to monetize the remaining life, or "face value", of a mortgage in one lump sum transaction. The affiliate typically receives a discounted amount of the face value, and in turn foregoes the monthly principal payments received from that mortgage. These transactions are most often established with local banks or credit unions, and state housing agencies. Some affiliates have been able to realize mortgage sales at face value, although this is a rare occurrence. Most mortgage sales are discounted, and discount rates vary by the organization.

One important point to note on these transactions is that most affiliates that sell mortgages retain servicing rights and have the obligation to buy-back delinquent mortgages. This means that those obligations stay on the affiliate's books for the remaining life of the sold mortgages. Therefore, these Habitat "mortgage sale" deals often show as debt or other liability on the balance sheet for the entire term of the "sold" mortgages. This is different from traditional for-profit mortgage sales, where the mortgages are sold outright.

**Sample Transactions**

The following mortgage sale proceeds are based on a $100,000, 25-year mortgage at 0% interest rate. The chart compares mortgage sales, at various discount rates, to the current value of an equivalent mortgage held on affiliate books.

| Discount Rate | Mortgage Sale Proceeds | % of value recovered | Current Discounted Value of Mortgage* |
|---|---|---|---|
| 0% | $100,000 | 100% | **$44,054** *(44% of value recovered)* |
| 2% | $78,643 | 79% | |
| 4% | $63,151 | 63% | |
| 6% | $51,736 | 52% | |

**Calculated with a discount rate of 7.77%.*

**Best Practices**

✓ ***Continue to partner with Habitat homeowners***

- Affiliates participating in mortgage sales must maintain the right to intervene in the event that a mortgage becomes delinquent.

✓ ***Seek mutually beneficial partnerships with a trusted partner***

- Affiliates should seek loans from state housing finance agencies, local non-profits and banks looking for CRA credits, as these investors are more likely to offer favorable terms. Because of the buy-back/guarantee provisions, Habitat affiliates will maintain a relationship with the investor for the entire term of the sold mortgages. Therefore, affiliates should seek partnership with credible institutions that understand the Habitat model.

✓ ***Negotiate low discount rates***

- Affiliates should primarily seek out programs that purchase mortgages at face value (using 0% discount rate). Several state housing agencies offer face value purchases.
- When comparing the mortgage sale proceeds to the current discounted value of the mortgage, affiliates should also take into account upfront fees that may further decrease their mortgage sale proceeds.
- HFHI recommend that affiliate leverage mortgages when they are able to recover at least 70% of the value of the mortgages.

✓ ***Negotiate a beneficial substitution policy***

- Affiliates should avoid programs with cash buy-back provisions. In most Habitat mortgage sale deals, if any of the "sold" mortgages become delinquent, affiliates must come up with lump sum cash to buy-back these mortgages.
- In order to avoid the buy-back provision above, which can deplete an affiliate's cash, an affiliate should negotiate a "substitution provision", pursuant to which the affiliate can swap a delinquent or prepaid mortgage with a current mortgage of equal or greater value.

✓ ***Maintain sufficient reserves***

- Even if it is not required, HFHI recommends that affiliates only sell or pledge up to 60% of their performing mortgage portfolio (mortgages less than 30 days delinquent). This is to ensure that the affiliate is not over-leveraged and to ensure that affiliates have sufficient mortgages to substitute for any delinquent or prepaid mortgages.

**Benefits and Drawbacks of Mortgage Sales**

| Benefits | Drawbacks |
|---|---|
| **Large Upfront Cash**<br>Depending on the discount rate, mortgage sales offer up to 70-100% of the cash flow from a mortgage. | **Inconsistent Financing Opportunities**<br>As mortgage lending regulations become tighter, property values decline and banking regulators increase scrutiny, some affiliates may experience increased reluctance from investors to engage in these transactions. Further, the discount rate used can get high in some instances. |
| **Relationships with Investors**<br>Relationship builder with local investors. Could potentially lead to other partnership opportunities like grants and volunteer engagement. | **Balance Sheet Impact**<br>Since affiliates usually have to guarantee the "sold" mortgages, a mortgage sale typically shows up as debt or other liability on the balance sheet for the remaining life of the mortgage. |
| | **Buy-Back Provisions**<br>Most lenders will require affiliate to buy-back delinquent mortgages. To mitigate the risk of having to come up with large lump sum of cash for buy-back, HFHI recommends setting aside a cash reserve or negotiating a mortgage substitution clause. |
| | **Labor Intensive**<br>Time involved in establishing these programs can be equated to fundraising activities. |

# Local Mortgage-Backed Loans

**Overview**

Local mortgage-backed loans typically take one of two forms, either as a line of credit (LOC) or an amortizing loan. A LOC usually has a 1 year repayment term, and allows an affiliate access to critical short term funding. Amortizing mortgage backed loans are sized by discounting the payment stream of the underlying pledged mortgage collateral.

**Best Practices**

✓ ***Continue to partner with Habitat homeowners***

- Affiliates participating in mortgage backed transactions must maintain the right to intervene in the event that a mortgage becomes delinquent and should remain the primary servicer on the loan.

✓ ***Seek mutually beneficial partnerships***

- Affiliates should seek loans from state agencies, local non-profits and banks looking for CRA credits. These investors are more likely to offer favorable terms.

✓ ***When considering a local mortgaged back loan, affiliates should consult HFHI and compare rates, terms and financial covenants to FlexCAP to ensure they are they are receiving the most optimal deal.***

✓ ***If possible, affiliates should seek unsecured lines of credit.***

- HFHI has noticed that many local mortgage-backed LOCs are over-collateralized. HFHI believes more optimal financing programs can be accessed with the mortgages and recommends an unsecured line of credit.

✓ ***Negotiate a beneficial substitution policy***

- Affiliates should avoid programs with a cash buy-back provision. In most Habitat mortgage leveraging deals, if any of the pledged mortgages becomes delinquent, affiliates must come up with lump sum cash to buy-back these mortgages.
- In order to avoid the buy-back provision above, which can deplete an affiliate's cash, an affiliate should negotiate a "substitution provision", pursuant to which the affiliate can also choose to swap a delinquent mortgage with a current mortgage of equal or greater value.

✓ ***Maintain sufficient reserves***

- Even if it is not required, HFHI recommends that affiliates only sell or pledge up to 60% of their performing mortgage portfolio (mortgages less than 30 days delinquent). This is to ensure that the affiliate is not over-leveraged and to ensure that affiliates have sufficient mortgages to substitute for any delinquent mortgages.

### Benefits and Drawbacks of Local Mortgage-Backed Loans

| Benefits | Drawbacks |
|---|---|
| **Short-term Financing**<br>Great for short term needs satisfied with a simple line of credit or short term loan. | **Inconsistent Financing Opportunities**<br>As mortgage lending regulations become tighter, property values decline and banking regulators increase scrutiny, some affiliates may experience increased reluctance from investors to engage in these transactions. Further, the interest rate used can get high in some instances. |
| **Relationships with Investors**<br>Relationship builder with local investors. Could potentially lead to other partnership opportunities like grants and volunteer engagement. | **Buy-Back Provisions**<br>Most lenders will require affiliate to buy-back delinquent mortgages. To mitigate the risk of having to come up with large lump sum of cash for buy-back, HFHI recommends setting aside a cash reserve or negotiating a mortgage substitution clause. |
| | **Labor Intensive**<br>Time involved in establishing these loans can be equated to fundraising activities. |

## Zero Interest Equivalent Mortgages

### Overview

With a Zero Interest Equivalent Mortgage (ZEM), an affiliate collaborates with a third party-lender who provides the mortgage loan to the Habitat homebuyer instead of the affiliate. This lender will charge the homebuyer a below-market or even market rate of interest, but the monthly payments for the family are the same as if the affiliate were providing a 0% interest loan directly to the family.

**Sample Transaction**

- Affiliate collaborates with a third-party lender that provides the mortgage loan to the homebuyer.
- The lender charges the homebuyer a below-market rate of interest, but the monthly payments for the family are the same as if a Habitat affiliate was providing a 0% loan directly to the homebuyer. This mortgage option by the lender reduces the principal of the loan to a level that produces equivalent monthly payments.
- Mortgage is held by a government or private entity. When partnering with a third-party financier, affiliates must retain the right to intervene if any borrower encounters difficulty in making monthly mortgage payments.

| Mortgage Type (30 year) | Traditional Habitat | Zero Equivalent Mortgage |
|---|---|---|
| **Market Value** | $75,000 | $75,000 |
| **Applicable Interest Rate** | 0% | 2% |
| **Mortgage** | $55,000 | $40,582 |
| **Down Payment** | $1,000 | $1,000 |
| **Monthly P & I** | $150 | $150 |
| **Discount on Price** | $0 | $13,418 |

**Best Practices**

✓ ***Continue to partner with Habitat homeowners***

- Affiliates participating in mortgage sales must maintain the right to intervene in the event that a mortgage becomes delinquent.

✓ ***Seek mutually beneficial partnerships***

- Affiliates should seek loans from state housing finance agencies, local non-profits and banks looking for CRA credits, as these investors are more likely to offer favorable terms. Because of the buy-back/guarantee provisions, Habitat affiliates will maintain a relationship with the third-party lender for the entire term of the ZEMs. Therefore, affiliates should seek partnership with credible institutions that understand the Habitat model.

✓ ***Negotiate a beneficial substitution policy***

- Affiliates should avoid programs with buy-back provisions. In most ZEM programs, if any of the ZEM mortgages become delinquent, affiliates must come up with lump sum cash to buy-back these mortgages.
- An affiliate should attempt to swap a delinquent or prepaid mortgage with a current mortgage of equal value, as opposed to cash buy-back.

✓ ***Maintain sufficient reserves***

- Even if it is not required, HFHI recommends that affiliates only pledge or sell up to 60% of their performing mortgage portfolio (mortgages less than 30 days delinquent). This is to ensure that the affiliate is not over-leveraged and to ensure that affiliates have sufficient mortgages to substitute for any delinquent or prepaid mortgages.

**Benefits and Drawbacks of Zero Equivalent Mortgages**

| Benefits | Drawbacks |
|---|---|
| **Larger Upfront Cash Amount**<br>With zero-equivalent deals, the affiliate is essentially the homebuilder and able to realize a discounted home value upon completion of construction. | **Program Development**<br>Has been challenging to establish (fewer than 5 U.S. affiliates have closed ZEM's transactions). |
| **Servicing**<br>Loan is serviced by the mortgager. | **Credit Score Limitations**<br>Lenders often require credit scores (sometimes over 650 credit score) that "price out" the typical Habitat home buyer. |
| **Relationships with Investors**<br>Relationship builder with local investors. Could potentially lead to other partnership opportunities like grants and volunteer engagement. | **Buy-Back Provisions**<br>Most lenders will require affiliate to buy-back delinquent mortgages. To mitigate the risk of having to come up with large lump sum of cash for buy-back, HFHI recommends setting aside a cash reserve or negotiating a mortgage substitution clause. |
| | **Labor Intensive**<br>Time involved in establishing these programs can be equated to fundraising activities. |

# USDA 502 Program

**Overview**

USDA 502 Direct Loans are made to low- and very low-income households (up to 80 percent of the Area Median Income). The housing eligible for the program must be modest in size, design and cost. In most instances, no down payment is required and interest rates are subsidized by the federal government. This program allows rural U.S. affiliates to recoup as much as 100% of their construction costs from a home at the time of sale. Those funds then become ready cash for the next project.

**Best Practices**

✓ ***Select homeowners wisely***

- To avoid default/delinquency issues, select homeowners unlikely to become delinquent.

✓ ***Timing***

- It's important for an affiliate to maintain a close relationship with local Area Office to determine when funds are available.

- If properly timed, the affiliate can use USDA funding to build homes when they are available and build homes with Habitat mortgages in the remainder of the year. This can improve efficiencies with staff and volunteers

**Benefits and Drawbacks of the USDA 502 Program**

| Benefits | Drawbacks |
|---|---|
| **Instant Cash Flow**<br>As much as 100% of costs recovered at time of sale. The pricing would be the same as is allowed under Pricing Policy 23, but it may not have to be lowered as much to achieve affordability. | **Not for Every Affiliate**<br>Funding is designated only for "rural" deployment. |
| **Servicing**<br>Loan is serviced by the USDA. | **Homeowner Relationship**<br>Without the affiliate proactively continuing the relationship with the homeowner, there may be a weaker relationship with the homeowner than in a traditional Habitat loan. |
| **Benefits Homeowners**<br>Home buyers may receive a lower monthly mortgage payment than with a traditional Habitat mortgage. | **Recapture Component**<br>All or a portion of the interest subsidy is subject to recapture. Terms vary depending on the recapture event (sale, refinance or repayment in full of mortgage). |
| | **Market Rate of Interest**<br>This process includes a market rate of interest that will be heavily subsidized for low income families. If the family's income increases, the amount of subsidy will decrease and the monthly payment will increase. |

# In Conclusion

Habitat affiliates in the U.S. have the potential to access more than a **billion** dollars of capital by leveraging their mortgages. If affiliates gained access to even 20% of those dollars, the impact would be dramatic: conservatively, it would provide simple decent housing to approximately 2,300 more families without leveraging any other funding source. Imagine the possibilities when we combine those resources with our typical fundraising activities.

As stated earlier, all of these strategies require careful consideration and planning at the affiliate staff and board levels. There are risks and potential pitfalls involved with leveraging mortgages. The impacts on fundraising, staffing levels, and cash flows are all important components to consider before entering into any of these or other mortgage leveraging strategies.

We must, however, consider that we are not simply stewards of assets on a balance sheet, but rather we are stewards of the Mission and future of Habitat for Humanity.