

**MEETING DATE:** October 25, 2022

**ITEM NUMBER:** XX.C

**SECOND READING:**

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**TYPE OF ITEM:** General Business

**PRESENTED BY:**

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**SUBJECT/AGENDA TITLE:**

Inclusionary Housing Discussion - Update on Sales Price Formula

## **EXECUTIVE SUMMARY:**

In 2021, Council requested that several items relating to the Inclusionary Housing (IH) Program be brought back for discussion and possible changes. One of those items was changes needed to the maximum sales price formula for for-sale homes provided under the Inclusionary Housing (IH) Program.

In the almost four years of implementing the IH program, no developers outside of Habitat for Humanity (as either the applicant or by partnering with a market rate developer) have yet opted to provide for-sale affordable units to meet their program requirement and two developments opted to provide for-sale middle-tier (attainable) units that kicked in the incentive for a reduced affordable requirement. Since 2021, staff has been doing extensive research and having conversations with community stakeholders to hear input about the existing formula and model different factors in the sales price formula to analyze the potential short and long term impacts of the calculation methodology. We heard that the existing formula does not accurately account for the total cost of a housing payment for low- and moderate-income households and could be putting vulnerable populations at risk of financial and housing instability. We also heard that the existing prices were cost-prohibitive for developers and builders; they could not make the numbers work when considering the complex financial stack needed to obtain equity investment and lending in order to construct.

The result of that work is a proposed formula methodology that attempts to balance the needs of families living in affordable housing with the feasibility of building affordable and attainable product so that the program provides attractive incentivizes to actually produce these units, all while building in flexibility to weather a volatile market.

## **CURRENT SALES PRICE FORMULA**

The IH code includes maximum sales prices for for-sale affordable homes provided to meet program requirements and for for-sale middle-tier homes provided that qualify the development for a reduced affordable requirement. Code states that the maximum price for an affordable or middle-tier home is the price in effect at the time that a building permit is issued for a unit. Sales prices should be updated annually once HUD publishes the year's AMI limits. The City's maximum sales prices are only the highest price at which a home may be sold; the code does not guarantee that a home will sell at the maximum price—developers may always choose to sell IH homes for less than the maximum price.

The incentive for providing middle-tier units is structured as shown below. Currently, the middle-tier units do not have to be deed restricted, no buyer qualification is necessary, and there is no limit on resale. However, the developer must use best efforts to ensure the initial buyers intend to use the home as their primary residence and provide documentation via sales contracts, loan documents, etc.

Tier Level	AMI	Reduction to 12% Affordable Housing Requirement
A	80.1-100%	100% (no requirement)
B	100.1-110%	60% (40% requirement owed)
C	110.1-120%	20% (80% requirement owed)

## SALES PRICE FORMULA CHANGE SUMMARY

The current formula for calculating IH affordable and middle-tier home sales prices for single family, townhome, and condo products does not sufficiently account for the costs of

- homeowner association (HOA) dues,
- private mortgage insurance (PMI),
- property insurance, and
- property taxes

Staff is referring to these combined expenses as ancillary housing expenses. A total housing payment is considered within the affordable range when a household pays no more than 33 percent of gross monthly income, including all costs that make up the mortgage payment. Council approved using 33 percent of gross income for the sales price formula in September 2018, which is consistent with the methodology used by the City's community partners. The current outdated formula does not accurately account for all ancillary housing costs and therefore results in prices that cause households to pay more than 33 percent of their gross monthly income for housing. This could put them at risk for financial struggles if they take on new debt, defaulting on their mortgages, and foreclosure.

Prices should be updated annually when the Department of Housing and Urban Development (HUD) publishes the year's Area Median Income (AMI) limits. The existing formula uses the corresponding AMI monthly gross income available for housing minus the

estimated ancillary housing expenses. The remaining gross income and the established interest rate are used to calculate the principal loan amount. The percent of down payment is then applied to determine the sales price. Interest rate and down payment are easily standardized in the calculation formula: an eighteen-month average of interest rates plus 0.5 percent for market fluctuations over the year and a down payment assumption of 5 percent of the purchase price.

The current formula assumes 3 percent of the mortgage payment is spent on ancillary housing expenses, leaving 97 percent of the mortgage payment to pay for principal and interest. A larger amount of money available for principal and interest equals a larger loan amount and a larger purchase price. However, based on research of survey data by staff, subtracting 3 percent for ancillary costs is insufficient for today's costs. For example, a household purchasing a three-bedroom single-family detached home under the current formula with updated incomes would actually pay 9 percent of their gross monthly income on ancillary costs. This means that under the current program, a household could end up paying 39 percent of their income towards their housing payment rather than 33 percent.

The proposed formula considers other ancillary costs in addition to property tax: HOA dues, PMI, and property insurance. Survey data collected from 37 Longmont HOAs for attached and detached homes were averaged to factor in a \$167 per month average HOA fee. An assumption of 0.55 percent of the mortgage amount for private mortgage insurance premiums was factored in based on data from the Urban Institute and the FHA. Property insurance calculations are included based on average rates in the state.

In addition to new factors, the last several years have shown us that we need to look back at the interest rate calculation methodology to ensure we are responsive to changes in the market. The 18-month look-back at monthly average rates resulted in a major imbalance in a fluctuating market. Staff analyzed a 12-month look-back in order to better reflect current market conditions but in a volatile market, this method again puts the calculation on the other end of the pendulum. A 15-month look-back ended up being a good balancing point that uses actual prior data but that can still provide some flexibility for changing market conditions.

## **FINDING THE RIGHT BALANCE**

A key guiding principle to the creation of the existing formula was ensuring that low- and moderate-income families moving into newly constructed housing units provided under the Inclusionary Housing Program were left in stable financial circumstances and truly affordable housing according to their income level. In the three years of experience with the program since, we have seen incomes rise, but the cost of construction and other housing costs rise even higher. This is evident in the fact that the number of for-sale

affordable or middle tier units provided through the IH program has been negligible since the program began. It is too difficult for developers to meet the current price points and still satisfy underwriting requirements from their financiers.

The proposed formula takes into consideration an expanded set of guiding principles to balance the fundamental mission to ensure low- and moderate-income households are placed into stable housing and financial situations with a formula that better takes into account current market conditions and incentivize providing units enough to actually enable developers to deliver affordable and attainable product.

If just current incomes were updated within the existing formula, maximum sales prices would be significantly higher. That increase is then tempered by the inclusion of the full cost of housing. A change to the formula to account for all housing costs within the sales price formula, combined with the increased HUD 2022 incomes and the revised interest rate assumption, results in an increase to the published maximum sales prices currently in effect.

## **ACCOUNTING FOR HOUSING TYPE**

The previous formula had maximum sales prices split out by single-family home, townhome, and condominium. Some community feedback received questioned why this was necessary – a buyer qualifies for a certain amount of a loan regardless of housing type. Staff did model a formula that did not differentiate between housing types, but then at income levels approaching 120% AMI, it would allow an above-market, luxury townhome or condo to qualify for a reduced IH requirement to provide affordable units or fee-in-lieu.

Instead, by looking at median monthly sales in Longmont as reported by IRES, averaged over the last 12 months, it is evident that there is a 29% difference between attached and detached home sale prices, as highlighted below.

***Median Attached Sales Price (October 2021-September 2022): \$436,577***

***Median Detached Sales Price (October 2021-September 2022): \$614,113***

$$1-(\$436,577/\$614,113) = 0.29 (29\%)$$

Rather than three housing type categories, the proposed methodology simplifies the formula to include a detached and attached maximum sales price and will base the percentage discount for attached homes on a 12-month average of median sale prices, to be updated annually.

However, the results of discounting all affordable (less than 80% AMI) and attainable (80% > 120% AMI) attached units meant that the affordable price limits were so extraordinarily

low as to be not feasible to build and sell. The reason for this is that as you get to the lower price levels, any significant price limiting factor has a higher impact with less room to work with. Therefore a 15% discount from the 12-month average of monthly median sales prices was run and struck a better balance for affordable price ranges. The proposed methodology for consideration in the attached chart shows the maximum sales prices with a 29% discount applied for attainable attached homes and a 15% discount applied for affordable attached homes.

## **ACTUAL MEDIAN SALES PRICES AS A GAUGE FOR INCENTIVE**

Using the 12-month average of monthly median sales price data also demonstrates an important factor to consider. In the attached proposed calculation chart, the range where the median actual sales price falls is called out in red text. Median actual sales prices are consistent across housing type in each affordability range, and fall within the 120% AMI range for two bedroom homes, 110% AMI for three bedroom homes, and 100% AMI for four bedroom homes.

Showing the median actual sales prices on the charts highlights that there are a portion of households/unit sizes that fall above the median actual prices. This would mean that inclusion of these price ranges in the IH program would result in larger sized, over-market homes at the top of the allowable scale that qualify for a reduced IH requirement to provide affordable units or fee-in-lieu. However, it may result in an increase in attached housing product and would be expected to result in more housing being provided in these price ranges, which are still considered affordable to households making 120% AMI.

**Option 1** for consideration allows these above-median maximum sales prices to be considered in the incentive program.

As an alternative, Council could choose to eliminate the above-market price ranges and associated unit sizes from the incentive program. **Option 2** for consideration would not allow homes falling in the price ranges and associated unit sizes shown in gray on the attached proposed calculation chart to benefit from a reduced IH requirement.

## **PROVIDING FLEXIBILITY FOR A RANGE OF HOUSEHOLD SIZES**

The final formula methodology change made is related to the assumption of household size. Previously, the formula assumed a single household size per unit size (based on number of bedrooms). The proposed formula includes a range of household sizes to better account for a diversity of household types. For example, the previous formula assumed a 3-person household income for a 4-bedroom house. The new formula uses a range of household sizes to determine the income ranges assigned to unit size, which does three things: allows for a more diverse household type (for example, a multi-generational household, other non-traditional households, etc.), provides a more realistic assignment of

household size to unit size, and provides flexibility for developers attempting to qualify buyers within a range of prices. Feedback from developers and community land trusts that operate for-sale affordable housing showed that a range of allowable sales prices is critical to allow for buyers with various levels of debt-to-income ratios to qualify and allow for flexibility given changes in market climate and the ability to sell the home.

## **IMPLEMENTATION OF PROPOSED SALES PRICE FORMULA**

The IH code states that staff should update the maximum sales price calculation annually based on a formula approved by City Council. Certain data points typically change annually, and others do not typically fluctuate significantly year over year. Formula data assumptions are proposed to be updated on the following schedule:

- HUD income limits – update annually
- Mortgage Interest – update annually using the prior 15 months of average monthly rates
- Property tax – update annually with revised assessment rate and mil levy
- Median actual sales price – update annually using an average of the prior 12 months of monthly median sales prices
- Property insurance – update every 3 years with industry data
- HOA fees – update every 3 years with survey data of Longmont HOAs
- Private mortgage insurance – update every 3 years with industry data

## **COMMUNITY INPUT**

Staff solicited input from the East County Housing Coalition advocacy group for feedback on the formula change options. The following summarizes that feedback.

- It is unfair for homebuyers to be hit with unanticipated costs (ancillary housing costs), it would be much better for those costs to be fully considered within the sales price.
- Implement the proposed formula as quickly as possible to ensure no one gets into a house they cannot afford.
- They would prefer the use of the actual ancillary housing costs rather than an average, if not too administratively burdensome. This would require calculating separate ancillary cost assumptions for each income level, each number of bedroom unit, and each unit type.
- They were adamant that the middle-tier homes should have deed restrictions and buyers should be income qualified. They felt that the program could be taken advantage of (turned into rental properties, used as investments, flipped for quick profit, etc.) and if so, it reduces inventory for those who need it.

Staff also solicited input from local area lenders and developers that have or are interested in providing for-sale units to meet IH requirements. The following summarizes that feedback.

- They believe one maximum sales price should be set regardless of unit type, rather

than splitting out separate maximum prices for single family detached, townhome, and condo.

- The ancillary cost assumptions and data sources are consistent with what is generally seen in the market.
- It is common for lenders to qualify buyers to pay up to 40% of gross monthly income for their housing payment, depending on qualifications.
- It is difficult if not next to impossible to build affordable and attainable homes at the current published prices without subsidizing that cost through pricing of market rate homes. Even with an increase, some market rate subsidy may still be required depending on the amount of the price increase.

Finally, staff ran some of the key assumptions through the team at Elevations Community Land Trust and discussed how best to align the income/pricing structure with Habitat for Humanity to get input from those with experience running for-sale affordable housing programs.

- It is important to have an appropriate buffer in the sales price compared to market rate to incentivize buyers that would purchase a deed-restricted home.
- A buffer in the pricing is also necessary to allow for a range of buyers with different qualifications. A narrow range of pricing can limit the buyer pool.
- Limiting the housing payment affordability to 33 percent of gross monthly income is consistent with their method.

## **COUNCIL OPTIONS:**

1. Should the revised formula include the assumptions outlined above and summarized below?
  - a. Revise mortgage interest rate calculation from an 18-month look-back to a 15-month look-back; and
  - b. Include ancillary costs in calculation of maximum monthly housing payment; and
  - c. Revise the number and type of housing types from single family/townhome/condo to attached/detached?
  - d. Include a 29% discount factor for attainable attached homes compared to attainable detached homes in the same income range and include a 15% discount for affordable attached homes compared to affordable detached homes in the same income range.
  - e. Provide a range of household sizes for income calculation purposes, which then provides a range of sales prices for each AMI level.
2. Should the maximum sales prices that fall above the actual median sales price receive the affordable housing incentive as currently allowed under code?

## **RECOMMENDED OPTIONS:**

1. Provide direction for implementation.

# CITY COUNCIL COMMUNICATION

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**FISCAL IMPACT & FUND SOURCE FOR RECOMMENDED ACTION: N/A**

**BACKGROUND AND ISSUE ANALYSIS: N/A**

**ATTACHMENTS:**

1. Proposed maximum sales price formula chart