United States General Accounting Office

GAO

Briefing Report to the Honorable
Jim Moody, House of Representatives

June 1988

HOME OWNERSHIP

Targeting Assistance to Buyers Through Qualified Mortgage Bonds

042554 / 136187

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-211508

June 27, 1988

The Honorable Jim Moody
House of Representatives

Dear Mr. Moody:

As you know, in our March 28, 1988 report, Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111), we questioned whether the authority to issue tax-exempt qualified mortgage bonds should be extended past the statutory termination date of December 31, 1988. Several analyses presented in that report showed that bond-assisted financing probably provides little increase in home ownership because of the limited nature of the assistance. It is also an inefficient way to assist buyers, since buyers are estimated to receive only 12 cents to 45 cents in benefits for every dollar of cost. However, we also recognized that, should the Congress choose to extend the authority to issue these bonds, it should better target assistance to buyers in need, and we suggested several ways to do this.

You requested that we present additional information on how eligibility criteria for first-time home buyers receiving reduced-interest rate loans through qualified mortgage bonds could be tightened to better target assistance. This briefing report discusses several options. We presented this information to you in a briefing on June 8, 1988.

In summary, assistance can be better targeted by changing existing income and purchase price eligibility standards and/or establishing household size and age eligibility standards so that those who are eligible will not have the same characteristics as unassisted first-time buyers, as is currently the case. Other approaches are (1) determining whether the buyer applying for a bond-assisted loan could buy the same house with a market-rate loan and (2) recapturing a portion of the subsidy from house price appreciation.

assisted loan arrangement if they were to lose a portion of the appreciation at the time of sale.

Another approach, recently presented in a journal article, is to use a "roll-over" mortgage loan. Currently, bond-assisted buyers receive the benefit of the reduced interest rate as long as they own their home. However, because first-time buyers are typically young, they can often expect real as well as nominal increases in income. The use of a roll-over mortgage, in which assisted-buyers are periodically reassessed for their need for the reduced interest rate, could limit assistance only to when it is actually needed. (See section 3.)

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We did not request agency comments on this briefing report since it discusses the same issues, for the most part, contained in our March 1988 report. We obtained agency comments on that report and do not expect that they will differ for the material presented here.

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

Should you need additional information on the contents of this briefing report, please call me on (202) 275-6111. Major contributors to this report are listed in appendix I.

Sincerely yours,

John H. Luke

John H. Luke
Associate Director

households. The Congress recognized that qualified mortgage bond programs operate in housing markets that differ considerably in affordability. As such, it legislated broad eligibility requirements. Through various legislative changes in 1982 and 1986, this flexibility has remained.

TYPICAL PROGRAM OPERATIONS

The issuer of qualified mortgage bonds, usually a housing finance agency, issues qualified mortgage bonds when it believes that sufficient demand exists for the resulting mortgage funds. It decides on the size of the bond issue and when it should be offered. The agency structures the bond offering to make it attractive to investors, provide a sufficient spread between the program's mortgage rate and the conventional market rate to attract home buyers, and meet federal and state and/or local requirements.

In a typical program, the housing finance agency issues bonds when it believes that the current bond interest rate plus "arbitrage" (no more than 1-1/8 percentage points, as limited by law) to help cover issuance and program costs will allow loans to be made at about 1-1/2 to 2 percentage points below the conventional mortgage rate for fixed-rate loans. The bonds are repaid from mortgage payments made by the individual home owners who received loan financing from the bond funds, and investment income from periodically idle funds. Program costs are also covered by one-time fees charged to developers, lenders, and home buyers who participate in the program (called participation fees) and, in some cases, agency reserves.

The prospective home buyer executes a purchase contract on a home and applies for assisted financing from a mortgage lender approved by the housing agency. The lender makes the fixed-rate loan after determining that the purchaser is a first-time home buyer, meets income and purchase price requirements, can afford the home at the below-market rate set by the housing agency, and meets other qualifying requirements. Generally, the housing agency or its agent then checks the loan documents to ensure that its requirements were met and then, if they were, purchases the loan from the lender.

SCOPE AND METHODOLOGY

To perform this work, we used two approaches. First, we used our existing data base of 177,786 bond-assisted home-purchase loans supplied by 15 state and 14 local housing finance agencies to determine the effect of different eligibility standards had they been applied to the assisted buyers. The data base includes all

SECTION 2

THE EFFECT OF CHANGING QUALIFYING CRITERIA ON THE CURRENT POPULATION OF BOND-ASSISTED HOUSEHOLDS

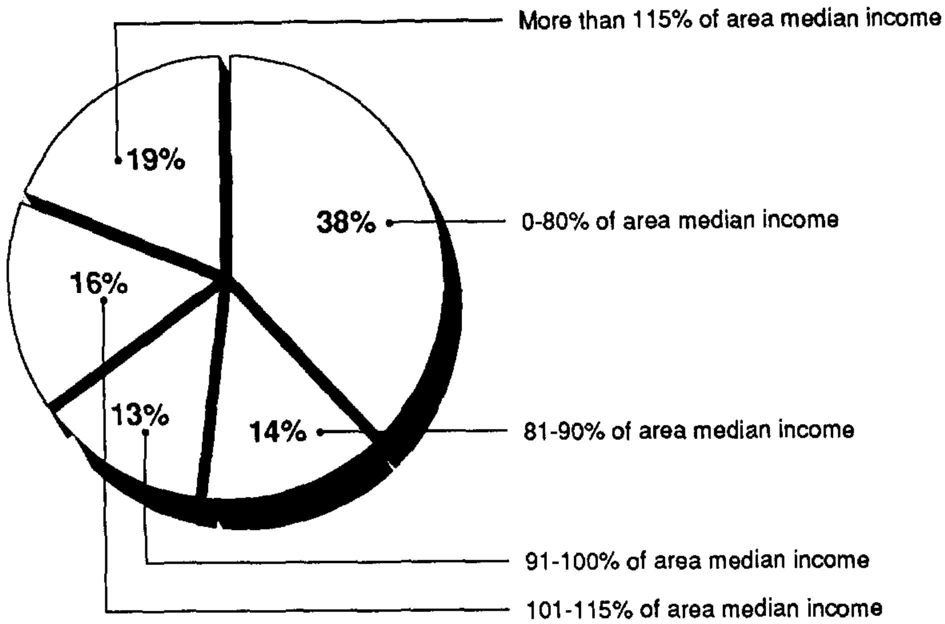
Bond assistance may have more of an impact on home ownership rates if it is targeted to households that are less likely to become home owners without it. Thus, the program would have to be targeted to households that are dissimilar to first-time buyers using conventional financing. Unassisted first-time buyers tend to have average incomes and purchase houses priced below average. They also are generally under 30 years old with small families (see ch. 2 of our March 1988 report). Average income first-time buyers purchase houses priced below average (about 73 percent of average) because they lack equity. Other home buyers can transfer equity from an existing house, allowing them to buy more expensive houses while reducing the size of the mortgage.

The current statutory income ceiling for bond-assisted households is 115 percent of area median, and the purchase price ceiling is 90 percent of area average. There are no restrictions on age or family size. If income and purchase price eligibility criteria were more restrictive, many households that could obtain financing in the conventional market would no longer qualify for bond assistance. Placing eligibility restrictions on household size and age would also prevent many households that are likely to become home owners on their own from qualifying for bond assistance. Thus, more of the bond funds would be targeted to renter households that are less likely to become home owners without bond assistance.

EFFECT OF CHANGING INCOME AND PURCHASE PRICE ELIGIBILITY STANDARDS

Figure 2.1 shows the distribution of purchase prices of bond-assisted houses compared with local area averages. Fifty-five percent of the bond-assisted households purchased houses priced at 70 percent or less of the area average. Only 16 percent purchased houses priced at 90 percent or more of the area average. These data suggest that the median bond-assisted purchase price is slightly less than 70 percent of area average, which is close to the conventional market norm of just over 70 percent.

Figure 2.2: Income of Bond-Assisted Buyers as a Percentage of Area Median Income



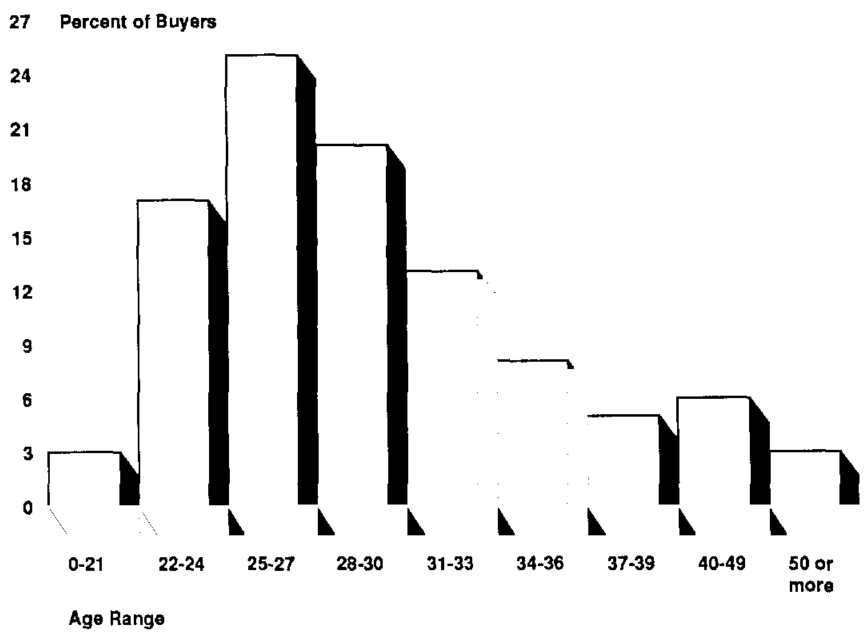
Note: Distribution of bond-assisted buyers contains 135,047 observations; 42,739 missing values excluded.

EFFECT OF ESTABLISHING HOUSEHOLD SIZE AND AGE STANDARDS

Figure 2.3 shows the distribution of household size for the bond-assisted households. Sixty-three percent have two or fewer people in the household. Only about 37 percent have three or more. The sample of conventional market first-time buyers has fewer single-person households--22 percent versus 29 percent for the bond-assisted sample. Thus, the conventional market serves a greater portion of larger families--44 percent with three or more people.

SECTION 2

Figure 2.4: Age Distribution of Bond-Assisted Households



Note: Distribution of bond-assisted buyers contains 111,148 observations; 66,638 missing values excluded.

EFFECT OF MORE RESTRICTIVE CRITERIA

Table 2.1 shows the share of assisted households in our data base that would qualify for bond financing under combinations of tighter restrictions on price, income, family size, and age. If income and price ceilings were restricted to levels about equal to those observed for conventional market first-time buyers--restricting price to no more than 80 percent of local area average, and restricting income to area median--50 percent of the recipients of bond assistance in our March 1988 study would have been excluded.

Progressively tighter restrictions on price and income, and the addition of restrictions on family size and age (encouraging participation of larger households and/or older buyers), would exclude greater shares of the assisted sample. For example, if bond assistance was limited to households with children (at the lower price and income limits cited above), only 23 percent of the assisted buyers in our sample would have been eligible. Alternatively, if only buyers who were 30 years old or older were eligible (again at the lower price and income levels), 22 percent of our sample would have remained eligible. Finally, combining the

Table 2.1: The Impact of Tighter Qualifying Criteria on the Current Population of Bond-Assisted Households

Tighter eligibility standards Price[a]/income[b]	Percent of buyers who would qualify: With tighter price and income restrictions	Adding a child standard[c]	Adding an age standard[d]	Adding age & child standards
80% / 100%	50%	23%	22%	11%
70% / 100%	40%	19%	18%	9%
80% / 90%	41%	19%	18%	9%
70% / 90%	34%	16%	15%	8%
Number of observations	124,019	93,078	80,433	74,603
Number of missing values	53,767	84,708	97,353	103,183

Note: The entries refer to the share of our sample of bond-assisted households that satisfy the criteria (exclusive of missing values).

[a]Price refers to purchase price as a percentage of the area average.

[b]Income refers to household income as a percentage of the area median.

[c]Households with more than two people, or single head of household with more than one person in the household.

[d]Household head aged 30 or older.

employment history. In this process, lenders typically determine whether housing-debt-to-income and total-debt-to-income ratios are within certain limits as indicators of whether buyers can afford monthly housing payments for the size and interest rate of the mortgage loan for which they are applying.

To determine whether buyers could afford the same house with a market-rate loan, the lender could run those same tests using housing payments (principal and interest payments on the mortgage loan, real estate taxes, and hazard insurance) at the market rate. If prospective buyers could afford the conventional loan, then they would not be eligible for a bond-assisted loan.

Legislating such a requirement might encourage persons to "buy up." That is, if buyers were to choose between a house with a conventionally affordable mortgage and a slightly higher priced house that, with qualified mortgage bond assistance, makes monthly payments lower than for the unassisted home, buyers are likely to choose the more expensive home. This situation could be addressed by taking back ("recapturing") some or all of the assistance when the house is sold. Therefore, a conventional affordability test, as discussed above, should probably be coupled with a recapture mechanism.

RECAPTURING SOME OR ALL OF THE SUBSIDY FROM HOUSE PRICE APPRECIATION

Recapture would help prevent buying up and also help focus assistance on those who could not otherwise purchase a house. Recapture returns to the federal government all or a portion of the assistance received from any house price appreciation at the time of sale. Those who otherwise could purchase the same home without bond-assisted financing or who might be induced to buy up would be less likely to participate since they could buy a home conventionally and not be subject to recapture.

This concept is similar to the recapture provisions in the Farmers' Home Administration section 502 rural home ownership program and HUD's section 235 home ownership assistance program. Both programs provide below-market interest rate loans to lower income households, and both recapture some or all of the subsidy from buyers, usually at time of sale. The two programs differ from the suggested qualified mortgage bond recapture in that they are operated through federal agencies rather than through state and local governmental tax-exempt financing.

As the recapture provision might be structured, the assisted buyer would agree to pay to the Treasury 50 percent of the home's appreciation at time of sale, with the amount not to exceed the

LIMITING THE DURATION OF ASSISTANCE THROUGH USE OF ROLL-OVER MORTGAGES

Those receiving qualified mortgage bond assistance receive the benefit of the reduced interest rate for the life of the mortgage, usually 30 years, or until they sell their house, whichever is less. Because first-time buyers, both assisted and unassisted, are typically young, they can often expect their real as well as nominal income to rise over time. Therefore, even though buyers may require assistance to buy the home, they may not need it beyond the initial years, if their income increases sufficiently. However, they still receive the benefit of the lower bond-assisted mortgage interest rate.

To limit bond-assistance to the period when it is needed, a roll-over mortgage might be used. The housing agency could offer a reduced-interest-rate loan, as at present. After a certain period, 3 or 5 years, for example, the owner's ability to afford the outstanding mortgage loan at the current market interest rate would be determined by the housing agency or participating lender. If a market-rate loan is affordable, then the bond-assisted owner would be required to obtain a market-rate loan. If the buyer could not qualify for the market-rate loan, the assisted mortgage could be extended for another 3- or 5-year period before being reassessed.

Two benefits result. First, assistance is provided to owners only as long as they need it. Second, the roll-over would be likely to reduce the average time buyers hold their bond-assisted mortgages. This could, in turn, reduce the term structure of the bonds. Typically, shorter term bonds carry lower interest rates than longer term bonds. The housing agency's reduced borrowing costs could then be translated into a greater spread between the conventional and bond-assisted rate.

On the other side, the periodic assessments would increase the administrative costs of the program. Also, the rule for deciding on a roll-over would have to be carefully crafted so that it would be difficult for an assisted buyer to take actions, such as increasing debt, so as to not qualify for the loan at the market rate.

RELATED GAO PRODUCTS

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

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

Rental Housing: Costs and Benefits of Financing With Tax-Exempt Bonds (GAO/RCED-86-2, Feb. 10, 1986).

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

Trends and Changes in the Municipal Bond Market as They Relate to Financing Bond and Local Public Infrastructure (GAO/PAD-83-46, Sept. 12, 1983).

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

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

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

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nominal value of the subsidy received.[2] That is, if the seller's subsidy was $50 per month (based on the difference between the bond-assisted mortgage rate and the conventional rate at the time the seller received bond-assisted financing) and the seller holds the home for 10 years, then the seller would pay the lesser of (1) the total subsidy received ($50 x 120 months) or (2) 50 percent of the appreciation on the house. This would allow the seller to retain some of the appreciation at time of sale for use in buying another home or for other purposes.[3] If the house does not appreciate, then no recapture is due. Also, if desired, the recapture could be forgiven if the house appreciated only slightly.

The recapture could be implemented through the Code. When filing an annual income tax return, the seller of a principal residence must report to the IRS on the sale or exchange of that residence for the purpose of reporting or postponing any gain from the sale of the house. In this reporting, the seller computes the gain by subtracting the basis of the house sold (purchase price of the home plus cost of improvements and certain purchase costs) from the selling price, less certain selling expenses. The home owner would then use this computed gain and the nominal value of the subsidy received to calculate the recapture due. The amount due would be included with the taxpayer's annual return.

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[2]Analysts would argue that the present value of the benefit should be recaptured since that approach recognizes the time value of money. Recapturing the present value of the subsidy would also generate a larger amount of recaptured funds than would the nominal dollar recapture. However, recapturing the present value of the subsidy would be somewhat more difficult to implement than our approach. Also, our proposed recapture is intended to serve as a self-selection device and not as a revenue-generating device.

[3]The conventional rate could be determined by the housing agency at the time loan is made. The agency could inform the buyer that the subsidy based on the difference between the below-market rate and the conventional rate was so many dollars per month. The home owner would use this information for computing the total subsidy received at time of sale.

OTHER MECHANISMS TO DIRECT ASSISTANCE TO THOSE MORE IN NEED

In general, a first-time buyer who meets income and purchase price restrictions set out in the Internal Revenue Code is eligible for bond-assisted financing. The Code does not require that the need for assistance be demonstrated.

In an effort to serve lower-income buyers, some housing agencies have set more stringent income and purchase price eligibility criteria than the Code requires. Additionally, some use other mechanisms, such as setting aside all funds for several weeks solely for lower income buyers before making the remainder of the funds available to any eligible buyer (or setting aside some funds at further reduced interest rates for lower-income buyers). However, 23 of the 25 agencies in our review did not attempt to determine whether assisted buyers could have bought the same house with a market-rate loan. (See ch. 3 of our March 1988 report.)

Our two separate analyses of about 178,000 bond-assisted buyers showed that most persons served would have been likely to become home owners if qualified mortgage bond assistance had not been available, and most could have probably bought the same house without bond-assisted financing. (See ch. 2 of our March 1988 report.) We believe that participation of households that do not need assistance should be discouraged.

Two modifications to the Code that would limit initial eligibility to those who need the assistance to buy a home are (1) limiting assistance to those who could not purchase a home conventionally and (2) recapturing a portion of the subsidy from any house price appreciation when the house is sold. (See also ch. 5 of our March 1988 report.) A third mechanism, which could be used to periodically assess the continued need for the reduced-interest rate loan is the use of a "roll-over mortgage."[1]

ASSISTING ONLY BUYERS WHO CANNOT AFFORD THE SAME HOME CONVENTIONALLY

To limit assistance to those who need it, the Code could be amended to contain such a requirement. Currently, participating mortgage lenders assess potential bond-assisted buyers' ability to make monthly mortgage payments at the bond-assisted rates, much as they do for unassisted buyers. These assessments include reviews of buyers' income, assets and debts, creditworthiness, and

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[1]D. Ling and M. Smith, "Another Look at Mortgage Revenue Bonds," Journal of Policy Analysis and Management, vol. 7, no. 3 (Spring 1988), pp. 562-564.

children and age restrictions with the lower price and income restrictions would have left only 11 percent of our sample eligible for bond assistance[1].

The households that would still qualify for bond assistance under tighter requirements would then be less like typical first-time home buyers and more likely to need the assistance they receive to purchase a house. However, buyers meeting a very low income eligibility limit may then not be able to purchase a house since assistance provided through the reduced interest rate loan is fairly small, averaging about $40 per month (after taxes) for buyers assisted in our sample. (See ch. 3 of our March 1988 report.)

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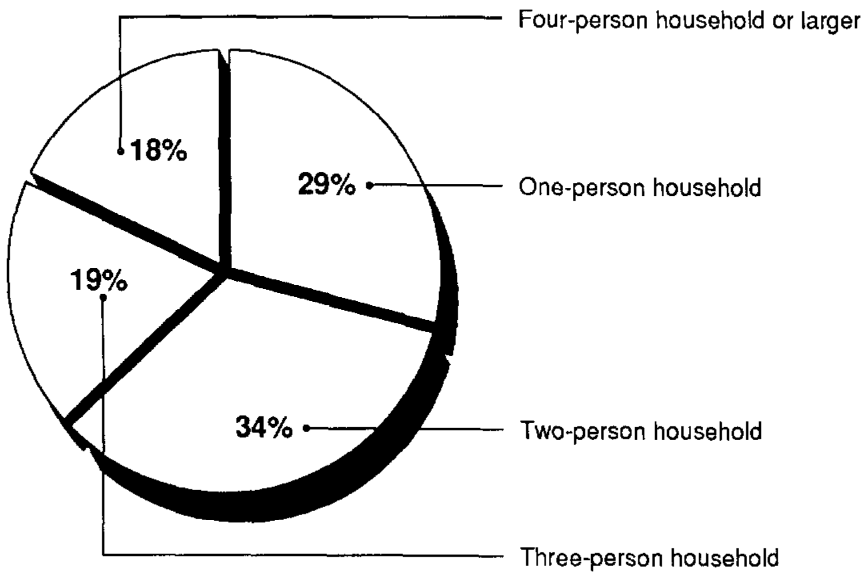
[1]These examples are illustrative only. For example, income and purchase price limits could be made progressively looser as household size or age of the buyer increased. See ch. 5 of our March 1988 report for an example of how a household size eligibility requirement might be structured.

 SECTION 2

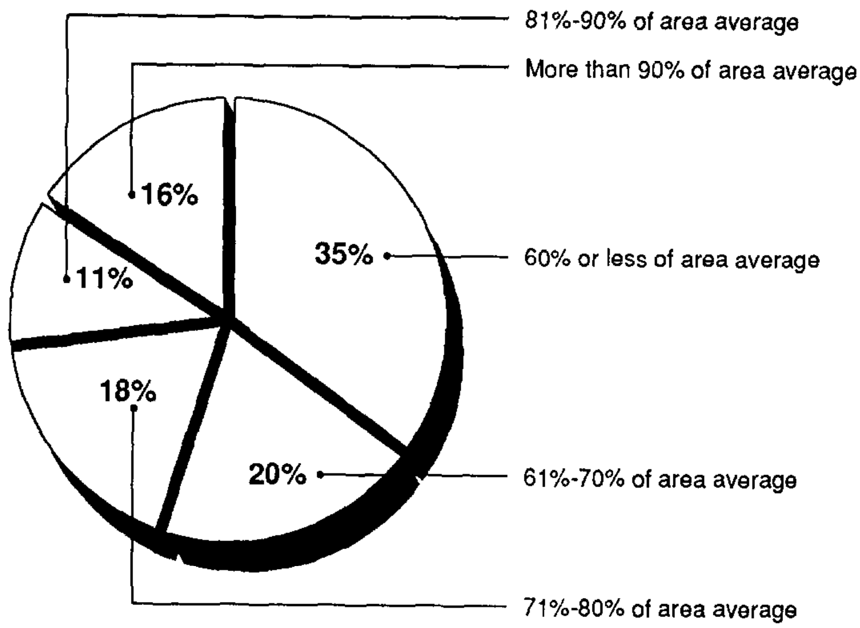
Figure 2.3: Household Size Distribution of Bond-Assisted Households



Note: Distribution of bond-assisted buyers contains 136,715 observations; 41,071 missing values excluded.

Figure 2.4 shows the age distribution of the bond-assisted households. Most bond-assisted buyers are between the ages of 22 and 33. Their profile is similar to first-time buyers in the conventional market, although there are 7 percent more bond-assisted households under age 30. For both bond-assisted and conventional market buyers, home ownership rates (first-time purchases) begin to drop off at about age 30 to 35.

Figure 2.1: Price of Homes Purchased by Bond-Assisted Buyers as a Percentage of Average Area Purchase Price



Note: Distribution of bond-assisted buyers contains 127,897 observations; 49,889 missing values excluded.

Figure 2.2 shows the distribution of income of bond-assisted households compared with local area median incomes. About 52 percent of the bond-assisted sample have incomes that are 90 percent or less of the area median. About 20 percent have incomes that are greater than 115 percent of the area median. Median household income nationwide is about $25,000 (in 1986 dollars), and the conventional first-time buyer's median income is about $27,000 for metropolitan areas. For the bond-assisted sample, median income is about $26,000, thus highlighting the similarity among the three groups.

loans in the agencies' automated data bases for the January 1983 to June 1987 period. (See section 2.)

Because we selected housing agencies judgmentally, our sample is not statistically generalizable to qualified mortgage bond activity nationwide. However, the agencies we selected represent about one-third of all bond activity for 1983 to 1986 and thus are strongly suggestive of overall population characteristics. Agencies' files did not always contain information for all data elements, such as household size, that we requested. Accordingly, each analysis shows the corresponding number of missing values.

As discussed above, the Tax Reform Act of 1986 tightened home purchase price eligibility requirements from the 1982 level and established an income requirement. Other factors, such as more liberal eligibility criteria in so-called "targeted areas," may also have had some effect on who has been served. However, housing agency files did not usually contain sufficient information for us to be able to separate out buyers served under the 1986 requirements, those in targeted areas, and whether they were first-time buyers without substantially reducing the size of the sample that we could analyze. Therefore, these 177,786 buyers represent many buyers served under more lenient eligibility criteria than are currently in law. Nonetheless, about 80 percent and 84 percent of these assisted buyers in our data base would have met the 1986 act's income and purchase price requirements, respectively, had these requirements been in effect for the entire period covered by our study.

Second, we identified other approaches to better direct assistance through our work and through reviewing published and unpublished literature. These approaches do not include mechanisms outside the tax-exempt bond financing mechanism, such as direct buy-downs of loans or assistance with closing costs. (See section 3.)

We performed our work in May 1988.

BACKGROUND

Since 1980, the Internal Revenue Code (the Code) has restricted state and local governmental units' abilities to issue tax-exempt revenue bonds as a method of providing financing for home purchases. Governments issue tax-exempt "qualified mortgage bonds"[1] whose proceeds are used to provide mortgages at below-market interest rates to first-time home buyers. Authority to issue these bonds is scheduled to expire on December 31, 1988. Our March 1988 report examines the efficacy of using qualified mortgage bonds to increase home ownership opportunities.[2]

LEGISLATION REGULATING QUALIFIED MORTGAGE BONDS

The Mortgage Subsidy Bond Tax Act of 1980 imposed the first statutory restrictions on the ability of state and local governments to issue these bonds. In this act, the Congress allowed the tax exemption on these bonds if the proceeds were used to provide assistance to first-time home buyers and the purchase price of the homes did not exceed 90 percent of the average purchase price of homes in the area. It also limited the volume of qualified mortgage bonds that could be issued within a state and a method for allocating this volume limitation between state and local issuers. In 1982, to aid a temporarily depressed housing industry, the Congress amended the act to raise the purchase price limitation to 110 percent of the average area purchase price.

The Tax Reform Act of 1986 again modified the home buyer eligibility requirements by, in part, lowering the limit on the home purchase price to 90 percent of the area average and establishing a purchaser income limit of 115 percent of the median income in the area. The act also provided a new mechanism for allocating the volume of certain tax-exempt bonds, including qualified mortgage bonds.

Serving Lower Income Households

In legislating the 1980 act, the Congress, while intending that lower income households be the primary beneficiaries, largely left it to the bond issuers to determine the proportion of proceeds that would be used for lower income

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[1]These bonds are commonly called "mortgage revenue bonds." However, current law terms them "qualified mortgage bonds," and we follow this convention.

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

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EFFECT OF CHANGING ELIGIBILITY CRITERIA

Bond assistance may have more of an impact on home ownership rates if it is targeted to households that are less likely to become home owners without it. To achieve this goal, the program would have to be targeted to households that are dissimilar to first-time buyers using conventional financing. Unsubsidized first-time buyers tend to have average incomes and purchase houses that are priced below average (about 73 percent of average) because they lack equity. They are also generally under 30 years old with small families. Other home buyers can transfer equity from an existing house, allowing them to buy more expensive houses while reducing the size of the mortgage.

The current statutory income ceiling for bond-assisted households is 115 percent of area median, and the price ceiling is 90 percent of area average. There are no restrictions on age or family size. Restricting income and price ceilings to levels about equal to those for conventional market first-time buyers--restricting price to no more than 80 percent of the local area average, and restricting income to the area median--would have excluded 50 percent of the recipients of bond financing in our March 1988 study. Lowering the income and price eligibility standards, or adding family size and age restrictions, would exclude many households that could more easily buy houses without bond assistance. With these limitations, a greater share of the funds would be available for households that have more difficulty becoming home owners on their own. (See section 2.)

OTHER MECHANISMS TO TARGET ASSISTANCE TO THOSE MORE IN NEED

Our March 1988 report presented two additional approaches that can be used to direct assistance to those most in need. The first is to prohibit households from receiving bond-assisted financing if they can afford to buy the same home with a mortgage at the market interest rate. This requirement could be implemented by having participating lenders determine whether buyers can afford to buy the home at the market rate when they apply for reduced-rate bond-assisted loans. However, a test of this sort may induce buyers to purchase more expensive homes, ones that they might not qualify for at conventional rates. A second approach, then, is to have the federal government recapture a portion of the subsidy from any house price appreciation when the house is sold. Buyers who do not need the assistance would be less likely to enter into a bond-