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REPORT TO THE CONGRESS

Opportunities To Improve Effectiveness And Reduce Costs Of Homeownership Assistance Programs

B 171630

Department of Housing and Urban Development
Department of Agriculture

BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

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COMPTROLLER GENERAL OF THE UNITED STATES
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To the President of the Senate and the
Speaker of the House of Representatives

This is our report on opportunities to improve effectiveness and reduce costs of homeownership assistance programs of the Department of Housing and Urban Development and the Department of Agriculture.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U S C 53), and the Accounting and Auditing Act of 1950 (31 U S C. 67).

Copies of this report are being sent to the Director, Office of Management and Budget, the Secretary of Housing and Urban Development, the Secretary of Agriculture, and the Secretary of the Treasury.

Elmer B. Staats

Comptroller General
of the Unites States

Contents

ABBREVIATIONS

FHA	Farmers Home Administration
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
OMB	Office of Management and Budget
SMSA	standard metropolitan statistical area
USDA	Department of Agriculture

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

OPPORTUNITIES TO IMPROVE EFFECTIVENESS AND REDUCE COSTS OF HOMEOWNERSHIP ASSISTANCE PROGRAMS
Department of Housing and Urban Development
Department of Agriculture
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D I G E S T

WHY THE REVIEW WAS MADE

Low- and moderate-income families are assisted in becoming homeowners through mortgage insurance, loans, and interest subsidies administered by the Department of Housing and Urban Development (HUD) and the Department of Agriculture (USDA).

National goals announced in 1970 called for about 2 8 million families to receive these types of assistance by 1978 HUD's program costs are estimated to range from $10 5 billion to $36.9 billion. At June 30, 1972, HUD had expended about $379 million for homeownership assistance payments No estimate was available of USDA's total costs, however, as of June 30, 1972, USDA estimated that its subsidy program had cost $37 million

Because of the magnitude of Federal funds involved and indications of problems encountered in administering the programs, the General Accounting Office (GAO) reviewed the programs to determine whether HUD and USDA could improve program effectiveness and reduce costs.

Specifically, GAO examined the allocation of program resources, quality of housing provided, mortgage default rates, housing options provided, and method of financing.

FINDINGS AND CONCLUSIONS

Allocation of program resources

HUD and USDA, in allocating program resources, did not insure that all eligible families had the same opportunity to participate in the programs regardless of where they lived.

The need for subsidized housing had not been identified adequately and was not used as the primary basis for allocating limited resources.

HUD headquarters' estimates of subsidized housing needs differed from its field offices' estimates, and the differences were not reconciled adequately. Neither USDA headquarters nor its field offices had developed estimates of rural subsidized housing needs as a basis for allocating program resources. (See p. 10.)

An area's capacity to produce housing was a major factor in distributing HUD program resources at both national and local levels. Allocations of USDA program resources at the national level were based primarily on prior years' housing production. Allocations at the local level were primarily on a first-come, first-served basis. (See p 12.)

Condition of housing

Houses with significant defects were sold under the homeownership

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assistance programs Many of the defects concern the safety and health of occupants, and the objective of providing low- and moderate-income families with decent, safe, and sanitary housing was not met Families that obtained such houses could face unexpected financial hardships in correcting defects or could give up houses because of dissatisfaction (See pp 24 and 29)

HUD and USDA have taken or have planned actions to improve inspection procedures and to insure that defects are disclosed before houses are approved for mortgage insurance or loans (See p. 31)

Additional procedures, however, are needed to provide for reinspecting all houses within the 1-year period during which purchasers are protected under builders' service policies and sellers' certifications Purchasers of existing rural housing also need a right of recourse similar to that of purchasers of urban housing (See p 33)

Housing options

HUD and USDA had not provided field offices with adequate guidelines on the types of housing eligible under homeownership assistance programs Some families could buy houses with such options as air conditioning, fireplaces, or extra bathrooms, while other families could not (See pp 34 and 36)

HUD needed to clarify the application of statutory ceilings up to which it could insure mortgages and of its administrative directive limiting assistance to the cost of a "moderate house " USDA needed to apply more uniformly its criteria for the type of housing that could be subsidized and to cooperate with HUD in applying common standards in communities served by both agencies (See p. 38)

Mortgage defaults

Preliminary information indicated that mortgage defaults could become a major problem in administering the programs Recent experience at HUD indicates a 10-percent default rate Such a rate would reduce program effectiveness and could result in costs to HUD of about $532 million to manage and dispose of acquired properties Therefore, HUD and USDA should analyze the causes of defaults and identify ways of reducing the default rate (See p 41)

Method of financing

HUD could save about $1 billion if its homeownership assistance program were financed through Government borrowings rather than through private lenders because of the lower interest rate at which the Government could borrow (See p 46.)

HUD and USDA internal audits

In fiscal years 1971 and 1972, HUD's and USDA's audit staffs reported significant weaknesses in homeownership assistance programs managed by their agencies GAO has summarized the audit findings and corrective actions taken or planned by HUD and USDA. (See p 52.)

RECOMMENDATIONS OR SUGGESTIONS

HUD and USDA should:

--Insure that program resources are

allocated primarily in proportion to identified needs (See p 23.)

--Reinspect all houses within the 1-year warranty period after purchases to insure that housing defects have been properly identified and corrected (See p 33)

--Clearly define the types of housing that may be subsidized in various areas of the Nation and cooperate in applying common standards for houses being provided in communities served by both agencies. (See p 39)

--Require in-depth studies to determine reasons for defaults and use such studies to develop guidelines for screening and counseling program applicants (See p. 45)

USDA should

--Make separate allocations of program resources for subsidized and unsubsidized housing loans according to need (See p. 23.)

--Establish procedures or seek legislation, if necessary, to provide the purchasers of existing rural housing with a right of recourse to the sellers for defects existing at the time of purchase (See p. 33.)

AGENCY COMMENTS AND UNRESOLVED ISSUES

Allocation of resources

HUD has increasingly considered needs in its allocation of program resources, but because a number of States have not received their proportionate share, HUD must first identify the true needs and allocate resources in accordance with them

USDA has directed that at least 50 percent of its program resources be allocated to subsidized rural housing, needs for such housing should be determined (See p. 22)

Reinspection of housing

HUD and USDA have agreed, within the constraints of available funding, to make reinspections (See p 33)

Housing options

HUD and USDA cited actions taken subsequent to GAO's review to clarify the types of housing to be provided under their programs. (See p 40.)

Mortgage defaults

HUD and USDA mentioned procedures for determining and listing causes of defaults, they should give attention to analyzing causes of defaults and minimizing future defaults. (See p. 45.)

Method of financing

HUD, the Treasury Department, and the Office of Management and Budget agreed that the cost of direct Government financing would be lower than financing through private lenders but said that factors other than cost must be considered and made certain observations on behalf of the present method of financing. (See p. 49.)

MATTERS FOR CONSIDERATION BY THE CONGRESS

The Congress should consider legislation which would permit HUD's homeownership assistance program to be financed by the

Government rather than by private lenders, because of the possible saving in interest costs GAO previously made a similar recommendation to the Congress on legislation for financing rural housing programs (See p 51)

CHAPTER 1

INTRODUCTION

The Housing Act of 1949 (42 U S C 1441) expressed a national objective of a "decent home and a suitable living environment for every American family " In the Housing and Urban Development Act of 1968 (42 U.S C 1441a), the Congress reaffirmed that objective and established a national goal of producing and rehabilitating 26 million housing units by 1978--6 million units to be provided to low- and moderate-income families with some form of Federal assistance Half of the 6 million units will be houses that such families can buy with Federal financial assistance The Federal Housing Administration of the Department of Housing and Urban Development (HUD) and the Farmers Home Administration (FHA) of the Department of Agriculture (USDA) are authorized to provide this financial assistance under two programs--the section 235 and section 502 programs

SECTION 235 PROGRAM

Section 235 of the National Housing Act, as amended (12 U.S.C. 1715z), which was added by section 101(a) of the Housing and Urban Development Act of 1968, authorizes HUD to assist low- and moderate-income families in becoming homeowners by providing mortgage insurance and subsidizing portions of the monthly payments due under the mortgages for principal, interest, taxes, insurance, and mortgage insurance premiums.

Generally, to be eligible, a family must have an adjusted income which does not exceed 135 percent of the income limit established in the area for initial occupancy of public housing Family assets cannot exceed $2,000 if the applicant is under 62 years of age, $25,000 if the applicant is between the ages of 62 and 64, and $35,000 if the applicant is 65 years of age or over. The family asset limitation may be increased by $500 for each dependent, plus an amount equal to the applicant's share of the mortgage payment for 1 year.

The purchaser is required to pay at least 20 percent of his adjusted income toward the total monthly mortgage payment. HUD pays the balance of the required monthly payment, however, HUD's payments cannot exceed the difference between the total required monthly payment for principal, interest, and mortgage insurance premium and that amount which would be required for principal and interest if the mortgage bore interest at a rate of 1 percent.

HUD requires a purchaser's income to be recertified every year to adjust assistance payments. As long as the required monthly mortgage payment exceeds 20 percent of the purchaser's adjusted monthly income, he will receive a subsidy even though his income exceeds the limits set for eligibility at the time of purchase. Assistance payments can be made to purchasers of either new houses (houses constructed or substantially rehabilitated in accordance with HUD-approved plans and specifications) or existing houses. Under current law, only 30 percent of the authorized funds can be used to assist families to purchase existing houses.

Under the section 235 program, HUD generally assists low- and moderate-income families in urban areas. The authorizing legislation provides that the Secretary of HUD assign a portion of the authority to make assistance payments to the Secretary of USDA to use in rural areas and small towns. An agreement between HUD and USDA stipulated that assistance payments authorized by USDA would be limited to rural areas. Through June 30, 1971, USDA had processed about 4 percent of the total section 235 loans.

The basic statutory mortgage limits for single-family dwellings are $18,000 for a family of four or less and $21,000 for a family of five or more. These limits may be exceeded by $3,000 in high-cost areas.

SECTION 502 PROGRAM

Section 502 of the Housing Act of 1949 (42 U.S C. 1472a) authorized USDA to make housing loans in rural areas. Section 1001 of the Housing and Urban Development Act of 1968 amended section 502 to provide subsidized loans to low- and moderate-income families if their need for housing could not be met with financial assistance from other sources, including assistance available under section 235. The subsidy (interest credit) can reduce the homeowner's interest rate to as low as 1 percent.

To be eligible for an interest credit loan, the applicant's adjusted annual income cannot exceed $7,000 and his net worth cannot exceed $5,000 when the loan is made. As under the section 235 program, a borrower eligible for a subsidy is required to make mortgage payments which are at least 20 percent of his adjusted income.

USDA and the borrower execute an initial interest credit agreement covering the time from loan closing to the end of the following calendar year. A new loan agreement is executed every 2 years to adjust the amount of the monthly payment. However, unlike the section 235 program, the borrower will no longer be eligible for a subsidy after his adjusted income exceeds the maximum established for his State, even though 20 percent of his adjusted income would be inadequate to make the total required mortgage payment.

No maximum mortgage amounts are set for section 502 loans, however, USDA regulations state that the home should be modest in design, cost, and size.

TARGETS AND ACCOMPLISHMENTS

The Congress directed the President to set production targets for each of the major housing programs for low- and moderate-income families during the 10-year period ending June 30, 1978, and to report each year on the accomplishments. Following are the reported targets and related accomplishments for the sections 235 and 502 programs.[1]

[1]The targets are those included in the President's Second Annual Report on National Housing Goals, dated April 1970. The accomplishments are those included in the Fourth Annual Report on National Housing Goals, dated June 1972.

Fiscal year	Section 235 Targets	Section 235 Accomplishments	Section 502 Targets	Section 502 Accomplishments
	(Thousands of units)			
1969	3	8	33	33
1970	48	70	63	48
1971	145	138	121	83
1972	141	141[a]	172	87[a]
1973	175		172	
1974	175		172	
1975	175		172	
1976	175		172	
1977	175		172	
1978	174		171	
	1,386		1,420	

[a]Estimated.

Targets for the section 502 program include loans to both borrowers who are eligible and borrowers who are not eligible for interest credit loans. Separate targets for housing to be provided under interest credit loans have not been established.

Targets have not been set for the number of existing units to be provided under either program, and they do not count toward meeting the housing goals because they do not add to the housing supply However, during fiscal years 1969, 1970, and 1971, about 31,000 existing units were provided to low- and moderate-income families under section 235 and about 25,000 units were provided under section 502.

ESTIMATED SUBSIDY PAYMENTS

Subsidies for the 1 4 million new and rehabilitated housing units planned under the section 235 program could amount to $10.5 billion. This estimate is based on information which HUD provided to the Congress in April 1972 on estimated payments under section 235 contract authorizations granted through 1972. The information indicated that the average purchaser would be eligible for a subsidy of about $7,600 over 12 to 14 years. If the purchaser remained eligible for a subsidy for the full 30-year term of the mortgage loan, the subsidy payments could amount to about $26,600 for each loan, or about $36.9 billion for the total program. At June 30, 1972, HUD had expended about $379 million in home ownership assistance payments.

Since USDA has not established separate targets for the housing units to be provided under section 502 interest credit loans, the subsidy cost for this program has not been determined. However, as of June 30, 1972, USDA estimated that its subsidy program had cost about $37 million.

SCOPE OF REVIEW

We reviewed selected aspects of the two loan programs because preliminary information indicated that HUD and USDA could improve program effectiveness and reduce costs. We reviewed the allocation of program resources, quality of housing provided, mortgage default rates, housing options provided, and method of financing.

Also, we considered HUD's and USDA's recent, comprehensive internal audits of the sections 235 and 502 programs.

Our review was generally confined to HUD and USDA activities in nine States--Alabama, Arkansas, Colorado, Georgia, Louisiana, South Carolina, Texas, Washington, and Utah--where about 38 percent of the section 235 loans and about 29 percent of the section 502 loans had been made from August 1968 through December 31, 1970. We interviewed HUD officials at headquarters, regional, and local levels and USDA officials at headquarters, State, and local levels. We examined pertinent legislation, administrative regulations, and program records. We inspected houses provided by USDA and monitored HUD's inspection of selected houses.

We also interviewed officials from the mortgage banking industry about certain aspects of loan processing and servicing.

CHAPTER 2

ALLOCATION OF PROGRAM RESOURCES

HUD and USDA did not allocate program resources[1] to insure that all eligible families had the same opportunity to participate in the homeownership assistance programs regardless of where they lived For an equitable distribution of their limited program resources, the two agencies should better identify the housing needs of lower income families and should distribute program resources primarily in proportion to identified needs.

HOUSING NEEDS NOT ADEQUATELY IDENTIFIED

HUD headquarters and field offices have estimated housing needs for lower income families, however, these estimates differed greatly and HUD did not reconcile them to arrive at reasonably reliable data. Neither USDA headquarters nor its field offices had developed estimates of rural subsidized housing needs for use in its allocation process

HUD estimates of need

To estimate the needs for subsidized housing for each standard metropolitan statistical area (SMSA)[2] and for each county with an urban center having a population of 8,000 or more, HUD headquarters updated 1960 census data on households and conditions of housing to reflect intervening construction, demolition, housing deterioration, growth in number of households, aging of population, and changes in

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[1]HUD program resources consist of authorizations to enter into contracts with lenders for paying subsidies. USDA program resources consist of the authority to make housing loans

[2]An "SMSA" is generally defined as a county or group of contiguous counties which contain at least one city of 50,000 inhabitants or more or twin cities with a combined population of at least 50,000

family income levels and distributions. HUD annualized the total estimates to reflect that portion of an area's needed units which, if provided, could be sold during a 1-year period.

Field office need estimates were to reflect the maximum number of subsidized housing units which could be sold in an area during a 1-year period. Field office personnel were allowed little time to prepare the estimates, and they told us that their estimates could be nothing more than educated guesses.

HUD headquarters' estimates and the field offices' estimates differed greatly, however, HUD did not reconcile these differences but instead used an average of both estimates in its allocation formula. For example, headquarters estimated that one field office needed about 6,600 units, whereas that field office estimated only about 2,000 units. Although the headquarters' estimate was over three times that of the field office, HUD used an average of 4,300 to determine how program resources would be allocated in fiscal year 1971.

Needs not identified by USDA

Neither USDA headquarters nor the nine USDA State offices included in our review had estimated the needs for subsidized rural housing. However, one USDA State director had begun a study to estimate housing needs projected to 1980, so that the county offices, as well as the builders, could be directed to areas in need.

NATIONAL ALLOCATION OF PROGRAM RESOURCES

A major factor in determining where HUD resources were to be allocated was an area's capability to produce housing. USDA's allocations were based primarily on prior years' production. As a result, not all areas of the Nation participated in the homeownership assistance programs in proportion to their indicated needs.

Allocation of HUD program resources

HUD allocated section 235 program resources to its 77 field offices primarily on the basis of a formula which considered production capacities and estimated needs for subsidized housing in the areas served by the field offices. The allocation formulas used prior to March 1971 emphasized production capacities rather than estimated needs, therefore, areas most active in producing subsidized housing received a greater proportion of the available program resources. HUD recognized that need is an important factor in allocating limited program resources and has taken some action to increase emphasis to this factor in allocating section 235 program resources. In the March 1971 allocation, HUD gave equal weight to subsidized housing needs and production capacities In the fiscal year 1972 allocation, HUD changed the relative weights assigned to these two factors to 60 percent and 40 percent, respectively.

HUD reassigned program resources among field offices when field offices had not used their allocations promptly. For example, to meet production goals for calendar year 1970, HUD reassigned program resources during December to various field offices on the basis of their areas' ability to start construction by the end of the year HUD provided enough contract authority to two field offices in December 1970 to enable them to increase calendar year 1970 construction starts in their areas by over 65 percent HUD records show that construction starts in these two areas totaled about 2,865 units in the last 3 weeks of December 1970.

HUD officials advised us that the headquarters' estimates were the best approximation of nationwide needs for subsidized housing. Therefore, we compared the actual distribution of housing units provided under section 235 from program inception (August 1968) through December 1971 with headquarters' estimates of housing needs by individual States. Because HUD's rental assistance program, authorized by section 236 of the National Housing Act, serves the same income group as the section 235 program, HUD developed one combined estimate of housing needs to be met by both programs. Therefore, our comparison includes housing units provided under both these programs.

Our analysis showed that several States received far fewer housing units than their share as indicated by estimated housing needs This was especially true for the Northeastern States.[1] About 11 percent of the housing units provided through December 1971 were in the Northeastern States, which would have received about 32 percent of the housing units had they been allocated on the basis of HUD need estimates. Following is the national ranking of selected States based on HUD headquarters' estimates of needs compared with the housing units provided (See app. I for a ranking of all States.)

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[1]As classified by the Bureau of Census

State	Estimates of needs (note a)		Housing units provided August 1968 through December 1971					
			Total		Section 235		Section 236	
	Units	Rank	Units	Rank	Units	Rank	Units	Rank
Northeast								
N J	25,980	7	4,815	32	2,460	31	2,355	27
N Y	110,770	1	11,855	13	2,633	30	9,222	6
Pa	39,440	4	11,750	14	3,700	27	8,050	7
South								
N C	13,130	15	8,145	21	5,098	19	3,047	20
W Va	3,835	36	1,261	45	599	44	662	43
North Central								
Mo	13,770	12	6,772	27	3,775	26	2,997	21
Wis	13,725	13	7,562	24	5,400	17	2,162	31

[a]These estimates, based on data furnished by HUD headquarters, represent the needs for units which could be sold in a 3-year period

Allocation of USDA program resources

USDA has allocated section 502 program resources to each of its State offices and its offices in Puerto Rico and the Virgin Islands primarily on the basis of prior production. USDA made allocations to State offices in aggregate for all section 502 loans, it made no separate allocations for loans to borrowers who are eligible to receive interest credit loans. However, in June 1971 USDA headquarters directed that at least 50 percent of all section 502 loans authorized for fiscal year 1972 would be made to lower income families.

We compared the distribution of housing provided under the section 502 program from August 1968 through December 1971 with rural census population statistics because estimates of rural housing needs were not available We recognize that population statistics may not be an accurate indicator of housing needs, however, we did find a high correlation between State population statistics and HUD's estimates of subsidized urban housing needs (see app. I), and a similar correlation may exist for subsidized rural housing needs.

About 10 percent of the housing units provided by USDA under the section 502 program were in the Northeast States, which had about 18 percent of the Nation's rural population, and about 23 percent were in the North Central States, which had about 30 percent of the Nation's rural population. About 58 percent of the housing units provided were in the South, which had about 41 percent of the Nation's rural population.

The State rankings by rural population differed greatly from those by the number of housing units provided under section 502 The following schedule shows the national ranking for several States. (See app. II for a ranking of all States.)

State	Rural population ranking	Housing units provided under USDA's section 502 program August 1968 through December 1971: Total Units	Total Rank	Interest credit loans Units	Interest credit loans Rank	Other loans Units	Other loans Rank
Northeast							
Maine	34	5,175	19	2,185	12	2,990	23
Pa.	1	4,101	23	695	27	3,406	21
South							
Ark	24	12,837	5	5,302	3	7,536	6
Miss.	21	15,616	2	5,849	2	9,767	2
North Central							
Mich	5	6,748	14	1,553	17	5,195	14
Ohio	4	5,924	17	1,358	20	4,566	18

Through June 30, 1971, USDA, acting as HUD's agent in rural areas for approving section 235 home ownership loans, approved about 7,360 loans USDA administered program resources at the national level and made them available to borrowers on a first-come, first-served basis As a result, about 26 percent of the loans approved by USDA in fiscal years 1970 and 1971 were in one State (Washington) which accounted for only about 2 percent of the Nation's rural population. During the 18-month period ended December 31, 1970, over half of the loans were made in one county of this State

LOCAL ALLOCATION OF PROGRAM RESOURCES

A basic problem encountered by HUD and USDA field offices was inadequate guidance by headquarters on the procedures and policies to follow in allocating program resources. Left on their own, most of the offices allocated resources on a first-come, first-served basis and therefore did not allocate program resources according to needs

Allocation of HUD program resources

Authority to approve section 235 loans was first delegated to field offices in July 1969. At that time, HUD instructed the offices to serve those communities with the greatest needs for housing and to make every effort to achieve a fair geographic distribution. Although HUD issued many circulars and directives on the operation of the section 235 program, it gave no guidelines on how a fair geographic distribution should be achieved.

Field offices used various methods of allocating program resources Many field offices covered by our review did not use their own or headquarters' need estimates as a basis for allocating resources There were wide variations in the extent to which the housing provided met the needs for subsidized housing in the areas served by the field offices

Many of the field offices relied on builders to determine the locations of houses For example, the Denver field office--which serves Colorado--allocated its funds for new units according to builder requests and each builder received a portion of the funds Few builders submitted proposals to build in small communities, therefore, larger communities received a disproportionate share of available resources. In Colorado 5,501 of 6,051 houses provided from August 1968 through December 1971 were in the three SMSAs of the State, while only 550 houses were in the rest of the State. Following is a comparison of the actual distribution of houses in Colorado with need estimates developed by HUD headquarters As mentioned earlier, we included the housing units provided under the sections 235 and 236 programs in our comparison because these programs serve the same income group

SMSA or county	Housing units provided from August 1968 through December 1971: Section 235	Section 236	Total units	Estimated needs: Units (note a)	Percent of needs met
SMSAs					
Colorado Springs	1,366	439	1,805	964	187
Denver	3,685	2,467	6,152	4,126	149
Pueblo	450	245	695	437	159
County					
Fremont	1	-	1	53	2
La Plata	5	-	5	55	9
Larimer	69	24	93	393	24
Las Animas	-	-	-	45	-
Logan	2	-	2	55	4
Mesa	17	90	107	192	56
Otero	5	-	5	121	4
Weld	57	-	57	318	18
Other	394	42	436	(b)	-
Total	6,051	3,307	9,358	6,759	138

[a]See note on page 13

[b]Needs were not estimated for these counties

At the Columbia, South Carolina, field office, we were told that funds were generally allocated on the basis of how much confidence the office had in the builders who submitted proposals A comparison of the actual distribution of houses with HUD's need estimates shows that the percent of needs met ranged from a low of 4.4 percent in one county to over 300 percent in another.

The director of the Seattle, Washington, field office told us that builders usually determined the locations of section 235 housing Our analyses again showed a concentration of houses in the State's two SMSAs and a wide variance in percent of needs met

SMSA or county	Housing units provided from August 1968 through December 1971: Section 235	Section 236	Total units	Estimated needs: Units (note a)	Percent of needs met
SMSA					
Seattle-Everett	4,583	2,593	7,176	4,608	156
Tacoma	1,708	655	2,363	1,757	134
County					
Chelan	18	-	18	207	9
Clallum	11	-	11	130	8
Cowlitz	33	145	178	245	73
Grays Harbor	57	-	57	214	27
Island	24	-	24	90	27
Kitsap	98	36	134	396	34
Kittitas	4	168	172	99	174
Skagit	228	46	274	172	159
Thurston	143	-	143	285	50
Whatcom	108	82	190	307	62
Yakima	298	-	298	721	41
Total	7,313	3,725	11,038	9,231	120

[a]See note on page 13.

The Seattle field office began allocating resources to counties on the basis of indicated needs after we discussed the results of our review with the office Under this method the director of the office informed builders and mortgagees of the number of houses which would be financed in each county under the section 235 program. Also the office planned to record the locations of housing provided to determine how well the needs of each area had been met

The Spokane, Washington, field office allocated resources in a planned, consistent manner starting in calendar year 1970. It allocated program resources equally between the one metropolitan area and outlying areas within its jurisdiction. It reviewed prior allocations and gave higher priorities to those areas which had not received their shares. As the following analysis shows, this method resulted in a somewhat more equitable distribution of resources between SMSAs and non-SMSAs than the methods used by the offices previously discussed

SMSA or county	Housing units provided from August 1968 through December 1971 Section 235	Section 236	Total units	Estimated needs Units (note a)	Percent of needs met
SMSA					
Spokane	1,514	612	2,126	1,115	191
County					
Benton (Wash)	146	-	146	144	101
Franklin (Wash)	100	54	154	108	143
Grant (Wash.)	48	37	85	116	73
Walla Walla (Wash)	132	48	180	180	100
Whitman (Wash)	47	100	147	126	117
Kootenai (Idaho)	101	66	167	117	143
Latah (Idaho)	25	55	80	119	67
Nez Perce (Idaho)	109	-	109	110	99
Total	2,222	972	3,194	2,135	150

[a]See note on page 13.

Allocation of USDA program resources

USDA State offices made section 502 program resources available to county offices largely on a first-come, first-served basis No guidance had been provided to State or county offices on how to distribute program resources, so distribution was left to individual county supervisors

The State offices included in our review had not determined the needs for subsidized housing The locations of section 502 housing in many States was determined primarily by builders and realtors, and loans were not distributed among counties according to population data For example, in Georgia, no section 502 interest credit loans were made in one county with a rural population of about 19,000 from July 1, 1968, to May 20, 1971, while 135 interest credit loans were made during the same period in another county with approximately the same rural population In Texas 16 section 502 interest credit loans were made in one county from July 1, 1968, through March 31, 1971, while 153 section 502 interest credit loans were made during the same period in an adjacent county with a similar rural population

USDA's Office of Inspector General (OIG) reported that some county offices were making only limited use of interest credit loans In a January 1970 audit report, OIG commented that

> "*** loans are *** made primarily on a 'first-come first-served' basis, i.e., the county supervisor who gets the largest amount of loan dockets to the National Finance Office will make the largest amount of loans Meanwhile, it is entirely possible that residents of areas served by other unit offices will not receive loans needed equally as much primarily because (a) the county supervisor in their area was not as adept in completing loan dockets, or (b) the county supervisor lacked initiative, ingenuity, or resourcefulness in making known to potential borrowers the manner in which FHA [Farmers Home Administration] loan programs could assist them."

In another audit report issued in August 1971 on the rural housing program, OIG pointed out that

> "FHA is not adequately meeting its Rural Housing Program objective of providing safe, decent, and sanitary housing for low to moderate income families. This is occurring because (1) the objectives of the currently funded Rural Housing Program are neither clearly understood nor fully accepted at State and county office levels in

some locations, and, (2) currently there is neither adequate National Office monitoring of field operations nor an effective system for qualitatively measuring the extent to which program objectives are understood and accomplished As a result, the housing needs of lower income families, in some areas, are not being adequately served *** "

AGENCY COMMENTS AND OUR EVALUATION

HUD views

In commenting on our proposal that HUD provide for a more equitable distribution of program resources, HUD stated (see app. IV) that it had increased emphasis on needs in its allocation formulas, to a point where it gave needs a 60-percent weight in the fiscal year 1972 allocation formula We believe, however, that HUD must first identify the true needs for subsidized housing. As a minimum, this would require that HUD headquarters need estimates and its field offices' estimates be coordinated, to arrive at reliable data. After HUD has determined needs, it should make every effort to allocate program resources according to the needs, even if this requires special actions or programs to spur the development of subsidized housing in certain areas.

HUD agreed that field offices should be more active in determining the areas' needs for subsidized housing and should give priority to developing areas with the greatest needs. Statutory limitations, restrictive income limits, increasing land costs and taxes, and the conservative attitudes of some banking institutions, according to HUD, had contributed to the disparity between the estimated needs for subsidized housing in the Northeastern States and the housing units actually provided HUD stated that the proposed Housing and Simplification Act, which the 92d Congress considered but did not enact, would improve this situation by permitting the Secretary to administratively determine mortgage and income limits.

USDA views

USDA informed us (see app. V) that its allocation of rural housing funds to States considers such factors as number of rural homes, conditions of homes, incomes of rural families, average costs of new homes, and historical lending patterns. USDA expressed the view that it is distributing the funds to States in accordance with needs.

Although USDA considered the cited factors when it distributed section 502 funds, historical lending patterns (prior production) were a major factor influencing such distribution For example, the initial distribution of fiscal year 1971 funds was based primarily on fiscal year 1970 distribution.

USDA advised us that for fiscal year 1973 it ranked the States for each of the five factors mentioned above and then adjusted the ranking on the basis of historical lending patterns to decide whether a State should receive a greater or lesser proportion of the total program resources than it did the previous year. We believe that this procedure continues to give undue weight to prior production instead of current needs.

USDA did not comment on the allocation of section 502 resources at the State or local level or on making allocations on a first-come, first-served basis or on the basis of the actions of builders and realtors.

USDA acknowledged that it had made no separate allocations of interest credit loans under the section 502 program but informed us that it would instruct the States to channel at least 50 percent of the loan funds into housing for low-income families We question whether allocating loan funds on the basis of a predetermined nationwide percentage would adequately meet the housing needs of low-income families.

RECOMMENDATIONS

We recommend that the Secretary of HUD and the Secretary of Agriculture insure that resources under sections 235 and 502 programs are allocated primarily in proportion to needs. We also recommend that the Secretary of Agriculture require separate allocations of the subsidized and unsubsidized housing loans according to needs.

CHAPTER 3

CONDITION OF HOUSING

Houses with significant defects were sold to low- and moderate-income families under the programs Because many of the defects concern the safety and health of the occupants, the program objective of providing low- and moderate-income families with decent, safe, and sanitary housing has not been met in many cases. Also, the families that obtained such houses could face unexpected financial hardships in correcting the defects or could give up the houses because of dissatisfaction.

HUD and USDA have taken some corrective actions and plan to take others. At the time of our review, it was too early to test the adequacy of these actions.

DEFECTIVE HOUSES PROVIDED UNDER THE HUD-ADMINISTERED SECTION 235 PROGRAM

A report by the staff of the House Committee on Banking and Currency[1] disclosed that houses with serious defects had been provided to low- and moderate-income families under the section 235 program. As a result of this report, HUD's Office of Audit reviewed HUD's program administration, which included physical inspections of 1,281 properties which HUD had previously inspected and approved. HUD's auditors found that 433 of the 1,281 houses had defects. About 24 percent of the new houses and 39 percent of the existing houses had defects.

HUD's original audit samples of 730 new houses and 633 existing houses were selected, on a statistical random basis, from the approximately 78,700 new houses and 40,600 existing houses insured by HUD at November 30, 1970 The original samples were reduced by 61 houses by eliminating those field offices where there were less than 10 properties

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[1]Investigation and Hearing of Abuses in Federal Low- and Moderate-Income Housing Programs, Staff Report and Recommendations, December 1970.

and by 51 houses where the auditors were unable to enter and inspect the houses. In addition to reviewing the HUD auditors' sampling techniques, we verified their inspection results by inspecting with them, or by reinspecting, 101 houses in 12 cities On the basis of that review, we believe that the results of the inspections can be projected nationwide. Such a projection indicates that, of those houses insured as of November 1970, about 18,900 new houses (24 percent of 78,700) and 15,800 existing houses (39 percent of 40,600) had defects.

The results of HUD's inspection and descriptions of the defects disclosed are set forth below

	New houses	Existing houses
Original sample	730	663
Houses inspected	672	609
Houses inspected that		
Had defects resulting from poor workmanship or materials	100	(a)
Had significant defects affecting safety, health, or livability	73	225
Should not have been insured (note b)	-	35
Total houses with defects	173	260
Percent of houses with defects to original sample	24	39

[a]Not applicable.

[b]HUD's Office of Audit concluded that the significant defects in these houses should have made them ineligible for mortgage insurance.

New houses--poor workmanship or materials. No switch to operate kitchen light, all corners cracked from ceiling to floor, stairway handrail to upper story loose and attached to sheetrock rather than studding, large two-pane picture window had inside portion of mullion missing, which allowed air to enter through crack that extends the full height of window.

New houses--significant defects affecting safety, health, and livability. Leak in drainpipe from kitchen and bath causing water to stand under house, electric circuit breaker cut power off at various times, particularly when furnace and range were both on, 2 to 6 inches of water standing in crawl space due to poor drainage, leak in roof, wingwall separated from main part of house, severe settling of concrete porch, steps separating from porch, no porch handrails, drainage problem because of improperly graded lot.

Existing houses--significant defects affecting safety, health, and livability. House required complete rewiring, and owner received notice of code violation from city, walls cracked throughout house, ceiling tiles falling down, subfloor and floor joists under bathroom and utility areas rotted, all windowsills rotted, roof leaked into kitchen, back porch, dining room, and hall, water in basement due to poor condition of foundation walls, porch deteriorated and handrails rotted, improper lot drainage and water in crawl space.

Our photographs of such defects are included in appendix III.

Inadequate inspection procedures

HUD officials told us that inspections were inadequate because:

1. Appraisers, who are responsible for inspecting properties they appraise and noting conditions needing repair, were not adequately trained to make these inspections. HUD's Office of Audit found a number of cases in which the appraisers had failed to identify significant defects. In other cases, the appraisers noted the defects but the repairs required by the appraisers were inadequate to correct the defects.

2. The emphasis on providing houses placed an unusually heavy workload on field office appraisers. HUD's Office of Audit found that in some field offices appraisers were making five or more appraisals a day. The Office concluded that this workload was unrealistic and resulted in poor inspections because of the time required to appraise and inspect houses, complete paperwork, and find and inspect comparable houses.

3 Appraisers were inadequately supervised HUD's Office of Audit concluded that many of the appraisal and inspection problems might have been discovered and corrected if supervisory reviews had been made as required.

4. Certain HUD personnel had non-consumer-oriented attitudes toward the section 235 program. HUD's Office of Audit commented on this matter in its December 1971 report.

"Over the past years FHA [Federal Housing Administration] has operated quite successfully as an insurer of mortgages, closely tied into the attitudes and postures of the home building and mortgage banking industries. The organization was not consumer oriented to any significant degree. With the advent of subsidized housing programs (rent supplement and interest subsidies) many of the personnel carrying out programs have not sufficiently adjusted their thinking and attitudes to encompass the Department's new programs.***

"We were informed, both orally and in written comments, that the word was out from the Central Office to relax the inspection requirements. FHA personnel advocated, and continue to do so in certain areas, the 'caveat emptor' concept. They stated that as long as the people were getting better housing than they were accustomed to the goals of the program were being met. The majority of the people housed under Section 235 have received good value and are living in better housing than they were accustomed to.***

"Many buyers of older inner city houses have not been fairly treated. The values stated as the result of appraisals have been high and the condition of many properties has been poor to bad *** Policies, procedures and instructions concerning complaints on existing construction were not sufficiently responsive to the homeowner. ***"

DEFECTIVE HOUSES PROVIDED UNDER THE USDA-ADMINISTERED SECTIONS 235 AND 502 PROGRAMS

In eight States we inspected 121 houses provided under the USDA-administered sections 235 and 502 subsidy programs and found that over 50 percent of these houses had defects similar to those found in the HUD-administered program USDA construction inspectors accompanied us on our inspections and agreed with us on the defects noted and on our classification of them The number of houses found with defects and descriptions of these defects are summarized below

	New houses		Existing houses
	Section 235	Section 502	Section 502
Total inspected	41	38	42
Houses with defects resulting from poor workmanship or materials	22	11	(a)
Houses with significant defects affecting safety, health, or livability	7	2	20
Total houses with defects	29	13	20
Percent of houses with defects	71	34	48

[a] Not applicable

New houses--poor workmanship or materials Glue penetrating and discoloring the bathroom vinyl flooring, inadequate lot drainage, causing standing water along side of house, exterior door improperly fitted

New houses--significant defects affecting safety, health, and livability Septic tank drained into basement, hot-water heater located in attic without pressure release value connected to the outside and no catch pan to handle any water overflow, only one electric heating device for living room, kitchen, and dining area

Existing houses--significant defects affecting safety, health, and livability Defective baseboard electric heating device, deteriorated porch steps, gas stove in living room only source of heat for two-story house, collapsed garage roof, steep and narrow stairs without handrails, callapsed cesspool

Our photographs showing examples of defects in some of the houses we inspected are included in appendix III

Inadequate inspection procedures

USDA officials advised us that inspections were inadequate because

1. County supervisors who were not qualified as housing inspectors inspected houses County supervisors have backgrounds in agricultural management and farm financing but generally do not have sufficient experience or training in homebuilding An OIG report dated August 1971 stated that more than 96 percent of the professional staff at the county level had educational backgrounds in agricultural management, however, rural housing programs accounted for about 65 percent of FHA's total loan activity.

2 The county office staffs were too small and were technically inadequate to administer the subsidized housing programs as well as other programs. OIG reported that from 1960 to 1971 housing loans increased more than 700 percent while the staff increased only 74 percent OIG reported over 1,300 deficiencies pertaining to such matters as water and sewage disposal systems, subdivision planning and development, and general construction and noted problems in the inspections, appraisals, and loan servicing done by USDA personnel

Site and subdivision development standards and technical staff were inadequate. A number of the significant defects found in houses provided under the USDA sections 235 and 502 subsidy programs were due to poor site development, which had caused poor drainage and water accumulation around and under the houses Some subdivisions approved by USDA had been previously rejected by HUD because of poor drainage or unacceptable sewage disposal systems OIG reported that, as of May 1971, USDA had made housing loans in 62 subdivisions in 14 States without adequately planning for overall development of the areas, which had resulted in inadequate water supplies, sewage disposal systems, and road development.

CORRECTIVE ACTIONS TAKEN AND PLANNED

By HUD

To help improve the administration of the section 235 program, HUD has increased its field offices' staff to reduce the workload of appraisers and to allow more time for better inspections

HUD has conducted training sessions emphasizing quality of inspections and the appraisers' obligations to the purchasers Field offices have increased their supervisory staff and have reemphasized spot checks of appraisals so that appraisers' work can be reviewed as required.

HUD planned, at the time of our review, to develop a quality control system to insure improved performance at the field level A professional staff, knowledgeable in mortgage underwriting, housing production, and mortgage credit techniques, was planned to make onsite reviews, evaluate the quality of appraisals and construction inspections made by field personnel, evaluate the correctness of mortgage credit determinations, evaluate the effectiveness of training, determine whether program procedures are being adhered to, and evaluate the effectiveness of regional office supervision. This staff would be directly responsible to the Assistant Secretary for Housing Production and Mortgage Credit

By USDA

USDA began to train county supervisors in homebuilding in States we visited and proposed similar training for all county supervisors In addition, some State and county offices either hired or planned to hire additional technical staff, such as construction inspectors

USDA issued several instructions to its field offices on developing rural housing sites and on establishing standards for acceptability of water and sewage disposal systems USDA officials advised us that they planned additional actions which include revising site development standards and revising the minimum property standards to closely correlate with HUD's minimum property standards

USDA issued instructions to field offices on debarring contractors who failed to correct defects and established a technical staff at headquarters to investigate USDA audit findings on housing defects and to serve as a clearinghouse for recommendations as a result of such findings.

STATUTORY PROTECTION

Purchasers of new houses under section 235 have been protected against defects by homeowner service policies which require builders to correct defects during the first year after purchase This type of protection was not available to purchasers of existing houses until December 31, 1970, when section 518 of the National Housing Act was amended to permit HUD to correct defects which seriously affected the use and livability of any existing house provided under section 235. The defects must have existed on the date of the mortgage insurance commitment and must be reasonably disclosed by proper inspection

This protection was made available to purchasers whose mortgages were insured before and after enactment of the amendment. Claims by mortgagors insured before enactment must be submitted within 1 year of enactment Claims by mortgagors insured after enactment must be submitted within 1 year after the mortgages were insured.

In addition, HUD can act against the seller of an existing house needing repairs to recover repair costs. HUD requires that the seller of an existing house certify the present condition of the house and, if he was not the most recent occupant, deposit 5 percent of the purchase price in escrow for 1 year to insure reimbursement should repairs be needed

Under the section 502 program, purchasers of new houses are also protected against defects by homeowner service policies provided by builders However, the statutory protection of purchasers of existing houses provided by section 518, for the section 235 program, is not available under the section 502 program

Even though purchasers of section 235 houses and section 502 new houses have some protection from defects, low-income families are often unable to detect housing defects and therefore may not request their correction Therefore, we believe that reinspections of houses by HUD and USDA before expiration of the 1-year period would protect the purchasers and would reduce the costs of needed repairs to be borne by the agency if the purchasers default and the mortgages are foreclosed

Also protection should be provided to purchasers of existing houses under the USDA section 502 program similar to that of purchasers of houses under section 235.

RECOMMENDATIONS

We recommend that the Secretaries of HUD and Agriculture require that all houses be reinspected within 1 year after purchases to insure that defects covered by builder service policies and sellers' certifications have been identified and corrected

We also recommend that the Secretary of Agriculture establish procedures or seek legislation, if necessary, to insure that USDA and/or the purchasers of existing housing under section 502 have recourse to the sellers to cover the costs of repairing defects that existed at the time of sale

AGENCY COMMENTS

In commenting on our recommendation to reinspect houses, HUD pointed out that such a requirement would increase the workload and that, since its budget would not cover the additional staff needed, it might have to use private fee inspectors. USDA stated that, if appropriations permit, it would require reinspections of all houses during the 11th month of the 1-year warranty period.

USDA stated that it would study our recommendation that purchasers of existing housing under the section 502 program be protected by a right of recourse to the seller

CHAPTER 4

HOUSING OPTIONS

HUD and USDA have not provided their field offices with adequate guidelines on the types of housing eligible under homeownership assistance programs for low- and moderate-income families As a result, some families can buy houses with such options as air conditioning, fireplaces, and extra bathrooms, while other families in the same general area cannot Because of these inconsistencies, neither agency can insure that all eligible families are offered the same opportunity to receive the extent of assistance intended by the Congress or that program costs are minimized so that the maximum number of families are assisted with the available funds

INCONSISTENCIES IN THE SECTION 235 PROGRAM

The initial statutory mortgage limits established for the section 235 program

	Statutory mortgage limits	
	Basic limit	Limit in high-cost areas
Family of four or less	$15,000	$17,500
Family of five or more	17,500	20,000

In June 1969 HUD instructed its field offices to estimate the cost of a modest house in their jurisdictions to establish administrative mortgage ceilings for the section 235 program A modest house was described as one containing approximately 1,000 square feet of finished floor space with three bedrooms, one bathroom, and the following options, a refrigerator, a range with a vented hood, and a garbage disposal Other options, such as a garage, a carport, a patio, carpeting, a fireplace, and air conditioning, were not to be included in the estimate, however, instructions for preparing the estimate stated that such options were not prohibited under the program if they could be produced within the mortgage ceilings applicable to the area

1969 amendments to the National Housing Act increased the mortgage limits for the section 235 program as shown below

	Statutory mortgage limits	
	Basic limit	Limit in high-cost areas
Family of four or less	$18,000	$21,000
Family of five or more	21,000	27,000

Because of the increase in mortgage limits, HUD headquarters instructed field offices to prepare new cost estimates for the modest house described above A February 1970 instruction stated

> "*** It was never intended that the increase in the 'basic statutory limit' would automatically result in an increase in the actual selling prices under Section *** 235. It was anticipated that in those areas where the typical selling price for a moderate cost, single-family dwelling had been below the new 'basic statutory limit,' most sales under the assisted homeownership program would continue *** at the customary selling prices for 'modest housing' in the area "

Another instruction in March 1970 stated that mortgage limits should not be established below $18,000, regardless of the field offices' cost estimates for a modest house. The field offices interpreted these instructions differently, and some offices set mortgage limits on the basis of the statutory limits while other offices set them on the basis of their estimates of the selling price of a modest house As a result, some families were able to obtain housing with options that were not available to other families

For example, one field office estimated that the modest house would sell for about $15,100 but decided to approve houses with mortgages up to the basic statutory limits. The typical three-bedroom house approved by that office had about 1,100 square feet of improved floor area, central air conditioning, an extra bathroom, carpeting, and an average replacement cost of about $16,800

Another field office in the same State estimated that a modest house would sell for about $15,200 and established $15,200 as the mortgage limit The typical three-bedroom house approved by that office had about 950 square feet of improved floor area and an average replacement cost of about $15,000 It did not have central air conditioning, carpeting, or an extra bathroom.

A field office in another State estimated that a modest house could be sold for about $15,650, however, it based the mortgage limit on the statutory limits After the statutory mortgage limits were increased in December 1969, the average mortgage increased from about $14,350 to about $17,300 as of May 1971 The houses approved by this office often had such options as a garage, carpeting, an extra bathroom, and air conditioning These houses, on the average, had about 160 more square feet of improved floor area than the modest house HUD described

USDA instructions on the section 235 program state that the maximum mortgage amount will not exceed $18,000 unless approved by HUD However, these instructions also provide that lower mortgage amounts should be encouraged in localities where suitable housing could be provided at a lower cost

Our review indicated that USDA generally was approving section 235 houses that were comparable in cost to those being approved by HUD in the same locality. However, in one State, USDA was not making available the same housing options that HUD was The USDA policy in this State was to provide a modest three-bedroom house of about 1,000 square feet, options were generally limited to a range and a carport USDA set a maximum mortgage limit of $14,500, although the HUD field office used the basic statutory limit of $18,000 The houses approved under section 235 by HUD in this State during the first 6 months of 1971 had an average mortgage loan of $17,200 and often included such options as a garage, a full basement, carpeting, an extra bathroom, and air conditioning However, the houses USDA approved during the same period had an average mortgage loan of $13,800 and were approximately 160 square feet smaller than the houses HUD approved, and options were generally limited to a range and a carport

INCONSISTENCIES IN THE SECTION 502 PROGRAM

USDA has not established mortgage ceilings for the section 502 interest credit program Guidelines state that houses approved for section 502 loans must be modest in size, design, and cost and that particular design features or options should not be included if such options are customarily not included in other adequate but modest houses being built in the area by families with moderate incomes

As a result of these rather general guidelines, county supervisors have been allowed to individually determine mortgage ceilings and housing options and housing options made available to section 502 purchasers were not consistent. For example, interest credit loans approved by a county supervisor in one State averaged about $16,000 and the houses usually contained such options as central air conditioning, a brick veneer exterior, and an extra bathroom At the same time the average section 502 interest credit loan in another county of the same State was about $11,000 and the houses had only one bathroom, no central air conditioning, and composition siding.

INCONSISTENCIES BETWEEN THE SECTIONS 235 AND 502 PROGRAMS

Because of the differences in mortgage ceilings and design criteria established for the sections 235 and 502 programs, houses provided to low- and moderate-income families in the same locality could vary significantly. For example, in one county the houses provided under section 235 averaged about 1,120 square feet of improved area and generally had two bathrooms and central air conditioning whereas the houses provided under the section 502 interest credit program averaged about 900 square feet of improved area and had one bathroom and no central air conditioning

EFFECT OF OPTIONS ON PROGRAM COSTS

Options included in houses approved for financing under the section 235 and section 502 subsidy programs generally result in increased cost to the Government. Options generally do not result in increased cost to the purchaser because the purchaser's payment is based on his income rather than the cost of the house.[1]

The following table shows that including $2,500 of options in a basic house costing $15,500 could increase annual subsidy costs by about $260 without increasing the purchaser's annual payment. For this table we assumed that the purchaser had an adjusted gross income of $5,100 a year and that the house was purchased subject to a 30-year mortgage bearing 7-percent interest.

	Basic house	House with options	Difference
Annual payment for principal and interest	$1,556.74	$1,815.24	$258.48
Less annual payment by purchaser (20% of adjusted income)	1,020.00	1,020.00	-
Annual payment by HUD	$ 536.76	$ 795.24	$258.48

[1]When the purchaser receives the maximum subsidy, he bears the cost of any options.

CONCLUSIONS

We believe that all eligible families should have an equal opportunity to receive the full extent of assistance intended by the Congress under the homeownership assistance programs. Because HUD and USDA guidelines have been inadequate, some families are being assisted in buying houses with options that other families in the same general area are unable to obtain.

We are not suggesting a list of options for the Nation, nor are we suggesting that purchasers be denied housing alternatives. We believe that HUD and USDA should determine what options are appropriate for houses in different areas of the country (air conditioning might be appropriate in one area and not in another) and should establish clear and uniform criteria on the basis of the estimated cost of providing houses with appropriate options in each area.

We believe that the Congress intended that HUD and USDA minimize costs consistent with the objective of providing decent, safe, and sanitary housing

Although the Congress has established mortgage limits for the section 235 program, HUD instructions have been unclear about how the field offices should apply these limits in determining the type of housing to be provided. For the section 502 program, for which statutory mortgage ceilings have not been established, USDA has not provided its field offices with adequate guidelines to enable them to make uniform, fair decisions on housing options.

RECOMMENDATIONS

We recommend that the Secretaries of HUD and Agriculture (1) clearly define the types of housing that will be made available under homeownership assistance programs in the various areas of the Nation and (2) jointly determine what housing options are appropriate for the houses being provided in communities served by both departments.

AGENCY COMMENTS AND OUR EVALUATION

HUD, in responding to our first recommendation, referred to additional guidelines for determining mortgage limits that were issued subsequent to our review. One guideline, dated August 1971, which superseded the guideline quoted on page 35, stated that mortgage ceilings would be based on statutory limits or the estimated replacement cost plus closing cost of a moderate cost property, whichever amount was less. Another guideline, dated February 1972, revised the description of a modest house and provided that a modest house could include those features or amenities necessary to insure marketability to other than subsidized purchasers in each market area

USDA recognized that counties varied significantly in the types of construction and the equipment being made available to low-income purchasers. USDA issued a bulletin in June 1972 which instructed State directors to reconcile differences and issue guidelines to insure a consistent application of the policy of financing adequate but modest housing

We believe that HUD's and USDA's revised guidelines, when fully implemented, should meet the objectives of our recommendation.

HUD did not comment on our second recommendation. USDA stated that there would be little advantage in establishing a joint HUD-USDA list of housing options because HUD and USDA serve different markets. We agree that HUD and USDA generally serve different markets, however, under sections 235 and 502 programs, houses are sometimes provided in the same market area. Under these circumstances, HUD and USDA should agree on what options should be made available under both programs

CHAPTER 5

MORTGAGE DEFAULTS

Preliminary information indicated that mortgage defaults could become a major problem in administering the section 235 program. The number of defaults on the section 502 program has been low to date, however, USDA officials anticipated that increased program activity would markedly increase the default rate. A high default rate would reduce program effectiveness and could result in significant costs to manage and dispose of acquired properties. Therefore, HUD and USDA should analyze anticipated default patterns and identify possible ways of reducing the default rate.

SECTION 235 PROGRAM DEFAULTS

We examined the default experience during the first 6 months of the program at 10 HUD field offices. As shown in the following table, the number of mortgages insured in this 6-month period and foreclosed or being foreclosed as of June 30, 1971, ranged from 2.2 percent of loans insured by the Salt Lake City, Utah, field office to 20.1 percent of loans insured by the Seattle, Washington, field office.

Foreclosures in Selected
HUD Field Offices as of June 197
For Section 235 Mortgage Loans Insured
January 1 through June 30, 1969

Field office	Insured mortgage loans	Mortgages foreclosed or being foreclosed (note a)	
		Number	Percent
Columbia, S C	179	21	11 7
Birmingham, Ala	143	9	6 3
Atlanta, Ga	72	10	13 9
Dallas, Tex	123	23	18 7
San Antonio, Tex	128	11	8 6
Shreveport, La	105	13	12 4
Little Rock, Ark (note b)		-	-
Denver, Col	206	8	3 9
Salt Lake City, Utah	45	1	2 2
Seattle, Wash	179	36	20 1
Total	1,180	132	11 3

[a] Includes acquired and assigned properties and properties for which foreclosure was started but not completed

[b] This office did not compile monthly default rates for mortgage loans insured prior to January 1, 1970 Subsequent statistics show that, of the 284 mortgage loans insured during the first quarter of 1970, 6 7 percent were foreclosed or being fore closed

BEST DOCUMENT AVAILABLE

HUD and USDA did not have separate data available on the default rate for the USDA-administered section 235 program. However, our review of defaults in one HUD field office that had insured about 26 percent of the total mortgage loans approved for insurance by USDA in fiscal years 1970 and 1971 showed that the default rates for the loans processed by USDA and those processed by HUD did not differ substantially.

At our request, HUD's actuarial staff prepared an estimate of the aggregate claim rate[1] for the section 235 program. The staff originally estimated that the claim rate for this program would be 25 percent, however, in commenting on our draft report, HUD stated that the estimate was too high. HUD said that the estimate was based on the assumption that defaults for the section 235 program would be higher than the defaults for the section 221(d)(2)[2] program which is another mortgage insurance program for low- and moderate-income families. Subsequent actuarial estimates, according to HUD, indicated that the section 235 program default rate at the end of the second program year was not as high as the default rate for the section 221(d)(2) program.

Actuarial data shows that the default rate for the section 235 program was higher than that for the section 221(d)(2) program at the end of the first year but was slightly lower by the end of the second year

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[1]"Aggregate claim rates" are defined as the total estimated percentages of mortgages upon which mortgagees can expect to be paid insurance benefits.

[2]Since 1961 HUD has administered a mortgage insurance program authorized by section 221(d)(2) of the National Housing Act, as amended (12 U S C. 1715L), to assist low- and moderate-income families by encouraging homeownership with very low downpayments.

The actuarial data on the section 221(d)(2) program shows that defaults during the first 9 years after mortgages were written reached a level of about 11 percent. A report prepared by HUD's chief actuary pointed out that it often takes 6 to 8 years to begin to obtain meaningful information about the experience risk on a mortgage insurance program Because the default rate for the section 235 program has followed closely the default rate for the section 221(d)(2) program, we believe that section 235 defaults could reach 10 percent.

Although a precise default rate for the section 235 program has not been developed, we believe that there are sufficient indicators that the potential foreclosure rate will be high enough to warrant special efforts by HUD to reduce or avoid foreclosures

CAUSES FOR DEFAULTS NOT DETERMINED

Although indications of a high default rate became apparent in the initial phase of the section 235 program, HUD did not analyze available data to identify possible ways of reducing defaults. Such an analysis could serve as a basis for developing criteria and guidelines for screening and counseling loan applicants to minimize defaults in the future. The analysis should include all pertinent data compiled by HUD on the section 235 program, supplemented by other information obtained through such means as interviews with mortgagors and mortgagees.

Information available to HUD includes, for example, data on (1) family characteristics of mortgagors, such as incomes, ages, and sizes of families, (2) types of properties insured, and (3) reported reasons for defaults HUD requires mortgagees to obtain information on families defaulting and to list various reasons for the defaults, such as curtailment of incomes, excessive obligations, distant employment, or unsatisfactory conditions of the properties.

HUD generally has no direct contact with families applying for assistance under the section 235 program and relies primarily on mortgagees to screen applicants. However, in January 1972, HUD initiated a counseling program for applicants in 15 of its field offices and planned to expand the program to other field offices later.

POTENTIAL FOR LOSSES ON ACQUIRED SECTION 235 PROPERTIES

As of June 30, 1972, HUD had incurred an average loss of $3,835 per property to manage and dispose of acquired section 235 properties and a total loss of about $15.2 million. Data provided by HUD's actuaries indicates that the average loss will be even higher in the future. However, if the average loss remained the same and if the default rate reached 10 percent on the 1.4 million properties to be insured through fiscal year 1978, HUD would incur a loss of about $532 million.

USDA ANTICIPATION OF SUBSTANTIAL INCREASE IN SECTION 502 MORTGAGE DEFAULTS

USDA officials expected that the default rate of section 502 mortgage loans would increase because of increased program activity. Housing loans tripled from $500 million in fiscal year 1969 to $1 5 billion in fiscal year 1971. USDA has handled this increased activity with little or no increase in staff, which has impaired the ability of county supervisors to screen applicants and to effectively administer the program Because of this situation, USDA officials expected that the default rate would increase substantially

As of January 1, 1969, USDA had acquired only 251 properties during the first 19 years of the basic section 502 program, in the next 3 years, it acquired an additional 1,250 properties

The number of loan transfers is also increasing USDA often transfers a loan in default to another eligible family rather than foreclose it. Although records at USDA headquarters did not distinguish between loan transfers made to avoid foreclosures and other loan transfers, only 1,911 loan transfers were made by assumption agreement during the first 19 years of the program whereas 1,351 loan transfers were made in the next 3 years. We were unable to obtain any nationwide information on default experience under the interest credit portion of the program.

AGENCY COMMENTS AND OUR EVALUATION

HUD, in commenting on the rate of anticipated defaults under the section 235 program, stated that a comparison (as of December 1971) of defaulted mortgages with insurance written at the field offices where we made our tests showed a significant decrease in defaulted mortgages This rate, calculated by HUD, ranged from less than 1 percent to 12 4 percent. We believe that a comparison of total mortgage defaults with total insurance written understates the foreclosure rate because mortgages most recently insured are less likely to default and be foreclosed than mortgages outstanding for a number of years The understatement would be particularly significant in the early stages of a rapidly expanding program, such as the section 235 program which grew from about 8,000 insured mortgages in 1968 to about 138,000 insured mortgages in 1971

HUD informed us that it had established a continuous review of the reasons for defaults in the section 235 program. USDA stated that existing regulations provide for a case-by-case evaluation of the delinquencies and the reasons for them. However, our review indicated that both HUD and USDA procedures were not adequate to obtain a useful analysis of all significant factors related to defaults The reasons for defaults, as shown on the mortgagees' applications for insurance claims from HUD and as categorized by USDA, are generally only the apparent after-the-fact reasons--curtailment of incomes, excessive obligations, divorces, and deaths--and do not enable HUD or USDA to identify in advance those applicants who have a high potential to default unless supplemented by further in-depth analyses of the characteristics of defaulting mortgagors and the properties on which the defaults occur.

RECOMMENDATIONS

We recommend that, to improve program effectiveness and reduce costs, the Secretaries of HUD and Agriculture require in-depth studies to determine the major reasons for defaults and what can be done to minimize foreclosures. In addition, we recommend that such studies be used as a basis for developing guidelines for screening and counseling program applicants.

CHAPTER 6

METHOD OF FINANCING

The Government could substantially save if the sections 235 and 502 housing loans were financed directly by the Government rather than by private lenders. This is possible because of the lower annual interest rate at which the Government could borrow money, compared with the interest rates in the private mortgage money market

We estimate that savings on the section 235 program could amount to $1 billion. The savings possible on the section 502 program and on certain other loan programs were discussed in a previous GAO report.[1] In that report we stated that the Congress may wish to amend the legislation governing these loan programs to enable USDA financing through Treasury borrowings rather than through sale of borrower's loan notes.

OPPORTUNITY TO REDUCE SECTION 235 PROGRAM COSTS

HUD-approved lending institutions make loans to purchasers of houses under the section 235 program, and HUD insures that the loans will be repaid The purchaser is required to pay at least 20 percent of his adjusted income toward the monthly payment for principal, interest, taxes, insurance, and mortgage insurance premiums. HUD pays the balance of the required monthly payment, but this subsidy shall not reduce the purchaser's obligation below the amount required if the mortgage bore interest at the rate of 1 percent.

The amount of assistance payments therefore depends on the mortgage interest rate For example, the maximum annual assistance payment for an $18,000, 30-year, 8-percent mortgage would be about $979, whereas the maximum annual

[1]Report to the Congress, "Legislation Recommended to Reduce Losses of Two Insured Funds of the Farmers Home Administration" (B-114873, July 20, 1971).

assistance would be about $831 if the mortgage had a 7-percent interest rate.

If the subsidized loans made under the section 235 program were financed with Treasury borrowings rather than by private lenders, the Government could take advantage of its ability to borrow funds at lower interest rates than those charged by private lenders. Data compiled by the Federal National Mortgage Association shows that the interest yield on home mortgage loans insured by HUD was 7.62 percent in August 1972. The interest yield on a recent issuance of long-term Treasury bonds ($2.3 billion, Aug. 15, 1972) was 6.5 percent.

On the basis of information in the President's "Second Annual Report on National Housing Goals," dated April 1970, we calculated that loans for new and rehabilitated houses planned to be provided under the section 235 program during fiscal years 1973 through 1978 will amount to about $19.7 billion. If these loans were made with Treasury borrowings and if the purchasers received assistance payments for an average of 13 years, the present value of the savings to the Government would amount to approximately $1 billion.[1]

We used the present-value method to estimate savings because we believe this is the most appropriate method of estimating long-range costs. Under the present-value method, the current values of fund flows over a specific period of time are calculated by use of a discount rate. The discounting of future costs makes them comparable to present costs, i.e., to the present value of costs. The 6.5-percent yield on a recent issuance of long-term Government bonds in August 1972 was used as the discount rate.

Our estimate considered (1) Federal tax revenues on income to investors in Government securities, (2) costs

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[1]This estimate was based on the 1.05 million new and substantially rehabilitated houses planned to be provided under the section 235 program during fiscal years 1973 through 1978. We could not estimate savings on loans for existing houses because under the section 235 program HUD had not forecast the units planned for financing.

incurred by the Government under the "tandem plan"--a plan under which the Government National Mortgage Association and the Federal National Mortgage Association provide joint financial assistance in financing section 235 mortgages--and (3) costs of servicing mortgage loans under a Government direct loan program.

LOAN PROCESSING AND SERVICING

Under HUD's mortgage loan insurance programs, private lending institutions process the loan applications and service mortgage loans. Our inquiries indicated that most private lending institutions involved in the section 235 program would be willing to process loan applications and service mortgage loans for loans financed through Treasury borrowings for the same fees that they presently receive for these services.

Private lending institutions generally require fees of at least 1 percent of the mortgage loan amounts to cover costs of processing mortgage loans. After the loans are made, the lending institutions service the loans, which includes accounting for receipts and payments of real estate taxes and insurance.

The lending institutions that make the original loans sometimes sell the mortgage loans to other investors but continue to service the loans. When this is done, the purchasers of the mortgage loans generally pay annual fees of three-eighths of 1 percent of the unpaid principals for these services Also, the lending institutions are required to do other special loan servicing, including monthly calculations of assistance payments due from HUD, for which they are paid a monthly fee of $3.50 for each section 235 mortgage loan held.

The president of the Mortgage Bankers Association of America and the vice president-controller of the Government National Mortgage Association advised us that most lending institutions involved in the section 235 program sold the mortgage loans to other investors and that, in their opinion, the lending institutions making the original loans were interested primarily in the mortgage loan processing and servicing fees. They concluded that most lending institutions involved in the section 235 program would be willing to process and service the mortgage loans for a federally financed loan program for the same fee that they presently receive for these services.

CONCLUSIONS

Costs of the section 235 program could be substantially reduced if HUD were authorized to make loans to eligible families with Treasury borrowings. The savings could be realized without significantly disrupting the relationship between HUD and the lending institutions.

We recognize that cost is not the only factor to consider in determining which method of financing is most appropriate for a particular program However, we believe that the Congress should be made aware of the costs that could be saved as a result of an alternative method of financing the section 235 program.

AGENCY COMMENTS AND OUR EVALUATION

HUD, the Department of the Treasury, and the Office of Management and Budget (OMB), although recognizing that the Treasury could borrow at lower interest rates than available in the private mortgage money market, made certain observations on behalf of the present method of financing. Their comments are presented in appendixes III, IV, and V and are summarized below.

HUD

HUD suggested that direct Federal financing of section 235 loans might increase the interest cost of Government borrowings. However, a Treasury official advised us that the increase in Treasury borrowings would not appreciably increase the cost of Government borrowings.

HUD stated that the cost of direct Federal financing might equal or exceed the cost under the present method because of the need for refinancing the public debt. Our estimate of savings is based on the assumption that funds would be obtained through long-term Treasury borrowings, therefore, refinancing should not be necessary.

HUD stated that substantial staff increases would be required to process loan applications and to establish and maintain accounting records and reports. Our review indicated that most mortgagees involved in the section 235 program would be willing to perform these services for HUD at no increase in cost over the present method. In these circumstances, substantial staff increases would not be needed.

HUD commented on the fact that direct Federal financing of the section 235 program would result in a larger Federal budget and increased cash flow from the Treasury. HUD estimated the amount to be about $3.5 billion for fiscal year 1973. We agree that the budget for the section 235 program would have to be increased and that direct Federal financing would initially increase cash flows from the Treasury. However, this would be true only during the early years because loans would be repaid together with interest in later years. Because of the more favorable interest rates for Government borrowing, the direct loan method could reduce costs to the Government without increasing costs to the purchasers.

Treasury

Treasury agreed that the present-value method was appropriate for this analysis but stated that enactment of legislation proposed by it in December 1971, which would create a Federal bank to finance Government loan guarantee programs, would substantially achieve the objective of our proposal. The Congress did not enact this legislation.

OMB

OMB, like HUD, commented on the fact that direct Federal financing of the section 235 program would require a larger Federal budget. In addition, OMB expressed the view that the Government should not seek a major role as a direct lender when the private economy can perform this function effectively. We believe that this is a policy question to be considered by the Congress in determining whether to approve direct Federal financing of the section 235 program.

MATTERS FOR CONSIDERATION BY THE CONGRESS

Because of the potential interest savings, we recommend that the Congress consider legislation which would permit section 235 loans to be financed by the Government rather than by private lenders. We have previously recommended that the Congress consider amending the legislation pertaining to the section 502 program to require direct Federal financing.

CHAPTER 7

HUD AND USDA INTERNAL AUDIT REVIEWS

OF HOMEOWNERSHIP ASSISTANCE PROGRAMS

OIG and HUD's Office of Audit have reviewed several important aspects of the administration of the sections 235 and 502 programs. Their audit reports, issued in fiscal years 1971 and 1972, pointed out significant weaknesses and the need for improvements.

HUD's and USDA's internal audit findings on physical defects of housing provided under the programs are presented in chapter 3 Certain other aspects of program administration and the corrective actions taken or planned by HUD and USDA in response to their auditors' recommendations are summarized in this chapter. We are bringing these matters to the attention of the Congress because they indicate that the departments are cognizant of major problems in the programs and are seeking ways to overcome these problems.

HUD AUDIT FINDINGS

HUD's Office of Audit reported in December 1971 that under the section 235 program (1) a number of families received assistance to which they were not entitled because procedures to insure their eligibility for assistance were inadequate and (2) actions in response to mortgagors' complaints were deficient and showed a need for greater emphasis on consumer protection.

Eligibility of families for assistance

HUD relied on the mortgagees to determine the annual incomes of families and to calculate the amounts of assistance families would receive. However, HUD's Office of Audit found that

1. HUD's guidelines for determining family incomes by mortgagees were inadequate.

2. Field offices were not required to make test reviews of mortgagees' operations but instead relied on the Office of Audit's reviews to determine whether

mortgagees were complying with applicable regulations and requirements.

3 Mortgagees were not required to verify reported family incomes used to determine eligibility for assistance.

4. HUD did not maintain records of the amount of assistance provided to each family.

5 Mortgagees were not required to verify either family size or family assets, both of which are used in determining eligibility for and amount of assistance.

Handling of mortgagors' complaints

HUD's Office of Audit reported that the policies and procedures for handling mortgagors' complaints about the conditions of existing housing were deficient and that, although the prescribed procedures on new housing were generally adequate, field offices needed to better implement them. The auditors found that many legitimate complaints made by buyers of existing housing were not resolved promptly, if at all.

HUD's Office of Audit concluded that consumer protection should be emphasized more and made several suggestions for accomplishing this.

--Provide the buyer of an existing house with a list of all repairs and improvements HUD requires the seller to make.

--Provide for standard sales contracts and settlement forms.

--Provide the buyer with a brochure containing information on such matters as homeownership costs, problems, and responsibilities; routine maintenance requirements, and procedures for filing complaints with HUD.

--Inform the buyer of HUD's limited responsibility for the condition of the house.

--Consider alternatives to the present counseling program, such as including fees in mortgage amounts to compensate appropriate organizations for counseling and assisting unsophisticated buyers.

Corrective actions taken and planned

HUD has issued revised procedures requiring the annual, rather than biannual, recertification of a purchaser's occupancy, employment, income, and family composition. These procedures require the homeowner to immediately report significant changes in status and provide for suspension, rather than termination, of assistance payments to a family whose income rises above the prescribed limits.

For better consumer protection, HUD took, or planned to take, a number of actions, including.

--Improving procedures for more effectively handling mortgagors' complaints on existing housing.

--Revising instructions to require that purchasers be informed of HUD's limited responsibilities for insuring the properties involved and of all repairs and/or improvements which HUD requires the sellers to make as a precondition to issuance of mortgage insurance.

--Developing standard sales contracts and settlement forms

--Developing a "Homeownership Preparedness" booklet dealing with money management, property purchase procedures, property care and maintenance, and other pertinent subjects.

--Planning a public education campaign through the news media to provide consumers with information on homeownership problems and responsibilities

--Initiating a counseling program in 15 field offices using authorized organizations to provide counseling to certain families.

USDA AUDIT FINDINGS

In August 1971 OIG commented on the need for (1) organizational changes in rural housing programs, (2) more technically trained staff, (3) strengthened guidelines covering eligibility requirements, and (4) certain other program improvements.

Need for organizational changes

OIG reported that the organization of FHA did not provide an effective system for routinely informing USDA headquarters of FHA field offices' compliance with policy directives, adherence to procedures, and accomplishment of program objectives. As a result, USDA headquarters was neither exercising effective control over State and county office operations nor receiving adequate feedback on program administration and accomplishments.

OIG noted that the FHA Administrator supervised 42 State directors in addition to his immediate staff and that the Administrator's staff advised the State directors and their staffs but did not exercise line authority over State and county office operations. OIG concluded that, considering the nature and extent of program irregularities uncovered by its audits, FHA should be reorganized to provide effective line authority over State and county office operations and should adopt a system of controls to routinely provide the Administrator and his staff with current and reliable information on field operations

Also, OIG reported that USDA headquarters was not adequately monitoring field operations nor receiving adequate information on field operations through existing reporting procedures. It recommended that USDA develop and use a system of review of program operations from which it could obtain qualitative data to evaluate the accomplishment of program objectives.

Need for more technically trained staff

OIG reported that USDA needed more engineers, architects, sanitarians, community planners, and construction specialists to provide the technical skills required for effective administration of the housing program. OIG found an imbalance between the areas of expertise of the present staff and the funding levels of the programs

OIG concluded that, on the basis of the funding of the loan programs, the number and technical capabilities of the professional staff, and the nature and extent of deficiencies disclosed by its audit and investigations, USDA should expand its staff both in numbers and technical capabilities, to strengthen program administration.

OIG also proposed adopting a career development plan for employees and initiating an intensified, continuous training curriculum provided by staff specialists.

Eligibility of families for assistance

OIG noted that in some areas the housing needs of lower income rural families were not being adequately served while middle-income families were receiving loans in conflict with program objectives and legislative intent.

OIG found that 1,424 of about 10,270 loans examined, or nearly 14 percent, either were made to ineligible borrowers or were made on houses in or near urban centers which exceeded the population limitations and/or other eligibility criteria. OIG reported that USDA needed to strengthen guidelines and instructions covering eligibility requirements.

Subdivision planning and development

OIG reported that USDA should strengthen its guidelines and instructions on planning and developing subdivisions financed with rural housing loans. Major problems found by OIG in the USDA-financed subdivisions were:

1. Some subdivisions were close to urban areas.

2. Water supply systems failed to comply with State regulations and/or failed to meet minimum standards recommended by the State departments of health and the U.S. Public Health Service.

3. Individual septic and/or community sewage disposal systems were inadequate in size, design, or treatment facilities.

4. Road development was inadequate

On the basis of its findings, OIG concluded that USDA was making rural housing loans in nonrural areas and was financing subdivisions with the potential to develop serious health hazards.

Corrective actions taken and planned

USDA has reorganized the FHA headquarters to accomplish the major objective of the OIG recommendations, i e , to provide FHA headquarters with more effective authority and control over State and county office operations. Also, USDA has taken a number of actions to increase monitoring of State and county office operations and to provide headquarters with the feedback necessary to adequately administer the housing programs.

A USDA official stated that budget constraints limit the extent to which USDA is able to expand its field offices' technical staffs; however, as noted on page 31, some State and county offices have hired or plan to hire additional technical staff. In addition, USDA has tried, through increased and better training programs, to more effectively use its present staffs.

USDA, in November 1972, was issuing instructions on subdivision planning and development. The instructions will include design and construction standards for water and sewage systems, street improvements, and storm drainage and will require prior approval of proposed subdivisions by the State and/or headquarters office under certain circumstances.

HUD ESTIMATES OF HOUSING NEEDS AND UNITS PROVIDED

UNDER THE SECTIONS 235 AND 236 PROGRAMS

AUGUST 1968 THROUGH DECEMBER 1971

State	Total population ranking	Estimates of needs (note a) Units	Estimates of needs (note a) Rank	Housing units provided: Total Units	Total Rank	Section 235 Units	Section 235 Rank	Section 236 Units	Section 236 Rank
Northeast									
Connecticut	24	9,915	21	7,512	25	609	42	6,903	11
Maine	38	3,480	38	1,257	46	502	45	755	41
Massachusetts	10	25,245	8	9,957	16	2,279	33	7,678	9
New Hampshire	42	2,760	41	2,097	40	824	40	1,273	35
New Jersey	8	25,980	7	4,815	32	2,460	31	2,355	27
New York	2	110,770	1	11,855	13	2,633	30	9,222	6
Pennsylvania	3	39,440	4	11,750	14	3,700	27	8,050	7
Rhode Island	39	3,590	37	1,528	44	439	48	1,089	38
Vermont	49	1,205	47	577	50	245	50	332	47
Total		222,385		51,348		13,691		37, 657	
South									
Alabama	21	11,170	17	9,653	17	8,346	12	1,307	34
Arkansas	32	5,345	32	5,504	31	4,181	24	1,323	33
Delaware	47	1,405	46	382	51	229	51	153	51
District of Columbia	41	11,850	16	2,808	39	599	43	2,209	28
Florida	9	24,930	9	25,925	4	18,301	2	7,624	10
Georgia	15	13,345	14	18,970	6	13,841	5	5,129	14
Kentucky	23	6,955	27	8,712	19	5,333	18	3,379	19
Louisiana	20	10,905	20	18,083	8	14,551	4	3,532	18
Maryland	18	8,010	24	6,948	26	790	41	6,158	13
Mississippi	29	4,960	34	8,130	22	6,918	13	1,212	37
North Carolina	12	13,130	15	8,145	21	5,098	19	3,047	20
Oklahoma	27	7,785	25	10,759	15	6,840	14	3,919	16
South Carolina	26	6,980	26	13,924	11	11,407	7	2,517	24
Tennessee	17	10,955	18	13,308	12	10,847	8	2,461	26
Texas	4	33,025	6	45,265	1	25,456	1	19,809	2
Virginia	14	8,280	23	8,895	18	2,414	32	6,481	12
West Virginia	34	3,835	36	1,261	45	599	44	662	43
Total		182,865		206,672		135,750		70,922	
North Central									
Illinois	5	44,935	3	18,798	7	10,813	9	7,985	8
Indiana	11	14,130	11	15,102	9	5,686	16	9,416	5
Iowa	25	5,060	33	7,566	23	4,740	20	2,826	22
Kansas	28	6,865	28	4,437	35	2,242	34	2,195	29
Michigan	7	20,680	10	26,934	3	13,830	6	13,104	4
Minnesota	19	8,625	22	5,762	30	2,017	35	3,745	17
Missouri	13	13,770	12	6,772	27	3,775	26	2,997	21
Nebraska	35	4,065	35	4,215	37	2,960	29	1,255	36
North Dakota	46	1,635	44	768	47	442	47	326	48
Ohio	6	36,540	5	22,999	5	9,651	11	13,348	3
South Dakota	45	1,130	49	3,431	38	914	39	2,517	25
Wisconsin	16	13,725	13	7,562	24	5,400	17	2,162	31
Total		171,160		124,346		62,470		61,876	
West									
Alaska	51	1,095	50	692	48	280	49	412	46
Arizona	33	6,060	31	6,650	28	4,461	22	2,189	30
California	1	72,285	2	41,172	2	18,111	3	23,061	1
Colorado	30	6,760	29	8,382	20	5,687	15	2,695	23
Hawaii	40	2,685	42	1,754	42	1,058	37	696	42
Idaho	43	1,410	45	1,845	41	1,361	36	484	45
Montana	44	1,810	43	1,620	43	998	38	622	44
Nevada	48	1,175	48	4,708	34	3,810	25	898	40
New Mexico	37	2,895	39	4,283	36	3,380	28	903	39
Oregon	31	6,686	30	5,817	29	4,341	23	1,476	32
Utah	36	2,860	40	4,764	33	4,565	21	199	49
Washington	22	10,929	19	14,130	10	9,839	10	4,291	15
Wyoming	30	850	51	670	49	488	46	182	50
Total		117,500		96,487		58,379		38,108	
U S total		693,910		478,853		270,290		208,563	

[a]These estimates based on data furnished by HUD headquarters, represent the needs for units which could be sold in a 3-year period

BEST DOCUMENT AVAILABLE

HOUSING PROVIDED UNDER USDA'S SECTION 502 PROGRAM

AUGUST 1968 THROUGH DECEMBER 1971

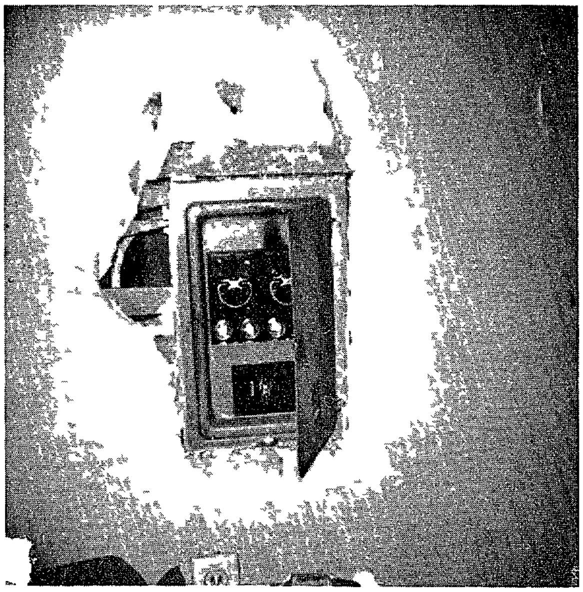
State	Rural population ranking	Housing units provided: Total		Interest credit program		Other loans (note a)	
		Units	Rank	Units	Rank	Units	Rank
Northeast							
Connecticut	32	675	45	160	46	515	44
Maine	34	5,175	19	2,185	12	2,990	23
Massachusetts	27	552	47	290	42	262	47
New Hampshire	41	1,157	41	533	33	624	43
New Jersey	29	2,970	30	393	36	2,577	26
New York	3	6,185	16	1,198	22	4,987	15
Pennsylvania	1	4,101	23	695	27	3,406	21
Rhode Island	49	194	50	76	48	118	50
Vermont	43	2,032	35	530	34	1,502	34
Total		23,041		6,060		16,981	
South							
Alabama	15	12,288	6	4,719	5	7,569	5
Arkansas	24	12,837	5	5,302	3	7,535	6
Delaware	46	720	44	211	45	509	45
District of Columbia	51		51		51		51
Florida	18	4,042	24	1,669	16	2,373	27
Georgia	9	11,243	7	3,948	6	7,295	7
Kentucky	13	7,729	11	1,782	14	5,947	10
Louisiana	20	4,112	22	1,153	24	2,959	24
Maryland	26	2,608	32	378	38	2,230	29
Mississippi	21	15,616	2	5,849	2	9,767	2
North Carolina	2	15,956	1	4,918	4	11,038	1
Oklahoma	28	7,427	13	1,500	18	5,927	11
South Carolina	17	14,318	3	7,974	1	6,344	9
Tennessee	12	10,544	8	2,613	10	7,931	4
Texas	6	13,357	4	3,790	7	9,567	3
Virginia	11	8,248	10	2,630	9	5,618	13
West Virginia	23	4,911	21	677	29	4,234	20
Total		145,952		49,109		96,843	
North Central							
Illinois	7	4,949	20	599	30	4,350	19
Indiana	8	7,701	12	1,883	13	5,818	12
Iowa	22	5,316	18	687	28	5,629	17
Kansas	30	2,879	31	538	32	2,341	28
Michigan	5	6,748	14	1,553	17	5,195	14
Minnesota	19	3,569	27	547	31	3,022	22
Missouri	16	10,170	9	3,758	8	6,412	8
Nebraska	33	2,056	34	342	39	1,714	32
North Dakota	38	2,357	33	761	26	1,596	33
Ohio	4	5,924	17	1,358	20	4,566	18
South Dakota	36	1,766	38	327	40	1,439	36
Wisconsin	14	6,404	15	1,478	19	1,926	16
Total		59,839		13,831		46,008	
West							
Alaska	45	284	48	32	50	252	48
Arizona	37	3 550	28	1 751	15	1,799	31
California	10	3,767	26	2,463	11	1 304	37
Colorado	35	1,485	39	391	37	1,094	38
Hawaii	48	941	43	242	43	699	42
Idaho	39	3,275	29	1,158	23	2,117	30
Montana	40	600	46	130	47	470	46
Nevada	50	219	49	68	49	151	49
New Mexico	42	1,183	40	308	41	875	41
Oregon	31	1,950	36	1,031	25	919	39
Utah	44	1,920	37	446	35	1,474	35
Washington	25	3,815	25	1,235	21	2,580	25
Wyoming	47	1,130	42	224	44	906	40
Total		24,119		9,479		14,640	
U S total		252,951		78,479		174,472	

[a]Includes housing units provided in July 1968

BEST DOCUMENT AVAILABLE

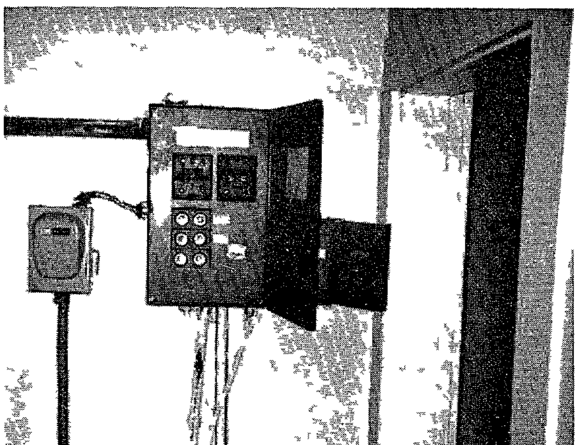
PHOTOGRAPHS SHOWING EXAMPLES OF DEFECTS IN HOUSES PROVIDED BY HUD AND USDA UNDER THE SECTION 235 AND 502 PROGRAMS

DEFECTS IN EXISTING HOUSES PROVIDED BY HUD



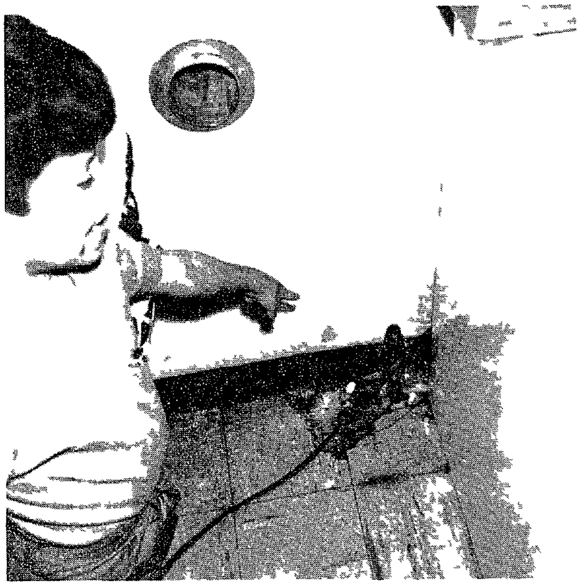
Unsafe fuse box, with exposed wiring located in kitchen
Seattle Washington

Inoperable bathroom sink blocking a portion of window
Seattle, Washington



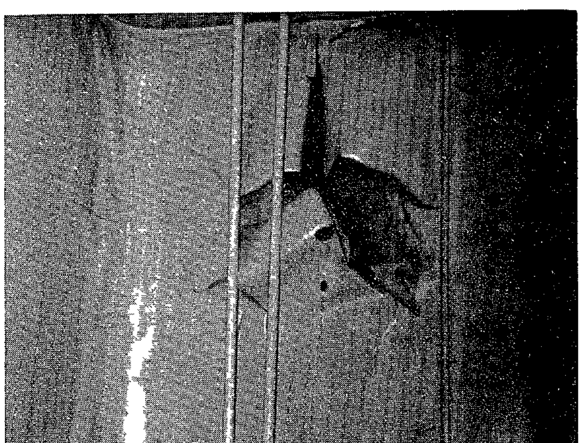
APPENDIX III

DEFECTS IN EXISTING HOUSES PROVIDED BY HUD

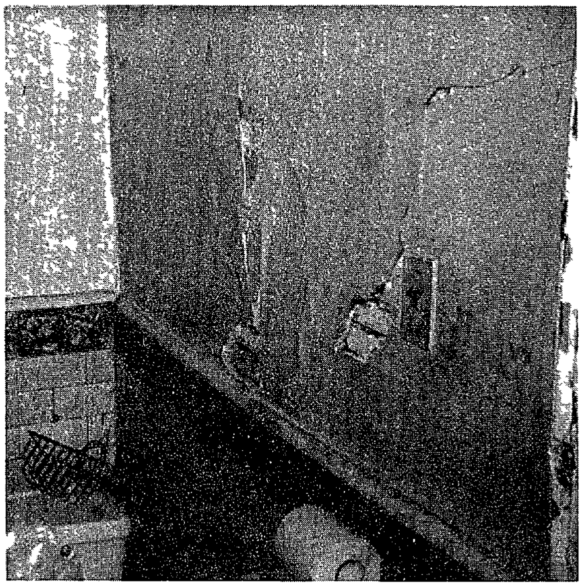


Uncapped gasline with shutoff valve which could be easily opened by small children Commerce City, Colorado

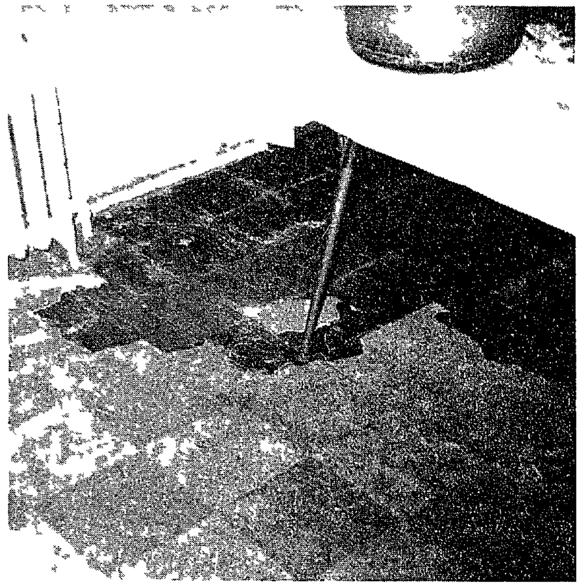
Structural defect brick wall cracked both below and above window Washington D C



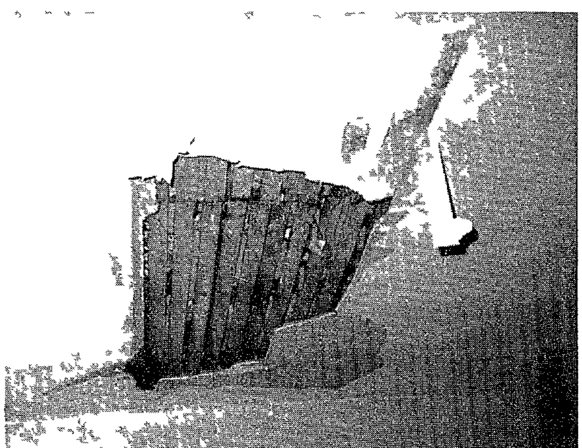
DEFECTS IN EXISTING HOUSES PROVIDED BY HUD



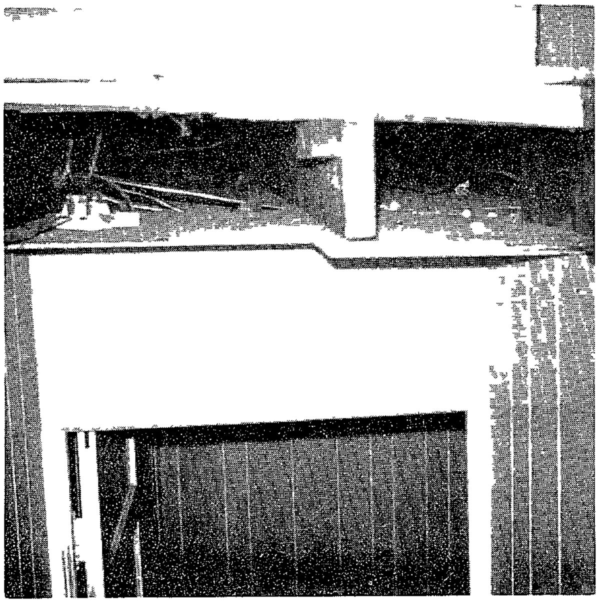
Plaster cracked and separating from bathroom wall
Washington, D C



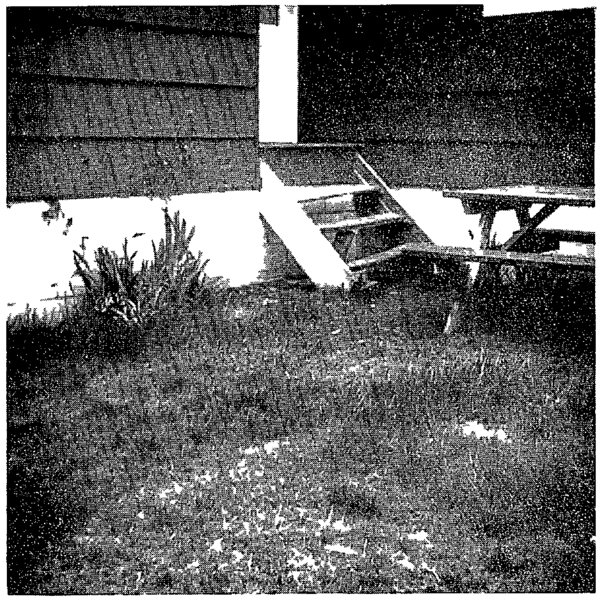
Broken and missing floor tiles in kitchen Washington D C



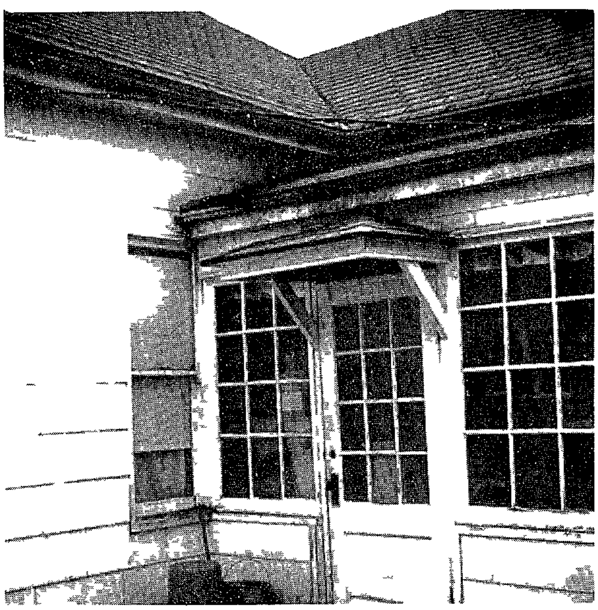
DEFECTS IN EXISTING HOUSES PROVIDED BY USDA



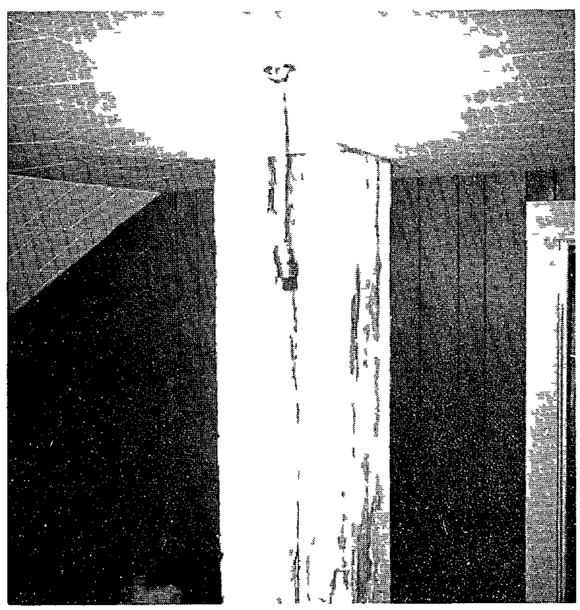
Uncovered area between first floor and basement with ex posed electrical wiring Chehalis Washington



Safety hazard dilapidated and rotting steps McCleary, Washington



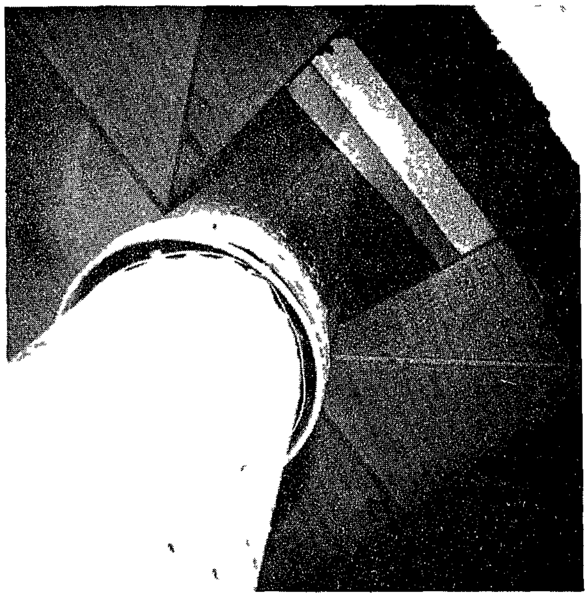
Dilapidated porch lack of gutters and warped door Montesano Washington



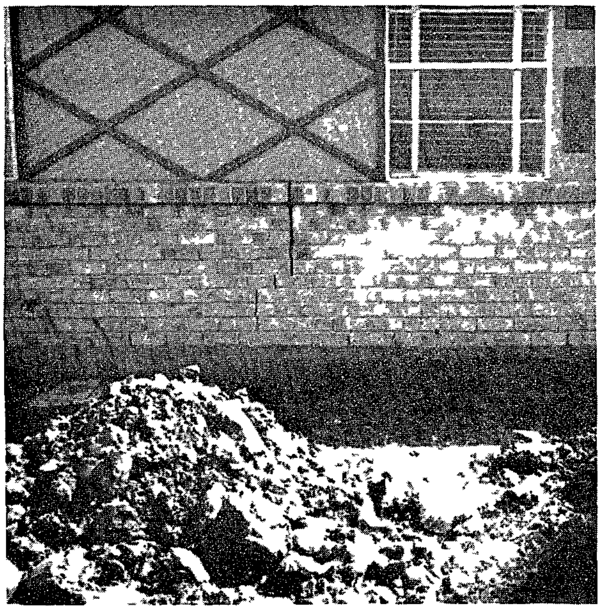
Safety hazard substandard electrical fixture Roof leaking around chimney McCleary, Washington

DEFECTS IN NEW HOUSES PROVIDED BY HUD

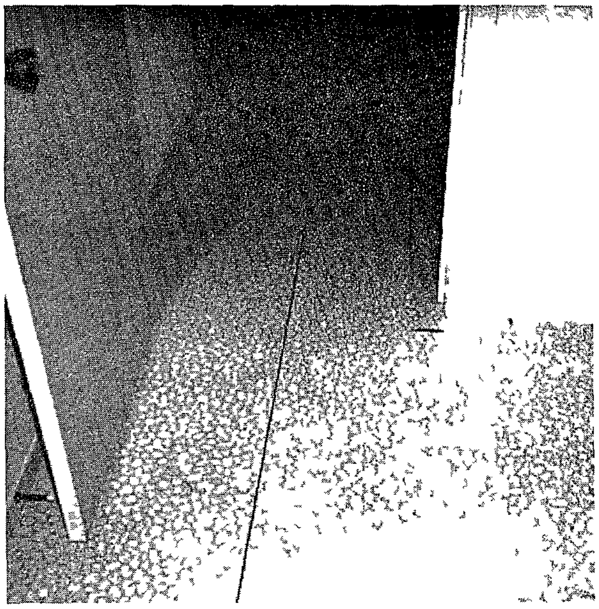
Improper grading resulted in water draining into crawl space at time of inspection 6 inches of water were under this house Lynwood, Washington



Fire hazard–opening in closet ceiling around flue should have been fireproofed Colorado Springs, Colorado

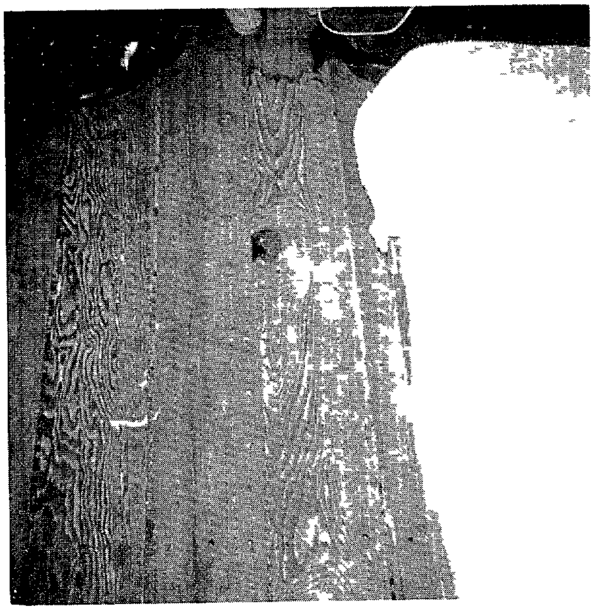


Structural defect–large crack in front of house caused by improper foundation Mesquite, Texas



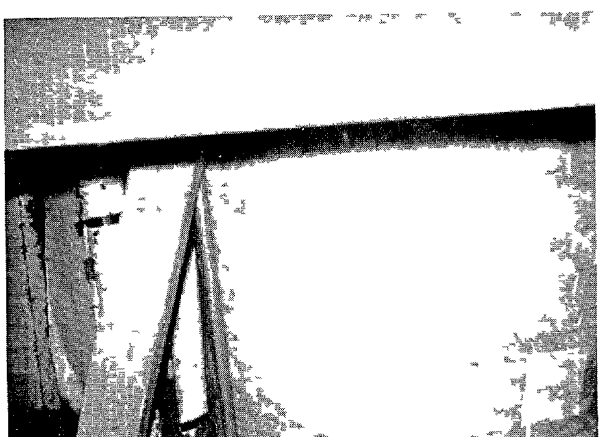
Interior flooring of house shown in photograph to the left Mesquite, Texas

DEFECTS IN NEW HOUSES PROVIDED BY USDA



No finished flooring material installed over subfloor Hole in bedroom floor through which rodents could enter, Redmond, Washington

Improper grading resulting in water ponding Marysville, Washington



DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
FEDERAL HOUSING ADMINISTRATION
WASHINGTON, D C 20411

JUL 17 1972

ASSISTANT SECRETARY-COMMISSIONER

Mr. B. E. Birkle
Associate Director
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Birkle:

In responding to your letter of April 27, 1972, transmitting to the Secretary copies of your draft report on "Opportunities to Improve Effectiveness and Reduce Costs of Homeownership Assistance Programs", I wish to express our gratitude for the time and constructive attention that your staff has given to the difficult and important subject. Comment is offered below with particular reference to the specific recommendations that have been tentatively stated.

Recommendation 1. - The report recommends that the Secretary of HUD and the Secretary of USDA provide a more equitable distribution of program resources.

On October 13, 1971, in testimony before the Legal and Monetary Affairs Subcommittee of the Committee on Government Operations, House of Representatives, I stated that, as with all the annual housing subsidy authorizations, Section 235 allocations are determined by a formula which contains four parts as follows:

1. Past production, which is measured in terms of comparable dwelling units started in similar programs in the various jurisdictions during the past year.

2. Need for subsidized housing, which is measured in terms of households within each jurisdiction and eligible for assistance in the program. Current needs are estimated by HUD in the Central Office by updating 1960 census data. This series on needs reflects in annual terms the 10-year goal of eliminating substandard housing and is given double weighting in the calculation of the composite percentages.

3. Next year's expected starts, which are estimated by HUD field office directors of the number of units that the industry will start during the next calendar year within each jurisdiction.

4. Market absorption capacity for additional subsidized housing, which is based upon HUD field office directors' estimates of the maximum number of additional units that would be occupied by eligible families within a coming 12-month period if there were no limitations on the number of additional units to be made available.

Need and market-absorption potential are weighted heavily (60%/40%) in relation to past and projected starts. The figures which the Central Office arrive at are reviewed at the Regional and Field Office levels and returned to the Central Office for final adjustment before allocations are made. Moreover, Project Selection Criteria, which govern distribution of contract authority at the field office level in the interest of equal opportunity will weigh heavily in determining the need for subsidized housing in any particular area in the future.

We do agree that the field offices should take a more active role, working with State and local governments, in determining areas of greatest need for subsidized housing, and that priority should be given to the development of these areas. Your report refers to the high need for low and moderate income housing in the northeast and the apparent shortage of housing to meet this need. It should be realized that contributing to this housing shortage are statutory mortgage limitations, restrictive income limits, increasing land costs and taxes and the conservative attitudes of some banking institutions. Passage of the proposed Housing and Simplification Act, which would permit the Secretary to administratively determine mortgage limits and income limits, would improve this situation.

Recommendation 2. - The report recommends that the Secretaries of HUD and USDA require that all houses be re-inspected within one year after purchase to assure that defects covered by builder service policies and seller certifications have been identified and corrected.

We agree in theory with this recommendation. However, the problems of fact finding and judgment necessary to distinguish between initial construction defects and poor maintenance are indeed difficult and time-consuming as has been amply demonstrated by the Section 518(b) claims being processed. Thus, without proper staffing, the reinspection of houses within a year after purchase would add another burden and further deteriorate our service. Inasmuch as our budget will not cover the addition of staff for this purpose, our only hope of accomplishing this work, if it were required in the near future, would be by use of private fee inspectors.

We are preparing consumer information that will fully explain what recourse the mortgagor has in having legitimate repairs made, and the channels he must use to secure such repairs.

Recommendation 3. - The report recommends that the Secretaries of HUD and USDA require their agencies to jointly determine what amenity options are appropriate for inclusion in houses being provided in various areas of the Nation and to establish mortgage limits that reflect the estimated cost of providing houses with the appropriate options.

We believe current guidelines for determining mortgage limits and amenities are adequate. These, of course, include guidelines issued after the period covered by your report.

Circular HPMC-FHA 4400.43 dated August 31, 1971, Limitations on Utilization of Basic Statutory Limits for Section 235(i) and 237, states in reference to mortgage limits and amenities:

> "The moderate cost property developed under these procedures is not to be considered a prototype for actual housing in the area. It is rather to be a hypothetical property used to establish mortgage limits. Within these mortgage limits, builders are free to develop housing with whatever amenities they feel necessary to meet the competitive market."

Handbook HPMC-FHA 4441.1A, Homeownership for Lower Income Families Section 235, Paragraph 10 (September 1971) states the need for Directors to establish mortgage limits below the statutory maximums; and Circular HPMC 4000.10, issued February 2, 1972, provides for the addition of certain features to the moderate-cost house used as a basis for establishing mortgage limits.

Recommendation 4. - The report recommends that the Secretaries of HUD and USDA require that in-depth studies be made to determine the major reasons for defaults and what can be done to minimize the default rate. In addition, the report recommends that such studies be used as a basis for developing guidelines for screening and counseling applicants.

On page 56 [1] of the report, the statement is made that HUD's actuarial staff has estimated an aggregate foreclosure rate of 25 percent for the Section 235 program. This estimate was made prior to the development of any actuarial data on the Section 235 program. As I believe was explained to the auditors by the actuarial staff at that time, the estimate of 25 percent was based upon the assumption that the program would sustain greater losses than Section 221(d)(2) and it included allowance for the possible occurrence of a major economic depression. Since that estimate was made, actuarial data on the 235 program have been received through calendar year 1971; the data indicate that the program is not sustaining as heavy a foreclosure rate as the Section 221(d)(2) program and that the estimate of 25 percent is much too high. The national average for actual foreclosures (conveyed titles and assignments later foreclosed) as of December 31, 1971, was 1.6 percent. In addition, a comparison (as of

[1]GAO note This page number refers to our draft report.

December 31, 1971) of the offices referred to in your report illustrates a significant decrease in defaulted mortgages, as shown in the table on this page.

The publicity given the foreclosure rate and associated problems in central-city areas of several metropolitan areas do represent very real and very vexing problems, but should not be allowed to distort our impression of the over-all experience in the low-cost subsidy programs.

We have established a procedure for a continuous review of the reasons for defaults in the Section 235 program. The reason for default is included by the mortgagee on the application for insurance claim. Our analysis of this information will not only provide data on the reasons for default but will assist the Department in developing an early-warning system designed to cure defaults and avert foreclosure or assignment.

Insurance Written & Defaults for Section 235 as of December 31, 1971

	Insurance Written	1/ Defaulted Mortgages	Percent of Mortgages Defaulted
Columbia	11406	901	7.9
	2/(179)	(21)	(11.7)
Birmingham	8349	270	3.2
	(143)	(9)	(6.3)
Atlanta	13440	592	4.4
	(72)	(10)	(13.9)
Dallas	9284	480	5.2
	(123)	(23)	(18.7)
San Antonio	7734	326	4.2
	(128)	(11)	(8.6)
Shreveport	5927	217	3.6
	(105)	(13)	(12.4)
3/Little Rock	4403	161	3.6
Denver	5691	90	1.6
	(206)	(8)	(3.9)
Salt Lake City	4574	31	.6
	(45)	(1)	(2.2)
Seattle	7438	922	12.4
	(179)	(36)	(20.1)

1/ Includes mortgages which were foreclosed by the mortgagee and title transferred to HUD, mortgages which were assigned to HUD, and mortgages which were in the process of foreclosure.

2/ ( ) figures expressed in GAO Report concerning default experience for mortgages insured during period from January 1, 1969 through June 30, 1969.

3/ Monthly default rates were not compiled for mortgage loans insured prior to January 1, 1970. However, 6.1 percent of the 284 mortgage loans insured during first quarter of 1970 were foreclosed or in foreclosure.

Recommendation 5. - The report recommends that the Congress consider amending the legislation pertaining to the Section 235 Homeownership Assistance program to require that the loans be financed by borrowings from the Treasury.

Whether or not it is in the public interest for HUD to enter the mortgage-banking business is a rather broad and basic question. If it is to be further pursued, I assume that the Office of Management and Budget will coordinate recommendations from the Executive Branch My response at the moment, therefore, is merely to pass along to you some of the factors that we would believe to require careful consideration.

Financing the 235 mortgage out of Treasury borrowings, as proposed, at an interest rate of 5 62%, the government borrowing rate, rather than the current 7.62% private rate, could conceivably save money. Presumably, the subsidy would be paid in a smaller amount and for a shorter period.

If this plan were in effect, however, the demand for government borrowings would increase and the government cost of borrowing might well increase. Simultaneously, the demand for market rate mortgages could be expected to decrease. This probably would be followed by a decline in market interest rates For HUD to finance Section 235 mortgages directly would involve cash outlays for the entire mortgage amount rather than for the monthly subsidy. The budgetary requirements would be greater in the short run to maintain similar production levels.

[See GAO note, p. 73.]

In any event, the recommendation for financing Section 235 mortgages through the Treasury would require a very substantial budget outlay annually For example, the 1973 budgeted level of 198,000 units, multiplied by an average mortgage amount of $18,040, would require a cash flow from the Treasury of $3,571,920,000 in one fiscal year. In addition to the initial outlay, there would be an interest subsidy which would be less than the current subsidy of approximately $76.00 per month per family unit insured under the program. Secondly, processing of applications (now handled by mortgagees for one percent placement fee paid by the buyer or seller under the 235 program), would have to be assumed by HUD, requiring either a substantial increase in manpower or processing of applications on a contractual basis would require a fee. With government refinancing of the public debt, it is entirely possible that this method of financing might result, over the long term, in costs equaling or exceeding the present method of financing home mortgages under the Section 235 program.

[See GAO note, p. 73]

The proposal does not indicate the intended tax status of Treasury borrowings for this purpose. If such borrowings were to be on the basis of tax-exempt notes, the loss of revenue in the form of interest income from the purchasers of the notes would be a factor for consideration in determining the over-all cost of the loan program.

It is further pointed out that accounting records would have to be established and maintained to show the status of mortgage loan balances. Monthly remittances from servicers covering the portions of mortgage payments collected from mortgagors would have to be supported by details to show the computation of both the mortgagor's share and the subsidy payment for each mortgage. This information would be necessary in order to make the transfer of the subsidy payment from the Section 235 Appropriation Account to the Treasury Borrowing Account. Substantial manpower would be required to perform this work.

[See GAO note, p. 73.]

This proposal obviously is one having many ramifications and requiring very careful consideration. We shall expect to study the matter further, if called upon to do so.

In conclusion, it would appear that, with continuing experience in subsidized single-family housing and additional manpower especially in the field, a more refined method of distribution will evolve along with improved administration of the program.

Sincerely,

Eugene A. Gulledge

GAO note Several statements in HUD's reply were discussed with HUD officials and, with their concurrence, have been deleted

UNITED STATES DEPARTMENT OF AGRICULTURE
FARMERS HOME ADMINISTRATION
WASHINGTON D C 20250

OFFICE OF THE ADMINISTRATOR

Mr Max Hirschhorn
Deputy Director
Resources and Economic Development Division
United States General Accounting Office
Washington, D. C 20548

JUL 3 1972

Dear Mr Hirschhorn:

This is in response to your request for our comments on the draft GAO report on "Opportunities to Improve Effectiveness and Reduce Costs of Homeownership Assistance Programs of HUD and USDA." Our comments on the recommendations are:

1 The allocation of rural housing funds made to states takes into consideration factors such as number of rural homes, condition of homes, income of rural families, average cost of new homes, and historical lending patterns Our evaluation is that we are distributing the funds to states in accordance with need. Although no separate allocation is made for interest credit loans, the states will be instructed to channel at least 50 percent of the allocation of rural housing section 502 funds into housing for low-income families

2 Should the congressional appropriation permit, we intend to put into effect a requirement that all houses be inspected during the eleventh month of the 1-year warranty period to determine whether any defects exist which may be covered by the warranty.

3. Under law we can finance only homes for low- and moderate-income families that are modest in size, design and cost. Our regulations provide that they will include only those features that are customarily included in modest homes in the area financed by other lenders for moderate-income families This policy has produced adequate but modest homes for low-income families at reasonable costs. To specify, a list of options and established cost limits would complicate operations and not assure better performance. Since HUD and FmHA serve different markets, there would be little advantage to establishing joint lists of options and mortgage limits. Where significant differences exist among counties within a state, administrative action will be taken to secure uniformity

4 The Farmers Home Administration has a regulation, "Special Servicing of Delinquent and Other Problem FHA Loans to Individuals" (FHA Instruction 460.1), which provides for a case-by-case evaluation of delinquencies The borrower's financial position and the status of his loan account are analyzed and the reasons for delinquency determined It has been found that they generally fall in the following categories economic conditions, divorce, extended illness, and death. Servicing action is on an individual case basis. We also intend to increase our staff at the National level so that we will be able to give proper direction to and make appropriate studies of account and property servicing.

5 The recommendations that a buyer of used housing has recourse to the seller to cover the cost of repairing defects that exist at the time of sale will be studied

In view of the previous data submitted and our discussion, there is need to update some of the information in the report This is particularly true of the references to the earlier OIG report.

[See GAO note.]

Sincerely,

Daniel A. Dunn

for JAMES V. SMITH
Administrator

Attachment

GAO note Appropriate changes have been made in the final report to recognize the deleted matters.

OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON D C 20220

June 7, 1972

Dear Mr. McAuley

This is in reply to your letter of April 28, 1972 to Secretary Connally requesting comments on Chapter 6 of your draft report, "Opportunities to Improve Effectiveness and Reduce Costs of Homeownership Assistance Programs -- Department of Housing and Urban Development and Department of Agriculture."

Draft Chapter 6 concludes that costs to the Federal Government under the section 235 homeownership assistance program could be substantially reduced if HUD were authorized to make loans to eligible families with funds borrowed by the Treasury, rather than the existing method of financing the program by insured loans made by private lenders. The draft Chapter recommends that Congress consider amending the legislation pertaining to the section 235 program to require that the loans be financed by borrowings from the Treasury. This conclusion and recommendation are essentially the same as those made in the July 20, 1971 GAO report to the Congress, "Legislation Recommended to Reduce Losses of Two Insured Loan Funds of the Farmers Home Administration -- Department of Agriculture."

With regard to technical aspects, draft Chapter 6 does not contain sufficient data to permit a detailed analysis. We believe that the present value approach which the draft Chapter indicates was used is appropriate for an analysis of this sort. Yet as indicated below we question the appropriateness of the discount rate used in the analysis.

The draft Chapter indicates that the calculations take into consideration "cost recoveries from Federal income taxes," yet there is no indication of how such recoveries were estimated.

[See GAO note,]

In order to provide for coordinated and more efficient financing and thus to reduce the cost of Federal and Federally assisted borrowing activities, the Treasury in December 1971 proposed the "Federal Financing Bank Act of 1971". Secretary Connally stated in his letter transmitting the draft bill to the Congress.

> Interest costs of the various Federal agency financing methods normally exceed Treasury borrowing costs by substantial amounts, despite the fact that these issues are backed by the Federal Government. Borrowing costs are increased because of the sheer proliferation of competing issues crowding each other in the financing calendar, the cumbersome nature of many of the securities, and the limited markets in which they are sold. Underwriting costs are often a significant additional cost factor due to the method of marketing.

Under the proposed legislation these essentially debt management problems could be shifted from the program agencies to the Federal Financing Bank. Many of the obligations which are now placed directly in the private market under numerous Federal programs would instead be financed by the Bank. The Bank in turn would issue its own securities. The Bank would have the necessary expertise, flexibility, volume, and marketing power to minimize financing costs and to assure an effective flow of credit for programs established by the Congress.

The Federal Financing Bank Act (S. 3001), as ordered favorably reported with amendments by the Senate Banking Committee on June 1, 1972, would permit the financing of loan guarantee programs, including the section 235 program, through the Financing Bank. Yet the Senate Banking Committee deleted language in section 7 of the Administration's proposal which would have permitted the Secretary of the Treasury to require guaranteed obligations to be financed through the Bank. We expect that the cost of borrowing by the Financing Bank would differ little from the cost of Treasury borrowing and we believe that enactment of this legislation as proposed by the Treasury would substantially achieve the purpose of your draft recommendations to the Congress.

Sincerely yours,

Jack F. Bennett
Deputy Under Secretary
for Monetary Affairs

Charles P. McAuley
Assistant Director
U.S. General Accounting Office
Treasury Annex Building
Washington, D.C. 20548

GAO note Material deleted because of changes made in final report

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON D C 20503

AUG 5 - 1972

Mr. Henry Eschwege
Director, Resources and Economic
Development
General Accounting Office
Washington, D. C. 20548

Dear Mr. Eschwege

This is in response to your request of April 28, 1972, for the views of the Office of Management and Budget regarding Chapter 6 of General Accounting Office draft report on Opportunities to Improve Effectiveness and Reduce Costs of Homeownership Assistance programs.

In Chapter 6, GAO discussed its finding that the program cost (interest subsidies) would be reduced if HUD financed the capital costs of the Section 235 Homeownership Assistance Program with Treasury borrowings rather than by private lenders as is presently required by statute. The Chapter also contains a reference to a similar but earlier GAO proposal for the USDA Rural Housing Program (Section 502) which is presently financed by the sale of borrowers notes.

In a letter to Mr. Samuelson dated February 19, 1971, OMB commented in opposition to the Section 502 proposal. Our views on that proposal remain unchanged at this time.

Regarding the Section 235 proposal, we recognize that, by some measures, Treasury can borrow at lower rates than private investors. However, the GAO projections appear to overstate substantially the potential savings as explained in the comments of the Departments of Housing and Urban Development and Treasury.

As you note in your report other factors must be considered in determining which method of financing is most appropriate for a particular credit program. We believe two factors deserve attention here. The first is the large budget impact of direct Federal financing. HUD estimates that initially an increase of roughly $3.5 billion in annual budget outlays would be required to maintain the Section 235 program level of roughly 200,000 units annually. This of course would be in addition to the continuing budget requirements for long-term interest subsidy payments.

The other factor concerns the desirability of having the Federal Government directly finance a major component of the housing market. The GAO proposal would replace this segment of the private housing market with Federal financing. Fundamentally, we do not believe that it is appropriate for the Federal Government to seek such a major role as a direct lender where the private economy can perform this function effectively. The U S. economy enjoys a rich variety of private financial institutions, and capital market mechanisms and resources There are imperfections in this market system, but, in general, the private institutions and mechanisms are remarkably efficient. This being so, the proper role for the Federal Government is to: (a) foster the improvement of institutional and market mechanisms, and (b) limit its credit assistance to providing market incentives for the allocation of financial resources to disadvantaged borrowers. Pursued to its ultimate logical conclusion, the position that the Federal Government should seek a major role as a direct lender could be pressed to justify the Government's taking over all private financial functions.

In our view the uncertain cost savings of a direct loan program do not justify the Federal take-over of this portion of the housing mortgage market, particularly when this part of the market appears to be adequately served by existing institutions and patterns of lending.

In closing, I should note that the Administration has recommended legislation to create a Federal Financing Bank which would have the authority to finance federally insured mortgages and other loans. As discussed in the comments of the Treasury Department, the proposed Bank could substantially achieve the purposes of the GAO recommendation were it determined to be appropriate at the time.

Sincerely,

Casper W. Weinberger

Director

PRINCIPAL OFFICIALS OF THE

DEPARTMENT OF AGRICULTURE AND THE

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

RESPONSIBLE FOR THE ADMINISTRATION OF ACTIVITIES

DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
SECRETARY OF AGRICULTURE		
Orville L. Freemen	Jan. 1961	Jan. 1969
Clifford M. Harden	Jan. 1969	Dec. 1971
Earl L. Butz	Dec. 1971	Present
ASSISTANT SECRETARY, RURAL DEVELOPMENT AND CONSERVATION.		
John A. Baker	Mar. 1961	Jan 1969
Thomas K. Cowden	Apr. 1969	Present
ADMINISTRATOR, FARMERS HOME ADMINISTRATION		
Howard Bertsch	Apr. 1961	Jan. 1969
James V. Smith	Jan. 1969	Present
SECRETARY OF HOUSING AND URBAN DEVELOPMENT·		
Robert C Weaver	Feb. 1961	Dec. 1968
Robert C. Wood	Jan. 1969	Jan 1969
George W. Romney	Jan. 1969	Present
ASSISTANT SECRETARY FOR HOUSING PRODUCTION AND MORTGAGE CREDIT AND FEDERAL HOUSING COMMISSIONER		
Eugene A. Gulledge	Oct. 1969	Present

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