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Briefing Report to the Chairman, Subcommittee on Housing and Community Development, Committee on Banking, Finance and Urban Affairs, House of Representatives

February 1988

RURAL RENTAL HOUSING

Impact of Section 515 Loan Prepayments on Tenants and Housing Availability

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Resources, Community, and
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February 11, 1988

The Honorable Henry B. Gonzalez
Chairman, Subcommittee on Housing
and Community Development
Committee on Banking, Finance
and Urban Affairs
House of Representatives

Dear Mr. Chairman:

You asked us to provide information on the impact that borrowers' prepayment of mortgage loans has had or may have on displacing lower income tenants and on low-income housing's availability. The loans in question were made possible by the Farmers Home Administration's (FmHA) section 515 rural rental housing program.

Borrowers participating in the section 515 program who have prepaid their loans have generally done so to achieve some benefit from terminating their involvement in the program. Benefits include avoiding various FmHA regulatory restrictions or requirements and increasing returns by raising rents above current section 515 limits. However, the Subcommittee and others are concerned that section 515 loan prepayments, and the subsequent higher rents that have resulted, have been financially burdensome for many lower income renters and, in many cases, have caused them to leave their housing projects. Consequently, the Congress has legislatively restricted, since October 18, 1986, the voluntary prepayment of section 515 loans originated prior to December 21, 1979. This restriction is due to expire on March 15, 1988.

As agreed with your office, we obtained information on (1) the legality of FmHA's practice of accepting voluntary prepayment of loans originated prior to December 21, 1979, (2) the impact that loan prepayments have had on tenant displacement and on low-income housing availability, and (3) the potential for future loan prepayments.

On August 12, 1987, we briefed your office on the results of our work, and, as agreed, are providing you with this briefing report. In summary, we:

-- have no basis to dispute FmHA's legal position that it is required to accept voluntary prepayment of unrestricted section 515 loans originated prior to December 21, 1979,

-- found that section 515 loan prepayments in the three states we studied adversely affected many lower income households and reduced the availability of low-income housing, and

-- estimate that section 515 loans for at least 6,600 projects with about 125,000 units are currently eligible for prepayment and that loans for at least another 6,000 projects with over 161,000 units will be eligible to be prepaid between 1995 and 2006.

LEGALITY OF SECTION 515 LOAN PREPAYMENTS

Section 502(c) of the Housing Act of 1949, as amended, generally prohibits FmHA from accepting prepayment of section 515 loans approved after December 21, 1979. However, no courts have ruled as to whether FmHA can refuse prepayment of loans approved prior to that date. FmHA maintains that this law generally requires it to accept offers to prepay loans originated before December 21, 1979.

A recent legal action sought to enjoin FmHA from accepting prepayment of section 515 loans made before this date on the basis that FmHA has authority to refuse prepayments under section 501(g) of the Housing Act of 1949, as amended. This general statutory provision states a policy against displacing low-income families. However, based on a settlement agreement between the various parties (including FmHA), this legal action was dismissed on September 25, 1987, and no decision was rendered on the legality of FmHA's practice of accepting voluntary prepayment of section 515 loans made before December 21, 1979.

In the absence of a specific prohibition, the more specific statute limiting FmHA's discretion in refusing prepayment of section 515 loans made before December 21, 1979, would prevail under normal statutory interpretation over general language in the Housing Act stating a policy against involuntary displacement of families. Therefore, we have no basis to dispute FmHA's legal position that it is required to accept voluntary prepayment of unrestricted section 515 loans originated prior to December 21, 1979. (See sec. 2

for a more detailed discussion of the legality of section 515 loan prepayments.)

EFFECT OF LOAN PREPAYMENTS ON LOWER INCOME HOUSEHOLDS AND THE AVAILABILITY OF LOW-INCOME RENTAL HOUSING

In three case study states--California, Minnesota, and South Carolina--few section 515 households had a rent burden (rent-to-income ratio of over 30 percent) before prepayment of the section 515 loans. After prepayment, however, the average rents in these projects increased--by 91 percent in California, by 64 percent in Minnesota, and by 14 percent in South Carolina. Even with the higher rents, over half of the affected households in each state remained in the prepaid projects, but between 25 and 35 percent of those households experienced a rent burden. While most of the households we identified in California that left the prepaid projects found alternative assisted housing, few households identified in Minnesota did. In South Carolina, we were unable to identify the housing status for most of the households that left the prepaid projects. Without rental assistance subsidies, which were generally limited to one area in California, the impacts on affected households would have been more severe.

Even though all the prepaid projects in our case study states remained in the rental housing stock, rents were generally increased to market-rate levels, which often reduced their availability to lower income households. The impact of section 515 loan prepayments on households and on the availability of low-income rental housing varied by state and market areas. Generally, the impacts were most severe in market areas with a high demand for rental housing and without rental assistance. (See sec. 3 for a more detailed discussion of the impacts of loan prepayments on households and on the availability of low-income rental housing.)

POTENTIAL FOR FUTURE PREPAYMENTS

Many owners may exercise their option to prepay their loans and leave the section 515 program when their loans become eligible for prepayment. Although our case study sample was too small to represent projects nationwide, we believe it is a good indicator of the characteristics of projects with a higher probability for prepayment. Borrowers in our case study prepaid their loans to avoid various FmHA regulatory restrictions or requirements and to increase returns by raising rents above current section 515 limits. These borrowers were either full- or limited-profit individuals, partnerships, or limited partnerships. Furthermore, the prepaid projects in our case study had more units and were located much closer to major cities than the averages for the total section 515 inventory. (See sec. 4 for a more detailed discussion of the potential for future section 515 loan prepayments.)

SCOPE AND METHODOLOGY

To determine the impact that loan prepayments have had on households and low-income housing availability, we conducted case studies of section 515 loans prepaid during fiscal year 1986 in California, Minnesota, and South Carolina. These included 33 projects with 1,009 units. Since our case study states were judgmentally selected, our results should not be used to make generalizations and inferences about prepaid section 515 loans nationwide. For each state selected, however, our sample included almost all projects prepaid during 1986. Therefore, we believe that our results fairly represent the impact of loan prepayments in California, Minnesota, and South Carolina. Appendix I lists the FmHA section 515 projects included in our case studies and appendix II provides a summary of the case study results.

Finally, we obtained and analyzed information, as of February 1987, on over 17,000 section 515 housing projects from FmHA's Multi-Family Housing Information Status Tracking and Retrieval (MISTR) System to determine when projects would become eligible for loan prepayment. Our analysis assumed that section 515 loans made prior to December 21, 1979, will become eligible when the current prepayment moratorium expires on March 15, 1988. We also compared the characteristics of the outstanding inventory with those of the prepaid loans in our case study analyses to identify those projects that resembled prepaid projects.

Our work was performed in accordance with generally accepted government auditing standards. (See sec. 5 for a more detailed discussion of our objectives, scope, and methodology.)

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We discussed the contents of this report with FmHA program officials, whose views are incorporated where appropriate.

The FmHA officials agreed with our case study results. However, as requested by your office, we did not request FmHA to review and comment officially on a draft of this report.

As agreed with your office, we are sending copies of this report to the Chairman, Subcommittee on Housing and Urban Affairs, Senate Committee on Banking, Housing and Urban Affairs; the Secretary of Agriculture; the Administrator, Farmers Home Administration; and other interested parties. Copies will be made available to others on request.

Major contributors to this report are listed in appendix III. If you have further questions, please contact me at (202) 275-6111.

Sincerely yours,

John H. Luke

John H. Luke
Associate Director

C O N T E N T S

ABBREVIATIONS

FmHA	Farmers Home Administration
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
MISTR	Multi-Family Housing Information Status Tracking and Retrieval
MSA	Metropolitan Statistic Area
P.L.	Public Law
RCED	Resources, Community, and Economic Development Division (GAO)
RHIF	Rural Housing Insurance Fund

SECTION 1

THE SECTION 515 RURAL RENTAL HOUSING PROGRAM

Section 515 of the Housing Act of 1949 (42 U.S.C. 1485), as amended, authorized the Farmers Home Administration (FmHA) of the Department of Agriculture to administer a rental housing program specifically for rural renters. Under the program, FmHA provides loans to borrowers who are willing to build, purchase, repair, and operate low-rent multifamily housing projects. From inception of the program in 1962 through fiscal year 1986, FmHA made about 20,000 loans, totaling about $9.3 billion, for over 365,000 low-rent apartment units in rural communities. Since 1984, however, over 5,500 units have been lost as borrowers have prepaid their section 515 loans and left the program. This section provides background on the section 515 program and discusses the current controversy regarding loan prepayments.

BACKGROUND

A primary objective of the section 515 program is to help lower income households obtain rental housing that they could not otherwise afford. Under section 515, FmHA provides housing loans to eligible borrowers who are otherwise unable to obtain credit at terms and conditions that would permit them to charge rents affordable to lower income households. Certain section 515 borrowers may be eligible to receive an interest credit subsidy to reduce the effective interest rate on their loans to as low as 1 percent. In addition, households may also be eligible to receive a rental assistance subsidy.

Program Eligibility

The section 515 program was originally authorized in 1962 to provide rental housing units for the elderly in rural areas. Subsequently, it was expanded in 1966 to serve low- and moderate-income families. Under the Rural Housing Amendments of 1983 (P.L. 98-181, Nov. 30, 1983), part of the Housing and Urban-Rural Recovery Act of 1983, FmHA is to give greater priority to assisting lower income households, i.e., low- and very low-income households, and those living in substandard housing. Low-income families are those with incomes of 80 percent or less of local area median income and include very low-income households with incomes of 50 percent or less of local area median income. Moderate-income households are those with incomes not more than $5,500 above the low-income limit.

The loan program is generally limited to rural areas, which include towns, villages, and other places that have not more than 10,000 people; are not part of an urban area; and have a rural character. Loans may also be made in areas with a population in excess of 10,000 but less than 20,000 if the area is not included in a Metropolitan Statistic Area (MSA)[1] and has a serious lack of mortgage credit for low- and moderate-income households.

Borrowers eligible for section 515 loans include individuals, Indian tribes, and organizations. Eligible organizations include consumer cooperatives, associations, trusts, state and local public agencies, private nonprofit corporations, for-profit corporations, partnerships, and limited partnerships. Individuals or organizations operating on a limited-profit basis are permitted to receive an annual return not to exceed 8 percent of their initial investment. The returns for individuals and organizations operating on a for-profit basis are not limited. Nonprofit borrowers are not permitted to receive a return.

How the Program Works

Originally, section 515 loans were available only for nonprofit corporations and consumer cooperatives. These loans had a straight 3-percent interest rate. This reduced interest rate subsidy mechanism was no longer available for new loans made after October 1980. Rents were established at levels necessary to pay operating expenses and the debt service on the loan. Units could be leased only to elderly persons with incomes below the moderate-income limit and families who met the low-income limit.

Section 515 loans are currently written at an interest rate equal to current long-term U.S. Treasury securities. Loans to nonprofit organizations and state or local public agencies can cover up to 100 percent of the development cost or the value of the rental property, whichever is less. Loans to other borrowers are limited to 95 percent of the development cost or the appraised value. The maximum repayment period is 50 years.

Under section 521(a)(1)(B) of the Housing Act of 1949, FmHA may provide borrowers with assistance in the form of credits so as to reduce the effective annual interest rate on section 515 loans to a rate of not less than 1 percent. These interest credits are available to nonprofit corporations, consumer cooperatives, state and local public agencies, or any individual or organization operating on a limited profit basis, provided their loans were made on or after August 1, 1968.

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[1]As defined by the Department of Commerce, an MSA is a large population nucleus together with adjacent communities that have a high degree of economic and social integration within that nucleus. Each MSA must include at least 1 city with 50,000 or more people or 1 urban area of at least 50,000 with a total MSA population of at least 100,000 (75,000 in New England).

Two rent schedules are prepared for units in projects with interest credit loans. A basic rental schedule is based on a 1-percent loan, and the market rental schedule is based on a loan at the FmHA current market rate for the section 515 program. Tenants pay either the basic rent, based on the 1-percent loan, or a higher rent, not exceeding the market rental, based on income. Prior to September 30, 1986, FmHA tenants paid a minimum of 25 percent of their monthly adjusted income for rent and utilities. However, FmHA changed its regulations, effective October 1, 1986, to increase the minimum tenant contributions to 30 percent as required by the Housing and Urban-Rural Recovery Act of 1983. In the case where even the interest credit subsidy does not reduce rent levels enough, low-income tenants may be eligible to receive further rental assistance through FmHA's section 521 rural rental assistance program or the Department of Housing and Urban Development's (HUD) section 8 leased-housing assistance program.

CONTROVERSY ABOUT SECTION 515 LOAN PREPAYMENTS

Economic factors are encouraging borrowers to prepay their section 515 loans and leave the program. Depending on when these loans were made, borrowers may be subject to legislative prepayment restrictive-use provisions for up to 20 years. However, since 1984 the number of borrowers prepaying their section 515 loans has dramatically increased. The Congress and others are concerned that these loan prepayments have forced lower income households to pay higher rents or move, while also reducing the availability of low-income housing in rural areas. Furthermore, concern exists that these impacts will continue in the future as more section 515 loans become eligible for prepayment.

Economic Factors Encourage Section 515 Loan Prepayments

Several economic reasons have encouraged some borrowers to prepay their section 515 loans, and these reasons can be expected to encourage more borrowers to prepay in the future. Among them is the expiration of tax shelter benefits, called "tax shelter burnout," from subsidized loans made to for-profit and limited-profit borrowers. These tax benefits usually expire 10 to 12 years into the life of a tax shelter. Expiration results in a project's generating taxable income but not enough cash to pay the taxes. To limit the impact of the "burnout," the project owner can sell the project to another investor. However, the need to comply with FmHA regulations discourages the sale of projects to investors who will continue to maintain them as low-income housing. For example, FmHA regulations, among other things, limit the new owner's rate of return to that of the old owner's. Furthermore, it is unclear at this time whether the tax credit provided by the 1986 tax law will provide a meaningful incentive to encourage investment in low-income housing.

Prepayments are also encouraged by other factors that vary across location and over time and are not caused by the tax code. Some projects may be located in areas where high rental demand has raised market rents substantially above the rents charged in FmHA 515 projects. In these areas, the owner may achieve a higher return by charging rents above those permitted by FmHA or by converting the project to cooperative or condominium use. Projects close to major cities may be likely to prepay because rental demand is often higher close to cities than in rural areas. Prepayments are also encouraged when market interest rates are relatively low because the owner's cost of a conventionally financed mortgage is reduced. The lower mortgage cost combined with the advantage of charging market rents makes prepayment more profitable.

Legislative Restrictions Limited Section 515 Loan Prepayment

The Housing Act of 1949, as amended in 1979 and 1980, imposes prepayment restrictive-use limitations for section 515 loans on the basis of the date that FmHA made the loan. Generally, FmHA is prohibited from accepting prepayment of loans made on or after December 21, 1979, for either a 15- or 20-year period from the date the loan originated. However, controversy has recently arisen concerning whether FmHA can accept prepayment of loans made before December 21, 1979, without due consideration of the impact on the tenants and on the local housing supply. In section 2 we provide information on the legality of section 515 loan prepayments.

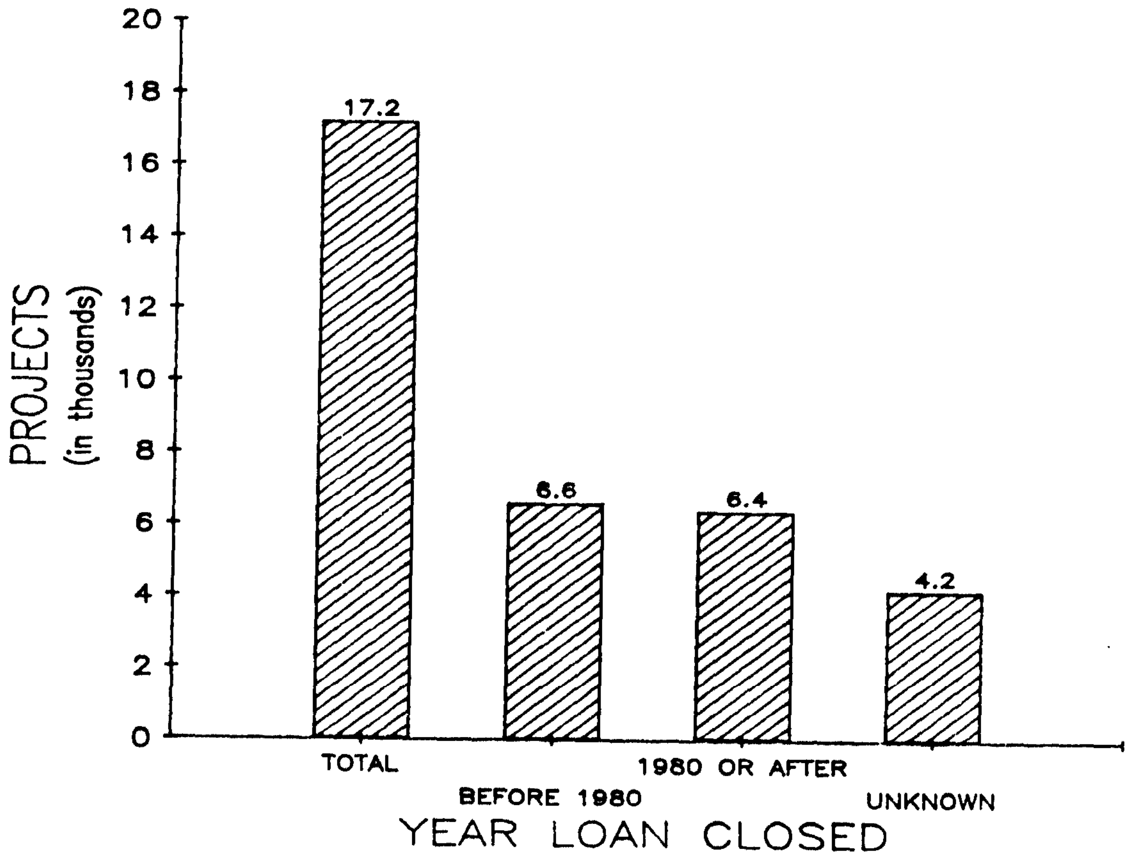
Section 515 Loan Prepayments Have Increased Since 1984

In practice, FmHA has been accepting project owners' offers to prepay section 515 loans originated before December 21, 1979. FmHA records and prepayment reports show that since inception of the section 515 program in 1962, FmHA has approved offers to prepay loans for 408 projects; 355 prepayments (almost 90 percent) have occurred since fiscal year 1984. These 355 projects contain 5,557 units. In fiscal years 1984, 1985, and 1986, loans were prepaid for 68 projects with 961 units, for 86 projects with 1,364 units, and for 176 projects with 2,756 units, respectively. In fiscal year 1987, through the end of February, loans had been prepaid for 25 projects with 476 units. We conducted case studies of section 515 loans prepaid during fiscal year 1986 in the states of California, Minnesota, and South Carolina. These case study states include 33 projects with 1,009 units. In section 3 we discuss the impact that these prepayments had on households and on the availability of low-income rental housing.

SECTION 515 INVENTORY OF PROJECTS AND UNITS

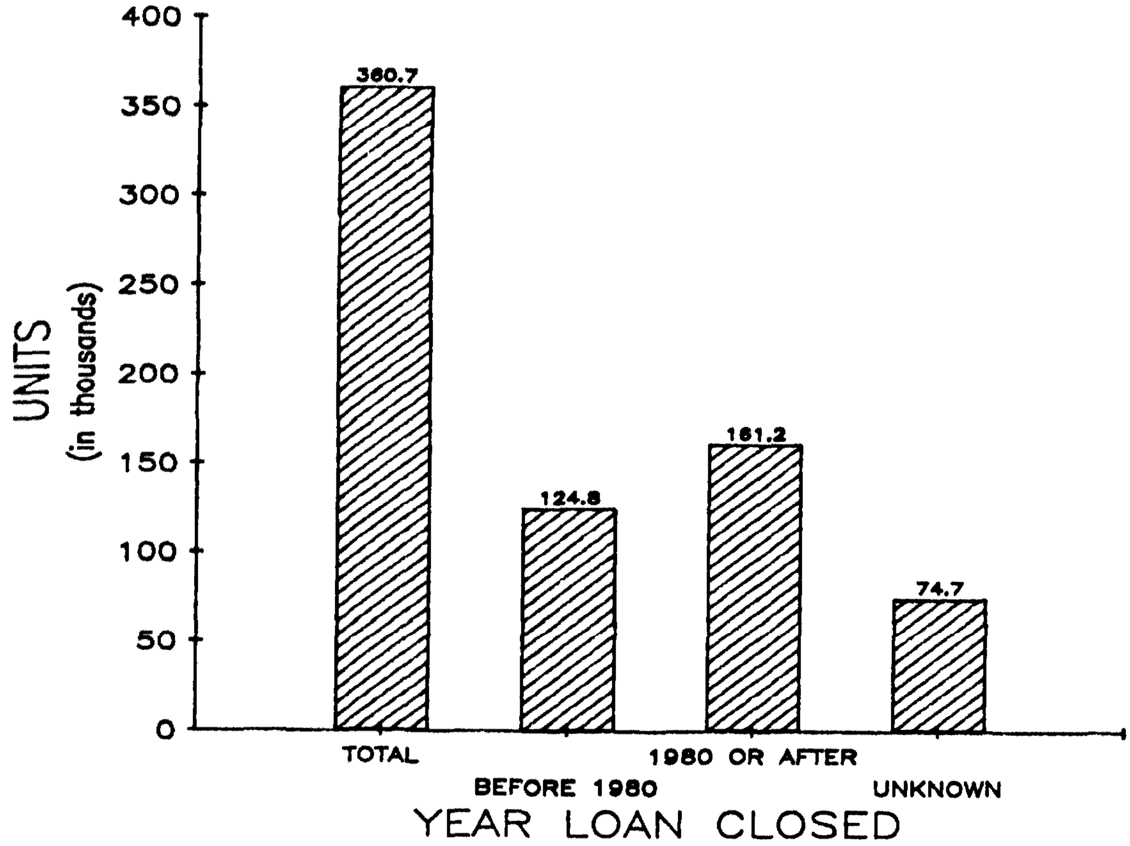
As of February 1987, FmHA had section 515 loans outstanding for 17,162 projects with 360,749 units. Figures 1.1 and 1.2 show that loans for 6,626 projects (39 percent) with 124,834 units (34 percent) were known to have been closed before 1980. Loans for 6,350 projects (37 percent) with 161,181 units (45 percent) were known to have been closed in 1980 or after, and therefore would generally be subject to 15- or 20-year prepayment restrictions. We were unable to determine from FmHA records the loan-closing dates for 4,186 projects (24 percent) with 74,734 units (21 percent). In section 4 we provide information on the potential for the current inventory of section 515 to be prepaid.

Figure 1.1: Section 515 Inventory of Projects as of February 1987



Source: FmHA MISTR System.

Figure 1.2: Section 515 Inventory of Units as of February 1987



Source: FmHA MISTR System.

SECTION 2

LEGALITY OF SECTION 515 LOAN PREPAYMENTS

Section 502(c) of the Housing Act of 1949, as amended, addresses prepayment restrictions for section 515 loans. According to FmHA, this provision generally requires it to accept offers to prepay loans made before December 21, 1979. However, a recent legal action sought to enjoin FmHA from accepting prepayment of section 515 loans made before December 21, 1979, on the basis that FmHA has authority to refuse prepayments under section 501(g) of the 1949 Housing Act. This general statutory provision states a policy against displacing low-income families. However, based on a settlement agreement between the various parties (including FmHA), this case was dismissed on September 25, 1987, and no decision was rendered on the legality of FmHA's practice of accepting voluntary prepayment of section 515 loans made before December 21, 1979.

Under normal statutory interpretation, the more specific statute (section 502(c)) limiting FmHA's discretion in refusing prepayment of section 515 loans made before December 21, 1979, would prevail over the general statutory provision (section 501(g)) stating a policy against displacement of low-income families. Therefore, in the absence of a specific prohibition, we have no basis to dispute FmHA's legal position that it is required to accept voluntary prepayment of unrestricted section 515 loans originated prior to December 21, 1979.

LEGISLATIVE HISTORY OF PREPAYMENT RESTRICTIONS

Section 503 of the Housing and Community Development Amendments of 1979 (P.L. 96-153, 93 Stat. 1101, 1134, Dec. 21, 1979), added subsection 502(c) to the Housing Act of 1949. As originally enacted, this subsection prohibited FmHA from accepting or requesting offers to prepay section 515 loans of contracts entered into before and after December 21, 1979, unless FmHA obligated the borrowers to utilize the property for the purposes of the section 515 program for a specified period. The restrictive period is 20 years from the date the loan was made if the project is receiving credits for low-interest loans under section 521(a)(1)(B), assistance payments under section 521(a)(2), or assistance under section 8 of the Housing Act of 1937. The restrictive period is 15 years for all other section 515 loans. However, prior to the end of the 15- or 20-year period, FmHA could permit prepayment if it determined that (1) a need no longer existed for the property to be utilized for section 515 purposes or (2) federal or other financial assistance provided to the residents of the housing will no longer be provided.

However, with regard to section 515 loans made prior to December 21, 1979, the law required FmHA to accept an offer to prepay, without the 15- or 20-year restriction, if tenants could reasonably be expected to remain in occupancy for the applicable period. Even if tenants were likely to be displaced, FmHA was still authorized to accept a prepayment offer if the displaced tenants were provided with affordable alternative housing. In the case of housing with more than 10 dwelling units, FmHA was barred from accepting any prepayment offer if the prepayment would have a substantially adverse effect on the supply of affordable low-income housing in the area.

The Housing and Community Development Act of 1980 (P.L. 96-399, 94 Stat. 1671, Oct. 8, 1980), repealed the prepayment restrictions applicable to section 515 loans made before December 21, 1979, because of concerns that the earlier law restricting prepayment of loans entered into prior to its enactment would unfairly invalidate existing contracts. The revised law requires FmHA to give displaced tenants a priority for relocation in alternative assisted rural housing. This priority is applicable only where the loan was prepaid or refinanced on or after October 8, 1980, and if displacement occurred because of rent increases, a change in the housing's usage, or other changes caused by prepayment or refinancing.

The Agriculture, Rural Development, and Related Agencies Continuing Resolution for 1987 (P.L. 99-500, 100 Stat. 1783-34, Oct. 18, 1986) restricted the voluntary prepayment of section 515 loans between October 18, 1986, and June 30, 1987. For loans made prior to December 21, 1979, but which are less than 20 years old, FmHA may accept a prepayment offer only if it determines that a supply of adequate, comparable housing is available in the community or that prepayment will not result in a substantial increase in rents or the displacement of tenants. The Supplemental Appropriations Act, 1987 (P.L. 100-71, 101 Stat. 391, 428, July 11, 1987) extended this prepayment restriction through September 30, 1987. The 1987 supplemental appropriations act was amended by P.L. 100-122, P.L. 100-154, P.L. 100-170, P.L. 100-179, and P.L. 100-200, respectively, to extend the prepayment restriction through October 31, 1987, November 15, 1987, December 2, 1987, December 16, 1987, and March 15, 1988, respectively.

FmHA'S POSITION IS THAT PREPAYMENTS ARE LEGAL

FmHA's position is that with appropriate notification to FmHA, all loans made prior to December 21, 1979, may be prepaid at any time barring existence of a restriction in a contract because of a servicing action, such as a loan reamortization, transfer, or assumption. Loans made after that date, or subject to restrictive use provisions, may be prepaid at the option of the borrower after the appropriate 15- or 20-year restriction period has elapsed and even before that time

> ". . . if the State Director determines that there is no longer a need for such housing and related facilities to be so utilized or that Federal or other financial assistance provided to the residents of such housing will no longer be provided."

In those cases where the FmHA State Director is required to determine whether or not to accept prepayment, tenant income ". . . and the concomitant rent overburden and displacement are required to be taken into account." For loans eligible to be prepaid (loans not subject to restrictive use provisions approved prior to Dec. 21, 1979, and all other loans when the appropriate 15- or 20-year restriction period has elapsed), tenant income and displacement are not required to be considered in accepting prepayments.

However, FmHA is required to give tenants displaced as a result of prepayment a priority for relocation in alternative assisted rural housing. Since June 1987, FmHA has been required to suspend and, subsequently, transfer to a different FmHA project any section 521 rental assistance provided to tenants in prepaid projects. When a tenant receiving rental assistance is displaced from a prepaid project, the rental assistance is transferred to the FmHA project to which the tenant moves. The displaced tenant is given first priority for a unit with rental assistance.

RECENT LITIGATION QUESTIONS THE LEGALITY OF PREPAYMENTS

We found no reported legal decision interpreting the prepayment provision on whether FmHA could refuse to accept prepayment of section 515 loans made before December 21, 1979. However, a recent memorandum decision by a federal district court in California granted a preliminary injunction pending litigation of this issue and others. The memorandum decision (*Gillanders* v. *Smith*, E.D. Calif. Civ. No. S-86-867-EJG), prohibits private defendants from evicting low-income tenants from certain apartment buildings constructed and subsidized under the section 515 program and prohibits FmHA from allowing the buildings to be withdrawn from the section 515 program by accepting prepayment of construction loans. This memorandum decision did not set any legal precedent because it merely granted a preliminary injunction pending litigation of the issues.

This case is significant because the loans at issue were made prior to December 21, 1979, and are not specifically subject to the 15- or 20-year restrictions on utilization of the property. The plaintiffs in this case contended that FmHA had authority to refuse prepayment under section 501(g) of the Housing Act of 1949, as amended. This general statutory provision states an intent to provide low-income housing and a general policy against displacement of low-income tenants. FmHA argued that the more specific and recent statute limits its discretion in refusing prepayment for loan contracts entered into prior to December 21, 1979.

On September 25, 1987, however, the court dismissed this case and ended the injunction on the basis of a settlement agreement between the various parties, including FmHA. Under the terms of the agreement, no decision was rendered on the legality of FmHA's practice of accepting voluntary prepayment of section 515 loans made before December 21, 1979. The key provisions of the agreement were to allow the properties to be sold to new investors, but FmHA is required to provide new section 515 loans and to renew rental assistance and interest credit subsidies. In return, the new investors are obligated to maintain the properties in the section 515 program for a minimum of 20 years from the date of the new loans.

GAO HAS NO BASIS TO DISPUTE FmHA'S POSITION ON LOAN PREPAYMENTS

Despite the general policy in the Housing Act of 1949 against displacement of tenants, no specific prohibition exists on accepting loan prepayments leading to displacement of tenants. In fact, the prepayment restrictive-use provisions under the Housing Act of 1949, as amended in 1980, do not apply to section 515 contracts entered into before December 21, 1979. Furthermore, there is a conflicting policy under section 502(b)(3) of the Housing Act of 1949, as amended, which may apply to some section 515 loans. This provision requires refinancing or graduation of loans whenever FmHA determines that the borrower's income or earning capacity would make the borrower eligible for financing from private credit sources.

Under normal statutory interpretation, the more specific statute (section 502(c)) limiting FmHA's discretion in refusing prepayment of loans made before December 21, 1979, would prevail over the general statutory provision (section 501(g)) stating an intent to provide low-income housing and a general policy against displacement of low-income families. Therefore, in the absence of a specific prohibition, we have no basis to dispute FmHA's legal position that, once appropriate notice has been given, FmHA must accept the prepayment of unrestricted section 515 loans made prior to December 21, 1979.

SECTION 3

EFFECT OF LOAN PREPAYMENTS ON LOWER INCOME HOUSEHOLDS AND THE AVAILABILITY OF LOW-INCOME RENTAL HOUSING IN THREE CASE STUDY STATES

We conducted case studies of FmHA section 515 loans prepaid during fiscal year 1986 in the states of California, Minnesota, and South Carolina. These case studies included 14 projects with 642 units in California, 11 projects with 150 units in Minnesota, and 8 projects with 217 units in South Carolina. Although the results of our work in these states is not sufficient to determine the impacts of section 515 loan prepayments nationwide, it does show that the impacts on households and on the availability of low-income rental housing varied by state and local market areas.

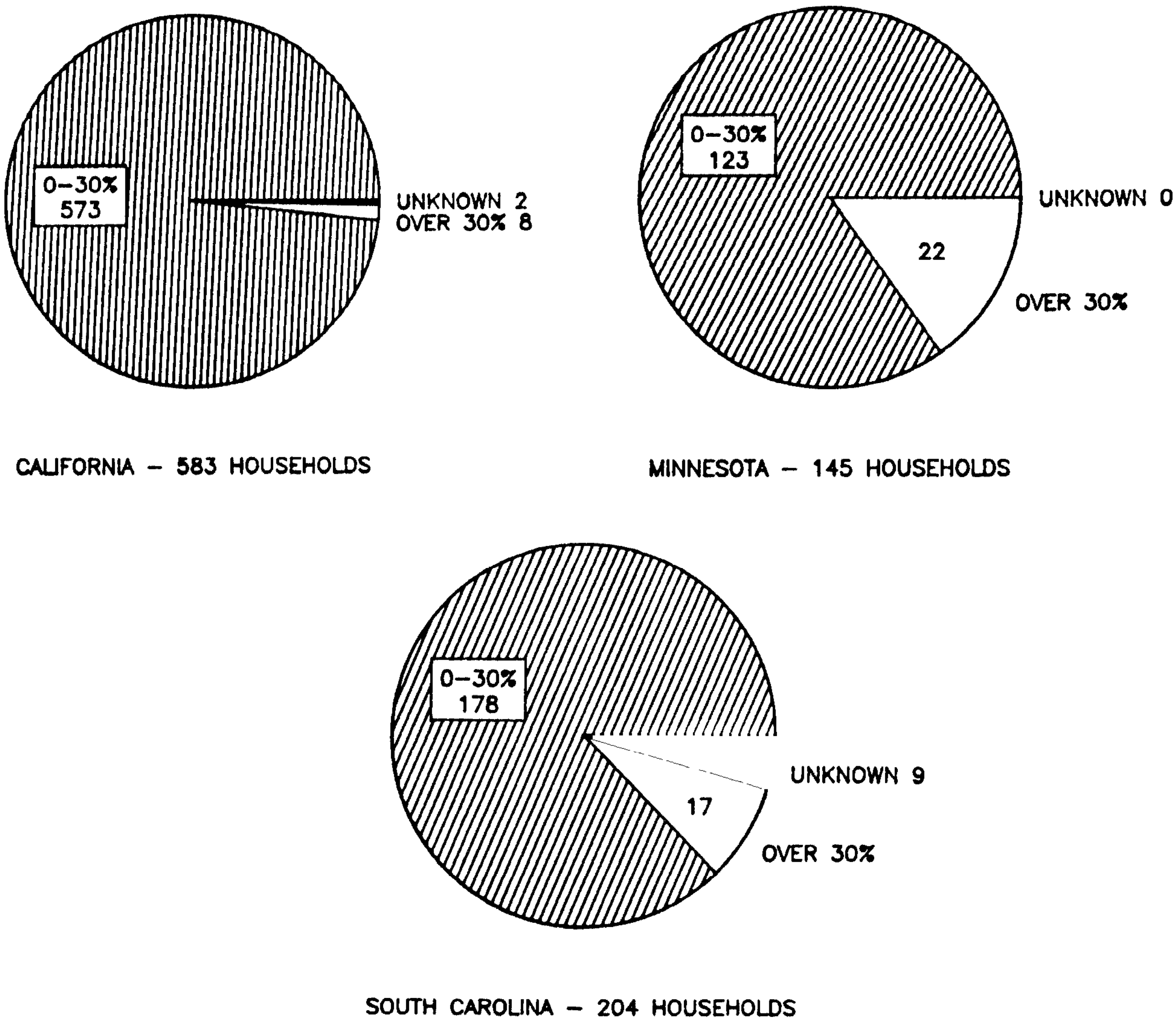
In each state, few households had rent burdens (households with a rent-to-income ratio of over 30 percent) before prepayment. After prepayment, however, owners increased monthly rents sharply in the affected projects--by 91 percent in California, by 64 percent in Minnesota, and by 14 percent in South Carolina. Even with the higher rents, over half of the affected households in each state remained in the prepaid projects, but between 25 and 35 percent of the households experienced a rent burden. While most of the households we identified in California that left the prepaid projects found alternative assisted housing, few households identified in Minnesota did. In South Carolina, we were unable to identify the housing status for most of the households that left the prepaid projects.

Even though all the prepaid projects in our case study states remained in the rental housing stock, rents were generally increased to market rate levels, which often reduced their availability to lower income households. Generally, the reduction in the availability of low-income rental housing was most severe in areas where the high demand for rental housing caused rents in prepaid projects to rise significantly and where alternative housing subsidies were limited.

FEW HOUSEHOLDS WERE RENT-BURDENED BEFORE PREPAYMENT

Before loan prepayment, 583 units, 145 units, and 204 units were occupied by households in California, Minnesota, and South Carolina, respectively. We found that few of these households had a rent burden before the section 515 loans were prepaid. As illustrated in figure 3.1, 22 households in Minnesota (15 percent), 17 households in South Carolina (8 percent), and 8 households in California (1 percent) had a rent-to-income ratio of over 30 percent before prepayment.

Figure 3.1: Few Households Were Rent-Burdened Before Prepayment



Source: GAO analysis of FmHA records.

Three factors account for the small number of households with a rent burden prior to the prepayment of section 515 loans. First, rents in the projects before prepayment were generally well below the market rate (see fig. 3.2). Second, in California, where 82 percent of the section 515 households had very low-incomes (those with incomes no greater that 50 percent of the area median income), the majority received an additional rental assistance subsidy. In fact, of the 583 households living in the California projects, 453, or 78 percent, received rental assistance, which largely explains why only 1 percent of all households had a rent burden prior to prepayment. Almost all of the rental assistance (452 households) was provided under FmHA's section 521 program. The other household received HUD section 8 rental assistance.

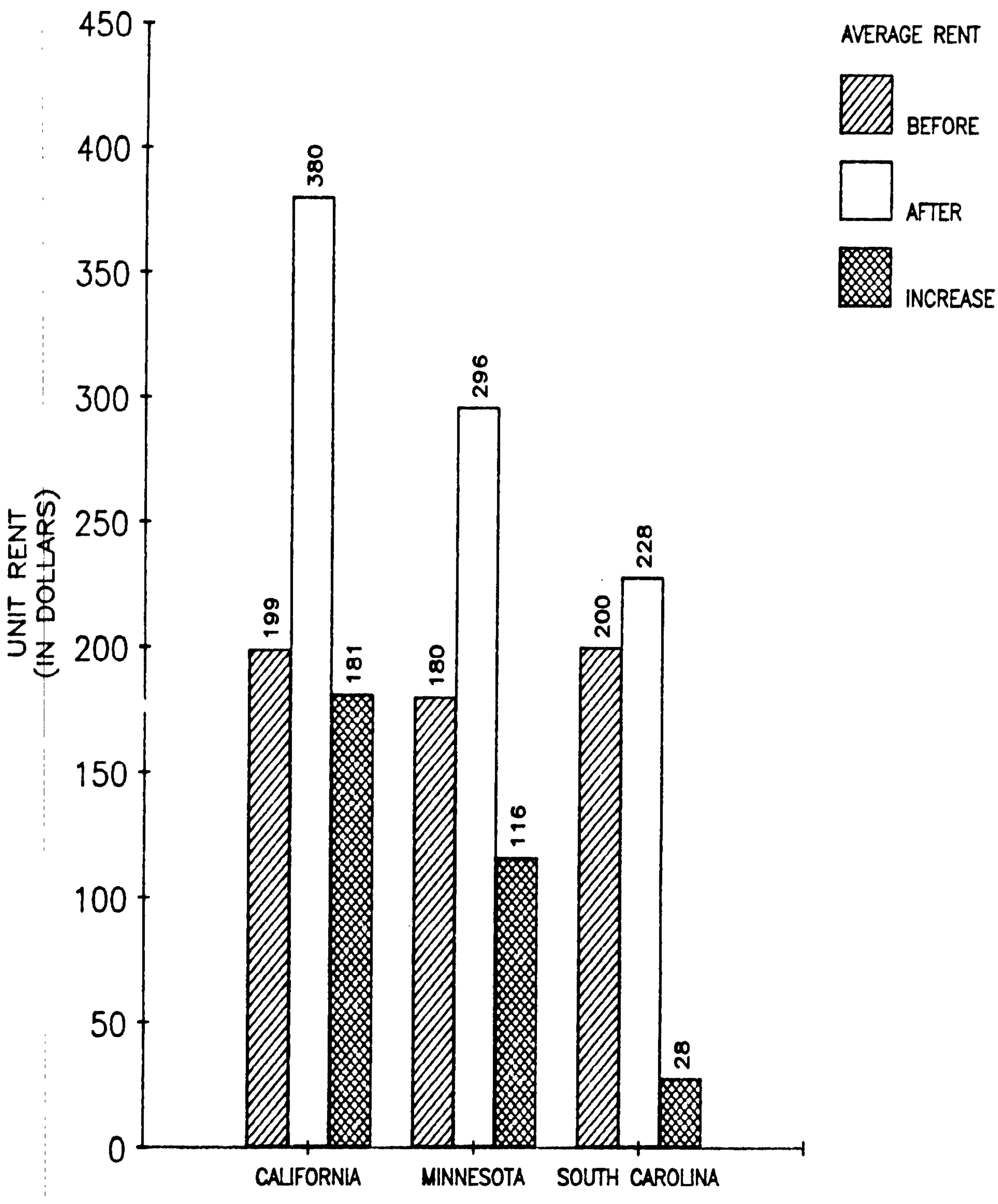
The third factor is actually a combination of two conditions which limited the number of households with a rent burden in Minnesota and South Carolina. In both these states, a much smaller percentage of households than in California were very low income--41 percent in Minnesota and 48 percent in South Carolina. Even though only 16 households in Minnesota received rental assistance (12 through FmHA's section 521 and 4 through HUD's section 8) and none received rental assistance in South Carolina, the higher relative income levels of these households combined with lower rents resulted in a small percentage having a rent burden.

RENTS INCREASED AFTER PREPAYMENT

Generally, owners increased rents for the units in the prepaid projects. The average monthly rent increases varied by state and were generally greater for those projects located near major cities, reflecting a strong market for these units.

Figure 3.2 shows the average monthly rent increases by state. In California, projects' monthly rent increases ranged from $124 to $280 and the average monthly rent for all units went from $199 before prepayment to $380 after prepayment, an increase of $181, or 91 percent. In Minnesota, projects' monthly rent increases ranged from $0 to $223 and the average monthly rent for all units went from $180 before prepayment to $296 after prepayment, an increase of $116, or 64 percent. In South Carolina, projects' monthly rent increases ranged from $0 to $101, and the average monthly rent for all units went from $200 before prepayment to $228 after prepayment, an increase of $28, or 14 percent.

Figure 3.2: Monthly Unit Rent Increases After Prepayment

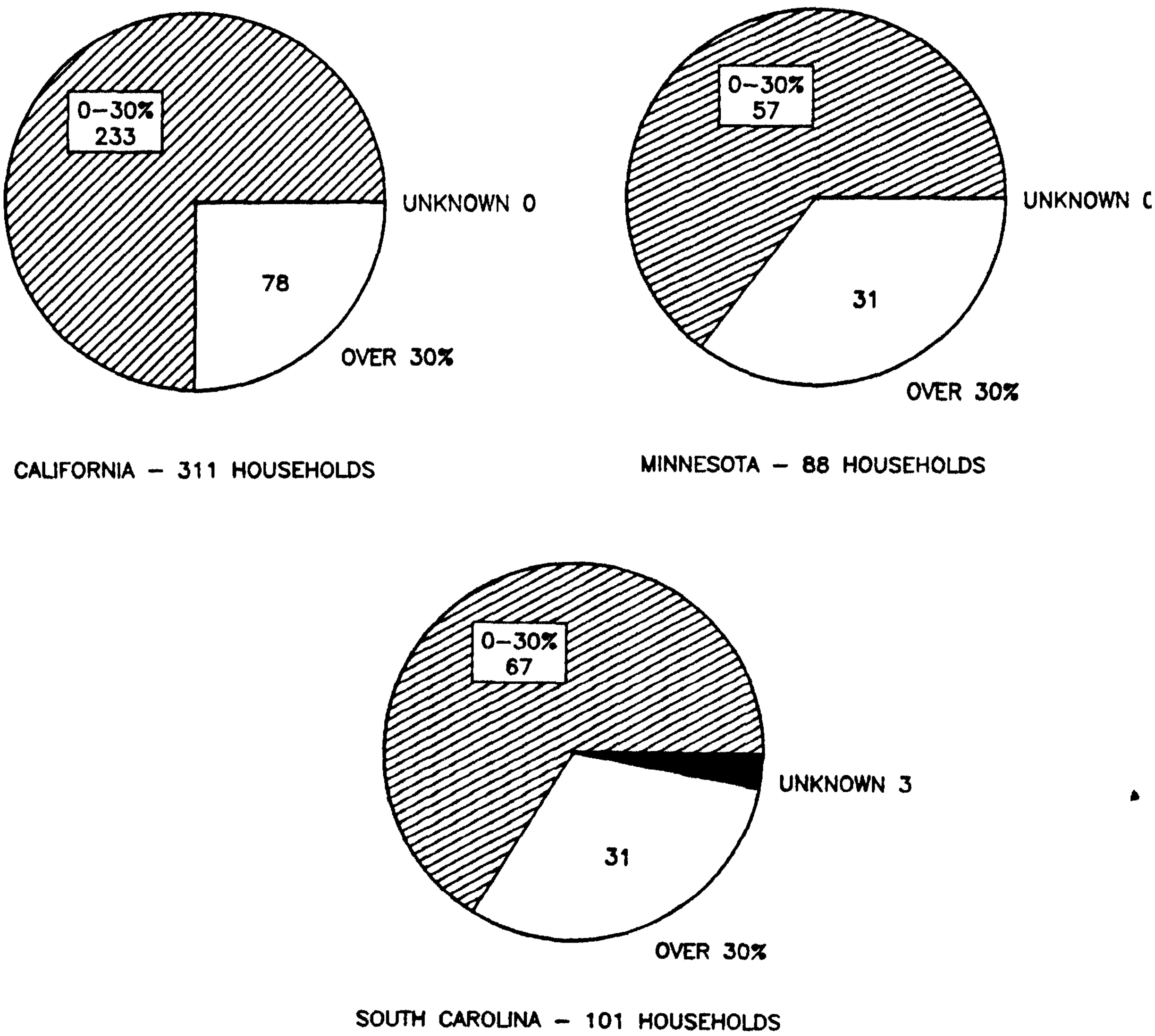


Source: GAO analysis of FmHA records.

OVER TWENTY-FIVE PERCENT OF HOUSEHOLDS REMAINING IN PREPAID PROJECTS HAD A RENT BURDEN

We found that 311 of the 583 California households, or 53 percent; 88 of the 145 Minnesota households, or 61 percent; and 1 of the 204 South Carolina households, or 50 percent; remained in the projects after prepayment. Figure 3.3 shows that as a result of higher rents, over 25 percent of the households remaining in t projects in each state had a rent burden after prepayment.

Figure 3.3: Households Remaining In Projects That Had A Rent Burden



Source: GAO analysis of FmHA records.

In California, 78 of the 311 households, or 25 percent, that remained experienced a rent burden. Of these 78 households, 62 lost their FmHA section 521 rental assistance, and 77 did not have a rent burden before prepayment. When project owners prepay their section 515 loans and leave the program, section 521 rental assistance payments on behalf of eligible households are suspended and, subsequently, transferred to different FmHA-financed projects.

The impact on households remaining in the projects in California would have been more severe had HUD section 8 rental assistance not been provided. Specifically, HUD section 8 rental assistance was provided to 221 of the 311 households, or 71 percent, that remained in the projects after prepayment. Overall, 191 of the 221 households that received HUD section 8 assistance had lost their FmHA section 521 subsidy.

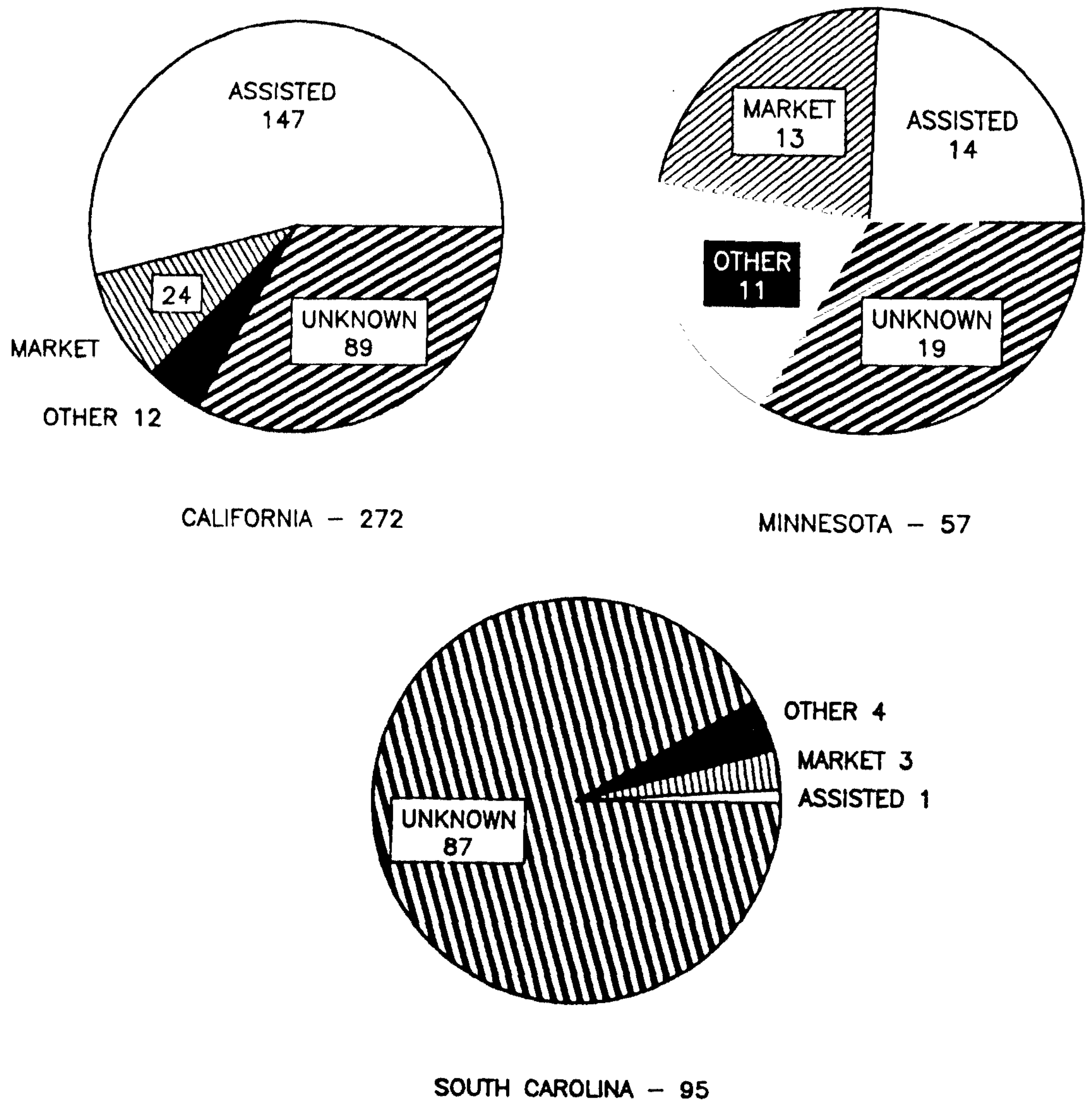
In Minnesota, 31 of the 88 households, or 35 percent, that remained experienced a rent burden. Of these 31 households, 2 lost their FmHA section 521 rental assistance and 20 did not have a rent burden before prepayment. HUD section 8 rental assistance was continued after prepayment for four households in one project in Minnesota.

In South Carolina, 31 of the 101 households, or 31 percent, that remained experienced a rent burden. Of these 31 households, 24 did not have a rent burden before prepayment. None of the households that remained in the projects in South Carolina received HUD section 8 rental assistance.

MANY HOUSEHOLDS THAT LEFT PREPAID PROJECTS FOUND OTHER ASSISTED RENTAL HOUSING

We found that 272 of the 583 California households, or 47 percent; 57 of the 145 Minnesota households, or 39 percent; and 95 of the 204 South Carolina households, or 47 percent, left the prepaid projects following the rent increases and/or loss of rental assistance. As illustrated in figure 3.4, most households that we could identify found alternative assisted housing; however, these households were located primarily in California.

Figure 3.4: Households That Found Other Assisted Rental Housing After Leaving Projects



Source: GAO analysis of FmHA records.

In California, we were able to identify the housing status for 183 of the 272 households that left prepaid projects. We found that 147 of the 183 households found other assisted housing after prepayment--58 moved into other FmHA housing and 89 moved into HUD assisted rental housing. Of the other 36 households that left prepaid projects, 24 moved into market-rate rental housing, 6 moved into nursing homes, 4 moved in with their families, and 2 moved into private homes or mobile homes.

In Minnesota, we were able to identify the housing status for 38 of the 57 households that left prepaid projects. We found that 14 of the 38 households found other assisted housing after prepayment--8 moved into HUD-assisted rental housing and 6 moved into other FmHA housing. We were able to determine that the remaining 24 households did not find other assisted housing. Of these, 13 households moved into market-rate rental housing, 7 moved into private homes or mobile homes, 2 moved in with their families, and 2 moved into nursing homes.

In South Carolina, we were able to identify the housing status for only 8 of the 95 households that left the prepaid projects. One household found assisted housing in another FmHA project. Of the 7 households not finding other assisted housing, 3 moved into market-rate rental housing, 2 moved into private homes or mobile homes, and 2 moved in with their families.

Finally, we were able to determine the rent burden for only a small portion of the households that left the prepaid projects. We found that 21 of 65 California households, 11 of 22 Minnesota households, and 1 of 6 South Carolina households had a rent-to-income ratio of over 30 percent after prepayment.

LOAN PREPAYMENTS REDUCED THE AVAILABILITY OF LOW-INCOME RENTAL HOUSING

Section 515 loan prepayments cause adjustments throughout the rental housing market. Even though all the prepaid projects in our case study states remained in the rental housing stock, rents were generally increased to market-rate levels which often reduced their availability to lower income households. The impact of section 515 loan prepayments on the availability of low-income rental housing varied by state and market areas. Generally, the reduction in low-income rental housing was most severe in market areas with a high demand for rental housing and without rental assistance.

Overview of Rental Housing Market Adjustments From Loan Prepayments

Units leaving the subsidized rental housing stock through loan prepayments reduce the number of low-priced rental units available and increase the number of higher priced rental units. Tenants in prepaid units who are forced to move because they cannot afford the higher rents will compete with other low-income renters for the available supply of low-rent housing. Because more households are trying to rent from a segment of the housing stock that has decreased, rents for low-priced units are likely to rise somewhat. Thus, households living in low-priced rental housing in a market area with prepayments will probably be slightly worse off because average rents for low-priced units will likely rise.

The prepaid units represent an increase in the supply of higher priced rental housing. Because the demand (the number of households looking) for higher priced rental housing has not increased, landlords will have to "bid" away tenants from other units by charging slightly lower rents. The landlords of other higher rent projects may have to reduce their rents as well in order to keep tenants. Thus, households living in higher priced units will likely benefit on average from the lower rents.

The magnitude of these price changes depends on the number of displaced households compared with the number of lower and higher priced rental units available in the market. For example, empirical evidence from several studies of housing demand suggests that if a prepaid project reduces the number of low-priced rental units available by 5 percent and increases the number of high-priced units by 5 percent, then the average rent of low-priced units will likely rise about 2 or 3 percent,[2] and rents will likely fall 2 or 3 percent for high-priced units. The impact of prepayments will be larger in small market areas because the prepaid units represent a greater share of the rental stock.

The use of prepayment receipts can also affect the supply of low-income housing. The outstanding mortgage balances for the prepaid loans in our case study states totaled over $13 million. However, these prepayment receipts were commingled with other sources of funds within the Rural Housing Insurance Fund (RHIF). The RHIF is a revolving loan fund administered by FmHA and is used to finance the section 515 program, along with the section 502 rural homeownership program and three much smaller loan programs. Each year, the Congress establishes the loan level activity that may be generated from the RHIF for each program. Accordingly, we did not attempt to determine if the receipts for the prepaid section 515 loans in our case study states were used to build additional low-income housing.

High Demand for Rental Housing in California and Prepaid Projects Experienced Substantial Rent Increases

In California all 14 projects experienced large rent increases in the 3 market areas we reviewed--Riverside, Santa Rosa, and Stockton. In these areas, according to local housing officials, low-income rental housing units were generally in high demand and short supply, and the availability of other subsidized rental housing was limited. This low-income housing situation, combined with high rent increases after prepayment and low household incomes, would have potentially caused almost all of the households

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[2]S. Mayo, "Theory and Estimation in the Economics of Housing Demand," Journal of Urban Economics, Vol. 10, No. 1, July 1981, pp. 95-116.

to either pay a higher share of their incomes for housing and/or move out of the prepaid projects. However, additional rental assistance was provided to many households, which lessened these adverse impacts.

As previously stated, the average monthly rent for the 14 projects increased by $181, to $380. On the other hand, the average monthly income for the 583 households was about $660, and over 80 percent of the households in each area were very low-income. However, 302 of the 583 households, or 52 percent, received HUD section 8 rental assistance. This assistance enabled 221 households to remain in the prepaid projects and 81 households to move to other rental housing.

Without the HUD section 8 rental assistance, most of which was provided to households in the Riverside area, the impact on households would have been more severe. For 7 projects located in the Riverside area, the average monthly rent increased by $208, to $396, and the average monthly income for the 265 households was $657. However, 249 of the 265 households in the Riverside area, received section 8 assistance. This assistance was provided to all 175 households that remained in the prepaid projects. In addition, 74 of the 90 households that left the prepaid projects received section 8 rental assistance. Of the remaining 16 households that left the projects, 7 found other assisted housing. We were unable to identify the housing status for 1 of the 16 households that left the projects.

In contrast, only 53 of the 318 households in the Santa Rosa and Stockton areas received HUD section 8 rental assistance, and the prepayment impacts were more severe. The average monthly rent increased by $166, to $370, for the seven projects located in the two areas. The average monthly income for the 318 households was $682. Rental assistance went to 46 of the 136 households that remained in the prepaid projects. Of the 90 households that were not assisted, 78 experienced a rent burden after prepayment. We were unable to identify the housing status for 88 of the 182 households that left the prepaid projects. Only 7 of the remaining 94 households leaving the prepaid projects in the 2 areas received rental assistance. In addition, 59 of the 94 households found other assisted housing.

Demand for Rental Housing Varied in Minnesota and Rent Increases in Prepaid Projects Were Moderate

In Minnesota, six prepaid projects were located in the Willmar area and five projects were in the St. Cloud area. Some communities in the Willmar area were experiencing a population loss, and in others new rental units had recently been built. In one community, however, vacancy rates were low for both subsidized and market rate projects. Most of the projects in the St. Cloud area were near a major city, and the communities in which they were located were thriving economically.

Eight prepaid projects (five in Willmar and three in St. Cloud) experienced rent increases which reduced their availability to lower income households. These projects were located near growing metropolitan areas. Overall, the average monthly rent for these projects increased by $115, to $296. The average monthly income for the 124 households residing in these projects was about $955. Of the 124 households, 71 remained in the projects and 53 left the projects after prepayment. Only 4 of the 71 households that remained were provided section 8 rental assistance, and 30 households had a rent burden after prepayment. We were able to identify the housing status for 35 of the 53 households that left the projects. None of the 35 households that left received section 8 rental assistance, and only 13 households found other assisted housing.

Three prepaid projects (one in Willmar and two in St. Cloud) were generally still available to lower income households. These projects were generally located in more outlying rural areas, on average, about 86 miles from major cities. While rents increased, these projects generally continued to serve lower income households, without rental assistance. Overall, the average monthly rent for the three projects increased by $70, to $240. The average monthly income for the 21 households residing in these projects was about $942. Of the 21 households, 17 remained in the projects after prepayment, and only 1 household had a rent burden. In addition, one of the four households that left the prepaid projects moved into another FmHA project. We were unable to identify the housing status for one of the four households that left, but none of the other three received section 8 rental assistance.

Demand for Rental Housing Also Varied in South Carolina and Rent Increases in Prepaid Projects Were Low to Moderate

In South Carolina, five projects were located in the Greenville area, two in the St. George area, and one in the Camden area. In the Greenville and St. George areas, local housing officials told us that sufficient low-income units were available to accommodate displaced section 515 households. However, in the Camden area, according to a local housing official, housing needs for low-income families were critical and waiting lists to obtain low-income units were long. FmHA officials in the Camden area told us that they could not meet the housing needs of the rural areas because of a lack of rental assistance. Without rental assistance, they said, many families could not afford the rents even if new low-income projects were built.

Six prepaid projects (four in Greenville, one in St. George, and one in Camden) generally continued to serve lower income households after prepayment. On average, these projects were located 36 miles from a major city. The average monthly rent for five of these projects (we could not determine the rent for one project in the Greenville area) increased by $14, to $200. The average monthly income for the 71 households residing in these projects was about $1,099, and only 37 percent were very low-income. Of the 71 households, 40 remained in the prepaid projects. While none of these households received rental assistance, only one had a rent burden. In addition, 29 households left the projects after prepayment, but we were unable to determine the status of 24. None of the other five households received rental assistance or found other assisted housing. We were unable to determine whether two households remained or left the prepaid projects.

Rents also increased in the two remaining prepaid projects (one in Greenville and one in St. George). The Greenville project was located 10 miles from a major city and the monthly rent increased by $101, to $267. The St. George project was located 50 miles from a major city and the monthly rent increased by $25, to $325. The average monthly income for the 133 households in the 2 projects was about $913. We were able to evaluate the impact for the Greenville project with 127 households. Of these households, 61 remained in the project and 66 left after prepayment. None of the 61 households remaining in the projects received rental assistance, and 30 households had a rent burden. We were unable to determine the status for 63 of the 66 households that left the project. None of the other three households received rental assistance, but one moved to another FmHA project.

SECTION 4

POTENTIAL FOR FUTURE SECTION 515 LOAN PREPAYMENTS

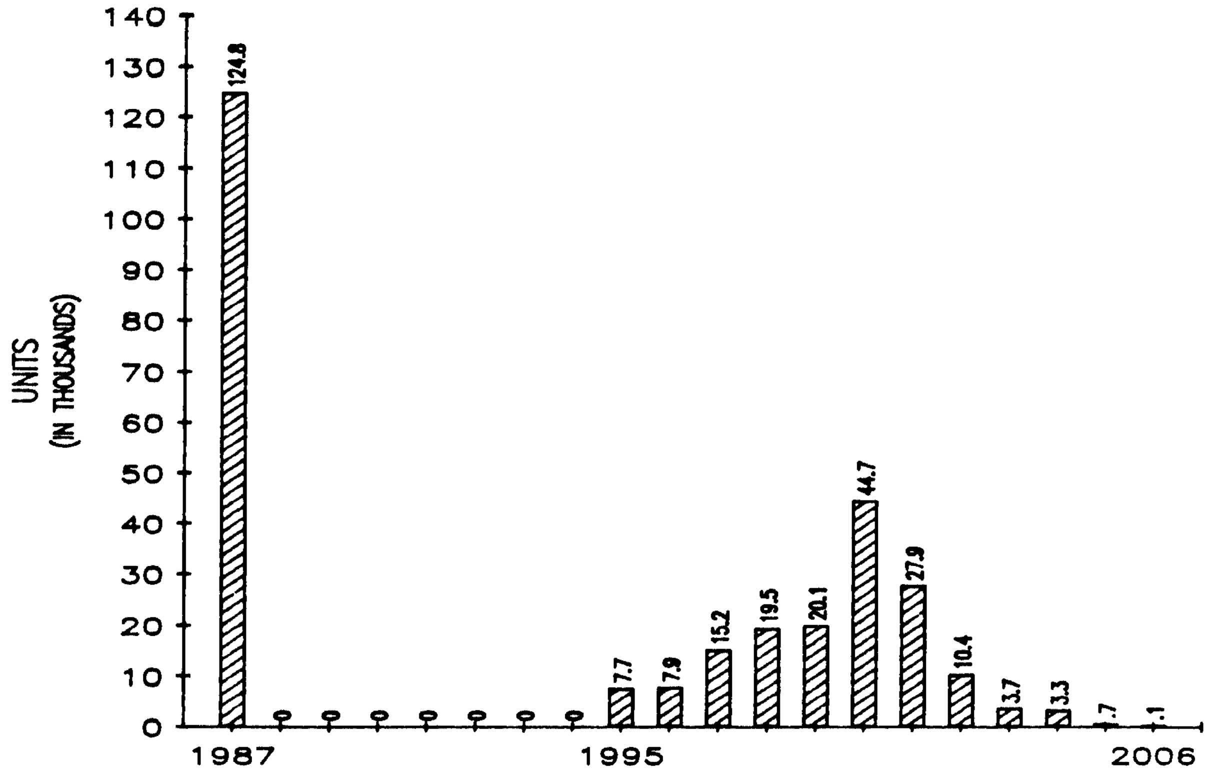
Many owners may exercise their option to prepay their loans and leave the section 515 program when their loans become eligible for prepayment. Although our case study sample was too small to represent projects nationwide, we believe it is a good indicator of the characteristics of projects with a higher probability for prepayment. Borrowers in our case study prepaid their loans to avoid various FmHA regulatory restrictions or requirements and to increase returns by raising rents above current section 515 limits. These borrowers were either full- or limited-profit individuals, partnerships, or limited partnerships. Furthermore, the prepaid projects in our case study had more units and were located much closer to major cities than the average for the total section 515 inventory.

LOANS ELIGIBLE FOR PREPAYMENT

As of February 1987, FmHA had section 515 loans outstanding for 17,162 projects with 360,749 units. We were unable to determine the loan origination date for 4,186 projects with 74,734 units and, therefore, did not estimate when these loans will become eligible for prepayment. We estimate, however, that loans for at least 6,626 projects with about 125,000 units are currently eligible to be prepaid. These loans are known to have been originated before 1980 and are eligible for prepayment after March 15, 1988, when the prepayment moratorium expires. Additionally, we estimate that loans for at least 6,350 projects with over 161,000 units will be eligible to be prepaid between 1995 and 2006. These loans were known to have been originated after 1980 and are subject to a 15- or 20-year prepayment restriction. Figure 4.1 shows the year that section 515 units are eligible for loan prepayments.

Data used to estimate when section 515 loans become eligible for prepayment were obtained from FmHA's Multi-Family Housing Information Status Tracking and Retrieval (MISTR) System. Our estimates assumed that prepayment restrictions do not apply to loans originated before 1980 and that prepayment of loans originated in or after 1980 is restricted for the appropriate 15- or 20-year period. While current law restricts the prepayment of loans approved prior to December 21, 1979, that are subject to restrictive use provisions because of a servicing action (reamortizations, transfers, and assumptions), FmHA data do not identify which loans, if any, this applies to. To the extent that loans originated before 1980 are subject to restrictive use provisions because of a servicing action, our estimate of the loans currently eligible for prepayment would decrease and our estimate of the loans eligible to be prepaid in later years would increase.

Figure 4.1: Section 515 Units Eligible for Loan Prepayment



Source: GAO analysis of MISTR data.

Source: GAO analysis of MISTR data.

PRIMARY FACTORS INFLUENCING PREPAYMENT

As previously noted, prepayments are encouraged by tax shelter benefits, interest rates, and opportunities to raise rents in high demand areas. According to the owners and/or managers of the case study projects we interviewed, the primary factors influencing their decision to prepay were to avoid FmHA regulatory restrictions and to enhance their investment returns by increasing rents above current section 515 limits. A factor related to increasing rents, according to several respondents, was that federal tax shelter benefits had been exhausted over time.

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Avoid FmHA Regulatory Restrictions

Fifteen respondents stated that they had prepaid their loans because they wanted to avoid being subject to FmHA's regulatory restrictions relating to the use of the property and/or FmHA's periodic paperwork requirements. Ten respondents indicated that this was the primary reason for prepaying their loans.

Specifically, 4 of the 10 respondents complained about having to prepare annual income eligibility certification for each household or objected to FmHA restrictions on unit occupancy and tenant selection. For example, in one project, the owner complained that he had little discretion in the tenant selection process and for this reason, many tenants residing in the project were undesirable. The other six respondents commented in general terms about the burdensome FmHA management restrictions and paperwork requirements.

Increasing Rents to Enhance Returns

Twelve respondents told us that the primary reason for prepaying their loans was because of FmHA restrictions on rents and investment returns and/or to increase project rents above the rent levels allowed by FmHA. Five respondents told us that they prepaid their loans because the tax shelter benefits had become exhausted over time, increasing their tax liability. Three respondents stated that this was their primary reason for prepaying.

The limited returns from operations, the higher market rents available, and the loss of returns from tax shelter benefits motivated many owners in our case study to prepay their section 515 loans. FmHA regulations permit project rents to be raised to cover increases in operating expenses but restrict the annual return from project operations for limited profit owners (most owners in our sample were limited profit) to 8 percent of their original cash investment. Market rents in the areas covered by our case study were generally higher than the FmHA-controlled rents. Furthermore, most of the projects were over 10 years old and the owners' returns from the tax shelter benefits for many of these projects may have been exhausted or approaching exhaustion. Consequently, prepayment enabled many owners in our case study to increase rents to enhance their investment returns.

Several project owners and/or managers felt that FmHA could encourage more owners to remain in the section 515 program by increasing the allowable return percentage and/or by basing allowable returns on the owner's current, not initial, investment in the project. They said that this would allow owners to charge higher rents, thereby increasing their investment returns.

CHARACTERISTICS OF PREPAID PROJECTS COMPARED WITH THE CURRENT SECTION 515 INVENTORY

Projects with section 515 loans originated before 1980 have a higher potential to be prepaid because they are generally not subject to prepayment restrictions. All loans for the 33 projects in our case study were originated before 1980. Section 515 borrowers who had prepaid their loans for these projects were either full- or limited-profit individuals, partnerships, or limited partnerships. Generally, the prepaid projects had more units than the average section 515 project and were located closer to cities with a population of 50,000 or more than the average section 515 project. The details of these characteristics are shown in table 4.1, which compares the characteristics of prepaid projects in our case studies with those of projects with outstanding section 515 loans as of February 1987.

As shown in table 4.1, the potential for future prepayments varies depending on the characteristic(s) selected for comparison. Using the borrower-type characteristic, our case study results showed that borrowers were either individuals (20), partnerships (7), or limited partnerships (6). In comparing these borrower types with the current loan inventory, we found that 57 percent of the projects with loans originated before 1980 and 78 percent of the projects with loans originated after 1980 had these types of borrowers. Overall, 70 percent of the total section 515 project inventory had these types of borrowers.

Using the loan-profit type characteristic, our case study results showed that borrowers were either full-profit (7) or limited-profit (26) borrowers. We found that 65 percent of the projects with loans originated before 1980, 84 percent of the projects with loans originated after 1980, and 76 percent of the total section 515 project inventory had full- or limited-profit borrowers.

Prepaid projects in our case study were located much closer to major cities than the average for the total section 515 inventory and were located in less populated areas. Twenty-three projects were located in areas with a population of less than 5,500, and 23 projects were located within 40 miles of cities with a population of 50,000 or more. The average distance for all projects located from a city with a population of 50,000 or more was 36 miles. The average distance for the total inventory of section 515 projects was 77 miles, and about 6,000 projects were located within 40 miles of cities with a population of 50,000 or more. Furthermore, over 12,000 projects were located in areas with a population of less than 5,500. Information was not available in our data base to determine the number of projects with these location characteristics in the before- and after-1980 inventories.

Table 4.1: Comparison of Characteristics of GAO Case Study and Current Section 515 Inventory

Characteristics	GAO case study	Current loan inventory Before 1980	1980 or after	Total inventory[a]
Number of projects	33	6,626	6,350	17,162
Number of units	1,009	124,834	161,181	360,749
Borrower-type (projects):				
Individual	20	2,036	735	3,290
Partnership	7	743	654	1,762
Limited partnership	6	969	3,590	6,964
Corporation	0	2,066	740	3,374
Other	0	812	631	1,772
Loan-profit type (projects):				
Full profit	7	1,063	130	1,398
Limited profit	26	3,266	5,202	11,722
Nonprofit	0	2,293	1,012	4,020
Other	0	4	6	22
Miles project located from city with a population of 50,000 or more:				
Average miles	36	(b)	(b)	77
Projects within 40 miles	23	(b)	(b)	5,944
Projects located in areas with population less than 5,500	23	(b)	(b)	12,431
Number of units in projects:				
Average number of units	31	19	25	21
Projects with 30 or more units	13	(b)	(b)	(b)

[a]Includes 4,186 projects and 74,734 units where loan origination dates were not available from FmHA records.

[b]Data were not available.

Finally, the average number of units in our case study projects was greater than the average number of units in the current section 515 inventory. Projects in our case study averaged 31 units, and 13 projects had 30 or more units. The average number of units was 19 for projects with loans originated before 1980, 25 for projects with loans originated after 1980, and 21 for the total section 515 project inventory. We were unable to determine the number of projects with 30 or more units for the section 515 inventory.

SECTION 5

OBJECTIVES, SCOPE, AND METHODOLOGY

On October 1, 1986, the Chairman, Subcommittee on Housing and Community Development, House Committee on Banking, Finance and Urban Affairs, requested that we provide information on the impact that prepaid FmHA section 515 loans have had or may have on tenant displacement and on the availability of low-income housing. As agreed with the Chairman's office, we obtained information on the

-- legality of FmHA's practice of accepting voluntary prepayment of section 515 loans originated prior to December 21, 1979;

-- impact that prepayments have had on tenant displacement and low-income housing availability; and

-- characteristics of prepaid loans compared with the section 515 loans currently outstanding to estimate the potential for future prepayments.

We conducted our review from January through May 1987 and performed our work in accordance with generally accepted government auditing standards.

LEGALITY OF LOAN PREPAYMENT

Section 502(c) of the Housing Act of 1949, 42 U.S.C. 1472(c), addresses prepayment restrictions for section 515 loans. We reviewed the legislative history of the prepayment provision and also reviewed a memorandum decision (Gillanders v. Smith, E.D. Calif. Civ. No. S-86-867-EJG) issued on November 26, 1986. This decision deals with the issue of whether FmHA can refuse to accept prepayment of section 515 loans made before December 21, 1979. However, this case was dismissed on September 25, 1987, on the basis of a settlement agreement between the various parties, including FmHA.

We also obtained FmHA's position on its interpretation of section 502(c) of the Housing Act of 1949, dealing with prepayment of section 515 loans. Specifically, we asked FmHA whether the prepayment provision

-- permits borrowers to voluntarily refinance or prepay their section 515 loans without being requested to do so by FmHA;

-- requires FmHA to consider the incomes of tenants, not borrowers, in accepting loan prepayments or requesting borrowers to refinance section 515 loans; and

-- prohibits FmHA from accepting loan prepayments or requesting refinancing if it would lead to involuntary displacement of tenants.

IMPACT OF LOAN PREPAYMENTS

FmHA instructions require the FmHA district office directors to prepare and send a report on each prepayment case to the FmHA state office director for indefinite retention. We obtained and analyzed information on section 515 loans prepaid since fiscal year 1984 from the prepayment reports maintained by each FmHA state office. Since 1984, FmHA has approved prepayment offers for 355 projects with 5,557 units, including 176 projects with 2,756 units in 1986. While these reports indicate how many loans have been prepaid, the information contained in the reports was not in sufficient detail to adequately determine whether prepayments have had an adverse effect on tenant displacement and housing availability.

Therefore, we conducted case studies of section 515 loans prepaid during fiscal year 1986 in the states of California, Minnesota, and South Carolina. Our case study states included 33 prepaid projects with 1,009 units. We selected fiscal year 1986 because of the high level of loan prepayments during the year, the likelihood that project files were still maintained at the FmHA district offices, and the potential to identify and contact more of the former project owners and displaced tenants. We selected the three states on the basis of FmHA data showing states with the highest incidence of prepayments in fiscal year 1986, taking into account the need for a wide geographical dispersion of states. The selected states provide coverage over a wide geographical area and include loan prepayments for about 19 percent of the projects and about 37 percent of the units that were made during fiscal year 1986.

Since our case study states were judgmentally selected, our results should not be used to make generalizations and inferences about prepaid section 515 loans nationwide. For each state, however, our sample included almost all projects prepaid during 1986. Therefore, we believe that our results fairly represent the impact of loan prepayments in California, Minnesota, and South Carolina.

For each state selected, we visited the appropriate FmHA district offices and the projects where loans were prepaid and/or discussed the impacts of section 515 loan prepayments with a variety of persons at these locations. These persons included FmHA state and district office officials; former and/or new project owners; and tenants who remained at the prepaid projects, as well as those tenants who left. In the areas where these projects are located, we visited and/or discussed section 515 loan prepayments and the rental housing markets with officials of local housing authorities, local real estate agencies, regional planning commissions, and/or low-income housing groups. Our case study field work was conducted from February 1987 to April 1987.

POTENTIAL FOR FUTURE PREPAYMENTS

We obtained information, as of February 1987, on over 17,000 FmHA housing projects nationwide from FmHA's MISTR System, which is a national data file on section 515 housing projects. We analyzed these data to determine the year the loans were closed and the borrower, loan, project, and tenant characteristics of the outstanding inventory. We identified the year in which each project would become eligible for loan prepayment by applying the appropriate prepayment restriction to the loan-closing dates. We also compared the characteristics of the outstanding inventory with those characteristics of the loans prepaid in our case study analyses to identify those projects that resemble prepaid projects.

We did not attempt to statistically verify the accuracy of the centralized data because of the extent of the information. In a prior review of the FmHA section 515 program (GAO/RCED-87-96), we selectively compared data in the centralized file with actual project records for 44 projects we visited to determine their accuracy. For the 33 projects we visited during this review, we also selectively tested and compared data in the centralized file with actual project records to determine their reliability. Overall, we consider that the data were suitable for our use.

FMHA SECTION 515 PROJECTS INCLUDED IN GAO'S STATE CASE STUDIES

California Projects	Date loan closed	Original loan amount (thousands)	Date loan prepaid	Loan balance prepaid (thousands)
FmHA Riverside District:				
Beaumont Park Valley Apartments	9/76	$ 470	1/86	$ 379
Desert Manor Apartments I	9/76	995	3/86	804
Desert Manor Apartments II	12/76	995	3/86	823
Vista De San Jacinto I	4/76	840	6/86	703
Vista De San Jacinto II	9/78	942	6/86	726
Vista De San Jacinto III	9/78	942	6/86	832
Yucca Valley Oasis	2/75	136	4/86	111
FmHA Santa Rosa District:				
Copeland Creek Apartments	10/75	2,033	3/86	1,623
Mission Terrace Apartments	8/75	544	8/86	450
FmHA Stockton District:				
Elk Grove Apartments	8/77	926	1/86	769
Jamestown Apartments	8/76	734	7/86	582
Sunset Apartments I	2/76	466	6/86	390
Sunset Apartments II	2/76	446	6/86	372
Willo Heights Apartments	7/76	438	12/85	353
Minnesota Projects				
FmHA St. Cloud District:				
Crow River Apartments	8/74	225	5/86	179
Elm Avenue Apartments	9/73	102	4/86	82
Meadowbrook Apartments	5/74	311	9/86	267
Oakdale Apartments	4/69	64	12/86	52
Warner Manor Apartments	8/73	108	4/86	84
FmHA Willmar District:				
Gran-View Apartments	3/75	213	6/86	172
Hillside Plaza	12/73	96	12/86	74
Meadowbrook I Apartments	11/73	195	8/86	152
Meadowbrook II Apartments	12/74	355	8/86	281
Shamrock Apartments	7/75	121	10/85	97
Villager Apartments	8/76	278	7/86	224

South Carolina Projects	Date loan closed	Original loan amount (thousands)	Date loan prepaid	Loan balance prepaid (thousands)
FmHA Camden District:				
Pinewood Apartments	4/77	$ 144	12/85	$ 139
FmHA Greenville District:				
Cameron Apartments	5/68	113	1/87	81
Palmer Apartments	7/70	47	10/85	38
Pickens Apartments	4/70	83	10/86	67
Village Apartments	2/70	300	1/86	272
Village Park Apartments	6/76	2,102	3/86	1,806
FmHA St. George District:				
Kingswood Apartments	10/74	91	10/86	88
Thompson Apartments	8/75	60	10/85	28

SUMMARY OF CASE STUDY RESULTS

Project Status	California	Minnesota	South Carolina
Number of projects	14	11	8
Number of units	642	150	217
Project located in area with population of:			
2,500 or less	1	6	2
2,501-5,500	6	5	3
5,501-10,000	6	0	2
10,001-20,000	1	0	1
Average miles from major city[a]	20	58	35
Household Status Before Prepayment			
Number of households (occupied units)	583	145	204
Number of tenants	919	231	466
Household average monthly income	$633	$966	$982
Average monthly unit rent	$199	$180	$200[b]
Households receiving rental assistance:			
FmHA section 521	452	12	0
HUD section 8	1	4	0
None	130	129	204
Household rent-to-income ratio:			
0-30 percent	573	123	178
Over 30 percent	8	22	17
Unknown	2	0	9
Rent Increases After Prepayment			
Average monthly unit rent	$380	$296	$228[b]
Average monthly unit rent increase	$181	$116	$28[b]

[a]Defined as a city with a population of 50,000 or more.

[b]Excludes one project for which rent data were not available.

Households Remaining In Project After Prepayment	California	Minnesota	South Carolina
Number of households	311	88	101
Number of tenants	411	130	233
Households receiving rental assistance:			
FmHA section 521	0	0	0
HUD section 8	221	4	0
None	89	83	100
Unknown	1	1	1
Household rent-to-income ratio:			
0-30 percent	233	57	67
Over 30 percent	78	31	31
Unknown	0	0	3
Households Leaving Project After Prepayment			
Number of households	272	57	95
Number of tenants	508	101	222
Number of households that:			
Received HUD section 8 assistance, then left prepaid projects	81	0	0
Moved to FmHA rental housing	58	6	1
Moved to HUD rental housing	8	8	0
Moved to market-rate rental housing	24	13	3
Moved to private/mobile home	2	7	2
Moved in with family/relatives	4	2	2
Moved to nursing home, etc.	6	2	0
Moved from area	25	5	3
Died since prepayment	7	2	0
Other	0	4	0
Unknown	57	8	84
Household Status Unknown After Prepayment			
Number of households	0	0	8
Number of tenants	0	0	11

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