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Report to Congressional Requesters

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RURAL HOUSING

Shift to Guaranteed Program Can Benefit Borrowers and Reduce Government's Exposure

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The Honorable Gary A. Condit
Chairman
The Honorable Craig Thomas
Ranking Minority Member
Information, Justice, Transportation,
and Agriculture Subcommittee
Committee on Government Operations
House of Representatives

Refinancings accounted for over half of the record trillion dollars in new mortgages in 1993, the year that saw a 30-year low in mortgage interest rates. The Farmers Home Administration (FmHA) saw a rise in the number of borrowers who paid off their FmHA housing loans and thus graduated to private credit during this same period.[1] However, in part, because of regulatory and legal financing restrictions, FmHA still has thousands of borrowers paying mortgage interest rates significantly higher than rates available to new FmHA borrowers or borrowers in the private sector.

FmHA makes both direct and guaranteed housing and farm loans to rural Americans who cannot otherwise obtain loans at reasonable rates. FmHA's direct loans for single-family housing are designed to promote successful homeownership for low-income rural residents by providing mortgage loans and, depending on borrowers' incomes, interest subsidies to lower monthly mortgage payments. The direct loans are meant to provide temporary credit—borrowers are required to graduate from the direct program when their incomes are sufficient to afford private credit. The loans are serviced by FmHA in about 1,700 county offices and account for about 35 percent of the county offices' workload.

In 1991, FmHA initiated a new program in the form of guaranteed loans for single-family housing that were designed to assist moderate-income rural borrowers. To qualify for the program, homes may be new or existing residences located in rural areas. In guaranteeing a single-family housing loan, FmHA agrees, in the event that a borrower defaults, to reimburse a commercial lender for up to 90 percent of lost principal plus accrued interest and liquidation costs.

[1]As part of the reorganized U.S. Department of Agriculture, the rural housing programs previously under FmHA will be administered by the newly formed Rural Housing and Community Development Service.

This report responds to your request to (1) describe the current status of FmHA's single-family housing loan portfolio and (2) examine the merits of allowing borrowers with direct loans to refinance their loans within the direct loan program or through FmHA's guaranteed loan program for single-family housing.

Results in Brief

As of September 30, 1994, FmHA held a portfolio of about 765,000 direct loans for single-family housing with a total outstanding principal balance of $18.6 billion. In fiscal years 1991 through 1994, FmHA guaranteed an additional 25,000 housing loans for about $1.5 billion.

The majority of FmHA's direct loan borrowers would not benefit from refinancing because the borrowers receive substantial subsidies, low interest rates, or a combination of the two. However, 92,000 nonsubsidized FmHA loans are held by borrowers who continue to pay interest rates of 9.5 percent or higher on an outstanding principal balance of $2.2 billion. About 13,000 of those loans carry rates of 13 percent or above. These nonsubsidized, high-interest-paying direct loan borrowers, along with an additional 7,200 borrowers who receive minimal subsidies but still pay above-market rates, would benefit from refinancing. However, current regulations prohibit lowering interest rates within the direct program, and refinancing using the guaranteed program would require a legislative change.

While lowering borrowers' interest rates within the direct program or refinancing other borrowers using the guaranteed loan program would help FmHA reach its objective of promoting successful homeownership, refinancing eligible borrowers through the guaranteed program would also help FmHA meet its requirement to graduate direct loan borrowers to private credit. A legislative change to allow such refinancings would provide an option for the thousands of moderate-income borrowers caught in the middle—ineligible for subsidies but unable to graduate to nonguaranteed private credit.

We identified up to $2.2 billion in loans held by direct loan borrowers who could benefit by receiving a lower interest rate if they were allowed to refinance through the guaranteed program. If these individuals refinance, the U.S. Treasury will receive immediate revenues from the loan payoffs, but it will also forgo future revenues from mortgage payments. Additional budget authority may be required to issue these loan guarantees. However, FmHA may realize savings because banks would be originating and servicing loans previously administered by FmHA's local county offices.

Background

In fiscal years 1988 through 1993, funding obligated for FmHA's new single-family direct loans remained fairly constant at approximately $1.3 billion annually. In fiscal year 1994, funding increased to $1.7 billion. FmHA currently originates new loans only for borrowers with incomes that are low enough to qualify for subsidy. FmHA's current regulations prohibit refinancing within the direct loan program.

FmHA may make a guaranteed single-family housing loan for up to 100 percent of the property's market value; the maximum loan amount is $67,500, except in designated high-cost areas, where the loan amount may be higher. For a borrower to obtain an FmHA-guaranteed loan, a lender must certify that it is unwilling to make the loan without a government-backed guarantee. Borrowers with direct loans cannot graduate to private credit using the guaranteed program because the 1991 legislation authorizing the guaranteed program does not include refinancing existing FmHA loans as an authorized purpose. The 1991 legislation limits the program to loans used to acquire or construct single-family residences.[2]

Status of FmHA's Housing Portfolio

As of September 30, 1994, the outstanding principal balance on direct loans for single-family housing was $18.6 billion. About two-thirds of those loans were held by borrowers who receive subsidies that reduce the effective interest rates on their mortgages to as low as 1 percent. (See app. I.)

FmHA's guaranteed loan housing program has grown from about 1,000 loans issued in fiscal year 1991 to about 11,000 loans issued in fiscal year 1994. A total of over 25,000 loans were issued in the program's first 4 years. Those loans initially had an outstanding principal balance of about $1.5 billion; about $1.2 billion is still outstanding.

[2]Section 502(h) of the Housing Act of 1949 (42 U.S.C. 1472(h)).

Lowering Interest Rates Within the Direct Program

Since we reported the effects of FmHA's prohibition against lowering interest rates within the direct loan program at a March 1994 hearing of a House banking subcommittee, FmHA has reexamined its policy and now believes that it has the authority to lower borrowers' interest rates under existing legislation without affecting current-year budget funds.[3] Lowering interest rates on existing loans within the direct loan program should better achieve the program's objectives of promoting successful homeownership by lowering borrowers' payments, reducing the need for subsidies, helping borrowers build equity, and decreasing delinquencies and foreclosures. However, lower payments could act as a disincentive to voluntary graduation to private credit and will result in reduced government revenues because of lower interest rates paid by borrowers.

FmHA plans to change its regulations to allow some existing borrowers to reduce their mortgage interest rates to the rates offered to new borrowers. However, because FmHA plans to include this change as part of an overall regulatory package of reforms, FmHA officials told us it will not occur before October 1996.

Refinancing Using the Guaranteed Program

A logical step in graduating borrowers from direct loans to private credit would be to replace direct loans with guaranteed loans when the borrowers qualify. FmHA has the legal authority to require borrowers to graduate if it appears that other credit can be obtained from another source at reasonable rates and terms.[4] Refinancing borrowers using guaranteed loans would have several advantages.

Assist Borrowers to Obtain Private Credit

FmHA's policy requires that borrowers move from direct loans to private credit at the earliest possible time. Because qualifying for private credit without a government guarantee is more stringent than qualifying with a guarantee, movement from a direct loan to a guaranteed loan is a logical progression for borrowers whose financial condition has improved but is still not sufficient to qualify for nonguaranteed private credit.

Allowing borrowers of direct housing loans to refinance using FmHA's guaranteed program would be a way to help borrowers as well as to increase the number of graduations from the direct loan program. Borrowers who qualify to graduate to the guaranteed program would

[3] Housing Issues: The Housing and Community Development Act of 1994 (GAO/T-RCED-94-148, Mar. 10, 1994).

[4] Title V of the Housing Act of 1949.

benefit from lower interest rates in many cases and from minimal downpayment requirements. Through graduation, FmHA borrowers may reduce their mortgage payments and improve their overall economic condition. In particular, the higher the rate of interest being paid by nonsubsidized FmHA borrowers, in comparison with lower market rates, the greater their incentive to graduate to the guaranteed program. Borrowers receiving a minimal subsidy but still paying above-market rates could also qualify and should not be prohibited from graduating to the guaranteed program if banks are willing to refinance their loans.

Achieve Greater Consistency With FmHA's Farm Programs

FmHA is statutorily prohibited from refinancing direct housing loans using the guaranteed program. However, another program, FmHA's farm loans, allows farmers to refinance their direct farm loans through FmHA's guaranteed farm loan program. If properly implemented, this refinancing process enhances FmHA's mission to supply temporary credit and makes direct loan funds available for other high-risk farmers needing financial assistance. FmHA began to use more guaranteed farm loans in the mid-1980s, and the Congress has supported this changed emphasis with increased funding authorizations. Granting FmHA the same authority for housing loans as is currently provided for farm loans could help the agency meet its goals for providing temporary credit and encouraging homeownership.

Reduce FmHA's Servicing Costs and Workload

Single-family housing loans account for 35 percent of the workload in FmHA county offices. Expanding the guaranteed program to refinance eligible high-interest-rate direct loans should lower servicing costs and reduce the workload because private banks will originate and service loans previously serviced by local county offices. Refinancings will help FmHA reach its objective to graduate those direct loan borrowers who qualify for private credit using the guaranteed program. Also, because FmHA's guaranteed loan program does not insure 100 percent of the loan balance, private banks take on a small share of the risk.

FmHA National Office officials agree that graduating direct loan borrowers using the guaranteed loan program would be a desirable option and would allow many borrowers to graduate. We interviewed 13 FmHA state Rural Housing Chiefs whose loans make up almost half of the direct loan portfolio's outstanding principal balance. The Chiefs agreed that graduation using the guaranteed program is a good alternative for those borrowers who meet the eligibility requirements. Some estimated that as many as 25 percent of their outstanding loans would be eligible.

Banking officials we spoke with agreed with FmHA. For example, officials of one bank that handles a large portfolio of FmHA-guaranteed loans told us that they would be interested in offering refinancing into the guaranteed program for all borrowers who meet the program's criteria. As of September 30, 1994, about 390,000 loans were still held by borrowers who were not receiving subsidies and might be eligible to refinance using the guaranteed program. Many of the loans were owed by moderate-income borrowers who either originally never received, or later did not qualify for, any interest subsidy. Thousands of loans representing billions of dollars of outstanding principal could potentially qualify for refinancing using the guaranteed program. However, allowing direct loan borrowers to refinance using the guaranteed program would require a legislative change.

We believe that thousands of direct loan borrowers could benefit from refinancing their existing loans through the guaranteed program. As noted above, 92,000 FmHA borrowers, whose loans have an outstanding principal balance of $2.2 billion, do not receive subsidies and are paying an interest rate at or above the current guaranteed-loan market rate of 9.5 percent. As in any refinancing situation, the greater the interest rate paid, the greater the incentive to refinance. An additional 7,200 loans held by borrowers who receive minimal subsidies but still pay above-market rates may also qualify and should also be considered for graduation using the guaranteed program.

All loans refinanced to the guaranteed program could count as graduated loans. Up to $2.2 billion in direct loans paid off would go back to the Treasury as revenues, but the Treasury would also forgo future mortgage payments. The interest rates on the loans that would be refinanced would likely exceed the interest rates on government borrowing that could be reduced as a result of the repayments. Therefore, the present value of the forgone mortgage payments would likely exceed the revenues from the loan payoffs. However, the reduced workload would free up time for county offices to deal with more problem loans. Additional loan authority may be required to issue new loan guarantees.

Conclusions

Allowing FmHA's direct loan borrowers to graduate using the guaranteed program as a means of refinancing existing loans would be a logical progression for borrowers whose financial condition has improved but is still not sufficient to qualify them for nonguaranteed private credit. Refinancing through the guaranteed program would also be an effective way to help FmHA continue to promote its homeownership objectives and would help meet the direct loan program's temporary credit goals. However, FmHA is statutorily prohibited from refinancing direct housing loans using the guaranteed program.

FmHA plans to change its regulations to allow interest rates to be lowered within the direct loan single-family housing program. Such interest rate reductions within the direct loan program can help homeowners better meet their monthly payments but will result in reduced federal revenues because of lower interest payments. Such refinancings also may reduce the borrowers' incentives to voluntarily graduate. Therefore, we believe that any action by FmHA to lower interest rates on existing loans within the direct program should be pursued only after all other graduation options have been exhausted.

Matter for Congressional Consideration

The Congress should consider amending the Housing Act of 1949 to allow FmHA's direct loan borrowers to refinance their loans using the guaranteed program. Additional budget authority may be required to issue these loan guarantees.

Scope and Methodology

To determine the status of FmHA's loan portfolio and the mix of loans at approximately 1,700 county offices, we analyzed files and records as of September 30, 1994, from FmHA's Finance Office in St. Louis, Missouri. To evaluate FmHA's refinancing policy, including the merits of allowing borrowers with direct loans to refinance through the guaranteed program, we interviewed personnel from FmHA's National Office and Finance Office. We also polled the FmHA Rural Housing Chiefs in the 13 states whose combined loans make up almost 50 percent of the total portfolio, and we discussed the issues with private banks and financial trade associations. We could not independently evaluate the potential universe of borrowers who could graduate to private credit or to the guaranteed program because FmHA's automated data base does not include key credit eligibility factors, such as property values and borrowers' incomes. Our review was conducted between March and November 1994 in accordance with generally accepted government auditing standards.

As requested, we did not obtain written agency comments on a draft of this report, but we discussed the report's contents with senior FmHA officials, including the Assistant Administrator for Housing. These officials fully agreed with our matter for congressional consideration. We have incorporated their comments in the report as appropriate.

As arranged with your offices, unless you publicly announce its contents earlier, we will make no further distribution of this report until 7 days after the date of this letter. At that time, we will send copies of this report to the Secretary of Agriculture; the Director, Office of Management and Budget; and interested congressional committees and Members of Congress. We will also make copies available to others upon request.

Please call me on (202) 512-7631 if you or your staff have any questions. Major contributors to this report are listed in appendix II.

Judy England-Joseph

Judy A. England-Joseph
Director, Housing and Community
Development Issues

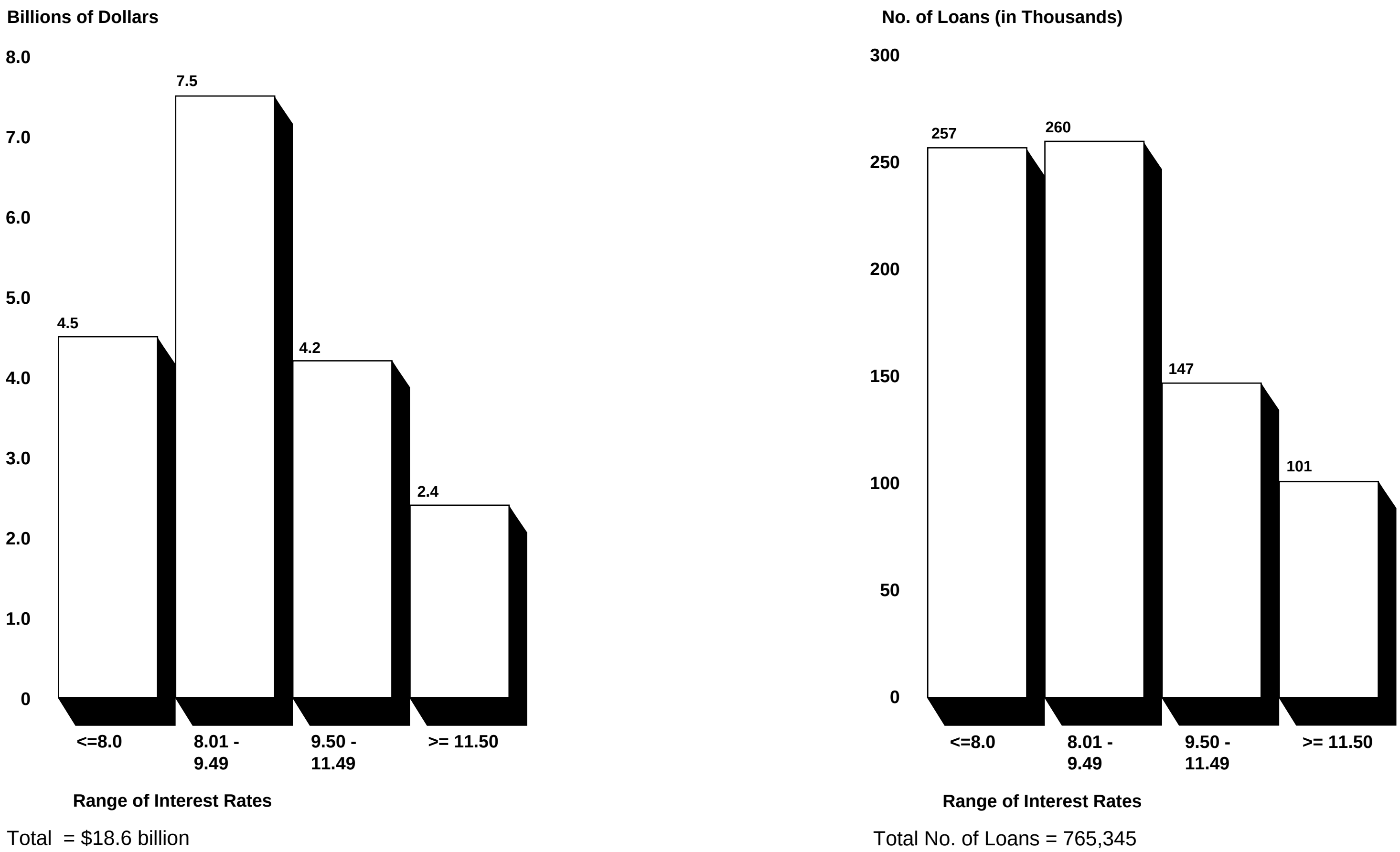
Contents

Abbreviations

FmHA Farmers Home Administration

Status of Single-Family Housing Program's Direct Loan Portfolio

Figure 1: Single-Family Housing Direct Loan Portfolio, by Dollars and Interest Rates (Sept. 30, 1994)



The Farmers Home Administration (FmHA) has a large direct loan portfolio for single-family housing. As of September 30, 1994, the outstanding principal balance on single-family housing loans was $18.6 billion. Since the program was first authorized in the Housing Act of 1949, as amended, FmHA has made almost 2.2 million direct loans for single-family housing for over $48 billion. In fiscal years 1988 through 1993, funding obligated for new loans has remained fairly constant at approximately $1.3 billion annually. In fiscal year 1994, funding was increased to $1.7 billion.

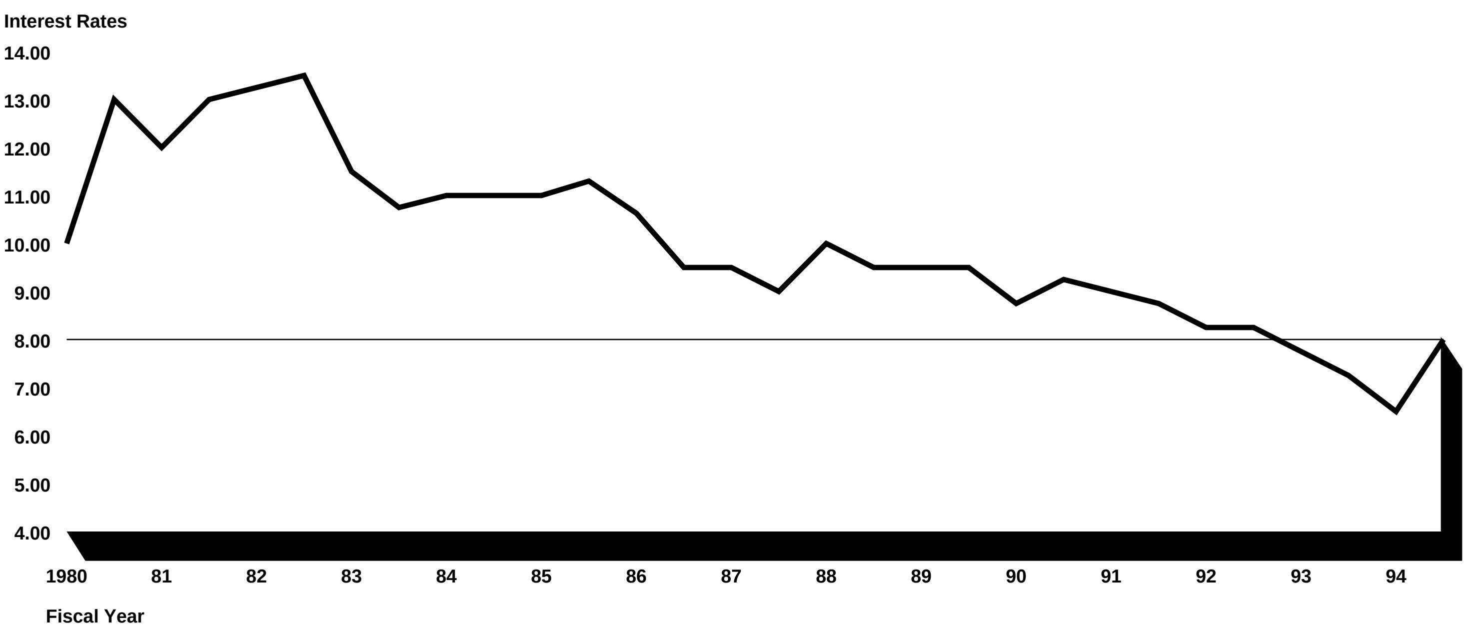
The loans are typically made for 33 years at a fixed interest rate based on the cost of the federal government's borrowing (8 percent on

September 30, 1994). Loan terms may be extended up to a maximum of 38 years for applicants whose adjusted annual income does not exceed 60 percent of the area's median income and who need the extra term to show repayment ability. Loans may not require a down payment, and FmHA can lend up to 100 percent of the property's market value.

FmHA's loans are processed and serviced through the 1,700 FmHA county offices and account for about 35 percent of those offices' workloads.

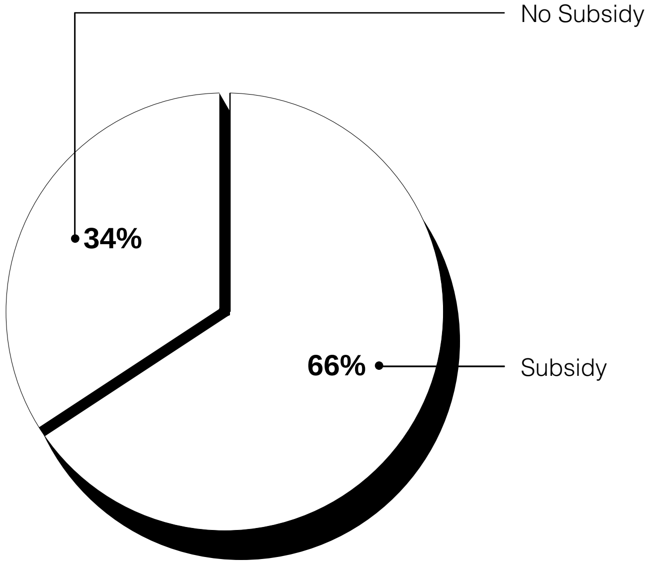
FmHA experienced increased refinancings to private sector credit when interest rates dropped from late 1992 to early 1994. As shown in figure 2, interest rates for FmHA's single-family housing direct loan program dropped as low as 6.5 percent in 1993.

Figure 2: Interest Rates for FmHA's Single-Family Housing Direct Loan Program, 1980-94



But as of September 30, 1994, 248,000 loans were still outstanding at 9.5 percent or above, including 101,000 at 11.5 percent or above.

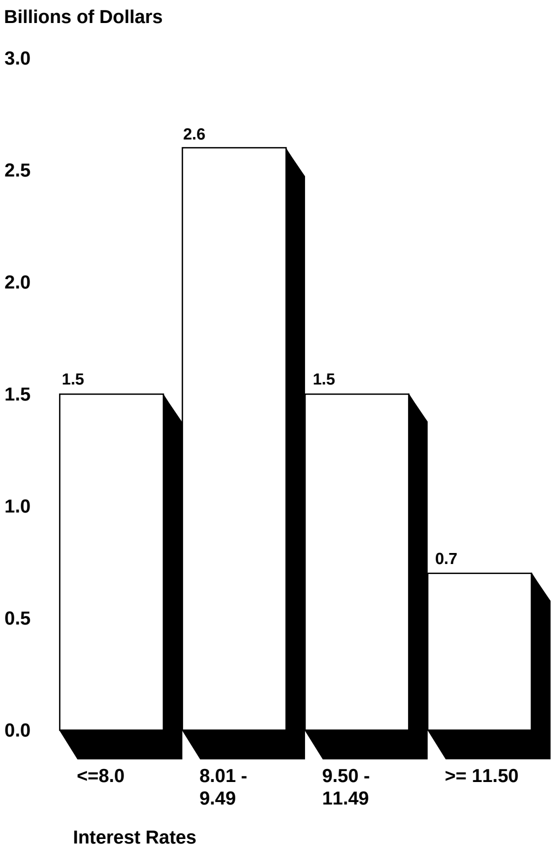
Figure 3: Subsidy Status of Direct Single-Family Housing Loans



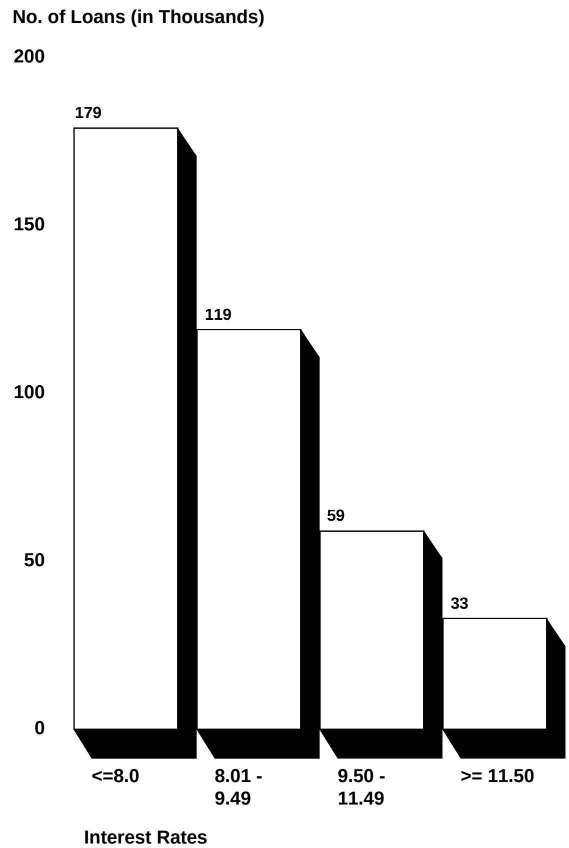
About two-thirds of single-family housing direct loan borrowers ($12.2 billion principal outstanding) receive subsidies, which may reduce the effective interest rates on their mortgages to as low as 1 percent. Interest subsidies are available to qualified very-low- and low-income borrowers in order to make the housing payments fall within the borrowers' means. The amount of subsidy is based on the borrower's verified income, real estate taxes, and property insurance. Under the program's current policy, FmHA makes loans only to borrowers who qualify for subsidy.

The remaining third of single-family housing direct loan borrowers ($6.4 billion principal outstanding) either never received subsidies or no longer qualify because of increased income.

Figure 4: Nonsubsidized Loans by Dollars and Interest Rates (Sept. 30, 1994)



Total Outstanding Principal = $6.4 billion

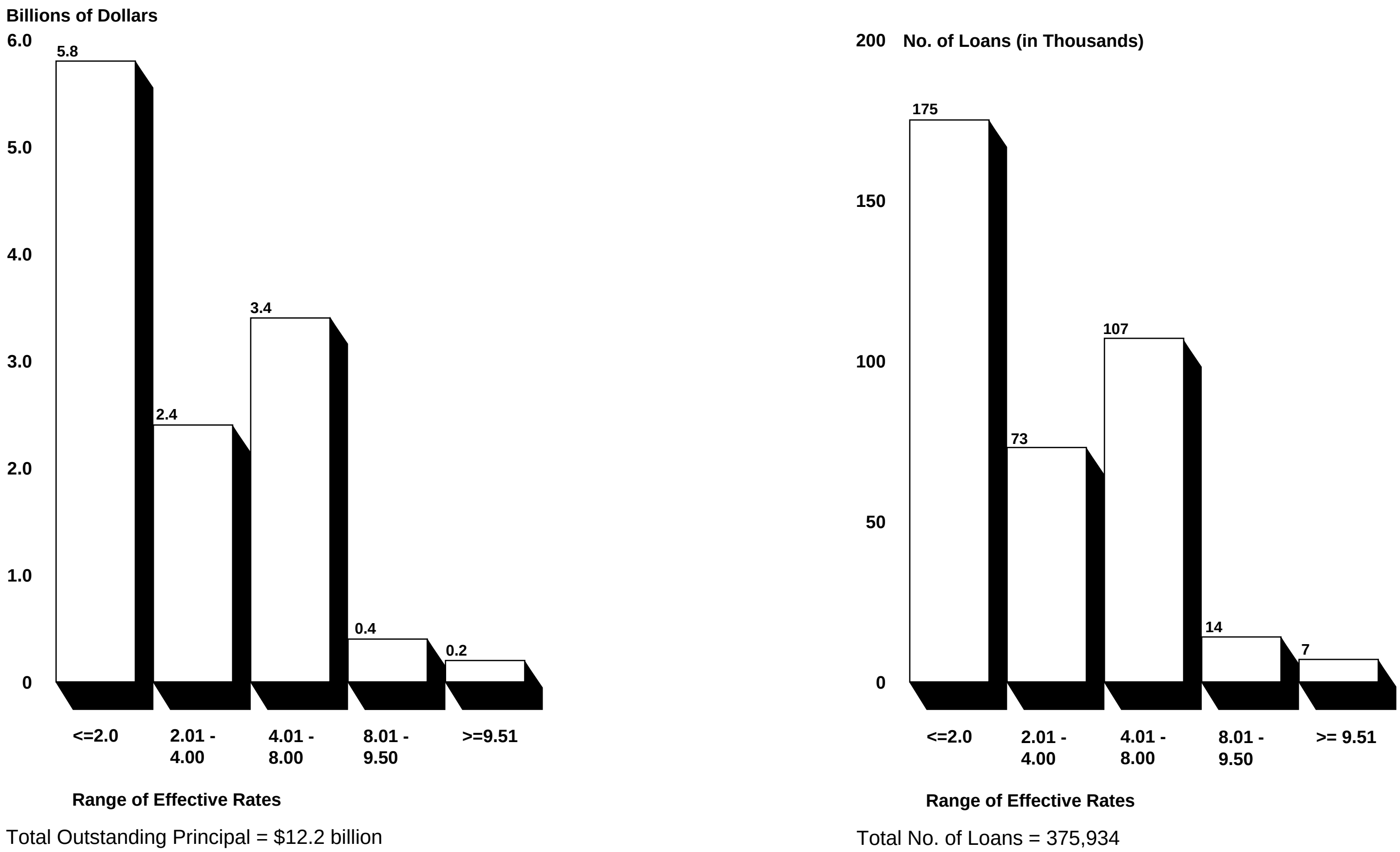


Total No. of Loans = 390,000

The $6.4 billion principal outstanding is made up of 390,000 nonsubsidized loans to borrowers who never received or no longer qualify for interest credit. As of September 30, 1994

- 211,000 loans with principal outstanding of $4.8 billion carried rates above 8 percent,
- 92,000 loans with principal outstanding of $2.2 billion carried rates of 9.5 percent or above, and
- 33,000 loans with principal outstanding of $700 million carried rates of 11.5 percent or above.

Figure 5: Subsidized Loan Effective Rates With Interest Credit by Loans and Dollars (Sept. 30, 1994)



Almost half of the subsidized borrowers receive interest subsidies that lower their effective mortgage interest rates to as low as 1 percent.[1] Subsidy payments can be for as little as $10 per month. As a result, about 21,000 partially subsidized loans with principal outstanding of about $600 million were still paying an effective interest rate on September 30, 1994, that exceeded FmHA's 8 percent interest rate for new loans as of that date. About 7,200 partially subsidized loans with principal outstanding of

[1]Subsidies provided to FmHA single-family housing borrowers are subject to repayment to the government upon disposition of the property. The amount of recapture is based on a formula established by FmHA that factor the total subsidy provided and home price appreciation.

about $180 million were still paying an effective interest rate of over 9.5 percent, the FmHA-guaranteed loan rate as of November 30, 1994.

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