

November 1995

# RURAL HOUSING PROGRAMS

## Opportunities Exist for Cost Savings and Management Improvement





**Resources, Community, and  
Economic Development Division**

B-265711

November 16, 1995

The Honorable Rick A. Lazio  
Chairman, Subcommittee on Housing  
and Community Opportunity  
Committee on Banking and  
Financial Services  
House of Representatives

The Honorable Doug Bereuter  
House of Representatives

The U.S. Department of Agriculture's (USDA) Rural Housing and Community Development Service (RHCDS) provides about \$2.85 billion per year for rural housing loans. As of June 30, 1995, RHCDS had an outstanding single-family and multifamily housing loan portfolio of about \$30 billion, which represents a significant federal investment in affordable housing for rural low-income Americans.

The largest portion of the loan portfolio is for single-family direct and guaranteed mortgage loans that are made to families or individuals who are without adequate housing and who are unable to obtain loans from private lenders at reasonable costs. On the basis of their incomes, direct loan borrowers are eligible for subsidy payments to reduce the cost of the interest on the loans. If after a loan is made the income of a subsidized borrower increases so that private mortgage credit becomes affordable, the borrower is required to "graduate" from RHCDS' direct loan program to private credit. Rural multifamily rental housing loans, made to finance apartment-style housing or to purchase and rehabilitate existing rental housing, constitute the remainder of the portfolio. Rental assistance payments are made to owners of RHCDS-financed rental projects to reduce the rents paid by low-income tenants.

This report responds to your request for information on RHCDS' single- and multifamily housing loan programs and for suggestions that we and others, such as RHCDS officials, have previously made that could result in cost savings and/or management improvements in those programs.

---

**Results in Brief**

The Rural Housing and Community Development Service is making progress in improving operations in both its single- and multifamily programs. However, we and others, including Service officials, have

---

identified opportunities to strengthen the way these programs are delivered to rural Americans. Improved program delivery can result in savings to the federal government and benefits to the borrowers and tenants in the programs.

In a September 1993 report<sup>1</sup> and subsequent testimonies, we found that centralized servicing of the Service's loans, a common practice of private businesses, could result in savings through greater staff productivity and efficiency. The Service and the Congressional Budget Office have stated that centralized servicing of the \$18.7 billion direct loan portfolio could save over \$100 million annually. These savings are primarily based on significant reductions in field staff. In December 1993, the Service began plans to establish a centralized loan-servicing system, but not until September 1995 did the agency begin to analyze the need for it to retain most of its field structure. Unless the Service makes a firm commitment to reduce the number of staff and field offices and develops plans for the centralized office to perform the customer services previously handled in local offices, most of the savings from centralized servicing may not materialize.

The number of borrowers graduating from the direct loan program to private credit sources could be increased by (1) changing the law to allow direct loan borrowers to refinance their loans using the Service's loan guaranty program with commercial lenders, as we suggested in a December 1994 report,<sup>2</sup> and (2) eliminating the Service's policies that prohibit considering certain loans for graduation. Such changes could help the Service meet its goal of providing temporary rather than long-term credit, reduce servicing costs, and in some cases lower borrowers' interest costs. However, because the Service has few mechanisms to force graduation, more fundamental changes in the program's design—such as changing mortgage payment terms, as suggested by Service staff—may be needed if the temporary credit goal is to be fully achieved.

Service staff are considering options for reducing the costs of the multifamily housing program by (1) eliminating equity loans made to owners to discourage them from prepaying their loans and replacing low-income tenants with those able to pay higher rents and (2) funding more projects that do not require rental assistance. Also, from a

---

<sup>1</sup>U.S. Department of Agriculture: Centralized Servicing for FmHA Single-Family Housing Loans (GAO/RCED-93-231BR, Sept. 23, 1993).

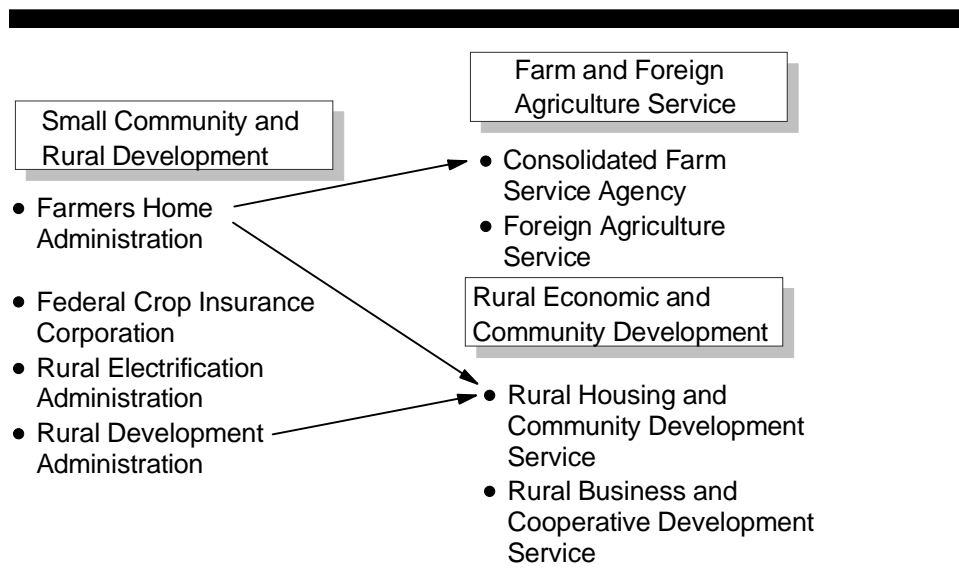
<sup>2</sup>Rural Housing: Shift to Guaranteed Program Can Benefit Borrowers and Reduce Government's Exposure (GAO/RCED/AIMD-95-63, Dec. 21, 1994).

management perspective, we<sup>3</sup> and others, including the Surveys and Investigations Staff of the House Committee on Appropriations, have found that the process currently used to fund individual projects does not ensure that the neediest areas receive assistance from the program.

## Background

RHCDS was established by Public Law 103-354, the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994, dated October 13, 1994. Its programs include the housing programs previously administered by the Farmers Home Administration and the rural community loan programs previously administered by the Rural Development Administration.<sup>4</sup> (See fig. 1.)

**Figure 1: Rural Housing in a Reorganized U.S. Department of Agriculture**



RHCDS' housing mission is to improve the quality of life in rural America by assisting rural residents in obtaining adequate and affordable housing. "Rural areas" include open country and places with populations of 10,000 or less, but some towns with populations between 10,000 and 20,000 may

<sup>3</sup>Rental Housing: Distribution and Use of FmHA's Rural Rental Housing Program Funds (GAO/RCED-94-141, June 1, 1994).

<sup>4</sup>The part of the Farmers Home Administration that handled farm loans has been consolidated into the new Consolidated Farm Service Agency.

---

qualify under certain circumstances. Major program activities, authorized by title V of the Housing Act of 1949, as amended, include single-family direct and guaranteed homeownership and repair loans, direct multifamily rental housing loans, and rental assistance payments.

---

## Rural Single-Family Housing

RHCDS' direct single-family loans are designed to promote successful homeownership for low-income and very-low-income rural Americans who cannot otherwise obtain loans at reasonable rates.<sup>5</sup> Houses must be modest in design, cost, and price. Interest rates on these loans are subsidized and, depending on the borrower's household income, the subsidy can reduce the borrower's effective interest rate to as low as 1 percent. RHCDS is required by law to recapture all or a portion of the subsidy it provides when the property is sold or vacated.

Direct loans are meant to provide temporary credit—borrowers are required to graduate from the direct loan program to private credit when their incomes are sufficient to afford private credit. RHCDS has loaned \$49 billion in making over 2 million direct loans since 1950.<sup>6</sup> As of June 30, 1995, RHCDS held a portfolio of about 750,000 direct loans made to 643,000 borrowers with a total outstanding principal balance of \$18.7 billion.<sup>7</sup>

In 1991, RHCDS initiated a new program to assist moderate-income rural borrowers through guaranteed loans for single-family housing. Guaranteed loan borrowers are not provided with interest subsidies. To qualify for the program, homes may be new or existing residences located in rural areas. In guaranteeing a single-family housing loan, RHCDS agrees, in the event that a borrower defaults, to reimburse a commercial lender for up to 90 percent of the lost principal plus accrued interest and liquidation costs. In fiscal years 1991 through 1994, RHCDS guaranteed 25,000 housing loans for about \$1.5 billion.

---

## Rural Multifamily Housing

RHCDS' multifamily housing loans are designed to help low-income rural renters obtain access to decent, safe, and affordable housing by holding

---

<sup>5</sup>Very-low-income applicants are those whose incomes are 50 percent or less of an area's median income; low-income applicants are those whose incomes are 51 to 80 percent of an area's median income.

<sup>6</sup>Dollar figures used in this report are actual dollars unless otherwise noted.

<sup>7</sup>Some borrowers have more than one loan. For example, a borrower can assume an existing loan and then receive a second loan from RHCDS to cover the costs of such items as the replacement of a furnace.

---

down mortgage costs. RHCDS and its predecessor agencies have financed more than 18,000 projects with more than 450,000 rental units since the loan program was first authorized in 1962. The loans, which are usually for 50 years at interest rates as low as 1 percent, can be made to individuals, partnerships, public agencies, limited equity cooperatives, Indian tribes, nonprofit organizations, and for-profit corporations. Recipients of the loans also must be unable to provide moderate-cost rental units without financing by RHCDS.

As of January 1994, RHCDS' rental assistance was available to about 235,000 housing units through a direct outlay program that is administered in tandem with RHCDS' multifamily loans. RHCDS makes payments directly to RHCDS-financed projects to reduce the rents (including utilities) paid by qualifying low-income households to no more than 30 percent of their monthly incomes, as adjusted for certain expenses. Residents in more than 90,000 other units, however, were paying a greater percentage of their income for rent.<sup>8</sup> (App. I contains information on proposed loan levels and outlays for RHCDS' major rural housing programs for fiscal year 1996.)

---

## Opportunities for Cost Savings in the Single-Family Area

There are opportunities to save millions of federal dollars in operating rural single-family housing programs. These opportunities include centralizing loan servicing, graduating borrowers from the direct loan program, and reforming the requirements for recapturing loan interest subsidies.

---

## Opportunities to Centralize Loan Servicing

Servicing RHCDS' 724,000 direct loans using a state-of-the-art system from a central location could eliminate the need for numerous manual processes currently required in each of RHCDS' hundreds of county offices. Thus, centralized servicing could reduce staff costs. In December 1993, the Administrator of RHCDS gave approval to begin planning for centralized servicing, and in May 1995, RHCDS awarded a contract to purchase an off-the-shelf servicing system. In September 1995, RHCDS began to study whether it would change the size of and functions to be performed by its field structure, given the new capacity for automation.

In our September 1993 report and subsequent testimonies, we endorsed the concept of centralized servicing of RHCDS' single-family housing loans

---

<sup>8</sup>As of January 1994, about 77 percent of the households in RHCDS' multifamily projects were classified as very-low-income. The average annual household income of these tenants was \$8,116 before the application of certain downward adjustments used to classify income for program purposes, and \$7,037 after these adjustments were applied.

---

as an example of the type of private-sector management concept needed to “reengineer” the Department of Agriculture. We reported that allowing the public and private sectors to compete for centralized servicing of the direct loan portfolio that was being serviced by local RHCDS field offices would fundamentally change the way RHCDS does business and could increase efficiencies, innovations, and customer satisfaction.

The private sector has shown that centralized servicing—using highly specialized personnel at one location to perform all loan-servicing actions after a home loan is closed—results in far greater staff productivity and efficiency.<sup>9</sup> The benefits of centralized servicing typically include lower delinquency rates as a result of more efficient servicing and reduced staff levels as a result of staff specialization. Also, escrow capability helps borrowers budget their payments and protects the government’s security interest by ensuring that taxes and insurance are paid.

In September 1993, we reported that RHCDS had developed three plans of action since 1988 for developing centralized servicing and escrow capability but that no final decision had been made to begin implementation. In December 1993, RHCDS developed a new plan that was approved by the Administrator. In December 1994, USDA officials gave the final go-ahead to request proposals from companies interested in selling RHCDS an off-the-shelf commercial loan origination and servicing system that would be modified to enable RHCDS to handle its particular loan-servicing requirements. RHCDS awarded a \$7.3 million contract to Data-Link System, a subsidiary of FIServ, Inc., in May 1995. RHCDS projects total budget costs of \$39 million for the system, expects to begin phasing in the system by October 1996, and plans to have placed in escrow by September 1998 the tax and insurance payments for all but existing borrowers who are current on their payments.

Centralized servicing should reduce the need for such labor-intensive tasks as researching county tax records and calling in tax-delinquent borrowers to work out repayment terms each year. RHCDS believes the system will substantially lower servicing costs, saving over \$100 million per year by fiscal 2000 and each year thereafter. A 1991 RHCDS study concluded that centralized servicing could yield a net savings of 2,200 staff positions and the consolidation or closing of 742 county offices. On the basis of this study, the Congressional Budget Office estimated about

---

<sup>9</sup>Centralized servicing operations typically include holding funds in escrow, reviewing interest credit, applying and collecting late payment fees, counseling on credit issues, and handling delinquent accounts.



---

\$171 million in budget outlay savings from the associated reductions in full-time employees in fiscal years 1999 and 2000.

However, these cost savings will not be fully achieved if RHCDS adds a new centralized staff and keeps most of its present field structure. RHCDS plans to phase in a new staff of about 700 employees in its St. Louis Finance Center to service its housing portfolio using a centralized servicing system.

The Secretary of Agriculture announced his Department-wide reorganization in December 1994, including the planned closing of about 1,200 field offices. The reorganization plan projects reducing RHCDS' field staff during fiscal years 1995 through 1999. However, centralized servicing technology was not specified in the criteria for identifying which offices to close.

In September 1995, the Under Secretary for Rural Economic and Community Development established a task force to recommend the size of and appropriate functions to be performed by a rural housing and community development field structure within a centralized servicing environment. In addition to studying the impact of centralized servicing on field offices, the task force expects to study whether some of the resources freed up as a result of centralized servicing should be used to meet other unmet rural development priorities. Included in the task force's preliminary description of critical unmet needs are job tasks such as providing technical assistance to rural communities, promoting the community facilities loan guarantee program, and providing outreach for the multifamily housing program. The task force is also expected to consider the second phase of the National Performance Review, which in August 1995 recommended a centralized servicing system for RHCDS' rural housing portfolio. The National Performance Review states that \$250 million in savings over 5 years would accrue from closing additional county offices and reducing staff by up to 1,200 full-time equivalents. The task force is expected to report back to the Under Secretary in November 1995.

In addition, the potential exists to reduce servicing costs to the levels obtained by private-sector companies by adopting private-sector processes and practices. However, private-sector efficiencies will not be achieved unless RHCDS focuses on changing the underlying work processes in keeping with the new technology. A 1992 study contracted by RHCDS concluded that with the proper procedures and communication methods in a centralized environment, the "need for face to face communications

---

with the borrowers and visits to the properties can be reduced to a minimum.”<sup>10</sup>

---

## Opportunities to Increase Loan Graduations

In our December 1994 report, we identified over \$2.2 billion in direct nonsubsidized loans, constituting 12 percent of the outstanding direct loan portfolio, whose borrowers could benefit by receiving a lower interest rate if they were allowed to graduate by refinancing through the guaranteed program. Such an approach would have the advantages of (1) assisting borrowers in obtaining private credit when their financial conditions have improved but are still not sufficient to qualify for nonguaranteed private credit and (2) reducing servicing costs that account for about 35 percent of the county offices’ workloads. In addition, allowing borrowers to refinance through guaranteed loans would be consistent with farm credit programs that allow farmers to refinance their direct loans through the guaranteed farm loan program.

RHCDS has the legal authority to require borrowers to graduate to private credit if it appears that credit can be obtained from another source at reasonable rates and terms. However, RHCDS is statutorily prohibited from refinancing direct housing loans using its guaranteed program. We recommended that the Congress consider amending the Housing Act of 1949 to allow RHCDS’ direct loan borrowers to refinance their mortgage loans using the guaranteed program. The administration has endorsed our recommendation and believes its implementation would increase the marketability of these loans to secondary market purchasers, such as the Federal National Mortgage Association. As of July 31, 1995, legislation had not been introduced in the Congress to implement this recommendation.

Other opportunities may exist to increase graduations involving loans with balances under \$5,000 and subsidized loans. RHCDS’ policy does not allow loans with balances under \$5,000 to be considered for graduation. Over 80,000 loans, or almost 12 percent of the outstanding portfolio, are over 10 years old and have outstanding balances under \$5,000. RHCDS pays more to service some of these loans than it receives in interest each year. For example, in 1994 RHCDS received \$152.70 in interest on a 26-year-old loan in Illinois. Yet RHCDS estimated servicing costs of about \$240 per loan for that year. RHCDS officials believe that eliminating this policy or offering incentives to borrowers with low loan balances could increase graduations. Similarly, RHCDS’ policy does not permit considering

---

<sup>10</sup>Analysis of Single Family Rural Housing Loan Servicing System, International Business Consultants Corp. (Sept. 16, 1992), p. 34.

---

borrowers with interest subsidies for graduation because of the general view that no banks would accept such borrowers. However, in our December 1994 report we pointed out that about 7,200 subsidized loans had effective interest rates which at that time exceeded the RHCDS-guaranteed loan rate.

RHCDS officials agree that changing the law to allow direct loan borrowers to refinance their direct loans using RHCDS guaranteed loans, providing incentives, and eliminating policies that prohibit considering loans with balances of less than \$5,000 and small subsidy payments for graduation should incrementally improve graduation rates. But more fundamental changes in the program's design are needed if temporary credit and the acceleration of graduation rates are to become more prevalent.

An RHCDS staff member suggested basing mortgage payments for nonsubsidized borrowers on income rather than having mortgage payments remain fixed. Such a policy could have a significant impact on graduation rates because it would help overcome the major disincentive for borrowers to graduate—holding a lower fixed-interest rate than the prevailing private-market mortgage interest rate.

When borrowers first enter the direct loan program, they typically receive interest subsidies when 20 percent of their adjusted annual incomes are insufficient to cover their payments for principal, interest, taxes, and insurance at the prevailing mortgage interest rate. Under the current program, borrowers make mortgage payments of 20 percent of their adjusted annual incomes and stop receiving subsidies when their incomes increase to the point where they can afford the full mortgage payments. However, as a borrower's income continues to increase, the percentage of income going toward the mortgage payment drops. If the mortgage interest rate is below the prevailing rates offered in private markets, the borrower has little incentive to refinance.

RHCDS and its predecessor agencies have historically not vigorously enforced the graduation requirement because the only option available was foreclosure and because the agencies believed that U.S. attorneys would not accept such cases. However, if the program is changed to require borrowers to pay 20 percent of their incomes as mortgage payments, the effective interest rates paid by higher-income borrowers will begin to exceed those required by established mortgage interest rates. When a borrower's effective interest rate exceeds those available on the private market, a strong incentive for graduation will exist. Payments

---

made in excess of the amount required by the mortgage interest rate could be credited to the borrower and used to retire the borrower's deferred obligation to pay back a portion of the interest subsidies provided over the life of the loan, which is discussed in the next section of this report.

Because RHCDS stops collecting income information once borrowers stop receiving interest subsidies, we cannot estimate the impact of such a program change. However, in examining individual loan files of borrowers who have graduated, we have seen consistent growth in incomes from the time borrowers stopped receiving interest subsidies to the time when they refinanced to private credit. Of course, such a change would increase graduation rates only if the household incomes of the borrowers who no longer qualify for interest subsidies continue to grow.

---

## Opportunities to Reform the Requirement to Recapture Interest Subsidies

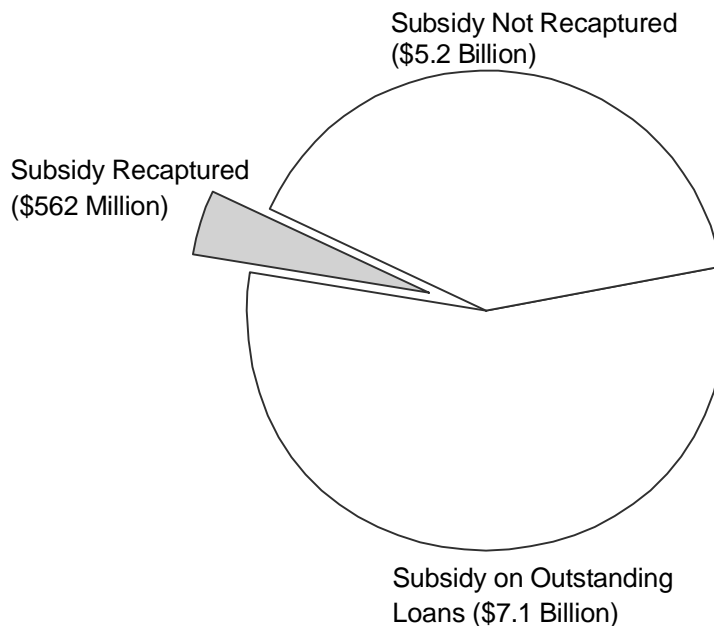
The Housing Act of 1949, as amended, requires RHCDS to recapture a portion of the subsidy provided over the life of the direct loan when the borrower sells or vacates a property. The idea is that because taxpayers paid a portion of the mortgage, they are entitled to a portion of the property's appreciation. Unlike a shared appreciation mortgage, in which the investor's return is fixed when the loan is originated, the amount recaptured by RHCDS is based on a complex formula that primarily factors in the subsidy provided, the reduction in principal attributable to the subsidy, and the property's appreciation. The total amount recaptured can equal the total of the subsidy provided and the reduction in principal attributable to the subsidy, but it can be no more than 78 percent of the property's appreciation.

The recapture process is administratively burdensome and fraught with reliability problems. RHCDS estimates that each year, 10 staff years are spent by its St. Louis Finance Office monitoring the recapture of interest subsidies. Field office staff perform the calculation each time a borrower expresses interest in refinancing to private credit. According to USDA's Inspector General (IG), the manual accounting system used to figure the recapture amounts and poor internal controls frequently result in incorrect or inconsistent recapture computations. RHCDS believes that the planned in-house centralized servicing system will overcome the problems cited by the IG.

As shown in figure 2, as of September 30, 1994, RHCDS had recaptured \$562 million, or less than 10 percent of the \$5.8 billion in subsidies provided on loans that have left the portfolio. About \$7.1 billion in subsidy

payments was outstanding on active loans. Whether the government should (1) attempt to increase revenues by recapturing a greater share of the subsidy in the future or (2) abandon the recapture program because of the high administrative costs and low expected appreciation rates are two extreme positions taken on the issue. Additional study is needed before any definitive conclusions can be reached.

Figure 2: Interest Subsidy



Note: Total subsidy granted—\$12.9 billion.

In addition, because recapture is not mandated when homes are refinanced, RHCDS' policy allows borrowers who pay off direct RHCDS loans but continue to occupy the properties to defer the payments for recapturing the subsidies. As of June 30, 1995, RHCDS' records show that about \$119 million is owned by borrowers who have refinanced their mortgages but continue to occupy the properties. RHCDS does not charge interest on the amounts owed by these borrowers.

RHCDS officials pointed out that a legislative change to require recapture when properties are refinanced, in addition to when they are sold or vacated, would save the administrative costs of calculating and setting up the borrowers' deferred obligations and increase federal revenues. As an alternative, legislative changes could be made to allow RHCDS to charge market rate interest on recapture amounts owed by borrowers to help recoup the government's administrative and borrowing costs. However, these changes would also likely reduce the number of borrowers of direct RHCDS loans who graduate to private credit.

## Opportunities for Cost Savings and Management Improvements in the Multifamily Area

RHCDS and others have proposed program changes aimed at reducing the cost of the multifamily program. Some changes would shorten benefit periods or serve higher-income populations. We and others have also found that the process for funding individual projects for multifamily rental housing does not ensure that the neediest areas receive assistance from the program.

While the multifamily housing loan program has a long history of serious problems, a number of managerial improvements have been undertaken by RHCDS during the past several years. (A discussion of instances of multifamily program fraud, waste, and abuse found by the IG, along with RHCDS' plans for addressing such problems, can be found in app. II.)

## Opportunities to Reduce Multifamily Programs' Costs

The basic goal of RHCDS' two principal multifamily housing programs is to make rental housing affordable to lower-income people in rural America. The two programs make rents more affordable by holding down project developers' mortgage costs and, to the extent possible, subsidizing tenants who cannot afford to pay the full amount of the projects' rents.

To hold down mortgage costs, RHCDS typically provides 50-year loans at an interest rate of 1 percent. Annual authorized loan levels for this program were about \$500 million to \$575 million in fiscal years 1987 through 1994. However, because of a number of concerns about the program, the Congress reduced loan levels to \$220 million in fiscal year 1995. This change has sparked interest in making more efficient and effective use of the available funds. The following are some of the ideas being considered by RHCDS officials:

- Shorten the term of the loan. This action would reduce the cost of the interest subsidy for each loan, but it would also reduce the time that the

---

housing was restricted to lower-income tenants. Net savings could be achieved by shortening the term of the loan from 50 to 40 years. Another option would be to shorten the term even more (say, to 25 years) but continue to amortize the loan as if it were for a 50-year term. This action would keep monthly payments low but would leave a large unpaid loan balance at the end of the term that would either have to be paid off in a lump sum or refinanced. Neither of these options would likely require a change to RHCDS' current legislative authority, according to RHCDS officials. However, RHCDS believes shortening the loan term could increase a project's monthly loan payments, which could lead to higher rents and the need for increased federal rental assistance or a greater rent burden on the tenants.

- Eliminate certain equity loans. These loans were authorized by the Congress to discourage the owners of qualifying older projects from prepaying their loans and replacing lower-income tenants with those able to pay higher rents. In general, a project funded before December 21, 1979, is eligible for an additional loan in an amount up to 90 percent of the owner's equity if the owner demonstrates to RHCDS the intent and financial ability to prepay. Approved applications are placed on a waiting list, and the loans are made as funds become available. Each year, RHCDS allocates a portion of its loan program appropriation to fund some of these equity loans. As a result, equity loans compete for available appropriations with loans for constructing new projects and with loans for rehabilitating older projects that are in poor condition. To date, RHCDS has made about 300 equity loans totaling over \$109 million; 74 more, totaling about \$26 million, are awaiting funding. These loans typically have been for the maximum allowable amount, which is 90 percent of the owner's equity in the project.

RHCDS officials told us they believe that relatively few property owners would prepay their loans and leave the program even without the equity loans. They noted that in a few local markets, projects might be more valuable to owners as commercial-rate rental property but that this situation is generally not the case. Eliminating the loans would require a change to the legislation that authorizes the multifamily loan program (the Housing Act of 1949, as amended).

- Increase the amount of equity that owners contribute to projects. The authorizing legislation also limits the amount of equity that RHCDS can require borrowers to contribute on original loans. The required equity contribution is limited to 5 percent of a project's cost for projects that receive federal low-income-housing tax credits and to 3 percent for other

---

projects. Raising this limit could reduce the size of individual loans and thus the government's cost of subsidizing the interest rates.

We were told by RHCDS multifamily program officials that the agency is drafting a legislative proposal that would allow it to vary borrowers' required equity contributions on the basis of local community resources and housing needs. USDA's IG subsequently recommended in August 1995 that RHCDS immediately seek a change to the authorizing legislation to eliminate the restriction on equity contributions that can be required of developers if tax credits are received. The IG also recommended that as soon as this limitation is removed, RHCDS implement procedures that consider tax credits as government assistance when defining the necessary level of individual loans.<sup>11</sup> In most cases, this change would result in lower loan amounts and larger equity contributions by borrowers than RHCDS' past procedures.

Reducing the costs of RHCDS' rent subsidy program without also increasing the tenants' rent burden is more difficult. RHCDS has considered the idea of setting aside 40 percent of the loan program's annual funding for projects that do not require rental assistance. In most cases, these would be projects with a mix of moderate- and lower-income households, in which residents could afford to pay the necessary rents. While existing projects predominately serve households in the very-low-income category, those in the low- and moderate-income categories are also eligible tenants.<sup>12</sup> While implementing this idea would mean that the program would be serving a somewhat higher-income population than at present, the program would still be serving households that are eligible to receive assistance under the authorizing legislation.

---

## Opportunities to Better Target Greatest Need

The funding of projects under RHCDS' multifamily rental housing loan program is now based on priorities set forth in the authorizing legislation. The legislation requires priority for projects that will serve those in the most rural areas who have the greatest housing needs because of their low incomes and inadequate housing. RHCDS allocates funds to each state and selects projects within each state using criteria designed to reflect these priorities. (See fig. 3.)

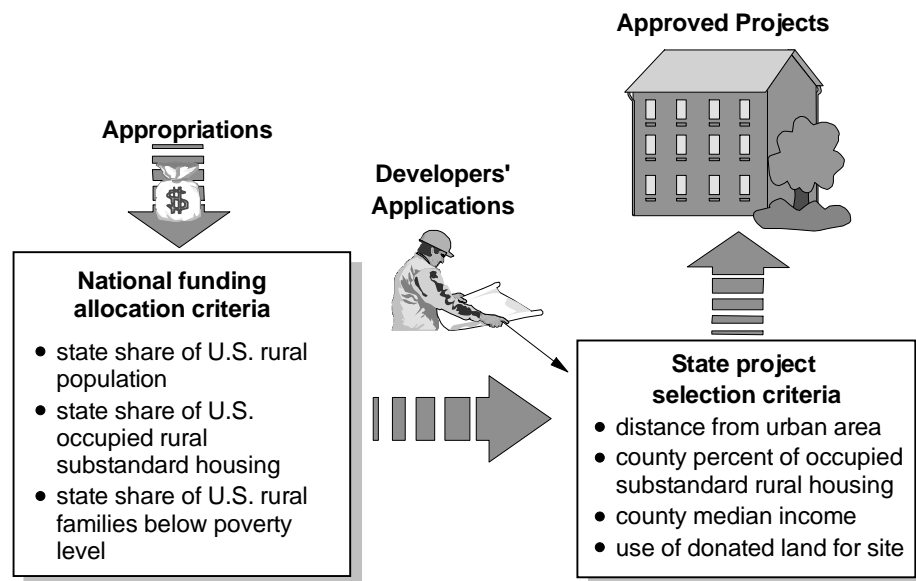
---

<sup>11</sup>Rural Housing and Community Development Service, *Rural Rental Housing Project Funding and Eligibility*, Washington, D.C., Audit Report No. 04601-1-SF, Aug. 3, 1995.

<sup>12</sup>For a household of four, the moderate-income category includes adjusted incomes up to \$5,500 above 80 percent of the local area median (with adjustments for areas with unusually high or low incomes or housing costs).



**Figure 3: Selection Criteria for Multifamily Projects**



However, this process does not ensure that the neediest areas receive assistance from the program. Our June 1994 report and reports by USDA's IG, the National Council of State Housing Agencies, and the Surveys and Investigations Staff of the House Committee on Appropriations have each identified problems in this area, including that (1) housing needs estimated by RHCDS may differ from actual needs; (2) developers determine the locations for proposed projects; (3) the projects selected for funding may be inconsistent with the priorities established by state and local governments; and (4) the project selection procedures give too much weight to proposals for projects located specified distances from urban areas. (See app. III for additional information on problems reported by us and others on the selection process for multifamily projects.)

RHCDS recognizes the limitations of the current funding process and is taking steps to better target RHCDS' projects to rural areas with the greatest need. Specifically, RHCDS officials said they would not object to statutory authority to discontinue the current project selection system and limit the selection of new projects to rural areas that, on the basis of objective criteria, have the greatest need. RHCDS envisions a system similar to that proposed last year in an amendment offered during deliberations on the

---

housing reauthorization bill (H.R. 3838). The reauthorization bill was not passed, but that amendment would have allowed RHCDS to identify counties and communities with the greatest need for rural rental housing funds and select projects only in those locations. The sources of information used by RHCDS to determine need would have included the U.S. Census and State Comprehensive Housing Affordability Strategy plans. RHCDS officials believe that a system of this nature, if enacted, would allow project selection to be more consistent with local priorities.

Pending enactment of a legislative change, RHCDS is proceeding with changes to the current project selection system to better direct funding to rural areas with the greatest need for affordable housing, while still meeting the current statutory priorities. Agency officials expect proposed regulations reflecting these changes to be published for public comment in the near future. The changes include reducing the weight given to projects at least 20 miles from urban areas; increasing the use of county data, rather than state data, in estimating needs under the project selection process; and giving additional weight to proposed projects that also use funding from other sources, projects in underserved areas, and projects in areas with the highest shares of households paying over 30 percent of their incomes for rent. While these measures would not address all of the concerns raised about the funding process, if effectively implemented, they could better direct rural rental housing assistance to the neediest areas.

---

## Agency Comments

We provided a draft of this report to RHCDS for its review and comment. We met with RHCDS officials, including the Acting Administrator and the Assistant Administrator for Housing, to obtain their comments. RHCDS officials generally agreed with the factual material presented in the report. The Acting Administrator pointed out that while she agrees that new centralized servicing technology was not specified in the criteria considered by the Secretary's reorganization task force, she believes the office-closing plans were, to a degree, driven by the planned technology. She also pointed out that the Under Secretary of Agriculture for Small Community and Rural Development has recently formed a task force with a 60-day mandate to decide on the appropriate field structure that will be needed to operate in a centralized servicing environment. The report was changed to reflect this view and new development.

RHCDS officials also provided other clarifying information, which we incorporated where appropriate.

---

## Scope and Methodology

To identify opportunities for cost savings and management improvements in RHCDS' rural single-family and multifamily housing programs, we interviewed personnel from RHCDS' Washington, D.C., office; Finance Office in St. Louis, Missouri; and field offices in Maryland, Illinois, and Missouri. We also obtained program regulations, guidance, and progress reports from RHCDS showing corrective actions based on GAO's and the USDA IG's previous recommendations and analyzed files and records as of March 31, 1995. We also met with IG officials and individuals representing banking, building, and rural housing groups to obtain their views on cost savings and other program reform opportunities. We conducted our work between January and October 1995 in accordance with generally accepted government auditing standards.

---

We are sending copies of this report to interested congressional committees and Members of Congress; the Secretary of Agriculture; and the Director, Office of Management and Budget. 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 IV.



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

---

# Contents

---

Letter	1
Appendix I Major Rural Housing Programs' Proposed Loan Levels and Outlays, Fiscal Year 1996	20
Appendix II Opportunities to Reduce Fraud, Waste, and Abuse in the Multifamily Program	23
Appendix III Summary of Prior Studies on Multifamily Project Selection Process	25
Appendix IV Major Contributors to This Report	28
Figures	
Figure 1: Rural Housing in a Reorganized U.S. Department of Agriculture	3
Figure 2: Interest Subsidy	11
Figure 3: Selection Criteria for Multifamily Projects	15
Figure I.1: Fiscal 1996 Proposed Loan Levels—\$2.85 Billion	20
Figure I.2: Fiscal Year 1996 Proposed Outlays—\$1.32 Billion	21

---

**Contents**

---

---

**Abbreviations**

GAO	General Accounting Office
IG	Inspector General
RHCDS	Rural Housing and Community Development Service
USDA	U.S. Department of Agriculture

# Major Rural Housing Programs' Proposed Loan Levels and Outlays, Fiscal Year 1996

As shown in figure I.1, proposed new single-family guaranteed loans totaling \$1.3 billion, new direct loans totaling \$1.2 billion, and multifamily rental housing loans totaling \$220 million constitute the vast majority of the proposed \$2.85 billion program loan level for fiscal year 1996.

**Figure I.1: Fiscal 1996 Proposed Loan Levels—\$2.85 Billion**

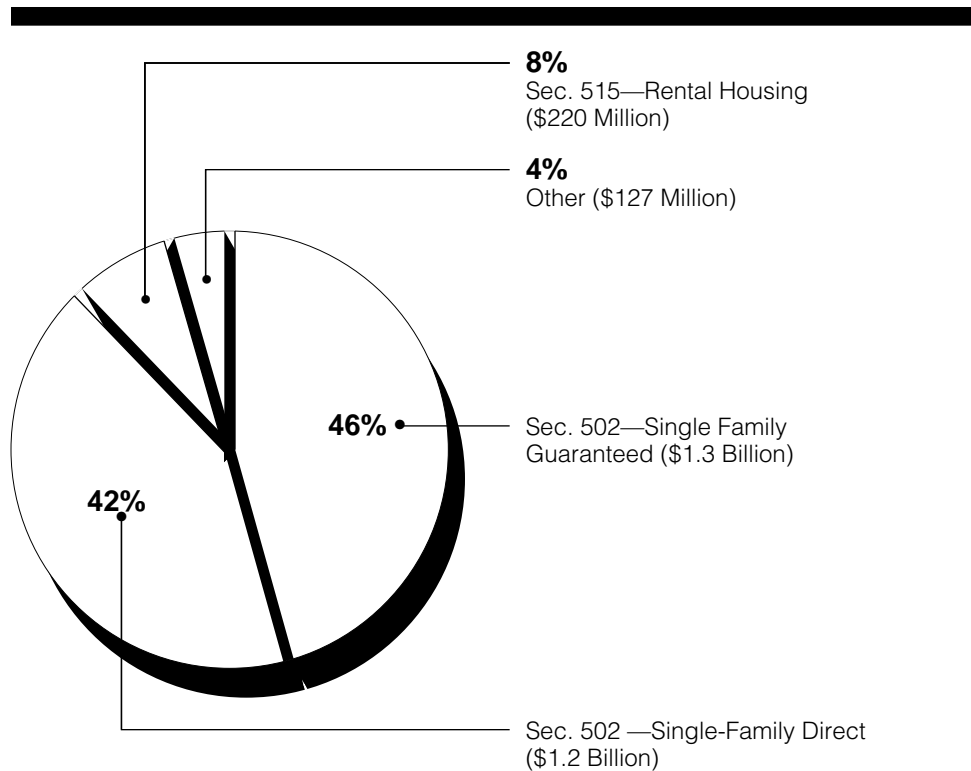
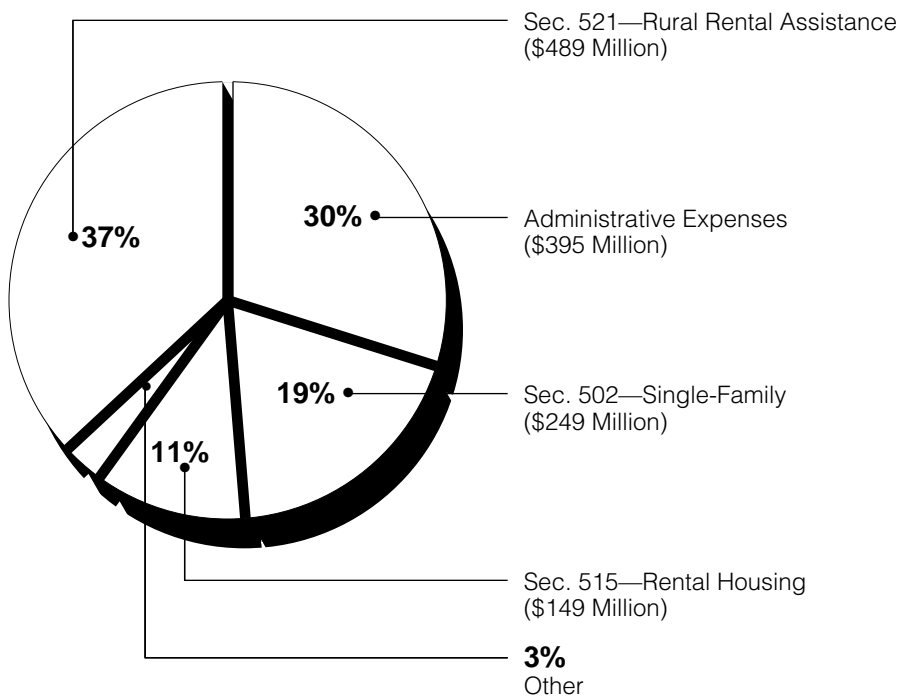


Figure I.2 shows proposed outlays of \$1.32 billion for rural housing in fiscal 1996.

**Appendix I  
Major Rural Housing Programs' Proposed  
Loan Levels and Outlays, Fiscal Year 1996**

**Figure I.2: Fiscal Year 1996 Proposed  
Outlays—\$1.32 Billion**



Note: Program subsidy amounts are estimated on a present value bases; the administrative expenses are estimated on a cash basis.

Outlays for the housing loan programs are lower than the loan amounts because they are based on subsidy costs and projected losses that are less than loan levels. For example, while proposed single-family guaranteed loans were the single largest portion of proposed loan levels in figure I.1 (\$1.3 billion), the proposed outlays associated with this loan level were \$6 million (these outlays are included in the “Other” category in figure I.2). This occurs because the guaranteed program’s borrowers do not receive interest subsidies and because expected default rates are lower than for the direct program.

The rural rental assistance program is the costliest program because it is a direct outlay program. The Rural Housing and Community Development Service (RHCDs) estimates that it will need more than \$2.4 billion just to

---

**Appendix I**  
**Major Rural Housing Programs' Proposed**  
**Loan Levels and Outlays, Fiscal Year 1996**

---

renew existing rental assistance contracts that will be expiring over the next 5 years (fiscal years 1996-2000). This amount assumes renewals of expiring contracts over a 5-year period. Given that the trend in tenants' average household incomes appears to be heading down, the cost may go even higher, according to RHCDS officials.



---

# Opportunities to Reduce Fraud, Waste, and Abuse in the Multifamily Program

---

The U.S. Department of Agriculture's (USDA) Inspector General (IG) has found instances of fraud, waste, and abuse by a number of participants in the Rural Housing and Community Development Service's multifamily housing loan program. Some of the more serious and persistent findings have been (1) inflated, improper, and undocumented charges for project construction costs; (2) unauthorized use of project operating funds and reserve accounts; (3) failure to perform essential maintenance; and (4) inadequate verification of tenants' incomes. The instances of abuse often have involved ownership or management ties between project developers' construction contractors, material suppliers, and property management firms. The IG's recently issued report on the multifamily housing loan program<sup>13</sup> addresses another potential area of abuse on which we testified in 1992<sup>14</sup>—that of developers realizing excessive profits on projects through the combined benefits derived from RHCDS' programs and federal low-income-housing tax credits.

RHCDS has taken a number of specific actions designed to address the problems identified by the IG's work, and more are under way. These actions relate to health and safety violations at RHCDS' projects, RHCDS' enforcement tools, and the agency's efforts to improve verification of tenants' incomes.

Because of confirmed reports of serious uncorrected health and safety problems at selected projects, RHCDS during 1994 conducted a nationwide review and inspection of all RHCDS-financed rural rental housing projects that were over 5 years old. About 7 percent of the 14,142 projects reviewed were found to have health and safety violations. According to RHCDS officials, these violations encompass a wide range of severity—from inoperable smoke alarms to severe structural deficiencies. About 9 percent of the projects had seriously deferred maintenance that did not pose an immediate health and safety danger. RHCDS officials concluded that conditions in the states of Texas, Oklahoma, Mississippi, Louisiana, and Illinois were serious enough to warrant special reviews of RHCDS' oversight efforts. Reports on these reviews should be completed soon.

In response to the waste, fraud, and abuse problems, RHCDS has bolstered its enforcement system to more effectively identify and deal with program abusers. In March 1994, it issued instructions establishing a system of civil

---

<sup>13</sup>Rural Housing and Community Development Service, *Rural Rental Housing Project Funding and Eligibility*, Washington, D.C., Audit Report No. 04601-1-SF, Aug. 3, 1995.

<sup>14</sup>Rural Rental Housing: *Excessive Profits and Program Fraud in Multifamily Housing* (GAO/T-RCED-92-63, May 13, 1992).

penalties (fines) for noncriminal violations of program rules. RHCDS officials also told us that they have improved their system for notifying field offices of individuals who have been barred or suspended from participating in RHCDS' programs because of misconduct and that they will soon have on-line a new automated system for tracking the performance of and identifying problem borrowers.

RHCDS officials are examining ways to address another problem area—verifying the incomes of tenants receiving rental assistance to ensure that they are eligible. Property managers are responsible for at least annually verifying tenants' incomes and reporting accurate income data to RHCDS. These data are used, among other things, to determine how much rent the tenant pays and how much, if any, rental assistance subsidy RHCDS pays. However, income verification tends to be an unpopular task with property managers, and understatement of tenants' incomes has been a recurring problem.

RHCDS now checks the reliability of reported income data primarily by matching it to wage data that employers report to state labor agencies. According to RHCDS officials, this process can be cumbersome, especially in states that do not have computerized records, and the process cannot be used universally. Some states have laws that prohibit the practice, and other states just are not interested in helping out for one reason or another.

We understand from RHCDS officials, however, that the Department of Housing and Urban Development is pilot-testing a new system that would allow automated, centralized verification of earned income with data reported by employers to the Social Security Administration and verification of investment income with data reported by financial institutions to the Internal Revenue Service via Form 1099. RHCDS hopes to also use this system, if it proves successful, as well as strengthen its current wage-matching system with the states.

---

# Summary of Prior Studies on Multifamily Project Selection Process

---

Our 1994 report<sup>15</sup> identified three reasons why rural rental housing needs estimated under the Rural Housing and Community Development Service's funding process may differ from actual needs:

- First, the process estimates needs at one point in time and therefore may not reflect current needs. The data used to estimate needs generally come from the U.S. Census and are not updated between Census years. As a result, the needs estimates do not capture fluctuations in state and local economic and demographic conditions during the 10 years between Censuses.
- Second, in selecting projects for funding, RHCDS has generally used data aggregated at the state and county levels to estimate needs. RHCDS has recognized, however, that even when county data are used, there may be more localized pockets of need that go unfunded in counties that have a relatively low estimated need overall. Accordingly, in fiscal 1994 RHCDS began to allow its state directors to use local data for specific communities if reliable data are available and vary from county data by a threshold amount.
- Third, the funding process may not account for all of the factors that can contribute to an area's need for rental housing funds. For example, project development costs, which can vary among states, are not considered in the allocation process. A state with relatively high costs may be able to fund fewer housing units with a given amount of money than other states with lower costs.

Our 1994 report also pointed out that project developers, rather than RHCDS, determine where proposed projects will be located. If developers consider that developing a project in a particular area is infeasible or unattractive, they will not propose projects for that location, even if projects are greatly needed. Under a targeting program established by legislation in 1990, RHCDS does set aside a portion of all rural housing program funds specifically for loans in counties that have very high levels of poverty and substandard housing and have been underserved by RHCDS' rural housing programs. However, providing program assistance to these targeted areas still depends on developers' willingness to propose projects in them.

A 1994 report by a task force of the National Council of State Housing Agencies identified other problems with the current project selection

---

<sup>15</sup>Rental Housing: Distribution and Use of FmHA's Rural Rental Housing Program Funds (GAO/RCED-94-141, June 1, 1994).

---

**Appendix III**  
**Summary of Prior Studies on Multifamily**  
**Project Selection Process**

---

process.<sup>16</sup> Among other things, the task force found that there was little or no coordination on project selection between RHCDS' field offices and the state agencies that allocate federal low-income-housing tax credits to certain projects. Many of the projects applying to RHCDS for loans are eligible for, and receive, these tax credits.

By law, the state agencies must develop project selection criteria that are consistent with the needs and priorities set forth in the state's Comprehensive Housing Affordability Strategy, a planning document required by the Department of Housing and Urban Development as a prerequisite for the state's receipt of federal housing assistance. Although legislation in 1992 directed RHCDS to require its state offices to establish a process for coordinating project selection with the housing needs and priorities established in the states' plans, the task force found that little coordination occurred. As a result, the projects selected under RHCDS' funding process may not be located in the areas identified by the states' plans as the neediest.

Before the task force's report, RHCDS issued regulations in March 1994 instructing its state directors to cooperate with the state agencies in the development of the states' housing affordability plans to ensure that, to the extent possible, RHCDS' resources are coordinated with the states' priorities. Under the regulations, such cooperation may include, but is not limited to, sharing data on RHCDS' estimates of need for areas within the state. However, the task force found that RHCDS had not provided its state directors with further guidance on how to coordinate their project selection with the states' plans. RHCDS officials point out, however, that they are bound by their own legislatively directed criteria, which are not necessarily consistent with the state agencies' criteria. As a result, RHCDS officials believe they can do little more to ensure consistency without a change in the legislation.

Finally, a 1994 report by the Surveys and Investigations Staff of the House Committee on Appropriations raised concerns about the weight that RHCDS' selection process gives to projects located away from urban areas.<sup>17</sup> According to the report, the preference given to proposed projects in rural communities located at least 20 miles from an urban area has resulted in some projects being built in small rural communities that have only a

---

<sup>16</sup>Report of the Tax Credit/FmHA Task Force to the Board of Directors of the National Council of State Housing Agencies, May 21, 1994.

<sup>17</sup>Practices and Procedures Regarding Certain Housing and Loan Assistance Programs Under the Farmers Home Administration, A Report to the Committee on Appropriations, U.S. House of Representatives, by the Surveys and Investigations Staff, April 1994.

---

**Appendix III  
Summary of Prior Studies on Multifamily  
Project Selection Process**

---

limited need for rental housing, while exempting projects in other communities that have a greater need but are too close to a defined urban area.

# Major Contributors to This Report

---

## Housing and Community Development Issue Area

Eugene J. Chuday, Jr.  
Patrick B. Doerning  
Andrew E. Finkel  
Woodliff L. Jenkins, Jr.  
Leigh K. Ward

---

## Financial Management Policy Issue Area

Christie M. Arends  
Arthur W. Brouk

---

### Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

**Orders by mail:**

U.S. General Accounting Office  
P.O. Box 6015  
Gaithersburg, MD 20884-6015

**or visit:**

Room 1100  
700 4th St. NW (corner of 4th and G Sts. NW)  
U.S. General Accounting Office  
Washington, DC

Orders may also be placed by calling (202) 512-6000 or by using fax number (301) 258-4066, or TDD (301) 413-0006.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

[info@www.gao.gov](mailto:info@www.gao.gov)

---

**United States  
General Accounting Office  
Washington, D.C. 20548-0001**

**Bulk Rate  
Postage & Fees Paid  
GAO  
Permit No. G100**

**Official Business  
Penalty for Private Use \$300**

**Address Correction Requested**

---

