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RATIONING ELIGIBILITY FOR MORTGAGE BOND LOANS

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INTRODUCTION

The "output side" of mortgage revenue bond (MRB) assistance has been studied extensively.[1] That is, much has been written about the financial and demographic characteristics of first-time buyers who receive MRB loans and the extent to which this assistance materially affects home ownership. However, less is known about the "input side" of the equation: how the housing-finance agencies that issue these bonds ration eligibility for MRB loans. Information from this perspective can provide insight into how state and local housing-finance agencies manage these high-demand programs that have had extensive statutory flexibility to determine who may be served.

This chapter describes how bond issuers—the state and local housing-finance agencies—ration MRB loans to prospective buyers and suggests that these agencies have had mixed results with their rationing methods. It also explains that a perceived lack of targeting has led to legislation setting tighter eligibility standards and may lead to even stricter standards in the future.

FEDERAL HOME BUYER ELIGIBILITY REQUIREMENTS AND CONGRESSIONAL EXPECTATIONS

In 1980, to stem the loss of tax revenues due to the huge amount of tax-exempt MRBs being issued, the United States Congress passed legislation that restricted the volume of these bonds that could be issued each year. It also imposed the first federal eligibility requirements for buyers receiving MRB loans. Since then, in response to congressional concerns that many buyers receiving MRB loans have not been households who truly needed the assistance to purchase their first home, Congress has continued to tighten eligibility requirements.

In establishing MRB loan eligibility standards in the Mortgage Subsidy Bond Tax Act of 1980, Congress stated that lower-income households should be the primary beneficiaries of MRB loans, but it permitted bond issuers to determine what proportion of MRB loans would be made to lower-income households. Specifically, the legislative history of the 1980 act speaks of directing assistance to those households "with the greatest need for the subsidy" and "those of low or moderate income who have difficulty in obtaining mortgage money." However, the legislative history did not define what those terms meant.

In its final 1980 deliberations, Congress declined to set eligibility standards based on household income. Instead, it required that most MRB loans be made to first-time home buyers who purchase homes that cost no more than 90 percent of the average purchase price of homes in the area.[2] Through this eligibility requirement, Congress targeted MRB loans but also recognized that the loans are made in housing markets that have considerably different house prices. (In 1982, to aid the depressed housing industry, Congress amended the 1980 act to raise the purchase-price limitation to 110 percent of the area average purchase price.)

Congress' next MRB-related legislative action, the Deficit Reduction Act of 1984, included a "statement of congressional intent" that MRB-loan programs serve lower-income households. It also required for the first time that bond issuers submit "policy reports" to the Internal Revenue Service describing the characteristics of the assisted buyers and the agencies' efforts to serve lower-income buyers before higher-income buyers.[3] However, the act did not otherwise modify the discretion that MRB program administrators had to determine who would receive MRB loans.

The population to be served by MRB programs was further defined by Congress in the Tax Reform Act of 1986. This act repealed the 1984 reporting requirement, but it imposed an income eligibility standard, requiring that households receiving MRBs have an income not exceeding 115 percent of the applicable area median income (except in targeted areas).[4] In this 1986 act, Congress defined for the first time in explicit terms which households have low or moderate incomes and therefore should qualify for MRB loans. The act also lowered home-purchase price limits to the level set in 1980.

Next, the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) tightened the eligibility requirements once again. Section 4005 of the act modified the uniform 115-percent income eligibility requirement by adjusting the eligibility level to take into account high-cost housing areas and by establishing different income eligibility levels based on household size; also it provided for a recapture of a portion of the subsidy if a home buyer who received an MRB loan disposed of the home within ten years. Explaining the recapture provision, the conference report stated:

> The conferees believe that in those [MRB-assisted] households where income has risen rapidly since acquisition, the special subsidy provided by the program was not necessary in order to become or remain a homeowner.[5]

Congress' latest legislative change to the MRB program, the Omnibus Reconciliation Act of 1990 (P.L. 101-508), modified the recapture provisions somewhat, but did not otherwise change eligibility requirements for MRB loans. Thus, while Congress has periodically expressed its intent that assistance be directed to more needy home buyers, it moved only in the 1986 and 1988 legislation to incorporate that intent into law through income eligibility requirements.[6]

Table 1: Methods Used by Finance Agencies to Ration Eligibility for MRB Loans

- Lower income limits. Set household income limits at levels lower than required by federal law.
- Lower purchase price limits. Set home-purchase price limits at levels lower than required by federal law.
- Household-size adjustments. Adjust income limits by household size to encourage participation of larger households (e.g., families rather than single-person households).
- Queuing methods. Establish queuing methods for accepting buyer applications to encourage lower-income household participation.
- Affordability tests. Select only those buyers who could not otherwise afford to purchase the house they intend to buy with a MRB loan.

SOURCE: Survey conducted in 1988 by the General Accounting Office (GAO 1988).

HOW AGENCIES RATIONED ELIGIBILITY

In a 1988 study, the U.S. General Accounting Office (GAO) examined the operation of MRB programs using a sample of 25 state and local agencies selected out of a universe of about 250 agencies (see appendix 1). One aspect of this study was a detailed review of how these agencies structured their programs to ration eligibility for MRB loans (GAO 1988).[7] The rationing mechanisms described below were in effect in early or mid-1987.

As discussed above, federal law has given state and local MRB programs wide latitude to determine whom they will serve. In deciding who will be eligible for their MRB programs, housing-finance agencies consider the requirements imposed by federal law, state laws or local ordinances, and their own charters, plus they take into account the target populations they wish to serve. Considering these factors, the agencies then set the home-buyer eligibility criteria for their programs. These agency-set eligibility standards change over time as one or more of the above factors change.[8]

The surveyed agencies used five different methods to ration eligibility for MRB loans even more than required by federal statute. For a summary of these five methods, see table 1.

Table 2 shows the use of these methods in the 25 agencies surveyed by the GAO.

Table 2: Use of Methods by Finance Agencies to Ration MRB Loans 1987

Method	Used by State Agencies	Used by Local Agencies	Not Used (%)
Lower income limits	7	2	16 (64)
Lower purchase price limits	4	2	19 (76)
Household size adjustments	4	1	20 (80)
Queuing methods	5	2	18 (72)
Affordability tests	2	0	23 (92)

SOURCE: Survey conducted in 1988 by the General Accounting Office (GAO 1988).

The first three methods are straightforward in their application. The first two set tighter numerical standards for incomes and home-purchase prices than are required by federal statute. Stricter income and purchase-price eligibility standards were used by nine (36 percent) and six (24 percent) agencies, respectively. For example, both Indiana and Maryland had established lower-than-required limits on income. The Maryland Community Development Administration had administratively set its income limit at $28,000 for single persons (about 87 percent of the state median income) and at $33,000 for households of two or more (about 103 percent of state median income). The Indiana Housing Finance Authority income limit was set, in part, by a state statute requiring that 40 percent of loans be made to buyers with incomes of less than 80 percent of the applicable area median income.

The third method is to adjust the income limits by household size. Such adjustments are common when allocating assistance in social programs. However, prior to 1988, household-size adjustments were not required by federal law for determining eligibility for MRB loans. Of the 25 agencies surveyed in 1987, only five agencies had chosen to make such adjustments. The Maryland example cited above shows how one agency adjusted its income limits based on family size.

The fourth method is to establish a buyer queue that reflects agency priorities for distributing MRB loans. This type of queue differs from the "first-come, first-served" queue created when MRB loans are provided to any household meeting the income and purchase-price standards (and other loan-origination standards), as long as bond funds are available. Under this first-come, first-served process, households with higher incomes displace prospective lower-income buyers if the higher-income buyers apply for the MRB loans first. This problem is ameliorated by a targeted queuing that reserves loans for those households the agency believes should have first priority.

Seven of the surveyed housing-finance agencies used some sort of queuing mechanism to rank some buyers ahead of others. For the most part, these agencies set aside a portion of the bond funds for a specific or an indefinite time. Usually, they reserved funds for a set time (typically one to four weeks) for buyers at the lower end of the income spectrum, and then made the balance of the loan funds available to the remainder of the eligible population on a first-come, first-served basis.[9] For example, the Illinois Housing Development Agency accepted applications during the first three weeks of its program from households with incomes less than $25,000, and then opened up the application process to all other eligible buyers.

The final method—and the one that would seem the most direct rationing device—is to determine whether a buyer applying for an MRB loan could purchase the same home with a market-rate loan. To make this determination, a housing finance agency could use either conventional affordability test or a different, agency-derived test. When an agency finds a prospective borrower could afford a market rate loan, it could disqualify that household and instead direct its MRB loans to households that need the reduced interest rate to purchase a home.[10]

A conventional affordability test was used by only 2 of the 25 agencies surveyed, the Maryland Community Development Administration and the Virginia Housing Development Authority. Both agencies required the participating mortgage lender to certify that, according to the information submitted, the mortgagor could not qualify for conventional financing. To support that statement, Maryland required the lender to complete a conventional affordability calculation if the buyer's cash assets were 20 percent or more of the purchase price. Virginia required the lender to submit both the lender certification and a net worth estimate (GAO 1988, 45).[11]

Table 3: Extent That Housing Finance Agencies Used One or More Rationing Methods 1987

Agency	Number of methods used (percent of row) 0	1	2	3
State Agency	3 (19)	8 (50)	1 (6)	4 (25)
Local Agency	5 (56)	2 (22)	1 (11)	1 (11)
Total	8 (32)	10 (40)	2 (8)	5 (20)

SOURCE: Survey conducted in 1988 by the General Accounting Office (GAO 1988).

Coupling Rationing Methods

Table 2 suggests that, for the most part, eligibility rationing methods were not being used in 1987 to a great extent, since each method was *not* being used by 16 to 23 of the 25 agencies (64 percent to 92 percent). On the other hand, another way of looking at the prevalence of use is to determine how many of the agencies were using one or more of the five mechanisms. This analysis presents a more positive picture: 17 of the 25 (68 percent) surveyed housing-finance agencies were using at least one method to ration MRB loans more rigorously than required by federal law, and 7 (28 percent) were using two or three of the rationing methods. None used more than three (see table 3).

Why Some Housing Finance Agencies Did More and Some Did Less

By imposing stricter or additional eligibility requirements for MRB loans, housing-finance agencies demonstrated either that they were trying to target assistance better or that they were required by their charters to have tighter restrictions. Those agencies with few or no rationing methods in place had rejected them because (1) their leaders believed that eligibility levels set by federal law provided sufficient targeting, (2) the agencies' boards of directors had no interest in additional rationing, or (3) they saw no harm in helping the "regular guy."

Limitations of This Study

This approach to identifying eligibility rationing has some limitations. First, it uses a cross-sectional sample of bond programs operating at the time of the survey. A longitudinal sample might show a different pattern of use of rationing methods. The methods may change over time because state and local housing-finance agencies alter eligibility requirements to adjust to changes in market conditions, government requirements, or agency policies. Thus, each of the 25 surveyed agencies may have changed its rationing methods soon after the GAO survey was completed. Second, the analysis does not control for housing market conditions that make it easier or harder for a housing-finance agency to impose stricter rationing of MRB loans. For example, a housing-finance agency serving an area with less expensive housing might be able to target its loans more precisely than an agency in an area with expensive housing. Third, exogenous changes, such as the changes in marginal income tax rates and the expanded alternative minimum tax as set out in the 1986 Tax Reform Act, may reduce the difference in market interest rates for mortgage loans and MRB loans, thus reducing the subsidy. As a result, housing-finance agencies may find it more difficult to target lower income households because the subsidies are too small to induce them to purchase houses. Finally, no consideration is made as to whether the federal eligibility restrictions are set at the "right" levels to exclude buyers who would have been likely to purchase homes in the absence of a MRB loan and could have afforded to have done so.

OBSERVATIONS

This survey has shown a mixed result in the use of rationing methods to serve a narrower segment of the buyer population than required by federal law. Each of five rationing methods was used only by a small number of the surveyed housing-finance agencies, but two-thirds of the agencies used at least one method.

Examining the restrictions on who may receive MRB loans is, of course, quite different from looking at the attributes of the buyers who ultimately receive them. That is, one could ask (as stated elsewhere in this book) if MRB programs do not increase home ownership rates, then does better rationing make a difference? Similarly, if one takes the other side of the argument, that MRBs do, indeed, positively affect ownership rates, then one could ask why is better rationing needed since, by that very result, the program is deemed effective?

The answer to these questions may be two-fold. The first part relates to social goals. With limited bond funds and a subsidy that is in great demand, an MRB program can achieve a higher public purpose by helping households with greater need for a housing subsidy before it helps those with a lesser need. The second part of the answer is more pragmatic: each time Congress considers whether it should extend authority for state and local housing-finance agencies to issue MRBs, the question is raised of whether the benefits of MRB programs are worth the tax-expenditure costs. To help lower costs and increase benefits, Congress has set increasingly stricter standards to determine who is eligible for MRB loans. In future years, as Congress struggles to reduce the federal deficit, it will face additional pressure to reduce tax expenditure costs associated with tax-exempt securities. To increase the probability that MRB programs will survive these pressures, MRB proponents may want to ration MRB loans even more carefully.

Appendix 1
State and Local Housing Finance Agencies Surveyed

STATE AGENCIES

California Housing Finance Agency
Florida Housing Finance Agency
Illinois Housing Development Authority
Indiana Housing Finance Authority
Iowa Finance Authority
Maryland Community Development Administration
Michigan State Housing Development Authority
Ohio Housing Finance Agency
Oklahoma Housing Finance Agency
Oregon Department of Commerce, Division of Housing
Pennsylvania Housing Finance Agency
State of New York Mortgage Agency
Texas Housing Agency
Virginia Housing Development Authority
Washington State Housing Commission
Wisconsin Housing and Economic Development Authority

LOCAL AGENCIES

California
Sacramento Housing and Redevelopment Agency

Illinois
Cook County (Comptroller's Office)

Maryland
Montgomery County Housing Opportunities Commission

Pennsylvania
Allegheny County Residential Finance Authority
City of Philadelphia Redevelopment Authority

Texas
Corpus Christi Housing Finance Corporation
Dallas Housing Finance Corporation
Harris County Housing Finance Corporation
Houston Housing Finance Corporation

ENDNOTES

The views expressed in this chapter are those of the author and do not necessarily reflect those of the General Accounting Office.

1. "Mortgage Revenue Bonds" is the popular name of "qualified mortgage bonds."

2. See GAO (1988, 10-13); the Omnibus Reconciliation Act of 1980, Committee on the Budget, House of Representatives, U.S. Congress (Report No. 96-1167, July 21, 1980), p. 447; and the Omnibus Reconciliation Act of 1980, Conference Committee, House of Representatives, U.S. Congress (Report No. 96-1479, Nov. 26, 1980), pp. 171-2.

3. Deficit Reduction Act of 1984 (PL 98-369), July 18, 1984, Section 611 (b)(5)(ii)(II).

4. Some exceptions exist. Under certain circumstances, a bond issue could retain its tax exemption if home buyer eligibility and other requirements are not met for five percent of the mortgages made. Also, bond issuers are required, generally, to set aside 20 percent of the bond proceeds for use in one year in poorer areas, the so-called "targeted areas." For these areas, income and purchase-price limitations in the Code are more lenient. This chapter deals with the general requirements, as set out in the body of the act.

5. Technical and Miscellaneous Revenue Act of 1988, Conference Committee, House of Representatives, U.S. Congress, Report No. 100-1104, vol. II (Oct. 21, 1988), p. 85.

6. The household-size adjustments discriminate among households based on the number of members in the households. Household size affects the maximum income that a household can earn and still be eligible for MRB loans. As household size increases, the income limits are higher. As a result, a household with, say, five members may be eligible for an MRB loan, but a single-person household with the same income would be ineligible. The recapture mechanism can be viewed as an eligibility rationing device because those households who could afford now or in the near future to buy a conventionally mortgaged home might not do so to avoid being subject to the recapture.

7. The state agencies were selected primarily on the basis of bond-issuance volume (primarily larger volume issuers), the diversity of geographic location, and the existence of local issuers. Local issuers were selected within the sampled states primarily on the basis of large issuance volume. Nothing was known about the individual bond programs in the agencies selected, although the general reputation of several of the agencies, as leaders and innovators, was known. At the agencies, senior officials were interviewed, and agency reports and documents were reviewed to determine how the agencies structured their programs to serve first-time buyers.

8. MRB assistance may be used for new and existing home purchases and home improvement, rehabilitation, construction, bridge loans, and other temporary financing. This survey deals only with home purchase loans because they make up an overwhelming majority of the MRB assistance provided to borrowers of assistance used. See Table II.6 of GAO (1988, 82) and agency profiles presented in the Council of State Housing Agencies' report, Production Activities of State Housing Finance Agencies 1985 and Cumulative.

9. The Pennsylvania Housing Finance Agency was alone in using a random choice lottery process. In 1984 and 1985, the State of New York Mortgage Agency experimented with a ranking process for all buyers based on income, but abandoned it in 1987 because of administrative complexity.

10. This, of course, ignores the argument that some buyers may use the MRB loan subsidy to buy a more expensive home than they would have been able to afford on the conventional market.

11. GAO did not assess the effectiveness of these two states' requirements.