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RURAL HOUSING SERVICE

Opportunities to Improve Management

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Financial Markets and Community Investment

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Highlights

Highlights of GAO-03-911T, a testimony before the Subcommittee on Housing and Community Opportunity, Committee on Financial Services, U.S. House of Representatives

Why GAO Did This Study

Federal housing assistance in rural America dates back to the 1930s, when most rural residents worked on farms. Without electricity, telephone service, or good roads connecting residents to population centers, residents were comparatively isolated and their access to credit was generally poor. These conditions led Congress to authorize separate housing assistance for rural residents, to be administered by USDA.

Over time, the quality of the housing stock has improved and credit has become more readily available in rural areas. Also, advances in transportation, computer technology, and telecommunications have diminished many of the distinctions between rural and urban areas.

These changes call into question whether rural housing programs still need to be maintained separately from urban housing programs, and whether RHS is adapting to change and managing its resources as efficiently as possible.

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What GAO Found

Our testimony is based on two reports addressed to this subcommittee—the September 2000 report on rural housing options and May 2002 report on multifamily project prepayment and rehabilitation issues. GAO found that while RHS has helped many rural Americans achieve homeownership and has improved the rural rental housing stock, it has been slow to adapt to changes in the rural housing environment. Also, RHS has failed to adopt the tools that could help it manage its housing portfolio more efficiently. Specifically:

- Dramatic changes in the rural housing environment since rural housing programs were first created raise questions as to whether separately operated rural housing programs are still the best way to ensure the availability of decent, affordable rural housing. Overlap in products and services offered by RHS, HUD, and other agencies has created opportunities for merging the best features of each. Even without merging RHS's programs with HUD's or those of other agencies, RHS could increase its productivity and lower its overall costs by centralizing its rural delivery structure.

- RHS does not have a mechanism to prioritize the long-term rehabilitation needs of its multifamily housing portfolio. As a result, RHS cannot be sure it is spending limited rehabilitation funds as effectively as possible and cannot tell Congress how much funding it will need in the future.

Source: GAO.

A distressed house in Mississippi where a homeowner lived for 46 years until his new home, financed with an RHS single-family loan and additional funding sources, was finished in February, 2000.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the management of Rural Housing Service (RHS) programs. RHS makes a significant investment in affordable housing for low-income rural Americans through a variety of direct and guaranteed loan and grant programs. RHS manages a single-family and multifamily direct loan portfolio of about $28 billion, oversees a program that guarantees about $3 billion in single-family mortgages annually, and administers over $700 million in rental assistance payments each year.

This statement is based on two reports addressed to this Subcommittee: our September 2000 report on rural housing options and our May 2002 report on multifamily project prepayment and rehabilitation issues.[1] I will also briefly discuss the objectives of our ongoing work on RHS's rental assistance program. My principle objective today is to present an overview of the concerns identified in our previous reports that you may want to consider as you deliberate on how best to improve housing services for rural Americans.

In summary, while RHS has significantly improved the quality of the housing stock in rural America and has helped many rural Americans become homeowners, it has been slow to adapt to changes in the rural housing environment. In addition, it has not adopted the managerial tools that are now available that would help it make better use of its housing portfolio and limited budgetary resources. Specifically:

- First, dramatic changes in the rural housing environment since rural housing programs were first created raise the question of whether separately operated rural housing programs are still needed to best ensure the availability of decent affordable rural housing. Overlap in the products and services offered by RHS, the Department of Housing and Urban Development (HUD), and other agencies opened up opportunities for merging the best features of each program. But even without merging the best features of RHS's programs with the best features of those of HUD or other agencies, RHS could increase its

[1] *Rural Housing: Options for Optimizing the Federal Role in Rural Housing Development* (GAO/RCED-00-241, September 15, 2000) and *Multifamily Rural Housing: Prepayment Potential and Long-Term Rehabilitation Needs for Section 515 Properties* (GAO-02-397, May 10, 2002).

productivity and lower its overall costs by centralizing its rural delivery structure.

- Second, RHS does not have a mechanism for prioritizing the long-term rehabilitation needs of its multifamily portfolio. As a result, RHS cannot be that sure that it is spending its limited rehabilitation funds as effectively as possible and cannot tell Congress how much funding it will need in the future.

Background

The government has been providing housing assistance in rural areas since the 1930s. At that time, most rural residents worked on farms, and rural areas were generally poorer than urban areas. For example, in the 1930s very few rural homes had electricity or indoor plumbing. Accordingly, the Congress authorized housing assistance specifically for rural areas and made USDA responsible for administering it. However, rural demographic and economic characteristics have greatly changed over time. By the 1970s virtually all rural homes had electricity and indoor plumbing. Today, less than 2 percent of the nation's population lives on farms, and advances in transportation, technology, and communications have – or have the potential to – put rural residents in touch with the rest of the nation. The federal role has also evolved, with HUD, the Department of Veterans Affairs (VA), and state housing finance agencies becoming significant players in administering housing programs.

Homeownership in the United States is at an all-time high with 68 percent of the nation's households owning their own home. In rural areas, the homeownership rate is even higher — 76 percent. However, according to the Housing Assistance Council, affordability is the biggest problem facing low-income rural households. Rural housing costs have increased and income has not kept pace, especially for rural renters who generally have lower incomes than owners. As a result, rural renters are more likely to have affordability problems and are twice as likely as rural owners to live in substandard housing.

Although the physical condition of rural housing has greatly improved over time, it still lags somewhat behind that of urban housing. The most severe rural housing quality problems are found farthest from the nation's major cities, and are concentrated in four areas in particular: the Mississippi Delta, Appalachia, the Colonias on the Mexican border, and on Indian trust land. Minorities in these areas are among the poorest and worst housed groups in the nation, with disproportionately high levels of inadequate housing conditions. Migrant farm workers in particular have difficulty finding affordable, livable housing. The higher incidence of housing quality problems, particularly in these four areas, offsets many of the advantages of homeownership, including the ability to use homes as investments or as collateral for credit.

USDA's Farmers Home Administration managed rural housing programs and farm credit programs until reorganization legislation split these functions in 1994.[2] Farm credit programs were then shifted to the new Farm Service Agency. Housing programs were moved to the newly created RHS in the new Rural Development mission area which was tasked with helping improve the economies of rural communities. RHS currently employs about 5,500 staff to administer its single family, multifamily, and community facilities programs.

RHS's homeownership programs provide heavily subsidized direct loans to households with very low and low incomes, guaranteed loans to households with low and moderate incomes, and grants and direct loans to low-income rural residents for housing repairs. Multifamily programs provide direct and guaranteed loans to developers and nonprofit organizations for new rental housing that is affordable to low and moderate income tenants; grants and loans to public and nonprofit agencies and to individual farmers to build affordable rental housing for farm workers; housing preservation grants to local governments, nonprofit organizations, and Native American tribes; and rental assistance subsidies that are attached to about half the rental units that RHS has financed. In addition, RHS administers community facilities programs that provide direct and guaranteed loans and grants to help finance rural community centers, health care centers, child care facilities, and other public structures and services.

For fiscal year 2003, RHS received an appropriation of $1.6 billion. Of this amount, the largest share, $721 million, is for its rental assistance program. Congress also authorized about $4.2 billion for making or guaranteeing loans, primarily for guaranteeing single-family loans.[3] RHS oversees an

[2]Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994, Pub. L. 103-354 (1994).

[3]Authorized dollar amounts represent the expected private-sector loan levels guaranteed by RHS as well as loans made directly by RHS during the year. Actual appropriations are much lower because they cover the subsidy cost, not the face value of the loans or guaranteed loans. The subsidy cost is the estimated long-term cost to the government of a direct or guaranteed loan calculated on a net present value basis, excluding administrative costs. In fiscal year 2003, the $4.2 billion in loan authorizations are estimated to require about $37 million in credit subsidy costs.

outstanding single-family and multifamily direct loan portfolio of about $28 billion. Table 1 lists RHS's programs, briefly describes them, and compares the spending for them in fiscal year 1999 with the spending for them in fiscal years 1979 and 1994. The table also shows that, although RHS's single and multifamily guaranteed programs are relatively new, by 1999 RHS had guaranteed more single- and multifamily loans than it made directly.

Table 1: Data on RHS's Housing Programs

Dollars in millions

RHS housing program	Total dollars spent, fiscal year 1979	Total dollars spent, fiscal year 1994	Total dollars spent, fiscal year 1999	Number of households helped, fiscal year 1999	Type of assistance
Single-Family Housing Direct Loans (sec. 502)	$2,870.0[a]	$1,656.8[a]	$966.9[a]	15,600	Loans subsidized as low as 1 percent interest
Single-Family Housing Guaranteed Loans (sec. 502)		$725.9[a]	$2,980.0[a]	38,600	No money down, no monthly mortgage insurance loans
Single-Family Home Repair Grants and Loans (sec. 504)	$33.7	$52.7	$46.8	9,021	Grants for elderly and loans subsidized as low as 1 percent interest
Single-Family Housing Mutual Self-Help Grants (sec. 523)	$5.6	$12.8	$25.4	1,350	Grants to nonprofit and public entities to provide technical assistance
Multifamily Direct Rural Rental Housing Loans (sec. 515)	$869.5[a]	$512.4[a]	$114.3[a]	2,181	Loans to developers subsidized as low as 1 percent interest
Multifamily Housing Guaranteed Loans (sec. 538)			$74.8[a]	2,540	Guaranteed loans for developing moderate-income apartments
Multifamily Housing Farm Labor Grants and Loans (secs. 516/514)	$68.8	$56.3	$33.2	622	Grants and loans subsidized at 1 percent interest
Multifamily Housing Preservation Grants (sec. 533)		$23.0	$7.2	1,800	Grants to nonprofit organizations, local governments, and Native American tribes, usually leveraged with outside funding
Multifamily Housing Rental Assistance (sec. 521)	$423.0	$446.7	$583.4	42,000	Rental assistance to about one-half the residents in RHS rental and farm labor units

Source: Rural Housing: Options for Optimizing the Federal Role in Rural Housing Development (GAO/RCED-00-241, September 15, 2000). pp. 15-16.

[a]Dollar amounts represents private-sector loan levels guaranteed by RHS or loans made directly by RHS during the year. Actual federal outlays are much lower because they cover the subsidy cost, not the face value of the loans or guaranteed loans. The subsidy cost is the estimated long-term cost to the government of a direct or guaranteed loan calculated on a net present value basis, excluding administrative costs.

While RHS administers its programs in rural areas, HUD, VA, and state housing finance agencies provide similar programs nationwide, including assistance to households that may be eligible for RHS programs in rural areas. For example, RHS's single-family loan guarantee program serves moderate-income homebuyers as does the Federal Housing Administration's (FHA) much larger single-family insurance program. VA and most state housing finance agencies also offer single-family loan programs. In the multifamily area, HUD's multifamily portfolio is similar to RHS's multifamily portfolio and HUD's project-based section 8 program operations parallel RHS's rental assistance program. Further, in contrast to RHS, HUD has more established systems for assessing the quality of its multifamily portfolio through its Real Estate Assessment Center (REAC) and for restructuring financing and rental assistance for individual properties through its Office of Multifamily Housing Assistance Restructuring (OMHAR).

Changes in the Rural Housing Environment Raise Questions About the Need to Maintain Separately Operated Rural Housing Programs

Given the diminished distinctions between rural and urban areas today, improvements in rural housing quality and access to credit, and RHS's increasing reliance on guaranteed lending and public/private partnerships, our September 2000 report found the federal role in rural housing is at a crossroads. We listed arguments for and against fundamentally changing the programs' targeting, subsidy levels, and delivery systems, as well as merging RHS's programs with HUD's or other agencies' comparable programs.

Arguments For and Against Separately Operated Programs

A number of arguments have been presented to support continuing RHS's housing programs separately from HUD and other agencies or for maintaining a separate system for delivering these programs, including the following:

- Some rural residents need the close supervision offered by RHS local offices because they do not have access to modern telecommunications or other means of obtaining information on affordable housing opportunities;
- Rural borrowers often need a local service office familiar with their situation in the first year of a loan;

- Rural areas could lose their federal voice in housing matters;

- Rural areas could lose the benefits of the lower rates and terms RHS's direct and guaranteed loan programs currently offer; and

- HUD and other potential partners have not focused on rural areas.

Proponents of arguments for merging RHS's housing programs with other housing programs or not maintaining a separate system for delivering housing programs in rural areas present a different set of arguments:

- RHS's field role has changed from primarily originating and servicing direct loans to leveraging deals with partner organizations;

- In some states, local banks, nonprofit organizations, social workers, and other local organizations are doing much of the front-line work with rural households that was previously done by RHS staff;

- The thousands of RHS staff with local contacts could provide a field presence for HUD, and other public partners, applying their leveraging and partnering skills to all communities; and

- RHS and HUD could combine management functions for their multifamily portfolios that are now provided under separate systems.

We also noted that without some prodding, the agencies are not likely to examine the benefits and costs of merging as an option. As a first step toward achieving greater efficiency, we suggested that the Congress consider requiring RHS and HUD to explore the potential benefits of merging similar programs, such as the single-family insured lending programs and the multifamily portfolio management programs, taking advantage of the best practices of each and ensuring that targeted populations are not adversely affected.

Actions Taken to Share Resources and Expertise

Since we issued our report in September 2000, it appears that RHS and FHA have shared some mutually beneficial practices. First, RHS's single-family guaranteed program plans to introduce its automated underwriting capabilities through technology that FHA has already developed and has agreed to share with RHS. Second, RHS, FHA, and VA have collaborated in developing common reporting standards for tracking minority and first-time homeownership statistics. Third, we understand that there have been discussions between RHS and HUD staff on developing a model to restructure RHS section 515 mortgages using techniques that HUD has learned through restructuring similar HUD section 236 mortgages.

Opportunities Exist to Improve RHS Program Efficiencies

Our September 2000 report also identified a number of actions that RHS officials and others have identified that could increase the efficiency of existing rural housing programs, whether or not they are merged. I will limit my discussion today to two issues that deal with RHS's field structure.

The first issue involves state delivery systems. When state Rural Development offices were given the authority to develop their own program delivery systems as part of the 1994 reorganization, some states did not change, believing that they needed to maintain a county-based structure with a fixed local presence to deliver one-on-one services to potential homeowners. Other states tried innovative, less costly approaches to delivering services, such as consolidating local offices to form district offices and using traveling loan originators for single-family programs. However, RHS has undergone a major shift in mission during the past few years. RHS is still a lending agency like its predecessor, the Farmers Home Administration, but it now emphasizes community development, and uses its federal funding for rural communities to leverage more resources to develop housing, community centers, schools, fire stations, health care centers, child care facilities, and other community service buildings. Some state Rural Development officials we spoke with questioned the efficiency and cost-effectiveness of maintaining a county-based field structure in a streamlined environment where leveraging, rather than one-on-one lending, has become the focus of the work.

For example, the shift in emphasis from direct to guaranteed single-family lending moved RHS from relying on a labor intensive loan generation process to one that relies on private lenders to underwrite loans. When we performed our audit work in 2000 we found that Mississippi, which maintains a county-based Rural Development field structure, had more staff and field offices than any other state but the next to lowest productivity as measured by dollar program activity per staff member. Ohio, however, which ranked fifth in overall productivity, operated at less than one-fifth of Mississippi's cost per staff member. We recognize that it is more difficult to underwrite single-family loans in the Mississippi Delta and other economically depressed areas than in rural areas generally, and Mississippi does have a substantial multifamily portfolio. Nevertheless, the number of field staff in Mississippi far exceeded that in most other states. Ohio, whose loan originators were based in four offices and traveled across the state with laptop computers, ranked seventh in the dollar value of single-family guaranteed loans made and fifth in the dollar amount per staff member of direct loans made. Ohio had also done a good job of serving all of its counties, while Mississippi had experienced a drop in business in the counties where it had closed local offices. Ohio's travel and equipment costs had increased with the use of traveling loan originators.

The Maine Rural Development office had also fundamentally changed its operational structure, moving from 28 offices before the reorganization to 15 afterwards, and in 2000 it operated out of 3 district offices. The state director at the time, who had also headed the Farmers Home Administration state office in the 1970s, said that he had headed the agency under both models and believed the centralized system to be much more effective. He added that under the new structure, staff could no longer sit in the office waiting for clients to come to them but had to go to the clients. He also maintained that a centralized structure was better suited to building the partnerships with real estate agents, banks, and other financial institutions that had become the core element of RHS's work.

The second issue involves the location of field offices. Consistent with its 1994 reorganization legislation, USDA closed or consolidated hundreds of county offices and established "USDA service centers" with staff representing farm services, conservation, and rural development programs. However, the primary goal of the task team that designed the service centers was to place all the county-based agencies together, particularly those that dealt directly with farmers and ranchers, to reduce personnel and overhead expenses by sharing resources. But while the farm finance functions from the old Farmers Home Administration fit well into the new county-based Farm Service Agency, the housing finance functions that moved to the new state Rural Development offices were never a natural fit in the centers. The decision to collocate Rural Development and Farm Service offices was based on the fact that Rural Development had a similar county-based field structure and the Department needed to fill space in the new service centers. Collocating Rural Development and Farm Service offices designed to serve farmers and ranchers makes less sense today, especially in states where Rural Development operations have been centralized.

RHS Does Not Have a Mechanism to Prioritize the Long-Term Rehabilitation Needs of Its Multifamily Portfolio

How to deal with the long-term needs of an aging portfolio is the overriding issue for section 515 properties. In the program's early years, it was expected that the original loans would be refinanced before major rehabilitation was needed. However, with prepayment and funding restricted, this original expectation has not been realized, and RHS does not know the full cost of the long-term rehabilitation needs of the properties it has financed. RHS field staffs perform annual and triennial property inspections that identify only current deficiencies rather than the long-term rehabilitation needs of the individual properties. As a result, RHS does not know whether reserve accounts will cover long-term rehabilitation needs. Without a mechanism to prioritize the portfolio's rehabilitation needs, including a process for ensuring the adequacy of individual property reserve accounts, RHS cannot be sure it is spending its limited rehabilitation funds as effectively as possible and cannot tell Congress how much funding it will need to cover the portfolio's long-term rehabilitation costs.

RHS's state personnel annually inspect the exterior condition of each property financed under the section 515 program and conduct more detailed inspections every 3 years. However, according to RHS guidelines, the inspections are intended to identify current deficiencies, such as cracks in exterior walls or plumbing problems. Our review of selected inspection documents in state offices we visited confirmed that the inspections are limited to current deficiencies. RHS headquarters and state officials confirmed that the inspection process is not designed to determine and quantify the long-term rehabilitation needs of the individual properties.

RHS has not determined to what extent properties' reserve accounts will be adequate to meet long-term needs. According to RHS representatives, privately owned multifamily rental properties often turn over after just 7 to 12 years, and such a change in ownership usually results in rehabilitation by the new owner. However, given the limited turnover and funding constraints, RHS properties primarily rely on reserve accounts for their capital and rehabilitation needs. RHS officials are concerned that the section 515 reserve accounts often are not adequate to fund needed rehabilitation.

RHS and industry representatives agree that the overriding issue for section 515 properties is how to deal with the long-term needs of an aging portfolio. About 70 percent of the portfolio is more than 15 years old and in need of repair. Since 1999, RHS has allocated about $55 million in rehabilitation funds annually, but owners' requests for funds to meet safety and sanitary standards alone have totaled $130 million or more for each of the past few years. RHS headquarters has encouraged its state offices to support individual property owners interested in undertaking capital needs assessments and has amended loan agreements to increase their rental assistance payments as necessary to cover the future capital and rehabilitation needs identified in the assessments. However, with varying emphasis by RHS state offices and limited rental assistance funding targeted for rehabilitation, the assessments have proceeded on an ad hoc basis. As a result, RHS cannot be sure that it is spending these funds as cost-effectively as possible.

To better ensure that limited funds are being spent as cost-effectively as possible, we recommended that USDA undertake a comprehensive assessment of the section 515 portfolio's long-term capital and rehabilitation needs, use the results of the assessment to set priorities for the portfolio's immediate rehabilitation needs, and develop an estimate for Congress on the amount and types of funding required to deal with the portfolio's long-term rehabilitation needs. USDA agreed with the recommendation and requested $2 million in the President's 2003 budget to conduct a comprehensive study. RHS staff drafted a request for proposal that would have contracted out the study, but the Undersecretary for Rural Development chose to lead the study himself. Plans are to develop an inspection and rehabilitation protocol by February 2004 on the basis of an evaluation of a sample of properties.

GAO Is Examining Rental Assistance Program Issues

Finally, I would like to mention some work we have begun on the Section 521 rental assistance program. With an annual budget of over $700 million, the rental assistance program is the largest line item appropriation to the Rural Housing Service. This is a property-based subsidy that provides additional support to units created through the Section 515 multifamily and farm labor housing programs. RHS provides this subsidy to property owners through 5-year contracts. The objectives for our current work are to review (1) how RHS estimates the current and future funding needs of its Section 521 rental assistance program; (2) how RHS allocates the rental assistance; and (3) what internal controls RHS has established to monitor the administration of the rental assistance program. We anticipate releasing a report on our findings in February of 2004.

Mr. Chairman, this concludes my prepared remarks. I would be pleased to answer any questions you or any other members of the Committee may have.

Contact and Acknowledgements

For questions regarding this testimony, please contact William B. Shear on (202) 512-4325 or at shearw@gao.gov, or Andy Finkel on (202) 512-6765 or at finkela@gao.gov. Individuals making key contributions to this testimony included Emily Chalmers, Rafe Ellison, and Katherine Trimble.

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