NATIONAL RURAL HOUSING COALITION

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Rural Housing Success Story: Section 502 Direct Loans

The purpose of this paper is to describe the important benefits to rural households of the Section 502 Direct Loan for Home Ownership Program, discuss recent trends in appropriations, and suggest improvements to the program.

Since its inception of the Section 502 program, the Department of Agriculture (USDA) has provided homeownership loans to almost two million families at an extremely low cost to the federal government. The Section 502 direct loan program is the only federal program targeting homeownership opportunities exclusively to low- and very-low income rural households. Eligibility is limited to households with incomes that do not exceed 80% of area median income (AMI). Under the law, at least 40% of Section 502 loan funds must go to very low income households (not exceeding 50% of median).

Today, the annual average income of a direct borrower is $27,500 and 80% of borrowers have annual incomes that do not exceed $35,000. A total of 40% of Section 502 funds go to the very low families and over 60% of loan obligations are committed to borrowers with incomes at or below exceeding 60% of median (Charts 1, 2).

CHART 1

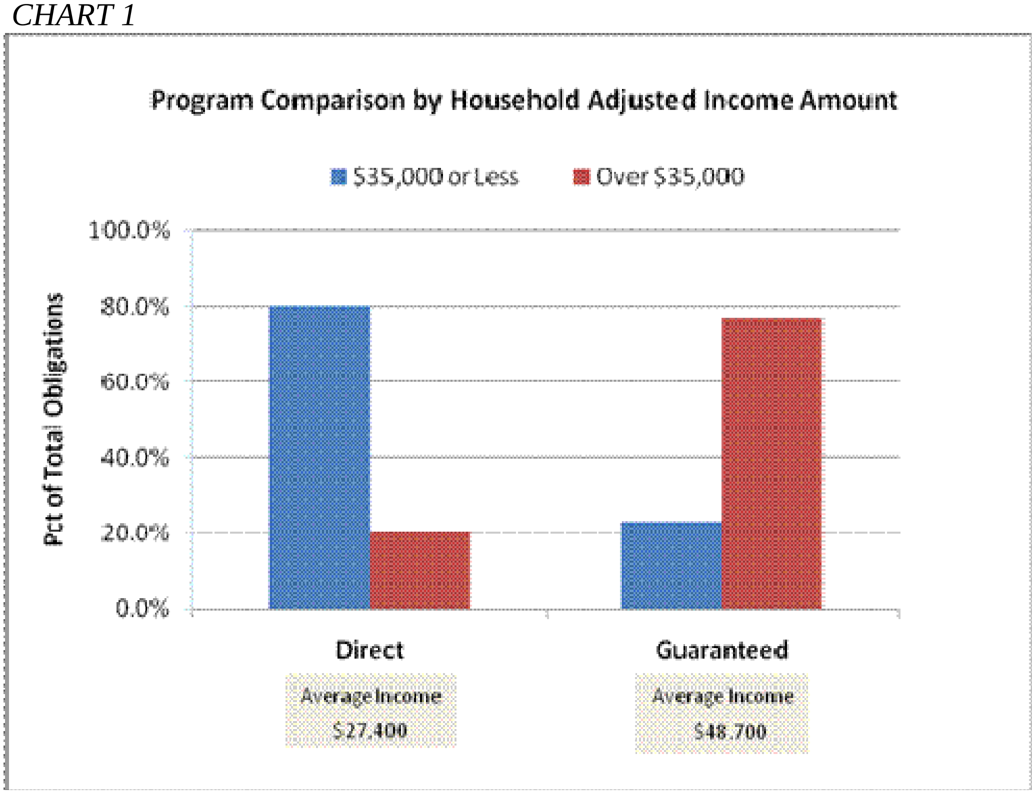
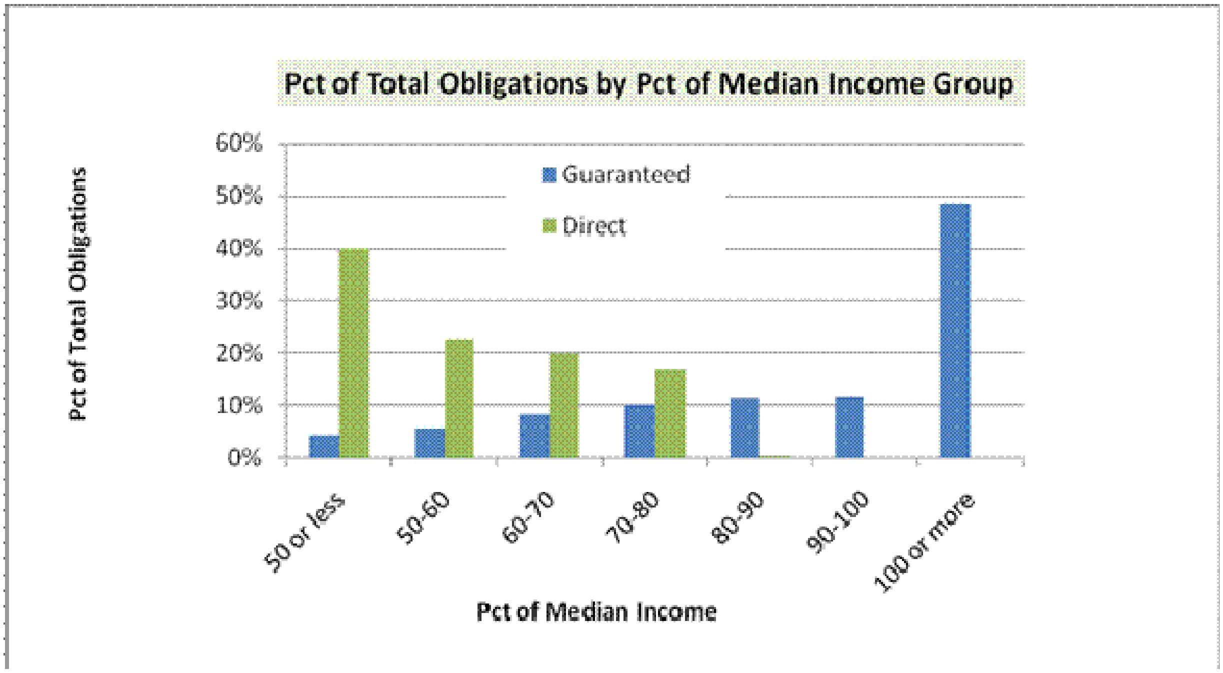


CHART 2



Applicants to the Section 502 Direct Loan Program may obtain 100% financing to purchase an existing dwelling, purchase a site and construct a dwelling, or purchase newly constructed dwellings located in rural areas. Mortgage payments are based on the household's adjusted income. Most loans are for 33 years.

In recent years appropriations for Section 502 loans have declined. Some of this is the result of declining interest rates that lower the cost of the subsidized loans provided through Section 502. Some of the reduction is a function of a lower level of subsidy available to families.

Between 2003-10, appropriations for budget authority necessary to support approximately $1.12 billion in Section 502 Direct Loans fell from $203 million to $45 million (Chart 3). During this period, as Congress and the Administration choose to freeze the program level, the number of loans made under Section 502 fell from 14,600 in FY 03 to less than 10,000 in FY 10, excluding Recovery Act appropriations (Chart 4).

It is important to compare this to a consistent backlog of applications that regularly total over 25,000 and over $2 billion. The current backlog for Section 502 Direct Loans exceeds $2.1 billion (as of 9/30/10).

The Section 502 program is extremely cost effective. Based on FY 10 subsidy rates, the total cost per unit for a Section 502 Direct Loan is $4,650. This is not an annual number; it is the total cost to the government. There is not another federal program that provides assistance to low and very low income households at such a low cost. For example, the annual Section 8 housing assistance payment in Washington State is close to $7000 per year.

CHART 3

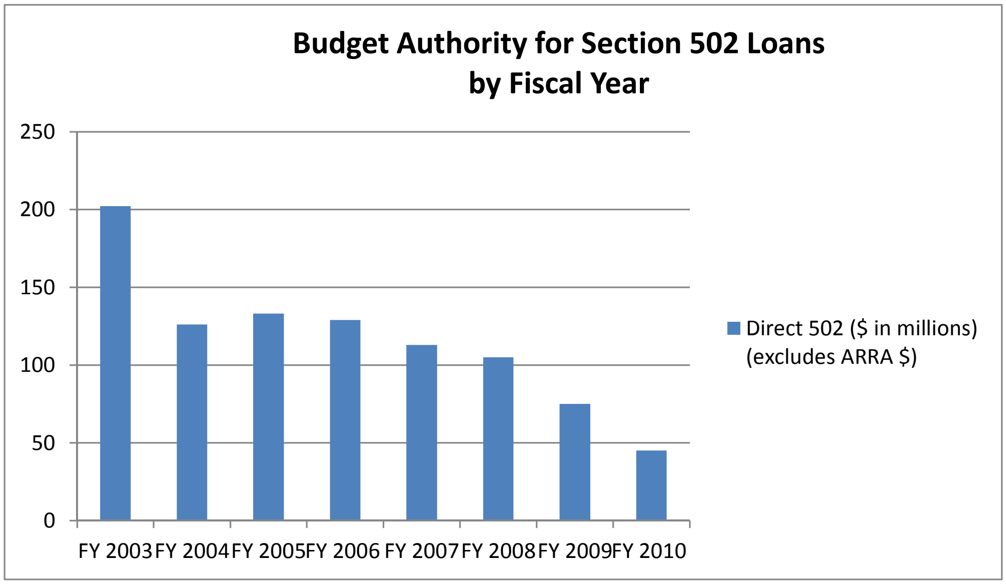
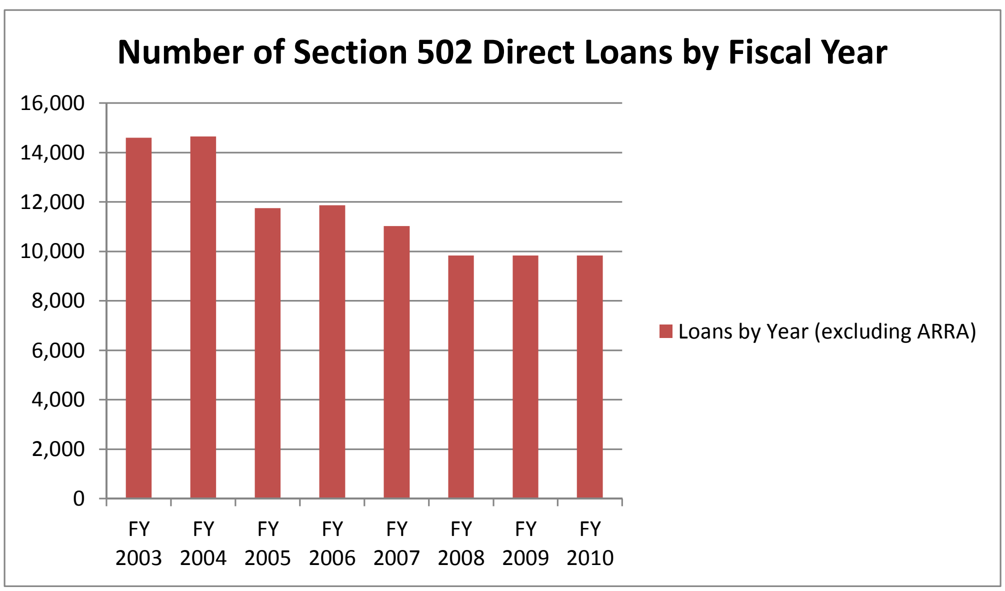


CHART 4



American Recovery and Reinvestment Act

In February 2009, Congress passed the American Recovery and Reinvestment Act (ARRA), which provided budget authority in an amount necessary to provide some $1.4 billion in additional Section 502 loans to low income families. ARRA funds were available through September 30, 2010. In FY 10, using a combination of appropriations from the ARRA and regular FY 10 appropriations, USDA and its Rural Housing Service (RHS) obligated a total of $2.145 billion in direct Section 502 loans, which is the most since 1983. Of the total, $755 million was used for loans for very low income households. Overall RHS made 17,640 loans with an average loan amount of $121,600.

Despite lending to families with limited incomes, the Section 502 Direct Loan Program has a record of success in not only improving housing opportunities, but also protecting the federal investment. For example, during the last year USDA Rural Development in California foreclosed on only 57 mortgages out of a loan portfolio of nearly 10,000 loans. This is a foreclosure rate of just over 0.5%. During the entire year just ended 176 loans went into foreclosure, which is a rate well below the conventional market, and stands in stark contrast to what is happening in the conventional market in California. Nationally the foreclosure rate on direct loans is 4.23%.

How Section 502 Direct and Guaranteed Loans Work Together

As Charts 1 and 2 indicate, the Section 502 direct and guaranteed programs serve very different populations but provide a continuum of financing options for very low, low and moderate income families. Close to 80% of direct households have incomes of $35,000 or less. About 75% of guaranteed borrowers have incomes above $35,000. Most direct program borrowers have incomes at or below 60% of median. Most guaranteed borrowers have incomes of at least 90% of median with almost 50% having incomes of at least 100% of median.

With the average income of direct borrowers at 56% of the income of guaranteed borrowers ($27,000 vs. $48,000), it follows that interest rates for direct loans are lower. Interest rates on Section 502 loans average 4% and are based on affordability to the family under USDA payment assistance regulations. Interest on guaranteed loans are set by the market but are capped at the Fannie Mae 90 day delivery rate plus 60 basis points rounded up to the nearest quarter. At this time the Fannie Mae rate is 5.125% for a 30 year term. In recent weeks mortgage interest rates have been on the rise.

Recommendation: Congress and the Administration should continue to support appropriations for Section 502 Direct Loans. There is no question that this is the most cost effective, affordable housing program in the federal government. It is also clear that the Section 502 guarantee program, while an important resource for rural America, does not serve the same market as the direct program. In fact, the sheer size of the guarantee program, which could reach $24 billion in FY 11, has distracted USDA and diverted staff resources from other programs designed to assist lower income households.

Limitations of Subsidy

For several years, USDA has reduced subsidies for Section 502 Direct Loans. In 1995, RHS changed the subsidy mechanism for Section 502 from an interest credit system to payment assistance. Under interest credit, eligible households could receive a mortgage interest rate as low as 1%. To save money, RHS moved to payment assistance, with the amount of the subsidy based on annual income and expenses. Eligible households pay 22, 24, or 26 percent of their adjusted annual income, depending on their income level. Payment assistance reduced Section 502 interest subsidy cost by about 30%, making it a far less costly program for the federal government.

In December, 2007, RHS finalized a new rule on Section 502, further reducing the cost to the federal government. For very low income households it raised the minimum housing payment (principal, interest, taxes and insurance) to the higher of 24% of income or a 1% loan. In effect, this rule ended 1% loans for many very low income families. RHS took this action despite receiving numerous comments of the negative impact on the families.

Delivery System Issues

The present day RHS delivery system constitutes 700-800 regional and state offices. The structure is a far cry from the 2,800 office in the Farmers Home Administration system in that was phased out beginning in the 1990's. In response to this diminished field capacity, USDA has shifted the manner in which it does business. More servicing is done electronically by the central processing office based in St. Louis.

USDA and Congress have also shifted the emphasis of assistance available. With expansion of the guarantee program USDA has shifted loan documentation and processing to private lenders. USDA has streamlined its processing so that guaranteed loans can be approved in as little as 24 hours.

None of the improvements made in processing guarantees have migrated to the direct side of the business. Rural housing organizations struggle with processing requirements and procedures that vary among states and between offices in the same state and in essence are an arcane way of originating mortgages

Despite the lack of consistency, there are success stories. For example, in the Northeast, PathStone Corporation has developed a way to work with USDA that allows swift approval. Of direct loan applicants, PathStone gets 50-60 502 loans through every year. With great cooperation from USDA, PathStone works with families to determine their eligibility and assist them by estimating the amount they can borrow, obtaining their credit report and scheduling appraisals. To assist the families in qualifying, PathStone comes up with grant assistance from other public and private sources. In other states, coordination between the state Rural Development offices is more limited and, therefore, the pace is much slower. Consequently, it is not unusual for a 2-3 month wait for processing of loans.

Often the major delay is the processing of required property appraisals. Under pressure to obligate loan authority available under ARRA and FY 10 appropriations, RHS modified its appraisal policy in the closing days of FY 10 to expedite the processing of Section 502 Direct Loans. It is important to note that at least some of the success of the PathStone program is their coordination with RHS scheduling appraisals.

In 2009, USDA launched a demonstration to allow trained packagers to work more closely with the RHS office on assembly and processing of the 502 loan requests. With training provided by national housing organizations, a local and regional organizations formed a regional consortia to coordinate with USDA state and national offices. While the launch was slow, the consortia that came together to work with RHS made progress in working with state offices. For example, in the Southeast, FAHE and its RD offices were able to reduce processing time from 118 days – the three year average (2005-08) – to an average of 52 days.

However, the demonstration is limited to 4 regions, serving portions of nine states, leaving much of the country uncovered. Resources are extremely limited for the non-profit organizations participating in the program. In addition, overall progress in streamlining, standardizing and improving processing of direct loans remains at the beginning stages.

Recommendation: RHS should accelerate efforts to streamline packaging and processing of direct Section 502 loans. This should include expanding the consortium model launched in 2009 as well as replicating the inter-agency cooperation such as that fostered by PathStone.

For many years, one of the key elements in the delivery of Section 502 Direct Loans has been the Self Help Housing Program. Self-Help Housing makes homeownership affordable by enabling low income families to build their own homes.

In many rural communities, particularly in the West, the steep decline in real estate values caused by the recession has resulted in a substantial slowdown in construction of affordable and Self-Help Housing. Even in communities in which there is substantial foreclosed inventory, the housing available is generally unaffordable to low income families. Yet, the availability of this housing is depressing real estate values, making it difficult to obtain appraisals that equal the cost of land and construction.

For profit housing developers acquire land with the hope that as land values rise, they will be able to earn a profit by selling at future appreciated prices. While these builders have also been ensnared by the declining value of real estate, substantial tax breaks enacted by the 111th Congress have allowed them to sell land at a loss and apply those losses to previous years, for which they incurred a federal tax liability. This so-called carryback provision totals $60 billion in revenue loss to the federal government.

Self-Help Homes and other non-profit housing developers invest in land for the opposite reason – to lock in costs in order to create opportunity for decent affordable housing for families who would otherwise be locked out of the marketplace. During the period of rapid, high appreciation, Self-Help Housing and other non-profits extended themselves in order to provide future opportunity for low and very low income self-help families. This investment went well beyond any guarantee, grant or program funds, and reflects a deep commitment to the future of mutual self-help housing. Using a combination of borrowed capital and our own resources, these organizations extended their finances in order to continue to meet the increasingly difficult challenge of providing homeownership opportunities for those families willing to invest themselves in mutual self-help homebuilding and other affordable housing efforts. However, the inevitable result of the land problem confronting many self help housing organizations is a falloff in production, and therefore, less production of Section 502 loans for low and very low income families.

Recommendation: RHS should revise regulations and procedures to facilitate the efforts of self help housing organizations working in communities with declining land values. In

these communities there is an unquestioned need for housing and economic benefit that comes with self help housing. Given USDA's stated commitment to double the size of the Self Help Housing Program, it is essential that the Department develop a workable solution in a timely fashion.

Why Do We Need Section 502?

In these tight budget times, there is some question about the need for section 502 and other rural housing assistance provided by USDA. Part of the answer lies in the performance of other federal programs in working with America's small town and farming communities.

For example:

- Less than 7 percent of FHA assistance goes to non-metro areas. On a per-capita basis, rural counties fare worse with FHA, getting only $25 per capita versus $264 per capita in metro areas;
- Only about 10 percent of Veterans Affairs housing programs reach non-metro areas and per capita spending in rural counties is only one-third that of metro areas;
- Only 12 percent of section 8 funds go to non-metro areas;
- There is no set-aside for rural areas under the HOME program. States receive 40% of Home funds. However, states have the authority to shift some of that 40% to urban areas so very often the amount going to small communities is less than 40%;
- Although the CDBG has the State and Small Cities Block Grant program, there is a significant problem for rural areas from a targeting standpoint. States may award grants to communities with populations up to 50,000. This means that small rural communities must compete with larger jurisdictions for funding; and
- Since the demise of section 515 in the mid-1990's had already made the made rental housing development in rural America exceedingly difficult. With the limited availability of a financing source to go with the LIHTC, with little or no rural rental assistance available for new construction and with the term of the rental assistance contracts shrinking it is little wonder that even before the current financial services debacle, rural areas were doing poorly on Low Income Housing Tax Credits**. A recent ABT report commissioned by HUD indicates a low rate of non-metro participation in the Low Income Housing Tax Credit. During 1995-2004, only 13% of the units financed by LIHTC went to non-metro areas.**

In short, even as spending on rural housing program has declined, there is little evidence that other federal agencies have picked up the slack. For many rural communities the only affordable housing in town is that finance by USDA.

January, 2011

Section 502 success stories

<u>Pathfinder Community Connections</u> has established a strong relationship with several regional USDA offices in Indiana. Working in conjunction with these offices Pathfinder Community Connections was able to package and close on 271 loans with an average PITI of $518 per month during the Federal FY2010. Currently for Federal FY2011, Pathfinder Community Connections has facilitated 25 closings and has 88 files in their pipeline with USDA offices. Pathfinder Community Connections attributes this success not only to their 12 year relationship with USDA rural Development staff, but also to the partnerships they have built with local builders, realtors and lenders. They are a one stop shop, assisting buyers through pre-qualification, financial fitness and homebuyer education, loan packaging, grant assistance, which amounted to $834,000 last FFY, the closing process and when needed post purchase counseling. In cooperation with USDA staff, Pathfinder Community Connections packages their loans, gathers all documentation required from the borrower, sends out all verifications necessary to process the loan, figures borrower and household income, analyzes credit reports and sends a complete electronic loan application file to USDA staff for their origination and underwriting. Additionally Pathfinder Community Connections collects the credit report fee from the borrower and sends it to USDA saving an average of one week of processing time. Pathfinder Community Connections maintains daily contact with USDA staff regarding the status of their files, helps to communicate to all parties about loan conferences and closing dates to ensure timely closings, and obtains further documentation from borrowers, realtors and builders as needed by USDA.

<u>Rosa Martinez</u>

This story begins with a family that was torn apart through divorce. Not only did this family lose the association of their husband and father, but they were uprooted from New Mexico and replanted in a new home in Utah. The family struggled to adjust to their new home, which was a small apartment in a complex for low-income families. Rosa and her family never really got used to living in a place that was dark and felt unsafe. The exterior lights of the apartment complex were always broken by unruly youth that also lived in the complex. It was a scary experience for her and her family to return home in the dark, and have the task of walking up several flights of stairs without any lights. Her teenage daughter had fallen down the unlit stairs once and was injured. Rosa's call for the lights to be replaced fell on deaf ears. Rosa knew she needed to improve her life and the lives of her children.

The first thing Rosa did was move her family into a more suitable apartment, and then she found part-time work as a flight locator and enrolled in an on-line school to get an education. Getting an education on-line allowed her to be home when her 9-year-old twin boys got home from school. Rosa could then spend the time necessary to help her learning disabled boys with their homework. Her two teenage daughters agreed to help around the house.

When Rosa heard about the Mutual Self-Help Program from a friend, she came into our office with hopes of finding better living conditions for herself and her four children. When she was finally approved to build an affordable 3-bedroom home in Eagle Mountain, she was elated.

The road for Rosa and her family has been hard one. Her attitude and determination to improve her life and the lives of her children will ultimately help her reach her destination. The road from here will continue to be bumpy, but the friendships and confidence that she is building as she is building her home, will help carry her over the rough parts. The scared, unsafe feelings once experienced by Rosa and her family will soon be replaced by feelings of success, friendship, optimism and hope for a better future.

Direct Section 502 Loan Assistance for Teachers in California

Jaime and April Huerta became homeowners on July 14, 2010 with the financial assistance of a direct Section 502 Loan from USDA — Rural Development and a cooperative effort with the Planning Department of the County of Santa Cruz.

Jaime Huerta is a Spanish language teacher at Monte Vista Christian School in Watsonville, California where he has taught for nine years. April Huerta is a homemaker and they have two young children, Rachel age 3 and Ethan age 2. Prior to moving into their new home, Mr. and Mrs. Huerta lived with their two children in a deteriorated two-bedroom modular rental home. Their rental home was structurally unsound and prone to pest infestations. With the purchase of their new home, they now live in a modern, energy-efficient three-bedroom, two-bathroom single-family residence. The home is located on a 6,000 square foot lot with a fenced and landscaped backyard that offers a safe environment for their children. Their new home is only two miles from Mr. Huerta's school.

While many direct Section 502 Loans were made in California in fiscal year 2010, this particular loan is out of the ordinary because it is the first direct Section 502 Loan made in Santa Cruz County in at least 30 years. Making the direct Section 502 Loan Program work in Santa Cruz County has long been challenging due to the high price of real estate. Even with the decline in real estate prices during the last three years, prices in Santa Cruz County have remained relatively high and beyond the means of many lower and moderate income families; particularly essential professionals such as teachers. With the unique financial assistance of the direct Section 502 Loan Program and a cooperative effort with the County of Santa Cruz, Mr. and Mrs. Huerta's dream of owning a safe, decent and affordable home in the community where Mr.Huerta serves as a teacher has been achieved.