Rural Rental Housing Prepayment and Preservation

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The Section 515 Rural Rental Housing program run by the U.S. Department of Agriculture (USDA) has proven extremely successful at providing decent, affordable housing for the lowest income rural Americans. The majority of Section 515 apartments were built before 1995, however, and many of these older buildings need significant physical repairs or updates. At the same time, significant numbers of Section 515 loans are in danger of being paid off, potentially enabling their owners to convert the units to market rents and displace current tenants.

RURAL RENTAL HOUSING NEED

Nearly 5 million rural households (about one-quarter of the total) rent their homes. They suffer some of the worst housing problems in the United States.

- Housing costs are the most significant problem facing rural renter households. More than one-third of them are cost burdened (i.e., they pay over 30 percent of their income for housing). There is no place in the country where the prevailing minimum wage is enough to afford the standard rent level established for a modest one-bedroom apartment by the federal Department of Housing and Urban Development (HUD).
- Worst case needs, as defined by HUD, afflict one in every four very low-income renter households in nonmetropolitan areas. That is, they are extremely cost burdened and/or inadequately housed, and they do not receive federal housing assistance. The vast majority of these households are severely cost burdened, paying more than half of their income for their housing costs.
- Rural renters are twice as likely as owners to live in physically substandard housing. Approximately 12 percent of nonmetro renters live in either moderately or severely inadequate housing; for minorities, the rate rises to 18 percent.

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- Elderly people often face some of the worst housing conditions. In many rural areas, if a low-income senior cannot find an affordable apartment, her choices are likely to be a nursing home or relocation to an unfamiliar urban area.
- Rent subsidies alone cannot end rural America's rental housing problems. Too often there simply are not enough rental units. Furthermore, funding for HUD's Section 8 vouchers, which help tenants pay rent for market-rate housing, is being frozen or reduced despite increases in rent costs. In some rural places, vouchers are not available because administering agencies do not exist everywhere.

THE SECTION 515 PROGRAM

The Section 515 Rural Rental Housing program provides mortgage loans to develop rental housing for very low-, low- and moderate-income tenants. Section 515 loans are often used in conjunction with Low Income Housing Tax Credits. Section 515 funds may also be used to provide equity to certain owners of existing Section 515-financed properties as an incentive to avoid prepayment and preserve affordable housing.

Section 515 is administered by the Rural Housing Service (RHS) at the national level. At the state and local levels USDA's Rural Development (RD) offices run this program as well as many others. Both RHS and RD are agencies of the U.S. Department of Agriculture and successors to the former Farmers Home Administration.

Section 515 has been the mainstay of the Rural Housing Service's efforts to serve the poorest of the rural poor. From 1963 (when Section 515 began operating) through 2005, the program has produced housing developments containing a total of 527,872 units – more than half a million rental homes that are affordable for low-income rural residents. As of November 1, 2003, RHS's Section 515 portfolio contained 15,899 projects providing homes for 434,296 households with an average annual income of $9,075. People who were elderly or had disabilities occupied 58 percent of the units.

Over the years, Section 515 has suffered severe funding cuts. New unit production peaked at 38,650 in 1979 and dwindled to a low of 783 in FY 2005. Funding reductions in the past decade seem to have been motivated both by the program's cost and by the belief that developers are obtaining excess profits from Section 515 developments, based on scandals in a small part of the portfolio in the early 1990s. Concerns about profittaking by developers have long since been addressed by changes in the program, however.

The Section 515 program does cost the government more than some other housing programs, such as Low Income Housing Tax Credits or loan guarantees (Section 538 is USDA's rental housing loan guarantee program). This is because it serves the lowest income rural residents – people who, without it, are likely to face serious housing problems.

USDA's Section 521 Rental Assistance (RA) adds further help for tenants, such as elderly and disabled people on fixed incomes. RA is available only for tenants of developments financed under Section 515 or the Section 514/516 farmworker housing program. Units produced with Section 538 or tax credit funding do not qualify for Rental Assistance and are not affordable to the lowest income tenants unless they obtain further aid from another source.

PREPAYMENT AND PRESERVATION IN SECTION 515

The term "preservation" can refer to (1) maintaining or improving the physical condition of Section 515 properties, or (2) keeping Section 515 properties available and affordable for the kinds of tenants the program currently serves.

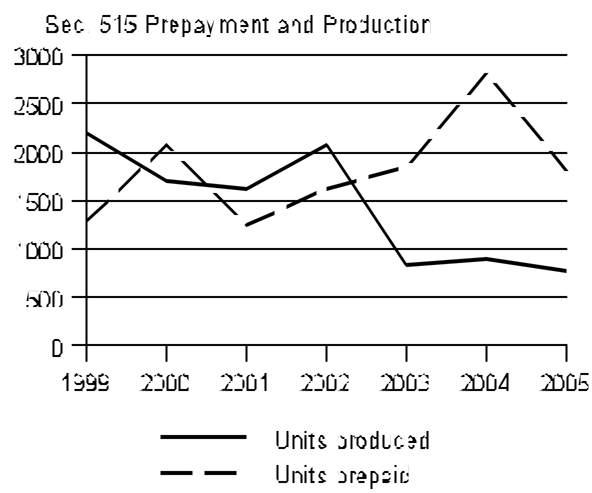
USDA, property owners, and tenant advocates all agree on the importance of maintaining or improving property conditions. According to a Comprehensive Property Assessment (CPA) conducted for RHS in 2003-2004, the average age of properties in its Section 515 portfolio is 23 years. Researchers found the physical conditions of the properties did not pose any serious immediate health and safety problems, but warned that many properties would face significant physical needs in the immediate future.

None of the properties has enough money in reserve to address its physical needs over time. Researchers calculated the total cost to prevent physical deterioration of Section 515 properties would be $2.6 billion over 20 years. People representing the various interests involved disagree on how to deal with that significant cost.

They also disagree on how and to what extent to keep current 515 properties available for very low-income tenants. USDA's Comprehensive Property Assessment reported that owners of 9,698 of the properties (61 percent) have the right to prepay their mortgages. (Section 515 mortgages made after December 15, 1989 cannot be prepaid.) Researchers calculated that it would be economically viable for owners to prepay mortgages on 1,648 of the properties (10.4 percent), accounting for about 46,000 apartments.

When a subsidized loan is prepaid the apartments may continue to be available to low-income tenants, or they may be converted to market rents or to condominiums. In the latter cases, tenants can no longer afford their homes.

The Section 515 stock is losing units to prepayment faster than new ones are being built. In fiscal year 2004, more than three times as many units were prepaid (2,812) as were produced (902); in FY 2005, fewer units were prepaid (1,812), fewer were produced (783), and fewer of the prepayments protected current tenants. In 2004, at least 72 percent of units were prepaid with provisions protecting their tenants, but in 2005 that proportion dropped to 47 percent. Furthermore, the rent protections seldom apply to future tenants, and when current tenants want or need to move the rent protections do not move with them.



Owners seek to prepay for varying reasons, including the expiration of tax benefits, the burden of increased servicing requirements, the desire of some small project owners to retire and, in some rural areas, an increase in vacancies due to out-migration. As is the case for owners of HUD multifamily projects, Section 515 owners' ability to prepay is restricted by federal law. The details vary depending when a loan was approved, but in all cases RHS is either permitted or required to offer owners incentives not to prepay, and in exchange the property continues to be restricted to low-income occupancy for 20 years. These incentives include equity loans, increases in the rate of return on investment, reduced interest rates, and additional rental assistance. In some cases, an owner that rejects the offered incentive(s) must offer the project for sale to a nonprofit or public agency.

The government may be required to pay damages to owners because of these prepayment restrictions. An August 2004 court ruling requires USDA to pay over $13 million in lost profits to the owners of 37 of the 41 projects involved in a case known as *Franconia Associates v. United States.* More details about litigation are provided in HAC's information sheet on current policy issues related to rural preservation.

RECOMMENDATIONS

At a national conference on rural rental housing preservation in April 2005, a multi-lateral task force released its final report on the subject. The group was comprised of individuals representing the many interests involved – owners, tenants, private lenders, local nonprofit developers, and national nonprofit housing organizations – and was convened by the Housing Assistance Council and the National Housing Law Project with funding from the John D. and Catherine T. MacArthur Foundation. The Task Force agreed on three broad recommendations and several categories of more detailed recommendations:

- *Strengthen incentives and administrative processes to encourage responsible stewardship of the 515 portfolio.*

  - ✓ Give more authority to the Rural Housing Service National Office and take other steps to ensure timely, consistent, coordinated actions by USDA Rural Development and RHS offices.
  - ✓ Facilitate transfers of properties to owners that commit to keeping them decent, safe, sanitary, and affordable for long-term occupancy by low- and very low-income households.
  - ✓ Identify special strategies to preserve small properties in remote areas.
  - ✓ Improve information sharing and communications.

- *Preserve for long-term occupancy by low- and very low-income households all properties currently in the Section 515 portfolio that are needed in their communities. Revitalize the properties' physical condition so that all are, and are maintained as, decent, safe, and sanitary housing.*

  - ✓ Increase the supply and efficiency of funding from all sources for all preservation purposes (revitalization, refinancing by remaining owners, and financing by new owners).
  - ✓ Empower and enable third-party funding.

- *Protect tenants.*

  - ✓ Protect tenants against displacement, ensure that their homes remain decent, safe, sanitary, and affordable, and ensure that the housing is managed in a manner that protects their interests.

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HAC, founded in 1971, is a nonprofit corporation that supports the development of rural low-income housing nationwide. HAC provides technical housing services, loans from a revolving fund, housing program and policy assistance, research and demonstration projects, and training and information services. HAC is an equal opportunity lender.

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