Report

Very Low-Income Loan Obligations Within USDA's Section 502 Direct Homeownership Loan Program

Housing Assistance Council

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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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In presenting this report, the Housing Assistance Council remembers Art Collings, who passed away in March 2010. A former Farmers Home Administration and HAC employee, Art worked tirelessly to improve USDA housing programs and make these resources available and accessible to low-income rural Americans.

EXECUTIVE SUMMARY

Since 1950, the U.S. Department of Agriculture's (USDA's) Rural Development (RD) Section 502 direct loan program has helped more than 2 million low-income households become homeowners. By statute, at least 40 percent of Section 502 direct lending must be set aside for very low-income borrowers (i.e., households with incomes less than 50 percent of area median income). In recent years, RD has had increasing difficulty reaching this 40 percent target. The Housing Assistance Council (HAC) was asked to conduct research to identify factors that have contributed to the decreasing rate of very low-income loan obligations and to recommend strategies to address these challenges.

Data Analysis

As part of this study, HAC analyzed more than 300,000 Section 502 direct loan application and loan obligation records to identify trends within the program that may contribute to the decreased rate of very low-income loan obligations. These data were supplemented with demographic, lending, and other data sources, including Home Mortgage Disclosure Act data and census data.

HAC also interviewed RD staff in states that have had varying experiences in meeting the 40 percent very low-income obligation rate. RD staff were asked to comment on the local housing market, program outreach, and loan processing. The insights provided through these interviews have been used throughout the report to illustrate program trends. HAC also hosted a roundtable discussion with nonprofit stakeholders who work with the program in efforts to offer affordable housing options to their clients. These interviews provided local context, as well as insight into how the program operates.

Using these data, HAC tested three theories to determine the extent to which the following specific factors have contributed to the decline in lending to very low-income borrowers:

- ***Application volume and disposition trends***. Has there been a decline in very low-income applications or an increase in denials to these applicants that account for decreased lending to very low-income borrowers?

- ***Program administration and terms***. Are there specific factors related to Rural Development's structure or the program itself that contribute to the decreased rate of lending to very low-income applicants?

- ***Economic and social factors***. What role do external factors, such as geography and housing markets, play in contributing to the decrease in lending to very low-income borrowers?

Findings

HAC's analysis of very low-income loan obligations in the Section 502 program revealed the following:

- ***The number of Section 502 applications has decreased.*** The decrease in very low-income loan obligations reflects an overall decrease in the number of Section 502 loan applications. From fiscal year (FY) 2004 through FY2009, the number of applications decreased by more than one third. This drop in loan applications is consistent not only with the decrease in loans to very low-income borrowers, but also with a precipitous decline in the volume of loan applications nationally as recorded in Home Mortgage Disclosure Act data. The proportion of very low-income loan denials has remained level over the past five years. Among those applications that were rejected, the predominant reason for rejection was credit history.

- ***RD has a reduced presence in many communities***. Rural Development has closed a number of local offices that had previously been located in rural communities. The pattern of funding shows that almost one-third of all Section 502 loan obligations were made in counties where there is currently a local office. As noted by RD staff, very low-income applications often require extensive one-on-one interactions in order to address the individual needs of those borrowers.

- ***Self-help housing reaches a lower percentage of very low-income borrowers***. Section 502 loan applications for self-help housing decreased in rates similar to the overall portfolio for the study period. However, the proportion of very low-income applications for self-help loans has traditionally been somewhat lower than the overall portfolio: In 2004, fewer than 50 percent of all self-help applications were for very low-income borrowers; this decreased to 38 percent in 2007–2008. The data suggest that the cost of constructing self-help units in some markets has increased to such an extent that very low-income households may have difficulty participating in the program.

- ***Leverage is often necessary but has an unintended impact.*** Although the number of very low-income loans has been consistent, the total dollar value of these loans has decreased to such an extent that RD is not achieving its 40 percent goal. Additional resources are often necessary to make these loans work for very low-income borrowers; however, these resources reduce RD's overall investment, contributing to lower obligation amounts for very low-income borrowers.

- ***Payment Assistance 2 (PA 2) has not been in place long enough to determine its full effect.*** The PA 2 formula may be contributing to an imbalance in the amount of subsidy provided to very low-income applicants as compared with low-income applicants. The analysis also reveals that low-income and very low-income borrowers within the program are impacted very differently in terms of the PA 2 subsidy option. As such, low-income borrowers primarily pay 24 percent of the adjusted annual income, while the vast majority of very low-income borrowers pay the 1 percent of PITI option for their monthly mortgage payment. These differences are largely a factor of borrower incomes in relation to increasing housing costs. Based on available data, however, there is no indication that the inherent structure of PA 2 is substantially affecting eligibility or the ability of very low-income applicants to acquire a Section 502 direct loan.

- ***Housing costs have increased but incomes have remained stagnant.*** Although rural housing prices have not experienced the dramatic price changes that have occurred in other markets, there has been a significant increase in the cost of homes purchased through the Section 502 program in recent years. This increase mirrors the national trend seen over the past five years. Although housing costs have increased, the incomes of program participants have remained stagnant, which is perhaps the most significant factor contributing to the decrease in very low-income participants. Without the income needed to sustain homeownership, very low-income households may be unable to access this program. The income issue also contributes greatly to the credit problems that many of these households face, as they engage in economic activities that jeopardize their credit, thus creating additional barriers to homeownership.

Recommendations

Rural Development can do very little to address the significant role that increasing housing costs and stagnating incomes are having on the Section 502 program and very low-income loan obligations. Based on its analysis, however, HAC offers the following recommendations to address related issues that could help counteract the decline in very low-income loan obligations in the Section 502 direct program.

- ***Expand RD's capacity to identify and process very low-income applications.*** Efforts to increase lending among very low-income borrowers will require more time and effort from RD staff. Expanding staffing options will counteract the office closures, specifically closures that have occurred in areas that have seen little very low-income loan activity. Increasing staff capacity will also help with program marketing and processing issues. Additionally, Rural Development could formalize its working relationships with local nonprofit organizations that work with the Section 502 program and leverage this resource into added capacity for the agency.

- ***Support increased funding for housing counseling.*** Given the extreme credit issues facing very low-income borrowers, RD could improve access to the program by increasing resources devoted to improving the financial literacy of potential borrowers. By expanding funding for USDA's Section 525 program, RD would be providing critical resources to address credit issues and support the work of nonprofit partners that market the Section 502 program. A targeted effort could have a dramatic effect on increasing obligations to very low-income applicants.

- ***Address the growing loan-to-dollar disconnect.*** USDA should consider pursuing a change in legislation to make the requirement either 40 percent of loans or 40 percent of dollars. The growing disconnect between the number of loans and the dollar value of those loans is inextricably linked to the increase in housing prices. Very low-income borrowers will continue to need subsidies to make homeownership affordable in this economic context. Acknowledging the role that larger economic realities play in affecting RD's investment may require a significant change in how to measure lending for very low-income households.

  RD could also improve its tracking of the additional subsidies provided to borrowers to reduce the cost of the unit. By accounting for these additional funds, RD would have a more realistic picture of the total cost of the unit and the federal resources that were used to create affordable homeownership opportunities for very low-income borrowers. Additionally, RD could make the case that the Section 502 loan leveraged the additional subsidies and should therefore be counted towards the very low-income obligation goal.

- ***Increase affordability for very low-income applicants.*** Increasing housing costs and declining incomes are larger economic forces that are largely out of RD's control; however, Rural Development can help make the program more affordable for very low-income borrowers. RD could require its staff to qualify every very low-income application using both the 33-year and the 38-year term. These applicants would then have both options presented and make an informed decision concerning the loan term that works best for them. Increasing the term of the loan will mean that it could cost more for the household in the long term; however, it will decrease the initial costs of homeownership and increase access for those who may have limited income at the time of application.

  RD would also improve its service to very low-income applicants by encouraging the use of additional subsidies for these households. Given that housing prices have increased and applicant incomes have been stagnant, finding additional sources of subsidy would improve access to the program for those very low-income applicants who have difficulty accessing the program.

- ***Continue monitoring Payment Assistance 2.*** From the analyses conducted, there is no indication that PA 2 is intrinsically affecting very low-income obligations. However, increasing housing costs, in concert with stagnant applicant incomes, are impacting how very low-income applicants and borrowers are treated under the current subsidy formula. These simultaneous pressures are squeezing out very low-income applicants which may lead USDA to consider a modification of the subsidy formula to help mitigate the inevitable increase in housing prices in the future.

INTRODUCTION

The U.S. Department of Agriculture (USDA) Rural Development (RD) Section 502 direct lending program has helped more than 2 million low-income households become homeowners. By statute, at least 40 percent of the Section 502 funds appropriated each year must be set-aside and made available to assist families with incomes less than 50 percent of area median income (AMI) (i.e., very low-income households). RD encourages states to meet this standard by establishing low- and very low-income obligation targets for each state. In recent years, obligation data for the Section 502 direct loan program has reflected a downward trend in total obligations for very low-income households.

The Housing Assistance Council (HAC) conducted research to examine this trend and to identify the various programmatic and contextual (e.g., market) factors that may have contributed to the decreasing rate of very low-income Section 502 obligations. Based on this analysis, HAC has offered several recommendations to help RD better meet its very low-income loan obligation goals under the Section 502 program.

USDA's Section 502 Program

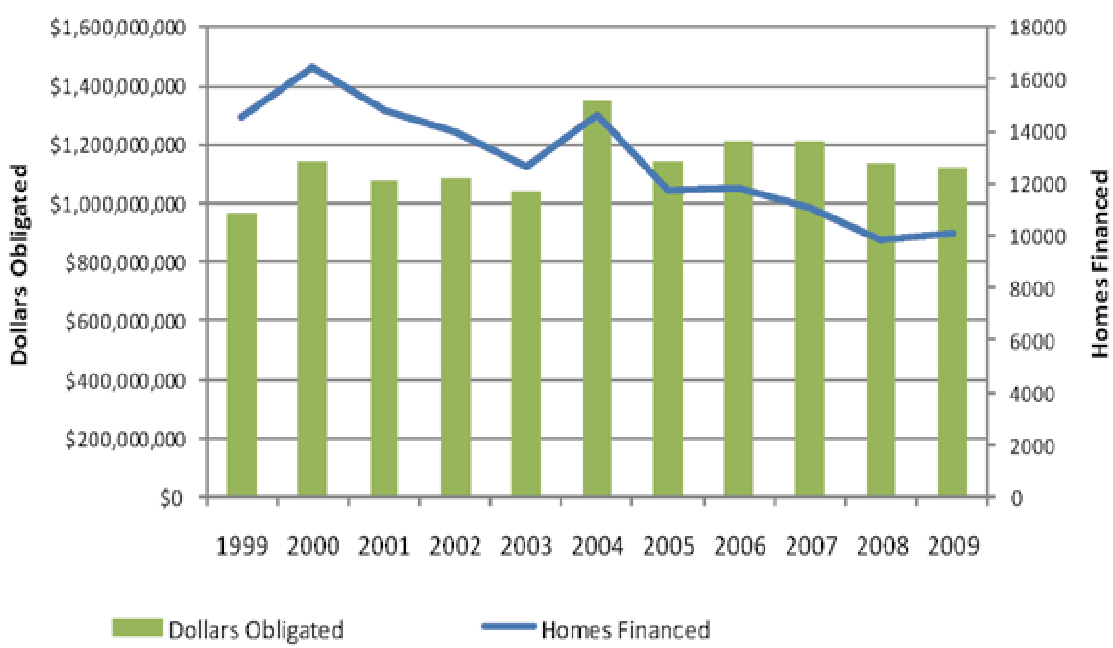
The Section 502 direct loan program, which is administered by USDA Rural Development, provides mortgages for low-income homebuyers in rural areas. Low-income residents can use Section 502 direct loans to purchase, repair, renovate, or relocate homes or to purchase and prepare sites, including providing water and sewage facilities. These loans may also be used to refinance debts to avoid losing a home or to make necessary home rehabilitation expenses affordable for a low-income household.

Funding for the Section 502 direct loan program has fluctuated slightly over the past decade. Since 1999, the annual Section 502 obligation has averaged $1.1 billion. These funds are distributed to each state based on an allocation formula that takes into consideration population, poverty, and housing needs.

Overview of Program Eligibility

Program applicants must have very low or low incomes. *Very low income* is defined as below

USDA Section 502 Direct Home Loan Program
Homes Financed and Dollars Obligated FY1999-FY2009



50 percent of AMI, while low income is between 50 and 80 percent of AMI. Families must be without adequate housing but be able to afford the mortgage payments, including taxes and insurance. In addition, applicants must be unable to obtain credit elsewhere, yet have reasonable credit histories.

An applicant's eligibility is also determined by repayment feasibility, which is a ratio of repayment (gross) income for principal, interests, taxes, and insurance (PITI) to total family debt. For very low-income households, PITI cannot exceed 29 percent of the repayment ratio, whereas for low-income borrowers it cannot exceed 33 percent. In addition, a borrower's debt load cannot exceed 41 percent of repayment income.

Loan terms are for up to 33 years, or 38 years for those with incomes below 60 percent of AMI and who cannot afford 33-year terms. The term for manufactured homes is 30 years. There is no required down payment for Section 502 direct loans.

Very Low-Income Obligation Requirement

By statute, at least 40 percent of the funds appropriated for the Section 502 direct loan program each year must be set aside and made available to assist families with incomes less than 50 percent of AMI. Specifically, Section 502(d)(1) of the Housing Act of 1949 (42 U.S. Code §1472(D)) states:

1. not less than 40 percent of the funds approved in appropriation Acts for use under this section shall be set aside and made available only for very low-income families or persons; and,
2. not less than 30 percent of the funds allocated to each State under this section shall be available only for very low-income families or persons.

In recent years the level of loan obligations to very low-income borrowers has continued to decline to the point of not meeting the statutory 40 percent very low-income obligation threshold. Data from the past few years illustrate a continuing reduction in the amount of Section 502 lending being made to very low-income households and signal a potential inability to meet the 40 percent threshold in coming years.

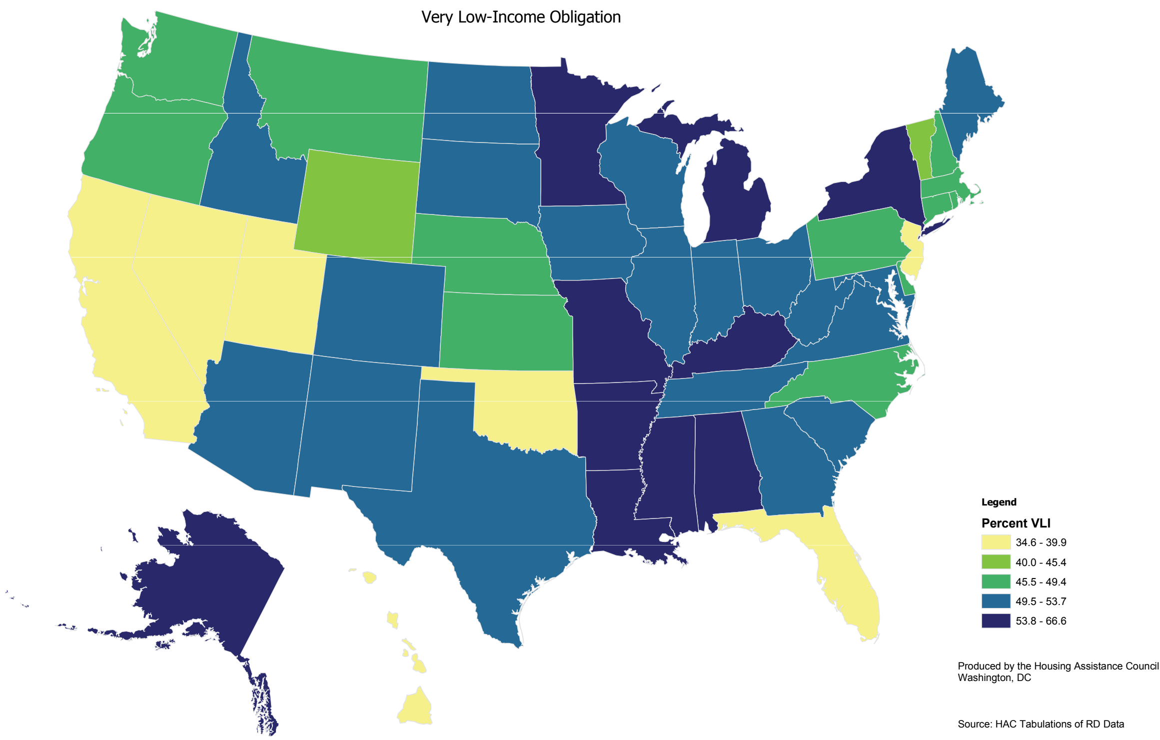
The extent of this issue is further highlighted by the geographic growth of this problem. In FY2004, only six states (California, Florida, Hawaii, Nevada, Oklahoma, and Utah) did not meet the 40 percent very low-income obligation threshold. By FY2009, the problem had become increasingly prevalent, as more than half of all states did not obligate 40 percent of their direct obligations to very low-income households.

HAC investigated those factors that contributed to the declining proportion of very low-income loan obligations. The purpose of this analysis is to determine the factors that make it difficult to lend to very low-income borrowers and to identify recommendations that address those challenges.

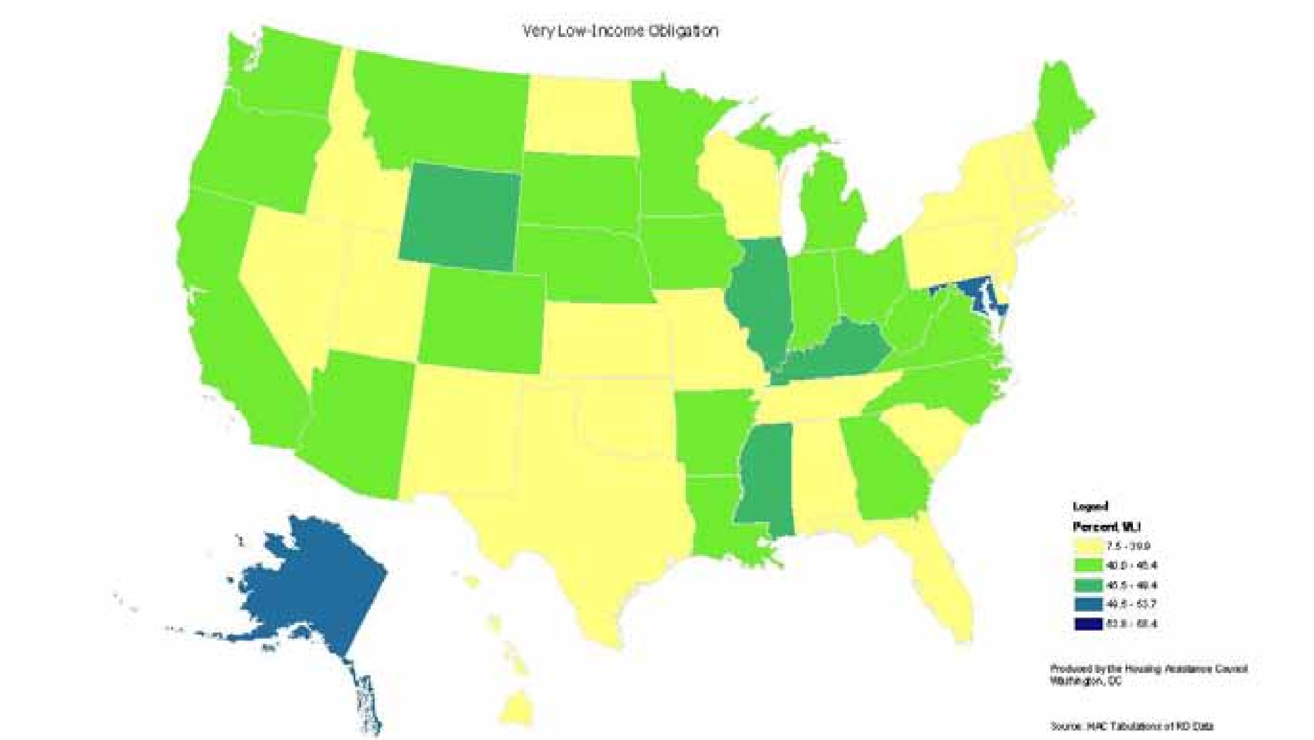
Table 1. Total Loan Obligation Amounts, FY2004 to FY2010

Fiscal Year	Low Income		Very Low-Income	
	Percent	Amount	Percent	Amount
2004	46.0%	$621,530,000	54.0%	$728,346,000
2005	48.7%	$537,643,371	51.3%	$565,487,591
2006	51.7%	$570,249,189	48.3%	$532,465,159
2007	52.2%	$576,661,470	47.8%	$528,456,623
2008	56.7%	$604,684,388	43.3%	$461,394,102
2009	60.0%	$672,745,679	40.0%	$448,469,097
2010	66.3%	$672,754,605	33.6%	$340,771,861

USDA Section 502 Very Low Income Loans Obligations FY 2004



USDA Section 502 Very Low Income Loans Obligations FY 2009



Methods

The Housing Assistance Council analyzed the Section 502 direct loan program to better understand factors and conditions that have contributed to the decline in very low-income loan obligations. This multifaceted analysis explored an array of internal and external factors associated with this lending program, as well as others revealed through interviews and an analysis of USDA data sets.

A primary component of the research included an analysis of Section 502 direct loan application and obligation data from FY2004 through FY2009. This analysis examined the extent to which very low-income loan obligations are affected by such characteristics as demand factors (e.g., a reduction in applications from very low-income applicants) and loan characteristics (e.g., loan types, terms, and rates). Another element of the study included an assessment of the Payment Assistance 2 (PA 2) formula to assess the formula's impact on determining applicant eligibility, specifically with regard to repayment ability.

The analysis also incorporated contextual factors, such as the cost of housing and construction; unit characteristics, such as the size and amenities of housing financed; potential impact of the self-help housing method; and geographic and regional variations. These contextual factors were included to the extent that reliable data are available and applicable.

In an effort to assess the impact of geographic and market factors, HAC also conducted qualitative interviews with RD officials and housing practitioners. These interviews, as well as assessments of the local housing and economic markets, illustrated the issues affecting various geographic areas. HAC then developed a series of recommendations, based on these analyses, that could be employed to address the very low-income loan trend.

Research Questions

Based on preliminary data analysis and interviews with stakeholders from the field, HAC identified three general areas of inquiry for this analysis. The following questions framed the overall analysis.

1. Can the decrease in very low-income loan obligations be accounted for by a parallel decrease in very low-income loan applications and/or by a spike in denials of these applications?

2. Are there structural factors related to the program or to RD's administration of the program that account for the declining very low-income lending rate? For example,
    - o What role does leveraging play in assessing the volume of lending to very low-income households?
    - o To what extent are self-help housing loans playing a role?
    - o Is the PA 2 subsidy formula making it more difficult for very low-income households to qualify for Section 502 loans?

3. Are there external economic or demographic forces that are making it more difficult for very low-income applicants to successfully access homeownership through the Section 502 direct program?

[1] FY2009 data provided by RD were through August 14, 2009. All references in this report to FY2009 figures are for the partial year from September 1, 2008 through August 14, 2009.

Data Collection and Analysis

HAC's analysis assessed internal (program-related) and external (contextual) variables and the extent to which these variables contributed to the decreasing rate of very low-income loan obligations. The research incorporated both quantitative and qualitative analyses of programmatic and demographic characteristics.

Data

To conduct the analyses, HAC solicited and received detailed programmatic information supplied by USDA. These data included a listing of approximately 239,000 Section 502 direct loan applications received between FY2004 and FY2009.[1] The application data provided basic information on each applicant, including location, income level, and disposition of the application. The analysis also incorporated information on recently obligated Section 502 direct loans. These data included approximately 65,000 detailed loan obligation records from FY2004 through FY2009. USDA provided longitudinal information on local programmatic loan and income limits, as well as supplemental information on structure-specific details for each home financed with a Section 502 direct loan from FY2004 to FY2009. In addition, external and market data from sources such as the U.S. Census Bureau, the U.S. Department of Housing and Urban Development, and the Home Mortgage Disclosure Act (HMDA), were used in this analysis.

Qualitative Interviews

The analysis included in-depth examinations of six states, which were selected based on several criteria. The primary factor used to select cases was very low-income obligation rate, which was calculated and averaged by state for the FY2004–FY2009 period; these averages were then ranked. Additional factors, such as total dollar obligation and program utilization, were used to aid in case study selection. In addition to state rankings, other factors, such as geographic diversity, were also taken into consideration.

In collaboration with RD and based on assessment of the criteria described above, HAC selected and investigated three states that have experienced difficulty meeting the 40 percent very low-income threshold (i.e., very low-income obligation rates below 40 percent): California, Florida, and Oklahoma. The research also includes information from states that consistently met or exceeded the 40 percent threshold: Louisiana, Maine, and Missouri. The research team conducted comprehensive interviews with RD housing staff members from each of the selected states to gain an understanding of local housing dynamics and to collect information on the marketing and processing of Section 502 loans.

In addition to these interviews, HAC hosted a roundtable discussion with nonprofit stakeholders from across the country. These stakeholders were asked to provide insight into the use of the Section 502 direct program in their communities, the challenges of reaching the very low-income population, and any recommendations they had for addressing this issue. Qualitative information from both the roundtable discussion and the individual interviews with RD housing staff is used throughout this report to illustrate trends reflected in the data and to highlight issues that cannot be thoroughly examined through the data analysis.

PROGRAM ACTIVITY

Inquiry 1
Can the decrease in very low-income loan obligations be accounted for by a parallel decrease in the volume of loan applications and/or by a spike in denials of these applications?

HAC analyzed 238,766 Section 502 loan application records to examine the level of program requests over the study period (FY2004-FY2009) and to identify loan disposition trends. This analysis provided some insight into the volume of Section 502 mortgage applications from very low-income applicants as it relates to the ultimate level of very low-income lending. Some limitations to these application data must be noted, however.

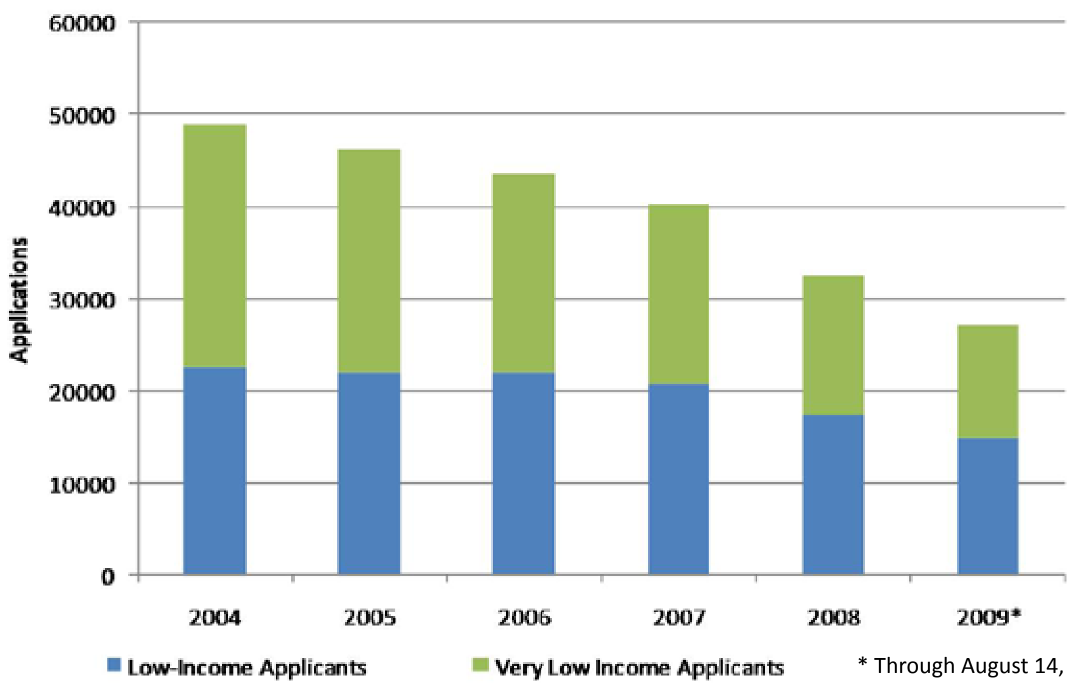
First, reporting on application data is uneven, and the amount and level of information provided varies greatly from state to state. As a result, there are gaps in the application data across states, as well as within individual applications. Second, the application data do not provide a complete picture of program demand, because an untold number of potential applicants may not officially apply to the program. Nonprofit stakeholders have noted that when they work with a family to apply for a Section 502 loan, they will often encourage the family to wait until they are certain the application meets USDA requirements. Consequently, there is a potential pool of applications that are not reflected in the data set because nonprofit partners or other entities are working with the applicants, preparing them for a successful application.

A third and related factor is the increased use of prequalifications during the study period. Several RD field staff reported the use of borrower prequalification and the impact this has had on application volume. With the prequalification system, a potential applicant is able to provide basic application information; RD can then determine whether the household is ready to move forward to the full application or whether more information or further counseling is in order. According to RD staff, this process is beneficial, because it provides a time-effective screen for the program; however, it has also reduced the number of overall applications.

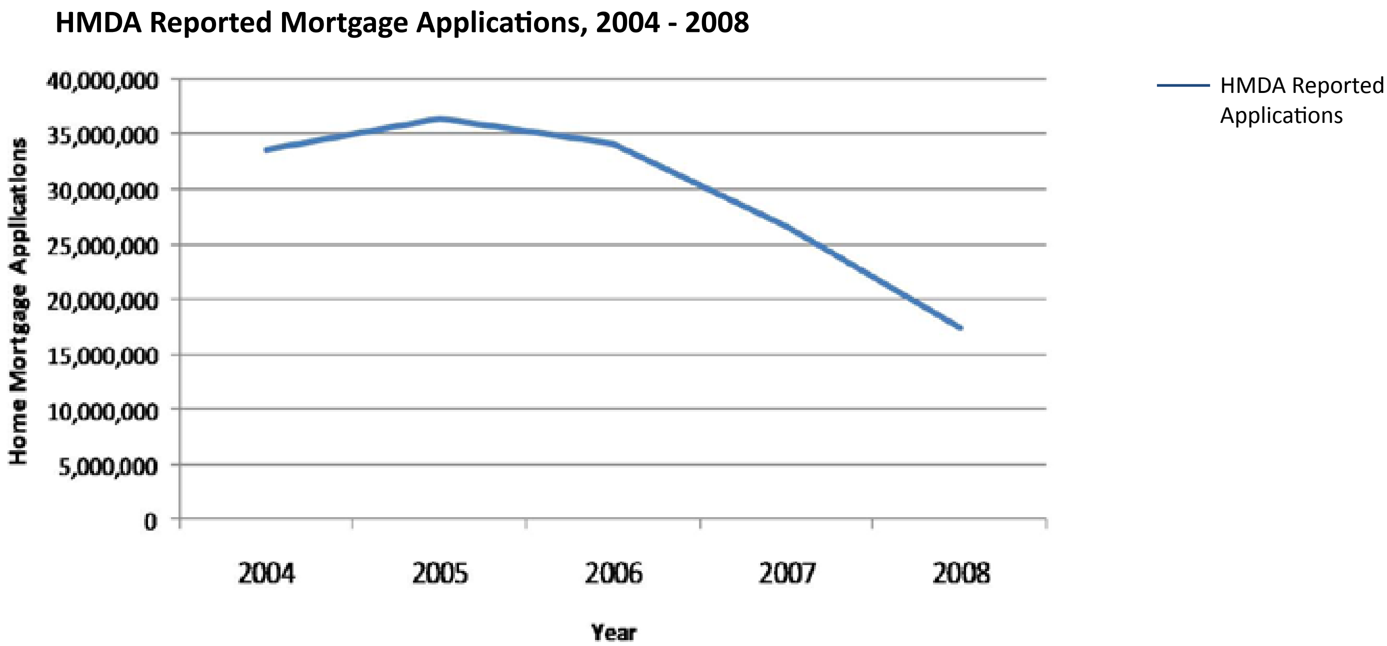
Application Volume

Despite the limitations in the application data, several important trends can be seen in this

USDA Section 502 Direct Homeownership Program Applications, FY2004-FY2009



* Through August 14, 2009



analysis. First, there has been a marked decrease in the number of loan applications received by RD for USDA Section 502 direct loans over the past five years. In FY2004, USDA reported nearly 50,000 applications for direct homeownership loans under the Section 502 program. By FY2008, the number of applications declined to approximately 32,000—a decrease of more than one third from the FY2004 level.

This reduction in USDA loan applications has somewhat mirrored the decline in mortgage loan activity nationwide. As reflected in Home Mortgage Disclosure Act (HMDA) data, the total number of mortgage loan applications nationwide declined from 33.6 million applications in 2004 to 17.4 million applications in 2008, a roughly 48.2 percent decrease in the five-year period (FFIEC, HAC 2008).

Very Low-Income Application Activity

Almost half of the application data (119,187) supplied by USDA was from very low-income applicants. Consistent with larger trends, the number of very low-income applications has declined over the past few years. In FY2004, there were more than 26,000 very low-income applicants, making up 54 percent of the total applicant pool. In FY2008, there was a little more than 15,000 very low-income applicants (less than half of all applicants), representing a 43 percent reduction since FY2004.
It is important to note that very low-income applications account for more than 60 percent of the decline in overall applications. Several factors may account for this precipitous decline. First, very low-income households are often operating at the financial margins and would be the first to avoid homeownership. Second, an increased number of subprime mortgage lenders began offering products targeted at low-income borrowers. In many cases, these lenders made loans more quickly than RD, often without stringent underwriting.

Loan Denials

Among the applications in the RD data set, a little more than 66,000 (27.7 percent) were "approved" during the five-year study period. More than half of the applications in the file (56.2 percent) were classified as "withdrawn," and about 6 percent (14,262) were identified as "pending." RD staff noted in interviews that many applications are classified as "pending" when applicants are told they need to provide additional information or address certain issues. Many of these applicants do not follow up on these needed actions, and some pursue alternative housing options.

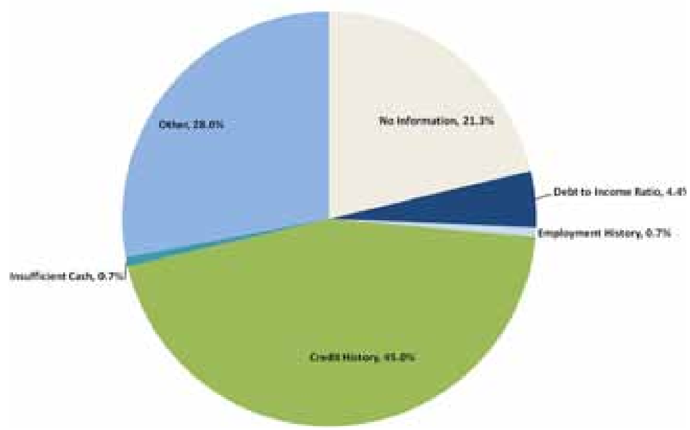
Over the five-year study period, 24,351 (10.2 percent) of the applications in the data set were rejected. The denial rate for very low-income applications was slightly higher, at 10.7 percent; this denial rate remained consistent over the five years.

Of the denied loan applications, the overwhelming reason for rejection was unfavorable credit history. Overall, 45 percent of denied applications were rejected based on credit history. Roughly one-fifth of denied applications lacked a reason for denial, and another 27 percent listed "other" as the primary reason for loan denial. Of the 12,440 very low-income loan applications that were denied over the study period, one-half were rejected because of credit history, a slightly higher proportion than in the overall portfolio.

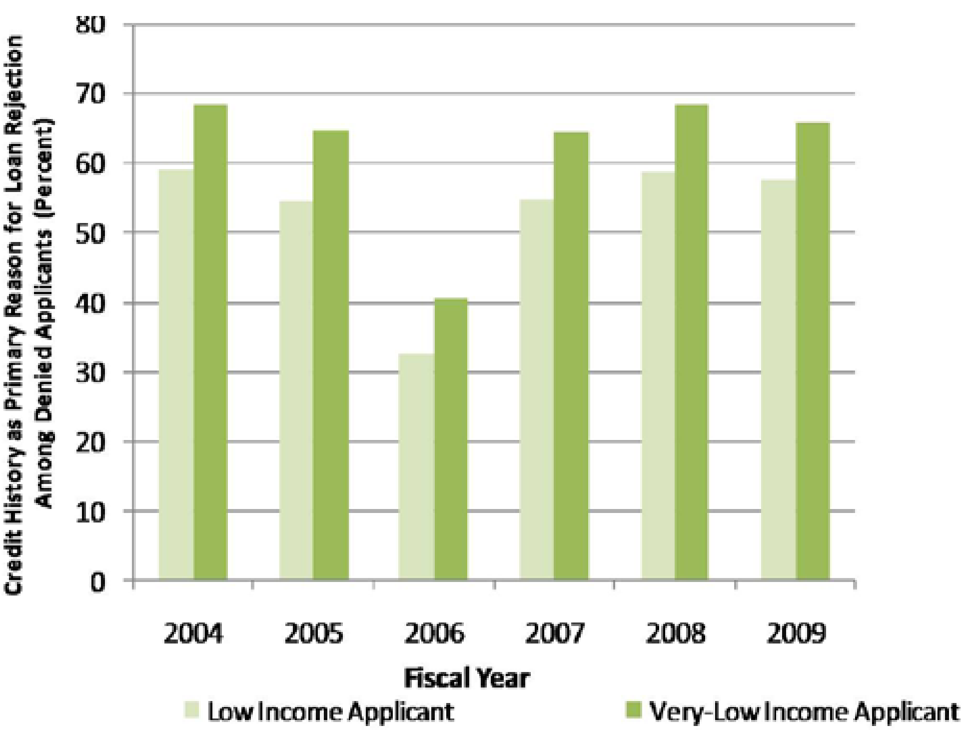
Nonprofit stakeholders have long commented that in order to qualify borrowers for homeownership programs, they must often go through hundreds of applicants. RD staff echoed this sentiment in their interviews, with several noting that they now must go through 50 to 100 potential applications in order to find one that qualifies for the program. Credit is the overwhelming reason for these denials. In addition to issues such as unpaid medical bills, several RD staff reported that there has been an increase in the number of credit collections associated with utility bills, cell phones, and other expenses.

For this and other reasons, several RD staff noted the need for face-to-face interaction with applicants—in particular, for very low-income applicants. Because of their credit issues, many very low-income households will either assume they do not qualify for the program or abandon their applications when they are informed that credit issues need to be addressed. According to RD staff, one-on-one dialogue with these applicants can help them understand the work that needs to be done and may lead to successful applications and borrowers.

USDA Section 502 Homeownership Program



Credit History as Reason for Loan Denial, FY 2004-FY2009



FINDINGS

- ***The volume of loan applications has decreased, particularly among very low-income households.*** The volume of Section 502 loan applications has decreased significantly over the past decade and a significant portion (60 percent) of that decrease is due to fewer loan applications from very low-income applicants. However, an unknown portion of this decline is the result of intentional prescreening on the part of RD and nonprofit stakeholders. For the most part, the decrease in applications mirrors loan application activity in the larger mortgage market, as reflected in the HMDA data set. The decrease in applications, specifically among very low-income applicants, reduces the overall pool of potential program participants.

- ***Denial rates for very low-income loan applications have not changed.*** Denial rates for loan applications submitted by very low-income applicants have remained at slightly more than 10 percent over the past five years.

- ***Credit is an overwhelming issue for many very low-income applicants.*** Although denial rates remained the same over the study period, RD staff noted that an increasing number of applicants could not qualify for the program because of poor credit history. Credit was an issue for more than 50 percent of the denied very low-income applications. Based on insights from RD staff, credit was likely a factor for many applicants whose files were marked as pending and/or withdrawn, as well as those loan program inquiries that did not become formal applications to the program. Additionally, many potential applicants never make it through the prequalification stage due to these credit issues and are therefore not reflected in the dataset.

PROGRAMMATIC FACTORS

Inquiry 2
Are there structural factors related to the Section 502 direct loan program or to Rural Development's administration of the program that account for the declining very low-income lending rate?

The Section 502 direct loan program relies almost solely on state and local RD staff to conduct outreach, solicit and process applications, and obligate funds. This activity requires a significant level of effort on the part of RD staff. For many years, RD offices were located in almost every county to provide direct services to applicants. In recent years, however, this unique structure has changed dramatically, resulting in fewer offices in rural communities and broadened responsibilities for staff. Given the role that staff and local offices play, it is possible that this change has affected RD's ability to meet the level of need and attention the program requires. In addition, several of the program's features—including leveraging, the self-help program, and the payment assistance formula—may have affected the cost of and access to the program for very low-income borrowers.

Rural Development Reorganization

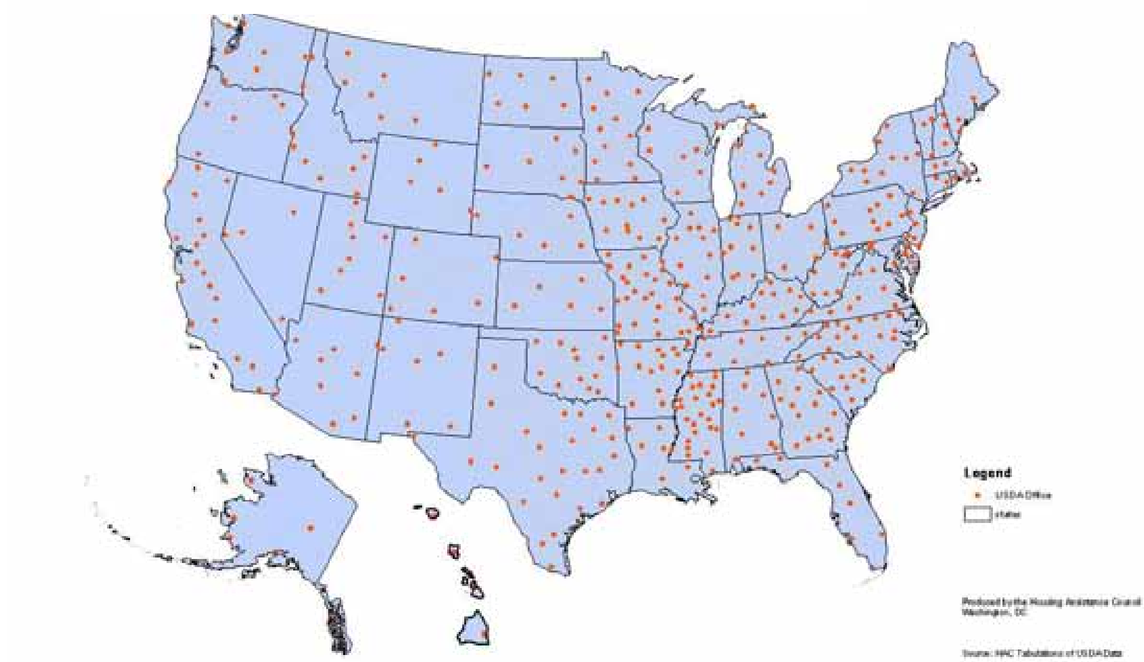
A unique characteristic of USDA's Rural Development programs and operation has been the use of county offices to provide direct services to local residents. From inception through the mid-1990s, the Section 502 direct loan program operated largely through county-level offices, where housing specialists worked one-on-one with rural households. Over the past decade, however, the number of county offices has decreased precipitously, reducing the agency's presence in rural communities. Five of the six states interviewed reported a significant decrease in the number of local RD offices over the past decade. In several cases, the number of offices decreased by 50 percent or more. Although each of these states had identified strategies to address this change in structure, several RD staff noted an ongoing need for one-on-one interaction with potential borrowers. RD staff stated that it is often critical to have face-to-face interactions with very low-income applicants in particular, to make the program work for this population.

To assess the impact of office location on access to loans, HAC plotted the location of each RD state or local office and examined lending patterns in relation to these office locations. This analysis of loans for the period from FY2004 to FY2009 showed that almost one-third of all Section 502 direct loans were made in counties that had an RD office. The majority (80 percent) of all Section 502 direct loans during this period were made either in those counties or in counties adjacent to an RD state or local office location. Without longitudinal data on the location of the closed county offices, it was not possible to determine the relationship between office location and lending activity. However, there was an evident concentration of activity in communities located near current office locations.

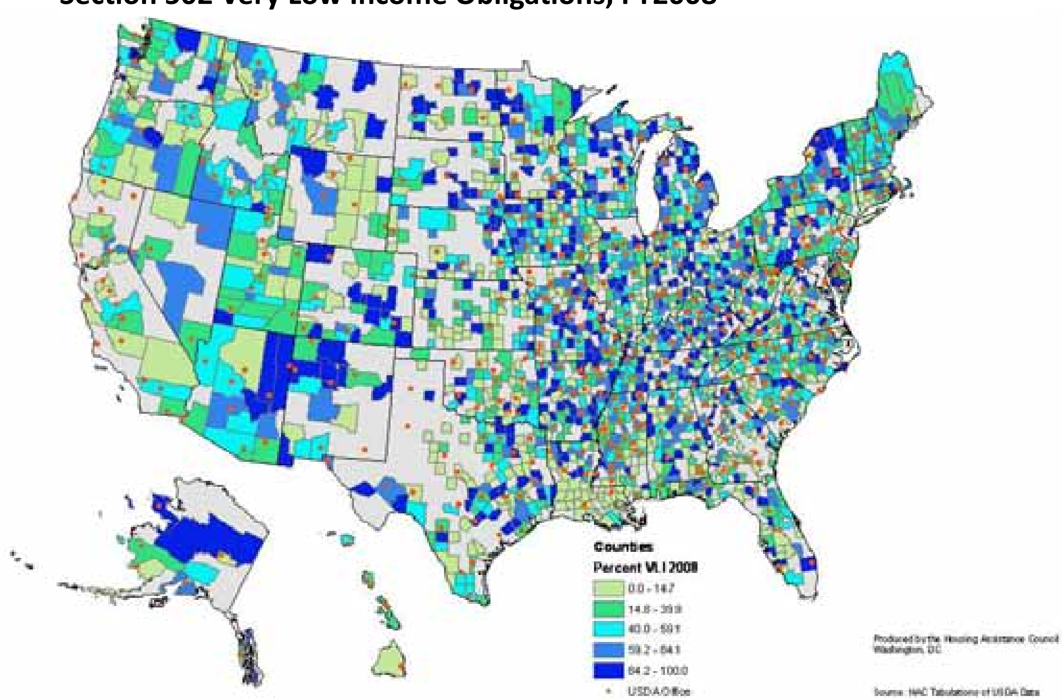
In light of the reduced local office presence, RD housing staff now use a number of methods to market the program. In interviews, RD staff reported an increased use of their networks with local Realtors and nonprofit organizations as a way of marketing the program and reaching out to those communities that may not have an office presence. They also post program information in community newsletters and church bulletins and work with employers to share information about the Section 502 program. These strategies have become an increasingly critical way for RD local staff to reach beyond the current structure and maintain connections and contacts with communities where they no longer have office space.

In addition to the office closures, programming consolidation has affected RD staff's ability to devote time and effort to the Section 502 program. Both nonprofit and RD staff noted an increased consolidation of programming, resulting in RD staff becoming responsible for a range of housing and community development programs. According to stakeholders in the field, these changes have had several impacts on access to the loan program. Stakeholders noted that

USDA Section 502 Direct Homeownership Program Area and Local Office Locations, 2010



USDA Office Presence & Section 502 Very Low Income Obligations, FY2008



RD staff have had to focus more attention on the guaranteed loan program[2] and other program areas, resulting in less time for and attention on the direct loan program. As a result, several nonprofit stakeholders noted a marked increase in the time required to process a Section 502 direct loan application.

Leveraging Additional Resources

Leveraged loans are an important component of the VLI obligation discussion. Leveraged loans allow mixed financing within the Section 502 direct program, with the intent of increasing collaboration and of stretching loan dollars to more borrowers. Leveraged resources include traditional bank financing, as well as other types of financial resources that reduce the overall cost of a home (e.g., grants, soft second or forgivable mortgages). Although this analysis focuses on officially recognized leveraged loans (i.e., those with added bank financing), significant issues related to the leveraging of other resources must be acknowledged.

Leveraged loans were heavily promoted from the late 1990s to the mid 2000s. Since then, however, there has been a decrease in the volume of leveraged lending through the Section 502 program. Between FY2004 and FY2009, USDA obligated approximately 19,000 leveraged loans through the direct program. Of these, approximately half were to very low-income borrowers. However, only 46 percent of the total dollars obligated through leveraged loans were to very low-income borrowers. Similarly, loan obligations for very low-income borrowers have also declined in recent years. In FY2004, very low-income obligations made up 54 percent of the total leveraged dollars; by FY2008, VLI leveraged-loan obligations had declined to 43 percent. Although this trend may reflect the lower loan values associated with very low-income loans, there may also be issues related to the additional subsidies attached to these loans that affect the overall VLI obligation levels.

Loan-to-Dollar Disconnect

The analysis of leveraged loans reveals a disconnect between the dollar obligations and the actual number of loans. As illustrated above, the actual number of VLI loans accounts for a slightly higher percentage of loans than dollars. In FY2004, very low-income loans constituted 56.6 percent of the dollars obligated and 57.6 percent of the actual loans made. However, as stated above, there is a growing disconnect between the number of loans and the dollar value of the total obligation; in fact, by FY2008, only 43.3 percent of dollars obligated were to very low-income borrowers, accounting for 46.1 percent of all loans.

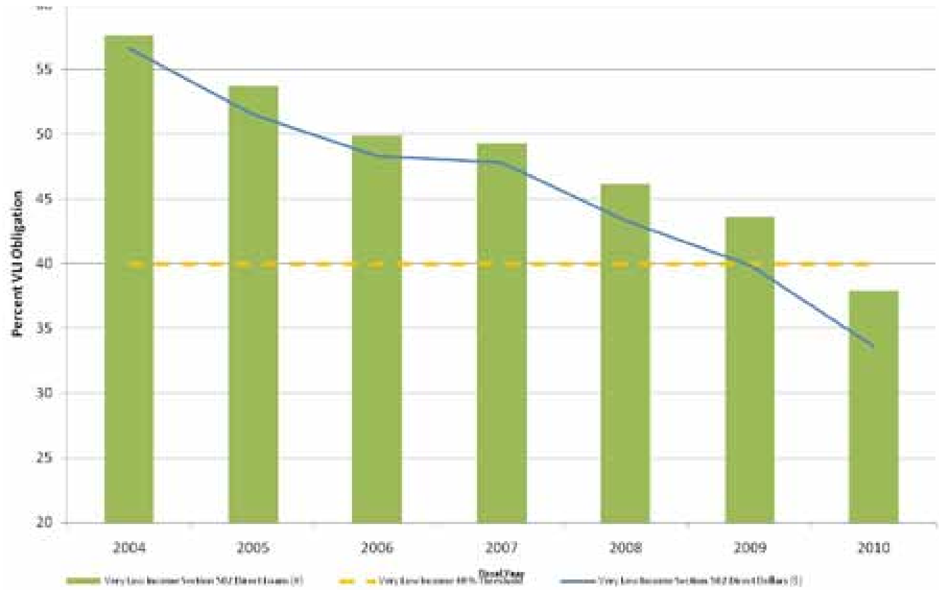
Although housing costs may account for a portion of this trend, this loan-to-dollar disconnect may be exacerbated by the added resources that are introduced to reduce the overall cost. RD and nonprofit staff often work together to identify grant funding in order to make the loan more affordable for lower income borrowers. These grant dollars make the unit more affordable and allow RD to stretch its resources to more borrowers; however, these funds also reduce the overall amount that RD commits to individual loans, thereby lowering the dollars being used for very low-income borrowers. The loan data provided do not allow for a full examination of this scenario.

Other Leveraging Concerns

RD staff remarked that the formal leveraging program has been difficult for many low-income borrowers to sustain over the long term. The added bank financing has placed an additional burden on these borrowers, and staff in at least one state noted that many of the delinquencies and foreclosures among its current Section 502 loans have resulted from the leveraged financing associated with the RD loan.

[2] The Section 502 Guaranteed Rural Housing Loan Program differs from the Section 502 direct loan program. Under the guaranteed program, the government guarantees mortgage loans made by commercial lenders, enabling low- and moderate-income rural residents to purchase modestly priced homes.

Section 502 Direct Very Low Income Obligation



Self-Help Housing

An allocation of Section 502 loans is reserved for use by households participating in programs sponsored by USDA Section 523 self-help technical assistance grantees. Families participating in mutual self-help projects perform a substantial amount (approximately 65 percent) of the construction labor on their own and each other's homes, under qualified supervision. The savings from the reduction in labor costs reduces the overall cost of homeownership for these participants. Most households that participate in USDA's mutual self-help program use Section 502 to finance their units.

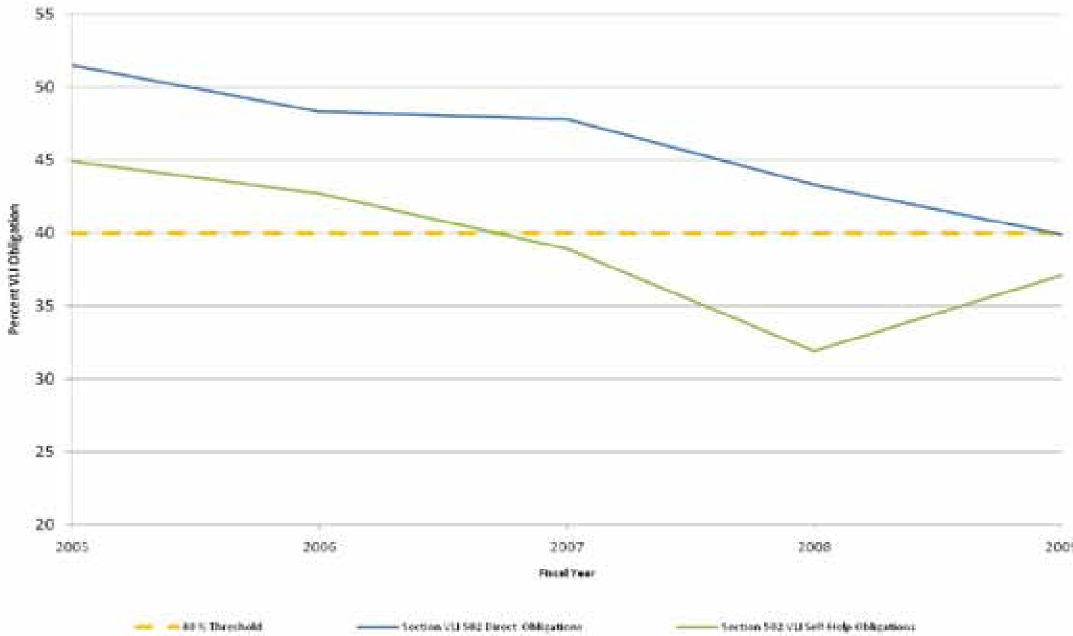
Although the application data have significant limitations, they reveal a definite trend in self-help loan activity. Application activity in the self-help program has dropped markedly, in terms of both total applications and applications from very low-income borrowers.[3] In FY2005, there were nearly 2,700 self-help applications, while in FY2008, this number had dropped by 1,000 applications to 1,728. Similarly, self-help demand among very low-income applicants has also declined. In FY2004, roughly half (49.3 percent) of all self-help applications were from very low-income households, while in FY2008, only 39 percent of applicants (673 applications) had very low incomes.

Very low-income loan obligations have traditionally been lower in the Section 502 self-help loan portfolio. In recent years, the level of very low-income self-help lending has declined dramatically. In FY2005, approximately 45 percent of self-help Section 502 dollars were obligated to very low-income borrowers. In FY2008, only 32 percent of those receiving self-help loan obligations had very low incomes. There was a rebound in very low-income activity in the self-help portfolio in FY2009.

It should be acknowledged that the self-help program reflects less than 11 percent of the total Section 502 loan obligations analyzed. If the self-help loans were removed from the analysis, the overall very low-income obligation level would increase by only .5 percent for FY2009.

[3] Although self-help applications constituted more than 5 percent of the total Section 502 applications over the study period, self-help loans were slightly less than 11 percent of the total obligations over the same time period. This disconnect is in part due to the counseling self-help organizations provide to applicants, which in effect reduces the number of applications RD ultimately receives from this source. [and increases the proportion of submitted applications that meet eligibility criteria?]

Section 502 Very Low Income Self-Help Obligations



Contributing Factors

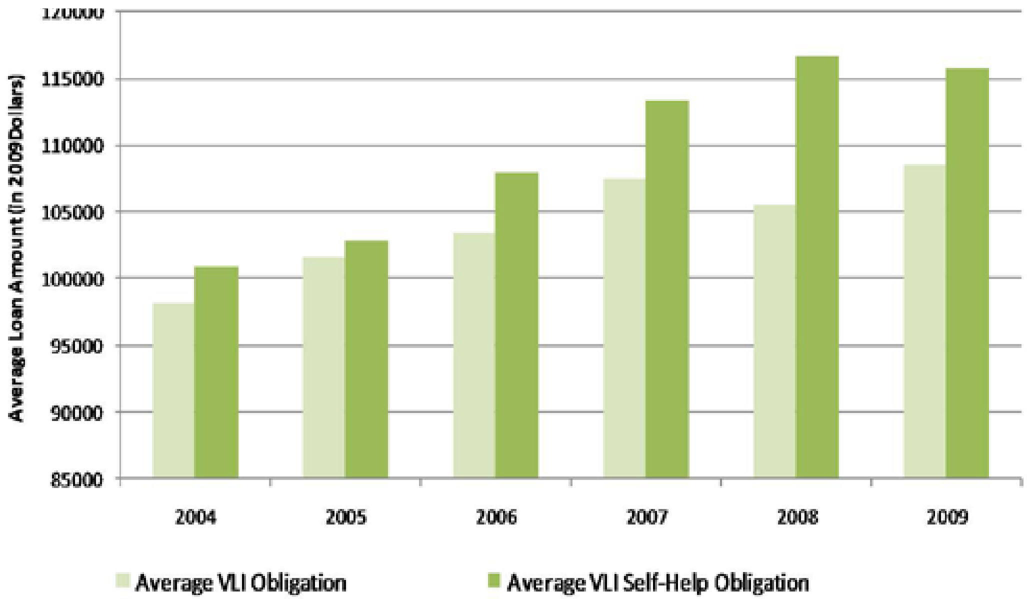
In some states, factors such as cost and geography have a significant impact on the overall level of income served by the self-help program and, consequently, this segment of the Section 502 loan program. While the majority of all Section 502 loans finance the purchase of existing units (60 percent), self-help is inherently a new construction program. There are many markets across the United States where it has been more cost effective to construct a unit using the mutual self-help method, given escalating home prices. In most markets, however, the cost of housing construction is higher than the cost of purchasing an existing unit. In the fourth quarter of 2009, the median purchase price of newly constructed homes nationally was $214,700, while the median purchase price of existing units was $173,500 (HUD 2010).

Within the Section 502 direct portfolio, the cost of self-help housing is higher than for non-self-help units. In FY2009, the average very low-income self-help loan obligation was $115,806, which is almost $7,300 more (7 percent higher) than the average obligation for all Section 502 very low-income loans in FY2009. This difference in costs between self-help and non-self-help Section 502 direct loans has been increasing. Between FY2004 and FY2009, the average loan obligation among all very low-income Section 502 loans increased by 10.5 percent. In that same time, the average very low-income self-help obligation increased by 14.7 percent.

It is important to note that a substantial portion of self-help housing activity is undertaken in states with traditionally "high cost" housing markets (e.g., California, Florida), which is likely to be a significant contributor to the higher cost of self-help loans. In fact, there is a large variation in housing prices within the self-help program across the nation. In FY2009, the average very low-income self-help obligation ranged from as high as $217,000 in Hawaii to as low as $50,000 in Texas.

Although self-help organizations work with families to identify added subsidies to reduce the overall cost of housing construction, the increasing cost of development may be making

Average VLI Loan Amount by Self Help Status, FY2004-FY2009



it increasingly difficult for the lowest-income households to qualify. Among those states where housing costs are high and self-help loans constitute a significant portion of the Section 502 loan activity, several have had difficulty meeting the 40 percent very low-income obligation threshold. From FY2004 to FY2009, the average very low-income obligation rate in Hawaii (38.1 percent), Utah (38.6 percent), and Florida (37.9 percent) has fallen below 40 percent.[4]

Payment Assistance 2

In 1995, USDA administratively replaced the Interest Credit subsidy formula with a new subsidy mechanism titled Payment Assistance (PA). PA established equivalent interest rates (EIRs) that borrowers would pay based on the ratio of annual adjusted income (AAI) to area median income (AMI). Borrowers were responsible for minimum PITI payments of 22, 24, or 26 percent of income based on AAI in relation to AMI. There were, however, several concerns with this formula, including the complexity and disparate subsidies for borrowers with the same income. In short, this formula gave residents in higher income counties a higher subsidy than borrowers with equal income and housing costs in lower income counties.

To address the inequities and complexities of PA 1, USDA RD introduced a new payment assistance formula in April 2008 called Payment Assistance 2 (PA 2). Under the new formula, an applicant generally pays the greater of either 24 percent of his or her AAI or an amortized loan payment with 1 percent interest.

Before implementing PA 2, RD acknowledged that "by definition, the new formula will decrease the amount of payment assistance some very low-income borrowers receive, as the expected borrower contribution will rise from 22 percent of AAI to 24 percent" (Federal Register 2007). The new formula may, in fact, be responsible for decreasing the amount of subsidy that some very low-income applicants receive. As a result, some very low-income applicants could be deemed ineligible based on repayment ability, resulting in a decreased number of approved very low-income borrowers.

[4] Nevada, New Jersey, and the Virgin Islands are the only other locations that have average very low-income obligation rates below 40 percent over the study period.

To help determine the effect of the new PA 2 subsidy formula on very low-income obligations, HAC conducted an array of tests on the subsidy formula, using both application and obligation level data supplied by USDA.

A central element of the PA 2 system is its dichotomous subsidy option. Specifically, a borrower is subsidized by one of two measures—the higher amount of either,

1. 24 percent of a borrower's "adjusted annual income" (AAI), or

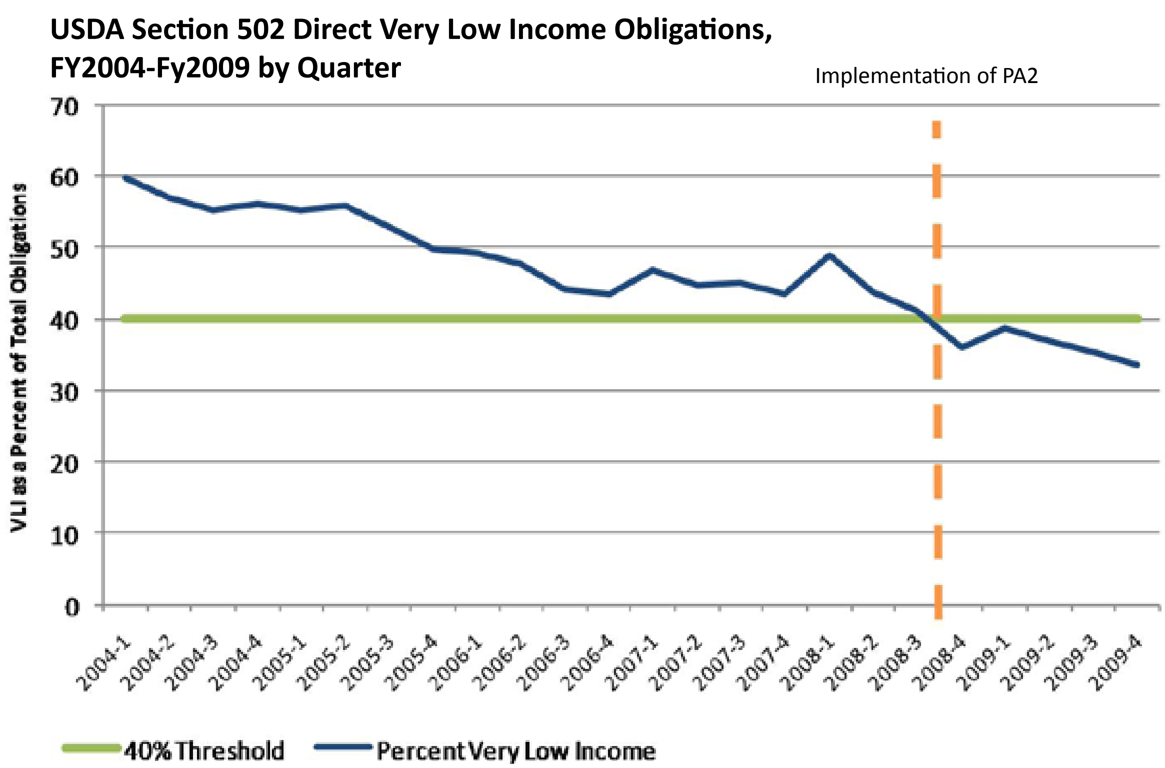
2. 1 percent of PITI. It should be noted that 1 percent is the maximum subsidy allowable under the program.

One of the primary findings from the review is that low-income and very low-income borrowers are impacted very differently in terms of the PA 2 subsidy option. Since the implementation of PA 2, approximately two-thirds of low-income loans were subsidized under the 24 percent of AAI option. In stark contrast, an overwhelming majority (73 percent) of very low-income loans were subsidized under the 1 percent PITI option.

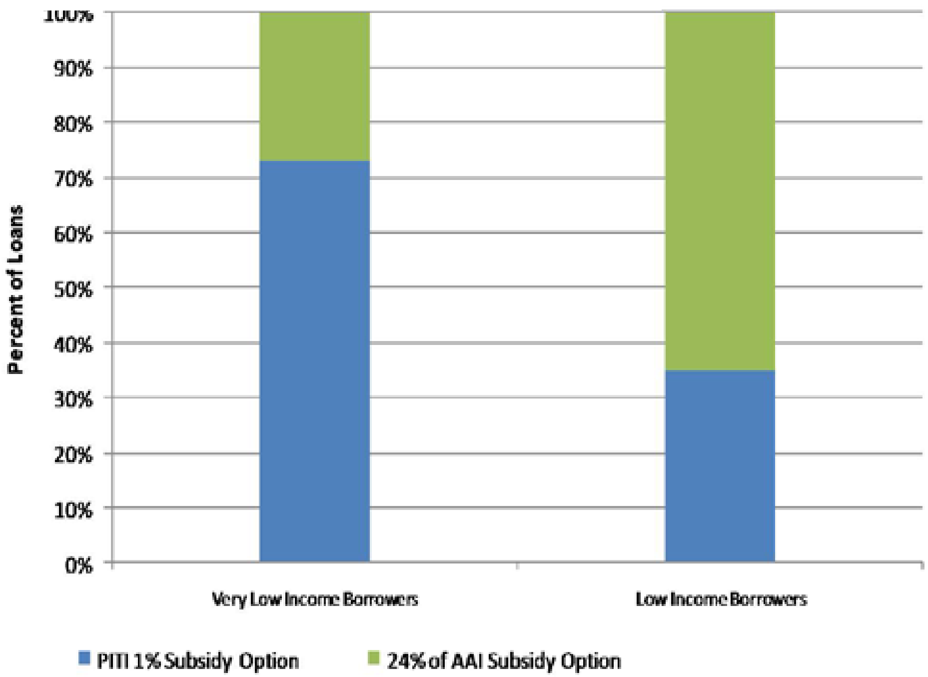
This disparity between subsidy options is likely explained by the lower incomes of very low-income borrowers and applicants. The difference may also be affected by the increasing costs of housing, however, which would favor the 1 percent PITI option for lower income borrowers.

The research revealed that these subsidy trends were also prevalent within the Payment Assistance 1 system. Nearly three-quarters of very low-income Section 502 direct loans made in FY2004 were subsidized at 1 percent of PITI as opposed to 22 percent of AAI (as was the threshold under that system). Likewise, most low-income borrowers in FY2004 were subsidized at 22 percent of AAI instead of the 1 percent of PITI option.

To further this analysis, HAC tested the potential impacts of the PA 2 system on applicant eligibility for the Section 502 direct loan program. Data from approximately 36,000 loan applications submitted after April 2008 were tested for potential impacts. In general, the study analyzed applicant feasibility under different payment assistance subsidy scenarios. The analysis calculated feasibility ratios (monthly payment as



PA2 Subsidy Option by Income Level Loans Obligated After April 2008



a ratio of applicant income) for all applications submitted under the PA 2 system.[5] If an applicant's monthly loan payment exceeded 29 percent of his or her monthly income, then that applicant was not eligible for the loan program.

Among the very low-income applicants tested in the scenarios, approximately 41 percent exceeded the 29 percent feasibility ratio and thus were not eligible for a median-priced loan in their state at a 33-year term. When PA 1 criteria were applied to the same scenarios (which involves reducing the AAI option from 24 percent of AAI to 22 percent of AAI), there was no discernable difference in the number of applicants who were eligible on the basis feasibility ratios. This finding is likely explained by the "higher of" provision in the subsidy mechanism, in which the borrower pays the higher of PITI or the percent of their adjusted income.

As noted above, most very low-income applicants would be required to pay the PITI 1 percent scenario instead of 24 percent of AAI. In fact, the analyses indicated that most very low-income borrowers under the PA 1 system also paid the PITI amount instead of 22 percent of AAI, signaling that this discrepancy in payment options has been ongoing for the past few years regardless of the change in the subsidy formula. (It is important to note that these calculations were based on broad applicant scenarios and were only tested for income. Other factors that would be considered to determine eligibility were not factored into this specific analysis.)

The model specifically tested feasibility under the PA 2 system on the basis of housing costs. Various scenarios were calculated to determine an applicant's potential payment and feasibility based on differing housing prices. Under these scenarios, factors such applicant income, tax and insurance rates, and loan term were held constant. For the calculations, the borrower's income was established at $20,535, which was the median very low-income applicant income in FY2009. Taxes and insurance were calculated at 1.6 percent of the total loan, and the loan term

[5] Some key elements of the data were tested using derived measures in instances where data were incomplete or lacking. For example, there was a moderate level of incomplete or missing data for values on estimated taxes and insurance. Therefore, an aggregate taxes and insurance figure was calculated by establishing a median taxes and insurance figure applied at the state level.

was set at the standard 33 years. The following chart illustrates the impact of increasing housing costs for applicant eligibility under the current PA 2 structure.

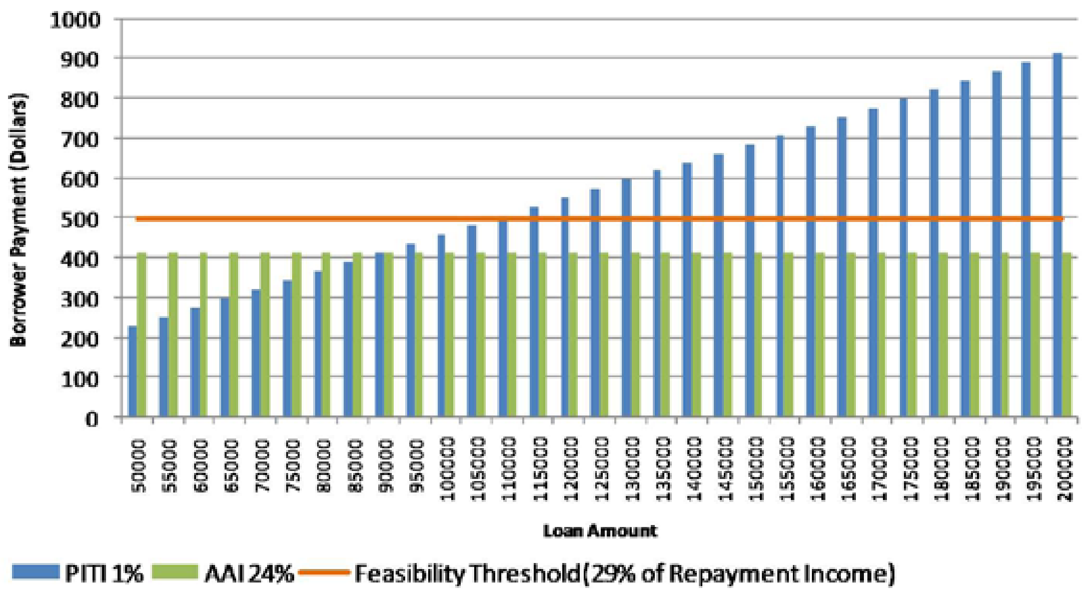
First, the subsidy option (either 24 percent of AAI or PITI at 1 percent) for the average very low-income applicant is definitely impacted by housing prices. With the underlying loan conditions held constant, the average very low-income applicant would pay 24 percent of their monthly adjusted annual income towards a loan valued at less than $90,000. For all loans above $90,000, the average very low-income borrower shifts to the subsidy option of 1 percent of PITI. That is, the PITI option "kicks in" with higher loan values.

Secondly, when the purchase price reaches $110,000 and above, the loan becomes unfeasible for the average very low-income applicant as the loan exceeds the 29 percent of income feasibility ratio. While these are basic scenarios, the realities and future implications of the current markets and demographics are readily apparent. In FY2009, the average very low-income loan amount was over $108,000, while roughly just one-third of very low-income obligations were below $90,000.

A longitudinal perspective further illustrates the impact of housing costs for very low-income eligibility. In FY2004, the median total loan obligation amount for very low-income borrowers was $83,800. In loans obligated in FY2008 and later, the median loan amount increased to $102,851. Under the PA 2 system, approximately 54.9 percent of recent applicants would be eligible for the median loan amount in their state. If the loan were priced at the FY2004 median value, however, nearly 74 percent of very low-income applicants would be eligible using the same PA 2 criteria. Given the data constraints, these calculations are somewhat generic scenarios that do not provide a great deal of specificity. However, they do allude to the impact of increased housing costs on the eligibility of very low-income applicants and borrowers.

For another perspective, the analysis incorporated local housing costs to assess how applicant repayment ability is impacted within the PA 2 subsidy system. The model estimated housing costs using median loan amounts and taxes and insurance adjusted based on an applicant's state. The scenario further calculated the minimum income needed to qualify for the average priced USDA home in that state in FY2009. These incomes varied widely, ranging from a low of $15,338 in Mississippi to a high of $39,583 for Rhode Island.

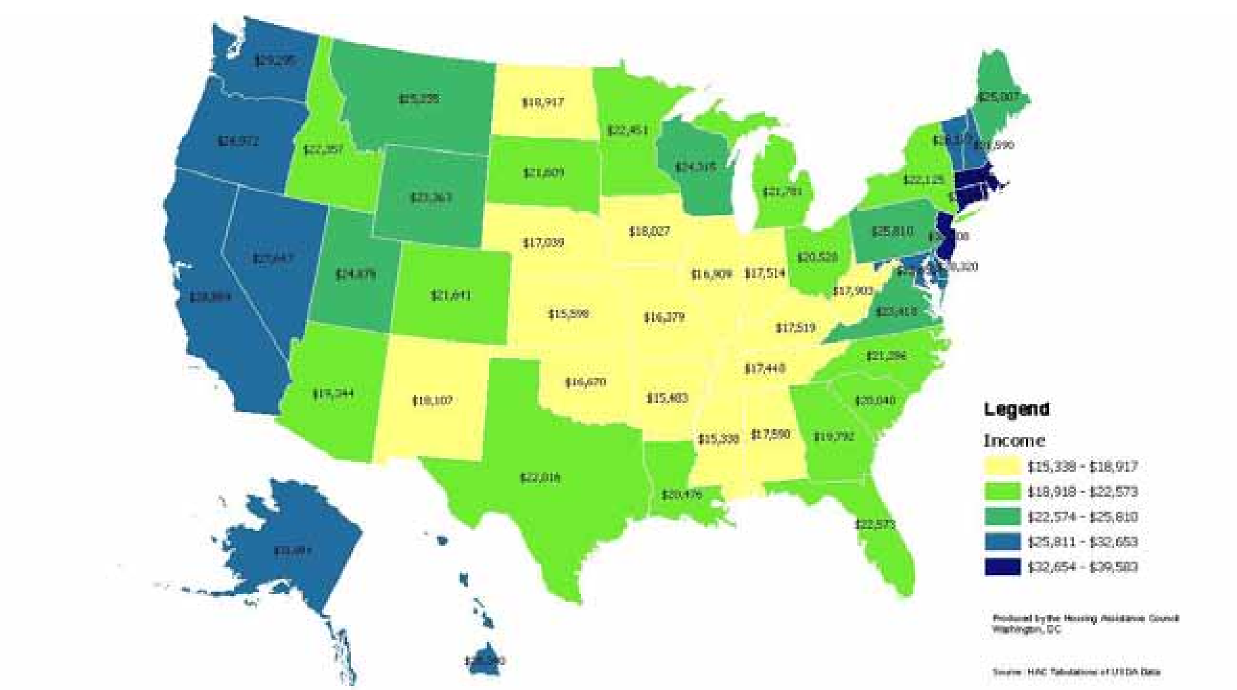
PA2 Scenario A: VLI Borrower Payment by Loan Amount
Assumptions: Average Applicant Income $20,535, Taxes and Insurance 1.6% of loan, 33 year term



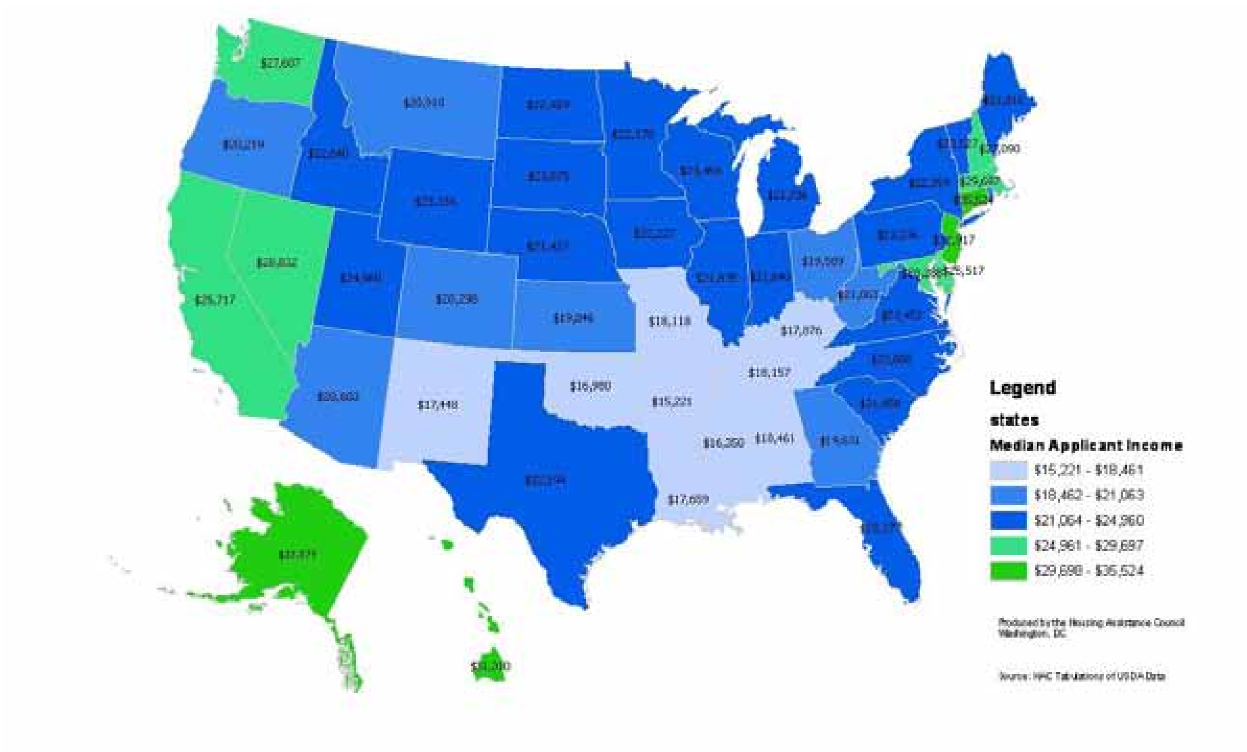
Finally, the review of subsidy mechanisms incorporated an analysis of loans already obligated under the Section 502 direct program. In interviews, several nonprofit housing practitioners and RD staff asserted that low-income borrowers were being over-subsidized, while very low-income borrowers were under-subsidized under the new PA 2 system. HAC examined the amount of subsidy that borrowers received under the PA 2 system based on their income status. The calculations estimated principal and interest payments for borrower loans at a market rate (estimated at 6 percent) and subtracted their PA 2 principal and interest amount to determine a subsidy amount. This analysis determined that low-income borrowers did, in fact, receive a larger subsidy amount (by an average of $20 per monthly payment) than did very low-income borrowers under the PA 2 system. Although the PA 2 subsidy formula does appear to have an impact on the amount of subsidy a borrower receives, the formula does not appear to impact program eligibility negatively for any specific group.

In summation, there is no indication in the analyses conducted by HAC that PA 2 is substantially affecting eligibility or the ability of very low-income applicants to acquire a Section 502 direct loan. Ultimately, increasing housing prices combined with stagnant applicant incomes are impacting the PA 2 subsidy formula itself much more than PA 2 is affecting VLI obligations. When USDA originally studied replacement options for PA 1 in 2006, many of its calculations were based on an average loan amount of $90,000 with a $21,000 average borrower income. Four years later, the reality is that the average loan amount has increased by more than 30 percent, while the average borrower income has remained virtually unchanged. These simultaneous pressures are squeezing out very low-income applicants, which may lead USDA to consider modification of the subsidy formula to help mitigate the inevitable increase in housing prices in the future.

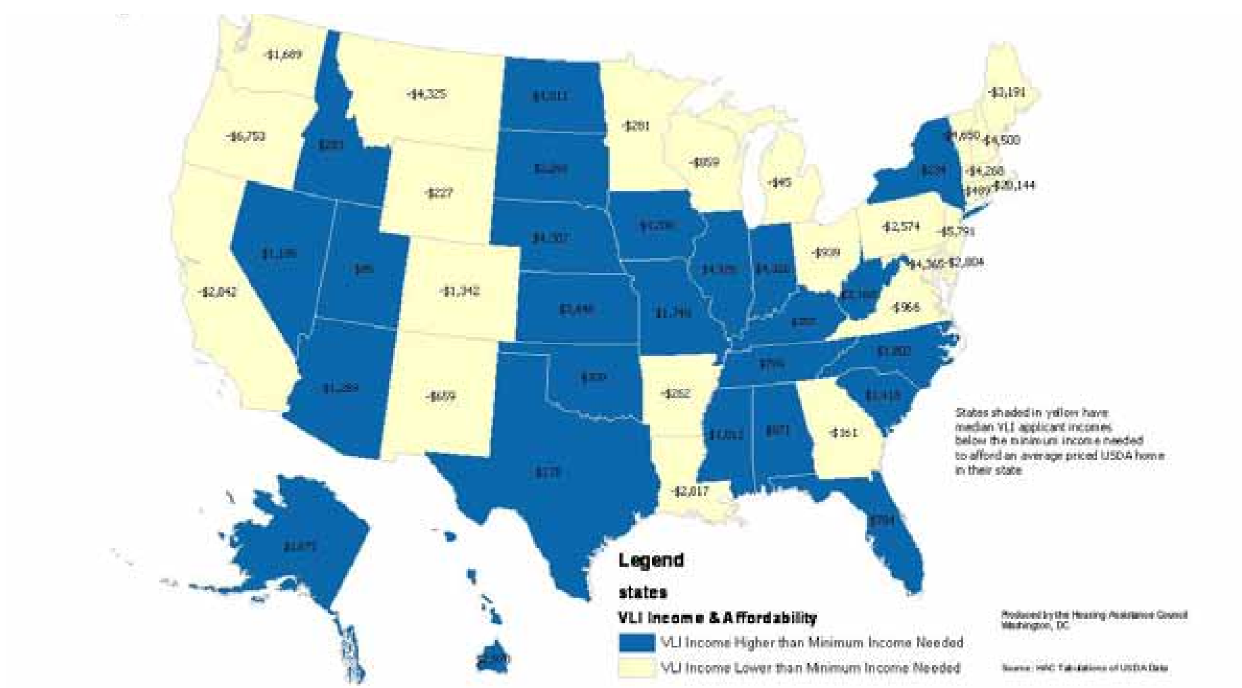
Minimum Income Needed to Afford an Average Priced USDA Home, By State - FY2009



Median Income Among Very Low Income Applicants By State - FY2009



Difference in VLI Applicant Income and Income Needed to Afford an Average Priced USDA Home, By State - FY2009



Loan Term

The USDA Section 502 direct loan program offers several loan term options. Loan terms are up to 33 years; however, borrowers with incomes below 60 percent of the AMI are eligible for loan terms of up to 38 years, if they cannot afford a loan at 33 years. Most manufactured home loans under the program are financed at 30-year terms.

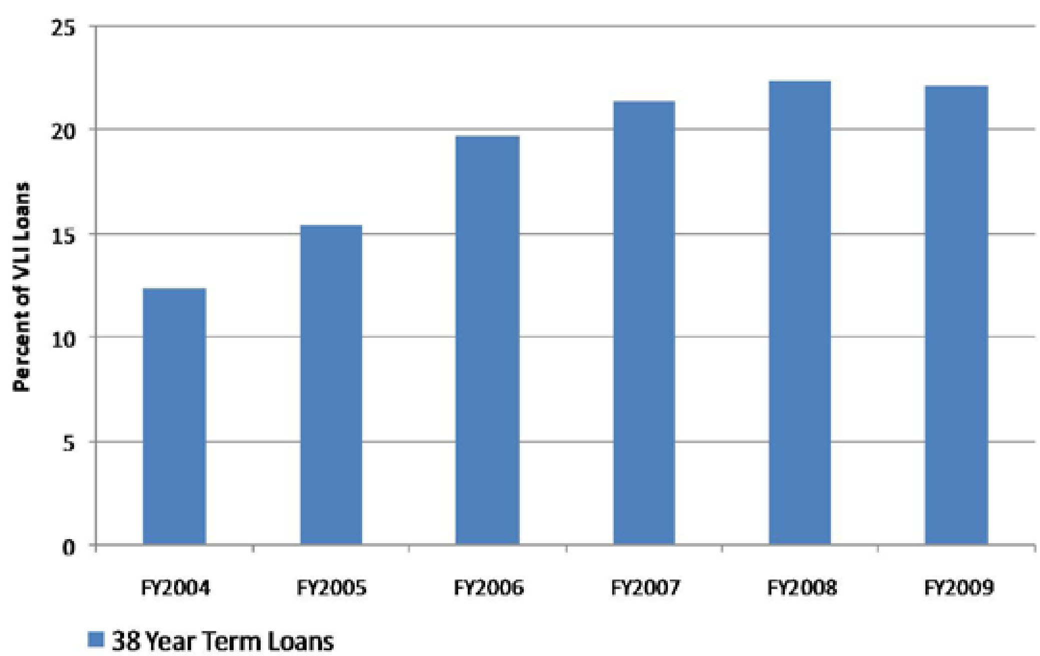
Approximately three-quarters of very low-income loan obligations over the study period were for 33-year terms, with 18 percent of these loan obligations being for 38-year terms.

The use of 38-year terms increased over the five years examined. In FY2004, approximately 12 percent of loans to very low-income borrowers were for 38 years. In FY2008, the level of longer term loans nearly doubled to 23 percent. The use of 38-year terms for very low-income borrowers in the self-help program was similar, increasing by about 21 percent over five years. When PA 2 was being formulated, HAC advocated for increased utilization of 38-year terms to increase very low-income obligations. Although the rates of 38-year terms have increased, they are still only about one-fifth of VLI loans made.

To test how an extended loan term may impact the eligibility of very low-income applicants, the study revisits the scenarios utilized in the PA 2 analysis of this report. These scenarios assessed very low-income applicant eligibility on the basis of differing housing costs for an average income borrower.

Under the original analysis, an average very low-income applicant with an income of $20,535 could feasibly afford a loan of just under $110,000 with a 33-year loan term. However, if the loan term were increased to 38 years, the same average applicant could afford a loan of just under $120,000. Therefore, the ability to increase loan term may assist very low-income applicants in accessing the Section 502 direct loan program by somewhat mitigating increasing housing costs and higher priced homes in high cost areas. It must be acknowledged, however, that modifications such as loan term increases are only partial measures and do not entirely ameliorate the systemic cost problems hindering very low-income applicants from accessing the Section 502 loan program.

UUtilization of the 38 Year Mortgage Term, FY2004-FY2009



FINDINGS

- *RD has a reduced presence in many communities.* Rural Development has closed a number of local offices that had previously been located in rural, low-income communities. The pattern of funding shows that almost one-third of all loan obligations were made in counties where there is currently a local office. As noted by RD staff, very low-income applications often require extensive one-on-one interactions in order to address the individual needs of those borrowers. Lacking a presence in remote, rural communities, RD staff have fostered partnerships with other stakeholders to market the program.

- *Increased leveraging results in lower obligations.* In order to make homeownership affordable for the lowest income applicants, additional subsidies are often required. However, the dollar amount of loans to very low-income households may be decreasing because of the added subsidies. Although the number of Section 502 loans being obligated to very low-income borrowers has remained high, RD uses fewer dollars to make these loans because of the added subsidy, contributing to a shortfall in meeting the obligation standard.

- *The increasing cost of self-help housing in some markets makes it difficult to serve very low-income households.* Self-help is largely a new construction program and the cost of new construction has increased dramatically, both within the program and in the larger housing market. Additionally, self-help is a popular affordable housing tool in many high-cost states (e.g., California, Florida) where the cost of homeownership is often out of reach for the lowest income households. The dual pressures of high cost housing markets and increasing construction costs are making it difficult to serve very low-income households in this niche of the Section 502 program.

- *Very low-income borrowers have received fewer subsidy dollars under Payment Assistance 2 than low-income participants.* HAC's analyses of the PA 2 formula did not show that the subsidy formula has had a significant impact on eligibility for very low-income borrowers. As was identified by stakeholders in the field, the formula may provide additional subsidy for low-income borrowers and slightly less subsidy to very low-income borrowers than the previous subsidies; this has not contributed significantly to loan denials among very low-income applicants, however.

- *A 38-year loan term can increase access to the program, given increased housing costs.* The 38-year loan term is an option available to make the program more affordable to very low-income applicants. The data analysis show that use of the 38-year term is increasing; however, it is still only being used for one-fifth of the loans made.

EXTERNAL HOUSING MARKETS AND FACTORS

Inquiry 3
Are there larger economic and/or demographic factors that make the Section 502 direct loan program unattainable or unaffordable for very low-income borrowers?

The Section 502 direct loan program operates within the larger housing market and is thus subject to the broader market forces that also affect the mortgage and finance industry. However, rural housing markets are defined by a number of additional factors that can make it more difficult to access mortgage financing.

A wide array of geographic and lending trends was examined to determine whether they play a role in the declining rate of VLI loans. Factors such as rurality, poverty level, housing distress, and subprime mortgage trends were analyzed. From this analysis, HAC determined that these characteristics do not have a substantial impact on very low-income obligations within the program.

HAC's analysis identified housing costs as a central issue that dramatically affected the Section 502 direct program. As a result, this inquiry focused primarily on the issues of cost and credit within the context of the very low-income obligation rate. For the purposes of this analysis, loan amounts are used as a proxy for housing costs.

Housing Costs

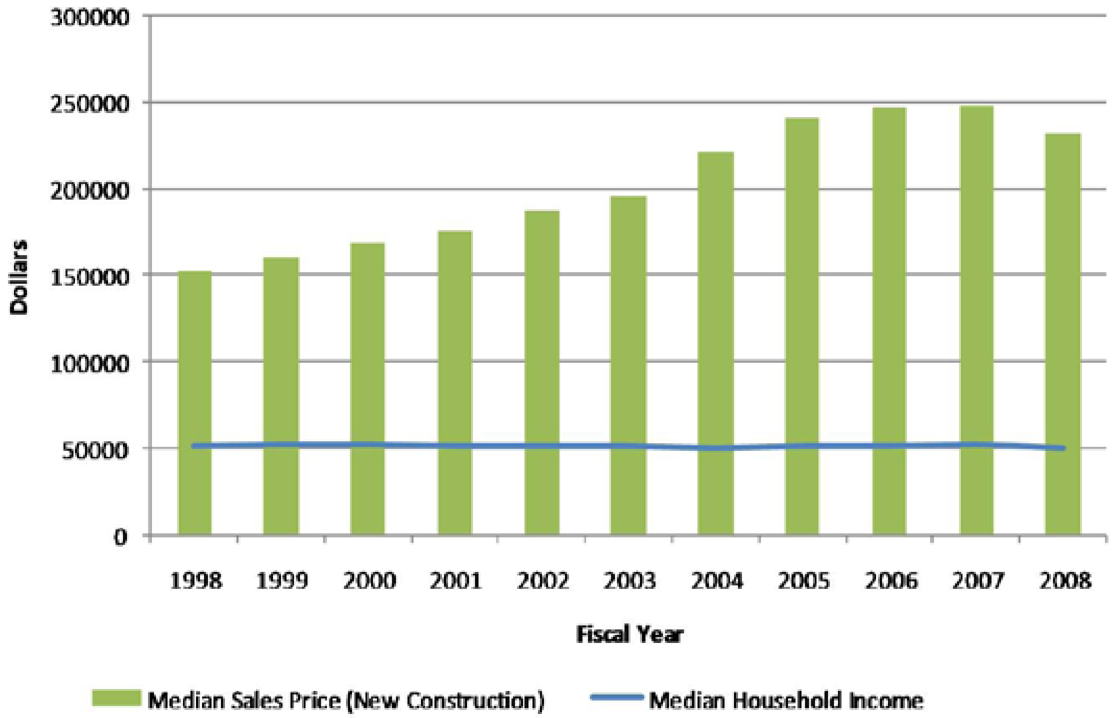
The change in housing prices was a recurring issue that was widely linked to the declining trend in very low-income obligations. Both housing practitioners and USDA staff have noted the dramatic increase in housing prices over the past decade. The U.S. Census Bureau's construction statistics indicated that the median purchase price of a newly constructed single-family home in 1998 was $152,500. In 2007, that price had increased to $247,900, a 62 percent increase in nine years. According to Federal Housing Finance Agency (FHFA) figures, in the past few years, there was also a substantial increase in the price of rural homes generally (FHFA 2009).

Recently, a troubled economy, record home foreclosures, and tightened credit availability have depressed markets and sent housing prices plummeting in many locales. Yet there is some indication that the boom-and-bust cycle for housing prices experienced in many markets did not follow the same pattern in rural America. Rural house price gains, though substantial, were not as dramatic as those seen by their metropolitan counterparts. Subsequently, rural areas have not experienced price declines as precipitous as those in urban locales (Wilkerson 2008). According to recent FHFA price index data, rural home prices increased by 1 percentage point from 2007 to 2008, compared with a 5 percentage point decline for metropolitan areas in the same time period (FHFA 2009). Likewise, many of the housing professionals interviewed indicated that house prices in their rural communities had not declined much. Furthermore, the data show that prices for homes financed by the Section 502 direct program had not experienced price declines as of yet as of 2010.

In any discussion of an affordable housing program, household incomes and housing prices are inextricably linked. Household incomes in recent years have not kept pace with housing prices. While median housing prices have increased nationally over the past 10 years, incomes have remained stagnant. Between 1998 and 2008, housing prices increased by 52 percent, while real incomes actually declined by 1.9 percent (HUD 2010). An almost identical pattern developed among housing prices and incomes in the Section 502 direct loan program. Between 1998 and 2008, median loan amounts in the program increased by 34 percent, while median borrower income declined.

Housing prices nationally have increased markedly over the past decade; this is also true for units within the USDA Section 502 direct loan portfolio. From FY1999 to FY2009, the average

U.S. Median Sales Price and Household Income 1998-2008



loan amount for a unit purchased with Section 502 financing increased from $86,503 (in 2009 dollars) to $117,784, representing a 36 percent increase in average housing costs.

Between FY2004 and FY2009, the average amount for a Section 502 direct loan was $107,846. Average loan amounts were slightly higher for low-income households ($112,502) over this same time period than for very low-income borrowers ($103,473).[6]

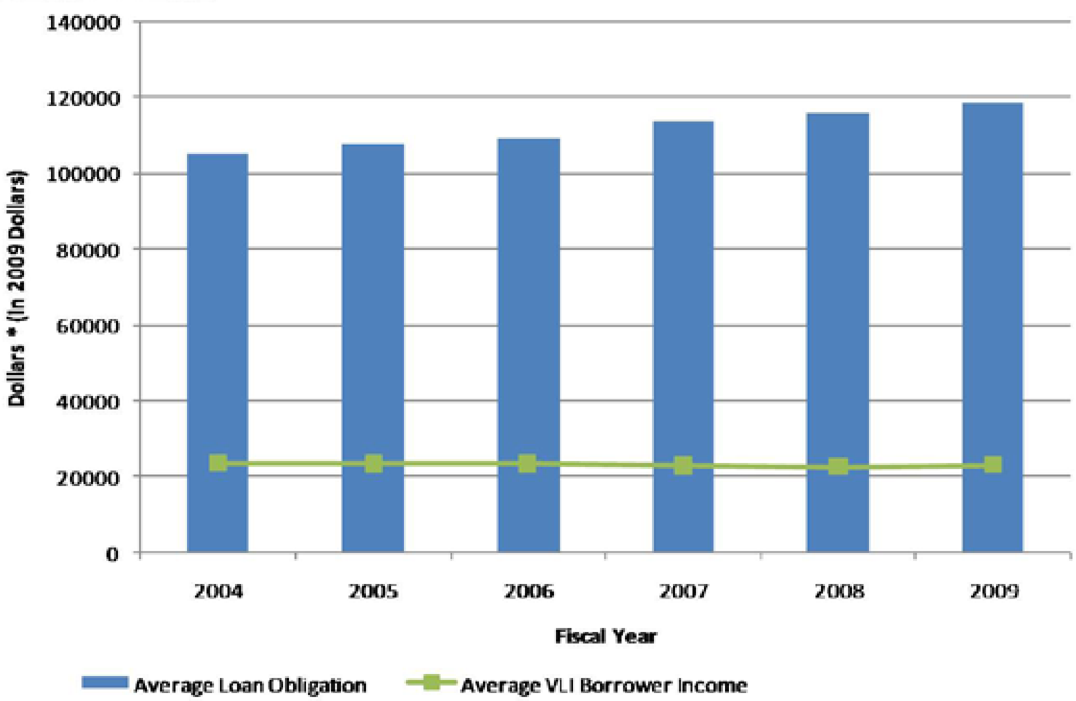
Average loan amounts for Section 502 direct–financed units steadily increased over the period studied. In FY2004, the average loan amount was $99,908. In FY2009, the average loan amount increased to $118,071—an 18 percent rise. For very low-income borrowers, the average loan amount increased from $98,126 to $108,638 in the same five-year period—approximately a 10 percent increase. The average low-income loan obligation increased by approximately 20 percent in that same period. Most significantly, incomes among borrowers have remained stagnant. In FY2004, the average borrower household income was $23,419. When controlled for inflation, the average borrower income of $22,986 in FY2009 actually declined by 1.8 percent from the FY2004 level.

States that have had difficulty reaching the 40 percent threshold have experienced a significant increase in the average very low-income loan amount. From FY2004 to FY2008, the average loan amount in these states increased by 35 percent.
There is a possibility that at least part of this increase in costs is related to an increase in the size and/or amenities of the homes financed. At least one RD staff person noted that the size of the units had increased. This staff member remarked that in some parts of the country, borrowers are purchasing homes that far exceed the modest dwellings the program is intended to support. The data provided do not allow for this analysis, however, as there is no consistently collected data on the square footage of the units financed.

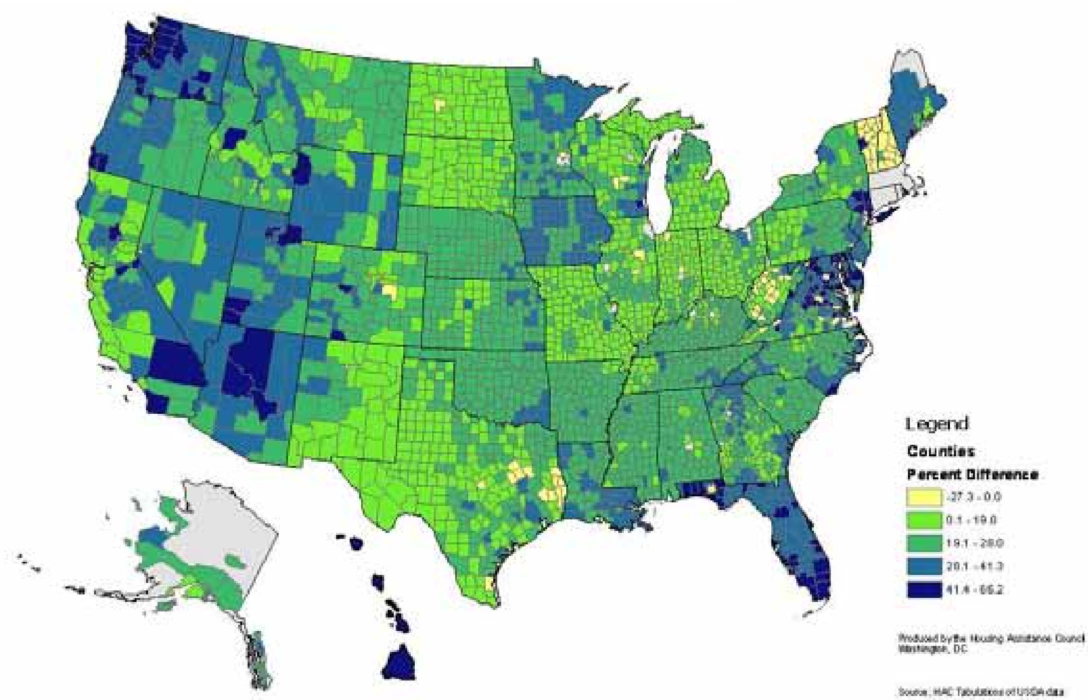
Another context in which to view housing prices in terms of the Section 502 loan program is loan limits. The program establishes area loan limits at the county and state levels by using various characteristics, including construction costs, comparable sales, and various other factors. In

6 These numbers are controlled for inflation (2009 dollars).

USDA Section 502 Average Loan Amount & Borrower Income, FY2004-FY2009



USDA Section 502 Direct Loan Program Loan Limit change FY2003-FY2010

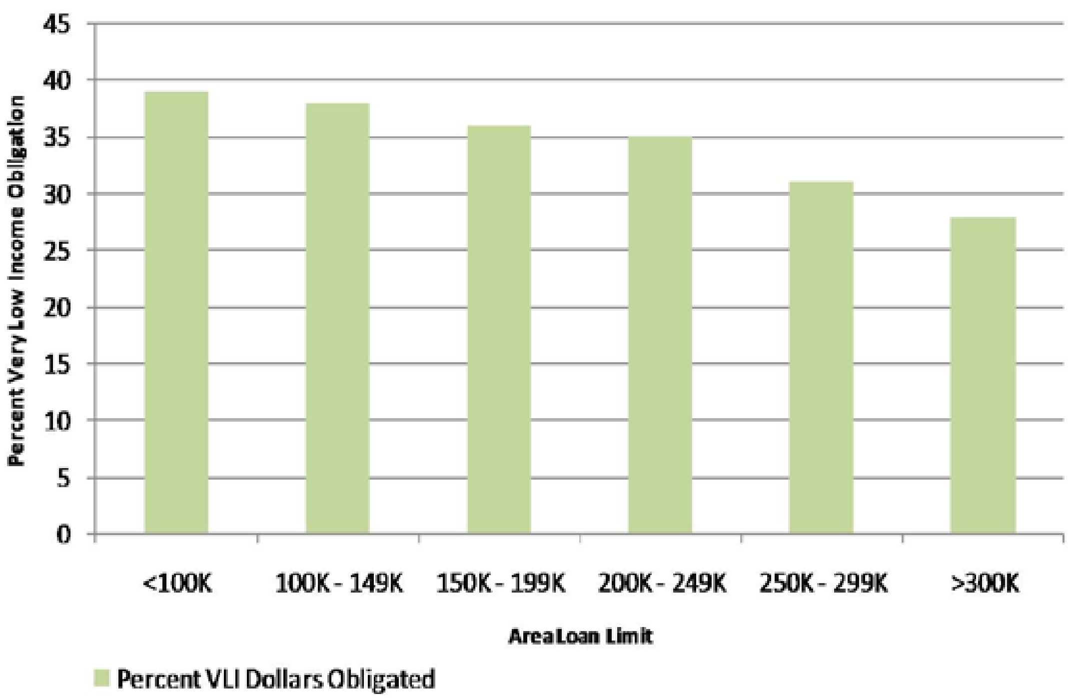


FY2010, area loan limits ranged from a low of $81,000 to a high of $569,389, with a median of $155,000. (Approximately 50 counties have loan limits of more than $300,000.) Similar to overall housing prices, loan limits increased approximately 21 percent between 2003 and the current limits. Overall, loan limits increased in most areas; in fact, in some communities, loan limits increased as much as 70 percent.

Although loan amounts and housing costs have risen in the program, they are still typically below the area loan limits. In FY2004, the average loan for an area was about 35 percent below the area loan limit. After PA 2, the average loan in an area was about 37 percent below the loan limit amount.

Loan limits provide an additional proxy for housing costs. To further illustrate the potential impacts of housing costs on very low-income obligations, county-level obligation levels were analyzed in terms of loan limits. In counties that had a loan limit of less than $100,000, approximately 39 percent of dollars were obligated to very low-income households. In areas with loan limits greater than $250,000, very low-income obligations declined to 34 percent of all loans. In areas with loan limits greater than $250,000, however, only 31 percent of loans were obligated to very low-income borrowers. It should be noted that, again, there was a disconnect between dollars obligated to very low-income borrowers and the number of loans made. Obligations represented a smaller proportion of the total than the number of loans did. These analyses were for loans obligated after the implementation of PA 2.

Percent VLI Obligations by Area Loan Limit - PA2 Loans



FINDINGS

- *Use of the program is not affected by rurality, poverty, or loan activity.* HAC's analysis of various geographic and social demographics on lending through the Section 502 direct program showed that these factors have had very little impact on access to this resource.

- *Housing costs have increased significantly over the past five years.* Both within the program and nationally, the cost of housing has increased. Although rural housing prices have not experienced the dramatic price changes that have occurred in other markets, there has been a significant increase in the cost of homes purchased through the Section 502 program that mirrors the national trend.

- *The units purchased using Section 502 funding have remained below area loan limits.* Although the cost of homes purchased through the program has increased, the analysis has shown that these units are within the area loan limits.

- *Incomes have remained stagnant and, in some cases, have decreased.* Although housing costs have increased, the incomes of program participants have remained stagnant. This is perhaps the most significant factor contributing to the decrease in very low-income participants. Without the income needed to sustain homeownership, very low-income households may be deterred from using this program. The income issue also contributes greatly to the credit problems that many of these households face, as they engage in economic activities that jeopardize their credit, thus creating additional barriers to homeownership.

CONCLUSION AND DISCUSSION

HAC's analysis of very low-income loan obligations in the Section 502 program revealed several trends that contribute to the decreased number of very low-income loan obligations. First there has been a decrease in the volume of formal applications to the Section 502 program. This may be due in large part to intentional pre-screening by RD staff and nonprofit partners who work with applicants to identify and address issues that may result in a denied application. The reduction in applications, particularly among very low-income households, may also be due in part to RD's reduced presence in low-income, rural communities. The decrease in very low-income applications and obligations has occurred within the context of these office closures and consolidations, which have resulted in an increased number of counties without a local RD office. The research found that more than one-third of all Section 502 loans were made within the counties where there is currently an RD office.

While there has been a decrease in the number of formal applications to the program, the rate of denials for very low-income applicants has remained constant over the past five years at slightly over 10 percent. Among those very low-income applications that were rejected, the predominant reason for rejection was credit history. Credit is an overwhelming issue for many very low-income households and debt issues are significantly hampering RD's ability to identify qualified very low-income applicants.

The analysis revealed that low-income and very low-income borrowers within the program are impacted very differently in terms of the PA 2 subsidy option. Low-income borrowers primarily pay 24 percent of the adjusted annual income, while the vast majority of very low-income borrowers pay the 1 percent of PITI option for their monthly mortgage payment. These differences are largely a factor of borrower incomes in relation to increasing housing costs. Based on available data, there is no indication that the inherent structure of PA 2 is substantially affecting eligibility or the ability of very low-income applicants to acquire Section 502 direct loans. However, it is too early to make a final determination on this factor, particularly given the current housing cost and income trends.

The most dramatic issues impacting the Section 502 loan program overall, and the very low-income obligation rate specifically, are the increasing cost of housing and stagnating incomes among very low-income applicants. Although rural housing prices have not experienced the dramatic price changes that have occurred in other markets, there has been a significant increase in the cost of homes purchased through the Section 502 program in recent years. This increase mirrors the national trend seen over the past five years. Although housing costs have increased, the incomes of program participants have remained stagnant, which is perhaps the most significant factor contributing to the decrease in very low-income participants. Without the income needed to sustain homeownership, very low-income households may be unable to access this program. The income issue also contributes greatly to the credit problems that many of these households face, as they engage in economic activities that jeopardize their credit, thus creating additional barriers to homeownership. While RD has increased the use of the 38-year term in recent years, loans with this term constituted slightly more than one-fifth of all loans in FY2008.

Given escalating housing costs, it is often critical to identify additional subsidies to make the cost of homeownership affordable for very low-income borrowers. While leverage is often necessary, it can also have an unintended impact. Although the number of very low-income loans has been consistent over the past five years, the total dollar value of these loans has decreased to such an extent that RD is not achieving its 40 percent goal. Additional resources are often necessary to make these loans work for very low-income borrowers; however, these resources reduce RD's overall investment, contributing to lower obligation amounts for very low-income borrowers.

Ultimately the research concludes that a confluence of factors have contributed to the decrease in very low-income obligations in USDA's Section 502 direct homeownership loan program. It is difficult to determine, however, which of these factors is impacting very low-income applicants the most. It is important to recognize the scope and scale of the market in which the Section 502 program operates. The USDA service area covers a vast portion of the U.S. landscape, encompassing many disparate communities and markets. In short, factors that impact some rural communities are not relevant in others, and vice versa.

The data show that two recurring trends, the increasing cost of housing and the burden of personal debt, are unequivocally impacting very low-income households seeking to utilize the Section 502 loan program. In some respects, the prevalence of these factors represents a paradigm shift within the USDA homeownership program. Housing costs, stagnant incomes, and rising debt burdens are critical barriers to homeownership, especially for persons with lower incomes. Unfortunately, these factors are also largely out of the control of USDA and its staffers. The research also identified other programmatic factors that may be manipulated or altered to further assist very low-income applicants achieve homeownership with the assistance of Section 502 financing. Ultimately, pragmatic insight, innovation, and a commitment to adequate resources will be necessary to make sure this program remains viable for very low-income rural households in the future.

Recommendations

In the recommendations solicited from RD staff and nonprofit stakeholders, several themes were identified. First, both viewed credit as a key issue and identified poor credit scores as a central reason for the declining trend in very low-income obligations. They did not, however, agree on the way to address this concern. While many nonprofit stakeholders called for RD to relax the credit requirements for the program, RD staff were almost uniformly against this proposal. The interviewed RD staff strongly believed that lowering the credit requirements would undermine the program in the long-term and result in increased delinquencies and foreclosures. Several RD staff called on the agency to make critical investments in housing counseling and financial literacy that would work to educate future very low-income applicants about credit and debt issues that may limit their access to this program. One RD staff called for increased support of nonprofits engaged in housing counseling and another recommended that RD engage in more intensive financial literacy campaigns as a strategic investment in the future of the program.

RD and nonprofit staff also agreed that housing costs and incomes have not kept pace and this is critically impacting the program. Several nonprofit stakeholders viewed PA2 as a contributing factor and recommended a change back to the previous subsidy formula increase very low-income lending. RD staff, for the most part, did not share this sentiment and on the whole felt that it was too soon to know the true impact of PA2. One RD staff person recommended increasing the subsidy provided to very low-income borrowers by making adjustments to PA2. Another recommended increasing the PITI ratio for very low-income applicants, if they have an adequate credit history. Lastly, it was also recommended that RD reassess the income limits and potentially base the income limits on the local housing market rather than on HUD's median income limits.

Based on the analysis, HAC offers the following recommendations to address the decline in very low-income loan obligations in the Section 502 direct program.

- ***Expand RD's capacity to identify and process very low-income applications.*** Efforts to increase lending among very low-income borrowers will require more time and effort from RD staff. Expanding staffing options will counteract the office closures, specifically closures that have occurred in areas that have seen little very low-income loan activity. Increasing staff capacity will also help with program marketing and processing issues.

- ***Support increased funding for housing counseling.*** Given the extreme credit issues facing very low-income borrowers, RD could improve access to the program by increasing resources devoted to improving the financial literacy of potential borrowers. By expanding funding for USDA's Section 525 program, RD would be providing critical resources to address credit issues and support the work of nonprofit partners that market the Section 502 program. A targeted effort could have a dramatic effect on increasing obligations to very low-income applicants.

- ***Address the growing loan-to-dollar disconnect.*** USDA should consider pursuing a change in legislation to make the requirement either 40 percent of loans or 40 percent of dollars. The growing disconnect between the number of loans and the dollar value of those loans is inextricably linked to the increase in housing prices. Very low-income borrowers will continue to need subsidies to make homeownership affordable in this economic context. Acknowledging the role that larger economic realities play in affecting RD's investment may require a significant change in how to measure lending for very low-income households.

  RD could also require staff to track the additional subsidies provided to borrowers to reduce the cost of the unit. By accounting for these additional funds, RD would have a more realistic picture of the total cost of the unit and the federal resources that were used to create affordable homeownership opportunities for very low-income borrowers. Additionally, RD could make the case that the Section 502 loan leveraged the additional subsidies and should therefore be counted towards the very low-income obligation goal.

- ***Increase affordability for very low-income applicants.*** Increasing housing costs and declining incomes are larger economic forces that are largely out of RD's control; however, Rural Development can help make the program more affordable for very low-income borrowers. RD could require its staff to qualify every very low-income application using both the 33-year and the 38-year term. These applicants would then have both options presented and make an informed decision concerning the loan term that works best for them. Increasing the term of the loan will mean that it could cost more for the household in the long term; however, it will decrease the initial costs of homeownership and increase access for those who may have limited income at the time of application.

  RD would also improve its service to very low-income applicants by encouraging the use of additional subsidies for these households. Given that housing prices have increased and applicant incomes have been stagnant, finding additional sources of subsidy would improve access to the program for those very low-income applicants who have difficulty accessing the program.

- ***Continue monitoring Payment Assistance 2.*** From the analyses conducted, there is no indication that PA 2 is inherently affecting very low-income obligations. However, increasing housing costs, in concert with stagnant applicant incomes, are impacting how very low-income applicants and borrowers are treated under the current subsidy formula. These simultaneous pressures are squeezing out very low-income applicants which may lead USDA to consider a modification of the subsidy formula to help mitigate the inevitable increase in housing prices in the future.

NOTES

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