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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Millions Of Dollars For Rehabilitating Housing Can Be Used More Effectively

Annually, as much as $240 million in Federal funds for housing rehabilitation assistance could be spent to better advantage. Rehabilitation funds are being used to

--refinance home mortgages rather than for housing rehabilitation,

--provide grants to many homeowners for all needed home repairs when other funding methods are available,

--make loans with extremely low payments available to homeowners who could afford to pay more, and

--provide rehabilitation funds to higher income property owners.

This report recommends that the Congress and the Department of Housing and Urban Development make needed changes in the Department's Section 312 Rehabilitation Loan Program and the Community Development Block Grant Program to increase housing rehabilitation and to provide greater assistance to lower income property owners.

UNITED STATES GENERAL ACCOUNTING OFFICE

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COMPTROLLER GENERAL OF THE UNITED STATES
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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses housing rehabilitation assistance provided by the Department of Housing and Urban Development. It makes certain recommendations to the Congress and the Department to increase housing rehabilitation and to provide more help to lower income families without increasing program resources.

We made this review because the Congress and the administration have emphasized rehabilitation as the key Federal strategy to preserve and increase the Nation's supply of adequate housing.

We are sending copies of this report to the Chairmen, Senate Committee on Banking, Housing and Urban Affairs and House Committee on Banking, Finance and Urban Affairs; and the Director, Office of Management and Budget; and the Secretary of Housing and Urban Development.

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

MILLIONS OF DOLLARS FOR REHABILITATING HOUSING CAN BE USED MORE EFFECTIVELY

D I G E S T

Annually, as much as $240 million in Federal funds for housing rehabilitation assistance under the Department of Housing and Urban Development's (HUD's) Section 312 Rehabilitation Loan Program and Community Development Block Grant Program are not being used effectively for rehabilitating housing.

Borrowers are refinancing existing home mortgages with low-cost rehabilitation loans, diverting substantial funds from housing rehabilitation. (See p. 3.) Some borrowers receive low-payment loans even though they could afford higher payments. (See p. 19.)

Communities often award direct grants to cover all rehabilitation costs rather than

--requiring homeowners to finance part of the cost from other sources or

--using loans that, when repaid, will return money to community rehabilitation programs. (See p. 14.)

Many communities are inconsistent or ineffective in giving funding priority to low- and moderate-income borrowers. They award loans to higher income borrowers who could obtain financial assistance from commercial sources instead of to more needy, lower income homeowners who require assistance. (See p. 26.)

REFINANCING DIVERTS FUNDS FROM HOUSING REHABILITATION

GAO estimates that in fiscal year 1980 over $24 million could be made available for housing rehabilitation if HUD were to stop refinancing home mortgages with funds authorized by section 312 of the Housing Act of 1964, as amended, and with community block grant housing rehabilitation funds. Refinancing diverts substantial rehabilitation funds from the actual repair of houses. To illustrate, HUD awarded 11 loans totaling $214,750

Housing repairs
Property improvement loans
Block grants
Loan repayments
Program management
Program evaluation

to accomplish only $36,781 of rehabilitation. (See p. 5.) Over $76 million of section 312 funds and a large amount of block grant funds have been used for refinancing since these programs began.

Deferred payment loans--loans that do not have to be repaid until the property is sold or transferred--can accomplish rehabilitation program objectives much more efficiently and effectively than refinancing. (See p. 8.)

BLOCK GRANT REHABILITATION FUNDS COULD BE USED MORE EFFECTIVELY

GAO estimates that communities will budget about $200 million of their block grant rehabilitation funds for grants in fiscal year 1980. Some of these grants will be combined with rehabilitation funds from other sources, such as homeowners' savings or bank loans, thus multiplying the amount of rehabilitation done with each grant. However, communities may award as much as $150 million in grants to property owners to cover all rehabilitation costs--a costly and inefficient use of limited program resources. Communities could use the $150 million more effectively if they would combine direct grant funds with other funds or use loans instead of grants to help homeowners.

Additional housing rehabilitation would be provided by multiplying the amount of rehabilitation done with block grant funds or by recycling the funds back into community rehabilitation programs. (See p. 14.)

ADJUSTING LOAN PAYMENTS TO BORROWERS' INCOMES

Payments established for many section 312 and block grant borrowers do not reflect their ability to repay their rehabilitation loans. For example, borrowers earning more than $30,000 annually generally make the same monthly payments (for rehabilitation loans of similar size) as borrowers earning less than $12,000. Although legislation authorizing the Section 312 Loan Program provides for repayment periods of up to 20 years, HUD does not require loan approving officials to determine the amount that borrowers can reasonably be expected to pay and adjust repayment periods accordingly. As a result, 85 percent of borrowers receive the maximum subsidy allowed--20-year loans at 3 percent interest.

In October 1978, the Congress authorized HUD to develop variable interest rates for section 312 loans based on a borrower's ability to pay. However, as of November 1979 HUD had not done so. (See p. 19.)

GAO estimates that an additional $27.7 million could be available for housing rehabilitation if HUD initiated variable interest rates and repayment periods.

Many communities operated rehabilitation loan programs with block grant funds, which also provide low-interest rates and long repayment periods. Communities need to base these loan payments on a borrower's ability to repay, thereby making more funds available for housing rehabilitation. (See p. 19.)

REHABILITATION FUNDS OFTEN AWARDED TO HIGHER INCOME HOMEOWNERS

Many communities GAO visited award section 312 funds on a first-come, first-served basis, which does not assure that low- and moderate-income homeowners receive priority as the law requires. HUD has not specified how such priority should be given to low- or moderate-income homeowners. Some communities awarded loans to higher income homeowners even though local officials said lower income homeowners still needed assistance. (See p. 26.)

GAO estimates that nationwide over $40 million in section 312 single-family home loans will go to higher income homeowners in fiscal year 1980. (See p. 29.) HUD needs to restrict these loans to low- and moderate-income homeowners other than for justifiable exceptions. (See p. 31.)

RECOMMENDATIONS TO THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

The Secretary of Housing and Urban Development should:

--Develop section 312 single-family loan regulations implementing higher interest rates and shorter repayment periods to reflect the applicant's loan repayment ability, as provided for by the enabling legislation. (See p. 24.)

--Develop section 312 regulations to require that low- and moderate-income borrowers receive funding priority by restricting loans to higher income homeowners to the exceptions defined by the Secretary. (See p. 32.)

--Amend block grant regulations to prohibit the use of grants unless they are combined with other funds. (See p. 18.)

--Provide technical assistance to communities in using deferred payment loans instead of grants to help lower income property owners who cannot afford to make monthly loan payments. (See p. 18.)

--Provide technical assistance to communities using block grant funds for single-family rehabilitation loans in developing methods to adjust loan payments to reflect the borrower's repayment ability. (See p. 25.)

RECOMMENDATIONS TO THE CONGRESS

The Congress should amend section 312 of the Housing Act of 1964 (42 U.S.C. 1452b) to provide for deferred payment loans and to prohibit the refinancing of existing indebtedness secured by a property being rehabilitated. In addition, the Congress should amend section 105 of the Housing and Community Development Act of 1974, as amended (42 U.S.C. 5301), to eliminate the refinancing of existing indebtedness secured by a property being rehabilitated as an eligible activity under the block grant program. (See p. 12.)

AGENCY COMMENTS AND GAO EVALUATION

HUD said that GAO's report and recommendations provide a useful analysis of some key issues in the Section 312 and Block Grant Programs. It agreed with the recommendations that loan payments be adjusted to a borrower's ability to repay and to a restriction of loans to higher income homeowners. HUD said it will include appropriate language in its new regulations consistent with these recommendations. (See pp. 25 and 32.)

HUD also said, however, that the use of rehabilitation grants should not be totally eliminated under the block grant program. GAO believes that the use of these grants is costly and inefficient and that other more efficient financing methods are available. Moreover, GAO did not recommend total elimination of the grants but that they be used in combination with other resources. (See p. 17.)

Because of certain statutory prohibitions, as pointed out by HUD, GAO has directed its recommendations concerning the use of refinancing and deferred payment loans to the Congress. (See p. 11.)

C o n t e n t s

ABBREVIATIONS

CDBG	community development block grant
GAO	General Accounting Office
HUD	Department of Housing and Urban Development

CHAPTER 1

INTRODUCTION

"The conservation and upgrading of our housing stock is important to maintaining the strength of urban areas." 1/

Housing rehabilitation is recognized nationally as an integral component of the Nation's urban policy. Two major federally funded programs which assist community housing rehabilitation are the Section 312 Rehabilitation Loan Program and the Community Development Block Grant (CDBG) Program. Together, these programs will finance over $600 million in housing rehabilitation during fiscal year 1979.

SECTION 312 REHABILITATION LOAN PROGRAM

Section 312 of the Housing Act of 1964 (Public Law 88-560), as amended, authorizes the Department of Housing and Urban Development (HUD) to make direct low-cost loans to property owners for rehabilitation of single and multifamily housing and nonresidential properties. To qualify for a loan, the property must be located in certain designated areas. The purpose of the program is to prevent unnecessary demolition of basically sound structures by providing funds to repair and improve the properties so they comply with local housing and building codes. Borrowers can receive loans up to $27,000 for each dwelling unit. Loans can be repaid over 20 years at a 3-percent interest rate.

Through March 1979, the aggregate value of section 312 rehabilitation loans had reached $528 million. HUD planned to loan over $200 million during fiscal year 1979, which represents the highest annual level of funding in the program's history. HUD's budget for fiscal year 1980 provides $185 million for this program. HUD estimates that 12,800 single-family and 4,500 multifamily units will be funded in 1980, for a total of 17,300 units.

Usually HUD does not get involved in the detailed administration of the program. Property owners request and receive loans through local government housing and community development agencies. In May 1978, there were about 460 cities participating in the program.

1/President's Message to the Congress on the National Urban Policy, Mar. 27, 1978.

CDBG HOUSING REHABILITATION PROGRAMS

The Housing and Community Development Act of 1974 (42 U.S.C. 5301), title I, as amended, established the CDBG Program. This program provides funds to localities for a variety of community development activities designed to eliminate slums and blight, assist low- and moderate-income persons, and respond to urgent local needs. Within general guidelines established by HUD, local governments receive funding for activities they have planned and are responsible for administering.

Over 1,500 localities throughout the United States have chosen to use some of their funds to operate property rehabilitation programs. The total CDBG dollars budgeted for rehabilitation loans and grants increased from $232 million in fiscal year 1975 to $431 million for fiscal year 1977. For fiscal year 1980, CDBG dollars budgeted for rehabilitation probably will exceed $500 million.

Assistance is usually provided to individuals through direct grants and loans or through private loan subsidies or guarantees. Individuals use these funds to repair, weatherize, or make cosmetic changes to their properties. Each locality determines its own rehabilitation program rules and regulations. Thus, CDBG rehabilitation programs differ in terms of eligibility requirements, the maximum amount of money to be loaned and/or granted, and overall program objectives.

SCOPE OF REVIEW

We reviewed the Section 312 Rehabilitation Loan Program and CDBG Housing Rehabilitation Programs for single-family properties to determine if program funds were spent effectively and efficiently.

We made our review at HUD headquarters in Washington, D.C.; the HUD region I area offices in Hartford, Connecticut, and Boston, Massachusetts; the HUD region IV area offices in Greensboro, North Carolina, and Atlanta, Georgia; the HUD region X area offices in Seattle, Washington, and Portland, Oregon; and various community locations in Washington, Oregon, Idaho, Georgia, North Carolina, Florida, Massachusetts, Connecticut, and Rhode Island. (See app. I.) We reviewed policies, procedures, reports, and records relating to these programs and interviewed selected HUD program officials and community representatives. We also examined selected loan and grant files. Our calculations of the cost of Government borrowing were based on the average yield of long-term Treasury bonds at May 1979.

CHAPTER 2

REFINANCING DIVERTS FUNDS

FROM HOUSING REHABILITATION

If the current practice of refinancing home mortgages with section 312 and CDBG housing rehabilitation funds were eliminated, millions of dollars could be made available to rehabilitate housing. We estimate that this could amount to over $24 million in fiscal year 1980 alone. Refinancing is an extremely costly and inefficient use of program funds, diverting large amounts of rehabilitation funds from the actual repair of houses. Many rehabilitation loans are used principally to refinance housing, not rehabilitate it. Over $76 million of section 312 funds and a potentially significant amount of CDBG funds have been used for refinancing houses, not rehabilitating them, since these programs began. Deferred payment loans--loans that do not require monthly payments until the property is sold or transferred--can accomplish rehabilitation program objectives much more efficiently and effectively.

SECTION 312 REFINANCING IS WIDESPREAD

Since inception of the Section 312 Program, borrowers have used over $76 million, or about 18 percent of the loan amount awarded to owners of single-family properties, to refinance their home mortgages. 1/ In fiscal year 1980, section 312 refinancing of home mortgages could amount to over $24 million.

Section 312 of the Housing Act of 1964, as amended, authorized refinancing to reduce monthly housing costs and thus lessen the financial burden of repaying a rehabilitation loan:

> "* * * the loan may exceed the cost of rehabilitation in order to include an amount approved by the Secretary to refinance existing indebtedness secured by such property if such refinancing is necessary to enable the applicant to amortize, with a monthly payment of not more than 20 percentum of his average monthly income, such loan and any other indebtedness secured by his property * * *."

1/"The term single-family properties" refers to owner-occupied structures with one to four dwelling units.

HUD's "Rehabilitation Financing Handbook," which is used as a guide for processing section 312 loans, strongly encourages refinancing at every suitable opportunity. Twenty-two of 25 communities we visited provided refinancing with section 312 funds. Three communities used refinancing in more than 50 percent of the loans they had made. Furthermore, many rehabilitation loans are used principally for refinancing. For example, in region IV, 42 of 87 section 312 loans we reviewed that included funds for refinancing were used principally for refinancing--not rehabilitating--housing. In these 42 loans, refinancing accounted for an average of 64 percent of the loan amount.

Refinancing is extremely costly and inefficient

Refinancing diverts millions of dollars from the funds available to rehabilitate houses. The inefficiency of refinancing is best demonstrated by the following example in which HUD loaned $27,000 to accomplish $10,350 in actual housing rehabilitation.

A homeowner in Seattle needed about $10,350 to rehabilitate his property. A section 312 loan for this amount would have required a minimum monthly payment of about $58. This $58 monthly payment combined with the homeowner's regular mortgage payment of $174 for principal and interest resulted in monthly payments ($232) that exceeded 20 percent of the homeowner's total monthly gross income of $947. Additional section 312 funds were therefore awarded to refinance the homeowner's existing mortgage. A loan of $27,000 at 3 percent interest for 20 years was made to finance $10,350 of rehabilitation work and to pay off an existing mortgage of about $16,650. The property owner's new monthly payment for the section 312 loan of $27,000 was about $150, or $24 less than his mortgage payment before the loan.

Additional examples highlighting the inefficiency of refinancing with section 312 funds are shown in table 1. (See p. 5.) In these examples, $214,750 of section 312 loan funds were used to do only $36,781 of housing rehabilitation. Therefore, refinancing accounted for about 83 percent of the loan amount. In addition, borrowers' monthly principal and interest payments after rehabilitation decreased an average of 44 percent.

Table 1

Examples of Refinancing With Section 312 Loans

Location	Loan amount	Rehabilitation portion		Refinancing portion		Housing payments		
		Amount	Percent	Amount	Percent	Before	After	Percent change
King Co., Wash.	$ 21,450	$ 3,765	18	$ 17,685	82	$154	$119	-23
King Co., Wash.	27,000	6,000	22	21,000	78	197	150	-24
Sheffield, Ala.	16,550	1,785	11	14,765	89	360	92	-74
New Haven, Conn.	17,400	3,416	20	13,984	80	186	97	-48
Miami, Fla.	9,300	696	7	8,604	93	173	52	-70
New Haven, Conn.	22,300	3,273	15	19,027	85	276	124	-55
Marietta, Ga.	14,600	6,411	44	8,189	56	108	81	-25
Memphis, Tenn.	14,850	1,487	10	13,363	90	125	82	-34
Yakima, Wash.	17,400	4,748	27	12,652	73	88	97	+10
Millford, Conn.	26,900	1,000	4	25,900	96	261	149	-43
Lynn, Mass.	27,000	4,200	16	22,800	84	208	150	-28
Total	$214,750	$36,781		$177,969				
Average	$ 19,523	$ 3,344	17	$ 16,179	83	$194	$108	-44

Because refinancing is so costly, the Federal Government could have saved money with all but one of the loans shown in table 1 by simply giving property owners the funds needed for rehabilitation, rather than making a section 312 loan for the rehabilitation amount plus refinancing. In other words, the Federal Government spent more to borrow the money used to make these loans than the rehabilitation portion of the loans themselves. In May 1979 the Federal Government borrowed money at about 9 percent and lent it to section 312 borrowers at 3 percent. This interest difference results in a present value loss to the Government of $3,836 on each $10,000 it lends over 20 years. 1/

Table 2 shows the cost to the Government of the 11 loans in table 1. One loan cost the Government more than 10 times the rehabilitation cost actually financed.

1/Present value loss is the difference between the principal and interest payments of the Government in borrowing the funds and the principal and interest payments of section 312 borrowers discounted at 9 percent over 20 years. Loan servicing fees were excluded from our computation.

Table 2

Cost to the Government of Rehabilitation Loans

	Loan amount (note a)	Rehabilitation portion (note b)	Cost of loan (note c)
	$ 21,450	$ 3,750	$ 8,228
	27,000	6,000	10,357
	16,550	1,785	6,348
	17,400	3,416	6,675
	9,300	696	3,567
	22,300	3,273	8,554
	14,600	6,411	5,600
	14,850	1,487	5,696
	17,400	4,748	6,675
	26,900	1,000	10,318
	27,000	4,200	10,357
Total	$214,750	$36,766	$82,375

a/Total amount of section 312 loan, including refinancing.

b/Loan amount less funds used for refinancing.

c/Based on 9 percent cost of 20-year funds borrowed by the Government. Lending rate of 3 percent. Twenty-year amortization. Excludes loan servicing fees.

Not all section 312 loans involve refinancing, and those that do, do not necessarily cost the Government more than the rehabilitation portion of the loan. Nonetheless, according to HUD statistics, about 18 percent, or more than $76 million of section 312 funds lent to single family property owners, have been used to refinance existing debt since the program started. Because of substantially increased levels of program funding in recent years, refinancing will also increase unless corrective action is taken. If refinancing continues to absorb about 18 percent of section 312 funds, refinancing of residential units could reach about $24 million in fiscal year 1980.

We discussed section 312 refinancing with selected HUD and city officials throughout the United States. Many agreed refinancing uses Federal funds inefficiently and should be restricted or replaced with something more efficient. Some officials suggested eliminating refinancing entirely.

Rehabilitation officials in Quincy, Massachusetts, and Portland, Oregon, said they do not use section 312 funds for refinancing because it takes business away from local banks and does not contribute directly to rehabilitating property. A Yakima, Washington, official said he does not encourage refinancing because the program is supposed to cover rehabilitation costs, not refinance home mortgages. A HUD rehabilitation specialist in Seattle, Washington, said refinancing is an inefficient use of rehabilitation money, particularly since several cities appear to have refinancing programs, rather than rehabilitation programs.

In spite of these problems, several rehabilitation officials were concerned that if refinancing were prohibited some property owners may not be able to afford a rehabilitation loan. We recognize that prohibiting refinancing without offering an alternative would be inconsistent with legislative objectives and may hinder some property owners from participating in the program. We therefore favor an alternative that can accomplish the same objectives more efficiently and effectively--the deferred payment loan.

Deferred payment loans accomplish rehabilitation objectives more efficiently and effectively

The deferred payment loan is simply a loan that is due in a lump sum when the borrower sells or transfers the property. There are no monthly payments on this kind of loan, and generally the loan is secured by a lien against the property.

Using deferred payment loans, HUD would only need to lend property owners the amount required for rehabilitating housing. A deferred payment loan could be made in combination with a direct loan. The direct loan would be given for the amount that would limit a borrower's loan payment to 20 percent of monthly gross income and a deferred payment loan would be given for the remaining amount. Such an approach would help property owners who can afford to repay some amount monthly but cannot afford the full monthly payment necessary to amortize the full loan amount.

The following is an example of how a combination direct/deferred payment loan can be used as an alternative to refinancing and can free additional moneys for housing rehabilitation. A property owner who received a $27,000 section 312 loan (see table 2 on p. 7) had a monthly income of $1,125 and a $197 mortgage payment (principal and interest) before receiving the loan. Based on the legislative criterion of 20 percent, this property owner could afford a $225 monthly payment (20 percent of $1,125); thus, he could pay an additional $28 a month to amortize a loan. A $28 per month payment could support a $5,049 loan at 3 percent interest repaid over 20 years. However, because the applicant needed $6,000, refinancing was used. Using the alternative we propose, the applicant could have received a $5,049 direct loan and a $951 deferred payment loan. This would have kept the property owner's monthly payment within the 20-percent limit and could have freed $21,000 ($27,000 $6,000) for improving someone else's property.

Although the cost of deferred payment loans is difficult to predict accurately because it is uncertain when they will be repaid, we believe they would be no more costly to the Federal Government than direct loans. Deferred payment loans are not due until the borrower sells or transfers the property. Although some borrowers repay deferred payment loans within 1 or 2 years, city officials we interviewed in Portland, Oregon; Boise, Idaho; and Greensboro, North Carolina, expect most deferred payment loans to be repaid within 7 to 10 years.

Assuming that a deferred payment loan carrying a 3-percent compounded interest rate is repaid in 8 years, the cost of the loan to the Federal Government would be about the same as a section 312 direct loan of the same amount at 3-percent interest repaid over 20 years. If the deferred payment loans were repaid earlier, the Government's cost would be less.

If deferred payment loans are repaid in 8 years, an additional $24.8 million (the amount projected for refinancing) in section 312 funds would be available for rehabilitating housing in fiscal year 1980. (See app. II.) Based on HUD's projection for fiscal year 1980, communities could use these additional funds to rehabilitate about 2,300 more housing units.

CDBG REFINANCING IS COSTLY AND INEFFICIENT

Communities are also allowed to use their CDBG housing rehabilitation funds for refinancing. As with section 312 refinancing, CDBG refinancing is an ineffective use of CDBG funds since it diverts funds from rehabilitating housing. HUD regulations regarding eligible CDBG activities states:

> "Refinancing existing indebtedness secured by a property being rehabilitated [is allowed] if such refinancing is necessary or appropriate to the execution of a Community Development Program."

HUD does not keep information on CDBG refinancing, but although the extent is unknown, refinancing with CDBG funds could be significant. During our review, we noted several communities using CDBG funds for this purpose. For example, in the loans we reviewed in Marietta, Georgia, over 40 percent of rehabilitation loan funds were used for refinancing. Boise, Idaho, spent an estimated $370,000 for refinancing during 1978.

Table 3 shows examples of CDBG rehabilitation loans that included funds for refinancing.

Table 3

Examples of Refinancing With CDBG Funds

Loan amount	Rehabilitation portion Amount (note a)	Rehabilitation portion Percent	Refinancing portion Amount	Refinancing portion Percent
$ 23,200	$ 6,363	27	$ 16,837	73
12,000	9,700	81	2,300	19
12,400	2,950	24	9,450	76
7,950	4,850	61	3,100	39
25,000	6,027	24	18,973	76
15,300	7,875	51	7,425	49
33,500	22,230	66	11,270	34
28,378	17,343	61	11,035	39
19,200	9,890	52	9,310	48
22,678	11,078	49	11,600	51
$199,606	$98,306	b/ 49	$101,300	b/ 51

a/Loan amount less refinancing portion.

b/Average of percentages.

As with section 312 refinancing, a combination of direct and deferred payment loans could accomplish rehabilitation objectives more efficiently by making funds used for refinancing available for rehabilitating housing.

CONCLUSIONS

Refinancing with section 312 and CDBG housing rehabilitation funds is a costly and inefficient practice, diverting substantial funds from their intended purpose--to repair houses. Nevertheless, many rehabilitation loans are principally used for refinancing, not rehabilitating housing. We estimate that over $24 million could be made available for housing rehabilitation in fiscal year 1980 if deferred payment loans were used in place of refinancing.

AGENCY COMMENTS AND OUR EVALUATION

In our draft report, we proposed that HUD should amend its regulations to (1) prohibit the use of section 312 and CDBG funds to refinance existing indebtedness of a property being rehabilitated and (2) provide for more effective alternatives, such as deferred payment loans.

In commenting on our draft report, HUD stated that we were correct in stating that refinancing with section 312 can be costly. However, HUD said that in many instances the only method of reducing housing costs that have grown onerous for low-income borrowers, while facilitating rehabilitation of these properties, is refinancing existing indebtedness through the Section 312 Program. Nevertheless, HUD stated that there is a need to revise its present refinancing procedures. Specifically, HUD will revise its "Section 312 Handbook" to provide that refinancing will be used only as a last resort and may incorporate similar language in its new regulations.

HUD also said it is considering increasing the portion of each section 312 loan that must be used for rehabilitation from no less than one-fifth to no less than one-third of the refinancing amount. In addition, HUD said that its new system of allocating funds to localities no longer encourages refinancing, as in previous years.

HUD said that while deferred payment loans are a useful method of accomplishing necessary rehabilitation, they are not a suitable replacement for refinancing. HUD gave the following reasons: (1) low income homeowners could conceivably be prohibited from selling their property in the future due to liens placed on the property and (2) the Section 312 Program has a statutory loan term of 20 years and there is no assurance that the borrower's property will be transferred during the 20-year period.

We have evaluated HUD's proposed changes to its regulations and have concluded that if properly implemented, the changes should improve HUD's rehabilitation program. However, the proposed changes do not go far enough to eliminate the problems we identified. We maintain that refinancing should be prohibited and that deferred payment loans can accomplish the same objectives as refinancing, but more effectively and efficiently. The use of deferred payment loans would not prohibit homeowners from selling their property; homeowners would be in basically the same financial position, as far as liens are concerned, whether HUD used a deferred payment loan or refinanced their existing indebtedness on the property.

HUD is correct in pointing out that the present statutory maximum loan term of 20 years precludes the use of deferred payment loans because, in certain instances, properties may not be transferred within the 20-year period. HUD also stated that, with regard to the CDBG Program, it might not be proper to endorse or implement policy changes relating to program design which may violate congressional discretion. We agree. Therefore, our proposal concerning the prohibition of refinancing and use of deferred payment loans is not included in this report as a recommendation to HUD.

However, because of the significant amount of funds that could be used more effectively for additional housing rehabilitation if our proposals were adopted, we believe the Congress should enact legislation prohibiting refinancing and authorizing the use of deferred payment loans. Accordingly, the following section includes our recommendations to the Congress and suggested language for revising the section 312 and CDBG statutes to accomplish such program changes.

RECOMMENDATIONS TO THE CONGRESS

We recommend that the Congress amend section 312 of the Housing Act of 1964 (42 U.S.C. 1452b) to provide for deferred payment loans and to prohibit the refinancing of existing indebtedness secured by a property being rehabilitated.

Suggested language for revising the act to achieve our recommendations follows:

Subsection 312(c)(4)(A) of Public Law 88-560, approved September 2, 1964, the Housing Act of 1964, as amended, (78 Stat. 791; 42 U.S.C. 1452b(c)(4)(A)), is amended by striking out the colon and all that follows up to and including the word "property" where it last appears.

Subsection 312(c)(2) of Public Law 88-560, approved September 2, 1964, the Housing Act of 1964, as amended (78 Stat. 791, 42 U.S.C. 1452b(c)(2)), is amended by adding, immediately before the period,

> "except that these limitations shall not apply to loans for residential property which are due only upon transfer of the property."

In addition, we recommend that the Congress amend section 105 of the Housing and Community Development Act of 1974, as amended (42 U.S.C. 5305), to eliminate the refinancing of existing indebtedness secured by a property being rehabilitated as an eligible activity under the CDBG Program. Suggested language for revising this act to achieve our recommendation follows:

Section 105 of Public Law 93-383, approved August 22, 1974, the Housing and Community Development Act of 1974, as amended (88 Stat. 642; 42 U.S.C. 5305), is amended by adding a new subsection (c) to read as follows:

> "A Community Development Program assisted under the title may not include refinancing of existing indebtedness in connection with rehabilitation of privately owned properties."

CHAPTER 3

LEVERAGING WITH DIRECT GRANTS OR USING LOANS INSTEAD OF GRANTS WOULD ALLOW ADDITIONAL HOUSING REHABILITATION

By combining grant assistance with other funds or by using loans in place of grants to help homeowners, communities could more effectively use millions of dollars of block grant rehabilitation funds annually. In fiscal year 1980, this could amount to more than $150 million. These changes could allow communities to rehabilitate additional housing by leveraging the amount of rehabilitation accomplished with CDBG funds or by recycling the funds for future use in community rehabilitation programs.

DIRECT GRANTS ARE COSTLY AND INEFFICIENT

We estimate that in fiscal year 1980, communities will budget about $200 million of their CDBG rehabilitation funds for grants. Communities will combine some of these grants with rehabilitation funds from other sources, such as homeowner savings or bank loans, thus multiplying the amount of rehabilitation accomplished with each grant. However, the majority of grants--which could amount to more than $150 million based on HUD's prior records--may be awarded to property owners to cover all rehabilitation costs. These "direct grants" are a costly and inefficient use of limited program resources. Direct grant funds are lost forever, they are not recycled into a community's rehabilitation program, nor are they used to increase the rehabilitation done with CDBG funds.

Several more efficient alternatives to direct grants (many of which were used by block grant communities we visited) are listed below:

--Direct loans--Communities loan CDBG funds directly to property owners to cover the cost of rehabilitation. The loans usually carry a lower interest rate and a longer repayment term than are available from private lenders. The community may use loan repayments to make new loans.

--Partial grants--Communities use CDBG funds to make direct grants to property owners to cover part of the cost of rehabilitation. The remaining part is financed by outside sources as determined by the property owner (savings, personal loan, etc.). This practice reduces the community's cost of the rehabilitation work and increases the amount of rehabilitation done with CDBG funds.

--Subsidized private loans--Communities use CDBG funds to subsidize the difference between the market interest rate and the rate a property owner can afford. Program money is "stretched" by combining it with private financing, thus helping to rehabilitate many more homes.

--Guaranteed loans--Communities use CDBG funds to guarantee payment cf rehabilitation loans made through private financial institutions. Often, lenders require communities to maintain a guarantee fund equal to a small percentage of the outstanding balance of all guaranteed loans. Thus, communities can finance a great deal more rehabilitation with CDBG funds than the amount of CDBG funds available.

--Deferred payment loans--Deferred payment loans are loans that require no monthly payment but must be repaid when the property is sold or transferred. (See p. 8). These loans can be used in the same way as direct grants: to provide financial assistance to property owners who cannot afford to make loan payments. Using a deferred payment loan in place of an outright grant multiplies program funds because over time, as properties are sold or transferred, the loans are repaid, thus making funds available for reuse.

Each of these financing alternatives is more efficient than direct grants because it either multiplies the amount of rehabilitation accomplished with CDBG funds and/or it could provide for additional rehabilitation to occur in later years through loan repayments.

Despite the economic benefits of alternatives to direct grants, many communities continue to operate grant programs. According to HUD and community rehabilitation officials, direct grants are used for providing financial assistance because:

1. Direct grant programs are simpler to operate than other alternatives.

2. Direct grants are needed to help low-income property owners who cannot make additional monthly loan payments.

3. Direct grants are needed to help people who refuse to accept loans.

As discussed below, we believe these reasons do not adequately support a community's use of direct grants.

Reason no. 1: direct grant programs are simpler to operate

Many communities provide no assistance to property owners other than to make direct grants from their CDBG funds. Seven of the 25 communities we visited used direct grants as the principal form of financial assistance to property owners. A December 1976 HUD study of CDBG rehabilitation assistance reported that 40 percent of the 1,102 cities responding to the HUD survey provided assistance only through direct grants.

Several community and HUD rehabilitation officials we interviewed said direct grant programs were used because they were simple to operate. Thus, the programs could be administered with small staffs, and/or block grant rehabilitation funds could be spent quickly. We recognize a legitimate need exists for some communities to use simple programs. Small or inexperienced program staffs could have difficulty managing programs that use sophisticated financing techniques. However, communities can maintain program simplicity and still use their funds more efficiently by using some of the above alternatives. One alternative, the deferred payment loan, operates the same way as a direct grant program and requires no program changes except to require homeowners to sign liens against their property. Another alternative, using partial grants, also is similar to direct grants but the homeowner finances part of the rehabilitation costs from other sources.

Reason no. 2: direct grant programs are needed to help low-income property owners

According to some community officials who administer direct grant programs with CDBG funds, direct grants are needed to help very low-income homeowners who cannot afford to make any monthly payments on a rehabilitation loan.

We recognize that many lower income homeowners may not be able to afford to rehabilitate their homes. Making the payments on a loan could be a hardship for families with extremely low incomes or for families already forced to devote a large share of their income to housing-related expenses. Nonetheless, using direct grants to meet the needs of low-income property owners is unnecessary and inefficient. Deferred payment loans, since they do not require monthly payments, can meet the same objectives more efficiently. Thus, deferred payment loans are a good alternative to direct grants for assisting borrowers who cannot afford to make additional monthly payments.

Three communities we visited were using deferred payment loans to help low-income homeowners. Portland, Oregon, for example, made over 700 deferred-payment loans to lower income property owners in its 1977-78 program year. Portland rehabilitation officials said deferred payment loans helped low-income property owners more efficiently than grants because eventually the funds would return to the city to finance additional rehabilitation.

<u>Reason No. 3: direct grants are needed to help property owners who refuse loans</u>

Several community housing rehabilitation officials said direct grants are needed to provide rehabilitation assistance to property owners who do not want a loan. Local officials told us some property owners are, or might be, reluctant to accept rehabilitation loans, including deferred payment loans, from the city.

Obviously, many property owners would prefer to accept a direct grant rather than a loan to pay for their housing rehabilitation costs. Since loans may require a community to place a lien against the rehabilitated property, and also must eventually be repaid, they are not as attractive to property owners as direct grants. However, it does not make sense to give property owners direct grants when alternatives are available that not only help property owners rehabilitate their homes but also allow CDBG funds to be recycled into the community's rehabilitation program to finance additional housing repairs.

Portland, Oregon, rehabilitation officials also said reluctance to accept a loan is actually, in their opinion, simply a preference for a direct grant. They said that since Portland does not offer direct grants, but only loans, property owners accept loan assistance.

CONCLUSIONS

Millions of dollars of block grant rehabilitation funds--which could amount to more than $150 million in fiscal year 1980--could be used more effectively each year if communities combined grant assistance with other funds or used loans in place of grants to help homeowners. These changes could provide for additional housing rehabilitation by leveraging the amount of rehabilitation accomplished with CDBG funds or by recycling the funds back into community rehabilitation programs to be used again in subsequent years.

AGENCY COMMENTS AND OUR EVALUATION

HUD agreed that grants are a costly method of providing rehabilitation financing and recognized that grants have been used in situations where other financing techniques could have been more appropriate. HUD said it would actively promote the use of deferred payment loans as well as "0-percent" loans as alternatives to grants but added that grants are sometimes necessary and should not be totally eliminated.

HUD stated that grants help lower income homeowners and are easily administered by small cities. These arguments are discussed and dismissed in our report (see p. 16.) which pointed out that deferred payment loans can achieve the same benefits more efficiently.

HUD also noted that some States preclude municipalities from placing liens on private property; thus, in some instances grants have been the only viable financing mechanism available for property rehabilitation. We believe that cities facing this restriction could make direct or deferred payment loans to homeowners without attaching a lien. Nothing is lost, since the grants now being made do not have liens either.

Our review showed that many CDBG communities used direct grants as the principal form of rehabilitation assistance to property owners. It is obvious to us that greater consideration could be given to combining grants with other resources.

Furthermore, we did not recommend that grants be eliminated entirely but simply that they be used in combination with other resources, such as homeowner savings or bank loans, to stretch the amount of rehabilitation accomplished with CDBG funds.

RECOMMENDATIONS

We recommend that the Secretary of HUD:

--Amend CDBG regulations to prohibit the use of grants unless they are combined with other resources.

--Provide technical assistance to communities in using deferred payment loans instead of grants to help lower income property owners who cannot afford to make monthly rehabilitation loan payments.

CHAPTER 4

ADJUSTING LOAN PAYMENTS TO BORROWERS' ABILITY TO REPAY WOULD PROVIDE ADDITIONAL FUNDS TO REHABILITATE HOUSING

Most section 312 borrowers and many CDBG borrowers do not have their rehabilitation loan payments adjusted to reflect their ability to repay the loan. For example, for loans of similar size, section 312 borrowers with incomes in excess of $30,000 annually generally have the same monthly payments as borrowers earning less than $12,000. By adjusting loan payments to reflect borrowers' ability to repay, as much as $27.7 million of additional rehabilitation funds could be available from fiscal year 1980 section 312 funds.

Although legislation authorizing the Section 312 Loan Program provides for repayment periods of up to 20 years, HUD does not require loan approving officials to determine reasonable loan payments and to adjust repayment periods accordingly. As a result, 85 percent of section 312 borrowers receive the maximum subsidy allowed--20-year loans at 3-percent interest. While the maximum subsidy is appropriate for some lower income property owners, our review shows that many section 312 loan recipients can afford higher payments.

In October 1978, the Congress enacted legislation authorizing HUD to develop variable interest rates for section 312 loans, based on ability to pay, for borrowers with incomes of more than 80 percent of area median income. However, as of November 1979, HUD had not implemented this legislation. We estimate that as much as $27.7 million in additional section 312 funds could be available for housing rehabilitation if HUD properly complied with the variable interest rate and repayment period provisions.

Many communities operate rehabilitation loan programs with CDBG funds, which also provided low interest rates and long repayment periods to borrowers regardless of income. We believe loan payments under CDBG programs should also be adjusted by varying interest rates and repayment periods according to a borrower's ability to repay the loan, thereby making additional CDBG funds available to rehabilitate housing.

MOST SECTION 312 BORROWERS RECEIVE THE MAXIMUM ALLOWABLE SUBSIDY, ALTHOUGH MANY CAN AFFORD HIGHER PAYMENTS

By offering low interest rates and long repayment periods, a section 312 loan can reduce the cost of rehabilitation financing by over 60 percent compared to conventional sources. (See table 4 below.)

Table 4

Section 312 Monthly Payments Compared to Conventional Financing (note a)

Type of loan	Loan amount	Interest rate	Repayment period	Monthly payment	Section 312 payment compared to conventional
		(percent)	(years)		(percent)
Section 312	$10,000	3	20	$55	-
Conventional	10,000	12	12	131	42
Conventional	10,000	12	10	143	39
Conventional	10,000	12	7	177	31

a/Private lending institutions we contacted quoted loan terms of 12 percent interest (or higher) with 7 to 12 years to repay. Section 312 borrowers are currently charged 3 percent interest and have up to 20 years to repay.

The extremely low loan payments available through the Section 312 Program may be necessary for some lower income property owners to afford rehabilitation loans. In many cases, however, we were told borrowers can afford higher payments without hardship. Furthermore, rehabilitation officials said most borrowers would rehabilitate, even with higher monthly payments.

HUD does not require loan approving officials to (1) determine the maximum loan payments a borrower can reasonably be expected to pay or (2) adjust monthly payments to reflect a borrower's ability to make higher payments. Thus, although many borrowers can afford higher loan payments, most borrowers receive 20 years to repay their loan--resulting in the lowest allowable monthly payment. According to HUD statistics, over 85 percent of the section 312 borrowers who received loans during 1977 and 1978 were given 20-year payback periods.

Since the capacity of section 312 borrowers to repay loans varies, it is unreasonable for most borrowers to automatically receive the maximum subsidy. Rehabilitation loan payments should be set at a level that encourages rehabilitation but does not cause hardship to the borrower. This would provide prompt repayment and avoid unnecessary costs to the Government.

INCREASING INTEREST RATES AND DECREASING PAYBACK PERIODS COULD SAVE MILLIONS OF DOLLARS FOR ADDITIONAL REHABILITATION

If section 312 loan payments were adjusted to reflect borrowers' repayment ability, millions of dollars could be made available to rehabilitate more houses. The amount of additional funds depends on the criteria used to determine repayment ability and whether interest rates or payback periods are adjusted to determine monthly payments.

One estimate of a borrower's capacity to repay a loan is the ratio of housing payments to monthly income. The section 312 legislation encourages HUD to keep a borrower's monthly principal and interest payments for all housing debt below 20 percent of gross monthly income. Using this criterion, which several rehabilitation officials said was a conservative measure of a borrower's capacity to repay, we found that many borrowers can afford larger section 312 loan payments.

In 1978, section 312 borrowers who received loans with 20-year repayment periods paid an average of 14 percent of their monthly incomes on housing debt. The following table shows examples of borrowers with low housing payments.

Table 5

Examples of Section 312 Borrowers With Low-Housing Debt Payments

Monthly income	Principal and interest payments (mortgage and 312 loan)	Payments as percent of monthly income
$4,500	$214	4.8
3,349	185	5.5
2,506	198	7.9
2,362	146	6.2
1,411	72	5.1
1,077	84	7.8
1,018	63	6.2
983	32	3.3
813	70	8.6
778	17	2.2
580	16	2.8

If section 312 borrowers with 20-year loans and housing debt less than 20 percent of income were given shorter loan repayment periods to increase their payments to 20 percent of gross income, we estimate an additional $16.7 million could be made available from reduced interest losses to rehabilitate more housing. In addition, HUD could save approximately $1.1 million in loan servicing fees. (See app. III for calculations.) We estimate that 7,350 (about 75 percent) of HUD's projected 9,800 fiscal year 1980 loans could have repayment periods shortened to an average of about 9 years. The $16.7 million could rehabilitate about 1,500 additional housing units.

Even more funds could be available to rehabilitate housing if section 312 borrowers had their monthly loan payments increased through higher interest rates rather than shorter payback periods. The 1978 amendments to the section 312 legislation authorize HUD to develop variable interest rates for section 312 loans based on borrowers' ability to pay. The amendments allow interest rates above 3 percent for homeowners with incomes above 80 percent of the area median income. The rate, however, cannot exceed the current Treasury borrowing rate.

We estimate that about half of the projected 7,350 borrowers who could qualify for shorter payback periods in fiscal year 1980 based on the 20-percent criterion could be charged higher interest rates. If these borrowers were charged higher interest rates up to the cost of Government borrowing instead of shorter payback periods, the Government's interest losses would be reduced further, thus providing additional funds to rehabilitate houses. For example, if half of these 7,350 borrowers obtained 20-year loans with 9 percent interest rates (assuming 9 percent to be the cost of Government borrowing), then a total of about $27.7 million, rather than $16.7 million, could be available from fiscal year 1980 loans. 1/ (See app. IV.)

Table 6 below shows the additional rehabilitation funds that could be available from selected fiscal year 1979 section 312 loans if payback periods were decreased or interest rates increased to reflect the borrower's ability to repay. For just five loans, totaling $87,900, over $19,000 in additional rehabilitation funds could be available from decreasing payback periods or about $34,000 from increasing interest rates.

1/However, since not all eligible borrowers could be charged a 9-percent interest rate based on the 20-percent criterion, actual savings could be less than this amount.

Table 6

Additional Rehabilitation Funds Available From Decreasing Payback Periods or Increasing Interest Rates--Selected Fiscal Year 1979 Section 312 Loans

Loan amount	Section 312 payment	Maximum affordable payment (note a)	Minimum payback period (note b)	Additional rehabilitation funds available (note c)	Monthly payment with higher interest rate (note d)	Additional rehabilitation funds available (note e)
$11,100	$ 62	$213	56 months	$ 2,855	$100	$ 4,258
9,550	53	163	64 months	2,317	86	3,663
27,000	150	449	66 months	6,457	243	10,357
20,750	115	316	72 months	4,707	187	7,960
19,500	108	188	121 months	2,838	175	7,480
$87,900				$19,174		$33,718

a/The maximum section 312 payment the borrower could make without monthly housing payments (principal and interest payments) exceeding 20 percent of monthly gross income.

b/Minimum payback period necessary to amortize loan amount with maximum affordable payment at 3-percent interest.

c/The present value of the monthly payments in column 3 discounted at 9 percent, less the present value of the monthly payments in column 2.

d/Monthly payment necessary to amortize loan at 9 percent interest with 20-year payback.

e/The present value of the monthly payments in column 6 discounted at 9 percent, less the present value of the monthly payments in column 2.

As table 6 shows, adjusting loan payments by charging borrowers higher interest rates can provide additional rehabilitation moneys more effectively than shortening payback periods. Unfortunately, as of November 1979 HUD had not implemented higher interest rates.

MANY CDBG LOAN RECIPIENTS CAN AFFORD HIGHER PAYMENTS

Communities could also free additional CDBG rehabilitation funds by adjusting borrowers' loan payments to reflect their ability to pay. We found that several CDBG rehabilitation loan programs gave borrowers low interest rates and long repayment terms similar to the section 312 program. For example, Boise, Idaho; Raleigh and Greensboro; North Carolina; Marietta, Georgia; and Mountlake Terrace, Washington, all provided 3-percent loans with 20 years to repay. A 1976 HUD study of 203 localities in 46 States found that over half had loan programs with fixed interest rates of 3 percent or less. If communities charged higher interest rates, the resulting higher monthly payments could be used to provide additional CDBG funds for housing rehabilitation.

Several cities already adjust loan payments by giving borrowers higher or lower interest rates based on income. Hartford, Connecticut, for example gives rehabilitation loans at either 5 percent or 3 percent interest based on borrowers' income. A July 1977 HUD survey found that 31 percent of the localities in region X operating housing rehabilitation programs adjusted interest rates based on applicants' income.

CONCLUSIONS

Section 312 and CDBG single-family rehabilitation loan payments should be set at a level that encourages rehabilitation and does not cause hardship to the borrower. However, the payment level should provide prompt repayment and avoid unnecessary costs to the Government. This can be done by properly adjusting the loan repayment period and/or interest rate to reflect a borrower's ability to pay. We estimate that in fiscal year 1980 as much as $27.7 million could be made available to rehabilitate up to 2,600 additional housing units if loan payments were properly adjusted.

RECOMMENDATIONS

We recommend that the Secretary of HUD:

--Develop section 312 single-family loan regulations implementing higher interest rates and shorter repayment periods to reflect the applicant's loan repayment ability, as provided for by the enabling legislation.

--Provide technical assistance to communities using CDBG funds for single-family rehabilitation loans in developing methods to adjust loan payments to reflect the borrower's repayment ability.

AGENCY COMMENTS AND OUR EVALUATION

HUD stated that we were correct that in many cases borrowers could conceivably repay section 312 loans over a shorter repayment period than the maximum 20-year term. HUD said it will review the need for shorter terms and include language in the proposed section 312 regulations to make sure that loan terms are appropriate and to require higher interest rates to middle- and upper-income borrowers.

HUD also agreed with our recommendation that CDBG communities should set rehabilitation loan payments to reflect the borrower's ability to repay the debt and that cities should be given technical assistance to encourage that. HUD stated that it is actively promoting this point through technical assistance workshops, publications, and training courses. HUD's actions, if properly implemented, will help resolve the problems we identified.

In our draft report, we suggested that until HUD issued its proposed regulations, it should require section 312 loan repayment periods for new loans to be adjusted so that borrowers' housing debt repayments are least 20 percent of monthly income.

In commenting on our draft report, HUD stated that much more than housing cost is considered in determining the appropriate level of monthly payments and that any simple formula would be very difficult to administer.

HUD's comment has merit, and because HUD has agreed to develop regulations implementing higher interest rates and shorter repayment periods to reflect the applicant's loan repayment ability, we have not included our proposal as a recommendation in this report.

CHAPTER 5

REHABILITATION FUNDS OFTEN

GO TO HIGHER INCOME PROPERTY OWNERS

Millions of dollars of section 312 funds awarded to higher income property owners could be used more effectively to assist low- and moderate-income property owners.

The Secretary of HUD is required by law to give priority to low- and moderate-income applicants 1/ for section 312 loans. However, HUD has not specified how such priority should be given. Community rehabilitation officials we interviewed differed in their interpretations of the "priority" requirements. As a result, communities varied considerably in the extent to which low- and moderate-income homeowners directly benefited from the Section 312 Program.

Many cities we visited processed section 312 applications on a first-come, first-served basis regardless of income. Such a processing system allows higher income 2/ persons to receive funds even though needy low- and moderate-income property owners also require assistance. Some communities awarded more than 50 percent of the loans we reviewed to higher income property owners, although local officials said there was a large unmet need for rehabilitation assistance among low- and moderate-income homeowners. Nationwide, about 30 percent of section 312 funds are loaned to higher income homeowners. This amount could exceed $40 million in fiscal year 1980.

We believe the section 312 rehabilitation program objectives are met best by giving priority to low- and moderate-income homeowners. HUD needs to develop regulations requiring communities to give priority consistently to low- and moderate-income property owners.

1/The term "low- and moderate-income," as defined by 1978 amendments to the Housing and Community Development Act of 1974, means income which does not exceed 95 percent of the area median income. Before Oct. 1978, the term meant not to exceed 80 percent of the area median income.

2/"Higher income" refers to those property owners whose income exceeds that of low- and moderate-income property owners.

THE SECTION 312 PROGRAM REQUIRES HUD TO GIVE LOAN PRIORITY TO LOW- AND MODERATE-INCOME PROPERTY OWNERS

The Section 312 Program imposes no income limits on applicants; however, the enabling legislation requires that HUD give priority to low- and moderate-income persons:

> "The Secretary shall, in making loans under this section, give priority to applications by low- and moderate-income persons who own the property to be rehabilitated and will occupy such property upon completion of the rehabilitation, including applications by condominiums and cooperatives in which the residents are principally of low and moderate income. For the purpose of the preceding sentence, the term 'low and moderate income' means income which does not exceed 95 per centum of the median income for the area."

HUD's section 312 rehabilitation financing handbook for processing section 312 loans repeats this legislative objective. Furthermore, a July 1978 memo from the Assistant Secretary of Community Planning and Development said communities have an obligation to give the required priority in a meaningful way. The memo added that, generally, lending for the direct benefit of low- and moderate-income persons should be the rule and lending for the benefit of others should be the exception.

Most HUD and local rehabilitation program administrators we interviewed agreed that communities should give priority to helping lower income families. Rehabilitation officials said giving priority to low- and moderate-income property owners was the most effective use of section 312 funds because these property owners usually could not qualify for financial help from private lending institutions and therefore could not rehabilitate without section 312 loans.

MANY COMMUNITIES DO NOT GIVE PRIORITY TO LOW- AND MODERATE-INCOME APPLICANTS

Although the enabling legislation clearly requires that priority funding be given to low- and moderate-income applicants, many communities do not have, and HUD does not provide, procedures for meeting this requirement. Some communities we reviewed awarded many single-family loans to higher income property owners. Nationwide, we estimate 30 percent of section 312 funds were awarded to higher income property owners in 1978.

Neither the section 312 legislation nor HUD program documents provide clear guidelines for implementing the priority provision. Therefore, communities administering Section 312 Loan Programs are free to decide how to give priority to low- and moderate-income applicants.

Rehabilitation officials we interviewed nationwide differed in their interpretations of the priority requirement. Several HUD and local officials told us Federal priority requirements were met if at least 51 percent of the section 312 loans or funds were awarded to low- and moderate-income families. Some officials said they give priority by restricting loans to applicants from low- and moderate-income target neighborhoods, regardless of income. Other officials argued that priority meant restricting loans exclusively to lower income families.

Because of the varying interpretations of the priority requirement and HUD's lack of clear guidelines concerning how the requirement should be implemented, communities vary considerably in the extent to which low- and moderate-income property owners benefit from the Section 312 Program. Some communities gave less than 50 percent of the loans we reviewed to low- and moderate-income families, while others used most of their loan funds for this income group.

Many cities we visited processed section 312 applications from target areas on a first-come, first-served basis, regardless of an applicant's income. Local officials said that this system allows higher income families to receive funds even though more needy low- and moderate-income homeowners also require assistance. For example:

--Boise, Idaho, awarded 19 of 30 single-family loans to higher income homeowners between June 1977 and October 1978. Five of the recipients had annual incomes exceeding $20,000 and a family size of two or less.

--Quincy, Massachusetts, awarded 19 of 44 loans between January 1978 and February 1979 to persons with incomes exceeding $21,300.

Some cities use funding systems which, if implemented properly, could provide greater assurance that low- and moderate-income families receive needed assistance. For example, officials in two cities told us they processed applications from all low- and moderate-income property owners before they processed applications from higher income families.

HUD reports that some localities have adopted policies of restricting section 312 funds to low- and moderate-income persons. HUD supports, but does not require, this approach. Only one community we visited had adopted this policy. Portland, Oregon, restricts applications to property owners with incomes less than the city's median income (adjusted for family size). Portland will receive one of the largest fiscal year 1979 allocations of section 312 funds in the Nation.

MANY HIGHER INCOME PROPERTY OWNERS RECEIVE LOANS

HUD reports that section 312 has principally benefited low- and moderate-income property owners nationwide because they receive about 70 percent of the single-family loans. Table 7 shows the income distribution of section 312 loans for 1978.

Table 7

Income Distribution of 2,957 Section 312 Single-Family Loans Awarded in 1978

Yearly income	Percent of loans	Percent of loan amount
$3,000 and under	2.2	1.0
3,012 - $4,500	4.2	2.2
4,512 - 6,000	6.1	4.7
6,012 - 7,500	7.5	6.7
7,512 - 9,000	8.9	8.5
9,012 - 10,500	9.5	9.3
10,512 - 12,000	9.5	9.6
12,012 - 13,500	9.4	9.7
13,512 - 15,000	7.4	7.8
15,012 - 16,500	7.5	8.2
16,512 - 18,000	6.1	5.8
18,012 - 22,500	10.6	11.8
22,512 - 30,000	8.0	10.0
30,012 - 74,700	2.7	4.1
74,712 and over	.4	.6
Total	100.0	100.0

If the past ratio of funding 70 percent low- and moderate-income families continues, we estimate that over $40 million in section 312 loans will be awarded to higher income families in fiscal year 1980. Whether the 70-percent figure shows that the Section 312 Program gives priority to lower income property owners is debatable; clearly, some communities are not meeting this provision. However, disregarding the priority issue, most community and HUD rehabilitation officials we interviewed said that (1) section 312 funds are used most effectively when they are given to low- and moderate-income families and (2) section 312 loans should be restricted to assure that greater emphasis is placed on funding needy low- and moderate-income property owners.

FUNDING LOW- AND MODERATE-INCOME HOMEOWNERS USES FUNDS MOST EFFECTIVELY

Several community and HUD officials said funding higher income property owners was using funds ineffectively and should be restricted. They also told us that many higher income families, particularly those with substantial incomes, usually could obtain loans from private lending institutions without incurring financial hardship. Some officials said higher income people would rehabilitate their homes even if Federal assistance were not available; thus, awarding loans to these families was not using funds effectively. Many local officials explained, however, that higher income property owners received loans simply because they were eligible by law. Examples of some higher income section 312 recipients with substantial incomes are shown below.

--A dentist with four dependents and a $54,000 yearly family income obtained a $10,350, 20-year loan.

--A university professor of medicine with four dependents and a yearly family income of about $40,200 obtained a $9,600, 20-year loan.

--An engineer with two dependents and a family income of about $32,200 obtained a $12,850, 20-year loan.

--An attorney with one dependent and a $44,600 family income obtained a $12,250, 20-year loan.

--A truck driver and his wife with a $43,200 family income obtained a $13,650, 20-year loan.

--A family of four with a $48,000 income obtained $27,000, 20-year loan.

--A physician with three dependents and a $34,200 family income obtained a $27,000, 20-year loan.

--A U.S. Army major and his wife with a $34,900 income obtained a $27,000, 20-year loan.

In our opinion, communities do not use the limited section 312 resources effectively when they loan the resources to property owners who can obtain assistance from private lending institutions. Not only can this practice exclude assisting needy low- and moderate-income property owners who cannot qualify for credit elsewhere, but it is inconsistent with the Federal goal of encouraging private financial institutions to make loans in deteriorating neighborhoods.

The staff director of the Urban Reinvestment Task Force agreed that funding affluent property owners is not a good policy. In testimony before a House subcommittee in March 1977, the director stated:

> "Homeowners of all income levels are eligible to receive section 312 loan funds, and we believe it is not desirable public policy for affluent homeowners who are fully capable of making payments on normal loans to receive this subsidy."

We concur with the many rehabilitation officials who contend that some restrictions should be placed on the use of section 312 funds. Such restrictions should (1) guarantee priority to low- and moderate-income property owners and (2) eliminate unnecessary single-family loans to property owners with substantial incomes.

Rehabilitation officials told us that an income ceiling would be the easiest way to achieve these objectives. Several officials added, however, that they would like to maintain the flexibility of making loans in exceptional cases, to higher income property owners. Such a provision would be consistent with a July 1978 memo from the Assistant Secretary for Community Planning and Development, which said,

> "In general, lending for the direct benefit of low- and moderate-income persons should be the rule and lending for others should be the exception."

We agree. Other than for justifiable exceptions, HUD should restrict section 312 loans to homeowners with incomes 95 percent or less of the median income for an area.

CONCLUSIONS

HUD could use millions of dollars in section 312 rehabilitation funds more effectively if it gave greater funding priority to low- and moderate-income homeowners. Many communities we visited award section 312 funds on a first-come, first-served basis, which does not assure that low- and moderate-income homeowners receive the priority required by law. Some communities awarded more than 50 percent of the loans we reviewed to higher income households, although local officials told us low- and moderate-income homeowners also needed assistance. We estimate that nationwide over $40 million in section 312 single-family loans will go to higher income families in fiscal year 1980. Other than for justifiable exceptions, HUD should restrict section 312 loans to low- and moderate-income homeowners.

RECOMMENDATION

We recommend that the Secretary of HUD:

--Develop section 312 regulations to require that low- and moderate-income single-family loan applicants receive funding priority by restricting loans to higher income homeowners to exceptions defined by the Secretary.

AGENCY COMMENTS

HUD agreed with our recommendation and stated that language clarifying the standards or criteria for issuing loans to higher income participants will be incorporated in the proposed section 312 regulations. In addition, HUD's process of allocating section 312 funds for fiscal year 1980 will require consideration of the locality's performance in meeting the priority for low- to moderate-income participants.

APPENDIX I

COMMUNITIES GAO VISITED

Connecticut:
- Hartford
- New Britain
- New Haven

Florida:
- Sarasota
- St. Petersburg

Georgia:
- East Point
- Marietta

Idaho:
- Boise

Massachusetts:
- Lowell
- Quincy
- Worcester

North Carolina:
- Durham
- Greensboro
- Raleigh

Oregon:
- Portland
- Salem

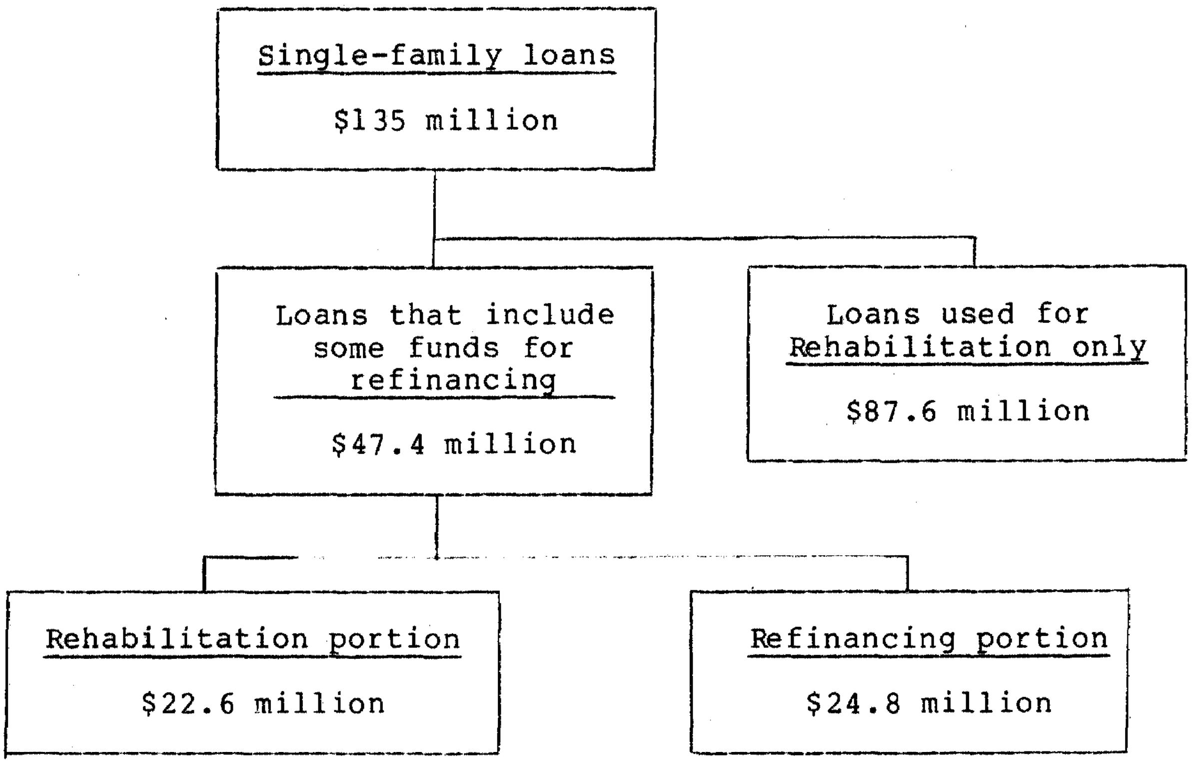
Rhode Island
- Providence

Washington:
- Everett
- King County
- Mountlake Terrace
- Seattle
- Spokane
- Tacoma
- Vancouver
- Yakima

PROJECTED IMPACT OF USING DEFERRED PAYMENT LOANS IN PLACE OF REFINANCING FOR SECTION 312 LOANS

FISCAL YEAR 1980

In fiscal year 1980, HUD plans to spend about $135 million for single-family loans to property owners. Based on past program experience, 35.1 percent of this amount ($47.4 million) will be given out in loans that include some portion for refinancing. Similarly, about $24.8 million of the $47.4 million can be expected to be used for refinancing, and $22.6 million for actual housing rehabilitation. (See chart below.)



Thus, as currently projected, HUD will loan $135 million in fiscal year 1980 but will finance only about $110.2 million of housing rehabilitation--since $24.8 million will be used to refinance home mortgages. We propose that HUD combine deferred payment loans with direct loans to finance the $22.6 million of the $47.4 million which is used for actual housing rehabilitation. This could "free" the remaining $24.8 million, used for refinancing, for housing rehabilitation.

The $24.8 million used for refinancing can be available for rehabilitation only if the Government's cost of making deferred payment loans does not exceed the cost of direct loans. (If deferred payment loans cost more than direct loans, some of the $24.8 million may have to be used to compensate for the additional cost.) The Government's cost is simply the difference between the present value of the Treasury's interest and principal payments for the loan amount and the present value of a borrower's loan repayments. For example, each $10,000 section 312 loan at 3 percent interest, repaid over 20 years, costs the Government about $3,836. The loss occurs because the Government borrows funds at 9 percent and lends them to section 312 borrowers at 3 percent.

A deferred payment loan for the same $10,000 could cost more or less than $3,836, depending on when it is repaid. The following table shows the cost of a $10,000 deferred payment loan for various payback periods. The calculations are based on the assumption that the deferred payment loan accumulates interest at 3 percent.

Cost of Deferred Payment Loans

Deferred payment loan amount	Years to repay	Amount due (note a)	Present value of amount due (note b)	Cost to the Government (note c)
$10,000	7	$12,334	$6,584	$3,416
10,000	8	12,709	6,203	3,797
10,000	9	13,095	5,843	4,157
10,000	10	13,494	5,505	4,495

a/Loan amount at 3 percent interest compounded for the number of years to repay.

b/The amount due discounted at 9 percent interest.

c/The loan amount less the present value of the amount due.

Based on this table, if a $10,000 deferred payment loan were repaid in about 8 years, the Government's cost would be slightly less than the $3,836 cost of a direct loan for the same amount. Since housing rehabilitation officials said they expected deferred payment loans to be repaid within 7 to 10 years, deferred payment loans should cost about the same as direct loans. Thus, if borrowers were given a combination of direct and deferred payment loans to finance needed housing rehabilitation instead of having their mortgages refinanced, an additional $24.8 million could be available for housing rehabilitation in fiscal year 1980.

PROJECTED ADDITIONAL HOUSING REHABILITATION FUNDS AVAILABLE THROUGH DECREASING SECTION 312 LOAN REPAYMENT PERIODS

FISCAL YEAR 1980

The calculation of additional housing rehabilitation funds is based on the following information:

Single-family loan amount	$135,000,000	(HUD estimate)
Number of loans	9,800	(HUD estimate)
Number of loans with 20-year terms and borrower paying less than 20 percent of monthly income on housing debt	7,350	(GAO estimate based on prior loans)
Average loan amount	$13,776	($\frac{\$135 \text{ million}}{9,800 \text{ loans}}$ = $13,776 per loan)
Average monthly income of section 312 bor rowers receiving 20-year loans and paying less than 20 percent of monthly income on housing debt	$1,116	(GAO estimate based on 1978 borrowers)
Average mortgage payment of section 312 borrowers before receiving a section 312 loan	$75.50	(GAO estimate based on 1978 borrowers)
Cost of Government borrowing	9%	(Average yield on long-term Treasury bonds--May 1979)

To calculate the additional housing rehabilitation funds available through decreasing repayment periods, it is first necessary to determine the maximum section 312 loan payment borrowers can afford without exceeding 20 percent of their monthly gross income. Next, the reduced repayment period possible with this increased payment should be determined.

Maximum payment

Criterion: Housing debt should not exceed 20 percent of average monthly income.

--Average monthly income of section 312 borrowers	$1,116.00
--20 percent of average monthly income	223.20
--Average mortgage payment before rehabilitation	75.50
--Maximum section 312 payment ($223.20-$75.50)	147.70

Reduced payback period

Assumptions:

--Average loan amount	$13,776.00
--Interest rate	3%
--Monthly payment	$147.70

Given these variables, a section 312 loan could be repaid in 106.3 months, or about 9 years.

Additional rehabilitation funds available

This calculation simply compares the present value of loan payments from 20-year loans to the present value of loan payments from 9-year loans.

Assumptions:

--Average loan amount	$13,776.00
--Cost of Government borrowing	9%
--Number of loans in our analysis	7,350
--Monthly payment necessary to amortize a 3-percent, 20-year loan of $13,776	$76.40

--Monthly payment necessary to amortize a 3-percent, 9-year loan of $13,776 (slightly less than the maximum affordable payment--$147.70)	$145.71

Present value of 3 percent, 20-year section 312 loans:

Total monthly loan payments ($76.40) x 7,350 loans	$ 561,540
$561,540 for 240 months (20 years) discounted at 9 percent	$62,412,338

Present value of 3 percent, 9-year section 312 loans:

Total monthly loan payments ($145.71) x 7,350 loans	$ 1,070,969
$1,070,969 for 108 months (9 years) discounted at 9 percent	$79,079,688
Additional rehabilitation funds available:	$16,667,350

In addition to the $16,667,350 present value savings, the Government could save additional moneys from the reduced costs of servicing 9-year loans instead of 20-year loans. Currently, the Government pays $4 per loan per month for servicing each section 312 loan. The $4 per month for 20 years, discounted at 9 percent interest, costs the Government about $445 (present value of payments), versus about $295 for 9 years of payments. The difference, $150 per loan, times 7,350 loans yields additional savings of $1,102,500.

PROJECTED ADDITIONAL HOUSING REHABILITATION FUNDS AVAILABLE THROUGH INCREASING SECTION 312 LOAN INTEREST RATES IN FISCAL YEAR 1980

We estimate that in fiscal year 1980, 7,350 1/ borrowers having 20-year section 312 loans could make higher loan payments without hardship, thereby qualifying for shorter loan repayment periods. (See app. III.) Based on HUD studies, we estimate that about half of these borrowers (3,675) probably will have incomes exceeding 80 percent of the area median. These borrowers could be charged higher loan interest rates. If these borrowers were given 20-year loans with 9 percent interest rates (assuming 9 percent is the cost of Government borrowing), reduced interest losses to the Government would result in an additional $19.4 million available for housing rehabilitation. 2/ Combined with the reduced interest losses to the Government, if the remaining borrowers received shorter repayment periods (calculated to save about $8.3 million), as much as $27.7 million could be made available for housing rehabilitation. Our calculations are as follows:

(1) 20-year section 312 loans eligible to pay higher interest rates:	3,675
Remaining 20-year loans eligible for shorter repayment periods:	3,675
Total:	7,350

1/The 7,350 represents the projected number of fiscal year 1980 section 312 borrowers with 20-year loans and total housing debt (including the section 312 loan) of less than 20 percent of average monthly income.

2/The borrowers' housing debt would average about 18 percent of monthly income.

(2) Cost to the Government to make 3,675 loans at 3 percent interest:

	(millions)
--Government funds disbursed for loans (3,675 loans at $13,776 avg. loan amount)	$50.6
--Less present value of monthly payments discounted at 9 percent interest	31.2
Cost to the Government:	$19.4

(3) Cost to the Government in lost interest from making 3,675 loans at 9 percent interest (Government borrowing rate for 20-year obligations--May 1979)	$ 0.0
(4) Funds available for housing rehabilitation by increasing interest rates (step 2 less step 3)	19.4 1/
(5) Funds available for housing rehabilitation by shortening repayment periods for 3,675 loans where borrower cannot be charged increased interest rates (one-half of $16,667,350 available for rehabilitation by shortening repayment periods for 7,350 loans, as estimated in app. III)	8.3
Total maximum funds available for housing rehabilitation	$27.7

This analysis does not include borrowers that would receive less than 20-year loans and had housing debts of less than 20 percent of income. If included, additional funds would be available to rehabilitate housing.

1/Since not all eligible borrowers could necessarily be charged a 9-percent interest rate, based on the 20-percent housing debt to income criterion, actual savings could be less than this amount.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

September 18, 1979

OFFICE OF THE ASSISTANT SECRETARY
FOR COMMUNITY PLANNING AND DEVELOPMENT

IN REPLY REFER TO:

Mr. Henry Eschwege
Director, Community and Economic
Development Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Eschwege:

We have reviewed the draft report prepared by the General Accounting Office (GAO) entitled, "Millions of Dollars for Housing Rehabilitation Can be More Effectively Used". The issues you have raised are important, and we have considered them carefully.

The draft GAO report and recommendations provide a useful analysis of some key issues in the Section 312 rehabilitation loan program and the local rehabilitation financing activities funded under the Community Development Block Grant (CDBG) Program. We have responded to each of the major points in the report as they apply first to the Section 312 and then to CDBG-aided rehabilitation financing activities.

Sincerely,

Robert C. Embry, Jr.
Assistant Secretary

Enclosure

I. RESPONSE TO COMMENTS ON THE SECTION 312 REHABILITATION LOAN PROGRAM

The following comments relate only to the Section 312 aspects mentioned in the draft GAO report:

A. GENERAL COMMENTS

The GAO report highlights many aspects of the 312 Program that are presently under serious review as part of the Section 312 Program regulation presently in draft form. Many of the Section 312 procedures cited in the GAO report have already been altered in the new regulation. Obviously, these proposed procedures are subject to further change as comment is received from the public and from within the Department. Substantive revisions are contemplated in Section 312 policies pertaining to refinancing, interest rates and loan term.

B. REFINANCING

GAO is correct in stating that refinancing with Section 312 can be costly. However, in many instances the only method of alleviating housing costs that have grown onerous for low-income borrowers, while facilitating rehabilitation of those properties, is the refinancing of the existing indebtedness using the 312 Program. With the growing problem of displacement of low-income people from urban neighborhoods, it is incumbent on this Department to maintain programs and policies that will allow low-income homeowners to continue in the residence of their choice.

Nevertheless, refinancing with 312 is in need of updating. The Section 312 refinancing procedures were developed in the mid-1960's when the program was primarily used in support of urban renewal activities. With the advent of Community Development Block Grant rehabilitation programs, and the change of focus in 312 to support community development rehabilitation programs, there is need to revise our present refinancing procedures.

Specifically, the Section 312 Rehabilitation Financing Handbook (7375.1) will delete reference to "strongly encouraging the use of refinancing at every suitable opportunity." Rather, refinancing will be used only as a last resort when Community Development Rehabilitation and/or Section 312 direct rehabilitation assistance is not feasible for the borrower without refinancing. Similar language may be incorporated in the new regulation.

The allocation of funds to localities no longer encourages refinancing as in previous years. Until FY 1979, funds were allocated on a first-come, first-serve basis from a pool of funds from each Area Office. Localities that used 312 funds to refinance properties early in the fiscal year were able to obligate more funds than cities that decided to take a more conservative view of refinancing. Beginning with the FY 1979 funding allocation system, all major users of 312 funds received notification at the beginning of the fiscal year of a Section 312 "target" allocation. This allocation sets a "ceiling" amount which cannot be exceeded during the fiscal year. As a result, localities must realistically and carefully plan the use of their funds over the course of the entire fiscal year and must control the limited resources being allocated for use in their communities. Since refinancing is more costly, it has less appeal except in those instances where it is clearly necessary as cited above.

We are considering increasing the portion of each refinancing that must be used for rehabilitation from no less than one-fifth of the refinancing to no less than one-third. In addition, only code-related repairs may be included in determining the rehabilitation portion of the loan. This requirement will, if enacted, prevent a local public agency from "loading up" on general property improvements in order to make the refinancing calculation work.

The GAO report suggests the deferred payment loans can accomplish the same objectives as refinancing but "more efficiently and effectively." While the deferred loans are a useful method of accomplishing necessary rehabilitation for borrowers unable to acquire suitable financing even under liberal terms, it is not a suitable replacement for refinancing. First, low-income homeowners could conceivably be prohibited from selling their property in the future due to the liens placed on the property, since, in effect, the existing debt plus deferred payment for rehabilitation may exceed the market value of the property. The likelihood of this scenario occurring is increased because of the deteriorating conditions found in many of the low-income neighborhoods receiving 312 funds. Second, Section 312 has a statutory maximum loan term of 20 years. There is no assurance that the borrower's property will be transferred during the 20 year period.

C. INTEREST RATES

The Section 312 proposed regulation will incorporate language requiring higher interest rate loans to middle- and upper-income borrowers (who will participate on an "exception" basis).

D. LOAN TERM

GAO is correct in stating that in many cases borrowers could conceivably repay Section 312 loans over a shorter repayment period than the maximum 20-year term. This is often the case on loans of only a few thousand dollars. However, the GAO suggestion that about 75 per cent of HUD's 1980 loans could have repayment periods shortened to an average of 9 years is unrealistic. Much more than the housing cost is considered in determining the appropriate level of monthly payments. Past credit history, non-housing expenses, employment history, family size, and the like all must be considered. Although it is virtually impossible to determine what level of monthly obligation is correct for each individual loan applicant through any simple formula, we shall review the need for shorter terms and include language in the proposed regulations to make sure that loan terms are appropriate.

E. LOANS TO HIGHER INCOME PARTICIPANTS

One of the primary goals of rehabilitation assistance including Section 312 is the preservation and revitalization of deteriorating neighborhoods. Loans to borrowers of higher income may in some cases be necessary in order to foster the upgrading. However, loans to higher-income participants are to be made on an exception basis. In an effort to reinforce the Department's present policy, the process of allocating funds to localities for FY 1980 will require consideration of the locality's performance in meeting the priority for low- to moderate-income participants.

In addition, language clarifying the standards or criteria for issuing loans to higher-income participants will be incorporated in the proposed regulation. Rewarding or penalizing localities with funding decisions is a more appropriate method of controlling the issuance of loans to higher-income borrowers than mandatorily imposing some HUD developed artificial income limits on participation. Local discretion is crucial to a successful rehabilitation strategy.

II. RESPONSE TO COMMENTS ON COMMUNITY DEVELOPMENT BLOCK GRANT REHABILITATION.

The following comments relate to the portions of the GAO report dealing with rehabilitation under the Community Development Block Grant Program.

A. GENERAL COMMENTS

All of our responses to the specific questions raised by the GAO in this area reflect our view of the following key aspects of the Community Development program and its impact on rehabilitation:

1) - When Congress incorporated a number of earlier HUD categorical funding programs into the Community Development Block Grant (CDBG) framework in 1974 it clearly intended to allow the funding eligiblity categories from the previous programs to continue under CDBG, unless specifically prohibited. In the rehabilitation area, Congress explicitly made rehabilitation loans and grants eligible activities for local funding.

2) - Although Congress consolidated earlier programs into Community Development Block Grants, it also incorporated a number of significant new approaches into the revised program. For example, Congress established simplified annual funding applications and review requirements that reduced the paperwork localities had to prepare and minimized delays in getting programs underway. Furthermore, Congress gave local governments the right to determine which eligible activities they wished to carry out and how to structure the specific programs needed to carry out localities' overall objectives. In the rehabilitation area, the Congressional interest was, and remains, to have individual jurisdictions design the specific delivery mechanism and guidelines for provisions of rehabilitation benefits.

3) - Once the CDBG program with its major emphasis on local policy making got underway, it proved a major element in the nationwide thrust towards property rehabilitation and neighborhood revitalization. From 1974 to 1979 the number of communities and/or counties annually utilizing public funds for rehabilitation loans and/or grants jumped from about 300 (users of Section 312 loans and Section 115 grants) to over 2,100. This includes the numbers for two annual cycles of small cities discretionary grants: activities generally stretch over two fiscal years, even on one year single purpose grants. Since urban county CDBG programs generally cover a number of communities, HUD estimates that citizens in nearly 3,000 communities now annually receive CDBG financed support. It is also important to note that this high level of rehabilitation funding is the direct result of local policy choices by officials who believe that the flexibility of the CDBG program makes it a particularly viable tool for rehabilitation financing.

4) - The CDBG process is generating a far higher level of specific rehabilitation activity than any other public program. HUD estimates that at least 75,000, and probably 100,000, loans and/or grants funded in whole or part under CDBG are now being processed annually. As the number of communities doing rehabilitation goes up, local experience in managing preservation efforts increases, and as the funding amounts available rise, the numbers of processed loans and grants are showing a dramatic increase each year. Many factors play a part in the marked increase in local productivity, but the ability under CDBG communities to set up simple, easy to understand, program guidelines and streamlined processing systems for their CDBG loan and grant activity is a critical factor in their growing success.

5) - Local CDBG rehabilitation programs have not been static. Many efforts initially relied exclusively on grants. Loan programs were limited to single interest rates. Few programs attempted to leverage public funds. But as localities gained experience, they made significant changes. Thanks in part to the growing citizen demand for limited rehabilitation resources, the number of "grant-only" programs is down dramatically since 1974. HUD estimates that no more than 10 percent of entitlement CDBG efforts now have a grant-only approach. As local officials grow more sophisticated in operating their programs, a number of communities have now established variable rate loan programs. As for leveraging, particularly with private sector loans and mortgages, there has been a marked increase in the combination of funding sources within local rehabilitation efforts. In 1976 approximately 15 percent of all local CDBG efforts involved private sector financing in their individual rehabilitation loan packages: today, that figure is up by at least 10 percent. The passage of the Community Reinvestment Act, requiring lender involvement in the communities where depositers reside, and the growing local need for supplementary funds are accelerating the trend towards leveraging.

There are now upwards of 8,000 local officials engaged in carrying out CDBG rehabilitation loan and grant programs. At least 6,000 of these local staff members had no previous experience in the public rehabilitation field prior to 1975. Given the rapid development of the field, local governments and the new rehabilitation profession have done a remarkable job in getting a major national initiative well underway. Throughout the country, neighborhoods are now beginning to show the physical and psychological results of the new aggressive local activity.

Every program involving public funds deserves continuing scrutiny. There are many areas of CDBG rehabilitation that need continuing improvement. As documented below, HUD is now taking a number of steps to increase the efficiency and quality of local CDBG rehabilitation efforts. Many of the expected results will be directly responsive to the concerns the GAO has expressed in its report. However, HUD is not prepared to endorse or implement by regulation specification policies relating to CDBG programs design which it believes violate the Congressional discretion in developing loan and grant efforts and, even more significantly, may cut off the local creativity which has already generated such positive results. The history of the public rehabilitation field in the country suggests that local policy making, backed up by HUD guidance and assistance, is by far the most viable approach to rehabilitation programming yet developed. We are unwilling to make any basic changes in a system which has been working so well.

B. REFINANCING

The arguments used in support of continuing refinancing under Section 312 loan program (I-B, para 1 above) are also relevant to the use of CDBG Funds for refinancing. It should also be noted that the GAO's arguments against refinancing and use of rehabilitation grants are, to some extent contradictory. Low-income homeowners in many parts of the country could only afford to purchase their homes by obtaining high interest, short term mortgages with large monthly payments, as no other financing was available. As a result, these owners' high level of current indebtedness makes it impossible for them to take out a loan for rehabilitation; they require grants. In such cases, use of public funds for refinancing can result in a loan package, to be repaid, covering more realistic monthly payments on both the past indebtedness and the cost of rehabilitation.

It should also be noted that HUD believes the use of public funds for refinancing under the CDBG has been very limited. In most communities, local funding resources do not meet citizen demands for rehabilitation benefits, and most governments have not been willing to provide individual homeowners with the relatively large amount of funding refinancing will require; the local political dynamic encourages spreading the wealth. The disincentive to refinance increases as rehabilitation becomes more popular and more neighborhoods and individuals press for participation.

HUD feels that refinancing should be permitted, but wants it to be a relatively limited aspect of the overall expenditure of loan and grant funds. Along with the GAO, we are interested in determining how much CDBG rehabilitation funds were used to refinance existing debts. A survey questionnaire to bring objective information on this item, as well as many others related to CDBG rehabilitation activities, is being prepared by the HUD Office of Urban Rehabilitation and will be sent to all communities that have budgeted block grant funds for local rehabilitation financing activities. We believe this survey will show that only limited CDBG funds are used to refinance existing debts, but we are prepared to discuss additional regulation restrictions if we are incorrect.

C. GRANTS

The GAO report states that grants are a costly method of providing rehabilitation financing. While we agree that grants are costly we do not conclude that grants should be totally eliminated.

In fact, grants perform very important functions in many rehabilitation programs and are the only legal rehabilitation financing mechanism available to some cities. Rehabilitation grants meet the needs of very low-income and elderly homeowners who could not otherwise participate in home improvement programs. Grants are particularly valuable in providing assistance to elderly owners who desperately need repairs to their homes, but who do not want to add any outstanding indebtness to their property.

Some states preclude the placement of liens by a municipality on private property. In such cases grants have been the only viable financing mechanism available for property rehabilitation.

Because grants are also very simple to administer, small rehabilitation programs and cities with one year block grant funding have found that grants are an efficient and cost effective method of providing rehabilitation assistance. These cities cannot rely upon future funding and staff to administer loan programs. Grants allow the cities to make needed improvements to properties without worrying about who and how the conditions of a long term loan will be administered.

D. DEFERRED PAYMENT LOANS

Although we believe that grants can play an important part in local rehabilitation efforts, we also recognize that grants have sometimes been used in situations where other financing techniques would have been more appropriate. The Office of Urban Rehabilitation and Community Reinvestment will continue to actively provide technical assistance to communities on the most efficient and effective rehabilitation financing techniques. Through workshops and seminars we are promoting the use of deferred payment loans as well as '0' percent interest loans as alternatives to grants.

E. LOAN PAYMENTS AND ABILITY TO PAY

We concur with GAO's recommendation that loan payments should reflect the borrower's ability to repay the debt and that technical assistance be provided to cities to encourage this. HUD is already actively promoting this point through technical assistance workshops, publications, and training courses. Through such assistance we are encouraging both very low interest financing for lower-income borrowers and higher interest rates for those who require smaller subsidies to accomplish rehabilitation. However, consistent with our general comments above, we are not prepared to mandate such systems.

F. TECHNICAL ASSISTANCE

An important new initiative of the Department is the active use of technical assistance to improve local rehabilitation programs. The need for a technical assistance program resulted from two related factors:

- the Community Development Block Grant (CDBG), Section 312 and Section 8 programs have vastly increased the resources available for publicly assisted rehabilitation.

- after many years of inadequate funding for housing, cities found themselves with insufficient and inexperienced staff to carryout rehabilitation programs.

In order for localities to manage the increased production and master the skills and procedures required for complex programs, both HUD and city staff view technical assistance as essential. Where, though, would it come from? Cities had no money to pay for assistance and HUD had traditionally been reluctant to offer much direction to localities.

HUD's Office of Urban Rehabilitation and Community Reinvestment realized that through technical assistance HUD could influence <u>how</u> rehabilitation programs are administered without jeopardizing a locality's important right to plan, organize and budget its own CDBG program. Using monies from the Secretary's Discretionary Fund, the OURCR has developed a comprehensive rehabilitation technical assistance program. The three major components are:

-- the Community Rehabilitation Training Center
-- the Rehabilitation Advisory Service
-- the Rehabilitation Publication Service

Through these three activities, the office offers nuts and bolts courses, direct technical assistance, and up-to-date literature on the state of the art. The principal goal of the Rehabilitation Technical Assistance Program is to increase the capacity of local government staff to effectively use, operate, and manage the expanded rehabilitation resource available to them.

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