Analysis Of Six Section 502
Rural Housing Demonstration Programs
USDA Farmers Home Administration

S U M M A R Y

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Executive Summary

Background

The Farmers Home Administration (FmHA) is an agency within the U.S. Department of Agriculture that assists agricultural and rural development in the United States. FmHA is the only Federal agency that serves as a direct lender to meet housing needs of low-income rural households who could not otherwise qualify for credit through conventional sources. FmHA's major housing programs were created as part of the 1949 Federal Housing Act. Since 1950, the FmHA has administered over 2 million individual grants and loans totalling over $56 billion in support of rural housing.[1] Initially, FmHA served farm families through farm ownership and water facilities projects but this focus has since shifted. In 1961, FmHA housing programs were opened to non-farm residents in rural areas. These residents are now the primary recipients of FmHA services.

The Farmers Home Administration Section 502 Rural Housing Program is the major federal program to serve housing needs of low-income rural households.[2] The FmHA Section 502 Rural Housing Program is a subsidized homeownership program that provides direct mortgage loans to low-income rural households. The loans require minimal or no down payments and have amortization periods of 33 or 38 years. Through an interest credit subsidy, FmHA pays the difference between market-rate interest and what the borrower can afford to pay based on household income. This can reduce the borrower's effective interest rate to as low as 1 percent. The program allows FmHA to recapture a percentage of these subsidies through the appreciation of the property at resale. Low-income households can use Section 502 loans to purchase or build homes, purchase land, or provide waste disposal and water facilities. The Section 502 program is administered through more than 1,900 County offices.[3]

In recent years, funding for the Section 502 program has been cut, while the availability of housing affordable to families with limited resources has declined. Rising housing prices made it increasingly difficult to assist very low-income families, even with the minimum interest credits. Congress passed the Rural Housing Amendments in the Housing and Urban-Rural Recovery Act of 1983, mandating that very low-income households receive at least 40 percent of all Section 502 loans. The amendments also encourage FmHA to find ways to reduce housing costs and provide affordable housing opportunities. Section 506 of these amendments established the Section 502 Rural Housing Demonstration Program (HDP).[3-4]

Housing Demonstration Program

The HDP program uses Section 502 Rural Housing funds to finance housing that uses cost-saving designs and components that are not part of published standards and lets FmHA test the impact of the innovations on market acceptance and cost. Congress set 2 conditions for the HDP:

- that the health and safety of the population of the areas in which the demonstrations are carried out will not be adversely affected and
- that the aggregate expenditures for the HDP may not exceed $10 million in any fiscal year.[4]

Each State receives an allocation of Section 502 funds calculated by a formula based on need. Funding for the HDP comes out of a reserve fund that is managed by the FmHA National office staff. The National office announces the program in the Federal Register and issues an Administrative Notice to field staff annually. Interested parties are referred to the FmHA State office. The State director often designates someone to administer the program, such as the State rural housing chief. Proposals are submitted by the State office with recommendations to the National office for approval. Projects are approved on a first-come, first-served basis. The National office advises the State Office of accepted demonstration concepts and authorizes the State office to obligate funds to eligible borrowers.

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Project Summaries and Findings

The **Connecticut** project tested:

- higher density land use through attached townhouse units and modular construction;
- suitability of condominium form of ownership; and
- a homeowners' association to manage commonly owned property and maintain quality control.

The project demonstrated that attached housing can be a good way to provide a less expensive alternative in a region of high land and housing costs. Condominium ownership can be a suitable solution to maintaining common areas and building exteriors in multi-family projects, but a well-managed homeowner's association is essential.[6]

In **Massachusetts,** the concept tested was the application of several principles from private housing construction practice to improve efficiency and cost effectiveness of the production system. The main techniques employed in this demonstration were standardization and volume discounts in a large-scale project. The project demonstrated that streamlining and standardizing the production process is an effective method to achieve cost savings and that volume discounts made possible by large-scale projects are cost-effective.[7]

The **New Hampshire** project tested cluster zoning of small houses and lots as a method to effectively use scarce buildable land in a region where attached housing would not be marketable. Also tested were a limited equity provision to cap the resale price and blending with other sources of funds to make the subdivision feasible and the units more affordable. The project demonstrated that the complexity involved in ambitious projects is likely to cause costly delays and added problems. Cluster zoning can reduce construction costs and preserve the natural environment in areas where suitable sites for affordable housing are scarce. In such areas, developers of affordable housing may settle for a difficult site at a good price, but this puts the project at the risk of a prolonged site planning and approval process. This experience also showed that in areas where speculation exists and where there are no other housing options, limited equity can restrict the resale price of a home and insure that the homes remain affordable to subsequent owners.[8]

In both **Ohio** and **Kentucky,** the same demonstration concept was tested: small houses with minimal amenities as a way to reduce construction cost and better reach the very low-income target market. These homes, called the "Warm and Dry Homes," were developed by a consortium of nonprofit housing organizations in rural Appalachia, an area with widespread poverty and substandard housing. These nonprofit intermediaries also provided counseling to ensure readiness for homeownership. In Kentucky, tandem financing was available to make ownership more affordable. The projects demonstrated that in certain markets, a house that is below conventional FmHA standards for size and appearance will serve a large number of people. In particular, very low-income households benefit from flexibility in the application of conventional FmHA standards. The projects also revealed limited potential for cost savings through reduced home size, because many project expenses are fixed, regardless of size. In addition, in remote locations with a large population of very-low income households, outreach is essential to target potential homeowners and assist in their successful transition to homeownership.[9]

Two similar projects in **North Carolina** tested higher density development through attached housing as a way to reduce costs and improved maintenance through a professionally-managed homeowners' association. This was a response to a change in FmHA regulations that limited the size of homes that single individuals could purchase. The projects attracted singles and elderly households who might not otherwise purchase a home if their only option was a detached home. The projects demonstrated that in certain markets, well-designed and well-managed attached housing projects can be a good way to achieve high density land use and preserve the resale value of FmHA-financed housing. However, problems may result if residents do not have a clear understanding of the role of the professional management.[10]

Capacity: FmHA staff have the expertise to administer the program, but many County offices reported that they find administration of HDP projects to be demanding. The reasons given for this include the higher volume of loans in a short period, the degree of responsiveness demanded by some developers, additional reporting requirements and the need to perform additional tasks. With this added workload, there may be a need to provide some County offices with additional staff or support.

Performance: Project performance depends on factors such as need, the developer's capacity, site characteristics and external conditions such as the economy. Evaluation of program performance must address availability and adequacy of data and performance criteria, funding level and reward systems for administrators and staff. FmHA staff maintain data in multiple files, and it can be time- consuming to sort and compile data for an evaluation. Staff do not systematically track actual ownership costs or comparable real estate market data.

Cutbacks in funding for conventional FmHA housing programs influence the behavior of buyers, builders and FmHA staff. Market response is distorted when HDP loans are one of the only ways to buy an FmHA-financed home. Builders view the HDP as a way to obtain funds not available otherwise. Some County office staff may be frustrated that funds are available only for HDP projects.

In many of the cases studied, FmHA administrators and staff provided the leadership critical for the project's success. In others, staff may have considered conventional programs to be more important than demonstrations, because management systems evaluate performance based on work targets such as volume of loan activity, loan delinquencies, and amount of properties in inventory. No rewards or recognition are given specifically for tasks involved in supporting demonstrations.

Leveraging: The HDP has no explicit matching requirement but encourages developers to obtain financing from other lenders. This is sound policy because it is socially preferable not to isolate FmHA borrowers in complexes, to which stigma is likely to attach, and it makes economic sense to leverage scarce Federal resources with other sources. In some ways, the HDP program is not designed to achieve these implicit objectives. HDP funding allocations are made for one fiscal year, with no guarantee of the future availability of funds. Other lenders, not surprisingly, may be similarly hesitant about making more of a commitment to an HDP project until it is more established.

Developers feel it is unrealistic to combine subsidized and conventionally financed sales in the same complex. This perception could be reinforced by the often conservative attitudes of lenders in small towns. Obtaining credit may be difficult for those likely to purchase homes in the same complex as FmHA borrowers. HDP projects face a "double whammy" in that they are both unconventional and targeted for low-income families. In addition, the often conflicting requirements of lenders can add costly delays. This suggests that the more flexible HDP regulations are, the easier it will be to leverage these funds by combining them with other resources.

Outreach: Outreach is an issue both in soliciting proposals from developers and in marketing the HDP units. The success of outreach efforts is dependent on the creativity and commitment of the individuals who perform this role. The result of outreach activities is a function of how program staff or builders define the pool of people they reach out to and how close they are to those individuals.

The HDP is most effectively marketed through statewide networks. However, this gives the National office little leverage to test a particular concept. Locations where FmHA housing programs are well-known and widely used are more likely to generate interest among competent, innovative builders than are places where the programs are not active. The National office could utilize intermediary organizations to improve HDP coverage.

Effective outreach is essential to sell HDP units, since there is no guarantee that a market exists for the innovation. For successful HDP implementation, developers must be willing and able to undertake appropriate outreach and marketing efforts.

people feel good about their home, they take better care of it. This can prevent losses due to poor maintenance and abandonment. A policy to invest Federal housing funds for long-term value may mean a tradeoff between the quality and quantity of housing that can be produced with limited resources.

Reduced Cost Alone Not Enough

Reducing unit size and construction cost is not always sufficient to reach very low-income buyers. Additional financing sources are needed to blend with FmHA loan funds to write down mortgage amounts, so that very low-income families can qualify for loans, and also to cover the gap between development costs and what homes can be sold for in areas where prices are low.

Homeowners' Associations

Attached-unit and planned-unit developments blend a rental and ownership situation. Residents may be confused about where management's role ends and where their responsibilities begin. FmHA borrowers may not have the skills to run homeowners' associations or even to hire and oversee the contract of a professional property management firm, without some form of training or technical assistance.

RECOMMENDATIONS

The following recommendations are based on the analysis of the 6 HDP projects studied and refer specifically to the HDP program. Some of these recommendations might also apply to the Section 502 program in general, but Section 502 projects were not analyzed as part of this study. Any broader implications derived from these recommendations would be up to the reader.

HDP Policy

1. Expand Program Resources

The HDP program is most effective when it serves as a mechanism to improve and extend the reach of the Section 502 program, rather than as a substitute source of funds. We recommend that both the HDP and Section 502 be preserved and expanded, with additional funding, staff and other resources.

2. Extend Term of Availability of Funding

The FmHA needs to assure the availability of HDP program funds for a reasonable period of time, relative to the needs of the demonstration project. One solution—that would require legislative action, however—is to extend the term of availability of funding: by allocating funding over 2 fiscal years; or, by obligating funding to the project for a year, starting at the time the proposal is approved. Another approach would be to obligate the entire amount to the project, allowing developers to draw on funds as needed, as in the FmHA multi-family rental program.

3. Review Cycle for Applications

It may be useful to consider proposal reviews according to a set schedule if interest in the HDP grows. As the HDP program is implemented in a greater number of states, it is very likely that interest in the program will grow. The experience of the County offices interviewed suggests that utilization of FmHA programs generates interest among people to take advantage of FmHA programs. The use of a set review cycle for HDP proposals would make the application process more competitive and help ensure that adequate coverage is given to a full range of regional needs.

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Broader Implementation of Concepts

The following innovations should be implemented in the Section 502 program:

9. The Total Housing Concept
In places where poverty and substandard housing are widespread, **a basic house that does not meet conventional FmHA standards for size and appearance** is appropriate for the needs of many people. FmHA should go beyond replicating the concept of a basic house, and **re-create the Federation of Appalachian Housing Enterprise (FAHE) model of a regional intermediary.** Such an intermediary can identify innovative housing concepts that evolve at a grass-roots level, sponsor HDP proposals on behalf of less experienced groups, and provide technical assistance in the implementation of projects. FmHA could also set aside loan funds for such intermediaries to administer, to enable the application of more flexible underwriting standards to serve very low-income families.

Expand Deferred Mortgage Program
The Deferred Mortgage Program provides an alternative to the minimum housing concept. To realize the full potential of this program will require a higher level of funding and participation by private banks.

10. Higher Density Land Use Concepts
Attached housing, cluster zoning of small lots and ownership alternatives such as condominiums and zero-lot line communities are efficient and environmentally sound approaches to development in areas that are faced with high land and housing costs. Approval of higher density projects ought to be parameter specific, based on factors related to the project location, the site itself, the demographics of the market, the size of the targeted market, availability of other housing options, the potential market share the project can garner, whether the design meets local standards, and management of the homeowners' association.

Landscaping and the design of common areas improves the livability of high-density communities and enhances market acceptance and value. The FmHA should encourage investment in landscaping, playgrounds and other site improvements by including them as allowable development expenses.

The organization and operation of the homeowners' association is an important factor in the success of high-density housing involving shared property ownership. FmHA should require the developer to inform buyers fully of their responsibilities as members of the homeowners' association, and possibly provide training workshops or a manual, which should be allowable development expenses. Professional property management is advisable, as most owners will not have the time or skills to take responsibility for the tasks required.

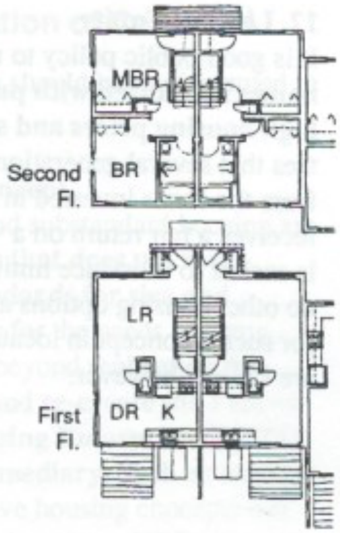
Six HDP Projects

Charter Oak
North Canaan, CT

2- and 3-bedroom townhomes w/ deck, appliances and full basement.

2 BR: 864 and 972 SF
3 BR: 1,080 SF

Avg. unit cost: $91,350
Avg. SF cost: $93.98

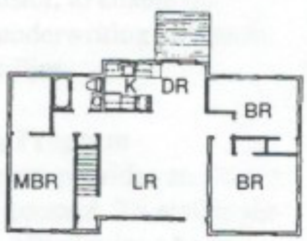


Sandy Heights
Winchendon, MA

3-bedroom ranches and capes w/ full basements and without appliances. Deck optional.

Ranch: 1,110 SF
Cape: 1,056 SF

Avg. unit cost: $88,567
Avg. SF cost: $81.78



Whitcomb Woods
Littleton, NH

2- and 3-bedroom split-entry slab-on-grade w/ appliances. Garage and deck optional.

2 BR: 932 SF
3 BR: 992 SF

Avg. unit cost: $83,309
Avg. SF cost: $86.60