REINVESTMENT THROUGH THE DIRECT AND INDIRECT LOAN PROGRAMS OF STATE HOUSING FINANCE AGENCIES

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REINVESTMENT THROUGH THE DIRECT AND INDIRECT LOAN PROGRAMS OF STATE HOUSING FINANCE AGENCIES

Summary

This is one in a series of papers analyzing publicly initiated reinvestment strategies. This paper examines the use of direct and indirect loan programs by state housing finance agencies to stimulate reinvestment through the provision of rental units and low interest home mortgages for low- and moderate-income families. The paper was originally prepared for a study of neighborhood revitalization being conducted by Woodstock Institute for the Missouri Housing Development Commission. For this reason, it begins with a summary of that agencies current efforts.

The Missouri Housing Development Commission (MHDC) is currently authorized to grant direct first mortgage loans for the construction and rehabilitation of residential housing for low and moderate income persons or families where there is a need for such housing. These loans may be interim or permanent. MHDC is also authorized to make temporary loans, with or without interest, to defray development costs to not-for-profit sponsors of residential housing for occupancy by persons and families of low and moderate income.

On October 31, 1977, MHDC carried on its project status and control report 115 multifamily projects accounting for 10,886 units either completed or in the pipeline. The total direct loan mortgage amount for those projects was stated at $200,208,500.[1]

MHDC also has a mortgage purchase program, which is characterized as an indirect financing program since MHDC does not directly make loans, but instead purchases loans originated by private lenders. On June 15, 1976, MHDC sold a bond issue in the amount of $28,175,000. As of October, 1977, MHDC had purchased 1095 mortgages using the proceeds derived from this bond issue. These mortgages had an aggregate value of $24,500,000. Of the 1095 mortgages, 118 were originated out-state, and 977 were made in areas of Kansas City and St. Louis.[2]

Another indirect financing program conducted by many housing finance agencies is the loan to lenders program. MHDC is currently not authorized to initiate such a program.

During the 79th Session of the General Assembly, a bill (see House Bills Nos. 351 and 501) was introduced to authorize MHDC to conduct a loan to lenders effort to finance "the construction and development of new or substantially rehabilitated residential housing and for the improvement, refurbishing or less than substantial rehabilitation of residential property located in such areas as the commission may from time to time designate." The bill failed to pass the 79th General Assembly, but similar legislation is scheduled to be refiled in the next session.

Reinvestment Through the Direct Loan Programs of State Housing Finance Agencies

1. Introduction

It has been said that the most significant function of state housing finance agencies has been the making of construction and permanent loans to developers of low and moderate income housing.[3] The Council on State Housing Agencies estimates that between 1968 and 1974 these activities have resulted in the production of nearly 203,000 housing units.[4] As with the indirect loan programs (see Part II), the primary source of state funds for direct loan activities has been the sale of tax-exempt bonds. The favorable, tax-exempt rate obtained by these agencies can be passed on to public, non-profit or limited dividend borrowers who are constructing low and moderate income housing. The intent is that this low interest rate will ultimately be enjoyed by tenants in the form of reduced costs. Experience has shown, however, that the 1 to 1.5% interest "break" enjoyed through the sale of tax-exempt bonds is often not large enough to result in affordable rents for low income families.[5] Nevertheless, direct loan programs have been a useful too, combined with other public subsidy dollars, in providing below market rate units is some states.

In order to bring the rental price of housing units down to low and moderate income levels, state housing agencies have "piggy-backed" their bond-financed construction programs with federal subsidy dollars. Prior to the 1973 moratorium on HUD's

interest subsidy programs, state housing agencies relied on Section 236 and rent subsidy programs for additional funds. Between 1968 and 1974, 117,265 of 202,674 units produced by state housing agencies involved the federal government's Section 236 interest reduction subsidy program.[6] Today, the link-up occurs with money provided through Section 8 of the Housing and Community Development Act of 1974.

2. Reinvestment Strategies

Direct loan programs may be used as reinvestment strategies by providing for new construction of rental units and low interest home mortgages for low and moderate income families.

State housing finance agencies in several states, including Missouri, have used also direct loan programs to provide low interest loans for rehabilitation as well as new construction. In Missouri, MHDC is limited in participating in single family rehabilitation due to the lack of statutory authority to make second mortgages. The Illinois Housing Development Authority, on the other hand, has lent money at low interest rates for the rehabilitation of both single-family and multi-family structures.[7] It should also be noted that cities are becoming active in this type of financing. In 1974, for example, a state law authorized the City of Minneapolis to issue general obligation bonds to pay the costs of administration, loan guarantees, and subsidies in a housing rehabilitation program for low and moderate income property owners.[8]

Rehabilitation is a "reinvestment" strategy in that older structures which might be forsaken by the private lending industry are preserved. Legislation pending in Connecticut, however, is designed to strengthen the "reinvestment" aspect of rehabilitation activity by seeing that rehabilitation funds are concentrated in the areas which need it most. Connecticut Senate Bill 104 begins with a familiar declaration of legislative intent. The bill is premised upon a finding that there is a serious lack of construction and permanent financing for rehabilitation activities that benefit low and moderate income families. The lack of financing is said to "severely limit the growth in the supply of housing for such families and persons."

Connecticut Senate Bill 104, however, is unique in that the rehabilitation of older buildings and the preservation of aging neighborhoods is posited as a socially and economically superior alternative to "suburban sprawl." The bill declares that the State has a major interest:

> "in insuring that urban areas do not further deteriorate because the cost (1) of accommodating continued development elsewhere than in urban areas, in terms of additional fire protection, sewer, water, education and energy requirements, of additional construction and maintenance of highways and transportation facilities, of the additional destruction of natural areas of the state, of the additional administrative and governmental requirements that result as underdeveloped areas grow in population and of such other similar public improvements and services that government is required to finance as a result thereof and (2) of redeveloping the urban areas, of the inefficient and under use of the public facilities and services presently available in the urban areas and of the increased expense of providing safety for persons continuing to reside in deteriorating areas, is and will continue to be an undue burden on the state, adversely

affecting the health, welfare, safety and general prosperity of the citizens of the state."

The proposed legislation takes the position that the Connecticut Housing Finance Authority must limit its lending and mortgage purchase activities to "urban areas," defined as towns or cities in the state with a population in excess of 75,000 or a population density of 3,500 per square mile as determined or predicted upon the 1970 United States Census. Direct loans can be made only if "the desired loan may not be otherwise available on reasonable terms." Applicants must prove to the agency that the required assistance has twice been refused by lending institutions in the private sector.

3. Problems and Prospects

As indicated previously, the ability of state housing direct loan activity to serve low and moderate income people is enhanced by "piggybacking" federal subsidy programs. An obvious constraint is the availability of federal dollars. For example, state housing agencies have complained about the size of their Section 8 allocations for 1977.[9] However, even without "piggybacking," the direct loan program results in lower housing costs for low and moderate income occupancy.

As Connecticut Senate Bill 104 indicates, it is possible to heighten the impact of direct loan programs upon certain areas. It is similarly possible to require that direct loan programs only assist people within certain income groups. It is necessary, however, to recongize the importance of program monitoring to the pursuit of an agency's social goals. For example, a recent Government Accounting Office report

indicated that a significant portion of HUD's Section 312 rehabilitation loans made in Chicago and San Francisco were received by property owners with substantial annual incomes and personal assets.[10] While there were no statutory limits on recipients' income, Congress had stipulated that priority be given to those who would qualify under the income limits applicable under the Section 221(d)(3) mortgage insurance programs. In addition, the GAO report found that many of the loans went to major reconstruction, which was not the primary purpose of the loans authorized by Congress.

These problems have been addressed by MHDC by the establishment of their own income limits which insure that the direct loan programs are targeted to and benefit low and moderate income families.

As a tool to accomplish reinvestment strategies, direct loan programs may also be targeted to specific geographic areas as well as to specific income groups.

Reinvestment Through State "Indirect" Mortgage Finance Programs

1. Introduction

Over twenty-eight state legislatures responded to the "tight money" situation of the late 1960's and early 1970's by authorizing quasi-public agencies to conduct "loans to lenders" and "mortgage purchase programs."[11] While the enabling legislation for these programs spoke in terms of assisting "low and moderate income people" obtain home mortgage loans, the way in which these programs generally operated revealed that the actual social goal of these programs was to assist practically anyone to obtain reasonably-priced home financing during what was perceived as a crisis in the private lending sector.[12] Several state indirect financing programs, however, contained features which were designed to encourage higher levels of investment in certain geographical areas.

This disucssion begins with a report of the economic climate which gave rise to state indirect finance programs. It then proceeds to describe briefly the basic theory and operational format of both loan to lenders and mortgage purchase activity. There then follows a brief discussion of the role of the tax-exempt government bond market.

Finally, the report details how loans to lenders programs may be used (1) to benefit low and moderate income people, and (2) to encourage reinvestment in particular neighborhoods. There follows a similar examination of the reinvestment strategies of mortgage purchase agencies.

2. The Economic Context

As indicated above, state-created indirect mortgage finance programs originated as a response to the economic climate of the late 1960's and early 1970's.[13] During periods of inflation there is a tendency for savings deposits to be withdrawn and placed in other investments that are earning a higher yield. Unfortunately for prospective home buyers in inflationary times, these savings deposits represent the principal source of conventional financing for single-family home purchases. An additional consequence of inflation is that financial institutions become reluctant to place their funds in long-term mortgage investments because of their relatively low and fixed rate of return. When the actions of savings account holders and lending institutions coincide in this way, the result is a "tight" mortgage money situation.

The State of New York Mortgage Agency (SONYMA) was the first operational response to the evaporating supply of residential mortgage money. The New York State Legislature created the nation's first state authorized, bond-financed mortgage purchase program in May of 1970.[14] Subsequently, the mortgage purchase concept has been adopted by twenty-eight states, including Missouri. By 1975, the ten state agencies with operative programs had purchase $743 million in existing home mortgage loans from lending institutions.[15] Other states created agencies which injected a different type of bond-financed stimulant into the private lending sector: the loans to lenders programs. As of March, 1974, twenty-four states

have authorized this approach.[16] By 1974, the four loans to lenders programs which were then active had already generated loans on an estimated 25,260 housing units.[17] It should be noted that many state legislatures have authorized the use of both loans to lenders and mortgage purchase programs.

Before describing the operational format of loans to lenders and mortgage purchase activities, two observations should be made about the laws which created these programs. First, a common legislative finding in these enabling acts is that there is a serious shortage of decent, safe and sanitary housing for people in low and moderate income brackets. Second, enabling statutes often limit the amount of bonds that the indirect mortgage finance agency can issue in pursuit of its corporate purposes. Since these programs were originally aimed at curing the private banking sector's inability to furnish a steady supply of residential mortgage money, several statutes explicitly state that the agency's activity should cease once the market has corrected itself.

3. Loans to Lenders and Mortgage Purchase Programs: Theory and Operational Format

The enabling acts of loans to lenders programs are premised upon legislative findings which state that private enterprise and investment have not been able to provide sufficient long-term mortgage financing for residential housing. The major objectives of these programs have been to channel capital into the housing market which might have been used in non-housing ventures and to bring into the state mortgage market funds from national money and capital markets.[18]

The basic mechanics of a loans to lenders program are easily stated. Authorized state mortgage finance agencies use their tax-exempt borrowing power to raise funds. The proceeds of these bonds are used to provide low interest loans to participating mortgage lending institutions which, in turn, agree to use the money to make new residential mortgage loans. In order to guarantee the effectiveness of the program, some programs impose "matching requirements" upon participating lenders.[19]

The basic mechanics of mortgage purchase programs are somewhat different. As with loans to lenders programs, state indirect mortgage finance agencies raise their capital through the sale of tax-exempt bonds. Using the proceeds from these sales, the agencies purchase existing home mortgage loans from the state's lending institutions. In order to guarantee the effectiveness of the program in generating new mortgages, a financial institution that sells mortgage loans to the agency must agree to make new residential mortgages in an amount equal to the purchase price it received within a certain period of time. As with loans to lenders programs, the result of mortgage purchase activity is to attract more capital into residential mortgage lending.

4. The Role of the Tax-Exempt Government Bond Market

As indicated previously, the state enabling acts declare that both direct and indirect loan activities are to serve the housing needs of low and moderate income people. In order to

understand how loans to lenders, or other programs, can ultimately furnish consumers with below market interest rates in their home loans, it is necessary to understand the role of the tax-exempt government bond and recent developments in the government bond market.

It is well known that government bonds pay lower interest rates than private debentures. State mortgage finance programs are able to compete for capital with higher yield investments because, generally, their bondholders do not pay federal income tax on the interest they receive.[20]

The critical role of the tax-exempt government bond is, therefore, quite clear. Should the cost of government borrowing increase, the ability of a state indirect mortgage finance agency to pass along a low interest rate to the housing consumer is reduced, although the spread can be maintained.

For several months, the financial difficulties facing both the City of New York and the New York Urban Development Corporation had a harsh impact on the sale of low interest government bonds. Investors were taking a hard look at the credit of public bodies throughout the country.

Another factor contributed to increases in the cost of this type of government borrowing. In 1974 there was a "massive" increase in both corporate and government borrowing through bonding.[21] In order to avoid the high cost of borrowing is such a market, state mortgage finance agencies had to become very cautious in timing their issues in order to get favorable rates.[22] The financial survival of both New York City and the New York Urban Development Corporation has subsequently lowered

the cost of government borrowing. In March of 1977, for example, the Missouri Housing Development Commission was able to sell an offer at a 5.94783 interest rate.[23]

5. Reinvestment Through Loans to Lenders Programs

A. Aiding Low and Moderate Income People

There are two ways in which loans to lenders programs can attempt to fulfill the function of assisting low and moderate income home buyers. The first technique is quite direct: the agency sets an income limit which states who can ultimately benefit from the loans to lenders program.

The second method used to steer the program toward benefiting low and moderate income families is to impose limits on the mortgage terms which can be exacted by participating lenders. While these devices do not guarantee that low income people will be the sole beneficiaries of the loans to lenders program, they make it economically feasible for low or moderate income people to acquire one of the mortgages generated by the state housing finance agency's bonds. State housing agencies will generally restrict the interest rates which participating lenders can charge housing consumers.[24]

B. Encouraging Reinvestment in Particular Areas

Several states have attempted to target particular areas. For example, the Illinois HDA has required participating lenders to pledge that they will use the proceeds of the Authority's loan to make new residential mortgages within the

institution's "primary service area." The "PSI" is defined as the region made up of contiguous "zip code" areas within the state where 60% of the deposits of the lending institution originate or "such other areas agreed upon by the authority and the lending institution."[25] The "PSI" requirement is an attempt to insure that loans to lenders money is not used in a way that ignores central city neighborhoods or rural areas in need of credit.

In contrast, the New Jersey Mortgage Finance Agency has used an incentive system to promote investment in certain cities through its loans to lenders program. As indicated previously, loans to lenders programs limit the amount of profit which can be realized by participating lending institutions. In order to encourage "reinvestment" in "urban aid" areas, the NJMFA simply permitted a .25% high yield spread to institutions making home loans in these municipalities.[26]

C. Problems and Prospects

Theoretically, loans to lenders programs are very attractive to lending institutions caught in a "tight money" crunch. The loans to lenders operation provides the institution with a supply of low cost capital that would otherwise be unavailable.

Nevertheless, lending institutions are reluctant to participate in loans to lenders programs if the restrictions involved appear to be too great. For example, both collateral requirements and bureaucratic red tape were blamed for the "disappointing" response of lending institutions to the

Vermont Housing Finance Agency's first bond issue.[27]

It is not inconceivable that an agency's beneficiary income limits, "primary service area" relending requirements, and mortgage term restrictions are viewed in the same light by the lending industry. Actors in the private sector do not have the same interest in guaranteeing that loans to lenders programs benefit low and moderate income families or combat the practice of "red-lining." As more requirements are imposed upon participating lenders in pursuit of social objectives, fewer institutions may decide to participate.

Housing finance agencies themselves must be careful to guarantee that their programs serve their stated social objectives. This means that the agency must engage in monitoring in order to determine how efficacious their loans to lenders efforts have been.

6. Reinvestment Through Mortgage Purchase Programs

A. Aiding Low and Moderate Income Families

As with loans to lenders programs, the enabling legislation for state mortgage purchase programs typically contains a legislative finding that recognizes "a serious shortage of housing for low and moderate income families and persons." The legislation then prescribes "state financial assistance for housing through the purchase of mortgages on such housing located in this state."[28]

State mortgage purchase agencies generally attempt to insure that low and moderate income people benefit from that activity by using the same techniques adopted by loans to

lenders programs. The direct way to guarantee this result, used by the Missouri Housing Development Commission, is to require that loans made in fulfillment of the participating institution's lending requirement be made to home buyers whose incomes are within a certain range.

A second technique, also used by MHDC, is to regulate the terms of the mortgages which participating lenders make.

B. Encouraging Reinvestment in Particular Neighborhoods

The New Jersey Mortgage Finance Agency has plans to issue $100 million in bonds during 1977 for the purpose of rejuvenating "redlined or underserviced" areas through its mortgage purchase program. The mortgage purchase vehicle has greater potential than a loans to lenders program for encouraging lending institutions to become involved in what may be perceived as high risk neighborhoods. This is because the structure of a mortgage purchase program does not require a participating lender to keep the home mortgage note in its own portfolio -- rather it is "purchased" by the mortgage finance agency. The NJMFA has allowed the definition of eligible Neighborhood Loan Program (N.L.P.) neighborhoods to be deliberately general. The mayors of New Jersey's cities have been given the flexibility to select their own unique strategies. It is anticipated that some cities will allow the funds to be used citywide, while others will attempt to concentrate on particular areas.

The New Jersey Mortgage Finance Agency can guarantee that the proceeds of its mortgage purchase bonds will be used in

N. L. P. neighborhoods by relying upon a device known as the "advance commitment." A similar device has long been used by the Minnesota Housing Finance Agency. In short, the agency makes a commitment to purchase a specified dollar volume of mortgages that are made on certain terms within a particular geographic area. The lender then makes loans which meet the agency's standards and delivers them at the agreed upon price. This device theoretically allows the housing finance agency to tap the loan organization and servicing skills of institutions in the private sector.

C. Problems and Prospects

New Jersey is using its mortgage purchase program in combination with other financial devices in order to assist low and moderate income people and encourage reinvestment. There are, however, several limitations and potential dangers that are worthy of mention.

As indicated above, the New Jersey Mortgage Finance Agency is supplementing its loans to lenders program with a mortgage purchase reinvestment strategy which relies upon the use of the "advance commitment." The practice of relying upon the advance commitment has its dangers. Lenders who realize that they can easily dispose of their mortgage loans may be less careful in making their initial lending decisions. The State of New York Mortgage Agency has been reluctant to rely upon the "advance commitment" in its mortgage purchase program. The agency believes this practice "has always served to assist the agency in obtaining quality loans in that the lenders at

no time can accurately anticipate which loans SONYMA will purchase. They are, therefore, all loans made by banks for their own investment.[29] In order to avoid the possibility that participating lenders will use the "advance commitment" to unload financially unsound loans on the mortgage purchase agency, it is necessary for the agency to protect itself by inserting purchase criteria in its contractual agreements with lending institutions.

Conclusion

Both direct and indirect loan programs may be used by state housing finance agencies to stimulate reinvestment through the provision of rental units and low interest home mortgages for low and moderate income families.

As reinvestment strategies, both programs may be targeted to serve low and moderate income families. State housing finance agencies throughout the country have experimented also with ways in which to serve specific geographic areas where special housing and investment needs exist.

In order to respond rapidly to public needs, it is necessary for state housing finance agencies to receive adequate statutory authority to conduct their programs before economic conditions severely affect the housing market for low and moderate income people.

Footnotes

1. Missouri Housing Development Commission, "Monthly Multi-family Project Status and Control Report," October 31, 1977.

2. Telephone conversation with Bob Smith, Deputy Director and Comptroller of the Missouri Housing Development Commission, October 14, 1977. (Analysis of geographic distribution within Kansas City and St. Louis is beyond the scope of this paper).

3. BNA Housing and Development Reporter, "State Housing Finance Agencies," Reference File 11/17/75 at 50:0011.

4. Council of the State Housing Agencies, "State Housing Agencies: Roles and Accomplishments," April 1, 1975, p.1.

5. BNA Housing and Development Reporter, note 1, at 50:0012.

6. Council of State Housing Agencies, supra, note 2, at 3.

7. Concerning IDHA participation in the rehabilitation of single family homes, see "Illinois Housing Development Authority Annual Report, 1974. " Regarding IHDA's involvement in the rehabilitation of multi-family buildings, see Rescorp Activity Report, July, 1975.

8. J. Fitzsimmons, J. Notter and K. Gilder, Housing Rehabilitation Loan Programs in Minnesota, May 1975 (Center for Urban Affairs, University of Minnesota).

9. See BNA Housing and Development Reporter, "Current Developments," 2/1/77, p. 753.

10. See BNA Housing and Development Reporter, "Current Developments,"6/28/76, p.60.

11. Data based upon the Council of State Housing Agencies, "State Housing Finance Agencies: Roles and Accomplishments," April 1, 1975, and subsequent Current Developments Reports from the BNA Housing and Development Reporter.

12. A study by McKinsey and Company, a New York-based management consultant firm, shows that 90 percent of the housing produced by HFA's has benefited buyers in the moderate to middle income range, and the vast majority of it -- 80 percent -- has been built in the suburbs. BNA Housing and Development Reporter Section 50:0001 (11-17-75)

13. These programs are called "indirect" mortgage finance programs because the actual source of capital -- the state

housing finance agency -- does not lend directly to the housing consumer. Loans to lenders and mortgage purchase programs are often referred to as "secondary" mortgage market programs as well.

14. See Robert S. Amdursky, "The State of New York Mortgage Agency, "The Urban Lawyer, vol. 3, p. 467 (1971).

15. Council of State Housing Agencies, "State Housing Agencies: Roles and Accomplishments, "April, 1975, p. 6.

16. See letter of Theodore E. Allison, Secretary of the Board of the Federal Reserve System, FR Doc 77-6996, Filed 3/9/77, at BNA Housing and Development Reporter, Section 50:8051.

17. Council of State Housing Agencies, supra., note 5, at p. 8.

18. For example, the Rhode Island Housing and Mortgage Finance Corporation reports that 83% of its 1974 bonds were purchased by investors outside the state. Rhode Island Housing and Mortgage Finance Corporation, "First Annual Report, 1974," p. 15.

19. In Illinois, for example, institutions which borrowed in excess of $300,000 were required to disburse an amount of their own funds for residential mortgage loans in the amount that its Illinois Housing Development Authority loan exceeded the $300,000 figure. This type of requirement stimulates additional mortgage lending beyond that which would otherwise take place. Without this type of matching requirement, fewer home loans are "leveraged" by bond-financed capital. The ultimate beneficiary of these programs is the consumer who had faced the difficulty of obtaining a relatively low-cost mortgage loan during a period of "tight" mortgage money.

20. See 26 U.S.C. Section 103.

21. Wisconsin Housing Finance Authority, "Annual Report, 1974," p. 3.

22. The Rhode Island Housing and Mortgage Finance Corporation, for example, revised its 1974 Series C Mortgage Finance Bonds and sold them at a later date to catch the market at a favorable moment.

23. Information obtained from the Missouri Housing Development Commission Staff, October, 1977.

24. For example, in Rhode Island home loans made pursuant to the loans to lenders program shall not bear interest:

> "at a rate in excess of the sum of (a) the rate of interest borne by the Loan, plus (b) an interest factor not to exceed 1.50% per annum, and plus (c) in the case of New Residential Mortgages which are

insured by a private mortgage insurer under state law within the meaning of Section 19-9-8(d) (1) of the Rhode Island General Laws of 1956, as amended an additional interest factor not to exceed .50% per annum.

"With respect to such New Residential Mortgages, no fees, premiums or bonuses, commonly referred to as points, shall be charged."

Rhode Island Housing and Mortgage Finance Corporation, "Statement of Terms and Conditions of Application and Commitment Agreement: Series C," p. 12.

25. Illinois Housing and Development Authority, "Official Statement," October 31, 1974, p. 3.

26. "Urban aid" areas are defined pursuant to a complicated formula found in Chapter 64 of the New Jersey Code. The formula weighs factors such as population, number of dependent children, and equalized tax valuation per capita.

27. See Vermont Housing Finance Agency, "Report to the General Assembly," Jan. 27, 1975, p. 2.

28. See, for example, Connecticut Housing Finance Authority, "Official Statement of the Connecticut Housing Finance Authority, "October 30, 1974, p. 7.

29. March 24, 1975 letter from Karl Tofal, Secretary and Treasurer to the State of New York Mortgage Agency to Jack Lawlor of the Northwestern University Center for Urban Affairs.