OVERSIGHT OF THE RURAL HOUSING SERVICE AND ITS FISCAL YEAR 2006 BUDGET

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY

OF THE

COMMITTEE ON FINANCIAL SERVICES

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OVERSIGHT OF THE RURAL HOUSING SERVICE AND ITS FISCAL YEAR 2006 BUDGET

Thursday, March 10, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING AND
COMMUNITY OPPORTUNITY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:11 p.m., in Room 2128, Rayburn House Office Building, Hon. Robert Ney [chairman of the subcommittee] presiding.

Present: Representatives Ney, Harris, Davis of Kentucky, Waters, Frank, and Davis of Alabama.

Mr. NEY. [Presiding.] Welcome today to the Housing Subcommittee. We do have another vote coming I think after about 10 minutes of debate, so once that happens members will be coming over. What I was going to do was go ahead with my opening statement, and that way we could go ahead and get this portion out of the way.

The Housing Subcommittee will meet this afternoon to discuss USDA's Rural Housing Service and the agency's budget proposal for fiscal year 2006. The U.S. Department of Agriculture Rural Development, RD, mission area administers programs that are designed to meet the diverse needs of rural communities with a variety of loans, loan guarantees, and grant programs, which include technical assistance and cooperative development.

Within Rural Development's mission area is the Rural Housing Service, RHS as it is known. RHS is responsible for providing decent, safe, affordable housing and community facilities in our rural communities. It issues loans and grants for rural single-family houses and rural rental housing apartment complexes. In this fiscal year 2006 budget proposal, RHS continues to address a multitude of management and budget challenges in both its single-and multifamily housing programs.

Rural housing continues to have a portfolio of about 17,000 existing multifamily developments that provide housing for about 470,000 low-income tenants, many of whom are elderly. These developments were primarily built in the 1980s and many are in need of repairs and rehabbing. The developments have an outstanding indebtedness, I understand, of about $12 billion.

We are concerned about the physical condition of the existing projects, of course, and the ramifications of allowing the projects to leave the program. Recently, the Supreme Court ruled in favor of project owners who wish to pre-pay their loans and remove their property from the subsidized market. I have been working on this issue a good number of years. I am glad to see that the RHS is making progress on addressing the issue. A recent capital needs assessment indicated that only about 10 percent of the projects are potentially viable for non-subsidized use and could leave the program itself. This is significantly less than what I think was probably projected.

The Section 538 multi-housing loan guarantee program was designed to leverage other sources of financing. The fiscal year 2006 budget proposal includes $200 million for Section 538. I am pleased that the administration has doubled the amount available for the program from last year, which would help leverage other sources of financing for the multifamily housing projects.

Only in operation for a few years, the program continues to evolve. RHS recently published a comprehensive revision of its multifamily housing regulations and the administration believes this will streamline the program and protect it against potential abuses. I support the administration's efforts to make the Section 538 program a more attractive component of the complete funding package, which includes access to secondary market funds and the use of tax credits and other subsidies. RHS programs differ from other federal efforts to assist homeownership. According to the President's budget, RHS programs are means-tested and more accessible to low-income rural residents.

In particular, the budget supports the Section 502 direct loan program. The mission of the Section 502 program is to provide direct assistance to those lower-income families that might be on the brink of homeownership. After experiencing an increase in income and home equity, the borrower is expected to graduate to private credit. In this program, the interest rate charged is directly related to the income of the individual. All loans are evaluated annually to determine if interest rates should be changed or if the borrower is eligible to graduate from the program. This is an important program and I look forward to working with the administration to improve its effectiveness.

Over the past year, management at RHS has made significant strides, I believe, to improve the programs under its jurisdiction. Recently, USDA commissioned a report to analyze the Rural Development Multifamily Housing Program, identify problems, and provide recommendations for changes to address such problems. It is my understanding that the department is in the process of reviewing this report to determine what legislative actions should or can be taken.

As part of this hearing, I have also invited the General Accountability Office, GAO, to discuss its three reports completed last year regarding the current issues facing RHS and its mission to provide affordable housing to rural communities. It is important that RHS continue to improve efficiencies so that its housing programs do not become vulnerable to possible future budget cuts. Often, RHS housing programs are the only option for low-and very low-income families.

My roots in rural America run deep. I have a very rural district and I was born and raised in the Ohio Valley. I grew to understand that a safe and secure home is a foundation for a family unit, whether you are in a rural area or in a city or wherever you are at in the country. We have done a lot on this subcommittee with Congresswoman Maxine Waters of California. In fact, we passed I think 11-some bills at one particular time last session without even a roll-call vote. This is a lot of credit to Republicans and Democrats on the committee, and also with Chairman Oxley and ranking member Barney Frank. They have done a lot of work on issues in the committee in general, but also in housing.

We have some areas to go. Minority homeownership, for example, is low and we have to do better. So again, whether it is a city or a rural area, it is important. But today, of course, we are focusing on the rural part. Today, my belief in the importance of homeownership remains the same as it always has been. As the Chairman of the Subcommittee on Housing and Community Opportunity, it is my goal to apply these fundamental values and rural experiences to help communities develop new economic vehicles that will enable them to grow and prosper.

I look forward to hearing from our two witnesses today on the various ways in which we can have safe, affordable home issues and strengthen our rural communities and contribute to the overall quality of life for our rural families.

Let me start with Mr. Russell Davis. He was appointed on July 12, 2004 to serve as Administrator of the Rural Housing Service. Mr. Davis has extensive housing, financial and business experience. Prior to his arrival at USDA, he served as Senior Policy Adviser with the United States Department of Treasury. He has 15 years of investment banking experience, specializing in public finance and economic development. He earned his bachelor's degree from Harvard and is currently pursuing a graduate degree in applied economics at Johns Hopkins University.

Mr. Bill Shear is Director of Financial Markets and Community Investment at the United States Government Accountability Office, GAO. Mr. Shear has directed substantial bodies of work addressing community and economic development programs, small business lending, the GSEs, which we talk about all the time these days, and FHA. Mr. Shear received his Ph.D. in economics from the University of Chicago and formerly served as a lecturer at the University of Pennsylvania.

I want to welcome both of you. With that, we will start with Mr. Davis.

STATEMENT OF RUSSELL T. DAVIS, ADMINISTRTOR, RURAL HOUSING SERVICE, U.S. DEPARTMENT OF AGRICULTURE

Mr. R. DAVIS. Thank you, Mr. Chairman and members of the subcommittee. I would like to thank you for the opportunity to present the President's fiscal year 2006 budget for USDA Rural Development's housing programs.

I am submitting my testimony in written form for the record and I will use this time to highlight our housing budget, which I should say has increased significantly from last year. We have a number of major new initiatives. In particular, I would like to expand on our major new initiative which is for multifamily revitalization programs. USDA Rural Development is the leading advocate for rural America, with 7,000 employees in over 800 offices nationwide. We are committed to the future of rural communities. We work every day to increase economic opportunity and improve the quality of life in rural America.

As an integral part of Rural Development, the rural housing programs assist rural communities in many fundamental ways. We provide a variety of single-family and multifamily housing options to residents of rural communities. We also help fund medical facilities and other essential community facilities. The President's budget provides an overall increase of $400 million in rural housing programs. The single-family housing programs provide several opportunities for rural Americans with very low to moderate incomes to purchase homes.

Of the $4.7 billion in program level requested, $3.7 billion will be available as loan guarantees for private sector loans, including $207 million for refinancing more affordable loans for rural families. Also, with $1 billion available for direct loans, our commitment to serving those most in need in rural America remains strong. This level of funding will provide homeownership for approximately 40,000 rural families.

The total program level request for multifamily housing is $1.07 billion. This represents an increase of 30 percent from last year's request; $650 million will be used for rental assistance, for contract renewals, farm labor housing and preservation. These funds will renew more than 46,000 4-year rental assistance contracts. We estimate using $27 million for multifamily housing direct loans to meet our preservation responsibilities, including prepayment prevention incentives.

The President is also requesting $214 million in new money for a multifamily housing revitalization initiative. While the budget contains only a single line item for this initiative, it is in fact a first step so that this valuable part of rural America's infrastructure can be preserved for another 20 to 30 years. There are approximately 17,000 properties in the Section 515 portfolio. These are small properties averaging only 26 units each. They are distinctly rural and can be found in over 9,000 distinct zip codes. There are a great number of small towns covered in this portfolio.

The tenants in these properties face two immediate dangers. The first is that property owners may leave the program by prepaying their USDA mortgage. This leaves the tenants potentially exposed to higher rents and possible eviction. The second danger that the tenants face is that their properties may fail either economically or physically, leaving them effectively in the same condition as in a prepayment.

Our goal in the initiative is first and foremost to protect the tenants. Protecting them from the prepayment problem has become increasingly important. First, we lost an important Ninth Circuit Court case, the Kimberly case, and related decisions last August. This gave owners the right to prepay immediately. A separate set of court challenges took an opposite tack, following the lead of last August's Franconia decision. These owners are not asking to prepay, but instead to be covered for damages for their lost profits, which they claim could have been received had the government not broken its contract with them. Over 800 properties have sued for damages and over 8,000 more are eligible.

In 2003, Rural Development commissioned a comprehensive physical assessment to quantify and place a price tag on this prepayment problem. In general, it found good news. Only 10 percent of the properties, approximately 1,700 properties, are in markets where rents are so high that the owners could prepay immediately. This represents approximately 50,000 at-risk units, but we only believe that only one-third will use legal or administrative means to prepay in fiscal year 2006.

The prepayment tenant protections for fiscal year 2006 are simply a recognition of the need to get ahead of a tenant displacement problem and manage it in a cost-effective manner. The Bush Administration will be submitting a legislative package in the near future which will describe our initiative whereby the tenants are protected.

Thank you for the opportunity to present our budget proposal. I look forward to working with the subcommittee.

[The prepared statement of Russell T. Davis can be found on page XX in the appendix.]

Mr. NEY. Director Shear?

STATEMENT OF WILLIAM B. SHEAR, DIRECTOR, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. SHEAR. Mr. Chairman, members of the committee, I am pleased to be here this afternoon to discuss work we have conducted at the Rural Housing Service. With my written statement provided for the record, this oral statement addresses three areas: first, a report on how the Rural Housing Service determines areas that are eligible for rural housing programs; second, three reports on the agency's rental assistance budgeting and distribution processes; and third, a report commissioned by the Rural Housing Service called the comprehensive property assessment.

In summary, the Rural Housing Service has recently begun to make progress in addressing problems we have identified in our work. However, several problems at present prevent the agency from making the best use of its resources. In particular, statutory requirements for program eligibility may not best determine areas that should qualify for the agency's housing programs. Changes to the way eligibility is defined might allow the agency to better designate rural areas and treat communities with similar characteristics more consistently. For example, while all definitions of "rural" are based in part on excluding the areas that are urban, we find that statutory requirements relating to metropolitan statistical areas problematic.

MSA classifications are county-based, and therefore are subject to political boundaries. MSAs are not intended to be urban-rural classifications and MSAs can contain, based on census bureau designations, both urban and rural areas. Based on our analysis, we have found a better guide than MSA to better differentiate urban and rural areas. In particular, population density and census designations of urbanized areas and urban clusters provide a more useful guide to make urban-rural distinctions. Such changes would require legislative action.

I will now turn to our analysis of the Rural Housing Service's budgeting and distribution processes for its rental assistance funds. Weaknesses in the agency's budget estimation and oversight of rental assistance funds increase the risk that the agency is not efficiently or appropriately allocating resources. We found that the agency had consistently overestimated its budget needs for rental assistance contracts in its Section 521 program. Namely, the agency used higher inflation rates than recommended and incorrectly applied those rates. Using and correctly applying the inflation rates provided by the Office of Management and Budget would help the agency more accurately estimate its federal assistance needs.

In addition, we found that the agency lacked sufficient internal controls to adequately monitor the use of rental assistance funds, particularly in its funds transfer processes, its methodology for supervisory reviews of tenant files, and tenant income verification processes. The Rural Housing Service has recently moved on a number of fronts to correct the rental assistance program shortcomings identified in our reports. While it is too early for us to fully review the impact of these changes, we believe that the changes in how rental assistance budgets are estimated and the strengthening of internal controls, consistent with our recommendations, would result in greater efficiency in the administration of this pivotal program.

Finally, I will provide a few comments addressing the recently completed comprehensive property assessment, which the Rural Housing Service initiated in response to our May 2002 study on long-term needs in the Section 515 Multifamily Housing Program. This Rural Housing Service assessment was done to develop a baseline for assessing the portfolio's physical and financial condition. For this purpose, the study collected detailed information from a sample of multifamily properties.

Its principal finding that the agency's multifamily housing portfolio was aging rapidly and property reserves and cash-flows do not appear sufficient for basic maintenance of long-term rehabilitation needs are consistent with our work in the area. As we have stated in the past, such information is necessary to help determine how to spend rehabilitation funds as effectively as possible and to inform congressional decisionmaking about how much funding may be needed in the future.

Mr. Chairman, that concludes my oral statement. I would be happy to answer any questions.

[The prepared statement of William B. Shear can be found on page XX in the appendix.]

Mr. NEY. Thank you. They have called a vote, so I am going to go over, and I assume some members will come back. Do you have the time to remain? Thank you.

You are from Maryland, right? You are living in Maryland?

Mr. SHEAR. Yes.

Mr. NEY. Clemson just beat Maryland. I hate to break the news to you.

[Laughter.]

Mr. SHEAR. I will get over it.

[Laughter.]

[Recess.]

Mr. NEY. Mr. Frank is on his way. I think what I will do is I will go ahead and ask a question and that way it will give a little more time when Mr. Frank comes for him to ask a few things.

I wanted to ask, Mr. Davis, can you describe what you see as some of the obstacles that we have to homeownership? Not every one of them, but the main obstacles we have in the rural areas?

Mr. R. DAVIS. We run into two problems continually, and that is the income levels of the tenants are not often high enough to afford the homes that are available, and their ability to repay because of debt levels or credit history do not allow them to qualify for a normal loan. Those are the two hurdles that we find ourselves addressing over and over.

Mr. NEY. What are some of the things that you can do that HUD could not, or why are the programs over there versus what HUD could do, or do you have a different flavor to what you are doing?

Mr. R. DAVIS. Sir, in the single-family homeownership program, we have a subsidy component in our direct program that allows us to go to much lower incomes than regular market-rate loans or even the traditional FHA loans. Our guaranteed loans are also targeted to rural areas, and we work with the lenders to help them understand the particular needs of rural borrowers. This is a distinctly rural program.

Mr. NEY. Have you initiated any dialogue as a result of GAO's reports? Have you initiated any dialogue internally yet on any changes or does Congress need to initiate that, or how do you see that working?

Mr. R. DAVIS. We have been working closely with GAO regarding the definition of "rural" areas. I will defer to Mr. Shear in one moment, if I could just say that we are also working with the Economic Research Service within the Department of Agriculture to identify the specific impact on our programs. We appreciate the work that went into the report by GAO and we believe that their recommendations merit that we work together. We do believe that out-of-date boundaries serve no purpose and we look forward to coming up with a good way of ensuring that we are covering all of our rural areas.

Mr. NEY. I do have a question for you, Mr. Shear, and I am sure Mr. Frank will have some questions.

I think, Mr. Davis, you quoted 10 percent of the properties, what was that quote, in your total portfolio? There was a quote about 10 percent, I think.

Mr. R. DAVIS. In the multifamily portfolio, we have 17,000 properties. There, at one time, had been a concern about how many potentially could prepay; 30 percent or 40 percent? We hired a series of consultants to actually go out and conduct a very detailed analysis of a statistical sample of properties. We found that approximately 1,700 or 10 percent of the portfolio are in areas where it is economically viable for them to prepay. So we believe that the prepayment problem is smaller than we originally expected.

Mr. NEY. Did GAO, Mr. Shear, find it at around 10 percent?

Mr. SHEAR. In what we did, and this was a report a couple of years ago, we did not have the specific property information that the Rural Housing Service used in their recent assessment. What we did is use some kind of macro-type of indicators and said that there might be up to 23 percent of properties that might consider prepaying, so it was only "might consider" repaying, not that they would, so we said up to 23 percent. We think the 10 percent that the Rural Housing Service just came up with is consistent with ours, and rather than saying who might consider prepaying, it would be a matter of who would be likely to prepay.

Mr. NEY. Your figures would be?

Mr. SHEAR. Yes, it would be consistent in the sense that we said it could be up to 23 percent who might consider it, but we did not have the specific information to be able to say who would be likely to prepay, and that is what this assessment that RHS just conducted was able to do for their sample of properties.

Mr. NEY. On the front of your report, I found this interesting, you note about the MSAs grandfathering communities and demonstrating a serious lack of mortgage credit are of marginal utility. So you believe, then, that those designations are just of marginal use in grandfathering?

Mr. SHEAR. Can I start with the MSA? Then I will go to the other characteristics. One of the things is that MSAs are county-based. They are based on political boundaries, and they have changed over time. And so you end up with some situations where it is such a blunt instrument, where certain things do not make sense. We think that you could probably devise a system that would not, in a sense, require so much grandfathering if you used finer-scale information that is available in a mapping-type of technology.

As far as the lack of mortgage credit, there are two points on that. One point is that Rural Housing Service basically says, all areas that are rural have a lack of mortgage credit. So it is not a distinguishing factor. And then the other thing is based on research by a number of parties, including USDA's Economic Research Service. It appears that the problems with lack of mortgage credit is more income-driven, rather than being geographically driven. So what makes sense to us, and I think it is consistent with RHS's policies, is that in terms of how you target your assistance once eligibility is determined, you would want to take into account the incomes of the potential recipients, rather than making the rural definition take into account lack of mortgage credit.

Mr. NEY. Thank you.

Mr. Frank?

Mr. FRANK. Thank you, Mr. Chairman.

Obviously, the series of votes has interrupted this. I do not think the sparsity of attendance is any indication of a lack of concern on the part of the subcommittee, so I appreciate your being here, and I appreciate to the Administrator, the chance we have had to discuss these things.

I think one of the misunderstandings people have is that when we talk about affordable housing that we are talking about Chicago, New York, Boston, et cetera. Clearly, providing affordable housing in the rural areas is a very important piece of this. We have some very well-run programs here. I am really focused on trying to particularly preserve the affordability. I have appreciated some of the conversations we have had.

Let me say to Mr. Davis, of the units that you now have that are in the affordability category, as I understand our previous conversation, you do not think there is going to be any significant loss of units due to gentrification or economic pressure? I understand that there may be some abandonment in some areas of the country where there is a sparsity of population. To the extent that we have a problem of economic forces driving this out of the inventory because people can make more money by dumping the poor people, am I correct that you do not think that is going to be a serious problem for us? That it is a small enough problem so through the right public policies we can essentially prevent it from happening?

Mr. R. DAVIS. This was one of the major concerns that led us to undertake our study. We were surprised when the physical inspectors went out and came back with their reports, to find that the portfolio was in much better condition than we expected. Properties have held up very well. They were well-constructed, but they were done under cost containment restrictions. Our properties were not designed to be the Taj Mahal at the time.

So we have two good forces working in our favor. Number one, the properties have held up and can be expected to hold up into the future, given adequate rehabilitation and maintenance. But at the same time, they are not so attractive and beautiful that they can be taken to very high-market rents. They do not have pools. A lot of the features of the architecture say that this is affordable housing for 1980, no fancy doors on the closets and so forth. So they are nice enough to last, but they are not nice enough to attract really high rents, and that was a surprise to us.

Mr. FRANK. You call to my mind a terribly sexist song, which I do not endorse but cite, if you want to be happy for the rest of your life, make an ugly woman your wife.

[Laughter.]

Obviously, I speak on that from a position of perfect neutrality. No one can accuse me of having any particular involvement here.

That is good news. I think one of the problems we have in the non-rural areas is that we tend from a combination of poor public policy, financial squeeze, and economic forces, to lose a lot of the units. I am glad to hear that that is not the case here.

Also, I am pleased that you have these plans through vouchers et cetera to protect the tenants, but I take it from our conversation that you agree that it is also important that we protect the tenancies, that we do not want to simply protect them for the existing tenants, and then when they move out, lose those to the inventory. You believe you are able to control that?

Mr. R. DAVIS. Absolutely. The voucher proposal in the President's budget, and it is $214 million of new money because we care very much about protecting them. But it is not designed to detract from the project-based Section 515 program. It is a temporary emergency measure to take care of people. I think of it kind of like a life raft. It is temporary. It is a last resort. We would like to keep them in their properties. We would like to keep the properties in our stock. This is only if the tenants are lost. Right now, the 515 program has no mechanism to protect them.

Mr. FRANK. And also, we talked about while the properties are in generally good shape, there is some need for repair, and we do note that this budget does not include a lot of money for that, but you have some reason to think that in future budgets we, and I hope we can kind of make those intentions as public as possible. We cannot make them binding, but maybe we can help them. It is a kind of a multi-year plan and you do assume later in this, before there is any deterioration to the point of uninhabitability, that we will get the money for the physical improvements necessary. Is that correct?

Mr. R. DAVIS. Yes. The important thing is that we want to see the entire portfolio rehabilitated and that rehabilitation used as a vehicle for extending the use restrictions, so that we essentially get the portfolio for another 30 years as cheaply as possible. The question is, do we just put all of the money in from appropriated money, or do we attract money from other properties, cash-flows, and from the private sector? Our goal is that we get as much money from other places as possible. We believe that we have identified a process to start with simple restructurings where we can move money possibly between properties or from tax credits.

Mr. FRANK. That raises a question. I would ask, Mr. Chairman, to facilitate this, because I would hope we could go forward with this, and obviously a lot of it is going to be in the appropriations process. Are there any things we can or should do through the authorizing legislation that would facilitate this?

Mr. R. DAVIS. Yes. We will have a legislative proposal coming up with the department's legislative package. We are looking to take the 515 program out of a very micromanaged 17,000 silos that cannot share resources, budget-based program, into something that incentivizes the owners to bring us extra money, bring in tax credit, and in other resources.

Mr. FRANK. I appreciate that. Mr. Chairman, I hope that we will be receptive to legislating to help on this.

Let me just ask, Mr. Shear, if you have any comments on the conversation we have just had in terms of does that strike you as feasible and within the realm of what we can accomplish?

Mr. SHEAR. I think that what is in next year's budget for vouchers is something that is very important in that there are probably going to be properties that are going to be prepaying, the estimate being about 10 percent of properties. It is important to protect those tenants. As far as going forward, I think back to before my time in housing, when you had certain adjustments made with the HUD portfolio, with the Section 8 portfolio, that RHS will be faced with some similar challenges, but RHS's might be perhaps more of a challenge, they are manageable, but they might be more of a challenge than what HUD had in the sense that you have properties with cash flows that do not appear to be sufficient to support those units without extra subsidy.

Mr. FRANK. Okay, I appreciate that. Of course, those would not be prepayments.

Mr. SHEAR. No, those are the other side of the equation.

Mr. FRANK. Are we doomed to lose 10 percent of the units to prepayment, or are there things that we could do, in cooperation with some of the owners, to diminish that?

Mr. SHEAR. We really have not done work on that to really form a basis for that.

Mr. FRANK. Ten percent sounds higher than you would have sort of estimated to me, in terms of units lost to prepayment.

Mr. R. DAVIS. We believe that 10 percent right now have an economic incentive. They could raise their rates more than 60 percent. That is kind of the cut-off. We believe that there is a good reason to save a lot of that stock and a lot of the State agencies are focusing their resources on those.

Mr. FRANK. Okay. I think that ought to be a priority. Again, anything we can do legislatively, and I know we cannot order people, we cannot by court decision and should not try to take away their property rights, but whatever we can do to diminish any loss of units there, I would appreciate it.

Thank you, Mr. Chairman.

Mr. NEY. Mr. Davis?

Mr. DAVIS OF KENTUCKY. Thank you, Mr. Chairman.

As some of you know, the housing issue is very near and dear to my heart because of my circumstances growing up, and particularly in our district. I see quite a number of uniquenesses. We are in a district that is transitioning, largely rural, transitioning into the Appalachian area. As you are looking at budgetary issues, and I am directing this question to Mr. Davis, I am interested in your views on some creative approaches to dealing with the challenges that we are having getting folks into homeownership so they can start building a nest egg, building a future, and strengthening the families and communities.

I see burdens ranging from cost, locally material costs, a code compliance cost that has nothing to do with safety or sound science. Federal regulations I think sometimes get a one-size-fits-all mentality. For example, in our area where we have what our friends out west would not call them mountains, but we do in Kentucky, where density issues can push them out of rural designation in certain parts of the district.

What I would be interested in you commenting on, if you would, because you have had an opportunity with your team to provide some extensive study of alternatives and needs as we adapt to the future. Would you share with us your views on the types of legislation that you would propose, and perhaps a priority of what is most important to you and your team to get people into housing?

Mr. R. DAVIS. Sure. First of all, if I could say that one of the strengths of USDA's Rural Development is that we have 50 State offices with the ability to manage their own policies locally. They use that flexibility to meet needs that are peculiar to their areas, and then they share that with the other areas. We would like to work with the committee to make sure that any of those ideas that are working in one area are translated up into something that could be made nationwide, and if there are any impediments in statute, we would certainly like to look to that.

The definition of "rural" is something that we are working on with GAO, and we will obviously implement the will of Congress in this matter, but we want to be particularly helpful in helping you understand the implications of different approaches to defining "rural." We want to make sure that we really are putting our money into rural areas and not diffusing it into too broad of a definition. But there is a distinction between what is an eligible area and what is an area that we want to target. Both of those are areas that we would like to work with the subcommittee on identifying ways that we can find things that work in particular areas in your state. Was there a particular program you had in mind?

Mr. DAVIS OF KENTUCKY. Well, you are somewhat familiar with our needs in the Midwest, and in Kentucky and the Ohio Valley, where the Chairman and I are from. Do you have any specific types of legislation or any specific piece of legislation that you would see as applicable, as a priority that you want to bring forward?

Mr. R. DAVIS. We do not have one in our legislative package that is being prepared at the moment. However, we do believe that we will have some comments in conjunction with GAO in the coming weeks and months, perhaps, if it may help understand where we can write some legislation, or if we could get some legislation that would help. In the Eastern Kentucky area or Northern Kentucky, there is a concern that density measures, which GAO has been discussing with us, will affect areas that might be very mountainous, for example, have a lot of people densely packed into a small valley. We want to make sure that any changes would not adversely affect those areas, and actually might help target them better.

Mr. DAVIS OF KENTUCKY. Just a further point. Mr. Shear, you may be the person to answer this question, but I am encouraged to hear that you are looking at best practices in different parts of the country. Is there an ability within the regulatory framework to assure that there is not a one-size-fits-all approach, that from a regional standpoint, a certain set of practices may be very applicable in that region, but not necessarily transferable to another region? To have some "autonomy" probably is not the correct word from an accountability standpoint, but a uniqueness that you can customize to a region and fit with an intent that gives fiscal accountability, but is ultimately getting folks into housing in effective programs.

Mr. SHEAR. I think you outlined what is really ideal state. One of the things that has always been present in our work on the Rural Housing Service is where does it make sense to have a specialized agency dedicated to rural housing? Among the areas in particular, I will take Eastern Kentucky in being part of the Appalachian region. There are certain regions of the country that we think have some very pressing housing needs, where those might be the areas where it makes more sense to have a separate Rural Housing Service that has the local offices, has the field offices, and can be somewhat adaptable to local conditions.

Mr. DAVIS OF KENTUCKY. Okay. Thank you.

I yield back, Mr. Chairman.

Mr. NEY. Thank you.

The gentlelady from California, our ranking member, Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman.

I am trying to understand the fact that there is an increase in the Rural Housing Service budget. At the same time, it appears that we are going to lose the opportunity to deal with some of the poorest tenants. The information that I am looking at, the Section 515 program has funded rental housing for some of the country's poorest people living in 17,000 properties in underserved rural communities across the United States. The majority of these properties were built between 1970 and 1980 and in need of modernization and repair. There was a report that was done that talks about the existing tenant base, the average age of the property, and of course the income and the program supposedly provides subsidized loans for three purposes: capital repair of aging 515 units, incentives to preserve units as affordable, and capital funds for the new construction of new affordable multifamily units.

How is it then that the budget request reduces Section 515 loan volume from $100 million to $27 million, a 73 percent cut? How do we deal with that?

Mr. R. DAVIS. If I can say that we are strongly committed to the 515 program. This is why we have a major initiative to preserve the program and have added $214 million as our first step in doing that. I would say that in the future we will be addressing the physical needs of the existing stock. The 27 million for Section 515 loans, that was $100 million last year. We are proposing a lot of for the 538 program. We have doubled the size of the Section 538 loan program.

Ms. WATERS. What is the 538? Describe what that money will do?

Mr. R. DAVIS. Section 538 is guaranteed loans; 515 is direct loans straight out of the Treasury to the borrower, and has a 1 percent interest rate. The 538 Program is guaranteed. The private sector makes the loan at essentially the government's borrowing rate. The 538 Program is much more flexible for use with the tax credit program, so that it can attract tax credits in for rehabilitation.

So of the difference between the $27 million and the $100 million, approximately half is for rehabilitation that we can do better in the 538 Program.

Ms. WATERS. Does the 538 have any subsidies for renters?

Mr. R. DAVIS. Section 538 does not itself have subsidies for renters. It has an interest rate credit component, so there is a buydown of the interest rate from higher market levels, but it is an indirect subsidy in that it goes into the property. What it does, though, is it can be used with the tax credits. The Section 515 Program, we cannot mix with tax credits because that is considered over-subsidizing under the tax code.

Ms. WATERS. The people who are covered by 515 now, would they be eligible for these 538 loans?

Mr. R. DAVIS. The 538 loans with tax credits will go to 40 percent of median income. To go below that, we look for other state funds or other ways.

Ms. WATERS. So what you are telling me is no; that the 538 money cannot really be used for these very, very poor people whose average income is $9,075? What are they going to do?

Mr. R. DAVIS. Again, we are first addressing the structural problems of the 515 Program through the revitalization initiative. We are using 538 to get people down to 40 percent. I understand your comment about the very, very low income, if you would categorize, I guess, below 40 percent as what we are missing. The difference in the amount being spent on new construction last year and in fiscal year 2006 is approximately 450 units, of which about one-third would have rental assistance. We are talking about a small amount. We have added a very large amount in the initiative of people that we will be bringing into the RA universe. Of the 15,000 units we expect to do next year, about 3,000 are people who are not getting RA right now.

Ms. WATERS. All right. I guess what I conclude is this, that there is a significant cut in the 515 Program. Do we agree on that?

Mr. R. DAVIS. We believe that we are addressing a major program.

Ms. WATERS. No, no, no, no. I did not ask what you are addressing. Is there a cut? Does this budget propose a cut in Section 515?

Mr. R. DAVIS. This budget proposes that we have a shift of funds from Section 515 to Section 538.

Ms. WATERS. From $100 million to $27 million.

Mr. R. DAVIS. For loans in Section 515.

Ms. WATERS. Okay. Section 515——

Mr. R. DAVIS. Yes.

Ms. WATERS. There is a cut from $100 million to $27 million. Now, do you want to qualify that in some way so that I am not talking about all of 515? So what is it you want to tell me about that cut?

Mr. R. DAVIS. What we look at is the number of people served, and we are expanding the number of people who are being served.

Ms. WATERS. Okay. So there is a cut, and you are proposing that your 538 funding will take care of the people who would normally be taken care of with 515?

Mr. R. DAVIS. No. I am saying that of the difference between $27 million and $100 million, half of that would not have been for new construction anyway. It would have been rehabilitation and we are not doing that in 515. We are doing it in 538. Of the difference, we are picking that up in our rental assistance accounts and picking up many more people than were covered in the loan account.

Ms. WATERS. Okay.

Mr. R. DAVIS. This is really not an attempt to cut the 515 Program. This is an attempt to broaden the 538 program.

Ms. WATERS. I do not care what the intent is. It looks as if some people are going to be lost in the way that you have described this funding. Am I right or wrong?

Mr. R. DAVIS. We will be doing less new construction with the 515 Program. We will be doing more with the 538 and we will be doing more with rental assistance.

Ms. WATERS. Okay. Then we have a problem here. I thought that there was an understanding that there was an increase that everybody would benefit from. It appears that that is not the case. Is that correct?

Mr. R. DAVIS. There is an increase in the housing budget.

Mr. NEY. Will the gentlelady yield?

Ms. WATERS. Okay. All right. Yes. It looks as if, and the staff is identifying that it is only the top 10 percent that is going to benefit with this 538 Program.

Mr. NEY. Okay. We think we have it solved.

Ms. WATERS. Well, what Clinton is suggesting is that you need to describe to us the voucher program and how it works. What is the plan here? How does the program work? How is it going to work so that it will satisfy our concerns, the voucher program?

Mr. R. DAVIS. The voucher program is a temporary tenant protection program. It is not an attempt to turn a project-based program into a tenant-based program. We have 50,000 units that are in high-cost areas, primarily California, Oregon, Washington and a few other high-cost cities where the rents could be raised so high if the property were taken to market that none of the residents could afford to live there. We have no mechanism in the Section 515 Program to provide them with a voucher or anything else.

Until 2006, actually, we have to go to HUD and ask for vouchers or ask the state to take care of things. That is a mechanism that has been missing in 515 and we are proposing that that be put in place. The way it is envisioned, and this again will be in our legislative proposal, but the idea is that the voucher would be something that could be used portably by the tenant to either stay in their current property and pay the higher rent, or move to another property in the same area. The voucher would be subject to automatic renewal, just as our RA program is. For budget purposes we had assumed that people who currently have a rental assistance contract unit would get a 5-year voucher at which point there would be an automatic contract renewal subject to appropriations. I cannot promise anything about future——

Ms. WATERS. Okay. That is the 10 percent in these high-priced markets.

Mr. R. DAVIS. Yes.

Ms. WATERS. Okay.

Mr. R. DAVIS. And may I just add one thing.

Ms. WATERS. Yes, go ahead.

Mr. R. DAVIS. I just wanted to say that one valuable feature, which is new, is that currently one-third of our units, in these properties probably one-quarter, one-quarter of the units have people who do not have RA right now. They are paying more than 30 percent of their income, so these are the overburdened tenants. These tenants who are not now being protected down to 30 percent of their income would come into the voucher program and would receive the extra assistance. So we are actually expanding the universe of people who are getting this.

Ms. WATERS. Okay. So then it is not just for what I was describing as the top 10 percent. Those people who are eligible based on what you just described, who are paying more than they should be paying, would also be eligible for vouchers.

Mr. R. DAVIS. Yes, in this tenant protection program.

Ms. WATERS. All right.

Mr. R. DAVIS. We are not trying to protect high-cost properties or owners. We are trying to protect the low-income tenants in these properties.

Ms. WATERS. All right. Thank you.

Mr. NEY. Mr. Davis?

Mr. DAVIS OF ALABAMA. Thank you, Mr. Chairman.

Let me pick up on I suppose the same area that Ms. Waters is pursuing, but a slightly different aspect of it. One of the concerns obviously that we have is around the vagueness of the voucher program, and frankly I do not know if we know as much about it as we would like to make a critique on it. One of the concerns that we have is are we going to be covering people who are suffering in rural areas and low-income areas to the degree that we need, or are we only going to be covering just a subset of those people who live in communities that have certain characteristics?

Alabama, for example, certainly rural Alabama does not have a hot real estate market. It is not an area where real estate values are exploding out of people's reach or capacity. The problem in rural Alabama is substandard housing, low incomes, poor housing stock, that kind of thing, lack of credit. How does this voucher program affect people? Does it reach people and will the money be there in the program to reach people who are living in rural areas that are not experiencing rapid rises in property values?

Mr. R. DAVIS. This voucher program is a tenant-protection program for those facing prepayment. So it is aimed at high-cost areas. I can get a list of any properties that might be affected in Alabama or other areas.

Mr. DAVIS OF ALABAMA. I can guarantee you, there are very few high-cost areas in Wilcox County, Green County, Perry County and Dallas County.

Mr. R. DAVIS. It is very likely. Where it could happen, though, is where an area was rural and then a town or a city grew and created upward pressure on rents. It may be possible that that has happened in one of your areas.

Mr. DAVIS OF ALABAMA. Let me tell you my concern about that. I am on the Budget Committee. We just finished our markup last night. We will vote up a budget next week in the House and Senate side. Over and over, this conversation happened, that we are trying to assess our priorities. We are trying to decide what we can really spend money on, where we can improve efficiencies. It strikes me that the primary housing problem in rural America is honestly not the one you just described. You have described a particular problem, people who have moved into rural areas and the values in these areas are escalating beyond their immediate reach. That is a problem in America.

The much larger, more acute problem in America, and rural America, seems to be low-income people who are living in areas, or even moderate-income people living in areas the banks do not want to go into, areas where there is not an active development market, and in areas where the quality of the housing stock may be poor. That seems to me to be a much more acute problem.

So as we refine the 515 Program, my concern is that it seems that we may be narrowing its scope instead of widening its scope to really get at the problem. I mean, tell me if I am wrong or if I am missing something when I say that.

Mr. R. DAVIS. You are correct that there is a problem with income levels in rural America for buying certain single-family homes above a very modest level. Let me speak to both of our single-family and our multifamily programs. Under our single-family programs, we are increasingly targeting areas of the country that private lenders shy away from. That is one of the values of our guarantee program, that we have targeted areas that we can direct lenders to provide financing. We do not want our private lenders to just sit in the cities and make the loans that are close by.

Mr. DAVIS OF ALABAMA. What is the criteria for those target areas?

Mr. R. DAVIS. Well, they generally are income and general economic indicators of median income and unemployment. The targeting decisions are administrative. When I spoke earlier of the 50 state directors, we have our State offices look to see what are the problems in their states to make sure that they set targeting criteria that are the most useful to them. So we have an effort there. In our direct loan program, we are increasingly targeting very low income people as opposed to low-income people. Fifty-five percent of our loans are now going to very low income as opposed to low income. So we are pushing that program farther down the income scale and we are pushing the guaranteed program farther out into the outer areas.

On the multifamily side, it is important to understand that this prepayment voucher program is part one of a two-part story. Part two is the 14,000 properties that need rehabilitation. That is something that will grow over the next 2 to 3 years and hit its stride, but will go on for another 8 to 10 years. We need to rehabilitate 14,000 properties basically in the next 10 years. But that will create an industry that knows how to make a lot of little loans in rural America for multifamily. We believe that that will help generate more of this housing in these areas from the private sector.

Mr. DAVIS OF ALABAMA. Okay. Mr. Chairman, my time appears to have expired.

Mr. NEY. We have a little bit more time, too. I was going to ask a question, but if you all want to ask any more questions, it would be fine.

The question I had is, as you start to develop from the report some changes that you want to do, do you sit down with GAO that wrote the report and try to get their perspective on it? They wrote the report and they know what it is.

Mr. R. DAVIS. For the prepayment problem or the rural definition issue?

Mr. NEY. Either that you want to change.

Mr. R. DAVIS. We work closely with GAO to get their input. We can provide information to you as it is developed.

Mr. NEY. The question I had, Mr. Shear, is you provide a lot of studies to GAO.

Mr. SHEAR. Yes.

Mr. NEY. I should say GAO has provided a lot of studies to the Congress and the committees. What is your assessment of the Rural Health Service at this time? Has it made progress? Has not? What is your assessment, just overall?

Mr. SHEAR. I think overall, I have something very positive to report, and certainly more positive than I have been able to report in the past in that when we look at certain suggested changes that would improve the efficiency of the programs, improve the efficiency of the subsidy process, that when we look at those operations there appears to be changes along the lines that are consistent with our recommendations.

So I would say certainly in the last few months, we have not been able to go back in and say, how well are these changes, whether it is in the budget estimation process or in terms of addressing internal control, but we see a much more receptive environment, a much more constructive engagement than we have experienced in the past. So we are hopeful. We have not been back in to take a close look at some of the things we have looked at even as recently as the last few months.

Mr. NEY. Bakersfield, California is in here; Brookside, Ohio, of course which I am familiar with, is in there, where you have a dividing line that divides one house from the other and one would be a different classification depending on which side of the street you are on. You have Bakersfield, and you mentioned Belpre, which is across, I used to represent Belpre a long time ago.

Those are examples of where the definitions should be changed.

Mr. SHEAR. I would call this that what we are pointing at is using a different type of guide. Population will always be important in defining what is a rural area, but what we are looking for is a different guide to try to make such determinations, rather than a county-based system where you are using political boundaries. I think that is the most important thing that comes out of this, because of the way different types of rural areas and urban areas change over time, and how even the definitions of "metropolitan areas" change over time.

In terms of the examples we have there, there is a question at the Economic Research Service at USDA, there is a lot of research that has gone into how do you define a degree of rurality, and that would get into this question of trying to pose how could you redefine eligible areas in terms of looking at rurality. Here, we use those examples in this testimony and in our report to try and give an example of where lines are blurred. Because of changes that have occurred over time, in either definition or in terms of demographics, it draws into question of how difficult it is to determine what is truly a rural area. We think it can provide, you know, the guidance that can lead to a better basis for defining what should be eligible for Rural Housing Service programs.

Mr. NEY. It is kind of tricky when you deal with the changed definition in the sense of, as you are writing up the law, how does it affect so many communities. It is a process that we have to be pretty careful on, is it not?

Mr. SHEAR. I think there is a lot of care involved either in using current statutory language like, for example, you brought up Belpre and I hope that we have not created a problem for ourselves by referring to a district that you used to represent. But at any rate, there is a problem with the existing definition when you have different state and field offices and loan officers, different officials from those field offices from RHS that are making decisions where there is no real clear guidance and it is hard to get at. What are we trying to get at with these rural definitions, when the characteristics of counties and their geographic extent is very different in different parts of the country. The definition of metropolitan statistical areas is very different.

So we think that to some degree coming up with a new guide to this might lead to greater clarity in how we define rurality because it is based on the characteristics of those specific geographic areas themselves, rather than being focused on political boundaries.

Mr. NEY. The gentlelady from California?

Ms. WATERS. Thank you very much.

Let me just change the questioning a bit to ask about how you are organized so that I can better understand. How are you organized? Where is your main office? Where are your offices? And how do you interact with all the rural areas of America? Just kind of give me a brief.

Mr. R. DAVIS. Sure. Rural Development's mission area within the Department of Agriculture has three areas: Rural Housing Service, Rural Utilities Service, and Rural Business Service. All three are headquartered in Washington, D.C., but are decentralized in the sense that every state has a State office with a political director who has the flexibility to make decisions within that state.

The offices in the field can offer any of the services from any of the different areas, so we have people who in the morning might work on housing issues and might work on business issues in the afternoon. We are really trying to get them all working together because in small communities you need to have different programs working well with each other.

The national office mostly sets the regulatory policy and provides guidance and instruction to the field, but the decision-making, the servicing of the loans and the origination of the loans, all of those decisions are done locally. We have 700 offices in rural areas, plus we can have temporary offices for areas that are farther out, Indian reservations and places like that. We can have people go out and set up for 1 day a month or 1 day a week, things like that. So we have very, very broad physical coverage of the country.

Ms. WATERS. If I may, and if you do not mind, I would like to ask about Alabama, because I get a better understanding of how you work based on what I have been able to see in that state. Where is your State office in Alabama?

Mr. R. DAVIS. It is in Montgomery.

Ms. WATERS. It is in Montgomery. If I am in Selma and I want to make a loan, I want to get the services, what do I do?

Mr. R. DAVIS. You would go to your local office and they would show you your options.

Ms. WATERS. You mean, if I was in Selma, I would go to——

Mr. R. DAVIS. There is probably an area office, I do not know what is closest to Selma, but there will be offices.

Ms. WATERS. In Birmingham? In Selma?

Mr. R. DAVIS. Near Selma, there will be a field office.

Ms. WATERS. Do you know where it is?

Mr. R. DAVIS. I do not know.

Mr. DAVIS OF ALABAMA. Is that a question to me, Ms. Waters?

Ms. WATERS. Yes.

Mr. DAVIS OF ALABAMA. I would assume if you have an office in Montgomery, you probably do not have one in Selma. Whether that is good or bad, that is my assumption because they are 45 minutes apart, but obviously I do not think you have an office in Selma.

Mr. R. DAVIS. I do not. We can provide a list of the offices.

Ms. WATERS. That is okay. I am just trying to get an idea of how you work, so I get a better feel for it. So that someone living in Selma wanted to avail themselves of the services, how do they get to know or learn about what you do?

Mr. R. DAVIS. We have regular outreach programs to the community, but most directly they would come to our office, the Rural Development office that is closest to them.

Ms. WATERS. Yes, but I am Miss Jones and I live over by the railroad track someplace. I have never heard of you. How do I hear about you?

Mr. R. DAVIS. We do community outreach efforts to advertise our existence and our programs, but we generally have the applicants apply directly to our offices. If you are asking if we set up in satellite buildings or something like that, is that something you would suggest?

Ms. WATERS. No, I am just asking how do you get the information out about your program? Where would you say you have the largest concentration of dollars in the United States? In what state?

Mr. R. DAVIS. The largest concentrations will be in the largest states. We allocate to the different states based on population measures.

Ms. WATERS. So you do have an allocation formula?

Mr. R. DAVIS. We allocate to the states according to a formula that may have some flexibility, but it is predominantly population in rural areas.

Ms. WATERS. So in the State of California, because I heard Bakersfield mentioned, California has an allocation that takes care of all of our rural areas also?

Mr. R. DAVIS. The state will get an allocation, and then they have areas, their area offices that they have divided the state and they will presumably allocate to each of those offices an amount for that area.

Ms. WATERS. Whatever it is that you are doing, does it work? I mean, do you feel that the information is disseminated in ways where the average person who needs the service would know about it?

Mr. R. DAVIS. We understand that marketing is something that we must continually be doing, and that is a major part of what people do with their time in our local offices. We are limited by the nature of our budget, but we spend an enormous amount of time reaching out to housing groups in the area, local community groups, getting the word out. Because if those allocations to each of the states are not put out, we pull it back and give it to another state that does put it out. So there is a lot of competition between the states to make sure they get rid of their monies, as it were, so that they do not lose it. So there is a real effort to get the word out.

Ms. WATERS. All right. I am going to ask if my staff can get with your staff so that I can get an organizational chart with the identification of all of your offices at the state level, and then the offices in the areas associated with the state. I want to take a look at the budget, for example, for my state.

Mr. R. DAVIS. Sure.

Ms. WATERS. And see how that works. We may need to interact with your staff to ask a number of questions so that we can get a better sense of how all of this works.

Mr. R. DAVIS. We would be happy to provide that information.

Ms. WATERS. Thank you.

Mr. NEY. Mr. Davis?

Mr. DAVIS OF ALABAMA. I have a few, Mr. Chairman, and I recognize Ms. Harris just walked in, so Ms. Harris I will try not to take too much time. Let me for a moment pick up on Ms. Waters' point because I want to make sure you all get the point that I think that she is trying to make to you. The problem in a lot of southern states is when we are trying to engage in efforts to reach people in the rural communities, we often put the offices in the nearest urban community to that rural community. You go to Montgomery and Selma because that is the more convenient place. I think the point that she is making, and I do it as a point that you should think about, is structuring some of your offices and some of your outreach to meet the physical realities in these communities.

It is a challenge doing outreach in rural Alabama, rural Mississippi and rural Georgia. You are dealing with people who may not have the same access to real estate agents. You do not have as many real estate agents. You do not have as many banks. The conventional kinds of institutions that you all depend on in your suburban southern cities just are not there in the rural areas, so it is not just enough to say, okay, we are in Montgomery, we are 45 minutes away. I assume that is the point that she was making to you.

Let me go back and spend my last round of questions on, again, priorities. If we are going to have a new $214 million on the table and we are going to try to do something of interest with the 515's, let's focus again on the choice. Are we trying to deal with tenant protection or are we trying to deal more with the housing stock problem? One criticism that has been offered of these changes is that by centering the relief, if you will, around the tenants and not around preserving the property, we are missing a major problem in rural America, which is the decline of housing stock.

This is how it plays out in practice. In the suburbs of the world, if one area kind of begins to deteriorate, you have a new subdivision spring up and they meet the demand, and people move out, they move into a new area, and everybody's kind of left better off. It does not work that way in the rural area, though, because as you all know very well, you do not get a lot of new subdivisions built in the Selma, Alabamas and some of these other communities. And when housing stock deteriorates in downtown Selma and downtown Marion, Alabama, it just stays deteriorated and no new divisions come along. This is a unique and particular problem in the rural south.

Is this the best use of your innovation? Is this the best use of this $214 million dealing with tenant protection, as opposed to finding ways to continue to push harder on the housing stock issue?

Mr. R. DAVIS. First of all, if I could say that we have increased our single-family lending programs by $400 million this year over 2005. We recognize there is a need and we are working to meet as much of the need as possible, given the difficult budget choices. The $214 million is for a very immediate problem that has very serious immediate consequences. Somebody cannot pay their rent, and is potentially being evicted, and is potentially being thrown out of the program.

We feel a need to protect the program overall by making sure that it is understood that we do not want this kind of a loss to the 515 program. So our first year's effort is aiming most of its money at the tenant protections. There are out-years, though, where we have a much bigger task, which is the physical rehabilitation and repair of these properties. This gets, I believe, to your issue of the general deterioration. We need to start putting money into these properties because there is no mechanism now to adequately fund rehabilitation.

Mr. DAVIS OF ALABAMA. I would just make two final points before Ms. Harris takes the floor. The first one, I would quibble a little bit with the priority choice because I understand the point that you are making. The point that you are making is we are trying to meet payment prices right now, but the problem is because of the way that you define the payment prices and the communities that would be within the ambit of that definition, you are not getting a whole lot of folks who are really in need. You are getting people who are frankly living in the Autauga Counties of the world. Autauga County is a rural county in Alabama that is having a lot of growth because a lot of new people and new businesses have moved in. Property values are taking off. But that is not the same as the Dallas Counties of the world that she was talking about, or the Perry Counties of the world, where you do not have the high values. I would think, if I had to weigh into the argument, that the need is more acute in these low-value areas.

The final point that I would make is, this housing stock issue is a critical one and I think that it should be very much what the heart of the 515 program is about because again you are not getting successor subdivisions in a lot of parts of rural Alabama and Mississippi. When these areas begin to decline, they stay in a permanent state of decline and that is a real problem. That is why housing stock is more critical and a more unique problem in the rural south than other places.

Thank you, Mr. Chairman.

Mr. NEY. Thank you.

The gentlelady from Florida, Ms. Harris?

Ms. HARRIS. Thank you, Mr. Chairman, and thank you for holding this important meeting today. I thank the guests for coming.

I come from a Florida district on the coast, but it goes into the center part of the state, and actually that is where I spend my summers. It is the heartland of citrus and cattle, but very fragile economies associated with it. Ironically, when we had four hurricanes, three swept through and devastated these communities that were already counties of critical economic concern. So consequently, there are still blue tarps everywhere. It might have devastated the community, but it has not devastated the residents' morale.

I will share with you. The Chairman came down in the fourth hurricane. We were having a barbecue for all those folks whose homes had been destroyed, and right when we were starting to eat, here comes the fourth hurricane. You know what they said? They are so glad it is coming in our path again because there is nothing left to destroy, and not hitting someone else. So the Chairman saw first-hand that kind of devastation.

What happens in Rural Development, while I commend you efforts, it is so difficult for some of these communities, as they were saying, Selma versus Montgomery, to understand the network and the challenges. It is also difficult for them to have the understanding of the data.

So what I would like to ask you first is, with regard to the hurricanes, what is the coordination that is going on between HUD and FEMA? Can you discuss the efforts from Rural Housing to assist in these areas? And do you believe that you have the necessary resources to provide this kind of assistance?

Mr. R. DAVIS. Thank you for asking these questions, because the hurricane situation was something that we cared very much about last year. It is actually leading to some of the initiatives in this budget. I would like to describe the linkage there.

First of all, you had asked about FEMA. There is kind of an ordering in which problems are dealt with. FEMA stands ahead of us in line. We have in our mortgage insurance programs, private insurers who have insured the homes, and FEMA and the insurers generally take care of those issues. A bigger issue is what we do with people who are displaced. We have 300 units of multifamily housing in Florida destroyed in the hurricanes last year. Our immediate concern was, how do we house the people who were in units that were destroyed? That was where it became very painfully clear that the Section 515 program did not have a backup like HUD's voucher program. We had no mechanism for putting those people into, say, HUD housing or into market-rate housing.

Now, we had a limited ability to put some of them into other Rural Development housing, but one of the reasons for our voucher program is to be able to use emergency tenant protections to cover just situations like this. So we believe that in the future we will be able to handle these types of things.

Second, we have a responsibility to our borrowers in Florida when a disaster occurs. We have a centralized servicing center that offers directly to the borrowers in the case of a disaster a moratorium on their mortgage statements. Within 2 days, I believe, of the end of the first hurricane last year, we had letters that had gone out to I believe it was 11,000 borrowers in Florida offering them no-questions-asked 6-month moratorium on their mortgage payments. They have other things to do with their money at that moment. The payments moved to the back end of the mortgage. So we have ways of helping the situation immediately from a financial point of view. We do not have the boots on the ground that FEMA has, but we do stand behind them in our ability to help.

Ms. HARRIS. Further on that, you were mentioning some of these programs, but these municipalities, one county has about 33,000; one has about 27,000. And there are tens of millions of dollars that they have not taken advantage of in years past, just through a simple lack of knowledge. So I think that in trying to anticipate those critical housing needs, we are going to have to come to understand how to address that technical assistance that is going to be so necessary for them to be able to access those essential funds.

Farm worker housing, I mean, not only do we have workforce housing that is a problem and then affordable housing, but now we have this hurricane housing and then of course our farm worker or temporary worker housing. It has been particularly impacted by the hurricanes this season. Many of the people that were affected were living in the woods or in shacks or in these containers, if you will, after the hurricanes. But whatever, however you look at it, it is really substandard.

A lot of the rural counties do not even have the manpower or the resources to provide for the laborers, and they are essential to the local economy. So we are really focused on trying to provide better technical assistance to the rural housing authority. Actually, Chairman Ney came down and met in this very small house that we were working with the housing authority. I guess my question would be, do you believe that you are creating a program that would provide better technical assistance to help with some of these concerns? And how would you go about addressing that, and where do you think we should go to be able to help those folks that are in such desperate and dire need?

Mr. R. DAVIS. It is a good question. You had mentioned farm labor housing. I was just looking at the numbers here. We are increasing our funding for farm labor housing this year. It was something that Secretary Veneman was personally interested in. I know that when I would go into meetings, she would always say, "How are the people down in Imokalee?" She had gone to the opening down there. This is something that we have $56 million in program funding proposed for the coming year, and an additional $5 million of rental assistance. Farm labor housing is something we understand is important to rural areas.

We have some existing tecnical assistance programs, and we would be happy to work with the committee on identifying new things that we might be able to try.

Ms. HARRIS. We are going to have a housing summit in our district that we are working on, but there is just such a vast continuum of needs. I just know that in such economically fragile areas that are agricultural in nature, if we do not have those temporary workers in a place for them to live, if we do not have the workers for construction, if we do not have the workers for the hospitality industry, all of these types of things that are so vital throughout our region, we will come to a grinding halt.

So the housing issue obviously is really crucial after such a devastating series of natural disasters that are hurricanes.

Mr. R. DAVIS. I appreciate that. Anything we can do to help, we will be glad to do.

Ms. HARRIS. We will be calling on you. Thanks.

Mr. NEY. I want to note that I appreciate the member's being here. We had floods back home, a series of three of them in most places. In Tuscola County, we evacuated about 6,000-some people, and then we have some communities that were really hard hit. I don't know if you are connected to this or not, I will have to find out, but we brought in the temporary, sometimes containers for people to live in, but I thought it was by FEMA. When I was up there with the emergency management services, I think FEMA I thought acquired them from HUD, but they possibly came from you?

Mr. R. DAVIS. I do not believe that those would have come from us.

Mr. NEY. The temporary trailers and things like that that were brought in.

Mr. R. DAVIS. Right. Those were probably FEMA's units, but we participate with FEMA whenever there is a disaster. We set up tent with them and work with them directly.

Mr. NEY. Yes. One other question, you are going to set up a voucher? That $200 million, that would be to set up a voucher program?

Mr. R. DAVIS. It will be predominantly a voucher tenant-protection program. We want to keep the focus on tenant protection as opposed to just vouchers because it sounds like we are being frivolous with the program. It is really what is the best way to protect the tenants in those prepaying properties. We believe that will be an enhanced voucher of some sort.

Mr. NEY. This must have been before your time, but now that you are there, but you had an 8-year plan developed. You all knew that we were going to lose the Supreme Court case, I assume, or we had a good chance to lose the case.

Mr. R. DAVIS. I am sorry I am not a lawyer. This is a Department of Justice issue.

Mr. NEY. Then I apologize. I am a teacher, not a lawyer.

Mr. R. DAVIS. They had been winning, however we lost our appeals on both the quiet title and the contract damages cases, both precedent-setting cases we lost.

Mr. NEY. I mean, it is a concern. We have talked about what happens to all the people. There is no incentive. So you have developed something towards an incentive program, though, over a period of years?

Mr. R. DAVIS. Well, we have a small program to handle prepayments that do come in. In fact, we have $5.9 million in RA for next year and $27 million for preservation loans to take care of those equity incentives. We give the owner their equity loan so that they stay in the program. So we do have that continuing program. The $214 million is in addition to that.

The comprehensive property assessment that we released showed that it was much more expensive to take the incentive approach than to take the voucher approach. So as a cost matter, we are looking more to vouchers as opposed to owner incentives.

Mr. NEY. We have the study here that the ICF did.

Mr. R. DAVIS. Yes.

Mr. NEY. Because one thing I had looked at in one of the programs was to get some incentive for people to come back in and to prepay, the people that owned the properties. Then it was a fear, well, people would just go in and then dump people out, but I always felt that the court case was coming so it was something that was going to have to be dealt with. So you should be able to take this?

Mr. R. DAVIS. Right. The purpose for this initiative is we believe that time is here.

Mr. NEY. This study that we have here, is this not going to be how you take this study and you make your strategic plan to deal with it?

Mr. R. DAVIS. Our legislative package will have more details in it, but we are following the general thrust of the study's recommendations, which is that we look toward tenant protections as opposed to incentives, and that we really focus on the 90 percent of the properties that need rehabilitation, getting money into them primarily through debt restructuring, and money from the outside wherever possible.

Mr. NEY. Thank you very much. I appreciate both witnesses.

I would note that some members may have additional questions for the panel, and the member who want to ask additional questions, they can submit it in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to the witnesses and place their responses in the record.

I appreciate your patience and time with us today. Thank you, and to the members, for being here.

[Whereupon, at 4:03 p.m., the subcommittee was adjourned.]

A P P E N D I X

March 10, 2005

Prepared, not delivered
Opening Statement

Chairman Michael G. Oxley
House Committee on Financial Services

Subcommittee on Housing and Community Opportunity
"Oversight Hearing on the Rural Housing Service"

March 10, 2005

Today, the Subcommittee on Housing and Community Opportunity welcomes Russell Davis, Administrator of the Rural Housing Services and William Shear with the Government Accountability Office. Mr. Davis, I want to congratulate you on your first year in office, and I look forward to continuing to work with you to provide affordable housing in our rural communities.

Over the past few years, this Committee and the Administration have continued to seek bipartisan ways to extend homeownership and to make existing housing programs work better.

For example, the Committee passed the American Dream Downpayment Act that benefits 45,000 new homeowners annually. For rural areas, the Committee passed legislation that would allow the Government National Mortgage Association (GNMA) to securitize Rural Housing Service multi-family loans as well as providing new homeownership opportunities for Native Americans.

This year, the President's fiscal year 2006 budget proposal would strengthen our efforts at supporting rural housing with a proposed increase of $350 million for the Rural Housing Services.

While I believe we are on the right track, certainly there is much to be done to aid the almost 80,000 rural families that are currently on the RHS waiting list for rental vouchers. Similarly, I am concerned by recent GAO reports that show an uneven RHS definition of "rural." We need to take a look at how RHS determines eligibility requirements to ensure that those families living in rural communities have access to the resources of RHS and can share in the American dream of homeownership.

I would like to thank Chairman Ney and others on this Committee for their diligence in advocating the needs of our rural communities and look forward to working with them and with you, Mr. Davis, to ensure that we do not overlook the affordable housing needs of our rural families.

March 10, 2005

Subcommittee on Housing and Community Opportunity

Hearing: Oversight of the Rural Housing Service budget for 2006

Rep. Katherine Harris' Statement:

Thank you, Mr. Chairman. I wish to express my appreciation for your leadership in scheduling today's hearing to review the Rural Housing Service's programs. I also wish to welcome our distinguished witnesses. I look forward to your testimony regarding how we can continue to assist our precious rural communities.

Rural Florida continues to occupy a very special place in my heart. I grew up in an agricultural community, and I represent central Florida's citrus and ranching heartland -- Hardee and DeSoto counties. This region symbolizes my state's rich heritage, as well as the fragile balance associated with agricultural economies.

Tragically, last year's hurricanes devastated both counties, threatening this delicate equilibrium while battering the morale of the residents, who have demonstrated extraordinary courage and resilience.

I commend Rural Development's exceptional engagement in recovery efforts. Nevertheless, difficult work remains before our communities can become truly whole again. I look forward to working with you to complete that job.

A significant challenge that we confront in connection with this task is small municipalities' dearth of knowledge and resources in addressing critical housing needs. Enhanced technical assistance for these jurisdictions is essential if they are to fully avail themselves of the funds that are available. I hope that we can make this objective a priority.

Thank you, Mr. Chairman.

Opening Statement of the Honorable Bob Ney
Chairman, Subcommittee on Housing and Community Opportunity

Hearing on the Rural Housing Service's FY 2006 Budget Proposal

Thursday, March 10, 2005

The Housing Subcommittee meets this afternoon to discuss USDA's Rural Housing Service and the agency's budget proposal for FY 2006.

The U.S. Department of Agriculture's Rural Development (RD) mission area administers programs that are designed to meet the diverse needs of rural communities with a variety of loan, loan guarantee, and grant programs, which include technical assistance and cooperative development. Within Rural Development's mission area is the Rural Housing Service (RHS).

RHS is responsible for providing decent, safe affordable housing and community facilities in rural communities. It issues loans and grants for rural single family houses and Rural Rental Housing apartment complexes.

In its FY2006 budget proposal, RHS continues to address a multitude of management and budget challenges in both its single and multifamily housing programs. Rural Housing continues to have a portfolio of about 17,000 existing multi-family developments that provide housing for about 470,000 low-income tenants, many of whom are elderly. These developments were primarily built in the 1980s and many are in need of repairs and rehabilitation. The developments have an outstanding indebtedness of about $12 billion.

I am concerned about the physical condition of existing projects and the ramifications of allowing projects to leave the program. Recently, the Supreme Court ruled in favor of project owners who wished to prepay their loans and remove their property from the subsidized market. I have been working on this issue over a number of years and I'm glad to see that RHS is making progress on addressing this issue. A recent capital needs assessment indicated that only about 10 percent of the projects are potentially viable for non-subsidized use and could leave the program. This is significantly less than what was originally projected.

The section 538 multi-housing loan guarantee program is designed to leverage other sources of financing. The FY2006 budget proposal includes $200 million for section 538. I am pleased that the Administration has doubled the amount available for the program from last year, which will help leverage other sources of financing for multi-family housing projects. Only in operation for a few years, the program continues to evolve.

RHS recently published a comprehensive revision of its multi-family housing regulations, and the Administration believes this will streamline the program and protect it against potential abuses. I support the Administration's efforts to make the section 538 program a more attractive component of the complete funding package, which includes access to secondary market funds and use of tax credits and other subsidies.

RHS programs differ from other Federal efforts to assist homeownership. According to the President's budget, RHS programs are means-tested and more accessible to low-income, rural residents. In particular, the budget supports the section 502 direct loan program. The mission of the section 502 program is to provide direct loan assistance to those lower-income families that might be on the brink of homeownership. After experiencing an increase in income and home equity, the borrower is expected to graduate to private credit. In this program, the interest rate charged is directly related to the income of the individual. All loans are evaluated annually to determine if interest rates should be changed or if the borrower is eligible to graduate from the program. This is an important program and I look forward to working with the Administration to improve its effectiveness.

Over the past year, management at RHS has made significant strides to improve the programs under its jurisdiction. Recently, USDA commissioned a report to analyze the Rural Development Multi-family Housing Program, identify problems, and provide recommendations for changes to address such problems. It is my understanding that the Department is in the process of reviewing this report to determine what legislative actions should be taken.

As part of this hearing, I have also invited the General Accountability Office (GAO) to discuss its three reports completed last year regarding the current issues facing RHS and its mission to provide affordable housing to rural communities.

It is important that RHS continue to improve efficiencies so that its housing programs do not become vulnerable to possible future budget cuts. Often, RHS housing program are the only option for low- and very-low income families.

My roots in rural America run deep. Born and raised in the Ohio Valley, I grew to understand that a safe, secure home is the foundation for the family unit.

Today, my belief in the importance of homeownership remains true. As the Chairman of the Subcommittee on Housing and Community Opportunity, it is my goal to apply those fundamental values and rural experiences to help communities develop new economic vehicles that will enable them to grow and prosper.

I look forward to hearing from our two witnesses today as we discuss the various ways in which a safe, affordable home can strengthen our rural communities and contribute to the overall quality of life for rural families.

For Release only by the House Committee on Financial Services

RURAL HOUSING SERVICE

Statement of Russell T. Davis, Administrator of the Rural Housing Service, submitted to the Financial Services Subcommittee on Housing and Community Opportunity.

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to present the President's Fiscal Year (FY) 2006 budget for the USDA Rural Development rural housing programs.

As an integral part of Rural Development, the rural housing program assists rural communities in many fundamental ways. We provide a variety of both single and multi-family housing options to residents of rural communities. We also help to fund medical facilities, local government buildings, childcare centers, and other essential community facilities. Rural Development programs are delivered through a network of 47 State offices and approximately 800 local offices.

The proposed budget for the rural housing program in FY 2006 supports a program level of approximately $6.49 billion in loans, loan guarantees, grants, and technical assistance. It also maintains the Administration's strong commitment to economic growth, opportunity, and homeownership for rural Americans. We believe that our efforts, combined with the best of both the non-profit and private sectors, will ensure that this budget makes a tremendous difference in rural communities. The FY 2006 Budget also includes a major initiative to revitalize the rural rental housing programs.

Let me share with you how we plan to continue improving the lives of rural residents under the President's FY 2006 budget proposal for our rural housing programs.

Multi-Family Housing Programs

The Multi-Family Housing (MFH) budget preserves Rural Development's commitment to maintaining the availability of affordable housing for the many rural Americans who rent their homes. Our existing portfolio provides decent, safe, sanitary, and affordable residences for about 470,000 tenant households.

The total program level request is $1.07 billion. This represents an increase of 30 percent from last year's request. $650 million will be used for rental assistance (RA) for contract renewals, farm labor housing, and preservation. These funds will renew more than 46,000 4-year RA contracts. We estimate using $27 million for MFH direct loans to meet our preservation responsibilities including prepayment prevention incentives.

Revitalization Initiative

In November 2004, we released a report titled the "Multi-Family Housing Comprehensive Property Assessment and Portfolio Analysis." This report analyzed the issues associated with the preservation of the portfolio and provided recommendations for changes to the MFH program. The FY 2006 budget addresses the immediate need to provide assistance for tenants of projects that prepay and leave the program. Included is \$214 million for the initial stage of the multi-family housing Revitalization Initiative that establishes a tenant protection program. Later this year, the Administration will propose legislation to ensure that projects remain in the program and that they are properly maintained. The authority to make rural housing vouchers is contained in the Housing Act of 1949. Regulations will need to be developed in order to use this authority.

The report recommended three primary strategies to revitalize our aging portfolio, which continue to play a critical role in delivering affordable rental housing to rural communities across the nation:

(1) Allowing prepayment while protecting tenants

While a significant segment of the portfolio has the legal right to prepay, the report concluded that prepayment is economically viable for only about 10 percent of owners. Recent court decisions require that owners of projects that are eligible to prepay under the terms of their loans, be allowed to do so. This would leave the tenants of these projects at risk of significant rent increase and potential loss of their housing. Therefore, we are proposing that all tenants of these projects be adequately protected through the use of housing vouchers.

(2) Creating an equitable new agreement with project owners electing to stay with the program

The report recommended that new agreements be reached with project owners to keep their projects in the program and, thus, be used for housing low income families. This new agreement would allow owners and project managers to exercise their entrepreneurial planning and management skills. Performance expectations and performance-based incentives would be provided so that high-performing owners and project managers are rewarded. Conversely, owners and property managers performing poorly would be subject to sanctions.

(3) Using debt relief as the primary tool to stabilize projects at risk of physical deterioration

The report also recommended that a majority of the existing MFH portfolio is in need of additional financial assistance to achieve long-term viability. The report recommended our using debt restructuring as the primary tool. Additional financial assistance would be provided in exchange for the owner's commitment to providing long-term affordable housing.

The Administration continues to evaluate the costs and benefits of various options to address items (2) and (3). We expect to complete this evaluation and to propose legislation later this year. However, for FY 2006 the Budget includes $27 million for direct loans that is to be used to meet immediate revitalization needs.

We anticipate our revitalization efforts will span the next several years and have initiated a demonstration program to test the viability of the revitalization concepts. In addition, we will be initiating a demonstration program for making loans through the use of revolving funds for preservation purposes, as provided for in the 2005 Appropriations Act.

Section 538 Guaranteed Rural Rental Housing Program

The FY 2006 budget request will fund $200 million in Section 538 guaranteed loans, funds that may be used for new construction. The Section 538 guaranteed program continues to experience ever-increasing demand, brisk growth, and is rapidly becoming recognized within the multi-family housing finance, development, and construction industry, as a viable conduit to facilitate the financing of housing projects. In fact, Rural Development received an overwhelming response to the latest Notice of Funding Availability with over 150 applications received.

In FY 2004, we distributed more than $99 million in guarantees to fund housing projects with over $243 million in total development costs. The risk exposure to the government continues to be very low, as loan guarantees to total development costs are well under 50 percent. We also have a very low delinquency rate of zero. A 'notice to proceed' was given to 44 applicants with an average loan guarantee request of $2.2 million and an average total development cost of $5.5 million. Thirty-five out of the 44 applications given the approval to proceed included the use of Low-Income Housing Tax Credits from the various state governments where the projects will be located.

Since inception of the program, the Section 538 guaranteed program has closed 71 guarantees totaling over $171 million. The program also has an additional 89 loans in process and not yet closed, totaling over $352 million. The 71 closed guarantees will provide over 4,200 rural rental units at an average rent per unit of approximately $500 per month.

The rural housing program recently published a final rule to address program concerns from our secondary market partners and make the program easier to use and understand. We look forward to administering the FY 2006 proposed budget of $200 million, which will enable Rural Development to fund a significant number of additional guaranteed loan requests.

The FY 2006 budget also request funds $42 million in loans and $14 million in grants for the Section 514/516 Farm Labor Housing program, $2 million in loans for MFH credit sales, and $10 million for housing preservation grants.

Single Family Housing Programs

The Single Family Housing (SFH) programs provide several opportunities for rural Americans with very low- to moderate-incomes to purchase homes. Of the $4.7 billion in program level requested for the SFH programs in FY 2006, $3.7 billion will be available as loan guarantees of private sector loans, including $207 million for refinancing more affordable loans for rural families. Also, with $1 billion available for direct loans, our commitment to serving those most in need in rural areas remains strong. This level of funding will provide homeownership opportunities for 40,400 rural families.

Effective outreach and an excellent guarantee, coupled with historically low interest rates have increased the demand for the Section 502 guaranteed program. Approximately 2,000 lenders participate in the guaranteed SFH program. The competitive low-interest rate environment has enabled the rural housing program to serve low-income families that would typically receive a Section 502 direct loan with a guaranteed loan instead. In FY 2004, approximately 32 percent of guaranteed loans were made to low-income families.

Section 523 Mutual and Self-Help Housing

The President's FY 2006 budget requests $34 million is for the mutual and self-help housing technical assistance program.

FY 2004 ended with over $35 million awarded for contracts and two-year grants. There were 39 "pre-development" grants awarded in FY 2004, including many first-time sponsors, several faith-based groups, and groups in States with no self-help housing programs. Pre-development funds may be used for market analysis, determining feasibility of potential sites and applicants, and as seed money to develop a full-fledged application. Groups in the pre-development phase typically need 6 to 12 months before they are ready to apply for full funding.

The FY 2006 proposed budget also includes $36 million in program level for home repair loan funds and $30 million for grants to assist elderly homeowners. It also includes $5 million in loan level for each of two site loan programs, $10 million in loan level for sales of acquired properties, and $1 million for supervisory and technical assistance grants.

Community Programs

The Community facilities budget request will provide essential community facilities, such as educational facilities, fire, rescue, and public safety facilities, health care facilities, and child care centers in rural areas. The total requested program level of $527 million includes $300 million for direct loans, $210 million for loan guarantees, and $17 million for grants.

In partnership with local governments, State governments, and Federally recognized Indian tribes, the FY 2006 budget will support more than 240 new or improved public safety facilities, 105 new and improved health care facilities, and approximately 80 new and improved educational facilities to serve rural Americans.

In FY 2004, we invested over $130 million in 113 educational and cultural facilities serving a population totaling over 3.3 million rural residents, over $97 million in 338 public safety facilities serving a population totaling over 1.7 million rural residents, and over $304 million in 141 health care facilities serving a population totaling over 3.2 million rural residents. Funding for these types of facilities totaled $531 million. The remaining balance was used for other essential community facilities such as: food banks, community centers, early storm warning systems, child care centers, and homeless shelters.

Program Highlights

I am pleased to provide you with an update on several highlights from our major programs, as well as key initiatives being undertaken.

Rental Assistance

We have continued to improve the internal controls in the Rental Assistance (RA) program and plan to implement a number of new initiatives in this regard with the recent publication of a comprehensive revision of our regulations. The new initiatives include an increased emphasis on verification methods and procedures for certifying income reported by tenants and improving management of tenants with no reported income. We are currently in discussions with the Department of Health and Human Services concerning USDA receiving access to the National Directory of New Hires database. This will enable us to match the data in the national directory against the information provided by the tenant, and therefore reduce fraud and abuse within the program. Additional training of borrowers and property managers will also be key to reducing errors when certifying tenants for residency in MFH properties.

The automated RA forecasting tool is now in place and operational. The forecasting tool was used to develop the FY 2006 RA budget and is able to forecast when RA contracts will either exhaust funds or reach their 4-year term limit. The forecasting tool can also develop the cost of new contracts based on an actual RA usage rate or a selected inflation rate. For the FY 2006 RA budget, an inflation rate of 2.4 percent was used, as recommended by the General Accounting Office. We will continue to provide State offices with additional guidance on the transfer of RA units and will centralize the redistribution of unused RA.

Automation Initiatives

Last year, we reported that the rural housing program was developing a data warehouse for MFH and SFH loans to improve our reporting capabilities. I am pleased to report that we are currently utilizing our data warehouses, making needed improvements, and training staff on how to expand their reporting capabilities. Our Multi-Family

Information System (MFIS) database is now in Phase 5 of development, following a very successful completion of Phase 4, which integrated electronic debiting and crediting of borrowers accounts and eliminated funds handling in area offices. We now have a website available to the public to locate all MFH properties, with property and contact information. Also implemented is the Management Agent Interactive Network Connection (MAINC), which allows property managers to transmit tenant and property data electronically to MFH via the Internet. This data goes directly into the MFIS database and the data warehouse.

Last year, we also reported that an Automated Underwriting System (AUS) was being developed that would allow lenders to input SFH customer application data, pull credit, and determine immediately whether the rural housing program would issue a commitment. The AUS should be fully operational by next winter.

In December 2004 our Centralized Servicing Center (CSC) in St. Louis, Missouri began the centralization of loss claims submitted by lenders under our SFH guaranteed program. As of September 30, 2004, CSC provided loss mitigation for approximately 110,000 guaranteed loans. CSC is also supporting the rollout of the Lender Interactive Network Connection (LINC), which is an Internet-based alternative for lenders to submit loss claims electronically. Centralization will improve efficiency, consistency, customer service to lenders, and provide better management data to program officials.

USDA's Five Star Commitment to Increase Minority Homeownership

The rural homeownership rate continues to outpace the national rate. In 2004, it stood at 76.1 percent compared to the national rate of 69.2 percent. But, while rural America has the highest percentage of homeownership, we are committed to do more, particularly to assist more minority families in living the American Dream.

For USDA's part, we developed a Five-Star Commitment to increase minority homeownership opportunities.

1. Reducing barriers to minority homeownership

Origination fees can now be incorporated into the loan amount. Through reduction of such barriers the program guaranteed a total of $3.18 billion in loans in fiscal year 2004, a record for the program.

2. Doubling the number of Self-Help participants by 2010

Over 54 percent of the families who participate in this program are minorities. In FY 2004, we helped over 1,100 families build their own home.

3. Increasing participation by minority lenders through outreach

Rural Development offices across the country have developed a marketing outreach plan to increase participation in the guaranteed loan program by lenders serving rural minorities.

4. Promoting credit counseling and homeownership education – critical to successful homeownership

Since the signing of an agreement with the Federal Deposit Insurance Corporation to promote and utilize their "Money Smart" training program, nearly 700 Rural Development field staff received training and will deliver the training to others. Over a third of our State offices have already made the Money Smart Program available to non-English speaking groups.

5. Monitoring lending activities to ensure a 10 percent increase in minority homeownership

USDA has jointly developed with the Departments of Housing and Urban Development (HUD) and Veteran Affairs (VA) an internal tracking system to measure the success of each of the 53 States and territories we serve. Overall, the number of loans to minorities has increased by more than 1,000 per year - an increase of more than 12 percent.

Improving Successful Homeownership

We are also pleased to report our achievement in helping our customers remain successful homeowners. Rural Development has lowered its direct loan housing program gross delinquency rate by 35.6 percent and new loan delinquency rate by 61.8 percent over the past five years. As of today, our gross delinquency rate is 12.85 percent and the new loan delinquency rate is 1.92 percent. Our portfolio recently outperformed the delinquency rate for sub-prime mortgage loans as tabulated by the Mortgage Bankers Association's National Delinquency Survey.

To ensure that we were also providing a high level of customer service, a satisfaction survey was recently completed. This was our first independent homeowner survey and established a benchmark for customer satisfaction. The survey was conducted by an outside contractor and showed an average homeowner satisfaction rate of 8.6 on a scale of 1 to 10. The study used the J. D. Power 2004 home mortgage study to compare these results to the results of other organizations providing financial services. The J. D. Power survey includes such well known and respected major lending institutions as Bank of America, Wells Fargo, and Chase. The average satisfaction level for the organizations included in the survey is 7.2 with the highest rating going to USAA (a private mortgage corporation) at 8.6. USDA Rural Development is at the top of the list for customer satisfaction at 8.6.

Rural Partners

In FY 2006, we will continue to stretch the rural housing program's resources and its ability to serve the housing needs of rural America through increased cooperation with HUD and other partners. We are committed to working with these partners to leverage resources for rural communities. For example, we are working with HUD and expect to adopt their "TOTAL" scorecard, modified for SFH guaranteed loans. This cooperation between USDA and HUD will save time and money in system development. Additionally, Rural Development information technology staff and the CSC worked with HUD and VA to develop a one-stop web portal, www.homesales.gov, to market government homes for sale.

In our MFH program, HUD has been extremely helpful in sharing data for development of our Comprehensive Property Assessment and in providing knowledgeable, professional staff from their Office of Affordable Housing Preservation to consult with before making determinations on our rural portfolio. This eliminates duplicative work and ensures better consistency.

Conclusion

Through our budget, and the continued commitment of President Bush, rural Americans will have the tools and opportunities they can put to work improving both their lives and their communities. We recognize that we cannot do this alone and will continue to identify and work with partners who have joined with the President to improve the lives of rural residents.

I would like to thank each of you for your support of the rural housing program's efforts. I look forward to working with you in moving the FY 2006 rural housing program budget forward, and welcome your guidance as we continue our work together.

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Housing and Community Opportunity, Committee on Financial Services, House of Representatives

For Release on Delivery
Expected at 2:00 p.m. EST
Thursday, March 10, 2005

RURAL HOUSING SERVICE

Overview of Program Issues

Statement of William B. Shear, Director
Financial Markets and Community Investment

GAO
Accountability * Integrity * Reliability

GAO-05-382T

March 10, 2005

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Accountability·Integrity·Reliability

Highlights

Highlights of GAO-05-382T, a testimony before the Subcommittee on Housing and Community Opportunity, Committee on Financial Services, House of Representatives

RURAL HOUSING SERVICE

Overview of Program Issues

Why GAO Did This Study

The rural America of 2005 is far different from the rural America of the 1930s, when the federal government first began to provide housing assistance to rural residents. Advances in transportation, computer technology, and telecommunications, along with the spread of suburbia, have linked many rural areas to urban areas. These changes, along with new fiscal and budget realities, raise questions about how Rural Housing Service (RHS) programs could most effectively and efficiently serve rural America.

What GAO Recommends

GAO suggested statutory changes to help improve eligibility determinations in rural housing programs and enhance RHS's tenant income verification process. GAO also made a number of recommendations aimed at improving RHS program operations.

www.gao.gov/cgi-bin/getrpt?GAO-05-382T.

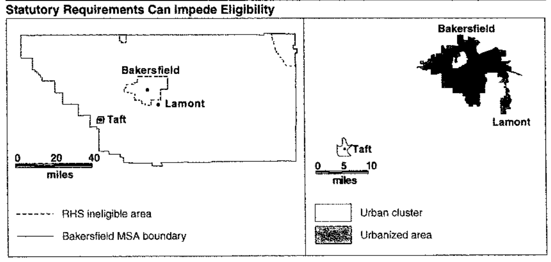
To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-4325 or shearw@gao.gov.

What GAO Found

This testimony is based on a report on how RHS determines which areas are eligible for rural housing programs, three reports on RHS's rental assistance budgeting and distribution processes, and a report we are releasing today on internal control issues with RHS's loans and grants databases. GAO found that while RHS has significantly improved the housing stock in rural America and has made progress in addressing problems, several issues prevent the agency from making the best use of resources. Specifically:

- Statutory requirements for program eligibility, including those related to metropolitan statistical areas (MSA), "grandfathering" communities, and demonstrating a "serious lack of mortgage credit," are of marginal utility. For example, using density measures rather than MSAs might allow RHS to better differentiate urban and rural areas, and phasing out the "grandfathering" of communities could better ensure that RHS makes more consistent eligibility determinations.
- RHS has consistently overestimated its rental assistance budget needs by using higher inflation rates than recommended by the Office of Management and Budget and incorrectly applying those rates. Also RHS lacked sufficient internal controls to adequately monitor the use of rental assistance funds, particularly for fund transfers and income verifications. RHS has been taking actions that should correct many of the rental assistance shortcomings GAO identified.
- GAO found incorrect, incomplete, and inconsistent entries in RHS's loans and grants databases. Until RHS can demonstrate that its system edit functions or other design features can ensure the accuracy of data in its databases, second-party review is necessary to meet internal control standards.

Statutory Requirements Can Impede Eligibility



Source: GAO analysis of Census data.

MSA and grandfathering make more rural Taft ineligible (left), while density-based measures could make it eligible (right).

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the management of Rural Housing Service (RHS) programs and our examinations of agency efforts. RHS makes a significant investment in affordable housing for low-income rural Americans through a variety of direct and guaranteed loan and grant programs. RHS manages a single-family and multifamily direct loan portfolio of about $28 billion, oversees a program that guarantees about $3 billion in single-family mortgages annually, and administers over $500 million in rental assistance payments each year. However, the rural America of 2005 is different from the rural America of the 1930s, when the federal government first began to provide housing assistance to rural residents. Advances in transportation, computer technology, and telecommunications, along with the spread of suburbia, have linked many rural to urban areas and blurred distinctions between them. Yet the need for decent, safe, and affordable low-income housing remains strong in rural areas. The changing face of rural America, advances in technology affecting program administration, and new fiscal and budget realities raise questions about how RHS programs could most effectively and efficiently serve rural Americans.

Thus, my principle objective today is to present an overview of issues you may want to consider as you deliberate on how to best improve housing services for rural Americans.

This statement is primarily based on reports we did for this Subcommittee as well as for the Ranking Minority Member of the Subcommittee on Agriculture, Rural Development, and Related Agencies, Senate Committee on Appropriations:

- a December 2004 report on how RHS determines which areas are eligible for rural housing programs;[1]

[1]GAO, *Rural Housing: Changing the Definition of Rural Could Improve Eligibility Determinations*, GAO-05-110 (Washington, D.C.: Dec. 3, 2004).

- three previous reports on RHS's rental assistance budgeting and distribution processes;[2] and

- a report we are releasing today addressed to the RHS Administrator that describes errors in, and internal control issues for, RHS's loans and grants databases.[3]

Finally, I will provide a few comments addressing the recently completed Comprehensive Property Assessment, which RHS initiated in response to our May 2002 study on long-term needs in the Section 515 multifamily housing program.[4]

In summary, while RHS has significantly improved the housing stock in rural America and RHS management has made progress in addressing problems we have identified in the past, several issues still prevent the agency from making the best use of its resources.

- Statutory requirements for program eligibility may not reflect changes in rural areas or best determine which areas qualify for RHS housing programs. Specifically, we found the statutory requirements relating to metropolitan statistical areas (MSA), the ability to "grandfather" eligibility, and demonstration of a serious lack of mortgage credit for low- and moderate-income families to be of marginal utility. Changes to these requirements, such as using density measures rather than the currently used MSA criterion, might allow RHS to better differentiate urban and rural areas. Also, phasing out the "grandfathering" of communities that experience changes in eligibility because of inclusion in an MSA could better ensure that RHS more consistently makes eligibility determinations for rural housing programs. Finally, "lack of credit" does not appear to be as great a challenge to rural Americans gaining access to affordable housing as lack of income or the inability to repay loans. RHS already

[2]GAO, *Rural Housing Service: Updated Guidance and Additional Monitoring Needed for Rental Assistance Distribution Process*, GAO-04-937 (Washington, D.C.: Sept. 13, 2004); *Rural Housing Service: Agency Has Overestimated Its Rental Assistance Budget Needs over the Life of the Program*,GAO-04-752 (Washington, D.C.: May 20, 2004); and *Rural Housing Service: Standardization of Budget Estimation Processes Needed for Rental Assistance Programs*, GAO-04-424 (Washington, D.C.: Mar. 25, 2004).

[3]GAO, *Information Resource Management Internal Control Issues*, GAO-05-288R (Washington, D.C.: Mar. 10, 2005).

[4]GAO, *Multifamily Rural Housing: Prepayment Potential and Long-Term Rehabilitation Needs for Section 515 Properties*, GAO-02-397 (Washington, D.C.: May 10, 2002).

targets its programs and services, based on income, to areas and populations of greatest need. As a result, the "lack of credit" requirement does not appear necessary to appropriately determine program eligibility.

- Weaknesses in RHS's budget estimation and oversight of rental assistance funds increase the risk that the agency is not efficiently or appropriately allocating resources. We found that RHS had consistently overestimated its budget needs for rental assistance contracts in its Section 521 program by using higher inflation rates than recommended and incorrectly applying those rates. Using and correctly applying the inflation rates provided by the Office of Management and Budget (OMB) would help the agency more accurately estimate its rental assistance needs. Additionally, RHS lacked sufficient internal controls to adequately monitor the use of rental assistance funds, particularly in its funds transfer processes, methodology for supervisory reviews, and tenant income verification processes. Establishing centralized guidance on transferring unused rental assistance, improving sampling methods in the tenant file review process, and improving processes for verifying tenant information could help ensure that these funds are being effectively administered and used. Also, making a statutory change to give RHS access to the Department of Health and Human Services' National Directory of New Hires, which provides recent nationwide data on wages, could help the agency verify tenant income information. RHS has recently moved on a number of fronts to correct the many rental assistance program shortcomings identified in our reports. While it is too early for us to fully review the impact of these changes, we believe that changes in how rental assistance budgets are estimated and the application or strengthening of internal controls, consistent with our recommendations, would result in greater efficiency and resource savings in this pivotal program.

- Although RHS has worked to improve its management information systems, we found incorrect, incomplete, and inconsistent entries in its loans and grants databases, and the system "edit" functions do not appear to flag or correct these errors. Further, RHS does not have a process to review these databases for accuracy. Additional internal control measures could ensure more accurate data entry and reporting, particularly at the field office level, and such an effort could ensure that RHS' investment in system upgrades would provide more meaningful and useful information to the agency itself, Congress, and the public.

- RHS recently contracted for a study called the Comprehensive Property Assessment. The study was done to develop a baseline for assessing the portfolio's physical and financial condition. Its principal findings—that RHS's multifamily housing portfolio is aging rapidly and property reserves and cash flows do not appear sufficient for basic maintenance or long-term rehabilitation needs—are consistent with our work in the area. The study concludes that leveraging market-based solutions with traditional approaches would provide a more cost-effective alternative to using only federal dollars. It also concludes that while the solutions proposed will cost more than current budget levels, delaying actions to address the physical, fiscal, and market issues documented in the study could result in even greater budget needs in the future.

Background

The Housing Act of 1949 authorized new rural lending programs to farmers, which were administered by RHS's predecessor, the Farmers Home Administration, within the U.S. Department of Agriculture (USDA). RHS now facilitates homeownership, develops rental housing, and promotes community development through loan and grant programs in rural communities. Over the decades, Congress changed the requirements for rural housing eligibility—for example, by changing population limits—and rural housing programs have evolved to serve low- and moderate-income people of all occupations. The current definition of rural considers factors such as whether an area is contained in an MSA, is "rural in character," and "has a serious lack of mortgage credit for lower- and moderate-income families."

RHS's Section 521 Rental Assistance Program is the agency's largest line-item appropriation, with an annual budget of more than $500 million. The program provides rental subsidies for approximately 250,000 tenants who pay no more than 30 percent of their income for rent (RHS pays the balance to the property owner). The units in which the tenants live are created through RHS's Section 515 Multifamily Direct Rural Rental Housing Loans and Section 514 Multifamily Housing Farm Labor Loans programs. The Section 515 and 514 programs provide developers loans subsidized with interest rates as low as 1 percent to help build affordable rental housing for rural residents and farm workers.

Some Eligibility Requirements for RHS Programs Can Result in Similar Areas Receiving Dissimilar Treatment

RHS staff determine which areas are eligible for RHS housing programs by interpreting statutory requirements and agency guidance; however, their determinations involve judgment and may be open to question. Additionally, some eligibility requirements often result in areas with similar characteristics receiving different designations. For example, the requirement that an eligible area cannot be part of an MSA often results in ineligibility for what appears to be a rural area. Also, the "lack of credit" in rural areas remains an eligibility requirement, even though USDA has reported that a lack of income and ability to pay the mortgage appear to be the greater problems than a lack of credit for rural Americans.

While Statute and Guidance Help RHS Staff, Determinations of Eligibility Require Judgment and Can Be Problematic

Section 520 of the Housing Act of 1949, as amended, defines rural for most RHS housing programs. Using the statute and instructions promulgated by the national office, state and local (together, field) offices determine the boundaries to delineate eligible areas from ineligible areas—a task field office officials acknowledged is time-consuming, based on judgment, and can be problematic.[5] The statutory definition generally identifies eligible rural areas as those with populations up to 20,000 and defines "rural" and "rural areas" as any open country or any place, town, village, or city that is not part of or associated with an urban area.

Specifically, there are several population levels at which communities may be determined eligible, but as a community's population increases, the statute imposes additional requirements that include being "rural in character" (a concept that is not defined in the statute), having a serious lack of mortgage credit, or not being located within an MSA. Certain communities with populations above 10,000 but not exceeding 25,000 may be "grandfathered in," based on prior eligibility if they still met the "rural in character" and "lack of credit" criteria. USDA's instructions give its field offices flexibility in implementing the statute. Field office officials said that drawing the eligibility boundaries required an element of judgment because "rural in character" is open to interpretation—even with the overall national guidance on the statute and review of census populations, MSA standards, maps, aerial photographs, and visits to communities.

Even when local supervisors fully understand the local conditions and rural character of an area, finding a way to equitably decide on a boundary

[5]The definition of rural applies to most RHS housing programs. However, two programs—farm labor housing loans and grants—do not require that applicants live in rural areas.

is sometimes problematic. For instance, field staff in Maryland told us that in response to December 2002 national guidance, they stopped using natural features such as rivers or mountains as eligibility boundaries for communities. Maryland now uses only roads. Figure 1 shows a new boundary, a road that divides the eligible area on the left from the ineligible area on the right. RHS local office officials told us that the "road only" criteria forced them to find the nearest public road to a populated section of Hagerstown, which happens to go through farmland. The result is that apparently similar rural areas received different designations.

Figure 1: Road Serving as Eligible Area Boundary outside Hagerstown, Maryland

Source: GAO.

Figure 2 shows an area in Brookside, Ohio, where the city line divides the eligible from the ineligible area. The Maryland example illustrates that using the only physical boundary available resulted in one piece of farmland receiving a rural designation and the other not. The Brookside example shows that using a political boundary also did not necessarily result in a readily discernible urban-rural difference.

Figure 2: City Line of Brookside, Ohio, Divides Eligible from Ineligible Area

Source: GAO.

Eligibility Interpretations of Associations with Urban Areas May Be Questionable

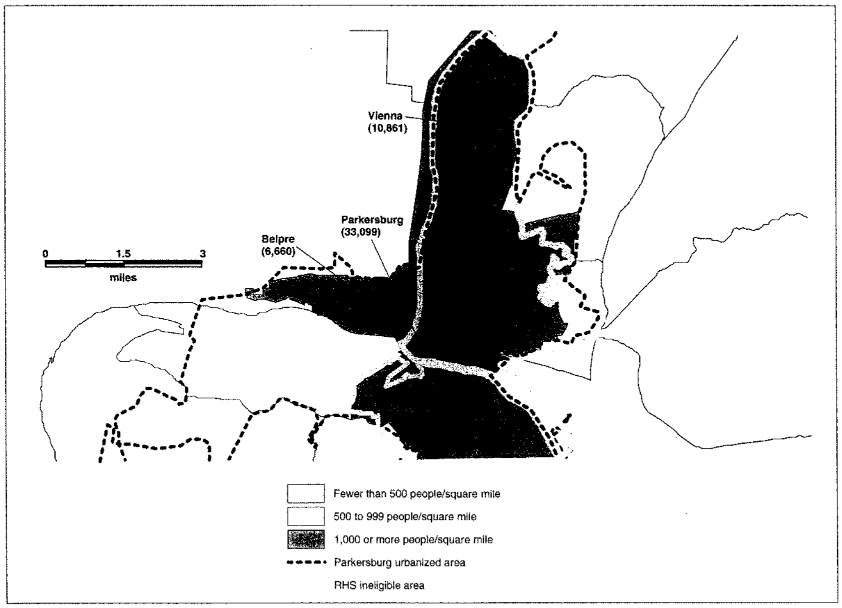
Our analysis of RHS eligible areas nationwide, compared with census data, found approximately 1,300 examples where communities with populations at or below 10,000 were within or contiguous with urban areas that had populations of 50,000 or more. The statute states that eligible communities cannot be a part of or associated with an urban area. Some field staff determinations of eligibility in these cases might be questionable as some of these communities, despite their low populations, might not be considered rural, and thus, eligible.

For example, field staff told us that Belpre, Ohio, is eligible for RHS programs because it meets both the population and "rural in character" requirements. However, Belpre is contiguous with Parkersburg, West Virginia, which has a population of more than 33,000 (see fig. 3).[6] In addition, the 2000 census considers Belpre, along with Parkersburg and Vienna, West Virginia, as part of an urbanized area because its total population exceeds 50,000. Although it is across the Ohio River from Parkersburg, bridges have connected Belpre and Parkersburg for decades and, according to a Belpre city employee, many people from Belpre work in Parkersburg. Furthermore, most of Belpre has a population density of

[6]Parkersburg, West Virginia, is not an eligible area.

1,000 people or more per square mile, which the Census Bureau considers "densely settled" and a measure of urbanization. For these reasons, it is unclear whether Belpre meets the eligibility requirements.

Figure 3: Belpre, Ohio, Is Part of the Parkersburg, West Virginia-Ohio, Urbanized Area



Sources: RHS and Census data.

Note: Area density levels are shown by census tract. Census tracts are small, relatively permanent statistical subdivisions of a county or statistically equivalent entity used to provide a stable set of geographical units for presenting decennial census data.

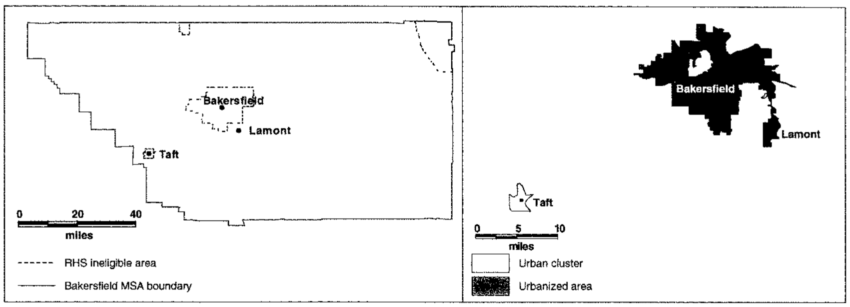
Changing Some Eligibility Requirements Could Better Delineate Boundaries for Urban-Rural Areas and Address Inconsistent Treatment of Similar Communities

Changes to the way eligibility is defined might allow RHS to better designate "rural" areas and treat communities with similar characteristics more consistently. For instance, eliminating the MSA requirement and "grandfathering" might help RHS better serve its clients. To illustrate, we found rural communities with populations exceeding 10,000 that were directly impacted by the MSA and "grandfather" restrictions. Because MSAs are county-based and may contain both urban and rural areas, the MSA restriction and the grandfathering of certain communities resulted in some communities being eligible while others with similar demographic profiles were ineligible.

We looked at two communities within the Bakersfield, California, MSA, which is basically rural outside the environs of Bakersfield (see fig. 4). Lamont was grandfathered because it lost eligibility when its population went above 10,000 at the 1980 census. Taft's population was already over 10,000 prior to the 1980 census, so Taft was not eligible for grandfathering. The right side of the figure shows what would happen if MSAs and grandfathered eligibility were removed from the equation and a density-based system such as the Census Bureau's urbanized areas/urban clusters were used to indicate changes in population.[7] Taft would be in its own urban cluster outside of the Bakersfield urbanized area, which happens to include Lamont. Based on our visit, we believe this scenario, where the more rural community would be the one eligible, is more in line with the overall purpose of the legislation than the current situation.

[7]Census defines an urbanized area as a continuously built-up area with a population of at least 50,000, comprising one or more places and adjacent densely settled areas. An urban cluster consists of densely settled territory that has at least 2,500 people but fewer than 50,000 people.

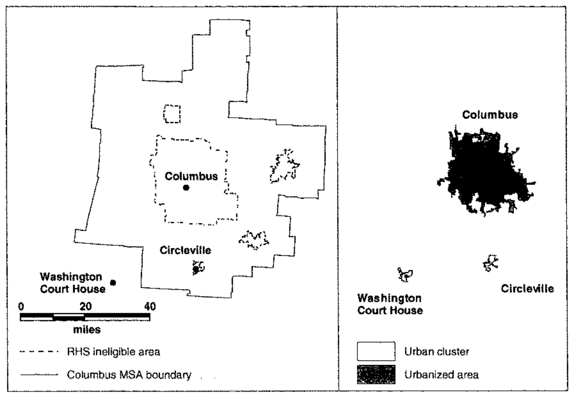
Figure 4: Taft, California, Could Be Eligible Under Density-based Criteria



Source: GAO analysis of Census data.

In another example, by eliminating the MSA criterion, RHS could review the eligibility of Washington Court House and Circleville, Ohio, based on population and rural character criteria. Additionally, using density-based mapping could help RHS draw boundaries around these communities, which although Census-designated as "urban clusters," still meet rural housing program population requirements (see fig. 5).

Figure 5: Eliminating MSA Criterion Could Allow Circleville to Be Considered for Eligibility



Source: GAO analysis of Census data.

"Lack of Credit" Requirement Does Not Appear Central to Determining Eligibility

The statute imposes a requirement to demonstrate a serious lack of mortgage credit for lower- and moderate-income families in communities with populations of 10,001 to 25,000. RHS has a policy stating that a serious lack of mortgage credit at rates and terms comparable with those offered by the agency exists in all rural areas. However, a study by USDA's Economic Research Service concluded that credit problems in rural areas are primarily limited to sparsely populated or remote rural areas; such communities generally do not fall into the population range specified above. Many of the RHS officials and industry experts with whom we spoke also saw the primary "credit" problem as lack of income rather than lack of credit.

Additionally, eligibility requirements for RHS programs are based on income levels. The agency uses funding set asides, funding allocations, application reviews, and state-level strategic plans to determine areas and populations of greatest need. As a result, RHS program activity already is focused on income issues, and given RHS's blanket policy, the "lack of credit" requirement is not central to determining participant eligibility.

Opportunities to Improve RHS Rental Assistance Budgeting and Allocation Processes Exist

We reported that weaknesses in RHS's budget estimation and oversight of rental assistance funds had resulted in largely overestimated budget levels and increased the risk that the agency was not efficiently or appropriately budgeting and allocating resources. Additionally, RHS lacked sufficient internal control to adequately monitor the disbursement of rental assistance funds.

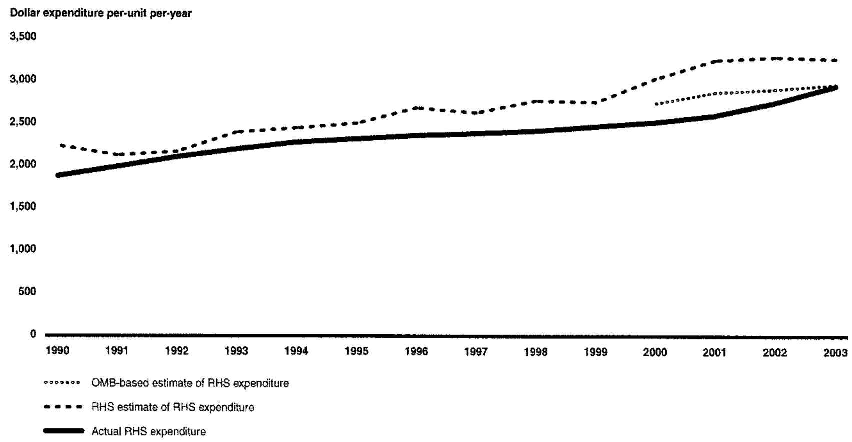
RHS Overestimated Budgets for Section 521 Program

In March 2004, we reported that since 1990, RHS had consistently overestimated its budget needs for the rental assistance program. Concern had arisen about this issue because in early 2003 RHS reported hundreds of millions of dollars in unexpended balances tied to its rental assistance contracts. Specifically, in estimating needs for its rental assistance contracts, RHS used higher inflation factors than recommended, did not apply the inflation rates correctly to each year of the contract, and based estimates of future spending on recent high usage rather than average rates.

First, the agency used inflation factors that were higher than those recommended by OMB for use in the budget process. Second, RHS did not apply its inflation rate separately to each year of a 5-year contract, but instead compounded the rate to reflect the price level in the fifth year and applied that rate to each contract year. The result was an inflation rate that was more than five times the rate for the first year. For example, using these two methods, RHS overestimated its 2003 budget needs by $51 million or 6.5 percent. Third, RHS based its estimates of future expenditure rates on recent maximum expenditures, rather than on the average rates at which rental assistance funds were being expended.

Additionally, our analysis of rental assistance payment data showed that the agency had overestimated its budget needs almost every year since 1990, the earliest year for which we gathered data. Where we were able to obtain sufficient data from RHS, our analysis showed that if RHS had used and correctly applied OMB inflation rates to its base per-unit rates, its estimates would have been closer to actual expenditures (see fig. 6).

Figure 6: Actual and Estimated Rental Assistance Expenditures, Per-Unit, Per-Year, 1990–2003



Source: GAO analysis of RHS data.

RHS Rental Assistance Program Was Not Adhering to Internal Control Standards

We also reported that RHS was not adhering to internal control standards regarding segregation of duties, rental assistance transfers, and tenant income verification reviews.

A single employee within the agency was largely responsible for both the budget estimation and allocation processes for the rental assistance program. According to GAO internal control standards, key duties and responsibilities need to be divided or segregated among different people to reduce the risk of error or fraud.[8]

[8]GAO, *Standards for Internal Control in the Federal Government*, GAO-AIMD-00-21.3.1 (Washington, D.C.: November 1999).

Moreover, RHS did not have a comprehensive policy for transferring rental assistance. As a result, insufficient guidance on the transfer process limited RHS's ability to move unused rental assistance to properties that had tenants with the greatest need.

Finally, because RHS conducts reviews infrequently and covers a small percentage of tenant files, the agency cannot reasonably ensure that tenants' income and assets, and ultimately rental assistance payments, are adequately verified. RHS's national, state, and local offices share responsibility for monitoring the rental assistance program, with the local offices performing the primary supervisory review every 3 years. These triennial supervisiory reviews are RHS's primary tool for detecting misreporting of tenant income, which may result in unauthorized rental assistance payments. But the shortcomings in the review process increase the risk that RHS will provide rental assistance to tenants that may not be eligible. Alternate methods of verifying tenant information, such as internal database checks and wage matching, also have limited effectiveness but could help improve internal control if properly designed or implemented.

Internal Control Issues Contribute to Errors in Loan and Grants Databases

Today we are releasing a report addressed to the RHS Administrator on internal control issues in the Information Resource Management (IRM) databases. We issued the report as a follow-up to our work addressing the definition of rural used for rural housing programs. During the earlier review, we identified several issues that raised concerns about the accuracy of the information in the IRM databases. For example, while we originally intended to geocode (match) 5 years of the national RHS housing loan and grant portfolio to specific communities, the time needed to ensure the reliability of the data required us to limit much of our analysis to five states.

In reviewing 29,000 records for five states we found incorrect, incomplete, and inconsistent entries. For example, over 8 percent of the community names or zip codes were incorrect. Additionally, inconsistent spellings of community names distorted the number of unique communities in the database. More than 400 entries lacked sufficient information (street addresses, community names, and zip codes) needed to identify the community to which the loan or grant had been made. As a result, some communities served by RHS were double counted, others could not be counted, and the ability to analyze the characteristics of communities served was compromised.

Since these data form the basis of information used to inform Congress (and the public) about the effectiveness of RHS programs, data accuracy is central to RHS program management and the ability of Congress and other oversight bodies to evaluate the agency and its programs. While the agency has worked to improve its management information systems (for example, since 2002, the agency has spent $10.3 million to improve its management information systems including developing single and multifamily program data warehouses which were designed to improve its reporting capabilities), the system still relies upon information collected and entered from field offices.

However, RHS does not have procedures for second-party review of the data in IRM systems. Moreover, while the IRM databases have edit functions in place that are intended to prevent the entry of nonconforming data (such as the entry of a community name in a street address field), the functions are not preventing incorrect or incomplete entries. Until RHS can demonstrate that its edit functions or other data entry design features can ensure the accuracy and completeness of the data in the IRM databases, second-party review would be necessary.

Comprehensive Property Assessment Advocates Leveraged Solutions

Our 2002 report to this subcommittee on RHS's Section 515 multifamily program concluded that with little new construction and limited prepayment at that time, maintaining the long-term quality of the aging housing stock in the program portfolio had become the overriding issue for the program. We found that RHS did not have a process to determine and quantify the portfolio's long-term rehabilitation needs. As a result, RHS could not ensure that it was spending its limited funds as cost-effectively as possible, providing Congress with a reliable or well-supported estimate of what was needed to ensure the physical and fiscal "health" of the multifamily portfolio, and prioritizing those needs relative to the individual housing markets. We recommended that USDA undertake a comprehensive assessment of long-term capital and rehabilitation needs for the Section 515 portfolio. We also recommended that USDA use the results of the assessment to set priorities for immediate rehabilitation needs and develop an estimate for Congress on the amounts and types of funding needed to deal with long-term needs.

In response to our recommendation, RHS commissioned a consulting firm to assess the condition and rehabilitation needs of its multifamily portfolio. RHS released the study in November 2004. The principal findings—that the housing stock represented in the portfolio is aging rapidly and that property reserves and cash flows are not sufficient for

We noted further opportunities for improvement in RHS's largest program—the rental assistance program, which has an annual budget of over $500 million and provides rental subsidies to about 250,000 rural tenants. Problems with its budget estimating processes caused the agency to consistently overstate its spending needs, resulting in hundreds of millions of dollars in unexpended balances. Consistently overstating funding needs for one program also undermines the congressional budget process by making funds unavailable for other programs. In addition, RHS's internal controls had not provided reasonable assurance that rental assistance resources were being used effectively. We questioned whether internal control weaknesses were preventing rental assistance funds from going to properties with the neediest tenants. RHS has recently moved on a number of fronts to correct the many rental assistance program shortcomings identified in our reports. For example, RHS has told us that it will follow OMB budget estimation guidance, that it is correcting the program's segregation of duty issues, has issued standardized guidelines on rental assistance transfers, and is revamping its supervisory review process. While it is too early for us to fully review the impact of these changes, we believe that changes in how rental assistance budgets are estimated and the application or strengthening of internal controls, consistent with our recommendations, would result in greater efficiency and resource savings in this pivotal program.

Finally, in reviewing RHS property data for selected states, we identified various errors that raise questions about the accuracy of agency's data. Although the agency is making efforts to improve its data systems, our findings suggest additional measures could ensure more accurate data entry and reporting, particularly at the field level. In addition to improving the accuracy of the information, such an effort could ensure that RHS's investment in system upgrades would provide more meaningful and useful information to the agency itself, Congress, and the public.

Matters for Congressional Consideration

To improve eligibility determinations in rural housing programs, we suggested that Congress may wish to consider eliminating the MSA criterion, recommending that RHS use density measures as a basis for its eligibility decisions, phasing out the practice of "grandfathering" communities, and eliminating the "lack of credit" requirement.

To help the agency verify tenant information, we also suggested that the Congress consider giving RHS access to the Department of Health and Human Services' National Directory of New Hires (New Hires), which includes centralized sources of state wage, unemployment insurance, and new hires data for all 50 states, and it would provide nationwide data for wage matching. Congress already granted HUD the authority to request and obtain data from New Hires in January 2004, and as part of its initiative to reduce improper rent subsidies for its rental assistance program, HUD is making New Hires information available to public housing authorities who are responsible for, among other things, verifying tenant income and calculating rent subsidies correctly. HUD plans to make the data from the new hires database available to property owners by fiscal year 2006.

Recommendations for Executive Action

To more accurately estimate rental assistance budget needs, we recommended that the Secretary of Agriculture require program officials to use and correctly apply the inflation rates provided by OMB in its annual budget estimation processes.

To ensure that rental assistance funds are effectively distributed to properties that have tenants with the greatest need, we recommended that the Secretary of Agriculture require program officials to establish centralized guidance on transferring unused rental assistance, improve sampling methods to ensure a sufficient number of tenant households are selected for supervisory reviews, and improve tenant verification of information, including more effective use of alternate methods of income verification.

To improve data entry and accuracy, we recommend that RHS formally advise field staff to establish a second-party review of data in the IRM databases are accurate and complete, require correction of errors in existing information, and ensure that system edit functions are properly functioning.

Agency Comments

USDA generally agreed with our matters for congressional consideration, stating that our report on eligibility articulates how the use of MSAs has resulted in disparate treatment of some communities. USDA added that applying a density-based measure might have merit but that further study would be needed to properly define such a measure for nationwide application. We concur with this position. In addition, USDA stated that the "lack of credit" requirement could be removed with no detriment to RHS housing programs. USDA initially disagreed with our finding that its rental assistance budget estimates were too high, questioning whether we demonstrated that using inflation rate projections from the President's Budget would provide a more accurate budget estimate. However, USDA has now reported that it will adopt OMB estimates, and it appears that RHS now agrees with our report findings. USDA also generally agreed with most of our recommendations on monitoring and internal controls. RHS has recently issued regulations and an asset management handbook on transferring unused rental assistance and expanded guidance on income verification. Also, it appears that RHS is acting on our recommendation to improve sampling methods to ensure a sufficient number of tenant households are selected for supervisory reviews; that is, the agency has informed us that it is revamping that process. Finally, the RHS Administrator has generally agreed to implement our recommendations on the IRM databases.

Mr. Chairman, this concludes my statement. I would be pleased to respond to any questions you or members of the Subcommittee may have.

Contacts and Acknowledgements

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Question from Congressman Stevan Pearce
March 10, 2005 Hearing

Question 1:
Please describe the relationship between HUD and RHS. Is there a consistent dialogue between the Departments? Are there resources that your two agencies can share that might alleviate some program expense? Is there duplication or overlap of programs?

Answer:
USDA Rural Development and the Department of Housing and Urban Development (HUD) have regular dialogue at staff and leadership levels. We work closely together to help provide the opportunity of homeownership to millions of Americans. Examples of this cooperation are found in both our Single Family Housing (SFH) and Multi-Family Housing (MFH) programs.

The TOTAL (Technology Open to Approved Lenders) Scorecard is used in SFH. Rural Development and HUD have an agreement to share mortgage scorecard technology that HUD developed for its FHA customers. The technology is used to predict single family residential loan performance. We will implement a version of TOTAL, modified to account for the unique characteristics of rural customers, in our new Guaranteed Underwriting System. By HUD sharing the TOTAL technology with us, we and the taxpayers have saved at least $1 million and two or more years of development effort because Rural Development did not have to develop the technology from scratch.

Last fall, Rural Development released the findings of a Comprehensive Property Assessment study. This report was prepared under a contract with USDA to analyze our MFH program, identify problems, and provide recommendations for changes to address such problems. We conducted a briefing for HUD officials regarding its findings, and have continued to discuss design and implementation of a new USDA Voucher (Tenant Protection) program that is part of the President's Fiscal Year 2006 budget. Additionally, we have brought knowledge of HUD's experience in doing restructuring work in urban areas.

Under a cooperative arrangement with HUD, a former Office of Housing and Multi-family Housing Assistance Restructuring (OMHAR) manager has been detailed to Rural Development to share with us their portfolio restructuring methods. This manager will also help develop Demonstration program for us and to provide advice on the strategy of revitalization.

Both Rural Development and HUD fill important roles in providing homeownership opportunities and affordable rental housing, but these programs are not duplicative. Where efficiency can be gained through cooperation, both organizations have shown that they are in favor of collaboration, and this relationship has continued to grow under this Administration. A recent GAO report about elderly housing demonstrated how we coordinate with HUD to ensure no overlap in delivery of housing.

Other examples of Rural Development and HUD sharing resources include coordination of Income Limits and use of the Credit Alert Interactive Voice Response System (CAIVRS). We also work together on various E-Gov initiatives including E-loans, E-Grants and Citizen Access to CAIVRS. Additionally, Rural Development, HUD, and the Veteran's Administration (VA), jointly prepare a minority homeownership report on a quarterly basis.

Question 2:
The Southwest Border Initiative is an issue of great concern to us in New Mexico. Can you please describe the status of RHS participation in the Southwest Border Initiative? Are we making progress in providing affordable housing to residents of *colonias*?

Answer:
Rural Development has been an active participant in the Southwest Border Initiative since the Memorandum of Understanding was signed in 2003. USDA hosted the most recent Partnership meeting in May 2004. The primary focus of that event was the progress being made in forming State level coordinating groups, as well as other initiatives that have surfaced at that level. Rural Development State Directors serving the Border States highlighted their successes, challenges, and opportunities during their presentations, and participated in an interactive panel on future challenges and opportunities for moving forward with improved program and service delivery in all areas of need within the region. The Partnership recognizes that the State level working groups are the critical coordinating mechanism to bring together all of the stakeholders whose involvement is required for the improved coordination and delivery of funding and technical assistance in the region. Specific projects and technical assistance needs that the Partnership can address have also been identified.

Rural Development annually sets-aside 5 percent of our housing funds specifically for underserved areas and the colonias. These set-asides assure that Rural Development can quickly respond to the housing needs of families in these areas.

Our Multi-Family Housing programs are very active in the colonias. In Fiscal Year (FY) 2003 and FY 2004, Rural Development invested over $35 million in multi-family housing loans and grants. These funds were highly leveraged with other affordable housing programs, helping develop 20 apartment complexes in the colonias and providing over 900 affordable housing and farm-labor housing units.

Our Single Family Housing programs are also very active in the colonias. In FY 2003 and FY 2004, Rural Development helped 130 families achieve the dream of homeownership through the investment of over $10.7 million in homeownership loans. We also provided over $750,000 in 1 percent loans and grants to 120 existing homeowners to make essential home improvements and repairs.

Question 3:
In your report on redefining "rural," you suggest changing to a density-based formula. Can you describe the benefits of such a change while highlighting any potential problems? Would you grandfather in the new definition?

Answer:
The subject report, entitled "RURAL HOUSING - Changing the Definition of Rural Could Improve Eligibility Determinations," was prepared and issued by the General Accountability Office (GAO) in December 2004. In the report, GAO provides several recommendations for Congressional consideration on changing the statutory definition of rural. One of those recommendations is the use of a density-based formula.

Rural Development responded to GAO's report indicating that their recommendations appear to have merit; however, a more in-depth analysis is needed to determine the best alternatives for redefining rural. Rural Development is currently working with its sister USDA Agency, the Economic Research Service, to identify these methods. Use of population density, by itself, could have potential adverse impacts in rural America. For example, there are many rural communities that, due to topography, may cluster housing and community development more densely than other rural communities. We must ensure that these rural communities and their residents are not excluded from participating in essential Rural Development programs. We also believe there is merit in considering whether communities currently defined as "rural" should be grandfathered if a statutory change is made.

Rural Development will work closely with Congress in determining any potential changes to the statute.

Responses to Congressman Steve Pearce's Questions

1) *Please describe the relationship between HUD and RHS. Is there a consistent dialogue between the departments? Are there resources that the two agencies can share that might alleviate some program expense? Is there duplication or overlap of programs?*

Our September 2000 report, *Rural Housing: Options for Optimizing the Federal Role in Rural Housing Development* (GAO/RCED-00-241), written for this subcommittee, describes the overlap between RHS's programs and programs offered by HUD and other agencies (see pp. 20–33). The report suggests that Congress consider requiring USDA and HUD to examine the benefits and costs of merging RHS and HUD programs that serve similar markets and provide similar products. As a first step, we suggested that the Congress consider requiring the agencies to explore merging their single-family insured lending programs as well as their multifamily portfolio management programs, taking advantage of the best practices of each and ensuring that targeted populations are not adversely affected.

Neither agency agreed with our suggestion to the Congress. RHS's Administrator, responding on behalf of USDA, stated that ... "Since there are more urban families than rural families, rural America's wheels will come to a slow and irrevocable halt if rural and urban programs are merged." HUD said that it would support increased sharing of information on best practices with USDA, but believed merging the programs would hurt rural areas because a national program would not be able to maintain the better rates and terms offered by RHS programs.

While serious discussions between the two agencies on a potential merger never materialized, RHS and HUD have been communicating more in recent years. For example, while we were performing our audit work in 2000 we found that RHS's new consolidated multifamily asset management regulations incorporate HUD's income and asset verification procedures and RHS has consulted with HUD in developing a methodology for estimating improper rental assistance payments. Also, HUD's Government National Mortgage Association (Ginnie Mae) and RHS staff have worked to modify and coordinate program policies and procedures so that Ginnie Mae can guarantee RHS's mortgage-backed securities.

2) *The Southwest Border Initiative is an issue of great concern to us in New Mexico. Can you please describe the status of RHS participation in the Southwest Border Initiative? Are we making progress in providing affordable housing to residents of colonias?*

We have not reviewed this program. RHS is in a better position to answer this question.

3) *In your report on redefining "rural" you suggest changing to a density-based formula. Can you describe the benefits of such a change while highlighting any potential problems? Would you grandfather the new definition?*

We see a density-based formula providing finer-scale information that better represents where people live. The current definition relies on metropolitan statistical areas (MSAs) and population. However, according to the Office of Management and Budget, MSAs do not equate to an urban-rural classification and counties included in MSAs may contain both urban and rural territory. In addition, 2000 census data show that (1) 13 percent of the population of counties currently in MSAs lived in rural areas and (2) that these rural residents (the 13 percent) included more than half the population that the Census Bureau defined as rural. Also, as the examples in our report show, using population figures alone may not be sufficient to distinguish between urban and rural areas. Casa Grande, Arizona, requires a congressional exemption to maintain eligibility for rural housing programs because it has more than 25,000 people, but its population is spread over 48 square miles. Only one of Casa Grande's nine census tracts has a density of more than 500 people per square mile, a figure which the Census Bureau uses to define densely settled areas. Likewise, Belpre, Ohio, is currently eligible for RHS programs. While the city has less than 7,000 inhabitants, most of Belpre has a population density of 1,000 people or more per square mile and is a part of an urbanized area with a total population of more than 50,000.

However, we do caution that although density measures can provide better information than population and MSA criterion, they should never be the sole eligibility factor. Mapping changes in density can help RHS better pinpoint where the boundaries dividing eligible from ineligible areas can be drawn, but if those boundaries were based on Census urbanized area/urban cluster lines they could also appear convoluted and thus difficult to use or map. Additionally, in some areas, higher and lower population densities do not correlate to urban and rural areas. For example, certain Colonias and Appalachian regions are both rural and densely populated because they have limited useable land. In such cases, the overall rural character of the area should be considered in the eligibility determination.

We believe that grandfathering could be phased out if the MSA requirement were dropped. Grandfathering was added to the law after rural communities within county-based MSAs became ineligible for RHS programs. A new density-based system based on finer-scale census information rather than political boundaries should negate the need for grandfathering in most cases. However, grandfathering should not be ruled out for special cases, such as the Colonias and Appalachian example cited above.

USDA United States Department of Agriculture

Rural Development - Alabama

State Office Information

The USDA Rural Development State Office is located in Montgomery, Alabama. Office hours are 8:00 a.m. until 4:30 p.m., Monday through Friday, CST.

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Rural Development - Alabama

Area Office Information

USDA Rural Development programs in Alabama are administered by four Area offices and seventeen Local offices across the state. Please contact the Area Office, listed below, serving your county for information on community facilities, business and industry, cooperatives, rural utilities, and/or multi-family housing programs. Area Offices are open Monday through Friday from 8:00 a.m. until 4:30 p.m., CST.

AREA 1

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