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LEGISLATIVE AUDIT COMMISSION

Program Evaluation Division

MINNESOTA HOUSING FINANCE AGENCY

April 19, 1977

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FOREWORD

The Program Evaluation Division of the Legislative Audit Commission was established by Chapter 204, Section 91 of the Laws of Minnesota for 1975. The Division is authorized to "determine the degree to which activities and programs entered into or funded by the state are accomplishing their goals and objectives, including an evaluation of goals and objectives, measurement of program results and effectiveness, alternative means of achieving the same results, and efficiency in the allocation of resources". This evaluation, *The Minnesota Housing Finance Agency,* is the second one undertaken by this Division.

For each report, a uniform review procedure is followed. After a preliminary draft is completed, it is submitted to all agencies directly involved in the evaluation for their verbal and written comments. The written replies of the Minnesota Housing Finance Agency are included in Appendix A. In addition, the report is reviewed by a subcommittee of the Legislative Audit Commission prior to its release.

We thank James F. Dlugosch, Executive Director of the Minnesota Housing Finance Agency, and his staff for their valuable time and assistance in this project.

Gary J. Miller was the project director and chief author of this report. Assisting him were James D. Cleary, Laurel A. Donaldson, Barbara A. Homce, Daniel J. Jacobson, and Charles E. Rogers, Jr. Ron Denhardt was responsible for the economic and fiscal aspects of the study, and he was assisted by John Asmussen, Wayne Carroll and Jack Kinne. In addition, Real Property Resources Corporation consulted on the project.

Tradition dictates that the Chairmanship of the Legislative Audit Commission alternate between the House of Representatives and the Senate. Representative Fred C. Norton was Chairman for 1976 and was succeeded in 1977 by Senator William W. McCutcheon.

March 31, 1977

Bruce Spitz
Deputy Legislative Auditor
for Program Evaluation

INTRODUCTION

The Program Evaluation Division of the Legislative Auditor's Office was directed by the 1976 session of the Minnesota State Legislature to:

> . . . study and report to the Legislative Audit Commission and the Minnesota Housing Finance Agency . . . on the performance, management and operations of the Agency.

In response to this mandate, we have conducted a comprehensive performance evaluation of the Minnesota Housing Finance Agency (MHFA). The major findings and conclusions of that evaluation are presented in this summary report. A number of other staff reports, containing the detailed methodology, findings and conclusions of this investigation, have also been prepared by the Program Evaluation Division and are available upon request. These reports are listed in Appendix B.

This evaluation of the Minnesota Housing Finance Agency consists of separate analyses of the three major programs of the Agency: the Homeownership Program, the Apartment Development Program, and the Home Improvement Program. It also includes analyses of MHFA investment practices, accounting procedures, overall management practices, and financing plans.

These investigations, in combination, evaluate the following aspects of the Agency's performance to date:

1. the effectiveness of its programs in meeting financing, production, and delivery objectives;
2. the efficiency of these programs;
3. the adequacy of internal program management procedures and regulations; and
4. the financial security of the Agency's programs.

This comprehensive evaluation involved two principal stages of investigation. In order to describe the basic purposes, structure and operations of the Agency, we first developed an evaluability assessment, which was presented to the Legislative Audit Commission in May, 1976. That preliminary report outlined the basic evaluation questions and the research strategy which generally guided our work during the remainder of the study. The second stage involved the collection and analysis of data relevant to the performance of the Agency, and it has culminated in the writing of this report and the more detailed supporting staff reports.

Data used in this study came from a variety of sources, including: interviews with MHFA staff and board members, key legislators, legislative staff, other housing officials in various levels of government, and officers of financial firms; systematic review of Agency files, documents, records, and financial statements; analysis of tenant application forms on file in the Agency; analysis of banker and recipient files of loan and grant programs; compilation of Minnesota census data on housing; phone and mail surveys of other state housing finance agencies; site inspections of apartment projects; review of Agency board meeting minutes; reviews of state, federal and local legislation; and reviews of relevant housing literature.

Chapter I of this summary report provides a brief description of the public purpose of the Agency, its history and powers, the objectives set for it, and the major programs it has established in order to meet its objectives. This overview provides the necessary background for interpreting and understanding the major evaluation findings.

Chapters II through IV contain summarized descriptions and evaluations of housing programs of the Minnesota Housing Finance Agency: the Apartment Development Program, the Homeownership Program, and the Home Improvement Program.

Chapter V addresses the major policy issues, both for the Agency and for the Legislature, which are raised by this evaluation.

CHAPTER I

AN OVERVIEW OF THE MINNESOTA HOUSING FINANCE AGENCY

CREATION OF THE AGENCY

The 1971 session of the Minnesota Legislature created the Minnesota Housing Finance Agency for the purpose of providing adequate housing for families of low and moderate income. The need for such a new housing finance agency was stated in the enabling legislation.[1]

> . . . as a result of public actions involving highways, public facilities and urban renewal activities, and as a result of the spread of deteriorated housing and blight to formerly sound urban and rural neighborhoods, and as a result of the inability of private enterprise and investment to produce without public assistance a sufficient supply of decent, safe and sanitary residential dwellings at prices and rentals which persons and families of low and moderate income can afford, there exists within the state of Minnesota a serious shortage of decent, safe and sanitary housing at prices or rentals within the means of persons and families of low and moderate income.

The agency was created to provide housing financing not available on equivalent terms and conditions from the private sector. This was to be accomplished primarily through the sale of tax-exempt revenue bonds, of which the proceeds would be used to provide interim and permanent financing to eligible borrowers at below market interest rates. By combining the interest reduction which arises from the tax-free nature of the Agency's bond issues with available federal subsidies, housing costs can be reduced to a level affordable by many of those who could not afford market rates for housing.

The Minnesota Housing Finance Agency operates in a complex and volatile environment and is required to develop and implement its various programs in relation to a number of other public and private actors. It is a public agency which provides a direct link between the public and private sectors of the housing industry. The Agency receives its operating mandate, some financial guarantee, and limited appropriations from the state government; it receives tax and rental subsidies from the federal government and administers these subsidy programs and the accompanying federal regulations; and it responds to local area and community needs and sentiments. It links these governmental funds and regulations with a number of private sector actors: private investors in the bond market, private lending institutions, private developers, and ultimately, homeowners and apartment tenants. This interactive system is illustrated in Figure 1.

CONTEXTUAL ISSUES

In order to understand MHFA's development, it is necessary to understand the context in which the Agency was created and in which it developed. Minnesota, like many other states, established a housing finance agency in order to counteract relatively recent economic trends which are increasingly eliminating persons and families of low and moderate income from the private housing market. The single family housing market has been severely affected by the high inflation of the late 1960s and 1970s. Mortgage interest rates have been high, credit terms have been stringent, and other homeownership costs have increased to such an extent as to limit the affordability of homeownership for low and moderate income

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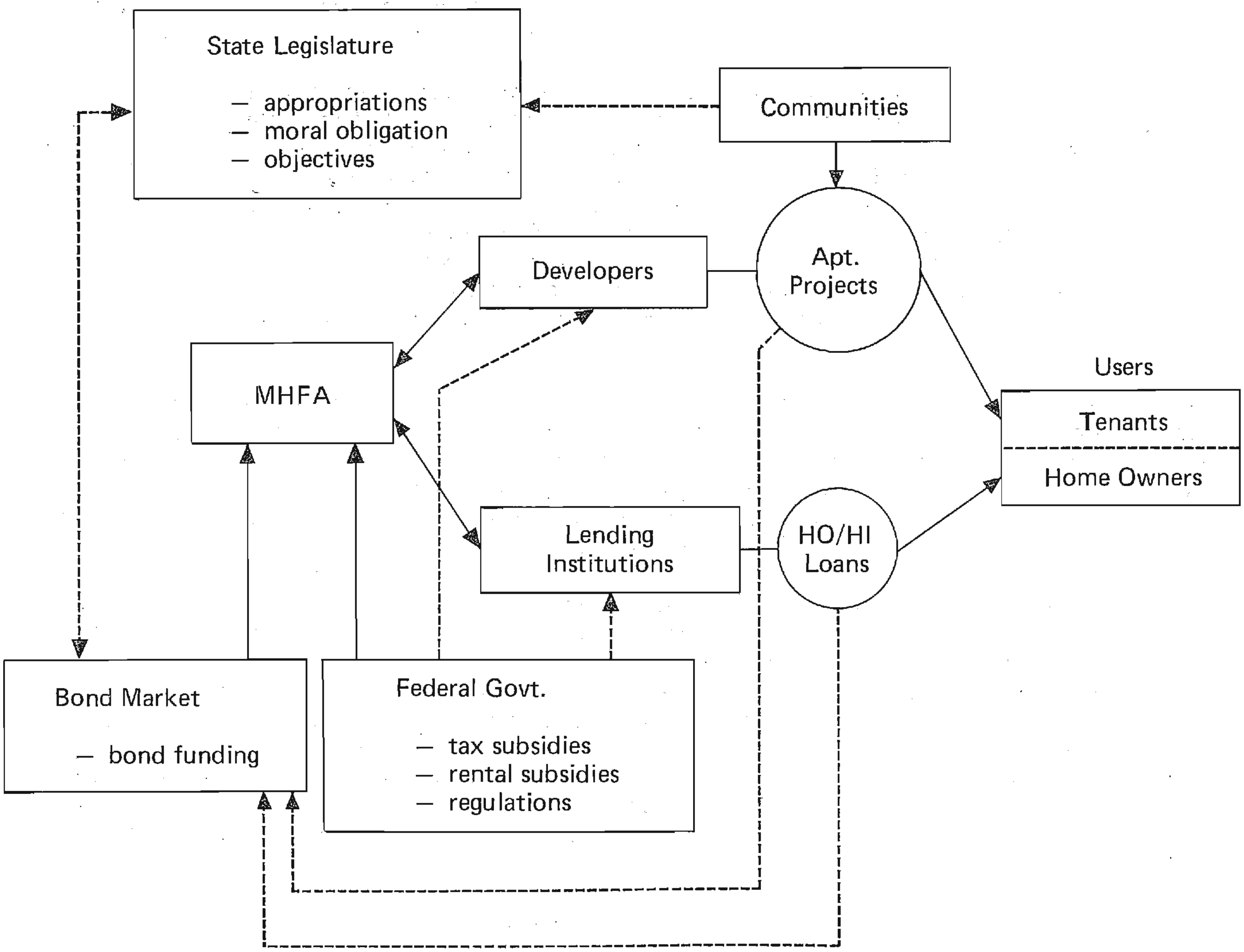
[1] *The 1971 enabling legislation provided for financing the construction of residential housing for low and moderate income families. The 1974 amendments added the powers to finance the rehabilitation of residential housing. Minn. Stat. Section 462A.01 to 462A.24 (1974), Amending Minn. Stat. Section 462A.01 to 462A.24 (1971).*

FIGURE 1
THE MHFA IN CONTEXT



families. The household income needed to sustain a home has increased dramatically. New housing construction has fallen far short of the estimated need. In addition, rapid inflation in interest rates, construction costs, land values, and operating costs have made it increasingly difficult for the private sector to construct profitable apartment projects. In these circumstances, the prospect of public support for new housing construction and renovation of the existing housing stock has grown increasingly attractive.

These very difficult economic trends also limited MHFA's ability to provide housing assistance to low and moderate income Minnesotans. The cost of housing financed by the Agency was affected by rapid inflation in interest, land acquisition, construction, and property management costs.

In addition, two sets of events external to the Agency restricted its ability to launch new programs. First, MHFA began issuing revenue bonds just prior to dramatic increases in the cost of capital. Interest rates, first of short-term notes and shortly thereafter of long-term issues, increased. These increases were caused by several factors: (1) general inflation, (2) problems in the municipal bond market created by the financial troubles of New York City bond repayments, (3) the financial troubles of the Real Estate Investment Trust industry, and (4) problems of other state HFAs in repaying short-term notes. While the initial bond issues of MHFA were made at a time when the bond market was willing to buy HFA revenue bonds at relatively low interest rates, by 1975 the Agency could market its funds only at relatively high rates of interest. This, in turn, restricted the Agency's ability to provide below-market-interest-rate funding. While bond market conditions have improved recently, interest rates are still relatively high, and the future viability of this source of funds is uncertain.

Secondly, the 1973 moratorium on federal Section 236 rental subsidies stopped the flow of federal apartment subsidies for a time. While MHFA was able to launch into apartment development in 1974 on the basis of prior commitments of Section 236 funding, the subsequent Section 8 federal rental subsidy program was slow in beginning and did not produce substantial amounts of rental subsidies for MHFA use until 1976. While extensive Section 8 subsidy assistance was delivered in 1976, the extent of Section 8 funds in the future is uncertain. The status of this program depends upon the housing policies of the Carter administration.

The development of MHFA has been affected by these economic conditions. In addition, a number of local political factors undoubtedly shaped the form of the Agency and its programs. The strong tradition of homeownership in Minnesota,[2] as well as the ease and low administrative cost of setting up such a program, encouraged the development of a single family homeownership loan program. Most other HFAs have concentrated primarily on apartment development. In addition, MHFA's reliance upon the private sector for distributing much of its program funds is consistent with the traditionally limited role of state government in housing. The Agency is primarily a mortgage lender and financial intermediary; it relies on the private sector to actually produce the housing. In general, MHFA serves as a stimulant and facilitator to the private sector in providing affordable housing for low and moderate income families throughout the state.

MAJOR AGENCY PROGRAMS

Housing financing is provided by MHFA in three general housing areas:

1. Apartment Development: The Agency provides mortgage loans for the private construction of multifamily housing for occupancy by persons and families who meet the Agency's income eligibility limits. MHFA provides both the interim and permanent mortgage financing for these developments. The apartment projects are privately designed, constructed, owned and managed, but are under the supervision of the Agency.

[2]*Minnesota ranked fourth in the nation in 1970.*

2. Homeownership: MHFA enlists private lending institutions to originate and service below market interest rate mortgage loans to eligible families. Generally, commitments for mortgage funds are sold to participating lenders, and after the loans are made they are purchased by the Agency.

3. Home Improvement: MHFA provides low cost Title I insured home improvement loans to low and moderate income families. The Agency sells commitments to participating private lending institutions or public agencies, which make loans to eligible borrowers and then sell the loans to the Agency. MHFA services the loans.

The Agency also has a number of other smaller housing assistance programs, some of which are funded by legislative appropriations. These programs will be discussed in this report within the context of the major programs. This report will concern itself mainly with the evaluation of the three major MHFA programs, as well as with overall Agency operations and management.

An overview of the major MHFA programs and their funding is provided in Table I.1. It is apparent from this table that the Agency has funded a diversity of housing programs, that a variety of additional subsidy mechanisms are used to supplement the Agency bond financing, and that apartment investments have increased in importance and have comprised an increasing portion of the long-term financing of the Agency since 1975.

TABLE I.1
MHFA PROGRAM FUNDING
($ in millions)

Source	Multifamily	Single Family	Home Improvement
Bond Issues			
1973		$30.0	
1974		$54.0	
1975	$18.6		$ 9.0
1976	$57.4		$15.9
1977		$80.0	$23.7
Total	$76.0	$164.0	$48.6
State Appropriations			
1976		$10.0[1]	$21.0[3]
1977		$ 7.5[2]	$31.5[3]
Total		$17.5	$52.5

[1] *Affordable Homes Program and Indian Housing Program.*
[2] *Homeownership Assistance Program.*
[3] *Grants and low interest loans.*

SOURCES OF FUNDING

The Agency receives funding from three main sources: tax exemptions, state appropriations and federal rent subsidies.

Tax-Exempt Financing

A primary source of Agency funding is provided through the sale of tax-exempt revenue bonds to private investors at reduced interest rates. The proceeds of these bond sales are used to provide interim and permanent financing to eligible borrowers at below market interest rates. The bonds are retired by the revenues generated by the loans.

In addition, the Agency recovers most of its operating costs through fees and excess interest earnings on its loans and interim investments. This eliminates the need for state appropriations for most Agency operating costs.

The interest rate and future marketability of Agency bonds depend upon the security or perception of security of these bonds. The security of these bonds depends primarily upon three factors:

1. The viability of the loans. To the extent that the loans made by MHFA are repayed in a timely fashion, sufficient revenue will be generated to repay the bonds. Thus, it is necessary that the Agency manage the loan portfolio adequately.

2. The adequacy of the Agency reserve account provisions. The enabling legislation provides for a capital reserve account equal to the next year's principal and interest payments. This reserve account includes a make-up provision from the state's general revenues, in the event that the Agency's normal operating revenues prove inadequate.

3. The commitment the state is willing to make to the Agency bonds. In general, the more willing the state is to guarantee bonds issued by the Agency, the lower the interest rate and the easier it is to find buyers for them. The state assumes only a moral obligation to stand behind these bonds; it does not pledge its full faith and credit to repay them. Thus, the taxing power of the state is not legally required to be used to service these bonds.

State Appropriations

The Minnesota state legislature periodically provides appropriations from general revenues for special housing programs, research and development activities, startup administrative costs, the debt service reserve fund, state-assisted home improvement loans, home improvement grants, low cost basic homes, and Indian housing.

Federal Rental Subsidies

Because of rapid increases in construction and operating costs in apartment development, it is not possible to develop apartment housing with rents affordable to lower income persons by relying solely upon interest reduction from bond financing. It is necessary to supplement the interest reduction with federal rent subsidies that are linked to the apartment units. To date, MHFA has used four types of federal rental subsidies. Its first ten apartment projects utilized the Section 236 federal rent subsidies, as well as the deeper rent supplement and rent assistance subsidies. All later apartment projects have used the Section 8 rental subsidies.

AGENCY OBJECTIVES

The major objectives set for MHFA in its enabling legislation are as follows:

1. to assist private industry in providing housing at prices and rentals affordable to low and moderate income persons and families;

2. to encourage construction in the areas of need and demand with a reasonable balance between nonmetropolitan and metropolitan areas of the state;

3. to supplement and implement federal housing assistance programs in Minnesota;

4. to house persons of varied economic means and a wide range of incomes in the same developments and neighborhoods;

5. to assist in the elimination of substandard housing conditions;

6. to provide for the rehabilitation and maintenance of the existing housing stock; and

7. to provide for the development of community facilities for the mentally ill, mentally deficient, physically handicapped, and drug dependent.

The ability of the Agency to achieve these housing objectives is constrained by a number of factors that it can only partially control:

1. The need to protect the fiscal integrity of the bonds. The necessity for the Agency to pay back bond holders from revenues generated by the mortgage loans requires prudent lending policy — in some cases requiring federal insurance, in other cases restricting efforts to reach lower income recipients, and in all cases requiring careful financial management and planning. The degree of Agency risk is relatively low in the Homeownership and Home Improvement Programs, since those loans are federally insured. However, the Agency assumes a high degree of financial exposure with the Apartment Development Program. Federal insurance has been used for only one of the existing apartment projects and will not be used in the future. Apartment development loans are larger, are carried over a longer term, and are typically more complex than the homeownership and home improvement loans. Thus, adequate management of the apartment development projects is necessary to assure the immediate financial integrity of the Agency and to maintain its ability to sell bonds in the future.

2. The bond market. While the state of Minnesota has provided the enabling legislation and the moral obligation necessary to float revenue bonds, the marketability of these bonds is largely dependent upon private market forces. These forces are historically highly volatile and to a great extent outside the control of the Agency, but they require that the Agency anticipate events and coordinate its financing activities with the capital market. In addition, the Agency directly affects the marketability of such bonds by its reputation for good financial management.

3. The private lenders. Both the Homeownership and the Home Improvement Programs are administered through private lending institutions or, in the case of Home Improvement, through local public agencies as well. While MHFA limits the lending activity of these institutions through its eligibility criteria and regulations, the actual loan decisions, processing, and monitoring are carried out by these institutions and not by the Agency. Thus, the geographic distribution of loans and actual decisions as to which applicants within the eligible pool of recipients receive MHFA loans are left primarily to the discretion of the lenders. Since MHFA relies upon the voluntary participation of these lenders, it is difficult for the Agency to exercise strict control over the loan delivery process.

4. The federal subsidies. The activity level of the Apartment Development Program is directly tied to the availability of federal rent subsidies. The availability of these subsidies has been uneven to date. As a result, it is difficult for the Agency to plan and manage its apartment development operations. Use of federal subsidies also produces timing problems. Developers must wait until federal allocations have been made before their applications to MHFA are considered.

5. The private developers. The Apartment Development Program utilizes private developers to design, construct, and manage its apartment projects. Because of the incentive system created by the structure of federal housing legislation, the developer is rewarded not so much for performance but from the sale of tax shelter prior to the completion of the housing itself. This type of incentive reduces the leverage that the Agency has over its developers and assumes critical importance in the management of operating apartment projects, since the developer has only minimal incentives to manage these units properly. The Agency is able to control a number of factors that promote financial security, such as rent levels, financing, subsidy type, and construction costs. However, the other critical factor, operating expenses, is not directly under the control of the Agency. Rather, it is up to the control of the management agent of the developers, with the agency implementing indirect control by reviewing and approving operating budgets.[3]

[3] *The Agency has minimal control over the management agent, since they must approve them and can discharge them. However, this does not represent direct control over operating expenses.*

Uncontrolled operating expenses can jeopardize the financial security of the bonds, especially under the Section 236 program.

Despite the above constraints, there are many aspects of its programs that MHFA can control in order to facilitate the achievement of its mandated objectives. Specifically, it can control to a significant extent:

1. loan selection;
2. apartment project and developer selection;
3. types of housing purchased or home improvements made;
4. design review and construction supervision of apartment projects;
5. oversight of loan and apartment project management;
6. the timing of bond sales and their maturity structure;
7. relationships with other governmental units; and
8. Agency staffing.

The manner in which the Agency implements each of these activities affects the achievement of its objectives.

THE STRUCTURE OF THE EVALUATION

This evaluation has focused on each of the three major MHFA housing programs, as well as the overall operations of the Agency. For each of these programs, there are many explicit and implied objectives. It would be quite difficult, costly, and of dubious value to evaluate the Agency in terms of all possible objectives. Instead, we have singled out the major objectives set forth in the legislation, as well as the Agency procedures and regulations which are a means to these objectives.

By choosing to establish the Minnesota Housing Finance Agency, the state has made an implicit decision to put more resources into housing and less into other parts of the public sector or into the private sector. It is important to determine whether the Agency's activities generate sufficient benefits to justify displacing resources from other sectors of the state's economy.

State intervention in the housing market has been based on the following logical reasons:

1. The judgment that the private market mechanisms do not produce the optimal amount of housing and that other state actions (construction of highways and public facilities, urban renewal, tax policies, housing regulations, etc.) may have played a role in decreasing the state's housing stock;

2. The judgment that the stock of housing should be distributed differently from that which occurs in the private market;

3. To take advantage of federal subsidies for housing which are available to the state at relatively little cost; and

4. The judgment that positive externalities are created by improving or adding to the housing stock, such as improved property values for the neighborhood, improved education, reduction in crime, improved health, etc.

These reasons were used to establish the following evaluation criteria for each of the programs:

1. To what extent has the program had a positive impact upon the state's housing stock?

2. To what extent have the benefits of the program been distributed to the appropriate target populations? To what extent do these programs meet the tests of equity?

3. To what extent does the program take advantage of the available federal subsidies?

4. To what extent do the social benefits from the program exceed the resource costs to the state?

The equity criteria developed to evaluate the Agency's programs are based on MHFA legislation, Agency goals, and two widely accepted notions of equity — vertical and horizontal equity. The concept of vertical equity is based on the assumption that people in different situations should be treated differently. That is, people with lower incomes should receive more assistance than those who are better off. Horizontal equity is based on the notion that individuals in similar circumstances should be treated equally.

Cost-benefit analysis is used to determine the extent to which the social benefits of a program exceed its resource costs to the state. This analytic technique treats cost and benefit concepts in a manner that makes it possible to estimate the net benefits of a program to the state. In general, these concepts differ from the Agency's definitions of revenues and costs.

We have not been able to gather information relating to the question of whether these Agency programs generate externalities, and thus, this will not be used as an evaluative criterion. However, the literature is relatively consistent in reporting that housing programs seldom generate measurable external benefits.[4]

In addition to these broad criteria, each program will be assessed in terms of its performance vis-a-vis specific production, delivery, and management objectives and standards established for that program or which can be expected to facilitate the achievement of the program's objectives.

Finally, since the Agency must protect the financial security of its housing programs, each program will be assessed in terms of the adequacy of its financial management and its managment of risk.

[4] *Housing in the Seventies,* *U.S. Department of Housing and Urban Development, Washington, D.C., 1974.*

CHAPTER II

THE APARTMENT DEVELOPMENT PROGRAM

The Apartment Development Program of the Agency plays a major role in providing adequate housing for low and moderate income families. It provides low interest loans to developers of multi-family housing and channels federal rent subsidies to tenants within these developments. This chapter summarizes our evaluation of the production, delivery, and management of this MHFA program. Detailed analysis can be found in the Legislative Audit Commission staff paper, *Evaluation of the Apartment Development Program of the Minnesota Housing Finance Agency*.

MHFA sells tax exempt notes and bonds to private investors in order to finance apartment developments at below market interest rates. Financing to cover construction costs is provided through the sale of tax-exempt bond anticipation notes — typically sold at low rates of interest relative to both the conventional market and long-term bonds. Long-term financing for the apartment developments is provided through the sale of tax exempt revenue bonds.

The Agency has developed a number of procedures for reducing the risks of its investments. Extensive review of project proposals and developer financial backing, as well as oversight of operating property management, is performed in order to control costs and insure adequate financial planning and security. In addition, a number of cash reserve accounts provide financial backup in the event of unforeseen financial difficulties. In the Apartment Development Program, a working capital escrow account is available to cover cost overruns or disallowances in construction and to handle difficulties in the rent-up phase. To date, the Agency has not used this escrow, but instead has used its leverage to obtain any extra capital required from the developers. Three cash reserve accounts exist to cover financial difficulties that may arise in operating projects — development cost escrow, replacement reserve, and painting and decorating reserve.

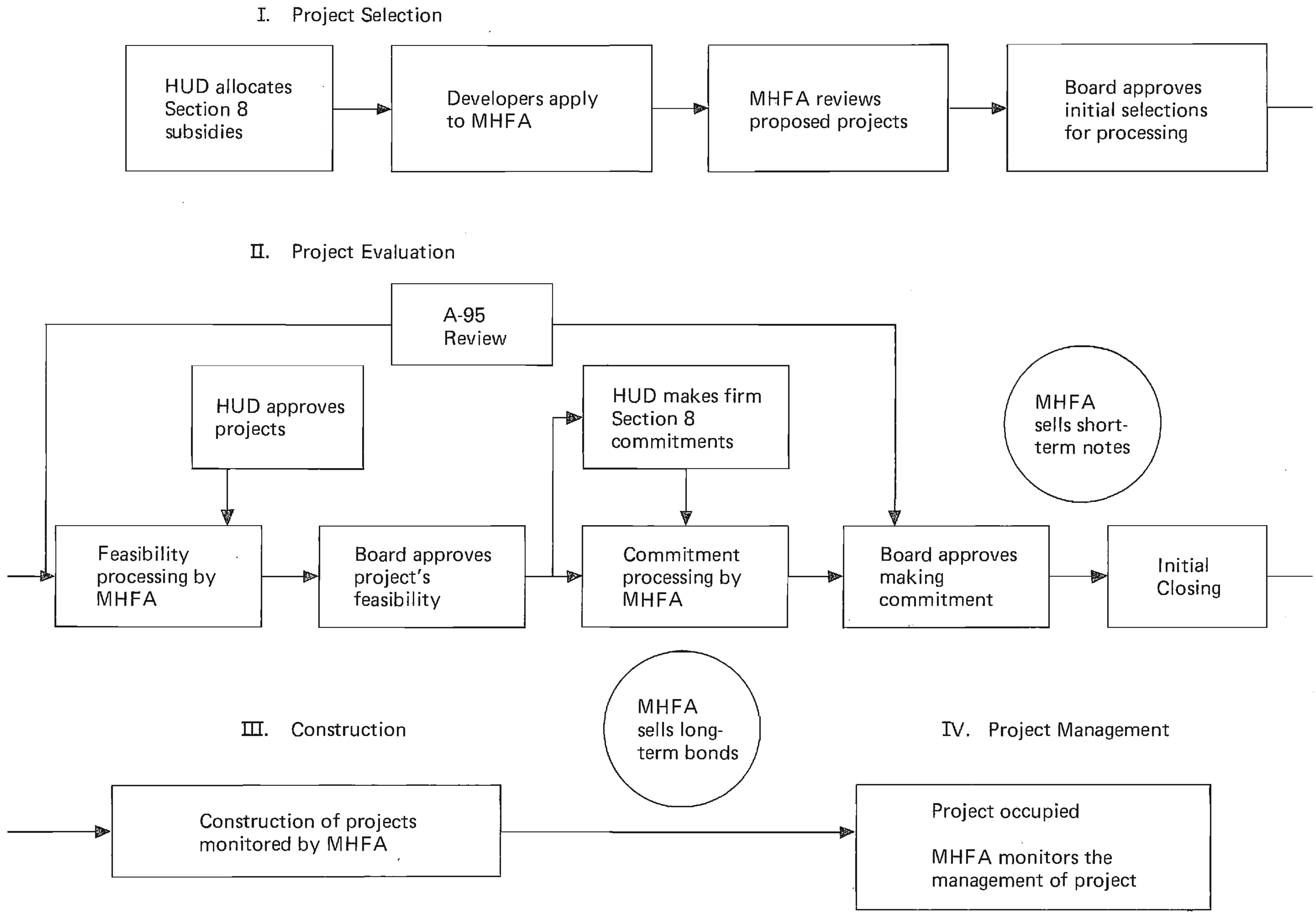
The MHFA Apartment Development Program finances new or substantial rehabilitation construction of projects for general occupancy, the elderly, a combination of the two, and in limited cases, for the handicapped. In addition, the Agency provides financing for group homes for the developmentally disabled. Developers must be limited dividend sponsors or non-profit developers in order to participate. Tenant eligibility for subsidy assistance is based upon federal Section 8 eligibility standards. Up to 25 percent of the units in a project can be rented to families whose adjusted incomes exceed the income limits set for the project.

The loan terms offered to developers by MHFA differ in several ways from the terms of conventional loans. The Agency's loans are offered for a longer period of time (typically 40 years rather than 20 or 30 years), comprise a larger percentage of total development cost (90 percent for limited dividend and 100 percent for non-profit sponsors as compared with 75 to 80 percent for conventional loans), and are made at a lower rate of interest. The exact interest rate for MHFA loans depends upon the bond market at the time of permanent financing. In addition, most MHFA projects are eligible for a 50 percent property tax abatement. Agency loans place a number of restrictions on the developer, among them income limits on prospective tenants, limits on return on equity, control over rent increases, supervision of operating management, and required Agency approval for transfers in ownership. Federal insurance is not used in this program, except for one project funded under the Section 236 subsidy program.

The Agency has developed a housing allocation plan, which includes targeted goals for the various economic development regions of the state. Initial selections of project applications by MHFA are made primarily on the basis of consistency with these geographic distribution goals, preliminary assessments of developer qualifications and financial backing, market analysis, and analysis of site location. At this point, MHFA applies to HUD for Section 8 reservations.

The process by which the Agency selects, evaluates, and develops apartment projects is illustrated in Figure 2. Once applications are selected for further processing, the Agency undertakes a more systematic review of project feasibility. In addition to market analysis and site analysis (if they have not already

FIGURE 2
MHFA APARTMENT DEVELOPMENT PROCESS



been performed), the Agency reviews and approves projected costs and rents and the capabilities of the developers, and performs an initial review of project design. Further, the consistency of the proposal with local housing assistance plans is reviewed through the A-95 review process.

Once the project passes the feasibility analysis, further review is performed prior to commitment. Architectural plans are initiated, working drawings are developed and examined, and detailed estimates of costs, operating expenses, and rents are made.

Prior to commitment, the Agency applies to HUD for firm reservations of Section 8 funds. Prior to initial closing, the Agency completes the review of architectural plans and the preparation of legal documents.

Once the project is closed, the construction begins, and the Agency regularly monitors the progress of the construction, approves all draws made by the contractor, and performs the cost certification. As the project nears completion, the marketing plan and operating budget are approved. The management agent begins to accept applications for occupancy.

Once the project is completed and rented up, the Agency continues to supervise and monitor the management of these units.

As this description indicates, the Agency is heavily involved in the review and supervision of the activities of the developers of apartment projects. Not only does the Agency control project selection, but it also participates extensively in the development of design standards and construction specifications, the control of construction costs, and the selection and practices of the management of operating projects. Such extensive involvement is necessary, because the apartment projects represent the source of revenue for repaying the bonds. The Agency assumes a high degree of financial exposure in the Apartment Development Program.

PROGRAM RESULTS

Basically, MHFA has three groups of apartment projects. The first group, now fully operational, consists of ten projects,[1] eight of which are subsidized under the federal Section 236 subsidy program. The second group, all of which are under construction, renting up, or soon to be operational, consists of 24 projects, of which all but one are subsidized under the federal Section 8 subsidy program. The third group, also based on the Section 8 program, consists of 80 projects for which the Agency recently made reservations with HUD and is now undergoing feasibility analysis.

Before turning to an analysis of these projects, a short description of the two major types of federal rent subsidies used by MHFA will be provided.

THE SECTION 236 PROGRAM

The Section 236 program of the 1968 Housing and Urban Development Act provides an interest rate subsidy to the owner of an apartment development — an interest subsidy equal to the difference between monthly mortgage payments amortized at market interest rates and mortgage payments amortized at as low as a one percent interest rate. The Section 236 subsidy is paid to the MHFA on behalf of the project owner and is passed on to the tenants in the form of reduced rent levels. Typically, rents for Section 236 units are reduced by about 35 to 40 percent. The tenants must pay a minimum of 25 percent of their adjusted family income as rent. For some tenants, additional and deeper subsidies in the form of rental assistance or rent supplements are also available — subsidies that pay the difference between the "basic" 236 rent and 25 percent of the tenant's income. The deeper subsidies in this program have been reserved primarily for the elderly and the handicapped.

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[1]Eleven projects were financed by MHFA in the first phase of apartment production. However, one of the projects was FHA-insured and is currently administered through the local area HUD office.

A major drawback of the Section 236 program is that it subsidizes interest only and does not readily provide further assistance to ease the burden of increases in operating costs. Therefore, rent increases arising from inflated operating costs must be absorbed by regular Section 236 subsidy tenants. At this point, approximately one-half of the units in these projects are covered by the deeper rent assistance and rent supplement subsidies, which can absorb increases in operating costs.

THE SECTION 8 PROGRAM

Unlike the Section 236 subsidy, the Section 8 rent subsidy is not directly tied to production costs, but rather is based upon the tenant's adjusted income. The subsidy is equal to the market rent of a unit, which is based upon HUD's assessment of comparable rents in the area, minus 15 to 25 percent of the tenant's adjusted family income. The actual percentage of tenant contribution depends upon family size and income level. Section 8 subsidies are provided to tenants whose household incomes do not exceed 80 percent of the median income of the area.

The Section 8 subsidy is more flexible in terms of what it covers than the earlier Section 236 subsidy. It is based upon a determination of total housing costs and not just mortgage costs. Thus, increases in project operating costs are absorbed by the subsidy payment and not by the tenant, as long as the Agency can demonstrate to HUD that it has exerted reasonable control over operating costs.

MHFA APARTMENT PRODUCTION

Tables II.1 to II.3 summarize MHFA apartment financing activities over the past three years. Given its brief existence and the fact that apartment production is a lengthy process, MHFA had produced only eleven completed and rented up projects as of late 1976. However, a significant number of additional projects are currently under construction and an even larger number are currently in the planning and feasibility stage of production. Altogether, considering both completed and in-process developments, the Agency has provided or will provide financing for approximately 115 apartment developments, involving approximately 9,210 units.[2]

TABLE II.1
APARTMENT PROJECT SUMMARY

MHFA Developments	Projects	No. of Units	Total Mortgage Amount	Average Mortgage/Unit
Completed (Sec. 236)	11	795	$15,693,745	$19,741
Just Completed or Under Construction (Sec. 8)[1]	24	2,154	$49,415,538	$22,941
To Be Constructed (Sec. 8)[2]	80	6,261		
Total	115	9,210		

[1]Includes Calhoun Beach
[2]Includes Galleria Towers

[2]In addition, 24 apartment projects received construction financing under the construction loan program. Permanent financing was not provided by MHFA.

TABLE II.2
RENT LEVELS

Rent Levels	General Occupancy	Elderly	Handicapped	Total	Percent
Completed or Under Construction					
Market Rent	759	61	0	820	28%
Shallow Subsidy[1]	222	76	0	298	10%
Deep Subsidy[2]	525	1,216	90	1,831	62%
Total	1,506	1,353	90	2,949	100%
Percent Units	51%	46%	3%	100%	
Planned					
Market Rent	1,639	0	0	1,639	26%
Section 8 Subsidy	1,464	3,121	37	4,622	74%
Total	3,103	3,121	37	6,261	100%
Percent Units	50%	50%		100%	

[1] *Regular Section 236 subsidy.*
[2] *Includes Section 8, rent supplement, and rent assistance subsidies.*

TABLE II.3
PROJECT LOCATION

Location of Development	Completed or Under Construction: Projects	Units	Percent Units	Planned: Projects	Units	Percent Units
Metro Area	12	1,367	46%	27	3,350	54%
Smaller SMSA's	5	401	14%	6	531	8%
Small Towns	18	1,181	40%	47	2,380	38%
Total	35	2,949	100%	80	6,261	100%

The Agency has produced apartment units up to its capacity in a relatively cost-effective manner, it has distributed the federal subsidies to the appropriate target populations in a reasonably equitable manner, it has had a positive impact on the state's stock of apartment housing, it has generated net benefits to the state, and it has produced projects of generally adequate quality. The following discussion documents this record in terms of the evaluative criteria outlined in the introduction to this report.

Impact on Housing Stock

Our analysis suggests that the Apartment Development Program has substantially increased the apartment housing stock in Minnesota in the short run. In 1976, the Agency financed 2,146 units, which represented about half of the total state production for that year. The Agency is able to have such a significant impact on apartment housing stock because of the currently low level of construction activity financed by the private sector. Very few apartment units are being constructed with conventional financing, since construction costs are too high to be supported by prevailing rents. Under these circumstances, the additional 80 projects totaling 6,151 units, projected by the Agency, should have an even larger impact on the apartment housing stock in this state.

This high level of production could potentially hold down state rent levels. However, the magnitude of this effect is uncertain. The main impact of the MHFA apartment program is likely to be concentrated on the low cost rental housing market. It seems likely that, within the low cost rental housing market, the impact on the housing stock will be relatively long lasting. However, it is probable that the impact of the MHFA Apartment Program on the moderate to high cost housing market will be offset by a future decline in private construction activity in this market.

Distribution of Benefits

The Agency has distributed the federal rental subsidies to the appropriate target populations. This conclusion is based upon analysis of tenant income data from the tenants in the Section 236 projects — the only projects rented up at the time of the analysis.[3]

Table II.4 presents the income distribution of all households in our Section 236 sample. As is evident from this table, the incomes of MHFA tenants in this sample are heavily concentrated toward the lower end of the income continuum. More importantly, the incomes of families and individuals receiving rental subsidies are even lower. Almost 60 percent of tenants receiving subsidies have annual gross incomes of less than $5,000; 96 percent of subsidy tenants have annual gross incomes of less than $10,000.

Further analysis of tenant demographic data indicates that the Section 236 rental subsidy, as administered by MHFA, serves elderly and handicapped low income households more substantially than it serves family households. This is because the Agency directs its deep subsidies under the Section 236 program primarily to the elderly and the handicapped. The "basic" Section 236 subsidy is generally not large enough to support a family with a very low income.

While only limited income data were available for the Section 8 projects (since only a small number were in the process of renting up), it appears that this subsidy program will reach even lower income family households than was possible under the Section 236 program. This subsidy program will have the same capacity to reach lower income elderly and handicapped households. Thus, it is clear that the Agency will be able to continue to provide rental housing assistance to lower income households under the Section 8 program and will, in all likelihood, be able to provide even more assistance to lower income family households.

TABLE II.4
INCOME DISTRIBUTION OF TENANTS IN SECTION 236 PROJECTS

Gross Annual Income	Market Rate	Regular Section 236	Deep Subsidy	All Subsidy Tenants	All Tenants
(N)	(201)	(262)	(231)	(493)	(694)
$5,000 or less	20%	40%	83%	60%	49%
$5,001 – $10,000	34%	53%	17%	36%	35%
$10,001 – $15,000	27%	7%	0%	4%	11%
$15,000 or more	19%	0%	0%	0%	5%

In addition, the Agency has served lower income groups with special housing needs. Based upon analysis of the tenancy in the initial ten projects, lower income households among the elderly, the handicapped, and minority populations have been served by the Apartment Development Program. In addition, the Agency has provided financing for a limited number of group homes for the mentally retarded.

[3] *Income and demographic data on MHFA tenants in the initial ten projects were gathered from tenant application forms. Data on 88 percent of the tenants were available. Comparisons of the tenant sample with Agency profiles of the ten projects indicated that the sample was reasonably representative.*

The only areas in which the program has not produced units to the degree that might be expected are for very large families and for special dependency groups other than the mentally retarded. In general, though, the Agency has delivered subsidized apartment units to the appropriate target populations.

The Agency has distributed its subsidy dollars in a manner which is vertically equitable. Overall, the lower income households receive the larger amounts of subsidy assistance. As household income increases, the average subsidy received decreases. On the other hand, horizontal equity remains a problem because of inadequate funds. Only a small fraction of households eligible for rental subsidies actually receive subsidies. This is partially attributable to the newness of the MHFA Apartment Program and to the fact that federal rental subsidies are limited. Housing subsidy programs are almost inevitably horizontally inequitable, and the amount of subsidy assistance is basically outside the control of the Agency. Within its limitations, the Agency has distributed subsidy assistance in a reasonably equitable manner.

Use of Federal Subsidies

To date, the Agency has fully utilized all federal subsidies available to it. Given the necessity of using federal subsidies to make apartment units affordable to lower income persons, the Agency has produced apartment units up to its capacity.

Whether Section 8 subsidies will continue to be available in large quantities is uncertain. It is too early to ascertain whether the Carter administration will continue to expand this program, substitute another type of housing subsidy, or perhaps curtail the use of housing assistance subsidies in favor of more direct forms of welfare assistance.

Benefit-Cost Analysis

A cost-benefit analysis of the Apartment Development Program projects was performed in order to ascertain whether the social benefits produced by financing apartment projects outweighed the total resource costs to the state. The results of this analysis were positive — the Section 236 projects and the Section 8 projects both yielded benefit/cost ratios greater than one. Benefit/cost ratios give the value of benefits generated from using one dollar of the states resources. If this ratio is greater than one, the program generates net benefits for the state. From the perspective of production efficiency, this program delivers apartment units in such a way that the social benefits from the program exceed the resource costs to the state.

Two sets of benefit/cost ratios were calculated for the apartment projects. One set of ratios treated property taxes as a resource cost; the other set of ratios treated property taxes as not representing a resource cost. Two sets of ratios were necessary, because it is not possible to determine what proportion of the property tax abatement (which represents a state subsidy and therefore is a cost to the state) reflects a payment for municipal services provided.

For the Section 236 projects, the average benefit/cost ratios were 1.20, with property taxes treated as a cost, and 1.58, with property taxes removed as a cost. All but one of these individual projects generated positive benefit/cost ratios. For a sample of Section 8 projects, the average benefit/cost ratios were 2.00, with property taxes treated as a cost, and 2.57 with property taxes removed.[4] All of the sample Section 8 projects had positive benefit/cost ratios. The actual benefit/cost ratios probably fall somewhere between the two sets of ratios, depending on the appropriate interpretation of property tax abatements.

Clearly, the benefits of this program exceed the costs to the state. In addition, the Section 8 projects appear to generate higher benefits, relative to costs, than the earlier Section 236 projects. In both programs, the relatively high benefit/cost ratios are primarily the result of the substantial direct federal rental subsidies which do not represent a cost to the state.

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[4] *Our calculations of benefit/cost ratios for the Section 8 projects probably inflated the benefits relative to costs because of sampling peculiarities and the assumption of full occupancy. See the staff paper, "Cost-Benefit Analysis of MHFA's Programs".*

Other Production Results

There are other evaluative criteria as well, by which MHFA's apartment development activities can be assessed. These include cost-effectiveness of construction, construction quality, geographic distribution, and economic integration.

The Agency has financed the construction of apartment projects in a relatively cost-effective manner. The first round of eleven projects was developed at a mortgage cost of less than $20,000 per unit, while the second round of projects will be developed at an approximate mortgage cost of under $24,000 per unit. This compares favorably with projects developed by other public agencies.

While it is difficult to judge the quality of the MHFA projects in any definitive manner, site inspections of a sample of projects yielded generally favorable judgments about project quality, especially in relation to cost. However, some instances of unevenness in the quality of design and construction were detected, suggesting that MHFA control over design standards and specifications could be tightened.

In response to the legislative mandate to distribute apartment subsidies throughout the state in the areas of need and demand with a reasonable balance between the metropolitan and outstate areas, the Agency developed geographic distribution targets for groups of economic development regions. The program has achieved these goals to a satisfactory extent. Approximately half of all units and of all subsidized units are located in the Twin Cities metropolitan area.

Finally, the mix of tenancy and rent levels appears adequate. The units financed serve the needs of both families and the elderly, with 44 percent of the earlier project units and 51 percent of the later project units being devoted to the elderly. The mix of units within individual projects provides for a range of rent levels, with over 70 percent of the units being covered by a federal subsidy. This mix of subsidized and market rate units fulfills both the legislative mandate for serving the low income segment of the population and the objective of developing projects with mixed income tenancy.

APARTMENT DEVELOPMENT PROCEDURES AND MANAGEMENT

The preceding section focused upon the outcomes of the apartment development program. This section examines the program procedures, regulations, and management.

PROJECT SELECTION

Some problems were noted in the Agency's past selection of apartment projects. In general, there is some concern that adequate Agency staff, time, and effort are not being given to careful project review prior to initial selection. In particular, there were some indications that analysis of site locations and developer qualifications was sketchy.

Relative to the initial selection processes for the first round of MHFA apartment projects, the selection procedures have become more systematic, although not always implemented with the degree of caution necessary. Project selection for the first round of projects was relatively informal and proceeded without systematic selection criteria — reflecting the newness of the time. Since then, the Agency has implemented more systematic selection criteria.

However, the Agency has had problems applying the more rigorous selection criteria. In 1975, a sudden order from HUD for Section 8 reservations required the Agency to quickly choose its initial selections without a thorough review of the projects, although provisions were made for later substitutions if necessary. In 1976, the large number of applications limited the amount of time that the staff could devote to each application. There were indications that some decisions were made with less than adequate pre-selection analysis.

It is at this processing stage that the Agency's leverage over the developer is greatest. Thus, a better program of pre-selection investigation is needed to alleviate the crush of work experienced in the past. If this is not done, there is no assurance that the problems experienced in the last round of project selections will not reoccur. It should be noted that the Agency intends to add additional staff in the near future. If this is done, this problem may be minimized. We recommend that the Agency consider adding experienced and technically trained staff, since relatively inexperienced additional staff will encounter difficulties dealing with site and design issues.

Selection in accordance with geographic targets has been satisfactory. However, the process of developing geographic targets might be improved if the Agency were to take into account the past and planned developments of other public housing agencies, specifically HUD and FmHA, rather than basing their targets only upon the housing needs assessment and past Agency production.

DESIGN REVIEW

Site inspections of a sample of apartment projects and analysis of project construction data revealed a degree of variability that suggested the Agency might not be fully utilizing its control and review powers. While the unevenness observed is not yet troublesome, it is worthy of Agency attention for two reasons: (1) it is symptomatic of a review process that needs strengthening, and (2) the situation may get worse under the pressure of the increased workload that will be created by the 80 new projects.

A number of alternative means exist for strengthening design review. Among them, the following are suggested: (1) the addition of technical staff with particular attention to a specialist in mechanical and electrical systems; (2) implementing design review and construction specification as early as possible in the selection process; and (3) increasing the budgets for construction in order to improve overall quality of its physical assets and to prevent potentially larger future maintenance and repair expenses. These suggestions imply that the Agency should assume a more aggressive stance toward both HUD and the developers. The Agency may have to negotiate with HUD in order to raise Section 8 rent level ceilings so that construction budgets can be increased. In addition, it must bargain aggressively with its developers in order to achieve better quality projects.

CONSTRUCTION INSPECTION AND COST CERTIFICATION

The staff and procedures used in construction inspection and cost certification are excellent. The field inspectors are well qualified, conduct frequent inspections, and do a good job of enforcing compliance with previously-established standards and specifications. Existing problems in project quality appear attributable to variability in the design review process and not to problems in construction inspection.

Cost certification procedures have been adequate. Also, nine of the ten Section 236 projects had no mortgage increases. The sole mortgage increase was attributable to minor design changes recommended by the Agency and to some rock excavation. Both of these additions were determined to be necessary after construction began.

FINANCIAL MANAGEMENT

Responsible management of operating projects and careful management of financial risk are extremely important to Agency operations, since the projects represent the source of revenue for repaying the bonded indebtedness. The manner in which the Agency manages its apartment developments and structures its reserve accounts can affect its ability to market apartment development bonds in the future.

Agency control over operating properties is especially critical, since the Agency, rather than the developer has the major long-term interest in financial viability. Presently, the sale of tax shelter is the primary reward for developer participation in federal subsidized housing programs. The sale of tax shelter forces the private developer to transfer the property prior to initial occupancy, thus giving little incentive to worry about the long-term viability of the project. As a result, there are special burdens placed upon the lender, MHFA, to set up a system of controls and escrows that will insure that the private developer completes and manages the property properly.

Management of Operating Projects

The financial management of the operating projects has been adequate for the small number of projects currently under occupancy. However, problems that were observed in Agency oversight and control could potentially present larger management problems in the future, as the proportion of projects in the Agency portfolio increases dramatically. Currently, the Agency oversees 764 occupied apartment units. By 1978, it is estimated that it will be supervising the operations of over 9,000 units.

Expenses of operating projects were broken down into two types of expenditures: operating expenses (administrative, maintenance, utilities, insurance) and financial expenditures (taxes, reserves, mortgage payments and fees, partnership distributions). In almost every category of expense, operating project expenditures have exceeded budgeted levels. Some of these expense overruns have been greater than reasonable, indicating a lack of expense control on the part of the Agency. However, by far, the problem of expenses exceeding budgeted levels can be attributed to inadequate initial budgeting. At the time the initial budgeting for the first round of projects was performed, the Agency did not have specialized property management staff and initial budgets were set too low.

Because of the inadequate initial budgeting and, to a lesser extent, the lack of expense control, some of the operating projects are experiencing a revenue shortfall. Five of these projects currently experience costs that are between 13 and 34 percent over current revenues. The other five projects are currently operating with expenses reasonably close to revenues generated by the current rent levels.

It appears that these expense overruns do not place the Apartment Development Program in serious financial jeopardy, if the Agency takes prompt ameliorative action. Unusually high operating expenses need to be brought under control. They are presently not out of line to such an extent that they cannot be brought under control by more diligent management.

More importantly, it appears that the Agency must take prompt action in obtaining rent increases for at least five of these ten projects. Prompt action in pursuing rent increases is necessary because of the long time required to get them approved and implemented. Recently, the Agency has obtained sufficient rent increases or additional subsidies for two of these projects; there is a need for similar increases for three others.

If rent increases are obtained for these projects, as we feel are necessary, then the Agency must monitor carefully the impact of such rent increases on the current tenants of these projects. Examination of the rent/income ratios of the current tenants suggests that some of the current tenants may have difficulty affording an increase in rent. While it is not inevitable, rent increases may shift the current income mix of Section 236 subsidy tenants upward.

While we observed problems in the initial budgeting and expense control of the ten operating projects, these problems will, in all likelihood, not characterize the later MHFA apartment projects, primarily subsidized by Section 8 funds. Initial budgeting for these later projects was considerably more adequate, primarily because a Director of Housing Management was added to the MHFA staff prior to this round of projects. In addition, the potential adverse impact of rental increases is less serious under the Section 8 program, since the subsidy will absorb rental increases attributable to operating expense inflation, provided that the Agency aggressively bargains with HUD for the increases and demonstrates that it has adequately controlled expenses.

While our analysis suggests that rental increases are not likely to be required for the Section 8 projects, unforeseen circumstances could change this interpretation. If future increases are needed, some difficulties may arise. Most of the Section 8 projects have projected contract rents that are at or very close to the established ceilings. Any possible requirements for rent increases can only be met by raising the ceilings. Analysis of these projects, some of which have reached operational status and some of which are close to beginning operations, should be performed in order to identify those projects that might require rent increases. In those cases, the Agency should make known to HUD the inadequacy of the current rent ceilings. Our investigation did not examine this issue in depth. However, it seems appropriate for the Agency to begin negotiating with HUD for increases in maximum allowable rents in those cases where further analysis reveals it is appropriate. Since projects typically experience a surplus of cash in the first year of operations, these potential problems will not appear acute for some time. Since such increases are not an automatic process, the Agency will be better off if it anticipates these future needs before they become acute.

A number of other problems were observed in the Agency's review and monitoring of project operating data. Most of the forms and regulations currently used are adequate. However, the Agency has not diligently reviewed these report forms. Review and monitoring of project operating data would be improved considerably by the introduction of an automated information system. This will be especially critical to cope with the expanded number of projects requiring Agency supervision.

Management of Risk

The Agency further protects itself from financial problems by establishing a set of cash reserves to cover resource shortfalls. An analysis of Apartment Development reserve accounts suggests that MHFA cash reserves for the Section 236 projects are substantial and appear adequate at least for the near future. The reserves can absorb the current level of deficits for about three years. Thus, the Agency is adequately protected by its reserves if it negotiates certain rent increases from HUD and begins to control unusual operating expenses.

The situation is better for the projects under the Section 8 subsidy program. These projects appear less risky, since initial rent levels were established more adequately and since the Section 8 subsidy covers reasonable future increases in operating expenses.

In general, the Agency does not appear to have overexposed itself financially with its apartment projects, nor will it incur such overexposure if it implements the above recommendations.

IMPLICATIONS FOR PROGRAM ORGANIZATION

The past sections of this review of the Apartment Development Program have presented the major findings of this evaluation. A number of organizational, procedural, and staffing changes are implied by these findings. This section presents the major changes that appear appropriate to correct for past problems or to adapt to future program needs.

AGENCY GROWTH AND FUTURE FINANCING NEEDS

The rapid growth of the Apartment Development Program, resulting primarily from the high level of funding in 1976 for the Section 8 program, could present the Agency with some new problems. In the past, the scale of operations in this program was quite small. This will change dramatically in the near future, as the 80 projects recently accepted for feasibility study will need to be reviewed and modified, then constructed, and finally managed.

The problem of arranging permanent financing for such a large number of projects and for continued growth will be one of the first impacts of this increased scale of operations. A large volume of both short-term bond anticipation notes and long-term revenue bonds will have to be issued. Two potential problems appear imminent, because of this continued high level of Agency financing. First, there is some question whether the Agency will be able to market, in the anticipated short time period, this large a volume of long-term bonds at rates considered reasonable. And secondly, there is the potential danger of a large overhang of short-term debt. The latter problem is presently recognized by the Agency, and the risk has been minimized by its self-imposed limit on short-term debt. The Agency has adopted a firm policy of limiting its short-term debt to $50 million and adopted a flexible financing plan capable of staying within this limit. The Agency's financing policies and plan are discussed more fully in the final chapter of this report.

Program Management

In the past, a rather informal organizational style has characterized this program. This division was small, staff consulted each other frequently, and decisions and procedures were as much reactive as they were planned. In the future, this informal style will be less possible and probably will have to give way to a more formal organizational or bureaucratic operational mode. The workload will, in all likelihood, increase to such an extent that the previous informal, collaborative mode will need to be replaced with staff taking on more specialized tasks and working more independently. In addition, it is likely that the executive director will have to delegate major program decisions to subordinates and confine his participation primarily to program review and planning. To some extent, this has already happened.

PROGRAM STAFFING

The number of staff currently employed in the Apartment Development Division appears reasonably adequate for present levels of apartment investments. In all likelihood, the Division will have to expand to keep pace with the rapid growth that is signified by the 80 new projects accepted for processing.

At this point, the most obvious stress point on Agency staffing is with the Housing Development Officers (HDOs). Their work loads are heavy and have recently expanded. At present, the technical demands placed on the HDOs appear greater than their collective experience warrants. Some pre-selection review responsibilities might be transferred to the design review staff.

In addition, there is a need for additional technical staff with prior experience in order to strengthen the design review process. Finally, the number of staff needed in the Housing Management Division should expand somewhat in the future.

Table II.5 illustrates exactly how the present growth rate will impact on the various sections of the Apartment Development Division over the next few years. The first and immediate impact of rapid growth is on the Housing Development Officer staff, as well as on the market analyst and the architect. Increases in the number of applications creates additional work for the HDOs and the market analyst, while the large number of projects selected for feasibility analysis impacts upon the HDOs, the market analyst, the architect, and the Housing Management Officer (initial budgeting of operating expenses). The second impact is delayed by six months to a year and primarily affects the construction inspection staff. The final impact is delayed by another six months and affects the time commitments of the project management staff (HMOs). As can be seen from the above table, the number of apartment units requiring Agency supervision and oversight will increase dramatically one to two years in the future.

It must be recognized that the ability of the Agency to attract and/or retain experienced people is constrained somewhat by having to work through the state civil service system. The salary levels attached to the various staff positions make it difficult to compete with the private sector. As a result, the Agency frequently must hire persons with limited experience and provide them with apartment development experience on the job. Once such experience is gained, it may be difficult to retain them. In a situation of rapid growth, the ability to train new personnel adequately, while simultaneously implementing the program, is difficult at best. It is apparent that the working relationship between the Agency and the Department of Personnel is strained and probably requires re-examination. This topic is discussed more fully in another Legislative Audit Commission staff paper, *An Evaluation of the Management of the Minnesota Housing Finance Agency.*

PROJECT SELECTION AND OVERSIGHT

We have already indicated that the quality and the financial viability of the Agency projects are heavily dependent upon a set of decisions made at the time of initial selection and design review. It is apparent that there is some need for tightening up the initial decisions and review of Agency projects. As the scale of operations of this program expands, there is some concern that insufficient staff and time will be left for careful project selection and review. Addition of technical staff in the design review process

TABLE II.5
PROJECTED AGENCY GROWTH PATTERN

Projects	1974	1975	1976	Est. 1977	Est. 1978
In Operation (HMO's)			10*	34	114
Under Construction (Construction Inspections)		11	24	80	
Project Analysis (HDO's, Technical Staff)	11	24	80		
Preliminary Submission (HDO's)	17	80	201		

Apartment Units	1974	1975	1976	Est. 1977	Est. 1978
In Operation			764*	2,918	9,179
Under Construction		794	2,154	6,261	
Project Analysis	794	2,154	6,261		

**30 units from the FHA insured project are not administered by MHFA.*

will help, as well as attempts to conduct preliminary design review and analysis of developer qualifications and financial backing as early as possible prior to firm Agency commitments to applicants.

MANAGEMENT OF INFORMATION

There currently exists a need for the development of a better system for compiling, managing, and analyzing information on the operating apartment projects. At present, the Agency manually reviews, analyzes, and compiles data. This process of information management will not prove sufficient for the anticipated increase in the number of projects requiring oversight and supervision. The analytic capabilities of the Housing Management staff would benefit from the development of a more adequate automated information system. Automated analysis of operating projects can aid the process of identifying problems and anticipating financial difficulties before they become serious. A better information retrieval and analysis system can provide project staff with financial data, budget information and comparisons, and tenant information to facilitate a host of Agency management decisions and actions. For example, such information would be helpful in project selection, in evaluating program effectiveness, in serving designated target groups, in assessing portfolio financial soundness, and in satisfying external reporting requirements.

CHAPTER III

THE HOMEOWNERSHIP PROGRAMS

The Homeownership Division of the Minnesota Housing Finance Agency provides below market interest rate mortgage loans to low and moderate income families for the purchase of single family homes. MHFA has funded and completed two homeownership mortgage loan programs – the GNMA-Insured Mortgage-Backed Security Purchase Program (GNMA Program) and the initial Mortgage Purchase Program. In addition, they have begun three other homeownership programs. These are the Affordable Homes Program, the Indian Homes Program and the modified Mortgage Purchase Program. This evaluation of the homeownership programs of MHFA focuses upon the first two of these five programs, since these are the only ones which are presently completed and for which performance data are available.

This chapter is divided into four sections:

1. a brief description of MHFA's five homeownership programs;
2. a summary of the findings of the evaluation of these programs;
3. a discussion of the implications of these findings for the management of MHFA's Homeownership Division; and
4. a discussion of the policy issues raised by the study.

A more detailed treatment of these and related topics can be found in the Legislative Audit Commission staff report: *Evaluation of The Homeownership Programs of the Minnesota Housing Finance Agency.*

The GNMA and Mortgage Purchase Programs, MHFA's first two homeownership programs, were financed through the sale of revenue bonds. The Agency sold to private investors tax-exempt revenue bonds which were backed by the mortgages, bond proceeds, and the moral obligation of the state. It used the proceeds of the bond sales to finance mortgage loans at below market interest rates. All loans were required to be FHA-insured or VA-guaranteed in order to reduce the risks to investors. The first program was provided with additional security through Government National Mortgage Association (GNMA) guarantees. Two of the current homeownership programs, the Affordable Homes and the Indian Housing Programs, have been financed through legislative appropriations rather than by bond proceeds. Such appropriation funded programs are able to provide a much deeper level of housing assistance than the bond funded programs, though their greater cost to the state limits their scope.

MHFA's homeownership programs are targeted toward low and moderate income households. In order to operationally define "low and moderate income", the Agency has established an upper limit on the adjusted gross annual family income of participants in the programs. Initially, the upper limit for metropolitan areas (the seven county Twin Cities metropolitan area, Rochester, Duluth, St. Cloud, and Moorhead) was set $1,000 higher than for rural areas, but more recently a uniform statewide upper income limit has been used. The limit has ranged from a low of $11,000 (nonmetro) and $12,000 (metro) for the GNMA Program (1973-74) to $16,000 for the newly launched second Mortgage Purchase Program. For the adjustment method used, participants' adjusted incomes have averaged about $1,100 less than their gross family incomes.

Most of the homeownership programs allow for the purchase of either new or existing homes. However, only new construction is permitted under the Affordable Homes Program. Under the modified Mortgage Purchase Program, mortgage interest rates for the purchase of new homes are 3/4% lower than for existing homes, since MHFA is attempting to stimulate a significant amount of new construction with it. All programs require that the home be owner occupied, though most allow for the purchase of one-to-four unit homes. Only the Affordable Homes Program prohibited the purchase of attached housing; the others allowed both attached and detached single family housing.

MHFA also set a limit on the cost of the housing which would qualify for mortgage loans. The limit has varied by program (from about $23,500 to $37,500) and has always been less than the median sales price of new homes sold during that time period. Most programs have had a somewhat lower limit for nonmetro areas than for metro areas.

MHFA uses private lending institutions to deliver its mortgage funds. Usually, lenders make advance commitments to the Agency to originate a mutually agreeable amount of qualifying mortgage loans. An advance commitment fee from participating lenders helps insure that they will actually originate the loans they agreed to originate. For the bond financed programs, the amount of commitments received helps determine the amount of bonds which will be sold.

The actual role of the private lenders in these programs is not greatly different from their normal mortgage lending role. That is, the lenders (or the tribes, for the Indian Housing Program) solicit applicants and screen them for eligibility using the criteria established by MHFA. The Agency itself also screens the mortgage applications which have been approved by the lenders. Once the loans are made and approved by MHFA, the lenders (or mortgage servicing institutions) service them, passing on the principal and interest payments (less the servicing fee) to MHFA so that the Agency in turn can repay the bond holders (for bond funded programs) or reloan the money (for appropriation funded programs). For participating in these programs, lenders receive mortgage origination and servicing fees fairly comparable to prevailing rates for these services.

Table III.1 summarizes many of these descriptive features of the homeownership programs.

TABLE III.1
CHARACTERISTICS OF MHFA'S HOMEOWNERSHIP PROGRAMS

Program Characteristic	GNMA Program	Mortgage Purchase Program	Affordable Homes Program	Indian Housing Program	Second Mortgage Purchase Program
Time period (approximate)	1973-74	1975-76	1976-77	1977	1977
Source of funds	bonds	bonds	appropriations	appropriations	bonds
Funding level (millions)	$30	$54	$5	$5	$80
Mortgage interest rate	6.75%	8-8.25%	1-8%	3.5%*	6.5-7.25%
Maximum adjusted gross income	$11-13,000	$15-16,000	$16,000	$16,000	$16,500
Maximum price/value	$34-36,000	$34-36,000	$23,500-32,500	$34-36,000	$37,500
Number lenders participating	8	84	50	**	147
Number mortgages	1261	1928	165-175	150-160	2200-2400
Percent new construction	34%	3%	100%	Est. most	Est. 90%

*One tribe has set this interest rate.
**To date, no private lenders are making loans under this program since it is being directly administered by the participating tribes.

PROGRAM RESULTS

MHFA has provided a large volume of mortgage loans to qualifying homebuyers. The GNMA and Mortgage Purchase programs have distributed approximately $80 million in homeownership loans to over 3,000 eligible families. By the time the three current programs are completed, the Agency will have provided approximately $162 million of below market interest rate mortgage money to over 6,000 eligible families. Of this amount, all but $10 million will have been generated by the sale of revenue bonds, with the remainder coming from legislative appropriations.

There were considerable differences among the programs in the levels of mortgage interest subsidy they provided. The interest rate under the GNMA program was 6.75 percent, about 1.75 percent below the market interest rates during that time period. The security and timing of the bonds was responsible for this relatively large subsidy. The bonds were doubly secure, since they were backed by the full faith and credit of the U.S. government, as well as by the moral obligation of the state and Agency reserves. The timing of the bond sale was optimal, since it occurred just prior to substantial increases in mortgage interest rates. The bonds for the Mortgage Purchase Program, on the other hand, were not guaranteed by GNMA and were sold just prior to a substantial decrease in market interest rates. These factors resulted in a very small interest subsidy for this program, only about 0.5 percent on the average.

Only eight private lenders participated in the GNMA Program. GNMA's minimum size limit for guaranteed mortgage pools prevented wider participation. Initially, this was set at $2 million (about 70 to 80 loans), a target which could be attained only by large urban lenders. The requirement that all mortgages be FHA-insured or VA-guaranteed further deterred participation, since many small rural lenders lacked the capability or willingness to process FHA or VA loans. Finally, the newness of MHFA (this was its very first program) engendered skepticism from many lenders, who adopted a "wait and see" attitude at the time.

For the Mortgage Purchase Program, one year later, there was no minimum size for lender participation, since GNMA was not involved. Moreover, lenders were generally enthused about the potential of the program. In all, 105 applied to participate in the program, and 84 of them actually committed themselves. This represented a substantial growth in lender participation. Since MHFA relies on private lenders to distribute its mortgage funds, broad lender participation in these programs is essential for obtaining a reasonable geographic distribution of the Agency's homeownership funds.

To date, MHFA's home mortgage loans have been distributed throughout the state, but it appears that the Twin City metropolitan area has been somewhat overserved relative to the outstate areas.

IMPACT ON THE HOUSING STOCK

An important objective of the homeownership programs has been to stimulate housing construction in the state. The Agency has attempted to do this by channeling at least part of its funds into mortgage loans for new homes. Its record has been uneven in this regard. While 34 percent of the mortgages under the GNMA Program went for new home purchases, only 3 percent of those under the Mortgage Purchase Program served this purpose. The Affordable Homes Program, while limited in scope, is totally directed toward new home construction. And the recently initiated modified Mortgage Purchase Program will channel an estimated 90 percent of its funds into mortgages for new homes by setting a lower interest rate for them than for mortgages for existing homes.

Despite these efforts to channel mortgage money toward new home purchasing, there is reason to doubt whether MHFA has achieved this. There is reason to believe that the mortgages issued by the Agency for homeownership might be offset to a significant degree by a substantial decline in private sector mortgage lending activity. Furthermore, by channeling funds toward new home mortgages, the Agency is less able to meet some of its other objectives. Specifically, this policy tends to eliminate lower income persons who cannot afford new housing, even with the shallow subsidy of the program, but who could afford to buy cheaper existing homes. In addition, fewer people can be served, since loans for new homes tend to be larger under these programs.

DISTRIBUTION OF BENEFITS

The programs vary considerably in the extent to which they subsidize mortgage interest rates. In general, appropriation funded programs are capable of providing significantly greater subsidies than programs funded by bond proceeds, but, because the former are quite costly to the state, they are more limited in the numbers of families they can serve. The Affordable Homes Program (the only program with sliding interest rates) provides interest rates of from 1% to 8%, depending on the applicant's ability to pay: i.e., the lower one's income, the greater the subsidy. The Indian Housing Program is also providing deep interest subsidies to its participants. The interest subsidies under MHFA's three bond funded programs, on the other hand, are much shallower, ranging from about 0.5 percent to 1.75 percent on the average.

The degree of interest subsidy offered by a program largely determines how deeply into the target population it can reach. As shown by the data of Table III.2, the GNMA and Mortgage Purchase Programs served primarily those with incomes in the upper qualifying ranges. Given the higher eligibility limits and shallower subsidies of the Mortgage Purchase Program, it served persons with somewhat higher incomes, on the average, than did the GNMA program. After adjusting for inflation, the incomes of those served by the Mortgage Purchase Program averaged about $1,000 higher than the incomes of those served by the GNMA Program. In addition, the interest rate under the Mortgage Purchase Program was both higher and less subsidized than the rate under the GNMA Program. Thus, it was even less able to reach low income persons. Significantly deeper interest subsidies than these would be needed to enable most lower income families to become homeowners. It is too early to tell how deeply into the target population the other three MHFA homeownership programs will reach. Presumably, the two appropriation funded programs (i.e., the Affordable Homes and Indian Housing Programs) will reach a greater proportion of lower income persons.

TABLE III.2
GROSS FAMILY INCOME OF MORTGAGE LOAN RECIPIENTS FOR MHFA'S HOMEOWNERSHIP PROGRAMS

	Homeownership Program	
Gross Family Income	GNMA (1973-74)	Mortgage Purchase (1975-76)
$0 – $3,999	0%	0%
$4,000 – $5,999	0.6%	0.2%
$6,000 – $7,999	4.9%	1.3%
$8,000 – $9,999	19.5%	8.1%
$10,000 – $11,999	45.8%	19.9%
$12,000 – $13,999	27.6%	32.1%
$14,000 – $15,999	1.7%	23.3%
$16,000 – $17,999		14.8%
$18,000 – $19,999		0.2%
$20,000 and over		0.1%
	100% (N=1261)	100% (N=1928)

USE OF FEDERAL SUBSIDIES

Another justification for state government intervening in the private market is to capitalize on federal subsidies. In the Homeownership programs, federal subsidies are available in the form of the tax break available to purchasers of Agency bonds. The use of this tax break allows the Agency to sell bonds at lower interest rates and to pass this savings along in the form of lower mortgage interest charges. Bond financed programs take advantage of this federal subsidy; state appropriation financed programs do not. However, as we have already indicated, the tax subsidy in bond funded programs is shallow.

BENEFIT-COST ANALYSIS

On the average, MHFA's bond financed programs can be expected to generate net benefits for the state, with the primary benefit being the interest subsidy they provide to participating mortgagors. Their ability to provide an interest subsidy arises not only from the tax break they offer bond buyers, as noted above, but also from the security inherent in the moral obligation of the state. Generally, the Agency's relatively secure tax free revenue bonds can be sold for about one-to-two percentage points less than the market mortgage interest rate. After adding administrative costs, the programs are generally able to provide average interest subsidies of about 0.5 percent to 1.75 percent, depending primarily upon whether market mortgage interest rates rise, fall, or remain constant after the bonds are sold.

The GNMA Program, for example, happened to anticipate sharp increases in market mortgage rates, and it provided interest subsidies of about 1.75 percent on the average (i.e., 6.75 percent versus approximately 8.5 percent). This enabled it to produce significantly more benefits than costs for the state; the benefit-cost ratio was 1.35. During the Mortgage Purchase Program, however, mortgage interest rates dropped sharply, leaving the program with an interest subsidy of only about 0.5 percent on the average (i.e., approximately 8.25 percent versus 8.75 percent). Largely because of this timing, the costs of the program to the state will probably slightly outweigh the benefits. The benefit-cost ratio was 0.98. The newest bond funded homeownership program, the modified Mortgage Purchase Program, apparently will provide interest subsidies ranging from about 0.75 percent to over 2.5 percent, for an average of roughly 2 percent, depending upon whether the comparison rate is the conventional or FHA rate. Provided the private market mortgage interest rates do not decrease significantly during the first half of 1977, this program should generate net benefits for the state.

GEOGRAPHIC DISTRIBUTION OBJECTIVES

The Agency has attempted to distribute homeownership loans throughout the state in order to achieve a reasonable balance between metropolitan and nonmetropolitan areas. However, the actual geographic distribution of the Agency's homeownership program benefits has been more limited than was initially intended. That is, rural areas have tended to receive less than a proportionate share of the benefits (as compared with their proportion of the state's population), while metropolitan and especially suburban areas have generally received a disproportionately greater share.

The primary reason for this pattern of distribution lies in the use of private lenders to distribute program funds. Small, rural lenders have been less willing to participate in these and other government programs. Furthermore, those that do participate tend to make many fewer loans than large, urban participating lenders.

The development of an extensive delivery system has been an important goal for MHFA. In general, the Agency has been able to expand the number of participating lenders with each homeownership program. This should better enable it to meet its geographic distribution goals in the future.

PROGRAM MANAGEMENT ISSUES

A number of program management issues are suggested by the above findings. These are discussed below.

PROGRAM GROWTH AND THE TIMING OF BOND SALES

The Agency has recently issued $80 million in bonds to finance a new Mortgage Purchase Program. This implies continued funding of the homeownership program at a high level, and it raises a number of questions concerning the optimal bonding strategy in this program. The Agency has two alternatives. It may go to the market on a fairly continuous schedule or it may choose to time its issues on an intermittent schedule.

The benefit-cost analysis of the first two homeownership programs suggested that programs which are timed such that their bonds are issued prior to rising private market mortgage interest rates (e.g., the GNMA Program) tend to generate significantly greater net benefits and have a stronger impact on the housing stock than those for which bonds are issued prior to declining market rates (e.g., the Mortgage Purchase Program). This implies that the Agency should attempt to time its bond sales in order to maximize the difference between the market mortgage rates and the yield on Agency bonds. If this were possible, the Agency could maximize the benefits per dollar of bonds issued and increase the financial viability of its programs.

Following an intermittent bonding program potentially offers two additional advantages over continuous bonding. First, it could help limit the amount of homeownership bonds the Agency would issue over a given period of time. This would minimize the chances that the Homeownership Program might crowd out other beneficial programs. Second, it would minimize the possibility of the Agency competing with private sector loans. There is some evidence, particularly during periods of declining interest rates, that a significant part of the Agency's loans may be offset by a decline in private sector loans. Since interest rates are difficult to forecast, it is not easy to implement such an intermittent bonding strategy. However, to the extent that proper timing is achieved, such a strategy offers a number of advantages over a continuous bonding strategy.

The primary advantages of a continuous bonding strategy appears to be the availability of continuous interest subsidies, the ability to more fully utilize the Agency staff working in the homeownership area and greater continuity in lender-Agency relationships.

DEVELOPMENT OF A DELIVERY SYSTEM

MHFA's decision to use private lending institutions to deliver homeownership funds has several advantages: (1) it enables the Agency to minimize the number of in-house staff working in this area; (2) this, in turn, allows some flexibility for pursuing an intermittent bonding strategy, since a small staff could be more efficiently reassigned or carried over during slack periods of program activity; and (3) the use of private lenders probably increases outreach to outstate residents.

Nevertheless, the outreach to rural areas is still much less than optimal. In addition, this reliance on private lenders results in the forfeiture of some control over program operations and decision making, e.g., in the recruitment and initial screening of applicants. MHFA has minimized this forfeiture of control by using a type of program (i.e., variations of the forward commitment mortgage purchase program) which gives it the opportunity to monitor more closely the delivery of loans to the target population. Had the Agency chosen a loan-to-lenders type of program that has been widely used by other state HFAs, it would have sacrificed review power. A better information system would further improve the Agency's capabilities to monitor its programs.

Attrition in lender participation has not been a problem for MHFA. The number of lenders participating has grown with each new program.

FINANCIAL MANAGEMENT

The fiscal viability of the bond financed homeownership programs depends upon whether program revenues will be sufficient and timely enough to meet the debt service requirements of the bond issues. To date, the delinquency and default rates of MHFA's mortgage loans has been very low and, given an adequate spread between bond yields and the mortgage interest rates, the programs can be expected to generate sufficient revenues. However, the timeliness of the revenues is not so clear. Since the Agency had not done explicit cash flow analyses for its homeownership programs at the time of our evaluation, it has not been possible to determine whether or not the cash flow will be adequate. Given its complexity, such an analysis, without an initial cash flow analysis as a base, was beyond the time frame of this evaluation.

The most serious question of financial viability exists for the initial Mortgage Purchase Program. There was considerable delay in the delivery of the funds for this program. This delay occurred as a result of the falling mortgage interest rates in the private mortgage market shortly after the program began. This effectively negated much of the relative advantage of participating in the program. Consequently, lenders experienced difficulty making loans. The falling interest rates also gave lenders an incentive to keep possession of the loans they had made instead of selling them to MHFA in a timely manner. Because of this delay in delivering the program funds, the Agency was forced to invest them elsewhere for a few months. But, it incurred a significant capital loss on this investment, which further reduced the viability of the program. As indicated above, it has not been possible for us to ascertain the ultimate financial impact of this delay.

PROGRAM POLICY ISSUES

This evaluation of MHFA's homeownership programs raises at least two major policy issues. These concern: (1) the target population, and (2) the stimulation of new construction. These issues are discussed below.

TARGET POPULATION

The finding that the bond financed programs serve primarily those with income in the upper ranges of the eligible population raises the issue of whether the Agency should attempt to serve lower income households with this type of program. Our findings indicate that, even with the optimal timing of the Agency's bond sales, the resulting interest subsidies are generally insufficient to reach lower income households.

Deeper subsidies are required in order to effectively assist lower income households with homeownership. There is some question about whether this alternative is worth the cost. Appropriation financed programs, while capable of providing deep subsidies, are very costly to the state. For example, the $5 million appropriated for the Affordable Homes Program will generate only about 170 loans. In addition to being quite costly, such programs also raise serious equity issues, since the few participants receive very substantial assistance while non-participants of comparable economic status receive nothing.

Some alternatives exist for restructuring bond financed homeownership programs in order to increase their capability of reaching lower income households. One alternative would involve de-emphasizing the more costly new construction and placing greater emphasis upon existing housing or more economical single family attached housing. However, these alternatives are likely to have limited impact. In addition, de-emphasizing new construction is contrary to MHFA's present legislative mandate.

There is no easy solution to this problem. Currently, MHFA's bond funded homeownership programs provide shallow interest subsidies to primarily moderate income families. There are political reasons for supporting such limited objectives. That is, homeownership has traditionally been prevalent and strongly preferred in Minnesota, and larger numbers of the state's residents could be served by the larger, but relatively cheaper, shallow subsidy bond funded homeownership programs than by deep subsidy appropriation funded programs.

THE STIMULATION OF HOUSING PRODUCTION

The apparent rationale for the legislative mandate regarding the stimulation of housing production is that it would increase the state's housing stock while stimulating employment in the construction industry. Our analysis raises doubts about whether MHFA's bond financed programs actually have this effect, since it appears that a sizable share of this lending, for both new and existing construction, is offset by a resulting decline in private sector mortgage lending activities.

Furthermore, the pursuit of this goal of stimulating housing production has various monetary and non-monetary costs which conflict with other Agency goals:

1. Program restrictions emphasizing new construction may increase program costs by slowing the delivery of funds. This would make programs less fiscally viable and/or less beneficial to participating mortgagors.

2. New homes are more expensive than otherwise comparable existing homes. Thus, program features which emphasize new construction discourage the participation of those less able to afford homeownership.

3. Mortgage loans tend to be larger for new homes. Thus, fewer loans can be made under a program emphasizing new construction than under an identical program which emphasizes existing construction.

Given these costs and the uncertainty that bond financed programs like the GNMA and Mortgage Purchase Program create a net increase in housing production, it is reasonable to ask whether the benefits from emphasizing new construction through these programs are worth these increased costs. There might be more effective means for the legislature to stimulate housing production in the state.

CHAPTER IV

THE HOME IMPROVEMENT PROGRAMS

The Minnesota Housing Finance Agency was the first state HFA in the country to make home improvement loans and grants on a statewide basis. Amendments to Agency enabling legislation in 1974 added the power to engage in rehabilitation activities to the previously existing powers to finance homeownership and apartment development. Since 1974, the Agency has completed two phases of the Loan Program. The evaluation of MHFA home improvement activities will focus upon these two phases. The Grant Program was initiated in September, 1976, and only minimal data were available at the time of this study. Hence, we will only describe the structure of this program. A more detailed description of the findings of this program review can be found in the LAC staff paper, *Evaluation of the Home Improvement Program of the Minnesota Housing Finance Agency.*

The MHFA Home Improvement Loan Program makes insured loans at below market interest rates to families and individuals meeting eligibility criteria. Phase I of the loan program, which ran from August, 1975 to June, 1976, was financed from the proceeds of a bond sale of approximately $9 million and provided installment loans at an interest rate of 7.75 percent. Phase II of the Loan Program, which ran from June to December, 1976, was funded from both bond proceeds and a legislative appropriation. $15.9 million in bonds were sold to finance this phase of the program, and in addition, the Agency used $4.6 million of legislation appropriations to supplement and provide additional security for the bonds. The appropriated funds were used to reduce interest rates in proportion to borrower income. The interest rate paid on mortgage loans in this phase varied from 8 percent to 1 percent, depending upon household income. Security for the home improvement bonds is provided through FHA Title I insurance, the establishment of cash reserve accounts, and careful management of the loan portfolio.

The Agency has developed a loan distribution plan that sets targets for each region of the state. The loans are distributed through a network of private lenders and public agencies that participate voluntarily in the program and are located in all regions of the state. The Agency solicits commitments from lenders to originate a specific amount of loans and requires that the lenders pay an advance commitment fee to insure that this amount of loans will be made. These commitments determine the amount of bonds to be sold.

Individual borrowers apply for the loans from participating lenders in their area of residence. The lender screens applicants for eligibility and sends the accepted loan applications to MHFA for review. If approved, the Agency purchases the loan, pays the lender a loan origination fee, and remits a portion of the commitment fee. The MHFA assumes responsibility for loan servicing and collection.

Persons and families with adjusted annual incomes of up to $16,000 are eligible for home improvement loans. Properties of one to six units and which are at least 15 years old or are in need of repair to correct hazardous conditions or damage caused by natural disasters qualify for home improvement assistance. The Agency allowed most types of property improvement eligible under the FHA Title I programs to be made during the first two phases of this program. Loans can be made for up to twelve years. Unsecured loans of up to $7,500 or secured loans of up to $10,000 can be made.

The MHFA Home Improvement Grant Program provides grants to eligible homeowners with adjusted gross incomes of up to $5,000. The program is funded entirely by legislative appropriations. Grants of up to $5,000 are made to single family or duplex properties that are at least 15 years old or need repairs to correct damages or hazardous conditions. Repayment of all or part of the grant is required if the grantee sells or transfers the property within five years of the grant approval date.

An allocation plan based upon certain indicators of need has been developed for this program. Grants are originated and distributed in all of the state's economic regions through MHFA selected Grant Administration Centers (GACs), typically local government bodies or nonprofit organizations. Presently, 72 city and county governments and 18 Community Action Agencies are serving as GACs. Their combined Agency defined service areas cover the entire state.

Prospective grantees apply at the GAC serving their area of residence. A property inspection is made to identify deficiencies and needed improvements. The GAC or a grant committee convened by the GAC determines applicant eligibility and then forwards the application to MHFA for review and approval. If approved, the grantee can begin work. Grant funds are held in escrow by the GAC until a final inspection determines that all planned work has been completed satisfactorily.

PROGRAM RESULTS

Table IV.1 presents basic information on the structure of the two home improvement loan programs, and the grant program. The Home Improvement Loan Program has made loans to approximately 5,700 borrowers, totaling over $24 million. In addition, the Agency had made 878 grants, totaling over $2.3 million, by the end of December, 1976. It is difficult to evaluate this level of production, since no external standards exist.

TABLE IV.1
CHARACTERISTICS OF MHFA HOME IMPROVEMENT PROGRAMS

	Loan Program Phase I	Loan Program Phase II	Grant Program
1. Period of Operation	Aug., 1975 – June, 1976	June – Dec., 1976	Sept., 1976 – July, 1977
2. Size of Bond Issue	$8,985,000	$15,895,000	NA
3. Appropriations Utilized for Program	– 0 –	$4,625,000	$9,000
4. Number of Participant Lenders or Grant Admin. Centers	73	176	90
5. Number of Loans or Grants Made	1,895[1]	3,804[1]	878[2]
6. Loan or Grant Dollars Distributed	$8,027,000[1]	$16,541,104[1]	$2,388,263[2]
7. Average Size of Loan or Grant	$4,236[1]	$4,348[1]	$2,720[2]
8. Average Interest Rate	7.75%	5.35%[1]	NA

[1]*Information taken from MHFA Home Improvement Weekly Status Reports, June 28, 1976 (Phase I) and January 12, 1977 (Phase II).*
[2]*Information taken from MHFA Home Improvement Grant Program Demographic Profile, December 29, 1976.*

Since lender participation is essential for delivering loans, this evaluation looked at the number of lenders recruited, the proportion continuing to participate, and the percentage of the eligible population that had already access to a lender participating in the Agency's Home Improvement Programs. By all of these criteria, the Agency was relatively successful. During Phase I, the Agency recruited 67 commercial banks, four savings and loan associations and two HRAs to serve as lenders for the program. During Phase II, participation increased to include 165 commercial banks, eight savings and loans and three HRAs. Data show that 90 percent of the lending institutions that participated in Phase I continued to participate in Phase II. Finally, it is estimated that ready access to a participating lender is available to over 80 percent of the state's population.

A lender survey indicated general satisfaction with the program and the Agency's technical assistance. The major complaint of lenders was that the income limits were too high and, consequently, the Agency's loans competed with their own.

IMPACT ON THE HOUSING STOCK

Amendments to the MHFA legislation suggest that an objective of the Home Improvement Program is for the Agency to finance loans directed toward physical improvement of the state's housing stock and toward the upgrading of substandard and deteriorating housing. The legislation dealing with home improvement allows these funds to be used for a variety of purposes.

It is difficult to assess the impacts of the home improvement loan programs upon the existing housing stock of Minnesota, because the Agency has collected only limited data on the type of home improvements made and because it is difficult to interpret the data that have been collected. Only two limited observations are possible.

One indicator of the type of property being improved is the age of the home. In general, it is reasonable to presume that older homes are more likely to be in need of repair. Data from Phases I and II of the loan program indicate that over 50 percent of the loans have been applied to homes that are over 35 years old. This provides some very limited indication that the loans are appropriately directed.

Secondly, the Agency collects data on the type of home improvements proposed by borrowers. Unfortunately, these data were classified in a manner that made it difficult to determine the extent to which the improvements helped to eliminate substandard or deteriorated housing. However, it was possible to recategorize approximately half of the improvements into three "impact" categories. Using this process, we found that approximately 28 percent of the loan dollars were spent on improving the market value of the home, 12 percent to eliminate substandard or deteriorating conditions, and 11 percent to improve energy efficiency. The impacts of the remaining 50 percent could not be determined.

Since the Agency has not established goals for the distribution of home improvement resources, it is not possible to make any substantive statements about these results. It appears that the Agency could make some fairly simple form changes which would improve the documentation of the results of its activities in this area. If after monitoring the distribution of resources, it finds that the resulting use of the loans is unsatisfactory, the Agency could attempt to impose further controls on the type of improvements made and property improved.

DISTRIBUTION OF BENEFITS

The target population for MHFA's Home Improvement Loan Program consists of Minnesota's low and moderate income homeowners. The Agency set the upper eligibility limit for the adjusted gross family income of participants at $16,000.

Table IV.2 (column "a") shows the estimated distribution of the state's eligible homeowners across various gross income categories. By comparing the actual distribution of participants in the Phase I and II loan programs (columns "b" and "d") to this distribution of the eligible population, it is apparent that these programs tend to serve disproportionately greater numbers of those families with gross incomes over $9,000.

Furthermore, under the Phase I program (column "c"), the average program benefit (i.e., interest subsidy) was greater for those with higher incomes, since on the average those borrowers tended to take larger loans for longer terms. Under Phase II (column "e"), in which loan interest rates varied proportionately to income, the reverse pattern was found. That is, Phase II benefits were inversely related to income, despite the fact that those borrowers with higher incomes still tended to take loans of greater size and longer terms. Thus, under this program, the actual distribution of benefits, or at least the portion arising from state appropriations (column "f"), was much more proportional to the distribution of the target population itself. Nevertheless, while the quantities of benefits going to persons in each qualifying income group was more proportional to need, there were still proportionately fewer in the lower income groups who participated.

The Home Improvement Grant Program, on the other hand, exclusively serves those with very low incomes. Virtually all grantees have gross family incomes of less than $6,000. When considering the

TABLE IV.2

DISTRIBUTION OF BENEFITS AMONG RECIPIENTS AT VARIOUS INCOME LEVELS LOAN PROGRAM, PHASES I AND II, AND GRANT PROGRAM

	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
		Phase I[1]		Phase II			Grant Program		Phase II Loans Combined with Grants	
Estimated Gross Income	Percent Eligible Population	Percent Loans	Mean Benefits[2]	Percent Loans	Mean Benefits[2]	Percent State Subsidy	Percent Grants	Percent State Subsidy	Percent of Total Number of Loans and Grants Distributed	Percent of Total State Subsidy for Both Programs
$1 – $6,000	21.1%	4.0%	$ 98	5.7%	$792	9.7%	100%	100%	31.9%	70%
$6,001 – $9,000	15.6%	8.2%	$168	15.2%	$733	22.7%			10.9%	7%
$9,001 – $12,000	18.6%	23.4%	$178	30.2%	$622	38.1%			21.7%	13%
$12,001 – $15,000	23.1%	34.4%	$204	30.8%	$484	24.2%			22.2%	8%
$15,000 and Over	17.6%	30.0%	$227	18.1%	$293	5.4%			13.0%	2%
Total	100%	100% (N=1871)		100% (N=2270)		100%	100% (N=878)	100%	100% (N=3148)	100%
							(Mean benefit = $2,700)			

[1] No state subsidies were involved in the Phase I programs, since the interest rate for all loans was 7.75 percent.
[2] This represents the present value of the benefits which will accrue over the entire loan term. The actual size of the benefits will be significantly greater.

combined distribution of the state appropriations involved in the Phase II Loan Program and the Grant Program (column "j"), we find that the under-$6,000 income group receives over two-thirds of the benefits from this source, and that generally fewer benefits go to Minnesotans in the higher qualifying income categories.

However, there is a deviation in that pattern for those with incomes between $6,000 and $9,000 which make up the group just above the income level qualified for the grant program. During Phase II, this group received 15 percent of the loans, which was nearly double the proportion received under Phase I. However, that group's share of the state loan subsidy was only 23 percent, which was lower than that of each of the next two higher income groups. When combined loan and grant data are considered, this group makes up over 16 percent of the population eligible for loans and grants, yet received only ten percent of the state subsidy available under the program. Those benefits are substantially less than those distributed (primarily through grants) to the income category immediately below, and less than those distributed through loans made to the next two highest income groups.

This inequity is mitigated somewhat in the Twin Cities, Duluth and in other localities where the HRA operates a local rehabilitation loan program funded from community development funds, HUD 312 funds or local resources. Those programs are administered by public agencies which emphasize serving lower income persons who frequently cannot qualify for private sector or FHA Title I insured loans. Consequently, a high proportion of those served are in the $6,000 to $9,000 income group, which is currently underserved by the State's program.

In summary, then, the following was found:

1. The Phase I Home Improvement Loan Programs served greater number of persons with gross incomes in the upper eligible range. This was also true of the Phase II Program, but to a lesser extent.

2. In the Phase I Loan Program, where there was a uniform loan interest rate, those with higher qualifying incomes received on the average much larger total benefits, since they tended to take larger loans with longer terms.

3. Under the Phase II Loan Program in which sliding rates were used, those in the lower income groups received significantly greater benefits on the average than those in the higher groups, and the distribution of the program's state subsidy funds was roughly proportionate to the distribution of the eligible population across these categories. Nevertheless, less than a proportionate number of the lowest income group were served.

4. The Home Improvement Grant Program served exclusively those in the lowest income group. The average benefits under this program are much greater than those for either loan program.

5. The lowest income group received the great majority of the state subsidy dollars involved in the Phase II Loan Program and the Grant Program combined. Higher income groups generally received decreasing shares, except for the group just beyond the limits of the Grant Program which received a relatively small share.

These data show an overall trend in the Home Improvement Programs toward increasing vertical equity in the distribution of program benefits, where those with lower incomes are receiving an increasing share of home improvement assistance. This is the result of the introduction of state subsidies in the form of reduced interest rates for the Phase II Loan Program and in the form of grants under the Grant Program. This increased vertical equity is thus not without increased cost to the state.

USE OF FEDERAL SUBSIDIES

As in the Homeownership Program, federal subsidies are available to the Home Improvement Loan Programs in the form of the tax break available to purchasers of Agency bonds. The bond financed Loan Program takes advantage of this federal subsidy. The appropriation-financed Grant Program and appropriation generated revenues for the Phase II Loan Program do not utilize federal subsidies, which can significantly reduce the costs of the program to the state.

BENEFIT-COST ANALYSIS

Based upon a cost-benefit analysis of the first phase of the Home Improvement Program, it is possible to say that this program has generated net benefits for the state. Fundamentally, the net benefits resulting from a bond financed Home Improvement Program depend upon the difference between the market rate for home improvement loans and the yield the Agency must offer on its bonds. The greater the difference, other things being equal, the greater net benefits generated by the program.

Since Phase II of the Home Improvement Program was too new to evaluate, only the results of the first phase of the Home Improvement Porgram are reported here. The results are fairly reliable. The only parameter that had to be estimated was the relative weight to be given to costs and benefits incurred at different time periods. Depending on the assumptions about this parameter, it was determined that the benefit/cost ratio for the Home Improvement Program (Phase I) was between 1.05 and 1.22. Thus, this program generated net benefits for the state. The results for the second loan program may be lower, because substantially more of the state's resources are used in this program. The benefit/cost ratio for the Grant Program might also be lower, since even more state resources are used in this totally appropriation-funded program and no federal subsidies are used.

OTHER PROGRAM OBJECTIVES

Another objective against which the Agency's Home Improvement Program must be assessed is the geographic distribution of benefits. In order to assess the Agency's success at meeting this objective, it is necessary to establish some criteria against which to measure Agency performance. For the purposes of this study, it was decided to use the Agency's established targets. Before presenting the results of the Agency's performance against these criteria, it is important to note that these targets are viewed by the Agency as guidelines. Furthermore, the Agency has only limited control over the geographic distribution of loans, since it relies upon private lenders for distribution.

During Phase I of the Home Improvement Program the Agency established simple geographic distribution goals — to distribute fifty percent of the resources in the Twin City metropolitan area, and fifty percent outside the metropolitan area. As measured by this criterion, the Agency was quite successful, for fifty-two percent of the loans were distributed within the metropolitan area and forty-eight percent to regions outside the metropolitan area.

Prior to Phase II, MHFA developed a refined distribution plan, based on the premise that resources should be distributed to each region in approximate proportion to the state's eligible households located in that region. The narrative accompanying the distribution plan also specified that "the level of resources targeted for the metropolitan area is adjusted from 37% to a range of 35-45% in recognition of the resources needed to combat central city deterioration and that because of the importance of improving housing delivery capacity outside of the Twin Cities area, commitments made by lenders will not in general be cut back if these exceed the suggested percentages". These comments suggest that the Agency intends that these targets be regarded as flexible guidelines rather than as absolute standards. With this in mind, it is possible to compare the Agency's targeted distribution of loan dollars among geographic areas with the actual distribution. Table IV.3 presents these regional distributional targets along with the actual results grouped into major geographic areas of the state.

The regions have been grouped in four areas: North Central, South and the Twin Cities metropolitan areas. There were two major reasons for the grouping. First, looking at the targets on a regional basis did not allow sufficient sample size to draw any conclusions. Second, the grouping provides a convenient method of reducing the detail to a level that is easier to grasp. The primary disadvantage of grouping the regions is that it is somewhat arbitrary. It is important to point out that, while it was quite unintentional, this particular grouping maximizes the variance from target. The data show that the Agency has come close to meeting its own distribution goals in the Central and South groupings of regions. However, it appears that the metropolitan area is over served by comparison with the other areas, though its Phase II proportion of loans exceeds by only three percent the upper limits established for that region. It is further evident that the Northern area of the state has been underserved during both phases of the program, and that the proportion of Phase II loans going to that area was even smaller than the proportion distributed during Phase I.

TABLE IV.3

COMPARISON OF PROPORTIONAL DISTRIBUTION OF LOAN DOLLARS AMONG GEOGRAPHIC AREAS

		Loan Dollars Distributed			
		Phase I		Phase II	
Geographic Area	Target	Proportion to Area	Variance from Target	Proportion to Area	Variance from Target
North (Region 1-5)	29.5	19.3	−10.2	14.3	−15.2
Central (Region 6-7)	11.3	14.9	+3.6	16.5	+5.2
South (Region 8-10)	22.3	13.3	−9.0	20.9	−1.4
Twin Cities Metropolitan Area (Region 11)	36.8 (35-45%)	52.1	+15.3	47.8	+11.0

PROGRAM MANAGEMENT ISSUES

The following are some program management issues that emerged from the evaluation of performance outcomes in the Home Improvement Loan Program.

TARGET POPULATION

The analysis of who receives the program benefits of the loan and grant program suggests that there are still some unresolved equity issues. For example, persons with adjusted gross incomes less than $5,000 receive much greater assistance under the Grant Program than under the Loan Program. Unfortunately, Grant funds are in short supply and so are not available to all eligible applicants. An even greater inequity is created by the large difference in benefits received by borrowers in the Loan Program with adjusted gross incomes just above $5,000 and those in the Grant Program with incomes below the upper limits of $5,000. In order to enhance vertical equity, the Loan and Grant Programs should be better integrated to smooth out this large difference in benefits. It might be possible to combine the monies of these two programs and to give those in the lower income categories a combination of loans and grants to enable them to secure the needed assistance though their "payback" capability is limited.

A second policy issue concerns eligibility limits for the Home Improvement Loan Program. For Phase I and Phase II Programs, MHFA has set the upper limit of adjusted gross family income at $16,000 (i.e., equivalent to an unadjusted income of about $17,500 for a family of four). This was higher than the state's median family income in 1976, and an estimated 61% of all Minnesotan homeowners could qualify on income criteria. In some outstate counties, nearly 90% of all homeowners could qualify for the program. Some participating lenders stated that, because these income limits were too high, the program competed with their own home improvement lending activity, since the same people qualified for both their conventional loans and MHFA loans. MHFA has proposed lowering the eligibility limit to an adjusted gross family income of $14,000. At this income level, somewhat over half of Minnesota's homeowners could have qualified in 1976. Even at that level, the program may still compete with some private lenders' home improvement loan activities.

DEVELOPMENT OF A DELIVERY SYSTEM

In order to develop a low cost system to deliver loans throughout the state, the Agency has had to rely primarily upon private lenders. The decentralized lending network utilized by the Agency has a number of advantages over systems that would rely more upon the public sector or upon a more centralized system. The two principal advantages are that it obviates the need for the Agency to develop a large in-house staff to administrate the program and it allows for a broader geographic distribution of loans. In fact, without substantial appropriations, it is unlikely that the Agency could have implemented the program in any other way. The principal disadvantages of the decentralized system are the loss of strong controls over the lending process and the assumption of risk on the part of the Agency for lending decisions which it did not make. Given the limited financial incentives that the Agency can offer to participating lending institutions, it is difficult for the Agency to impose strong controls over the loan program without risking the loss of lenders. The consequences of separating the loan origination function and the risk-bearing function is discussed in the section on financial management which follows.

A final disadvantage of relying upon the private sector for loan origination and distribution is that the Agency cannot directly control the geographic distribution of the loans. We have already reported that the Agency has had some problems in meeting its geographic targets for the Northern area of the state. If the objective of achieving proportional distribution of loans is viewed as an important goal, there are two alternative strategies the Agency might pursue. It could attempt to recruit more lenders in the areas that have been relatively underserved. However, it is possible that changing the distribution may come at the cost of reduced production due to allocating recruitment efforts away from more productive regions. The other alternative would be to limit commitments in areas that get a greater-than-proportional distribution of loans. This choice would clearly be made at the cost of reduced loan production.

FINANCIAL MANAGEMENT

The quality and management of the loan portfolio is a critical factor in determining whether the program will generate adequate cash flow to meet the bond debt service requirements. The primary impact of the loan portfolio on the cash flow is through delinquent payments and, in more extreme cases, through defaults.

The Agency's criteria and procedures for review of lender-approved loans to insure compliance with FHA guidelines were the subject of two FHA reviews. In the opinion of both field reviewers, the Agency lacked sufficiently detailed and restrictive loan review criteria and procedures in a number of areas. While there are trade-offs between taking risks and being able to serve certain classes of borrowers, the reviewers made a number of recommendations that should reduce the inherent risk in the Agency's loan portfolio. In the case of the Agency loans, this criteria is particularly important, since private lenders, who actually perform the credit review, do not assume the risk of the loan, although they must warrant proper credit underwriting.

The LAC auditors also assessed the adequacy of the Agency's loan review process. The findings and concerns were similar. Some of the findings in the LAC review of Phase I of the program were that loan applications did not contain adequate investigation of the applicant's credit, that notes in the loan files had material defects and a significant percentage of the loan files contained no verification of the applicant's income. It is apparent that these problems were a result of understaffing and a lack of explicit review standards. The Agency has recognized that there were problems in the loan review process and has taken steps to mitigate the problems. After the first two months of Phase II, most of the problems mentioned above were eliminated.

The Agency's collection procedures generally follow FHA guidelines. The 90 day delinquency rate has increased somewhat over the past six months. It is difficult to determine whether this is a natural result of the aging of the loans or is due to inadequate collection activity. There are some indications that collection activity declined at the beginning of Phase II. During the first five months of that phase, the professional staff spent almost all of its time in loan reviews and approval. The Agency recognized the problem and transferred the collection activity to a support unit, where an accounting officer was designated to devote his time exclusively to collection activities. More recently, it was decided to contract with a private-sector firm for collection services.

The Agency significantly reduced the potential cost of defaults by using FHA "Title I" insurance. This insurance essentially provides for reimbursement equal to the sum of 90 percent of the net unpaid amount of the loan and 90 percent of the uncollected interest earned up to the date of default. The Home Improvement Loan Program is otherwise too new to adequately assess the risk associated with the loan portfolio. The Agency has reduced potential risk by using Title I insurance and by responding to problems in the loan review and collection process. On the other hand, the lack of implementation of adequate review criteria and early problems in the loan review process may have resulted in greater risk among Phase I loans than would have been necessary had the Agency followed a more prudent course of action.

Unfortunately, lack of comparative situations makes it difficult to assess the implications of these factors. Consequently, we did a cash-flow analysis which enables us to determine how sensitive the financial viability of these programs is to alternative assumptions about default rates, as well as other factors.

The cash flow analysis of the first phase of the loan program indicates that the total receipts over the life of the program may decrease by approximately $209,000 from the initial estimates. This is primarily attributable to the fact that the Agency delivered its loans more slowly than anticipated. If our estimate is correct, then the Agency's initial estimate of a surplus of receipts over disbursements of $77,000 must be adjusted. Our calculations suggest that the program may suffer a deficiency of approximately $132,000. The Agency currently has sufficient reserves to cover this deficiency.

Additional analyses were done to determine how sensitive the program's viability would be to changes in default rates and earnings on interim investments. It was found that, under some plausible assumptions, the program may need more reserves than are presently dedicated to the bonds. However, since it is difficult to determine if the Agency's credit creiteria and review process are deficient, it is not possible to conclude that additional reserves will definitely be needed for this program. It does appear that much of the current reserves will be depleted. If additional reserves are required, they are unlikely to be needed until the later years of the program.

The Phase II program has more than adequate cash flow to meet almost any plausible outcome. Furthermore, since the loan review process has improved under this program, the loan portfolio may be of higher quality.

CHAPTER V

SUMMARY AND MAJOR POLICY ISSUES

This final chapter summarizes the findings of this evaluation and discusses a number of policy issues raised by these findings. For convenience, we distinguish between the policy issues dealing with the internal operations of MHFA and the implementation of its housing programs and those facing the legislature in its role as policymaker and overseer of state agency operations.

SUMMARY OF FINDINGS

The analyses of the three major programs of MHFA have yielded a number of specific findings. This section reviews these findings in terms of the overall problem facing the Agency: how well has the Agency financed housing construction, purchase, and rehabilitation for low and moderate income families, and at the same time minimized the financial risk of these programs by structuring them in such a way that they generate sufficient revenues to repay the bonds or are protected by adequate reserves?

PROGRAM PERFORMANCE

There are a number of ways to summarize the performance of the various Agency housing programs. For convenience, we will recapitulate the findings of this evaluation in terms of a number of evaluation criteria:

Loan Production: The Agency's loan production record has been good. In each of its three major programs, the Agency has demonstrated the ability to raise the capital necessary to finance home purchases and rehabilitation and to finance apartment construction. Each of these programs has grown over time, making more money available for housing assistance. Since 1973, the Agency has financed or, based upon present commitments, will finance approximately 11,500 units of new housing, 3,600 units of existing housing, and 6,500 units of rehabilitated housing. The Commission on Minnesota's Future has estimated an annual need for 40,000 new housing units per year for Minnesota from 1976 to 1985. It is apparent that, while the Agency has contributed substantially to annual housing production, the need for new housing continues to remain large.

Program Mix: Much of the past strength of the Agency has been its ability to serve the needs of a variety of people through its mix of programs directed toward new single family and apartment construction, as well as the rehabilitation and preservation of the existing housing stock. This response to a diversity of housing needs is in contrast to many other state HFAs, which have concentrated upon new apartment construction.

Impact on State Housing Stock: In Apartment Development, the Agency has financed the construction of units at a time when private sector financing was decreasing dramatically. This program has had a strong, and probably long-lasting, impact on the construction of apartment units directed at the low and moderate income apartment housing market and has probably served to keep rent levels down in this market. On the other hand, there is some reason to believe that the Homeownership programs have not had an impact on the single family housing stock, because Agency financing may be largely offset by a decline in private sector financing. In Home Improvement, there is strong reason to believe that, as the program is presently structured, Agency loans compete with private sector loans. In addition, it is not possible to document to what extent Agency rehabilitation loans contribute to the preservation of the existing housing stock, as opposed to merely improving property values.

Distribution of Benefits: Each of the three programs distributes housing assistance to low and moderate income households, as "low and moderate income" has been defined by the Agency. However, there are major differences in the degree to which these different programs reach lower income households. By far, the Apartment Development Program serves proportionately more lower income households than the Homeownership and Home Improvement Programs. This is a result of the deeper subsidies from the federal government and because of the lower cost of multifamily housing. Both the Homeownership and Home Improvement loan programs attract primarily households with incomes toward the higher end of the eligible population. Table V.1 summarizes the data on housing assistance recipients for each of the three housing programs.

Use of Federal Subsidies: In order to fulfill its function of providing subsidized housing without drawing on state appropriations, the Agency must continue its policy of taking advantage of federal subsidies when and where they are available, with the recognition that these funds may be expected to fluctuate in magnitude and focus. The largest amount of federal subsidies available to MHFA is in the Apartment Development Program — the direct rent subsidies. To date, the Agency has fully utilized this source of funding and has produced apartment units to the capacity provided by the subsidies. Without these subsidies, all bond-financed programs take advantage of a federal subsidy in the form of a tax break for bond investors.

Benefit-Cost Analysis: Each of the three housing programs can be expected to generate net benefits for the state. Only the Mortgage Purchase Homeownership Program failed to generate a positive benefit-cost ratio, primarily because of problems in the timing of the bond sale. It is not likely that this problem will reoccur to this extent. The Apartment Development Program generated the highest benefit-cost ratios, primarily because of its utilization of available federal rental subsidies. To the extent that state appropriations are used to fund programs in whole or in part (as has been done in the Affordable Homes Program, the Indian Housing Program, and the second phase of the Home Improvement Program), the benefit-cost ratios can be expected to decline.

Geographic Distribution: The geographic distribution of apartment units has been reasonably consistent with the Agency-defined targeted objectives, with approximately half of the subsidized units being located in the Twin Cities metropolitan area (Region 11). Given the Agency's weak controls over lender participation, the geographic distribution of loans under the Homeownership and Home Improvement programs was satisfactory. However, the Homeownership Program has underserved rural areas relative to the Twin Cities metropolitan area, while the Home Improvement Program has underserved the northern part of the state. Aside from attempting to encourage greater participation of lenders in those areas, the Agency has little direct control over this problem.

Program Management Issues: The following summarizes a number of findings related to the management of each of MHFA's housing programs.

1. Apartment Development Program: While the use of formal and explicit project selection criteria has improved since the first round of apartment selection, the Agency continues to experience problems analyzing the large number of project applications that it receives. For example, the preliminary selection process for the third round of apartment developments was hampered by the necessity of dealing with 80 projects in a short period of time and with limited staff. There is concern that this problem will reoccur for the next round of selections as well. Thus, better scheduling of project application review and the addition of technically-trained staff as is planned by the Agency would help alleviate the crush of work experienced in the past.

   Overall, project quality has been good, but analysis revealed a degree of variability that suggests the Agency might not be fully utilizing its control and review powers. While construction inspection and cost certification have been excellent, the design review process should be strengthened. In addition to the hiring of technically-trained staff, the Agency should analyze project design and construction specifications as early as possible in the selection process.

   In order to control operating risk, the Agency has developed and implemented a practice of risk-sharing which places the main burden for performance upon the private and non-profit developer. However, the initial Section 236 projects have experienced operating deficits created primarily by inadequate initial budgeting and secondarily by lack of expense control. The Agency appears to have corrected for this problem in its budgeting for the later Section 8 projects. Yet, expense control still needs tightening and would be aided by the development of a more adequate management information system. In addition, rent increases will be required for at least five of the ten

TABLE V.1

INCOME STATUS OF HOUSEHOLDS SERVED BY EACH MHFA PROGRAM

Gross Family Income*	Apartment Development (Section 236 Only): Market Rate (1976)	Apartment Development (Section 236 Only): Shallow and Deep Subsidy (1976)	Apartment Development: Total	Homeownership: GNMA Program (1973-74)	Homeownership: Mortgage Purchase Program (1975-76)	Homeownership: Total	Home Improvement: Loan Program Phase I (1975-76)	Home Improvement: Loan Program Phase II (1976)	Home Improvement: Grant Program (1976-77)	Total
$6,000 or Less	25%	73%	59%	1%	0%	0%	4%	6%	100%**	22%
$6,001 – $9,000	19%	21%	21%	12%	3%	7%	8%	15*	%	10%
$9,001 – $12,000	25%	5%	11%	58%	26%	39%	23%	30%	%	22%
$12,000 – $15,000	12%	1%	4%		44%	38%†	34%	31%	%	27%
Over $15,000	19%	0%	5%		27%	16%†	30%	18%	%	19%
Total	100%	100%	100%	100%	100%	100%	99%	100%	100%	100%
	(201)	(493)	(694)	(1,261)	(1,899)	(3,160)	(1,871)	(2,270)	(935)	(5,076)

*These data are not entirely comparable between programs since they were gathered during different time periods. In addition, some of the programs are still ongoing. Thus, these data should be regarded as gross, rather than precise, indications of the economic status of the households served by MHFA.

**Direct data on the incomes of home improvement grant recipients was unavailable at this time, but it is assumed that nearly all will have gross incomes of less than $6,000, since their adjusted gross incomes cannot exceed $5,000.

†Under the GNMA Program, only 20 (1.7%) of the mortgagors had gross incomes of $14,000 or more. We have assumed that one-fourth of these (5) had incomes over $15,000.

original apartment projects in order to eliminate current deficits. The Agency will also need to improve its review of monthly operating reports in order to continue to control costs.

2. Homeownership Program: Administration of this program has, for the most part, been satisfactory, although it should be noted that most of the administration is carried out by the lending institutions. The timing of the GNMA program was good, resulting in an adequate interest reduction. However, the timing of the bond sale for the Mortgage Purchase program was less fortunate, resulting in very little interest reduction.

3. Home Improvement Program: Credit review and loan collections were a problem in the first phase of this program, but corrective action was taken to improve on these activities for the second phase.

FINANCIAL VIABILITY

A major objective of this evaluation was to assess the financial viability of the Agency. An analysis of the Agency's loan portfolios, reserves, and cash flow indicates that the agency has no immediate financial problems. However, as discussed in Chapter II, it is important that the Agency immediately pursue needed rent increases on its Section 236 projects in order to avoid a depletion of its reserves.

In addition to the need for rent increases, it was found that the monthly 236 project operating reports were not being reviewed. There is still need for corrective action in this area.

The evaluation uncovered two other potential problems, though these are of less significance than those discussed thus far. The first concerns the Phase I Home Improvement Program. After completing audits of this program, both the FHA and the Legislative Audit Commission expressed reservations about the adequacy of MHFA's loan review criteria and processes. Because this program is relatively new, it is not possible to determine whether the above problem had a significant impact on the quality of the Agency's loan portfolio. The second problem concerns the Mortgage Purchase Program. As discussed in Chapter III, the Agency encountered some problems in the early stages of this program. At the time of this evaluation, the Agency had not performed a cash flow analysis for this program; nor have we done that analysis, since it would have been too time consuming for this evaluation. Consequently, it has not been possible to determine whether these problems can be handled with the current reserves allocated to this program.

The problems noted above generally occurred in the early stages of the respective programs. MHFA responded to the early problems of the Apartment Development Program by developing more adequate budgets. In addition, the Section 8 projects appear to be inherently more viable than the Section 236 projects because of the structure of the federal funding. Considerable improvement was found in the loan review process during Phase II of the Home Improvement Program. The problems that occurred in the Mortgage Purchase Program were primarily a result of unfortunate timing. The GNMA Homeownership Program was very successful, and it appears that the most recent Homeownership Program of the Agency has been well timed.

It is important that these findings are viewed in the proper perspective. The major problem involves the Section 236 apartment development projects. If the agency can successfully implement the needed rent increases and take corrective action to maintain proper monitoring in the future, then the program should be financially viable. While it is too early to be certain, it is not likely that the potential problems of the Mortgage Purchase Program and Phase I Home Improvement Program will affect the financial viability of the Agency.

The evaluation also addressed the Agency's management of its interim investments. With the exception of the purchase of the GNMA securities, the Agency's investment management was found to be satisfactory.

ACCOUNTING PRACTICES

As part of this comprehensive evaluation, the Financial Audit Division of the Legislative Auditor's Office conducted a limited review of the records of the Minnesota Housing Finance Agency. The following areas were investigated: loan file compliance, monthly operating statements of multi-family projects, interfund transfers, file security, disbursement control, integration of the MHFA accounting system with the Statewide Accounting System, and the Construction Loan Note Program. The findings of this audit are summarized in detail in the LAC report, *Evaluation of the Management of the Minnesota Housing Finance Agency.*

In general, the current accounting practices of the Agency were judged adequate. However, the audit revealed certain instances of inadequate review by Agency staff of home improvement loan files and monthly operating statements for multi-family projects.

In addition, there was some question with regard to disbursement control in using the bond counsel for the printing of bond resolutions. It was the opinion of the State Printing Office that the cost of printing the resolutions would be significantly less if state services were used instead. Moreover, that office suggested that the practice of using the bond counsel for printing bond resolutions was in direct violation of state law regarding bidding by state agencies for services that exceed $5,000.

AGENCY INTERNAL POLICY AND ADMINISTRATIVE ISSUES

This evaluation of the three major MHFA housing finance programs has yielded numerous findings about the operations and performance of each of these programs. The individual program descriptions contained recommendations concerning ways in which these individual programs might be improved. This section will highlight the major policy recommendations implied by the findings and will discuss them in the context of overall Agency policy and operations.

AGENCY GROWTH AND FUTURE FINANCING NEEDS

In the near future, the Agency will have to contend with the implications of its rapid growth. Over the past three years, each of the major housing finance programs has increased in scale. Apartment Development accounts for much of this growth. Beginning with eleven projects in 1974, this program has grown to its present level of processing 80 new projects during the coming year. With its recent $80 million bond issue, the Agency almost doubled the long term debt issued to support home mortgages. The Home Improvement Program has increased substantially in a short period of time. It has granted over 5,500 loans since August, 1975. Overall, the Agency has grown from a small staff of five in 1973 to a large organization of over 50 staff members in 1977. In addition, it is planning to add 21 new positions by the end of FY 1977.

The future financing needs of MHFA will be large. The Agency plans to issue a high volume of both short-term notes and long-term bonds at frequent intervals. According to the Agency's financing plan, the estimated bonding requirement for MHFA over the next 18 months totals between $305 and $350 million, compared with a previous total bonded indebtedness for the Agency of about $232 million (as of 1/1/77).

Access to the bond market is presently favorable. This is particularly true for the MHFA because of the good reputation of the Agency and the state as a whole for fiscal responsibility. However, the bond market is highly volatile. This volatility makes the availability of long-term financing for the Apartment Development Program uncertain. Thus, as the Agency commits itself to a large number of projects in order to use the available federal subsidies, it is important that it minimize the accumulation of a large volume of short-term notes issued to finance construction. In recognition of this potential risk, the Agency has developed a financing plan to minimize this problem and to incorporate its policy of limiting unfunded short-term debt to $50 million. Furthermore, the Agency director has indicated that, if difficulties occur in refunding the short-term debt, it will delay further project commitments. The Agency's self-imposed short-term debt limit and the development of a plan to keep within this constraint are excellent steps toward reducing the inherent risk of this program. It is highly recommended that the Agency continue this policy.

Some concern has been expressed about the overall debt level of the Agency, especially in relation to the state's debt. The existing and projected capital needs of MHFA have become significant in comparison with those of the state. As of June 30, 1976, the Agency had a total long-term debt of $209 million, compared with the state's long-term debt of $615 million as of December 31, 1975. Thus, the Agency's liabilities equaled about 34 percent of those of the state. Two factors make these figures appear even more important: (1) much of the debt issued by MHFA is of long maturity — 30 to 40 years; and (2) the future bonding plans of the MHFA programs. If the Agency growth objectives are achieved, MHFA outstanding bonds will be equal to about 80 percent of the present outstanding debt for all other agencies and programs of the state.

At the present rate of activity, the Agency will reach the $600 million debt ceiling around the end of FY 1978. Thus, the legislature must either choose to extend the debt limit or to curtail expansion of the Agency's programs.

This decision involves some difficult trade-offs. The exact nature of the trade-off is highly dependent on the financial viability of the Agency's programs and what the bond market perceives as the underlying security of the bonds. There are indications that the bond market currently perceives the MHFA as a well-run, financially viable Agency. If the market continues to view the Agency in this manner and looks to the programs for the financial security of the bonds, then the Agency's bonding should not impede the state's ability to issue general obligation bonds. Under these circumstances, the cost of increasing the Agency's debt limit does not seem high. On the other hand, if the market looks to the state for the underlying security of the Agency's bonds, the trade-off becomes more difficult. It then may be possible that the Agency could impede the state's ability to raise funds for other programs.

The effect of the Agency's overall debt upon the state's ability to issue general obligation bonds is contingent upon the attitude of the bond market. To the extent that the bond market continues to evaluate Agency bonds in terms of Agency program viability, there appears to be little need to legislatively limit overall Agency debt. Under these conditions, the market should impose constraints upon Agency growth. It is not possible to predict the future of the bond market psychology. If it should change, then large increases in Agency financing might impinge upon the ability of the state to issue general obligation bonds. The decision to raise the overall Agency debt limit must be made with this imprecisely defined risk in mind.

PROGRAM MIX: THE ALLOCATION OF SCARCE RESOURCES

The early history of the MHFA has been characterized by the relative availability of capital. Furthermore, it is presently an opportune time to raise funds in the bond market. Consequently, aside from its legislatively-imposed debt limit, the Agency has had little reason to consider questions of program trade-offs or program mix.

However, it is likely that at some time in the future, the Agency will encounter constraints on its ability to obtain resources. This may occur as a result of legislatively imposed debt limits, changes in the availability of federal subsidies, or changing conditions in the bond market. These constraints will require that the Agency choose among alternative programs. The selection from these alternatives involves the following four considerations (which correspond to our major evaluation criteria): (1) which programs generate greater net benefits to the state; (2) which programs positively impact on the state housing stock; (3) which programs best serve the appropriate target populations; and (4) which programs are most politically acceptable.

If MHFA is faced with difficult choices about the allocation of its resources, as we feel it will, the answers to the above questions should provide guidance as to which programs should receive funding priority. The findings of this evaluation, while not yielding unequivocal answers, do provide initial guidance. In short, the Apartment Development Program appears to perform best in terms of the ability to meet the diversity of objectives set for the Agency. Thus, if MHFA must at some future time choose to limit some activities in order to continue expanding others, it appears that the Apartment Development Program should be given priority over the Homeownership and Home Improvement Programs. This recommendation is subject to a number of qualifications delineated below.

Table V.2 presents both actual and adjusted benefit-cost ratios for each of the MHFA housing programs. Two conclusions emerge from an examination of unadjusted benefit-cost ratios: (1) with the exception of the Mortgage Purchase Homeownership Program, all MHFA programs generate benefits greater than resource costs to the state. These programs generally can be expected to provide net benefits because of the availability of federal tax and rental subsidies that are not treated as costs to the state; (2) the Apartment Development Program Section 8 projects are likely to generate the greatest net benefits of all of these programs.

One could conclude that the programs with relatively high benefit-cost ratios should be given priority over those with lower ratios in order to maximize the MHFA's benefit to the state. However, there is some ambiguity to the unadjusted benefit-cost ratios. The unadjusted ratios are heavily affected by differences in the yields of the various bond issues of these programs. These different yields reflect the recent instability of the bond market, to some extent. Thus, it is necessary to account for these changes in the bond market over time in order to predict the benefit-cost ratios of future programs.

TABLE V.2
BENEFIT/COST RATIOS

Program	Actual B/C Ratio	Adjusted B/C Ratio
Apartment Development — Section 236*	1.17	1.12
Apartment Development — Section 8*	2.00	1.72
Homeownership — GNMA Program	1.35	1.01
Homeownership — Mortgage Purchase	0.98	1.00
Home Improvement — Phase I	1.22	1.00

**These ratios include property taxes as a cost.*

A set of adjusted benefit-cost ratios were calculated. Unfortunately, the adjustment process eliminates the federal interest subsidy attached to the bonds and the effect of the difference in risk of a particular bond issue. This adjustment process understates the value of a program that offers relatively high security to bondholders. However, the adjusted benefit-cost ratios still can be employed to give some indication of the relative benefits of MHFA programs.

The most striking feature of Table V.2 is the dichotomy between the high apartment development ratios and the lower ratios in other programs. This is due to the presence of large federal subsidies in the Apartment Development Program which enter as benefits in the benefit-cost ratios. If the MHFA has to make a choice in the future between expanding its apartment development activities and expanding other programs, it should choose the former alternative. This conclusion is subject to two qualifications:

(1) Another program may be more favorable, if it can be funded by bonds with a much lower yield. For instance, since the bonds funding a program such as the Homeownership GNMA Program generally present less investor risk than bonds in the Apartment Development Program, it may be advisable in the future to issue some of the relatively secure homeownership bonds in order to take advantage of their low bond yields and, in effect, draw funds into the state.

(2) The MHFA faces a limited supply of federal commitments for new apartment development subsidies. The benefit-cost ratios presented above are representative of the results that could be

expected in future programs as long as the MHFA does not exceed its federal subsidy constraints. If the Agency builds apartment projects in the future with smaller proportions of subsidized units than its current programs, their benefit-cost ratios could be expected to fall below the results presented in Table V.2.

Conclusions drawn from the results of the cost-benefit analysis are based on an implicit assumption that the goal of state policy is to maximize the value of the benefits generated by its programs, regardless of the distribution of those benefits and the form they take. In reality, the state legislature has expressed its interest in other goals, and state programs must be judged on the basis of their contribution with respect to these goals as well as their net benefits.

In terms of impact on the state housing stock, the Apartment Development Program has clearly increased the stock of apartment housing in the state, has probably had a positive impact on holding down rents in the low income market, and is likely to have a long run positive effect on the low cost apartment housing market. The impact of the other housing program on the stock of housing is less clear. It does not appear that the bond-funded Homeownership Programs will have a positive long run impact on new construction, while the appropriation-funded programs are necessarily limited in scope. The impact of the Home Improvement Program on the stock of existing housing is difficult to measure.

Similarly, the Apartment Development Program appears to transfer benefits to low and moderate income individuals more effectively than the other MHFA programs. Because of the use of federal rental subsidies, the Apartment Development Program more effectively reaches lower income persons and families and will generate a large number of relatively deep subsidies for low income households. This program has also made major efforts to serve the special needs of the handicapped and developmentally disabled.

Thus, the Apartment Development Program appears to perform better than the Homeownership and Home Improvement Programs on three major evaluative criteria: generating benefits for the state, impacting on the housing stock, and distributing benefits to the appropriate target populations. This is not to imply that the other MHFA programs are impractical — they also generate net benefits for the state and distribute housing benefits to moderate income households, although it is difficult to determine that they impact positively on the housing stock. It is to imply that, in a situation of limited resources, Apartment Development deserves priority.

The fourth evaluative criteria, political acceptability, points in another direction. Although it is difficult to measure this, it appears that the Homeownership and Home Improvement Programs generate less political opposition or controversy than the Apartment Development Program. It is not possible to suggest how important political acceptability should be in overall Agency activities, but it cannot be ignored. It certainly argues against a total curtailment of all but Apartment Development activities.

Until now, the Agency has not been faced with stringent funding limitations, although it is always possible to say that funding falls short of need. However, if it becomes apparent that high levels of bond financing of one housing program serves to limit the ability to sell bonds for another program, then it may be necessary to re-evaluate the continued existence of the Homeownership and Home Improvement Programs at their present levels of funding.

AGENCY MANAGEMENT

Until recently, the executive director has played a strong and pervasive role in the activities and decisions of each of the major MHFA programs. However, the rapid increase in the scope of Agency activities and the increase in the size of the organization limit his ability to participate directly in all of the major decisions and processes. It is likely that the executive director will increasingly have to delegate major decisions to subordinate program managers and confine his involvements in program operations to program review and planning. In addition, the informal process of decision making will have to be replaced by more formal, public, and accountable criteria for major program decisions, such as the establishment of eligibility criteria, apartment project selection criteria, and so on.

AGENCY STAFFING

The number of staff employed by the Agency over time reflects the recent expansion in Agency activities. In 1973, five employees were on board; in 1975, this had increased to 30; by 1976, 56 were employed.

In spite of this, there is a strong need for additional staff in the Apartment Development Program and a more limited need for more staff in the Home Improvement Program. It is recommended that the Agency pursue alternatives to past practices of bringing in relatively inexperienced junior staff and giving them on-the-job training. The need for experienced and technically trained staff in Apartment Development should be given priority. The Agency's recent budget to the Department of Finance indicates the intention to add 21 new positions.

In the past, the Agency has had problems working through state civil service procedures, claiming that the classified system is not responsive to Agency needs for rapid recruitment and selection and that promotional requirements are cumbersome and rigid. As a consequence of these problems, the Agency has relied on the use of provisional appointments and the Governor's Internship Program. This should be discontinued. In addition, the salary ranges for professional staff are rather low and should be re-examined. The working relationship between the Agency and the Department of Personnel should also be re-examined. Some attention should be devoted to the possibility of reclassifying or de-classifying some professional positions.

MANAGEMENT INFORMATION SYSTEM

Program planning, selection decisions, program monitoring, and management control in all three housing programs would be facilitated considerably by the development of a computerized system of information retrieval and analysis which would be under the direct control of the Agency. At present, the analytic capacities of Agency staff are limited by poor management of information and operating data. An improved management information system would not only assist program managers in implementing and monitoring loans and programs but would also facilitate Agency accountability to external bodies, such as the legislature and HUD.

INTERIM INVESTMENT PERFORMANCE AND MARKETING OF BONDS

Some members of the legislature have expressed concern about the Agency's interim investment performance and their techniques of marketing bonds. These issues have not been addressed in the main body of the report because they are not program specific.

A detailed analysis of the Agency's interim investment performance and policies is available in the staff report, *Analysis of MHFA Investment Practices.* In brief, it was found that with one exception the Agency has managed its interim investments in a satisfactory manner. The one exception was the Agency's decision to purchase GNMA securities with part of the then undelivered funds of the Mortgage Purchase Program. Three factors account for the unsatisfactory investment:

(1) the difficulty of forecasting the time path of interest rates;

(2) a lack of expertise in the GNMA market on the part of the MHFA's staff and financial advisors;

(3) an unforeseeable fall in the market value of GNMA securities.

This analysis indicates that there is little reason to change the policies of the Agency to improve its investment performance. The investment report does offer some policy alternatives that would give the State Board of Investment a more active role in the management of the Agency. However, the major gain that would result from these alternatives would be to reduce private sector control of the Agency's investment activity.

The question about the Agency's marketing of bonds involves the decision to sell these bonds via negotiated arrangements with underwriters. This evaluation did not extensively research this issue, because there are strong indications that the Agency has had no real alternative. However, the issues are summarized below.

There are two ways in which MHFA can market its bonds: negotiated arrangements and competitive bids. Under both methods, one or a group of investment banking firms working together on an issue assure the Agency a definite sum of money at a definite time. The underwriting investment banking firms are willing to back their judgment as to the marketability of the issue at a proposed public offering price by agreeing to purchase the entire issue at a certain firm price, assuming the risk that they will be unable to resell the issue to the public. Thus, the investment banking firms assure, or underwrite, the issue and add the function of risk-taking to their selling function. Underwritten issues may be marketed under either negotiated arrangements or public sealed bid arrangements, commonly known as competitive bid deals. In negotiated arrangements, price and other key factors are determined by a pure bargaining situation between the underwriter and the institution that wishes to raise the funds. Under competitive bid arrangements, the bonds are effectively sold to the highest bidder.

There has been considerable controversy concerning the asserted advantages of these alternative underwriting techniques. Under negotiated arrangements the underwriter is involved from the early stages of the decision to issue bonds. Consequently, it plays an active role in designing the bond issue and in some cases the program itself. This allows a great deal of flexibility with the client institution. In addition, it is possible for the underwriter to provide advance information to the prospective buyers. This enables potential buyers to evaluate the issue and therefore increases the speed with which the securities can be marketed. Since this reduces the underwriters need to hold an inventory of securities for a relatively long time period, it reduces the cost of marketing the bonds. In the competitive bid arrangement the institutions which bid on the issue usually enter at a late stage of the financing process. Thus, the issuer and its bond counsel, or other consultants, design the issue entirely by themselves prior to soliciting sealed bids for the issue.

The primary advantage of the competitive bid process is that it may facilitate the determination of "fair" compensation for the underwriting process. This advantage has to be weighed against the lack of flexibility and the need for the Agency to have either sufficient in-house expertise or to hire a consultant to design the bond issue.

Since state housing finance agencies are relatively new and their bonds are complex, the advantages that are inherent in the negotiated arrangements appear to dominate. As of the writing of this report, there have been only four housing agency bonds issued via competitive bid among all state HFAs. One of these was a well secured issue by the MHFA, the State Assisted Home Improvement Program Bonds, 1976, Series A.

THE ROLE OF THE BOARD

Three major issues emerged from a consideration of the role of the MHFA Board of Directors. First, the Board has changed in composition over time. Initially, the Board had a number of citizen members from the housing industry who were familiar with many technical issues in housing finance and construction. Concerns about potential conflict of interest have led to a change to one of less technically-oriented citizen members. Examination of a set of Board issues led us to conclude that non-technically oriented citizen members are able to discharge their policymaking and oversight responsibilities without the suspicion of conflicts of interest.

Secondly, there remain a number of policy issues that need clarification from the Board. Among these are Board review and approval of Agency growth and future financing plans, clarification of the interpretation or intention behind geographic distribution targets, decisions about the respective emphasis on shallow and deep subsidies, determination of the extent to which greater emphasis needs to be placed upon overall quality of apartment developments, and discussion of program mix issues. Consideration of such issues can be given either through the development of explicit Agency policy or through its review of Agency financing and program development.

Thirdly, the enabling legislation sets broad objectives for the Agency. It attempts to meet these objectives through its various programs. Some degree of ambiguity exists regarding the respective roles and purposes of the three major housing programs in the Agency. Some of this ambiguity undoubtedly reflects a process of gradual evolution and fine tuning of the various programs. However, there still appears some need for the Board, as the policymaking arm of the Agency, to clarify the purposes of each program.

Aside from the general mandate to serve low and moderate income persons, it is not entirely clear what each specific program is fundamentally attempting to accomplish. For example, the bond funded Homeownership programs provide only a shallow subsidy and have difficulty serving families with incomes below approximately $10,000. Is this sufficient justification for continuing and expanding this program? The Agency has made limited efforts to provide a deeper subsidy through the Affordable Homes Program, but this program is extremely costly to the state and can reach only a small number of families. Is it worth the high cost per capita to the state to provide deeper subsidies for homeownership that will serve only a small number of families?

Similar policy issues exist in the other programs. The analysis of the Apartment Development Program uncovered a certain degree of ambiguity in MHFA's emphasis on project quality. Our analysis suggested that the Agency might profit from placing more emphasis on tighter and more rigorous design and construction standards. This suggestion was premised on the belief that the Agency would profit from increasing initial construction costs through increased design standards and construction specifications rather than risking later and potentially higher maintenance, repair, and operating costs. In Home Improvement, the issues of whether this program has income eligibility limits that are too high or whether the Agency should further restrict the uses to which home improvement loans can be applied were raised. Each of these policy questions must be initially decided upon by the Board. Ultimately, however, they must be decided by the legislature.

We also encountered some difficulty in determining how each program, singly or in combination, addressed overall Agency objectives. For example, the Agency is mandated to distribute its housing assistance throughout the state "with a reasonable balance between nonmetropolitan and metropolitan areas of the state". In order to meet this objective, the Agency has endeavored to distribute housing resources within each program throughout the state. An alternative to this strategy would be to concentrate the various programs or subprograms in those areas of the state with the greatest need or possibility of impact, while distributing overall funds throughout the state in a reasonably equitable fashion. Legislative clarification regarding interpretation of the geographic distribution mandate would be helpful.

LEGISLATIVE POLICY ISSUES

A number of policy issues deserving of legislative consideration emerged from our evaluation of the Minnesota Housing Finance Agency:

The Need for Legislative Oversight: This evaluation is one exercise in legislative oversight. While it is extremely difficult to provide an overall summary of Agency performance, this report concluded that the Agency's past performance in developing and implementing its housing programs has been satisfactory. It has done a number of things very well, e.g., the Apartment Development Program. Some problems have surfaced in places, but these problems can be corrected by prompt Agency administrative action. The future of the Agency promises greater expansion, and there is some reason to monitor this expansion. Thus, there is a need for continuing legislative oversight in terms of the Agency's ability to meet its major production, delivery, and financial objectives. However, the need for legislative oversight of Agency internal management practices is minimal, since the financial and management operations of the Agency must be flexible in order to respond to the volatility of its environment.

Legislative oversight is most appropriately focused upon major Agency performance outcomes, such as impacts upon the housing stock, how program benefits have been distributed to recipients, assessments of financial risks in the various programs, as well as reviewing planned growth in the Agency. Agency reporting to the legislature would be facilitated by improved statistical analyses of Agency operating information.

MHFA Overall Debt Limit: The legislature is being asked to raise the long-term debt ceiling for MHFA. This issue has been discussed in the section of this chapter on Agency Growth and Future Financing Needs.

Geographic Distribution Objectives: If the issue of geographic distribution is important to the legislature, then clarification of the vague mandate to "encourage such construction in areas of need and demand with a reasonable balance between non-metropolitan and metropolitan areas of the state" is appropriate. Currently, the Agency attempts to distribute housing units in each of its programs throughout the state. An alternative would be to distribute housing units or total dollars across the three major programs throughout the state. This latter option would allow some specialization of programs according to the most pressing needs of a particular geographic area. There is some question whether this latter strategy would be consistent with the legislative mandate, and clarification would be helpful.

Housing Assistance to Lower Income Households: The Agency is mandated to finance housing for low and moderate income families. Generally, bond-financed programs do not provide a substantial enough reduction in housing costs to bring housing within the financial reach of the lower income households in Minnesota. The Apartment Development Program is able to reach lower income households because of the use of deeper federal subsidies. In like manner, the Affordable Homes Program, the Indian Homes Program, and the Home Improvement Grant Program are able to reach lower income households because of the state provided subsidy. In addition, the use of the sliding interest rate in the recent Home Improvement Loan Program has enabled it to attract relatively more lower income households than the first phase, but its ability to substantially assist households with incomes between $6,000 and $9,000 is still quite limited. Thus, programs relying upon bond financing alone are limited in their ability to help families with less than moderate incomes.

The legislature has decided to supplement bond-financed programs with state appropriations in some of the Homeownership and Home Improvement Programs. However, this is costly to the state and, if funded at present levels, will provide more substantial assistance to only a limited number of lower income households. The trade-off is basically between providing limited assistance to a larger number of households and providing more substantial assistance to a smaller number of households. State-financed subsidy programs provide greater assistance to households at the lower end of the income continuum, but they are substantially more costly to the state and there is some question whether they will generate net benefits to the state. The benefit-cost ratios that were calculated for the bond financed Homeownership and Home Improvement Programs would decrease with the use of appropriated state subsidies.

Impact on the Housing Stock of the State: There is some reason to doubt that the MHFA Homeownership Program will result in a net increase in new housing construction in Minnesota, since there are indications that a sizable share of MHFA lending in homeownership is offset by a resulting decline in private sector mortgage lending activities. Thus, if the legislature desires to provide stimulation for new single-family housing construction, it should look to other devices such as tax incentives.

Lack of an Overall State Housing Policy: Presently, Minnesota does not have an overall state housing policy. This situation indirectly places the primary state housing agency, the Minnesota Housing Finance Agency, in the position of being everything to everybody. While the Agency was created to play primarily a financing role, it is sometimes confronted with criticism for not playing a more extensive role. There appears to be some need for the legislature to more clearly define the roles of the different state agencies concerned with housing.

Agency Staffing: The requirement that MHFA work through the state civil service system should be re-examined by the legislature, given the problems the Agency has in attracting and retaining high quality, experienced, and technically-trained program managers and staff.

ADDENDUM

Aside from the questions of Agency debt limits and the appropriateness of target population definitions, there are few major and immediate legislative issues. This evaluation has proposed a number of program changes that could improve the efficiency, effectiveness, or ability to channel benefits to the target populations, but these changes are primarily internal to the Agency and are of primary concern to the Agency board and top management. The Agency has performed reasonably well in meeting its legislative mandate of providing benefits to low and moderate income families without jeopardizing the financial integrity of its bonds. There are ways in which its programs could be improved, and we have indicated a number of alternatives, but major changes in program structure or Agency objectives do not appear warranted at this time. Given the continued growth of MHFA, there will remain a need for legislative oversight, and in the future, difficult decisions about the appropriate size of Agency debt must be made.

APPENDIX A

AGENCY RESPONSE

minnesota housing finance agency

July 12, 1977

Mr. Bruce Spitz
Legislative Audit Commission
Veterans Service Building
St. Paul, Minnesota 55155

Dear Mr. Spitz:

Please accept the following as my formal comments in response to the final report of the Legislative Audit Commission, Program Evaluation Division, regarding their evaluation of the program related performance of the Minnesota Housing Finance Agency. In preparing these remarks, I have not attempted to respond in specific detail to the background materials nor the chapters of the final report dealing with specific program discussions. I have confined my comments to the content of the Summary and Major Policies Issues chapter of that report, and will relate to the background material only in cases where the conclusions or observations seem to arise from inaccurate or incomplete assessment of the relevant facts and material.

As you know, the Minnesota Housing Finance Agency (MHFA), as a relatively new agency, is still in the process of developing its organization. Thus, observations of situations existing a year ago do not necessarily apply to the Agency today. As is noted in the report, the Agency has recognized the need for adjustments in its programs in the past, and will continue to improve its systems as a result of its own evaluation as well as evaluations of others such as the LAC.

The following are my comments on the summary chapter.

1. IMPACT ON STATE HOUSING STOCK

It is observed in the report that there is reason to believe the Agency's homeownership programs have not had an impact on single family stock because Agency financing may be largely offset by a decline in private sector financing. Generally, the homeownership program should not be evaluated across the board on the basis of its impact on the single family housing stock. This is only one of the objectives of the program, and may not be an objective at all at a particular point in time. For example, the major homeownership program evaluated by the Legislative Audit Commission deliberately did not attempt to target on new construction. Instead, the program had as its primary objective the provision of mortgage money at a time when costs had reached historical highs, making mortgages essentially unavailable except to those who were capable of meeting debt service at 9-1/2% to 10% interest rates. Evaluated against this criteria, it would appear that this program was highly successful. Currently, the Agency is operating a single family program where the primary objective is the stimulation of new construction. Our experience to date indicates that our goal of two-thirds of the funds going for new construction will be exceeded by a substantial amount.

It is observed that in the home improvement program, there is reason to believe that the program competes in part with private sector loans. Apparently this observation comes from a review of our income limit against the incomes of people in the areas where loans are being made. It is of interest to note, however, that the average income of borrowers under our program is less than three-fourths the income of conventional loan recipients.

A further observation with respect to the impact on housing stock of the rehabilitation loan program suggest that it is not possible to assess the impact of rehabilitation loans on the preservation of housing stock as opposed to merely improving property values. We would agree that further attention needs to be paid to this question. The Legislature in establishing the program indicated a broad range of purposes for which the funds were to be used but, except in the energy area, did not indicate a system of priorities for use of the funds nor did it allocate specific percentages to specific types of improvements. While we are comfortable in permitting localities to target funds in areas which they identify as being most critically in need, and permitting private lenders to respond to needs as perceived by the people carrying out the rehabilitation, it is apparent that the Agency must effectively gather data on the types of improvements being accomplished and the potential impact on overall housing stock. We have been working with ISD in an attempt to accomplish this.

2. BENEFIT COST ANALYSIS

A major element in the evaluation of Agency programs was to assess the relative benefits versus the apparent cost of each program. Generally, this type of analysis of a social program is difficult, since it is not possible to quantify the value of decent housing on the total living environment for a family. Moreover, the Agency has not had an opportunity to review the methodology used in performing the benefit-cost analysis. We are, therefore, unable to respond to the references to this analysis in the report.

3. PROGRAM MANAGEMENT ISSUES

A. Apartment Development Program - Several statements are made in the report with respect to the Agency's selection of projects for financing under the Apartment Development Program. These observations result from a mistaken perception that the Agency's reservation of financing and subsidy funds and requesting of a formal application for a development represents the most critical step in the application process. The Agency has generally utilized this step only for the purpose of equitable allocation of a scarce resource and to secure within a very narrow time frame subsidy funds as they become available. It is communicated clearly to all those involved that the invitation to submit an application does not in any way constitute a commitment by the Agency to finance the development. Very few developments retain the same characteristics at the time of start of construction that they had at the time they were initially submitted for consideration. In fact, contrary to the observation in the report, the period of greatest leverage over developments is not prior to invitation to submit an application, but is prior to the issuance of a feasibility letter. Typically, a development during this stage will undergo a re-evaluation of the specific site proposed, a review of the make up of the units, a thorough analysis of the design features and the potential for a more effective utilization of the site, a review of the capacity of the developer to proceed, and many other features of the proposal which are likely to be changed prior to issuance of a feasibility letter. It has been our experience that the opportunity to affect these kinds of changes is greater after the application is submitted than it is before submission. A developer is not likely to be willing to expend the kind of energy and financial resource necessary to make these changes before he knows whether his application has been formally accepted for feasibility processing. Further, it would not be appropriate for the agency to accept formal applications for a resource which is not available to us in the case of federal subsidy funds.

Additional observations have been made with respect to project quality in developments being financed by the Agency with the concern expressed that this quality is variable from development to development. Specific detail is not provided in this regard. We are, therefore, unable to respond to this observation. We would, however, generally concur with the observed need for technically trained support staff in this and other areas.

With respect to the control of operating risk, the report notes that the Agency has developed and implemented a practice of risk sharing which places the main burden for performance upon the private and non-profit developer. It is of interest to note that this observation, with which we are in total agreement, is in conflict with an earlier concern evidenced in the report regarding the lack of interest in project performance beyond final closing on the part of the developers obtaining financing through the Agency. Generally, the combination of risks faced in the event of recapture of depreciated values by the Internal Revenue Service and the practice of the Agency to not permit the use of shell corporations has produced a stronger sense of commitment to the solvency of a development on the part of sponsors than has been the case in similar publicly assisted housing programs in the past.

The report notes some concern with respect to the operating performance in the early projects financed by the Agency relative to the budgets which were prepared for these operating costs. It should be pointed out that these operating budgets are generally the responsibility of the developer. Therefore, underestimates of operating costs made by the developers create exposure for the developer to additional financial contributions to make up any deficits. As a result, we have found that the developers have not attempted to deliberately underestimate the cost of operating a facility in order to establish early feasibility.

The majority of operating deficits occurring in developments financed by the Agency have been experienced because utility costs exceeded estimates made in 1974. These estimates, of course, were prepared in advance of the oil embargo and the rapidly escalating heating costs since that time. This is a problem experienced in all real estate development and is not unique to developments financed by the Agency. Although we are in agreement with the observation that the rents must be increased in these developments in order to carry current projected operating costs, consideration must also be given to the affect of these increases on low and moderate income tenants. Rent increases have been reviewed and approved for the majority of these developments, with the balance pending analysis.

B. Homeownership Program - The report finds that this program has performed satisfactorily in meeting its objectives. As noted earlier, the homeownership program operates with a variety of objectives, some of which are more prominent at times than others. Lower interest rates, for example, may not be as important at times as the provision of mortgage funds in a tight market.

C. Home Improvement Program - Credit review and loan servicing procedures have been altered significantly over time in the home improvement program to ensure that reasonable standards are met in making loans and that the loans are serviced in a businesslike fashion. As is noted by the Federal Housing Administration, our standards of performance are producing a portfolio of loans not at variance with experience.

4. AGENCY GROWTH AND FUTURE FINANCING NEEDS

The Agency has taken significant steps to reduce our potential dependence on short-term borrowings to finance our long-term commitments. We have amended the procedures for financing in our Apartment Development Division to permit us to issue bonds in advance of the start of construction. While this results in financing the construction period with higher cost money, this feature is offset by requiring that the development pay interest on the full amount of the loan from the time of construction start. Therefore, from initial closing the development is supporting the full cost of obtaining financing. This practice will result in significantly lower long-term interest rates as well as much greater flexibility in the timing of bond sales.

5. ALLOCATION OF SCARCE RESOURCES

This section of the report relies very heavily on the performance of an undefined cost benefit analysis to determine the relative merits of each of the programs operated by the Agency. Nevertheless, it does raise the significant issues with respect to resource allocation which must be faced as the Agency encounters more limited availability of those resources. While we agree with the conclusions of this discussion, we are not able to comment on the analysis that led up to these conclusions.

6. AGENCY MANAGEMENT

The Agency has recognized the need for increased delegation of decision-making in order to assure that programs are maintained as responsive to the needs of the people intended to be served, and has been moving in the direction of increased formalization of operating procedures to ensure that systems are capable of maintaining operation irrespective of the basic personalities involved.

7. AGENCY STAFFING

We generally agree that adjustments in the Agency's relationship with the Personnel Department are desirable. Some of these adjustments were accomplished during this past legislative session. However, we remain handicapped in attempting to recruit people with high personal capabilities irrespective of the direct relationship of their previous job experiences to Agency operations. Current procedures hamper us in retaining adequate experienced technically trained staff at the supervisory positions. While we are currently able to maintain our technical responsibilities with highly motivated personally capable people attention must continue to be paid to remaining obstacles in the way of replacing them.

8. MANAGEMENT INFORMATION SYSTEMS

The Agency has retained on a full time basis the services of a Systems Analyst who is focusing on the need for more complete management information systems. This process would be facilitated if greater flexibility in gaining access to computer services were available.

9. INTER-INVESTMENT PROCEDURES

This section observes that there is little reason to change current policies of investment of unexpended Agency funds. While the main report suggests that the possibility that the State Board of Investment might play a more direct role in the placement of Agency funds secured through the sale of bonds, it should be recognized that this would likely alter the relationship of the State to its investors. It is possible that on balance, the State is much better off having a private institution act as fiduciary for investors in order to maintain the integrity of the advocacy relationship of the trustee with the Agency.

10. ROLE OF THE BOARD

We are in agreement with the need for the Board to continue to focus its energy on clarification of policy issues relative to Agency operations. We also concur in the recommendation that the appointments to the Agency Board focus on the need for broad policy oriented people and attempt to avoid potential conflicts of interest to maximum extent possible.

11. LEGISLATIVE POLICY ISSUES

This section raises legitimate questions which ought to be addressed in some detail by the appropriate committees of the Legislature.

The Minnesota Housing Finance Agency has found the performance evaluation report helpful in its identification of the need for personnel and management information systems adjustments within the Agency. It will also be of assistance to the Legislature in identifying legislative policies which need clarification. We are pleased that the analysis found the Agency to be both organizationally and financially sound.

The Agency has attempted during its first four years to maintain its focus on the provision of assistance to low and moderate income persons in the state in securing decent, safe and sanitary housing within their ability to pay. We are pleased that the Legislative Audit Commission, Program Evaluation Division, has concluded that our results are reflective of our intended purposes.

Thank you for the opportunity to review this report.

Sincerely,

James F. Dlugosch
Executive Director

JFD:rk

APPENDIX B

LIST OF STAFF PAPERS

EVALUATION OF THE APARTMENT DEVELOPMENT PROGRAM OF THE MINNESOTA HOUSING FINANCE AGENCY	Daniel Jacobson Gary Miller
EVALUATION OF THE HOMEOWNERSHIP PROGRAMS OF THE MINNESOTA HOUSING FINANCE AGENCY	James Cleary
EVALUATION OF THE HOME IMPROVEMENT PROGRAMS OF THE MINNESOTA HOUSING FINANCE AGENCY	Barbara Homce
EVALUATION OF THE MANAGEMENT OF THE MINNESOTA HOUSING FINANCE AGENCY	Laurel Donaldson Bruce Spitz Ronald Denhardt
BENEFIT-COST ANALYSIS OF MHFA PROGRAMS	Ronald Denhardt Wayne Carroll
ANALYSIS OF MHFA INVESTMENT PRACTICES	Wayne Carroll Ronald Denhardt
BOND MARKET ANALYSIS	Real Property Resources Corporation
FEDERAL SUBSIDY AND REGULATORY ENVIRONMENT	Real Property Resources Corporation

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