TARGETING PROGRAMS OF STATE HOUSING FINANCE

AGENCIES: PROGRAM DESIGN ISSUES

by

Gail Louise Monahan

B.A. Wellesley College
(1978)

SUBMITTED TO THE DEPARTMENT OF URBAN STUDIES AND PLANNING IN PARTIAL FULFILLMENT OF THE REQUIREMENTS OF THE DEGREE OF

MASTER OF CITY PLANNING

at the

MASSACHUSETTS INSTITUTE OF TECHNOLOGY

June 1982

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Signature of Author

[Signature]

Department of Urban Studies and Planning
May 18, 1982

Certified by

[Signature]

Lynne B. Sagalyn
Thesis Supervisor

Accepted by

[Signature]

Langley C. Keyes, Jr.
Chairman, MCP Committee

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MASSACHUSETTS INSTITUTE
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AUG 3 1992
TARGETING PROGRAMS OF STATE HOUSING FINANCE
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GAIL LOUISE MONAHAN

Submitted to the Department of Urban Studies and Planning on May 18, 1982 in partial fulfillment of the Degree of Master of City Planning

ABSTRACT

Discussed here are the choices a State Housing Finance Agency, the Massachusetts Home Mortgage Finance Agency must make in the redesign of one of its programs, one that targets a portion of the Agency's bond proceeds into neighborhoods in need of single-family home mortgage financing. A newly-enacted federal act, the Mortgage Subsidy Bond Tax Act is found to have significant impact on the Agency's targeting program, the Neighborhood Preservation Area Program. The central dilemma of the Agency in the choice of its program elements is found to be the need to trade-off its legislatively-mandated public purpose with the need for acceptance by the financial community.

Thesis Supervisor: Dr. Lynne Beyer Sagalyn
Title: Assistant Professor of Urban Studies and Planning
ACKNOWLEDGMENTS

The author would like to thank the staff at the Massachusetts Home Mortgage Finance Agency for providing a supportive work environment while this was being written. Thanks also go to Prof. Lynne Sagalyn for her tireless, careful advice. Richard Mandel, Marty Blatt, Lisa Warenski and Amy Weisman must be mentioned, as well.

Special thanks go to Greg Polk and Barbara Burnham.
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SECTION I
INTRODUCTION

PROBLEM STATEMENT

The client, the Program Developer/Coordinator of the Massachusetts Home Mortgage Agency (MHMFA), has asked the writer to prepare a report that will examine program design issues involved in the Agency's Targeting Program, the Neighborhood Preservation Area Program.

Over the past two years, MHMFA has experienced a number of organizational difficulties that have damaged the Agency's standing in the financial community. Since the Agency must issue bonds in the tax-exempt municipal bond market in order to operate its homeownership program, its reputation in the financial community is important.

In the same time period, the federal government enacted a series of regulations, included in the Mortgage Subsidy Board Act, that have a direct impact on the Agency's Targeting Program, possibly changing the way the Neighborhood Preservation Area Program operates. The Mortgage Subsidy Bond Tax Act also changes the perception the financial community has of all single-family housing bond issuers.

In all program decisions the Agency must make trade-offs between its public purpose and its need to maintain good standing in the financial markets. However, at this time,
because of the Agency's recent down rating in the financial community and because the federal Act will require a re-structuring of the Agency's Targeting Program, the tension between these two objectives is particularly acute.

This report will examine how the Mortgage Subsidy Bond Tax Act will affect several of the program design elements of the Agency's Neighborhood Preservation Area Program. For each one of the program design elements, the Agency faces a number of choices. The principal purpose of this report is to explicitly state the trade-offs the Agency will have to make as it chooses which program design elements will comprise its Neighborhood Preservation Area Program.

In the remainder of this first section, the circumstances of the Agency will be explored more fully. Special efforts will be made to show how these circumstances affect the Agency's Neighborhood Preservation Area Program. The purpose of this section is to place the Agency in a framework that presents the constraints within which the Agency must operate.

FRAMEWORK: CONSTRAINTS OF THE AGENCY

The Agency's public purpose is clearly stated in its enabling legislation:

It is hereby found that as a result of the continuing increases in the cost of construction or rehabilitation, municipal taxes, heating and electricity expenses, maintenance and repair expenses and the cost of land, low income persons and families and moderate income persons and families in many areas within the
commonwealth, including areas which contained formerly stable neighborhoods, are unable to purchase, rehabilitate and maintain decent, safe and sanitary housing which provide an opportunity for home ownership either directly or through a condominium or cooperative form of ownership. The inability of such families to purchase and hold housing in the commonwealth results in the decline of new housing and in the decay of the existing housing stock and of existing neighborhoods with attendant increases in municipal costs for welfare, police and fire protection. The decline in new housing together with the decay of existing housing stock, has produced a critical shortage of adequate housing in the commonwealth adversely affecting the economy of the commonwealth and the well-being of its residents. Private enterprise without the assistance contemplated by this act cannot achieve the construction or rehabilitation of any housing for persons and families of low or moderate income and the alternative of forcing such families to live in substandard housing is undesirable since it tends to decrease the interest of such families in their communities, the maintenance of their property and the preservation of their neighborhoods.

A large and significant number of commonwealth residents have and will be subject to hardship in finding decent, safe and sanitary housing unless new facilities are constructed and existing housing, where appropriate, is rehabilitated. Unless the supply of housing and the ability of low income persons and families and moderate income persons and families to obtain mortgage financing is increased significantly and expeditiously, a large number of residents of the commonwealth will be compelled to live in unsanitary, overcrowded and unsafe conditions to the detriment of the health, welfare and well-being of these persons and of the whole community of which they are a part. By increasing the housing supply of the commonwealth and the ability of low income persons and families and moderate income persons and families to obtain mortgage financing, the clearance, replanning, development and redevelopment of blighted areas will be aided, and the critical shortage of adequate housing will be ameliorated.

MHMFA was created to mitigate this crisis by providing funds at interest rates affordable to low- and moderate-income persons.

Throughout the first years of MHMFA's operation, the Agency had a clearly-defined sense of public purpose. At the first meeting of the Agency's Board of Directors, a resolution was passed reaffirming the Agency's commitment to ameliorating the housing problems of the Commonwealth. In the Agency's first annual report, its executive director stated that:

The goals and objectives of MHMFA include not only the reduction in housing costs for eligible homeowners, but the preservation of the existing housing stock and the stabilization of older neighborhoods.

The Agency's Targeting Program, the Neighborhood Preservation Area Program, was the most concrete manifestation of the Agency's public purpose. The program targets portions of the Agency's mortgage funds that have experienced a shortage of conventional financing. The goal of the program is to utilize these funds to aid in the revitalization of these areas without displacing current low- and moderate-income occupants. The program is conceptualized as a partnership between local banks, municipalities and community-based organizations.

In the Agency's first two bond issues the Neighborhood Preservation Area (NPA) Program performed quite well.

---

2 Minutes, First Meeting of the Agency's Board of Directors, December 3, 1979.

Approximately 220 loans made in the ten Neighborhood Preservation Areas, representing a value of around $3.5 million (or around 5 percent of the Agency's total assets).\(^4\) (figs. 1 & 2)

Loans made in targeted areas have not been any riskier than loans in the Agency's total portfolio. Down payments for houses bought in Neighborhood Preservation Areas were equal to those for homes bought statewide.\(^5\) The average loan-to-value ratio for both NPA loans and loans in MHMFA's portfolio was 80 percent. Individuals buying homes in Neighborhood Preservation Areas spent less of their income for mortgage principal and interest payments than individuals buying homes with MHMFA funds statewide. The average housing expense of NPA loans was 22 percent, as compared to 23 percent for the MHMFA portfolio. Mortgage terms of the two sets of loans did not differ significantly. Mortgage terms of NPA loans averaged 26.5 years; statewide mortgage terms were 27 years. No defaults

---

\(^4\) These statistics (and most of those cited in this section represent data from the Agency's two bond issues. Statistics for the Agency's second bond issue were compiled from loan participation agreements, from Agency internal files. They are also included in an evaluation of Neighborhood Preservation Area Program Performance in the Agency's second bond issue, a report prepared by the author.

Statistics showing the total value and number of NPA loans in the first bond issue are not available. The numbers used here are estimates derived from the amounts committed to Neighborhood Preservation Areas.

Any statistics quoted as to loan characteristics include the second bond issue NPA loans only.

\(^5\) As noted above, all of these statistics conveying loan characteristics are for loans made in the second bond issue only.
Neighborhood Preservation Areas in the First and Second Bond Issues

<table>
<thead>
<tr>
<th>City and Neighborhood</th>
<th>First Bond Issue</th>
<th>Second Bond Issue</th>
</tr>
</thead>
<tbody>
<tr>
<td>City:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Boston</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Columbia/Savin Hill,</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Dorchester</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Mission Hill,</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Roxbury</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-SAV-MORE, Roxbury</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>-Hyde and Egleston</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Squares and the</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stoneybrook neighbor-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>hood, Jamaica Plain</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Plain</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Brookline</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Central Village and</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>North Brookline</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cambridge</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Cogswell Avenue</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Chelsea</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Addison Neighborhood</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Fitchburg</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Water, Cleghorn and</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>College Streets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lowell</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Lower Belvidere</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Springfield</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Upper Hill Neighborhood</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Worcester</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Main South/Columbus</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Park</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Comparison of the Average Mortgage Loan Characteristics for MHMFA Second Bond Issue: May 1980

<table>
<thead>
<tr>
<th>Loan Characteristic</th>
<th>Average Total: MHMFA Portfolio</th>
<th>Average Total: Neighborhood Preservation Areas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Amount</td>
<td>$28,645.</td>
<td>$22,160.</td>
</tr>
<tr>
<td>Sales Price</td>
<td>$35,741.</td>
<td>$27,103.</td>
</tr>
<tr>
<td>Mortgage Term (years)</td>
<td>27.0</td>
<td>26.5</td>
</tr>
<tr>
<td>Loan-to-Value Ratio (%)</td>
<td>80.0</td>
<td>80.0</td>
</tr>
<tr>
<td>Housing Expense* (%)</td>
<td>23.0</td>
<td>22.0</td>
</tr>
<tr>
<td>Borrower's Ave (years)</td>
<td>34</td>
<td>31</td>
</tr>
<tr>
<td>Annual Household Income</td>
<td>$17,484.</td>
<td>$15,108.</td>
</tr>
</tbody>
</table>

*Housing expense includes principal and interest payments, taxes, mortgage insurance and other Escrow payments.

have been experienced in the Agency's NPA loan portfolio, the default rate for the Agency as a whole has been 2 percent.⁶

Most importantly, the characteristics of loans made in the second bond issue indicate that relatively low-income individuals have been able to participate in the Program and have been able to purchase lower-than-average priced housing. The loan amounts, sales prices and incomes of home buyers, on average, have all been lower for the Neighborhood Preservation Area Program than loans made by the Agency statewide. The average loan amount of NPA loans was 23 percent lower and the average sales price was 26 percent lower than the total portfolio. Homebuyers in Neighborhood Preservation Areas had a lower average income (14 percent lower) than the bond issue as a whole. In the first two bond issues, therefore, the Neighborhood Preservation Area Program seems to have fulfilled its goal of providing mortgages to lower income individuals in designated targeted areas.

Since the closing of the Agency's second bond issue and the present, however, a number of changes have occurred in the Agency's environment and within the Agency itself that indicate that the Agency's Targeting Program may not continue to operate as in the first two bond issues.

In mid-1981, the Agency experienced the first of a set of significant internal difficulties. The Agency's financial

officer was discovered to have made an unauthorized investment of the Agency's funds and was fired. The financial officer had bought long-term ship bonds and borrowed short-term funds against the long-term bonds to meet Agency mortgage commitments. The short-term borrowings were made at a loss. The investment as a whole cost the Agency $1,389 million. Moody's Investor's Service suspended the Agency's credit rating, because of these actions and later reinstated it at a lower rate.

Soon after the financial officer's error was discovered, the Agency's executive director resigned. The executive director's resignation was reportedly unrelated to the financial officer's dismissal, but rather due to tension that had been building between the executive director and the Agency's Board of Directors and the governor's administration.

The Bond Market: Both of these events damaged the Agency's credibility in the financial markets, which, as mentioned above, is important for the Agency. Particularly crucial is the determination of the Agency's credit rating by Moody's Investor Service and Standard and Poor's. This credit rating is a partial determinant of the interest cost of the Agency's bonds, and consequently, the cost of the mortgages offered by the Agency. The lower the credit rating is, the higher the cost of the bonds to the Agency will be and the higher the interest rate on mortgages made to consumers.

The rating agencies base their credit rating of the Agency on their perception of risk as manifest in the Agency's financial management procedures and as manifest in the Agency's assets, its loan portfolio. Therefore, the decisions made by the Agency in structuring its programs are considered input by the rating agencies to determine the Agency's credit rating.

Of particular concern to the rating agencies are the characteristics of the loans included in the Agency's portfolio (loan-to-value ratios, mortgage terms, types of insurance offered), the kinds of dwellings on which these loans are made (single versus two- to four-family), the geographic distribution of these loans, the lien provided on the financial property, whether the property will be the mortgagor's principal place of residence and whether mortgages will be made on new or existing homes.

Table 1 is a comparison of what elements are generally considered low-risk and high-risk program elements.

The rating agencies are also concerned about the delivery period of the loans made by the Agency. Shorter delivery periods ease the concern of the rating agencies that interest rates on home mortgages will drop during the time period after a bond has been issued.

The Agency's Neighborhood Preservation Area Program theoretically presents a concern to the rating agency. The NPA program directs a portion of the Agency's bond proceeds into a set number of geographic areas in which conventional financing
### TABLE 1

**LOW- AND HIGH-RISK PROGRAM ELEMENTS**

<table>
<thead>
<tr>
<th>Lower Risk</th>
<th>Higher Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>low loan-to-value ratio</td>
<td>high loan-to-value ratio</td>
</tr>
<tr>
<td>first lien on the property</td>
<td>not a first lien on the property</td>
</tr>
<tr>
<td>FHA or VA insurance or private insurance</td>
<td>no insurance</td>
</tr>
<tr>
<td>geographically diversified dwellings</td>
<td>high commitment to a specific geographic area</td>
</tr>
<tr>
<td>strong demand for housing in underlying housing market</td>
<td>weak demand for housing in underlying housing market</td>
</tr>
<tr>
<td>good financial position of homebuyer</td>
<td>poor financial position of homebuyer</td>
</tr>
</tbody>
</table>


was not widely available in the past. The lower income of the homebuyers in the NPA program may indicate that they are in a relatively poor financial condition. Yet, as has been shown above, the Agency's NPA Loan Portfolio is actually comprised of quite high quality loans, at least comparable to the Agency's loan portfolio as a whole, and in some ways better. The risk associated with the Agency's NPA loan portfolio is at least comparable to that associated with the Agency's total loan portfolio. This will be an important point to remember as the
Agency considers which NPA program elements to maintain in the future.

The Mortgage Subsidy Bond Tax Act: During the same time period that the Agency was experiencing its organizational difficulties, U.S. Congress enacted the Mortgage Subsidy Bond Tax Act (the "Act"). The Act severely restricts the issuance of tax-exempt bonds for single-family home mortgages and contains a number of provisions that have a direct impact on the Agency's Neighborhood Preservation Area Program.

Generally, the Mortgage Subsidy Bond Tax Act places restrictions on the volume of single-family housing bonds a state can issue, on the type of borrower eligible for loans provided by tax-exempt single family housing bonds, on the prices of homes that can be bought with these funds, the profits that can be made on investments of bond proceeds and the interest cost that can be charged to borrowers.

The Mortgage Subsidy Bond Tax Act affects housing bond issuers by increasing their costs of operating programs, while at the same time decreasing program income, restricting the number of eligible program applicants and limiting the types of homes that can be purchased with the housing bond loan proceeds.

MHMFA already had mortgage purchase limits. The first time homebuyer requirements also do not pose problems for MHMFA. The regulations that limit the profits on investments, including mortgages, made by the Agency do pose...
problems. For a time, the Agency thought that, in order to issue its third bond series, it would have to receive an infusion of funds from an outside source. This may or may not prove to be true, but the time MHMFA has spent exploring program structures so that this fund infusion would not be necessary has been substantial. Other housing bond issuers have experienced similar situations. While the Mortgage Subsidy Bond Tax Act has not curtailed the issuance of tax-exempt bonds for single-family housing, it has certainly complicated their issuance.

The Mortgage Subsidy Bond Tax Act mandates that all housing bond issuers implement a targeting program.

The regulations\(^8\) provide a choice between two targeting programs. The first program, Qualified Census Tracts, requires that a housing bond issuer set aside a portion of its lendable bond proceeds to loan in census tracts in which 70 percent of the population has incomes which are 80 percent of the statewide median income. Currently, these qualified Census Tracts are determined using 1970 census. The census tracts that meet the program criteria are cited in regulations published by the U.S. Treasury. There are currently thirty qualified census tracts in Massachusetts.

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\(^8\) Information about the Mortgage Subsidy Bond Tax Act can be obtained from several sources. The two most important are:

The second program, Areas of Chronic Economic Distress, can be implemented in place of the first program. Under this program, the Agency designates a number of areas that meet criteria specified in the federal Act. These criteria include the following:

(a) the condition of the housing stock, including the age of the housing and the number of abandoned and substandard residential units,

(b) the need of area residents for owner-financing under this section, as indicated by lower per-capita income, a high percentage of families in poverty, a high number of welfare recipients, and high unemployment rates,

(c) the potential for use of owner-financing under this section to improve housing conditions in the area, and

(d) the existence of a housing assistance plan which provides a displacement program and a public improvements and services program.

If an issuing jurisdiction includes a targeted area, at least 20 percent of the lendable proceeds of a bond issue (but no more than 40 percent of the market share of the targeted areas) must be available for one year for mortgage loans in the targeted areas. Mortgage financing for a targeted area is exempted from the new homeowner requirement and the maximum
purchase price limit increases to 110 percent of the average purchase price of the area from 90 percent. The Agency must incorporate these changes mandated by the Mortgage Subsidy Bond Tax Act in its Targeting Program. Depending on the decisions that the Agency makes, the Neighborhood Preservation Area Program may or may not be changed.

The federal provisions for targeting affect the Agency's targeting program because they differ in several important ways from the Neighborhood Preservation Area Program—the selection of areas for the federal targeting program of Qualified Census Tracts uses income criteria, rather than housing stock criteria, as does the Agency's program. The Agency's Neighborhood Preservation Area Program involves municipalities and community based organizations in the selection of targeted areas and the administration of these areas. Neither federal targeting program, Qualified Census Tracts or Areas of Chronic Economic Distress, provides for the involvement of these groups.

The financial community is concerned about the targeting provisions required by the Act. The provisions the financial community is concerned about specify the proportion of bond proceeds that must be set aside for targeted areas, and the period of time (one year) for which the funds must be set aside. The rating agencies prefer that housing bond issuers

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9First Boston Housing Finance Agency Newsletter, Tax-Exempt Market Comment.
set aside the minimal amount of their lendable bond proceeds for targeting areas. In general, the rating agencies are concerned that the targeting program mandated by the Mortgage Subsidy Bond Tax Act may be a liability for housing bond issuers.

On the other hand, MHMFA's experience with its Neighborhood Preservation Area Program indicates that a targeting program need not be a liability to housing bond issuers. MHMFA may want to be sure that, when the rating agencies evaluate the Agency's programs under the Mortgage Subsidy Bond Tax Act, they understand that MHMFA has had experience with a targeting program and its efforts have been quite successful. These facts may make the financial market's impression of the Agency more favorable.

CONCLUSION

The Agency must incorporate these changes mandated by the Mortgage Subsidy Bond Tax Act in its Targeting Program at a time when its standing in the financial community is shakiest. At the same time, the Agency must fulfill its public purpose as stated in its enabling legislation and as achieved in the Agency's first two bond issues.

The organizational difficulties that the Agency experienced over the last two years make much more apparent the inherent conflict between the Agency's standing in the financial community and the Agency's public purpose mandate. As this report examines ways in which the Agency's Targeting
Program can be modified to conform to the provisions of the federal Act this tension will be illustrated. Resolution of these issues will necessitate trade-offs between these goals.

Due to a number of factors, the Agency is under a substantial amount of pressure to prepare a program and issue bonds quickly. First, the Mortgage Subsidy Bond Tax Act limits single-family housing bond volume for each state to $200 million per year. MHMFA did not issue bonds in 1981, the first year of the Act, and thus has already lost its first authorization. If MHMFA does not issue $200 million or less this year, it will lose this second authorization.

A second factor is that the Act contains a sunset provision curtailing tax-exempt status for single-family housing bonds after 1983. With only two years left during which it can issue tax-exempt bonds, the agency should attempt to utilize as much of its remaining $400 million authorization.

Finally, there are political pressures on the Agency to issue bonds for its homeownership program as soon as possible. Incumbent Governor King is facing reelection this year. One of the governor's principal goals is to promote homeownership within the Commonwealth. In campaign speeches across the state, the governor has discussed the "problem of housing affordability" and has cited the homeownership program of the Massachusetts Home Mortgage Finance Agency as one of the solutions to this problem.
As a result of these time pressures, the Agency will be leaving a number of issues unresolved in its third bond issue. These are the issues that this report will examine.

In the next section of this report, three important issues facing the Agency will be examined as to their impact on program design and impact.
MHMFA: DECISION POINTS:

MHMFA must make a number of important decisions on the design of its targeting program. The most important decision the Agency must make is how it will integrate its targeting program, the Neighborhood Preservation Area Program, with the targeting program elements required by the federal government. Basically, the Agency must decide which of the two federally-defined targeting programs, Qualified Census Tracts or Areas of Chronic Economic Distress, the Agency will implement.

The Agency must also decide if it would be advantageous for it not to implement its Neighborhood Preservation Area Program and implement only one of the federally-defined targeting programs. This decision has implications for the types and number of target areas designated, the proportion of funds set aside for these target areas, the amount of time for which these funds are set aside, and the ease of implementation of the program.

MHMFA must also decide whether or not to offer lenders incentives to lend in targeted areas. If the Agency decides to offer incentives, it must decide which ones are appropriate. The Mortgage Subsidy Bond Tax Act allows MHMFA to increase the purchase price limit on homes bought in targeted
areas and to waive in targeted areas the federal regulation that restricts MHMFA mortgages to first-time homebuyers. In its third bond issue, the Agency has chosen not to implement these relaxations of the federal Act and, instead, to keep targeted area guidelines consistent with non-targeted area guidelines. Yet, there may be advantages to implementing these relaxations and these will be explored. Whether or not MHMFA should waive income limits in its targeted areas, as do other housing bond issuers, will be explored here as well.

The federal Act also calls into question the roles lending institutions, municipalities and community groups should play in delivering loans to targeted areas. The Agency's Neighborhood Preservation Area Program currently mandates the participation of community-based organizations and municipalities. Neither of the targeting programs mandated under the federal regulations legislate the involvement of these groups. The advantages and disadvantages of including community-based organizations and municipalities in the loan delivery structure will be examined.

In the following pages, these unresolved issues will be examined and alternative courses of action will be presented. The advantages and disadvantages of each alternative will be stated and a series of recommendations presented detailing which courses of action are most likely to best serve the goals of the Agency.
ISSUE #1

MHMFA must decide which of the federal targeting programs, Qualified Census Tracts or Areas of Chronic Economic Distress, would be most advantageously combined with its own targeting program, the Neighborhood Preservation Area Program.

In addition, the Agency has also approached key figures in the Massachusetts State Legislature regarding the possibility of amending MHMFA's enabling legislation so that the Neighborhood Preservation Area Program would be optional. The Legislature's response to this change was favorable, and it looks as though the change will be one of those included in a whole set of changes to the Agency's enabling legislation.¹

Given the high probability that the Agency's enabling legislation will be modified, the Agency must decide whether or not to implement its Neighborhood Preservation Area Program. Thus, the Agency has three options:

Option #1

The Agency can implement the federally-defined targeting program, Qualified Census Tracts, and its own

¹An interesting point here is that it will only take the change of one word in the Agency's enabling legislation: replacing the word "shall" in the legislation with the word "may", to render the Neighborhood Preservation Area Program optional. Thus, the change is not significant psychologically, even if it is a significant policy change.
targeting program, the Neighborhood Preservation Area Program.

Option #2
The Agency can implement the federally-defined targeting program, Areas of Chronic Economic Distress and its own targeting program, the Neighborhood Preservation Area Program.

Option #3
Contingent upon the amendment of MHMFA's legislation so that its Neighborhood Preservation Area Program is rendered optional, the Agency can choose not to implement its NPA Program and only implement one of the federally mandated targeting programs.

These three options have different impacts for the Agency in terms of types and numbers of areas designated, program characteristics (proportion of funds set aside and loan delivery period) and ease of implementation.

OPTION #1

Implementing Both Qualified Census Tracts and the Neighborhood Preservation Area Program

Types and numbers of Areas Designated: If the federal definition of Qualified Census Tracts is used to define targeted areas, then MHMFA will have to implement two programs. Because the areas delineated by the federal definition of Qualified Census Tracts overlap very little
with areas delineated by MHMFA's Neighborhood Preservation Area Program (only one Qualified Census Tract, in Jamaica Plain, Boston, overlaps with a Neighborhood Preservation Area) two sets of targeted areas would have to be designated.

Chances are, as Qualified Census Tracts are redefined based on 1980 census data, these areas will still not overlap. This is because the delineation of Qualified Census Tracts is based on an income criterion, whereas the delineation of Neighborhood Preservation Areas is based on housing stock criteria.

**Ease of Implementation:** The number of census tracts designated by the federal Act's Qualified Census Tract Program could create a problem for MHMFA. The federal regulations delineate thirty census tracts. While many of these are contiguous, they are still located in five different cities and towns: New Bedford, Springfield, Shirley, Lowell and Boston. Within Boston, the census tracts form four distinct areas. Thus, the Agency would be responsible for administering eight Qualified Census Tract areas in addition to the ten Neighborhood Preservation Areas. This would almost double the size of the Agency's Targeting Program.

MHMFA has a very small staff, consisting of only four professionals and four support personnel. In the past, one full-time staff person was directly responsible for monitoring the Neighborhood Preservation Area Program, with support
from other members of the staff. Doubling the Agency's Targeting Program would directly impact the amount of time that could be spent monitoring each targeted area, perhaps cutting the time spent on each in half. Therefore, the quality of administration of the Targeting Program could be diminished.

On the other hand, since Qualified Census Tracts are defined by the federal Act and designated by Treasury, the Agency has to spend little administrative time defining and designating the areas.

Program Characteristics:

Proportion of Funds Set Aside: Under this option, two allotments of funds would have to be set aside. The federal regulations require that up to 20 percent of lendable bond proceeds must be set aside for targeting to federally-designated areas. After this, 20 percent is set aside (and not available for distribution to other parts of the state), another portion of funds must be set aside for MHMFA's Neighborhood Preservation Area Program. Hence, the total percentage of lendable bond proceeds set aside for targeted areas could well exceed 20 percent. A potential problem with this option is that it requires a large portion of the Agency's lendable bond proceeds to be reserved for targeted areas.

The rating agencies would perceive a large set-aside for targeting areas as definitely posing a problem for
MHMFA. Recognizing that the federal regulations require a minimum of funds be set aside, the rating agencies would be interested in MHMFA minimizing this set-aside amount.

Minimizing the set-aside amount for targeted areas could be accomplished by using an alternative formula allowed by the Mortgage Subsidy Bond Tax Act for determining set-aside amounts for the federally-defined target areas. This formula\(^2\) is based on the population of the targeted areas:

\[^2\text{The formula is described in the Mortgage Subsidy Bond Tax Act as based on the average, over three years, of the aggregate principal amount of mortgages executed in the targeted areas. However, calculating the mortgages executed in the targeted areas proved too difficult even for Qualified Census Tracts and especially for Areas of Chronic Economic Distress, because mortgage origination information is only available from a number of different sources. Therefore, in the Treasury regulations (the "safe harbors") the formula is given as } P = .2(X/Y \times Z),\]

where \(P\) = required portion to be made available in targeted areas,

\[X = \text{average annual aggregate principal amount of mortgages executed during the preceding three calendar years for single-family owner-occupied residences,}\]

\[Y = \text{total population within the state, based on the most recent decennial census for which data are available,}\]

\[Z = \text{total population within the targeted areas, based on the most recent decennial census for which data are available.}\]

As \(Z\) increases, the amount required to be set aside for a targeted area increases. The formula prescribed by the federal government is based on population, not mortgages executed, in the targeted areas.
as the population of these areas increases, so does the amount targeted to these areas. A housing bond issuer is allowed to utilize the formula that sets aside the smaller of the two amounts of lendable bond proceeds. MHMFA could, therefore, minimize the amount of funds set aside under the Qualified Census Tract Program by minimizing the population in the designated census tracts.

Loan Delivery Period: The federal regulations also require that funds for federally-mandated targeted areas be reserved for a year. Funds set aside for MHMFA's targeted areas can be set aside for any time period less than five years.

The rating agencies would like to minimize the set-aside time period. Any funds set aside for federally-defined targeted areas are, by law, set aside for a year. Since the set-aside time period for MHMFA's targeting program is more flexible, the rating agencies would probably advocate setting funds aside for the Neighborhood Preservation Area Program for a minimum period of time.

In the Agency's third bond issue in which both Qualified Census Tracts and Neighborhood Preservation Areas are implemented, funds for the NPA Program are set aside for three months (after this initial three months, lenders have the option of setting the funds aside for another three months). In MHMFA's first two bond issues, funds
for Neighborhood Preservation were set aside for six months and lenders could renew this commitment for three months in addition to the initial six months.

OPTION #1: ADVANTAGES AND DISADVANTAGES

Advantages: (a) The fact that the federal Treasury delineates the Qualified Census Tracts makes MHMFA's administration of the targeting program a little easier.

Disadvantages: (a) The fact that two targeting programs must be implemented
(b) The large number of qualified designated under the federal regulations
(c) The improbability of the Neighborhood Preservation Areas and the Qualified Census Tracts overlapping
(d) The proportion of funds that must be set aside for targeting areas
(e) The length of time for which the funds for the federally-defined areas must be set aside curtails the amount of time for which funds for Neighborhood Preservation Areas must be set aside.
Option #2

Implementing Both Areas of Chronic Economic Distress and the Neighborhood Preservation Area Program

Types and Numbers of Areas Designated: Implementing the federally-defined Areas of Chronic Economic Distress and the Neighborhood Preservation Area Program would enable MHMFA to combine the two programs.

Both the Areas of Chronic Economic Distress and the Neighborhood Preservation Area Program are designated on the basis of housing stock criteria (see figure 3). Two of the criteria, those that indicate housing stock condition, and need of area residents for owner financing, are practically identical. Two of the criteria used to define the targeted areas differ: the area's potential for improvement and the existence of a Housing Assistance Plan.

The federal government criteria for an area's potential for owner financing mandates that an area be improved by the use of owner-financing without large expenditures of funds and without creating displacement of current residents. Thus, MHMFA's criteria for defining a targeting area differ from those of the federal government because they stipulate that the target area chosen should be in a condition such that it can be improved with a moderate expenditure of funds in order to minimize the displacement of area residents. These "mitigating clauses" allow NPA program administrators to designate less "bottomed out" areas than would the federal regulations.
### FIGURE 3

**A COMPARISON OF CRITERIA USED TO DEFINE THE FEDERAL TARGETING PROGRAMS AND MHMFA'S TARGETING PROGRAM**

<table>
<thead>
<tr>
<th>Indicator Used</th>
<th>Federal Targeting Programs</th>
<th>MHMFA's Targeting Program</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Qualified Census Tracts</td>
<td>Areas of Chronic Economic Distress</td>
</tr>
<tr>
<td>Defined by These Criteria</td>
<td>Income</td>
<td>Housing Stock</td>
</tr>
<tr>
<td>70 percent of the families in the census tract must have incomes of not more than 80 percent of statewide median income</td>
<td>Housing stock condition</td>
<td>Need of area residents for owner financing</td>
</tr>
<tr>
<td></td>
<td>Area's potential for improvement</td>
<td>- by use of owner financing</td>
</tr>
<tr>
<td></td>
<td>Existence of a Housing Assistance Plan</td>
<td>- without large expenditures of funds</td>
</tr>
</tbody>
</table>
MHMFA should argue to HUD that the mitigating criteria used in the selection of its Neighborhood Preservation Areas should also be applied to Areas of Chronic Economic Distress. This is necessary to ensure that the designated areas have housing stock in a condition in which a homeownership program could be used effectively. In addition, being selective about the types of areas designated, could minimize displacement of current residents.3

Not only are the criteria used to define the federally-defined Areas of Chronic Economic Distress and MHMFA's Targeting Program similar, but it also appears as though they could be used to define the same set of areas. The experience of other state housing finance agencies with pre-federal-Act targeting programs bears this out. Of the four housing bond issues with pre-federal Act targeting programs, two have applied and have had their targeted areas designated as Areas of Chronic Economic Distress with little modification.

New Jersey Mortgage Finance Agency was able to designate thirty-seven of forty-one state-targeted municipalities

3 The other difference between the criteria to define the federal targeting program and the criteria used to define MHMFA's targeting program is that the federally-defined criteria mandate the existence of a Housing Assistance Plan. This criterion can be waived if the area designated fulfills the other criteria mandated by the Act.
as Areas of Chronic Economic Distress.\footnote{\textit{New Jersey Mortgage Finance Authority, Neighborhood Loan Program Four, Highlights, January 4, 1982.} Conversation with Melina Mann, Public Information Officer, New Jersey Mortgage Finance Agency.} Connecticut Housing Finance Agency (CHFA) was able to have three of its nine targeted urban area cities approved as Areas of Chronic Economic Distress in whole. Specific census tracts from five of the remaining nine cities qualified under the federal guidelines as well. This rate of approval for CHFA's pre-federal act targeting program is surprising in light of the loose definition used by the Connecticut Housing Finance Agency for a target area. CHFA defined its target areas as cities with a population over 75,000 or with a population density in excess of 3,500 persons per square mile of accessible land area.

As discussed above, MHMFA's definition of a Neighborhood Preservation Area is much closer to the federal definition of an Area of Chronic Economic Distress. If CHFA was able to get most of its Urban Area cities designated Areas of Chronic Economic Distress, then it appears that MHMFA should be able to have most of its targeted areas approved as well.

A chief advantage of implementing the federally-defined program of Areas of Chronic Economic Distress and the Neighborhood Preservation Area Program is that the two programs can be combined, so that only one targeting program has to be implemented.
Ease of Implementation: A major drawback to implementing the federally-defined program Areas of Chronic Economic Distress is that the Agency must have the areas approved by the U.S. Department of Housing and Urban Development (HUD) and U.S. Treasury. This approval process requires that a formal application be prepared that includes statistics showing that the areas meet the federally-defined criteria for an Area of Chronic Economic Distress. The time needed to prepare this application has varied, ranging from one to two months. The application then has to be approved by HUD; both the area office of HUD and the central offices of HUD in Washington, and by the Treasury. The time period for this review procedure has also varied, ranging from two weeks to two months. Thus, the Agency should expect a minimum application time period of one and a half months and a maximum application time period of four months.

Although combining the federally-defined program of Areas of Chronic Economic Distress and the Neighborhood Preservation Area Program may make the program easier to administer on an ongoing basis, because the Agency must engage in an approval process for the ACED program, it is fairly difficult to start up initially.

Program Characteristics:

Proportion of Funds Set Aside: If MHMFA implements the federally-defined program of Areas of Chronic
Economic Distress and the Neighborhood Preservation Area Program, then the federal guidelines regarding set aside portion of lendable bond proceeds must be followed. Hence, the Agency must set aside up to 20 percent of its lendable bond proceeds for use in the targeted areas. Depending on the areas chosen for targeting, this could mean that a significant amount of money is set aside for targeted areas.

Using the ten currently designated Neighborhood Preservation Areas for an example (population approximately 10,000), one finds that around $5.4 million would have to be set aside for targeted areas. If these areas received this amount of mortgage funds over several bond issues, then all eligible housing and eligible homeowners in the Neighborhood Preservation Area may be exhausted. The availability of such a large amount of funds for targeted areas could result in housing price increases in and displacement of current residents from the targeted area.

To mitigate this impact, MHMFA could expand the number and/or size of targeted areas. Unfortunately, expanding the number of targeted areas

\[ \frac{P}{5} = 0.2 \left( \frac{1,555,000,000}{5,737,037} \times 100,000 \right) = 5,420,917 \]
may create problems for the Agency administratively. As mentioned above, the amount of staff time that can be spent monitoring each targeted area is very important and decreases as the number and size of targeted areas increases.

Thus, the proportion and amount of funds to be set aside for targeted areas under this option may present a dilemma for the Agency. On the one hand, the Agency will not want to saturate a targeted area with MHMFA mortgage loans, yet on the other, the Agency cannot designate a large number of targeted areas without creating administrative problems.

**Loan Delivery Period:** If this option is implemented then the funds must be set aside for one year, as required by the federal regulations.

**OPTION #2: ADVANTAGES AND DISADVANTAGES**

**Advantages:**
(a) Under this option, the Agency would only have to implement one targeting program
(b) The Agency could probably designate its Neighborhood Preservation Areas as Areas of Chronic Economic Distress with minimum likelihood of HUD rejection of these areas
(c) Funds for one targeting program only would have to be set aside
(d) Loan delivery period for all targeted area loans would be the same--one year
Disadvantages: (a) MHMFA would have to apply to HUD and the Treasury to have its Areas of Chronic Economic Distress approved. This approval procedure could take from one and a half to four months.

(b) Using Areas of Chronic Economic Distress as target areas presents the Agency with a dilemma: It can either maintain the current number of target areas and run the risk of saturating the housing markets in those areas or it can expand the number of target areas and run the risk of designating too many areas for the Agency to administer.

OPTION #3

Contingent upon the amendment of MHMFA's legislation so that its Neighborhood Preservation Area Program is rendered optional, the Agency can choose not to implement its NPA Program and only implement one of the federally-mandated targeting programs.

Types and Numbers of Areas Designated: If this option were pursued, then the Agency would be implementing one of the federally-defined targeting programs without the contribution (or hindrance) of the Agency's Neighborhood Preservation Area Program.
If the Agency implemented the Qualified Census Trust Program without the Neighborhood Preservation Area Program, then it would lose all discretion in the types and numbers of areas designated. The areas designated by the QCT program criterion may not be areas that MHMFA feels need mortgage funds. In fact, the criterion is so arbitrary they could be areas not in need of mortgage-financing at all--either industrial or commercial areas or areas with no privately owned one-to-four family homes. MHMFA would have no control over these designations.

In contrast, the federally-defined program of Areas of Chronic Economic Distress would allow the MHMFA to designate its own areas. On the other hand, implementing the federally-defined program of Areas of Chronic Economic Distress without the Agency's Neighborhood Preservation Area Program may present a problem for the Agency. As mentioned above, the federal criteria for ACED designation do not contain the "mitigating clauses" of MHMFA's criteria for NPA designation. Unless MHMFA's mitigating clauses are applied to the choice of an area, then areas in appropriate for a homeownership program may be chosen. The program may be ineffective in revitalizing the area or it may result in the displacement of the current residents.

Ease of Implementation: Implementing one of the federal targeting programs without the Neighborhood Preservation
Area Program would be straightforward. Funds would be set aside for either Qualified Census Tracts or Areas of Chronic Economic Distress. As mentioned above, a Qualified Census Tract Program could be implemented quite expeditiously while Areas of Chronic Economic Distress would have to be approved by HUD.

Program Characteristics:

Proportion of Funds Set Aside: Funds would be set aside according to the federal guidelines. Thus, up to 20 percent of lendable bond proceeds would be set aside for the target areas. The exact amount of funds set aside would depend upon the federal program chosen (Qualified Census Tract or Areas of Chronic Economic Distress, and the areas designated under these programs.

Loan Delivery Period: Funds for targeted areas must be set aside for a year, as required by the federal regulations.

OPTION #3: ADVANTAGES AND DISADVANTAGES

Advantages: (a) The program would be easy to implement, neither requiring that two targeting programs be implemented separately or that two targeting programs be combined. Only one federal targeting program would have to be implemented. (b) Only one portion of funds would have to be set aside for targeted areas
Disadvantages: (a) The federal targeting programs are not well designed for MHMFA. The Qualified Census Tract Program removes all discretion from the Agency for designation of targeted areas. The areas delineated by the program criterion may not be areas in need of targeted homeownership funds. (b) The Areas of Chronic Economic Distress Program may also designate areas inappropriate for an unsubsidized single-family homeownership program.

ISSUE #1: RECOMMENDATION

In this section, the impact of the new federal targeting requirements would have on the Agency's Neighborhood Preservation Area Program was explored. Three ways in which the federal targeting program(s) and the Agency's targeting program could be combined were explored. These three options were:

Option #1
Implementing the federally-defined targeting program, Qualified Census Tracts and MHMFA's targeting program, Neighborhood Preservation Area Program.

Option #2
Implementing the federally-defined targeting program, Areas of Chronic Economic Distress and MHMFA's targeting program, Neighborhood Preservation Area Program.
Option #3
Implementing only one of the federally-defined targeting programs (contingent upon the amendment of the Agency's legislation).

These three options were then examined as to their impact upon the Agency in terms of types and numbers of areas designated, ease of implementation and program characteristics (proportion of funds set aside and loan delivery period). A summary of these impacts and their significance is presented in Figure 4.

As can be seen from this figure, the two options that appear to be most advantageous for the Agency are option #1 and option #2. Unfortunately, it is difficult to make a choice between the two options. The chief drawback to option #1, designating Qualified Census Tracts and Neighborhood Preservation Areas as targeted areas, is that the Qualified Census Tract Program requires the designation of a large number of census tracts as target areas, with little input or choice from MHMFA.

On the other hand, there are two drawbacks to option #2, designating Areas of Chronic Economic Distress and Neighborhood Preservation Areas. A fairly important disadvantage to this option is the amount of time and energy that must be invested in the initial start-up of the federally-mandated targeting program. Another fairly important disadvantage to this option is the dilemma that it presents the Agency with
Fig. 4

Summary Impact Chart

How MHMFA could combine the federal targeting requirements
with its own targeting requirements: Implications of the
three options.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Option #1: QCT &amp; NPA&lt;sup&gt;1&lt;/sup&gt;</th>
<th>Option #2: ACED &amp; NPA&lt;sup&gt;2&lt;/sup&gt;</th>
<th>Option #3: QCT or ACED&lt;sup&gt;3&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Types and numbers of areas designated</td>
<td>---</td>
<td>++</td>
<td>--</td>
</tr>
<tr>
<td>Ease of Implementation:</td>
<td></td>
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<tr>
<td>Initial Startup</td>
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<td>--</td>
<td>+</td>
</tr>
<tr>
<td>Ease of Implementation:</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Ongoing administration</td>
<td>--</td>
<td>++</td>
<td>+</td>
</tr>
<tr>
<td>Program Characteristic:</td>
<td>--</td>
<td>--</td>
<td>+</td>
</tr>
<tr>
<td>Proportion of funds set aside</td>
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</tr>
<tr>
<td>Program Characteristic:</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Loan Delivery Period</td>
<td></td>
<td></td>
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</tbody>
</table>

See notes on next page for explanation of symbols.
notes to figure 4:

1. QCT & NPA: Qualified Census Tracts and Neighborhood Preservation Area Program

2. ACED & NPA: Areas of Chronic Economic Distress and Neighborhood Preservation Area Program

3. QCT or ACED: Choice between the two federally-defined targeting programs: Qualified Census Tracts and Areas of Chronic Economic Distress

Key to Ratings:

+++ Very Significant Advantage

++ Fairly Important Advantage

+ Slight Advantage

0 Neutral

- Slight Disadvantage

-- Fairly Important Disadvantage

--- Very Significant Advantage
regard to funds set aside for targeted areas. The Agency can either maintain the current number of target areas and run the risk of saturating the housing markets in those areas or the Agency can expand the number of target areas and run the risk of designating too many areas for the Agency to administer.

A recommendation must be made, nonetheless. Despite the disadvantages associated with option #2, it is recommended that the Agency combine its own targeting program, the Neighborhood Preservation Area Program, with the federally-defined program, Areas of Chronic Economic Distress. Using Areas of Chronic Economic Distress, as opposed to the alternate federal program offered, Qualified Census Tracts, will enable MHMFA to define its present Neighborhood Preservation Areas as Areas of Chronic Economic Distress.

As more and more housing bond issuers apply to the Departments of Housing and Urban Development and the U.S. Treasury for designation of certain areas as Areas of Chronic Economic Distress, the types of areas eligible are becoming increasingly apparent. Based on previous approvals, it seems reasonably clear that MHMFA will have little trouble qualifying its targeted areas as Areas of Chronic Economic Distress.

Using the federal program, Areas of Chronic Economic Distress, will enable the Agency to combine the federal guidelines with its own guidelines. Combining the federal and state programs into one would simplify the administrative task for the Agency.
Administrative simplicity would also be achieved independent of the program merger, if the Agency uses Areas of Chronic Economic Distress, as opposed to Qualified Census Tracts. The large number of census tracts designated under the latter option, coupled with the inflexibility of the program generally, make the Qualified Census Tract Program more difficult for the Agency to administer.

The disadvantages associated with option #2 are avoidable. The Agency could avoid the excess administrative burden associated with designating Areas of Chronic Economic Distress if it requires municipalities and community-based organizations to submit the required statistics with their application to MHMFA. MHMFA has then only to assemble the data and forward it to HUD and Treasury.6

MHMFA could avoid the dilemma of having to choose between saturating the housing markets in target areas and designating too many target areas to administer effectively by applying for the areas in stages. This is the strategy Virginia Housing Development Authority has employed in its targeting program.7 Initially, the Agency could apply for designation of only its Neighborhood Preservation Areas.

6In the ACED designation procedure HUD actually forwards applications to Treasury.

7Conversation with Robert Adams, Virginia Housing Development Authority, May 18, 1982.
The following year the Agency could then apply to HUD to add other targeted areas. The targeted areas would thus be changing, with the Agency emphasizing different areas at different times. The targeting program would grow incrementally, so that MHMFA could apply systematically the administrative tasks associated with the targeting program.

In summary, because of the ease of combining the federal program of Areas of Chronic Economic Distress with the Agency's Neighborhood Preservation Program and the relative unworkability of the Qualified Census Tract Program, it is recommended that the Agency do combine the two programs. As a result, the Agency would be fulfilling the federal targeting mandate by operating its own program.

ISSUE #2
Incentives MHMFA Offers to Lenders to Loan in Targeted Areas:

MHMFA's current Neighborhood Preservation Area Program provides lenders with an incentive to participate in the Program through the Agency's fund allotment process. Community groups overseeing MHMFA-approved NPA Programs approach local lenders, requesting that the lenders set aside a certain portion of the funds they receive from MHMFA for Neighborhood Preservation Areas. The lender then decides whether or not to commit the funds. The incentive provided to the lender to participate in the Program is that MHMFA will give those participating lenders more points in the allotment procedure.
These points will aid the lender in obtaining a greater allotment of funds from MHMFA. The lender can then use this greater amount of funds anywhere in its lending area. Once a set-aside amount has been established for the NPA, there are no incentives, other than community pressure, for the lender to lend in the NPA. The lender can choose, without penalty, to make loans in other parts of its lending area and make no loans in the Neighborhood Prevention Area.

The only provision MHMFA makes to direct funds to the targeted areas as opposed to the rest of the lender's lending area, is the set-aside time period. The longer the set-aside time period, the greater the probability that the funds will be expended in the targeted area and not reverted back to the Agency for statewide use.

The purpose of this section is (1) to outline the incentives that MHMFA could offer to encourage lenders to make loans in its targeted areas and (2) to examine the implications for the target area of MHMFA offering these incentives. There are three incentives MHMFA could offer to encourage lenders to loan in targeted areas. Two of these, suspending the first-time homebuyer requirement and raising sales price limits, are included in the Mortgage Subsidy Board Tax Act, and are discussed together in option #1. The third incentive, waiving income limits in targeted areas, is discussed in option #2.
OPTION #1

The federal Act permits housing bond issuers to relax two of its restrictions for mortgages made in targeted areas. Housing bond issues have the option of suspending the first-time homebuyer requirement and of raising the sales price limit from 90 percent to 110 percent of the area's average sales price.

Most other housing bond issuers have utilized these relaxations of the rules when implementing targeting programs under the federal Act. There are advantages to these relaxations. Relaxation of the first-time homebuyer requirement would provide the lender with a larger pool of potential mortgagees. Allowing higher sales price limits in targeted areas could expand the proportion and number of houses that could be financed under the program in a targeted area and thus could aid in the revitalization of the area.

Yet there are slight disadvantages to relaxing the rules in the targeted areas. Waiving the first-time homebuyer requirement in targeted areas could make the Program more administratively complex: Lenders would have to apply a different set of rules to targeted areas than to non-targeted areas. Allowing higher sales price limits for houses in targeted areas could increase the probability of housing price inflation occurring in the target area, displacing current residents.

MHMFA has chosen not to relax the federal regulations in targeted areas for its third bond issue. All participating
homebuyers must be first-time homebuyers. Purchase price limits are uniform across targeted and non-targeted areas. The reason cited for this decision is administrative simplicity.

OPTION #2

There is another incentive that MHMFA could offer lenders. If income limits were waived in targeted areas, then lenders would prefer to loan in these areas because they would have a pool of higher income borrowers that the MHMFA Program would not otherwise allow them to tap. The higher income borrowers would represent better credit risks to the lenders.

Other housing bond issuers have relaxed income limits in their targeted areas in the past. Before 1978, the Connecticut Housing Finance Authority did not have income limits for loans made in its targeted Urban Areas Program.

MHMFA could also pursue this option, since it is not prohibited from doing so by the federal regulations. The Agency's enabling legislation does not prohibit this option, and could be amended to specifically permit the Agency to waive its income limits in targeted areas.

On the other hand, the Agency's goals must be recalled. The Agency is attempting to bring about urban revitalization by providing mortgage loans for low and moderate income people without displacing current neighborhood residents. Waiving income limits in targeted areas would help bring about urban
revitalization, but would curtail program benefits directed to low and moderate income people. The program could possibly harm them, if it led to their displacement.

ADVANTAGES AND DISADVANTAGES OF THE OPTIONS

Option #1: Waiving the First-Time Homebuyer Requirement and Raising Purchase Price Limits in Targeted Areas

Advantages: (a) Would provide the lender with a larger pool of potential mortgagors.  
(b) Would expand the number of houses in a targeted area that could be financed with MHMFA funds.

Disadvantages: (a) Could make the program more complex administratively.
(b) Could increase the probability of housing price inflation occurring in the target area, displacing current residents.

Option #2: Waiving Income Limits in Targeted Areas

Advantages: (a) Lenders would have a pool of higher income borrowers in targeted areas, thus would be enticed to make more loans in these areas.

Disadvantages: (a) May create housing price inflation in targeted areas, which may lead to the displacement of current residents.
(b) Could make the program more complex administratively

**ISSUE #2: RECOMMENDATION**

MHMFA should retain its current policy of not offering special incentives to lenders to loan in targeted areas. The incentives discussed above do not offer MHMFA any special advantages and they change the impact of the Agency's targeting program. Waiving income limits in targeted areas is the least beneficial change the Agency could make. The Program change offers the Agency only one advantage: creating a pool of higher income borrowers in targeted areas, and has two disadvantages associated with it: creating housing price inflation in targeted areas and complicating the administration of the program. The advantages and disadvantages of the first option, the incentives of targeted areas offered by the federal government, are more evenly matched. Neither of the advantages: providing the lender with a larger pool of potential mortgagors or expanding the number of houses eligible for a MHMFA loan in a targeted area, outweigh the disadvantages: complicating the administration of the program and possibly creating housing price inflation in targeted areas. When the next bond issue is implemented, MHMFA should monitor loan activity in targeted areas. If the agency finds that funds are being channeled to targeted areas at a much slower rate than funds for targeted areas, then the agency may want to relax some of the restrictions on loans made in targeted areas.
Chances are, it will not be necessary to provide these incentives for lenders to loan in targeted areas. In the past, MHMFA has had little problem encouraging lenders to loan in targeted areas. In the Agency's second bond issue, for example, 83 percent of the funds committed to targeted areas were loaned in these areas.

However, just in case the Agency faces difficulty encouraging lenders to place loans in targeted areas in the future, it may want to consider implementing one or several of these incentives in targeted areas.

Given that the agency should balance program goals and ease of program implementation, it should ease the restrictions one at a time. Also, the agency should ease last those restrictions that conflict with the agency's goals. Thus, the agency may want to waive the first-time homebuyer requirement first. The purchase price limits should be relaxed (increased from 90 percent of the average area price to 110 percent) next. Relaxing this requirement could have an impact on housing prices in the neighborhood, so sales price trends should be watched. Finally, the agency could relax its income limits in targeted areas. This action would be last, also, because it might require a change in the agency's legislation.
ISSUE #3

The Roles of Lending Institutions, Municipalities and Community Groups in MHMFA Loan Delivery to Targeted Areas

In the Agency's past two bond issues, the loan delivery process of MHMFA's targeting program has differed from the loan delivery process of the rest of the program. In MHMFA's homeownership program, the loan delivery process only involves two entities: MHMFA and the lending institution. Borrowers interested in obtaining a MHMFA loan contact a local bank or savings and loan institution and apply for the MHMFA loan much as they would for a conventional loan.

Loan delivery in the Agency's NPA targeting program differs from this basic model. As it has functioned in the Agency's first two bond issues, the Neighborhood Preservation Area Program involves four entities: MHMFA, the lenders, municipalities and community groups. A NPA is designated by MHMFA at the recommendation of local residents, the municipality, and local mortgage lenders. Participating lenders agree to set aside a portion of their mortgage funds for use exclusively in the NPA. The municipality agrees to improve public facilities and services in the neighborhood. In the Agency's legislation, the participation of community groups in the review process of the Neighborhood Preservation Area Program has been mandated. MHMFA recommends that the NPA Program be used in conjunction with existing local programs with established neighborhood preservation plans.
MHMFA, in its targeting programs for the first two issues, has emphasized the linkages between these three groups: lenders, municipalities and the community. Community groups were seen by the Agency as the entities that would perform the actual linking.

A model of MHMFA's targeting program would appear as follows:

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MHMFA  $  Lenders  $  Borrowers
         ↓   Community   ↓   Community-Based
                  Organizations/
                  Municipalities
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The principal advantage of this model of loan delivery is that the community-based organization links the lender with the neighborhood and could potentially direct certain kinds of borrowers to participate in the program who otherwise may not have participated. The community-based organization link between the community and lenders makes MHMFA's targeting program a much more active, as opposed to passive, program.

In order to determine if this loan delivery process is the most advantageous for MHMFA, an assessment of other loan delivery processes will be made.

**OPTION #2**

In the Mortgage Subsidy Bond Tax Act, the federal government does not specify how money is to be made available in the targeted neighborhoods. Thus, housing bond
issuers will probably make money available for federally-defined target areas through commitment agreements to lenders. Lenders would then make mortgages available to borrowers in the targeted area. After the loan is made, the lenders would sell the mortgages to MHMFA.

Thus, the implicit model of loan delivery proposed by the federal government is a relatively simple one.

Although this model has been used frequently by local entities issuing housing bonds, most state housing finance agencies have not used this structure.

The New Jersey Mortgage Finance Agency is an exception to this statement. The NJMFA delivers loans to targeted areas using this simple structure. The NJMFA is probably only able to use this simple structure with its "targeting program" because that is its only single-family homeownership program. All single-family mortgages are made in forty-one Eligible Neighborhoods. No special effort needs to be undertaken to encourage lenders to channel mortgage funds into targeted neighborhoods since lenders are only able to loan in these neighborhoods. This is because, in most targeting programs, this link to the community is very important. The community-based organizations and municipalities promote the homeownership program in the targeted
area, ensuring that a reasonable number of loans are made in these areas. Their promotional activities take the form of publicity (leaflets and homeownership seminars), financial counseling to potential homebuyers and word-of-mouth dissemination of information. Community-based organizations can also pressure lenders to make loans in targeted areas. The presence of community-based organizations could therefore be important if a lender is initially not responsive to the mortgage loan needs of the targeted area. Thus, it appears as though municipalities and community-based organizations are important for the targeted areas administratively and strategically.

OPTION #3

Besides MHMFA's loan delivery model and the simple loan delivery structure outlined above, there is one other way for the loan delivery process to be carried out. Municipalities and community-based organizations can package the loans for sale to lenders or the state agency. Several state housing finance agencies utilize this model. Their experiences will be explored below.

In Michigan, persons living in targeted neighborhoods apply for loans (in this case, rehabilitation loans) through their city government rather than through a lender. The State Housing Finance Agency there, the Michigan State Housing Development Authority (MSHDA), transfers the home
improvement loans for targeted areas through the area's municipal government. 8

According to Howard Miles, Director of the Home and Neighborhood Improvement Program, lenders like the arrangement provided by the targeted Neighborhood Improvement Program, because it saves them time and energy. The municipality packages the loans for presentation to the local lender, the lender has only to service the loans once they are made. 9

In California, as well, municipalities are quite involved in delivery of the California Housing Finance Agency's Home Ownership and Home Improvement Program (HOHI). Municipalities are responsible for marketing HOHI loans in conjunction with other Community Development Block Grant-funded housing programs in HUD-approved target areas (called Concentrated Rehabilitation Areas). 10 About one-half of all loans were placed in these neighborhood preservation-type areas.


9 Howard Miles, Director of the Neighborhood and Home Improvement Programs, Michigan State Housing Development Authority, March 22, 1982.

Thus, the Michigan SHDA and California HFA programs are distinguishable in that the municipalities are responsible for organizing the loans, for delivery to lenders, rather than organizing the borrowers for delivery to the lenders.

The three possible loan delivery models are:

MHMFA MODEL:

\[
\text{Bond Issuer} \rightarrow \text{Lender} \rightarrow \text{Borrower} \\
\text{Community} \leftrightarrow \text{Community-Based Organization/Municipality}
\]

IMPLICIT FEDERAL MODEL:

\[
\text{Bond Issuer} \rightarrow \text{Lender} \rightarrow \text{Borrower}
\]

MICHIGAN SHDA AND CALIFORNIA FHA MODEL:

\[
\text{Bond Issuer} \rightarrow \text{Community-Based Organizational/Municipality} \rightarrow \text{Borrower} \rightarrow \text{Lender}
\]

The goals and emphasis of the three models of loan delivery differ. The first model is a more conventional model of loan delivery than the latter two models. It is also a more passive model, in that the borrowers approach the lender.
In the other two models, there is an intermediary involved in the process. The involvement of an intermediary with ties to the community creates the potential for more outreach to normally hard-to-reach borrowers.

On the other hand, the involvement of other actors in the loan delivery process could potentially create problems if unnecessary complexity is created. For example, involving municipalities and community-based organizations in the loan delivery process would add one or two more entities with which MHMFA and participating lenders must communicate. Community-based organizations are only useful to the targeting program if they are familiar with the bank's loan policies and are able to keep track of the amount of funds left in the lender's commitment amount. Lenders, therefore, must spend time educating and corresponding with the community groups. The extra effort that the lender has to spend on the targeting program may be a disincentive to a lender's participation in the program.

MHMFA would also have another set of actors with which to communicate, creating more administrative work for the Agency's staff.

DISCUSSION OF THE THREE MODELS

In order to determine which loan delivery model would be best for MHMFA, a more careful analysis of the advantages and disadvantages of each model must be made.
The three models are associated with different goals. The first model, the "implicit federal model", is clearly designed for a straightforward homeownership program. The principal goal of a program using this loan delivery process would be to deliver loans to a given population as expeditiously as possible. In this model, it is assumed that all borrowers have equal access to the program and are equally knowledgeable of the existence of the program, house-hunting procedures and mortgage loan application procedures. It is assumed that a group of individuals participating in the MHMFA Program would be fully representative of the eligible population.

The second model is that of a homeownership program, but with the associated goal of community development. The sponsoring agency forms the link with the community-based organization of a certain neighborhood in order to promote homeownership and home rehabilitation within that neighborhood.

The second model assumes that some groups in the population will be more difficult to reach than others. The community-based organization can reach out to those groups in the population that would be less likely to participate in the programs. These groups may be less informed about general goings-on or they may be less familiar with the mortgage loan application procedure. These groups could also be those sometimes excluded from homeownership because of
prejudice. Households that marginally qualify for homeownership may belong in this group of overlooked borrowers, as may households that use some other language than English. Theoretically, the community-based organization would know how to reach these groups and in some cases would have already formed linkages with them. Thus, the community-based organization acts as an intermediary between the lender and the community.

The homeownership counseling provided by community-based organizations participating in MHMFA's Neighborhood Preservation Area Program can also be used for an outreach to groups in the community. For example, the community-based organization could provide a bilingual homeownership counselor to explain the program to non-English speaking potential applicants.

The third model of loan delivery also interjects an intermediary between the borrower and the lender. In this model, the municipality or community-based organization performs some of the tasks normally performed by the lenders. The lender's work and thus, to some degree, costs are reduced. This type of program structure would give the lender an incentive to participate in the targeting program. At the same time, however, the costs borne by municipalities or community-based organizations participating in the program would be increased, providing a possible obstacle to their participation in the program.
ADVANTAGES AND DISADVANTAGES OF THE OPTIONS

Option #1: MHMFA Model

Advantages: (a) This model could reach hard-to-reach community residents and inform them of the Agency's homeownership program.
(b) This model provides a vehicle by which homeownership counseling can be provided to the community.

Disadvantages: (a) Could create unnecessary complexity and discourage some lenders from participating in the Neighborhood Preservation Area Program.

Option #2: The Implicit Federal Model

Advantages: (a) Loans can be provided expeditiously to the targeted area, without any complicating interconnections.

Disadvantages: (a) Some groups in the community may not be informed about the targeting program, and may not participate.

Option #3: Michigan SHDA and California HFA Model

Advantages: (a) Would be an incentive for lenders to participate in the targeting program.

Disadvantages: (a) Could discourage community-based organizations or municipalities from participating in the program.
(b) Could create unnecessary complexity.

ISSUE 3#: RECOMMENDATION

It is recommended that the Agency continue with its current loan delivery process for its targeting program and involve municipalities and community-based organizations as intermediaries between MHMFA, lenders and borrowers. These intermediaries would not package loans to sell to lenders or to MHMFA, but would serve only coordinating and information-spreading roles.

The simple structure, the implicit federal structure, is not recommended because of the need to provide outreach to certain groups in the Agency's targeted areas. The simple structure is also not recommended because the Agency is trying to implement more than just a homeownership program in these targeted areas; it is trying to implement a community development program.

The loan delivery model used by the Michigan State Housing Development Authority and the California Housing Finance Agency is also not recommended. Obligating municipalities and community-based organizations to package loans for lenders would place a burden on the municipalities/community-based organizations without apparent benefit to the program as a whole. The primary benefit of this model is that lenders are provided with an incentive to participate in the program. It is not clear that this incentive is needed.
In the Agency's second bond issue, lenders participated in the targeting program, distributed among ten Neighborhood Preservation Areas, even with the minimal incentives provided them.

The option in which municipalities and community-based organizations participate, but do not have to package loans for the lenders, is the best alternative for the Agency.

CONCLUSION

The purpose of the targeting provisions of the Mortgage Subsidy Bond Tax Act was to ensure that a portion of the proceeds from the sale of tax-exempt bonds for single-family housing was directed into deteriorated neighborhoods.\textsuperscript{11} The targeting provisions, therefore, are intended to guarantee that tax-exempt bonds for single-family housing fulfill a public need.

Despite these good intentions, the provisions create difficulties for housing bond issuers. The targeting provisions place an additional administrative burden on housing bond issuers. At the same time, other provisions of the Act limit the ability of housing bond issuers to cover their administrative costs. Most housing bond issuers have found they have been unable to structure single-family bond issues without an infusion of capital.

\textsuperscript{11} U.S. Congressional Budget Office, Mortgage Subsidy Bond Tax Act: Experience under the Permanent Rules, Staff Working Paper, March 1982, p. 1
The Mortgage Subsidy Bond Tax Act presents MHMFA with the same problems. Yet, for MHMFA, the dilemmas associated with the targeting provisions of the Act do not center on how the Agency will structure a targeting program. Rather, they center on how the Agency will combine its targeting program with the federal targeting program. In fact, the federal regulations place MHMFA in a curious position. MHMFA's targeting program embodies many of the qualities of the federal targeting program. The Neighborhood Preservation Area Program targets a portion of the Agency's lendable bond proceeds into areas with deteriorating housing stock, just as the federal targeting program, Areas of Chronic Economic Distress, requires.

The difficulty of the Agency is that its Neighborhood Preservation Area Program, in many ways, goes beyond the federal requirements. The Neighborhood Preservation Area Program establishes an organizational network among MHMFA, lenders, municipalities and community-based organizations. These groups work together to implement the Neighborhood Preservation Area Program. The NPA Program also expects more from lenders than the federal targeting program. The Neighborhood Preservation Area Program expects lenders to execute loans in targeted areas without additional incentives.

The Mortgage Subsidy Bond Tax Act places single-family housing bond issues at a disadvantage relative to other tax-exempt bond issue types. Many of the provisions of the Act add
additional costs to the issuance of single-family housing bonds. Still other provisions of the Act increase the risk of housing bond investors. Since investors require an interest rate premium to compensate for this risk, these provisions also increase the cost of issuing single-family housing bonds.

Under these conditions, the Agency and the Agency's representatives and overseers in the bond market (the underwriters and the rating agencies), must look for ways to diminish risk and cost. The risky and costly program elements most likely to be cut are those not mandated by the federal Act. Several of these riskier and costlier program elements are part of the Neighborhood Preservation Area Program.

As a result, NPA program elements, such as the involvement of municipalities and community-based organizations in the delivery of loans, are questioned. Any targeting program decision is scrutinized carefully, its necessity evaluated and its probable reception by the financial community gauged. The necessity for implementing the federal targeting requirements may result in the curtailment of the Agency's targeting program.

Many of the progressive elements of MHMFA's targeting program--its organizational structure at the community level, the way the targeted areas are chosen--are endangered by the federal targeting provisions. This is ironic, given that the
federal targeting provisions ostensibly have the same purpose as the Agency's targeting provisions.

The Agency's experience with the Mortgage Subsidy Bond Tax Act thus presents us with an example of the complexity of intergovernmental relations, the difficulty of balancing regulative flexibility/inflexibility, and the inadvertency of policy impacts.
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