HOUSE RESEARCH ORGANIZATION bill analysis | 5/10/99 | HB 3315 Cuellar (CSHB 3315 by Najera)

SUBJECT: Guaranteed construction loans and conversion of contracts for deed

COMMITTEE: Urban Affairs — committee substitute recommended

VOTE: 6 ayes — Carter, Bailey, Clark, Edwards, Ehrhardt, Najera

0 nays

3 absent — Burnam, Hill, Hodge

WITNESSES: *(On original version:)*
For — John Henneberger, Texas Low-Income Housing Information Service

Against — None

On — John Garvin, Texas Department of Housing and Community Affairs; Scott Hendrix and Bee Moorhead, Comptroller of Public Accounts; Reymundo Ocanas, Texas Association of Community Development Corporations

BACKGROUND: A contract for deed (CFD) is an agreement between a buyer and seller of property in which the seller keeps the title and all rights to the property until the customer pays the price in full. The down payment and monthly payments under a CFD are less expensive than under a mortgage. However, the seller can reclaim the property and any improvements made to it in the event of late payment.

The Texas Department of Housing and Community Affairs (TDHCA) administers the Home Investments Partnership Program (HOME). This federal program is aimed at expanding the supply of affordable housing for low-, very low-, and extremely low-income households, those with incomes at or below 80 percent of the average median income in their region. TDHCA distributes HOME funds through statewide or regional competitions or by direct award. The HOME program covers construction and rehabilitation of owner-occupied housing and home ownership development.

DIGEST:

CSHB 3315 would amend the Government Code to direct TDHCA to establish an interim construction loan program and a program to help low-income housing owners convert CFDs to warranty deeds. Both programs would be guaranteed by the state.

Under the loan program, TDHCA would have to cooperate with construction supply companies and nonprofit housing assistance organizations to provide interim construction loans for eligible owner-builders. The agency also would have to provide other services to facilitate implementation of the program, including assistance with CFD conversion and with refinancing interim construction loans to provide private market-rate mortgages for participating owner-builders.

TDHCA would guarantee loans for the program but could not use state funds to do so. Eligibility criteria for both programs would include a priority for individuals and families of low, very low, or extremely low income.

Interim construction loan program. An interim construction loan could be used to build new residential housing or to develop, renovate, or otherwise improve existing residential housing. TDHCA could adopt rules necessary to achieve the program's purpose.

TDHCA would have to enter into participation agreements with construction supply companies or nonprofit housing assistance organizations to guarantee loans made by those companies or organizations to eligible owner-builders. The bill would define an owner-builder as a person who owned a property, either through a CFD or a warranty deed, and who undertook to make improvements to the property. The term would not include an owner or operator of a construction business.

TDHCA would have to help participating owner-builders refinance their interim construction loans to pay the loan balance and other debts on the property and to obtain a mortgage loan on the improved property. The agency also would have to identify private lenders to provide private market-rate mortgages for participating owner-builders and would have to identify nonprofit organizations and housing assistance programs to help owner-builders who did not qualify for private market-rate mortgages.

Participating construction supply companies or nonprofit organizations would have to administer the loans, provide technical assistance to owner-builders, and perform or help to perform inspections for improvements made to the property.

Loan guarantees. TDHCA would have to establish by rule a limit on the percentage of a loan that the department would guarantee under the program, based on the estimated value of the property after improvements were completed. Any agreement to back a loan would have to allow the agency to renegotiate the guarantee percentage annually, and the agency would have to do so when possible to obtain a better percentage for the state. A participating construction supply company or nonprofit organization could require an owner-builder requesting an interim construction loan to provide a warranty deed for the property as collateral.

Loan eligibility. TDHCA would have to establish eligibility requirements for owner-builders to participate in the program. The requirements would have to include a priority for families or individuals of low, very low, or extremely low income. TDHCA could select nonprofit housing assistance organizations to certify the eligibility of owner-builders to participate, using the agency's requirements.

Funding. TDHCA could not spend state money to fund a loan guarantee under the program. The agency would have to identify appropriate funds for the program and could cooperate with nonprofit housing assistance groups to establish loan guarantee pools that could be used to obtain loans.

Report on the program. TDHCA would have to prepare an annual report evaluating repayment history and coinciding guarantee percentages for loan guarantees issued under the program. The agency would have to deliver the report to the governor, the lieutenant governor, and the speaker no later than January 1, 2001.

CFD conversion program. TDHCA's Office of Colonia Initiatives would have to establish a program to guarantee loans made by private lenders to convert CFDs into warranty deeds. The office would have to use funds allocated to TDHCA under the federal HOME program and could use the services of the Texas Affordable Housing Corporation when necessary.

The office and the private lender would have to agree on the criteria for issuing a CFD conversion loan, including the percentage of the guarantee to be issued by TDHCA. Any agreement would have to allow the office to renegotiate annually the percentage guarantee for a loan issued by the lender, and the office would have to do so when possible to obtain a better percentage for the state. The office would have to establish eligibility criteria for CFD holders, and the requirements would have to include a priority for individuals and families of low, very low, or extremely low income.

The Office of Colonia Initiatives would have to prepare an annual report evaluating repayment history and coinciding guarantee percentages for loan guarantees issued under the CFD conversion program. The office would have to deliver the report to the governor, the lieutenant governor, and the speaker no later than January 1, 2001.

This bill would take effect September 1, 1999.

SUPPORTERS SAY:

CSHB 3315 would direct TDHCA to guarantee construction loans made by private construction supply companies and nonprofit groups to help the lowest-income Texans and their families build or improve their own homes. The bill also would help low-income Texans convert CFDs into standard mortgages so they could build equity into their property. Both of these measures were recommended in *Challenging the Status Quo*, a report by the comptroller's Texas Performance Review in March 1999.

Interim construction loan program. The bill would help hard-working, low-income citizens who have the requisite skills to make improvements to their homes but cannot afford the materials or tools to do so. Owner-built housing is an effective, affordable option for those who have the skills and financing to do it. Many residents of unincorporated areas wish to build or improve their homes, but conventional construction financing is not available for people with no record of construction and no capital or collateral. An unbuilt house cannot serve as collateral on a loan.

Sometimes owner construction projects proceed in a haphazard manner whenever the owner can accumulate cash, and this can result in substandard housing. Under the bill, participating construction supply companies would provide technical assistance to owners and would inspect properties to make sure they met local building codes.

If CSHB 3315 were enacted, a large construction supply company like Home Depot or Lowe's would be willing to lend money to low-income households if the state could guarantee a percentage of the loan. All parties would benefit from this approach. The homeowner could have a decent house, the state could improve housing for very low-income Texans at little cost, and the company would gain a new set of customers.

Large construction supply companies often are more accessible and less intimidating to low-income citizens than are financial institutions, and they also could help loan recipients negotiate the local building permit process. Home Depot executives, for example, have made it known that the company would be happy to make interim loans to owner-builders if the state could guarantee the loans, and the company would allow inexperienced owner-builders to use Home Depot's existing technical support program.

CSHB 3315 would give low-income Texans a chance to improve their homes and become less marginalized in their communities. When standards of living are raised and people feel proud of their homes, they are more likely to become productive taxpaying citizens with a stake in their communities. Communities, in turn, would be revitalized by additional jobs at local construction supply companies and by increased tax revenues.

Allowing the state to leverage private resources would expand the resources available to TDHCA. The bill would promote public-private partnerships to help those who otherwise could not obtain credit or mortgages in traditional ways. There is simply not enough state or federal money to begin to address the needs of lower-income Texans, so the state must begin to try innovative approaches with other sources of revenue.

This bill would give TDHCA another tool with which to meet critical housing needs in the state. TDHCA may find that the interim construction loan program created by CSHB 3315 would be more effective than other programs in helping low-income Texans.

The bill would not require that interim construction loans be financed through TDHCA's HOME program, although HOME funds could be used for that purpose. Funds also could come from private sources and from nonprofit organizations such as Habitat For Humanity. Only the CFD conversion program would have to be financed with HOME funds.

TDHCA would be guaranteeing only *a percentage* of the loans, and that percentage would be negotiated between the state and the lender. Since the lender could be liable for a sizeable portion of the loan if the borrower defaulted, the lender would have an incentive to screen loans carefully and follow through to see that the money was used wisely.

Opponents have suggested that the rate of default on these loans could be high. CSHB 3315 would provide safeguards by requiring TDHCA to promulgate rules to ensure that eligible loan recipients would have minimal risk of defaulting on their loans.

CSHB 3315 would help many Texans living in colonias in counties along the Texas-Mexico border. Colonias residents are too poor to take advantage of conventional loans, and when they bought their land, they often bought unserviced subdivided lots from developers under CFDs. Colonia families live in prefabricated trailers or build their own home using cheap, locally available materials. Most colonia residents are decent, hardworking people who would not renege on a loan if they could obtain one. CSHB 3315 would help many colonia residents realize their dreams.

According to housing finance experts, Texas has not maximized the potential of its federal housing funds. CSHB 3315 would give TDHCA another means to finance low-income housing improvements without directly lending the money and administering the program itself. This program is designed to complement, not compete with, other TDHCA programs.

CFD conversion program. Under a CFD agreement, the seller can reclaim the property and any improvements made to it in the event of late payment. In the past, CFDs have been abused by unscrupulous developers. Very low-income people, however, may have no other options for buying a piece of property.

In 1995, the Legislature instructed TDHCA to convert CFDs held by colonia residents into mortgages to allow residents to earn greater equity on their lot payments and to give them greater security against losing their homes. The Legislature authorized $20 million in tax-exempt bonds for fiscal 1996 and 1997 to finance the conversions.

TDHCA found it too difficult to issue the bonds because of lack of investor interest in the rate of return, and eventually the Bond Review Board rejected the project. The agency has resolved to implement a conversion program of its own. Since October 1998, it has completed 29 conversions at a cost of more than $500,000 and has allocated more than $5 million to convert 451 contracts before April 2000.

CSHB 3315 would increase the rate at which TDHCA could complete CFD conversions by guaranteeing loans by private lenders. Converting CFDs into traditional notes and deeds for trust would allow colonia residents to build equity and gain access to loan funds for construction and rehabilitation. The state guarantee would encourage private lenders to participate in the program and would increase the amount of funds available statewide for CFD conversion.

OPPONENTS SAY:

CSHB 3315 would create a program in which the state would guarantee high-risk home improvement and construction loans made by private lenders. TDHCA would be expected to guarantee these loans at a time when the agency can barely serve 1 percent of the demand for affordable housing in Texas. Also, the bill would provide no recourse for either the state or a private lender if borrowers defaulted on their loans.

The bill would not provide a mechanism by which TDHCA could oversee private companies' interim construction loans. It would be difficult to ascertain whether the company really was giving priority to low-, very low-, and extremely low-income people.

In addition to the CFD conversion program, the interim construction loan guarantee program would have to be financed by HOME funds because TDHCA would have no other funds available. HOME funds already are oversubscribed at a ratio of four to one. Adding an untested program that would have to be funded through HOME funds would reduce the funding available for other proven strategies. HOME funds can be used only to assist housing that meets the standards of the U.S. Department of Housing and Urban Development. Many homes owned through CFDs would not meet these standards.

HOME fund rules only allow loan guarantees up to 20 percent of the loan amount, and private lenders might well ask for a greater percentage because of their underwriting criteria. Due to low loan amounts, the 20 percent limit, and the time involved in completing a package for a low-income contract for deed holders, lenders probably would charge a higher interest rate to cover their expenses, thereby making the program unaffordable.

Interim construction loan program. It would be inappropriate for the state to guarantee loans made by Home Depot, Lowe's, or other large construction supply companies to people who wanted to make home improvements. Such companies already provide credit to their customers through credit cards and borrowing plans. Under CSHB 3315, the state would guarantee loans made by private companies who would benefit from the extra business at no risk to themselves.

There is no guarantee that the interest on these loans would be reasonable. Regardless of the state guarantee, the lender still would be at risk of a non-performing loan with substandard collateral. A construction supply company would have to charge the borrower a fairly high interest rate and fees for the loan to be cost-effective, especially if the company had to provide technical assistance for the construction.

Encouraging low-income owners to build their own houses or make their own renovations might work in some cases, but if these owners did not have the proper expertise to build a home that would meet building codes, the state would, in effect, be subsidizing substandard housing. The state might even wind up being held liable for that housing if it burned down because of faulty wiring, for example. The bill would allow owner-builders and building supply companies to circumvent contractors who usually ensure that building standards are upheld and who, because they receive discounts through contractor wholesale agreements, might be able to offer renovations for almost the same cost. There is also a question as to whether an owner-builder could afford to subcontract for an electrician or plumber.

To qualify for the loan, the owner-builder would have to be working full-time, which would make it almost impossible to build the house or make the improvement in a timely manner. Interim financing like the loans proposed in CSHB 3315 usually is for a six-month to one-year term.

CFD conversion program. CFD conversion is very time-consuming because CFD holders are often very low- and extremely low-income people who are unfamiliar with the concept of a mortgage. Sometimes they must be walked through every step of the process, as they have never even obtained a loan before. Some are migrants who disappear during certain seasons. This potentially could lead to a high default rate on these types of loans.

NOTES:

The original bill would have required TDHCA to cooperate only with construction supply companies for the interim construction loan program and did not mention nonprofit housing assistance organizations.

The Senate companion bill, SB 1703 by Ellis, which would create an interim construction loan program but includes no provisions for a CFD conversion program.

A related bill, SB 1287 by Lucio et al., would create an owner-builder loan program funded by TDHCA loans from grants, gifts, the Housing Trust Fund, and other sources. It would include certain eligibility requirements, loan limits, and requirements for educational classes for owner-builders.

Another related bill, SB 867 by Lucio, would create a CFD conversion program similar to the one proposed in CSHB 3315.

All three of these bills have passed the Senate and been referred to the House Urban Affairs Committee.