USDA

U.S. Department of Agriculture
Office of Inspector General
Midwest Region
Audit Report

RURAL HOUSING SERVICE
APPLICATION OF INTEREST SUBSIDY
PAYMENTS TO HOUSING LOAN
ACCOUNTS

Report No.
04601-7-Ch
OCTOBER 2000

USDA

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250

DATE: **NOV 2 0 2000**

REPLY TO
ATTN OF: 04601-0007-Ch

SUBJECT: Application of Interest Subsidy Payments to Housing Loan Accounts

TO: James C. Kearney
           Administrator
           Rural Housing Service

ATTN: Leroy Jones
           Acting Director
           Financial Management Division
           Rural Development

This report represents the results of our review of the Rural Housing Service's application of
interest subsidy payments to the housing loan accounts of rural rental and single family housing
borrowers. Your responses to the draft report are included as exhibits D and E, with excerpts and
the Office of Inspector General's position incorporated into the Findings and Recommendations
section of the report.

Individual responses from officials of the single family and multi-family housing divisions
disagreed with our conclusion that your method of applying subsidy to borrower accounts
resulted in effective interest rates that were below 1 percent and, therefore, are not in compliance
with the Housing Act of 1949. One of the responses cited a 1979 Office of the General Counsel
opinion to establish compliance with the Act. However, we interpreted the opinion differently.
Thus, we have not reached management decisions for Recommendations Nos. 1 and 2. To help
reach management decision for each recommendation, we request that you seek another opinion
from the Office of the General Counsel to determine if the governing statute allows the effective
interest rate on borrower accounts to fall below 1 percent.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days
describing the corrective action taken or planned and the timeframes for implementation of the
recommendations. Please note that the regulation requires a management decision be reached on
all findings and recommendations within a maximum of 6 months from report issuance.

JAMES R. EBBITT
Assistant Inspector General
   for Audit

EXECUTIVE SUMMARY

RURAL HOUSING SERVICE
APPLICATION OF INTEREST SUBSIDY PAYMENTS
TO HOUSING LOAN ACCOUNTS

REPORT NO. 04601-7-Ch

RESULTS IN BRIEF

This audit presents the results of our review of the Rural Housing Service's (RHS) application of interest subsidy payments to the loan accounts of Rural Rental Housing (RRH) and Single Family Housing (SFH) borrowers.

RHS applies a fixed amount of interest subsidy to borrowers' accounts, rather than an amount that correlates to the interest accruing on the loan. As a result, subsidy is applied to the loan principal of RRH and SFH borrower accounts, causing the effective interest rate to fall below 1 percent at a certain point in the life of the loans. This occurs after approximately 35 years for RRH loans and 22 years for SFH loans. The point in time is different because the length of the loans is not the same, typically 50 years for RRH versus 33 years for SFH, and subsidy payments on SFH loans adjust each year as borrower income changes.

The Housing Act of 1949 (the "Act") allows the Secretary of Agriculture to provide RRH and SFH borrowers "…with assistance in the form of credits so as to reduce the effective interest rate to a rate not less than 1 per centum per annum for such periods of time as the Secretary may determine…" RHS officials interpret this to mean that the effective interest rate over the lifetime of a loan cannot fall below 1 percent. Consequently, they do not believe there is a problem with the effective interest rate falling below 1 percent over a 12-month period, as disclosed by our audit. RHS officials also contend that the effective interest rates over the lifetime of these loans does not fall below 1 percent.

We disagree with RHS' interpretation of the law and with their calculation of the loan's effective interest rate. First, the Act specifically states that a borrower's effective interest rate cannot fall below 1 percent "per annum", i.e. per year. Second, our analysis shows that the effective interest rate does fall below 1 percent over the lifetime of a loan. As a result, RHS will pay over $877 million more in subsidy on RRH loans than it should using its method of applying subsidy to borrower accounts.

RRH officials also contend that this is not a problem because RRH loans are refinanced, transferred to other borrowers with new rates and terms, or paid

off before the loans reach maturity. However, RHS has nothing to support this position and since the loans were written and amortized based on the terms (typically 50 years) stated in the promissory notes, we could not assume the loans will not reach maturity. While we recognize that most RRH loans have not reached the point where principal is subsidized, RHS' accounting records indicate that over $400,000 in principal has been subsidized over the past 5 years. (See exhibit C.)

Since 1995, RHS has applied almost $388 million in subsidy to the principal portion of borrowers' accounts for SFH and RRH loans. In addition, RHS will apply another $2.6 billion of subsidy to principal if the approximately 11,000 current RRH loans reach maturity. We did not perform this analysis for SFH loans because subsidy is not granted to a borrower for the life of a loan, as with RRH loans. Therefore, there is no assurance that borrowers currently receiving subsidy will receive it in the future.

KEY RECOMMENDATIONS

We recommend that RHS revise the system it uses to apply subsidy to housing borrowers' accounts. We also recommend that RHS collect excess subsidy from housing borrowers whose loans were subsidized below an effective interest rate of 1 percent.

AGENCY RESPONSE

In its written response to the draft report, RHS officials stated that in 1979, the Office of the General Counsel (OGC) opined that RHS could write down principal at the note rate while requiring payment at the interest credit rate so long as the payment required was sufficient to amortize the loan balance at the time interest credits were granted at a 1 percent interest rate over the remaining life of the loan. They also had numerous other concerns regarding the findings and implementation of the recommendations. These included the following:

- That the definition of effective interest rate presented in the report was inaccurate,

- That the findings and recommendations did not consider the statutory intent of the housing programs

- The potential increase in subsidy costs, and

- That the findings overstated the monetary impact to the Government.

Thus, RHS disagreed with our conclusions, and was unwilling to implement the recommendations stated in the report.

OIG POSITION

We continue to believe that RHS' method of applying borrower payments and interest credit subsidy is not in compliance with the Housing Act

of 1949. RHS used excerpts from the 1979 OGC opinion to establish that it was in compliance with the Act. However, the excerpts, in our determination, did not provide the full scope of the OGC opinion. We interpreted additional statements in the opinion to place restrictions on the application of subsidy towards principal in borrowers' accounts, and allowing the effective interest rate to fall below 1 percent.

Our analysis also establishes that the effective interest rate on borrower accounts falls below 1 percent. RHS' responses provided numerous other arguments to repudiate this finding, and other issues in the report. Their responses are provided as exhibits D and E.

Since the fundamental issue is whether the effective interest can fall below 1 percent, we would like another OGC opinion pertaining to this matter. Management decision on the recommendations would be contingent on the outcome of the OGC opinion.

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INTRODUCTION

The Housing Act of 1949 (the "Act") authorized the Rural Housing Service (RHS) to provide loans to purchase and construct occupant owned and rental housing for low and moderate income persons in rural areas. RHS provides this housing through the Rural Rental Housing (RRH) and the Single Family Housing (SFH) Programs. Through the RRH Program, RHS provides loans to individuals, partnerships, and not-for-profit organizations to purchase or construct apartment style housing. Similarly, through the SFH Program, RHS provides loans to individuals to purchase or construct owner occupied dwellings. RHS administers these programs through its National Office in Washington, D.C., and its 47 Rural Development State offices nationwide.

The Act authorizes RHS to subsidize a portion of the payments of eligible borrowers in the RRH and SFH Programs. RHS applies subsidy to the interest portion of a borrower's loan payment which, in turn, lowers the amount the borrower is required to pay each month. This results in a lower effective interest rate. The law allows RHS to reduce the effective interest rates on these loans to not less than 1 percent. [1]

In the RRH Program, RHS calculates the amount of subsidy to be applied to a loan account as the difference between a borrower's payment at the promissory note rate and a borrower's payment if the loan were amortized at 1 percent. The subsidy is fixed at this amount and is applied to a borrower's account each month over the life of the loan.

In the SFH Program, RHS calculates the amount of subsidy to be applied to an account based on a borrower's annual income. The amount of subsidy is fixed until a borrower's income level changes. Therefore, the amount of subsidy could change each year as a borrower's income changes.

Because the subsidy applied to both RRH and SFH loans is fixed, there is no correlation between the amount of subsidy provided and the amount of interest that is due (i.e. accrued) according to the loan amortization schedule. In a loan amortization schedule, a portion of a borrower's payment is applied to interest as a cost of borrowing money. The amount of interest is calculated as a percentage of the outstanding loan balance. Therefore, the interest paid each month decreases because the outstanding loan balance is decreasing.

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[1] 42 U.S.C. section 1490a dated January 26, 1998.

RHS applies subsidy to the amount of interest due for that month according to the loan amortization schedule. The borrower's payment is applied to the remaining interest and principal that are due. If the amount of subsidy applied exceeds the amount of accrued interest, the difference is applied to principal. When this occurs, the borrower's entire loan payment is applied to principal.

RHS has provisions in its SFH Program regulations to collect, or recapture, all or a portion of the subsidy provided to a borrower over the life of a loan. These provisions allow RHS to collect the lower of 50 percent of a property's appreciated value or the amount of subsidy provided to a borrower when that borrower ceases to occupy the property or transfers title. As of September 30, 1999, RHS had recaptured $151 million and was owed another $137 million by SFH borrowers.

In the RRH Program, RHS collects overage from tenants who, due to their income level, pay higher rent than the total basic monthly charge. Overage collected from tenants is applied to borrower's loan accounts as a reduction in the amount of subsidy provided by the Government.

OBJECTIVE	To determine if RHS was applying subsidy to the interest portion of RRH and SFH borrower accounts in accordance with applicable laws and regulations.

SCOPE	The scope of our review included 11,405 RRH direct loans outstanding at the time of our audit that received subsidy and had an amortization effective between July 1, 1985, and January

22, 1998. We selected loans that were amortized after the July 1985 date because RHS began using its current amortization method for the first time in June 1985. We did not select any loans made after January 22, 1998, because RHS changed the terms of RRH loans from 50 years to 30 years with a balloon payment at the end of the loan term. RHS had nearly 18,000 RRH loans outstanding as of December 1998, and provided nearly $733 million in subsidy to RRH accounts during fiscal year 1998.

RHS provided over $500 million in subsidy to SFH loans for fiscal year 1998. As of October 1999, RHS provided subsidy to 260,000 of the over 590,000 outstanding SFH loans. We did not prepare amortization schedules for the 260,000 loans because subsidy is not granted to a borrower for the life of a loan, as is the case with RRH loans. Thus, there is no assurance that a borrower currently receiving subsidy would receive it in the future. Instead, we reviewed the method RHS uses to amortize and apply subsidy to its SFH loans.

Our audit work was performed from July through December 1999. We conducted our audit in accordance with <u>Government Auditing Standards.</u>

METHODOLOGY

To accomplish our objectives, we evaluated RHS' procedures to calculate and apply payment subsidies to borrower accounts for RRH and SFH Loans. We also reviewed RHS' files containing historical information on the development of the current amortization methods.

We obtained loan data on 11,405 RRH loans from RHS' Automated Multifamily Housing Accounting System. To evaluate the application of subsidy, we recalculated the amortization schedules by changing the amount of subsidy applied each month to reflect the borrowers paying an effective annual interest rate of 1 percent. We then compared the amount of subsidy provided under RHS' amortization schedules to our amortization schedules.

We reviewed SFH procedures for loan amortization and subsidy application. We were unable to determine the amount of subsidy RHS would provide throughout the life of these loans because subsidy is granted on a yearly basis, and can change from year-to-year. Therefore, we obtained the amount of subsidy applied to principal from general ledger account 5310(5228), *Principal Reduction Due to Interest Credit Agreements/Single Family Housing.* We also reviewed general ledger account number 5310(5227), *Principal Reduction Due to Interest Credit Agreements/Multi-Family Housing,* to determine the amount of subsidy applied to RRH loans accounts.

We interviewed RHS officials to discuss the development of the amortization systems and obtain an understanding of the application of subsidy to borrower loan accounts. We also interviewed officials from RHS' Centralized Servicing Center to discuss the application of subsidy to borrower principal and obtain information on the amount of subsidy applied to principal on SFH loans. This information is maintained in the FASTeller System, which is a mainframe based system used to service loans and monitor loan performance. We compared reports from this system to the general ledger to determine if the amounts maintained by both systems agreed.

We spoke with officials from Rural Development's Finance Office, located in St. Louis, Missouri, about the current amortization methods and the accounting treatment of subsidy. These officials maintain the general ledger system, which is used to report the amount of subsidy applied to principal and prepare RHS' financial statements.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	SUBSIDY APPLIED TO LOAN PRINCIPAL

FINDING NO. 1

RHS applies subsidy to RRH and SFH borrowers' loan principal, causing the effective interest rate to fall below 1 percent. This occurs because the amount of subsidy applied to borrower accounts is fixed and is not related to the amount of interest accruing on the loan. Over the past 5 years, RHS has applied over $388 million in subsidy toward borrower principal even though the enabling legislation mentions only interest subsidy. Further, because subsidy on RRH loans is granted for the life of a loan, we estimate that RHS will pay approximately $2.6 billion of principal if the 11,405 loans (at the time of our audit) receiving subsidy reach maturity.

The Act allows the Secretary of Agriculture to provide RRH and SFH borrowers "…with assistance in the form of credits so as to reduce the effective interest rate to a rate not less than 1 per centum per annum for such periods of time as the Secretary may determine…".[2] RHS accomplishes this by applying subsidy to the interest portion of a borrower's loan payment, which in turn lowers the amount the borrower is required to pay each month. This results in a lower effective interest rate.

RHS calculates the interest that accrues on the loan each month as a percentage of the outstanding loan balance, as set forth in the loan agreement. The amount of interest that is due with each loan payment gradually decreases over the life of the loan because the outstanding loan balance is decreasing. However, the subsidy RHS applies to the loan accounts is fixed, and is not related to the amount of interest due, or accruing, on the loan. (See Background Section for an explanation of subsidy calculations.) Consequently, the loans reach a point in time where the amount of subsidy applied exceeds the amount of interest due.

The chart below illustrates how accrued interest on an RRH or SFH loan is higher in the early years and gradually decreases as the loan matures. However, subsidy is a fixed amount that is lower than accrued interest in the early years of the loan, and later exceeds accrued interest. At the point where subsidy exceeds accrued interest, it is applied to a borrower's loan

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[2] 42 U.S.C. section 1490a dated January 26, 1998.

principal. The example in the chart is an RRH loan, but the same procedures are used to amortize SFH loans. **(NOTE:** We developed the chart to illustrate RHS' current process, not to highlight the point in time when the effective annual interest rate falls below 1 percent.)
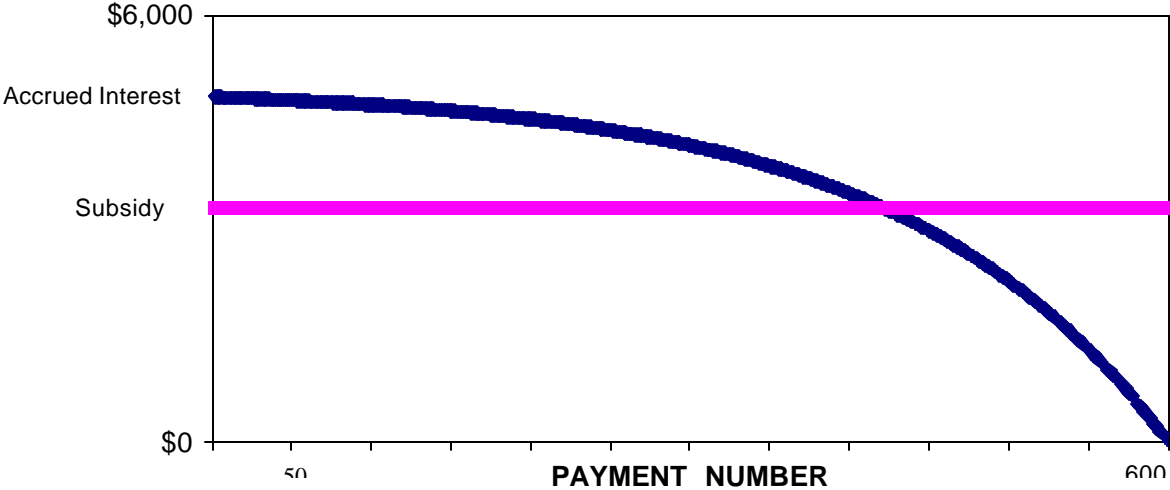

Figure 1

When this condition occurs, RHS applies any subsidy in excess of accrued interest to loan principal. In addition, the entire borrower's payment is also applied to loan principal. Because the borrower is not paying any interest, the effective interest rate of the loan is 0 percent. (See chart 1 in exhibit B.) Further, RHS does not disclose to borrowers in the subsidy agreement or promissory note the true effective interest rate or the fact that the effective interest rate changes.

The point in time when this occurs is after approximately 35 years for RRH loans and 22 years for SFH loans. The point in time is different because the length of the loans is not the same, typically 50 years for RRH versus 33 years for SFH, and subsidy payments on SFH loans adjust each year as borrower income changes.

We reviewed RHS' general ledger accounts used to record subsidy applied to principal for RRH and SFH loans, and determined that from 1995 through 1999, over $388 million in subsidy had been applied to loan principal of borrower accounts. A majority of this amount ($387 million) was applied to

SFH borrower accounts, as these loans are generally older than RRH loans and have shorter loan terms. The amount reported here represents the amount of principal subsidy recorded in RHS' general ledger over the past 5 years, and should not be used to project the amount of principal subsidy that will occur in the future. The amount posted to the general ledger has declined over the last 5 years due to RHS' change in borrower payment posting, fewer borrowers receiving subsidy, and a change in the subsidy calculation method. (See exhibit C.)

The remaining amount, over $400,000, was applied to RRH loans. An RHS official stated that principal subsidy should not be occurring on RRH loans because the current amortization method was not implemented until 1985, and the application of subsidy to principal does not occur until after 35 years. We asked an official from Rural Development to trace the $400,000 to individual borrower accounts. The official informed us that while possible, it would be a time consuming process. Consequently, we did not request Rural Development to gather this information. However, we are reporting this amount as evidence that principal subsidy does occur, and that RHS records it in the general ledger as such.

To determine how much loan principal will be subsidized in the future, we prepared amortization schedules and analyzed the amount of principal, interest, and subsidy for the 11,405 RRH loans outstanding at the time of our audit. (See chart 1 in exhibit B for an example.) Our analysis disclosed that RHS would apply approximately $2.6 billion of subsidy to loan principal if each of these loans reached full maturity. We did not perform this analysis for SFH loans because subsidy is not granted to a borrower for the life of a loan, as is the case with RRH loans. It is granted on an annual basis, based on a borrower's income. Thus, a borrower's income may increase in the future. This would decrease the amount of subsidy applied to their accounts. Consequently, there is no assurance that a borrower currently receiving subsidy would receive it in the future.

RRH Program officials did not agree with this position and stated that this is not a problem because most RRH loans will not reach the point where principal is subsidized due to reamortization or transfer of ownership. However, RRH officials were not able to provide data to show that this would occur. Further, we cannot assume that these loans will not reach maturity because the loans were established at the rates and terms set forth in the promissory notes.

RHS officials also stated this is not a problem because they interpret the Act as allowing the interest rate to fall below 1 percent for a given period of time, as long as the effective interest rate does not fall below one percent over the lifetime of the loan. Officials contend that the higher effective annual interest rates resulting from less subsidy being applied at the beginning of the loans offsets the zero percent effective annual interest rates at the end of the loan

term. They believe the net effect is that the overall effective interest rate would not fall below 1 percent.

We disagree with RHS' position for two reasons. First, the Act specifically states that the effective interest rate cannot fall below 1 percent "per annum", or per year. Second, we performed an analysis that showed that the effective interest rate on a sample loan amortized at the promissory note rate, fell below 1 percent when subsidized using RHS' current subsidy application method.

To perform our analysis, we reviewed a sample loan amortization schedule provided by RHS. Its schedule showed that over the life of a $100,000 loan, a borrower would pay $36,976 in interest and $80,474 in principal, for a total of $117,450. (See chart 1 in exhibit B.) SFH officials showed that if the loan were amortized at 1 percent, the borrower would pay $17,447 in interest. They stated that because the borrower is paying more interest than if the loan were amortized at 1 percent, the overall effective interest rate of the loan exceeds 1 percent.[3]

We evaluated RHS' position and concluded that it is incorrect for two reasons. First, RHS' calculation of the amount of interest the borrower pays does not consider the fact that the borrower is repaying only 80 percent of the loan amount. If RHS had properly treated this, the amount of interest the borrower would have paid would total $17,450 plus an additional $19,526 in principal due on the loan.

Second, RHS' calculation does not consider that the borrower would owe more interest if the loan were subsidized to an effective interest rate of 1 percent and amortized at the promissory note rate than if the loan were amortized at 1 percent. For illustrative and analytical purposes only, we amortized RHS' sample loan at the promissory note rate and applied interest subsidy on the loan in order to reduce a borrower's effective annual interest rate to 1 percent. Our analysis disclosed that the borrower would pay principal of $100,000 and interest of $22,201, for a total of $122,201. In RHS' example, the borrower repaid $117,450, rather than $122,201, a difference of $4,751.

The difference of $4,751 is paid by RHS in the form of subsidy. In the sample loan, RHS would pay $132,402 in subsidy, whereas it would pay only $127,651 if the loan were subsidized to an effective interest rate of 1 percent. Thus, RHS provided $4,751 more in subsidy using its current method of subsidy application. (See table 1.)

The chart below compares the amount of subsidy paid by RHS and interest paid by the borrower under RHS' current method and if the loan were

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[3] In RHS' example, the borrower pays only $80,474 of the $100,000 loan, and the Government pays the remaining $19,526.

subsidized to an effective interest rate of 1 percent. As illustrated in the chart, the amount of subsidy that would be paid on the sample loan using RHS' current method is greater than if the loan were subsidized to an effective interest rate of 1 percent.

	At an Effective Interest Rate of 1 percent	RHS' Current Method	Difference
Loan Amount	$100,000	$100,000	$ 0
Note Rate Interest	149,852	149,852	0
Total Due	249,852	249,852	0
Less: Subsidy	(127,651)	(132,402)	$4,751
Interest and Principal Paid by Borrower	$122,201	$117,450	$4,751

TABLE 1

This difference occurs because less principal is paid each month when loans are amortized at higher interest rates. For example, the borrower would pay principal of $68.44 on the first payment of the sample loan at the note rate of 6.75 percent. However, if the loan were amortized at 1 percent, the borrower would have paid principal of $213.25.

We are not recommending that RHS implement this specific method of subsidy application. We performed our analysis using this method to show that more subsidy is being provided than if the loans were subsidized to an effective interest rate of 1 percent. RHS officials acknowledged this fact in a memo by stating that "the cost of subsidy will be nominally higher under RHS' present calculation of subsidy than under the OIG's recommended method." Here, RHS is acknowledging that the amount of subsidy is greater than the amount needed to subsidize the loan to an effective interest rate of 1 percent. Therefore, the effective interest rate over the lifetime of the loan is less than 1 percent.

Using the same analysis, we prepared schedules for 11,405 RRH loans and determined that RHS will provide, as stated above, $2.6 billion to loan principal. During the early years of the loan, the borrowers would pay $1.7 billion more in interest. The net effect is that under the current method of applying subsidy, RHS will provide $877 million in excess subsidy over the life of these loans.

SFH officials stated their subsidy application method is not a problem because they collect, or recapture, subsidy from borrowers. While this is

true, the entire amount of subsidy may not be collected because recaptured amounts are limited to the lesser of 50 percent of a property's appreciated value or the amount of subsidy provided to a borrower. In addition, enabling legislation did not mention the application of subsidy to loan principal. Thus, RHS should implement procedures to ensure that all subsidy applied to principal is collected from the borrowers.

While RHS has provisions to collect subsidy from its borrowers in its SFH Program, the only provisions in the RRH Program to collect excess subsidy relate to the collection of overage from tenants whose rent exceeds basic rent due to their income levels. Since most RRH borrowers are limited partnerships and subsidy directly benefits their tenants, RHS should collect from borrowers any excess subsidy that caused effective interest rates to fall below 1 percent.

RECOMMENDATION NO. 1	Revise the current method of applying subsidy to prevent the effective interest rates from falling below 1 percent in the future.

RECOMMENDATION NO. 2	Implement procedures to collect the excess subsidy applied to loans which caused the loans effective interest rate to fall below 1 percent.

RHS Response

In its written responses to the draft report, RHS disagreed with our conclusions and provided numerous reasons for the disagreement. (See exhibits D and E for the entire single and multi-housing responses.) One of the primary reasons was an OGC opinion dated May 1979. RHS cited an excerpt from the opinion which stated, "It is our opinion that FmHA {sic} can write down principal at the note rate while requiring payment at the interest credit rate so long as the payment required is at least sufficient to amortize the loan balance at the time interest credits are granted at a   one percent interest rate over the remaining life of the loan." RHS contended that this excerpt provided the authority to implement the current system.

RHS' responses cited numerous other reasons why conclusions in the report were inaccurate. One concern was with our definition of effective interest rate.   Both responses argued that our definition had no legal or statutory basis, and was not consistent with mortgage industry definitions.

The single-family housing response stated "Two basic issues fall into disagreement. First, what is the intent of Section 521 of the Housing Act of 1949. And second, what is the definition of effective interest rate." These statements, along with the OGC opinion, appeared to be the primary areas of concern expressed by RHS.

OIG Position

RHS requested the OGC opinion in 1979 to determine if the agency, "in applying borrower payments under the interest credit program, must assure itself that at no time is the effective rate of interest paid by the borrower less than one percent."   The excerpt cited in RHS' multi-family housing response appears to support that its method of applying interest credit and payments to borrower accounts is acceptable. However, we believe that other excerpts in the OGC opinion placed restrictions on the application of subsidy towards principal in borrowers' accounts, and allowed the effective interest rate to fall below 1 percent only under certain conditions and within short periods of time.

The OGC opinion stated section 506 of the Housing and Community Development Amendments of 1978 clarified the provisions of section 521(a) by enacting the following: "From the interest rate so determined, the Secretary may provide the borrower assistance in the form of credits so as to reduce the effective interest rate to a rate not less than 1 per centum per annum for such periods of time as the Secretary may determine…"

OGC also stated that "This provision makes clear that credits are given over a period of time determined by the Secretary of Agriculture (i.e., the two-year interest credit renewal period) in order to reduce the note rate of interest ("interest rate so determined") to an effective rate of not less than 1 percent." We interpret these statements to mean that while the effective interest rate could fall below 1 percent for a given period of time, such as a two-year interest credit renewal period, it cannot fall below 1 percent for the life of the loan.

Since a fundamental issue is whether it is legal for the effective interest rate to fall below 1 percent, we would like RHS to request another OGC opinion pertaining to this matter. Therefore, to reach agreement on management decision for Recommendations Nos. 1 and 2, we need an OGC opinion on RHS' current method of applying subsidy and payments to borrowers' accounts. Management decision for both recommendations would be contingent on the outcome of the OGC opinion.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

Finding No.	Description	Amount	Category
1	Excess subsidy provided on RRH loans over the loan term	$877 million	Funds To Be Put To Better Use
1	Subsidy already applied to SFH and RRH loan principal	$388 million	Questioned Costs /No Recovery Recommended
TOTAL		$1.26 billion	

EXHIBIT B – SAMPLE LOAN AMORTIZATION

RHS' Loan Amortization uses a fixed subsidy per loan payment. Note that the borrower's effective interest rate (EIR) decreases with each payment.

Payment Number	Beginning Balance	Interest at Note Rate	Subsidy to Interest	Subsidy to Principal	Borrower Payment		Total Payment	Ending Balance	Annual EIR
					Interest	Principal			
1	100,000.00	562.50	334.35	0.00	228.15	68.44	630.94	99,931.56	2.74%
2	99,931.56	562.12	334.35	0.00	227.77	68.82	630.94	99,862.74	2.74%
265	58,672.81	330.03	330.03	4.32	0.00	296.59	630.94	58,371.70	0.00%
266	58,371.70	328.34	328.34	6.01	0.00	296.59	630.94	58,069.10	0.00%
267	58,069.10	326.64	326.64	7.71	0.00	296.59	630.94	57,764.80	0.00%
Total over life of loan		149,851.30	112,875.34	19,527.26	36,975.96	80,473.68	249,852.24	0.00	

Chart 1

Payment Number	Beginning Balance	Interest at Note Rate	Subsidy to Interest	Subsidy to Principal	Borrower Payment		Total Payment	Ending Balance	Annual EIR
					Interest	Principal			
1	100,000.00	562.50	479.17	0.00	83.33	68.44	630.94	99,931.56	1.00%
2	99,931.56	562.12	478.84	0.00	83.28	68.82	630.94	99,862.74	1.00%
265	58,672.61	330.03	281.14	0.00	48.89	300.91	630.94	58,371.70	1.00%
266	58,371.70	328.03	279.70	0.00	48.64	302.60	630.94	58,069.10	1.00%
267	58,069.10	326.64	278.25	0.00	48.39	304.30	630.94	57,764.80	1.00%
Total over life of loan		149,851.30	127,651.15	0.00	22,200.15	100,000.00	249,852.24	0.00	

Chart 2

Loan Amortization if subsidy corresponded to accrued interest. Note the borrower's effective interest rate equals 1 percent annually.

EXHIBIT C – PRINCIPAL REDUCTION DUE TO INTEREST CREDIT AGREEMENTS

YEAR	SINGLE FAMILY HOUSING GENERAL LEDGER ACCOUNT 5310 (5228)	MULTIFAMILY HOUSING GENERAL LEDGER ACCOUNT 5310 (5228)
1999	$ 42,699,794	$124,296
1998	42,814,433	154,845
1997	88,848,063	80,916
1996	108,206,018	(72,237)
1995	105,275,898	174,608
5-YEAR TOTAL	$387,844,207	$462,428

EXHIBIT D – RURAL HOUSING SERVICE RESPONSE TO THE DRAFT REPORT (SINGLE FAMILY HOUSING)

JUL 18 2000

TO:	James R. Ebbitt
	Assistant Inspector General for Audit
	Office of Inspector General
THROUGH:	Sherie Hinton Henry
	Director
	Financial Management Division
	Rural Development
FROM:	David J. Villano
	Deputy Administrator
	Single Family Housing
	Rural Housing Service
SUBJECT:	Single Family Housing's Response to the Office
	of Inspector General Report No. 04601-7-Ch
	Rural Housing Service Application of Interest
	Subsidy Payments to Housing Loan Accounts

Attached is Single Family Housing's response to the above subject Audit Report. As you are aware, the subject audit addressed both the Single and Multi-Family Housing programs of the Agency. Multi-Family Housing is providing their response under separate cover.

Based upon our previous meetings and discussions with your staff, we continue to disagree with the subject report. We continue to believe that OIG has clearly misinterpreted the intent of the statute and if your recommendations are implemented, will increase costs to the government and force many very-low and low income homeowners into losing their homes through no fault of their own. Two basic issues fall into disagreement. First, what is the intent of Section 521 of the Housing Act of 1949. And second, what is the definition of effective interest rate.

Section 521 of the Housing Act of 1949, provides the Agency with the authority to subsidize a customer's loan to an interest rate as low as one-percent. A customer's income is reviewed on a routine basis and their payments are adjusted accordingly. As a customer's income increases, their subsidy is reduced. Payments are based upon the customer's income, taxes, and insurance to ensure affordability and the success of the customer.

Effective interest rate is not defined by statute. The Agency utilizes the same standards for determining effective interest rate as used in the entire residential lending community.

Amortization tables are developed for the life of the loan, based upon the promissory note rate and a one-percent interest rate. OIG disagrees with the Agency's position and argues that utilizing an amortization table at a one-percent interest rate for the life of the loan violates the statute. OIG argues that the statute uses the term "*per annum*," meaning that the Agency must readjust the interest charge to our customers on an *annual* basis. In the lending industry, interest rates are quoted on an annual basis. Even a conventional fixed rate mortgage is quoted on a "per annum" basis; however, the lender does not adjust a customer's interest rate on an annual basis. We find OIG's interpretation of two words in the statute to be inconsistent with the section in which it is contained.

OIG also reports significant monetary findings in their report. Paradoxically, these monetary findings are based upon a subsidy application methodology that OIG clearly states "we are not recommending that RHS implement." We are perplexed by OIG's assertion that there are $1.26 billion in monetary benefits based upon methodology that OIG cannot itself recommend.

The methodology utilized by OIG does not base the customer's payments upon their ability to repay the loan. The examples used by OIG assume that a customer receives full subsidy for the entire 396-month loan period. This assumes that the customer does not have an increase in income for 33 years. While the example illustrates OIG's position, it is unrealistic to assume that a customer's income will not increase in 33 years. While unrealistic, the methodology presented in the OIG Report would require such a customer to pay 14 percent of their income towards payments in the beginning of the loan to a top rate of 36 percent at the end of 33 years. Throughout the years, the customer's payments will increase; however, the increase is not based upon any increase in income. In the later years of the mortgage, the customer would not be able to reasonably afford the payments causing them to lose their home through liquidation, voluntarily or involuntarily. This is clearly not the intent of the statute. The attached charts clearly illustrate the negative impact of OIG's methodology on subsidy and the homeowner.

OIG Recommendation No. 1: "Revise the current method of applying subsidy to prevent the effective interest rates from falling below 1 percent in the future."

Agency Response (Single Family Housing): As this recommendation is in conflict with the statutory intent of the program, will increase subsidy costs, and have a devastatingly negative impact on our customers, the Agency cannot adopt this recommendation.

On the surface, when reviewed on an individual loan basis for a single month, the audit finding stating that the present method of applying payment subsidies causes "a loan's effective annual interest rate to fall below 1 percent" may appear to have some merit. However, a more detailed analysis of the application of subsidy reveals that the findings do not present a clear and accurate picture of the impact on the cost of subsidy and legal and regulatory implications. The recommendations also need to consider the impact on the customer, program objectives, and the intent of Congress.

We have organized our concerns into the following four areas:

1. **Definition of Effective Interest Rate** – OIG does not accurately define effective interest rate.

2. **Inconsistency with Legal/Regulatory Requirements** - The findings and recommendations presented by OIG in the report are not consistent with the mission of the program or statutory intent.

3. **Impact on the Cost of Subsidy** - If implemented, the recommendations presented by OIG will substantially increase the cost of subsidy to the government.

4. **Impact Overstated** - The monetary impact of the findings presented by OIG is overstated.

Definition of Effective Interest Rate

The effective annual interest rate on the Agency's single family housing program loans does not fall below 1 percent. Section 521(a)(1)(B) of the Housing Act of 1949 [42 U.S.C. 1490(a)] states that "From the interest rate so determined, the Secretary may provide the borrower with assistance in the form of credits so as to reduce the effective interest rate to a rate not less than 1 percent per annum **for such period of time as the Secretary may determine**" (emphasis added). Section 501(b)(2) [42 U.S.C. 1472] provides that the loan instruments shall "provide for the repayment of principal and interest in accordance with schedules and repayment plans prescribed by the Secretary."

We conducted research on mortgage industry websites to obtain a definition of effective interest rate. Effective interest rate is generally defined as the "cost of credit on a yearly basis expressed as a percentage," and "the rate actually being charged." The use of the words "yearly" and "per annum" in the mortgage banking industry defines the timeframe over which interest is calculated (spread) on a loan. When the outstanding principal balance is multiplied by the per annum interest rate, the result is the amount of interest that accumulates for one year (i.e. per annum). An 8 percent per annum interest rate is equal to a 0.67 percent interest rate per month or a 16 percent per biennium interest rate. Per annum does not refer to how often the calculation is completed, but the timeframe represented by the result of the calculation.

The recommendation includes a calculation of the borrower payment and subsidy that includes a rate based on a loan amortization schedule for the note's principal and interest payment and the subsidy rate. This methodology combines two otherwise separate and distinct methods of determining payments into one calculation. Using OIG's methodology, the actual borrower's payment (note payment less subsidy) is different than the payment amount for the account amortized at 1 percent.

OIG is imputing an "effective interest rate" on a monthly basis throughout the course of the loan, using a combination of the borrower's net payment amount and the unpaid principal balance based on a loan amortization schedule at a higher note rate. This method of calculation may be appropriate for determining the rate of return on an income stream but it is not appropriate for computing the effective rate of interest charged on a loan. OIG's computation may be beneficial in performing cash flow analyses for credit

reform modeling purposes; however, it is not an appropriate to measure compliance for a loan program.

Interest accrues on loans at the note rate, rather than the effective interest rate, so that subsidized borrowers do not increase their equity position in a property at a faster rate than unsubsidized borrowers. There is nothing in the statute that prohibits subsidy from being applied to principal. The application of subsidy to principal is made necessary only by the accrual of interest at the note rate. Effective interest rate must be measured separately from interest accrual at the note rate. As previously provided to OIG, using RHS's method of subsidy, the interest cost to a borrower who receives maximum subsidy for the entire loan is equal to the cost of interest if the loan was amortized at 1 percent for the entire life of the loan.

We believe all loans currently comply with the appropriate definition of effective interest contained in 7 CFR Part 3550.68(c) which reads: "The amount of Payment Assistance granted is the difference between the installment due on the promissory note and the greater of the payment amortized at the equivalent interest rate or the payment calculated based on the required floor."

Inconsistent with Legal/Regulatory Requirements

In order to implement Recommendation No. 1 using OIG's interpretation of effective interest rate for program compliance, it would be necessary to recompute each subsidized borrower's payment amount monthly. In OIG's example in Exhibit B, Chart 2, the borrower's payment increases monthly from $151.77 for payment number 1 to $352.69 for payment number 267. This increase is not due to any change in the borrower's ability to pay, but purely due to the machinations required by imputing an effective interest rate monthly in tandem with a loan amortization schedule at a higher note rate. We believe that this interpretation is in direct conflict with the intent of the enabling statute that was written to provide decent, *affordable* housing to very-low and low-income families. The intent of the statute is to subsidize a customer's payments consistent with their ability to repay the loan. OIG's methodology does not provide for an amortization schedule that is consistent with a customer's ability to repay, and will threaten the ability of very-low income customers to repay their loans in later years.

The concept of varying the borrower's monthly subsidy and accordingly their monthly payment brings up several issues:

- The Truth In Lending Act, Real Estate Settlement Procedures Act (RESPA), Fair Housing Acts, and Agency regulations all emphasize the importance of providing information regarding borrower payment at the time of origination to the applicant. If the borrower's minimum payment is not consistent throughout the life of the loan, then the disclosure is no longer valid. The borrower cannot make an informed decision on their ability to repay the loan in the long term, if they are not aware of the long-term program consequences.

- The borrower's payments will increase as the loan matures, although the customer's income never increases. As the borrower approaches retirement, the payments increase precipitously decreasing the level of assistance at the very time that they may need it the most. The fact that subsidy is being

applied to principal is indicative of the fact that the borrowers cannot afford, based on their financial circumstances, an interest rate in the later years of their loans at more than 1 percent. The proposed methodology would increase the failure rate for the very borrowers for whom the program was designed. Imagine owning a home for over 25 years, and then being forced into liquidation because it is no longer affordable through no fault of your own.

- RESPA requires that payment changes be communicated to the borrower at least 30 days prior to their effective dates. This would require a monthly notification under the OIG's methodology. For loans on Daily Simple Interest (DSI) which includes all loans originated prior to 1997, the payment change is dependent on the credit date of the most recent payment. Once the payment is applied, the new bill could be sent, but an assumption is required as to when the next payment will be received and posted. If the posting date is anything other than the date anticipated, the borrower payment amount is wrong. Payments posted prior to the stated date would have less interest accumulation so the subsidy amount quoted in the letter would be too high or would again be posted to principal. Payments posted after the stated due date would have too little subsidy and the full amount of the payment would not be received from the borrower and the borrower would become delinquent.

3. Impact on the Cost of Subsidy

If, in the rare instance a customer receives full payment subsidy for the entire 396-month life of their loan, the cost of subsidy will be nominally higher under RHS's present calculation of subsidy than under the OIG's recommended method. In fact, it is only more expensive if the loan is on the books for greater than 30 years. Conversely, the monthly subsidy cost is higher under the OIG's proposed method than the present method for the first 19 years of the loan. Since subsidy under the OIG's method is more heavily granted on the front end of the loan and the average loan is paid-off well before the account reaches maturity (the average loan is paid-off in 11 years) the cost of subsidy would escalate significantly under OIG's methodology. OIG failed to include the increased cost of subsidy to the government in their estimate of monetary benefits.

4. Impact Overstated

Using the past 5 years to project the future amount of principal reduction is not supportable. The amount of subsidy granted during the 5 years' reviewed by OIG includes a posting method no longer used by RHS. Prior to converting to the Centralized Servicing Center (CSC) (the first 2 ½ years of the 5 years reviewed), subsidy was posted every month on the borrower's due date. Borrowers who made payments prior to their due date would have paid significantly less interest and, as a result, would have had more subsidy going to principal. Subsidy is now applied when posting the borrower's payment, so the amount of principal credited due to subsidy is significantly less.

Also, because the Payment Assistance Method of subsidy is less generous in its initial calculation, the number of borrowers receiving one percent is also significantly less. All new borrowers receiving loans receive subsidy using the Payment Assistance Method. As a result, the amount of subsidy posted to Principal will be reduced as the portfolio

converts from the Interest Credit Method to the Payment Assistance Method. Under the Payment Assistance Method, 6.36 percent ($ 22,072,310) has been posted to as of March 31, 2000. The Payment Assistance Method was established for use beginning in 1995 and represents 32.2 percent of the entire "subsidy pool." On the other hand with the Interest Credit Method (Payment Assistance Method 2), which must be carried out under the terms of eligibility prior to 1995/Fiscal Year1996, 14.27 percent ($ 478,414,713) of the subsidy has been posted to principal. Interest Credit method represents 67 percent of the "subsidy pool." Deferred Credit is the balance of the "subsidy pool" which was in effect for a couple of years. The aforementioned figures represent "Loan to Date (LTD)" posting which is a balanced view of the portfolio. For the reasons stated above, the $388 million impact in the audit report is not an accurate projection of the future amount of subsidy applied to principal. In fact, OIG's proposal will increase costs to the government.

Again, the attached charts clearly illustrate the negative impact of OIG's methodology on subsidy and the homeowner.

Recommendation No. 2: "*Implement procedures to collect the excess subsidy applied to loan that caused the loans effective interest rate to fall below 1 percent.*"

Agency Response (Single Family Housing): Since we do not agree with, nor can implement Recommendation 1, we cannot implement Recommendation 2. See our response to Recommendation 1 for further information.

Attachment

1. DEFINING EFFECTIVE INTEREST RATE

COMPUTING AN EFFECTIVE INTEREST RATE REQUIRES THREE VARIABLES:

- UNPAID PRINCIPAL BALANCE (UPB)*
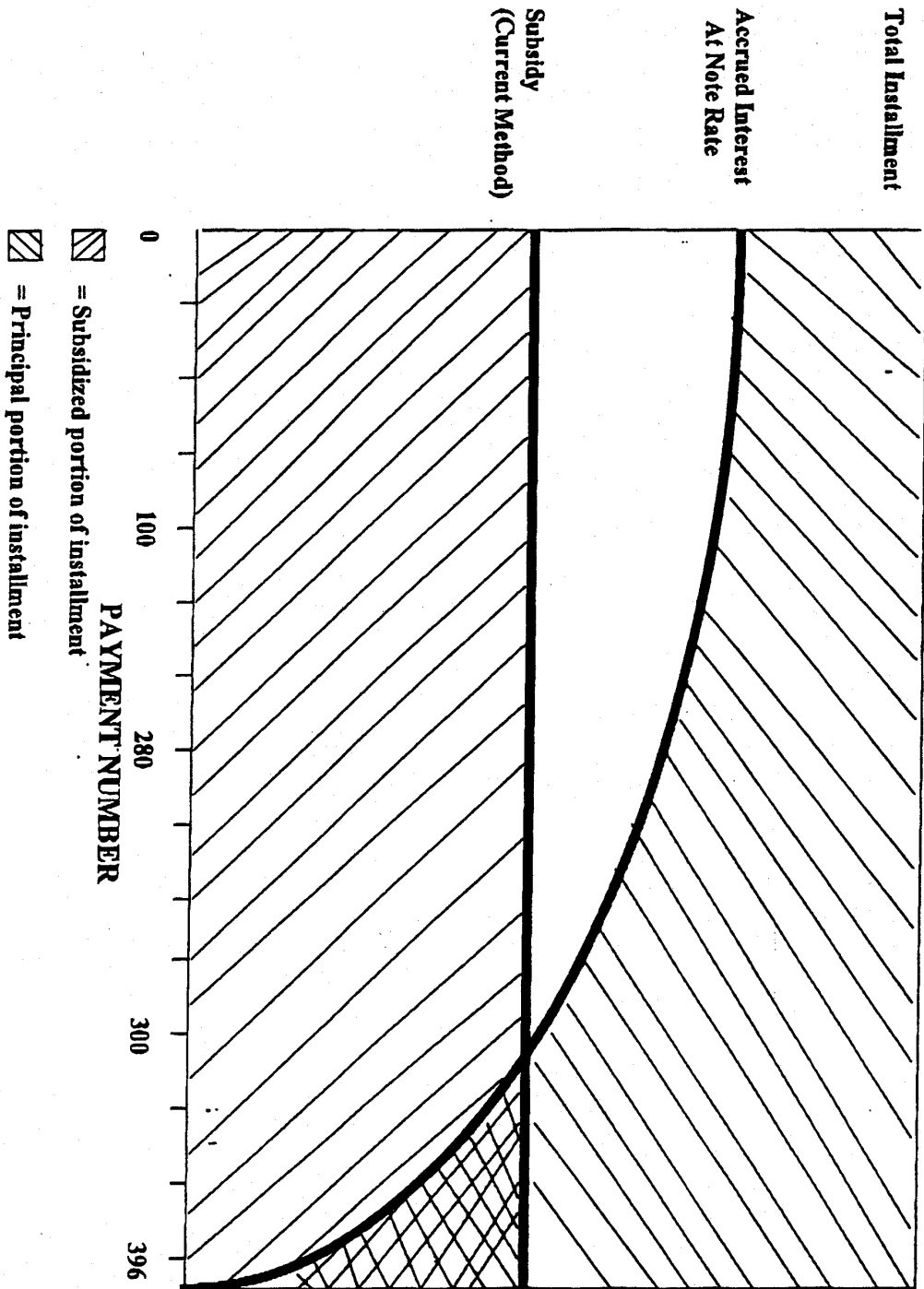- PAYMENTS
- REMAINING TERM

<u>OIG</u>

- UPB (GOVERNMENT/BORROWER)

<u>RHS</u>

- UPB (AT 1%)

*DIFFERENCE = OIG INCLUDES IN UPB AMOUNT PAID BY GOVERNMENT

1. DEFINING EFFECTIVE INTEREST RATE (Cont'd)

CURRENT METHOD

Total Installment

Accrued Interest
At Note Rate

Subsidy
(Current Method)

▨ = Subsidized portion of installment

▨ = Principal portion of installment

PAYMENT NUMBER

0   100   280   300   396
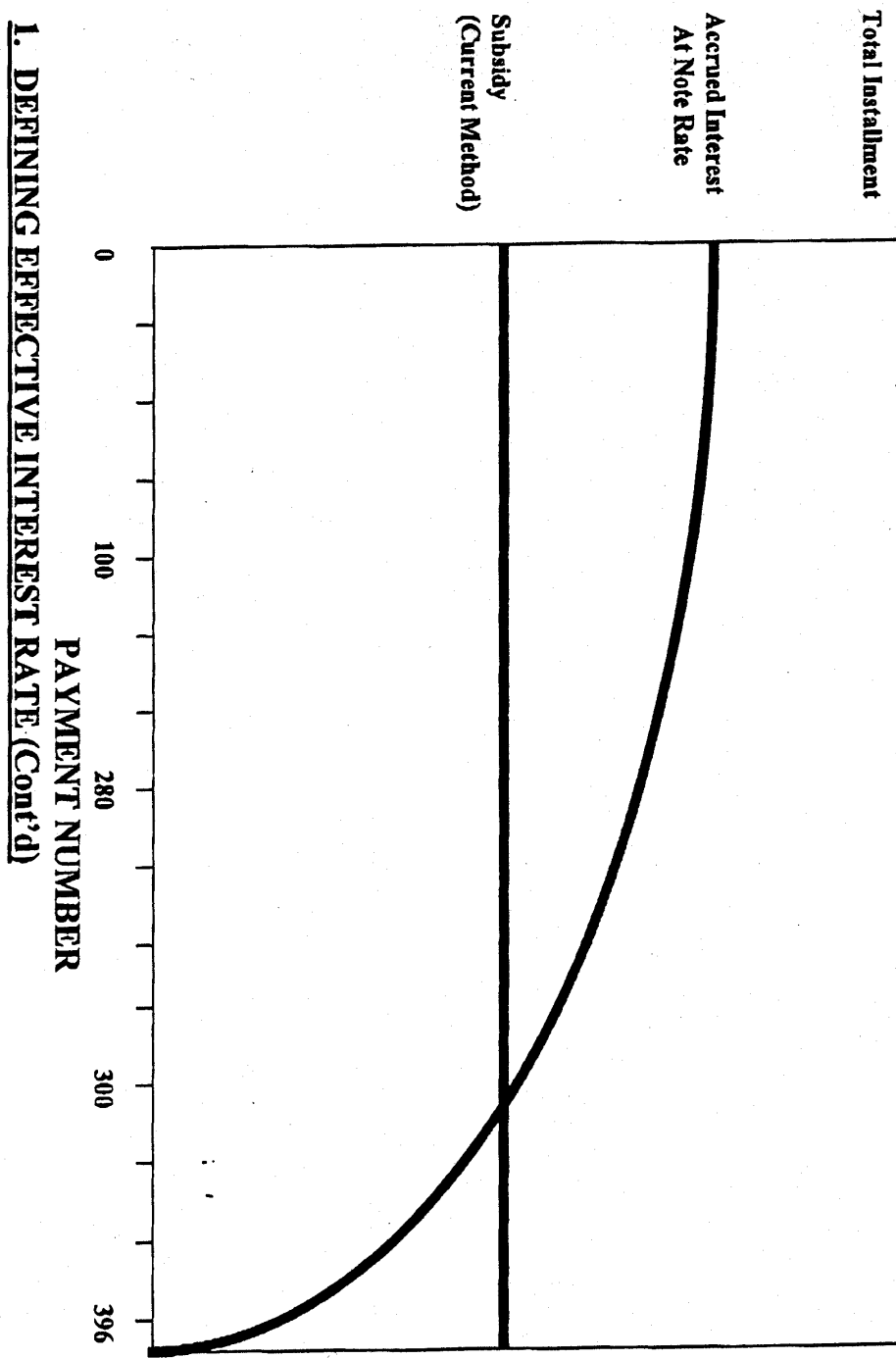
CURRENT METHOD

1. DEFINING EFFECTIVE INTEREST RATE (Cont'd)

1. DEFINING EFFECTIVE INTEREST RATE (Cont'd)

AVERAGE SINGLE FAMILY HOUSING LOAN IMPACT
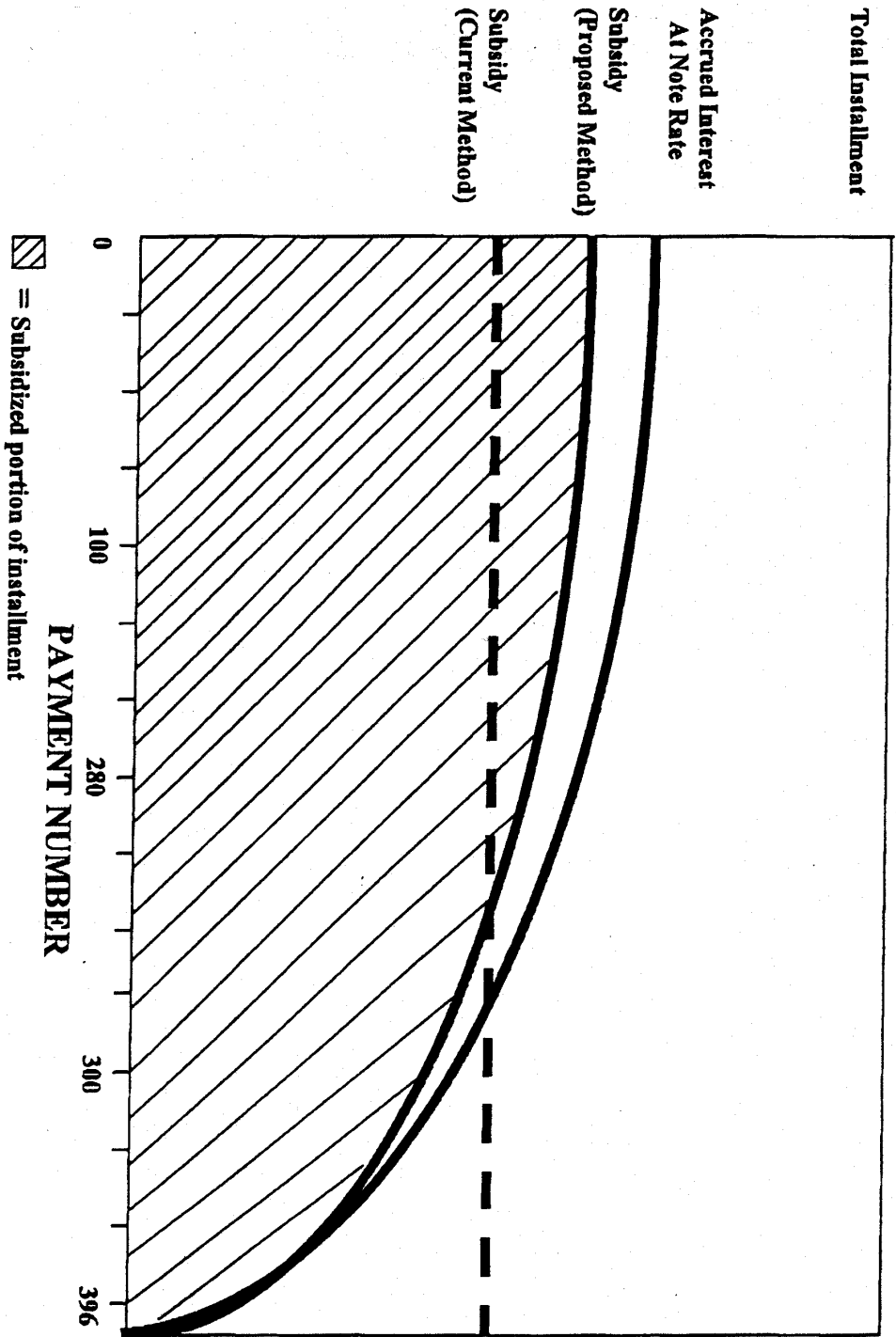
UPB - $42,000

RETAX - $860

INSURANCE - $300

INCOME REQUIREMENT - $1,107

- 20% PITI

Year	Monthly Income	Current RHS Method			Recommended OIG Method		
		PITI	Per Cent of Income	Income for Non-Housing Expenses	PITI	Per Cent of Income	Income for Non-Housing Expenses
10	$1,107	$221	20%	$886	$172	15.6%	$935
15	$1,107	$221	20%	$886	$194	17.5%	$913
20	$1,107	$221	20%	$886	$226	20.5%	$881
25	$1,107	$221	20%	$886	$277	25.0%	$830
30	$1,107	$221	20%	$886	$355	32.1%	$752
32	$1,107	$221	20%	$886	$397	35.9%	$710

OIG PROPOSAL (EXAMPLE)

- SUBSIDY WILL VARY BY MONTH
- PAYMENTS NOT BASED UPON BORROWER INCOME/REPAYMENT ABILITY
- EARLY-ON 14% INCOME PITI
- LATER 35% PITI
- 131% PAYMENT INCREASE
- 24% DECREASE IN DISPOSABLE INCOME

PROPOSED METHOD (OIG)

Total Installment

Accrued Interest
At Note Rate

Subsidy
(Proposed Method)

Subsidy
(Current Method)

⊠ = Subsidized portion of installment

PAYMENT NUMBER

0   100   280   300   396

EXHIBIT E – RURAL HOUSING SERVICE RESPONSE TO THE DRAFT REPORT (MULTI-FAMILY HOUSING)

USDA

United States Department of Agriculture
Rural Development

Rural Business–Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

TO: James R. Ebbitt   AUG - 2
Assistant Inspector General for Audit
Office of inspector General

THROUGH: Sherie Hinton Henry
Director
Financial Management Division
Rural Development

FROM: Obediah G. Baker, Jr.
Deputy Administrator
Multi-Family Housing

SUBJECT: Multi-Family Housing's Response to the Office of Inspector General
Report No. 04601-7-Ch, Rural Housing Service Application of Interest
Subsidy Payments to Housing Loan Accounts

This memorandum is Multi-Family Housing's (MFH) response to the subject Audit Report. As you are aware, the subject audit addressed both the Single and Multi-Family Housing programs of the Agency. Single Family Housing's response is under separate cover. However, we are in agreement with their response and will not duplicate their comments. We do offer the following additional comments as they relate strictly to the Multi-Family Housing's perspective.

Background:

The Multi-Family Housing's Predetermined Amortization Schedule System (PASS) was implemented in May 1985. This system was implemented due to an existing accelerated pay-down of principal problem as reported to the then Assistant Secretary for Rural Development by the Office of the Inspector General (OIG) in October 1980. From approximately 1982 through 1984, development of the system was undertaken and implemented. Throughout this period, numerous decisions regarding the implementation of this system were addressed by a number of various groups such as the Office of General Counsel (OGC), Internal Revenue Service (IRS) and United State General Accounting Office (GAO). Documentation of these decisions was made available to the auditors during this audit.

OIG Recommendation No. 1: *"Revise the current method of applying subsidy to prevent the effective interest rates from falling below 1 percent in the future."*

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Agency Response (Multi-Family Housing):

1. The MFH staff provided your staff with a memo dated May 31, 1979, where this question was raised as to whether it is legal to write down the principal at the note rate while accepting borrowers payment at the interest credit rate. After a period of time, the "interest credit" granted would become a credit in excess of the one percent interest rate and would begin to subsidize principal.

   OGC stated, "It is our opinion that FmHA can write down principal at the note rate while requiring payment at the interest credit rate so long as the payment required is at least sufficient to amortize the loan balance at the time interest credits are granted at a one percent interest rate over the remaining life of the loan."

   During the development of the Predetermined Amortization Schedule System (PASS), the question was raised to OGC regarding the application of principal repayments on all loans at the promissory note rate of interest. Interest would be charged at a reduced rate on the loan balance outstanding during the term of subsidy. OGC stated, "your proposed changes in procedure are legally permissible under present regulations and under section 521(a) of the Housing Act both as to new interest credit borrowers and existing interest credit borrowers when their present agreement expires and a new agreement is negotiated. With this OGC opinion, development continued to progress and a new interest credit agreement was implemented along with the new payment system.

2. Definition for effective rate of interest is incorrect based on private business practices.

   The effective rate of interest is not based on annual year but is the total cost of a loan over the number of years that a borrower is expected have a loan outstanding.
   (Source: http://guarantymortgage.net/library/glossary/EffectiveRateCost.htm)

   This definition used in the report is the opinion of OIG and has no legal or statutory basis.

3. The amortization schedule used by OIG in our opinion does not meeting the intent of the law.

   Payments would increase approximately 76% over the life of the loan. By increasing the payment, the rental charges would be required to increase annually to cover the additional debt service. For the MFH program, this would have two major impacts on the tenants (and not on the borrower): 1. The amount of additional "deep" subsidy of rental assistance would increase for those tenants receiving rental assistance, and 2. Those tenants not receiving rental assistance would be required to pay a higher percentage of their income for rent. Again, as a reminder, this would have a direct negative impact on the individuals that this program was designed to assist.

   The borrower would experience decreased financially viability of the property being compromised and could ultimately lead to foreclosure actions and ultimately to government inventory.

4. We disagree with the statement, "RRH Program officials did not agree with this position and stated that this is not a problem because most RRH loans will not reach the point where principal is subsidized due to reamortization or transfer of ownership. However, RRH officials were not able to provide data to show that this would occur."

   This statement fails to explain the true situation of the RRH program. There are three groups of loans that should have been explained in this report to understand that our position has merit. The three groups are as follows:

Loans closed prior to 1979 – currently do not have any restrictions and may pay off with approval by the Agency. These loans were not reviewed in the audit due to the fact they are under the old method of payment system called Daily Interest Accrual System (DIAS).

Loans closed in 1979 – 1989 – currently have a 20-year restriction for prepayment. Of these loans, only the loans closed after May 1, 1985, are under PASS.

Loans closed in 1990 – 1998 – have a restriction of 50 years for prepayment.

Loans as of January 1999 – are made for a period of up to 30 years from the making of the loan, but based on an amortization schedule of 50 years with a final payment of the balance due at the end of the term of the loans.

While many of the loans have restrictions, this does not mean that at any point of the loan that the borrower does not have option to transfer the loan to an eligible transferee. In the past three years, approximately 450 loans have been transferred. In other words, we have experienced 2.5% turnover just in the last three years and had a reduction of 89 RRH properties in the portfolio in the past year. We do acknowledge that many of these loans are loans closed prior to 1979. However, this trend provides a blueprint of what we can expect as the loans evaluated in this audit will experience the same process. So, to assume that loans will continue with only their present terms neglects the proceeding.

5. We disagree with the statement, "Since most RRH borrowers are limited partnerships and subsidy directly benefits their tenants, RHS should collect from borrowers any excess subsidy that caused effective interest rates to fall below 1 percent."

There is no statutory basis for this requirement.

The MFH program does collect overage from tenants whose rent exceeds basic rent due to their income levels. The overage collected directly reduces the amount of subsidy provided to the borrower. This was acknowledged in the audit. But this audit fails to understand the essence of the program. The government provides subsidies to the borrower so that in return the borrower can pass the savings in debt service to tenants through lower rents. It should be noted that most of the limited partnerships are single entity borrowers and the loans are non-recourse, therefore little possibility of recapturing these amounts exists.

6. Statement - "We are not recommending that RHS implement this specific method of subsidy application."

This statement is ambiguous. It appears that while OIG is critical of RHS accounting practices, it is not suggesting a more appropriate alternative.

Recommendation No. 2: *"Implement procedures to collect the excess subsidy applied to loan that caused the loans effective interest rate to fall below 1 percent."*

Agency Response (Multi-Family Housing): Since we do not agree with, nor can implement Recommendation 1, we cannot implement Recommendation 2. See our response to Recommendation 1 for further information. It is also our prediction that borrower lawsuits over the Agency's attempt to collect the so-called 'excess subsidy' would cost the Government far in excess of what it would collect.

GLOSSARY OF TERMS

AMAS	Automated Multi-Housing Accounting System developed to process and track RRH loans and grants.

AMAS   Automated Multi-Housing Accounting System developed to process and track RRH loans and grants.

Amortization schedule   The projected application of periodic payments to principal and interest at the promissory note rate so the debt will be paid in full over the number of years specified in the promissory note, assumption agreement, or re-amortization agreement. Computation is based on a 30-day month and a 360-day year.

Effective rate of interest   The cost of credit on a yearly basis expressed as a percentage.

Interest   Sum paid or charged for the use of money. The rate percent per unit of time represented by such payment or charge.

Subsidy (RRH)   The difference between a borrower's monthly promissory note installment and the monthly-subsidized installment.

Subsidy (SFH)   Payment assistance is the difference between the installment due at the promissory note rate and the amount the borrower must pay, based upon income.

Principal   A capital sum as distinguished from interest or profit.

Recapture   Single-family borrowers are required to repay subsidy amounts subject to recapture when the title to the property transfers or the borrower is no bnger living in the dwelling, unless the borrower ceases to occupy the property for a reason that is acceptable to the agency. Loans prior to October 1, 1979, are not subject to recapture unless they were assumed on new rates and terms after that date.