

The Role of the Lender in Housing Quality: An Evaluation of FmHA Section 502 Housing in Maryland

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This report presents the current approach to dealing with defects in homes financed by the Farmers Home Administration, and, to help ascertain the extent of defects in FmHA homes, presents research which compares the quality of FmHA Section 502 – financed units in Maryland to other new, three bedroom, single family homes in eight southern states. Of the total sample, 140 were FmHA Section 502 financed units in Maryland, 89 houses were financed by the 502 program in states other than Maryland, and 131 were houses financed by other means in states other than Maryland. Analysis of the data indicated that Sec. 502 housing in Maryland had a significantly higher incidence of 1) cracks in the walls or ceilings, 2) decay of door and window frames, 3) decay of porch and outside steps, and 4) uneven floors. Policy changes to remedy the problem are suggested.

Since the introduction of government insured mortgages, there has been a question of whether the government agency should not only insure the mortgage, but should also insure the quality of the house. There are several cases in the courts at present, and the Supreme Court will be asked to rule on the role of the lending agency in relation to its borrowers. Are the supervision, inspections, and the appraisal procedures prescribed by the law for the purpose of protecting the lender's

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interest in making a sound loan only, or does the lender have an obligation to protect the interests of the homebuyer as well?

The Farmers Home Administration interprets its role to be that of lender only — they provide the money and the borrower buys a house. If their inspections and appraisals are faulty, the risks inherent in the loan are higher, and the taxpayers assume that higher risk. Alex Mercure, Assistant Secretary for Rural Development, USDA, wrote that,

We do not believe we can discriminate against the local site builder. We believe that the choice of builder and the quality of housing he can produce — site-built or manufactured — should be left to the potential homeowner (1980).

In the frequently cited case of *United States v. Neustadt* (1961), the Supreme Court held that a

faulty inspection and appraisal under FHA was not actionable because the government is exempt from suits against "misrepresentation," and stated that Congress did not intend to convert the FHA appraisal into a warranty of value or otherwise extend to a purchaser any actionable redress by reason of negligent inspection-appraisal. In this case the judge said that "there is no legal relationship between the FHA and the individual mortgagor." In the case of *Reynolds v. U.S.* (10th Circuit Court, 643F, 2nd [1981] a house sitter became paralyzed from carbon monoxide because the furnace was hooked up wrong. The court ruled that "FmHA owed no tort duty of ordinary care to the safety of its borrower's invitee."

Others cite the language of the 1949 Housing Act, with its intent stated as providing "decent, safe, and sanitary living conditions," as reason to believe that Congress gave a statutory intent to provide assistance to the home purchaser. Further, by providing the Compensation for Construction Defects program, Congress has indicated its intention that FmHA, to carry out its responsibility, should have funds to amend mistakes in its role as protector of the purchaser. A Sixth Circuit Court of Appeals judge has ruled that FmHA has a responsibility to the homebuyer stemming from its authority to supervise, inspect, and appraise the building of the house (*Neal v. Bergland*, No. 80-1278, 1981). Until the Supreme Court rules on the statutory responsibilities of the government lending agencies in relation to their borrowers, it will be difficult to issue information to borrowers which explains clearly what the program covers.

The incidence of defects in all newly constructed housing is documented also by Kaluzny (1980) in his nationwide study of 1,812 houses between 12 and 30 months old. Sixty-two percent of the households in his study reported having at least one problem that was not resolved by the builder in the 30 month period following closing, with an average repair cost estimated at \$1,411. About 8 percent of all homeowners reported re-

pair costs of \$2,000 or more for the period. Twenty-two percent reported having a "serious disagreement" with the builder with respect to one or more problems and about 7 percent consulted a lawyer in an attempt to resolve the disagreement.

Trained inspectors examined a sample of 299 of the houses in the Kaluzny study. They found below average materials in 15 percent of the houses and below average workmanship in 19 percent of the houses. The variation in the workmanship quality assessment measure was statistically significant with respect to purchase price, household income, respondent satisfaction with the house, and subdivision size. The highest incidence of defects was found in houses of families with incomes of less than \$15,000, and the study also noted that when builders did not fix problems, many remained unfixed.

The Defects Compensation Program

Congress included a Farmers Home Administration Defects Compensation Program in the Housing and Community Development Act of 1977. It gave the Secretary of Agriculture the authority to compensate borrowers for structural defects in new houses by 1) correcting the defects, 2) paying the claims of the owner of the property arising from such defects, or 3) acquiring title to the property. The Act also said,

The Secretary shall, by regulation, prescribe the terms and conditions under which expenditures and payments may be made under the provisions of this section (PL 95-128-Oct. 12, 1977, Title V, Sec. 504, 42 USC 1479).

The report of the conference committee on the bill included a statement of intent on the part of the conferees that the term "structural" should be broadly construed by the Secretary to include those defects which, though serious, did not necessarily threaten the integrity of the unit, but which would significantly reduce the useful life or habitability of the unit.

The low incomes of the families served by FmHA programs render them more apt to have defects (Kaluzny, 1980). Since over 80 percent of the participants in the FmHA Sec. 502 program nationally are first time homebuyers, they are less apt than any other group to be able to protect themselves against unscrupulous practices by homebuilders. That even higher income and experienced buyers have difficulty in obtaining a sound product is made clear by this author's research and by the Kaluzny study.

In fiscal 1980 there were 332 claims, and the settlements awarded totalled \$589,568.12. Five of the claims were from Maryland, and were awarded a total of \$9,294.78. In the first three months of the fiscal year 1981, there were 106 claims, and \$334,000 was awarded (one from Maryland, awarded \$3,068).

Vague language plagues the program in two ways. One is that the Secretary of Agriculture was given a vague directive by the language in the bill as to what he should pay for. The second is the vagueness of the provisions as conveyed to the homebuyer. In an article in the *Chicago Tribune*, August 23, 1981, Lew Sichelman cites a GAO report which criticizes the Federal Housing Administration (FHA), the Veterans' Administration (VA), and the Farmers Home Administration (FmHA) for the murkiness of the provisions of their warranty programs. The GAO recommended.

that the three housing agencies revise their warranty and defects programs to meet the disclosure requirements of the Magnuson-Moss Warranty Act by clearly describing the defects covered and procedures used to settle claims (Sichelman, 1981).

Under the FmHA Compensation for Construction Defects Program, there are four avenues of redress, and they must be exercised in the following order: 1) the homeowner must first try to get the defect corrected by the builder, and if that proves impossible, the owner then 2) files a claim with the Secretary of Agriculture under the Compensation for Construction Defects Pro-

gram. The Secretary may correct the defect, pay the owner for the defect, or agree to take the house back, OR rule that the defect is not compensable and refuse the claim. If the Secretary denies the claim, the homeowner/borrower can 3) institute a tort claims procedure in which he alleges that he has been harmed by the failure of an employee of the government to carry out his duty. Usually, the claimant argues that a Farmers Home Administration inspector or appraiser failed to detect a structural fault while carrying out his duty, and therefore the borrower has been harmed by being left with an unsafe structure. Only when the borrower has exercised these three avenues of redress without satisfaction is he eligible to 4) go to court to press his suit.

The purpose of the research reported here is to help determine the presence of defects in homes built with FmHA financing when compared to similar homes not built with FmHA financing. As the data are *not* based upon reports of defects filed by owners, but on a sample of homes built, it should present a clearer picture of the quality of all homes — not just with problems great enough to be reported.

The research reported in this paper is based on data gathered as a part of the regional research project S-95, Quality Housing Environment for Rural Low Income Families, funded by the United States Department of Agriculture. This report evaluates the quality of housing built under the provisions of the Farmers Home Administration (FmHA) Sec. 502 program in Maryland between 1969 and 1975. This analysis compares the FmHA-financed homes in Maryland to recently built single family houses from the southern region of the United States on the basis of deficiency measures, some of which were used in the Annual Housing Survey.

The Sec. 502 Program

The Sec. 502 program offers mortgages for single family homes in non-metropolitan areas for purchasers whose incomes, after deducting 5 per-

cent of the gross and \$300 for each child under 18 years of age, are not above a stated level. In 1975, the level was \$12,900. If the adjusted income was less than \$8,500, the family was eligible for a reduction in the interest rate to as low as 1 percent. Nationally, the median income of families moving into FmHA Sec. 502 homes between 1974 and 1976 was \$10,433.

The Samples

The Maryland Sample

There were 2,427 Sec. 502 loans made in Maryland between 1969 and 1975 (Warner, 1977: 38). It was not possible to obtain a listing of all the households from the Farmers Home Administration office in Washington, D.C. The sample of households for this study was provided by the staffs of fifteen Maryland FmHA county offices who attempted to list loans made between 1969 and 1975, for three-bedroom homes. There were 239 households on that list, or about 10 percent of all possible households. Those who were found to be renters or who had lived in the house less than one year were not interviewed. Nine families had moved away. Not-at-homes, refusals, and incomplete interviews accounted for twenty-seven cases. Excluding the ineligible respondents, the response rate was 87.89 percent. After interviewing, it was found that forty-five houses were more than six years old and eleven had more than three bedrooms, leaving a sample of 140 households.

The average unadjusted annual income for the Maryland sample was \$11,401 and is close to the median annual income, \$10,433, found by the Annual Housing Survey for families who had FmHA mortgages and had moved into their homes between 1974 and 1976.

The Regional Sample

A sample of 3,738 households was drawn from the following eight states: Alabama, Arkansas, Florida, Georgia, North Carolina, Oklahoma, Texas, and Virginia. Rural counties within these

states were ranked by median income, and from one to three counties in the lowest third of the list in each state were chosen. Clusters of about twenty houses each were marked out in the counties, and a random sample of forty clusters was drawn. Every fourth household in a cluster was interviewed for a sample of 200 households in each county. Most of the data were collected in 1975 in the southern states, and in January and February of 1976, in Maryland.

Of the total sample, those homes which were single family, three-bedroom houses, owner-occupied for at least one year, with the added criterion of having been bought or built new between 1969 and 1975, were selected for analysis. There were 140 FmHA Sec. 502 houses in the Maryland sample that fit these criteria, 89 FmHA Sec. 502 homes in the regional sample, and 131 houses that were not FmHA financed in the regional sample, that fit the criteria. Table 1 shows the distribution of the houses by state in the South.

TABLE 1. — Location of Households in the South

State	Not FmHA	FmHA
Alabama	19	31
Arkansas	20	3
Florida	7	6
Georgia	13	16
North Carolina	27	18
Oklahoma	11	2
Texas	14	5
Virginia	20	8
Total	131	89

The Variables

The quality variables were based upon residents' reports of the presence or absence of leaky roofs; cracks in the walls and ceilings (worse than hairline); minor and major decay of door frames, window frames, porches, and outside steps; broken or missing materials in the outer walls or foundations; uneven floors; sags or bulges in the

walls or ceilings; peeling paint on the inside and outside walls; broken or missing window panes; rodent or insect damage; and water problems in the last six months.

These variables represent deficiencies “more likely to be present in the dwelling units of the low-income than the high-income population” (Goedert and Goodman, 1977: IX) of rural non-farm households and thus are particularly suitable for the present analysis.

The Analysis

The hypotheses are 1) houses built under the FmHA Sec. 502 program are of the same quality as houses built for the general market, and that 2) Sec. 502 houses in the South will be of the same quality as Sec. 502 houses in Maryland. A chi-square test was employed in order to decide whether the observed differences between the percentages of houses having the deficiencies in each sample were due simply to chance fluctuations from one sample to another or whether

they reflected a real difference in the quality of the houses. This is a classical significance test for the difference between two sample proportions.

FmHA Homes Compared to Non-FmHA

The chi square test for significant differences in the percentages of deficiencies between the two samples found the only area of difference was that the FmHA-financed houses in the South had a higher incidence of rodent or insect damage than the non FmHA houses (Table 2).

FmHA Sec. 502 Houses in Maryland vs. General Market Houses in the South

A comparison of the 140 FmHA-financed houses in Maryland and the 131 general market houses not financed by FmHA in the eight southern states, found a significant difference in the incidence of deficiencies on the following five measures:

- 1) cracks in the walls and ceilings
- 2) decay of door and window frames

TABLE 2. — A Comparison of the Incidence of Deficiencies of Quality in Matched Samples of FmHA-Financed and Non-FmHA-Financed Houses in the Southern Region.

Deficiency	Occurrence in Percent of Homes: Significance		$\alpha = 05^*$
	FmHA Financed	Not FmHA Financed	
Leaks in the roof	6	8	—
Cracks in the walls or ceilings	5	2	—
Sags or bulges in the walls or ceilings	2	2	—
Peeling paint on the inside walls	2	3	—
Peeling paint on outside walls	10	14	—
Decay of door and window frames	2	2	—
Decay of porch and outside steps	0	3	—
Uneven floors	3	5	—
Broken or missing window panes	6	7	—
Broken or missing materials in the outer walls or foundation	3	0	—
Rodent or insect damage	25	4	*
Water problems in the last six months	2	11	—

*Differences are significant at the .05 level.

TABLE 3. — A Comparison of the Incidence of Deficiencies in 140 Single Family Owner-Occupied Houses in Maryland Six Years Old or Less, Financed by the Farmers Home Administration Sec. 502 Program with a Matched Sample of 131 Houses from Eight States in the South, Not Financed by the Farmers Home Administration (FmHA) Sec. 502 Program.

Deficiency	Occurrence in Percent of Homes: Significance		
	Maryland	The South	$\alpha = .05^*$
Leaks in the roof	4	8	—
Cracks in the walls or ceilings	12	2	*
Sags or bulges in the walls or ceilings	6	2	—
Peeling paint on the inside walls	6	3	—
Peeling paint on outside walls	14	14	—
Decay of door and window frames	21	2	*
Decay of porch and outside steps	12	3	*
Uneven floors	16	5	*
Broken or missing window panes	11	7	—
Broken or missing materials in the outer walls or foundation	9	1	*
Rodent or insect damage	4	4	—
Water problems in the last six months	20	11	—

- 3) decay of porch and steps
- 4) uneven floors
- 5) broken or missing materials in outside walls or foundations.

The FmHA-financed houses in Maryland were of poorer quality on each measure. If the houses in the sample from the southern region had been concentrated in one or two states, the argument could be made that some local factor caused the quality difference, but as the houses were well distributed among all eight states of the South, this is unlikely (Table 3).

Sec. 502 Houses in Maryland vs. Sec. 502 Houses in the South

Comparison of the 140 Sec. 502 houses in Maryland to 89 Sec. 502 houses in the eight southern states shows the Maryland homes had a significantly greater occurrence of deficiencies in the following four areas:

- 1) cracks in the walls or ceilings
- 2) decay of door and window frames

- 3) decay of porch and outside steps
- 4) uneven floors

The data support the statement that FmHA-financed Sec. 502 housing built in Maryland between 1969 and 1975 have a significantly higher incidence of at least four quality faults than comparable housing in the southern region, whether or not that housing was financed by the Farmers Home Administration. The faults would seem logically to be related to construction materials and/or processes. Uneven floors and cracks in the walls and ceilings might indicate poor foundations; decay of door and window frames, porches and outside steps might indicate poor site drainage.

Since program requirements result in approximately the same income dispersions in all states, the incomes of the two FmHA-financed samples may be assumed to be not significantly different. Therefore, the difference in the structural quality of the houses cannot be explained by the difference in income between the two samples.

TABLE 4. — A Comparison of the Incidence of Deficiencies in Quality in Matched Samples of Houses Financed by the FmHA Sec. 502 Program: 140 in Maryland and 89 in the South.

Deficiency	Occurance in Percent of Homes: Significance		
	Maryland	The South	$\alpha = .05^*$
Leaks in the roof	4	5	—
Cracks in the walls or ceilings	12	3	*
Sags or bulges in the walls or ceilings	7	2	—
Peeling paint on the inside walls	6	2	—
Peeling paint on outside walls	13	10	—
Decay of door and window frames	21	2	*
Decay of porch and outside steps	11	0	*
Uneven floors	16	3	*
Broken or missing window panes	12	6	—
Broken or missing materials in the outer walls or foundation	9	3	—
Rodent or insect damage	4	25	*
Water problems in the last six months	20	12	—

*Differences are significant at the .05 level.

While the analyses conducted on this data identified only significant differences in the incidence of defects between the three groups of houses, the level of incidence of defects in all three groups merits attention as well (see Tables 2, 3, and 4). Peeling paint on the outside walls and water problems in the last six months occurred in over 10 percent of all the housing surveyed regardless of source of mortgage funding and level of income of the households.

Discussion

If the true intent of the Congress in enacting FmHA, VA, and FHA housing subsidies is to benefit low income families wanting to own their homes, then the evidence suggests that the interests of those families need to be protected. If it is true that inexperienced first time homebuyers do not recognize faults, do not report faults, and do not pursue redress (Kaluzny, 1980), the problem has the potential to be larger than any study will show.

Whether the control should be exercised through more effective supervision of the building process or through an expanded Defects Compensation Program is a choice that Congress should consider. Even if the intent of Congress is to benefit builders rather than homebuyers, and to stimulate the economy through activity in the construction industry, does Congress intend to subsidize the construction of defective buildings?

There are at least five, and probably other, measures that might be tried to correct this situation, as follows:

- 1) *An inspector* from FmHA could inspect the houses more often during construction. Such an inspector needs special training in engineering or architecture to be able to judge the considerable inventiveness of builders.
- 2) *The appraiser* of an FmHA property should employ procedures to compensate for the buyers' inexperience and do a more detailed appraisal of the property.

- 3) A *builder guarantee*, like the Home Owners Warranty offered by some members of NAHB, could be required. The guarantee should be to FmHA, not the individual homeowner, since FmHA would be better able to enforce it.
- 4) FmHA used to give out *approved house plans with materials lists and specifications stipulated*. A return to that practice might be advisable.
- 5) *The use of approved prefabricated (factory-built) houses* could be required by FmHA. Quality control procedures are more easily administered in a factory setting.

The first four suggestions require highly trained personnel in the field, either several different individuals whose services are contracted for by the FmHA county supervisor or especially trained county supervisors who are able to carry out all of the functions themselves. The Farmers Home Administration has begun a process that puts county supervisors with a little on-the-job training in counties with a high level of housing activity. However, that policy leaves most counties with lower levels of housing activity either essentially unprotected or spending considerable sums for the professional services of qualified appraisers and inspectors.

The alternative solution, that of restricting loans to prefabricated units constructed from approved plans and materials, should be explored. With several plans to choose from, the prospective buyer would be no worse off than in the usual scenario in which a buyer must select a home already built on speculation. The Farmers Home Administration would be able to carry out its Sec. 502 program with lower administrative costs while at the same time getting more value for the taxpayers' dollars spent on the program.

Such centralized quality control would have one secondary consequence that would be timely, in that solar systems that are an integral part of the structure could be approved by the central office and prefabricated in a factory setting, thus eliminating opportunities for builder error on systems that they do not understand. Low income house-

holds need relief from high fuel costs, and prefabricated passive solar system houses are available now. Long term savings on maintenance and fuel costs would decrease the risk on the mortgage loans on solar houses.

This perusal of the problem seems to suggest three steps to improve the quality of the units built under the FmHA Sec. 502 program. The first is to clarify the intent of Congress as to the relationship between the lender and the borrower so that responsibility for the quality of methods and materials can be clearly assigned. The second is to improve the quality of the construction by more effective inspections, bonding of the builders or builder warranties, delay of the last draw to the builder, etc. The third is to rewrite the warranty so that the borrowers understand what is covered and what is not, so they can protect themselves where necessary.

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