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FHA Restructuring Proposals: Alternatives and Implications

Kerry D. Vandell
University of Wisconsin–Madison

Abstract

This article evaluates problems of the Federal Housing Administration (FHA) under its current structure, develops criteria for judging alternative structures, and suggests one alternative—an assigned risk pool—that encourages efficiency in the insurance function while still promoting low- and moderate-income housing. A historical introduction explains how the current institutional relationships came about and created FHA's problems.

FHA's decline resulted from the mixing of a heavy social agenda with the basic insurance objective, a destructive reorganization of the Department of Housing and Urban Development that caused FHA to lose control and focus, and government's inherent inability to respond to market signals. Yet the economic rationale for government involvement in FHA functions is strong. An FHA organized as an independent government agency, a government-sponsored enterprise, or even a privatized entity structured as an assigned risk pool could improve efficiency of underwriting, pricing, and administration while achieving the redistributional objectives.

Keywords: Federal Housing Administration; Insurance; U.S. Department of Housing and Urban Development

Introduction

In recent months, discussion of the future of the Federal Housing Administration (FHA) has reached a new level of intensity. The U.S. Department of Housing and Urban Development (HUD) had already identified FHA as a primary focus for "reinvention" soon after the current administration took office in 1993. This had been prompted by studies by the HUD Office of the Inspector General (1993), the U.S. General Accounting Office (1991), the National Academy of Public Administration (NAPA 1994a, 1994b), and Price Waterhouse (1990), which all suggested that FHA lacked appropriate management control and data systems, was woefully inefficient in its primary functions of processing insurance and asset management, and faced massive losses on its portfolio of multifamily loans (for details, see U.S. Senate Committee on Banking, Housing, and Urban Affairs 1993).

However, the 1994 elections created a new sense of urgency about dealing with FHA's problems. HUD was earmarked by the incoming Republican majority for possible elimination, with FHA's functions to be spun off into an independent entity or possibly sold off or eliminated altogether. Thus, there is an expectation that something will be done soon and that whatever it is must deal decisively with the identified problems of FHA in carrying out its mission.

The purpose of this study is to come to some conclusions about what shape the new FHA should take. Scores of studies have analyzed FHA's problems and made recommendations for reform (Apgar 1994; Chappelle 1995; Cincotta 1995; Downs 1995; Foote 1986; Gates 1995; Grassano 1995b; HUD 1994a, 1994b; Hutchinson 1995; Joint Center for Housing Studies 1994a; Knight 1995; Kogut 1995a, 1995b; National Association of Home Builders 1994; Perry 1995; Retsinas 1995; Schoenbeck 1995; Snow 1994; Van Order and Gates 1995). This study differs from them in several ways:

1. It steps back and then forward to examine FHA's basic objectives in the context of American housing policy.

2. It relates these objectives to classical rationales for government intervention in the marketplace.

3. It uses these relationships to explain where and why conflict and inefficiencies can occur in FHA's accomplishment of its mission.

4. It uses these findings to derive a set of recommendations for restructuring FHA that can best accomplish its broader social mission as well as its narrower economic mission yet remain in harmony with political and economic realities.

Thus I attempt to provide a broader theoretical foundation for the restructuring effort. Toward that end, in the next section I provide a brief history of the evolution of FHA, focusing on its perceived mission and changes in that mission over time, together with the identification of the problems that began to plague it in the 1970s.

History of FHA

Early days

The first 20 years of the development and expansion of FHA have traditionally been seen as a classical case study of how federal government intervention in the housing market can successfully deal with its inefficiencies, thus expanding homeownership opportunities and increasing living standards.

Before the Great Depression, most home mortgages were short-term (3- to 15-year), nonamortizable balloon instruments at loan-to-value ratios (LTVs) below 50 to 60 percent. The liquidity crisis facing the banking system in the early 1930s forced lenders to call these notes as they came due. Since all lenders were affected, refinancing was not available, and borrowers without adequate resources were forced into default. Other borrowers became unemployed and so became delinquent on their notes, ultimately causing lenders to foreclose to protect their investments. Finally, as unemployment spread and the capital markets contracted, property values dropped, throwing many of those households not already affected into a negative equity situation with a greater incentive to default.[1]

The National Housing Act of 1934 was the first large-scale federal government program of intervention into the housing market. Among its other purposes, it created FHA with two primary intents: (1) to generate employment by jump-starting the market for new housing (new starts had dropped from more than 700,000 during the 1920s to as few as 93,000 in 1933) and (2) to reactivate and stabilize the homeownership market by overcoming lenders' aversion to providing home mortgage credit for fear of another depression.

The response was a program of loan insurance for owned single-family homes (Section 203(b)) that would insure 100 percent of the loan amount in the event of default. Creating the insurance product required standardization of mortgage products and underwriting procedures, which assured lenders and the capital markets that the loan, the borrower, and the underlying asset itself met certain quality standards. Appraisals, property inspections, and quality ratings were required, and the borrower's credit record and financial capability were evaluated. The loan

[1] For a recounting of conditions in the pre-FHA era and the early days of FHA, see Jacobs et al. (1982), Lloyd (1994), and Mitchell (1985). Weicher (1980, 1988) provides excellent commentaries evaluating FHA's policy role.

product was transformed to a longer term (initially 20-year) fully amortizable note at a higher LTV (initially 80 percent) (table 1). At first, interest rates were restricted to below 6 percent, and loan amounts below $16,000. Since the median house price in 1930 was only $4,778, this was not a serious constraint. The ceiling was reduced to $6,000 in 1938, but that level was still sufficient to cover more than 85 percent of owner-occupied homes. By 1940 less than 5 percent of all homes were worth more than $10,000.

The Section 203(b) program was clearly intended to deal with the vast bulk of the homeownership market, excepting only the wealthiest few. Its neighborhood risk standards also eliminated the lowest income and racially transitional neighborhoods, as shown by these excerpts from the *FHA Underwriting Manual* (FHA 1938, secs. 911, 929, 937):

> Varying social characteristics of neighborhood occupants must be carefully considered and incorporated into the rating.
>
> Areas surrounding a location are investigated to determine whether incompatible racial and social groups are present, for the purpose of making a prediction regarding the probability of the location being invaded by such groups. If a neighborhood is to retain stability, it is necessary that properties shall continue to be occupied by the same social and racial classes. A change in social or racial occupancy generally contributes to instability and a decline in values.
>
> Having determined the Economic Background Rating for the area, the first step in making Established Ratings of Location is to determine ineligible or caution areas.

Thus, initially, FHA was narrowly targeted to the promotion of single-family homeownership but broadly targeted to all but the lowest and highest income markets.

The Mutual Mortgage Insurance (MMI) Fund was created to receive the 0.5 percent annual premiums as a reserve against loss. Required to be actuarially sound, the fund grew steadily. In 1943 it began reimbursing borrowers in cash (distributive shares) upon loan prepayment after they survived the initial high-risk years of the policy for their excess contributions to the fund relative to losses incurred, a practice that continued until 1991.

Table 1. **FHA Market Penetration and Constraints on Lending Terms, 1934–1995**

Year	Median Single-Family Home Price ($)[a]	Median FHA Home Value ($)		Maximum Loan ($)	Maximum Loan as % of Median Home Price	Maximum LTV (%)	Maximum Term to Maturity (Years)	Maximum Interest Rate (%)	Premium (%)
		New	Existing						
1934	5,096	NA	NA	16,000	314.0	80	20	6	Annual 0.5
1935	5,025	NA	NA		318.4			5[b]	
1936	5,308	5,625	4,673		301.4			5[b]	
1937	5,804	5,467	4,705		275.7			5[b]	
1938	6,016	5,326	4,602	6,000	99.7			5[c]	
1939	6,016	5,136	4,540		99.7			4.5	
1940	6,228	5,028	4,600		96.3			5	
1941	6,794	5,045	5,004		88.3				
1942	7,290	5,368	5,272		82.3				
1943	7,927	NA	5,535		75.7				
1944	8,705	NA	5,484		68.9				
1945	9,271	NA	5,511		64.7				
1946	10,121	6,558	5,934		59.3			4.5	
1947	12,739	7,574	6,769		47.1				
1948	13,801	8,721	7,579	8,100	58.7				
1949	14,013	8,502	8,700		57.8				
1950	14,367	8,286	8,865	20,000	139.2	95		4.25	

Table 1. **FHA Market Penetration and Constraints on Lending Terms, 1934–1995** *(continued)*

Year	Median Single-Family Home Price ($)[a]	Median FHA Home Value ($)		Maximum Loan ($)	Maximum Loan as % of Median Home Price	Maximum LTV (%)	Maximum Term to Maturity (Years)	Maximum Interest Rate (%)	Premium (%)
		New	Existing						
1951	15,358	9,007	9,843		130.2				
1952	15,783	10,022	10,289		126.7				
1953	15,924	10,140	11,061		125.6			4.5	
1954	15,995	10,678	11,549		125.0		30[d]		
1955	16,349	11,742	11,555		122.3				
1956	16,844	13,203	12,261		118.7			5	
1957	16,915	14,261	12,572		118.2			5.25	
1958	16,915	14,207	12,778		118.2				
1959	16,278	14,329	12,914		122.9			5.75	
1960	16,986	14,607	13,043		117.7				
1961	16,986	14,918	13,474	25,000	147.2	97[e]	35	5.5	
1962	16,986	15,151	14,082		147.2			5.25	
1963	16,844	15,789	14,342		148.4				
1964	17,057	16,063	14,614		146.6				
1965	17,623	16,561	15,128		141.9				
1966	18,331	17,163	15,148		136.4			5.5–6	
1967	19,038	17,992	15,828		131.3			6	
1968	20,100	18,797	16,081		124.4				
1969	21,800	20,213	16,617	33,000	151.4			7.5	
1970	23,000	22,957	17,773		143.5				

Table 1. **FHA Market Penetration and Constraints on Lending Terms, 1934–1995** *(continued)*

Year	Median Single-Family Home Price ($)[a]	Median FHA Home Value ($) New	Median FHA Home Value ($) Existing	Maximum Loan ($)	Maximum Loan as % of Median Home Price	Maximum LTV (%)	Maximum Term to Maturity (Years)	Maximum Interest Rate (%)	Premium (%)
1971	24,800	23,866	18,856		133.1				
1972	26,700	24,665	19,691		123.6				
1973	28,900	24,641	18,729		114.2			7.75	
1974	32,000	26,761	21,959		103.1			8.25–8.5	
1975	35,300	32,546	26,177		93.5			8–9	
1976	38,100	35,223	26,884		86.6			8.5–8	
1977	42,900	37,227	28,903	60,000	139.9			8.5	
1978	48,700	41,151	33,088	60,000	123.2			8.75–9.5	
1979	55,700	50,406	38,442	67,500	121.2			10–11.5	
1980	62,200	56,042	44,054	67,500, 90,000[f]	108.5, 144.7			12–14	
1981	66,400	60,993	47,067		101.7, 135.5			14–17.5	
1982	67,800	62,425	50,586		99.6, 132.7			16.5–12	
1983	70,300	63,878	56,236		96.0, 128.0			11.5[g]	3.8% at origin[h]
1984	72,400	66,652	53,259		93.2, 124.3				
1985	75,500	70,280	58,726		89.4, 119.2				
1986	80,300	71,250	65,396		84.1, 112.1				
1987	85,600	76,682	67,378		78.9, 105.1				
1988	89,300	NA	65,532	67,500, 101,250[i]	75.6, 113.4				
1989	93,100		67,227	67,500, 124,875[i]	72.5, 134.1				
1990	95,500		NA	67,500, 124,875[i]	70.7, 130.8				

Table 1. **FHA Market Penetration and Constraints on Lending Terms, 1934–1995** *(continued)*

Year	Median Single-Family Home Price ($)[a]	Median FHA Home Value ($) New	Median FHA Home Value ($) Existing	Maximum Loan ($)	Maximum Loan as % of Median Home Price	Maximum LTV (%)	Maximum Term to Maturity (Years)	Maximum Interest Rate (%)	Premium (%)
1991	100,300			67,500, 124,875[i]	67.3, 124.5				3.8% at origin plus annual 0.5% depending on LTV[j]
1992	103,700			67,500, 151,725[k]	65.1, 146.3				
1993	106,800			67,500, 151,725[k]	63.2, 142.1				3.0% at origin plus annual 0.5% depending on LTV[j]
1994	NA			77,197, 152,362[k, l]					
1995						98.75[m]			2.25% at origin plus annual 0.5% depending on LTV[j]

Sources: Housing and Development Reporter, FHA Series Data Handbook.
Note: NA = not available; blanks indicate that figure is unchanged from previous year.
[a]Before 1968, estimated with residential implicit price deflator; 1968 and after, based on National Association of Realtors existing home sales.
[b]Plus 50-basis-point service charge to the lending institution.
[c]Service charge to lending institution eliminated.
[d]In certain cases, 35 years permitted.
[e]In certain cases, only a $200 down payment required, with remainder financed.
[f]High-cost areas: 95 percent of area median home sale price or $90,000, whichever is less.
[g]In 1983, the maximum interest rate was deregulated. Earlier it was set by the HUD secretary.
[h]Financeable (see Szymanoski 1993).
[i]Maximum is 95 percent of area median housing price or statutory cap, whichever is less.
[j]Term for annual premium payment extended for lower upfront premiums to result in same present value for purposes of actuarial soundness.
[k]Maximum is 75 percent of conforming loan limit.
[l]Minimum is 38 percent of conforming loan limit.
[m]For value less than $50,000, maximum is 97 percent of acquisition cost or 98.75 percent of appraised value, whichever is less. Over $50,000, maximum is 97 percent of first $50,000, 95 percent of the amount over $50,000 (up to $125,000), and 90 percent of the amount over $125,000.

The purpose of FHA broadened in 1938 with the passage of a revised Section 207 of the National Housing Act. Section 207 was intended in the original act to provide rental housing sponsored by federal or state agencies or nonprofit corporations to low-income households. However, it was little used. The transformation in 1938 was intended to make the program the multifamily counterpart of Section 203(b). It provided insurance to lenders making loans to private for-profit sponsors of approved multifamily projects intended for middle-income households. Premiums went into a newly created reserve fund, the General Insurance (GI) Fund. It was originally intended that the Section 207 program, although directed toward multifamily rental housing, would also remain actuarially sound.

By the war years, the homeownership and multifamily markets were again on stable ground. Although housing production was not exceedingly high during the years preceding World War II (certainly relative to the postwar years), this was due more to lack of purchasing power among households than a lack of credit availability. FHA is traditionally given credit for this turnaround.[2]

FHA is also often credited with fueling the massive growth in homeownership and the housing stock after the war, although a more correct interpretation may be that such activity was fueled by the tremendous pent-up demand after 15 years of depression and war and only facilitated by the market stabilization that FHA fostered. At any rate, the homeownership rate grew from less than 44 percent in 1940 to 55 percent in 1950 (table 2). The production of new single-family units went from 118,000 in 1944 to 1,689,000 in 1950. The MMI Fund grew from $22.6 million in 1938 to $480 million in 1959. FHA mortgages made up 23 percent of new lending between 1935 and 1939 but 45 percent during the war years. The FHA share dropped off suddenly after the war to 18.5 percent in 1945 to 1949, because of the introduction of the guaranteed Veterans Administration (VA) loan, the instrument of choice for many returning servicemen.

Starting at the bottom in 1934, FHA had never been tested by another widespread depression, and because of its conservative underwriting criteria it was not enveloped by the decline in the older inner cities that started in the late 1940s as the white

[2] There is some argument to the contrary, however. Lloyd (1994) concludes that since longer term fully amortizable mortgages were commonly offered by savings associations before 1934, the real constraint on their broad introduction was federal regulatory policy affecting commercial banks.

Table 2. **Homeownership, Housing Production, and FHA Lending Activity, 1933–1994**

Year	Homeownership Rate (%)	Single-Family Housing Production (Thousands)	FHA MMI Fund Balance (Equity, billion $)	FHA as a % of Single-Family Lending: By Number of Loans		By $ Volume	
				Vs. Total[a]	Vs. VA & PMI	Vs. Total	Vs. VA & PMI
1933		76					
1934		109	0.01[b]				
1935		183	0.01				
1936		244	0.02				
1937		267	0.02	23			
1938		317	0.02[c]				
1939		399	0.03				
1940	43.6	486	0.03				
1941		604	0.04				
1942		293	0.05	45			
1943		144	0.07				
1944		118	0.08				
1945	53.2	290	0.09				
1946		937	0.10[d]				
1947		1,152	0.11	18.5			
1948		1,180	0.12				
1949		1,229	0.12				
1950	55.0	1,689	0.13				
1951		1,275	0.15				
1952		1,304	0.18	20.2			
1953		1,251	0.15				
1954		1,397	0.19				

Table 2. **Homeownership, Housing Production, and FHA Lending Activity, 1934–1994** *(continued)*

Year	Homeownership Rate (%)	Single-Family Housing Production (Thousands)	FHA MMI Fund Balance (Equity, billion $)	FHA as a % of Single-Family Lending			
				By Number of Loans		By $ Volume	
				Vs. Total[a]	Vs. VA & PMI	Vs. Total	Vs. VA & PMI
1955		1,494	0.24				
1956	60.4	1,195	0.29[e]				
1957		980	0.34	18.2			
1958		1,048	0.41				
1959		1,234	0.48				
1960	61.9	995	0.56				
1961	62.4	974	0.65				
1962	63.0	991	0.73	16.2			
1963	63.1	1,012	0.78				
1964	63.1	971	0.79				
1965	63.1	964	[f]				
1966	63.4	779					
1967	63.6	844		14.3			
1968	63.9	897					
1969	64.3	811	1.38				
1970	64.2	813	[f]	29.4	70.7		61.8
1971	64.2	1,150		25.6	55.9		50.3
1972	64.4	1,309		15.7	35.8		32.3
1973	64.5	1,132	1.72	7.9	22.7		18.1
1974	64.6	888	[f]	7.1	23.4		18.7
1975	64.6	892	1.91[g]	8.4	29.1		24.6
1976	64.7	1,162	1.99	9.4	24.3		20.3
1977	64.8	1,451	2.04	9.0	24.2		19.5
1978	64.8	1,433	2.24	8.8	24.0		20.4

Table 2. **Homeownership, Housing Production, and FHA Lending Activity, 1933–1994** *(continued)*

Year	Homeownership Rate (%)	Single-Family Housing Production (Thousands)	FHA MMI Fund Balance (Equity, billion $)	FHA as a % of Single-Family Lending: By Number of Loans		By $ Volume	
				Vs. Total[a]	Vs. VA & PMI	Vs. Total	Vs. VA & PMI
1979	65.2	1,194	2.40	NA	32.9		29.1
1980	65.6	852	2.59[h]	10.2	36.6	11.2	34.6
1981	65.4	705	2.88	7.0	31.6	10.7	28.1
1982	64.8	663	3.21[i]	6.0	28.5	11.9	23.4
1983	64.7	1,068	3.41	13.7	34.6	14.1	29.9
1984	64.5	1,084	3.55	7.0	18.8	8.2	16.1
1985	63.9	1,072	3.75[j]	8.5	30.6	12.9	26.6
1986	63.8	1,179	4.09	15.0	49.6	15.3	44.7
1987	64.0	1,146	4.02	21.5	57.7	10.3	52.1
1988	63.8	1,081	3.44	15.0	52.4	10.0	42.9
1989	63.9	1,003	1.02[k]	17.0	57.0	10.0	46.5
1990	63.9	895	0.92	19.3	58.2	13.0	45.2
1991	64.1	840	0.87	17.0	50.2	8.2	39.2
1992	64.1	1,030	1.16	13.0	36.2	5.7	27.7
1993	64.0	1,128	1.18	13.1	39.2	8.1	30.8
1994	64.0	1,196	NA	NA	41.9	14.0(Q2)	33.7

Source: U.S. Bureau of the Census; Federal Housing Administration; National Association of Realtors. Single-family starts from 1945 to 1958 are estimates.

[a]New loans only.

[b]1934–37: Net worth of fund = total assets less total liabilities (from FHA annual reports).

[c]1938–45: Excess of resource over liability = assets less liabilities (from FHA annual reports).

[d]1946–55: Capital and statutory reserve (from HHFA annual report).

[e]1956–64: Capital = total assets less total liabilities (from HHFA annual report).

[f]1965–68, 1970–72, 1974: Data unavailable.

[g]1975–79: Fund balance = total assets less liabilities = reserve plus appropriations plus borrowing (from FHA income statement).

[h]1980–81: Fund balance = assets less liabilities = reserves plus appropriations (from FHA income statement).

[i]1982–84: Fund balance = assets less liabilities = reserves plus appropriations (from Financial Highlights by Insurance Fund).

[j]1985–88: Fund balance = assets less liabilities = reserves plus appropriations plus participation (from Summary of Mortgage Insurance Operation).

[k]1989–93: Total government equity (deficiency) (from FHA annual management report).

middle class began moving to the suburbs (via their new FHA mortgages), leaving their older apartment units to the newly arrived lower income (and often minority) immigrants from the countryside, especially from the South and Appalachia.

During the early years of FHA, the primary theme beyond growth was increasing liberalization of the basic mortgage instrument as experience provided evidence of its soundness. Maximum LTVs for the Section 203(b) program were increased from 80 to 95 percent, and finally to as high as 97 percent. In certain cases, only a $200 down payment was required, with prepaid items and closing costs counted against it. Terms to maturity extended from 20 to 25 years, and finally to 30 years, with 35 years permitted in some situations. LTVs on multifamily projects went as high as 90 percent of value and in some cases up to 100 percent of cost. Although these changes certainly increased the inherent risk of the underlying mortgages, because the post–World War II era was generally a period of recovery and expansion, such risk was in little evidence. Only in 1952 and 1957 did mild recessions cause upward blips in the default rate. The MMI Fund continued to grow.

Broadened social mission

It was not really until the war that FHA first tentatively broadened its mission beyond the narrow economic function of providing actuarially sound mortgage insurance to support middle-class homeownership and rental. Specialized mortgage programs began to be introduced as conditions called for them. Each was intended to have its own risk reserve at first; these were later absorbed into the GI Fund in 1965. Among the first programs were war housing during World War II (Section 611) and veterans' emergency housing (Veterans' Emergency Housing Act of 1946). These were followed, beginning in the late 1940s and continuing through the 1960s, by programs to produce urban renewal housing (Section 220), relocation housing for displaced persons (Section 221(d)(2)), military housing (Section 809), national defense housing (Section 903), cooperatives (Section 213), condominiums (Section 234), nursing homes (Section 232), major home improvements (Section 203(k)), housing for members of the military (Section 222), property improvement and mobile home parks (Title I), housing for the elderly (Sections 202 and 231), group practice medical facilities (Title XI), and hospitals (Section 242).

These programs were generally considered special risk situations, separate from the primary single-family Section 203(b) program, that could incur costs in excess of their premium income. Hence the GI Fund, originally perceived as an actuarially sound reserve fund for multifamily programs, was transformed and began to be expected to require annual appropriations to maintain the proper reserve level. FHA's entrance into these new, higher risk situations was a departure from its earlier, narrower economic function; however, most of the purposes had broad political support and did not involve major redistributional consequences targeted to a specific class. Moreover, because this was a period of economic expansion, the risk was not generally felt through increased defaults.

It became common during this period to think of "cross-subsidization" as characterizing FHA. Within the MMI Fund, the higher risk high-LTV borrowers were considered to be subsidized by the remaining borrowers so that the overall program was actuarially sound. In addition, although the GI Fund was increasingly seen as a high-risk fund requiring appropriations, some considered the "profitable" MMI Fund to be effectively making up for some of these losses. These notions of cross-subsidization were to become increasingly unviable over time.

Beginning with the Kennedy administration in the early 1960s and extending through Johnson's Great Society years, a much more aggressive assignment was handed to FHA. For the first time since the creation of the public housing program, housing policy began to be used broadly as an active instrument of social policy.[3] Furthermore, explicit subsidies in the form of reduced interest rates were for the first time to be combined with more lenient underwriting standards to increase housing opportunities. These subsidized housing programs and programs for housing in older declining areas included the following:[4]

1. The Section 221(d)(3) Below-Market Interest Rate (BMIR) program was the precedent of the Section 236 program before 1968 and the primary rental subsidy program of the Kennedy era. It provided rental housing for low- and moderate-income families through mortgages at

[3] Even public housing was originally perceived to be for the "deserving" poor temporarily displaced as a result of the depression or, later, without available housing as a result of the war (Jimmy and Rosalynn Carter at one point lived in public housing) (see Meehan 1985).

[4] For a good summary of the new subsidized FHA housing programs initiated in the 1960s, see Jacobs et al. (1982).

below-market interest rates as low as 3 percent. Because federal accounting rules required the entire loan amount to be included in the federal budget in the year it was made, the program proved unpopular with the federal government.

2. The Section 221(d)(4) program had somewhat lower per-unit loan limits than Section 221(d)(3). It later became a favorite financing vehicle for Section 8 projects, since it could be combined with the Government National Mortgage Association (GNMA) tandem program to create a 40-year 7.5 percent mortgage. Without Section 8 subsidies, the program was essentially a moderate-income one, but HUD could restrict rent increases.

3. The Section 223(e) program was included in the Housing and Urban Development Act of 1968. Intended to provide for mortgage credit in areas otherwise deemed to be of questionable viability, this program unfortunately provided ambiguous guidelines as to what constituted an acceptable risk.

4. The Section 233(a)(2) program was intended to support the production of experimental housing.

5. The Section 235 homeownership program, also included in the 1968 HUD Act, was intended to make homeownership affordable to low-income households by providing low down payment requirements and subsidizing mortgage interest rates in theory all the way down to 1 percent. Complex regulations based on income and cost levels restricted the actual subsidy available.

6. The Section 236 multifamily rental program, another provision of the 1968 HUD Act, was the rental counterpart to the Section 235 program. Income and cost restrictions regulated the rent level and amount of mortgage interest subsidy available to a developer.

7. The Section 237 program was intended to provide mortgage insurance eligibility to families who could not qualify for a loan under one of the regular FHA programs because of a bad credit record. It was often used as a supplement to the Section 235 program.

8. The Section 238(c) program allowed FHA to insure mortgages in areas affected by the closing of military installations.

Except for the Section 221(d)(3) and 221(d)(4) programs, which were placed in the GI Fund, all these high-risk loan programs were placed in a new insurance fund called the Special Risk Insurance (SRI) Fund (table 3). By 1969, FHA was operating four insurance funds. Besides the MMI, GI, and SRI Funds, there was the Cooperative Management Housing Insurance (CMHI) Fund for cooperatives. The combined reserves of these funds at the end of 1969 stood at $1.60 billion (table 4). The size of the total reserve fund pool had grown steadily from the 1950s, and in fact by 1970 was increasing at an even higher rate because of the addition of the new funds.

The basic Section 203(b) program and its counterpart, the MMI Fund, changed little in terms of their risk characteristics by the end of the 1960s. While still intended to be actuarially sound, the Section 203(b) program was gradually targeted lower and lower in the income distribution by means of both more lenient terms, as cited above, and binding loan ceilings.[5] This dynamic was offset, however, during the 1960s by raising the mortgage limit to attract greater numbers of higher income households. The mortgage limit of $6,000 in 1938 was raised to $8,100 in 1948, $20,000 in 1950, $25,000 in 1961, and finally $33,000 in 1969 (table 1). These increases enabled the maximum loan limit as a percentage of median home price to rise to 151.4 percent by 1969, the highest ratio since FHA's earliest days. However, the value of the median FHA-financed existing unit was 24 percent below the value of the median existing unit, a figure that had dropped from 14 percent below since the mid-1960s. Thus, there was some hint that the Section 203(b) program was starting to focus more on the lower end of the market.

As a result of increased targeting during the 1960s, the development and spread of the conventional loan market in conjunction with the private mortgage insurance (PMI) industry,[6] and the continued competition from the VA loan guarantee program, the market share of the FHA Section 203(b) program fell to about 14 percent in the late 1960s for newly financed units (table 2). Among lower priced units, the share was somewhat higher.

Thus, by 1970, FHA's mission had evolved from what it was at its inception. In 1934 it aimed broadly at the homeownership

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[5] This targeting downward was also reinforced by the elimination of restrictions against redlining by FHA through administrative action in 1962 (Executive Order 11063).

[6] The Mortgage Guaranty Insurance Company, created in 1957, was the first of the modern private mortgage insurers.

Table 3. **Assignment of Individual FHA Insurance Programs to Insurance Reserve Funds**

	MMI Fund	GI Fund	SRI Fund	CMHI Fund
Insurance Program (and Inception Date Where Available)	Section 203*—Mutual Mortgage Insurance and Insured Improvement Loans (1934)	Title I—Property Improvement and Mobile Home Loans (1934, 1969) Title X—Land Development (1965) Title XI—Group Practice Medical Facilities (1966) Section 2—Insurance of Financial Institutions Section 203(k)—Major Home Improvement (1961) Section 207—Multifamily Rental Housing and Manufactured Home Parks (1934, revised 1938, 1955) Section 213—Nonprofit Cooperative Housing Section 220—Urban Renewal (1954) Section 220(h)—Improvement Loans in Urban Areas Section 221—Low-Cost Mortgage Insurance for Moderate-Income Borrowers (1954) Section 221(d)—Multifamily Housing Co-Insurance (1974) Section 221(h)—Nonprofit Rehabilitation Projects for Resale to Low-Income Purchasers Section 222—Servicepersons (1954)	Section 203(o),(p),(q)—Native Americans Section 223(e)—Housing in Older Urban Areas Section 233(a)(2)—Experimental Housing Section 235—Insurance and Assistance Payments for Homeownership and Renovation (1968) Section 236—Low- and Moderate-Income Multifamily Rental Housing (1968) Section 237—Special Mortgage Insurance for Low- and Moderate-Income Borrowers (1968) Section 238(c)—Mortgage Insurance for Federally Impacted Areas Near Military Installations (1974) Section 243—Subsidized Homeownership for Middle-Income Families	Section 213(k)—Management-Type Cooperatives (1950)

Table 3. **Assignment of Individual FHA Insurance Programs to Insurance Reserve Funds** *(continued)*

MMI Fund	GI Fund	SRI Fund	CMHI Fund
	Section 223(f)—Existing Multifamily Rental Housing and Multifamily Housing Insurance (1974)		
	Section 225—Military Housing		
	Section 231—Elderly (1959)		
	Section 232—Nursing Homes (1969)		
	Section 233—Experimental Housing		
	Section 234—Condominium Housing (1961)		
	Section 240—Loans for Title Purchases		
	Section 241—Supplemental Loans for Multifamily Projects and Health Care Facilities (1968)		
	Section 242—Hospitals (1968)		
	Section 244—Single Family Home Mortgage Co-Insurance (1974)		
	Section 245—Graduated Payment Mortgages (1974)		
	Section 251—Adjustable Rate Mortgages (1983)		
	Section 255—Home Equity Conversion for Elderly Homeowners		
	Section 608—Defense/Veterans Multifamily Housing		
	Section 609—Manufactured Housing		
	Section 611—Single-Family Loans, War Housing		
	Section 809—Armed Services Housing for Civilian Employees		
	Section 810—Rental Housing for Military or Civilian Personnel		
	Section 903—Individual Residences, National Defense Housing Mortgage Insurance		
	Section 908—Military Housing		

Sources: HUD (1990); Jacobs et al. (1982); Schoenbeck (1995); U.S. House Committee on Banking, Finance, and Urban Affairs, Subcommittee on Housing and Community Development (1991).
*Except subsections (k), (o), (p), and (q).

Table 4. **Growth in FHA Insurance Fund Reserves and Appropriations Required for Nonactuarial Funds, 1954–1993**

Year	MMI Fund Balance (billion $)	GI Fund Balance (billion $)	SRI Fund Balance (billion $)	CMHI Fund Balance (billion $)	Total Fund Balance (billion $)	Appropriations Required: GI Fund (billion $)	Appropriations Required: SRI Fund (billion $)
1954	0.19[a]	0.20[a]			0.39		
1955	0.24						
1956	0.29[b]						
1957	0.34						
1958	0.41	0.28[b]			0.69		
1959	0.48						
1960	0.56						
1961	0.65						
1962	0.73						
1963	0.78						
1964	0.79				1.13		
1965	[c]	[c]			[c]		
1966							
1967							
1968							
1969	1.38	0.20	0.00	0.02	1.60		
1970	[c]	[c]	[c]	[c]	[c]		
1971							
1972							
1973	1.72	–0.16	–0.35	0.02	1.22		
1974	[c]	[c]	[c]	[c]	[c]		
1975	1.91[d]	1.21[d]	0.78[d]	0.02[d]	3.92	0.04	0.10

Table 4. **Growth in FHA Insurance Fund Reserves and Appropriations Required for Nonactuarial Funds, 1954–1993** *(continued)*

Year	MMI Fund Balance (billion $)	GI Fund Balance (billion $)	SRI Fund Balance (billion $)	CMHI Fund Balance (billion $)	Total Fund Balance (billion $)	Appropriations Required	
						GI Fund (billion $)	SRI Fund (billion $)
1976	1.97	1.14	0.56	0.02	3.71	0.04	0.10
1977	2.04	1.12	0.53	0.02	3.71	0.08	0.20
1978	2.24	0.98	0.41	0.02	3.65	1.34	0.72
1979	2.40	0.92	0.38	0.02	3.72	1.51	0.92
1980	2.59[e]	–1.67[e]	–1.66[e]	0.03[e]	–0.71	1.60	1.02
1981	2.88	–1.51	–1.71	0.02	–0.32	1.72	1.15
1982	3.21[f]	–0.47[f]	–1.35[f]	0.03[f]	1.42	2.00	1.36
1983	3.41	–0.98	–1.67	0.03	0.79	2.00	1.38
1984	3.55	–0.83	–1.62	0.03	1.13	2.15	1.46
1985	3.75[g]	–0.33[g]	–1.41[g]	0.02[g]	2.02	2.39	1.61
1986	4.09	0.15	–1.06	0.02	3.20	2.54	1.70
1987	4.02	0.08	–1.04	0.02	3.08	2.71	1.80
1988	3.44	–0.15	–1.35	0.02	1.96	2.83	1.85
1989	1.02[h]	–6.37[h]	–1.33[h]	0.02[h]	–6.66	4.01	2.15
1990	0.92	–7.18	–1.32	0.02	–7.56	3.51	2.07

Table 4. **Growth in FHA Insurance Fund Reserves and Appropriations Required for Nonactuarial Funds, 1954–1993** *(continued)*

Year	MMI Fund Balance (billion $)	GI Fund Balance (billion $)	SRI Fund Balance (billion $)	CMHI Fund Balance (billion $)	Total Fund Balance (billion $)	Appropriations Required: GI Fund (billion $)	Appropriations Required: SRI Fund (billion $)
1991	0.87	–4.77	0.53	0.02	–3.34	8.78	4.12
1992	1.16	–8.71	–1.16	0.02	–8.69	10.26	4.12
1993	1.18	–6.24	–1.24	0.02	–6.29	11.04	4.12

Source: Housing and Development Reporter, FHA.
[a]1954–55: Capital and Statutory Reserve (from HHFA annual report).
[b]1956–64: Capital = total assets less total liabilities (from HHFA annual report).
[c]1965–68, 1970–72, 1974: Data unavailable. GI fund increased with consolidation of a number of separate specialized programs in 1965.
[d]1975–79: Fund balance = total assets minus liabilities = reserves plus appropriations plus borrowing (from FHA income statement).
[e]1980–81: Fund balance = assets less liabilities = reserves plus appropriations (from FHA income statement).
[f]1982–84: Fund balance = assets less liabilities = reserves plus appropriations (from Financial Highlights by Insurance Fund).
[g]1985–88: Fund balance = assets less liabilities = reserves plus appropriations plus participation (from summary of Mortgage Insurance Operation).
[h]1989–93: Total government equity (deficiency) (from FHA annual management report).

market and, although experimental, was intended purely to overcome lender risk aversion that was creating mortgage market inefficiencies. Its function was primarily economic, both job creating and market stabilizing, and social only insofar as it promoted homeownership. However, by 1969 the mission had changed. FHA's standard mortgage program had become increasingly targeted to the lower priced segment of the market, and it had taken on a much greater social mission: to become an active tool of social policy by directing homeownership and affordable private-market rental opportunities to low-income households in inner-city neighborhoods. The belief was that such credit provision would stabilize the inner-city housing and commercial market, thus helping prevent urban violence and enhancing economic opportunities for inner-city residents.

Note that throughout this period, FHA remained an independent agency with a commissioner, a separate staff, and autonomous budget authority. In 1934 FHA was created as an independent agency. It was strongly decentralized in its field operations, with 63 field offices across the United States and at least one office in every state. However, it had strong central underwriting and technical standards, underwriting controls, and central supervision. Five zones were created that served as links between Washington and the field offices. The lines of authority were short and direct. This clear organization, together with a clear and simple mission, is often credited with FHA's great success in the early years (Bazan 1974).

FHA became a part of the temporary National Housing Agency during World War II and in 1947 was included in the Housing and Home Finance Agency (HHFA) along with the Federal Home Loan Bank Board and the Public Housing Administration. HHFA supervised and coordinated the activities of all the major housing agencies, including FHA, but the agencies continued to act as separate entities. In the 1950s and early 1960s, HHFA took on the additional responsibility of administering an increasing number of categorical programs, but FHA still administered its own programs.

Even the creation of HUD in 1965, which transferred to the secretary of HUD all authority in urban and housing policy, still left FHA the right to administer its own programs with its own staff and commissioner, who was given the rank of assistant secretary. FHA's field structure remained essentially intact from 1965 to 1968, and service remained prompt. Typically, 95 percent of conditional commitments were processed in 5 days or

less, and 95 percent of firm commitments were processed in 3 days or less.

However, some aspects of the reorganization presented problems from the standpoint of efficient service delivery. The zone operations commissioners were replaced by assistant regional administrators who were stationed in HUD regional offices and were responsible for increased coordination with other HUD program initiatives. This change did not significantly impair program administration, but it began a regional layering of the organization and a separation of the commissioner from the field offices.[7]

Another set of problems also emerged in the 1965–68 period as a result of the creation of HUD. Certain service functions previously performed independently were consolidated. These included printing, computer operations, supply and procurement, and other general services. FHA, which had handled these services for itself in the past, was made to "buy" them from HUD. FHA's loss of control of its computer facilities—the most sophisticated in the department—was to prove especially serious. Once these facilities were transferred to the jurisdiction of the HUD assistant secretary for administration, FHA had to make a case for increased usage share and ended up receiving less than it needed.

In summary, by the end of 1969 FHA had been entrusted with a large, new mission. It had performed well to that time: The insurance reserve funds had grown steadily, and it was efficiently processing a continuing stream of applications with a dedicated and professional staff, an adequate data-processing support system, and clear lines of management authority. Although the creation of HUD had necessitated some adjustments, the institution was still clearly viable.

But storm clouds were gathering on the horizon.

The post-1969 era: A legacy of failure

Political opposition to supply-side categorical programs. Beginning in 1969, a variety of events in close succession buffeted FHA and formed the legacy of the agency from that point to the present. Unfortunately, this was not a propitious legacy; in fact, the story is a classic one of institutional failure.

[7] The discussion of the organizational problems at HUD and FHA beginning in the mid-1960s, here and in the next section, relies heavily on Bazan (1974).

The 1968 Housing Act began to be implemented in an environment of changed attitudes as a result of the Vietnam War and the urban riots. A new administration was charged with its implementation, an administration elected on a “get us out of Vietnam” plank by an electorate with a lessened appetite for addressing the “urban crisis” through complex and expensive categorical grant programs in housing and community development. Many of the new FHA programs included in the act, such as the Section 235 and 236 programs, were quite “Republican” in their design (Republican Senator Charles Percy of Illinois was the prime sponsor of the Section 235 program). As supply-side programs, they subsidized the suppliers of low- and moderate-income units and were thus supported broadly by the home-building community and others who benefited from new construction or substantial rehabilitation. According to theory, supply-side programs could both increase the supply of standard housing and lower unit housing costs.

However, supply-side categorical grant programs carried the seeds of their own destruction. The conservatives in Congress and within the Republican administration never felt comfortable with the strong redistributional aspect of these housing programs.[8] Unlike previous commitments to encourage the construction of military and defense housing, housing for those displaced by urban renewal, and nursing homes, these programs were explicitly limited to low- and moderate-income households, especially minority households from the inner city. Charges of horizontal and vertical inequity were leveled. Moreover, many new projects were being planned for suburban areas, to the consternation of many suburban constituencies.

Finally, there were increasing charges that the programs were too costly, inefficient, and prone to fraud. The interest subsidies, all the way down to 2 percent in certain cases, became quite costly during the interest rate run-up of the early 1970s. Unit costs of production were high relative to comparable private sector units, suggesting that the market was not operating efficiently. Finally, evidence began to emerge that producers were profiting handsomely from the production of inferior units.

Thus, although the first Nixon budget for fiscal 1970 maintained previous levels of funding for the major low- and moderate-income housing programs, conflict soon set in. George Romney, Nixon’s first HUD secretary and a former head of American Motors Corporation, had an idealized notion that technology and

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[8] This opposition is documented at length by Welfeld (1992).

proper program delivery systems could improve the effectiveness of American urban policy. He proposed Operation Breakthrough, a program to encourage technology transfer in the housing industry, to deal with technological inefficiencies. The structure of program delivery systems he found more inscrutable. One of Romney's first acts after being confirmed in February 1969 was to suspend for 30 days all action on HUD grants and other resource expenditures to allow the new administration to become familiar with the myriad of programs and regulations.

HUD reorganization of 1969 to 1970. A second factor adversely affecting FHA in the early 1970s, partly related to the political opposition cited above, was created by Secretary Romney's response to what he called "the entire Rube Goldberg structure" of housing and urban development laws. Intending to unify the department's mission and enhance its efficiency, he proposed the complete restructuring of HUD. Unfortunately, many of the changes had effects exactly opposite to those intended. The following changes took place in FHA's structure and management as a result of the 1970 reorganization and earlier executive orders in 1969:[9]

1. FHA's Personnel Division was transferred to the new assistant secretary for administration and merged with HUD's Office of Personnel. The result was lowered efficiency, higher overhead cost in obtaining professional employees, and abandonment of a previously developed automated, integrated system for personnel records and accounting.

2. FHA's Audit Division, which had primary responsibility for evaluating mortgagees, project mortgagors, brokers, and contractors, was also transferred to the assistant secretary for administration and merged with the HUD Division of Audit. The result was the loss by the FHA commissioner of a critical control function.

3. The FHA General Counsel was abolished, and the FHA Legal Division was merged with the HUD Office of General Counsel. The result was the elimination of specialized legal advice, a slowness in the issuance of regulations, and the need for FHA to compete for limited legal staff.

4. The federal housing commissioner became the assistant secretary for housing production and mortgage credit–federal housing commissioner. He was assigned a variety of

[9] These issues are developed at length in Bazan (1974).

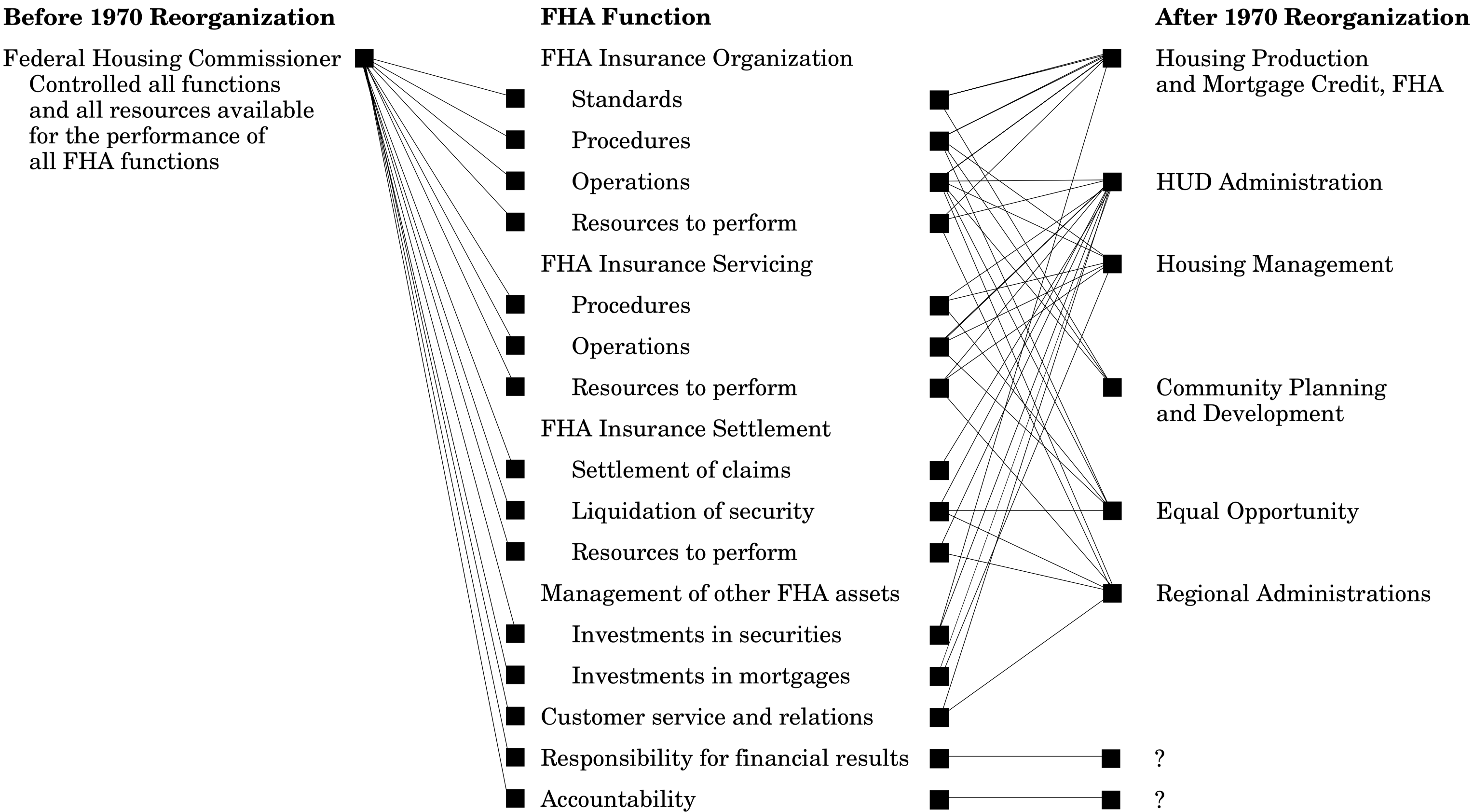
new tasks, including administration of the public housing program, production of other housing, and jurisdiction over GNMA. However, he lost three important functions: servicing of FHA-insured single-family mortgages, servicing of FHA-insured and assigned multifamily mortgages, and disposition of properties and mortgages acquired by FHA as a result of insurance claims. The first function was taken over by the assistant secretary for housing management, and the other two by the assistant secretary for renewal and housing management. The result was a muddying of the commissioner's sphere of responsibility and a balkanization of insurance-related functions without a clear notion of where the buck stopped. The fragmentation resulting from the reorganization is summarized in figure 1.

5. HUD field reorganization resulted in 10 regional offices and 39 area offices. This decentralization paralleled FHA's decentralized structure from the 1930s. The adverse impact on FHA was that it duplicated locally the sort of fragmentation that occurred at the federal level: FHA functions were cannibalized among various divisions, with multiple layers of program managers who had responsibility for obtaining cross-approvals. More seriously, FHA employees per se ceased to exist. They became employees of the Housing Division with responsibilities torn between traditional FHA functions and other programmatic duties. The result was reduced accountability and efficiency in the traditional insurance functions of underwriting, loan processing, servicing, and loan and property management and disposal.

6. FHA became entangled in a variety of federal regulatory initiatives that it could have handled more efficiently as an independent agency. Examples are the National Environmental Policy Act, which required environmental review of "major federal actions," and Budget Circular A-95 from the Office of Management and Budget (OMB), which required that certain activities be referred to area clearinghouse agencies for comment relating to budgetary impact before a decision is made. These changes delayed and complicated actions relating to FHA insurance functions. If FHA had not been so intertwined with HUD activities because of the reorganization, it would have been much less affected by such regulations.

7. One of the most egregious consequences was the impact of the reorganization on the administration of the new FHA insurance programs for low-income developments. The

Figure 1. **FHA Fragmentation as a Result of the 1970 HUD Reorganization**



Source: Bazan (1974).

Section 223(e) program was especially affected, but the Section 235, 236, and 221(d)(3) programs also felt the consequences. For the Section 223(e) program, determination of what constituted a "reasonably viable area" and an "acceptable risk property" was made at too high a level with inadequate understanding of the realities of the underwriting process and default risk. The result was catastrophic losses far in excess of what would have been necessary under realistic underwriting guidelines.

8. Finally, FHA's absorption into the general bureaucracy of HUD had the effect of considerably expanding its responsibilities related to nondiscrimination and affirmative action. Both are laudable goals, but the added burden increased overhead costs and programmatic inefficiencies for FHA's insurance function in the face of private market competition. An example is HUD's response to Title VIII of the Civil Rights Act of 1968, which prohibited discrimination in the sale, rental, financing, or marketing of housing. FHA had already taken steps to satisfy these requirements through administrative action, but HUD decided to go beyond the statutorily required mandates to require "affirmative marketing" efforts to attract minority occupants. Each FHA applicant was required to produce an "affirmative fair marketing plan," adding an additional level of review and, at the margin, reducing FHA's efficiency and competitiveness.

The net result of these conflicts was an emasculated FHA by the mid-1970s. The effect of the reorganization on FHA's primary product delivery—the timely processing of single-family applications—is illustrated in table 5. Although applications had increased significantly by May 1970, approval times were still largely under 3 or 5 days. After the reorganization, approval speed dropped dramatically. It was not until 1973 that approval efficiency rose to within its previous range (and even then it remained low for appraisals and property approvals), and this was for a volume of applications less than half that being handled in 1970.

Significant deterioration between 1969 and 1973 is evident in FHA insurance fund performance (table 6) and losses incurred as a result of sale of acquired properties (table 7). Although the MMI Fund continued to grow and was solvent, net income dropped by more than half between 1969–70 and 1972–73. The CMHI Fund remained small and solvent (and relatively inactive). But the real story was in the performance of the GI and SRI Funds. The GI Fund was solvent in 1969 with a small net

Table 5. **Delays in FHA Loan Processing as a Result of the 1969 HUD Reorganization**

	Appraisals and Property Approvals		Credit Approvals	
Week Ending	Number Processed	% Processed in 5 Days or Less	Number Processed	% Processed in 3 Days or Less
Before reorganization				
May 15, 1968	15,815	99	8,691	94
May 15, 1969	18,562	96	10,960	90
May 14, 1970	20,009	94	11,680	93
After reorganization				
May 13, 1971	23,628	53	15,199	55
May 11, 1972	14,526	59	10,703	66
May 10, 1973	7,746	87	6,109	95
May 2, 1974	8,333	89	4,730	95

Source: Bazan (1974, 30).

Table 6. **FHA Insurance Fund Performance, 1969–1973 (Million $)**

	MMI	GI	CMHI	SRI
Insurance reserves				
As of June 30, 1969	1,379	195	20	–1
As of June 30, 1973	1,716	–164	23	–354
Change	+337	–359	+2*	–353
Net income or loss				
July 1, 1969, to June 30, 1970	+167	+13	+4	–2
July 1, 1972, to June 30, 1973	+74	–239	+5	–228

Source: Bazan (1974, 38).
*Does not add because of rounding.

Table 7. **FHA Insurance Fund Losses, 1969–1973 (Loss on Sale of Acquired Properties as a Percentage of Claim Amount)**

Section of National Housing Act	Properties Sold in Fiscal 1969	Properties Sold in Fiscal 1973
203(b)	26	42
221(d)(2)	31	52
223(e)	36	72

Source: Bazan (1974, 39).

income, but by 1973 it had incurred huge losses, rendering it insolvent and requiring annual budgetary outlays of about $240 million. The SRI Fund, the only fund originally intended to require subsidies to maintain solvency, increased its losses more than a hundredfold, requiring annual appropriations near $230 million.

This same trend is evident in loss recoveries in 1973 versus 1969 (table 7). Losses associated with major programs increased from the 26–36 percent range to the 42–72 percent range. Thus, not only were there dramatic increases in defaults, but much lower loss recoveries compounded the hemorrhaging in the GI and SRI Funds.

Of course, many other events were taking place during this period that may have had nothing to do with the FHA reorganization but that still created problems for the agency. For example, administering the many new subsidized housing programs introduced during the 1960s was a daunting task even with an efficiently structured FHA and an administration committed to their successful implementation. But there is no doubt that FHA restructuring, whether intentionally or not, contributed to the problems and bears part of the blame for their pervasive influence.

Aftermath. By late 1970, the Nixon administration was coming into direct conflict with Congress over housing policy. On August 13, 1970, the president vetoed the HUD-independent offices appropriations bill as too costly in view of the budget deficit, the debt limit, and the possible impact of housing production on inflationary tendencies in the economy (*Congressional Quarterly Weekly Report [CQWR],* January 15, 1971, p. 119). In early 1971, the administration withheld urban development funds already appropriated during 1971 for the same reason (*CQWR,* March 19, 1971, p. 608). A December 1970 congressional committee staff report first revealed significant problems of fraud and abuse in the Section 235 and 236 programs, which Secretary Romney acknowledged in January 1971 (*CQWR,* April 9, 1971, pp. 803–4). Blame was cast in both directions: The administration asserted that Congress had loosened the controls on program administration to permit a higher volume of production, refused to approve homeowner counseling programs, and failed to approve administration plans to consolidate and simplify housing programs; Congress asserted that the administration had sabotaged the programs to get rid of them.

The conflict came to a head in January 1973 when the administration imposed a moratorium on new commitments under the Section 235, Section 236, rent supplement, low-rent public housing, and college housing programs (*Congressional Quarterly Almanac,* 1973, pp. 428–32).[10] Newly confirmed HUD secretary James T. Lynn, a former undersecretary in the Commerce Department, defended the moratorium as a way to stop the hemorrhaging of cash from fatally flawed programs and to provide time for the development of the administration's Better Communities Act. By this time, philosophical opposition to the supply-side programs had hardened within the administration; it intended to replace them ultimately with a demand-side housing allowance program and Community Development Block Grants. Congress and the home builders were firmly opposed, and this stalemate lasted until the compromise Housing and Community Development Act of 1974, when limited temporary extension of the Section 235 and 236 programs was permitted and the Community Development Block Grant and Section 8 programs were passed (*Congressional Quarterly Almanac,* 1973, pp. 345–63). The Section 8 program, which had both demand- and supply-side characteristics, provided for direct payments to landlords, funding the gap between market and "affordable" rents. Such programs would permit local community discretion over the use of community development funds, not impose federally subsidized projects on the suburbs, and cost less than the interest rate subsidy programs.

Carter interlude. Surprisingly, despite widespread criticism of the HUD reorganization's role in gutting the subsidized FHA programs of the 1960s, there was little institutional response to the criticism from either HUD or FHA. A sense developed that indeed certain of the housing subsidy programs had fundamentally flawed designs that, combined with their costs, would have rendered them unviable even under the best of circumstances. The Carter administration focused closely on budgetary impacts during the "Era of Limitations." Hence it displayed little interest in returning to the expensive categorical programs of the 1960s, in spite of an aggressive report by the Task Force on the Future of FHA (HUD 1977), which recommended a more active role in promoting minority housing opportunities outside of central cities and increased focus on the needs of low-income households and those who would otherwise not have access to mortgage credit.[11]

[10] For a detailed discussion of the debate on the HUD moratorium, see Welfeld (1992).

[11] Weaver (1985) details the Carter administration's record in urban policy.

Meanwhile, FHA settled into its new role as an integral component of HUD largely without its own identity. It retreated largely to its traditional single-family role (though it was less efficient and handled a lower volume) and attempted to manage its past losses in the GI and SRI Funds.

Reagan-era hostility. The Reagan era brought a second major blow to FHA. Whereas the blow of the early 1970s had been struck by well-intentioned reorganizational efforts and perhaps less well-intentioned political reprioritizations, the blow of the early 1980s came in the form of explicit neglect combined with active hostility toward the aims of HUD.[12] Under Secretary Samuel Pierce's weak administration, Section 8 and other multifamily project approvals were routinely steered toward political cronies. Inadequate asset management and property disposition programs permitted losses in the GI and SRI Funds to increase substantially during the 1980s. Total budget authority at HUD dropped dramatically during the Reagan-Bush years, from $33.4 billion in 1981 to $14.3 billion in 1989, compounding an already inadequate fiscal capacity to carry out basic FHA functions. Lax underwriting and inadequate fiscal controls to prevent fraud and abuse began to permeate the FHA insurance programs in the 1980s. The situation deteriorated so rapidly that by 1985 the General Accounting Office was unable to conduct its audit, which was mandated by law. In 1987 it brought in Price Waterhouse, which also was unable to provide an opinion. However, Price Waterhouse did uncover enough evidence to support a prediction of substantial future losses from the GI and SRI Funds. A number of internal program and fund management problems were revealed, including accounting weaknesses in the monitoring of third-party contractors, poor financial management systems, and inadequate controls over cost and claim settlements.[13]

At the same time, FHA was increasingly targeted to the segments of the housing market with the very lowest incomes and highest proportions of minorities. The Housing and Community Development Amendment Act of 1981 established requirements for targeting very low income persons and households in housing

[12] Although these words and the discussion that follows seem strong, they are largely supported by most students of that period, regardless of their political leanings, having been brought out by extensive testimony in numerous hearings and trials (see, e.g., U.S. House Committee on Government Operations, Subcommittee on Employment and Housing 1989; Welfeld 1992).

[13] See U.S. House Committee on Banking, Finance, and Urban Affairs, Subcommittee on Housing and Community Development (1989), and U.S. House Committee on the Budget, Task Force on Urgent Fiscal Issues (1989), for a detailed treatment of these problems.

programs. The basic FHA loan limit was left at $67,500 from 1980 through 1993, while housing prices increased substantially (the median existing home price in 1993 was $106,800; table 1). Even the high-cost ceiling of $152,362 is now only 75 percent of the conforming loan limit for Freddie Mac and Fannie Mae loan purchases, down from 96 percent in 1980. Minimum down payment requirements also dropped during the 1980s. New FHA buyers in the 1980s typically had little or no equity in their property because FHA permitted many of their closing costs to be added to the loan amount, and a complex formula permitted down payments as low as 3 percent. These underwriting standards meant that loans with down payments under 5 percent increased from 32 percent of all FHA lending in 1980 and 1981 to 44 percent by 1988 and 1989 (for details, see Szymanoski, Reeder, and Neal 1994).

This increased targeting of FHA loans in the 1980s, combined with continuing competition from private mortgage insurers, meant that the FHA market share stagnated, at least in terms of share of total insurance dollars in place, ranging from 10 to 13 percent for most of the decade.[14] In terms of number of mortgages originated, however, FHA's market share increased from around 28–35 percent in the first half of the decade to 50–58 percent in the last half, driven by increased FHA concentration on the very low income segment of the market and a general boom in lending on large homes (see table 2).

A variety of factors contributed to poor FHA claim experience in the single-family loan program during the 1980s (see Hendershott and Schultz 1993). These included the issues discussed above—very low down payments, lax underwriting standards, inadequate fiscal controls—as well as a series of "rolling" recessions affecting the Rust Belt in the early 1980s, the Energy Belt after 1984, the Northeast and New England after 1987, and California after the end of the decade. To compound matters, housing in general ceased its secularly high rate of appreciation after 1981. The net result was that FHA's MMI Fund capital reserve fell from more than 5 percent of the outstanding balance of insurance in force in 1980 to less than 1 percent by the end of the decade. The fund was still considered solvent but was no longer actuarially sound (i.e., with sufficient cushion to survive a sudden market downturn) (see Hendershott and Waddell 1991).

[14] Weicher (1980, 1988) attributes the loss of FHA market share from the 1950s to the 1970s primarily to growing competition from the VA and especially the PMI industry.

Revelation and reform. HUD under the Bush administration and Secretary Jack Kemp made a credible attempt to recognize the magnitude of the problems incurred during the Reagan years and to begin dealing with them.[15] The National Affordable Housing Act of 1990 restructured FHA's single-family loan programs with the intent of restoring the MMI Fund reserve balance. This was done through a combination of increased premiums and increased equity requirements. FHA's premium had been an annual charge of 0.5 percent of the outstanding balance from 1934 until 1983, when it was changed to an equivalent one-time charge of 3.8 percent up front (which could be rolled into the loan amount and financed). The new premium structure in 1990 added to the upfront premium a 0.5 percent annual charge that would run for a specific term, depending on the LTV. The equity requirement was implemented in the form of caps on the LTV permitted. A schedule was established for the gradual reduction of the upfront premium in exchange for an extension of the annual charge to result in a constant present value cost of about 6.5 percent.

These changes apparently were successful in that the MMI Fund's capital reserves had reached 1.44 percent by 1993 and were projected to increase to 3.4 percent by 2000. These reforms, however, were responsible for a loss of market share by FHA to as low as 6 to 8 percent of total dollar volume (36 to 40 percent of total loans underwritten). One factor that may have encouraged refinancing out of FHA loans during the 1991–93 refinancing boom is the fact that the "unused" portion of the FHA insurance premium could be refunded to borrowers upon refinancing and provided in cash if they chose conventional refinancing (though not if they refinanced with FHA). The aggressive partnering of the private mortgage insurers with Freddie Mac and Fannie Mae in providing affordable housing loans during this period also accounted for FHA's loss of market share.

HUD was, unfortunately, not as successful at righting the FHA multifamily program during the late 1980s and early 1990s as it was at correcting the single-family program. Many multifamily projects built during the 1980s were poorly underwritten, leading to high rates of default during the low- or negative-appreciation years of the latter part of the decade. The Tax Reform Act of 1986 did not help matters, since it destroyed previous incentives for syndications to invest in multifamily housing, thus causing a

[15] The Bush administration's response to the FHA crisis is cited in Vandell (1994).

repricing throughout the industry and further reducing equity positions. The final blow was the large number of subsidized multifamily projects built during the late 1960s and early 1970s that were now reaching the end of their compliance term without the prospect of new financing, especially subsidized financing, to ensure a continuing tenant and revenue base. Many of these would go into default unless they happened to be in market situations that permitted their transformation to “market” projects (a solution that created its own set of problems). By the end of September 1991, although the SRI Fund had climbed back to a positive $531 million in equity, the multifamily GI Fund had slipped to a negative $4.77 billion in equity and was continuing downward. The prognosis was not good.

In response to the situation, the Clinton administration took several actions soon after it took office. The MMI Fund continued to be monitored closely. In 1995 a drop in the upfront FHA premium to 2.25 percent (the second such drop since 1991) was offset by a lengthening of the annual premium payment period, thus maintaining present value cost at about 6.5 percent and keeping the fund at an actuarially sound level. The multifamily problem was recognized early on and dealt with aggressively. The GI Fund’s loss position was reduced by $1.6 billion in 1993, and its inventory of multifamily properties dropped 34 percent. Furthermore, in recognition of FHA’s need to partner with the government-sponsored enterprises (GSEs) and the private sector in accomplishing its objectives, risk-sharing agreements were signed with 19 state and local housing finance agencies, Fannie Mae, Freddie Mac, and others to target lending to the more affordable sector of the market. Finally, FHA’s financial statements for the first time received a clean opinion from its Price Waterhouse auditors.[16]

However, these improvements did not mean FHA was out of the woods. It still faced severe management and control problems. It had retreated considerably in its mission of giving America’s lower income households the opportunity to access mortgage capital. There was a real question whether FHA continued to hold a legitimate role in today’s structure of housing institutions—a question magnified by the election of a new Congress in November 1994, clearly bent on questioning the wisdom of continued government involvement in the private markets. FHA was truly at a crossroads.

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[16] The problems facing the Clinton administration when it took office as they relate to HUD and FHA are presented in detail in a series of reports in *Housing and Development Reporter* by Robert Freedman and others between 1992 and 1995 (see references and bibliography). See also Vandell (1994).

How did FHA get into this mess?

The previous discussion of the evolution of FHA and the status of its program over the past 60 years should have provided some insight into the forces that led to its present condition and pessimistic prognosis. The causes are many and complex, in some cases related but in other cases entirely independent. The list includes the following:

1. *Conflict of the basic insurance mission with the goal of providing mortgage credit to the lowest income households.* The original Section 203(b) program was actuarially sound. However, as the program was targeted to lower and lower income households, there was a secular shift toward higher risk, low-equity loans that were not always properly underwritten or priced. This led naturally to pressures on reserves.

2. *Competition from private mortgage insurers, other government agencies, and other housing finance institutions.* When FHA started out, it was alone, fulfilling a role no other institution, public or private, was willing to undertake. However, over time this situation has changed. There is now an active, healthy PMI industry that is increasingly attempting to move into FHA's traditional market niches. There are a number of other governmental programs, such as those of the VA and the Rural Housing and Community Development Service, that compete directly with FHA. In addition, the GSEs—Freddie Mac and Fannie Mae—and state and local housing finance agencies are increasingly beginning to develop programs that take on some of the risk of mortgage lending, especially to those households at the margin, usurping some of FHA's traditional roles. This change is a natural devolution of FHA's role that should occur in a market-oriented economy, so in that sense it is not bad. However, it did push FHA to focus on those segments remaining outside the private insurance market sector, both to justify its existence and because it was the only market opportunity remaining.

3. *Lack of competition and proper incentive structure.* It is ironic that FHA can suffer both from competition and from lack of competition, but that is exactly the case. As a governmental entity, FHA is motivated by incentives different from the need to maximize value to shareholders that its private sector counterparts face. This allows it the luxury of considering worthy goals of social policy but also imposes on it the

burden of being less finely attuned to the discipline of market forces and the need to achieve efficiencies in all aspects of its operations. Even though the private insurers exist as a reference point, FHA is less concerned about market share or the profitability of its operations so long as it can point to the achievement of its social goals. Indeed, one line of thinking suggests that governmental activities should not be profitable, for if they are they can be successfully privatized.

4. *Increasing focus on lower income inner-city minority households.* Lower income households became FHA's primary client group beginning in the 1960s because of competition from the PMI industry. While that part of the market was properly considered to be the most underserved, along with the changing focus came certain realities. First, there often were reasons beyond pure discrimination why such households tended to be underserved. Many were at higher risk of default because of life events, income instabilities, or other factors or lived in higher risk markets with lower expectations and greater uncertainty in future property values. Redistributional programs narrowly targeted to one population group were a lightning rod for conservative critics. Thus, FHA became increasingly vulnerable as the political winds changed.

5. *Organizational dissolution of FHA.* The merging of FHA into HUD, the removal of its separate identity, the elimination of a clear chain of accountability, and the layering of programmatic approvals produced at best inefficiencies and at worst confusion and mismanagement.

6. *Philosophical and political opposition.* During both the Nixon and the Reagan administrations, opposition especially to the subsidized FHA programs created institutional responses designed to thwart what were seen as wrongheaded policies. Unfortunately, the FHA's unsubsidized basic insurance functions were also adversely affected, given their intertwined relationship with HUD in general.

7. *Mismanagement, unintentional and otherwise.* The confusing regulations and the elimination of clear lines of authority after 1970 resulted in frequent episodes of program mismanagement. There is also evidence that individual FHA and HUD employees sabotaged the programs they were to administer and even engaged in fraud and corruption in underwriting, project approval, asset management, and

property disposition.[17] These practices were most common during periods of permissive oversight practices.

8. *Resource inadequacies.* After the reorganization of HUD and with the loading of multiple missions (some of them quite costly) on the back of FHA, the agency consistently found itself inadequately supported. FHA was lacking in both properly trained personnel and support facilities such as data-processing systems.

9. *Regulatory overkill.* Congress and HUD itself entered into a frenzy of mandates and regulation writing beginning in the 1970s. This resulted from two factors: perceived abuses in the administration of programs and a desire to achieve broader social purposes such as nondiscrimination and equal opportunity. The result, especially in the absence of sufficient resources to administer the mandates, was bureaucratic gridlock.

10. *Misdesign of programs and regulatory and legislative initiatives.* The problem of misdesign ranges across a wide variety of issues. It includes the problems in the design of such programs as Sections 235, 236, and 223(e), which were exceedingly costly to the Treasury and did not properly control for risk or adverse incentives. It includes such flaws in underwriting formulas as the effective reduction of down payments to zero or below and the design of the old coinsurance program to share risk between lenders and FHA. It includes improper pricing of insurance premiums, both in experimental "high-risk" situations and in the more traditional Section 203(b) program. It includes such legislation as the 1986 Tax Reform Act, which had the unintended consequence of throwing thousands of syndicated FHA-financed multifamily projects into foreclosure, costing the Treasury billions of dollars. Finally, it includes the notion that, in spite of their legal separation, the four FHA insurance funds could be used to cross-subsidize each other—that is, that "profits" from the MMI Fund could offset "losses" from the GI and SRI Funds.[18]

[17] See Welfeld (1992) and the Lantos Hearings (U.S. House Committee on Government Operations, Subcommittee on Employment and Housing 1989) for a recounting of these behaviors.

[18] This concept of cross-subsidization was not as broadly shared as that of cross-subsidization within the MMI Fund alone, but it nonetheless continued to creep into FHA consciousness (see FHA 1994; "HUD Seeks Flexibility" 1994).

11. *Adverse economic circumstances.* Finally, we must recognize that some of what befell FHA was beyond its, and possibly anyone else's, control. The 1973–74 period was one of severe "stagflation," which adversely affected the property markets and the economy in general. These conditions compounded the adverse effects of the HUD scandals of the early 1970s. The 1980s also saw a series of rolling recessions, already alluded to, that caused severe value declines and hence the erosion of equity and defaults. Inner-city neighborhoods throughout the 1980s did not fare well. Their decline may have been connected with federal policies, but it could also have been a manifestation of the general declines in real income among the lowest income households, caused in part by technological change and the globalization of markets.

It is evident from the array of factors that seem to have contributed to FHA's downfall that none can be singled out as the fundamental cause. Rather, several factors seem to have interacted to reinforce the decline and produce the policy disaster. For example, the organizational and management problems of FHA and HUD might not have been fatal by themselves. But combined with a huge new work load in the form of new programs with higher risk and greater redistributional consequences—as well as political opposition, general economic problems, and structural program flaws—they meant disaster.

A corollary of this observation is that not all of FHA's problems can be pinned on its being a government-run operation. FHA worked perfectly well as a government-run operation for its first 35 years. Rather, the problem came when this government-run operation began to be assigned responsibilities that were subjects of political debate in a new economic environment that included aggressive private sector, public sector, and GSE competition and highly advanced technologies that could render FHA impotent.

This implies that any policy solution to FHA's problems that promises a quick-fix reorganization is doomed to failure because it does not recognize the complexities and interrelatedness of the causative factors.

Several observations may be noted about the logical structure describing the interrelatedness among the causes of FHA's decline:

1. Just a few fundamental factors seem to have been responsible for many of the problems. The original goal of

providing actuarially sound insurance led to competition from others, but otherwise it had little influence on later adverse events.

2. However, the targeting of lower income minority inner-city borrowers appears to have been quite important—in provoking philosophical and political opposition, in increasing risks and losses, in prompting greater regulatory oversight, and in promoting HUD integration.

3. Adverse conditions in the economy in general can thwart both the insurance and the equal opportunity goals, but they have greatest impact when the equal opportunity goal has interfered with proper pricing of the default risk.

4. The fact that FHA is a public authority without an adequate private-market benchmark is most damaging where goals and standards of performance are less clear (e.g., in carrying out the goal of equal opportunity).

5. The end results—resource inadequacies, programmatic inefficiencies, decreased market shares, and defaults and losses—are clearly just the final manifestation of earlier problems.

Later sections address the various “reinvention” proposals for FHA and how well they deal with the complex causes of FHA’s decline. Certain factors, such as general economic decline or the goal of increasing housing opportunities for lower income households, are state variables; that is, they are outside the control of policy makers or are policy mandates that are unlikely to be changed. Other factors, such as inadequate resources and organizational problems, are control variables—conditions that can be mitigated through legislation or regulation. When evaluating policy responses to state variables, the purpose must be to find solutions that insulate FHA from adverse effects, not to change the conditions themselves. However, control variables can be dealt with directly. This lesson will be applied in the discussion that follows.

Rationales for government or other collective intervention

To get a sense of the appropriate ownership structure for FHA, one must first overlay its mission with the classical rationales for government or other collective activity in private markets,

particularly the housing and mortgage markets. This discussion makes use of the typology developed by Follain and Szymanoski (1995) for evaluating the appropriateness of government's role in the multifamily mortgage markets, which in turn was derived from classical public finance theory (e.g., see Arrow 1983).[19]

Market failures

Follain and Szymanoski cite market failures as a primary rationale for intervention in private housing and mortgage markets. Market failures represent the inability of the private market alone to provide the quantity of a good or service at which the marginal social benefits of an additional unit just equal the marginal social costs of producing that unit. In the case at hand, this means an inadequate supply of standard housing, or homeownership opportunities, for lower income or other classes of households at an affordable price. Such a failure provides an incentive for an agent (not necessarily government) to intervene to bring about the "proper" level of housing production or homeownership.

Externalities. Market failures can be caused by a variety of factors. First is externalities, or unpriced by-products of production or consumption. The presence of such externalities can cause a divergence between marginal social benefits and costs at the market price. Examples in the housing market context are the assumed positive spillovers of homeownership or enhanced housing consumption by certain household classes and potential negative spillovers associated with discrimination or inferior neighborhood quality. Government, or some other agent with coercive power, may be justified in intervening in this situation. Another possible solution is "internalization" of the externality through the assignment of property rights over the unpriced production or consumption.

The increased presence of externalities can reduce market efficiency in the sense of the volume of resources required for a given level of production. In the extreme, externalities are represented by pure public goods, which are characterized by their inability to exclude certain classes from consumption. Hence, individuals acting on their own would rationally understate their demand for the good to avoid payment. In the housing market,

[19] Rationales for government or other collective intervention in the housing and mortgage markets are further discussed by Aaron (1985); Struyk, Tuccillo, and Zais (1982); and Van Order and Gates (1995).

neighborhood effects can create "free rider" behavior among landlords. Government, again through its power of coercion and its power to tax, may be the logical intervenor in such a market situation, but other solutions are possible, such as private associations of market participants (e.g., neighborhood associations).

Monopoly power. Market failures can also be caused by monopolies formed by producers or consumers. In the classic monopolist case in the housing market, the monopoly landlord can enforce a shortage of affordable housing of sufficient quality and thereby reap excessive profits. Government, through its powers of regulation, enforcement, and taxation, could be most effective in some circumstances in overcoming monopoly situations, but private market solutions are possible through encouraging and supporting competitors, as is happening with public utilities and cable television.

Uninsurable risks. In markets with uncertainty, two other factors could result in market failures: uninsurable risks and information costs. Uninsurable risks are those risks that cannot be priced accurately. Various causes could be responsible for such inability, including adverse selection, moral hazard, catastrophic loss, and government risk. *Adverse selection* exists when a market participant with high (or low) risk is not treated as such in terms of pricing. Hence, too many or too few such participants exist. Adverse selection is caused by asymmetric information, which is dealt with later specifically in the FHA context. A generic example in the housing market is the acceptance of a tenant who (unknown to the landlord) is poor. Government may be best capable of enforcing and paying for information searches, although private associations of market participants could conceivably play this role.

Moral hazard is defined typically in an insurance context in which behavior by a market participant is riskier with insurance than without it. Thus, the insurance is mispriced. In a housing market, moral hazard could result from occupancy guarantees to households. The regulatory, coercive, and enforcement powers of government may make it ideal to control and bear such risk, but private associations could also take an active role.

Catastrophic loss cannot be insured against because it is large and affects all participants. Examples are natural disasters and systemwide economic conditions, such as declining property values, which affect all market participants. Government commonly provides disaster assistance for catastrophic acts of God or man, but private insurers can also control losses in certain

cases through risk-sharing arrangements and reinsurance with large private entities that are well diversified.

Finally, *government risk* arises from the power of government, especially the federal government, to adversely affect conditions in an entire market. Not only are the effects large, but they cannot be hedged because of the power of government to control the process to accomplish other ends. Recent examples in the housing market are the 1981 and 1986 tax acts, which dramatically changed the rules for investment in multifamily housing, creating huge misallocations of capital and subsequent losses. This risk is virtually uninsurable even by government, which would in effect be compensating for the costs of its own directives, hence limiting their effects and the desirability of issuing them in the first place.

Information costs. Beyond uninsurable risks, a second factor that could result in market failures in markets with uncertainty is information costs. The adverse effects of information asymmetry were mentioned above. This asymmetry is caused by excessive information costs. Even without information asymmetry, however, excessive costs for acquiring information could reduce market efficiency. Examples in the housing market include buyers searching for units to purchase and in the mortgage market include readily available information to aid in the pricing of default or prepayment risk. According to Follain and Szymanoski (1995), joint collection of mortgage market performance data provides the best case for government intervention in the market for multifamily housing finance, since substantial benefits could accrue through the availability of additional information, but the costs would be excessive for a single private entity to provide it, and there may be individual disincentives for providing data (since such information resembles public good because of inability to exclude free riders).

Income and wealth redistribution

Another rationale for government intervention that is unrelated to market failures but nonetheless lies behind many government programs is income and wealth redistribution. This is one of the most debated of governmental activities, but if an extreme distribution of income or wealth is seen either as socially or economically unstable or as inherently inimical to American ideals of opportunity and upward mobility, it is perhaps one of the most important. Examples from the housing market include the

provision of housing subsidies and tax policy as it affects shelter deductions.

Thus, depending on conditions in the marketplace, a number of factors could be responsible for creating housing or mortgage market failures or extreme income or wealth distributions that justify the intervention of government or some other agent. The next section compares this typology with FHA's activities to get some notion of where a government role is most (and least) justified.

FHA activities in the context of rationales for government intervention

The various functions of FHA and the corresponding rationales for government intervention are summarized in table 8. Following is a discussion of each of these in turn.

Unsubsidized single-family mortgage insurance program

The unsubsidized single-family mortgage insurance program is essentially the Section 203(b) program, which makes up the MMI

Table 8. **Rationales for Government Involvement in the Housing and Mortgage Market as They Relate to the Functional Areas of FHA Activity**

	Unsubsidized Single-Family Mortgage Insurance Program	Unsubsidized Multifamily and Other Insurance Programs	Subsidized Mortgage Insurance Programs
I. Market failures			
A. Externalities (including in the extreme public goods)	○	○	●
B. Monopoly power			○
C. Uninsurable risks			
1. Adverse selection	○	●	●
2. Moral hazard			●
3. Catastrophic loss	●	●	●
4. Government risk			
D. Information costs		●	●
II. Income and wealth redistribution	○	○	●

Note: ● = primary rationale, ○ = secondary rationale.

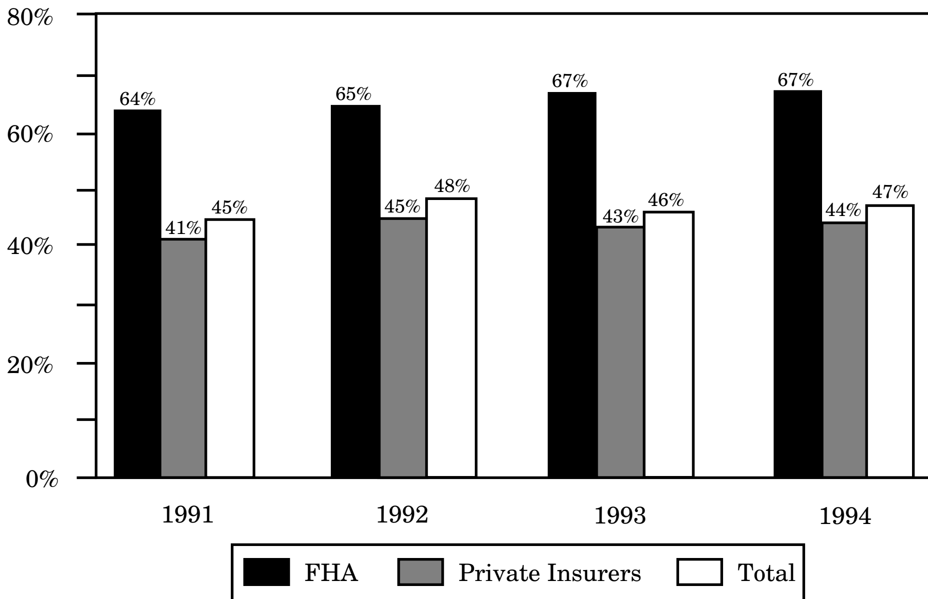
Fund, easily the largest of all the FHA programs ($285.5 billion in 1993, which is 79 percent of the total insurance in force). After a period of inadequate funding in the late 1980s, this program is again actuarially sound. Recent evaluation of how well it is targeting the designated household classes (lower income, first-time home buyers, and often inner-city minority households) suggests it is doing a relatively good job (see figures 2 through 5). Only a segment of the Section 203(b) market seems to be competing directly with the PMI market as it currently exists. The latest repricing of FHA insurance renders it more expensive than PMI for conventional loans, suggesting that adverse selection is operating and FHA is getting the higher risk borrowers. However, the evaluation of the adequacy of the MMI Fund reserve suggests that this risk is being priced properly.

What does this suggest about whether the MMI Fund should remain a government entity or move toward some form of privatization? Market failure, the original rationale for creating the Section 203(b) program, is not present anymore, given the subsequent development of the highly competitive market for private insurance on conventional loans. The enhancement of market efficiency through the reduction of negative externalities, however, is still a rationale. The private mortgage insurers believe FHA's continued presence on the fringe of their own markets stabilizes their industry, especially to the extent that it absorbs the riskiest end of the market.[20] The Section 203(b) program is also considered important in actively directing mortgage credit to minority households and inner-city neighborhoods; there is some evidence that both still experience discrimination in the market for mortgage credit (Yinger 1991), so the rationale exists for a continuing government presence from this standpoint. The program also provides stability to the mortgage insurance market over time. During regional or national recessions, there is a common pattern of withdrawal of private mortgage insurers from the marketplace, and FHA's market share invariably increases. Part of the rationale for the government's continued presence in the market is its more diversified position, so this rationale, too, is applicable.

The final externality-based rationale for government involvement that the Section 203(b) program makes use of is the lower cost of capital. The MMI Fund is actuarially sound, but pricing would have to be higher if FHA were private because (1) it would

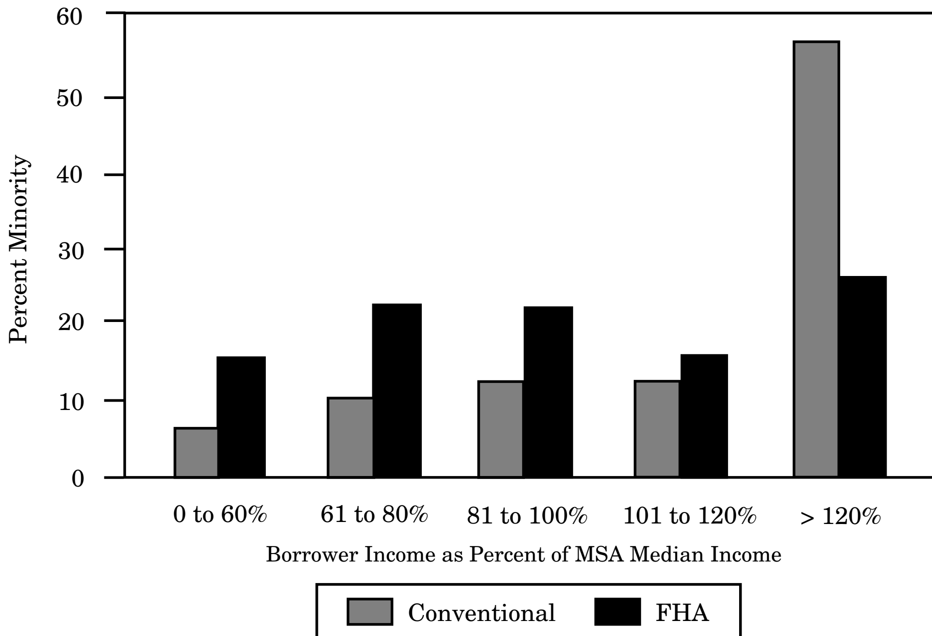
[20] See Hutchinson (1995), the Mortgage Bankers Association (1995b, 1995c), and "Mortgage Bankers Back Plan" (1995), for a discussion of the PMI industry's position on the continued presence of FHA in some form.

Figure 2. **Evaluation of FHA 203(b) Program—First-Time Home Buyers as a Percentage of Home Purchase Loans (FHA Share)**



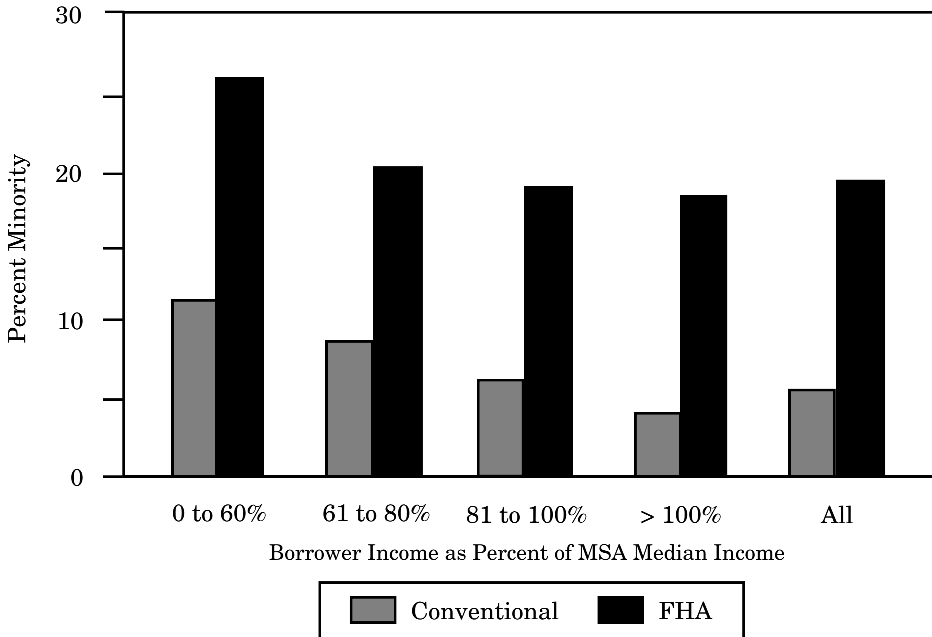
Source: Van Order and Gates (1995).

Figure 3. **Evaluation of FHA 203(b) Program—FHA Share of Low- and Moderate-Income Borrowers**



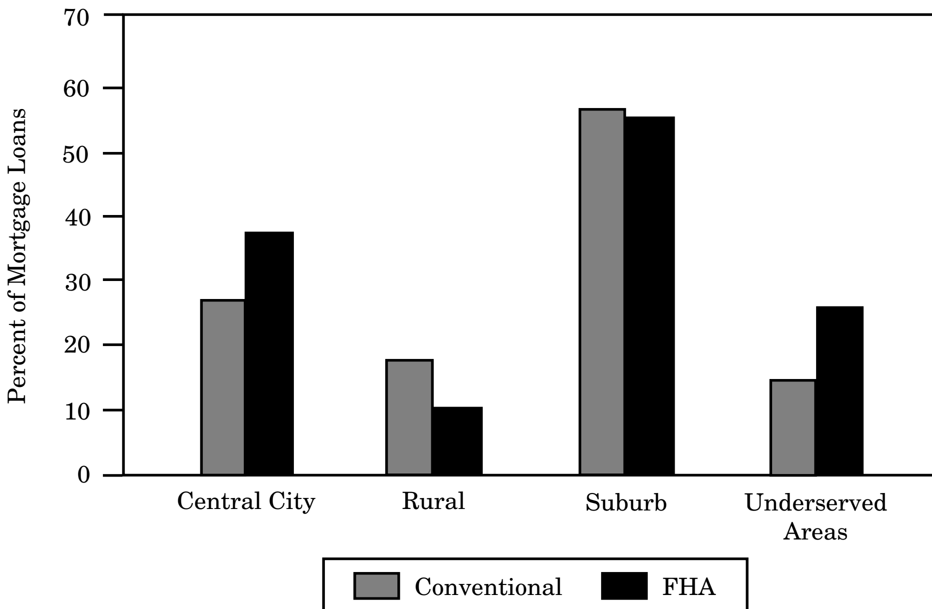
Source: 1993 Home Mortgage Disclosure Act data, Van Order and Gates (1995).

Figure 4. **Evaluation of FHA 203(b) Program—FHA Share of African-American and Hispanic Borrowers**



Source: 1993 Home Mortgage Disclosure Act data, Van Order and Gates (1995).

Figure 5. **Evaluation of FHA 203(b) Program—FHA Share by Area/Market**



Source: Van Order and Gates (1995).

have to make a profit, (2) it would have to use the more costly private debt markets for its capital needs, and (3) it would not be backed by the full faith and credit of the federal government.

Elimination of monopoly power is no longer a rationale for the Section 203(b) program, given the high degree of competition present today in both housing and mortgage markets. However, certain aspects of uninsurable risks are present. To a minor degree, adverse selection must be overcome in underwriting borrowers and qualifying properties, but there is not clear evidence that government is better at doing this than the private sector. FHA does insure against catastrophic loss, since, unlike the PMI industry, it insures 100 percent of the loan balance.

Finally, the Section 203(b) program is not typically considered to redistribute benefits toward lower income households, since benefits are not directly removed from higher income households. Rather, the major rationale for the program is to enhance homeownership and housing consumption in the lower income, inner-city, minority, and first-time homeowner segments of the market—a pursuit considered worthy because of the positive spillover effects it is presumed to generate in the form of opportunity. However, that income and wealth redistribution is still shown as a secondary rationale in table 8 because the source of FHA support is the public at large.

I conclude that there remains some rationale for government involvement in the Section 203(b) program and the MMI Fund, especially from the standpoint of insuring against catastrophic loss and (to a lesser extent) addressing negative externalities, adverse selection, and income and wealth redistribution. However, this involvement could mean anything from continued HUD dominance to a privatized entity with government guarantees. The optimal form of this governmental involvement is considered later.

Unsubsidized multifamily and other insurance programs

The unsubsidized multifamily and other insurance programs include the CMHI Fund and certain components of the GI Fund. I consider any multifamily program to be included here that is permitted to be underwritten and priced in such a way that the revenues are sufficient to fund claims and expenses. Most of the above conclusions about the appropriateness of government involvement for the unsubsidized single-family program would hold here also. That is, the primary rationale would be insuring

against catastrophic losses, but secondary rationales would include overcoming certain negative externalities (such as possible discrimination against minorities or low-income households), addressing the lack of effective competition in certain market segments, increasing stability, and reducing capital costs. Income and wealth redistribution would also be a secondary rationale.

In the unsubsidized multifamily market, overcoming adverse selection and reducing information costs move upward in importance to become primary rationales for government involvement. The heterogeneity of multifamily properties and mortgages and the introduction of a new and largely unknown class of production agents, the nonprofit developers, into the market complicate evaluation of performance and hence mortgage pricing. Government is ideally suited to bring together the resources necessary to obtain such information and permit efficient pricing.

The above discussion assumes that the unsubsidized FHA multifamily insurance programs satisfy two criteria: (1) Such insurance is not competing directly with existing PMI programs, and (2) such insurance is in fact targeting identified client groups. Criterion 1 seems to be satisfied. Although PMI programs do not exist for the multifamily market,[21] there are a variety of noninsurance credit support mechanisms that permit lending at reasonable terms, including letters of credit, overcollateralization, and guarantees. However, for the most part, these are not widely available at the lower end of the market. As for criterion 2, the degree of targeting within the unsubsidized multifamily program, no data are available that identify recipients, as there are for the single-family program. However, the underwriting criteria for the programs that restrict costs result in rents in the moderate range. Thus, both criteria could be considered to hold.

This segment of the market unfortunately has been commingled with other specialized high-risk insurance programs within the GI Fund. The unsubsidized multifamily program should be resurrected to serve a distinct market segment, for theoretically it should be able to be the multifamily counterpart to the Section 203(b) program—that is, perform in an actuarially sound manner without direct subsidies. It is possible to target such

[21] In 1967, the Mortgage Guaranty Insurance Company created the Commercial Loan Insurance Corporation to provide commercial mortgage insurance, but lack of understanding of the default and loss characteristics of commercial mortgages, combined with mispricing, resulted in its failure (see Dennis 1981).

housing to the lower middle income renter population because FHA does not require a profit margin and can make efficient use of the government support provided by a lower cost of capital and the backing of the federal government.

Subsidized mortgage insurance programs

Subsidized mortgage insurance programs include those programs within the GI and SRI Funds that, through their permissive underwriting or restrictive pricing guidelines, are intended to require supplemental government appropriations. Such programs, even more so than those above, are intended to correct perceived market failures—to overcome discrimination and enhance economic opportunity, overcome negative neighborhood externalities, stabilize markets over time and over space, provide lower costs of capital, and promote competition. In addition, overcoming the monopoly power of certain landlords and providers of low-income housing credit is at least a secondary rationale, unlike the situation in the unsubsidized markets. Uninsurable risk management is also a primary rationale in the subsidized multifamily market. Adverse selection problems abound in the selection of developers, lenders, sponsors, and tenants. The potential for moral hazard is high when occupancy is guaranteed, losses are insured, and nonrecourse financing is common. Because the insurance represents full coverage, catastrophic loss is covered. The potential for FHA to reduce information costs is significant—in fact, even more significant than in the unsubsidized multifamily case—because of greater problems with adverse selection among both developers/owners and tenants and greater heterogeneity in product and markets. Finally, income and wealth redistribution is a significant rationale for the subsidized multifamily program, although it comes primarily in the form of direct rental subsidies to the tenants or supply-side subsidies to the landlords as opposed to subsidized mortgage insurance premiums.

It is clear from the above that the unfettered private market is incapable at the low end of providing an adequate supply of affordable housing without some form of intervention. The risk the low-end multifamily insurance market incurs is so high and the subsidy requirement is so deep that it cannot be handled simply by adjustments in pricing, the indirect federal aid cited above, and the cross-subsidization of riskier loans by those considered less risky. Rather, it requires both subsidized pricing and supplemental appropriations to render it solvent. Subsidies would typically be expected to come through the federal

government, so the taxpayers at large would bear the cost. But it is conceivable that a "privatized" system, in which the subsidies are borne by another class of individuals or institutions, could replace government involvement, at least in part. Possible structures for such alternatives and the most cost-effective form of government or private involvement are discussed later.

Functional areas within FHA

The above discussion deals only with the administration of the basic insurance functions of FHA. In fact there are a number of administrative functions within FHA that individually could be privatized or, more correctly, "outsourced" to a private or nonprofit agent. Possibilities include R&D, new product development, marketing, underwriting, loan servicing, troubled loan management, property management and disposition, technical support, and administrative support. In some cases (e.g., delegated processing) such outsourcing has already been experimented with.

The desirability of such outsourcing is determined by considerations somewhat different from those discussed above. It depends not on the fundamental form of ownership and management of the entity but on its pieces. In each case, decision making about whether outsourcing is desirable, in what way, and to what extent must explicitly evaluate the tradeoffs: the reduction of permanent overhead costs, greater flexibility in use of resources, and possibly enhanced productivity of the private sector versus the higher training needs for shorter term employees, the need to pay a higher return on invested private capital, and the possible loss of efficiency through the use of improperly incentivized long-term monopolistic contracts. There are examples of both successes and failures with outsourcing in the past. For example, FHA did not find that delegated processing was cost effective, and coinsurance was a disaster (Snow 1994). However, initial reports on the effectiveness of delegated underwriting and servicing through Fannie Mae are promising (Snow 1994). What is required is a thorough review of each outsourcing possibility, supplemented with a variety of experiments on a small scale.

I conclude that there is ample rationale for continuing government or other collective involvement in the basic FHA insurance programs, including even the unsubsidized single-family Section 203(b) program, as long as FHA's mission of targeting lower income, first-time, largely minority inner-city borrowers is

considered legitimate. However, the optimal form of that government involvement remains to be evaluated. There is a continuum of possibilities, from a wholly government response to one that is primarily private with costs shared by the private markets, and every hybrid in between. Further, the question of outsourcing the various administrative functions of FHA remains open, requiring individual evaluations of each administrative function and experimentation before firm decisions can be made. The next section makes recommendations about the various organizational structures that have been proposed.

Evaluating FHA's options

The shape that government support for FHA should take and the proper structure for the policies and programs of a reinvented FHA are not clear. I attempt to address these issues here by making use of the lessons of history, the rationales for intervention discussed above, and FHA's unique mission in expanding housing opportunities. Each of the possible areas of restructuring and programmatic change will be discussed in turn.

Two principles can serve as reference points throughout this section.[22] The first is that deciding whether an institution with a public purpose should be "privatized" depends on trading off the need to trust a private institution to pursue the public purpose versus the need to trust a public institution to operate efficiently. The goals of a government-run institution are typically more compatible with those of the public the program is intended to serve, but the government is inherently less efficient because it lacks a profit motive. Thus, any comparison of the benefits of one structure versus the other evolves into a comparison of the inefficiencies of government production versus the monitoring costs associated with private production.

The second guiding principle is one that bedevils most financial regulation in this country: the inherent conflict between safety and soundness and social goals. For example, the Community Reinvestment Act has caused problems for the Federal Deposit Insurance Corporation and will continue to cause problems for the Office of Federal Housing Enterprise Oversight (OFHEO). Nonetheless, policy structures have continued to assume that both goals can be met simultaneously with no tradeoff. Thus FHA has been saddled with both the allocation of subsidies and the issuance of guarantees. I suspect this ambiguous response

[22] My thanks to a referee for suggesting these principles.

arises partly from a perceived political and budgetary need to hide the true cost of a program. Later I recommend a restructuring that renders the subsidies explicit and separate from the issuance and pricing of guarantees.

Should FHA be restructured internally? In what way?

Virtually all the recommendations for FHA's reform (e.g., NAPA 1994a, 1994b) have agreed that there must be a fundamental change in the way FHA is organized and managed, and I agree. The present HUD structure is clearly flawed because it buries FHA and its mission in the broader bureaucratic structure and mission of HUD. Regardless of whether FHA stays within HUD, moves outside of HUD as an independent agency, or even becomes private, there is a need to establish a clearly identifiable management structure *with significant autonomy* that is organized to respond directly to FHA's mission and contains all the functional elements necessary to carry out that mission.

First, FHA's mission must be identified operationally. The primary product at the core is (or should be) the provision of mortgage insurance; thus the organizational structure must be built around this core. The old FHA and the PMI industry can be used as examples for this structure. The following divisions are integral to the insurance function:

1. R&D and new product design (including actuarial pricing)
2. Marketing
3. Underwriting
4. Servicing, asset management, and control (early warning system)
5. Troubled loan management (workout, assignment, foreclosure)
6. Management and disposition of property inventory
7. Investment management
8. Corporate finance
9. Technical support (including data systems support)
10. Administrative support services (secretarial, accounting, legal, etc.)
11. Management and board of directors

Management must have full authority over each division, with direct control over field operations. The reinvented FHA should be presided over by a strong commissioner with a high degree of autonomy who has primary authority and responsibility for meeting the goals of the organization. Management and the

board together should ensure that all FHA activities are consistent with the clearly stated mission and are being accomplished as efficiently as possible. There should be no muddying of the mission with extraneous goals imposed unilaterally by the board, management, or others. This structure is entirely consistent with that of a publicly held PMI company.

Along with proper management authority must come sufficient resources to carry out the insurance mission. This implies enough funds to support a sufficiently large and well-trained staff to administer the insurance funds and sufficient support services, including data processing, accounting, and control. State-of-the-art technology and management systems like those of private mortgage insurers should be the goal.

But any restructuring must not ignore FHA's supplemental mission of addressing the needs of lower income, first-time, often minority and inner-city home buyers. This implies internal management structure to ensure that such goals are also being met. To the extent that such goals can be articulated externally through legislative or regulatory mandate, FHA must be structured to meet them as efficiently as possible and in a manner entirely consistent with the insurance mission. The new structure could include an office within FHA (possibly an opportunities compliance office), with its own director reporting to the FHA commissioner, who monitors the allocation and terms of credit availability to ensure consistency with mandated social goals. Note that this office is not expected to advocate for the most aggressive underwriting it can. Rather, it serves primarily as a comptroller to ensure compliance.[23]

The gain from such a reorganization ought to be reflected in improved efficiency and control over the production process. However, it must be recognized that there may also be costs, perhaps including some loss of economies of scale in allowing employees and systems to "double up" their service to both HUD and FHA. Probably more important to policy makers is the cost of loss of policy coordination and control over a more autonomous FHA.

Certainly, a full evaluation of these costs and benefits must be carried out before any reorganization plan is adopted, and the plan will have to be amended to mitigate the more adverse consequences. But I suspect that the prospective gains in

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[23] Such a role could also be filled by an external office, such as OFHEO, or by an internal and external office in tandem.

efficiency from greater identifiability and autonomy of the organization will overwhelm the costs, given that FHA is grossly underperforming its mission under existing organizational structures.

Should FHA remain as a separate unit in HUD or be spun off?

Most analysts agree on the need to restructure FHA internally and render it more autonomous. But at that point the agreement ends. A continuum of external restructuring proposals has been set forth by various constituencies:

1. *An autonomous unit within HUD,* with its own staff, support systems, and commissioner appointed by the president. The commissioner would be jointly responsible for administration of the agency with a board headed by the secretary of HUD. This is essentially the proposal put forth by HUD (for details, see Poduska 1995).

2. *An independent agency within the executive branch,* with its own staff, support systems, budget, and commissioner appointed by the president for an explicit term, usually proposed to be six years. Proposals vary on the nature of governance, ranging from a powerful commissioner with no board, to joint governance with an independent board, to strong oversight by a board headed by the secretary of HUD. NAPA (1994b) supports the first arrangement, with a strong commissioner.

3. *A GSE formally outside the federal government,* similar to Freddie Mac and Fannie Mae. Such an organization would enjoy implicit guarantees by the federal government on its obligations and its insurance product but would be freed from the regulatory and legislative restrictions of a federal government agency. Unlike Freddie Mac and Fannie Mae, however, it would require direct federal grants to cover the actuarial gap in the higher risk insurance pools. Ownership of the GSE FHA could take a number of forms, ranging from 100 percent government ownership, to participation by the PMI industry or other entities such as Freddie Mac or Fannie Mae, to public ownership. Governance would likely be in the hands of a strong commissioner with no set term but answerable to the board. The board could include representation from the government, interested constituencies, the PMI industry, and the public. One proposed structure

would absorb FHA into the existing secondary market institutions (Grassano 1995b).[24]

4. *A totally privatized FHA,* either left intact (less likely) or broken up into its constituent parts. In this scenario, the PMI industry would take on the actuarially sound functions of FHA, and the high-risk subsidy-demanding functions would be taken care of either by a residual governmental entity or by the private sector with appropriate federal guarantees.

Each structure on the continuum has advantages and disadvantages. In general, the more closely held the organization is by the federal government, and especially by HUD, the more easily it can serve as an organ for HUD policy—that is, reflect the broad aims of housing and urban development policy as articulated by the administration. This includes consideration of the broader role of homeownership with respect to community development goals as well as redistributional and equal opportunity goals. The greater the degree of autonomy, moving toward "privatization," however, the more attuned the organization is likely to be to the incentives of the marketplace. Hence it can respond more efficiently to opportunities and be freed from federal regulatory shackles, including everything from the Davis-Bacon employment requirements to complex procurement policies. The optimal structure should accomplish the following objectives:

1. Eliminate budgetary and political constraints to permit focusing on the efficient administration of FHA's insurance programs.

2. Create incentives for the market to guide proper action without the need to rely on voluminous regulations.

3. Provide sufficient accountability for the accomplishment of broader policy goals.

4. Avoid committing the government to what the private sector can do more efficiently.

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[24] Under this alternative structure, mandates would be imposed on the GSEs, and FHA's role would be simply to monitor the performance of the GSEs and set their goals. This supposedly would recapture some of the implicit subsidy granted to the GSEs through the federal guarantee. Such proposals have been made as a part of the ongoing study of the GSEs by the General Accounting Office, HUD, and the Congressional Budget Office.

For these reasons, I reject certain of the options cited above, while embracing others. I reject HUD's proposal to maintain FHA as a separate entity within HUD. While such a reorganization would provide more autonomy and identifiability, it would still be vulnerable to the dramatic swings in political and ideological intervention that have created much of FHA's trouble in the past. During periods in which HUD and the administration are aggressive in pushing a housing and urban development agenda that departs considerably from the status quo, they will naturally seek to use FHA as another tool in that quest through increasingly lenient underwriting standards and targeted lending quotas, resulting in some cases in high default risks. This has the danger, as in the 1960s, of jeopardizing FHA's basic insurance soundness requirement for the sake of social goals.[25]

On the other hand, during periods in which the ideology of the administration reflects the attitudes of the early 1970s and the Reagan years, there is a clear danger of at best benign neglect and at worst sabotage of the social component of FHA's mission, too often also at the sacrifice of its insurance soundness requirements.

One may argue that responsiveness to the political policy considerations of whatever administration is in power is exactly the purpose of a federal cabinet department. This then becomes a powerful reason for keeping FHA within HUD. I disagree, for the reason that within HUD the policy implementation role of allocating subsidies and designating insured classes apparently cannot be disassociated adequately from the primarily administrative function of running a mortgage insurance business efficiently. The policy implementation function should be left within HUD and remain responsive to administration policy. However,

[25] A recent statement by Commissioner Nicolas Retsinas suggests that the current administration intends to use FHA as such a tool: "When asked if he thought FHA should be a separate agency from HUD, Retsinas was firmly against the idea. Instead, he wants FHA to be more accountable to the American people, to be a fundamental tool of the government, and to be integrated into overall goals to help solve such problems as homelessness and public housing" (Snow 1994, 102).

Such an attitude is also evidenced in the administration's recent proposals to begin insuring 100 percent LTV loans, eliminating the requirement that borrowers have equity in their homes for large Title I home improvement loans, the current HUD practice of selling FHA real estate owned (REO) at discounted prices to public providers of shelter for low-income families, and leasing REO to public agencies at no cost for three years to house the homeless (see Freedman 1994a; National Association of Home Builders 1994; "Retsinas Announces Major Changes" 1994; Snow 1994).

efficiently managing each insurance program and pricing premiums at actuarially sound levels should remain an independent function within the new FHA. Another way of viewing this rationale is that it is roughly analogous to the need for an independent Federal Reserve, which can remain focused on longer term economic soundness as opposed to short-term political priorities.

I conclude that the administration of FHA must be insulated from the more extreme swings in ideology at the federal level. The insurance mission and the need to accomplish it as efficiently as possible should be the sine qua non for FHA. The redistributional, equal opportunity, and other social goals should be made as explicit as possible with respect to the allocation of insurance by area, size, property type, and borrower type and should be provided externally to FHA management. FHA then should be given a market-based incentive to accomplish these goals efficiently.

To achieve this idealized policy outcome, one could operate within the structure of any of proposals 2, 3, and 4 as presented above, depending on the detailed allocation of rights and responsibilities and on institutional reality. In fact, there may well be an optimal "progression" of institutional structure—from an independent agency to a fully privatized FHA—as we learn from experimentation with various innovative market products and as we develop the infrastructure necessary to support such a framework.

The independent agency model could well be optimal initially, as long as the commissioner is strong and has a set term not coinciding with that of the administration. Such a structure would provide ample identifiability and probably enough autonomy to eliminate the more extreme political problems of the past. It would not provide strong incentives for efficiency and innovation, however, since it would still be relatively remote from the discipline of the marketplace that envelops the PMI industry. New products and programs would have to be built to provide these reference points to the market, but these would take time. Such possible products and programs are discussed later.

The GSE model would provide greater market discipline, yet steps would have to be taken to ensure accountability for achieving both the efficiency and allocative goals of FHA. This would likely require that the commissioner be appointed by and answerable to a board made up of the FHA's constituencies, as in any private corporation. Depending on the makeup of the board,

the commissioner could be sufficiently insulated from political influences, though this is certainly not guaranteed. OFHEO could also act as a conduit for broader social policy goals, just as it now does for Freddie Mac and Fannie Mae.[26] The organization would be considerably freed from the more oppressive federal regulatory restrictions, adding to efficiencies. At the same time, the implicit government guarantee would permit FHA to be competitive in markets the private sector would consider submarginal.

However, there are fundamental problems associated with the creation of a GSE or the privatization of FHA under the current set of programs and institutional relationships. To identify these problems, one must first step back again to examine FHA's basic mission: to provide mortgage insurance. If this were all FHA was about, there would be no debate over its appropriate structure: FHA clearly should be private, since it would be in direct competition with the PMI industry. There would be no rationale for its separate existence.

For private mortgage insurers the objective of management is simple: to maximize firm value as reflected in the stock price or some other measure of productivity. To accomplish this, a number of benchmarks are referenced: profitability of product lines, market share, cost structure, degree of diversification, effectiveness of portfolio management and property disposition strategies, and others. Management actions are taken to provide the greatest value added to the firm at the margin. This objective provides a quite forceful incentive structure for every employee, from the entry-level secretary to senior management. Such discipline, for a well-managed PMI firm, ensures survivability in a competitive environment.

For FHA, however, the simple mission of providing mortgage insurance is complicated by the twin social policy mandates of (1) targeting that insurance to lower income, first-time home buyers, often minority households living in the inner city, or to multifamily project developers or investors providing shelter to lower income, often minority and inner-city households and (2) providing insurance that would not be provided by the private sector, at least not at the price FHA sets.

[26] Note that this relationship itself could become a politically troublesome one, as in the recent administration proposal that Freddie Mac and Fannie Mae take a more active role in purchasing affordable housing loans (see Connor 1995).

Thus, an FHA simply converted to a GSE or privatized entity under current conditions would not easily be afforded the luxury of simple profit-maximizing behavior. There would be an ambiguity of purpose that is a direct product of the character of the market the newly created entity must operate in. It could behave to some extent as a private entity in the single-family MMI and CMHI Funds, which are required to remain actuarially sound, in that it would still have an incentive toward efficiency and profit maximization. However, even there, because it would still be required to price high-risk borrower policies (for example, high-LTV loans) the same as lower risk loans, it would still be forced to achieve this profit maximization through cross-subsidization, in which low-risk borrowers are charged a higher premium than their risk merits while high-risk borrowers are charged a lower premium. The problems associated with this state of affairs are discussed later; for the present purpose it is sufficient to recognize that this complicates profit-maximizing behavior.

Nonetheless, if a GSE version of FHA were backed by the implicit guarantee of the federal government (and hence provided lower capital costs), more broadly diversified, and not required to make a competitive return on capital, it would still be able to serve targeted lower middle income borrowers who would be unserved without such federal involvement. Complete privatization would be more problematic, in that the form of federal support might have to be modified to render it more politically palatable and to justify support for a "private" entity. However, there is no reason theoretically why such support could not occur, thus continuing FHA's social mission embodied in the MMI and CMHI Funds.

It would be much more difficult, however, for a GSE or privatized version of FHA to achieve the "high-risk" objectives of the GI and SRI Funds, which require annual appropriations from Congress to render them viable (see Downs 1995). Even if annual appropriations could continue to be passed through to a GSE or fully privatized FHA, a fundamental problem exists in that there is no benchmark for efficiency. FHA would continue simply to carry out its mandated social objectives, report its losses, and draw appropriations to fill the gap. To be sure, there would be political scrutiny of this and continued oversight; hence some form of discipline would be imposed. But this would be no different from the current state of affairs, which has been widely agreed to provide inadequate incentives for efficiency and potentially to permit inappropriate political intrusion. What would be needed would be some institutional or programmatic innovation that could impose such market discipline.

A further complicating factor is that, since FHA is prevented by statute from competing directly with the private mortgage insurers, a GSE or privatized version of FHA would be a monopolist in its low-end market. Thus, even if it were given the incentives to maximize profit, it would do so as a monopolist and not a competitive market institution, requiring additional levels of oversight to lower premiums to competitive levels. As GSEs operating in basically the same markets, Fannie Mae and Freddie Mac compete directly against each other, thus driving loan rates down to levels reflecting the full benefit of the implicit federal guarantee. However, under the current set of circumstances, no other institution, government or private, would compete directly against FHA in its market.

I conclude that under current conditions FHA would be most likely to carry out its mission successfully as an independent federal agency; however, there is clear evidence that a GSE or privatized version of FHA could ultimately prove more efficient. But it may be necessary to move toward such structures over time and not immediately, especially to allow FHA to continue to achieve its high-risk mission. There must first be innovation in the form of new institutional relationships and new products that will permit the necessary pass-through of subsidies yet provide the proper incentives for efficient management and competitive pricing of the insurance programs.[27] This implies a need for continuing experimentation by the independent-agency FHA with the intent of continuously reinventing itself as it moves toward greater efficiency in carrying out its mission. The remainder of this article examines possible innovations with respect to their desirability and potential.

Should GNMA be made a part of FHA?

Several commentators have recommended incorporating GNMA into FHA.[28] The rationale is that FHA's insurance on individual

[27] One additional important advantage in moving toward an institution incentivized by market forces is the enhancement of the quality of administrative personnel. "Brain drain" at FHA has been a long-standing concern; many of the most experienced and qualified personnel have left. Removal of the most onerous federal personnel constraints and replacement by a system that competes in the private insurance or PMI marketplace via compensation, benefits, and performance standards would go a long way toward reinvigorating the agency. This is an additional reason why retaining FHA within HUD, or even as an independent government agency, may not be desirable in the long run.

[28] See, for example, comments by Dale (Joint Center for Housing Studies 1994d) and the recommendations of NAPA (1994a, 1994b).

loans is currently an integral part of GNMA's mortgage-backed securities activities. Further, GNMA, through its pool guarantee facility, would have a close relationship to a "wholesale" FHA involved in insuring loan pools only. However, I feel that these relationships are insufficient to justify the merging of the two institutions. GNMA is involved with much more than simply the guarantee function. It is intimately involved with secondary market activities, including forming or qualifying the pools, marketing, sales, and the creation of a variety of derivative products. Thus, its core mission is fundamentally different from FHA's. Merging administration and staff would be a marriage with insufficient commonality of interest to thrive. Such a reorganization would dilute the focus of each institution much as the 1970 HUD reorganization had adverse consequences for FHA.

One final signal that there is not enough "natural" affinity to justify a merger between FHA and GNMA is the fact that such relationships do not exist in the private sector, and one would expect that market forces would have created them had there been sufficient incentive. No private mortgage insurer has merged with any secondary mortgage conduit for conventional mortgages, and there is no thought being given to doing so. In fact, a conflict of interest could be considered to exist whenever the entity that provides assurances to the market of credit quality is also involved in marketing its own product.

GNMA may certainly have problems owing to the imposition of HUD's departmental controls on a government corporation.[29] However, that is reason to consider its disassociation from HUD, not to encourage its future association with FHA. A further issue is whether GNMA ought to exist at all. A credible argument can be made that the GSEs could do everything GNMA does and more, especially if FHA goes away or is transformed radically. However, this issue is beyond the scope of this article.

Should FHA form partnerships to accomplish its mission?

A number of partnerships have been proposed in the recent debate over the future of FHA that are intended to accomplish a variety of purposes:

[29] See discussion of OMB's fiscal 1996 budget passback proposal in "Current Developments" (1994). See also the HUD response to the OMB proposals in "HUD Seeks Flexibility" (1994).

1. *Risk sharing* with state housing finance agencies (HFAs), financial institutions, pension funds, state and local governments, private mortgage insurers, and others to share credit risk by jointly providing credit enhancements. Under a current multifamily program with state HFAs, the HFAs agree to reimburse FHA for their portion of the loss on any loan insured under the program that goes into default (Snow 1994). Two levels of risk sharing are possible, with the highest level permitting the HFA to use its own underwriting standards and no statutory loan limits. Annual mortgage insurance premiums are lower for the higher degree of risk borne by the HFA. Other similar plans are being discussed.

2. *Becoming a "wholesaler"* of credit enhancement by guaranteeing pools of mortgages underwritten to certain standards by others such as state HFAs, builders, financial institutions, mortgage bankers, and private mortgage insurers, rather than insuring individual loans. Such a program goes beyond delegated underwriting in that it relies on the originator not simply for individual loan underwriting according to FHA standards but for assessing the credit risk for entire pools of mortgages. FHA announced in early 1994 that it would move aggressively into the wholesaling function, but it has backed off since then, certainly as a replacement for individual loan processing, in the face of considerable opposition from the Mortgage Bankers Association and others.[30]

3. *Partnerships* with local builders and community-based housing development organizations. Such involvement would be responsive to the frequently articulated need to be flexible to deal with local conditions. In such a program, according to the view provided by many community housing advocates in the recent series of FHA symposia, the FHA would tailor a loan program to local market conditions, working closely with the community and borrowers to ensure continuing credit quality.

These partnership arrangements should all be evaluated according to how well they help FHA meet its goals, as articulated above. Risk sharing can in fact stretch thin federal resources,

[30] The wholesaler role for FHA is discussed by Snow (1994), Van Order and Gates (1995), and Jacobs (1994). See Snow (1994) and "Mortgage Bankers Back Plan" (1995) for a summary of the Mortgage Bankers Association's arguments against wholesaling.

hence increasing the overall credit enhancement level through leverage. However, the incentive structure embodied in individual designs is critical in determining whether the program will work or replicate the experience of the ill-fated FHA coinsurance program of the early 1980s. In the coinsurance program, the lending institutions were insufficiently at risk in the event of default but at the same time were able to pocket substantial revenues in the form of fees.[31]

Wholesaling and other forms of risk sharing can also be effective in reducing the demand for FHA personnel in a resource-constrained era. However, the design of the underwriting and control function in the program is again critical. Conflicts of interest compounded by inadequate monitoring, oversight, and control will invariably result in program failure.

A final consideration is the extent to which such partnering arrangements complement, rather than displace or compete with, existing private sector efforts. One frequently stated condition is that FHA not compete directly with the PMI industry or other institutions in the private sector. However, this directly contradicts the oft-stated need to use high-quality loans in the Section 203(b) program to cross-subsidize the more marginal loans, which implies that FHA must compete to survive. The Mortgage Bankers Association (1995a) has estimated that 20 to 40 percent of the loans made by FHA would not be made if FHA did not exist (Mortgage Bankers Association 1995a; "Mortgage Bankers Back Plan" 1995). This implies that 60 to 80 percent *would* be made, presumably by the PMI industry, although possibly at higher cost and with stricter terms. The suggestion is that there is currently significant displacement going on in terms of FHA picking up product at the expense of the private mortgage insurers.

It is by no means clear, however, that the PMI industry considers such displacement an undesirable intrusion. In fact, the profile of FHA loans suggests that FHA preempts the most marginal and risky loans. In the absence of FHA, competition may indeed force the private mortgage insurers to move down the quality queue to pick up a certain portion of these loans, but they may find it more comforting—indeed more profitable—to have FHA there as a backstop, so long as the primary function of

[31] The coinsurance debacle showed that substantial monitoring efforts have to be a part of the process (e.g., checks on equity and reserve accounts) and payments to the coinsurers cannot be heavily front-loaded with origination fees and other costs.

the backstop is to take away risk and not to cut into the core business. Thus, before any potential competition for loan markets is automatically rejected as undesirable, one must look into the details of the displacement that is taking place and analyze its broader implications.

I conclude that the various partnership arrangements that are being proposed and undertaken are desirable as experiments in the enhancement of program efficiencies and the development of market reference points. They should be encouraged so long as they are first designed as small-scale demonstration projects, so long as they are carefully designed and monitored to ensure their soundness with respect to their cost and the compatibility of their incentive structures with fiscal soundness, and so long as they are determined not to compete directly with markets already occupied by the private sector.[32]

Should FHA underwriting standards be liberalized? Should explicit income or other targeting be implemented?

Proposals to reduce the minimum down payment requirement to as low as zero and other modifications in underwriting standards have been made recently by the Clinton administration, although not included ultimately in legislative proposals.[33] Some policy observers have also suggested a modification in loan eligibility criteria to target FHA lending directly to lower income households rather than to maximum loan sizes that are intended to serve as a proxy for income levels.[34] The purpose of these proposals is to target FHA's support more directly to those households considered to be the heart of its constituency.

The desirability of such proposals depends on their effect on the viability of FHA's other primary mission: the basic insurance

[32] An alternative view, which is certainly defensible, is that radical and swift action in restructuring is called for in view of the political window of opportunity presented. However, such sudden shifts can produce unintended and undesirable consequences, as seen in the HUD coinsurance scandal.

[33] See "FHA Loans in Revitalization Areas" (1994) and "Legislative Proposals" (1992). The administration also proposed changes in the Title I home equity improvement loan program to eliminate the requirement that borrowers have equity in their homes (see "Retsinas Announces Major Changes" 1994).

[34] See Ols (1990), "New FHA Markets" (1994), and the amendment offered to the 1994 housing bill by Rep. Bobby L. Rush (D-IL) to restructure the FHA single-family program by basing eligibility on family income (Freedman 1994b).

programs. Unfortunately, there is ample empirical evidence that lenient underwriting criteria can lead to dramatic increases in default and loan losses. Moving to a 100 percent LTV is the best example, since the initial LTV consistently has been shown to be the dominant predictor of default (Quercia and Stegman 1992). Moreover, limiting FHA mortgagors to only the lowest income strata of borrowers would remove the higher income segment of the mortgage pool, with lower LTVs on average (and hence lower risk), which historically has been relied on to cross-subsidize the higher risk borrowers and keep the insurance pool actuarially sound (see later discussion).

I believe it would be unwise to suggest such policy changes without making explicit estimates of the losses expected in the insurance funds as a result and taking explicit measures to provide for funding of these losses. The administration has proposed an increase in the loan ceiling to pay for such an innovation, but this, of course, creates problems of its own in terms of competition with the PMI industry and runs directly counter to the policy goal of targeting the lowest income borrowers.

There may be other creative ways to achieve the same set of redistributional objectives without dramatically affecting the viability of the insurance funds or by paying for them in a less onerous manner. Examples include tax incentives to save for a down payment and novel ways of providing a down payment in which the borrower is truly at risk, such as sweat equity, personal loans with recourse and garnishment provisions, and amortizing grants. Ways of targeting lower income borrowers without relying on cross-subsidization also exist and are discussed later. The primary point here is that such improved targeting schemes are worthy objectives but must not be considered in a vacuum without concern for their impact on the viability of the insurance program.

Should FHA reduce its insurance coverage?

Those interested in stretching limited credit enhancement resources as far as they will go have proposed reducing FHA insurance coverage from 100 percent to only the top 30 to 50 percent, rendering it comparable to that of the private mortgage insurers. Those in favor, including Republican legislators, argue that there is typically little need for the bottom-end coverage, given the magnitudes of most loss recoveries. Hence, there would be an opportunity to spread coverage further among marginal borrower groups. Those opposed, including the Mortgage Bankers

Association, respond that if the arguments of the proponents are in fact true, and there is little need for the bottom-end coverage, then the change would reduce premiums only slightly, leaving little room for expansion of coverage. Moreover, it is precisely the bottom end of coverage—representing catastrophic losses—that FHA is most suited to provide and that is in fact most needed. Risk-sharing arrangements are being proposed that tend to be built around the assumption that FHA will provide the bottom-end coverage.

I feel there is merit in the arguments against reducing coverage. The private mortgage insurers typically provide coverage for the upper 30 to 50 percent of losses, with the lower end going "uncovered" (in effect being self-insured by the owners or covered through pool insurance or reinsurance programs).[35] If in fact the private sector will not provide top-end insurance for the marginal set of borrowers served by FHA, then FHA must certainly step in to provide it. However, the need for FHA may in fact be greatest at the bottom end of loss exposure. Certainly, there needs to be evaluation of the relative risk of loss (both incidence and loss severity) at both the top end and the bottom end of both the FHA and conventional markets.[36] It may well be that the greatest need for FHA involvement comes at the bottom end for various reasons such as more extreme value fluctuations within FHA markets and the fact that greater losses tend to be sustained after disasters. The federal government is better able to cover these.

Should FHA continue to practice cross-subsidization, or should risk-based pricing be implemented?

The notion of cross-subsidization has become an essential part of FHA's insurance program since the early days, after FHA began to target the lower end of the market. Cross-subsidization

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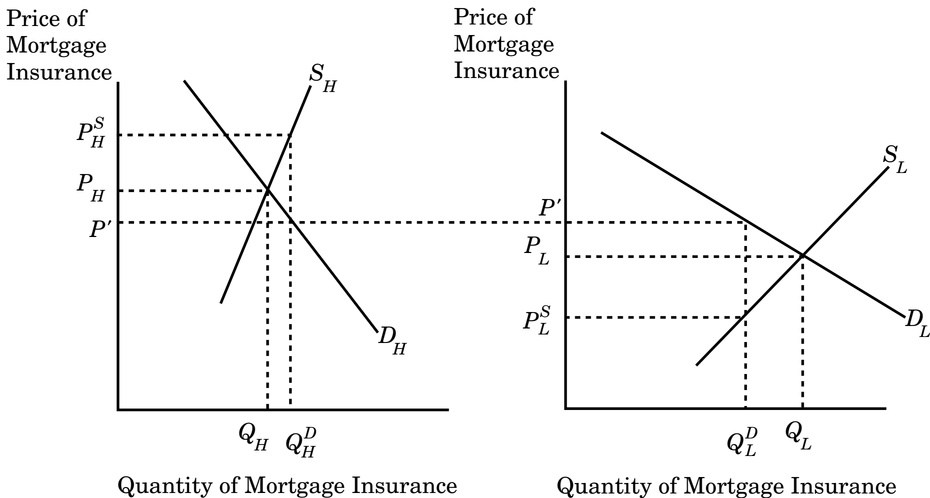
[35] Pool insurance is provided against default losses on pools of mortgage-backed securities. Reinsurance is provided to insurers to cover residual risk claims.

[36] Kau, Keenan, and Muller (1993) evaluate the relative magnitudes of loss at the top and bottom ends and conclude that the FHA premium would be little reduced if coverage were restricted to the top end only (i.e., there is little risk at the bottom end). However, their conclusions are built on the results of a pure option-theoretic model of mortgage and insurance pricing behavior that does not consider actual default behavior and loss experience. A recent paper by Childs, Ott, and Riddiough (1995) suggests that the holder of the senior portion of the risk (the bottom end) might actually receive a discount (i.e., pay a negative premium) because terminations would produce early prepayments.

permits FHA, under a common pricing scheme for insurance premiums, to use the profits from higher quality loans to subsidize the losses from lower quality loans. A recent concern is that because the FHA loan limits have not kept up with house price inflation, FHA is increasingly being relegated to the lower end, higher risk portion of the market. Hence, cross-subsidization is becoming increasingly unviable. There are fewer high-quality loans subsidizing more low-quality loans, requiring an ever-higher risk premium and resulting in a shrinking market. This state of affairs, as pointed out above, satisfies those who feel that FHA should not compete in any way with the private sector, but it flies in the face of the requirement to keep the MMI Fund actuarially sound.

Consider the existence of cross-subsidization in an insurance program theoretically (figure 6).[37] Insurance normally works when all policyholders of like risk, as determined by proper underwriting, are priced at the same level and those of higher risk pay more than those of lower risk. Ex post, certain policyholders will default. But no one, including the policyholders themselves, knows who the defaulters will be ex ante. The premiums charged in aggregate permit the policyholders to obtain more mortgage credit at lower cost, enough to offset the cost of the premiums, and allow insurers to pay off all claims and receive a surplus return for their efforts and the risk borne.

Figure 6. **Illustrating the Long-Term Unviability of FHA's Cross-Subsidization Pricing Strategy**



[37] The arguments contained here have been developed fully by Stiglitz and Weiss (1981).

In figure 6, the low-risk borrowers would pay their premium at price P_L under a differential pricing scheme, while high-risk borrowers would pay at higher price P_H, given their higher supply cost function, reflecting increased risk. However, under a common-pricing, cross-subsidization scheme, the low-risk borrowers are charged $P' > P_L$, and the high-risk borrowers are charged $P' < P_H$. For the program to remain actuarially sound, the net revenue from charging the low-risk borrowers a higher premium $Q_L^D\,(P' - P_L^S)$ must be exactly offset by the net cost incurred when charging the high-risk borrowers a subsidized premium $Q_H^D\,(P_H^S - P')$. $Q_L^D\,(Q_H^D)$ is the quantity of mortgage insurance demanded by low-risk (high-risk) borrowers at price P', and $P_L^S\,(P_H^S)$ is the marginal cost of supplying the quantity $Q_L^D\,(Q_H^D)$.

However, a certain proportion of low-risk borrowers would be expected to sort themselves in response to the higher premium and seek out a cheaper alternative elsewhere (most likely the PMI market), represented by the reduction in low-risk volume $Q_L - Q_L^D$. At the same time, additional high-risk borrowers will be attracted by the lower premium, represented by the increase $Q_H^D - Q_H$. The net result leaves FHA with a higher risk pool of borrowers.

Depending on the price elasticities of demand and supply in each submarket, the market results of cross-subsidization could vary substantially. To the extent that PMI represents a viable alternative for many in the low-risk population, their price elasticity of demand would be rather high, and there would be a substantial reduction in the number of low-risk borrowers. This would reduce total revenue considerably from this market segment, though the reduction would depend on the price elasticity of supply. If supply is relatively elastic, as one would expect it to be within a range, then the net result is a reduction in the net revenue available for cross-subsidization. This would imply the need to raise the common premium level P', which would further drive out low-risk borrowers.

In the high-risk segment of the market, the cross-subsidization program would be more effective from a policy standpoint if a higher number of new borrowers were brought into the market—that is, if the price elasticity of demand were quite high. However, this would also mean a greater revenue loss that, in turn, would require a higher subsidy from the low-risk borrowers, driving more of them from the market. At some point the cross-subsidization scheme becomes unviable because the pool of low-risk borrowers is too small to support the level of subsidy required.

The net effect of cross-subsidization via common pricing of differential risk classes is clearly seen to be a loss of efficiency. Moreover, it is clear that the cross-subsidization that goes on is to the highest risk mortgage borrowers from those just above them in the credit quality queue. As the latter become fewer and fewer, the adverse impact individually on the upper end borrowers becomes greater and greater.

Thus, one could argue that this form of cross-subsidization not only results in "less bang for the buck" in the form of credit support provided per dollar of premium but also imposes increasingly heavier burdens on those lower middle income borrowers just emerging into self-sufficiency while leaving the rest of society untouched. And this is in spite of the fact that the benefits of encouraging homeownership among young, lower income, first-time home buyers are purportedly shared by society as a whole, especially other homeowners, by way of higher property values and more stable neighborhoods.

The National Affordable Housing Act of 1990 imposed a limited form of risk-adjusted pricing of mortgage insurance premiums.[38] However, any discussion of full risk-based pricing of FHA mortgage credit in the form of significantly higher premiums for higher LTVs has up to now been dismissed as politically impractical.[39] This option can no longer be dismissed out of hand. There must be either a clear movement up in the credit quality scale in the loans that FHA will insure, in order to keep the cross-subsidization scheme viable, or a clear move toward full risk-based pricing, in order to keep the MMI Fund actuarially sound. But the former risks alienating the PMI industry. Moreover, it fails to deal with inefficiency and the increasingly heavy burdens on "emerging" households necessary to make the scheme work.

I propose an alternative set of considerations that could revive program efficiency within the MMI Fund, keep premiums low, and promote broader sharing of the burdens of subsidizing the low end of the market:

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[38] After full phase-in of the act's provisions in October 1994, the premiums became 0.5 percent annually (0.55 percent for LTVs over 95 percent) for the life of the loan if the initial LTV is 90 percent or more and otherwise required the annual fee to be paid for 11 years (see Szymanoski 1993).

[39] An alternative to adjusting pricing of insurance premiums at various LTVs is to adjust the LTVs themselves downward through a tax incentive plan for savings or by other means to increase down payment availability, especially at the low end of the market. Such a policy has been suggested by Freddie Mac and others (e.g., see Green and Vandell 1995).

1. First, there would need to be an effort to put all borrowers into proper risk classes actuarially and to establish a proper "market" premium level necessary to render the insurance pool sound. Note that the propensity to default, and hence the required premium level, is not independent of FHA assignment practice. In particular, the refusal of FHA (unlike private mortgage insurers) to pursue deficiency judgments against defaulting borrowers may need to be reconsidered.

2. Then, there must be a determination of the allowable premium for each risk class, based on both ability to pay and the magnitude of private and social benefits and costs. In some cases this premium may be at or somewhat above market, and in other cases it may be considerably below market.

3. The allowable premium schedule must then be translated into an anticipated aggregate subsidy requirement via an actuarial model of loan loss.

4. This subsidy may be borne by some or all of a number of classes of borrowers and nonborrowers:

   a. All taxpayers
   b. Private mortgage insurers and conventionally insured borrowers
   c. All homeowners
   d. Certain classes of homeowners—for example, low-risk FHA borrowers (as in the current cross-subsidization program)
   e. The subsidized borrowers themselves at another point in time—for example, later in life after they have accumulated greater income and wealth

5. Costs of the subsidies should then be allocated in proportion to the allocation of benefits, with the exception of designated "entitlements" assigned to certain classes.

6. It should then be recognized that different cost allocation formulas would have different effects on efficiency and equity. For example, loading all subsidy costs onto a small class of lower risk FHA borrowers, as is being done currently under the Section 203(b) program, can result in considerable loss of economic efficiency because such borrowers would be encouraged to abandon FHA, permitting fewer higher risk borrowers to be subsidized.

7. To the extent that the benefits of having access to mortgage credit and homeownership at the margin of what the private sector would provide are broadly shared, this would suggest the vast bulk of the subsidy should be borne by a broader population group than simply the few lower risk FHA borrowers left in the pool, including the higher risk borrowers themselves at a later time. But this would be contrary to the current practice of cross-subsidization and could require direct appropriations, thus abandoning the notion of an actuarially sound insurance program. Thus, an alternative arrangement is required that (a) pays for itself in terms of not requiring direct federal outlays and (b) provides incentives for efficiency and behaving in a profit-maximizing manner.

How should FHA deal with its multifamily problem?

Finally, I have to this point said little about FHA's massive problem with its subsidized and unsubsidized multifamily portfolio in the GI and SRI Funds and its responsibility for multifamily insurance going forward. However, if one truly believes that one of FHA's primary mandates is to enhance housing quality among the nation's low- and moderate-income households, one cannot dismiss the rental housing stock, which provides the vast bulk of such shelter. Thus, the considerations of the previous section, which are intended to identify and price market premiums and any necessary subsidies for various insurance programs and borrower classes, must include the multifamily sector.

This means that there must be a concerted effort to identify and price the risk associated with multifamily lending. One obvious recommendation in this regard is cooperation with the current efforts by the GSEs and the Multifamily Housing Institute to gather information on multifamily loan performance to be used in the development of mortgage and insurance pricing premiums. Divergence between these premiums and "allowable" premiums based on the rent-paying ability of tenants and the magnitude of private and social benefits and costs is then estimated and an aggregate premium subsidy volume determined.

Note that rent subsidies would be externally provided through HUD, with their levels determined through the normal legislative process. Required insurance premium subsidies, on the other hand, would be estimated by FHA through an actuarial model of loan loss based on projected rental income flows (including rent subsidies), operating expenses, loan terms, and

projections of property value trends over time. Provision of these insurance premium subsidies would then be assigned to certain classes of borrowers or nonborrowers, as in the single-family case. By separating the setting of rent subsidies from the estimation of required insurance premium subsidies, FHA is better able to resist the temptation to mix the social policy and insurance objectives by insufficiently pricing default risk. The next section discusses more explicitly one possible allocation of such subsidies across various classes.

This still avoids the question of what to do about the massive inventory of defaulted, or about-to-default, multifamily loans currently on FHA's books (possibly as many as 18,000 projects representing $11.9 billion in loan volume) and the significant volume of expiring use properties (approximately 470,000 at last count) about to become problems. I recommend that the restructuring proposal suggested above be considered a new start by FHA in multifamily housing and the basis for a "steady-state" multifamily mortgage insurance policy going forward. The spinning off and separate liquidation or restructuring of the existing problem multifamily portfolio—whether by "mark-to-market" or some other means—would permit HUD (or possibly the Resolution Trust Corporation) to focus exclusively on the workout function, whereas the new FHA could concentrate on building a new, sound multifamily insurance portfolio.[40]

Exploring an alternative structure for a "privatized" FHA: The case for assigned risk pools

As discussed earlier, it will be necessary to create and evaluate new institutional relationships and programmatic structures before a GSE or privatized version of FHA can be effective. These must be mechanisms that still are compatible with the redistributional aims of FHA but that eliminate or reduce politically undesirable direct federal outlays and provide incentives for profit-maximizing by FHA management.

One of these structures, which to my knowledge has not yet been examined explicitly as one within which a GSE or privatized FHA could best fit, is the "assigned risk" or "shared residual" insurance pool structure. This is the most common framework

[40] HUD is proposing to permit values of multifamily properties insured under FHA programs to be "marked to market" (reduced to current market levels), thus reducing the amount of HUD subsidy necessary to close the gap between the market rent and 30 percent of income.

within which high-risk lending with a social purpose is handled in the private insurance markets. It is most common in the automobile insurance market but also exists for the property, medical malpractice, and other insurance markets.[41] It works as follows:

1. An assigned risk class of insurance applicants is designated that is considered uninsurable by individual companies for whatever reason but is considered to have a public-policy rationale for being insured. For example, in the automobile insurance market, it is deemed desirable that there be universal coverage for drivers, in spite of their risk level, so long as they are qualified to hold a driver's license. Typically, the greater the restriction on risk-based pricing of insurance premiums, the higher the proportion of applicants in the assigned risk pool. In the automobile insurance market, the proportion of insured in the assigned risk pool ranges from less than 1 percent in Ohio to as much as 38 percent in South Carolina.

2. An institutional structure is created to handle administration of this assigned risk pool, providing coverage and administering losses. In the automobile insurance market, these institutions take one of seven forms:

    a. *Automobile insurance plans,* in which the applicants are assigned to individual insurers randomly in proportion to their insurance in force. Premiums are restricted to regulated maximums. Losses are then borne by individual insurers, who make up for them by slightly increasing the premiums for other policyholders. This is the most common private passenger program, having been adopted in 40 states and the District of Columbia.

    b. *Joint underwriting associations (JUAs),* which exist as pooling mechanisms. A limited number of companies acting as service carriers are designated to provide coverage. Operating losses are then shared among all insurers in proportion to their insurance in force through a JUA. JUAs have been created in Florida, Hawaii, Michigan, and Missouri.

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[41] See Insurance Information Institute (1994) and Kenney (1993a, 1993b, 1993c) for discussions of the scope and workings of the assigned risk insurance market. Similar insurance arrangements have been developed for a variety of other markets to ensure broad or universal coverage—for example, among oil companies to protect against oil spills and among property owners to protect against potential environmental contamination claims.

c. *Reinsurance facilities,* a hybrid program that resembles both an automobile insurance plan and a JUA. Private insurers are required to provide coverage to any driver but may cede a percentage of these to the reinsurance facility. Losses are shared among all insurers. Reinsurance facilities exist in three states: New Hampshire, North Carolina, and South Carolina.

d. *State fund,* which acts as insurer, collecting premiums and paying out claims, with the insurers reimbursing for net losses. This exists in Maryland alone.

e. *Buyouts.* The state of Massachusetts permits any automobile insurer to buy out of responsibility for participation in the assigned risk program by paying a fee to another to take on the risk. The market would supposedly set the cost of the buyout.

f. *Commercial automobile insurance procedure.* This is the most common assigned risk structure for commercial vehicle insurance, existing in 30 states, and has certain features in common with JUAs. A limited number of servicing carriers issue policies and service the business, with the operating results being shared by all commercial automobile insurers.

g. *Special risk distribution program.* Three states—Alaska, New York, and Wisconsin—have adopted this procedure, in which a limited number of carriers agree to handle large commercial risks. Operating results, in turn, are shared by all commercial automobile insurance carriers.

There are similar programs in place for property and medical malpractice insurance in those states that have assigned risk pools. Assigned risk pool property insurance in the form of Fair Access to Insurance Requirements (FAIR) plans exists in 29 states and the District of Columbia and in the form of beach and windstorm insurance exists in 7 states along the Atlantic and Gulf Coasts. The FAIR program's purpose was to overcome perceived property insurance market failures in higher risk areas, such as the inner city. In 1992, the California FAIR plan suffered 29 percent of all U.S. operating losses (totaling $30 million) because of claims stemming from the Los Angeles riots. Other high-loss states were Michigan (23 percent), Massachusetts (17 percent), New Jersey (9 percent), Pennsylvania (4 percent), and Illinois (3 percent). Losses per premium dollar

were highest in Michigan ($1.53 per $100). The JUA set up in Florida in the aftermath of Hurricane Andrew recently began offering bounties to private insurers to reduce fund size and exposure in a possible future storm (see Scism 1995).

Medical malpractice assigned risk programs are primarily established as JUAs and are most active in those states with high claim rates and awards, including Massachusetts, Rhode Island, South Carolina, and Wisconsin.

Note that in each case there exists a structure by which the assigned risk program is administered and losses are shared among all carriers. In the automobile insurance market, the assigned risk pools total about 5 percent of the market in the 50 states plus the District of Columbia, but this figure is dropping as the private market alone is slowly picking up the residual. The property residual market totals only about 0.7 percent of the market overall but is higher in individual states. The medical malpractice residual market makes up only 6.6 percent of the overall market for medical malpractice insurance but represents 14.6 percent in those 11 states with JUAs and is as high as 80 percent in Massachusetts.

The assigned risk structure is thus seen to accomplish the primary intent of the FHA insurance programs, including both the single-family Section 203(b) program, which makes use of cross-subsidization, and the high-risk single-family and multifamily programs that require external subsidies to remain solvent. It provides insurance to an otherwise uninsurable clientele with risk characteristics that are excessive under the existing premium pricing structure. In fact, it goes beyond FHA by providing universal coverage in many cases. Moreover, the assigned risk structure accomplishes this without explicit government subsidies except in the highest risk classes. Instead of the risk being borne by the taxpayers in general or a small class of lower risk policyholders, for most programs it spreads the risk among all insurance carriers in proportion to their policies in force and, by inference, to all policyholders. The insurance pools remain actuarially sound. In the highest multifamily risk classes, such a cross-subsidization scheme could be supplemented with explicit government premium subsidies or support from the GSEs, since they clearly would benefit from its existence. A major advantage of this risk-sharing structure is that risk is allocated within the market in such a way that insurers are motivated to behave in an efficient profit-maximizing manner in underwriting, pricing, and handling claims. Because they all share the risk of loss, they all have a stake in minimizing such loss while still

accomplishing the social mission of providing universal coverage at the regulated price.

As applied to the mortgage insurance market and a GSE or private organizational structure for FHA, the assigned risk structure would operate as follows:

1. FHA would assume the role of a JUA or reinsurance facility and would continue to see to it that mortgage insurance is provided to designated high-risk borrowers, those considered too risky for whatever reason to be insured through the conventional insurance market. (These ultimately may be a smaller set than the current set of FHA borrowers.)

2. This association could be a GSE, with access to capital at the government rate, or entirely private. Under the GSE model, the commissioner would be appointed by and answerable to a board representing the ownership interests in the GSE—the government, Freddie Mac and Fannie Mae, the PMI industry, HFAs, community groups, and possibly others, such as private investors. Under the fully private model, risk would probably be borne entirely by the PMI industry, which would own the FHA JUA. In either the GSE or the fully private case, the entity could be organized as either for-profit or nonprofit.[42]

3. Criteria for coverage and terms would be set externally through the policy process, just as they are now for the automobile insurance market by individual states, ideally upon the lines outlined above in terms of considering ability to pay, benefits, and costs. In addition to proportional exposure to losses, it may be found desirable to provide additional disincentives for individual insurers to take on excessive risk, especially when fees are generated through underwriting. This could be done through a monitoring of loan loss experience for those policies underwritten by individual companies and assignment of penalties if those

[42] The issue of ownership and control of the JUA is an important one. It is anticipated that the GSEs would play a major role, since their continued viability would depend on the efficient operation of the FHA JUA. They may also play a role as the de facto regulators of the private mortgage insurers. A completely private FHA JUA would probably have to rely heavily on risk sharing with the GSEs. Ownership and control would also depend on the defined beneficiary class. If it includes the subsidized multifamily market, the government would play a more active role in financing and governance, at least for that program.

reach beyond certain levels, just as the delegated underwriting programs for FHA work currently.

4. The FHA JUA would manage the assigned risk insurance pool by continuing to take in premiums and administering losses through foreclosures and restructurings. The PMI industry, controlling the FHA JUA, has an incentive to minimize such losses.

5. Net losses created by losses in excess of premium pay-ins and loss recoveries would be allocated back to the member private mortgage insurers, in the case of an entirely privatized FHA, in proportion to their insurance in force. Under a GSE ownership structure, the government may share in a proportion of the losses through its provision of access to lower cost capital, other implicit subsidies such as tax credits to private mortgage insurers or investors, or in certain cases (such as high-risk lending in inner-city markets) explicit subsidies through appropriations. This risk-sharing arrangement is clearly superior to the present situation, in which a small class of low-risk FHA borrowers subsidizes all higher risk FHA borrowers. Broader sharing of risk by other insured homeowners and possibly to some extent by all taxpayers has less impact on individual policyholders and allocates losses more in line with the distribution of benefits in the form of stable homeownership markets, especially at the higher risk end (i.e., those required to have mortgage insurance).

6. All existing FHA funds could be consolidated into one single-family and one multifamily program. The single-family program could be immediately participated in by the PMI industry, given their experience in this market (only the lowest end would require some “learning” first). Government involvement would be required for the multifamily program at first, however, until the private mortgage insurers gain experience in underwriting and pricing such insurance.

The assigned risk pool structure has been shown to be one feasible means by which a restructured FHA may function in an efficient market-driven manner. It creates a true partnership between FHA and the PMI industry, though one that individual companies may not embrace universally at first. However, it certainly is not the only possibility. The ultimate criterion for acceptance of a specific structural alternative is its efficiency at providing a given level of access to standard housing, whether through a guarantee or insurance-based program or a direct

subsidy to the intended beneficiary class. The challenge is to continue to explore options for making use of existing market and institutional incentive structures to create vehicles for moving the functions of FHA toward greater efficiency and effectiveness in addressing America's housing needs.[43]

Who gains and who loses from an assigned risk pool restructuring of FHA?

An important question in considering the political viability of an assigned risk pool restructuring of FHA as described above is the extent to which existing institutional stakeholders would gain or lose. I identify the stakeholders below along with the expected impact of my proposal on their operations and their expected position:

1. *PMI industry.* The private mortgage insurers prefer an FHA that uses its guarantee to partner with the private sector to better target those households on the margin of the market capable of being served by the PMI industry (see Hutchinson 1995). They support individual tailoring of programs to respond to local needs, the involvement of the community, and broad risk sharing. Under an assigned risk pool restructuring, the PMI industry must take on a share of the risk previously borne by FHA alone. On the other hand, the private insurers also gain a market once removed from them.[44]

[43] Economic purists may question why I do not go all the way in proposing simply an income supplement program that would permit recipients to allocate a portion toward purchasing mortgage insurance from private carriers at the market rate. I believe that such a policy response would perpetuate the market inefficiencies and failures that affect the homeownership, mortgage, and mortgage insurance markets. These include the "prisoner's dilemma" situation facing owners, lenders, and insurers in low-end markets, in which rational market participants acting individually will underparticipate and overprice risk as compared with a collective policy intervention strategy, hence keeping lower-end neighborhoods inherently unstable with little lending for ownership purposes.

[44] It could be argued that the PMI industry is too small to bear the full brunt of default risk, especially if the subsidized multifamily program is included. However, it must be remembered that the PMI market would grow substantially with the transformation of FHA. Furthermore, explicit subsidies to cover the gap between the permitted and actuarially sound premium levels would not necessarily be provided entirely by the PMI industry. Government or the GSEs are another possibility.

2. *Mortgage bankers.* The Mortgage Bankers Association has been arguing very hard for the continuation of FHA in something close to its current form (see, e.g., Chappelle 1995; Mortgage Bankers Association 1995c; and "Mortgage Bankers Back Plan" 1995). Its underlying concern is both a reduction in lending to the lower end of the market, especially during cyclical downturns, and loss of its members' participation in the underwriting process (mortgage bankers currently originate 55.6 percent of all FHA loans). It supports continuation of whole loan insurance (not simply wholesaling) and 100 percent insurance. Interpreted narrowly, an assigned risk pool response would be opposed by the Mortgage Bankers Association, since it represents a significant change in FHA ownership and administrative structure. However, as conceived, an assigned risk pool restructuring would address the essential elements of the association's concern. Whole loans would still be insured, and the level of insurance is a separable issue. Moreover, the marginal market would continue to be served, perhaps even more broadly, with ample opportunity yet for mortgage bankers to perform their traditional underwriting and loan-processing role.

3. *GSEs.* Freddie Mac and Fannie Mae are interested in any insurance arrangement that has maximum efficiency and is most broadly inclusive in terms of potential borrowing households.[45] They welcome insurance programs at both the pool and individual loan levels and are amenable to entering into risk-sharing arrangements with FHA and others as long as the benefits, broadly defined, outweigh the costs.[46] The assigned risk pool proposal would make the provision of insurance services more efficient and could be at least as inclusive as the current program. It could conceivably

[45] The aims of the GSEs with respect to a restructured FHA are presented in commentaries by Van Order and Gates (1995) and by Dale (Joint Center for Housing Studies 1994d).

[46] The benefits may include credit by the federal government toward their affordable housing commitment as well as direct monetary rewards. A recent proposal by former HUD secretary Jack Kemp and 73 first-term Republican Representatives is to shift FHA's responsibility to Fannie Mae (see Grassano 1995b). The agencies might support such a merger because it would help with their affordable housing goals. However, I believe the mortgage insurance and secondary market functions to be sufficiently distinguished to require separate entities (see earlier comments concerning the merging of FHA and GNMA). I have seen no private market tendency for the private mortgage insurers to join the GSEs. Thus, there is little market evidence that such a merger would be a good idea.

include pool insurance as well as insurance at the individual loan level and could be designed so that the GSEs are given a stake in the restructured insurance program and share some of the risk. Thus, the assigned risk pool program is not inherently inimical to the objectives of the GSEs.

4. *State housing agencies.* The state housing agencies are interested in the ready availability of insurance, especially on the affordable multifamily product they are most involved with.[47] They are willing to accept creative risk-sharing arrangements such as those currently being formed with FHA in which they accept the top-end risk in exchange for fees, the ability to control the underwriting process, and the broadening of affordable housing opportunities. Such risk-sharing arrangements and the expansion of multifamily insurance programs would continue to be possible under an assigned risk pool restructuring of FHA. In fact, the flexibility of a GSE or privatized structure may enhance such opportunities. Thus, there is no inherent conflict of this proposal with the state housing agencies' aims.

5. *Community-based nonprofits.* The community-based nonprofits have become important players in today's market for multifamily debt finance.[48] Thus, their opinion is important in assessing the likelihood of any FHA reform effort. The community organizations are interested in supporting any effort that will broaden affordable housing opportunities and are concerned about any plan for restructuring FHA that could reduce such commitment.[49] However, many of the groups see FHA as having been as much a part of the problem as a part of the solution in past years. Thus, they tend to support cleaning up the administration of FHA to maximize the effectiveness of loan management, property disposition, inventory management, and other FHA functions that will minimize foreclosures and enhance neighborhood

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[47] See the testimony of Angle and Pyne before the FHA-sponsored "Forum on the Future of FHA" in Denver (Joint Center for Housing Studies 1994c) for insights into the goals of the state housing agencies with respect to a restructured FHA.

[48] See "Deals from Hell" (1994) for a detailed discussion and case studies dealing with the role of nonprofits in multifamily housing production and financing.

[49] Cincotta (1995) and Knight (1995) provide insights into community-based organizations' attitudes toward FHA restructuring. See also comments by neighborhood representatives in the "Forum on the Future of FHA" in Charlotte and Detroit (Joint Center for Housing Studies 1994b, 1994d).

stability. They also are concerned that programs be able to respond to local neighborhood conditions and the special needs of lower income households rather than following a mass-produced, computerized, "one-size-fits-all" mentality. Community groups would naturally be concerned about greater privatization if they felt there would be less ability to accomplish the redistributional mission of FHA. However, assuming the redistributional mission could become an integral part of the assigned risk pool structure adopted, there should be no inherent conflict between it and the community groups' interests.

6. *Congress.* There is considerable debate going on now in the new Republican Congress on the future of FHA.[50] Representative Rick Lazio (R-NY), chairman of the Housing Subcommittee of the House Banking Committee, feels HUD should remain, but he is undecided about the future of FHA and GNMA. Seventy-three newly elected Republican members of Congress have called for the elimination of HUD and the transformation of FHA into either a private or a government-owned corporation. Representative Sue Myrick (R-NC), who chairs the HUD task force for the group, favors the maintenance of FHA's functions, but not in its present form as an integral part of HUD. These opinions thus call for more radical change than the administration has called for in the transformation of FHA. However, such a transformation is entirely compatible with an assigned risk pool structure, which would make use of a privatized or GSE form of FHA.[51]

7. *HUD and FHA.* HUD secretary Henry Cisneros and FHA commissioner Nicolas Retsinas have concentrated their attention on the "cleanup" of FHA, including dealing with the defaulted property inventory, handling workouts, and

[50] See Grassano (1995a, 1995c) for a discussion of recent Republican congressional initiatives as they relate to FHA.

[51] One argument that is commonly heard concerning the future viability of FHA is that government institutions that focus on special groups and require subsidies to operate are highly vulnerable in today's political environment. Thus, FHA is forced to play the game of cross-subsidization and to keep its targeted beneficiary classes relatively broad. The proposed risk pool structure would continue cross-subsidization and draw from a broader population—the entire PMI industry—requiring no explicit government budgetary allocations. At the same time, the beneficiary classes could be broadened. Although only the "otherwise uninsurable" would remain within the JUA itself, borrower households at the margin of qualifying for PMI insurance under the current system could clearly be privately insured under the assigned risk pool alternative.

restructuring management and the authority structure.[52] Innovation has focused on risk-sharing partnerships with the state housing agencies, the PMI industry, the GSEs, and other players. The attitude of HUD, as revealed in recent proposals, is that FHA can continue as an autonomous agency within HUD. Loss of FHA would considerably reduce HUD's power to influence housing policy, especially at the low end of the market. HUD's dominant fear in this regard is that a privatized or GSE FHA would act independently of the urban policy goals of HUD. This issue—loss of HUD influence, especially in directing and coordinating housing policy at the low end of the market—represents a fundamental point of conflict with an assigned risk pool restructuring of HUD and must be dealt with in the ultimate restructuring plan.

Conclusions

I have determined that the current deteriorated state of FHA is no accident, but the expected outcome of a number of historical conditions that caused it to deviate from the path of efficiency and fiscal soundness, including the overlay of a heavy social agenda over the basic insurance objective, a reorganization that submerged its basic mission beneath a broader redistributional urban agenda, political sabotage, and government's inherent inability to respond to the signals of the marketplace.

However, I also found that there is a real reason for the government to be involved in the functions mandated to FHA: the provision of credit enhancement via insurance to permit lending to otherwise marginal lower income, first-time, often minority home purchasers or multifamily developers providing decent affordable housing in inner-city neighborhoods.

My analysis has led me to conclude that a viable FHA is possible, but it cannot exist as an arm of HUD. At the very least, under current conditions, it must be an independent agency with complete autonomy and a commissioner whose term is independent of the comings and goings of presidential administrations. The goal of this independent FHA should be to reinvent itself continuously through experiments intended to find institutional

[52] The HUD/FHA position on FHA restructuring is embodied in its reorganizational proposals of December 1994 (see "HUD Seeks Flexibility" 1994). Retsinas (1995) summarizes these issues nicely. HUD's case against a privatized FHA is made in HUD (1995a, 1995b).

structures and programs that permit it to seek greater discipline through the market, ultimately via a GSE structure or complete privatization.

Several structures and programs are promising. One that already exists to provide high-risk insurance in the automobile, property, and medical malpractice areas is the assigned risk pool structure. Such a structure for FHA provides market incentives for behavior in underwriting, pricing, and policy administration yet achieves the intended redistributional social objectives, while doing so with fewer explicit government subsidies. Many other restructuring alternatives are possible and require serious evaluation.

Author

Kerry D. Vandell is Director of the Center for Urban Land Economics Research and Professor of Real Estate and Land Economics at the University of Wisconsin–Madison.

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