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Comment on James E. Wallace's "The Dilemma of the Disposition of Troubled FHA-Insured Multifamily Rental Property"

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Introduction

In "The Dilemma of the Disposition of Troubled FHA-Insured Multifamily Rental Property," James Wallace provides a helpful review of the problem the Federal Housing Administration (FHA) has with troubled multifamily property. He also recommends several sound administrative and legislative steps to improve FHA's response to the problem. In general, the article reflects the thorough understanding of federal housing policy and of the U.S. Department of Housing and Urban Development (HUD) for which Wallace is nationally respected.

However, an article like Wallace's can do more than demonstrate the existence of a large problem and present reasonable remedies. Policy analysis can bring fresh understanding, illuminate new options, and help build a consensus for more effective action than would otherwise be taken.

Wallace's policy prescriptions are disappointing, ultimately, because they do not go beyond legislative proposals already being considered by Congress when action was taken on the Multifamily Housing Property Disposition Act of 1994 (Public Law 103-233). Many of those proposals were included in the legislative request the Clinton administration sent to Congress a few months after taking office. The proposals were drawn with caution so as to minimize controversy and maximize the likelihood that at least some needed changes in law would be enacted quickly. Congress had to seek legislative agreement based on perceptions of FHA's problem that were already generally accepted.

Wallace has the ability to take us beyond the limitations of accepted wisdom. That should be done not only to uncover any need for additional legislative remedies, but also to expand the administration's political options under authority Congress has already granted.

In this comment, I argue that FHA's troubled inventory results largely from unusual events of the last decade, including nationwide excesses in real estate investment, administrative neglect of FHA, and legislative reaction to low-income housing need and possible losses of affordable housing stock. I argue for action bold enough to put this problem behind us soon and adapt FHA to changing mortgage markets. The longer the problem lingers, the more it endangers future housing policy.

I begin by setting out starting assumptions. I examine one of Wallace's recommendations—his call for budgetary reform—to illustrate the need to build a consensus for action powerful enough to overcome obstacles to proposed remedies. I then explain why I believe that Wallace considers FHA's problem in a context that is too static, and I suggest a more useful context: the changing economic, managerial, and political forces that have been shaping FHA's troubled property problem. Finally, I describe some implications for action.

Starting assumptions

The following assumptions underlie my comments:

1. There will be a continuing need for FHA in the nation's mortgage finance system. The multifamily housing market will need FHA support especially for rental housing at the more affordable end of the market and in locations the private lenders would otherwise not serve adequately.

2. FHA can be a significant player in a rapidly evolving market only if it becomes far more competent and nimble than it has been in recent years. FHA must greatly improve its capabilities both as a primary mortgage insurer and as a partner with other participants in the multifamily mortgage finance system through reinsurance or other risk-sharing arrangements.

3. Time works heavily against efforts to rebuild FHA. The longer the troubled inventory lingers, the more likely will be a strong political reaction against FHA's continued involvement with multifamily mortgage insurance.

4. HUD must therefore move quickly to transfer the troubled multifamily property that is worth saving into the hands of those who can provide the capital and managerial expertise needed to maintain good, affordable housing for the long

term. Policies that make this transfer more difficult are, to my mind, not in the ultimate interests of either the public or low-income renters.

A montage of estimates: The best available picture

The greatest strength of Wallace's article is its overview of the size and financial condition of FHA's troubled multifamily inventory. That picture is hard to obtain because so little reliable information is available on the financial performance of multifamily properties. FHA's own data systems have long been notoriously flawed, and the multifamily experience of other lenders can provide little insight because their documentation and terminology are not standardized. Wallace therefore provides the best picture possible: a montage of estimates by various analysts using diverse methodologies. The recent results of Wallace's own analysis of the FHA-insured stock are particularly valuable as an advance indicator of problems that could be in store for FHA if economic circumstances worsen.

The magnitude of FHA's problem raises some fundamental questions that deserve more attention in the article. One question is whether the currently contemplated remedies take into account the gap between HUD's capabilities and those needed to meet the challenge posed by the troubled inventory. Thousands of troubled properties require action, and each project raises unique issues. Some properties may not warrant further spending. Many will involve local political controversies. Solutions inevitably require tough decisions and expose HUD employees to criticism. In short, the troubled property problem requires bold, entrepreneurial action that is quite alien to the institutional culture fostered in HUD over many years. Thus, the solution cannot be limited to giving HUD more authority. Some of the tough decisions need to be moved to an organizational setting where they can be made quickly, competently, and in the public interest.

A second question is whether too much attention is being focused on the disposition of HUD-owned properties and not enough on achieving long-term financial viability for other distressed FHA-insured properties. The HUD-owned inventory involves unpaid principal balances of $850 million, compared with $7.3 billion in unpaid principal balances for the HUD-held mortgages.[1] While the HUD-owned inventory includes about 180 properties, with

[1] Personal communication, HUD Budget Office, April 5, 1994.

32,000 units, the HUD-held inventory includes about 2,400 properties, with 350,000 units. Wallace's own estimate is that the total HUD-insured and HUD-held inventory includes more than 3,000 distressed properties, with 380,000 units. As Wallace points out, an important task is to create methods for preventing properties from entering foreclosure. Unless HUD develops effective strategies for avoiding foreclosure on distressed properties, the numbers of HUD-owned properties could easily rise despite improvements in HUD's property disposition procedures. Such strategies are also indispensable if FHA is to prevent properties from falling back into foreclosure after they are sold.

A third question concerns the implications of the current problem for FHA's long-term institutional structure. HUD's troubled inventory may point out not just the need to improve FHA's ability to deal with distressed property, but also the need to radically restructure FHA into an institution that can operate in the more sophisticated mortgage market that is fast emerging.

Budget treatment of Section 8: Difficulty of action in a complex environment

Although Wallace provides a good overview of the problem, he does less well in analyzing why current policies need to be changed and in highlighting obstacles to his recommendations. One example illustrates the difficulties to be overcome. Wallace recommends a change in federal budget procedures so that HUD can make more rational choices when deciding whether to hold foreclosed property or sell it with the Section 8 rental assistance now required by law. While HUD owns the property, it drains government resources, the property deteriorates, vacancy rates increase, and residents are disrupted. Selling the property to an appropriate entity can cut HUD's administrative burden, attract new capital needed for modernization, place the housing under competent management, and provide more affordable housing.

Although sale is almost always in the public interest, federal budget rules encourage HUD to hold a property, as Wallace explains. When HUD wants to sell a property, it must by law provide Section 8 assistance, which comes from appropriations that have been too low to accommodate the sales. However, virtually unlimited funds are available if the property remains in HUD's inventory, since property holding costs are classified as mandatory spending not subject to appropriations. Although HUD's own analysis shows that holding a property costs as much

in the long run as selling it, the differences in budgetary treatment not only force HUD to hold properties in its portfolio, but also make HUD too reluctant to foreclose on delinquent owners.

Wallace appropriately recommends a change in federal budget procedures to reflect the government's real cost alternatives when making hold-or-sell decisions. This should be among the easier remedies to implement, since it is a technical change that involves neither significant government cost nor controversy among outside interest groups. Nevertheless, it is proving a difficult step to take.

One reason is that no single decision-making body can make the proposed change. Current budget practices are generally governed by statute, which divides authority among the Office of Management and Budget (OMB), the Congressional Budget Office (CBO), and the General Accounting Office. Time is required to achieve a consensus among all three, since action could be blocked if any one of them objects.

In addition, one or more congressional committees may also have to agree. One approach would be to reclassify the Section 8 subsidies as mandatory spending, which would require agreement by the congressional budget committees, whose members are reluctant to establish precedents that could weaken budget controls. Another approach would be to convert the Section 8 subsidies into direct spending through authorizing legislation, requiring agreement by the House and Senate Banking Committees, which may not want the burden of having to find offsetting savings from other activities in future years. A third approach would be to establish a special mandatory appropriations account for these Section 8 subsidies, requiring agreement by the House and Senate Appropriations Committees, which are intensely protective of their discretionary power. In practice, a consensus will have to be reached among all the interested committees, since opposition from any one of them could block the legislation.

Not surprisingly, FHA's property disposition problem is not the highest priority for any of these agencies or committees. Each has to weigh a variety of political, practical, or theoretical concerns before agreeing to a proposed change.

As this is written, the various parties have been discussing this problem intensely for about six months, and the administration's 1995 budget proposes a solution similar to that recommended by

Wallace. Enactment, however, is still far from certain. An effort was made to include this proposal when Congress was taking action on the Multifamily Housing Property Disposition Act of 1994. The provision was dropped, however, after it ran into stiff opposition.

Perhaps the most serious obstacle is that the proposal would create a new form of entitlement spending, which many members of Congress resolutely oppose in principle. Another obstacle is that the proposal's budgetary impact is uncertain. CBO budget estimators are not as certain as the administration that the proposal is budget neutral, with costs completely offset by savings. There is also some disagreement over methods for verifying any savings. Finally, some key members of Congress have little confidence in any of these budget projections.

In this environment, effective veto power lies in many hands. Proponents of this change in budget procedures must move with care, since strong objection from any quarter could ignite controversy, solidify opposition, and doom the proposal. Since the proponents themselves have other priorities and cannot devote unlimited energy to this one issue, even a relatively low-grade, lingering controversy can be fatal.

The lesson of this illustration is not that solutions are too difficult. The lesson is that if we are to get solutions implemented, we need to make a case so politically compelling that it captures the attention of many decision-makers and overcomes their reasons for inaction. We need to work with the powerful forces that shaped FHA's problem and that are now transforming it.

The need for a dynamic, not static, analysis

We need more than an estimate of the problem's size. We need answers to such questions as the following: What forces caused FHA's troubled inventory to increase? What forces undermine HUD's ability to cope with this inventory? Which forces are no longer as influential? Which are growing? Which developments make it harmful to continue current policies? What dangers await us if we don't change course? What new factors are opening new options? Policy analysis could make needed action more likely by helping us understand FHA's challenge in a dynamic context.

Unfortunately, Wallace's article presents FHA's problem in a rather static context, referring, for example, to HUD's troubled

property problem as a “dilemma,” a situation where all the choices are undesirable. FHA’s problem has festered this long because many have seen it that way, and government generally takes to a dilemma like a hiking party takes to a skunk. Decisions are avoided, and even modest steps get caught up in controversy. Temporizing results, especially when government action depends on agreement among many different power centers in Congress and the executive branch, as has been the case with HUD’s troubled inventory. We need to help decision-makers break out of perceived dilemmas, not just by recommending courses of action, but also by helping to build a politically compelling consensus for taking such action.

Another sign of static analysis is that Wallace believes that FHA’s problem should be understood within the broader context of the lack of low-income housing entitlement. It is true, of course, that HUD’s property disposition would be less controversial if rental assistance were available to all low-income renters. But that is little more than a theoretical observation.

A federal low-income housing entitlement has long had devoted advocates, but it has never been a serious option in Congress. Tightening federal budgets make a low-income housing entitlement ever more unlikely. The lack of a housing entitlement has been a static condition and will continue to be so for the foreseeable future. Discussing such an entitlement provides no more guidance in the search for new solutions to FHA’s problem than would a discussion of many other unlikely changes in the nation’s economy or polity.

A more helpful approach would be to analyze HUD’s current problem in its operative context, by considering the dynamic economic, managerial, and political factors that shaped the problem and by exploring how expected changes in those factors might affect FHA’s course of action.

Economic context: Causes not unique to FHA

FHA is not alone in its losses. HUD’s troubled property problem was spawned in part by powerful economic forces that affected virtually every segment of the nation’s mortgage credit system. During the early 1980s, waves of enthusiastic lending flowed into all forms of real estate. The 1981 tax bill had created unprecedented incentives for real estate investment. A booming economy fueled expectations that asset values would climb

steadily. Mortgage underwriting reflected that optimism with high loan-to-value ratios and low debt service coverage.

These currents grew stronger after the 1982 Garn–St Germain Depository Institutions Act permitted thrifts to provide large amounts of federally insured funds to real estate. Insurance companies and commercial banks also sharply increased their lending for multifamily housing. The result was substantial overbuilding of multifamily housing, particularly in certain regions and income segments of the market.

Then, just as dramatically, the bottom fell out. The 1986 tax act eliminated the 1981 tax incentives for investment in real estate and replaced them with powerful disincentives, such as new passive loss rules. Recession hit real estate hard in much of the country. The cumulative shock triggered a collapse in real estate values and deep losses to virtually every major institution involved in real estate lending or investment.

In more recent months, the economy has given FHA some rare opportunities. Regional economies have shown signs of recovery, mortgage interest rates have been low, and capital has flowed into multifamily rental housing. Such developments have created an unusually favorable environment for restructuring the financing of troubled properties to place them on a sound, long-term financial footing.

FHA's problem should be analyzed more carefully in this context. First, it highlights the aspects of HUD's troubled property problem that were caused by short-term phenomena. FHA's troubled inventory results, in significant measure, from the unusually overheated real estate investment climate of the 1980s, not from conditions inevitably associated with multifamily lending. The currently favorable economic environment may also be short lived. In fact, as this is written, long-term interest rates have begun to increase. FHA needs to move swiftly while problems with troubled properties can be more easily solved.

However, HUD cannot take advantage of this improved environment without addressing the structural financial problems of its troubled properties. HUD's early response was to make marginal adjustments to procedures that were designed to deal with properties undergoing temporary adversity. For example, in early 1994, the maximum allowable workout period was increased from the previous three-year limit to six or nine years. Owners were still expected to bring mortgage delinquencies current within that period. Unfortunately, the root problem for most of

FHA's currently troubled property is not temporary adversity but a permanent decline in property values across large market areas. Revenues and property values are stabilizing at levels far below projections made when the mortgages were underwritten. Many properties, therefore, simply can no longer support their debt load. Owners struggling to avoid default often have had to defer normal investments, so many properties now need significant infusions of new capital.

Consider, for example, a property that now carries a $20 million mortgage. Assume that with $2 million in improvements, the property could realistically be expected to achieve revenues that would justify a valuation of $14 million. That means the property is now worth only $12 million. The questions are how to attract that $2 million in new capital and what to do with the $8 million of insupportable debt. Since current FHA policy precludes debt forgiveness except through foreclosure, a bold rethinking of FHA's authority is needed to address those questions adequately.

Second, viewing FHA's problem in this economic context calls attention to how other financial institutions have responded to the real estate collapse of the 1980s. Banks, thrifts, insurance companies, and other institutions have struggled with large inventories of troubled properties, and their strategies hold valuable lessons for FHA. Although insurance companies and banks are reluctant to reveal the magnitude of their losses and the details of their response, much information is available.

Private lenders have taken decisive action in response to their troubled inventories. Under a typical workout for a property that is carrying excessive debt, the lender would write down the loan to a level the property can realistically carry on an ongoing basis, and the owner would put in the investment needed to make the property competitive. That maximizes the value of both the property and the loan.

The strategy of the Resolution Trust Corporation (RTC) has been to take control of an underperforming asset and liquidate its inventory as quickly as possible. RTC has assembled teams of consultants to negotiate the sale of multifamily mortgages at the best market price available, without a formal competitive process. Each team includes a real estate expert, a lawyer, and a government official. RTC also created a market for multifamily assets through its bulk sales of underperforming loans and properties.

The Federal Deposit Insurance Corporation (FDIC), in contrast, tries to avoid taking control of troubled property and seeks ways to keep it under private ownership and management. FDIC has developed various loss-sharing arrangements that encourage sound financial institutions to acquire and manage the entire portfolio of a troubled bank.

Banking regulators have approved a variety of "good bank/bad bank" arrangements under which a financial institution (the good bank) creates an independent organization (the bad bank) whose sole function is to acquire and liquidate the sponsor's troubled assets. While the bad bank focuses its energies on liquidating the troubled portfolio in ways that maximize value, the good bank is free to concentrate on promising new business opportunities.

Context of past management failures and program flaws: Causes unique to FHA

FHA's own unique shortcomings also contributed to its troubled property woes. Government auditors and others have for years called attention to serious flaws in FHA management and practices. HUD established blue ribbon task forces in 1974 and 1977 to evaluate its operations (Task Force on HUD Departmental Reorganization 1974; Task Force on the Future of FHA 1977). Senate hearings in October 1977 explored the need to modernize FHA (U.S. Senate Committee on Banking, Housing, and Urban Affairs 1977). Each inquiry identified serious problems, many of which still existed 15 years later.

With outmoded procedures and inadequate staffing, FHA was notoriously slow in approving applications for FHA multifamily mortgage insurance. As a result, FHA tended to get applications primarily from projects that could not get mortgage insurance elsewhere. FHA's long processing times actually increased FHA losses because, when decisions finally did get made, they were often based on outdated data and cost estimates.

The Reagan administration further weakened FHA in an effort to reduce or privatize federal mortgage insurance rather than make it a more effective part of the housing finance market. Many of FHA's most talented staff left. Underwriting procedures deteriorated. Decision making became increasingly politicized. The mismanagement of that era eventually erupted in the highly publicized HUD scandal of 1989.

The Bush administration initially showed interest in rebuilding FHA's capabilities. But then, in reaction to breaking scandal and soaring FHA losses, the administration and Congress enacted the HUD Reform Act of 1989 (Public Law 101-235), which, among other things, made HUD much less able to cooperate with owners to minimize losses on financially troubled property. In January 1990, HUD Secretary Jack Kemp abruptly shut down FHA's coinsurance program and decided to minimize HUD's involvement with multifamily housing. Staff resources continued to erode. A strong culture of inaction took hold as HUD's field personnel were given little recognition for solving problems and harshly punished for making mistakes. Troubled properties were left to fester, increasing FHA's long-term costs and exacerbating the agency's current problem. Firms working with FHA found that the capable staff who remained were few and stretched impossibly thin.

Viewing FHA's troubled inventory against this background raises concern that the task of resolving that inventory exceeds the department's capacity and procedures. Although HUD has begun to encourage more responsiveness and imagination in its field offices, it is unreasonable to expect a sudden, dramatic transformation in a federal department's capabilities and culture.

Policy analysis should examine ways that temporary, new institutional arrangements could transfer some of the tough property disposition decisions from HUD to entities that can make them quickly, competently, and in the public interest. I am concerned that Wallace largely limits his recommendations to giving HUD more flexibility to carry out an unprecedented task that it is structurally incapable of performing.

Past political context: Causes related to congressional action

HUD's problem has also been shaped by past congressional action. As Wallace points out, HUD's effort to deal with troubled property has been complicated by legislation enacted in recent years.

HUD's choices have been limited by a statutory framework that gives priority to expanding the low-income use of HUD-owned property. To be sure, current law resulted from long and intense negotiations in Congress, and many influential people share the concerns reflected in the statute. Nevertheless, policy analysis

should not assume that congressional options are constrained by recently enacted law. Influence in key committees shifts over time. Members of Congress come to see priorities and problems in new ways. Time pressures often forced negotiators to strike compromises that few of the participants would now accept. Statutory provisions are often interpreted, either in regulations or in the courts, in ways that legislators neither anticipated nor favored.

Policy analysis needs to explore the changing political context within which relevant legislation was developed and within which any amendments would now be considered. This is especially true for provisions of law that now constrain HUD's ability to deal with troubled property. These provisions reflect a legislative environment that was peculiar to 1980 through 1992, when control of the legislative and executive branches of government was split between the two parties. During the early 1980s, congressional supporters of federal housing programs worked intensely, usually on a bipartisan basis, to block Reagan administration efforts to reduce sharply the government's role in housing. Before that period, legislation was usually drafted to give the HUD secretary broad authority to carry out specified purposes. However, when the Reagan administration used its administrative discretion to achieve objectives opposed in Congress, members of Congress increasingly sought to draft legislation more explicitly to force specified actions by resistant administration officials. President Reagan's congressional supporters, particularly in the Senate, responded by blocking the passage of housing legislation. On those rare occasions when Congress succeeded in enacting provisions the administration opposed, the administration often responded by reinterpreting congressional intent or refusing to implement the law. Frustration and suspicion rose on both sides as legislative drafting became increasingly detailed and prescriptive.

Those legislative habits persisted in 1987, when Democrats regained control of the Senate and the legislative deadlock suddenly broke. By then, housing advocates had become alarmed by homelessness, the impending losses in the nation's low-income housing stock, and other issues the Reagan administration had been avoiding. With little hope for substantial increases in low-income housing production, congressional housing advocates concentrated on preserving the low-income affordability of housing that had already been produced with federal assistance. Since many housing advocates had come to believe that the administration's obstinacy had exacerbated the nation's housing problems, much of the resulting legislation was designed to place rigid constraints on administrative discretion.

The legislation was developed under less than ideal conditions. The Reagan administration generally opposed these initiatives and refused to participate in the legislative process. Congressional authorizing committees had little access to the career staff who would implement the law. The legislative product, shaped by committee negotiations, often incorporated layers of incompatible purposes: disposing of HUD's inventory, saving tax payer costs, expanding the supply of affordable housing, increasing tenant ownership, promoting the nonprofit sector, and assisting more low-income families.

The authorizing committees could directly influence only a few of the tools needed to carry out a coherent policy. They could not, for instance, force congressional appropriators to provide enough funding to preserve the low-income use of the property after sale. They therefore sought to build pressure on OMB and the appropriations committees by prohibiting HUD from taking certain desirable actions, such as selling HUD-owned property, unless the required funding were available. We now know that OMB and the appropriators are not so easily embarrassed. Thus the authorizing legislation served only to place HUD in a damaging straitjacket, unable either to sell the property or to manage it well.

A final element of FHA's political context in coming months is that Congress and other political forces are unlikely to be patient if the troubled inventory persists as a contentious and costly problem. Slow resolution of this problem could lend credence to charges that HUD is inherently problem-ridden and could damage efforts to revitalize FHA's future role in the housing finance system.

Viewing FHA's current problems in this changing political context suggests that the menu of realistic solutions may be expanding. Working relationships between Congress and HUD are better. New members of Congress, who are not identified with past legislative battles, have moved into positions of influence. Commitment to the old ways of doing things is further weakened by lower expectations for funding and greater recognition of the unintended consequences of prior legislation. All these changes open the way for alternatives that may not have been considered before.

Policy analysis should explore in more depth not just how HUD's resources and flexibility might be marginally increased, but also how the nation's financial and managerial capacity could be mobilized to get the troubled property problem behind us. I am concerned that Wallace's recommendations do not push beyond

what the administration and Congress have already been considering.

Implications for action

I believe that analyzing HUD's troubled inventory within this more dynamic context has several implications for action.[2] First, federal policy should place top priority on selling the HUD-owned property as promptly and cost-effectively as possible. HUD should get as much of this housing as feasible into the hands of entities that can provide the capital and managerial skill required to return this property to full service as quality, affordable housing for the long term.

Federal policy should be concerned primarily with the quality of the housing, its long-term affordability, and the residents' quality of life. These public objectives can be met through well-designed deed restrictions, dividend limitations, and other mechanisms carefully crafted to reflect the economics of multifamily housing. Scarce housing subsidies should not be directed to housing just because of its status as HUD-held or HUD-owned property. Doing so will distort the allocation of federal housing assistance.

Second, more attention should be given to the inventory of HUD-held loans, which affects 10 times more properties than the HUD-owned inventory. The secretary should be given clear authority to sell troubled loans into the secondary market, drawing on the lessons of RTC and other agencies. That authority should accommodate such techniques as the following:

1. Teams of real estate experts, lawyers, and government officials to negotiate the sale of multifamily mortgages at the best market price available, without a formal competitive process

2. Bulk sales of nonperforming FHA mortgage loans to take advantage of the enormous market that RTC and Wall Street have created for such products

3. Sale to lenders other than the assigning mortgagee

[2] This section draws heavily on suggestions made by a task force of multifamily housing professionals, including Anthony Freedman of Powell, Goldstein, Frazer and Murphy; Jerry Levine of Holland & Knight-Dunnells & Duvall; Ronald Ratner of Forest City Residential Development; and Jack Murray of Insignia Management.

4. Implementation of the memorandum of understanding between FHA and the Government National Mortgage Association (GNMA) that would permit HUD to reassign formerly coinsured loans to GNMA and allow for a reduction of interest rates to the lower levels now existing in the market

5. Modification of mortgages to reflect current interest rates, after the mortgagors bring them current, so that they can be sold at auction

6. Sale of mortgages on a negotiated basis at below-market interest rates in conjunction with tax-exempt bond financing

7. Repackaging mortgages by splitting them into (1) a performing first mortgage, which could be financed at lower rates and then sold in the marketplace to achieve a return to the insurance fund, and (2) a second mortgage, which HUD could hold or structure for sale, with specified repayment terms based on how the project performs over a defined period

Third, the secretary should be given broad, temporary authority to approve realistic workouts using mechanisms that are well proven by other federal agencies and private financial institutions. That authority should include the ability to forgive debt when necessary to return a property to financial viability.

Prudent, long-term workout should be negotiated if HUD finds that continuation of the current mortgagor is in the interests of the government and residents. A straightforward workout procedure could include five steps:

1. Determine the amount of hard debt that project revenues could support.

2. Determine an appropriate contribution of equity the owner should make.

3. After determining the amount of debt that should be forgiven, if any, design a second mortgage that gives the investor a reasonable return on new capital and gives HUD a share of any cash flow after payment of project expenses and the first mortgage.

4. Analyze the full, long-term government costs both of foreclosing and of restructuring the debt as noted above to provide economic viability for the project.

5. Choose the best and most cost-effective course of action from the point of view of the government and the public interest.

The secretary should be given broad authority to supplement HUD's staff capacity through contracts with public and private entities that can negotiate sound workouts.

Finally, FHA should be restructured as an independent government corporation that can operate as a competent participant in the fast-evolving mortgage market. The legislative changes proposed by Wallace will make it easier for HUD to reduce its troubled inventory. Administrative reforms proposed by the Clinton administration will bring long-overdue accountability to FHA's management. However, these changes by themselves will not produce an FHA that is able to manage its mortgage insurance risks. FHA should be given two things: a market-responsive structure, and authority to carry out a market-driven business strategy. It should be freed from the civil service constraints that prevent it from attracting the expert staff required by its mission. Care must be taken to ensure that an independent FHA functions as a competent arm of federal housing policy and serves segments of the market that would not otherwise be served. Because FHA's current task is so challenging, now is the time to begin that restructuring.

Conclusion

Although Wallace usefully describes the magnitude of HUD's troubled property problem and offers some reasonable recommendations, his article would have been even more helpful if it had approached FHA's problem within the dynamic context of the economic, managerial, and political forces that shaped it. This approach provides a richer menu of remedies than is now being considered and could help build a more powerful consensus for resolving FHA's troubled inventory before it further damages FHA's ability to support housing finance.

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