Comment on Kerry D. Vandell's "FHA Restructuring Proposals: Alternatives and Implications"

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Overview

I agree wholeheartedly with Professor Vandell on the fundamental point of his article: The Federal Housing Administration (FHA) needs change. This 61-year-old institution, buffeted over the years by bureaucratic, political, and philosophical crosswinds, is left today as a process-driven organization, ill prepared to act decisively or responsively as today's financial markets demand.

This is not to say that FHA no longer contributes to America's affordable housing landscape.[1] On the contrary, FHA continues to be a singularly important source of affordable housing. Over the years, it has made homeownership possible for 23 million households (at no cost to taxpayers) and has enabled financing for approximately 4.2 million rental units and more than 326,000 beds in community hospitals, nursing homes, and assisted living facilities (data from the Office of the FHA Comptroller, U.S. Department of Housing and Urban Development [HUD]).

Furthermore, as Vandell himself notes, the insurance fund supporting FHA's basic single-family program is actuarially sound, and this year FHA received a clean opinion on its financial statements from Price Waterhouse for the second consecutive year (Price Waterhouse 1994, 1995).

Nevertheless, advances in financial markets demand that FHA must change to continue to serve those in need.[2]

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[1] Bunce et al. (1995) show that in the single-family arena, FHA is serving buyers who would otherwise remain unserved.

[2] See reports by the Joint Center for Housing Studies at Harvard University (Apgar and Franklin 1995) and the National Academy of Public Administration (NAPA 1994). Both reports address the notion that FHA must change to

Vandell's article is well timed. At this writing, FHA is undergoing some of the toughest scrutiny in its history. No institution enjoys being under a public microscope, but close examination is a vitally important step in fundamentally reshaping an entity like FHA.

In fact, in an era of scarce resources and downsized government, it is imperative that we rethink the mission and effectiveness of all public institutions. FHA, burdened by a financially troubled multifamily portfolio,[3] layers of micromanagement, and its own antiquated systems and skills,[4] cries out for a reformulated mission and a new strategic plan.

Vandell's is a thorough and insightful analysis of the economic, bureaucratic, and political forces that have brought FHA over the years to its current state. Within that context, he seeks to determine (1) the role that the federal government should

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do its job effectively in the future. The NAPA report, which was produced to meet a congressional requirement, states, "At a time when the real estate industry and the financing mechanisms associated with it have been changing rapidly, FHA's government management systems do not permit it to spend reasonable amounts of money to avoid major long-term problems, hire the skills it needs, or keep its work force adequately trained" (p. 23). The Joint Center report, which resulted from eight public forums held around the country to gather input from housing, real estate, nonprofit, and financial professionals on the future of FHA, says in its executive summary, "Participants . . . depicted today's FHA as being out of touch with the fast-changing system of housing finance and poorly structured to be an effective partner with existing housing finance and development organizations" (Apgar and Franklin 1995, 1).

[3] The problems with HUD's multifamily portfolio have been widely discussed; Vandell himself makes note of them. For example, Susan Gaffney (1995), HUD's inspector general, said, "For a variety of reasons—including poor underwriting, inadequate servicing, excessive rental rates, and owner abuse—HUD's portfolio of multifamily projects has deteriorated dramatically both financially and physically over the past decade."

[4] Price Waterhouse (1995), in its fiscal 1994 audit of FHA performed for HUD's Office of the Inspector General, discusses FHA's "lack of staff and administrative resources" and the need to improve and modernize automated systems:

> Management has made efforts to re-invest resources in HUD's people and computer systems—areas where such an investment is sorely needed—and to remove barriers to addressing and curing troubled loans, only to be frustrated by budgetary or legislative constraints. Similarly, efforts to quickly take advantage of a favorable interest rate environment to refinance or sell-off HUD-held mortgages were slowed by poor automated tools . . . and by a cumbersome procurement process. . . . It is clear . . . that FHA does not currently operate in an environment that is very conducive to cost/benefit driven decision-making or rapid response to changing market conditions. (p. 5)

play, through FHA, given the growing capacity of the public and private market participants and (2) how best to address FHA's root problems, to transform it into a goal-oriented, market-driven, and market-responsive institution that can effectively expand housing opportunities for Americans of modest means.

While I differ with Vandell on his specific proposal that FHA should be independent of HUD, I agree with his underlying conclusions that (1) FHA should continue to provide credit enhancement to expand housing opportunities and (2) FHA needs far greater autonomy to accomplish that role effectively.

I believe that to be most effective, a reinvented FHA should be a wholly owned government corporation within HUD. HUD proposes just such an organization, combining an entrepreneurial, market-driven mode of operation with a public-purpose mission and mind-set. The organization would be known as the Federal Housing Corporation (FHC).

I also support Vandell's point that partners will be key to FHA's success.[5] In fact, his proposal for an assigned risk pool is based on the premise that all the institutions in the housing capital finance system have a role to play in meeting the needs of the underserved. While I do not agree with Vandell's proposal to apply an assigned risk pool model to the housing credit market, it reflects the appropriate spirit of public and private partners working in tandem to deliver credit to markets in need.

In these comments, I will detail HUD's proposal for a revamped and revitalized entity that will become FHC and HUD's vision of the organization's mission. I also will set forth the rationale behind HUD's view that FHA should be more autonomous but is best left within HUD, and that FHA's status as a public entity enables it to serve those that a privatized entity could not or would not. Throughout the discussion, I will reinforce the idea that while Vandell and I disagree on the specific structure of a

[5] The point that the federal government cannot and should not serve unmet housing needs by itself has long been a premise of federal housing policy in the United States. The Housing Act of 1949 makes it clear that the nation's housing policy should be designed to help the private sector to better serve the nation's housing needs:

> The policy to be followed in attaining the national housing objective hereby established shall be: 1) private enterprise shall be encouraged to serve as large a part of the total need as it can; [and] 2) governmental assistance shall be utilized where feasible to enable private enterprise to serve more of the total need. (p. 413)

new FHC, we fundamentally agree on the underpinnings of an organization poised to serve those in need.

Tough scrutiny

HUD's FHC proposal stems from tough scrutiny of FHA by housing providers and experts far beyond Washington, DC. When the Clinton administration took office in January 1993, Secretary Henry Cisneros quickly recognized that HUD's problems required more than a patch. While FHA—like all of HUD—was taking serious steps to improve management of specific programs, it was clear that HUD had to rethink the institution's core missions and the best ways to accomplish them in today's environment.[6]

At Secretary Cisneros's direction, FHA last year conducted an eight-city series of forums to examine (1) whether there continues to be a role for FHA in the housing finance system, and (2) if so, how FHA should be organized to best carry out that mission. The forums were sponsored by FHA and organized and chronicled by Harvard University's Joint Center for Housing Studies. The forums had more than 150 participants representing private, public, and nonprofit players in the housing finance world.[7]

The report on the forums (Apgar and Franklin 1995), released by the Joint Center in May 1995, found that there are housing needs in the United States that remain unmet by the private sector but that could be met with the backing of the full faith and credit of the federal government. A revitalized FHA, the report states, could be "the model of a streamlined, downsized, entrepreneurial, and accountable government agency that relies

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[6] NAPA's 1994 study addresses what it terms "HUD's Mix of Missions: A Prescription for Problems" by stating that

> HUD has from its creation struggled to find a coherent identity. Because of the mismatch of goals and resources and its many communities of users, HUD faces a tandem *performance deficit* (the gap between what HUD is supposed to do and has the ability to accomplish) and *expectations glut* (unrealistic perceptions of what HUD can accomplish). The result is a prescription for problems. (p. 3)

[7] Participants included three former FHA commissioners, state and local elected and nonelected officials, nonprofit and for-profit housing providers, HUD employees, residents of FHA-insured housing, low-income housing advocates, state and local housing finance agency representatives, builders, mortgage bankers, real estate agents, and investment bankers.

on public-private partnerships and market mechanisms to achieve public purposes" (p. 4).

While many forum participants saw the need for FHA to be more autonomous than it is today, the report also says that FHA is a "critical component of federal housing policy" (p. 3) and should remain a part of the cabinet department that coordinates federal housing policy. A new FHA, continues the report, should be built on three principles:

1. *Partnership* of FHA's federal credit with private and public sector delivery systems to better reach underserved markets

2. *Flexibility* to work well as a partner within the mortgage finance arena

3. *Accountability* for meeting unmet housing needs and maintaining financial safety and soundness

A panel of the National Academy of Public Administration (NAPA) reached similar conclusions in a July 1994 study of the future direction of HUD, produced for HUD in response to a congressional mandate. NAPA acknowledges the value of FHA's public-purpose role and the need for flexibility and autonomy to work effectively within the world of housing finance. NAPA's recommendation is that FHA should become a government corporation, operating with greater managerial flexibility and autonomy within HUD.

The independent accounting firm Price Waterhouse, which has conducted audits of FHA for the last six years, also called for changes to increase FHA flexibility in its most recent audit:

> HUD has proposed changes to FHA which, in effect, would grant it more autonomy and allow it to function more like a corporate entity, including applying standards of accountability and actuarial soundness. We believe any changes that would give FHA the flexibility it needs to more quickly and effectively respond to the volatile market and economic factors that are common to any provider of credit would be a significant improvement. (Price Waterhouse 1995, 5)

HUD has also engaged in extensive studies to examine the underlying rationale for government intervention in the private housing and mortgage markets. For example, in an article by Follain and Szymanoski (1995), which Vandell cites as a

framework for his discussion, HUD examines the rationale for government involvement in the multifamily mortgage market.[8]

HUD has also sponsored research on the nature of the market failures in the single-family mortgage market. One such study is a 1994 report by ICF, Inc., which uses Home Mortgage Disclosure Act (HMDA) data to examine how a borrower's income and neighborhood characteristics affect his or her choice of FHA. The ICF study shows that higher risk borrowers choose FHA—a finding consistent with previous credit-rationing studies (e.g., Canner, Gabriel, and Woolley 1991) and evidence of failure in the single-family market.

Another HUD-sponsored study (Rosenthal, Duca, and Gabriel 1991) shows that FHA financing mitigates the effects of credit rationing. Yet another, by Onder (1994), finds that evidence from HMDA data indicate that FHA is a major source of mortgage financing for African Americans and plays an important role in low-income neighborhoods. If FHA mortgage insurance programs cease, these groups will be the most affected.

The FHA forums, the Joint Center report, the NAPA report, and the research on mortgage market failures, along with dozens of General Accounting Office studies, Inspector General reports, independent audits, congressional hearings, and almost two years of experience at HUD, formed the basis for the proposal announced by President Clinton last December to transform FHA into a new FHC. On May 1, 1995, Secretary Cisneros transmitted to Congress the Federal Housing Corporation Charter Act[9] embodying this proposal.

A new FHC: Mission, business strategy, and structure

HUD's proposal shares much common ground with Vandell about the organization's underpinnings, although Vandell does not specifically agree with the structure HUD proposes for a new FHC or that it should be a part of HUD. Vandell and HUD are in accord, however, about the continuing mission of FHA and the need for a more flexible and autonomous structure to carry out that mission.

[8] Follain (1994) provides a good discussion of topics in multifamily housing on which additional research is needed.

[9] Title III of the American Community Partnerships Act.

Mission

The mission of the new FHC would be to continue to serve FHA's historic role in an ever-changing marketplace:

1. To expand access to capital to creditworthy people, neighborhoods, and markets that the private sector determines are too risky for it to profitably serve

2. To provide access to capital and stability in mortgage markets during economic downturns when the private sector is driven to withdraw

3. To pioneer and demonstrate untested products that the private sector will not offer because the risk is uncertain

4. To provide a market alternative that prompts private actors to compete more efficiently in lower profit market segments, making more capital available for consumers and lowering homeownership costs

The new FHC would carry out this mission in a self-sustaining fashion, requiring no credit subsidy to operate its business.[10] It could accomplish this mission without credit subsidy because of its unique government advantages: lower reserve requirements, lower cost of capital, no obligation to enhance shareholder

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[10] Credit subsidy is the net present value of the cost of operating a government credit program—that is, the net present value of expected program revenues minus expected costs. Under the 1992 Credit Reform Act, Congress required that an agency receive an appropriation of credit subsidy to pay for the expected cost of program operation over its lifetime in the year the credit obligation is incurred.

Today, virtually all of FHA's single-family programs are self-sustaining, but some of its multifamily programs are not. Given dwindling resources and FHA's weakened credibility after significant multifamily insurance losses, HUD concluded that the FHC should be self-sustaining and began to design new multifamily products that could be operated without credit subsidy. The need for this approach became clear sooner than HUD expected. In August 1995, the House of Representatives reduced the level of credit subsidy for multifamily insurance in the fiscal 1996 HUD–Veterans Affairs (VA) appropriations bill. The accompanying Appropriations Committee report said:

> It is not the intent of the Committee to end FHA multifamily insurance for those programs that currently require a federal credit subsidy. Instead, the Committee urges the authorizing committees to act expeditiously in enacting program modifications that will enable these multifamily insurance programs to become self-sufficient. (U.S. House Committee on Appropriations, Subcommittee on VA, HUD, and Independent Agencies 1995, 38)

return, no taxation, and a public-purpose motivation. These advantages will allow FHC to serve, on a self-sustaining basis, segments of the market that the private sector cannot consistently serve.

Some fear that FHA will use its lower cost of capital to compete with the private sector,[11] but the facts show otherwise. FHA uses its lower operating costs to bear credit risk that the private sector cannot profitably assume, whether to offer credit enhancement for higher risk or untested borrowers or products, or to provide credit enhancement to stabilize mortgage markets during national and regional recessions.[12] To address the higher risk, FHA charges higher premiums than private credit enhancement sources.[13] Borrowers who can qualify for a privately enhanced loan will take that lower cost, easier option. FHA's mission is to serve those without another choice, and market forces leave FHA with that business.[14]

Some argue that FHA should be prevented from serving borrowers that the private sector can serve; they would leave FHA with only first-time home buyers with below-median incomes (Hutchinson 1995).[15] Unfortunately, neither income nor housing history is an adequate proxy for whether the private sector

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[11] See, for example, the *Washington Times* article by Stephen Moore (1995), director of fiscal policy studies at the Cato Institute.

[12] In the early 1980s, FHA maintained a presence in the recession-hit "oil patch" states when many private mortgage insurers pulled out, paying as little as 40 cents on the dollar for their obligations. FHA's presence headed off worse declines in property values.

[13] There is no private mortgage insurance (PMI) industry for multifamily loans, although various forms of credit enhancement are offered by conduits, government-sponsored enterprises (GSEs), and others.

[14] FHA's recent experience lends considerable support to the proposition that FHA borrowers have nowhere else to turn. In 1991, FHA effectively doubled its premiums, as mandated in the 1990 National Affordable Housing Act. If FHA borrowers with loan-to-value ratios (LTVs) under 95 percent could have switched to PMI, one would have expected to see a drop in the proportion of FHA loans with lower LTVs. Instead, the proportion remained over 40 percent, roughly the same level as in the two years immediately before the premium increase (see Bunce et al. 1995). The FHA borrowers could not switch because they did not qualify for the loans they needed from the private sector. Bunce et al. found that FHA low-LTV borrowers differed from PMI borrowers in type of housing market, neighborhood location, income level, loan size, and household demographics.

[15] See also Moore (1995), who adds that FHA should be precluded from insuring loans above $100,000, even in high-cost areas.

believes the loan offers an acceptable level of risk. Any arbitrary cutoff will exclude from homeownership many borrowers that only FHA can afford to serve.

A cutoff also will leave FHA with a more homogeneous pool of borrowers, violating the basic principle of insurance—diversifying risk. If FHA's diversification is limited and risk increases, so too must premiums,[16] excluding others from access to homeownership and causing yet others to spend more income on housing.

Finally, risk levels will change with market conditions. As regional economies get weaker and private capital dries up, the composition of those without access to credit will change. Any fixed definition of FHA borrower characteristics will preclude FHA's reaching those newly unserved borrowers and serving its countercyclical market function.[17]

HUD proposes an alternative to targeted eligibility requirements: goals that measure (1) how well a new FHC is serving markets underserved by the private sector and (2) FHC financial safety and soundness.[18] This mechanism will give private market participants confidence that FHC is devoted to serving underserved markets, not competing for already well-served borrowers. It will also assure Congress and the taxpayers that FHC remains financially safe and sound and, finally, ensure adequate flexibility to allow FHC to serve whatever unmet needs arise and to allow the goal setters to adjust the goals to meet changing conditions.

The HUD secretary would establish programmatic goals measuring service to the following markets:

1. Home buyers typically underserved by private markets

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[16] Isaac and Marino (1995) predict that FHA premiums would have to increase by 35 to 40 percent if FHA were limited to serving only those persons below median income.

[17] The income necessary for financing a home purchase is tied directly to the level of interest rates, rising as interest rates rise. If FHA eligibility were limited by income, the number of borrowers eligible to benefit from FHA would be substantially reduced during periods of higher interest rates—precisely when FHA is most needed to maintain effective demand and stabilize housing markets.

[18] This oversight scheme is similar to that used to regulate the secondary-market GSEs—Fannie Mae and Freddie Mac (see the Federal Housing Enterprises Financial Safety and Soundness Act of 1992).

2. Rental markets and health care facility financing needs underserved by private markets

3. Previously underserved urban, suburban, and rural areas

4. Low- and moderate-income families

Like affordable housing goals for the government-sponsored enterprises (GSEs), the statute would not prescribe precisely how the goal is to be measured or the level of the goal to be achieved.[19] Instead, as research demonstrated better ways to measure the underserved markets, as economic conditions changed, and as the financial soundness of FHC showed that it could afford to make even greater efforts to reach underserved borrowers, both the focus and the level of the goals could be adjusted.

FHC's financial health would be monitored by the Office of Federal Housing Enterprise Oversight (OFHEO), which is the safety and soundness regulator for Fannie Mae and Freddie Mac. OFHEO would measure the adequacy of FHC's capital against a risk-based model. The OFHEO director also would be required to certify, before implementation, that FHC's business plan did not threaten its safety and soundness. As a result, FHC would be subject to unprecedented financial scrutiny: a prospective demonstration of prudence before business is undertaken *and* a retrospective review of actuarial soundness.

Strategic business plan

Today, each product FHA offers is known by the section of the National Housing Act in which it is described. Under the FHC charter, product design would not be done by statute. FHC would be given broad authorities to enhance credit, consistent with meeting its financial and programmatic goals. FHC could then establish and continually adjust business lines (e.g., single-family, multifamily, and hospitals), product lines (e.g., direct insurance, risk sharing, and pool insurance), and individual products. Each year's business plan would set forth an appropriate business mix.

[19] The charter act would establish interim programmatic goals measured as the GSE goals are measured—as a proportion of their business meeting specific criteria—and established at the levels that FHC achieved in fiscal 1994. Even the interim level would have FHC devoting significantly more of its business to underserved markets than the GSEs must—an appropriate difference between publicly and privately owned institutions.

FHA's single-family product mix would not change radically. FHC would continue to offer FHA's traditional 100 percent individual loan insurance product line, although new products such as two-step mortgages and three- and five-year adjustable-rate mortgages might be added if they provide opportunities to help unserved borrowers.

FHC might also experiment with pioneering mortgage products, such as lease-purchase loans, products that insure only the initial high-risk years, and low-down-payment products with home buyer education components. These experiments could help FHC better identify nontraditional borrowers with risk levels that it can afford to absorb, and distinguish them from borrowers whose risk is unacceptably high even for FHC.

FHC also could innovate with its delivery systems. Reengineering the traditional program could make the program more efficient and attract new lenders who in turn may reach FHA-type borrowers currently not served.

Experimentation with risk sharing and reinsurance also may allow FHC to better reach new borrowers, whom FHA's traditional products do not reach, without assuming greater risk. Partners may be better able to discern credit quality or market to communities that FHA does not penetrate well. However, as Vandell suggests, the incentive structure and oversight and control functions of shared-risk programs should be carefully designed to avoid the flaws of past risk sharing, such as the ill-fated coinsurance program in the 1980s. Partners' interests should be aligned with FHC's, so that FHC's risk is minimized and program objectives are achieved.

Fear that FHC would shut down the current FHA single-family programs in favor of one of these innovations is unwarranted. No private business would abruptly end production of its existing successful business lines. Untested products are inherently riskier. No sound business plan would abandon a prudent mix. And, as Vandell recommends, new products should be tested until their effectiveness can be shown. Some of those tests will succeed; others will fail. In time, some newly developed products will take the place of those no longer as effective, but others will coexist, serving different market needs.

FHC's multifamily business will differ greatly from FHA's current product mix, but these changes are already under way. FHA is pioneering multifamily risk-sharing partnerships with state and local housing finance agencies, the GSEs, and others. These

programs allow FHA to rely on competent partners, with risk of their own, for origination, loan servicing, and—if necessary—asset disposition responsibilities. These partners often can process loans more quickly, better allocate credit to local needs, and better assess risk at the local level.

Change is coming also because it is clear that neither FHA nor FHC will continue to receive the level of credit subsidy that FHA receives today. As noted above, FHA has begun to design multifamily products that could be self-sustaining. There clearly are market needs currently unserved by the private sector for which credit enhancement could be profitably offered by an entity with the advantages of Treasury backing.[20]

Surveys of market participants repeatedly conclude that there are a number of credit gaps that FHC could help fill. For example, much of the nation's best housing stock in many communities is in small properties (5 to 50 units), often in the hands of small businesses and individual entrepreneurs. The condition of this stock, however, is perilous, and we risk losing much of it as affordable housing. At the same time, many lenders would like to increase their community reinvestment lending but cannot afford to tie up their capital in multiyear loans.

The lack of standardization and the specialized knowledge needed for due diligence have deterred investors from purchasing these loans. FHC credit enhancement on these loans could help lenders attract secondary market capital and spur dramatic increases in community-based lending.

Other products could be designed to offer capital for construction and permanent, long-term, fixed-rate financing and for the development and redevelopment of large projects timed to anchor state and local community redevelopment efforts.

HUD envisions that the FHC multifamily operation could deliver its credit enhancement in at least three ways:

1. By risk sharing or reinsurance of individual mortgages, building on the success of current risk-sharing initiatives

[20] Some higher risk credit needs may require credit subsidy. After FHC has demonstrated that it can be self-sustaining, it will restore some of the credibility that FHA lost with the large losses of the late 1980s. Then, when government resources are less scarce, Congress may choose to provide FHC with credit subsidy for a particular need as a low-cost, efficient way to use government resources to leverage private capital to meet public purposes.

2. By providing pool insurance on loans pledged as collateral for a multifamily mortgage-backed security

3. By direct insurance offered through a streamlined FHC, making use of delegated underwriting, asset management, and processing if appropriate[21]

Of course, these plans indicate only a strategic direction. Ongoing market research and product pricing will dictate actual products offered. The important point is that market conditions and credit needs will change over time. FHC needs the flexibility to adjust its business plans constantly to respond to those changing conditions. Oversight of programmatic and financial performance, however, will ensure that shifting business plans continue to produce products that meet FHC's public purposes in a safe and sound manner.

Structure

The new FHC that HUD proposes, while under the policy direction of the HUD secretary, would be structured to permit it the flexibility to make business decisions in a businesslike environment. In addition to setting programmatic goals, the secretary would oversee major policy issues and approve each year's business plan. The secretary also would be accountable for FHC's bottom-line financial and programmatic performance to both Congress and the president. Day-to-day management, however, would be accomplished by a chief executive officer appointed by the president with the advice and consent of the Senate.

Vandell shares HUD's belief in management by a strong chief executive. However, HUD proposes that the secretary, not a board of directors, should be the policy overseer. The 1994 NAPA report best articulates why, in government, a board of directors is not conducive to effective management:

> Experience has demonstrated that boards are best suited for deliberative functions such as rulemaking, adjudication, and regulation, but rarely do well when called upon to manage complex operations. (p. 25)

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[21] Direct insurance capacity will be especially important for research and development of innovative products, for providing credit in emergencies and natural disasters when effective partnerships cannot be formed quickly enough to meet urgent needs, and in communities and markets where the need is clear but no effective partners are available.

Autonomy and flexibility will be hallmarks of the new FHC. HUD's proposal shares Vandell's premise that, although it is a public entity, a new FHC must have significant autonomy to effectively carry out its work.

New flexibility would derive from many sources. First, dozens of prescriptive statutory insurance programs would be consolidated into a few broad insurance authorities, allowing FHC to develop and modify its product lines to respond to changing market conditions, take advantage of new opportunities, quickly address emerging vulnerabilities, and better achieve its financial and programmatic goals. Fewer statutory prescriptions will mean fewer of the regulations and handbooks that today govern virtually every step of FHA staff and program participants.

Second, the charter would provide more flexibility to hire and train staff and procure resources as business needs dictate, while ensuring fairness and nondiscrimination. Much of the criticism of today's FHA stems from inadequately trained staff and bureaucratic systems that prevent FHA from hiring and reorganizing staff and procuring products and services quickly enough to be a player in housing finance markets.[22]

FHC's staff, though federal employees, would not be covered by certain civil-service pay and classification provisions—similar to the staffs of the bank regulatory agencies. This flexibility would help FHC hire and retain qualified financial and technical experts and rapidly respond to business needs.

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[22] A number of participants in the forums on the future of FHA referred to such problems. The Joint Center report (Apgar and Franklin 1995) summarizes the gist of the comments:

> Current and potential FHA partners . . . —mortgage bankers, conventional and community-based lenders, developers and realtors—depict FHA programs as rigid and cumbersome. They characterize FHA operations as burdened with excessive documentation and reporting requirements, and describe its technology as archaic. In fact, some participants testified they had given up on working with FHA altogether because the protracted delays in processing applications drive project risk to unacceptably high levels. (p. 7)

The fiscal 1994 FHA audit performed by Price Waterhouse (1995) for the HUD Office of the Inspector General specifically notes the ramifications of such problems: "The lack of resources, both personnel and budgetary, prevent HUD from placing adequate resources on loss mitigation functions, properly managing troubled assets, and quickly implementing new automated systems for FHA" (pp. 5–6).

Finally, the charter would give FHC greater flexibility to operate its business with the bottom line, but not prescriptive details, adopted in the federal budget. The president's budget would reflect estimates of the overall performance of a given year's business plan, certified by the OFHEO director to be reasonable; but there would be fewer line items prescribing the program mix. Moreover, a display that clearly illustrated how the funds for FHC's salaries and operating expenses are to be paid from FHC revenues might make it less likely that Congress would put ceilings on these levels for reasons more political than business related.

Of course, for a public-purpose entity, flexibility and autonomy must be balanced by accountability.[23] The new FHC would be even more accountable to Congress than the current FHA. Today, statutory and bureaucratic dictates provide ample excuses for not meeting programmatic and financial goals. The charter act would set a bottom line for performance but provide the flexibility for FHC's managers to determine the best ways to meet or exceed those standards (Retsinas 1995).

Structure: Why an independent agency is not the answer

Political reality

Vandell argues against leaving FHA within HUD by claiming that FHA would remain in the fire of what he terms "dramatic swings in political and ideological intervention that have created much of FHA's trouble in the past." It is naive, however, to assume that severing FHA's connection to HUD would protect FHA from political crosswinds. Vandell offers no evidence to suggest that independent agencies are subject to fewer reversals of course than cabinet departments are. Any organization charged with executing the public's business will—and should—remain subject to public and political scrutiny.

Separation of responsibilities

Vandell appropriately makes the point that the "policy implementation role of allocating subsidies and designating insured classes" should be separated from "efficiently managing each

[23] Flexibility, autonomy, and accountability are basic premises for a revitalized FHA as discussed in the Joint Center report (Apgar and Franklin 1995).

insurance program and pricing premiums at actuarially sound levels." In fact, HUD's FHC proposal is based on this same premise.

However, the problem today is not that both functions are housed in the same cabinet department, but that both—as has been the case for many years now—are handled by the same staff. For example, asset management staff in headquarters and the field have made decisions about subsidy allocations for developments in insurance portfolios that they also personally service. HUD's proposal to set FHC staff apart from other HUD programs, and to require an annual, actuarially sound FHC business plan, would provide the functional separation that Vandell advocates without a severe loss of accountability and responsiveness to national policy.

Accountability

An organization (such as FHA or the new FHC) whose obligations are backed by the full faith and credit of the U.S. Treasury has a unique capacity to expose the taxpayers to risk, and a unique obligation to use that power to serve public ends. It is therefore appropriate that such an entity include the strongest possible mechanisms of public accountability.[24]

At the same time, as Vandell ably demonstrates, running a business efficiently requires some flexibility and freedom from micromanagement of business decisions by other layers of government. I believe that HUD's FHC proposal finds an appropriate balance between these two concerns. The new FHC would be held accountable for achieving the bottom line but would be left to determine how best to achieve those results. This offers the American taxpayers the best of public and private business worlds: a business driven to serve a public mission but flexible enough in its operations to act quickly and cost-effectively in changing market conditions.

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[24] John C. Weicher (1995), senior fellow at the Hudson Institute, discussed government's accountability in a statement before the House Committee on Appropriations, Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Subcommittee. As echoed in his comment in this issue, he said that the government guarantee is FHA's "main asset" and that "The right to commit the full credit of the federal government should remain a responsibility of the federal government, and not be given to private entities or other levels of government which will not have to bear the costs if they make mistakes."

An advocate with a seat at the cabinet table

HUD's proposal calls for the HUD secretary to establish program goals, approve the business plan, and exercise general oversight of FHC policy. As a result, the HUD secretary, and the president, would be accountable to Congress for FHC's performance. Because Congress can only devote attention to so many issues at a time, it is imperative that the executive branch feel that it is accountable for the performance of any agency that is able to incur significant obligations on behalf of the taxpayers.

Equally important is the fact that the HUD secretary would have a stake in the success of the agency and could be a powerful advocate for the agency and its activities. There is no doubt that both Congress and the executive branch are more attentive to cabinet secretaries. In a government in which hundreds of agencies compete for attention and scarce resources, losing the HUD secretary as its representative could harm FHA's ability to serve its public mission.

A coordinated federal housing policy

Access to safe, decent, and affordable housing has been a fundamental goal of federal housing policy since the creation of FHA. HUD is the cabinet agency charged with pursuing this national objective, and FHA is one of the nation's most powerful tools for accomplishing that end. To remove FHA from HUD's toolbox would be to deny HUD the tools to do its job. It also would increase the likelihood of inconsistent—and even counterproductive—policy efforts from different sectors of government.

Why private ownership is not the answer

Vandell argues convincingly about the continued need for a government role in housing finance, so I am puzzled by his comment that a GSE or privatized version of FHA could prove more efficient. While I would not dispute that the private sector can sometimes operate more efficiently than government, FHA's most valuable asset—the full faith and credit of the U.S. Treasury—would be lost with private ownership.

Its status as a public entity allows FHA to do work that the private sector cannot or will not do. A privately owned FHA would entail returns on investment for shareholders, higher reserve levels, higher costs of capital, and taxation. These higher

costs would easily overwhelm any greater efficiencies and would ensure that FHA would perform no greater public purpose than the private sector performs today. Instead, HUD plans to find ways to take advantage of the strengths of both the public and the private sectors, by pairing FHA's credit enhancement with the most efficient services and delivery systems of private partners.[25]

Some have argued that private mortgage insurers now offer lower down payment products that diminish the need for FHA's single-family programs. I do not agree. Even in those limited circumstances in which the conventional market has begun to serve borrowers with similar loan-to-value ratios or payment-to-income ratios, FHA borrowers differ in other ways from those typically approved by private mortgage insurers. Factors such as type of housing market and neighborhood location, relative income and loan size, household demographics and minority status, and personal credit histories disqualify many FHA-eligible buyers from private mortgage insurance (PMI) approval (Bunce et al. 1995). As Vandell argued, there is a need for FHA's involvement in the market; that need would not be met if FHA were privatized.

Why an assigned risk pool is not the answer

Vandell proposes an assigned risk pool structure for FHA. And while it is based on the concepts of partnerships and harnessing the power of the private sector to serve FHA's public mission—which I support—I do not believe that assigned risk is a practical or politically feasible structure for accomplishing that mission.

Specifically, Vandell's proposal would replace FHA's backing by the full faith and credit of the U.S. government with a system of cross-subsidies that, under his fully private model, would enable the PMI industry to serve all currently insured borrowers, including FHA borrowers.[26]

There are three major problems with Vandell's proposal. First, the loss of the full faith and credit guarantee immediately raises the cost of mortgage insurance for FHA borrowers, thereby

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[25] The same point is made by Van Order and Gates (1995).

[26] Loans that are currently not profitable for private mortgage insurers (i.e., loans to most of FHA's current borrowers) would be subsidized through higher charges to currently profitable loans (i.e., loans to current PMI borrowers).

negating any efficiency advantages of privatization.[27] Second, the added charge that current PMI borrowers would pay to subsidize FHA's current borrowers would be in effect a tax on PMI borrowers. A new tax on middle-income homeowners is not politically feasible. Finally, the number of borrowers needing the subsidy would be approximately the same as the number paying the extra charge, making this proposal impractical.[28] The assigned risk pools that have been used to finance auto liability insurance, for example, are based on a far smaller proportion of high-risk to low-risk insured.

Perhaps Vandell is led to the idea of privatization by his concern about the inefficiency of cross-subsidization. However, I feel that he places too much emphasis on the role that cross-subsidization plays in FHA's portfolio. With the cost advantages deriving from its full faith and credit backing, FHA can provide mortgage insurance to higher risk borrowers that the private sector cannot afford to insure. It is primarily this advantage—not cross-subsidization from lower risk borrowers—that allows FHA to serve many of the borrowers in its portfolio that the private sector will not serve.[29] A privatized FHA would have no such advantage.

Conclusion

Any future FHA can only be improved by the amount and caliber of debate that has gone into its formation. Months of tough scrutiny, and listening to the ideas—and the frustrations—of FHA's many constituencies, have provided the information and insights on which HUD has based its proposal for a new FHC.

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[27] That is, a private insurer, upon taking over an FHA loan, has additional costs, such as paying investors a risk-adjusted return on equity held as capital. Some of these costs might be offset by a private insurer's greater efficiency in loan origination and servicing. However, since FHA already relies extensively on the private sector for loan origination and servicing, the offset is unlikely to be as great as the added costs.

[28] FHA and the PMI industry have served approximately the same number of borrowers in recent years, and most of FHA's current loans pose too much credit risk for private insurers to serve them profitably (see Bunce et al. 1995).

[29] FHA does rely on reserves built up during good economic conditions to weather losses it may incur when it continues to serve borrowers who pose higher risks during economic downturns, while the private sector retreats. In that sense, FHA borrowers during good times do cross-subsidize FHA borrowers in recessions, but all homeowners benefit from the economic results of FHA's countercyclical role in the market.

It is true that Vandell and I differ on specifics. I believe that FHC should remain within HUD, for a number of reasons related to good policy. Furthermore, Vandell's concern about conflicting roles in a HUD-overseen FHA has been addressed in the proposed FHC structure. I also believe that privatization of FHA would be disastrous, since it would take away FHA's most valuable asset—the full faith and credit of the U.S. Treasury.

It is most important, however, that Vandell and I share so much common ground in terms of the thinking behind a new FHA: that there is a role for government in carrying out FHA's work and that FHA needs autonomy to be effective. The dialogue on the future of FHA will remain lively, no doubt, and establishing common ground is a measure of progress. Throughout the process, however, we cannot lose sight of the point that this nation's families depend on FHA, now and in years to come.

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