

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

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Thanks to the 1994 election and the Clinton administration's reaction to it, the future of the Federal Housing Administration (FHA) is again a public policy issue. The administration has proposed a major reorganization of FHA as part of its larger proposal to "reinvent" the U.S. Department of Housing and Urban Development (HUD); this proposal has provided the impetus for the current political debates. It has also provided the impetus for Kerry Vandell's article, and for these comments, which set forth my own view of FHA's role and its problems. Where appropriate, I discuss specifically both the administration's proposals and Vandell's article.

Both Vandell and the administration devote most of their attention to structural issues. In my view, the structure of FHA is less important than its programs, and both should be determined by its basic public policy purposes. I discuss FHA's purpose, its functions, and its structure in turn, as separate issues, before concluding with a consideration of their interrelationships.

Purpose of FHA

Promoting homeownership

FHA is a federal government agency created to serve a public purpose. Its original and continuing primary purpose is to promote homeownership, on the grounds that homeowners are better citizens because they have a stake in the society.

FHA has employed two methods of promoting homeownership. The first is to popularize mortgage market innovations: the long-term, fixed-rate, level-payment, low-down-payment, self-amortizing mortgage, which was not the predominant mortgage instrument in the 1930s; the mortgage-backed security (through the Government National Mortgage Association [GNMA]) in

the 1970s; and other mortgage instruments such as the graduated-payment mortgage in the 1970s and the home equity conversion mortgage in the 1990s.

The second is to insure mortgages that are riskier than the ones private lenders can afford to offer or private mortgage insurers can afford to insure. Insuring such mortgages became FHA's predominant role once the viability of the FHA mortgage was clearly established in the 1940s. FHA has focused on serving young, moderate-income families who are seeking to buy their first homes.

As a government agency, FHA is in a position to take risks that private entities cannot and to demonstrate the viability of various innovations. Its actions reflect its status and mission.

FHA has been concerned with two issues in achieving its primary purpose: (1) facilitating the flow of mortgage credit to "underserved" areas (originally growing regions of the country such as the West, more recently rural areas and lower income or minority neighborhoods in central cities) and (2) providing a source of mortgage finance during cyclical downturns. These concerns might be characterized as smoothing out the flow of mortgage credit over time and space.

It is important to recognize that *FHA is* a government agency and that it exists to serve a public purpose. It is not a profit-maximizing private firm, nor is it supposed to leverage its status in the federal government to compete with private insurers or other entities in areas of the market that they now serve effectively.

But FHA is supposed to serve its part of the market without losing money. By statute, the FHA single-family Mutual Mortgage Insurance (MMI) Fund is supposed to operate on an actuarially sound basis. Because it is a federal government agency, with the backing of the federal government, FHA should be able to take risks that private entities cannot take and still cover its costs. This is true even though government agencies are seldom as efficient as private firms. If FHA cannot take risks beyond those that private entities can take, it has no real public purpose. Exactly what risks those are will vary from time to time. FHA is thus always having to strike a balance between its public purpose and its safety and soundness, to determine whether it can take a little more risk or should be a little more cautious. These are marginal decisions, made within the broad context of FHA's role, as determined by statute, of promoting

homeownership for those not served by the private sector and of covering its costs while doing so.

FHA as a business

Neither the administration nor Vandell has this view of FHA. FHA officials have spoken of it as "a Fortune 500 company" and have expressed concerns about FHA's diminishing market share (Engel 1995; Retsinas 1995). FHA is not supposed to be maximizing market share but rather serving the part of the market that is not served by the private sector. With the full faith and credit of the federal government standing behind FHA, it could offer mortgage insurance at lower cost than any private company. It would have to operate as efficiently as private insurers do to drive them out of business, and that might not prove easy for a government entity, but its cost advantage would give it a price advantage over the private insurers. Maximizing FHA's market share at the expense of private insurers has never been public policy in the United States and is one reason FHA has been subject to maximum mortgage limits.

Vandell's view of FHA appears to be similar to the administration's, though his discussion is not fully consistent. He describes FHA as "a mortgage insurance business" and frequently refers to FHA's insurance mission as its basic mission, which should not be "muddied" with extraneous social policy goals. He refers disparagingly to the "overlay of a heavy social agenda" and a "broader redistributive urban agenda" that "submerged" FHA's basic mission. Diminution of FHA's market share is mentioned in negative terms. At one point, Vandell does state that the major rationale for FHA home mortgage insurance is to serve "the lower income, inner-city, minority, and first-time homeowner segment of the market," but elsewhere he characterizes the targeting of insurance to these groups as a social policy mandate that complicates "the simple mission of providing mortgage insurance" and also as a "supplemental mission." The weight of his remarks indicates that he sees FHA mainly as a business rather than a government agency with a public purpose.

Perhaps most significantly, Vandell believes that FHA should be independent of government "intervention" and protected against political shifts that "depart considerably from the status quo," mentioning specifically the early 1970s and early 1980s. This notion of independence from public policy is relevant for private

firms, but it is surely naive, as well as inappropriate, for a government agency with the full faith and credit of the U.S. government behind it. Why should any government program be invulnerable to changes in political sentiment? No president and no Congress have ever had the right to bind their successors, nor should they. Vandell has every right to criticize the policies of the Nixon and Reagan administrations, but they were elected by the voters of the United States to make policy, and he was not. For that matter, both were reelected after making the changes he objects to.

Other goals: Multifamily housing and subsidies

I have stressed FHA's single-family home mortgage insurance because that is by far its largest program and was its original *raison d'être*. Its multifamily mortgage insurance programs do not have a very clear purpose and are small, both as a share of FHA's portfolio and as a share of the multifamily mortgage market. Its subsidy programs did have a clear public purpose—to provide decent housing for poor households that could not afford it—but they did not achieve that purpose efficiently; all of them have been terminated, and administrations of both parties have deemed them inferior to tenant-based assistance (housing vouchers and certificates) as a method of providing housing assistance to the poor.¹

But these programs have been and remain extremely important contributors to HUD's problems, including its public image. The subsidy programs pose the most complicated policy issues and are the most difficult to manage, and the worst managed, within HUD. These are the programs that occasionally turn up on the front pages of the newspapers and in congressional hearings as prime examples of fraud, waste, and abuse.

The multifamily housing and subsidy programs and their purposes should be analyzed separately from FHA's basic goal and its home mortgage program if FHA's problems are to be clearly understood. Because much of the public discussion of HUD does not distinguish among the programs, it blames all FHA programs for problems that are specific to the multifamily and subsidy programs.

¹ These programs include Section 221(d)(3) Below-Market Interest Rate (BMIR), Section 236, and Section 8 New Construction.

FHA's effectiveness

Single-family mortgage insurance

FHA fulfills its basic purpose of promoting homeownership reasonably well. At present more than 5 million homeowners have FHA insurance, and about 800,000 more buy homes with FHA-insured mortgages each year. The insurance premiums cover the costs of foreclosures and claims. The MMI Fund has a positive net worth, calculated by Price Waterhouse at \$4.5 billion at the end of 1993. And thanks to reforms proposed by HUD secretary Jack Kemp and President Bush and enacted by Congress in 1990, the fund is moving toward an actuarially sound status.

FHA could be better targeted by limiting it to first-time home buyers and lower income home buyers (e.g., those in the lower half of the income distribution). The current policy of allowing families with incomes of up to \$80,000 to qualify for FHA insurance is a far cry from serving families who cannot be served by the private sector.² But FHA does serve a market of young, moderate-income families who are not served effectively by the private sector, and FHA serves that market without losing money.

To be clear, the fact that FHA does not lose money on its home mortgage insurance is not a justification for its existence; the justification is that it serves a public purpose. Serving that purpose without losing money is an indication that the FHA home mortgage insurance program works reasonably well—not perfectly, but reasonably well.

It is useful to keep that fact in mind when considering the various proposals to reinvent or reform FHA. FHA's biggest program is now serving FHA's basic purpose effectively.

Multifamily mortgage insurance

By contrast, the multifamily insurance programs do not work very well. The insurance premiums do not cover the costs; the programs require annual appropriations to cover losses. This has

² The \$80,000 figure is derived by calculating the price of a house that can be purchased at the FHA ceiling with a minimum down payment and then applying FHA underwriting criteria to calculate the income. FHA of course has no income limit for mortgagors.

been true for more than 20 years.³ FHA has had to establish a \$10 billion reserve for future losses against an outstanding portfolio of \$44 billion. The losses are continuing: The 1996 budget includes a 7 percent subsidy rate for multifamily insurance on average, meaning that losses are projected at 7 cents on every dollar of multifamily insurance, in addition to the 5-cent insurance premium. That projected loss will require an appropriation of \$188 million in fiscal 1996.⁴ Subsidies on individual programs vary widely; some are projected to cover their losses, while others are projected to lose up to 12 cents per dollar of insurance (and in the case of one small program, 27 cents).⁵

Mortgages on multifamily projects are difficult to underwrite and insure—and not just for FHA. Freddie Mac lost money on its multifamily mortgage purchases in the late 1980s and early 1990s and discontinued its program. Every multifamily project is unique and has to be analyzed carefully, which is very staff intensive.

Also, because multifamily insurance is difficult to underwrite, it is prone to abuse. There have been scandals in FHA multifamily insurance, going back to the Section 608 program in the 1940s. The scandals typically involve fraudulent underwriting: inflating the estimated project costs so that developers are able to obtain insurance for more than the value of the project. Developers can thus avoid committing any money of their own and walk away with a profit even if the project is a complete fiasco.

FHA has about eight times as much single-family mortgage insurance in force as multifamily insurance. However, FHA's staff is split about 52 to 48 percent between single-family and multifamily insurance. Multifamily insurance takes a vastly disproportionate share of the staff time and resources, including the central management of the department, and even then FHA

³ Whether losses were contemplated at the time the programs were enacted is a much-discussed question. Section 207 was supposed to be actuarially sound, like Section 203. For the low-income subsidy programs, the policy based on actuarial soundness was replaced by one based on "acceptable risk," but the term was not defined legislatively, and its significance was debated by contemporaries. Semer et al. (1976, 70–71) assert that "Congress did not intend to authorize the issuance of unsound loans."

⁴ This figure is calculated as the present value of the projected streams of insurance premiums, losses on claims, and revenues from the sale of foreclosed properties.

⁵ This program is Section 221(d)(3)/Section 223(d). These subsidy rates are from the Office of Management and Budget (1995, tables 2, 4, and 6).

loses money on it—it still costs the taxpayers substantial amounts.

FHA does not serve a particularly large share of the multifamily housing market—less than 10 percent in each year since at least 1980 and typically less than 5 percent. In 1994 FHA insured about 7 percent of all multifamily mortgage originations (\$2.2 billion out of \$31 billion) and about 8 percent of all new apartments (13,000 out of 155,000).⁶ FHA multifamily insurance is a small program for all the headaches it causes at HUD.

Subsidized projects

The problems with multifamily insurance are compounded when the projects are designed for low-income tenants and HUD is subsidizing the project as well as insuring the mortgage. About three-quarters of FHA multifamily insurance falls into this category (known as the “insured assisted inventory”). This insurance was issued under three successive programs, each created and then terminated within a few years: Section 221(d)(3) Below-Market Interest Rate (enacted 1961, repealed 1968), followed by Section 236 (enacted 1968, repealed 1974), followed by Section 8 New Construction (enacted 1974, repealed 1983). Successive Congresses and administrations—of both parties—have never been satisfied with either the cost or the quality of the housing produced under these programs. The programs are therefore terminated and replaced—a rare event for any government program and one that vividly demonstrates the problems.

In these programs, HUD's role as insurer has always gotten in the way of its role as provider of subsidies for decent housing, and vice versa. There was pressure to underwrite these projects generously “to make the program work” (a phrase used routinely at HUD). Then there was pressure to provide generous subsidies to support the mortgages. Even with generous subsidies, many projects got into financial difficulties within a few years; the project-based subsidies were not enough to support the project, or the landlord was unable to manage the project efficiently. When projects have trouble, HUD makes strong efforts to avoid foreclosure, which would be an admission of failure.

The alternative is to provide additional subsidies. HUD's role as insurer therefore forces it into a role as continuing provider of

⁶ These data, from the HUD Office of Policy Development and Research (1995), exclude congregate facilities and nursing homes; FHA insured \$700 million of such facilities in 1994.

subsidies, in programs such as Flexible Subsidy and the Troubled Projects Program. The subsidies take various forms, including lump-sum payments for repairs or mortgage write-downs, and annual payments to supplement the tenants' rent. These subsidy programs have been in existence for more than 15 years, without restoring the solvency of many projects.

The additional subsidies create new difficulties. Determining how much subsidy is needed poses the same kind of underwriting problems as the original insurance commitment. It is hard to limit the subsidies to exactly the amount needed to keep the project operating and not give the owners a windfall profit. Project owners therefore try to influence the allocation of subsidies, often with the help of well-placed "consultants," as in the Section 8 Mod Rehab program in the late 1980s, in which subsidies from HUD were combined with the low-income housing tax credit. Scandals are especially likely when subsidies are piled on top of each other. Thus these programs invite abuse.

FHA insurance also makes it hard for HUD to enforce the contractual responsibilities of the project owners, because they always have the option of defaulting and forcing HUD to take over the project, which it does not want to do. Ultimately, FHA insurance makes HUD the slumlord of last resort for the worst projects.

For these good reasons, there were no programs combining insurance and subsidies between 1983 and 1990. But although the programs have been terminated and no new projects have been built in a decade, the problems they have created live on. Among other consequences, there is still about \$24 billion of FHA insurance outstanding on subsidized projects. And these projects create many of FHA's continuing problems and contribute substantially to the perception that it needs reform.⁷

Reforming FHA's programs

Given this history, one might reform FHA by terminating multifamily insurance while keeping the single-family program in place. That would enable FHA to concentrate on what it does

⁷ While this discussion addresses only the problems of combining insurance and subsidy in multifamily housing, similar problems exist in single-family insurance programs for subsidized homeownership, such as Section 235. The combination of subsidy and insurance does not work well for rental housing or for homeowners.

well and serve its basic public purpose effectively, without the distractions of the complicated multifamily programs that take much more than their share of FHA's resources. Above all, FHA should stay out of the business of combining insurance with subsidies, which has turned out again and again to be a tempting quagmire. Neither Vandell nor the administration recommends this approach, however.

Vandell favors continuing all three types of programs, although his brief discussion of "subsidized mortgage insurance programs" does not clearly identify which programs should be continued or revived (the largest subsidy programs were all terminated many years ago), and he does not discuss specific subsidy programs except in the context of their implications for the operation of FHA. He proposes to continue FHA's unsubsidized multifamily programs, on the grounds that the federal government is "ideally suited" to obtain the information to "permit efficient pricing"—surely an optimistic view after a quarter century of steady losses and a half century of problems. Vandell's suggested system of insurance premium subsidies to cover the losses on these programs appears to be essentially the same as the current system of appropriating funds for expected losses required by the federal credit reform enacted in 1990.⁸

The administration's position has been much more fully articulated. It is perverse, in terms of FHA's experience. FHA would stop doing what it does well and go on doing what it does badly. Multifamily insurance would continue unabated and unreformed. Moreover, the combination of insurance and subsidy would be encouraged; state and local governments would be invited to use FHA insurance in combination with the Affordable Housing Fund (successor to the HOME block grant created in 1990) to build housing for lower income families. Once insured, these subsidized projects would be candidates for future federal subsidies, and the dreary cycle of past insured assisted programs would probably be repeated.

At the same time, the administration wants to fix FHA home mortgage insurance, which is not broken. Full insurance of whole mortgages would be supplemented and perhaps superseded by risk-sharing arrangements with nonfederal entities and by wholesaling of mortgage credit.

⁸ Like Vandell, I follow the conventional terminology of referring to these programs as "unsubsidized," although as noted above there is a subsidy in most of these programs because the losses exceed the premium income and the federal government makes up the difference through congressional appropriations.

The history of risk-sharing arrangements is not encouraging. In the 1980s FHA created a coinsurance program for mortgages on rental properties similar to what the administration now proposes for single-family loans. FHA shared insurance premiums and risks with private lenders, letting them do the underwriting. When defaults occurred, it turned out that the lenders had no capital to meet their share of the losses, and HUD wound up taking the full loss. Multifamily coinsurance has been one of its costliest failures ever—a “disaster,” as Vandell notes.

The administration seems to envision state housing agencies as major partners in the new risk-sharing arrangements. State agencies have more capital than the private lenders did, but splitting the risk is still an issue for them. The agencies have always wanted the federal government to take the full risk in any partnership with HUD. When HUD made a similar proposal in last year’s housing bill, the House of Representatives wanted to limit FHA’s risk exposure on each mortgage to 35 percent of the original amount borrowed, which is close to FHA’s average loss on a defaulted mortgage, but the state agencies said the 35 percent limitation would destroy the program. Fortunately, Congress did not pass either version.

This experience brings out the basic issue in any joint insurance scheme: Who has the right to commit the full credit of the federal government? Should it remain a responsibility only of the federal government, or should it be given to private entities or other levels of government that will not have to bear the costs if they make mistakes?

Even if some degree of risk sharing is legislated, large units of government can still go bankrupt, as Orange County is now demonstrating, and nobody’s pockets are as deep as the federal government’s.

Moreover, virtually all FHA mortgages are sold to investors in the form of securities issued by GNMA, which guarantees the timely payment of principal and interest even if the homeowner defaults, and which therefore has to make up for any delay by the nonfederal participant in meeting its obligations. GNMA and FHA had to make good the losses in the multifamily coinsurance program. The reinvention plan explicitly raises the possibility that GNMA would participate in risk-sharing arrangements and proposes to transfer GNMA’s reserves to FHA, putting GNMA’s ability to honor its commitments at risk.

Vandell recommends caution in implementing any partnerships between FHA and the private sector; the partnerships should start as carefully designed small-scale demonstrations. This prudence is commendable, but I believe that enough demonstrations have already occurred, and their record is clear: FHA has demonstrated that joint insurance is a fine way to lose money. The taxpayer is better served when the federal government alone can commit its full faith and credit and bears the consequences of its mistakes. The likely outcome of the administration's reinvention of FHA is that HUD would continue to bear all the cost but with less premium income. Both the losses and the lower premium income would show up in the current year's budget. Home buyers could pay higher mortgage rates as well, if the capital markets conclude that joint insurance dilutes the federal guarantee, because the federal government does not formally promise to pay all claims up to 100 percent of the mortgage balance.

Structural problems and proposals

Both Vandell and the administration advocate drastic change in the organization of FHA and its role within the federal government. Their specific recommendations are different, but both are ultimately based on a similar misreading of FHA's history.

The golden age of FHA and the 1970 reorganization

Vandell devotes nearly half his article to the history of FHA. This detailed and explicit discussion is useful because it brings out clearly the underpinnings of his argument for changing the structure of FHA, and much of it is relevant to the Clinton administration's rationale for reorganization as well.

Vandell has a rather romantic view of FHA as uniformly successful in the halcyon days before it was forced to become part of HUD—a kind of golden age. He blames the 1970 HUD reorganization implemented by Secretary George Romney for many of FHA's 1995 problems and the administration of Secretary Samuel Pierce in the 1980s for others. As someone who did not serve in either of those administrations but came to HUD immediately after both of them, I have a different sense of their significance. I also have a different view of FHA in its pre-HUD incarnation.

FHA's problems long antedated the creation of HUD. Once it had demonstrated the viability of the FHA mortgage and mortgage insurance, FHA began to lose market share in the home mortgage market to conventional lenders such as savings and loan associations and to the private mortgage insurers. This loss was only to be expected and was fully consistent with FHA's basic purpose. Vandell's data in his table 2 show that FHA's share began declining right after World War II, and while this decline may initially have been partly due to the Veterans Administration (VA) program, by the early 1950s there was a clear and recognized downward trend. The only upward blips came in the early 1970s, during the heyday of Section 235 (which was also during the Romney reorganization); in the late 1980s; and during some recession years. Contemporary research concluded that the decline was due primarily to the growth of private mortgage insurance (see Kaserman 1977). It was neither exacerbated nor mitigated by the creation of HUD or the 1970 reorganization.

In the multifamily and subsidized programs, FHA's experience was far from satisfactory. The Section 608 multifamily insurance program generated major scandals in the years immediately after World War II and set a pattern for subsequent scandals.⁹

FHA had also had its first negative experience with programs combining insurance and subsidy, in the Section 221(d)(3)(BMIR) multifamily program. The program was expensive—more so in budget terms than in reality, but still expensive enough in reality—and it did not serve low-income families.¹⁰ It was terminated after seven years.

Contemporaries viewed FHA as something other than a smoothly running agency. Robert Weaver, the last administrator of the Housing and Home Finance Agency (HHFA) as well as the first secretary of HUD, referred to HHFA as “an administrative monstrosity” (“Time for Federal Housecleaning” 1966). This is the same HHFA that Vandell praises because FHA could operate independently within it.

⁹ See Mayer (1978, chap. 6) for a vivid discussion of Section 608.

¹⁰ The subsidy took the form of a mortgage write-down. FHA insured a project mortgage that carried a below-market interest rate and then bought the mortgage at par (e.g., 5 percent) and sold it at whatever price would yield investors the market rate (e.g., 8 percent). The full value of the mortgage when purchased by FHA was counted as a budget outlay under the budgeting rules of the time. See the National Commission on Urban Problems (1969) for a critique of Section 221(d)(3)(BMIR), including data showing that the program did not serve low-income families but rather those “at the higher end of the moderate income range.”

It is in this context that the HUD reorganization of 1970 occurred. Vandell quotes only one source on the reorganization, an FHA official who strongly opposed it at the time, was on the losing side, and left the agency in 1973. He ignores its purposes and accomplishments. A major purpose was to consolidate the location of field offices for different HUD programs so that state and particularly local officials could work with one field staff in one office in implementing their own housing and urban initiatives—something that is now fashionable under the rubric of “one-stop shopping.” Before the reorganization, state and local officials had to go to several different locations, some quite distant, and could not resolve interprogram complications except in Washington. The reorganization also was intended to facilitate an integrated approach to urban problems, on both the federal and the local levels.¹¹

Following his source, Vandell attributes 8 or 10 problems at FHA—virtually everything significant that happened for several years after 1970—to the reorganization. (He does mention “other events” but gives them very little attention.) This is the fallacy of *post hoc, ergo propter hoc*. It is highly unlikely that an independent FHA would have been exempted from discrimination and affirmative action requirements, either by legislation or by judicial decision. Nor would it have been exempted from the National Environmental Protection Act, which applied to “major federal actions,” not to specific agencies.

Vandell also asserts that the administration was not committed to the success of the new subsidy programs created in 1968 (Sections 235 and 236). This is simply wrong. It was clear at the time that Secretary Romney tried very vigorously to make the new programs work, and indeed HUD subsidized more than 200,000 FHA-insured units per year from 1970 through 1972 and another 100,000 public housing units—records that have rarely been matched. These subsidies resulted in a dramatic expansion of FHA activity, as Vandell's table 2 shows: The years of what he characterizes as political opposition by the administration to categorical subsidized housing programs were in fact years of extraordinary production of subsidized housing and FHA activity. FHA's peak year for both single-family and multifamily insurance volume was 1971, which does not suggest either that it lacked commitment to the new programs or that it was

¹¹ For a brief discussion of the 1970 reorganization and subsequent administrative changes, see Orlebeke (1978).

hamstrung by the reorganization (see HUD 1980).¹² Its market share in 1970 and 1971 reached levels not seen since the Korean War, if not World War II—at a time when housing production was setting all-time records. The annual data in Vandell's table 2 are much better indicators of FHA activity than the figures for a single week he cites in table 5.

Given the unusual volume of FHA activity in the early 1970s, it is not surprising that processing times slowed. At the same time, the data on losses in Vandell's table 7 suggest that rapid processing is not necessarily optimal. The usual pattern of defaults shows a peak three or four years after the endorsement year, so the high postreorganization losses in 1973 probably were incurred predominantly on properties underwritten in the pre-reorganization years of 1969 and 1970, when 95 percent were processed in five days or less.

Secretary Romney's efforts to make the new subsidy programs work also revealed their flaws, which he recognized before leaving office, as did many members of Congress in both parties. These were structural flaws, such as higher subsidies for households with higher incomes and higher out-of-pocket housing costs for households when their income declined.¹³ They were not problems arising from the reorganization.

In focusing so much on the 1970 reorganization and its critics at the time, Vandell ignores subsequent reorganizations and other administrative changes, most notably Secretary Patricia Harris's decision to strengthen the authority of the assistant secretaries (including the FHA commissioner) over the program field staff, at the expense of regional and area office directors—substantially reversing the 1970 reorganization.

In the 1980s, HUD was certainly not well managed, as Vandell points out. But it is important to remember that nearly all the management problems and all the scandals Vandell cites occurred in the multifamily programs, as did the reduction in HUD's budget authority.¹⁴ The reduction occurred mainly

¹² The single-family volume was not exceeded until 1975; the multifamily volume has never been exceeded.

¹³ For a full discussion of the problems with Sections 235 and 236 in particular, see National Housing Policy Review (1974, chap. 4).

¹⁴ The best known single-family scandal involved "Robin HUD," a private escrow agent employed by HUD who was able to keep the sales proceeds when HUD-owned homes were sold instead of sending them to the agency, taking

because 15-year and 30-year commitments for subsidized projects were replaced with 5-year certificates and vouchers. The money for all 15 or 30 years had to be authorized in the budget for the year the projects were approved. HUD's actual outlays, on subsidized housing and in toto, increased steadily during the 1980s (Congressional Budget Office 1994, app. A).¹⁵

Vandell states that FHA's single-family programs stagnated under Secretary Pierce because of policy decisions to target lower income buyers. This is not borne out by the data in his table 2. From 1973 through 1980, FHA's annual share of single-family insured mortgages (including those by the VA and private mortgage insurers) was 27.1 percent; from 1981 through 1985, its share was 28.9 percent. Dollar volume data before and after 1980 are only reported relative to VA and the private insurers. From 1973 to 1980, FHA's share in terms of dollar volume was 23.2 percent; from 1981 through 1985, it was 24.8 percent.¹⁶

Policy changes during these years also do not bear out Vandell's characterization of the administration's attitude. Lowering the minimum down payment, though perhaps not a prudent act, was hardly indicative of "active hostility" toward HUD's mission. Nor for that matter was the 1986 creation of the previously mentioned multifamily coinsurance program the act of an administration hostile to housing.

advantage of flaws in FHA's information systems. The Robin HUD scandal was spectacular, but the problems in the information systems were remedied once her actions were discovered in 1989. The \$7 million she was able to steal was not a large share of the total cost of FHA scandals at the time, unfortunately; the multifamily scandals were much more important.

¹⁵ HUD budget figures show a decline in outlays from 1985 to 1986 because HUD spent \$14 billion in 1985 to pay for the cost of building the public housing projects that had been constructed since 1974; the projects had been financed with short-term debt while the government waited for long-term interest rates to come down. In addition, and more relevant to the subject of FHA, outlays in 1986 fell because HUD's income from FHA mortgage insurance premiums and GNMA guarantee fees rose by \$2.5 billion; these payments are treated as offsetting receipts in the budget and reduce the recorded total of agency outlays.

¹⁶ FHA's annual share of single-family mortgages is not reported on a consistent basis. For 1978 and earlier years, it is reported for new loans only; for 1980 and later years, it is reported for all loans. Taken at face value, the data show no decline. From 1973 to 1978, FHA's share was 8.4 percent on average; from 1981 through 1985, its share was also 8.4 percent; and it rose after 1985. (Including 1980 with previous years raises the average to 8.7 percent.) Vandell does not report data for 1979.

Certainly the management of FHA could be improved; it lags behind other program offices in HUD. Currently, HUD's most severe management problems and administrative shortcomings are in FHA. The most serious is that it does not have an adequate accounting and budgeting system for Section 8 projects. FHA does not know how much it should now be paying in rent subsidies to project owners. This problem affects both the amounts HUD is now paying each year (subsidies are based on household income) and its ability to forecast what it should be paying in the future. It was identified as HUD's "number one material weakness" in the last administration, and a major effort was begun to create an adequate system. Of necessity, the development of the system has carried forward into the present administration; after two years, the HUD Office of the Inspector General (1994, 5) reported that "progress is slow." Until the system is in place, FHA's inability to budget and account for Section 8 project subsidies is costing the taxpayers hundreds of millions of dollars per year. Indeed, the entire program area of FHA multifamily insurance has serious management problems; other major information systems under development are described as progressing still more slowly than the Section 8 system. In a hearing before the House Oversight Subcommittee last year, senior FHA officials acknowledged that they did not have adequate information about the physical condition of Section 8 projects and could not say which ones needed major repairs (U.S. House Committee on Government Operations 1994).

These problems do not reflect a hostility to HUD's mission or its programs, however, but rather an unwillingness to devote resources to the sustained management of complicated programs. That unwillingness did not arise when FHA was incorporated into HUD, and it will not automatically disappear if FHA is turned into an independent agency.

This history is relevant today because it is employed as evidence for what structural changes should now be made in FHA. As with most golden ages, the past is interesting not for its own sake but to buttress a proposal for the future. Vandell argues that FHA should be an independent federal agency once again. HUD's role would be to allocate subsidies to an independent FHA, which would manage the programs on an actuarially sound basis. Vandell offers no discussion of how coordination of subsidy and insurance will be easier when it involves two separate federal agencies instead of two offices within FHA; issues that are now resolved by the FHA commissioner would have to be resolved by the president. Even more fundamentally, there were scandals and program failures at FHA before it was part of

HUD, and there is no magic in re-creating an independent FHA to prevent scandals and failures in the future.¹⁷

The concept of a Federal Housing Corporation

The Clinton administration's proposal is less of a change on paper but perhaps essentially the same in substance. Certainly it raises the same concerns. FHA would become a government-owned corporation within HUD. This change would allow it to pay its employees more than the federal scale. In the administration's expectation, it would become a "streamlined, market-driven" corporation (HUD 1994, 14). These words are appealing, but such a status will not make FHA run any better if it is doing the same things in the future that it has done badly in the past. An FHA that continues its multifamily insurance programs on the same basis, and that offers to insure subsidized projects built with federal funds, will continue to do the same things that have caused most of its problems. Creating a Federal Housing Corporation (FHC) instead of a Federal Housing Administration is likely to be no more effective than reconstituting FHA as an independent agency in addressing the problems. The Postal Service, after all, is a government-owned corporation, but it is neither streamlined nor market driven.

Indeed, some of the specific changes invite new problems. Although FHA (or FHC) would remain within HUD, the secretary would lose some authority over it. The secretary would still be responsible for policy direction and performance oversight but not for monitoring financial safety and soundness, which would be the responsibility of the Office of Federal Housing Enforcement and Oversight (OFHEO), an entity created in 1992 to evaluate the safety and soundness of the two housing-related government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac.

Giving this new regulatory responsibility to OFHEO is an odd arrangement. The only agencies with demonstrated ability to monitor FHA are HUD and the Office of Management and Budget. Under this plan, both would lose their authority. OFHEO itself has yet to promulgate the standards by which it will assess FHA and is several months behind the legislatively

¹⁷ While I have criticized Vandell's recommendations for the structure of FHA, it is worth noting that I agree with his analysis of several important issues, especially the difficulties of cross-subsidization and the merits of full federal insurance to protect against catastrophic losses.

mandated schedule for doing so.¹⁸ It is not surprising that a new agency would get behind schedule, but it is surprising that the authority to evaluate the soundness of a federal agency with \$500 billion of government commitments would be given to an untested regulator.

Regulation would be further complicated if OFHEO were moved from HUD to the Treasury Department, as some members of Congress have proposed (e.g., Bond 1995).¹⁹ OFHEO is now within HUD but effectively independent of the secretary. If it were moved, responsibility for FHA would be split between HUD and Treasury. Such an arrangement is likely to lead to either the effective independence of FHA—the pre-1965 status—or its subordination to Treasury.

Other structural arrangements and their functional implications

The organizational forms favored by Vandell and the administration both are based on FHA's continuing to enjoy the full faith and credit of the federal government so that lenders are assured that FHA can pay its insurance claims. The key issue in any reorganization is the future status of that federal commitment. If the federal government is not going to continue that guarantee, several other futures for FHA are possible. It is useful to consider the implications of some of these options for FHA's ability to provide mortgage insurance:

1. FHA could be established as a quasi-governmental entity or GSE along the lines of Fannie Mae and Freddie Mac. These firms do not have the full faith and credit of the federal government explicitly behind them, but they have federal charters and various privileges such as the ability to borrow from the U.S. Treasury in an emergency and exemption from state and local income taxes, and the financial markets certainly expect that the government will not let them fail. A government-sponsored FHA could have the same sort of

¹⁸ The risk-based capital standards were due in November 1994. It should be noted that OFHEO has started the process of developing the capital standards and has engaged in other regulatory activities.

¹⁹ See also the Federal Housing Reform and Local Empowerment Act, which would abolish HUD; it has been proposed by a task force of first-term Republican representatives under the leadership of Sam Brownback (R-KS) and Sue Myrick (R-NC) and supported by Senate Majority Leader Bob Dole (R-KS) and a Senate task force appointed by him.

privileges, which would enable it to operate at lower cost than the private mortgage insurers and give it an advantage over them. It would become difficult for the private insurers to compete for business that they now serve quite adequately.

The rationale for GSE status is that FHA could use its advantages over competitors to insure riskier mortgages than they do. But this is what it does now. With less of a federal guarantee than it now has, FHA would have to become more efficient—or else it would have to undertake less risky business, moving away from its basic public policy purpose. Its financial incentive would be to leverage its ties to the government so as to maximize profits for its stockholders. There would probably be continuing conflict with the federal government over whether FHA was adequately serving individuals and groups who could not obtain private mortgage insurance.

2. FHA could be sold or transferred to Fannie Mae or Freddie Mac. Without a full government guarantee, however, neither would be able to replace FHA fully; they already compete with FHA and have not been able to take away all its business. Competition in the mortgage market would be reduced; instead of three large entities, there would be only two. The GSE that acquires FHA would also be in a position to dominate the private mortgage insurance market, just as if FHA itself were turned into a GSE.
3. FHA could be privatized, in the sense that it would no longer carry any federal guarantee. It would then be no different from any other mortgage insurer. The private mortgage insurers are free to compete with FHA now, but they have not been able to take all its business. As a private insurer, therefore, FHA would not be able to insure all the mortgages it now insures.
4. FHA could simply be terminated. This would have the same effect in the mortgage market as privatizing it. There would be one less mortgage insurance firm, but there are enough firms for a competitive industry now, and new firms are free to enter the industry. Perhaps one or more would. But, as with a privatized FHA, some families who now buy homes with FHA insurance would be unable to obtain private mortgage insurance.

As these options demonstrate, ultimately what FHA is able to do depends on whether it has any continuing ties to the federal government and what the nature of those ties is. If it continues as a government agency, for instance, it retains the full faith and credit of the United States and is able to continue serving risky, relatively low-income home buyers. If it is given the same sort of status as Fannie Mae or Freddie Mac, it probably could not serve the full range of home buyers that it now serves. If it loses its government guarantee, it becomes simply another private mortgage insurer. Without a full government guarantee for its riskiest borrowers, FHA cannot serve them under any administrative arrangement or in any legal structure.

Conclusion

The fact that FHA is achieving its basic public purpose of promoting homeownership—and moving steadily toward actuarial soundness while doing so—is being lost in the discussions of reorganizing it. FHA's problems exist in its multifamily insurance programs and its subsidy programs, which are a small part of its portfolio. Those problems can be solved by reforming the programs of FHA, most directly by eliminating multifamily insurance. Conversely, they cannot be solved by reorganizing FHA unless the programs are reformed.

Adopting the structural changes proposed by the administration or by Vandell would move FHA away from its public purpose and closer to behaving as a private business, without reforming the multifamily or the subsidy programs. First-time home buyers who need FHA would lose, and taxpayers would not gain.

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