

FEDERAL HOMEOWNERSHIP POLICY
AND HOME FINANCE:
A STUDY IN PROGRAM OPERATIONS
AND IMPACTS ON THE CONSUMER

by

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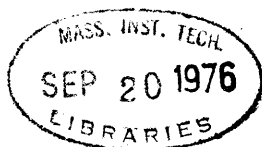
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ABSTRACT

Federal Homeownership Policy and Home Finance: A Study of Program Operations and Impacts on the Consumer

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The policy of homeownership for low-moderate income families gained popularity in the mid- and late-1960's and in 1968 a series of programs were enacted which enabled a new group of families to become homeowners. However, the programs encountered difficulties and, by 1973, they had fallen so completely out of favor by the Administration, that they were discontinued. The major conclusion of this thesis is that homeownership for low-moderate income families is still a viable policy and that it awaits a better planned and better executed trial.

This conclusion is based on several issues which are analyzed in the thesis: Homeownership legislation; home finance institutions and the activities of the Department of Housing and Urban Development (HUD).

Homeownership legislation in this country has always had a variety of goals, in addition to providing and expanding homeownership opportunities, *per sé*. In addition to a series of economic, political and social goals, the government has encouraged the participation of lending institutions in order to increase the supply of mortgage credit. It has done this through a series of institutions which have been aimed at decreasing risk for lenders by providing them with liquidity and removing the possibility of losses due to foreclosure. Due to the multiple goals of homeownership legislation, the consumer has never been the primary concern. Some of these multiple goals, have, in turn, conflicted with consumer needs. Sections I and II analyze the multiple goals embodied in homeownership legislation--from the Homestead Act to the Housing and Urban Development Act of 1968--and discuss how these goals have impacted consumers. These sections also focus on the specific institutions that have grown up over time--Federal Housing Administration; Federal Home Loan Bank System; Federal National Mortgage Association and Mortgage Companies. Ways in which the operations of these institutions conflict with consumer needs are discussed.

In the course of the government's shifting risk away from lenders, it has shifted the risk onto itself. However, the major point of Section III is that the government has not accepted the responsibility which is inherent in its risk-taking position. And, as a result, the consumer's interests have been harmed and the likelihood of his having a successful ownership experience is reduced. Section III examines HUD's pre-purchase procedures, post-1968, and demonstrates how it has neither acted to minimize its own risk or to protect the consumer. This section also focuses on the default situation--a point at which HUD's risk is considerable--and criticizes HUD's primarily inactive role and assesses how other actors in the home finance system respond. Various reasons why HUD's guidelines for providing relief to defaulting mortgagors are not used by mortgagees are also explored in considerable detail.

The thesis concludes with recommendations for how the homeownership/home finance system could be changed to benefit the position of the consumer.

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BIOGRAPHICAL NOTE ABOUT RACHEL G. BRATT

Ms. Bratt received her B.A. in Psychology from Brooklyn College of the City University of New York in June, 1967. Her professional experience has included research and planning work at the Laboratory of Community Psychiatry of Harvard Medical School; Justin Gray Associates; The Organization for Social and Technical Innovation; The City Manager's Office of Planning and Community Development in Worcester and Arrowstreet Associates. In the course of the latter, she contributed to the writing of City Signs and Lights.

Ms. Bratt has also served as a consultant to Abt Associates; the Boston Model Cities Administration and the Federal Home Loan Bank Board. In connection with her work for Boston Model Cities, she prepared a report: "A Home Ownership Survey: The Boston Banks Urban Renewal Group" and testified before the Senate Subcommittee on Antitrust and Monopoly in September, 1972. For the Federal Home Loan Bank Board, she co-authored a report: "Financial Institutions and Neighborhood Decline: A Review of the Literature". The summary and conclusions of this report appeared in the "Home Mortgage Disclosure Act of 1975" Hearings Before the Committees on Banking, Housing and Urban Affairs, U.S. Senate, May 1975.

Ms. Bratt was an Instructor in the Department of Urban Studies and Planning at M.I.T. in 1972-1974 and taught at Boston University in the Summer of 1974. During 1973-1974, she was a "Charles Abrams Fellow" at the Joint Center for Urban Studies of M.I.T. and Harvard and received a research grant from the Federal National Mortgage Association.

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CHAPTER 1: INTRODUCTION

1. FEDERAL HOUSING AND HOMEOWNERSHIP POLICY:

With the passage of the Housing and Urban Development Act of 1968, Congress reaffirmed the goal articulated in the Housing Act of 1949: the "realization as soon as feasible of the goal of a decent home and a suitable living environment for every American family."¹ A key feature of the 1968 legislation, aimed at reaching this objective, was a group of programs which expanded homeownership opportunities -- to lower income families; to families with poor credit histories; and to families wishing to purchase homes in inner city areas, respectively known as the Section 235, 237 and 223(e) programs.²

Launched amid high hopes and bi-partisan support, these programs have encountered serious problems and have been the subject of widespread criticism. A particularly dramatic and troublesome outcome of the post-1968 homeownership programs has been that thousands of families are seriously behind in their mortgage payments and thousands more have lost their homes through foreclosure. This has not only been problematic for the families involved, but the Federal government has lost millions of dollars during recent years.

As a result of these difficulties, by the end of 1973 it looked as though the government's seven year old policy³ of expanding homeownership

¹Housing and Urban Development Act of 1968, Public Law 90-448, 82 Stat. 476, 601; Sec. 1601.

²*Ibid.* Secs. 101(a), 201(a) and 103(a), respectively. Secs. 235, 237, and 223(e) of the National Housing Act, respectively. See Appendix 1-1 for a detailed description of these programs.

³The policy of homeownership for lower income families began in 1966 with the 221(d)(2) program. Section 221(d)(2) of the National Housing Act; Disaster Relief Act of 1966, Public Law 89-769, 80 Stat. 1316, 1317; Sec. 4(a).

opportunities for low and moderate income people had come to an end. In January of that year, the Secretary of Housing and Urban Development (HUD), George Romney, announced a moratorium on all subsidized housing and rehabilitation programs. Following ten months of evaluation and study of Federal housing programs, HUD's long awaited report was published. "Housing in the Seventies" found that:

Although homeownership has long been encouraged by a variety of Federal laws, no major programs offering homeownership to the poor in the 20th century were enacted until the 1960's. Since that time the problems which have arisen from the operation of those programs -- principally the Section 235 and Section 221 (d)(2) programs -- are so serious as to raise questions about the validity of the concept itself.⁴

The Housing and Community Development Act of 1974 was in line with this thinking.⁵ The new legislation, which presented the Federal government's new strategies for attacking housing and urban problems, included no assistance for lower income families who wanted to purchase homes. Section 8 of that Act, the major new piece of housing legislation, provided subsidies only to renters.

But only two years after the publication of "Housing in the Seventies" homeownership for low-moderate income families was revived. In October 1975, Carla Hill, the new Secretary of HUD, announced the temporary resumption of the Section 235 program. However, this resumption in funding was based more on Congressional inquiries regarding the legality of HUD's impoundment of the housing funds than on any rekindled feeling about the value of the policy on the part of the Administration.

⁴Department of Housing and Urban Development "Housing in the Seventies" October, 1973 p. 4-108.

⁵Housing and Community Development Act of 1974, Public Law 93-383, 88 Stat., 633.

Thus, the policy of homeownership for low-moderate income families has received no support by the Ford Administration and the future of this policy is dim.

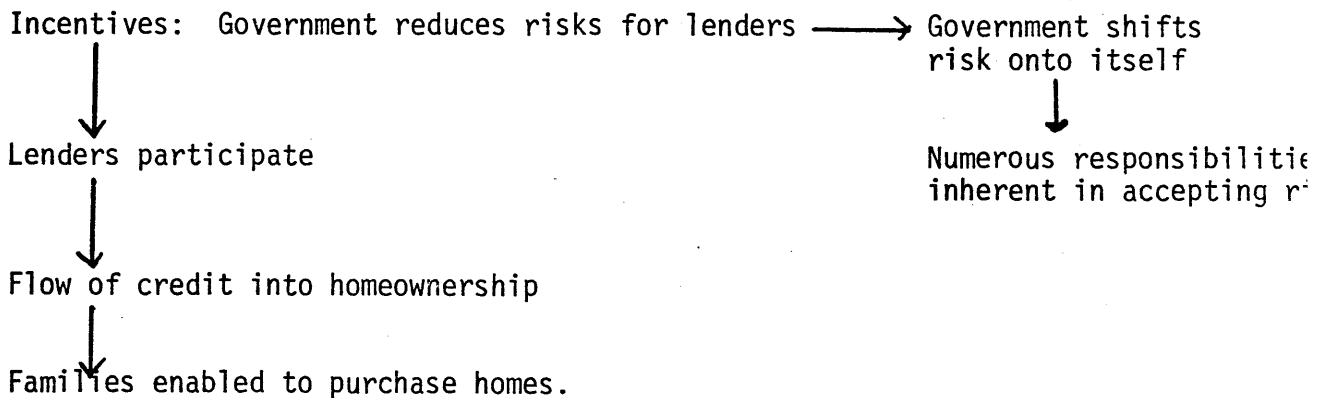
Thus, the experiment of enabling low-moderate income families purchase homes has, for all intents and purposes, come to an end. A major public policy, undertaken with great fanfare in the late 1960's has been removed from the Federal agenda.

The central goal of this thesis is to examine how and why Federal involvement in homeownership for low and moderate income people has come to this abrupt halt. Such an examination involves a detailed analysis of a variety of complex institutional arrangements that have grown up over a period of decades -- the Federal Home Loan Bank System (FHLBS); the Federal Housing Administration (FHA) and HUD; the Federal National Mortgage Association (FNMA) and the mortgage banker -- to determine the ways in which their activities and interactions have been played out in the low-moderate income housing effort. The critical task in this analysis is to assess the role and influence of the Federal government in the homeownership/home finance system and to understand the extent to which the termination of this policy was the inevitable consequence of a set of problems inherent in this complex system and if the policy could still prove to be viable if existing problems are corrected.

Since the 1930's, the Federal government has intervened in the homeownership/home finance system by trying to maintain a flow of credit.

into housing.⁶ It has done this by encouraging financial institutions to lend money through a variety of incentives. These incentives have had the purpose of shifting risk away from the lending institutions and onto the government. Thus, by reducing risks for lenders, the government has sought to encourage their participation in maintaining a flow of credit into homeownership in order to enable people to buy homes.

Thus:



In the course of reducing the risk for lenders, the government has shifted much of the burden onto itself. This thesis asks the following critical questions:

1. How has the government-supported homeownership/home finance system reduced risk for the lending institutions? What impacts have these efforts had on the consumer?

⁶Critical to homeownership is the ability of purchasers to obtain credit, or a mortgage. Over 82% of the single family owner-occupied units purchased in 1970 and the first ten months of 1971 carried mortgages. The percentage of people who have mortgages on their homes has increased from 39.8% in 1920 to 60.6% in 1971. (Statistical Abstract of the United States, 1973, p. 693.) Thus, home finance, or the lending of money to enable families to purchase homes is closely associated with homeownership.

2. How has the government carried out the responsibilities which are inherent in having shifted risk onto itself? How have these functions impacted the consumer?

Consumer, as defined in this thesis, is the least equipped, yet still eligible, individual to enter and maintain his participation in the system. He is "least equipped" by virtue of his relative lack of information, experience, resources, and income. He is "eligible," however, because of a preference for homeownership and an ability to afford it, with or without a government subsidy.

It was not until the late 1960's that the consumer, as defined above, was offered an opportunity to become a homeowner. Prior to that time, Federal policy provided homeownership opportunities only to middle income families. But, in addition to focusing on impacts on the consumer group, defined above, the thesis also assesses impacts on a wider range of homeowners under the Federal government's homeownership programs. Many aspects of the homeownership/home finance system also have direct impacts on the group of homebuyers -- those with middle incomes -- who have historically been the primary participants in the Federal homeownership programs.

HUD's and the Administration's conclusion that homeownership for low-moderate income families is not a viable policy is particularly important in view of the role that homeownership has played in this country. In addition to homeownership being a central theme in American history, most people prefer homeownership over a rental situation. In 1970, almost

63% of the total number of occupied units in this country were owner-occupied.⁷ (See Appendix 1-2)

⁷Compared to other countries, homeownership is considerably more prevalent in the United States. For example: only about 40% of England's houses are owner-occupied; in eastern European countries, such as the Soviet Union, homeownership is even less common. See, Glenn H. Beyer, Housing and Society (New York: The MacMillan Co., 1967) p. 518, and Charles Abrams, Man's Struggle for Shelter in an Urbanizing World, (Cambridge, Mass: MIT Press, 1966) pp. 31 and 49.

2. COMPLEXITIES AND RISK IN THE HOME PURCHASE PROCESS:

The high frequency of homeownership in this country should not, however, lead one to believe that buying a home is a simple process. Both because a home is usually the single largest expenditure that most families ever make and because the step to homeownership often involves either a short or long-distance move, the entire procedure is likely to be filled with considerable risk and tension.

Home buyers must risk some money in the form of a downpayment and, as the principal portion of their mortgage payments builds, the family is continually risking a greater and greater sum of money. Thus, if either payment difficulties arise or if the family wants to move for any other reason, the equity in the house cannot be recaptured unless the house is worth at least as much as the original purchase price. Furthermore, if the family finds that the house requires substantial, unexpected repairs the family must risk an additional amount of money and, again, would hope that this money could be recaptured when the property is sold.

In addition to the monetary risks involved in purchasing and owning a home, the emotional risks can also be substantial. The family that has made the wrong decision in purchasing a home may face considerable inconvenience and irritation with their living situation that could lead to intense dissatisfactions.

If the prospective purchaser has had experience living in his own home and if he has negotiated the home purchase process before, buying

a home could, however, turn out to may be relatively painless. If, on the other hand, the experience is totally new, the homeowner-to-be may find the task overwhelming.

In the midst of this risky and potentially anxiety provoking situation, homebuyers must address a series of critical questions and deal with an array of individuals and institutions. Many questions should come to a purchaser's mind and if one is naive about the process, answers may be elusive. Or, even worse, the real neophyte may not even know enough to be able to articulate the important questions.

For example:

- 1) Is the house worth the money that is being paid?
- 2) Is the house in good repair?
If not, what repairs are needed and how much will they cost?
Who will pay for them: buyer, seller, builder?
- 3) Does the house meet the needs of the purchasers? Where and how accessible are jobs, shops, schools etc.?
- 4) What is the quality and future of the neighborhood?
- 5) Which financial institution will give the most favorable financing arrangement?
- 6) How much will it cost to close the sale? lawyers fees; title search; recording fees; escrow costs; taxes; etc.?
- 7) What are the responsibilities of a homeowner -- in caring for the property? in making mortgage payments?
- 8) Will the purchaser be able to meet all the financial costs involved in owning the home? mortgage payments; taxes; utilities; maintenance?
- 9) What recourse is there if something goes wrong?

Unless these questions are answered satisfactorily, the home purchase process and the actual experience of homeownership can become a nightmare.

The complex set of issues involved in the decision to buy is made even more problematic for the purchaser by the array of interests involved in the home purchase process. As a result, "caveat emptor" -- let the buyer beware -- has been long-ingrained in most home buyers. Recently, however, more and more observers of the home purchase process have begun to acknowledge that the consumer is usually at a severe disadvantage when buying a home and simply advising the buyer to beware is not a sufficient safeguard.¹

The problems faced by all home buyers have been amplified by the growing concern over the particular plight of lower income, inexperienced purchasers -- relative newcomers to homeownership. On this issue, a 1972 report by the Committee on Government Operations noted that:

Historically, HUD has relied on the assumption that value and price are fairly determined when a prudent buyer and a knowledgeable seller meet in the marketplace and negotiate for the purchase and sale of a house. For low and moderate income families this is often not the case.²

This type of purchaser, naive about the home purchase process, might assume that the various individuals and institutions with whom

¹See, for example, Melvin Mencher, editor The Fannie Mae Guide to Buying, Financing and Selling Your Home, (New York: Dolphin Books, Doubleday & Co., Inc., 1973) Foreward p.V.

²Fifteenth Report By the Committee on Government Operations, "Defaults on FHA-Insured Home Mortgages -- Detroit, Michigan." June, 1972, p. 16.

he will come into contact will be able to offer advice. These actors are the seller/builder; the real estate broker; and the lending institution. Unfortunately, however, none of the above share a complete identity of interest with the home buyer. As a result, information offered to the consumer may be incomplete, biased, or even totally inaccurate and misleading. The Committee on Government Operations went so far as to say that:

Often,...a very knowledgeable, if not unscrupulous, speculator deals with an uninitiated and unknowledgeable buyer. The consequences are tragic.³

The following discussion presents a brief review of the key interests of the three major non Government actors that most home buyers encounter in the course of purchasing a home.

Seller/Builder:

Depending upon whether or not the purchaser is interested in an existing or new home, he will have to deal with a seller or a builder. In either case, the interests of the party making the sale would probably be to do few, if any, repairs; to maximize the sale price and to make the sale progress quickly. Clearly, these sentiments are exactly the opposite of those of any level-headed purchaser. Concerning this last point, most buyers desire time to think, want to view the property several

³Ibid. p. 16.

⁴Unless the purchaser is a handyman looking for a house that needs repairs in lieu of a higher cost, most people look for homes that are in good repair.

times, and feel pushed and anxious if they sense that things are moving too rapidly.⁵

Real Estate Brokers:

Since most real estate brokers are helpful and solicitous to the prospective home buyer, it is very easy for the latter to forget that the broker is really an agent, under contract, for the seller. As such, his interests coincide most closely with those of the seller/builder, as described above. Furthermore, the more money that the broker is able to negotiate for the sale of the house, the greater will be his commission. Thus, if a broker is working on a 6% commission, the difference between selling a \$25,000 and \$30,000 home will be \$300 (\$1500 and \$1800 commissions, respectively). While, in fairness to the real estate brokerage profession, brokers are bound by codes of honesty, and are supposed to deal with purchasers fairly, the fact remains that their clients are the sellers and not the buyers.

Lending Institutions:

Similar to the two actors described above, lending institutions also have independent concerns from the buyer's that may also tend to

⁵Ronald G. Yelenik, an attorney for East New York Legal Services, Inc. has argued that "there should be a grace period when the buyer-mortgagor could decide whether or not to go forward with the contract." Hearings Before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, "Competition in Real Estate and Mortgage Lending" U.S. Senate, 92nd. Congress, 2nd Sess; Parts 2A and 2B; 1972 p. 118. (Referred to as "New York Antitrust Hearings")

conflict with his needs. First, while lenders appraise the home that is being bought, they usually do not inspect it. Thus, the fact that a home may need a new roof may be of no interest to the lender and the appraiser may not even have noticed the defect. As long as the lender is confident that the home is worth at least as much as the mortgage amount, his interests will be protected. As a result, the lender is generally not interested in either the absolute condition of the house or whether the purchaser is paying a fair price.

And, second, while the lender does not usually play an active role in determining the sales price of the house, he may be more amenable to lending money if the price is higher, rather than lower. The cost to the lender of originating and servicing mortgages varies directly with the number of mortgages and not with their dollar value. The fewer the mortgages that an institution handles, the smaller the staff and the less the amount of time necessary to maintain the accounts.⁶

Furthermore, lenders may be more interested in dealing with higher priced homes because of "points." Depending on money market conditions and the policies of the lending institution, points may or may not be charged at the time that the mortgage is written. Each

⁶U.S. Commission on Civil Rights Staff Report, "Home Mortgage Financing and Racial and Economic Integration" Washington, D.C. 1970 p. 615, and Home Ownership Development Program, "Home Ownership and the Baltimore Mortgage Market," Baltimore, Md. 1974 p. 16.

point that is charged costs the buyer 1% of the mortgage amount.⁷

For example, if a financial institution is charging 3 points, it would receive \$750 for originating a \$25,000 mortgage and \$900 for originating a \$30,000 mortgage.

Thus, financial institutions are neither concerned that the property be free from defects or that the cost be as low as possible. In fact, as described above, lenders are probably more interested in lending money on higher priced houses and may therefore exert a subtle, inflationary pressure on the housing market.

Furthermore, the common desire of everyone dealing in the home purchase process -- except the buyer -- is to inflate the price of the home as much as possible. Summing up this situation, Howard E. O'Leary, Staff Director and Chief Counsel to the Senate Subcommittee on Antitrust and Monopoly, has stated that:

...given the nature of this market, it seems that it is in everyone's interest to have the appraisal come in high; namely, the greater the amount of mortgage, the more the real estate broker makes in commission, the more he makes as a speculator if he has previously bought the property himself.⁸

Thus, not only are the actors in the home finance system considerably more savvy than most home buyers, particularly those who are new to the

⁷ However, if the mortgage is insured by the Federal Housing Administration all points must be paid by the seller. For a lengthy discussion on points, see Chapter 5 and Appendix 5-1.

⁸ New York Antitrust Hearings, *op. cit.* p. 122.

process, but they also cannot be expected to operate with the interests of the buyer as their primary concern. The balance of power is clearly tipped against the consumer.

To compound the advantageous position of the system actors is the fact that, similar to the home buyer, each actor also has something at stake, or is risking something, in the sale of the property.

Thus, builders and sellers own a piece of property in which they have invested a considerable amount of money and which is at risk until their equity is recaptured through the sale. Real estate brokers also risk a great deal of time prior to the final sale of a house -- time which is not reimbursed until or, indeed, if the sale is eventually finalized. Thus, the time and money at stake for each of these actors constitutes a real risk which does not disappear until the sale of the house is closed.

The risk to lending institutions is also substantial, although risk is not an issue until the money has actually been lent to the buyer. Prior to the buyer's assumption of the mortgage debt, however, the lending institution tries to minimize its future risk by making certain that the property is worth at least as much as the mortgage amount, as discussed above. To do this, the lender assesses the value of the property and the ability of the prospective borrower to make the monthly payments on the mortgage. Only when the lender is satisfied that the mortgagor will be able to make the payments and recapture its money in the event that it must take over the property and then sell it, due to a foreclosure, will it extend the money to the buyer. If the lender has made any inaccurate

judgments, either in the value of the property or in the ability of the borrower to pay, its risk is increased dramatically.

Clearly understanding the needs of lending institutions, the essence of Federal homeownership policy has been the government's encouragement of the participation of lending institutions in its programs by providing them with incentives aimed at substantially diminishing their risk position.

Thus, the government has, on the one hand, sought to make maximum use of the resources among private⁹ institutions in the home finance system and to make the system work more efficiently, by reducing risk, while, on the other hand, it has been trying to implement homeownership programs. This thesis will show that while the government has spent an enormous amount of energy focused on how to involve the financial sector in housing, and has created an elaborate system to protect lenders against losses by shifting their risk onto government or quasi-government institutions, it has neither accepted its own position of risk nor has it directed its efforts at minimizing the risk of the individual home buyer.

⁹An important thrust of the Housing and Urban Development Act of 1968 was Congress' call for the "fullest practicable utilization of the resources and capabilities of private enterprise" to reach the nation's housing goal. op. cit. Sec. 2.

3. OUTLINE OF CHAPTERS:

The research has been divided into three major sections¹. Section I analyzes the history of Federal homeownership legislation and policy in terms of how they have shifted risk away from the lending institutions and how the consumer has been impacted. More specifically, Chapter 2 looks at homeownership in the 19th century and two of the key post-Depression recovery measures that related to homeownership -- The Home Owner's Loan Corporation and the Federal Home Loan Bank System. Chapter 3 discusses, in some detail, the pre-1968 experience of the Federal Housing Administration, the third post-Depression housing recovery measure. Chapter 4 examines the multiple goals behind the emergence of the homeownership package embodied in the Housing and Urban Development Act of 1968. Thus, Section I explores the ways in which the government has minimized risk for lenders, by accepting more of the risk itself, in order to induce their participation in homeownership. The fact that this desire to minimize risk has been viewed as a goal in itself, in conjunction with the government's desire to address a variety of other goals through the legislation, have had some negative impacts on consumers. Furthermore, the homeownership/home finance system which is discussed in the remainder of the thesis requires the reader to have a thorough understanding of the 1968 legislation that opened the way for the lower income family's participation in the homeownership/home finance system.

¹See Appendices 1-3 and 1-4 for a note on research methodology and a list of the individuals consulted in the course of the research, respectively.

Section II describes and analyzes the operation of three of the major components and aspects of the home finance system. Chapters 5, 6, and 7 look at The FHA Interest Rate Ceiling, Mortgage Companies, and the Secondary Mortgage Market, respectively. Section II also continues the theme of Section I -- that in order to involve lenders in homeownership, a complex set of institutions and policies have been created to minimize their risk, which have had the effect of placing the bulk of the risk onto the government. And, again, some aspects of this sophisticated system have had negative impacts on consumers. X

Section III, the final and most expansive section of the thesis presents a framework for understanding how HUD has operated and the extent to which it has accepted the responsibility which is inherent in its risk-taking position. HUD's activities will be analyzed in terms of how they have impacted the consumer. Chapter 8 analyzes HUD's activities during the pre-purchase period and evaluates whether HUD has accepted this risk and has operated in a consumer-oriented manner. Chapter 9 and 10 focus on a critical stage in the homeownership experience, default, and assess HUD's role in this process-- a point at which HUD's risk is substantial.

Chapter 11 presents conclusions and recommendations for how the homeownership/home finance system could be changed to operate in a more consumer-oriented manner, by re-shifting the risk assumed by key actors.²

²See Appendix 1-5 for an image of an hypothetical consumer oriented homeownership/home finance system.

SECTION I:

ANALYSIS OF GOALS OF FEDERAL
HOMEOWNERSHIP POLICY

CHAPTER 2: MULTIPLE GOALS OF EARLY HOMEOWNERSHIP PROGRAMS

1. INTRODUCTION:

Federal housing policy and legislation have always had a variety of objectives. Indeed, it has frequently been noted that the history of Federal housing policy is a story of competing and, sometimes, conflicting goals. Some of the key goals of housing policy have stemmed from the Federal government's desire to safeguard lenders against risk. Others have grown out of other pressing objectives. As a result, the needs of the consumer have often been subordinated to other concerns. The multiple goals of Federal housing legislation have often been problematic for consumers.

Since 1949, the stated objective of Federal housing policy has been to achieve "a decent home and a suitable living environment for every American family."¹ While this rings of a "welfare" orientation, Federal housing policy has, nevertheless, always been directed toward the realization of a variety of "economic," "social" and "political" objectives.²

¹Housing Act of 1949, Public Law 171, 63 Stat. 413, 414. Reaffirmed by Housing and Urban Development Act of 1968, op. cit.

²Definitions for this discussion:

Welfare -- For the benefit of the individual within society. i.e.; the consumer.

Economic -- For the economic well-being of society; the nation as a whole.

Social -- For the well-being, other than economic, of society.

Political -- For the benefit of specific public or private interest groups within society. This benefit can be economic gain or the enhancement of prestige or power of the particular interest group.

Political -- For the enhanced power of the Administration.

For example, making the argument that the slum clearance movement of the late nineteenth and early twentieth centuries was aimed at benefiting society in general, rather than the slum dwellers, Lawrence Friedman stated that:

Throughout American history...men have frequently advanced solutions to urban housing problems which meet external difficulties only. The law has emphasized fire prevention, sanitation, minimum standards of building and maintenance, and outright demolition of the slums. These are ways of protecting society from contamination rising out of the slums. The pathology of this...approach is its tendency to disregard the problems of people who live in the slums.³ (underline added)

Further, Charles Abrams has viewed housing policy as being molded primarily by economic objectives:

The economic motivation had been the dominant ingredient in Federal housing recipes from the inception and the stated ideal of better housing for everybody had simply supplied the sweetening...⁴

Similarly, Peter Marcuse has observed that housing policy has been "input" rather than "out put oriented."

National housing policy in the United States has traditionally been input-oriented; it has been concerned with the production of housing; or its rehabilitation; its financing or its management, but rarely with what it is itself supposed to produce.⁵

In 1968, the President's Committee on Urban Housing summarized this multi-goal nature of Federal housing policy by reporting that:

³ Lawrence M. Friedman, Government and Slum Housing (Chicago: Rand McNally and Co., 1968) p. 12.

⁴ Charles Abrams The City Is The Frontier (New York: Harper & Row, 1965) p. 85.

⁵ Peter Marcuse, "The Legal Attributes of Homeownership for Low and Moderate Income Families," (Washington: The Urban Institute, 1972) Working paper 209-1-1; pp. 1-2.

Housing programs have been enacted for a variety of purposes -- to create jobs, to clear slums, to improve the tax base of central cities, and to help the poor.⁶

Thus, the notion that housing policy has been shaped by a variety of forces, needs and objectives is well accepted by writers on the subject.

As a critical component of the government's overall involvement in housing, Federal homeownership policy has also had a variety of goals in addition to providing good housing to individual homeowners. This multiple goal orientation was apparent during the three major phases of Federal involvement with homeownership -- the land settlement movement of the 19th. century; the post-Depression period of the 1930's; and the urban and racial crises of the 1960's. During each of these periods, there were discussions, sometimes quite passionate, on the benefits of homeownership. But, while valued as a worthwhile objective by itself, homeownership has always been viewed as a means to other important ends.

However, this multiple goal orientation of homeownership policy need not be problematic. Housing, by its very nature involves a wide variety of people in its production, sale, and management. To ignore this fact -- and the fact that housing legislation must be responsive to the needs of these actors -- is to ignore an important reality. But when translated into actual programs, this can cause problems for the consumers of housing.

While it is not possible to eliminate multiple goals from housing policy or legislation, it is important for students of housing policy to:

⁶The Report of the President's Committee on Urban Housing, A Decent Home, 1968, p. 53.

1) Understand and assess the multiple goals of each piece of homeownership legislation and;

2) Identify the conflicts, if any, between these goals and consumer needs, particularly as the goals become expressed in operational terms.

These two points will provide the framework for reviewing the history of homeownership legislation. Similar to the other two periods in which homeownership was a popular issue, the multiple goals associated with the Homestead Act conflicted with consumer needs.

2. HOMESTEAD ACT: 1862:

In 1828, the Committee on Public Lands of the House of Representatives issued a report which articulated the welfare-oriented underpinnings of the Homestead Act. The Committee wrote that free land would assist

...many families who...have met with the usual share of the difficulties always accompanying the settlement of a new country, and who...never expect to see the day arrive when they will be enabled to save enough, with all their efforts, from their means of support, to purchase a farm and pay for it in cash.¹

However, the report went on to argue for "free land to settlers" from a highly pragmatic, social, and political/administration viewpoint.

...such small earnings (of settlers) applied to the improvement and cultivation of small tracts, scattered through the public domain, would be as advantageous to the public as though they should be paid directly into the treasury. No axiom in political economy is sounder than the one which declares that the wealth and strength of a country ...consists not so much in the number of its citizens as in their employment, their capability of bearing arms, and of sustaining the burdens of taxation whenever the public exigencies shall require it. The poor furnish soldiers, and an experience shows that the patriotism which exists apart from an integrated love of country cannot be relied upon. The affections of good citizens are always mingled with their homes and placed upon the country which contains fields and their gardens.²

In addition to these motivations, many Congressmen voiced the compelling need for land settlement in economic terms. Haynes of South Carolina observed that "...free land (is) the only means of building up in a wilderness great and prosperous communities." (underline added)

¹Benjamin Horace Hibbard A History of the Public Land Policies (New York: MacMillan Co., 1924) p. 351.

²Ibid., p. 352.

³Ibid. p. 354.

And, in 1844, Congressman Ficklin of Illinois argued, somewhat poetically, that:

Unless the government shall grant head rights, settlement rights, or donations of some kind, these prairies with their gorgeous growth of flowers, their green carpeting, their lovely lawns and gentle slopes, will for centuries continue to be the home of the wild deer and wolf; their stillness will be undisturbed by the jocund song of the farmer, and their deep and fertile soil unbroken by his ploughshare. Something must be done to remedy this evil. It is idle and senseless to continue at the present price such a wide expanse of unmitigated prairie.⁴ (underline added)

The stipulations of the Homestead Act, which finally became law in 1862, reflected the desire of Congress for homesteaders to truly be willing to settle.

The person applying for the benefit...shall, upon application... make affidavit...that his entry is made for the purpose of actual settlement and cultivation...No certificate, however, shall be given...until the expiration of five years from the date of such entry.⁵

Measured in terms of the number of homesteads established, the Homestead Act was an enormous success. Between 1862 and 1923, 1,346,163 homesteads were registered consisting of about 213,867,600 acres (up to 160 acres per homestead).⁶

⁴Ibid. p. 355.

⁵Circular from the General Land Office Showing the Manner of Proceeding to Obtain Title to Public Lands Under the Pre-Emption, Homestead, Timber, Culture and Other Laws, Washington, D.C. 1880, Title XXXII - The Public Lands, Ch. 5, Homesteads, Sec. 2289-2290.

⁶Hibbard op. cit. 398.

Conflicts with Consumer Needs:

But despite this apparent record of success, the Homestead Act also presented problems for some of the participants in the land settlement program. By 1873, the government began to realize that many settlers were either ill-equipped to farm or that certain homesteads suffered from soil or climate problems.

Hibbard writes that:

The great weakness of the Homestead Act was...its utter inadaptability to the parts of the country for which it was not designed. The idea of the small farm in acres within the semi-arid regions was...untenable. It was even vicious in its operation.⁷

As a result, the government stepped in to try to help the homeowner. In so doing, it attempted to reduce the ill-effects which resulted from its program of land settlement and, instead, focussed its concern more directly on the needs of the homeowner. In order to try to prevent widespread abandonments of homesteads, Congress passed a series of relief acts aimed at assisting the faltering settler.⁸ These acts generally granted homesteaders a temporary leave of absence from their claims in order to permit them to earn a living elsewhere during periods of crop failure. For example, following complete destruction of crops by grasshoppers in 1873, Congress responded by granting these types of leaves and, in turn, extended the period of time allowed for payment of the homestead.

⁷Ibid. p. 409.

⁸For a lengthy discussion on the relief acts see Ibid. p. 390-408.

By 1890, the number of homesteaders who were facing severe problems -- with or without crop failure -- mushroomed. In 1894, Congress passed legislation extending the period of payment to all settlers. While this form of relief was well accepted by Congress, more direct forms of support for the homesteader were not popular with the majority of legislators.

Enthusiasm and wild land, by themselves, could not automatically be turned into prosperous homesteads. Many families lacked the resources to purchase the necessary equipment and furnishings. In 1878, a bill was introduced in the House which would have granted loans of up to \$500 to each homesteader whose goods were worth no more than \$300. However, this bill, and similar ones which would have provided outright grants to settlers, failed to pass.

Thus, while Congress was willing to offer some forms of relief to struggling homesteaders, it also kept its assistance within well-defined limits.

Clearly, the two goals -- land settlement and homeownership are inter-related. But, as demonstrated by the Homestead Act, too much emphasis on the former, without adequate thought for the latter, produced problems for some settlers. Yet, it is noteworthy that, upon realizing the conflict, the government stepped in to try to correct at least some of the problems which the Homestead Act presented to settlers.

3. MORTGAGE LENDING AND THE DEPRESSION:

While the Homestead Act encouraged homeownership through the provision of free land, Congress was also eager to enhance the social, political and economic well-being of the country through the very action of land settlement. Similarly, while the post 1932 Depression recovery measures had strong pro-homeownership aspects the primary goals of these measures were also geared to economic, political, and social needs, and not simply to increasing or supporting homeownership per sé (welfare). In particular, the goal of encouraging the participation of lenders, by reducing their risk, was the dominant theme of the post-Depression recovery measures.

To examine the goals of the recovery activities, it is necessary to begin by looking at the mortgage market in the years preceding the Depression.

Prior to 1932 mortgage loans were considered good investments by lenders. Willis Bryant, writing about mortgage lending in the early 1920's observed that:

Mortgage loans had proven to be one of the most stable and dependable revenue-producing assets of banks, life insurance companies, savings and loan associations, individuals, and others for over one hundred years.¹

However, as the economy weakened in the late 1920's, the positive outlook of the financial community toward mortgage lending was reversed. As the depression deepened in the early 1930's, many homeowners became

¹Willis R. Bryant Mortgage Lending (New York: McGraw-Hill, 1962) p. 18.

unable to meet their mortgage obligations.

The problematic situation for homeowners was compounded by the prevailing pattern of mortgage lending during the pre-Depression era. Most mortgages written in the 1920's were either partially amortized or unamortized; the terms of the loans were extremely short; there were low loan to value ratios; and interest rates were high.

By 1933 the foreclosure situation had become extremely serious, with over a thousand homes being foreclosed per day.²

To make matters more difficult for mortgagees, huge numbers of unemployed people also started to withdraw their savings from intermediaries. Thus, mortgagees were quickly losing liquidity as the inflow from mortgage payments diminished and the outflow to depositors increased. In addition, the liquidity problem was exacerbated by the lack of funds available from commercial banks, the traditional source of credit for mortgage lenders.

The high default and foreclosure rates on home mortgages and the near bankruptcy days of the early 1930's left most lenders shaken and cautious. It became clear that innovative measures were necessary to stimulate mortgage lending activity.

Acknowledging the magnitude of the problem, Herbert Hoover, in late 1931 convened "The President's Conference on Home Building and

²Senate Subcommittee on Housing, Committee on Banking and Currency Federal Home Loan Bank Board and Federal Savings and Loan Insurance Corporation, A Study of Relationships, Staff Report, 1956, p. 4.

Home Ownership."³ The major outcomes of this meeting were the reaffirmation of the nation's strong pro-homeownership policy and the creation of the Federal Home Loan Bank System (FHLBS) during the following year. But while the FHLBS had important implications for the long-term growth of home finance, it was not sufficient in the short-run. Lenders remained cautious. Home-building stagnated. Owners continued to lose their homes. For lenders to lend again and borrowers to borrow, wider reforms were needed. This dim outlook was the challenge for the Roosevelt Administration.

³Herbert Hoover, "President's Conference on Home Building and Home Ownership," Tentative Reports of Committees, December 1931.

4. HOME OWNER'S LOAN CORPORATION:

In 1933, Franklin Roosevelt presented his first major housing legislation to Congress. Accurately assessing the problems facing lenders, the Home Owner's Loan Corporation Act (HOLC)¹ was aimed at minimizing the two key elements of risk for mortgagees: losses due to foreclosure and a lack of liquidity.

The creation of the HOLC was a timely, innovative measure. By purchasing mortgages in default from lenders who were no longer able to carry them, losses due to foreclosure were avoided and lenders were provided with desperately needed liquidity. But, in addition to assisting lenders, the HOLC was also a great help to homeowners. By refinancing the mortgage notes, it enabled over a million defaulting families, many of whom were several years behind in payments, to keep their homes. Past-due mortgage payments, real estate taxes, and even deferred repairs were included in new, moderate interest rate mortgages that were fully amortized over an extended number of years.

Another positive outcome of the HOLC was that its activities were not a drain on the Treasury. While Congress originally assumed that the HOLC would lose several hundred million dollars, the corporation was liquidated in 1951 showing a profit of over 14 million dollars,

¹Homeowners' Loan Act of 1933 - Public Law No. 43, 73rd Congress H. R. 5240. "To provide emergency relief with respect to home mortgage indebtedness, to refinance home mortgages, to extend relief to the owners of homes occupied by them and who are unable to amortize their debt elsewhere...and for other purposes."

payable to the U. S. Treasury.²

The HOLC was also credited with beginning the process of modernizing mortgage lending procedures, which was to be continued by the Federal Housing Administration. Nathaniel S. Keith has pointed out that:

The repayment pattern set by HOLC on its refinanced mortgages was also of great influence in modernizing mortgage lending practices, in contrast to the crazy-quilt of multiple short-term loans which had largely prevailed during the twenties.³

And, according to Arthur M. Schlesinger, Jr. the HOLC contributed, not only to social stability, but also enhanced the power of the Roosevelt Administration. (Political/Administration)

...by enabling thousands of Americans to save their homes, it (HOLC) strengthened their stake both in the existing order and in the New Deal. Probably no single measure consolidated so much middle-class support for the administration.⁴

Thus, the HOLC was premeated with far-reaching objectives of social and economic stability, including reducing risks for lenders, in addition to its desire to assist defaulting mortgagors. The sweeping national concerns which the HOLC was to address were well stated in Frankin Roosevelt's original message to Congress about the Home Owner's Loan Act:

²Housing and Home Finance Agency and Federal Home Loan Bank Board, "Final Report to the Congress of the United States Relating to the Homeowner's Loan Corporation" p. 38, 1957. This profit was realized from the spread between the cost of money to the Corporation through the bonds that it issued -- with its \$2 billion bonding authority -- and the amount of interest charged on the refinanced mortgage loans.

³Nathaniel S. Keith Politics and the Housing Crisis Since 1930 (New York: Universe Books, 1973) p. 24.

⁴Arthur M. Schlesinger, Jr. The Coming of the New Deal (Boston: Houghton, Mifflin Co., 1959) Quoted in Keith, Ibid. p. 24.

Implicit in the legislation which I am suggesting to you is a declaration of national policy. This policy is that the broad interests of the nation require that special safeguards should be thrown around home ownership as a guarantee of social and economic stability, and that to protect home-owners from inequitable enforced liquidation, in a time of general distress, is a proper concern of the government.⁵

The HOLC left an enviable record: over 80 percent of the 1,017,821 families who were accepted for HOLC assistance were able to bring their mortgage payments current.⁶ However, it is also important to point out that the HOLC refused over 800,000 applications for assistance,⁷ viewing them as either ineligible under the Act or beyond help. Thus, in spite of HOLC's accomplishments, many families were excluded from its benefits.

Thus, while the HOLC clearly had a variety of objectives, as discussed above, it is noteworthy that this did not seem to diminish the program's success in assisting homeowners. And, aside from excluding some potentially eligible families from participation, conflicts with consumer needs were absent from the HOLC's program. Indeed, the ability of the HOLC to successfully combine a variety of goals sets it apart

⁵Homeowner's Loan Act, op. cit.

⁶HHFA and FHLBB "Final Report" op. cit. p. 23.

⁷Ibid. p. 17.

from most other government efforts in housing.

While the HOLC was tremendously successful in helping to stabilize existing homeownership, it was never thought of as a long-term component of the home finance system.⁸ Instead, the Federal Home Loan Bank System and the Federal Housing Administration were created as the long-range measures to stimulate and support mortgage lending activity. While the HOLC was able to minimize the risk to lenders for loans that had been made prior to the Depression, the Federal Home Loan Bank System and the Federal Housing Administration were mechanisms for minimizing risk on yet-to-be-made loans.

The remainder of this chapter will be devoted to a brief review of the Federal Home Loan Bank System and an assessment of how its operations have both minimized risk for lenders and have conflicted with consumer needs. Chapter 3 will then focus entirely on the Federal Housing Administration.

⁸Unfortunately, HOLC was not maintained as a backstop for the consumer once the high default rate accompanying the Depression had declined. During the late 1950's and early 1960's, and then in the early 1970's, foreclosure rates were again on the upswing. However, the services which had been performed by the HOLC were not available to the consumer. Despite the fact that the usefulness of this agency had been demonstrated, no attempts have been made to revive the HOLC.

One possible reason is that during the latter periods, lenders have had FHA insurance as their cushion against losses due to foreclosure. Without their input, consumers could not muster the necessary support to reinstitute an HOLC-type program.

5. THE FEDERAL HOME LOAN BANK SYSTEM (FHLBS):

In the preceding sections of this chapter, the multiple goals of the Homestead Act and the Home Owner's Loan Corporation were assessed. Support and maintenance of homeownership was, quite clearly, a major goal of both pieces of legislation -- although by no means the only one. In the case of the HOLC a key competing goal was the reduction of risk to lenders by providing them both with liquidity and reducing the fear of loss due to foreclosure.

In examining the Federal Home Loan Bank System (FHLBS), it will become clear that while homeownership was again an important objective, it was deeply buried within the government's overriding need to strengthen the nation's faltering financial institutions. It accomplished this by minimizing the risk of financial institutions by providing liquidity.

The FHLBS emerged as the first major emergency measure of the Depression period, preceding the HOLC by eleven months, and was always intended to provide "a permanent framework for the nation's home financing institutions."¹

Starting in 1918, various groups acknowledged the need for a government agency to support mortgage credit activities. In that year, several savings and loan associations joined together to lobby for a government sponsored "mortgage rediscount bank." However, without a sense of urgency and with most savings and loan associations having both adequate

¹United States Savings and Loan League. 1973 Savings and Loan Fact Book (Chicago, 1973) p. 109 See also: Charles Haar, Federal Credit and Private Housing: The Mass Financing Dilemma; (New York: McGraw-Hill, 1960) p. 345.

capital and investment opportunities, this proposal, as well as a similar one introduced in 1928, received little response in Congress.²

However, in July, 1932, amid a steadily collapsing mortgage market, Herbert Hoover signed into law the Federal Home Loan Bank Act. But, as suggested above, the FHLBS was unable to revive the depressed mortgage market,³ the goal which Hoover had set for the new institution. Analyzing the reasons behind the system's short-run failure, Lowell Harriss observed that the very design of the system precluded its effectiveness during the chaotic days of the Depression.

The System was built along traditional concepts of financial soundness;...In effect, the Federal Home Loan banks could give aid only where the risk was slight, where the need was insignificant.

The significance of the FHLBS has been its role, subsequent to the Depression, in shaping one of the country's two major systems of home finance. Modeling the FHLBS after the Federal Reserve System, the FHLB Act of 1932 authorized the establishment of regional banks, under the direction of the Federal Home Loan Bank Board (FHLBB). The board, now consisting of three members, is appointed by the President of the United States and oversees the operation of the twelve Federal Home Loan Banks.

The Federal Home Loan Bank System serves a variety of functions

²Henry E. Hoagland and Leo D. Stone, Real Estate Finance (Homewood, Illinois: Richard Irwin, Inc. 1973) p. 440.

³Ernest Bloch, "The Federal Home Loan Bank System" In George F. Break, Jack Guttentag et al., Federal Credit Agencies, (Englewood Cliffs, N.J.: Prentice-Hall, Inc. 1963) Commission on Money and Credit, p. 168.

⁴C. Lowell Harriss, History and Policies of the Homeowner's Loan Corporation (New York: National Bureau of Economic Research, 1951) p. 8-9.

to its members; to its adjuncts, the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Home Loan Mortgage Corporation (FHLMC);⁵ as well as to the depositors and borrowers who deal with member institutions. But despite its many functions, the FHLBS is primarily a regulatory agency for savings and loan associations (S & L's)

As the regulatory agency for savings and loan associations,⁶ the FHLBB establishes general operational and accounting procedures for members to follow; charters new Federal Savings and Loan Associations; approves and disapproves association mergers; establishes reserve and liquidity ratios; establishes maximum interest rates payable on savings deposits in member institutions; and establishes interest rates and loan to value ratios on mortgages. In addition to regulation, the FHL banks also provide technical assistance and advice to member institutions.

But, advancing credit is probably the most important service that the FHLBS provides member institutions. Money for these advances, or loans, is raised by the FHLBS in the open market. Credit is then extended to member institutions by each regional bank based on the security of mortgages held in the institution's portfolio. Thus, if an institution

⁵See Appendix 2-1.

⁶All Federally chartered savings and loan associations are required to become members of the FHLBS. In addition, qualified state chartered S and L's, mutual savings banks, and life insurance companies may join on a voluntary basis. As of 1972, 2,044 Federally chartered S and L's and 2,368 other institutions formed the membership of the FHLBS. S and L Fact Book, op. cit. p. 112.

is faced with low cash reserves and is suddenly confronted with a rush of withdrawals, it has the assurance that it can obtain the needed liquidity by borrowing from the FHLBS or, in other words, taking an advance.

Thus, similar to the HOLC, the FHLBS minimized risk to lenders by providing them with a source of liquidity -- one of the two major problems faced by lenders after the Depression. The FHLBS can also be credited with two additional accomplishments. First, it has firmly established and lent support to a coordinated system of home mortgage lending. By providing member institutions with guidelines and rules for their operation -- as well as liquidity and added flexibility through credit advances -- the FHLBS has contributed to legitimizing and strengthening a major system of home finance in this country.

Second, the FHLBS began the procedure of channeling funds from areas of the country where investment surpluses exist to areas where mortgage money is limited. Until the creation of the FHLBS, money that was available for mortgages was highly localized. If a lender in the West had a great demand for mortgage money but only a small amount of money available, mortgage lending would have been out of the question. The FHLBS has changed this situation. Now, if the West is short of money the FHLBS can float bonds, thereby raising money for advancement to the member institutions. With a scarcity of capital in the West, the purchasers of the bonds would most likely, be located elsewhere, such as in the East. Hoagland and Stone have observed that:

By the sale of these bonds and notes, the member institutions have access to the capital markets of the country. This represents an abrupt change from the prevailing dependence upon local funds that obtained before this bank system was started.⁷

Thus, the creation of the FHLBS was a significant step toward nationalizing the mortgage market.⁸

An important and basic assumption of our present home finance system took shape with the emergence of the Federal Home Loan Bank System. For the first time, a smooth flow of credit was seen as a critical component of Federal homeownership policy. It was assumed that if lenders could be persuaded to re-enter the mortgage lending business -- by reducing one element of risk, liquidity, and if credit surpluses and scarcities could be evened out among the various sections of the country, then potential home purchasers would be able to enter the homeownership market. Thus, achieving a smooth flow of credit was seen as a key means of promoting homeownership.

It is important to emphasize that the needs of the financial institutions to reduce risk were, therefore, the major concern of the system and that consumer needs were expected to be met once a smooth flow of credit was achieved.

Thus, the Federal Home Loan Bank Act only dealt with consumer needs as the end result of the improved functioning of the financial institutions. While it is difficult to visualize how most families could purchase homes

⁷Hoagland and Stone, op. cit. p. 443.

⁸While the FHLBS provided the mechanism for member S & L's to gain access to additional credit through the advance system, they have often been reluctant to take advantage of this. Thus, despite the national framework, the S and L's have, until recently, operated in a primarily local area. Marvell has noted that "the actual amount of advances has always been far below what is allowed by (the rules) and policy statements. At least one-half of the associations have no advances at all and many others have just nominal amounts." Thomas B. Marvell, The Federal Home Loan Bank Board (New York: Praeger, 1969) p. 69.

without an availability of credit, the point to be made here is that credit has often been seen as the only need of the consumer. While this may, in fact, be the case for some home purchasers, many other people who enter the homeownership market also require other types of assistance. The assumption that only a good flow of credit is needed to assure a viable homeownership program is one that has persisted to the present and is still an important factor whenever legislators address themselves to improving homeownership programs.

Yet, even on the credit-flow issue, there has been much debate as to the effectiveness of the FHLBS. For example, Harry Schwartz, a Vice President of FNMA has noted that:

Most important, however, was the explicit statement (in the legislation which created the FHLBS) that supply of mortgage credit should be regulated so as to avoid building booms and to support normal construction over time. This is the buffer or contra-cyclical device reinforced by an injunction to prevent excesses in residential construction activity. It is this function which would appear most important to maintaining an adequate volume of mortgage credit, and it is this phase of the FHLB's activity that has been at the center of many episodes of criticism and debate.⁹

Similarly, Rosen and Kearn have argued that prior to 1968, the FHLBS did not focus its efforts on helping to maintain an even flow of funds into housing. Moreover, they even have blamed the FHLBS for exacerbating tight money periods, such as the credit crunch of 1966.¹⁰

⁹ Harry S. Schwartz, "The Role of Government-Sponsored Intermediaries" in Housing and Monetary Policy. The Federal Reserve Bank of Boston, Conference Series no. 4, 1970, p. 70.

¹⁰ Kenneth Rosen and James Kearn, "A Simultaneous Equation Model of Housing Starts, Mortgage Flows, Federal Home Loan Bank Board and Federal National Mortgage Association Behavior." January 30, 1974. Unpublished Manuscript p. 6.

Conflicts with Consumer Needs:

Thus, it is debatable as to whether or not the FHLBS has done as much as has been needed or as much as it could to even out mortgage credit cycles. The point is, however, that credit availability was the major way in which the FHLBS was to benefit the consumer. As mentioned earlier, the FHLBS provided no direct supports to the consumer. Also problematic for the consumer has been the system's lethargic attitude toward ensuring equal access to credit to all potential borrowers. As the regulatory agency of S & L's, the FHLBB has permitted various forms of overt and covert discrimination in home finance to occur. The U.S. Commission on Civil Rights, in investigating this matter in Baltimore in 1970, issued a report which concluded with the following:

Policies of the FHLBB permit, but do not require, savings and loan associations to service the low-income market...FHLBB regulations could indicate that there is an affirmative duty on the part of each federally chartered or insured S and L to review its policies for mortgage credit to determine to what extent they operate to the disadvantage of minority persons...The adoption of a policy resolution opposing discrimination, with no accompanying enforceable regulations, appears to mean that failure to comply with the resolution neither jeopardizes the association's charter or insurance, nor subjects the institution to the cease and desist authority of the Board.¹¹

It is to the credit of the FHLBB that since the publication of the Commission's 1970 report, it has become the only financial regulatory agency to have issued fair housing requirements in the form of regulations.¹²

¹¹U.S. Commission on Civil Rights (1970) op. cit. p. 619.

¹²A Report of the U.S. Commission of Civil Rights, "The Federal Civil Rights Enforcement Effort -- 1974; Volume II, To Provide...For Fair Housing" Washington, D.C. p. 152.

On April 27, 1972, the FHLBB published regulations which prohibited discrimination in the preapplication phase of the mortgage lending process on the grounds of race, color, religion, or national origin of the applicant. And, furthermore, the regulations prohibited discrimination based on the racial, ethnic, or religious composition of the neighborhood for which the loan was being sought.¹³

While the FHLBB later issued guidelines which were aimed at assisting S & L's in implementing these regulations,¹⁴ there is still much more that the FHLBB could do to ensure an end to the discrimination practiced by member institutions. Both the regulations and the guidelines lack requirements for affirmative action; racial, ethnic, and sex data collection; compliance reviews; and, perhaps most disconcerting of all, enforcement.¹⁵

Thus, a key way in which the FHLBS has conflicted with consumer needs is by not taking more positive steps to safeguard the rights of all consumers to gain equal access to credit. It has concentrated far more on the goals of preventing credit crunches and on providing liquidity than on guaranteeing that all potential purchasers will be able to finance

¹³Fed. Reg. 8436 (April 27, 1972).

¹⁴Fed. Reg. 34653 (December 17, 1973).

¹⁵U.S. Commission on Civil Rights (1974) op. cit. p. 155. Unfortunately, little data exist which identify discriminatory practices among S & L's or the actual extent of monitoring and supervision performed by the FHLBB. However, a recent survey of 46 Washington area S & L's found several instances of noncompliance with the Civil Rights Act of 1968 and insufficient monitoring by the FHLBB. Eileen C. Sweeny, "Nondiscrimination in Mortgage Lending Practices ..." The Housing Opportunities Council of Metropolitan Washington, October, 1974.

their homes.

Since the FHLBB is a public agency, it is appropriate to question why these exclusionary practices exist. There are at least two plausible reasons. The first one relates to the complex mixture of public and private aspects of the FHLBS. While the FHLBS is a public agency, it is independent of the Federal government for funding. Since the creation of the FHLBS, the trend has been toward diminished government involvement and increased privatization. By 1939, the government had invested nearly \$1.3 billion in the savings and loan industry, with capital supplied to the FHL Banks totaling \$125 million.¹⁶ However, by 1950, the member institutions had bought up all the FHL Bank's capital stock, thereby eliminating the investment of the U.S. Treasury in the FHL Banks.¹⁷

On this point, Ernest Bloch has noted that:

The admixture of government aid (has been) much diluted from the original Act, and even more from the Depression setup...The Federal government's role in the financial structure of the System has shifted from direct support of member associations and of the Home Loan Banks, to the point where all funds used at all levels of the System are now private.¹⁸

Yet, in spite of its private funding, the FHLBS is definitely a public agency. First, the FHLBS is a creature of the Federal government. It was first created by an act of Congress in 1932 and, since then, major

¹⁶Bloch, op. cit. p. 173. In addition to capital supplied to the FHL Banks, the government also provided \$100 million in capital to the FSLIC; direct aid of \$260 million to associations in the form of deposits and indirect aid totaling \$770 million for HOLC purchases of mortgages.

¹⁷Ibid. p. 176.

¹⁸Ibid. pp. 178-179.

changes in its operation have occurred through Federal legislation.¹⁹

Second, the FHLBS is governed and regulated by a three-man board whose members are appointed by the President of the United States. The board, an independent agency within the executive branch of the Federal government, is subject to review by Congress.

And, the third "public" aspect of the FHLBS is its relationship to the U.S. Treasury. Using the Federal Reserve System as a model Congress, in 1950, provided the Secretary of the Treasury with the authority to purchase, at his discretion, up to \$1 billion of the FHLBS' obligations. This authority was expanded by the Rate Control Act of 1969, which increased the purchasing authority of the Secretary of \$4 billion. However, the Act specified that this "backup" is to be used only in situations in which the open market is not able to absorb these obligations. Thus, the Secretary of the Treasury was advised to only act in emergency situations "to avoid substantial impairment of the Home Loan Bank System because of monetary stridency or rapidly rising interest rates."²⁰ While this "backup" is not an explicit Federal subsidy, Penner and Silber have suggested that "this safety device undoubtedly lowers the interest rate

¹⁹For example, the Financial Institutions Supervisory Act of 1966 gave the FHLBB the power to issue "cease and desist" orders to any member institution suspect of wrong-doing or non-compliance with regulations. And, also in 1966, the Interest Rate Control Act empowered the FHLBB to set limits on the interest rate that member S and L's could give on their savings accounts. Another example of how Federal legislation has shaped the FHLBS is The Emergency Home Finance Act of 1970 which authorized \$250 million to be disbursed through the FHLBS for the purpose of lowering the interest rate on mortgages for low and middle income families. (Known as the Housing Opportunity Allowance Program.)

²⁰Hoagland and Stone, op. cit. p. 445.

which the FHLBB must pay for funds."²¹ Thus, although FHLBS obligations are not actually guaranteed by the U.S. Government, investment in these types of notes are still extremely attractive, and are perceived as only slightly less safe than Treasury bills.

In summary, then, charges that the FHLBS has not acted with a stronger consumer orientation could be countered with arguments pointing to the ambiguity between its role as a public agency with private funding.

The second characteristic of the FHLBS that probably accounts, in part, for its weak position vis a vis the consumer is its role as a regulatory body. Not only is the FHLBS part-private and part-public, but its close connection to private interests, as the regulator of S & L's, has further served to diminish its public orientation.

Much has been written about the relationship among regulatory agencies, those entities that are regulated, and the general public. The literature suggests that regulatory agencies are primarily set up and function to serve the needs of the regulated. For example, writing on the regulator-regulatee relationship between the Interstate Commerce Commission and the railroads, Gabriel Kolko has concluded that:

National regulation of the railroads, from 1887 until 1916, was an attempt to create a political capitalism for the sake of the railroads, and the railroads supported it for precisely this reason. Indeed, they were the most crucial factor behind the federal regulation of the railroads. And although it was necessary to pay lip

²¹ Rudolph G. Penner and William L. Silber, "Federal Housing Credit Programs: Costs, Benefits, and Interactions" in The Economics of Federal Subsidy Programs: Part 5 -- Housing Subsidies, A Compendium of Papers Submitted to the Joint Economic Committee, Congress of the United States, October 9, 1972, p. 670.

service in political rhetoric to the desire to enhance and protect the general public welfare, at least Roosevelt explicitly made it clear that the public welfare would be served by the government concerning itself first with the welfare of the honest railroads.²²

Based upon this well-accepted observation, one might expect that the FHLBS' services would be geared toward the regulated institutions, rather than toward the welfare of the general public. Similar to the I.C.C., the FHLBS was intended to stabilize and strengthen the regulatees -- the mortgage lenders.

By supplying credit to member institutions their resources were expected to be strengthened and supplemented. And, just as the above quote indicates Roosevelt's belief that the public would ultimately be served by first regulating the railroads, the FHLBS was, as discussed above, also intended to serve the public by increasing and stabilizing the availability of mortgage money, by strengthening the member institutions.

On the surface, there is no reason to believe that this situation would produce conflicts between S & L needs and consumers. However, if one goal of the FHLBS is to support and strengthen S & L's and another is, or should be, to maximize money available to all consumer groups, conflicts could arise if the latter would tend to threaten S & L's. Whether risks are real or perceived, many S & L's have chosen to

²²Gabriel Kolko, The Triumph of Conservatism (New York: Free Press of Glencoe, 1963) p. 238.

avoid lending to minorities, women and to families wishing to buy inner city properties.²³ And, as discussed earlier, it is significant that the FHLBB has made only slow and incomplete efforts at correcting these discriminatory practices among S & L's.

Thus, it appears that the regulatory and private aspects of the FHLBS have dominated over its public orientation, both in its own practices and policies and in the way its activities have been perceived by others.²⁴

²³See, for example, "Where the Lender Looks First; A Case Study of Mortgage Disinvestment in Bronx County, 1960-1970", "Richard J. Devine et al. National Urban League, New York City, 1973; "Mortgage Money: Who Gets It? -- A Case Study in Mortgage Lending Discrimination in Hartford, Connecticut," U.S. Commission on Civil Rights. Clearinghouse Publication No. 48. June, 1974; "Discrimination in Home Finance" Daniel A. Searing. Notre Dame Lawyer, June, 1973. Michael Stegman, Housing Investment in the Inner City. MIT Press 1972; and "Patterns and Practices of Discrimination in Lending in Oakland, California "A Report of a Study by NCDH/HUD Urban Renewal Demonstration Project." February 1972,(Mimeo). For a good discussion on this subject including a review of the above studies see: Kerry Vandell, Barbara Hodas and Rachel Bratt, "Financial Institutions and Neighborhood Decline: A Review of the Literature" Prepared for the FHLBB, Nov. 1974.

²⁴The following example substantiates this conclusion. In 1968, bitter attacks were launched against the Federal Housing Administration (FHA) for not taking the lead in trying to stimulate lending activity in inner city areas and to lower income and minority families. (See Chapter 3, Section 4d) But despite this awareness of the government's role in contributing to discriminatory lending practices, no criticism was directed to the activities of the FHLBS. And, yet, blame would have been in order. Both because of its role as the regulatory agency of S and L's as well as its function of providing cash advances to member institutions, the charge could have been made that the FHLBS was as guilty as the FHA for permitting red-lining and other discriminatory practices by S and L's. But because the FHLBS was generally perceived as a private regulatory banking institution, it escaped the frequent and harsh attacks that fell on the FHA.

CHAPTER 3: FEDERAL HOUSING ADMINISTRATION

1. INTRODUCTION:

The previous chapter noted that while the HOLC addressed both major components of risk -- fear of loss due to foreclosure and the lack of liquidity -- the FHLBS addressed only the latter. However, the FHA mortgage insurance mechanism created by the National Housing Act of 1934¹ was aimed at decreasing the risk due to foreclosure thereby attempting to increase the participation of financial institutions. The same legislation also created the Federal National Mortgage Association, another important cushion against illiquidity (see Chapter 7). Both of these institutions shifted risk from the lenders and onto the government, although the FHA was the most significant government effort in reducing lender liability.

The discussion of FHA will follow the framework set up in Chapter 2. That is, the FHA will be analyzed in terms of the various goals that were embodied in the legislation and the subsequent impacts that these goals have had on consumers.

¹National Housing Act, Public Law 479, 48 Stat. 1246.

2. MULTIPLE GOALS OF THE FHA:

a. Need for Broad-Based Participation of Lending Institutions:

The FHLBS was two years old when the National Housing Act of 1934 was enacted. In view of its experience in home mortgage operations, it is appropriate to question why the government's home modernization and mortgage insurance programs were not placed under the direction of the FHLBB. Marvell offers a possible reason:

By 1934, the FHLBB was already very much under the influence of the savings and loan industry, which did not like the insurance scheme because it called for insured mortgages made by banks and insurance companies as well as by S and L's. The industry figured that government insurance would offer the banks and insurance companies a chance to eat into what it considered its own share of the mortgage market.¹

Thus, because other lending institutions, in addition to S and L's, were welcome to participate in the new mortgage insurance program, Roosevelt's advisors feared that the FHLBB would not administer the program fairly.

It is problematic as to whether or not the FHLBB would have administered the insurance program impartially so as to permit the participation of non S and L lenders. However, statements from representatives of the building and loan industry, at the Senate Banking and Currency Committee hearings of 1934, indicate that there was little enthusiasm for the new program. The articulated opposition to the scheme ranged from criticism of creating a new agency -- to ambivalence about the need for such a program -- to practical objections to the government's getting

¹Thomas B. Marvell, op. cit. pp. 27-28.

involved in the business of guaranteeing mortgages.

In response to a question concerning the proposed insurance mechanism, Morton Bodfish, the Executive Vice President of the U. S. Building and Loan League articulated his opposition to the creation of a new agency:

We have a substitute program that we think would be more immediate and more feasible to use the existing agencies. To use the Home Owners' Loan Corporation and the Home Loan Bank System...²

John H. Fahey, Chairman of the FHLBB, voiced his ambivalence:

...this proposal of the insurance of individual mortgages is a novelty. None of us who have been giving it attention believe that there is going to be a general demand for its immediate use...³

And, Maco Stewart the President of the largest building and loan association in Texas raised political objections to the mortgage insurance plan:

If the U. S. Government goes into guaranteeing the payment of mortgages, secured mortgages, as they call them in this bill, someday or other, in the next depression, if one ever comes... We will all go blooie.⁴

But with the sentiment both within Congress and the Roosevelt Administration leaning strongly in favor of providing employment opportunities and stimulating the home building industries, the interests and concerns

²Hearings Before the Committee on Banking and Currency, U.S. Senate. 73rd. Cong. 2nd. Sess. May 1934, p. 254 (Referred to as "National Housing Act Hearings").

³Ibid. p. 209.

⁴Ibid. p. 100.

of the S and L's were not heeded. The Federal government was trying to involve a wide range of financial resources and lending institutions in the economic recovery of the nation and mortgage insurance was perceived as a means to that end.

The decision to create a new agency to administer the mortgage insurance program marked the emergence of the dual home finance structure. While attempts were later made to coordinate the activities of the FHLBS and FHA, they were unsuccessful. Writing about one such attempt, Miles Colean points out that:

The Reorganization Act of 1939 brought the two agencies together in the new Federal Loan Agency. This move, however, did not result in a basic reorganization. Even duplicate administrative functions were not eliminated. Research divisions and technical operations were still separate and administrative conflicts, created partly by agency rivalry and partly by fundamental differences in philosophy, remained.⁵

One can view the creation of the dual home finance system as the outcome of the Federal government's intervention in an area dominated by private actors with varying interests. Since the S and L's had been the prime mortgage lenders prior to the Depression,⁶ this group first received attention and remedial support in the form of the HOLC and FHLBS. However, with the additional goal of stimulating home building, the government

⁵Miles L. Colean, American Housing (New York: 20th Century Fund, 1944) p. 269.

⁶Marvell op. cit. p. 19: "Savings and loan associations held one-third of the nonfarm home mortgages in the early 1930's, considerably more than any other type of lender, although insurance companies and savings banks were also important home-mortgage lenders. Commercial banks were the only organizations with enough funds to be in a position to help the home owners, but they were hoarding their money, afraid to risk it during the hard times of the Depression. Therefore, the government looked to the savings and loan associations, along with insurance companies and savings banks, to help solve the plight of the home owners."

chose to broaden the range of lending institutions involved in home mortgage lending through the new mortgage insurance program.

b. Mid-Depression Needs of the Construction Industry:

In addition to its clear priority to involve a broad range of lending institutions, the government was also under substantial pressure from the construction industry to assist them in regaining their lost momentum. That industry had suffered enormous setbacks during the Depression as housing unit starts fell well below the foreclosure rate.

In 1933 only about 40,000 new homes were built,⁷ while only eight years earlier the new housing construction rate had topped 800,000 units.⁸ This plunge in construction fueled the spreading nationwide unemployment. By 1934, the unemployment rate in the construction industry was about 85% of a total on-site work force of at least a million and a half and an off-site work force of about 6 million.⁹

The combined efforts of the FHLBS and the HOLC were not able to significantly affect the unemployment rate or substantially stimulate the construction industry. The answer for the construction industry was contained in Title I of the National Housing Act, a labor-intensive home

⁷National Housing Act Hearings, op. cit. p. 288.

⁸Glenn H. Beyer, Housing and Society op. cit. p. 197.

⁹National Housing Act Hearings, op. cit. p. 412-414.

modernization program, and the Title II mortgage insurance programs. While the construction industry was unable to recapture the momentum of the mid-1920's, by 1941 the FHA programs managed to stimulate the construction of about 700,000 units.¹⁰

Title I of the National Housing Act provides insurance to private lenders on loans made to homeowners for the purpose of "financing alterations, repairs, and improvements upon or in connection with existing structures..."¹¹ The insurance that is provided under this title only covers 90% of the loss encountered by a lending institution on a foreclosed loan.

Title II of the Act provides complete insurance to private lenders on loans made to people who are purchasing a new or existing home, thereby eliminating risk from the lending decision. By the end of 1973, over 10 million families had become homeowners using Title II FHA insurance, while almost 3 million families were assisted in making repairs to their homes through Title I.¹²

Whether one views the creation of the second home finance system, the FHA, as an outcome of the interests of lending institutions, the construction industry, or both, it seems clear that it evolved out of the

¹⁰Beyer, op. cit. p. 197.

¹¹"Basic Laws and Authorities on Housing and Urban Development" (Revised through Jan. 31, 1971) Committee on Banking and Currency, House of Representatives, 92nd. Cong. 1st. Sess. p. 6-7.

¹²HUD Statistical Yearbook, 1973, Washington, D.C. p. 142.

government's desire to assist the private actors who were already key participants in the housing industry. Based upon this interpretation of why this country created a dual approach to home finance, as well as because the insurance mechanism was aimed at protecting lenders, it is fair to conclude that the major clients of the 1934 Federal housing legislation were the lending institutions and the construction industry. The consumer was not intended to be the first-order recipient of the benefits of the legislation.

The following comments by noted students of housing policy sum up the multiple goals of the National Housing Act -- with economic, political, and social objectives taking priority over welfare goals.

Charles Haar:

(FHA) was designed to provide an adequate home financing system, to exert a stabilizing influence on the mortgage market and to encourage improvement in housing standards and conditions.¹³

John Dean:

The favorable attitudes of those testifying at the hearings before the Senate Committee which handled the FHA legislation indicate whose bread was to be buttered by the passage of the act. (i.e., lumbermen, building trade representatives, real estate men, building materials suppliers, and bankers all spoke with enthusiasm for the FHA.)¹⁴

Nathaniel Keith:

While the establishment of the FHA mortgage insurance program had some reform aspects from the standpoint of correcting the mortgage abuses of the Twenties, it was primarily sold politically as a program to unfreeze the home building industry and thereby

¹³Charles Haar, op. cit. p. 21-23.

¹⁴John P. Dean, Homeownership: Is It Sound? (New York: Harper and Row, 1945) p. 48.

stimulate employment and the economy.¹⁵

Miles Colean:

The new measures had far-reaching implications and were for the most part intended to be of indefinite duration, but they were enacted when emergency conditions prevailed and had an emergency point of view. Each new housing bill was advocated as a means of stimulating the durable goods industries or putting men to work. Housing thus was looked upon as a remedy for general economic ills rather than a problem in itself. This confusion of objectives has hindered the coordinated development of Federal housing policy.¹⁶

Thus, the creation of the FHA represented a landmark decision on the part of the Federal government. The National Housing Act of 1934 opened the way for financial institutions to become re-involved in mortgage lending through the use of the risk-reducing mechanism of FHA insurance. The government's position was clear: "We'll insure you against risk if you get back into lending." Explicit in this was the government's willingness to act as a backstop to the financial institutions and to assume the risk inherent in mortgage lending.

Following a brief review of the early accomplishments of the FHA, the various ways in which the multiplicity of goals of the National Housing Act led to conflicts with consumer needs will be examined.

¹⁵Nathaniel S. Keith, op. cit. p. 24.

Interestingly enough, the same groups that had spoken so positively about the FHA were, just three years later, to oppose the new public housing program. Keith observes that this "was viewed as a dangerous threat to private enterprise in real estate...The ideological opposition of these groups (Chamber of Commerce; National Association of Real Estate Boards, The U.S. Savings and Loan League; and the National Association of Retail Lumber Dealers) to Federal intervention in housing did not extend to the entities formed to support private enterprise...the FHA and the FHLBS. On the contrary, these organizations had played a role in the enactment of the legislation establishing FHA and the HLBB. But they viewed public housing as an enemy wedge for the eventual socialization of residential real estate." (pp. 29-30).

¹⁶Miles L. Colean, op. cit. pp. 261-262.

3. EARLY ACCOMPLISHMENTS OF THE FHA:

As mentioned above, FHA's primary task was to minimize the risk of loss due to foreclosure for lending institutions. But, in addition, it standardized the mortgage lending process and actually helped to revolutionize mortgage lending procedures.

a. Minimizing Risk Due to Foreclosure:

In the case of Title II programs, an insurance premium is paid by the mortgagor and deposited in one of FHA's four insurance funds. This premium is based on 1/2 percent/year on the outstanding balance of the principal mortgage amount. In effect, the premium equals an interest rate increase to the buyer of 1/2 percent. But, in return, the buyer is permitted to make a lower downpayment than if the mortgage were written without government insurance, on a conventional basis.

A very substantial benefit also accrues to the mortgage lender. Without any cost to him, FHA insurance promises the lender that, in the event that the mortgagor is unable to meet his mortgage obligations and a foreclosure occurs, the FHA, drawing upon the appropriate insurance fund, will reimburse the mortgagee for 100% of the outstanding balance of the loan plus foreclosure expenses and lost interest payments. This insurance settlement payment, originally made in an illiquid form of asset, debentures, has, since 1965, been made almost exclusively in cash. Thus, FHA has minimized one of the most prominent fears of any business -- the fear that money may be lost on investments.

b. Standardizing Mortgage Lending Procedures:

The creation of the FHA insured mortgage was also the first major step toward standardizing mortgage lending procedures. Rules were laid down by the FHA on the type of property that would be considered a reasonable security for the loan and the necessary income and credit standing of prospective purchasers. FHA rules went into great detail on these points -- and even went so far as to prescribe the type of neighborhood that would be acceptable in terms of its racial composition.¹ Thus, a banker in Boston that was lending money with FHA insurance was following the same ground rules as his counterpart in Boise. This standardization paved the way for the buying and selling of FHA insured mortgages. If the banker in Boston had more deposits than he could invest in his own area, he could now purchase mortgages in Boise. The Boston banker would not have to know the neighborhoods and property values in Boise, the quality of a particular appraiser's work, or the characteristics of the local borrowers. FHA guidelines specified the exact type of loan on which its insurance could be issued. Personal familiarity on the investor's part disappeared as a critical component of the investment decision. If the banker in Boise, as well as the FHA insuring office in Boise, both thought that the loan was good, then why shouldn't the banker in Boston buy it?

¹Federal Housing Administration, "Underwriting and Valuation Procedures Under Title II of the National Housing Act," Section 937, 1938.

The answer is that he should and he does.² But, while similar to the advance system of the FHLBS in which surplus capital from one part of the country is channeled into mortgage money in another, there is also an important difference. In the case of the FHA system, mortgages are actually originated in one area of the country and sold in another, while in the case of the FHLBS, it is only capital that is transferred.

c. Revolutionizing Mortgage Lending Procedures:

As mentioned earlier, prior to the Depression, most mortgages had short terms to maturity; were only partially amortized or completely unamortized; and had low loan to value ratios. But with the bulk of the risk removed, lenders using FHA insurance were willing to extend the terms of mortgages; to write fully amortized loans; and to accept higher loan to value ratios.

But even lenders writing non-FHA insured mortgage loans quickly began to adopt the practices authorized for lenders using FHA insurance. Thus, the FHA insurance programs had a profound impact on revolutionizing the entire quality of home mortgage lending in this country. However, as suggested above, the FHA also presented an array of problems to some consumers. While the following discussion focuses on these negative side-effects, it is important to keep in mind that the FHA provided substantial benefits to numerous homeowners.

²The mechanics of this operation are lengthy and complex and require a chapter of their own (see Chapter 7). For the present, it is sufficient to note that there has been a steady growth in the buying and selling of FHA insured mortgages. Moreover, the government has contributed to this growth by the creation of the Federal National Mortgage Association, the Government National Mortgage Association, and the Federal Home Loan Mortgage Corporation. These three agencies are the government-sponsored secondary mortgage market facilities.

4. CONFLICTS WITH CONSUMER NEEDS:

With the New Deal and Congressional goals for FHA directed at stimulating the construction industry and safeguarding financial institutions, FHA was destined to grow into an industry-oriented, rather than consumer-oriented, institution. Some observers were able to foresee this at an early stage.

During the hearings on the proposed housing legislation, in 1934, the new bill was denounced for the lack of orientation toward the homeowner. Marvin Farrington, representing a national organization of homeowners (Home Owner's Protective Enterprise, H.O.P.E.) testified that:

The title of Senate bill No. 3603 as well as the publicity given it thus far, conveys the impression to the homeowner that this legislation is primarily in his interest. It is respectfully submitted that this is not true.¹

Farrington continued, pointing out two aspects of the bill which, he felt, were not in the best interests of the homeowner:

[First] there is not a line in the bill assuring or guaranteeing the homeowner that his presently due or past due mortgage shall be renewed or refinanced.

To which Senator Bulkley responded:

It is not intended to do that here. That is financed in the Home Owner's Loan Act.

Mr. Farrington: That is true. But the Home Owner's Loan Act is very limited...that language...is limited to those really in distress...

Senator Bulkely: Yes, of course, but that is what we intended to do for the fellow who was in distress. This bill does not pretend to do anything from that direction. It is for an entirely different purpose. It is not a fair criticism of this bill to say that it

¹National Housing Act Hearings op. cit. p. 372-382.

does not do anything for the distressed homeowner, because we have already done what we thought was right for him in another piece of legislation.

Mr. Farrington: [Second] proper care has not been exercised by the draftsmen of the bill in the matter of protecting the homeowner himself.

And, Senator Buckley responded:

Well, of course it is to be assumed that the homeowner won't enter into a contract for renovation unless he thinks it is to his benefit. It is entirely voluntary with him whether he enters into a contract or not.

And, further, Mr. Farrington accurately predicted one of the outcomes of the legislation although he didn't believe it could happen:

It taxes common sense...to believe that homeowners, very many of whom are now distressed by due or past due mortgage indebtedness, to say naught of their reduced incomes, are going to further obligate themselves for repairs or improvements if they know their estates are in jeopardy by foreclosure.²

In the same vein, Marie L. Obenauer, an official of H.O.P.E., claimed that her group had proposed a different method of home repair, but with a more homeowner-oriented component:

[The group's proposed plan] provides for competent and disinterested counsel to the homeowner as a guard against needless further debt commitments and unsound charges for credit. Neither of these things are done by Senate bill 3603. Furthermore, the bill could effectually block such services to the home owners of the country.³

Yet, the momentum for passage of S. 3603 was great and, aside from the above objections, opposition was minimal.

Following its legislative mandate, FHA undertook its mission with a fervor rarely seen in public agencies. Launching a publicity campaign that

²Ibid.

³Ibid. p. 388.

could rival even the most successful commercial advertising ventures, thousands of people joined the FHA home improvement and purchase programs, (See Exhibit 1).⁴ The intensity of the "own you own home" movement, which began to gain momentum during the early 1930's, prompted one writer to warn that: "Every prospective home buyer should be immunized with an antitoxin against the blah-blah of own-your-own-home campaigns."⁵

John Dean, a well-noted mid-1940's critic of the one-sided nature of the FHA campaign urged that home-buying families ask themselves: "Just what is it we expect to get out of owning this home...?" Instead, "American families are encouraged to bypass this kind of reflective consideration of home ownership and to step boldly ahead."⁶ Further, he wrote that:

It may be urged that criticism of the activities of those merchandising houses is captious, because they are simply engaging in normal business practices. But since the purchase of a home represents the largest single purchase a family ever makes and since a house and lot represent a highly complex choice, the rightness or wrongness of which colors a family's future for years, the delivery of the conditions of promotion and sale over to ballyhoo by interested groups of sellers...is a questionable social policy.⁷

While Dean never detailed actual cases in which families were badly burned by the ownership experience, he suggests that there are numerous ways in which homeownership may not live up to a family's

⁴Federal Housing Administration, "Portfolio of Publicity for a Local Better Housing Program," 1934.

⁵Rose Stein, "More Homes or More Mortgages" The New Republic, Sept. 7, 1932, p. 90.


⁶John Dean, op. cit. p. 18.

⁷Ibid. p. 39.

MISCELLANEOUS PUBLICITY

To
PROPERTY OWNERS
wishing to borrow money for
*Repairs, Alterations
and Improvements*
under the terms of the National Housing Act.

<p>1. Who may apply?</p> <p>2. To what use of the property?</p> <p>3. Must I be a taxpayer?</p> <p>4. How much money may I apply for?</p> <p>5. May I borrow for work on more than one property?</p> <p>6. How much time will I have to pay?</p> <p>7. What kind of security will I have to give?</p> <p>8. Can the money be used for other purposes?</p>	<p>9. Is the plan to be used for the same purpose as the original mortgage?</p> <p>10. What security will I give?</p> <p>11. What return must I give?</p> <p>12. Must I have a certain amount of equity in the property?</p> <p>13. How do I pay the note?</p> <p>14. May the owner of one type of property apply?</p> <p>15. Are there any particular types of building materials?</p>	<p>16. May I borrow to buy movable personal equipment?</p> <p>17. Can I borrow money from the Government?</p> <p>18. How do I make the payments?</p> <p>19. May I get it if the work is not completed?</p> <p>20. May I use more than one installment at a time?</p>
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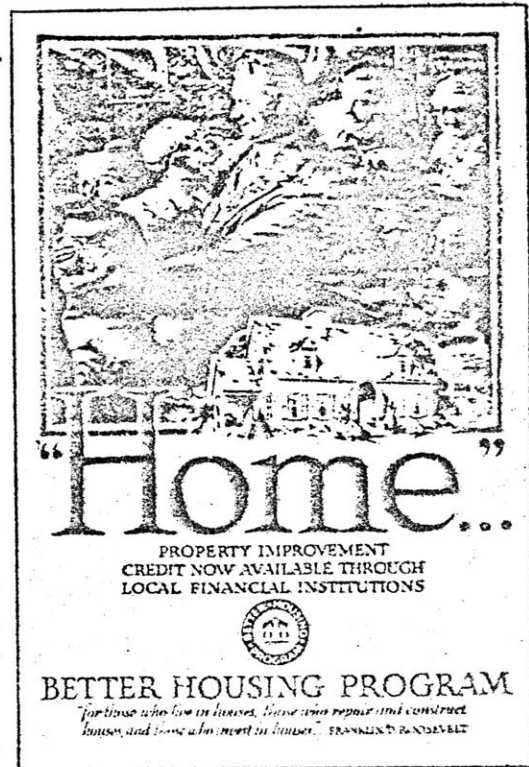
FHA-208

Information Bulletin, for wall or window posting (cardboard). 14 by 22 inches, giving questions and answers about financing plan of National Housing Act. Red, white, and black.



FHA-206

Metal Sign (28 gage), 8½ by 11 inches, 3 colors, red, white and blue. For use by dealers and contractors on trucks or at their places of business.



FHA-205a

"Home" Poster, 14 by 22 inches (cardboard), 2-color offset, sepia and buff. For use on windows, walls, posts, etc.

FHA-205

"Home" Poster, same as above except 8½ by 13½ inches (paper), sepia rotogravure.

FHA-205b

"Home" Poster, 28 by 44 inches (paper), 2-color lithography. Sepia and buff. For use on walls, billboards, neighborhood posting panels, windows, etc.



FHA-320

Mat of "Home" Poster, 2 inches wide. For use in literature, advertisements, newspapers, and other publicity.

FHA-321

Mat of "Home" Poster, 4 inches wide. For use in literature, advertisements, newspapers, and other publicity.



FHA-319


Mat of Better Housing Emblem, 2 inches wide. For use in literature, advertisements, and other publicity.

"Community Campaign" Booklet, 6 by 9 inches, 36 pages, illustrated, giving detailed instructions on how to conduct a community modernizing and improvement campaign. For use of committee members, campaign workers, field canvassers, and others.

National Housing Act (full text). A few copies of this should be on hand at campaign headquarters for reference and other uses.

Community Campaign

How Your City can get the greatest Benefit from the **National Housing Act**



A suggested plan for organizing your local community.

Community Planning

In Relation to the Modernization Phase of the **National Housing Act**

Suggestions to Building & Planning Officials, City Planning and Housing Commissions & Associations, Architects, etc., interested in the Better Housing Program

FEDERAL HOUSING ADMINISTRATION
WASHINGTON
D. C.

(Public No. 473-730 Congress)
(H. R. 9028)
AN ACT

To encourage improvement in housing standards and conditions, to provide a system of federal housing insurance, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "National Housing Act."

TITLE I—HOUSING RENOVATION AND MODERNIZATION

SECTION 1. CREATION OF FEDERAL HOUSING ADMINISTRATION

Section 1. The President is authorized to create a Federal Housing Administration, all of the powers of which shall be exercised by the "Administrator," who shall be appointed by the President, by and with the advice and consent of the Senate, shall hold office for a term of four years and shall receive compensation at the rate of \$10,000 per annum. In order to carry out the provisions of this title and titles II and III, the Administrator may establish such agencies, offices and units, such voluntary and non-profit organizations, utilize such Federal officers and employees, and with the consent of the State, such State and local officers and employees, and appoint such other officers and employees, and with the consent of the State, such State and local officers and employees, of other laws applicable to the employees of the United States, and delegate any of the functions and powers conferred upon him under this title and titles II and III to such officers, agents, and employees as he may designate or appoint, and may make such expenditures (including expenditures for personal services and rent of the seat of government and elsewhere, for law books and books of reference, and for paper, printing and binding) as are necessary to carry out the purposes of this Act.

BULLETIN

For **Manufacturers Advertising Agencies & Publishers**

National Housing Act

Explaining how you may **PROFIT** by helping the Better Housing Program sponsored by the United States Government

FEDERAL HOUSING ADMINISTRATION
WASHINGTON
D. C.

"Community Planning" Booklet, 6 by 9 inches, illustrated, telling how various group modernization and improvement projects might be organized under the Better Housing Program. For use of building and planning officials, city housing commissions,

"Manufacturers" Booklet, 6 by 9 inches, telling specifically what manufacturers, advertising agencies, publishers and others profitably can do to help support the Better Housing Program and their local community campaign.

Spot Announcements for Radio

(TEAR HERE)

1

You can have a modernized home NOW; and as much as 3, and in some cases 5, years in which to pay for it. For details, ask any financial institution approved by the Federal Housing Administration.

2

Thousands of property owners are getting action today on needed home and business building improvements. Just ask any financial institution, approved by the Federal Housing Administration, for the facts.

3

Owners of apartment buildings, stores and business property, industrial plants and farm property, are entitled to the new property improvement loans. Ask any financial institution approved by the Federal Housing Administration.

4

The National Housing Act authorizes home and business property improvement loans of \$100 to \$2,000, with as much as 3 (sometimes even 5) years to pay. Ask any financial institution approved by the Federal Housing Administration.

5

Needed improvements to homes and business property are a wise investment—and they help put unemployed men back to work. For details ask the Better Housing Committee.

6

To make old homes young again—that is one of the worth-while purposes of the National Housing Act. Any financial institution approved by the Federal Housing Administration can tell you about the liberal loans now available.

7

Perhaps your wasted attic or basement space can be put to serviceable use at small expense. The National Housing Act makes it possible to finance such improvements on liberal terms.

8

Homes long overdue for a paint job will welcome the National Housing Act. Work of this kind can now be paid for on easy terms. Ask your local Better Housing Committee.

9

An important book telling how home and business property owners can benefit under the National Housing Act may be obtained free from your local Better Housing Committee.

10

Your home improvement job may seem small in itself, but millions of such jobs will go a long way toward bringing back prosperity. Support your local Better Housing Program.

11

Need a new garage or an extra bedroom? The National Housing Act has made private capital available for such improvements. Ask any financial institution approved by the Federal Housing Administration.

12

Women know how new color and new conveniences in the home can add to family happiness. Now is a good time to make these improvements. Support your local Better Housing Program.

13

Proper insulation of home or business building will save fuel and add to comfort. Loans are available to property owners for this

work. Ask your local bank or other financial institution.

14

Does the roof leak? That's an important and needed repair which can now be financed on liberal terms. Ask any financial institution, approved by the Federal Housing Administration, for the details.

15

Your property improvement loan under the National Housing Act may run for any number of months up to 3 years, or even 5 years in certain cases. For complete details ask any financial institution approved by the Federal Housing Administration.

16

The provisions of the National Housing Act apply to property improvements on the farm, in villages, and in cities. Get complete details from your local Better Housing Committee.

17

Are you one of millions of Americans in city, suburb, and farm whose home is in need of repairs? Liberal loans are now available with which to make them. Ask your local bank or other financial institution.

18

Does your store or place of business need repairs or a modern front? Such improvements can now be financed on easy terms. Ask any bank cooperating with the Federal Housing Administration.

19

The first recovery expenditure an owner ought to make is for needed property repairs. It is common-sense security to put property in order—and the provisions of the National Housing Act make the financing of such improvements possible on easy terms.

(TEAR HERE)

BETTER HOUSING PROGRAM MEANS MORE JOBS FOR BUILDING WORKERS

Chairman of Local Committee Declares Plan Was Evolved by Business Leaders

The National Housing Act is the Nation's challenge to the forces of depression which have left in their wake lagging construction and capital-goods industries.

Explaining the objectives of this highly important legislation today, Mr. _____, Chairman of the _____ Better Housing Campaign Committee pointed out that the program is more than a plan to revive a single industry. "It is", he said, "a broad recovery measure regarded as one of the most far-reaching in importance that has been enacted by Congress since the National Recovery Act."

"It is a plan to remove the largest remaining obstacle in the way of full recovery", Mr. _____ declared, "one which is destined to restore to useful, private enterprise the largest group of workers still unemployed."

"No single man or industry proposed the National Housing Act. It is the work of a group of leading business men, among them the heads of the largest commercial organizations, banks, and insurance companies, and representatives of important manufacturing and trading interests."

"Early last winter these men became concerned with the slow progress toward recovery of certain basic industries. They found that whereas consumer goods had made a substantial come-back since the bank holiday of 1933, there were other industries, principally those dealing in heavy or durable goods, that were falling far behind. The most important of these was the construction industry. It was found that new home building had dropped nearly 90 percent from the 1926-29 level, and that nearly one-third of all the families then on the relief rolls were the families of workers normally engaged in building. It was to solve this situation that the National Housing Act became law."

"It is expected to alleviate the distress among a large portion of the 4,000,000 persons in the United States

who normally depend upon the construction industry for their livelihood."

The Federal Government, through the Housing Administration, will insure lending agencies against 100 percent of all losses, provided the total of such losses does not exceed 20 percent of the aggregate amount of funds advanced for property improvements. This insurance is virtually an iron-clad guarantee of protection for the financial institutions, since the highest known loss ratio on similar types of loans has not exceeded 3 percent. Experts in this field have expressed the opinion that it is hardly conceivable that these credits, extended by prudent institutions, could result in losses greatly exceeding this previous experience. The insurance, they agree, is tantamount to a complete guarantee for financial institutions. That is, if a lending agency acquires notes aggregating a total volume of \$100,000, it will be insured against 100 percent of loss on all items up to total aggregate losses of \$20,000. Losses of this proportion have never been approached in America on this type of business, even in the worst depression years.

The Federal Housing Administration, in its rules and regulations covering the making of loans, will not require collateral, except in some cases where the State law demands mortgages as security for loans. This is true of some building and loan associations and savings banks, but the great majority of loans to be made under this plan will be in the form of character loans, based solely on the reputation of the borrower and his ability to repay. Endorsers and co-makers will not be needed.

James A. Moffett, the Housing Administrator, emphasizes that while the Federal Housing Administration is anxious to receive the heartiest cooperation from property owners and the public, no modernization loans that are not fully justified on the grounds of sound judgment are desired.

NOTE.—Suggested feature story for use during campaign on women's page. Use blank, page 103, to order mat

(TEAR HERE)

BASEMENTS MAY BE BROUGHT TO LIFE

Recreation or Play Room Is Valuable Addition to a Modern Home

The long-neglected basement is being brought back to life. Many homeowners throughout the country are transforming this space, which in the past has been little used, into an attractive play room or recreation room or into living quarters.

This transformation has been made possible by the new types of flooring equipment now on the market which eliminate dirt and free up the space formerly used for storage.

Improvements to the basement can now be made with no down payment and on liberal monthly terms through credit facilities opened up by the National Housing Act.

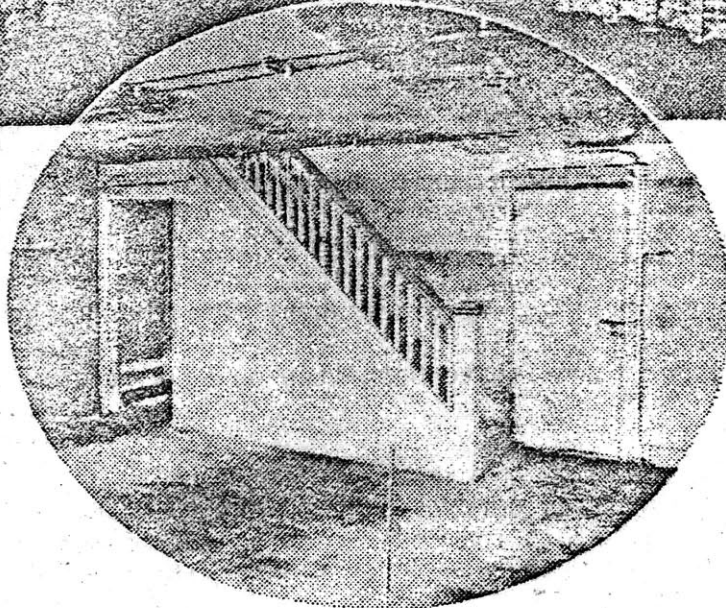
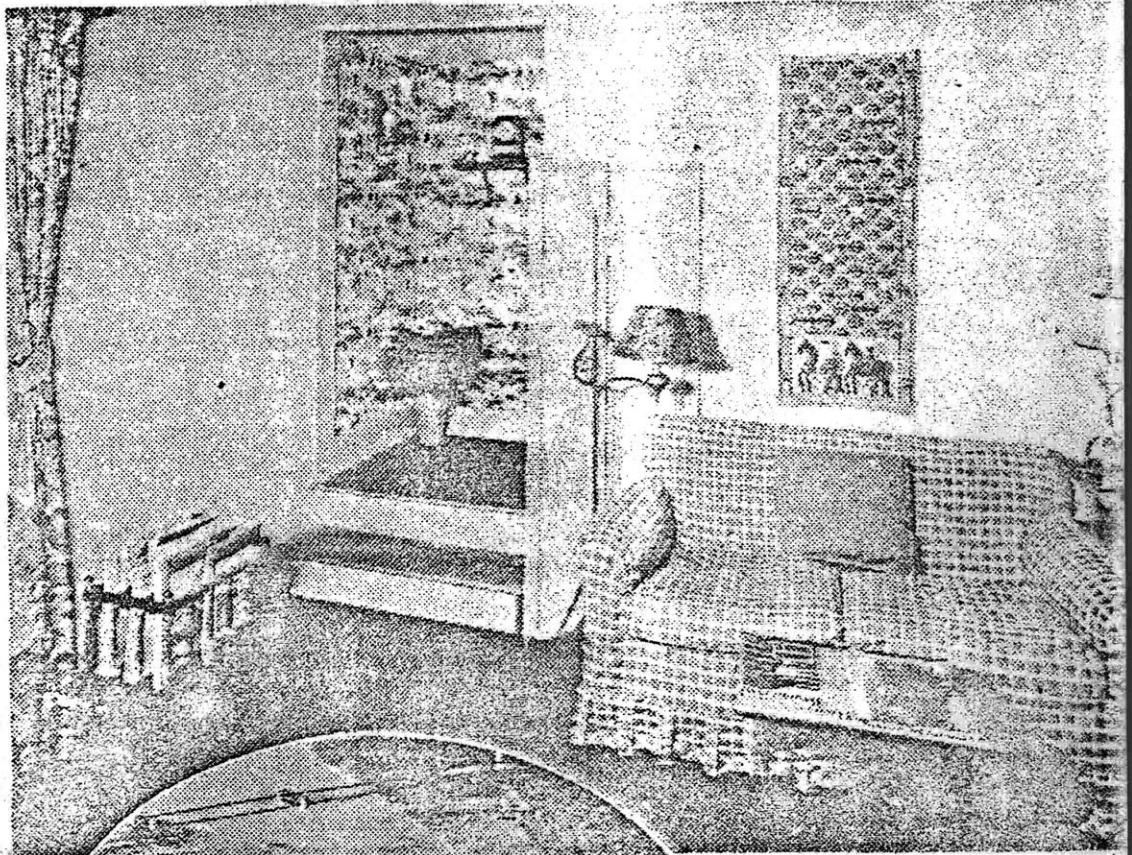
From your local bank or other financial institution approved by the Federal Housing Administration you can borrow up to \$2,000, repayable over a period up to 3 years, (5 years in certain cases), for improvements of this kind.

Many people in _____ are interested to make improvements of this sort as a part of the Better Housing Program.

The first step in building a modern basement is, of course, a solid floor and complete waterproofing of foundation walls. This done, the walls and floors can be painted or covered with a number of the attractive materials now on the market.

When partitioning off the basement it is advisable, where possible, to have the stairway lead directly to the recreation or play room, so that guests will not have to pass through the furnace room.

(Mat No. FHA 301)



How an unused basement converted into an attractive living space is shown in these illustrations. Above is the completed room: installation of new automatic heating equipment made this transformation possible.

expectations or be suited to a particular family's needs. However, other studies and Congressional hearings between the 1940's and the 1960's pointed to problems which the FHA and, later, the Veterans Administration (VA) programs were causing for home buyers.

The following discussion is not intended as an exhaustive evaluation of FHA's early failures. Rather, it is intended to underscore the fact that FHA has had its share of difficulties; that many of its problems have been of a recurring nature; and that at least some of the problems can be attributed to the strong pro-industry goals which were embodied in the 1934 legislation and which have set the tone for the implementation of the FHA programs.

a) Title I problems:

In 1955, the Senate Committee on Banking and Currency issued a report which disclosed abuses in the FHA programs. The hearings confirmed Marvin Farrington's and John Dean's fears that many families would be duped into undertaking home repairs because of the publicity campaign and without understanding their obligations. But, in addition, the 1955 hearings exposed what was to be a recurrent theme in the FHA/VA programs: Uncontrolled exploitation by private businessmen. Homer Capehart, Chairman of the Senate Committee on Banking and Currency, stated the problem:

The act (Title I) permits a homeowner to make repairs without making any downpayment to the contractor and permits the contractor to discount the homeowner's note at a bank with an FHA guaranty. Over the

years "suede-shoe salesmen" and "dynamiters" whose ranks have included racketeers and gamblers have infiltrated this business. They have used fraudulent and deceptive sales practices on thousands of homeowners.

In the belief that home repairs of substantial value would cost them little or nothing, many homeowners have signed contracts which they did not read or understand. After obtaining work which was either unsatisfactory or worthless, these homeowners found that a bank held their note for a substantial sum of money and that under the law they had no defense to the payment of the note, in spite of the frauds practiced upon them. The testimony shows that many lending institutions were, at a minimum, careless in accepting notes from questionable dealers and thereby encouraged these fraudulent practices. Most home repair contractors are both honest and reliable. But the laxity in the administration of the Title I program enabled dishonest people to make illicit profits from owners of small homes who perhaps could least afford the losses.⁸

The accurateness with which Capehart's statement predicted the problems that were to plague the FHA home programs of the 1960's and 1970's is both incredible and alarming: poor HUD-FHA administration; the tendency of even ethical private actors to renege on basic responsibilities in a risk-free situation; and the opportunity for a fringe of totally irreputable characters to exploit the FHA programs.

b. Title II Problems:

In 1952, the Subcommittee on Housing of the House Committee on Banking and Currency convened hearings:

⁸Hearings Before the Senate Committee on Banking and Currency, U.S. Senate, 84th. Cong. 1st. Sess., 1955, p.5.

...in order to determine to what extent the insurance or guaranty of...loans (by any department or agency of the United States) has been granted in the case of housing which is defective with respect to construction, drainage, sanitary conditions, and other features, and to what extent the practices and procedures followed by any such agency or department, and any acts of omission or commission of officers or employees thereof, have facilitated or made possible the insuring or guaranteeing of loans for defective housing.⁹

In almost a thousand pages of hearings, investigating 9 cities, the Subcommittee heard testimony charging FHA and VA with faulty inspection procedures. This led, witnesses claimed, to situations in which large numbers of people bought FHA insured and VA guaranteed homes that had significant defects.

One of the worst aspects of this problem, according to observers, was the sense of deception experienced by many people who believed that their homes were guaranteed by the insuring agency and, therefore, were approved by the government. Rep. Reva Bosane of Utah described a defective FHA single family housing project in her home state.

When the homeowners looked around for someone to hold responsible for failure of the heating units, there was no one to help them. FHA had no authority to finance any such adjustments. It could not put pressure on the building corporation because that corporation no longer existed. The homeowners could not appeal to the corporation for the same reason...The project clearly shows that actually the home buyers have no legal protection. If FHA falls down on its part of the job, or if the builders go bankrupt, then the purchaser is the goat.¹⁰

⁹Hearings Before the Subcommittee on Housing, House Committee on Banking and Currency, House of Representatives, 82nd. Cong. 2nd. Sess. 1952, p. 1.

¹⁰Ibid. p. 80.

Further making clear FHA's responsibility (or lack thereof) to mortgagors, Isidore Dollinger, a New York Congressman, stated that:

The government did not guarantee...that the home would be in good condition...there has been a misconception of the idea...The government never approved the building. All it says is that the loans are guaranteed to the builder or to the bank.¹¹

In response to this confusion, FHA personnel made attempts to clarify the meaning of FHA insurance. For example, the New Jersey District Director of FHA, Mr. Whitsell, testified that he had:

Requested discontinuance of a sign in front of a builder's operation, where it says, FHA approved. Because the FHA does not approve. It passes on the eligibility for insurance only.¹²

Yet, such instructions were slow to become enforced, as George Armour, a New Jersey FHA homeowner pointed out:

I think it was Mr. Whitsell who mentioned that the "FHA approved" stamps on homes were taken off these advertisements. Well, in 1949 and until September of 1950, those signs were still out there. You can go up and try to buy a home in these developments and ask "Are these FHA approved?" They will say, "We can get you any one you want."

Rep. Albert Cole: Probably we can leave that out and then the government can guarantee that it is properly built, or we should require them to put big signs upon each house that "you buy at your own risk. Pay no attention to anything that anybody said to you about specification."

Mr. Armour: I would not be here today if that was the case. If we can't trust the Government, what are we going to do?¹³

This problem -- the assumption among mortgagors that an FHA inspection means that FHA also guarantees the quality of the house -- has, unfortunately,

¹¹ Ibid. p. 163.

¹² Ibid. p. 125.

¹³ Ibid. p. 157.

been a recurrent one.

For example, twenty years later, a Government Audit team reported that the mortgagor has no way of learning "the extent of responsibility, if any, which HUD assumes in connection with the condition of a house involved in an insured mortgage transaction."¹⁴ Without any additional information, mortgagors assume, not illogically, that if the government has inspected the house, that it must therefore be adequate, at the very least.

Many mortgagors told us that a seller, broker or salesman had represented the house to be free of significant defects, as evidenced by a completed or to-be-made inspection and appraisal by HUD; however, many mortgagors informed us and our inspections confirmed the existence of defects that should have been corrected before the sale was closed. Even when no such overt or implied representations are made, the unsophisticated mortgagor could mistakenly assume that he can rely on HUD to insure detection and correction of defects. If data were furnished to prospective home buyers to explain the function of the HUD appraisal and the risks inherent in the purchase of a house, many unfortunate misunderstandings usually at the expense of the buyer might be avoided.¹⁵

But it is not only the unsophisticated mortgagor who has been confused by the meaning of the FHA inspection. In more recent Congressional hearings, it has been pointed out that there is also confusion among the general public about the meaning of an FHA-insured or VA-guaranteed loan. The following exchange took place in 1972 between the President of a New York bank, John Payne, and Senator Philip Hart of Michigan:

¹⁴ HUD Office of Audit, "Audit Review of Section 235 Single Family Housing," 05-2-2001-4900, December 10, 1971 p. 55. (Referred to as "235 Audit")

¹⁵ Ibid.

Mr. Payne: As the Secretary points out, it would be interesting to make a survey among the higher salaried, better educated, better informed section of the population and ask them what they feel that this mortgage guarantee or the FHA, or sign of the eagle means to them. And I'm afraid you get probably the same feeling expressed among them as you do among the lower disadvantaged group. They would say, "Well, that must be a Government program."

Senator Hart: I'm sure that would be the case.

Mr. Payne: If I didn't know better, I might assume the same thing.

Senator Hart: Certainly.¹⁶

c. Veterans Administration:

While this thesis does not concern itself with the VA homeownership programs, a brief overview of early problems in the VA is presented here for two reasons: First, the early VA experience underscores the recurring and similar nature of many of the problems encountered by the FHA and, second, the early abuses of the VA programs received a great deal of attention during the 1950's.

John Keats, a 1950's critic of the post-World War II VA programs reported that:

In the nine months between July 1, 1947 and March, 1948, the Housing Expeditors' Office in Washington received 31,233 veterans' complaints against builders. The plain fact was, the chisel was the tool most often used to construct the postwar development houses...¹⁷

In response to these complaints, in 1952 a House Select Committee, under Representative Olin Teague of Texas was convened to investigate

¹⁶New York Antitrust Hearings, op. cit. p. 218.

¹⁷John Keats, The Crack in the Picture Window (Boston: Houghton-Mifflin Co., 1957) p. 24.

abuses in the VA home guarantee programs. Keats has summarized some of the findings of that committee, based upon testimony from 26 cities:

The committee found everywhere indications of the skillfully wielded chisel. Veteran purchasers complained of no insulation, of missing streets, sidewalks and driveways -- sometimes of missing rooms. Linoleum had been substituted for tile in bathrooms, refrigerators were missing, as were window and door screens, waterproofing and weatherstripping...¹⁸

Echoing the charges of more recent Congressional committees,¹⁹ the Teague committee:

found evidence of "widespread criminal conspiracy" on the part of Veterans Administration loan guaranty officials, fee appraisers and inspectors, officials of lending institutions and builders.²⁰

As a result, indictments were turned in by juries in at least nine cities.

But, beyond the uncontrolled abuses of the program, the VA mortgage itself had the potential for creating enormous problems for mortgagors. While the veteran was allowed to sell his home to another mortgagor -- and the new mortgagor could assume the old mortgage -- the veteran was seldom told that if the new mortgagor defaulted, he was still liable for payments!

The Teague committee's report on the Washington area summed up the orientation of the VA program. The VA conceived the loan guaranty program:

to be a builder's program, rather than a veterans program, and operated on the assumption that the builder must be pacified at all costs, without regard to the effect...on the homeowner veteran.²¹

¹⁸ Ibid. p. 25.

¹⁹ See, for example, New York Antitrust Hearings, op. cit. and Hearings Before the Ad Hoc Subcommittee on Home Financing Practices and Procedures of the Committee on Banking and Currency. "Financing of Inner City Housing" House of Rep., 91st. Cong. 1st. Sess., Part 1, June, 1969.

²⁰ Keats, op. cit. p. 27.

²¹ Ibid. p. 27.

But, why, Keats asked, does the veteran still choose to buy? Answering his own question:

The answer is twofold. First, few veterans had any business experience, and practically none had experience in real estate ventures. Second...[the veterans]...were in desperate need for living space...[Since] no other quarters were available on the market, [they] would have signed any contract put in front of them.²²

Thus, the travails of the unsophisticated home buyer in a savvy housing market, as discussed in the Introduction, is a problem that surfaced at least twenty-five years ago.

d. Exclusionary Practices: 1934 -- Mid-1960's:

In addition to causing problems for some participants in the FHA/VA programs, Federal housing policy, until the mid-1960's, was overtly discriminatory and exclusionary. Thus, similar to the FHLBS, another way in which the early FHA programs were non-consumer-oriented was in excluding minority and lower income families and certain inner city areas from FHA eligibility.

Exclusion of Non-White Families and Urban Properties:²³

The most crucial aspect of the lending decision has always been

²²Ibid. p. 33.

²³This section is an expansion of a discussion contained in a manuscript which this writer co-authored with Kerry D. Vandell and Barbara Silbert Hodas, "Financial Institutions and Neighborhood Decline: A Review of the Literature" op. cit. Pages 45-48 of that report, on which the present discussion is based were, however, written by this writer.

the appraisal of the real estate which secures the mortgage. In fact, it has only been since 1934 that emphasis also began to be placed on the credit worthiness of the borrower himself.²⁴ The appraisal process usually consists of two parts -- an assessment of the property and an evaluation of the neighborhood. Historically, "hard-nosed" business practice was the operating philosophy.

Following the traditional pattern of mortgage lending, the FHA paid considerable attention to the quality of the neighborhood in which the property to be insured was located. Through an eight-point Location Rating Scale, the notion that good location must include certain social, racial, and economic characteristics became a written law of mortgage lending practice. Section 929 of the FHA Underwriting Manual of 1938 stipulated that the "varying social characteristics of neighborhood occupants must be carefully considered and incorporated into the rating."²⁵ And, Section 937 articulated the importance of racial and social homogeneity:

Areas surrounding a location are investigated to determine whether incompatible racial and social groups are present, for the purpose of making a prediction regarding the probability of the location being invaded by such groups. If a neighborhood is to retain stability, it is necessary that properties shall continue to be occupied by the same social and racial classes. A change in social and racial occupancy generally contributes to instability and a decline in values.²⁶

²⁴Willis R. Bryant, op. cit. p. 181.

²⁵"Underwriting and Valuation Procedures Under Title II of the National Housing Act." op. cit.

²⁶Ibid.

In addition to espousing racial homogeneity -- which, for the most part, meant no insurance for minority families -- the FHA manual even defined the practice that has since been termed "red-lining." Section 911 stated that:

Having determined the Economic Background Rating for the area the first step in making Established Ratings of Locations is to determine ineligible or caution areas. The central downtown area can usually be outlined and considered as ineligible. However, such downtown reject areas must be outlined with the greatest care in order to avoid unfair decisions in connection with application for mortgage insurance covering properties which lie within such borders. Central reject areas include slum and blighted areas as well as the central business and commercial sections of the city.²⁷

Charles Abrams has pointed out the continuing role that these early FHA policies have played in discriminating against minority families and in shaping two housing markets -- one for whites and one for blacks.

A government offering such bounty to builders and lenders could have required compliance with a nondiscrimination policy. Or the agency could at least have pursued a course of evasion, or hidden behind the screen of local autonomy. Instead, the FHA adopted a racial policy that could well have been culled from the Nuremberg laws. From its inception FHA set itself up as the protector of the all-white neighborhood. It sent its agents into the field to keep Negroes and other minorities from buying homes in white neighborhoods. It exerted pressure against builders who dared to build for minorities, and against lenders willing to lend on mortgages.²⁸

Thus, with the FHA taking a firm discriminatory stance, the unavailability of mortgages for minorities in certain areas became a well-entrenched tenet of mortgage lending practice.

²⁷ Ibid.

²⁸ Charles Abrams, Forbidden Neighbors (New York: Harper and Brothers, 1955). p. 229.

By 1949, FHA had dropped all references to "inharmonious racial groups" or "areas threatened by minority infiltrations." However, Abrams has written that:

The damage had been done. It was more serious than most realize. It was the first time in our national history that a federal agency had openly exhorted segregation...The evil that FHA did was of a peculiarly enduring character. Thousands of racially segregated neighborhoods were built, millions of people re-assorted on the basis of race, color, or class, the differences built in, in neighborhoods from coast to coast.²⁹

The FHA continued to be an extremely conservative force in mortgage lending until the mid 1960's. The Section 203 program, (of the 1934 Housing Act) the standard home mortgage insurance program of the FHA, provided that "no mortgage shall be accepted for insurance...unless the Secretary finds that the project with respect to which the mortgage is executed, is economically sound."³⁰ According to the Committee on Government Operations this policy enabled the FHA "to avoid the risks of mortgages on properties in declining inner-city neighborhoods, or of mortgagors whose income was considered too low to assure loan repayments without excessive risk."³¹

The first relaxation in FHA's "economic soundness" criterion occurred in 1954 with the passage of the 221(d)(2) program. Section 221, which was aimed at providing housing for low- and moderate-income families and displaced families (i.e., by Urban Renewal and other public actions), introduced the notion that properties must meet the less stringent require-

²⁹ Ibid. p. 234.

³⁰ Quoted in Fifteenth Report by the Committee on Government Operations, op. cit. p. 51.

³¹ Ibid.

ment of "acceptable risk."³²

Yet, in 1965-1966, only 37.9% of FHA's insurance activity was in the central cities and 62.1% was outside of them.³³ Thus, even slower to disappear from FHA policy than the racial restrictions, were the FHA's anti-urban prejudices. It was not until 1966 that FHA began to insure properties in older, urban areas. In the text of the Demonstration Cities and Metropolitan Development Act of 1966, a more explicit exemption from the "economic soundness" criterion of Section 203 was articulated by Congress:

The Secretary is authorized to insure...any mortgage...if he determines that 1) the dwelling covered by the mortgage is situated in an area in which rioting or other civil disorders have occurred or are threatened, 2) as a result of such actual or threatened rioting or other disorders the property...cannot meet the normal requirements with respect to economic soundness, and 3) such property is an acceptable risk giving due consideration to the need for providing adequate housing for families of low and moderate income in such area.³⁴

But, in spite of this new mandate, the response of the FHA was sluggish.³⁵ In 1968, the Report of the National Commission on Urban Problems clearly described the prevailing nature of the FHA home insurance program and its impact on neighborhood decline:

³²Ibid. p. 52 For a description of the evolution of the concept of risk, in the FHA home insurance programs, see Appendix 3-1.

³³Hearings Before a Subcommittee of the Committee on Government Operations, "Review of Federal Housing Administration - (Part 2 - Update of FHA Mortgage Insurance Funds Deficits) House of Representatives, 93rd. Cong., 2nd Sess., March, 1974. p. 159-160.

³⁴Ibid. p. 52.

³⁵See for example Chapter 4, Section 4 testimony of Senator Edward Brooke and George Sternlieb during 1968 Senate hearings.

The experience of members of the Commission and others convinced us that up until the Summer of 1967, FHA almost never insured mortgages on homes in slum districts, and did so very seldom in the "gray areas" which surrounded them. Even middle-class residential districts in central cities were suspect, since there was always the prospect that they, too, might turn as Negroes and poor whites continued to pour into the cities, and as middle and upper-middle income whites continued to move out.

The result was a general, even if unwritten agreement between lending institutions and FHA that most of the areas inside the central cities did not have a favorable economic future, and that their property values were likely to decline.

...Redlining by insurers weakened still further the ability of the slums to obtain loan capital with which to improve existing housing or to construct new units.

There was evidence of a tacit agreement among all groups -- lending institutions, fire insurance companies, and FHA -- to block off certain areas of cities within "red lines," and not to loan or insure within them. The net result, of course, was that the slums and the areas surrounding them went downhill farther and faster than before.³⁶

When, in the late 1960's and early 1970's, FHA finally began to insure mortgages for lower income families (Section 235), families with poor credit histories (Section 237) and families in older, declining urban areas (Sections 221(d)(2) and 223(e)), it did so with a strong reluctance, since this policy was contrary to its historical prudence and conservatism.

Yet, FHA did comply with the new Federal programs and Area and Insuring offices all over the country began to write insurance on inner city properties. In sharp contrast to the insurance patterns of 1965-1966, in 1973 33.7% of FHA insurance activity was outside the central cities and 66.3% was inside of them.³⁷

³⁶ Douglas Commission, Report of the National Commission on Urban Problems to the Congress and to the President of the United States, Building the American City, 1968, p. 100.

³⁷ "Review of FHA - (Part 2...)" op. cit. p. 160.

Exclusion of Lower Income Families:

In view of the preceding discussion, it will come as no surprise that the FHA excluded lower income families from participation in its programs and, instead, dealt almost exclusively with middle income home buyers.

Until the 1960's there appears to have been little difference between the types of people who participated in the FHA and conventional home finance systems. While enabling families to become owners with minimal downpayments and on lenient terms, FHA still had strict guidelines which dictated the income levels that would be needed to support ownership. And, as noted above, FHA had a conservative and "economically sound" orientation.

Interestingly enough, data collected during the 1950's indicated that families who purchased homes with FHA insurance had even higher incomes than those who bought their homes with conventional financing.

In 1950, almost 40 percent of FHA mortgagors had incomes above \$5,000 while only 30 percent of the conventional mortgagors had incomes exceeding this amount. Similarly, in 1956 while over 70 percent of the FHA mortgagors had incomes above \$5,000, only about 60 percent of the conventional mortgagors had incomes exceeding this amount. (See Tables 1 and 2)

Conversely, at the lower income levels, the data reveal that a greater percentage of conventional mortgagors had lower incomes than FHA mortgagors. In 1950, over 44 percent of the conventional mortgagors

TABLE 1

Comparison of Incomes of Borrowers Using FHA-Insured
and Conventional Financing -- 1950

<u>Income</u>	<u>FHA</u>	<u>Conventional</u>
Under \$2,000	4.5%	13.9%
2,000-3,499	21.2	30.7
3,500-4,999	34.5	25.8
5,000-7,999	31.1	20.7
8,000-9,999	4.2	3.7
10,000 and over	4.5	5.2
	<u>100.0%</u>	<u>100.0%</u>
Median Income:	\$4,400	\$3,700

Source: Residential Finance, p. 171 [From 1950 Census of Housing Vol. IV
Residential Financing Part I. Chapter 3. Table 14-14c]

TABLE 2

Comparison of Incomes of Borrowers Using FHA-Insured
and Conventional Financing -- 1956

<u>Income</u>	<u>FHA</u>	<u>Conventional</u>
Under \$2,000	2.2%	5.1%
2,000-2,999	2.0	5.7
3,000-3,999	7.2	12.9
4,000-4,999	17.4	15.6
5,000-7,999	48.1	36.1
8,000-9,999	12.1	10.4
10,000 and over	11.0	14.2
	<u>100.0%</u>	<u>100.0%</u>
Approximate Median Income:	\$6,100	\$5,400

Source: Federal Credit Agencies Break, p. 39. (Computed from 1956
National Housing Inventory Vol. II. Financing of Owner-
Occupied Residential Properties, p. 22)

had incomes below \$3,500 while only about 26 percent of the FHA mortgagors had incomes below this amount. Similarly, in 1956 almost 11 percent of the conventional mortgagors had incomes below \$3,000 while only 4 percent of the FHA mortgagors had incomes below this amount. (See Tables 1 and 2)

But, despite the overall picture of higher incomes among FHA than conventional buyers, the latter also tended to slightly outweigh the FHA buyers at the highest income levels. For example, in 1950 while 5.2 percent of the conventional mortgagors had incomes above \$10,000, only 4.5 percent of the FHA mortgagors had incomes exceeding this amount. And, in 1956, while 14.2 percent of the conventional mortgagors had incomes above \$10,000, only 11.0 percent of the FHA mortgagors had incomes exceeding this amount. (See Tables 1 and 2)

Basing their comments on an independent survey³⁸ conducted between late 1950 and early 1951, which confirmed the findings of the 1950 and 1956 censuses, Saulnier, Halcrow, and Jacoby noted that:

... Federal programs...are employed with the greatest relative frequency by a middle class of home buyers. Individuals both in the lowest and in the highest income brackets, those buying the least, and those buying the most, expensive homes,...are more frequently found borrowing on a conventional basis than are those in the in-between groups, where the dependence on FHA-insured or VA-guaranteed loans is greatest.³⁹

Similarly, Ratcliff, Rathbun, and Honnold, summarized the 1950 data with this strong statement:

³⁸Survey conducted by National Analysts, Inc. for the Board of Governors of the Federal Reserve System.

³⁹R.J. Saulnier, Harold G. Halcrow and Neil H. Jacoby, Federal Lending and Loan Insurance (Princeton, N.J.: Princeton U. Press, 1958) p. 306-307.

Although typically granted on relatively illiberal terms, conventional loans are widely used by all classes of borrowers and are of particular importance in meeting the needs of borrowers of above-average credit risk.⁴⁰ Conventional loans are of major importance in the case of low-income borrowers, low-cost properties, loans on older properties, and borrowers of above-average age.⁴¹

Thus, not only did the FHA programs create some problems for program participants, as discussed in Sections 4a-c, but they also excluded large numbers of potential consumers -- among them, those in greatest need of improved housing -- lower income and minority families and families wishing to purchase homes in inner city areas.

⁴⁰It is interesting to note that at least some early observers of the FHA programs predicted that the FHA borrower would be the higher risk. Dean quotes H.E. Hoagland as having observed the following, sometime before 1938. "It is no secret that many such (mortgage) institutions insure only their weakest loans -- those that they would not make except for the insurance protection." Dean, *op. cit.* p. 50.

⁴¹Richard U. Ratcliff, Daniel B. Rathbun and Junia Honnold, Residential Finance (New York: John Wiley & Sons, Inc. 1957) p. 175.

5. SUMMING UP THE FHA: PINPOINTING REASONS FOR ITS OVERALL SUCCESS:

Based upon the above, it is evident that through exclusion, lack of good management practices, and inadequate consumer safeguards and education -- even the "old" FHA caused mishaps for consumers. But in spite of this non-consumer orientation -- with the scale always tipped against the consumer and in the direction of the real estate/construction/mortgage interests -- the great majority of participants in the FHA programs seemed to fare adequately, if not admirably. FHA is generally considered to have been extremely successful between 1934 and 1969. Old-time FHA personnel point to FHA's early record with pride. Horace Bazan, an FHA official for 31 years, recently wrote:

FHA's achievements, during 35 years of public service without cost to the taxpayer, were enormous. Its influence was far-reaching. Every American family who had bought a home with 20 percent or less downpayment and financed the balance with a long-term, level payment mortgage was, directly or indirectly, the beneficiary of FHA. Homeownership during those 35 years had increased from about 45 percent to about 65 percent of American families.

FHA's financial record was enviable. It had reserves of \$1.5 billion, accumulated from net earnings after payment of expenses and losses. It had repaid, with interest, the capital that the Treasury had advanced to get it started, a total of about \$86 million. It had paid about \$200 million to home purchasers as partial return of premiums under the mutuality feature of its legislation.¹

Thus, prior to 1968 FHA's lack of a consumer orientation did not appear to substantially diminish its record of overall success. FHA

¹Horace B. Bazan, "The Fragmentation of FHA" Prepared for the Mortgage Bankers Association of America, Washington, D.C. June, 1974. p. 5.

operated with an unbeatable and virtually fool-proof formula -- "Don't take any risks -- either real or perceived." In this type of rarified and totally safe lending environment, the need for strong consumer safeguards and cushions was minimal. FHA could maintain its pro-industry orientation and still manage to assist vast numbers of homebuyers.

Yet, there were still problems along the way, as discussed in Section 4 of this chapter. Furthermore, while the FHA encouraged the participation of lenders by insuring them against losses due to foreclosure, FHA's strict underwriting policies were very much in line with traditional concepts of mortgage lending. Whether or not a loan was to be insured, strict interpretations of risk seemed to be operating. Standard market forces determined who would participate in the government's homeownership programs, in spite of the FHA insurance.

But, as alluded to several times in the preceding discussion, after 1968, Federal homeownership policy opened the way for a totally new consumer to enter the home purchase process. Families with lower incomes, many of whom bought older, inner city homes, were, for the first time, able to purchase homes with FHA insurance.

Unfortunately, the post-1968 HUD-FHA home finance system was neither prepared for these new consumers nor did HUD accept the responsibilities inherent in its risk-taking position. Furthermore, Congress either lacked the foresight or was unable to build into the Housing and Urban Development Act of 1968 the safeguards that would have been necessary to fully protect the interests of the consumer.

CHAPTER 4: FORCES BEHIND THE HOUSING AND URBAN DEVELOPMENT ACT OF 1968

1. INTRODUCTION:

The Congressional hearings of 1967 and 1968, on proposed housing legislation, focused more directly on expanding homeownership opportunities for consumers, and particularly those consumers with low-moderate incomes, than ever before. Yet, similar to the circumstances surrounding the enactment of the post-Depression recovery measures, a variety of objectives also helped to shape the Housing and Urban Development Act of 1968. While these goals were, indeed, critical they have been responsible for some of the difficulties which arose in the post-1968 HUD-FHA home finance system and which have had adverse impacts on some consumers.

The following objectives played an important role in molding the shape of the Housing and Urban Development Act of 1968.¹

- Desire to stimulate the construction industry and to achieve high levels of production. (Political/Private Interest Groups; and Political/Administration)
- Desire of the Johnson Administration to be the author of any new homeownership program. (Political/Administration)

¹At least two additional goals surrounded the passage of this legislation: One goal was the desire to reduce mortgage credit shortages in "credit crunch" periods and to even out the cyclical flow of funds. (Political/Private Interest Groups; Economic). However, this goal had its most direct implication on changes in secondary market institutions, rather than on the shape of the homeownership legislation. For this reason, a discussion of this objective, as well as its implications for the consumer will be postponed until Chapter 7. A second goal that will not be addressed here was the desire of the Johnson administration to minimize the deficit in the Federal budget. This was one of the motives behind making the Federal National Mortgage Association a private agency and the changeover from the 221(d)(3) to the 236 program.

•Desire of HUD-FHA to maintain its power. (Political/Public Interest Group)

These various interests were the key forces behind the final shape of the homeownership package embodied in the Housing and Urban Development Act of 1968. This package included a homeownership subsidy for lower income families (Section 235); mortgage insurance for inner city areas (Section 223(e)); and mortgage insurance for families with poor credit histories (Section 237). Each of these objectives will be assessed below.

2. DESIRE TO STIMULATE THE CONSTRUCTION INDUSTRY AND TO ACHIEVE HIGH PRODUCTION LEVELS:

A critical goal of the 1968 legislation was the production of new housing units -- "26 million new or substantially rehabilitated units over the next decade." The Kaiser and Douglas Commissions assigned a number to the nation's housing need, President Johnson echoed this in his message on the cities and Congress created the programs and appropriated the funds to make the goal a reality.

Interest in production of new units was not, however, unanimous among spokesmen from the various housing-related industries. Those who had a stake in existing housing spoke against the new production program. For example, Fred Tucker, Chairman of the Realtor's Washington Committee, National Association of Real Estate Boards, voiced his objection to the minor role that existing units were to play in the proposed homeownership program:

We are at a loss to understand why existing housing units cannot be utilized more widely...The administration apparently views the primary purpose of this program to increase the supply of low-cost housing. While we recognize that this objective should occupy a lofty position on the list of national priorities, we believe this should be incidental rather than a planned benefit of the new program. We feel that the present limitations in the bill preventing more widespread use of existing dwellings would, unfortunately, delay accomplishment of the program's over-riding objective--to provide decent housing for ownership by low-income families. For this reason, we urge the subcommittee...to permit the use of existing dwellings.¹

¹Hearings Before the Subcommittee on Housing and Urban Affairs of the Committee on Banking and Currency, "Housing and Urban Development Legislation of 1968", U.S. Senate, 90th Congress, 2nd Session, March, 1968, p. 453 (Referred to as "HUD Senate Hearings, 1968".)

Not surprisingly, both the home builders and labor were strongly in favor of the production goals. Lloyd Clarke, President of the U.S. National Association of Home Builders made clear his organization's interest in the passage of the bill.

Our association has taken the lead in calling for the establishment of such national housing goals (i.e., goals in numbers)... Central to this whole concept is what now has become a generally accepted thesis -- that the only way to meet housing needs is to build housing in a volume far greater than at present...Give us the tools...and we (i.e., the homebuilders) can do the job.²

Thus, while the construction industry was, by no means, in the desperate state that it had been in during the 1930's, the anticipation of 26 million new units of housing was clearly of considerable interest to the home builders. Putting the 26 million figure in perspective, between 1946 and 1968 a total of 22 million housing units were built. Thus, 2.6 million units per year represented over a doubling of the production levels of the previous twenty years.³

Similarly, while the unemployment rate was the lowest that it had been during the decade,⁴ labor welcomed the possibility of new jobs opening up. Andrew Biemiller, Director, Department of Legislation, AFL-CIO, stated that the 1967 "AFL-CIO convention reaffirmed organized labor's support for a massive program of federally assisted housing," and urged

²Ibid. p. 289.

³Ibid. p. 290.

⁴Statistical Abstract of the United States, 1972, p. 221.

that "2 1/2 million new housing units be built yearly..."⁵ And, Walter Reuther, President Industrial Union Department, AFL-CIO, explained exactly how this would benefit construction workers:

What this nation ought to really do is that we ought to get around to the kind of massive, long-range housing problems and the total task of rebuilding America so that we could say to every construction worker: "We need all the skill that you can bring there. We need all the manpower...we will work out a guaranteed annual wage so that you are guaranteed that you are going to be fully employed." And then take this job on.⁶

Clearly, the production goals of the Housing and Urban Development Act of 1968 were well supported by the new-housing interest groups.

⁵HUD Senate Hearings, 1968, op. cit. p. 168.

⁶Ibid. p. 378.

3. DESIRE OF THE JOHNSON ADMINISTRATION TO BE THE AUTHOR OF ANY NEW HOMEOWNERSHIP PROGRAM:

Confronted with the increasingly unpopular Vietnam war, the Johnson Administration was sorely in need of good publicity which might follow the passage of an appealing piece of legislation, such as a homeownership program.¹ The intensity of this desire became evident during the battles waged over the Housing and Urban Development Act's forerunner, Senator Percy's bill, S.1592.

Criticism for FHA's non-low income, minority, and inner-city orientation became widespread in the mid- and late 1960's. For example, scoring FHA's exclusionary practices, (discussed in Chapter 3, Section 4d), the Douglas Commission pointed out that:

The main weakness of FHA from a social point of view has not been in what it has done, but in what it has failed to do -- in its relative neglect of the inner cities and of the poor, and especially Negro poor. Believing firmly that the poor were bad credit risks and that the presence of Negroes tended to lower real estate values, FHA has generally regarded loans to such groups as "economically unsound." Until recently, therefore, FHA benefits have been confined almost exclusively to the middle class, and primarily only to the middle section of the middle class. The poor and those on the fringes of property have been almost completely excluded.²

Acknowledging the difficulty that FHA would probably have in adapting itself to social goals, Republican Senator Charles Percy proposed the idea of creating a National Home Ownership Foundation (NHOF) as the vehicle

¹Christa Carnegie, "Homeownership for the Poor: Running the Washington Gauntlet." AIP Journal, May, 1970.

²Douglas Commission, op. cit. p. 100.

for expanding homeownership opportunities for low and moderate income families. S. 1592 of 1967, would have enlisted private enterprise to provide a wide range of technical assistance to lower income home buyers.³ But, unable to acquire bi-partisan support, amid HUD Secretary Robert Weaver's charges that Percy's program was "a snare and a delusion and a cruel hoax",⁴ S. 1592 died.

The debates over the provision of counseling services underscore the political nature of the Administration's opposition to Senator Percy's 1967 homeownership plan.

Counseling was an important component of the NHOF. The Technical Assistance Service, a part of the Foundation would have been authorized:

to assist eligible borrowers (i.e., local nonprofit housing association, cooperative, or limited dividend corporation) to obtain through both public and private channels, the access to supporting programs in the fields of training employment and counseling, and other related programs necessary to the success of a homeownership program...⁵

And further:

The eligible borrower must be conducting, or otherwise arranging for, supporting programs in such fields as training, employment, credit counseling and budget management as needed to enable lower income families to assume the privileges and responsibilities of homeownership.⁶

³Hearings Before the Subcommittee on Housing and Urban Affairs of the Committee on Banking and Currency, "Housing Legislation of 1967" U.S. Senate, 90th Cong., 1st Sess., July-August, 1967. p. 1426-1427 (Referred to as "Senate Housing Hearings, 1967").

⁴HUD Senate Hearings, 1968 op. cit. p. 35.

⁵Senate Housing Hearings, 1967 op. cit. p. 1427 [Sec. 108(a)(6)].

⁶Ibid p. 1432 [Sec. 110(a)(2)].

However, according to Secretary Weaver these provisions were inadequate:

The provisions of the bill that are addressed to counseling and other supporting services are also inadequate. The bill would provide for a Federal grant of up to \$3 million to the NHOF to assist it in meeting initial organizational and operating expenses and to provide initial capital for the contemplated technical service. Thereafter, the cost of such services would be financed through expected contributions from private and public sources or from adding to the mortgage debt.

It will take substantial sums of money to assist both the local non-profit organizations that will be providing the housing and the low-income homeowners themselves, particularly where services for the homeowners are extended to meaningful programs of job training, employment and the many health and welfare programs faced by the poor. This is true even though the counseling and other services are those of an intermediary between the homeowners and pre-existing sources of help. The bill assumes that somehow the funds will be found. The assumption may prove to be correct, but the risk is too great since the success of the entire program will depend on these services being skillfully performed at the precise times and places they are needed. (underline added)⁷

During the 1968 hearings, when the Administration presented its own homeownership program, a bitter Senator Percy challenged Secretary Weaver's apparent change of heart on the issue of a homeownership program for lower income families.

Senator Percy: On June 10, 1967, less than 10 months ago, you said: "I think to promise large numbers of low-income people that in the immediate future they are going to be able to achieve home ownership is a snare and delusion, and it can be a cruel hoax." What has caused you to change your mind?

Claiming that he hadn't changed his mind and that he still felt his statement was true, he outlined the three things that would have to be done to ensure that this would not happen. Weaver's second point

⁷Letter to John Sparkman from Secretary Weaver, July 14, 1967 on S. 1592. Reprinted in Ibid. p. 1448-1449.

⁸HUD Senate Hearings, 1968 op. cit. p. 35.

related to counseling:

...in order to provide a sound program of homeownership,...for low- and moderate-income families you have to do more than to simply say, "It's desirable and we are going to give you some financial assistance in terms of an interest subsidy." You have to have a counseling service as we have provided for here, and it must be adequately funded..."⁹

Despite Percy's protestations, Weaver refused to accede that NHOFF had provided for similar, if not superior counseling services to the Administration's recommendations.

The outcome of the counseling battle was the Section 237 program -- "Special Mortgage Insurance Assistance."

(a) The purpose of this section is to help provide adequate housing for families of low and moderate income, including those who, for reasons of credit history, irregular income patterns... are unable to meet the credit requirements of the Secretary for the purchase of a single-family home...but who, through the incentive of homeownership and counseling assistance, appear to be able to achieve homeownership.

(e) The Secretary is authorized to provide, or contract with public or private organizations to provide, such budget, debt management, and related counseling services to mortgagors whose mortgages are insured under this section...

(g) There are authorized to be appropriated such sums as may be necessary to carry out the provisions of Subsection (e) of this Section.¹⁰

In view of Secretary Weaver's strong statements about counseling services, it is particularly revealing that HUD made no request for an appropriation for counseling in its FY 1969 budget. (See Chapter 8,

⁹ Ibid. p. 35

¹⁰ Section 237, National Housing Act; op. cit.

Section 3) This, in conjunction with Weaver's reversal on homeownership and his objections to the counseling services provided by NHOF clearly expose the political overtones of the controversy. Further trying to give the Administration credit for the new homeownership program, Secretary Weaver touted the proposed 1968 bill as the remedy for the gap in the current housing programs.¹¹ However, provision for a new agency to administer the new program was glaringly absent from the proposed legislation.

¹¹ HUD Senate Hearings, 1968, p. 7.

4. DESIRE OF HUD-FHA TO MAINTAIN ITS POWER:

The Administration's omission of any suggestion of a new agency to administer the 1968 homeownership programs can be construed as its way of thanking Secretary Weaver for his role in killing Senator Percy's S. 1592. During the 1968 Senate hearings, with the full weight of the Administration behind him, Secretary Weaver stood firmly to the position that homeownership for lower income families was "in", but that a new agency to administer the new program was "out". When questioned by Senator Percy about the absence of the NHOF in the Administration's package, Weaver claimed that he "found great difficulty...in discovering what the Foundation...(was) to do and what its functions...(were) to be."

Further he said:

I have read the legislation. I have read the report of the Committee, and I have still not been able to find out the role that it plays or its basic rationale, and for that reason, I have not included it in the recommendation.¹

However, Christa Carnegie has suggested another, more plausible, reason why the NHOF was omitted from Secretary Weaver's recommendation:

...some of the principles of S. 1592 were a threat to HUD as an organization because the program was designed to circumvent HUD. Although the HUD Secretary would be on the board of the NHOF, he would have no firm control...By competing with HUD and being semi-private, NHOF was seen as a threat to HUD's purported *raison d'etre* -- efficient and coordinated exercise of federal influence to aid the rational development of urban areas.²

Thus, HUD, which was still in its early years of establishing itself as a cabinet level department, was strongly opposed to competition.

¹Ibid. p. 53.

²Carnegie, op. cit.

However, many Senators and Representatives disagreed with Secretary Weaver and readily saw the need for a new agency with a clear-cut social mandate. Trying to revive Percy's original NHOF of 1967, Senator Edward Brooke proposed the creation of a separate division in HUD to administer the "socially oriented low- and moderate income housing programs which would otherwise be administered by FHA."³ The need for a "Moderate Housing Division" was based on Brooke's perceptions of FHA's inability to change its operations. Senator Brooke stated that the Administration's proposals:

...authorize FHA to take the risk of going into the ghetto. But I would point out to the committee that the Commissioner of FHA has himself been unable to persuade his people that FHA must enter the ghetto area.

A 1965 directive to the regional offices (FHA) noted a "hesitancy on the part of insuring offices to make FHA programs available in older neighborhoods"; a July 1967 directive made the same point in identical language, while at the Directors Conference in October the Commissioner again repeated: "We have got to recognize that stimulating a flow of mortgage funds to the inner city...is an FHA mission of the highest priority."

It is not an easy matter to change longstanding policies. It is still more difficult to ask that the old policy be applied in some cases and the new one in others. It is especially hard when administrators accustomed to the old ways are obliged to depart from their familiar practices.

Surely the prospects that this system will succeed are slim. The different nature of low and moderate income housing programs demands that they be administered separately. The urgency of the Nation's need for this housing demands that the programs be given priority. I believe this can be achieved most sensibly and effectively through a Moderate Housing Division.⁴

³HUD Senate Hearings, 1968, op. cit. p. 126.

⁴Ibid. p. 128-129.

And further:

The Government is really going into a new business when it goes into low and moderate income housing...philosophically FHA has just not been attuned to such a program. They have done excellent work in the job that they were created to do, but now government moves into social purpose legislation... into the ghettos, into the social areas.

The criteria are different. The procedures are different. And even though Commissioner Brownstein has attempted, and I think unquestionably in good faith, to move low- and moderate-income housing, the personnel that he has just are not attuned to doing it...If we are really going to have a low- and moderate-income housing bill, we need new personnel who are attuned to doing exactly this job.⁵

Many others, including scores of businessmen, politicians, newsmen and academics could also see the need for a new organization with the special mandate to tend to the needs of lower income home buyers.⁶

Pinpointing why he felt that FHA could not do the job, George Sternlieb noted that FHA's mandate had been narrower than the goals of the proposed legislation.

If we attempt to add to it (the FHA), the responsibility for facilitating the housing of the poor and lower moderate incomes, we can only water down its capacity to deal with the groups with which it has been very successful, while still inhibiting the development of facilitating activity for those less fortunate.

I think that the FHA has been criticized for not doing things which it in turn simply was never given the primary responsibility and mandate for. The mechanisms of the FHA are reasonably adequate to deal with middle income new construction mortgage guarantees; we can only impair its effectiveness if we continue to link this activity with the quite different activity of providing essential inputs into the financing of housing for the poor.⁷

⁵Ibid. p. 131.

⁶Ibid. p. 45-53.

⁷Ibid. p. 143.

This view must have been based, in part, upon some of Sternlieb's observations concerning the difficulty which FHA Commissioner Brownstein was having in trying to persuade FHA personnel to redirect some of their efforts to inner city housing. Echoing Brooke's comments, Sternlieb noted that:

I have had the privilege of reading some of Commissioner Brownstein's -- I was going to say "encyclicals" to his parish heads, if you will. They are as strong, as from the heart, as the strongest housing person could ask for. They are as earnest and as solid. They are wonderful documents.

The mere redundancy of them indicates on the other hand that, somehow or other, we are hitting mattresses in there.

If I saw one of them I wouldn't think so. And if I had seen maybe two or three of them I would think he's just giving a reminder. But those things come out, you know, like the monthly mail.⁸

Chairman John Sparkman, responding to Sternlieb's observations, added his own:

I notice some of the personnel of FHA, when they get these encyclicals as Dr. Sternlieb speaks of it, throw them away. They are interested in promotions and what not. And their records have been built on the basis of the number of cases that they have been able to work on which have been successful.

In other words, they are always avoiding these risks, and they don't want to take anything that looks like a risk because they don't want to have any failures on their record. It has become quite a thing in FHA. You just don't proceed up the ladder if you have had several cases that exhibit failures.

...people who have been working with this in mind as a paramount concern are not apt to take on any social-purpose cases and certainly not apt to take on anything which is below the economic risk that they had in the first instance, and this is no matter how many encyclicals are received by them.⁹

⁸Ibid. p. 142.

⁹Ibid. p. 142.

In the midst of these attacks, FHA Commissioner Brownstein was making a desperate effort to maintain the strength of FHA, already weakened as a result of its recent repositioning within HUD. He argued that his staff would be capable of abandoning its middle-class orientation and administering the new socially oriented programs. In an impassioned speech at an FHA Directors and Underwriters Conference, Brownstein told his staff that he had faith that they could adapt to the requirements of the new social legislation.

I suppose that it has come to your attention that there are some who say FHA cannot do this new job. There are those who believe FHA is too wedded to the split-level house for middle-class residents of suburban subdivision to be interested in, or capable of, mounting a massive effort to help private enterprise house families of low and moderate income. It is also believed that FHA has no interest in the inner city -- that we, like most private lenders, redline large segments of the central city -- where the housing needs are greatest and the problems most pressing. There are others who say that FHA has lost its drive, that it is too cautious and too bogged down in inflexible rules, immovable procedures and tortuous redtape to mobilize itself and private enterprise to do the job which must be done...There are people today who are urging that this job be taken away from FHA and be given to a new organization in the Department or somewhere else.

I do not agree with these sentiments, and I will tell you why. First, FHA personnel have the skills to do the job that must be done. We have the experience, and the organization. It would take time and be difficult to create a substitute of the same size and competence...Second,...FHA has already gone some distance in the direction of turning its programs and its talents to the inner city and to providing housing for low- and moderate-income families...Third, I have faith that FHA, as an organization, can make the additional changes in attitude and action needed to accelerate the job we have already begun.¹⁰

¹⁰ Ibid. p. 309. Reprinted from remarks of Commissioner Brownstein at Directors Conference, October 23, 1967 on "FHA's Job Today."

In his concluding comments, Brownstein spelled out what would happen to the FHA and its employees if it failed to respond to the needs of the inner city and low-moderate income families. What comes through clearly from Brownstein's statement is his desperate desire to see FHA survive the threat of the creation of a new organization to administer the socially oriented programs.

Just as surely as you are sitting here today, if FHA fails to respond effectively and affirmatively to this challenge, if FHA fails to produce the results needed, then no longer will FHA be looked at as our Nation's housing agency and the need and justification for its continuation may very well be the central theme. Undoubtedly alternative organizations will be developed because the need is too great and too critical to leave a void.

I have given a number of reasons why I believe FHA must mount a major effort to accelerate and expand use of our programs which serve families of low- and moderate income and revive and rebuild the inner city. Let me give you one more reason. You should work at this task as though your job depended on it, because it may.¹¹

Thus, both HUD and FHA were vehemently opposed to the Percy-Brooke plans to create a new agency either within or outside HUD. The main thrust behind this opposition appears to have been the fear of losing political clout and power.¹²

¹¹ Ibid. p. 312.

¹² HUD-FHA's opposition to any suggestion that a new agency be created confirms Don Schon's view that: "Because of its dynamic conservatism, a social system is unlikely to undertake its own change of state. Because it sees every effort at transformation as an attack, transformation becomes a kind of war. Major shifts in the system come about in response to the system's failure or to the threat of failure." Don Schon, Beyond the Stable State (New York: W.W. Norton & Co. 1971) p. 55.

5. HIGH HOPES FOR HOMEOWNERSHIP: PANACEA FOR MINORITY AND LOWER INCOME FAMILIES AND INNER CITY AREAS:

The previous three sections have explored key forces that helped to shape the Housing and Urban Development Act of 1968. Superimposed on these was a strong move toward expanding homeownership opportunities for lower income families. So, while a variety of political and economic motives molded the specific form of the homeownership package, the fact is that homeownership, per se, was more of a dominant theme in the late 1960's than ever before.

Ironically, it was Secretary Weaver who helped set the strong pro-homeownership tone during the 1968 Senate hearings:

Today, homeownership is out of reach for most low and moderate income families. Yet, it remains the goal toward which many American families strive. To own one's own home is to have a sense of place and purpose. Homeownership creates a pride of possession, engenders responsibility and stability. Until now, however, Federal help to low and moderate income families to achieve homeownership has been very limited. Section 101 of the bill would remedy this gap in our housing programs.¹

Yet, as strong as this move toward homeownership was, proponents of the legislation still had hopes that other pressing social objectives would be addressed. Building upon the precedent and conventional wisdom that emerged from the Homestead Act and the post-Depression recovery measures, homeownership was grasped as the means to quiet the unrest among blacks and to help rejuvenate the cities.

¹ HUD Senate Hearings, 1968. op. cit. p. 7.

Extrapolating from his findings in Newark, George Sternlieb helped to popularize this view. In his testimony before the Senate on the proposed housing legislation, for 1967, he argued that:

There is no question that the chance of riots in Newark or for that matter any other major core area would have been substantially lower with more Negro ownership.²

And, echoing the rhetoric of earlier years -- that homeownership is good for the social well-being of the nation -- the Kerner commission stated that:

The ambition to own one's own home is shared by virtually all Americans, and we believe it is in the interest of the nation to permit all who share such a goal to realize it.³ (underline added)

Putting these concerns into the context of the 1968 Senate Hearings, Senator Charles Percy stated that:

Our hearings last year were held just after the Newark riots. And today we are holding our hearings in the aftermath of the report issued by the Civil Disorder Commission. If we do not begin to do what the Commission recommends, what do you think will happen in the cities this summer?⁴

²Senate Housing Hearings, 1967, op. cit. p. 1607.

³Kerner Commission, Report of the National Advisory Commission on Civil Disorders, (New York: Bantam Books, 1968), p. 477.

⁴HUD Senate Hearings, 1968, op. cit. p. 41.

6. SUMMARY AND PREVIEW:

The Housing and Urban Development Act of 1968 was a landmark piece of legislation. The homeownership package which was contained in it presented homeownership opportunities to vast numbers of previously excluded homebuyers. Indeed, there was something for almost everyone -- including "the good, the bad and the ugly." The "good" lower income family could purchase a home with a subsidy through the 235 program; the "bad" credit risk family might be eligible to obtain a mortgage through the 237 program; and the "ugly" or older sections of cities became viable sections for FHA insurance with the 223(e) program.

Yet, as discussed in this chapter, the desire to expand homeownership opportunities, per se, was only one aspect of the 1968 Act. Similar to the Homestead Act and the post-Depression recovery measures, the late 1960's concept of homeownership for the poor, gained popularity not only for its welfare orientation but for its ability to address various political, social and economic objectives. But this most recent homeownership movement was also unique in that it was more directly concerned with consumers than either of the two earlier periods. While a coalition of forces certainly contributed to the final shape of the 1968 legislation, the lower income family and the inner city neighborhood were viewed as the direct beneficiaries of the legislation. In light of this, the problems that arose in the implementation of the 1968 Act are all the more sobering. Some of the reasons for this problematic outcome can be found in the variety of forces behind the Act, as discussed in this chapter.

The remainder of the thesis will analyze how the 1968 homeownership legislation impacted the consumer. The following summarizes the key aspects -- or omissions -- of the 1968 Act that will be particularly relevant to the following chapters.

1) An "old" HUD-FHA with a pre-1968 business orientation being given the mandate to administer the new socially-oriented homeownership programs.

2) Pressure on HUD-FHA to insure a high volume of mortgages as an indication that they could meet the demands of the new socially oriented legislation and to meet the nation's housing goal.

3) Weak role of counseling services.

4) No other direct supports for consumers authorized in the legislation.

5) A new lower income consumer and a new type of inner city property becoming eligible for FHA insurance for the first time.

6) Absence of concern or an understanding for how the home finance system would adapt to the new consumer.

7) No consideration for how HUD would make the transition to handle the new people and the new properties and no acknowledgement of the risks involved in insuring the new mortgagors.

In concluding this analysis of homeownership legislation it is important to underscore the fact that minimizing risk of lending institutions in order to induce their participation was a recurring theme. Stemming from the problems that surfaced during the Depression, Congress created several tools to do this.

Yet, in spite of the risk-free lending environment, the conservatism of FHA combined with the traditional conservatism of the lending institutions, excluded the participation of people and properties that market forces would have excluded in any case. HUD-FHA's attempts to reorient its outlook, combined with the mandate of Congress to include a wide range of buyers, without any consideration for how HUD-FHA would accept its new responsibilities and the enormous risks that it was undertaking, produced a formidable set of problems.

SECTION II

KEY ASPECTS OF THE
HUD-FHA HOME FINANCE SYSTEM

Since the creation of the FHLBS, the assumption that by increasing the flow of mortgage capital, the homebuyer would benefit, has persisted. (See Chapter 2) Since the 1930's, the government has repeatedly intervened to expedite this flow. As Miles Colean has stated:

Having entered the housing stage from the financial wing, the Federal Government has played its part chiefly from a financial point of view...¹

Yet, government efforts to enhance the flow of capital and decrease the risk of financial institutions by protecting them against losses due to foreclosure and increasing their liquidity have been more than means to the end under discussion -- the expansion and support of homeownership. Again, as discussed in Chapter 2, the near catastrophic situation of financial institutions in the 1930's started the precedent of government intervention in home finance with the specific goal of assisting the faltering banks, as a goal in itself.

In view of this, it is ironic that the early savings and loan associations, known as building associations, were set up only to enable families to attain homeownership.² Most early associations never had any aspirations beyond this basic objective and their own existence had no legitimacy beyond the goal of enabling people to finance their homes.

¹Miles L. Colean, op. cit. p. 262.

²See, for example, Henry E. Hoagland and Leo D. Stone, op. cit. p. 178 and William Atteberry, Modern Real Estate Finance (Columbus, Ohio: Grid, Inc., 1972) p. 131.

For example, the goal of the first building association, which was organized in Pennsylvania in 1831, was to "enable the contributors thereof to build or purchase dwelling houses."³ Describing the localized, small scale nature of the original building associations, Atteberry writes that:

...these first associations were managed and operated like today's local civic clubs or investment groups...members would buy shares and pay dues; when sufficient funds accumulated, they were loaned to members. The choice of which member or members were entitled to borrow the accumulated funds was made in different ways...In order to encourage and compel thrift while providing for a constant input and availability of funds, members were required to pay fines if they missed dues payment dates; in some cases they ...forfeited their membership.⁴

Moreover, one type of early association known as "terminating" associations actually ceased operation once each member "had acquired a home and paid for it in regular installments. When all had been served in this manner, the association was expected to dissolve, since it had reached its objective."⁵

Today, savings and loan associations are the single largest mortgage lender on 1-4 family residential properties. In 1972, S & L's held 47.9 percent of the 1-4 family nonfarm mortgage debt. (See Table 3) But, in spite of this dominant position in the 1-4 family market, S & L's have never been major participants in the FHA-insured home programs, preferring

³Henry E. Hoagland and Leo D. Stone, op. cit. p. 179.

⁴William Atteberry, op. cit. p. 131.

⁵Henry E. Hoagland and Leo D. Stone, op. cit. p. 180.

TABLE 3

1-4 Family, Nonfarm Mortgage Loans Outstanding, by Type of Lender, Year-End 1972

	Dollar Amount (in Billions)	Percent
Savings & Loan Associations	\$165.9	47.9%
Commercial Banks	55.7	16.1
Mutual Savings Banks	41.6	12.0
Life Insurance Companies	22.3	6.4
Federally Supported Agencies	30.4	8.8
Others	<u>30.3</u>	<u>8.8</u>
TOTAL	\$346.2	100.0%

Source: 1973 Savings & Loan Fact Book, United States Savings and Loan League, Chicago, Illinois. p. 38.

instead to invest in conventional mortgages. (See Table 4)

S & L's have been reluctant to participate in the FHA programs for several reasons. First, the S & L's were so bitter about the creation of the FHA that utilizing its programs could have been perceived as "joining the enemy." Second, the highly localized nature of the S & L lending philosophy probably made them wary of the nationwide scope of the FHA. And, third, there are an array of technical reasons that S & L's articulate for not participating in the FHA programs.⁶ Thus, the S & L's aversion to the FHA, in conjunction with the financial structures created by the Federal government -- FHA and FHLBS -- has served to further shape and solidify the two systems of home finance -- FHA and conventional.

In the void left by S & L's, financial institutions, known as mortgage companies, have become the dominant lender in the HUD-FHA home finance system. But the mortgage company also warrants special attention in the context of this thesis for another reason.

All the other "social programs" that emerged in the 1960's provided services to recipients, or clients, through some type of specifically created social service agency. Head start programs, neighborhood health

⁶For example, administrative requirements and regulations under FHA, so-called "red tape;" time delays in processing FHA insurance forms; low interest rate ceiling on FHA loans; ability of S & L's to meet their investment needs through lending in their local market area; and an ideological opposition to the government assuming the risk in mortgage lending. Leon T. Kendall, The Savings and Loan Business, Commission on Money and Credit, (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1962) pp. 90-91.

TABLE 4

Mortgage Activity of Savings and Loan Associations in FHA, VA, and Conventional Loans: 1950, 1960, and 1970.

(Amounts in Millions of Dollars)

	1950		1960		1970	
	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
FHA	848	6	3,524	6	10,178	7
VA	2,973	22	7,222	12	8,494	6
Conv.	9,836	72	49,324	82	131,659	87
TOTAL	<u>13,657</u>	<u>100%</u>	<u>60,070</u>	<u>100%</u>	<u>150,331</u>	<u>100%</u>

Source: Statistical Abstract of the U.S. - 1972, p. 450.

centers, offices of economic opportunity, community action programs -- and so on -- proliferated during the years of the "Great Society." But, unlike these programs, the lower income homeownership programs, although also oriented to social needs, did not operate out of a specially designed office. Instead, the mortgage lender (and, most often, this was a mortgage company) was the only actor that was certain to come into contact with home buyers. Thus, the prime responsibility for initiating the family to homeownership rested with the mortgage lender. Chapter 6 examines the mode of operation and the unique characteristics of mortgage companies and discusses how these characteristics have had negative impacts on some home buyers.

Chapter 7 then goes on to look at the secondary mortgage market -- what it is, how it operates, and how its activities have affected consumers. The main point of this chapter will be to show how, in the course of the government's improving the position of lenders, by minimizing their risk, -- through enhancing their liquidity and expediting the flow of capital, some consumers have been negatively impacted. The creation and growth of the secondary mortgage market is a good example of how government intervention in housing has served the needs of the financial sector as an end in itself -- although, here too, the assumption that the consumer would benefit through easier access to credit, has prevailed.

But before going on to Chapters 6 and 7, it is first important to present a short chapter on the "FHA Interest Rate Ceiling." Chapter 5

examines the rationale for a government-controlled maximum interest rate on FHA-insured mortgages and will describe the side-effects of this policy. This chapter is critical as a background for understanding the workings of the HUD-FHA home finance system.

CHAPTER 5: THE FHA INTEREST RATE CEILING AND "POINTS"

1. RATIONALE FOR AN INTEREST RATE CEILING:

Since the passage of the National Housing Act of 1934, Congress has determined the maximum interest rate that may be charged on FHA-insured loans. On the surface, this would appear to be a consumer-oriented policy. Supporters of FHA mortgage interest rate ceilings have argued that this form of regulation can maximize benefits to the general public by keeping interest rates low.¹ Further, they have claimed that a carefully administered rate ceiling can also serve as a kind of "anchor" that keeps mortgage interest rates from rising as much as they might otherwise during tight money periods and can help bring mortgage rates down more quickly than otherwise when monetary policy eases. (i.e.: money becomes more available.)²

Wright Patman, long-time Chairman of the House Banking and Currency Committee was probably the most adamant supporter of this position. He, along with Congresswoman Leonor K. Sullivan, argued that the movement to remove interest rate ceilings "is inimical to the consumer."³

Yet, many other Congressmen and economists have disagreed with Patman and Sullivan, primarily because of the negative side-effects

¹"Report of the Commission on Mortgage Interest Rates to the President of the United States and to the Congress" August, 1969, p. 63 (Referred to as "Interest Rate Commission Report")

²Ibid.

³Ibid. p. 124. Dissenting Views of Congressman Wright Patman and Congresswoman Leonor K. Sullivan.

which the interest rate ceiling has created. The most important of these side-effects is "points."

2. SIDE-EFFECT OF THE INTEREST RATE CEILING: POINTS:

At the same time that FHA interest rates have been regulated by Congress, the market place has determined interest rates on conventional mortgage loans as well as on other types of investments. Frequently, the two mortgage interest rates -- conventional and FHA -- have not been the same.

While Congress has granted discretionary authority to the Secretary of HUD to raise the interest rate on FHA mortgages "to maintain a competitive position in the market place,"¹ market rates have frequently changed more rapidly than changes in the FHA rate. One might logically assume that, since the FHA mortgage is insured and the conventional one is not, lenders might be willing to accept lower yields in view of the lesser risk. However, this has not been the case. Lenders have insisted upon trying to make up the interest rate differential through a system which circumvents the FHA-controlled interest rate ceiling. "Points" or "discounts" are fees which are charged by lenders at the time that mortgages are originated: One point is equal to one percent of the mortgage amount. For each two points charged, the effective yield to the lender is increased by approximately one quarter of a percentage point above that provided by the contract interest rate.²

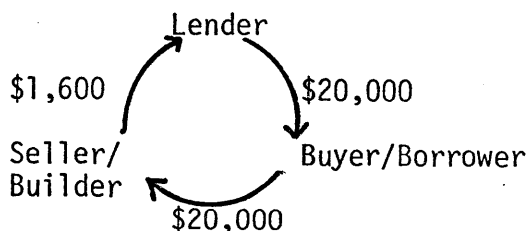
For example, if the FHA interest rate ceiling is seven percent, but competitive investments are yielding seven and a half percent, lenders who

¹Staff Report of the Subcommittee on Domestic Finance, Committee on Banking and Currency, "Financial Institutions: Reform and The Public Interest" House of Representatives, 93rd. Cong. 1st. Sess., Aug. 1973, p. 29.

²Interest Rate Commission Report" op. cit. p. 28.

are originating FHA loans might charge four points at origination thereby increasing the yield on the FHA mortgage to about seven and a half percent. During periods in which the FHA interest rate ceiling is considerably lower than yields on other investments, it has not been uncommon for as many as seven or eight points to be charged at origination.³

Thus, during periods in which "deep discounts" are being charged, lenders are actually lending considerably less money than that represented by the full face value of the mortgage note. For example, if eight points are being charged to originate a \$20,000 mortgage, the lender's net outlay is only \$18,400. Since the FHA does not allow the buyer to pay these points,⁴ they must be paid by the seller/builder. As a result, the actual transfer of funds at closing would be as follows.⁵



Lender net outlay = \$18,400
Seller/Builder net amount received = \$18,400
Buyer/Borrower net amount borrowed = \$20,000
At an interest rate of 7.0% the yield to the lender would be 8.1%.

³New York Antitrust Hearings op. cit. p. 541-542.

⁴According to HUD Guidelines the buyer may only be charged a one point origination fee, which is separate from the additional points which can be levied due to market conditions.

⁵The example does not include any of the other fees or transfers of funds which are associated with closing, such as lawyers', title search, recording and buyers' one percent origination fee.

3. SIDE EFFECTS OF POINTS:

Points have been cited as the cause of several undesirable side-effects. First, since the seller does not receive the full amount of money from his sale he would certainly choose to sell on a conventional basis, if possible. This could result in many homes being closed off to potential FHA buyers. But, second, if the seller or builder knows that the house will be sold with FHA insurance, he will probably add the amount of the anticipated discount to the original sale price of the house.¹ Ultimately, then, the buyer ends up paying the discount and ends up with a house that has an inflated value.

This situation, according to a recent HUD report will, in turn, lead to a third effect: an increase in the risk of foreclosure. The report stated that:

We believe risk is increased whenever a mortgagor assumes a liability ...without receiving equivalent value in property...In today's market the cost of selling a house with an FHA or VA mortgage may easily consume ten percent to fifteen percent of the sales proceeds (six percent real estate sales commission, three percent to seven percent loan discount, and in some states one percent to three percent seller's closing costs.) Consequently, a mortgagor with a minimum investment cannot realize enough sales proceeds to cover the indebtedness against the property, unless his house has benefited from inflation. Such a situation discourages mortgagors from selling their houses, particularly in slow markets, and encourages them to let their mortgages go into foreclosure.²

¹Interest Rate Commission Report op. cit. p. 30 and "Report on Internal Audit of HUD Single Family Appraisal/Inspection Procedures and Mortgagees' Loan Processing Activities" HUD Office of the Inspector General, Office of Audit, Washington, D.C. September, 1973. p. 54. (Referred to as "All Homes Audit")

²All Homes Audit op. cit. p. 54. Points can also cause an increase in the risk of foreclosure in another way. However, because of the complexity of this issue a closer examination of this critical side-effect of points will be postponed until Chapter 10.

And, fourth, points can also change the level of lender participation in mortgage lending and thereby reduce the amount of mortgage money available. The Commission report noted that:

Especially large discounts -- as occur when market interest rates rise well above the FHA-VA ceilings -- have an independent constraining effect on the real estate and mortgage markets...some lenders simply are reluctant to make discounted loans -- especially when the discounts are large.³

Since discounts can be confusing to home buyers and sellers, some lenders would rather completely withdraw from the FHA-VA market rather than be susceptible to criticism and adverse publicity. For example, while many Boston bankers actively buy out-of-state FHA and VA loans, they have been unwilling to use FHA-VA programs in their local lending areas. One plausible reason for this is that the conservative Boston banking community has found it "cleaner" to buy loans with high yields rather than having to negotiate competitive yields by charging several points to local customers.⁴ (See Chart 1 for a summary of side-effects of the FHA interest rate ceiling.)

³Interest Rate Commission Report op. cit. p. 64.

⁴"Competition in Real Estate and Mortgage Lending" Hearings Before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary U.S. Senate, 92nd Cong. 2nd. Sess. Part 1, September 1971 (Boston). (Referred to as "Boston Antitrust Hearings")

CHART 1

Summary of Side-Effects Which Can Result From FHA
Interest Rate Ceiling and the Points System

Progression of
Side Effects

Seller

Sellers that can choose between FHA and conventional, would choose the latter.



Receives less than the full amount of money from his sale.



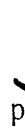
Inflates price of house to avoid above.

Buyer

Some buyers may be cut out of the market while others may have a reduced choice of homes because of the reluctance of sellers to use FHA.



Buys inflated property.



Unless property value inflates, owner may have a negative equity in the house and, if forced to move, may end up in foreclosure.

Lender

Some lenders may choose to not get involved with points at all, thereby reducing the availability of mortgage money.



Obtains a mortgage note for which he paid less than its face value.



Because of above, lender may be less willing to assist a mortgagor in default with relief measures, because the FHA insurance will reimburse him for more than what he paid for the mortgage note. (See Chapter 10)



Points may become an ingrained aspect of home finance and some lenders may use them arbitrarily, rather than as a mechanism to adjust yield.

Source: Gathered from information presented in the Report of the Commission on Mortgage Interest Rates.

4. POINTS AND THE MARKET PLACE:

While attempts have been made to control discounts it has been difficult for the Federal government to alter well-established patterns within the home finance system. Except during periods of declining interest rates, an increasingly rare occurrence, secondary mortgage market investors usually charge several points in order to get the best yields. The practice of only buying at a discount has, in fact, become a standard part of the operating procedures of many secondary mortgage investors, most notably, FNMA.¹ Thus, unless the mortgage banker is willing to absorb this discount -- which, of course, he is not -- he, too, must originate the loans at a discount. The following was the official position of the Mortgage Bankers Association (MBA) on this issue as of January 1974:

Mortgages originated without a discount must be marketable in the secondary market with a discount or a premium, depending upon whether rates rise or fall during the warehousing period. Premiums are generally not acceptable to institutional investors because the premium becomes a capital loss if the loan is paid off before maturity. Neither FNMA nor GNMA purchase mortgages at prices above par. Thus to prohibit discounts would mean that the mortgage banker could break even or lose, but could never gain on the sales of mortgages in the secondary market. This is an impossible business risk and the destructive effect of a prohibition against discounts on the secondary market is clearly total.²

While there has been no legislation on discounts since 1958, it has continued to be a much - discussed issue within Congress and various

¹ N.Y. Antitrust Hearings op. cit. p. 523.

² "Critical Legislative Year" Mortgage Banker, January, 1974.

ways to eliminate discounts have been suggested. For example, in 1969, the Commission on Mortgage Interest Rates recommended that "the Congress permanently abolish the present statutory ceiling -- on the interest rate on FHA-VA mortgages." And, further, the Commission noted that "the desirability of limiting...discounts is perhaps the sharpest single argument for complete abolition of the FHA-VA interest ceilings."³

In addition to the many negative side-effects of discounts, the Commission argued that:

As discounts persist, they tend to get built into (or buried in) selling prices of all homes -- whether sold with FHA, VA, or conventional financing -- or institutionalized in some other way. They then take on a life of their own and no longer serve simply as a flexible mechanism for adjusting mortgage yields.⁴

However, the Commission acknowledged that since "present institutional practices in the FHA-VA market...have evolved over a considerable period of time" they will not be easily discarded.⁵ Thus, rather than recommending total abolition of interest rate ceilings the Commission recommended that Congress enact legislation that would create a dual market system, for a three year trial period. One part of the system would operate with a fixed interest rate ceiling and with discounts permitted (basically status quo). In the other, innovative part of the system:

³Interest Rate Commission Report op. cit. p. 65-67. Congressman Patman and Congresswoman Sullivan dissented and opposed the abolition of the statutory ceiling.

⁴Ibid. p. 64.

⁵Ibid. p. 66.

The rate on FHA-VA mortgages would be determined in the marketplace, without regard to any administrative (or statutory) ceiling, provided the mortgage originator or lender neither charges nor collects any discount from any party in connection with the transaction.⁶

Further explaining their position, the Commission added that their:

Concern applies only to discounts in the so-called primary market, i.e., on new mortgage originations. Discounts also exist, of course, in the secondary mortgage market. In that market, however, they do serve the necessary function of adjusting prices on already existing mortgages traded among investors...discounts in the secondary market are absolutely essential and are performing their function well.⁷

However, the Commission was also quick to point out that a ban on discounts could prove disastrous to the current operations of the home finance system, particularly to the mortgage banking business.

Current conditions in the mortgage market are such that an absolute ban on discounts on mortgage originations -- unless phased in gradually -- could be highly disruptive to the market...Mortgage banking companies in particular, might have problems in quickly adjusting to a system absolutely banning discounts on new mortgages...In cases in which no prior commitments are involved, a rise or fall in mortgage prices between the origination and sale produces a profit or loss for the company. If the origination must be at par (because of a ban on discounts) any upward price movement would bring the mortgage to a "premium." But there is widespread feeling that lenders...would resist buying mortgages at premium prices, and thus that a complete ban on discounts on new mortgages would leave the mortgage banker on a one-way street in which he could lose or maybe come out even but never make a profit.⁸

With this reality of the marketplace in mind, it is difficult to understand why the Commission believed that a gradual phase-in of the discount ban could deter the problems that mortgage bankers would have

⁶Ibid.

⁷Ibid. p. 67.

⁸Ibid. p. 68.

to face -- whether sooner, later, or gradually. While the Commission stated that "in time mortgage bankers and other market participants could adjust to a ban on discounts in the primary market" it never suggested how this adjustment could come about or what form it would take.⁹ The Commission did acknowledge, however, that it would probably not be the mortgage banker who would participate in the "innovative" part of the dual market system:

Many "over-the-counter" mortgage transactions involving a local lender and borrower will opt for this part of the dual market from the beginning. Discounts are not needed in these transactions and many lenders do not like the adverse publicity that sometimes comes when points are charged.¹⁰

The Commission's recommendations were never followed and the question of how or whether to control discounts has persisted. The Commission's idea of creating a dual market system was revived by the Subcommittee on Housing and Urban Affairs of the Senate Committee on Banking, Housing and Urban Affairs in both 1971 and 1972.¹¹ However, Wright Patman's opposition to this position helped to block the enactment of such legislation. (See Appendix 5-1 for a more detailed discussion on attempts at controlling discounts.)

What emerges from this discussion is the reality that, at this point in time, points have less to do with FHA interest rate ceilings than with the well accepted workings of the primary and secondary mortgage

⁹Ibid. p. 69.

¹⁰Ibid. p. 69.

¹¹Hearings Before the Subcommittee on Housing and Urban Affairs of the Committee on Banking, Housing and Urban Affairs, "Mortgage Settlement Costs" U.S. Senate, 92nd. Cong. 2nd. Sess. March, 1972 p. 17.

markets. To discuss abolishing points, without also examining how secondary market investors would adjust their operations, is a useless exercise.

As interest rates have continued to climb upward and, in some cases, to surpass state usury ceilings, points have also become an increasingly familiar occurrence in the origination of conventional mortgages. Further, as the sale of conventional mortgages to secondary investors has become increasingly common,¹² points are being used as a cushion to originators against rising interest rates between origination and sale.

¹²There are three factors that have contributed to increased secondary mortgage market activity, in conventional loans: Increased use of private mortgage insurance; Creation of the Federal Home Loan Mortgage Corporation in 1970 and, also in 1970, the granting of permission to FNMA to purchase conventional mortgages (Emergency Home Finance Act of 1970 P.L. 91-351, 91st. Cong., July 24, 1970).

CHAPTER 6: MORTGAGE COMPANIES: THE DOMINANT LENDER IN THE HUD-FHA HOME FINANCE SYSTEM

1. MORTGAGE COMPANIES: A DEFINITION:

A mortgage banker recently was discussing his business and its future. "Generally," he said, "things look pretty good." But he did have one problem. "My kids don't know what I do. My wife finally understands but she can't explain it to anyone else, so the neighbors don't know what I do, either."¹

In spite of this mortgage banker's problem, mortgage banking is not conceptually difficult to understand. Mortgage banking has two major components -- origination and servicing. Origination includes all the activities which are performed by the mortgagee which terminate in the lending of money to the mortgagor -- "the processing of a mortgage application leading to the closing of a mortgage transaction."² The two key activities of origination are property appraisal and an assessment of the credit worthiness of the borrower.

Servicing is the monthly procedure of receiving and recording mortgage payments made by the mortgagor. More specifically, servicing includes: The collection of payments of principal, interest, and escrows, such as hazard insurance premiums, real property taxes, FHA mortgage insurance premiums, as called for by a mortgage. Included in servicing is the payment of premiums and taxes when due, periodic inspection of the mortgaged property, loan analysis, delinquency

¹"Mortgage Middlemen Try Opening New Doors," Business Week, September 26, 1964.

²William Atteberry, op. cit. p. 384.

followup, and foreclosure.³

Clearly, origination and servicing are also routinely performed by any institution involved in mortgage lending -- whether a savings and loan association, mutual savings bank or commercial bank. However, the distinction between these institutions and mortgage companies is that these functions are the latter's principal activity while the other financial institutions also carry out additional functions. In addition, mortgage companies usually originate loans with a pre-commitment from another investor to purchase them.

Thus, the mortgage company services loans which are owned by other investors. In contrast, most other mortgage lenders originate or acquire loans with the intention of holding them in their own portfolio as long-term investments. This is an important difference between mortgage companies and other types of institutions involved in mortgage lending and it will be discussed in greater detail later in this chapter.

³Ibid.

2. MORTGAGE COMPANIES AND THE FHA:

At the time of the passage of the Housing and Urban Development Act of 1968, the mortgage company was firmly established as the dominant mortgage lender in the HUD-FHA home finance system. In 1946 mortgage companies originated only slightly more than one-quarter of all FHA insured home mortgages. However, by the late 1950's mortgage companies began to originate at least half of all FHA-insured 1-4 family homes. (See Table 5.)

Since then, this percentage has increased substantially. In 1972 mortgage companies originated 74.3 percent of all FHA-insured home loans. (See Table 6.)

In addition, out of all types of home loans originated by mortgage companies, over 60 percent are FHA or VA.¹ Thus, mortgage companies are heavily dependent upon the FHA, and the FHA also relies upon mortgage companies.

This relationship is one which has grown steadily since the creation of the FHA in 1934. Saul Klamon, the author of the first major study on mortgage companies wrote that:

More than any other type of institution active in mortgage markets, mortgage companies owe their present structure and method of operation, as well as their extraordinary rapid postwar growth, to the introduction and later expansion of federal mortgage insurance and guaranty.²

¹Economics and Research Department, Mortgage Bankers Association of America, "Highlights of 1971."

²Saul B. Klamon, The Postwar Rise of Mortgage Companies, (New York: National Bureau of Economic Research, 1959), p. 1.

TABLE 5

Financing of FHA-Insured Home Mortgages,
By Type of Institution, 1946-1970, Selected Years

(Percentage Distribution of Face Amount of Mortgage)

	1946	1950	1954	1958	1962	1966	1970
Mortgage company	26.7	27.7	35.2	51.4	58.6	60.3	69.2
National bank	24.3	15.8	22.0	12.1	12.8	9.6	8.4
State bank	17.7	13.8	12.5	7.4	6.3	8.0	4.0
Insurance company	15.4	20.8	11.8	5.5	3.8	1.3	1.1
Savings & Loan Assoc.	9.8	10.8	10.8	12.2	9.6	6.6	12.2
Savings bank	3.2	7.6	5.8	7.9	6.9	6.4	3.8
Other	<u>2.9</u>	<u>3.5</u>	<u>1.9</u>	<u>3.5</u>	<u>2.0</u>	<u>7.8</u>	<u>1.3</u>
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: 1973 HUD Statistical Yearbook, p. 173.

TABLE 6

Financing of FHA-Insured Home Mortgages
by Type of Institution, 1972
(Dollar Amounts in Thousands)

	Number	Percent	Dollars	Percent
Mortgage company	317,701	74.3%	5,921,632	73.5%
National bank	32,506	7.6	655,017	8.1
State bank	17,366	4.1	355,046	4.4
Insurance company	1,859	0.4	34,798	0.4
Savings & Loan Assoc.	42,344	9.9	790,845	9.8
Savings bank	15,539	3.2	263,329	3.3
Other	<u>2,041</u>	<u>0.5</u>	<u>36,760</u>	<u>0.5</u>
TOTAL	427,901	100.0%	\$8,067,818	100.0%

Source: 1973 HUD Statistical Yearbook, p. 161.

Describing how mortgage companies were well suited to the needs of the new Federal programs, Klamon continued:

The FHA and VA mortgage underwriting programs, with their standardized mortgage contracts, uniform and improved property and borrower appraisal techniques, and minimization of risk, have reduced geographic barriers to mortgage investment and enhanced negotiability of contracts. In the broadened national mortgage market that developed, accompanying the marked postwar expansion in residential building and financing, mortgage companies grew rapidly in response to the increased need by out-of-state investors for local institutions to originate and service mortgages.³

Thus, unlike other mortgage lenders who, for the most part, have chosen to minimize their participation in the FHA insurance programs, mortgage companies have drawn their life-blood from the FHA.

In spite of this considerable involvement with the FHA, the mortgage company has escaped close examination. Klamon's 1959 observation on the lack of current information on mortgage companies also holds true for 1976:

Despite the integral and uniquely important role of mortgage companies in postwar mortgage markets, very little quantitative or qualitative information has been available on their background and development, on their financial structure, or on the nature of mortgage operations.⁴

While Klamon's own work made important contributions to understanding the history and role of mortgage companies up to the mid-1950's, little research has focused on these institutions in the past twenty years.

Recently, however, several journalistic accounts have been published documenting some scandalous activities of mortgage companies; various Congressional committees have heard testimony related to the

³Ibid. p. 1.

⁴Ibid. p. 2.

practices of mortgage companies; and, within the past few years, HUD has finally begun to examine some of its own procedures in connection to mortgage companies.

Brian Boyer, in introducing his section on mortgage companies in his book, Cities Destroyed for Cash, stated that: "The proper -- and unreadable -- way to present this dissection of the mortgage banking industry would be in a scholarly tome replete with footnotes."⁵ While Boyer chose "to charge through with his own interpretation,"⁶ this section will attempt the "proper" and, hopefully, still readable alternative.

This chapter will describe the unique characteristics of mortgage companies and assess how these qualities open the way to performance inadequacies that can have adverse impacts on mortgagors.

⁵Brian D. Boyer, Cities Destroyed for Cash,
Publishing Co., 1973), p. 94.

(Chicago: Follett

⁶Ibid.

3. UNIQUE CHARACTERISTICS OF MORTGAGE COMPANIES AND IMPACTS ON MORTGAGORS:

a. Geographic Boundaries:

In its role as an originator of loans, the mortgage company has come a long way from the localized lending patterns so characteristic of savings and loan associations. Unhampered by geographic boundaries, mortgage companies carry out transactions on a nationwide basis.

The issue of local vs. national service area has been a fundamental concern of the banking industry for a long time. During the Congressional hearings which preceeded the enactment of the National Housing Act of 1934, this divergent geographic outlook was clearly articulated. In opposing the program which was to become the FHA, Morton Bodfish, the Executive Vice President of the U.S. Building and Loan League¹ testified that:

...The first mortgage concerns to fall in this depression were concerns trying to operate nation-wide,...It shocks us that this bill, proposed under Federal sponsorship, should repeat that on 80 percent loans.

I hope the Federal Government will encourage sound local cooperative institutions. That is the only way in the world you can make 75 percent or 80 percent loans and ever hope to collect them back. It is when a little group of neighbors makes a loan to somebody they know. That is the reason for the Federal Government to conceive one savings and loan program. (Underline added.)²

Currently, Federal savings and loan associations can originate loans only "within 100 miles of any branch or agency office so long as no state boundaries are crossed."³ In contrast, mortgage companies both do not

¹The trade association for early S & L's.

²National Housing Act Hearings op. cit. pp. 256-257.

³Atteberry, op. cit. p. 149. But, "in order to enable savings and loan associations in areas with capital surpluses to offer their funds to areas which are capital poor, savings and loan associations can invest 20 percent of their assests nationwide, provided they have a local loan servicing agent such as a mortgage company."

and cannot confine themselves to local markets. While much of a given company's lending activity may be directed to a certain area, investors are usually solicited from diverse and sometimes distant locations.

Interestingly enough, this situation has come about only within the past decade. Similar to S & L's early mortgage companies were also primarily local institutions, serving as local correspondents (loan originators and servicers) for a single life insurance company. Thus, they grew out of the need of large life insurance companies to have local lending offices. While the FHA insured mortgage was an attractive investment for the bulging post-World War II assets of life insurance companies, not experienced in mortgage lending, the life insurance companies looked to middlemen, the mortgage companies, to carry out all the dealings with mortgagors.⁴

But as other investors began to enter the mortgage market, mortgage companies began to operate more independently. Unhinged from working for a single investor, the present day mortgage company usually sells mortgages to a variety of investors. Out of the one hundred largest mortgage companies in the country, thirty-three service loans for at least one hundred investors. Most striking is Lomas and Nettleton, the largest mortgage company in the country with a record six hundred investors.⁵

(See Chart 2)

⁴Statement of Everett Mattson, President, Mortgage Bankers Association of America, to the Subcommittee on Housing and Urban Affairs of the Senate Committee on Banking, Housing, and Urban Affairs, April 11, 1973, p. 1-2, (Reproduced by the Mortgage Bankers Association of America).

⁵Atteberry, op. cit. p. 202.

CHART 2

Servicing Activity of Selected Large Mortgage Companies

	Rank	Volume of Mortgages Services	Number of Mortgages Serviced	Number of Investors
Lomas & Nettleton Financial Corp.	1	\$3,267,279,424	264,513	600
Advance Mortgage Corp.	4	1,534,336,170	101,528	349
J.I. Kislak Mortgage Corp.	6	670,150,000	49,381	208
Colonial Mortgage Service Co.	20	1,236,499,778	74,457	235
First Mortgage Corp.	30	557,598,000	23,652	135
Mellon National Mortgage Co.	38	494,740,000	19,208	43
Northland Mortgage Co.	41	462,071,232	20,379	106

Source: American Banker, New York, 1971. Reproduced in Modern Real Estate Finance, William Atteberry, p. 202. Data as of June 30, 1971.

In 1971, S & L's became the largest customer of mortgage company originations, by-passing purchases of mortgages by life insurance companies by almost one billion dollars.⁶ (See Table 7)

At present, HUD is the only regulatory body with the authority to restrict the geographic lending area of mortgage companies. However, HUD guidelines impose no locational restrictions on mortgage companies, provided that certain financial requirements are met. HUD's Handbook 4000.2 states the following:

Any approved mortgagee in Group 3 (the group in which the great majority of mortgage companies fall...Non-supervised institutions) may request HUD-FHA approval to establish branch offices through which it originates and services insured mortgages...There are no financial requirements for approval if the branch office is located in the mortgagee's home state or in a contiguous state. However, to establish a branch office in a non-contiguous state, the Group 3 mortgagee must have acceptable net worth of at least \$150,000. For each non-contiguous state to that of its main office, in which it establishes a branch office or offices, Group 3 mortgagees must have an additional \$50,000 in net worth until net worth reaches \$250,000. Upon reaching this level, no further increase in net-worth will be required if branches are opened in additional non-contiguous states.⁷

Thus, a mortgage company with only \$250,000 in net worth may have any number of branch offices any place in the country.

As one might expect, many mortgage companies have taken advantage of this provision. Donald A. Luff, Executive Vice President of the

⁶"Highlights of 1971," op. cit.

⁷A HUD Handbook, 4000.2 "Mortgagees' Handbook: Application Through Insurance (Single Family), March, 1975; p. 3-4,5.

TABLE 7

Mortgage Company Sales to Investors, 1971

	Volume (in billions)	Percent
S & L's (not including GNMA securities)*	\$4.5	25%
Insurance Companies	3.6	20
FNMA	3.3	18
GNMA Securities*	2.3	13
Mutual Savings Banks	1.9	11
Other investors, each purchasing less than a billion dollars each.	2.4	13
TOTAL	<u>\$18.0</u>	<u>100%</u>

*The GNMA securities are ultimately purchased by other investors, such as S & L's and life insurance companies. For example, almost half of the GNMA securities \$1.2 billion, were purchased by S & L's, thus bringing the total purchases of mortgages by S & L's of mortgage banker originations to \$5.7 million.

Source: "Highlights of 1971," Economics and Research Dept., MBAA

Mellon National Mortgage Company of Ohio, the thirty-eighth largest in the country,⁸ noted that his company has four origination offices, but only one servicing office, located in Cleveland. In addition, while Mellon National focuses its origination activities in Ohio, with only a minor amount of origination occurring in one other state, the company services mortgages located in five states.⁹

Similarly, while the First Mortgage Corporation has seven origination offices, they service mortgages located in seven states out of a central servicing office in Richmond, Virginia.¹⁰

Not only is HUD permissive concerning mortgage company branching, but the guidelines are also extremely unclear when describing how mortgage companies are expected to service loans. The following excerpt from HUD Handbook 4191.1, is permeated with vague and undefined terms, as underlined below.

3. MORTGAGEE RESPONSIBILITY. Approved mortgagees are required to service their insured mortgage accounts in accordance with the accepted practices of prudent lending institutions...HUD...expects the investing mortgagee to insure that adequate facilities to service the loans are available in the area in which the property is located. Insured mortgage accounts shall be handled in the same manner as are those accounts which are not insured, where the mortgagee is entirely dependent on the property as security for the protection of its investment. The investing mortgagee may appoint any individual or firm to service its insured portfolio. However, the actions of any such servicer will be considered by HUD to be the actions of the approved mortgagee holding the mortgage ...A prudent lender's practices evolve from a broad range of knowledge and sound judgments as well as flexible, far-sighted administration of its servicing responsibilities. The lender is expected to provide competent and aggressive servicing that will result in fewer defaults and foreclosures...

⁸Atteberry, op. cit., p. 102. This was the rank as of June 30, 1971. At that time, the Mellon National Mortgage Company was called Jay F. Zook, Inc.

⁹Interview, Donald A. Luff, Executive Vice President, Mellon National Mortgage Company, Cleveland, Ohio, November 7, 1974 (telephone).

¹⁰Interview, Stuart Blanton, Senior Vice President, First Mortgage Corporation, Richmond, Virginia, November 7, 1974 (telephone).

4. SERVICER RESPONSIBILITY. Servicers are not restricted to geographic areas in which they may service insured mortgages. However, a servicer must establish adequate facilities to assure that loan information is available to individual borrowers and to HUD personnel when needed. Moreover, the servicer's staff shall be readily available to borrowers desiring individual loan consultation. A wide range of alternatives is available to servicers in meeting these requirements, and servicers may select a communication technique best suited to their portfolio, provided only that techniques utilized do not work unreasonable hardship on any borrower. The use of local servicing offices or toll-free telephone service are examples of acceptable communication techniques. HUD does not consider it prudent servicing to expect borrowers to pay for long distance telephone calls in order to obtain information or discuss their loans.

5. STAFFING. Lenders are required to be adequately staffed with trained personnel who are competent in all aspects of mortgage servicing, including the area of field collection activity...¹¹

b. Impacts of Unrestricted Lending and Servicing Areas on Mortgagors:

The permissiveness of the HUD guidelines, above, allows mortgage companies to originate and service loans any place in the country and at any distance from a branch office. This leniency, compounded by vagueness, can present problems for mortgagors. While interviews with HUD and counseling agency personnel did not disclose any problems for mortgagors at origination, regardless of where the mortgage company was located, considerable concern was voiced by several individuals over the absence of mortgage company servicing offices in many, particularly less densely populated, sections of the country.

¹¹ A HUD Handbook, 4191.1, "Administration of Insured Home Mortgages," April, 1974, p. 2.

A FNMA regional office official, who had been with the agency for more than twenty years, observed that:

The problem with all seller-servicers is the servicing. It's the bastard end of mortgage banking. There's a high turnover among the servicing personnel; a lack of expertise; and lower salaries. The suede shoe part of the business is origination.¹²

Another FNMA employee, in charge of working with mortgagees, articulated her concern over the lack of personal contact resulting from the nationally oriented mortgage company.

Loans are being made more fluid -- the good part of this is making more money available in the mortgage market -- but the bad part is the impersonalization. A mortgage company used to be required to have an office within 100 miles of any loan that it was servicing. But, if you go back to that, you lose the liquidity.¹³

In addition to lack of expertise and impersonalization, there are also indications that long-distance servicers are less willing to follow HUD guidelines and that simple communication between mortgagors and servicers is thwarted. For example, the Community Services Advisor in the HUD Insuring Office in Phoenix, Rose Strickland, commented that:

The major problem that our mortgagors have is that servicers only have production (i.e. origination) offices, not servicing offices. Getting distant mortgage bankers to accept long-distance calls from mortgagors has been a problem.¹⁴

Similarly, William Bonner, the Housing Counselor in the Shreveport,

¹²Interview, Norman Camber, Assistant Regional Vice President, FNMA Los Angeles, March 1974.

¹³Interview, Ellen Allison, Senior Loan Representative, FNMA, Los Angeles, March 1974.

¹⁴Interview, Rose Strickland, Community Servicers Advisor, HUD Insuring Office, Phoenix, March 12, 1974. (telephone).

Louisiana Insuring Office, said that:

Out of state mortgagees are a problem -- primarily because communication with them is costly. Except for one Jackson, Mississippi mortgage company, the out-of-state lenders don't do the servicing in Shreveport; they merely have origination offices.¹⁵

According to Thomas Clendenon, the HUD Housing Counselor in Louisville, out-of-state servicers who service Kentucky mortgages are the ones who do particularly poor servicing. "They do collection and that's all -- they don't do what they get paid to do." He related a story about a woman who lived in a small town in Kentucky. For some reason, she needed to contact the servicer of her mortgage - perhaps to notify them that her payment was going to be late. Since her loan had been originated by an originating branch office of Lomas and Nettleton in her home town she went there first for assistance. But she was told that no servicing problems were handled there and that she would have to contact the Louisville office. Upon doing this, she was referred to the Lomas and Nettleton office in Philadelphia -- but even this didn't work and she was finally advised that her problem could only be solved by contacting Lomas and Nettleton in Dallas!

According to Mr. Clendenon, this, unfortunately, was not a unique or isolated example of the problems that can arise from the lack of geographic boundaries. Mr. Clendenon's solution is simple:

Servicers should not be allowed by HUD to service a loan unless they can really service it. And this means being within a reasonable distance from the mortgagor.¹⁶

¹⁵ Interview, William Bonner, Housing Counselor, Shreveport, Louisiana Insuring Office, December 1972.

¹⁶ Interview, Thomas Clendenon, December 1972. In addition, the problems arising from long distance servicing were also underscored during telephone interviews with Katie Washington, HUD Housing Counselor, Little Rock, Arkansas; and Lucille Henderson, HUD Housing Counselor, Kansas City, Kansas, February, 1974.

Emphasizing the difficulty of communicating with out-of-state servicers, the Organization for Social and Technical Innovation (OSTI) Inc. in a February 1974 report to HUD, noted that:

All six (counseling) agencies reported that at one time or another, they had encountered difficulties establishing effective lines of communication with servicing mortgagees...Usually these difficulties were mentioned in connection with out-of-state mortgage servicing and with computerized servicing techniques.¹⁷

Furthermore, at least some high-ranking officials at HUD's Central Office are aware of the problems presented by out-of-state servicers.

A 1973 intra-department memorandum noted that:

"Absentee Mortgagees" (Mortgagees with servicing offices in cities other than that where mortgagors reside) make the servicing of Section 235 and 237 mortgagors difficult.¹⁸

Thus, while it is impossible to say how many people have been troubled by out-of-town servicing problems or in how many cases foreclosure was due to this reason, interviews yielded sufficient information to conclude that this has definitely been a problem for a group of mortgagors.

c. Capital Requirements and Sources of Income:

Two additional unique and important characteristics of mortgage companies

¹⁷Organization for Social and Technical Innovation (OSTI) "An Evaluation of the HUD Concentrated Default Counseling Program." Final Report to HUD, January 1974, p. 40. The six agencies referred to were HUD certified 237 counseling agencies in Spokane, Washington; Shreveport, Louisiana; Louisville, Kentucky; Jacksonville, Florida; Milwaukee, Wisconsin; Washington, D.C.

¹⁸HUD Memorandum from Clifton P. Landers, Jr. Counseling and Community Services Division to Paul Williams, Director Office of Administrative and Program Services. "Report of Fact Finding Visits to Delinquency and Default Counseling Contractors and Government Technical Representatives" - February, 1973. p. 7-8.

are their minimal mandatory capital and their absence of depositors.

Unlike other institutions that are involved with mortgage lending, mortgage companies do not usually have much capital of their own. In order to receive HUD certification as an "approved mortgagee" -- a mortgagee that is entitled to originate and/or purchase FHA insured mortgages -- mortgage companies must have "sound capital funds of not less than \$100,000."¹⁹ However, this capital is not used to invest in mortgages. In contrast to this, thrift institutions such as S & L's have depositors whose funds are invested by the institution.

Since, unlike other financial intermediaries, mortgage companies do not invest their own money,²⁰ their income does not come from interest on investments. Rather, the bulk of their income is derived from fees charged to investors for mortgage origination and servicing.

Customarily, mortgage companies receive a 1% (of the mortgage amount) fee from the buyer for originating the mortgage. Once the loan is being serviced for the long-term investor, mortgage companies are allowed to charge a set fee for servicing the loan. This fee is usually calculated on the basis of 3/8 or 1%/yr. of the outstanding balance of the mortgage loan. Thus, if a mortgage company originates a \$30,000 mortgage, it would be entitled to receive \$300 as an origination fee and the first year it would collect a little under \$112 in servicing fees. (Assuming little amortization during the first year and that the outstanding balance

¹⁹ HUD Handbook -- 4000.2, op. cit. p. 3-2.

²⁰ Between the time that a mortgage is originated and sold to an institutional investor, mortgage companies usually borrow the money from a commercial bank. "Warehousing," usually performed by commercial banks, is the holding of long-term mortgages for the interim period between origination and sale to an investor. The interest which is received on warehoused loans is used to offset the interest payments on the short-term loans that were used to finance the original mortgage loans.

will be close to \$30,000.)

d. Impacts of Non-Reliance on Depositor Capital, in Conjunction with FHA Insurance, on Mortgagors:

A basic quality of thrift institutions is their strong sense of responsibility toward the assets of their institutions and their concern over safeguarding the investments of their depositors.²¹ This protective attitude toward the institution's assets is based upon the notion that the lender assumes a risk in any investments that it makes. However, an interesting characteristic of many mortgage lenders is that even when no risk is being taken, they still act with the same caution and conservatism that accompanies truly risky situations. In the FHA insured programs, in which the risk to the lender is virtually nonexistent, the sense of caution among lenders can still dominate.

For example, when asked during Senate hearings in 1971, "What is the risk to the bank if the Federal government insures the mortgage?", an ex-Chairman of the Board of a large Boston mutual savings bank responded:

Well, the risk to the bank is...that we consider any loan that goes sour on us a poor investment. We do not care whether it is insured or not.²²

²¹For example, interviews with Thomas Wilmore, Loan Officer Cambridge Savings Bank, Cambridge, Mass. January, 1974 and William Sawyer Northeast Federal Savings and Loan Assoc., Watertown, Mass. February 1974. In addition to the internal sense of responsibility of financial institutions, financial regulatory agencies are firm about how financial institutions must handle their assets to safeguard depositors and to assure the viability of the institution.

²²Boston Antitrust Hearings, op. cit. p. 254.

Similarly, Lon Worth Crow, the First Vice-President of the Mortgage Bankers Association of America, in testifying on the proposed housing legislation of 1968; made clear the basic conservatism of many investors, in spite of FHA:

Despite FHA insurance, it is difficult to attract substantial funds for loan programs which are likely to have higher than normal rates of default and foreclosure.²³

At the other extreme, in the period following the Housing and Urban Development Act of 1968, many mortgage companies, have not viewed their responsibility with anything approaching Mr. Bacheller's or Mr. Crow's sense of caution. This is certainly due, at least in part, to the fact that in order to make FHA insured investments even more attractive to mortgagees, since September 1, 1965, FHA has paid mortgage insurance claims in cash.²⁴ Prior to that time payments were made in the form of long-term debentures that had a lower yield than the mortgage investment.

²³Hearings Before the Subcommittee on Housing of the Committee on Banking and Currency, "Housing and Urban Development Legislation and Urban Insurance" House of Representatives, 90th Cong. 2nd Sess., Part I, March 1968, p. 278. See also testimony of Julian H. Zimmerman, Commissioner of FHA, In Hearings Before the Subcommittee on Housing of the Committee on Banking and Currency, "Emergency Home Ownership Act." House of Representatives, 86th Cong. 2nd Sess. January, 1960. p. 28.

²⁴Authorized by Housing Act of 1964, Public Law 88-560. September 2, 1964, 78 Stat. 769, 772.

It appears that for some mortgage companies, the combination of using someone else's money on virtually risk-free, FHA insured, investments has contributed to irresponsible mortgage loan originations. For example, a mortgage loan officer for one of the largest national mortgage companies, located in Philadelphia, indicated that he would not screen out applicants even if he felt that they were ineligible for a mortgage loan. He felt that this was HUD's job, not his.

Even if only four out of 10 marginal cases make it (i.e., get approval from HUD) they (the mortgage company) will take all 10 -- and let HUD decide.²⁵

Similarly, in testimony before the Senate Subcommittee on Antitrust and Monopoly, a former Chairman of the Board of a New York mortgage company stated that:

It was the practice of United Institutional Servicing Corp. to close all loans, approved by FHA or VA...it was our feeling that for every foreclosure at least 19 families would be enabled to find (better) quarters...²⁶

Interviews with two mortgage companies in Louisville demonstrated the variation in lender attitudes on the issue of property inspections. An officer at the larger company bluntly commented: "We don't do property inspections, that's HUD's job."²⁷ But, in contrast, an officer at a much smaller company noted that:

²⁵ Interview, Romeo Valentino, Loan Officer, Colonial Mortgage Company, Philadelphia, Pa. January, 1973.

²⁶ New York Antitrust Hearings, op. cit. p. 289.

²⁷ Interview, Harold Dickson, Assistant Vice President, Pence Mortgage Co., Louisville Ky. February 19, 1974 (telephone).

We inspect properties at origination. We've always done it. We wouldn't disqualify a house, (because of bad repairs) but we would write down what repairs are needed -- and send this off to HUD with the forms.²⁸

The sentiments expressed by the latter mortgage company are most in line with classical notions of the role of the mortgage lender, whether dealing with conventional or FHA loans.

Writing in the early 1960's, Willis Bryant, author of a text on mortgage lending, described the importance of the lender's screening function in the FHA system:

Each loan application should be approved by the lender in all respects for any type of FHA loan or VA loan prior to submitting the application to the FHA or the VA. It should be remembered that these agencies do not see their potential borrower. Over a period of more than twenty-seven years of handling FHA loans and seventeen years of VA loans, because of preliminary screening by the mortgagee, the number of applications disapproved by FHA and VA after preliminary approval by lenders is almost negligible.²⁹

Thus, Bryant visualized the lender in the FHA programs as a true representative, almost an arm, of the FHA.

Unfortunately, however, the Committee on Government Operations, in examining the default and foreclosure problem on FHA-insured homes in Detroit found that most mortgage companies in that city behaved more like the first Louisville mortgage banker, quoted above.

²⁸Interview, Bill Salyer, Assistant Vice President, Louisville Mortgage Co., Louisville Ky. February 21, 1974 (telephone).

²⁹Willis R. Bryant, op. cit. p. 143.

Mortgage companies write mortgages for home purchasers and then sell 100 percent FHA-backed mortgages to FNMA. Because of the security afforded by this guarantee, most mortgage companies have abdicated responsibility for screening potential home purchasers and determining if the mortgaged property is structurally sound and fairly valued. Neither FHA nor FNMA has taken steps to bar imprudent mortgage lenders from doing business.³⁰

The following exchange between Rep. George Collins of Illinois and Lawrence Katz, a former Director of the HUD Area Office in Milwaukee, contributed to the Committee's conclusion, as stated above:

Mr. Collins: ...don't you feel that the obligation of determining the quality of the security should be assured more by the lender rather than FHA than it has been?

Mr Katz: It is a theory, but in fact it doesn't work; it doesn't work for the very simple reason the lender is an interim lender. The mortgages are taken by FNMA and GNMA.

Mr. Collins: He doesn't give a damn?

Mr. Katz: His risk is almost nonexistent. He is not going to hold a mortgage for 30 years. He turns it over to the quasi-government agency, and the Government agency is the one who takes the mortgages and the risk. All of your mortgage bankers operate this way.³¹

In contrast to this type of mortgage company operation, it appears that at least some commercial and savings banks are still cautious in evaluating FHA-insured loans. Moreover, these types of lenders often register shock upon learning that many mortgage companies do not operate

³⁰ Fifteenth Report By the Committee on Government Operations, op. cit. p. 4-5.

³¹ Hearings Before a Subcommittee of the Committee on Government Operations, "Defaults on FHA-Insured Mortgages (Part 2)" House of Representatives, 92nd Cong. 2nd Sess. February and May, 1972. p. 161-162.

in a similar manner.

For example, John H. Payne, the President and Chief Executive Officer of the Empire National Bank learned, to his surprise, that their recently acquired mortgage company never did any evaluation of FHA mortgages:

(In an)evaluation of the mortgage company's operations, (it was) reported to me that one of the major problems influencing the control of the quality of mortgages was the fact that there were no internal procedures for approval of mortgage loans accepted for processing.

In other words,...any mortgage on which a firm commitment was issued by the FHA or VA was automatically closed without any further internal investigation.

Because these loans were Government insured or guaranteed, it was apparently assumed that there would be no substantial loss to the company irrespective of whatever loss there might be to the Government by virtue of its insurance or guarantee.

To those of us who have been used to doing a commercial banking business, this was a novel procedure because we don't operate on a nonapproval or nonreview practice. What the mortgage company was doing was not consistent with what we've been accustomed to doing in our bank relative to all types of loans, including those which carry a Government guarantee;...

The functions of the marketplace in the mortgage banking area are quite different from those of commercial banking. While we recognized this before we acquired (the company)...we were not prepared to accept some of the practices those companies followed, practices which were apparently common to the mortgage banking industry.³²

Upon realizing that their acquired mortgage company had no procedures for evaluating mortgages, Empire National Bank instituted its own internal reviews. However, they found that the volume of mortgages derived from local real estate brokers fell off substantially. With their income coming

³²New York Antitrust Hearings op. cit. p. 212-213.

from commissions on sales of real estate, most brokers chose a prospective mortgagee based upon how likely and how rapidly they felt the financing would be approved. Payne testified:

We recognize the validity of the real estate brokers' reply to tougher underwriting standards, and I quote, "So, OK, I'll go to another company. They'll accept anything I bring in."

And as the word spreads among the brokers that we are tightening up, and as the word becomes exaggerated in its second and third repetition, even the high-quality producer becomes concerned about getting his mortgage approved and seeks alternate companies to work with.³³

Because of the possibility of a painful decline in business "the temptation of the mortgage company to accept any and all cases the broker produces is great."³⁴

Thus, the lender that unilaterally tries to tighten its procedures or to impose lending standards could find itself out of business. This, Payne felt, is a key rationale for tighter regulation of mortgage companies:

It is really not enough for individual mortgage companies, such as our own, to tighten procedures and quality controls; the mortgage banking industry needs legislated and regulated standards, much as the banks of the country have through their banking regulatory authorities.

Such regulations, in combination with quality standards applied without favor by mortgage guarantee and mortgage insurance agencies, will enable us all to compete on an even basis.

And, as most of us in the mortgage banking business do business in many States, I believe that uniformity of these regulations and standards among all of the States is vital.³⁵

³³Ibid. p. 215-216.

³⁴Ibid. p. 215.

³⁵Ibid. p. 216.

During the December, 1972 Hearings Before the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, Rep. Ben Blackburn of Georgia noted that:

One of the criticisms of this program (235) has been that the Government has given a check to the lender and said in effect, "Whatever loss occurs, we will bear"...Under our present operation the lender has no incentive to protect the houses to see that they are properly maintained...³⁶

Thus, the classic mortgagee job of assessing a family's ability to pay the costs of the mortgage, or underwriting, has simply not been performed by some mortgage companies. Similarly, property appraisal -- including assessment of the house and location -- another long-standing function of mortgagees has also been ignored by some mortgage companies. Clearly, since HUD does not require the mortgagee to undertake any major screening function, there is really very little motivation for mortgagees to do so.³⁷ But whatever type of job is performed by the lender, HUD ultimately takes full risk and responsibility.³⁸ In view of both the

³⁶Hearings Before the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, "Housing Subsidies and Housing Policies" Congress of the U.S. 92nd. Cong. 2nd Sess. December 1972. p. 31-32.

³⁷There may also be real motivation for mortgagees not to screen applicants, lest they be charged with discrimination. This point was made during a Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 94th. Cong. 1st. Sess. Chicago, July, 1975, p. 104.

³⁸In some states, such as Massachusetts, state regulated financial institutions are required to perform property inspections regardless of whether the mortgage will be FHA-insured or conventional. Regulations governing FHA loans by savings banks state that "all statutory requirements in respect to appraising and approving real estate as security for conventional loans shall be complied with..." Further, the bank must obtain for its files "an appraisal of property securing the loan and certification as to the general physical condition of the property..." (Quoted in letter to David Rogers, Boston Globe, from Thomas W. Lawless, Jr., Attorney for Massachusetts Commissioner of Banks, June 6, 1974).

minimal decision-making role of mortgagees, and of HUD's substantial risk, one would expect that HUD would act in such a way that would consistently serve to minimize its vulnerability. The extent to which HUD has fulfilled this expectation will be discussed in Section III.

Ironically, not only has the lack of concern for underwriting not been forbidden, it seems to be understood -- if not completely condoned -- by some HUD-FHA officials. For one thing, many HUD-FHA personnel were, at one time, in the mortgage banking business themselves and still have close ties and allegiances to the industry.³⁹

After being the Assistant Secretary for Housing Production and Mortgage Credit and Commissioner of the FHA for only four days, Sheldon Lubar, coming straight from a mortgage banking firm to the FHA, expressed these sentiments:

³⁹Interview, William Bonner, *op. cit.* See also Boyer, *op. cit.* p. 95. Boyer relates a story told to him by one of Secretary Romney's aides about a powerful HUD Under Secretary and the Under Secretary's attempts not to discipline a mortgage company that had been publicly caught with its hand in the "honey pot." The aide had argued for strong measures against the firm including long-term or permanent suspension. "Listen, you son-of-a-bitch," the Under Secretary told the aide. "You can be righteous, because your future is open to you but I have to go back to the industry." Another indication of the close ties between the mortgage banking industry and HUD-FHA was pointed to during Congressional hearings held in 1970. Based upon an interview with an FHA appraiser, it was learned that: His regional office is heavily influenced by the mortgage and real estate industries. He denied any specific knowledge of outright bribes but told of common occurrences where overtures had been made to him personally. Moreover, many of the appraisers feel that their only future lies in the possibility of 'good jobs' with the mortgagees or the real estate firms." Committee on Banking and Currency, "Investigation and Hearing of Abuses in Federal Low- and Moderate-Income Housing Programs" Staff Report and Recommendations, House of Representatives 91st. Cong. 2nd Sess. December 1970, p. 6.

...You find that mortgage bankers or anyone else involved in the housing industry, do whatever they are allowed to do. And if 221 financing is available for houses that are not inspected or the credits are not looked at, I suppose they are generally going to take advantage of it.⁴⁰

Legislators, upset about the problems with the 235 program, have looked for new techniques to modify the risk-free nature of mortgage lending under the HUD-FHA programs in the hope that this would put a halt to irresponsible mortgage lending.

For example, Rep. Blackburn, after making the observation quoted above, went on to note that:

We have protected the lender completely, and I think he ought to share some of the loss. And if he did, he would look at the value of that land, and he would say, "Wait a minute, I know the fellow next door just bought a hundred acres at fifty percent less or one-third of what they have appraised this land. I am not going to loan money like that on this land."⁴¹

Thus, according to Blackburn, if lenders assume some risk, they are likely to exert a tempering effect on the market and to act more responsibly in lending decisions.

Outlining the basic theme of Congress' "coinsurance" program,⁴² Blackburn suggested:

that we instruct the lender, the mortgage bankers in effect, to understand if this loan goes sour they are going to share in the loan to the extent of at least twenty percent.⁴³

⁴⁰Hearings Before a Subcommittee of the Committee on Government Operations, "Review of Federal Housing Administration" (Part 1 -- The Financial Status of FHA Mortgage Insurance Funds), House of Representatives, 93rd. Cong., 1st Sess. July, 1973. p. 56 (Referred to as "Review of FHA Part 1, Hearings").

⁴¹Ibid. p. 42.

⁴²Title III, Section 244; Housing and Community Development Act of 1974.

⁴³Review of FHA Part 1, Hearings, op. cit. p. 32.

According to this view, then, the lack of risk associated with the mortgage companies' business is the primary cause of the irresponsible types of activities which have been described above. Shifting some of the risk in mortgage lending away from HUD and back onto the lenders is one key way in which the HUD-FHA home finance system might be improved. This issue will be discussed in greater detail in the final chapter.

e. Regulation:

Perhaps the two unique characteristics of mortgage companies, discussed above, would have fewer adverse impacts on mortgagors if the regulation of mortgage companies were tighter. However, in sharp contrast to other types of lenders, mortgage companies are subject to little direct regulation or supervision. Unlike banks, savings and loan associations, insurance companies, and mutual savings banks, which are under the rigorous supervision of an array of state and/or Federal financial agencies,⁴⁴

⁴⁴The Federal Reserve Board regulates state chartered banks which are members of the Federal Reserve System; The Federal Deposit Insurance Corporation regulates insured state banks which are not members of the Federal Reserve System; The Comptroller of the Currency regulates national banks; and as discussed in Chapter 2, the Federal Home Loan Bank Board regulates federally chartered savings and loan associations.

In general, the above regulatory bodies supervise and examine member banks. More specifically, the types of activities included in this regulation are: establishing interest rates on deposits and loans; overseeing financial records; establishing criteria for chartering, branching and mergers; and setting reserve requirements.

mortgage companies come under regulation only through the corporation laws of the particular state in which they are incorporated. In addition, since the great majority of mortgage companies seek HUD certification and approval and have extensive dealings with FNMA, they must also meet various requirements of HUD and FNMA. The relative lack of regulation of mortgage companies is their third unique characteristic and, as mentioned above, may be the one that makes the other two so potentially problematic.

Klaman offers an explanation for the comparatively limited supervision of mortgage companies:

(This) may perhaps be explained on the grounds that they do not hold deposits or other large reservoirs of funds of the general public as do financial intermediaries.⁴⁵

Yet, it is interesting to note that in 1971 the role of mortgage companies in dealing with over three million FHA mortgagors, representing almost \$46 billion in FHA-insured mortgages,⁴⁶ has not qualified them, in the Federal government's opinion, for stricter regulation, more closely approaching the supervision required of the other financial institutions.⁴⁷

The fact that HUD is the only regulatory agency of mortgage companies does not necessarily mean that supervision is not performed properly.

⁴⁵Saul B. Klaman, op. cit. p. 9.

⁴⁶Calculated from MBA highlights of 1971, op. cit. and HUD Statistical Yearbook, 1971, Washington, D.C. p. 184.

⁴⁷Regulation of the other financial intermediaries has also come under fire; not for its laxity, but for its excessive strictness. For example, there has been a movement toward enabling S&L's and mutual savings banks to perform a wider range of banking functions. See, "Financial Institutions: Reform and the Public Interest," op. cit. and "The Report of the President's Commission on Financial Structure and Regulation" Reed O. Hunt, Chairman. December, 1971.

However, it is unfortunate that this appears to be the case. Since the shortcomings are largely HUD's, the issue of regulation will be postponed until Chapter 10. For the present, it is important to note that a recent report by the Comptroller General of the U.S. disclosed widespread inadequacies and inconsistencies in HUD's mortgagee approval, monitoring, and suspension procedures. While the intent of the report was not "to develop the significance...of weaknesses noted"⁴⁸ these oversights in mortgage company regulation have opened the way for a variety of careless, at best, and dishonest, at worst, mortgagee underwriting practices.

Obviously, concerning the issue of regulation, mortgage companies are content with the status quo. Oliver Jones, the Executive Vice President of the MBA has noted that FHA, VA, FNMA, and GNMA all play a supervisory role over mortgage companies. Although HUD has not exerted its authority adequately, it is their responsibility to "find ways to implement the nation's laws in an efficient and business-like way."⁴⁹

Further, Jones outlined exactly what he feels is at stake if mortgage companies become subject to more stringent regulation:

⁴⁸Report to the Subcommittee on Antitrust and Monopoly Committee on the Judiciary, "Processes for Approving and Monitoring Nonsupervised Mortgagees" U.S. Senate by the Comptroller General of the U.S. Nov. 8, 1973, p. 5.

⁴⁹"Mortgage Banking Is Regulated!" The Mortgage Banker, Mortgage Bankers Association of America, July, 1972, Vol 32. No. 10, p. 10.

Before the would-be regulators move into the field of mortgage banking, they should consider the economic significance of a financial institution that has the freedom to be flexible in adjusting to change; the freedom to move into commercial lending, into financing apartments; the freedom to seek mortgage funds from all types of financial institutions, from the securities markets, and from pension and trust funds...The nation must retain the mortgage banker's flexibility to make these adjustments. Other lenders are too restricted by regulation, law, and custom to meet the nation's changing demands for mortgage credit...⁵⁰

In contrast to Jones' views, other institutional lenders have articulated the need to regulate the mortgage banking business. Reflecting on his bank's experience in purchasing a problem-laden New York City mortgage company, John H. Payne testified before the Senate Subcommittee on Antitrust and Monopoly:

...the mortgage banking business needs to have some intelligent program of regulation to protect the people of this country, just as in the commercial banking business.

The State and national banking departments have set certain requirements for the people who are allowed to go into this business, both on the basis of their own moral backgrounds and financial standards. We have certain capital requirements. We have certain limitations of how, when, and where we can do business. And we are examined, not only to make sure that our financial records are all right, but also that we are following the ethical rules and regulations laid down by the banking supervisory authorities.

And I submit, Mr. Chairman, that we need this in the mortgage banking business, too. I'm not prepared to be an expert in how to set up the proper supervision of the mortgage banking business, particularly only having been in it about 9 months, but I can see the great similarity between that and commercial banking, and certainly can see some of the things that need desperately to be done, if we are going to protect the buyer, the public, and the Government, and the taxpayer.⁵¹

⁵⁰Ibid. p. 10.

⁵¹New York Antitrust Hearings, op. cit. p. 217-218.

Echoing Payne's comments, Isidore J. Lasurdo, the Executive Vice-President of the Green Point Savings Bank in Brooklyn called for:

all mortgage companies (to) be licensed and regulated so they can operate in a more responsive and responsible manner. Supervisory authorities should regularly examine not only their records, but their overall objectives and operations.⁵²

Yet, at this writing, the situation is basically unchanged. Although the mortgage company is the key lender in the HUD-FHA home finance system, no regulatory body has been created to oversee their operations. However, on a more encouraging note, as discussed in Chapter 10, Sections 7 and 9, HUD has made some efforts to improve its own regulatory functions. The extent to which these will be effective remains to be seen. But it must be emphasized that regulation of mortgage companies is a key way in which HUD could reduce its position of risk and, in turn, serve the consumer's interests.

⁵²Ibid. p. 755.

CHAPTER 7: THE FEDERAL NATIONAL MORTGAGE ASSOCIATION AND THE SECONDARY MORTGAGE MARKET

1. INTRODUCTION:

The Federal National Mortgage Association (FNMA, known as "Fannie Mae"), is the most important agency of the secondary mortgage market and has been called "the key factor of the entire housing situation."¹ Indeed, FNMA is the link in the HUD-FHA home finance system that brings the components together.

While the FHA created a standardized mortgage instrument that could be traded throughout the country it did not, however, also create the vehicle, or the market place for those transactions. Furthermore, while the FHA was able to reduce the lender's fear of loss due to foreclosure -- or, in other words, minimize his risk -- it never addressed the other critical fear of lenders -- also stemming from the Depression -- of not having enough liquid assets to meet the demands of depositors. Since mortgages are long-term investments a rush of withdrawals, such as the one that occurred during the Depression, could leave lenders without sufficient cash reserves. The FNMA has addressed these dual needs: To make the FHA mortgage negotiable and to enable lenders to achieve a totally liquid position.

The FNMA and mortgage companies function hand in hand. Mortgage companies, lending money without any real assets of their own, rely on a close relationship with FNMA -- as a so-called "secondary source of funds" -- to provide the money to purchase their mortgages.

¹Charles M. Haar, op. cit. p. 74.

FNMA's growth as a holder of FHA insured home mortgages has been dramatic. As of 1971, FNMA held slightly under 10%² of these mortgages while in 1974 FNMA purchased 69% of all FHA insured mortgages issued that year.³ FNMA's total portfolio more than quadrupled between 1968 and March 1975 -- from an outstanding balance of \$7.2 billion to almost \$30 billion.⁴ (See Table 8) Thus, with the creation and growth of the secondary mortgage market a new layer of bureaucracy was added to the HUD-FHA home finance system.

The growth in the secondary mortgage market has meant that there is a growing trend for FHA-insured mortgages to be serviced by an agent other than the holder. In both 1950 and 1960, about 45% of the FHA-insured mortgages were not serviced by the mortgage holder. By 1970, the percentage had jumped to 62%. (See Table 9)

This is in striking contrast to the servicing of non FHA-insured loans. Between 1950 and 1970, at least 89% of the conventional loans were serviced by the mortgage holder. (See Table 9)

In addition, as of 1971, only 36% of the FHA insured single family mortgages had been originated by the current holder, as compared to an overwhelming 88% of the conventional mortgages. (See Table 10) Also

²U.S. Bureau of the Census, Residential Finance, 1971, op. cit. p. 70

³Hearings Before a Subcommittee of the Committee on Government Operations, "Mortgagee Servicing and HUD Property Management," House of Representatives, 94th. Cong. 1st. Sess. July, September and October, 1975, p. 74.

⁴Ibid. p. 84.

TABLE 8

Dollar Value of FNMA Loan Portfolio as of March 31, 1975
(In Billions)

	Subsidized	Non-Subsidized	Total
Home Mortgages:			
FHA	3.0	10.3	13.3
VA	-	8.3	8.3
Conventional	-	2.2	2.2
Project Mortgages:			
FHA	<u>4.8</u>	<u>1.3</u>	<u>6.1</u>
TOTAL Unpaid Principal Balance	7.8	22.1	29.9

Source: "Mortgage Servicing and HUD Property Management," p. 84.

TABLE 9

Servicing of FHA & Conventional 1-Unit Owner-Occupied Properties

1950-1970

	Serviced by Holder	Serviced by Agent	TOTAL
1950			
FHA	55%	45%	100%
Conv.	89%	11%	100%
1960			
FHA	54%	46%	100%
Conv.	89%	11%	100%
1970			
FHA	38%	62%	100%
Conv.	93%	7%	100%

Source: U.S. Bureau of the Census, Residential Finance
1950, 1960, 1970.

TABLE 10

Holder's Acquisition of First Mortgage
1-Unit Homeowner Properties, 1971
United States

(Numbers of Mortgages in Thousands)

	FHA	%	VA	%	Conventional	%	TOTAL	%
Originated by Holder	1471	36	1058	38	10878	88	13407	70
Purchased from Present Servicer	1977	50	1245	45	704	6	3926	20
Purchased from Someone Else	521	13	453	16	517	4	1491	8
Not Reported	28	1	27	1	221	2	276	2
TOTAL	3997	100	2783	100	12320	100	19100	100

Source: Residential Finance p. 71

significant is the fact that 13% of all FHA mortgages were held by mortgagees that had neither originated the mortgages nor purchased them from the current servicers, as compared to only 4% of all conventional mortgages.⁵ (See Table 10) Thus, in these mortgage transactions, at least three parties were involved.

This chapter will present some background material on the secondary mortgage market and FNMA and will discuss how its activities have further minimized risk for lenders and impacted the consumer.

⁵U.S. Bureau of the Census, Residential Finance, 1971, op. cit. p. 71.

2. NATIONAL MORTGAGE ASSOCIATIONS: PREDECESSORS OF FNMA:

The National Housing Act of 1934 not only created the FHA, but it also contained the enabling legislation for the creation of private national mortgage associations "to purchase and sell first mortgages on real estate."¹

In the following statement, Charles Haar summarizes why a need for this type of institution was perceived by the drafters of the legislation.

The financial community had grown accustomed to short-term, low-ratio, unamortized mortgages. Draftsmen of the National Housing Act foresaw that the FHA mortgage, with its low interest rate, long term, and high loan-to-value ratio would be an object of suspicion to bankers, inevitably a conservative group, despite the existence of government insurance. In addition, lenders, in those days of the Great Depression, harried by a need for liquidity, would hesitate to take up FHA mortgages were they unsalable beyond the immediate confines of a local and, owing to the newness of the FHA mortgage, spotty market. Thus, the private national mortgage associations were looked on as a means of assuring lenders that the FHA mortgages were sound and would be taken off their hands should they so desire.²

Thus, the key role that the national mortgage associations were to play was to help lenders gain confidence in the new FHA mortgage by providing them with both liquidity and new markets for the sale of FHA mortgages. In addition, Jones and Grebler note that:

¹Title III, National Housing Act of 1934, op. cit. Sec. 301.

²Charles M. Haar, op. cit. p. 76-77.

The associations were also intended to supply a means by which funds could be more easily transferred from capital-surplus to capital-deficit areas and effective mortgage interest rates more nearly equalized throughout the country. As primary lenders were given access to dependable purchasers of FHA loans, it was hoped that they would use the proceeds from the sale of existing mortgages for investment in new ones.³

The creation of national mortgage associations was perceived as a critical component of the post-Depression home finance package and a stimulant to the ailing construction industry. The first annual report of the Federal Housing Administration stated that:

...the operation of such associations is regarded as vital to the effective and rapid growth of the mutual mortgage insurance plan, and should constitute an enduring part of the new home financing system which this Administration is fostering."⁴

It is indeed a credit to the Congress that this sophisticated measure was conceived and enacted at the same time that the FHA mortgage insurance plan was created. However, there was a pervasive lack of interest among private parties to form national mortgage associations.

Despite repeated attempts by Congress to entice private capital into this type of venture, private national mortgage associations never became more than a much-talked about idea.⁵ A variety of reasons have been offered to try to explain why no private associations were ever formed.⁶ One particularly plausible reason is suggested by Jones and

³Oliver Jones and Leo Grebler, The Secondary Mortgage Market (Los Angeles: University of California, 1961) p. 115.

⁴Quoted in Ibid. p. 115.

⁵In Ibid. p. 116-117 and Charles M. Haar, op. cit. p. 79-80 the series of amendments passed by Congress in attempts to encourage the formation of private national mortgage associations are reviewed.

⁶For complete and excellent discussions on the lack of interest in forming private national mortgage associations see Ibid. p. 117 and p. 83, respectively.

Grebler:

The depressed general conditions of the thirties were not conducive to the formation of new financial institutions as private ventures. The investment quality of the insured mortgage was yet unproven.⁷

Thus, if bankers were conservative about using the FHA-insured mortgage, it is likely that they, as well as other private parties, would be even more wary about an even more complex concept. The national mortgage association was to enter into transactions considerably more intricate than simply originating mortgages. Yet, business activity would still be based on the inherent worth of the FHA mortgage something that, as mentioned previously, was still unfamiliar. However, once the FHA mortgage did begin to prove itself as a worthy instrument, it is interesting that even then -- and up until 1948 -- when authorization to form private national mortgage associations was finally repealed -- that no private party took the initiative. Haar's explanation is that: "given a government supported secondary market it was more profitable for lenders to operate in the primary field where two backstops were present."⁸ Thus, with FHA insurance greatly reducing risk due to foreclosure and with the promise of liquidity through the government supported secondary market, mortgage lenders began to enjoy a relatively risk-free business environment.

⁷Oliver Jones and Leo Grebler, Ibid. p. 117.

⁸Charles M. Haar, op. cit. p. 84.

3. THE EMERGENCE OF A GOVERNMENT SUPPORTED SECONDARY MORTGAGE MARKET:

a) RFC Mortgage Company:

With no interest to form national mortgage associations generated in the private sector, the government perceived a need to become directly involved with this function; the Reconstruction Finance Company (RFC) Mortgage Company was created in 1935 for this purpose.

Ironically, while the legislators who enacted the National Housing Act of 1934 had realized that there would be a need for institutions that could trade FHA-insured home mortgages that had been originated by private lenders, the initial role of the RFC Mortgage Company was not directed to this goal. Instead, it was authorized to originate and finance mortgages on apartment houses, motels and office buildings, if financing was not obtainable at reasonable rates from private sources. Thus, the RFC Mortgage Company's activities were originally limited to loans for new construction or to the financing of income-producing real estate.¹

Shortly after its creation, however, officials of both the FHA and RFC instructed the RFC Mortgage Company to purchase FHA-insured mortgages on residential housing, thereby hoping to further stimulate the construction industry and loosen the mortgage market. Between 1935 and 1948, when the RFC Mortgage Company was dissolved, it had purchased

¹Federal National Mortgage Association "Background and History, 1973", p. 2. To carry out its functions, the RFC supplied the RFC Mortgage Company with an initial revolving fund of \$10 million. This was later increased to \$25 million. Oliver Jones and Leo Grebler, op. cit. p. 117.

63,424 mortgages with a value of over \$250 million.²

b) FNMA:

With the recognition that the RFC Mortgage Company could not alone provide the needed secondary source of funds to the still sluggish housing industry Congress, in 1938, created the Federal National Mortgage Association.³ Clearly focusing on the need to stimulate construction, Congress limited FNMA purchases to mortgages on new construction. The RFC Mortgage Company then assumed the responsibility of purchasing mortgages not eligible for FNMA purchase, such as those on existing housing.⁴

While the mandate for national mortgage associations and, later, FNMA, grew out of the need to help stimulate construction by offering lenders liquidity on FHA-loans, FNMA has also been used for a variety of other functions.

Writing in 1960, Jack Guttentag observed that FNMA carried out four distinct functions that had been legislated by Congress.⁵ Among those that were specified in the 1938 legislation were, as discussed above, "to increase the general level of residential construction" and "to make a market in Federally underwritten mortgages."⁶ Two additional

²FNMA "Background and History," op. cit. p. 3, Between 1946 and 1948 the RFC Mortgage Company also purchased 24,070 VA guaranteed mortgages with a value of over \$140 million.

³The FNMA was chartered on February 10, 1938 and was originally called the National Mortgage Association of Washington. Two months later this name was changed to FNMA.

⁴Oliver Jones & Leo Grebler, op. cit. p. 121.

⁵Jack Guttentag, "The Federal National Mortgage Association" -- Research Study #2 in George F. Break et al. Federal Credit Agencies (Englewood Cliffs, N.J.: Prentice Hall, Inc., 1963) p. 67.

roles were made explicit in the Housing Act of 1954 -- "to provide special assistance to specific housing programs"⁷ and "to convert to private ownership."⁸

This last goal was realized with the passage of the Housing and Urban Development Act of 1968; FNMA became privately owned although it is still subject to Federal supervision and regulation. The 1968 legislation also removed two of FNMA's earlier functions -- the financing of so called "special assistance" programs and the management and liquidation of certain mortgages held by the Federal government. The Government National Mortgage Association, (GNMA, known as "Ginnie Mae") a wholly owned government entity was created to carry out these two functions. FNMA, as it now stands, conducts secondary mortgage market activities in FHA, VA, and conventional mortgages.

⁷ Assistance to special housing programs, such as armed services and disaster housing had developed on an ad hoc basis between 1951 and 1954. It was not, however, made a formal part of FNMA's activities until 1954. Ibid. p. 68.

⁸ While this did not become explicit until 1954, the desire to create a private secondary mortgage market facility was, as mentioned above, the original intent of the 1934 legislation.

c. GNMA

GNMA is another mechanism which the government has created to encourage the involvement of lending institutions in order to increase the volume of housing and, particularly, low-moderate income housing. GNMA, along with FNMA, provides lenders with liquidity. However, unlike FNMA, GNMA only buys certain loans that the government has designated eligible in order to increase mortgage credit for special purpose housing programs.

GNMA's basic operation is known as the Tandem Plan. GNMA buys loans at par, or close to par (the full face value of the mortgage) and then sells it to FNMA at prevailing market prices. The difference in price --or, the loss to GNMA, is subsidized by the government. Thus, GNMA's operation is one of buying high and selling low.

In addition to selling loans to FNMA, GNMA can also sell loans back to the originator of the loan at a lower price, which is in line with current market prices. In this way, GNMA supports the price of mortgages and encourages the participation of private investors, with the end-of-the-road goal of increasing the supply of housing for low-moderate income families.

4) THE MORTGAGE MARKET AND FNMA:

The level of housing construction swings up and down. However, peaks in construction do not occur during economic booms. Instead, they occur when the economy is sluggish. A Decent Home has explained this seeming paradox:

When industrial production is high, there generally is an expansion of capital investment which tends to increase the cost of money, in turn resulting in higher housing costs. When the economy starts down, the cost of money decreases and housing production tends to increase. For this reason economists tend to say that housing production is "counter-cyclical."¹

While some economists feel that it is appropriate for housing to function as a "sponge" and to help stimulate a faltering economy², others feel that housing carries an unnecessary, unfair and costly burden.

As mentioned above, one of FNMA's original goals was to increase the general level of residential construction. However, FNMA's role as a counter-cyclical device -- pumping money into the mortgage market when financing for mortgages becomes scarce and interest rates high -- was not made explicit until 1968.

In introducing the 1968 Housing legislation to the Senate, Secretary Weaver concluded his comments concerning the partitioning of FNMA into two agencies by adding that:

¹ A Decent Home, op. cit. p. 127.

² For example, Prof. Arnold C. Harberger has gone so far as to state that: "I'd be worried if housing were not being squeezed, because the tight monetary policy would not be having its desired effect... We have got to allow tight monetary policy if we are going to have an effective fine-tuning or short-run stabilizing policy tool in our kit..." in "Housing and Monetary Policy" The Federal Reserve Bank of Boston, Conference Series No. 4 p. 37.

It is my hope, too, that (these measures) can reduce the scope of cyclical movements in the mortgage money market that we have experienced in the past.³

Several other witnesses at the House and Senate Hearings echoed Weaver's desire to offset the swings in the construction industry. For example, Lloyd E. Clarke, President of the National Association of Home Builders, observed that there is an:

imperative need to remove some of the impediments to unleashing the vigor and capacity of private enterprise...The homebuilding industry is still suffering from the credit debacle of 1966 and is now being hit by another money squeeze. Real, substantial, and sustained progress toward curing the housing problems of America is extremely difficult, if not impossible, so long as the homebuilding industry is allowed periodically to become the first and sometimes the only casualty of tight money.⁴

Although FNMA's counter-cyclical goals did not become explicit until 1968, many of FNMA's earlier efforts were aimed at evening out the swings in the construction industry. However, by being tied to the Federal budget, it was difficult for FNMA to carry out this function optimally. Rosen and Kearn offer a concise explanation:

³HUD Senate Hearings 1968, op. cit. p. 15.

⁴Ibid. p. 289. However, Clarke was pessimistic that this could be achieved through the FNMA/private - GNMA/public combination: Certainly the concept of a private FNMA has a great deal of appeal. It would free the secondary market function from the present budget and other constraints...Yet, in considering our position on this issue...we question whether the resultant institution would be adequate to do the job -- whether the revised FNMA could continue to perform the vital functions of support for the mortgage financing of homebuyers and of the homebuilding industry...We think the objective of removing FNMA Secondary market operations from the Federal budget could be accomplished in some other way and with less risk of disturbing the entire mortgage market. p. 296.

Prior to (1968) FNMA operations were included in the Federal budget and as a consequence mortgage acquisitions which added to the Federal deficit were discouraged even when they were needed to stabilize the market.⁵

Thus, while FNMA might have tried to purchase mortgages during periods of tight money, thereby pumping more money into the mortgage market, those purchases were discouraged by the Federal government because they were treated as deficits.

Since 1968, however, FNMA has been credited with diminishing the severity of credit crunches and with helping to maintain a flow of credit into housing.⁶ Thus, FNMA plays a critical role in the housing and money markets.

But while the production of housing is an end-of-the-road goal, other intervening goals are also addressed by FNMA's activities. For example, many private actors, such as homebuilders and mortgage lenders depend upon FNMA for helping to stabilize their businesses. It is clearly

⁵Kenneth Rosen and James Kearl, op. cit. p. 3.

In addition, Guttentag has noted another interesting conflict between FNMA's counter-cyclical goal and another of its original, as well as present, purposes -- that of providing a market for mortgages:

It is characteristic of this function (making a market) that although the dealer himself determines the price at any given moment (which is what "making a market" means), over a period of time he is a completely passive agent; he registers, as it were, the consensus of others. The function of making markets is thus quite distinct, and to some extent probably operationally inconsistent, with functions that involve influencing markets -- for example, exercising a counter-cyclical influence on construction, or reducing yield differentials between different areas of the country. It would be extremely difficult to register the consensus of the market with one hand while altering it with the other. Jack Guttentag, op. cit. p. 124-125.

⁶Dr. Harry Schwartz in "Housing and Monetary Policy" op. cit. p. 85.

critical to bankers that FNMA pump money into mortgages when other investors look to other higher yielding investments. Without FNMA, many mortgage banking concerns would suffer. In addition, the construction industry, as articulated in the above statement by Lloyd Clarke, has a significant interest in a constant level of residential construction.

Similar to the multiple goals of housing legislation, FNMA is charged the major tasks of helping to stabilize a key sector of the economy--housing, as well as enabling more people to purchase homes. In addition, as mentioned earlier, FNMA provides lenders with liquidity, thereby giving them a second level of protection, on top of the FHA insurance.

5. OPERATION OF FNMA:

FNMA buys FHA and VA mortgages from approved mortgagees, primarily through its Free Market System. FNMA has created an "auction"-like procedure whereby mortgagees bid to sell mortgages to FNMA at a specific price. Prior to the "auction", which is usually conducted every other week, FNMA decides on the minimum and maximum amounts that can be bid by any mortgagee.

Based upon the mortgagee's knowledge of the mortgage market, he decides on the dollar amount of mortgages to be offered and the yield. That is, he estimates the lowest yield that he feels FNMA is likely to accept. Mortgagees making bids in this manner must pay an "offer fee" to FNMA of .01 percent of the mortgage amount being offered.

When all the bids are entered, FNMA decides on the dollar amount of mortgages and the range of yields to accept. If a mortgagee's bid is accepted, he must pay FNMA a "commitment fee" of .5 percent of the mortgage amount. Thus, if a mortgagee's bid on mortgages worth \$500,000 is accepted by FNMA, the mortgagee will have to pay a total of \$550 to obtain the commitment. (\$50 = offer fee; \$500 = commitment fee)¹

If a mortgagee does not want to bid competitively he also has the option of bidding non-competitively or, in other words, he agrees to

¹Mortgagees whose bids are rejected must also pay the offer fee, which is nonrefundable.

accept the average yield which FNMA determines through the auction procedure. For the seller, bidding non-competitively carries the advantage of excusing him from the .01 percent non-refundable "offer fee." However, it is disadvantageous in that the seller loses the opportunity of obtaining a commitment at less than the average yield. Therefore, while the seller won't pick up a bargain through non-competitive bidding, it is certainly a less risky and less costly way of obtaining a commitment.

If a seller's bid is accepted, FNMA agrees to purchase the accepted amount of mortgages at the specified yield for a period of four months. If the seller cannot meet this deadline, or if he chooses to sell the mortgages to another investor with whom he can get a better yield, he is released of any commitment to FNMA.

If, however, the seller does wish to sell to FNMA, he must deliver the package of mortgages, at the specified yield, to FNMA within 4 months of the commitment. Upon delivery, the seller must pay .25 percent of the unpaid principal balance of the mortgages he is selling to FNMA. This sum represents a subscription to FNMA common stock.

Chart 3 presents an example of a series of possible bids during a given auction. After the close of the bidding, FNMA decides that it will buy mortgages offered with prices between 95.07 and 96.00, with corresponding yields of 9.731% and 9.589%, respectively. Based upon this decision, sellers 2 and 4 would not receive commitments, while all the other bids would be accepted.

CHART 3

Hypothetical FNMA Auction

•FNMA will accept bids of up to \$2,000,000

•FHA Interest Rate = 9%

	\$ Amount of Mortgages Being Offered	Yield	Price/\$100	Selling Price
Seller 1	85,000	9.703	95.25	80,963
2	1,480,000	9.505	96.56	1,429,532
3	190,000	9.642	95.65	181,735
4	45,000	9.560	96.19	43,286
5	725,000	9.600	95.93	695,493
6	1,300,000	9.589	96.00	1,248,000
7	810,000	9.689	95.34	772,254
8	340,000	9.671	95.46	324,564
9	190,000	9.731	95.07	180,633
10	1,660,000	9.712	95.19	1,580,154

These yields and prices are based upon an actual open bid auction held during the first week of December, 1974. However, the specific bids are hypothetical.

FNMA accepts mortgages with prices - 95.07-96.00; which have corresponding yields of 9.731%-9.589%.

Source: Federal National Mortgage Association, "Mortgage Yield Conversion Tables and Supplemental Amortization Tables," 2nd. Edition, 1972.

It is important to point out that the lower the price that FNMA has to pay for a given block of mortgages, the higher the yield. Thus, sellers "3" and "9", who are both offering mortgages with a principal balance of \$190,000, sell these mortgages to FNMA at two different prices, based on the yields which they bid. Clearly, seller "9" does not do as well as seller "3". Seller "3" will receive \$181,735 while seller "9" will only receive \$180,633 for \$190,000 worth of mortgages. However, from FNMA's point of view, it is happier with the deal that it makes with seller "9". On seller "9's" mortgages, FNMA's yield will be 9.731%, while the yield will only be 9.642% on seller "3's" mortgages.

FNMA raises money to buy these mortgages by selling debentures and short term discount notes on the open market. These securities, while not backed by the full faith and credit of the United States, have the special "Federal Agency" status which makes them highly marketable. As of March, 1975, FNMA's outstanding debt totaled \$2.8 billion in discount notes and \$25.4 billion in debentures.²

In addition, FNMA has raised equity capital through the issuance of about 47.5 million shares of stock which are held by about 18,500 individuals and organizations.³ Servicers are required to purchase and retain stock equal to 1/4 of 1% of the principal amount of mortgages held by FNMA. Thus, if a mortgage company services mortgages with an outstanding balance of \$3 million for FNMA, it would be required to hold \$7500 in FNMA stock.

²"Mortgage Servicing and HUD Property Management" op. cit. p. 85.

³Ibid. p. 85.

6. IS FNMA A TRUE SECONDARY MARKET FACILITY? POSSIBLE IMPLICATIONS OF THIS QUESTION:

Jones and Grebler, authors of one of the most important analyses of the secondary mortgage market have offered the following definition of this function.

The secondary market for residential mortgages is that part of the mortgage market in which existing mortgages are bought and sold. The primary market, on the other hand, is that part of the market in which mortgages are originated. Thus, the primary market involves an extension of credit and the secondary market a sale of the credit instrument.

This definition excludes transactions from the secondary market that were preceded by the buyer's promise to purchase the loans prior to their acquisition by the seller. In such "sales," the transaction is no more than a transfer from agent to principal and is, therefore assigned to the primary market. Thus, the definition of the secondary market is limited to sales of mortgages without prior commitment from the buyer.¹

Jones and Grebler also note that their definition of the secondary mortgage market is unique.

The FHA, for example, classifies statistics on activity in FHA mortgages according to originations, purchases, and sales. The latter are labeled "secondary market transfers" without distinguishing between committed and uncommitted transactions. Similarly, it is common in the trade to describe the aggregate volume of purchases and sales as the secondary market.²

While Jones and Grebler are willing to accept such transfers as secondary market transactions in a statistical sense, they "cannot be classified as secondary market activities for purposes of economic analysis."

¹Oliver Jones and Leo Grebler, op. cit. p. 4.

²Ibid.

The key factor then, in determining whether a given transaction is primary or secondary rests upon whether or not the originator has a pre-commitment from a buyer. Only when no pre-commitment has been made, do Jones and Grebler label the transaction as secondary. Thus, "the compelling criteria are entrepreneurial decision-making and risk-taking."³

Prior to the passage of the Housing and Urban Development Act of 1968, FNMA operated as a secondary mortgage market facility, as defined by Jones and Grebler. In purchasing mortgages "over-the-counter" lenders had to make the lending decision without assurances as to whether or not FNMA would purchase these mortgages.⁴

But with FNMA's auction procedure, in which delivery of the mortgages is optional, depending on whether the mortgage originator can sell them for a higher price to another investor, FNMA has been criticized for being something of a lender of "last resort."⁵ That is, a lender that is willing to buy any mortgage as long as it is FHA insured.

³Ibid.

⁴Dr. Harry S. Schwartz, Vice President and Chief Economist of FNMA has noted that the "over-the-counter" program had a component that enabled lenders to deliver mortgages 45 or even 90 days in the future. Thus, even pre-1968 FNMA was not a strict secondary mortgage market facility according to Jones and Grebler's definition. Harry S. Schwartz, In "Housing and Monetary Policy,"op. cit. 1970. p. 77.

⁵Brian Boyer, op. cit. p. 109.

Comments by high FNMA officials provide fuel for this argument.

For example, Raymond H. Lapin, while president of FNMA, made the following comments before the First Annual meeting of stockholders of FNMA, in 1969.

In effect, we treat FHA and VA loans as interchangeable assets such as negotiable securities. To us, one FHA or VA mortgage is just as good as another. There is nothing unique about any one mortgage. The house itself is not the critical criteria, nor is the location, nor is the home owner. As a mortgage investment, the thing that matters is the FHA insurance or VA guarantee.⁶

Similarly, Oakley Hunter, the present Chairman of the Board and President of FNMA, has recently stated that:

FNMA does not itself underwrite FHA insured loans which it purchases. This means that FNMA fully accepts the FHA insurance in making its investment in an FHA insured loan without regard to the credit worthiness of the individual borrower, the character of the neighborhood in which the property is located, or the value of the property itself...FNMA believes that it should and must be the ultimate responsibility of the FHA to make the determination as to the credit worthiness of the individual borrower and the investment value of the property securing the FHA insured mortgage.⁷

Unlike FNMA, not all purchasers of FHA/VA mortgages on the secondary market view the mortgages as simply "interchangeable assets" or "paper."

For example, Isidore Lasurdo, the Executive Vice President of the Green Point Savings Bank in Brooklyn expressed what he felt were the unique practices of his bank before they were willing to purchase mortgages.

⁶Raymond H. Lapin, President, FNMA; speaking at the First Annual meeting of stockholders of FNMA, reprinted in FNMA News, May 15, 1969.

⁷"Mortgage Servicing and HUD Property Management" op. cit. p. 89.

...we appraise each property. We inspect each property...Whether we originate it directly or by assignment. We do not buy bulk loans by assignment. If the package is offered to us, we entertain on one loan at a time...If we buy \$1 million worth of loans by assignment...and say they constitute 50 different loans, we will issue 50 different commitments, assuming we take the 50. We may just take 25 or 30. For whatever reason, if...we do not like something about any particular loan, that we look at, we do not commit for it. We only commit for those loans that satisfy our practices as we understand them--evaluation and underwriting.⁸

And, Frank Caruso, an official of a large New York bank testified that:

There are some investors who are much more stringent in their requirement. We use, internally, a term, we say, "there are buyers of paper" and then, "there are buyers of loans"...In other words, as long as it's insured or guaranteed, they will buy. Others will look at the credit criteria and they will set their own standards which you'll have to meet.⁹

Yet, in spite of these comments, interview with mortgage originators produced a mixed reaction to the question: "Are some investors choosier than others about the loans that they buy from you? What type of investor is FNMA?"

Similar to the above testimony by the New York bankers, a Boston savings and loan association official stated:

Mortgage bankers sort out the stuff (the loans). FNMA usually gets the junk.¹⁰

Harold Dickson, a Louisville mortgagor banker said:

All investors have different underwriting criteria. For example, Western Southern Life Insurance Company, (their major purchaser) is stricter than FNMA.¹¹

⁸New York Antitrust Hearings, op. cit. p. 757.

⁹Ibid. p. 225.

¹⁰Interview, C.L. Gildroy, Northeast Federal Savings and Loan Association, Watertown, Mass. February, 1974.

¹¹Interview, Harold Dickson, op. cit.

And, a Vice President of the Kislak Mortgage Company responded:

Some investors are absolutely choosier than others... We know what the investor wants...But some investors do send some stuff back anyway. FNMA is less choosy. They will buy any FHA or VA loan period. And thank God for FNMA and GNMA.¹²

But, balancing out these comments, other mortgage bankers felt that FNMA's requirements for purchasing mortgages was equal to, or even stricter than those of other investors.

For example, the Senior Vice President of a Richmond, Virginia mortgage company said that:

FNMA has strict underwriting rules. I have no sense that we sell them the worst mortgages. But some of the mortgages that we have sold to GNMA are loans that you wouldn't make and I wouldn't make, but FHA approves them.¹⁴

Thus, there is no definitive conclusion on the extent to which FNMA's presence in the mortgage market encourages lenders to originate marginal loans only because of the added cushion and assurance of liquidity which FNMA provides. Based upon the above comments, one can only conclude that FNMA has sometimes, and to some lenders, provided a negative influence on the quality of mortgage loan originations, thereby allowing some people to become homeowners who should probably be screened out of homeownership.

¹²Interview, Robert R. Jordan, Vice President, J.I. Kislak Mortgage Company, Newark, N.J. November 6, 1974 (telephone).

¹³Interview, Donald Luff, op. cit.

¹⁴Interview, Stuart Blanton, op. cit.

7. SUMMING UP THE POST-1968 HUD-FHA HOME FINANCE SYSTEM: IMPACTS ON THE CONSUMER AND QUESTIONS YET TO BE ANSWERED:

The HUD-FHA home finance system, since at least 1968, has had the following characteristics:

- 1) The interest rate that can be charged on FHA-insured mortgages is regulated by Congress. An important side-effect of this policy is "points" or discounts, which results in mortgage notes which have a greater value than the actual amount of money forwarded by the lender.
- 2) Lenders have two cushions against risk. FHA insurance diminishes the risk due to foreclosure and FNMA provides liquidity.
- 3) The FHA insurance, combined with the lack of mortgage companies having any capital from depositors, has encouraged many, if not most, lenders not to perform the classic mortgagee tasks of property appraisal and mortgagor credit analysis.
- 4) Servicers are the representatives of mortgagees and neither lender nor servicer is required to be in close proximity to the mortgagor.
- 5) Mortgages are sold and traded on the secondary mortgage market, frequently without any concern for either the quality of the property or the ability of the mortgagor to pay.
- 6) Mortgage bankers are regulated primarily by HUD and, to some extent, their activities are also under scrutiny by FNMA.

In Chapter 6, the impacts of points 3 and 4, above, on the consumer were discussed. Yet, the question of what impacts these other characteristics have on the consumer remains to be answered.

The government has supported home finance and has made lending relatively risk-free and, in so doing, has shifted risk onto itself. FNMA has pumped money into the mortgage market; it has fueled the growth of the mortgage banking business and it has assisted the construction industry, at least to some degree, in stabilizing new housing construction.

In the course of these improvements to the home finance system, the consumer has also benefited by being given an easier access to a more stable flow of mortgage credit. But have these characteristics also had negative impacts on the consumer?

As one FNMA employee said, quoted in Chapter 6, the bad part of the current operations of the home finance system is the "impersonalization." But what does this really mean? Close personal contact between mortgagee and mortgagor may not be at all important as long as no problems arise. Thus, it may not matter that the "behind the scenes" activities of the mortgage market are humming along. But when a mortgagor does need to make contact with the lender the simple act of communication is, as discussed in Chapter 6 Section 3.b., more difficult.

Thus, the cushions for the lender in the home finance system and the extra layer of bureaucracy represented by the secondary mortgage market, may not be particularly problematic as long as there is no need for contact to be made between mortgagee and mortgagor. But in the default situation, the mortgagor must contact the system and the mortgagee or his servicer must respond if the family is to avoid foreclosure.

In addition, for the lower income, more marginal mortgagor, who needs extra help and understanding, the impersonalization of the home finance system may have serious implications. It may mean that families who are really in no position to become homeowners are allowed to do so, since the secondary mortgage market and FHA shift the risk in the lending decision away from the mortgage originator.

Both FNMA and many mortgagees look to HUD-FHA for making the lending decision. The historic role of the lender in underwriting is gone and the secondary mortgage market investors are involved in maintaining the flow of mortgage credit and providing lenders with liquidity. The traditional risk-takers in the home finance system no longer assume any risk; the dominant feeling is that "This is HUD's job." The key question then becomes: What has HUD's role been in accepting this risk and, in turn, in protecting the consumer, particularly the low-moderate income consumer, in homeownership?

In addition to the above, the remaining portions of the thesis will focus on how the home finance system operates when a mortgagor goes into default. Specifically,

- How do mortgage servicers respond?
- What role does FNMA play when a mortgagor goes into default?
- What role does FNMA play in supervising mortgage companies, particularly as they act in the default situation?
- What is the significance of points, specifically with regard to the default situation?

SECTION III:

THE ROLE OF HUD IN
ACCEPTING RISK AND IN
PROTECTING CONSUMER
INTERESTS IN HOMEOWNERSHIP
PROGRAMS

In the first two sections of this thesis Federal homeownership legislation and key aspects of the home finance system were analyzed in order to understand how the government has shifted risk away from private lending institutions and onto itself; how the goal of enhancing lender participation by reducing their risk, in conjunction with the other goals of homeownership legislation, have impacted consumers; and how various operations of the present complex home finance system have presented problems for some homeowners.

In this section, HUD's role in relation to the consumer will be analyzed in order to assess the extent to which HUD has assumed the responsibilities inherent in its risk-taking position. Given HUD's vulnerability, as well as its role as a public agency, one would anticipate that HUD would take a strong stand in protecting its own interests and the interests of consumers.

This expectation has a basis in Federal legislation. The Housing Act of 1954 clearly articulated the consumer-oriented role of any Federal housing agency, administering any housing program:

The first responsibility...of any agency administering...the housing program(s), is to protect and preserve the public interest in general and the rights of homeowners in particular. Agencies participating in housing programs shall at all times regard as a primary responsibility their duty to act in the interest of the individual home purchaser and in so doing protect his interest to the extent feasible.¹

Yet, HUD must manage to protect itself and to perform in a consumer-oriented fashion without any formal direct contact with individuals. In

¹Housing Act of 1954, Public Law 560, 68 Stat. 590, 593.

fact, the purchaser can go through the entire home purchase process without ever communicating with a HUD representative.²

On this point, George Romney, in meetings with FHA officials is said to have expressed amazement at learning that the FHA rarely, if ever, has any contact with the family buying the house beyond a review of the application form.³

But in spite of Romney's surprise, a HUD Handbook makes this indirect relationship between the FHA and the home buyer explicit:

If the lender is willing to make the loan, it provides the proper forms and helps the borrower complete them. Then it forwards the papers to the FHA insuring office that serves the area in which the property is located.⁴

But while direct contact between HUD and the home buyer is minimal, HUD's policies, regulations and procedures still serve to protect HUD's and the consumer's interests.

There are three major points at which the consumer comes into contact, albeit indirect, with HUD:

1. All the pre-purchase activities that are related to home buying (underwriting; appraisal of the property, etc.)
2. If the family registers a complaint about its house.
3. If the family goes into default.

²This point was also cited in: Vincent DiPentima, "Abuses in the Low Income Homeownership Programs--The Need for a Consumer Protection Response by the FHA" Temple Law Quarterly, Spring, 1972, Vol. 45, No. 3 p. 467.

³Lambarth, "The "235" Hassle: Counselling and Preventive Law" Clearinghouse Review, National Clearinghouse for Legal Services, Vol. 5, No. 1.

⁴U.S. Department of Housing and Urban Development, Pub. No. 43-F, Home Mortgage Insurance (March, 1970) p. 2.

During the past six years, there have been many inquiries concerning the role that HUD has played during pre-purchase, the initial point of contact. These investigations have focused on the effects on homeowners of abuses by private actors, and mismanagement and even indictable offenses by HUD personnel. However, there has been little investigation concerning the second and third contact points. But, here, too, HUD's activities have direct impacts on consumers.

Unfortunately, very little information exists on how HUD handles complaints and, since this was not a prime interest of this research, the existing data are briefly reviewed in Appendix 8-1.

In this section, particular focus will be placed on the default situation. Default is a critical point at which the needs of the consumer and the needs of private actors may come into direct conflict and, it is a point at which HUD's own liability is increased substantially.

At all three points mentioned above, HUD has the opportunity to intervene to protect itself and on behalf of the consumer in three major ways: The first and most overt is by providing counseling services. The second and third are less apparent but still have direct impacts on homeowners: --HUD's internal procedures and HUD's relationship with mortgagees.

Before going on to look at the default situation in Chapters 9 and 10, Chapter 8 will review the studies that exposed major problems in the pre-purchase process. This will be presented in terms of the three methods of intervention that HUD has at its disposal--counseling; internal procedures; and relationships with mortgagees. Chapter 8 will also, wherever possible, present explanations, or analyses, of HUD's behavior.

Chart 4 summarizes the three contact points, the three forms of intervention and the primary sources of data for each.

CHART 4

HUD's Methods of Intervention at Three
Points of Contact With The Consumer

<u>Points of Contact</u>	<u>Methods of Intervention</u>		
	<u>HUD's Internal Procedures</u> includes all activities that HUD, itself, carries out in the administration of the homeownership programs.	<u>Counseling</u> --Direct assistance or other information giving to the consumer.	<u>Relationship with Mortgages;</u> includes overseeing adherence to guidelines.
Pre-Purchase (Chapter 8)	1) 235 Audit; ^a 2) All Homes Audit; ^b 3) Non-Supervised Mortgagee Report; ^c 4) Congressional testimony; 5) Interviews; 6) OSTI Final ^d	1) OSTI Final	1) Non-Supervised Mortgagee Report
Complaints (Appendix 8-1)	1) 235 Audit; 2) All Homes Audit; 3) OSTI Interim	None	None
Default (Chapters 9 and 10)	1) OSTI-D+D Reports ^e 2) Interviews	1) OSTI-D+D Reports 2) Interviews	1) OSTI-D+D Reports; 2) Interviews

(superscript letters, a-e, refer to references, described on next page)

a) A December, 1971 Report by the Office of Audit of HUD on 52 HUD Area/Insuring Offices' handling of the 235 Program. This Audit also included a reinspection of 1281 new and used 235 and 223 (e) homes.

HUD Office of Audit "Audit Review of Section 235 Single Family Housing" 05-2-2001-4900, December 10, 1971 (Referred to as "235 Audit").

b) A September, 1973 Report by the Office of Inspector General of HUD on 9 HUD Area/Insuring Offices' handling of all FHA-Insured Home Programs. This Audit also included a reinspection of 700 FHA insured single family homes and audits of 80 mortgagees.

HUD Office of Inspector General, Office of Audit "Report on Internal Audit of HUD Single Family Appraisal/Inspection Procedures and Mortgagees' Loan Processing Activities." 05-2-4001-0000, September 14, 1973 (Referred to as "All-Homes Audit").

c) A November, 1973 Report by the Comptroller General of the United States on the Processes followed by HUD in approving and monitoring non-supervised mortgagees. Procedures at Central Office and at eight HUD Area/Insuring Offices were assessed.

Comptroller General of the United States, "Processes for Approving and Monitoring Non Supervised Mortgagees" Report to the Subcommittee on Antitrust and Monopoly; Committee on the Judiciary, U.S. Senate, November 8, 1973 (Referred to as "Non Supervised Mortgagee Report").

d) A May, 1974 Report prepared by the Organization for Social and Technical Innovation, Inc., (OSTI) under contract to HUD assessing twenty voluntary pre-purchase counseling agencies and the locales in which they operate. Also, a June 11, 1973 Interim Report on this study by OSTI.

Organization for Social and Technical Innovation, Inc. (OSTI) "A Study of the Effectiveness of Voluntary Counseling Programs for Lower Income Home Ownership" Submitted to HUD under contract H-1881, May, 1974 (Referred to as "OSTI Final") and "Interim Report on the Study of the Effectiveness of Homeownership Counseling Services for Lower-Income Families" June, 1973 (Referred to as "OSTI Interim").

e) Two additional reports prepared by OSTI on the Delinquency and Default Counseling Program as it operated in six locales.

Organization for Social and Technical Innovation, "Evaluation of the Operation of the Concentrated Default Counseling Program". First Stage Report, Under contract H-1881 to HUD February, 1973 (Referred to as "D & D #1") And, "An Evaluation of the HUD Concentrated Default Counseling Program". Final Report Submitted to HUD January, 1974. (Referred to as "D + D #2").

This writer served as the D + D evaluation project head, on the OSTI staff, from July 1972 to March 1973. This role included major responsibility for the first-stage field collection efforts and preparation of the first report. In addition, this writer helped to organize the second stage data collection effort and, along with Victor Bach, Study Director, played a role in devising the overall evaluation design.

CHAPTER 8: HUD'S PRE-PURCHASE INTERNAL PROCEDURES

1. HUD'S APPRAISAL, UNDERWRITING AND CLOSING PROCEDURES:

Before HUD-FHA will issue a commitment to insure a property, the agency must carry out three key functions--all of which are inherent in HUD's risk taking position and which have direct impacts on homebuyers. First, HUD must assign a value to the property in order to determine the maximum allowable amount of mortgage insurance. According to HUD Handbook 4000.2:

Appraisal of the property is the "A" in the "ABC's of Processing." It is the property appraisal which determines the maximum mortgage which can be insured by HUD-FHA. The estimate of value represented by the appraisal serves as a guide to the buyer in determining how much he should pay for the property.¹

HUD's second major task is to determine the credit worthiness of the prospective mortgagor in order to ascertain his ability to carry the costs of the home. According to the HUD Handbook, "the buyer's credit is the B in the ABC's of Processing."²

And, last, HUD is also in charge of overseeing the closing process and making certain that documents are accurate and complete prior to issuing the insurance certificate. Again, according to the HUD Handbook, "closing the loan is the C in the ABC's of Processing."³

Each of these three functions will be discussed below with the emphasis on how they were carried out between 1968 and the early 1970's. (See Chart 5)

¹HUD Handbook 4000.2 op. cit. p. 5-1. (This handbook superseded HUD Guide, FHA G4005.8, in effect at the time that the data presented in this section was collected. However, the handbooks are substantively the same.)

²Ibid. p. 6-1

³Ibid. p. 8-1

CHART 5

Basic Processing Procedure for all FHA-Insured

Single Family Homes

Prospective Mortgagor Selects House.
Seeks FHA Insurance. Supplies Mortgagee with Information related to house and income.

Mortgagee files "Application for Property Appraisal" with local HUD office.

Valuation staff appraises property.

Appraiser assigns value to house which, in turn, determines maximum amount for FHA insurance.

Appraiser determines whether an inspection will be required.

HUD issues "Conditional Commitment". Commitment is conditional upon approval of borrower and other conditions specified by appraiser being met.

Mortgagee files "Application for Mortgagor Approval" with local HUD office. Along with application, mortgagee must submit credit report and employment and bank verifications.

Mortgage credit staff reviews application.

Mortgagee requests credit check from agency having local contract with HUD.

Credit agency sends report to mortgagee.

Mortgagee requests verification of employment.

Employee(s) send verification(s) to mortgagee.

Mortgagee requests verification of bank deposits.

Bank(s) send(s) statement verifying amount of deposits.

Issues a "Firm Commitment" for FHA Insurance.

Closing

a. Determining Value:

The value of a home is critical to any home purchaser. If a family pays more for a home than the property is worth, resale for the original price can become impossible. Rather than selling for a lower price than the family paid--and possibly facing owing money to the mortgagee--the family's only alternative may be to walk away from the property, lose the equity that it has built up in the home and allow the mortgagee to foreclose and take the property.

The fact that HUD-FHA plays the key role in determining the value of any home to be insured is therefore an important way in which the consumer's interest can be protected. Unfortunately, however, there is a substantial case against HUD-FHA for poor appraisal practices, particularly concerning 235 homes.

As early as December 1970 the House Committee on Banking and Currency issued a report and recommendations on its "Investigation and Hearing of Abuses in Federal Low- and Moderate-Income Housing Programs." Basing its findings on the 235 housing market in ten cities across the country, the Committee disclosed numerous instances of poor HUD-FHA practices which resulted in appraisals which were "inflated by several thousands of dollars above the true value of the home."⁴

⁴"Investigation and Hearing of Abuses"...op. cit. p. 1.

It was not uncommon, for example, to find that a home that had been sold with FHA insurance under the 235 program was, only a month or two earlier, bought for half the price of the appraised value.⁵

Shortly after the problems in the 235 program were reported nationwide, Congress began to focus attention on Detroit--an area particularly hard hit by abuses and mismanagement in the HUD-FHA home insurance programs. In a June 1972 report issued by the House Committee on Government Operations several problems in valuation procedures were cited. Inadequate appraisal personnel and the resulting reliance on part-time appraisers, fee appraisers, who often had conflicts of interest with the properties which they were appraising, were pointed to as major causes in the over-evaluation of homes.⁶

More recently, several investigations have pointed to continuing deficiencies in the appraisal practices of 235 homes as well as problems in appraising homes insured under the other HUD-FHA home programs. The following examines some of the technical findings related to appraisal procedures discussed in the All Homes Audit.

The use of comparable properties as a tool in establishing value is an important aspect of the real estate business. In assigning values to properties, HUD-FHA guidelines require the use of three comparable properties, of which one must have been conventionally financed.⁷

⁵Ibid. Examples appear throughout the text.

⁶Fifteenth Report By the Committee on Government Operations, op. cit. p. 5 and pp. 22-24.

⁷All Homes Audit, op. cit., p. 25 (quoted from Circular HPMC-FHA 4441.27)

However, the Audit found that for about 20% of the houses in its sample, comparables were:

inappropriate due to age, condition of the house, size and amenities, distance from subject/property, and excessive reliance on FHA and VA cases to the exclusion of conventional sales.⁸

In one extreme violation of HUD-FHA guidelines, in Boston, a "comparable" property was used which sold for \$20,000 more than the value placed on the subject property. Equally incomparable was another case from the same area, in which a "comparable" was located more than 50 miles from the subject property.⁹

The All Homes Audit found widespread deficiencies in the use of comparables in most of the nine HUD Area offices reviewed. It concluded that:

The volume of questionable comparables observed...causes us to conclude that the Central Office needs to evaluate HUD-FHA's method of deriving comparables and develop a consistent program to be used by each field office.¹⁰

HUD-FHA suggests several other methods, in addition to the "market" approach (i.e., use of comparables) to arrive at value. However, the "capitalized income" and "replacement cost"¹¹ approaches have not, according to the Audit, been used appropriately. Based upon their findings, the

⁸Ibid.

⁹Ibid. p. 26.

¹⁰Ibid. p. 27.

¹¹In the capitalized income approach value is arrived at by estimating the market rental income from the unit. In the replacement cost approach value is arrived at by estimating the current cost of replacing an existing unit.

audit team recommended that HUD evaluate the possible usefulness of these alternative approaches and:

either require the field offices to carry out steps that are necessary and clearly prescribed in HUD manuals to correctly use...(these approaches) or discontinue the facade of a three-pronged approach to estimating value.¹²

Thus, it is clear from the above that HUD-FHA's appraisal practices have often been in violation of department guidelines. This is a critical way in which HUD has failed to fully accept the risk that it is taking in its insurance programs. As a result of this failure, the consumer has been left vulnerable to purchasing over-priced homes.

Assessing Condition of Property

Probably the most blatant way in which HUD-FHA has neglected to take responsibility for the homes that it is insuring is in its refusal to be accountable for the condition of the property. HUD Handbook 4000.2 stresses that HUD does not warrant the condition of the property.¹³

Yet, in spite of this disclaimer, the property is, nevertheless, supposed to meet an array of "acceptability standards"--including minimum property standards.¹⁴ In addition to determining the value of the property, the

¹²All Homes Audit, op. cit., p. 37.

¹³Ibid., p. 5-17.

¹⁴Ibid., p. 5-3 -- 5-5. This ambiguous role with regard to HUD's responsibility for the condition of the property has, since the inception of FHA, caused confusion among many homebuyers. For example, on this point, former Secretary Romney noted that: "Buyers expect the Government involvement to mean that the house is sound and free from major maintenance problems." Hearing Before the Committee on Banking and Currency, House of Representatives, "Interim Report on HUD Investigation of Low- and Moderate-Income Housing Programs" 92nd Cong. 1st sess. March 31, 1971, p. 11. See also Chapter 3, section 4.b.

HUD-FHA appraiser must also specify any conditions that must be satisfied prior to issuance of the insurance certificate. Thus, the appraiser must decide whether any repairs will have to be completed and, if so, whether a department inspector will have to visit the property or whether a certificate of completion by the mortgagee will suffice.¹⁵

If the appraiser stipulates that a visit by a HUD-FHA inspector will be required to determine whether the repairs or other defects have been remedied, a "compliance review" must be performed. Unfortunately, various reports issued in the early 1970's disclosed that faulty compliance inspections by HUD-FHA were frequent. The 1970 Report on the "Investigation and Hearing of Abuses in Federal Low- and Moderate-Income Housing Programs" disclosed numerous new and existing 235 homes that were found to have severe defects.

The staff found cases of families who have become disappointed owners of houses which will not even come close to lasting the life of the mortgage. In existing Section 235 housing the most common deficiencies are faulty plumbing, leaky basements, leaky roofs, cracked plaster, faulty or inadequate wiring, rotten wood in floors, staircases, ceilings, porches, lack of insulation, faulty heating units, and the like...The staff also examined two Section 235 new construction projects in Everett, Washington, and Elmwood, Missouri. In these two cases, in the staff's opinion the construction is of such poor quality and the cost so questionable that the projects can best be described as "instant slums."¹⁶

Similar to the appraisal situation, discussed above, these early disclosures of HUD's inadequate inspection procedures did not seem to greatly alter HUD's operations. Both the 235 Audit, which was performed in late 1971

¹⁵ HUD Handbook 4000.2, op. cit. p. 5-16.

¹⁶ "Investigation and Hearing of Abuses..." op. cit., p. 3.

and the All Homes Audit, performed two years later, disclosed many defects in homes that had been insured by HUD-FHA.

As part of the 235 Audit, 1,281 homes were reinspected to determine the frequency of deficiencies -- 740 "235" homes and 541 "223(e)" homes. Overall, about one-third of the homes were found to have significant defects, with a considerably higher percentage (43%) occurring in the existing housing. Table 11 summarizes the deficiencies found during the reinspections.

Similarly, part of the All Homes Audit consisted of reviewing and reappraising 700 single family homes that had been insured since December 10, 1971. The Audit

revealed an unacceptable number of existing properties containing significant defects as well as many minor defects in both new and existing houses in most of the nine field offices audited.¹⁷

Slightly over 10% of the homes re-inspected contained "major" defects -- "which could affect livability or safety" and 56% of the homes "contained more than one minor defect which should have been corrected prior to HUD's insuring the mortgages."¹⁸ As Table 12 indicates, considerably more defects

¹⁷Ibid. p. 13.

¹⁸Significant or "major" defects included items that could not be corrected "without extensive or expensive repairs." For existing houses, this category included items such as rusted out plumbing systems, rotting floor joists and supports, foundation failures, severe drainage problems, inadequate wiring and significant termite damage. Major defects in the new houses included bedrooms and baths without heat because the ductwork had not been run; steel beams and girders without the required support; severely cracked walls and improper sealing of roof around the chimney, causing water to leak into the house.

The minor defects "may adversely affect the safety or livability of the houses but generally would not cost much to repair or correct." Included in this category were, for example, for existing houses: unvented furnace, buckling ceiling, rotting porch columns, leaky plumbing, significant foundation cracks and deteriorated and sagging roofs. And, for new houses, minor defects included inoperative appliances, such as dishwashers, sloppy and incomplete painting, problems with electrical switches and wiring, and cracks in foundation and brickwork. Ibid. p. 17-18.

TABLE 11

Defects Found in 235 and 223(e) New and Existing Houses During Reinspections

	<u>New Construction</u>			<u>Existing Housing</u>			
	235	223(e)	% of Total(A)	235	223(e)	%Total (A)	Total A % Total (A)
Total numer of Houses Reinspected - B Total - C	398 672	274	52%	342 609	267	48%	$\frac{1281}{100\%}$
Evidence of Poor Workmanship or Materials Total	67 100	33	100%	NOT APPLICABLE			$\frac{100}{7\%}$
More Significant Deficiencies Affecting Safety, Health, or Li Total	34 73	39	25%	99 225	126	75%	$\frac{298}{23\%}$
Aggregated Deficiencies Which Should Have Made House Not Insurable Total	NONE	-	-	19 35	16	100%	$\frac{35}{3\%}$
Total No Inspected With Problems	101 173	72	13%	118 260	142	20%	$\frac{433}{33\%}$
%Total (B)	$\frac{101}{398}$ = 25%	$\frac{72}{274}$ = 26%	-	$\frac{118}{342}$ = 35%	$\frac{142}{267}$ = 53%	-	-
%Total (C)	$\frac{173}{672}$ = 26%		-	$\frac{260}{609}$ = 43%		-	-

Source: 235 Audit, p. 71

TABLE 12

Defects Found in FHA-Insured Houses Reinspected by
Inspector General of HUD, September 1973

	With Major Defects	With More Than One Minor Defect	No Significant Defects	Total
<u>Existing Construction</u>				
203(b)	16	93	84	193
221(d)(2)	23	115	67	205
235	<u>24</u>	<u>64</u>	<u>13</u>	<u>101</u>
Total Existing	63	272	164	499
% Existing	13%	54%	33%	100%
<u>New Construction</u>				
203(b)	3	34	23	60
221(d)(2)	1	11	2	14
235	<u>6</u>	<u>75</u>	<u>46</u>	<u>127</u>
Total New	10	120	71	201
% New	5%	60%	35%	100%
Total New and Existing	73	392	235	700
% New and Existing	10%	56%	34%	100%

Source: All Homes Audit, p. 16

TABLE 13

Percent of Defects in Reinspected Houses in Nine Area/Insuring Offices

	#Houses with Major Defects and More Than One Minor De- fect (New and Existing)	% Total Defects	# Houses Reinspected	% Total Re- inspected
Boston	43	9%	65	9%
Newark	46	10%	61	9%
Washington, D.C.	64	14%	68	10%
Atlanta	30	7%	90	13%
Indianapolis	81	17%	90	13%
Dallas	85	18%	91	13%
St. Louis	28	6%	69	10%
Denver	57	12%	78	11%
Los Angeles	31	7%	88	12%
Total	<u>465</u>	<u>100%</u>	<u>700</u>	<u>100%</u>

Source: All Homes Audit, p. 18

were found in existing homes than in new constructions. Overall, only about one-third of the homes reinspected contained no significant defects. (See Tables 12 and 13.)

Additional evidence pointing to major defects in FHA insured homes was gathered by OSTI Inc. in the course of their study of counseling services for lower income homebuyers. A survey of 526 "235" owners in ten cities disclosed a high frequency of major problems in the house at the time of purchase. A staggering 56% of all homes had major problems according to homeowners interviewed.¹⁹ (See Table 14.)

Based upon these findings, OSTI concluded:

That large numbers of counseled as well as uncounseled families purchased housing in inadequate condition -- even with FHA property screening and appraisal -- is a serious indication of how poorly the federal lower-income ownership programs functioned in the consumer's interests in this respect.²⁰

¹⁹OSTI Final, op. cit. p. 179. Major problems are those related to the basic structure of the house -- the condition of the roof, foundation, basement, walls and ceilings and the functioning of the basic utilities such as heating, electricity and plumbing. Minor problems include poor workmanship and finishing, as well as decor issues such as paint, carpeting and linoleum. p. XXI Appendix. In addition, a survey of 118 defaulting "235" homeowners in Columbia, South Carolina disclosed that one third of the homes -- all new units -- had major defects that affected livability. William B. Traxler, Jr. et al. "The 235 Housing Program in Action: An Empirical Examination of its Administration and Effect on the Homeowner-Participant in the Columbia South Carolina Area" South Carolina Law Review, Vol. 25, No. 1, 1973, p. 128.

²⁰OSTI Final, op. cit. p. 180.

TABLE 14

Age of House Versus Severity of Housing Problems at Purchase

	Major Problems		Minor Problems		None		Total	
	No.	%	No.	%	No.	%	No.	%
New	118	46	32	13	104	41	254	48
-29 Years Old	68	61	11	10	32	29	111	21
30 or More Years Old	107	67	10	6	43	27	160	31
Total	293	56%	53	10%	179	34%	525	100%

Source: OSTI Final p. 179

The above findings are all the more alarming in view of the fact that, to check that the appraisal is done properly, HUD procedures require that a supervisor review the appraisals of at least 10% of the appraisals made by fee appraisers and 5% made by staff appraisers.²¹

However, the 235 Audit "disclosed that no reviews were being made in some offices and only minimal reviews in others."²² While the situation had improved by September, 1973, the All Homes Audit found that several field offices were still not performing the review function adequately.

For example, in Washington, D.C. reviews were performed much too late to be effective -- three to nine months following appraisals. And, in Boston, one appraiser's work was field reviewed seven times of which four reviews ranged from 180 to 274 days following the appraisals.²³ Field reviews that are performed after a firm commitment has been issued or after the loan has been insured are practically useless in that any repair modifications that may result from the review are difficult to implement at this late date.

Early reviews can, on the other hand, "be used to assure that required repairs are completed,"²⁴ thereby enhancing the likelihood of mortgagors receiving homes with fewer defects. HUD regulations do not even require that reviews be made prior to loan closing. However, a good

²¹All Homes Audit, op. cit. p. 19.

²²Ibid.

²³Ibid. p. 19-20.

²⁴Ibid. p. 25.

rationale for the regulations to be changed to require more timely reviews is based upon a finding of the All Homes Audit:

Where our audit revealed the least number of uncorrected defects, most field reviews were made prior to issuance of conditional commitments or clearance of final inspections.²⁵

Another problematic finding of the All Homes Audit was that several Area offices performed far less than one review per five or ten appraisals. Particularly striking was the situation in Dallas, in which one staff inspector made 773 inspections, and one fee inspector made 597 inspections without any being field reviewed. According to HUD guidelines, about 97 of these appraisals should have been reviewed. (38 plus 59, respectively).²⁶

Also deficient in this regard was the situation in Denver, in which only 149 of the 666 required field reviews in a fourteen-month period were made.²⁷ (January 1972-February 1973).

In Indianapolis, not only was the number of reviews inadequate -- 380 of those required during 1972 were not made -- but the quality of many reviews that were made was poor. One reviewer who had been considered to be a "good" worker over a 5-year period was "observed to be so poor (in approach and performance) that administrative action was contemplated."²⁸

However, poor reviews were not always the blame of the reviewers. The All Homes Audit report states:

²⁵ Ibid.

²⁶ Ibid. p. 21.

²⁷ Ibid.

²⁸ Ibid.

In one field office we were informed by a staff member...that he was instructed by supervisory personnel to temper the criticisms he reported on Form 1038. He showed us copies of two Form 1038 reviews in his personal records. One was highly critical of the appraiser's performance and included photographs to substantiate the reviewer's findings. He gave the appraiser a poor rating for his negligent performance, but the official field²⁹ review file contained no evidence of the review or rating...

In another field office, while field reviews may not have been tempered to camouflage inadequate appraisals, "poor" appraiser ratings often went unnoticed. "Neither sufficient performance upgrading efforts (training) nor disciplinary measures were evidenced by management."³⁰

Thus, there is a substantial case against HUD-FHA for problematic inspection procedures. According to Michael B. Bixby of the Center for Urban Law and Housing of Wayne County Neighborhood Legal Services in Detroit, HUD-FHA has flagrantly disobeyed the law in its performance of inadequate inspections:

The Federal Housing Administration has, in many instances, failed to abide by the clear requirements of Federal law. One section of the National Housing Act which governs both sections 221(d)(2) and 235 housing requires, and I quote: "To be eligible for insurance under this section a mortgage shall...be secured by property on which there is located a dwelling...meeting the requirements of all state laws, or local ordinances or regulations relating to the safety, zoning or otherwise, which may be applicable thereto." In hundreds of cases the Department of Housing and Urban Development has quite simply ignored this rather clear expression of Federal law. Congress foresaw the problem and expressed its desire that only dwellings meeting all applicable codes should be insured. Somehow, in the face of this mandatory directive HUD continues to claim that it has no duty to inspect homes to determine if they meet local codes. How HUD can take this position despite the clear wording of the statute is beyond me.³¹

²⁹Ibid. p. 22.

³⁰Ibid. p. 23.

³¹Hearings Before A Subcommittee of the Committee on Government Operations, House of Representatives, 92nd Cong. 1st sess. "Defaults on FHA Insured Mortgage (Detroit)"Dec., 1971, p. 113.

HUD's protestations that it is not responsible for the condition of the house that it is insuring are all the more absurd in view of Section 518(b) of the National Housing Act. The Housing and Urban Development Act of 1970 authorized the Secretary of HUD to:

make expenditures to correct, or to compensate the owner for structural or other defects which seriously affect the use and livability of any single family dwelling which is covered by a mortgage insured under Section 235.³²

To receive compensation, the property must have been at least one year old at the time the property was insured, the claim must be filed within one year from the date the property was insured and

the defect is one that existed on the date of the issuance of the insurance commitment and is one that a proper inspection could reasonably expect to disclose.³³

Through January 1975, HUD had paid a total of \$7,626,426 in claims to 9,896 Section 235 homeowners; the average claim being \$770.³⁴

The Housing and Community Development Act of 1974 revised Section 518(b) to include homes with two units, as well as one family homes, and any property

which is located in an older, declining urban area and is covered by a mortgage insured under Section 203 or 221 on or after August 1, 1968, but prior to January 1, 1973.³⁵

Data concerning the number of people who have filed claims under the expanded 518(b) program are not yet available.

³²P.L. 91-609, December 31, 1970 84 Stat. 1770, 1771; Sec. 104.

³³Ibid.

³⁴Letter from George O. Hipps Jr., Acting Director, Office of Underwriting Standards, HUD. to Rachel G. Bratt. June 10, 1975.

³⁵P.L. 93-383. 93rd Cong. August 22, 1974 88 Stat. 633, 741. This revision to Section 518(b) was prompted, at least in part, by the activities of community groups organized by Gale Cincotta and the National Training and Information Center.

Based upon the above findings, the conclusion that one must arrive at is that HUD-FHA appraisal and inspection procedures have frequently been deficient and, as a result, many HUD-FHA insured homeowners have bought homes in various states of disrepair. The impacts of this situation on consumers have, in some cases, caused major financial hardships, and even abandonment of the property.³⁶ But whatever the outcome, HUD has neglected one of its major and most critical responsibilities inherent in accepting risk and has placed purchasers, as well as itself, in an extremely vulnerable position. While HUD-FHA has managed to make amends to some homeowners through the 518(b) program, its own risk has been underscored as a result of this program.

b. Determining Credit of Mortgagor:

While property appraisals and inspections are under HUD's direct control and supervision, HUD delegates the responsibility to mortgagees to supply them with the forms pertaining to the prospective mortgagor's ability to purchase and maintain payments for his home. While faulty inspections are, as discussed above, due to inadequate or improperly implemented internal procedures of HUD, faulty credit reporting is the work of mortgagees and relates to improper supervision of mortgagees by HUD. As such, this discussion will be postponed until the general discussion on HUD's regulation of mortgagees in Chapter 10, Sections 7 and 9.

However, HUD personnel do have responsibility for reviewing 3 specific types of credit-related mortgagee-supplied information, in

³⁶Fifteenth Report by the Committee on Government Operations, op. cit. p

addition to any other documents pertinent to the prospective mortgagor's financial position.

- credit reports;
- employment and salary verification forms;
- bank deposit verification forms.

Credit Reports

While the personal interview is usually a critical component of the lending decision,³⁷ as mentioned earlier, HUD personnel rarely have any personal contact with prospective mortgagors. As such, HUD depends heavily upon accurate and reliable credit reporting. To maximize the likelihood of good reporting, HUD awards annual contracts to local credit agencies on a competitive basis. In addition, HUD requires field offices to determine the reliability of information supplied by these credit agencies.³⁸

In response to disclosed deficiencies in credit-reporting, HUD issued detailed procedures for the systematic verification of credit reports in July, 1972. The purpose of these guidelines was to enable field offices to ascertain the extent of poor credit reporting; to identify those agencies producing systematically poor reports, by rechecking reports with a second agency; and to ultimately improve the overall quality of credit reporting.³⁹

³⁷ Willis R. Bryant, op. cit. Chapter 5.

³⁸ Non Supervised Mortgagee Report, op. cit., p. 19

³⁹ Ibid.

Based upon observations in eight HUD Area offices, the Comptroller General of the United States found noncompliance with the July 1972 instructions in some Area offices. In other offices, which had implemented these procedures, many inaccuracies in the credit reports were found upon cross-checking.⁴⁰

The major reason for noncompliance was the absence, in several cities, of more than one HUD-contracted credit agency. While the July 1972 guidelines called for cross-checking credit reports received by HUD-contracted agencies with reports from other HUD-contracted agencies -- Lubbock, Philadelphia, Camden and Wilmington each had only one agency under contract with HUD and were therefore unable to comply with the guidelines.⁴¹ Since the Comptroller General's report, HUD has made attempts to contract at least one more agency in each of these cities.

But the real usefulness of cross-checking is in locating inaccurate reports and repeatedly deficient agencies. For example, in Los Angeles/Santa Ana, of the 362 credit reports that were verified, 98 (27%) were deficient.⁴² The following are three examples taken from this Area office on the types of discrepancies found between the original and backup credit reports.⁴³

⁴⁰ Ibid. p. 26.

⁴¹ Ibid. p. 21-23.

⁴² Ibid.

⁴³ Ibid. p. 21.

Original Credit Report	Backup Credit Report
1. No credit established.	Four short-term debts outstanding and \$200 per month child-support payments due.
2. One short-term debt being paid as agreed. Two dependents.	One short-term debt being paid as agreed. Also 3 long-term debts amounting to \$454/month with 10 late charges. Four dependents.
3. No credit established.	Three short-term debts owed. Two long-term debts amounting to \$89 per month.

Fortunately, in these three cases, the backup reports were completed in time to preclude the issuance of a final commitment for FHA insurance. However, in 18 of the 98 cases in which deficient reports were disclosed, final commitment had already been made.

According to HUD officials:

If the backup credit reports had been received before the time the final commitment was issued, these 18 cases would not have been approved.⁴⁴

Based upon these findings, Los Angeles and Santa Ana reported three credit agencies to HUD for the preparation of 69 deficient credit reports.⁴⁵ Subsequently, HUD terminated its contracts with two of these agencies.⁴⁶

⁴⁴Ibid. p. 21.

⁴⁵In addition to the reports filed by Los Angeles and Santa Ana at least one agency in each of the other 6 areas were reported to HUD -- 10 in all -- representing 31 deficient credit reports. Ibid. p. 24.

⁴⁶Ibid. p. 25.

Employment and Bank Verification Forms

In addition to checking a prospective mortgagor's credit, it is also important to check his employment record and bank assets. However, HUD guidelines do not require field offices to test the reliability of the employment and cash asset data received from mortgagees on prospective mortgagors. Thus, it is not surprising that none of the eight field offices assessed by the Comptroller General were performing any such verifications.

However, the need for this type of effort was disclosed during hearings before the Senate Subcommittee on Antitrust and Monopoly:

Mr. O'Leary: (Chief Counsel) What are you telling us is that if the buyer said that he worked for Yellow Taxi Cab, and he made x number of dollars, the mortgage company would feed that information to the retail credit bureau and they would feed it right back?

Mr. Morales: (El Sol Realty) Right. They would feed it right back. They would not call the Yellow Taxi Cab Co., or anybody. They would say that he works there as far as they know, because the buyer told them so.

Mr. O'Leary: They would type that up on a form?

Mr. Morales: That is correct...

Mr. O'Leary: And that would then go to the FHA?

Mr. Morales: Right.

Mr. O'Leary: Now what happens if the mortgage company calls you and tells you to check with the bank, and your buyer does not have \$500 in there like he is supposed to? Let us say that he has only got a hundred dollars in the bank. What do you do then?

Mr. Morales: I would advise my client to go and borrow money and place it in the bank.

Mr. O'Leary: I take it, that in the trade that was not uncommon, right? If for some reason it looked like the deal was going to fall through, the mortgage company would call you, and you would tell your buyer what had to be done?

Mr. Morales: That is correct.⁴⁷

Thus, whenever HUD fails to verify the ability of home buyers to carry the commitments of the mortgage, it increases its risk substantially.

On this point, the All Homes Audit concluded that:

HUD assumes the risk of reimbursing the mortgagee if the home buyer defaults and the mortgage is foreclosed. HUD increases this risk because it approved buyers for mortgage insurance without determining the reliability of the employment and cash asset data received on the buyer.⁴⁸

It is ironic that HUD, itself, has offended the practice of thoroughly assessing and checking the prospective mortgagors' credit. While the most crucial aspect of the lending decision has always been the appraisal of the real estate which secures the mortgage, it has only been since 1934 -- with the creation of FHA -- that emphasis also began to be placed on the credit worthiness of the borrower himself.⁴⁹ Thus, HUD-FHA has not fulfilled its responsibilities and has failed to protect the consumers' interest in both aspects of the lending decision -- in the appraisal of the property and in the assessment of the borrower's credit. This, alone, would be sufficient evidence to question HUD's concern for families whose homes are insured by the FHA. Unfortunately, however, additional support for this view is found by examining HUD's other pre-purchase activities that have impacts on the consumer, as discussed throughout this chapter.

⁴⁷ New York Antitrust Hearings, op. cit., p. 457-458.

⁴⁸ All Homes Audit, op. cit., p. 26.

⁴⁹ Willis R. Bryant, op. cit., p. 181.

Closing

Closing is the final stage of HUD's pre-purchase activities: the point at which the buyer pays the seller and title to the property is transferred. If a mortgage is involved, the bank pays the seller the principal mortgage amount and the new mortgagor signs the mortgage note, thereby assuming the mortgage debt. If insurance is involved, the insurer issues its insurance certification to the mortgagee at closing or shortly thereafter. All fees, such as real estate commissions and mortgage origination fees are also paid at closing.

Closing is a point at which the prospective owner is extremely vulnerable. He is very much locked into the purchase and probably anxious to assume ownership. For example, if the buyer were to suddenly learn that it was going to cost him another \$500 to buy his home, he would be likely to pay it, perhaps without even understanding the reason for the additional cost.

Closing personnel at HUD are responsible for making sure that all documents related to closing are in compliance with HUD guidelines and, upon approval, they are authorized to issue the FHA insurance certificate. If the loan closing statement is incomplete, inaccurate, or charges have been levied which are in excess of those permitted, insurance endorsement could be withheld pending correction. However, the All Homes Audit reported that closing section personnel "were not withholding insurance endorsement of mortgages in such instances" and were not, moreover, receiving adequate information on which to base their assessments.⁵⁰

⁵⁰ All Homes Audit, op. cit., p. 56-57.

The Audit found that in six of the nine field offices reviewed, incomplete closing statements were commonly accepted by HUD.

...we were told by loan closing personnel in several field offices that they had not withheld insurance endorsement on mortgage because they had not received instructions or training as to what elements a closing statement must contain in order to be considered a complete loan settlement.⁵¹

Moreover, the Audit went on:

One field office did not have any closing clerk positions and closing statements were reviewed only for the signatures of the parties involved in the loan closing.⁵²

Clearly, if HUD were at all interested in being a watchdog in the home finance system, closing would provide an excellent opportunity to review and approve all aspects of the transaction. HUD also could hold out a critical stick to mortgagees at this stage. By threatening to withhold the insurance certificate-- and meaning it -- HUD could play an important control function. Yet, control is meaningless if HUD personnel are not aware of exactly what it is that they are supposed to be watching for.

The Audit reported that some field offices

have not made available to their closing section a schedule of maximum allowable customary fees and charges for services provided by mortgagees. As a result, closing section personnel are unable to determine if the charges on closing statements are within the limitations set forth in the FHA regulations.⁵³

⁵¹ Ibid. p. 57.

⁵² Ibid. p. 58.

⁵³ Ibid. p. 59.

Unfortunately, several sources have pointed to irrational and inflated closing costs in many sections of the country.⁵⁴ For the lower income mortgagor, the burden of excessive closing costs can precipitate immediate financial problems and signal a downward spiral ending in foreclosure.⁵⁵

Thus, it is clear that closing is another critical stage of the pre-purchase process -- a stage at which tighter procedures by HUD could serve to both minimize HUD's risk position and to protect consumers against inflated costs.

⁵⁴ See, for example, Hearings Before the Subcommittee on Housing of the Committee on Banking and Currency; House of Representatives, "Real Estate Settlement Costs, FHA Mortgage Foreclosures, Housing Abandonment, and Site Selection Procedures" 92nd Cong., 2nd sess. Part 1, February 1972; especially pages 1-23. See also, "Mortgage Settlement Costs" Report of the Department of Housing and Urban Development and Veterans' Administration, March 1972 (Printed as Part 2 of the above hearings.)

Among the major findings of this report were: 1) In some areas there are charges for services which are apparently excessive or unnecessary; and 2) Rates of charge are based on factors unrelated to the risk involved or to the cost of providing the services.

The great variation in costs involved in closing FHA-insured homes in various parts of the country was disclosed in the above report, as follows: (March 1971)

Washington, D.C. - \$936
Duval County (Jacksonville, Fla.) - \$856
Los Angeles County - \$717
Bexar County (San Antonio, Texas) - \$613
Marion County (Indianapolis, Indiana) - \$536
Suffolk County (Boston, Mass.) - \$468

(Data based on sales prices of FHA-insured homes in the \$24,000-27,999 range.)

These hearings were prompted, in part, by a request set forth in the Emergency Home Finance Act of 1970. (Public Law 91-351) Title VII, Section 701 (48 Stat. 1246., 12 USC 1701) of that Act directed the Secretary of HUD and the Administrator of Veterans' Affairs to prescribe the maximum allowable settlement costs in any area for FHA-insured and VA guaranteed homes. The two agencies were further directed to undertake a joint study and to report to HUD within one year of the enactment of the Act concerning legislative and administrative actions that would reduce and standardize settlement costs.

⁵⁵ All Homes Audit, op. cit., p. 59.

2. CAUSES OF HUD'S DIFFICULTIES:

The first section of this chapter presented an account of some of the key ways in which HUD's internal procedures in the pre-purchase period were frequently deficient. The negative impacts which these problematic procedures can have both on consumers and in increasing HUD's risk should be clear. Yet, the questions of "what went wrong" or, "why did HUD have so much difficulty implementing the post-1968 homeownership programs" remain to be answered.

There are several plausible explanations which account for HUD's difficulties stemming, in part, from the forces behind the legislation, as discussed in Chapter 4. These can be grouped into two types of problems -- which can be called "technical" and "philosophical."

Falling under HUD's technical problems are: a) late 1960's reorganization of HUD; b) inadequate staffing; c) corruption on the part of HUD personnel.

HUD's philosophical problems include: d) confusion over whether HUD's mandate was to insure a large volume of loans or to insure quality loans; e) difficulties in dealing with a new type of property -- inner city -- and a new type of home buyer -- lower income.

a. Reorganization of HUD:

According to Horace B. Bazan, a 31-year-veteran employee of FHA, the November 1969 reorganization of HUD was the key reason why HUD-FHA had so much difficulty in implementing the homeownership programs in the early 1970's. Whereas under the "old FHA organization the Commissioner

ran FHA as an integrated agency...(and) was accountable for successful operation of FHA" each of the 10 new Regional Administrators "adopted their own methods and approaches to supervision."¹

Further, according to Bazan,

the resulting supervision varied in scope, content, method, and frequency...the Assistant Regional Administrators for Housing Production and Mortgage Credit...had sharply varying degrees of training and experience in mortgage underwriting. At one point, only two out of ten persons occupying the position...(had) substantial experience in performing or supervising FHA mortgage insurance origination.²

Bazan claims that this poor supervision -- the direct outcome of HUD's reorganization -- was the cause of many of HUD-FHA's problems of the early 1970's. For example, Bazan blames the high losses under the 223(e) program on HUD's inability to translate Congressional intent into effective administrative procedures. He stated that:

A decision on FHA underwriting procedure was made at too high a level with inadequate understanding of the mortgage underwriting process, the legal requirements, the elements of risk, and the probable consequences.³

While Bazan's criticism is certainly relevant, it is not the whole story. Yet, a 1976 report by the House Committee on Government Operations also targeted HUD's reorganization. It stated that:

(the reorganization)wrenched so many functions and offices out of shape that the Department is just now beginning to recover from the negative effects.⁴

¹Horace B. Bazar., op. cit., pp. 25, 28.

²Ibid. p. 28.

³Ibid. p. 25.

⁴Nineteenth Report by the Committee on Government Operations, "HUD's Responsiveness to Previous Recommendations for Corrective Action," 94th. Cong. 2 Sess. March 29, 1976, p. 4.

While it may be logical for a massive, new piece of legislation such as the Housing and Urban Development Act of 1968, to trigger a reorganization by the implementing agency, in order to allow the agency to gear up for its new functions, it can also be the worst possible time for such a reorganization to take place. Not only did HUD employees have to redefine their own roles within the Department but they also, and at the same time, were expected to implement a new and challenging piece of legislation.

b. Inadequate Staffing:

In addition to the above-quoted House Committee's finding that the reorganization contributed to HUD's problems, they also concluded that: "HUD has never had a sufficient amount of trained staff to deal with problems it is responsible for solving."⁵

The problem of inadequate staffing at HUD was pinpointed in the early 1970's. A 1972 report by the Committee on Government Operations stated that:

The question of FHA Staff inadequacy is a national concern. Between fiscal year 1968 and fiscal year 1971, the total number of units in mortgage loan applications increased nationally by 66 percent...Undoubtedly, some greater efficiency could be expected with increased volume, but about a 50-percent increase in processing productivity per staff member apparently could not be achieved without some loss of protection of the public interest...It would...

⁵Ibid.

be expecting more than could be accomplished to have a 66-percent increase in workload absorbed by a 9-percent increase of the staff without a great loss in program administration effectiveness.⁶

Thus, with HUD personnel overworked and with responsibilities and lines of supervision shifting due to the reorganization, HUD had its problems. However, this wasn't all; HUD's difficulties also included outright corruption on the part of some part-time appraisers and other personnel.

c. Corruption on the Part of HUD Personnel:

Federal housing programs have a history of being abused by speculators and shady characters working on the fringe of the real estate business.⁷ Unfortunately, many unscrupulous people took advantage of the Federal guarantees and subsidies of the 1968 homeownership programs,⁸ including some HUD employees. Hearings held in Detroit in 1971 disclosed that "fee appraisers," appraisers hired

⁶"Defaults on FHA-Insured Home Mortgages -- Detroit, Michigan." op. cit. p. 25.

⁷See Chapter 3, Sections 4a-c and Charles Abrams' discussion of the windfall profits stimulated by Section 608 of the Housing Act of 1942. The City is the Frontier (New York: Harper and Row, 1965) p. 87-92.

⁸The abuses have been documented extensively by Congressional committees and by journalists. See, for example: "Interim Report on HUD Investigation of Low and Moderate Income Housing Programs, op. cit."; "Defaults on FHA-Insured Mortgages; (Parts 1 and 2 and Fifteenth Report by the Committee on Government Operations) op. cit. New York Antitrust Hearings, op. cit., Hearings Before the Committee on Banking, Housing and Urban Affairs, "Housing Management, Foreclosures and Abandonments" U.S. Senate, 94th Cong. 1st Sess. July 1975, Chicago; Brian Boyer, op. cit. and Leonard Downie, Mortgage on America (New York, Praeger) 1974.

by HUD on a "piece-work" basis to perform appraisals when the full-time staff was overloaded, often had interests in the property which they were appraising.⁹

In addition to potential or actual conflicts of interest on the part of fee appraisers, a handful of HUD employees have been indicted for fraud related to the housing programs. As of April 1975, 65 HUD employees and over 1000 other individuals had been indicted.¹⁰

While the number of indictments among HUD employees seems quite small, there is evidence that many more HUD employees were probably engaged in less flagrant, yet dishonest, schemes for which they were never caught. For example, the Senate Subcommittee on Antitrust and Monopoly heard a Brooklyn Savings Bank executive testify that:

(Abuses and kickbacks and payoffs) are very widespread in our metropolitan area. I would say in the FHA level, it ranges down from the clerk at the desk to the man at the top, and it does not miss too many people...¹¹

In addition, testimony at the same hearings pointed out that short of outright fraud, HUD-FHA personnel frequently processed applications from certain mortgage companies much faster than from other lending institutions. But, as one witness put it, FHA's excuses were "on the surface, very legitimate"¹² and, therefore, nothing could be

⁹"Defaults on FHA-Insured Mortgages" (Part 1) op. cit. p. 39.

¹⁰Housing and Development Reporter Vol. 1, No. 24, April 21, 1975. p. 1185.

¹¹New York Antitrust Hearings, op. cit. p. 759.

¹²Ibid. p. 76-77 and p. 759.

done in protest and the possibility of illegal behavior could not be substantiated.

Thus, HUD was plagued by considerable "technical" difficulties which hampered its execution of the homeownership programs. However, less tangible, yet very important to understanding why HUD's implementation was defective, are the philosophical explanations.

d. Quantity vs. Quality:

It will be recalled from Chapter 4 that President Johnson articulated, for the first time, a housing goal in numbers. In order to reach the housing goal set by Congress in 1949 -- "a decent home and a suitable living environment for every American family" -- the President asked for the construction or substantial rehabilitation of 26 million housing units over the following decade. Thus, FHA's long-standing production orientation was reinforced.

FHA Commissioner Brownstein, in an October 1967 speech before HUD-FHA Area office directors emphasized the need for field offices to insure a large volume of mortgages:

I want you to go looking for applications. I want you to know that applications involving the inner city, rehabilitation, BMIR and rent supplements are the first things your staff should work on, not the last...You will also hear more discussion of my recent field letter eliminating the requirement for a finding of economic soundness in riot or riot-prone areas of the city. This has the effect of making our programs available everywhere in the city.¹³

¹³Remarks of P.N. Brownstein, Assistant Secretary-Commissioner at Directors Conference, October 23, 1967 on "FHA's Job Today." (Printed in HUD Senate Hearings 1968) op. cit. p. 310.

Yet, almost in the same breath, Brownstein added some caveats, making clear that standards were still in force and that the quality of the property should not be overlooked.

...risks are inherent in an insurance program (otherwise there would be no justification or need for insurance); that since the vast majority of the Congress as well as the executive branch expect us to carry out the mission (of assisting and encouraging private enterprise to house low- and moderate-income families, and to revive the inner city)...then they must expect us willingly to take the risks inherent in such a mission.

This does not by any means require the elimination of prudence and common sense...I want us to develop and support projects which give reasonable promise of improving the housing conditions of low- and moderate-income families, and improving the inner city...A project should be rejected if it does not appear to give reasonable promise of accomplishing these objectives. It should not be rejected simply because it involves poor people, or because it is in a portion of the city you have been accustomed to rejecting or red-lining for old-fashion, arbitrary reasons.¹⁴

Unfortunately, Brownstein's plea for maintaining standards was not heeded. Instead, the message which many of the personnel took back to their offices was the quantitative goal and the need and desire for "decent housing" got lost in the mad rush to swell the production figures.

Reflecting on the 1968 housing goal and the way in which HUD responded, the "235 Audit" stated that:

The entire field structure was tending to emphasize production of new housing units and processing of appraisals on used houses to the degree that too little emphasis was being placed on the quality of the units produced or appraised. Although the need for more and better housing are great, production and appraisals must be measured in terms of the quality of the end products as well as in terms of the number of housing units provided, both new and used.

¹⁴Ibid. p. 311.

Throughout the country we have been informed, both formally and informally, that the word was out from the Central Office to "produce units."¹⁵

By early 1972, Secretary Romney acknowledged the need to focus more attention on insuring quality mortgages; his official stance stressed quality over high production levels. In testimony before the House Legal and Monetary Affairs Subcommittee he stated that:

Above all, we will insist on quality production and have instructed area and insuring offices to restrict their processing and supervision to what can be done on a quality basis -- even if that means reduction of total production levels from 1971 highs.¹⁶

Yet, by 1972 much of the damage had been done. For the previous four years high production levels were the focus of HUD policy and Romney's call for a return to quality mortgages had the ring of a "Monday morning quarterback."

But in spite of Romney's admission that the quality of mortgages insured had been slipping he, nevertheless, tried to place the blame on Congress for a faulty legislative mandate.¹⁷ In rebutting these charges, Senator John Sparkman, Chairman of the Senate Banking and Currency Committee stated:

To keep the record straight, there was never any Congressional intent to authorize local FHA offices to insure substandard housing or to accept as mortgagors the poor whose financial condition did not justify homeownership. The strong language in the 1968 Housing Act and subsequent administrative rulings

¹⁵"235 Audit" op. cit., p. 8-9.

¹⁶"Defaults on FHA-Insured Mortgages" (Part 2) op. cit. p. 303.

¹⁷"Defaults on FHA-Insured Home Mortgages -- Detroit, Michigan." (Part 1) op. cit. p. 56. See also "Real Estate Settlement Costs, FHA Mortgage Fore-closures, Housing Abandonment, and Site Selection Procedures." op. cit.

were intended to eliminate "redlining" in older declining urban areas, but not to blanket in as insurable risks all units in such areas regardless of their condition or otherwise insurable qualifications.¹⁸

e. Lower-Income Mortgagors and Inner City Properties:

HUD administrators, in charge of carrying out the Housing and Urban Development Act of 1968 clearly wanted HUD-FHA to become the housing agency responsible for lower income families and inner city areas as well as the safe and suburban middle class. Even if a major motivation for trying to adopt a new, social orientation was self-interest, the desire to avoid competition with another housing agency (as discussed in Chapter 4), HUD personnel seemed aware of the challenge. Yet, it was extremely difficult for long-time FHA personnel to shift their thinking and adapt their procedures to suit the new mortgagors and properties.

On this point, the 235 Audit observed that:

With the advent of subsidized housing programs...many of the personnel carrying out programs have not sufficiently adjusted their thinking and attitudes to encompass the Department's new programs ...While we recognize that the buyer must always share the responsibility for the selection and purchase of his home, we believe that intensified efforts are required to dispel remaining vestiges of the "caveat emptor" philosophy and to more effectively implement current Departmental policy objectives.¹⁹

While many long-time HUD-FHA personnel had a great deal of difficulty accepting the social goals of the FHA insurance programs and resented the drastic change in orientation, many young personnel who joined

¹⁸Address to Homebuilders, January 25, 1972. Reprinted in "Defaults on FHA-Insured Home Mortgages -- Detroit, Michigan" op. cit. p. 56.

¹⁹235 Audit, op. cit., p. 8.

the HUD staff, not the FHA staff, have openly accepted the ideals of the program. This view was expressed by the young Housing Counselor/Community Services Advisor from the Phoenix HUD Insuring office:

There is a real split in our office. Some of us work for HUD and others -- the old timers, still work for FHA.²⁰

But whether or not HUD employees really believed in the new, socially oriented programs, they were all expected to carry out the mandate of both the President and Congress.

Talking about the new, unsophisticated mortgagors and their special needs, Gene Birkle, of the General Accounting Office, noted that:

...the group of people that you are dealing with in subsidized housing programs have never owned a home before. Many of them, or most of them, are not aware of the type of defects they might run into, and when they see defects they do not necessarily realize their significance;...In order to make the program work you are going to have to deal with these people in a different manner than you deal with the people in your regular unsubsidized FHA programs.²¹

But in HUD's desire to carry out their mandate and to reverse the exclusionary policies and red-lining practices of the pre-1968 era, (see Chapter 3, Section 4a) many HUD personnel seemed to lose sight of the fact that there is probably a group of families who really should not be homeowners, for financial and/or psychological reasons.

²⁰Interview, Rose Strickland, op. cit.

²¹Hearings Before the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, "Housing Subsidies and Housing Policies" U.S. Congress, 92nd Congress 2nd Session, December 4, 5, and 7, 1972, p. 29.

Representative Ben Blackburn, during hearings of the Subcommittee on Priorities and Economy in Government, went so far as to state that the cause of the problems with the lower-income homeownership programs (235 and 221(d)(2)) was that program participants were not suitable for homeownership. Arguing that the programs had no intrinsic value, he stated that:

The problem is that we have been putting families into homes who have no sense of responsibility of homeownership and that is where the problem has been, and that is the intrinsic problem in the program...Can we not conclude that there are some people who do not have the sense of responsibility or the economic income to own a home?²²

While it is clear that Representative Blackburn's comments were one-sided and ignored the array of other reasons why the lower-income homeownership programs encountered so much difficulty, an important dilemma -- a "damned if you do and damned if you don't" situation -- arises from this discussion.

If, indeed, there is a group of people who are not capable of being homeowners, how can HUD and mortgagees make the determination of who should own and who should not, without being overly lenient or overly strict? Thus, since the post-1968 homeownership programs have been faulted for laxity in underwriting and appraising, and the pre-1968 programs have been faulted for their conservatism and discrimination -- is it possible to administer a program fairly -- allowing parti-

²²Report of the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, "Housing Subsidies and Housing Policy" March 5, 1973, p. 41-42.

icipation by those who can own, yet barring participation by those who clearly cannot? John H. Payne, Jr., an executive of a New York bank accurately presented the problem before the Senate Subcommittee on Antitrust and Monopoly:

...when I talk about quality control, I don't want to have it interpreted to mean that we, or other mortgage bankers, are not interested in nor are sensitive to the plight of those who desire and require adequate housing of those who feel deeply the desire we all share to own our own home. We recognize the need for some form of guarantee or insurance in order that home purchase terms may be available on an almost a hundred-percent financing basis, and on the long-term payout not otherwise offered in the market.

However, quality control also means keeping a man from drowning himself in debt service, keeping him from being saddled with payments he cannot meet, and saving him and the Government insurance agency from certain foreclosure, and most often from certain dollar losses...

As the social pressures of various programs have mounted it is easy for certain people to point their fingers at the mortgage company who refuses to accept the mortgage application which is loaded with danger signals, as being a company which is discriminating against people who need housing the most.

However, none of us do any service to an individual or to his family if we let him assume a mortgage whose total dollar amount and monthly payments are something he cannot cope with. The results of that are tragic.

On the other hand, if we bow to the social pressures and allow these properties to be mortgaged, we are then subject to -- and properly so -- pronounced criticism when the delinquency ratios become too high and the foreclosure rates astronomical.²³

What seems to be needed is a system to assist in the lending/insuring decision particularly involving borderline cases. This issue will be examined in the last chapter.

²³New York Antitrust Hearings, op. cit., p. 216-217.

Thus, there are several technical and philosophical explanations which account for the array of problems which were associated with the implementation of the post-1968 homeownership programs, as discussed in the first section of this chapter. Based upon the above, it is clear that many of HUD's difficulties can be traced to an unfortunate mixture of mismanagement and traditional practices which were not easily overcome. But HUD's attitude toward counseling services alludes clear explanations, as discussed in the following section.

3. HUD'S PRE-PURCHASE COUNSELING APPROACH AND ACTIVITIES:

The most direct means which HUD has at its disposal for intervening on behalf of the consumer and for diminishing its own risk, is through a home buyer counseling program. While HUD's official posture on this issue has been positive, it has failed to play a strong and consistent role in supporting consumer counseling programs. This section will first examine HUD's role in the legislative history of funding counseling programs. Following this, the emergence and the record of private, voluntary counseling agencies will be examined.

The third part of this section will assess HUD's attitude and actions toward the most consumer-oriented staff person in the Area/ Insuring office -- the Housing Counselor. And, finally, the section will conclude with a short case study of HUD's most recent effort at launching a homeownership counseling program -- the Homeownership Information, Advice and Assistance Program.

a. Legislative History of Funding Counseling Programs:

It will be recalled from Chapter 4 Section 3 that counseling was a key issue in Secretary Weaver's rationale for opposing Senator Percy's 1967 homeownership legislation. The outcome of this controversy was Section 237 of the Housing and Urban Development Act of 1968, which authorized the funding of counseling services to Section 235 mortgagors and for mortgagors who could meet the standards of one of the FHA insurance programs, but who had faulty credit histories.

A report issued by the House Committee on Banking and Currency in 1968 articulated the need for a counseling program:

Since many of the families who would be assisted have had little experience in the proper care of a home and the budgeting of income to meet regular monthly payments on a mortgage, this section (235) would authorize appropriate counseling, either directly by HUD or by contract with public or private agencies, to assist these families in meeting their new responsibilities.¹

And, further, on the 237 program, the report noted that:

An important element in this program is the counseling, either directly or by contract with public or private organizations, the Secretary would provide mortgagors and to prospective homeowners who lack sufficient funds to supply a downpayment. While many families who would be eligible for mortgage insurance under this section have strong aspirations to become homeowners, their experience in handling large financial responsibilities may be meager. Through counseling these families can be helped to use their resources efficiently in meeting homeownership responsibilities.²

But, in spite of this strong language and the critical role that counseling had played in the earlier Congressional debates on homeownership, Congress did not fund counseling for the 235/237 homeownership programs during the first year of their operation. This action proved to set an unfortunate precedent: Congress rejected HUD requests for funding counseling for fiscal years 1970 and 1971.

During the Senate Appropriation Hearings for FY 1971 Secretary Romney argued that counseling was a key component of the new homeownership programs. He stated that:

¹House Committee on Banking and Currency, House Committee Report on the 1968 Act, H. Rep. No. 1585, 90th Cong. 2nd Sess. p. 10.

²Ibid. p. 11.

In basic concept, the statute recognizes the need for providing family budget, credit management, and related counseling services to help special credit-risk families to qualify for, and to obtain, homeownership. The legislative intent of the program cannot be achieved through voluntary effort alone; funding is essential to a successful counseling program.³

Specifically, the HUD proposal for fiscal 1971 was as follows:

The budget request for \$3,100,000 for 1971 will provide 300,000 counseling sessions for 25,000 families. It is expected that 2,500 of these families will become applicants for home mortgage insurance under Section 237 without recourse to assistance payments.

Counseling for 25,000 families is a modest beginning for the program in that it will provide counseling for only about 125 families in each of over 200 metropolitan areas with a population of 100,000 persons or more...Total requirements for the program are estimated at \$3,100,000.⁴

However, the final appropriations for FY 1971 ignored Romney's request and deleted the \$3,100,000 requested for counseling from HUD's budget. The final word on this issue from the House Appropriations Committee was the following:

³Senate Hearings Before the Committee on Appropriations, Department of Housing and Urban Development, Space, Science, Veterans, and Certain Other Independent Agencies Appropriations, 91st. Cong. 2nd. Sess. Fiscal Year 1971, p. 889.

⁴Senate Hearings Before the Committee on Appropriations, Department of Housing and Urban Development, Space, Science, Veterans, and Certain Other Independent Agencies Appropriations, 92nd. Cong. 1st Sess. Fiscal Year 1972, p. 776 (Referred to as "Senate FY 1972").

The conferees suggest that any needed counseling services can be provided by voluntary groups and existing community services, but where such services are not provided they may be made available as part of the normal mortgage insurance initiation and servicing activities.⁵

By the time that the House convened its appropriations hearings for FY 1972, Romney had retreated on seeking funding for counseling agencies. The official stance of the agency became one of increasing in-house capabilities to manage volunteer counseling efforts and of seeking funds for counseling from other department resources.⁶

Similar to the statements of the previous year, Romney's remarks before the Senate Committee on Appropriations for FY 1972 began by acknowledging that voluntary counseling efforts alone were not sufficient. However, rather than going on to request funding for these agencies, he proceeded to request funding to support additional HUD personnel.

Secretary Romney stated that:

Hopefully, the House and Senate Appropriations Committees will see fit to appropriate some money for that program (237 counseling) this year, because unquestionably one of the real deficiencies in our effort is the ability to give proper counseling to low-income families, both before they move into housing units, particularly on a homeownership basis, and after they get in.⁷

We have undertaken 237 counseling on a voluntary basis to the extent we could. But we have had no funds for 237 counseling and we have no funds for counseling under 235...We have gone as far as we can go on a voluntary basis with 237.

⁵House Report No. 91-1345, 91st. Cong. 2nd. Sess. p. 9.

⁶Statement by Senator Walter F. Mondale quoting Assistant Secretary Eugene Gullledge, in testimony before the House Appropriations Subcommittee, April 1971. In Senate FY 1972, op. cit. p. 964.

⁷Ibid. p. 350.

We have about 90 organizations in about 80 cities doing it on a voluntary basis, but we are not doing nearly as much as we should be doing...we need a certain staff nucleus to direct the voluntary effort. The funds would be used for that purpose...it would mean having staff in each of the area and FHA offices, who could organize the voluntary effort in the communities...we think we need about \$3 million a year...⁸

In the testimony that followed, HUD Assistant Secretary Richard Van Dusen and Secretary Romney lauded the efforts of the volunteer organizations, essentially back-tracked on their earlier comments which indicated that these efforts were not sufficient, and continued to argue for additional funding for HUD staff.

Mr. Van Dusen: The Urban League provides these services (counseling) in many cities, the Salvation Army, organizations of that kind.

Secretary Romney: We succeeded in getting Sears and Roebuck to make use of their credit personnel in a number of cities to help identify the principal experts who could volunteer their time to counsel some of these special risks with respect to homeownership. And then there are many other organizations, nonprofit organizations of various kinds. We believe we could get real estate personnel and other people of that type to volunteer their time on an organized basis to give such assistance. But you would need a certain nucleus organization to make certain that it operates effectively. That is where we need some money.⁹

One possible explanation for why Romney did not prescribe a cure -- funds for the agencies -- that followed his own analysis of the problem -- inadequate funds available -- may have been because earlier attempts to fund these agencies directly had been unsuccessful.¹⁰ Perhaps Romney's

⁸Ibid. p. 351.

⁹Ibid. p. 352.

¹⁰On this point, Mr Spellman, President of the Mortgage Bankers Association America stated that: "We have to assume that the reason they (the Administration didn't ask for funding) is because they had been rebuffed in past years." Ibid. p. 817.

request for funding additional HUD personnel to monitor counseling efforts was a new approach that he felt may be more attractive to Congress, but that he, himself, did not completely believe in.

However, Romney's retreat was premature. At the same time that he was changing his approach, Congress was also making a 180 degree reversal. Most surprising were the actions of the House Appropriations Committee in earmarking \$3 million to fund counseling services, although HUD had not requested this for FY 1972. From that point on, the counseling issue continued to gain momentum. Faced with a growing awareness of the problems that were plaguing the homeownership programs, counseling was grasped as the key to salvaging these programs.

By the time that the FY 1972 Senate Appropriations Committee convened, many Congressmen and special interest groups were openly supporting the funding of counseling. While Senator Gordon Allott's opening comments reaffirmed the view of the FY 1971 House Appropriations Committee Report, he went on to support funding counseling:

I have a suggestion from a member of my staff, that one of the reasons for not funding this in the past was that this has been funded to some considerable extent by charitable organizations... We have a letter from one of our cities now saying these funds are drying up, and there are insufficient funds available for this purpose...It has (all been done on a voluntary basis), and this is why the question about 237, because I have communications from Pueblo and the private financing of this service through eleemosynary organizations has started to dry up and they can't continue to operate on the same level as they have in the past. (See Exhibit 2)¹¹

Similarly, Senator Pastore simply said: "What bothers me, the administration didn't ask for a dime." (for counseling)¹²

¹¹ Ibid. p. 351-353.

¹² Ibid. p. 812. See also testimony of Senators Walter Mondale and Jacob Javits, p. 964 and 678, respectively.

SOCIAL SERVICES

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EXHIBIT 2:

OF

302 Jefferson
Pueblo, Colorado 81004
544-4233

PUEBLO ... UNITED

SERVING THE COMMUNITY OF PUEBLO

June 2, 1971

Senator Gordon Allott
Senate Office Building
Washington, D.C. 02169

Dear Senator Allott:

I have received the statement of James P. Twomey made to the sub-committee on HUD - SPACE - SCIENCE of the House Committee on Appropriations. This presentation was made on May 13, 1971. I whole heartedly concur with Mr. Twomey's statements and especially am I asking your support for the Homeownership Assistance Program Section 237.

Our agency, Social Services of Pueblo...United, has been certified as a counseling agency for applicants eligible for the services provided by Section 237. As you are well aware the counseling services is without remuneration from the federal government.

Our agency receives funds from both the United Fund of Pueblo and the Catholic Diocese of Pueblo. Our funding has never been sufficient to provide all of the services requested of us and this year because of the economic situation within our own community our funding resources from the United Fund have even been reduced.

Despite this we have seen the inestimable value of Homeownership Counseling for those individuals who are eligible under Section 237. Without this counseling not only would the eligible individuals be unable to receive subsidization provided by the Homeownership Assistance Program but because of their own inability, for sundry reasons, to handle their own budgetary problems would eventually become delinquent in their housepayment and subsequently loose ownership.

Our agency has provided this counseling service since August, 1969 and during this time have interviewed 68 families, of this number we have recommended 26 to be accepted for subsidization under Section 237 and all have been accepted. To date none of the families we are counseling have become delinquent in their housepayment.


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The Homeownership Counseling Program can well be expanded in our agency were we able to provide more staff time. As I indicated above because of our own financial situation we have been unable to hire additional staff and in effect have asked staff to assume the additional responsibility of providing this service. In most instances this requires volunteer time on their part.

We in the agency have seen the results of this counseling program and have a keen awareness of the necessity for its continuance if the provisions of Section 237 are to be effective for those families who are inadequately housed because of low income and a history of financial difficulties. They will be unable otherwise to make the essential move from inadequate to adequate housing. I'm sure all of us recognize the implications of poor housing not only to the family and children concerned but to our entire communities, states and nation.

If the Homeownership Counseling Program under Section 237 is not funded certainly we will not be able to expand this counseling program and there is every possibility we may have to terminate it. In the name of those clients who are benefited by this program I ask your support for funding of this program.

Sincerely,


(Rev.) Marvin D. Kapushion, ACSW
Director

In addition to the pro-counseling mood within Congress, the National Housing Conference, the National Association of Home Builders and the Mortgage Bankers Association of America testified that counseling was a critical component of the homeownership programs and that its absence was a factor in providing an atmosphere in which abuses could flourish.¹³

The Senate Appropriations Committee responded favorably to these sentiments. They increased the House Appropriation from \$3 to \$4 million and specifically directed HUD on how these funds were to be used:

The Committee directs that wherever feasible, these funds be used to support recognized and qualified charitable or public service type non profit organizations engaged in counseling and assisting eligible low income families rather than for development of duplicative in-house capabilities.¹⁴

The result was a compromise appropriation of \$3.25 million for counseling. This was the first and only time that Congress has ever funded counseling services.

However, rather than using the funds to support pre-purchase counseling efforts, about \$2 1/2 million was used to fund thirty-one counseling agencies in twenty cities to do delinquency and default counseling. (See Chapter 9 Section 6) The remainder of the appropriation, about \$750,000,

¹³See Ibid. p. 815; 756; and 774-776, respectively.

¹⁴Senate Hearings Before the Committee on Appropriations, Department of Housing and Urban Development; Space, Science, Veterans and Certain Other Independent Agencies Appropriations, Fiscal Year 1973, 92nd. Cong. 2nd Sess. p. 557 (Referred to as "Senate FY 1973").

was used by HUD to fund two studies, contracted to private consulting firms, to study the effectiveness of pre-purchase counseling efforts (OSTI contract) and to develop a training program for counseling agency staff.

During the Senate Appropriations Hearings for FY 1973 an apparently annoyed Senator Allott questioned Secretary Romney on his use of the counseling funds.

You will recall that Senator Pastore and I specifically expressed concern that the moneys appropriated by Congress not be utilized for administrative purposes. Yet, from reports available to me, it appears that the appropriated amount of \$3.25 million was not made available directly to local counseling agencies...I am informed that this money was utilized for what is termed "technical, promotional and administrative purposes."¹⁵

Romney denied this charge. His response suggested that, with the aid of a new "\$100 Fee Program," in which the seller would pay \$100 to a counseling agency on behalf of the counseled purchaser, the voluntary agencies would be able to perform pre-purchase counseling adequately.¹⁶

While the favorable response to counseling, by Congress and others, should have been a signal to HUD that counseling was an "in vogue" issue, likely to continue to gain support, HUD's FY 1973 budget submission again made no requests for counseling. It simply stated that any additional funding that would be necessary to complete the demonstration developed from the FY 1972 appropriation would be provided under the Department's research program.¹⁷

¹⁵Ibid. p. 557.

¹⁶Ibid. p. 557-558; 563.

¹⁷Ibid. p. 562.

While HUD's apparent anti-counseling attitude in 1972 and 1973 eludes obvious explanation -- in light of its pro-counseling rhetoric -- several explanations exist:

First, the channeling of the bulk of FY 1972 funds to a default counseling program is, perhaps, easiest to understand. In view of the mounting default and foreclosure rates HUD chose to ignore Congress' wishes to assist agencies in their pre-purchase counseling efforts and, instead, opted for a program that had a chance of reducing the embarrassing and costly foreclosures -- its most pressing short-term problem. (See Chapter 9 Section 2)

Up until 1969 HUD's insurance reserves were plentiful. However, by the early 1970's, several of the insurance funds began to show substantial deficits. (See Chapter 9 Section 2) This must have been intensely embarrassing for an agency that had always been fiercely proud of its financial solvency. HUD's decision to create a default counseling program was a significant attempt to reverse the mushrooming deficits.

A second reason why HUD's pro-counseling stance might have been easier to talk about than to carry out involves FHA's historically close relationship to the mortgage banker and the lack of a well-defined role for the newcomer to the home purchase system -- the counseling agency. While the MBAA was in favor of counseling, there is evidence that at least some mortgage bankers resented the intrusion of the counseling agency¹⁸ in matters that, heretofore, had involved only HUD and mort-

¹⁸OSTI D + D #2. p. 40-45.

gages. Thus, the emergence of counseling agencies presented a new actor into a well-established system and HUD, similar to the mortgage banker, may have been wary about how the new agency would mesh with its prevailing practices.

Not only was the counseling agency a newcomer and not only was there a great variety in agency types and functions, (See this Chapter Section 3.b.) but the unit within HUD that had responsibility for all counseling functions was extremely weak (See this Chapter Section 3.c). Thus, the sheer variety in agencies, combined with an almost non-existent internal structure for coordinating and monitoring them, provides a third plausible explanation for HUD's unwillingness to request funds for counseling agencies.

b. Emergence of Private, Voluntary Counseling Agencies:

In the absence of funds to support pre-purchase counseling activities, private social service agencies voluntarily provided these services. After the Housing and Urban Development Act of 1968, HUD began to certify existing or newly formed agencies to do 235/237 counseling. This opened the way for certification to almost any interested agency. John Andrews, the Boston HUD Area Office Housing Counselor described the process as follows:

The certification process helps the agencies to clarify their own objectives concerning counseling. It's really more for their benefit than for HUD's. Once an agency has applied for certification, I'll work with it until its application is acceptable

to HUD. If it's interested, it will certainly get certified.¹⁹ But, in spite of this leniency, by the end of 1970 only 63 agencies in the entire country had received HUD certification.²⁰ This may have been due to: a scarcity of eligible or interested agencies; the lack of Federal funding; or, HUD Central Office, rather than Area/Insuring office administration of the certification process.²¹

But by Summer 1972, there were about 200 HUD-certified counseling agencies and an additional 100 non-certified agencies. Based upon a telephone survey with counseling agency personnel, OSTI Inc. found the following patterns among the agencies:

The largest discernible groups were publicly-funded agencies that were spin-offs of local OEO Community Action Programs, Model Cities programs, and in some instances local welfare programs and local housing authorities.

Among the over 300 voluntary counseling agencies...only 94 had assisted as many as 50 lower-income families in actual purchases prior to 1972. Agencies that had provided services to as many as 100 purchasers were extremely rare.

Agencies differed greatly in the services they tended to provide regularly as a part of their pre-purchase counseling activities. Taken as a whole, the range of services they reported cover a wide spectrum of alternative content area

¹⁹Interview, John Andrews, Housing Counselor, HUD Area Office, Boston, Mass. August 18, 1972. Andrews also described the variety of reasons why agencies sought HUD certification, in spite of the lack of funding:

- in the hope that Federal funding would be forthcoming and that their status as a certified agency would make them eligible for funding;
- to help them attain credibility with local funding sources;
- to expedite their dealings with local mortgagees and builders;
- to help them attain credibility with prospective mortgagors.

²⁰OSTI Final, op. cit. p. 30.

²¹HUD Central Office originally had the responsibility of certifying counseling agencies, until this responsibility was designated to the Area/Insuring offices in July, 1972. Interview, John Andrews, op. cit.

and modes of service delivery: Informational; training; advice; referral; direct assistance; advocacy intervention.

Although voluntary counseling agencies regularly provided informational services -- particularly dealing with budget management -- and most provided some advisory resources for clients, only a minority of the agencies offered some form of direct, advocacy, or referral services on a regular basis.²²

Thus, the picture that emerged from the telephone census was of a great diversity in counseling agency styles, concerns and services. Not only were the great majority of agencies relatively inexperienced but, while most seemed genuinely concerned with consumer problems, only a handful offered a wide range of consumer-oriented services.

The 235 Audit came to a similar conclusion:

In the absence of funding of Section 237, except for isolated arrangements for counseling by non-profit groups, there has been no existing arrangement which insures that the buyer who needs counseling receives it...If marginal mortgagors are to be successfully housed under Section 235, both pre-sale and post-sale counseling is required.

We recognize that adequate funding of Section 237 to provide needed in-house or out-of-house staff for the desirable degree of counseling, advice and assistance to low-income and otherwise disadvantaged mortgagors, can minimize these problems.²³

Based upon the above, it appears that Secretary Romney's later suggestions that the voluntary agencies were providing sufficient services, in spite of the lack of funding, were unfounded. But while counseling agencies might have been better equipped to provide more comprehensive, consumer-oriented services, had funding been available,

²²OSTI Final, *op. cit.* pp. 54, 56 and 59-61. This writer organized and directed the OSTI telephone survey of counseling agencies.

²³235 Audit, *op. cit.* p. 56.

the record of private voluntary counseling agencies is, nevertheless, noteworthy.

The most comprehensive study on the effectiveness of pre-purchase counseling efforts was performed by OSTI Inc. in 1972-1974. Field studies were conducted in twenty cities across the country to observe how local counseling agencies operated in the context of the prevailing 235 homeownership program and the success which these agencies had in assisting home purchasers to prepare for homeownership.

In general, OSTI found that:

Although many voluntary counseling efforts have been unable to provide an adequate range of needed services, we find that past program experience is indicative of the potential of consumer-oriented counseling in promoting increased effectiveness in federal housing programs.²⁴

More specifically, the OSTI researchers found that there were several critical ways in which counseled families were better prepared for the ownership experience than similar uncounseled families:

Although counseled families more frequently purchased older houses, they encountered less severe housing condition problems upon purchase than did uncounseled purchasers. Furthermore, counseled purchasers were more knowledgeable than uncounseled purchasers about things wrong with their houses at purchase, and experienced fewer and less severe unexpected housing condition problems as a result.

That the counseled were better protected in the housing they purchased is probably attributable to the independent inspection services and quasi-legal assistance that some of the voluntary agencies studied have provided their clients. However, most voluntary agencies did not provide these services, and many counseled families were insufficiently protected against inadequate housing. Nevertheless they fared better than uncounseled purchasers.

²⁴OSTI Final, op. cit. p. 1.

As a result of the consumer-protective aspects of pre-purchase counseling, the counseled families incurred lower (in relation to their incomes) housing-related expenses to maintain their homes in adequate condition during the subsequent period of ownership and, when interviewed, anticipated fewer major expenses in the coming year. We conclude that the experience of the voluntary agencies indicates the effectiveness of counseling both in reducing risks faced by lower-income families in the purchase market and in promoting their interests.²⁵

Additional support for OSTI's conclusion comes from the results of the Buyer's Agent Program. This program was designed:

to test whether or not, with counseling and subsidy payments, lower income families within a 50-mile radius of San Francisco could become homeowners.²⁶

Preliminary results of the program have indicated that participants in the Buyer's Agent Program have had extremely good ownership experiences. Specifically, in relation to their payment records, the report states that:

For the first 303 mortgage loans made under BAP, there were less than 7 percent showing any late payments. And the bulk of these were only one month late. By contrast, figures for the State of California covering all Section 235 purchases showed delinquencies totaling more than 15 percent, with over a third of these due for three or more months. Only one BAP loan, three-tenths of one percent, had been foreclosed as of August, 1974 (two and one half years after the program started), whereas foreclosures throughout the state were running at 2.25 percent, for Section 235 loans for the quarter ending September 30, 1974.²⁷

Based upon these early and encouraging findings the San Francisco researchers reported that:

²⁵Ibid. p. 5.

²⁶Edward W. Moose, "The Buyer's Agent Program" -- Final Report, Prepared for the San Francisco Development Fund, March, 1975. p. 22.

²⁷Ibid. p. 46.

Homeownership for lower income families, and specifically Section 235, can be made to work if those to whom a subsidy is given are carefully selected and if they are well-informed as to responsibilities they are assuming. The provision of such "guidance," "counseling," or "training," was intended when plans for the Section 235 legislation were first formulated. It is unfortunate that these plans were not carried out.²⁸

A key recommendation of the research was that any ongoing program of homeownership for lower income families include this type of consumer protection.

We recommend...the mandatory participation of selected prospective buyers in pre-purchase homeownership training classes as a standard requirement of a subsidy program. Regardless of how well they may be selected, first-time buyers with little knowledge of ownership responsibilities and no experience in the housing market need information and guidance. In the follow-up analysis of the pilot experiment it was found that the effect of counseling services persisted over time in several important respects.²⁹

Thus, there is good evidence supporting the important role that homeownership counseling can play, particularly with regard to lower income, first-time homebuyers. That this evidence was not yet available to HUD while they were making their non-requests for funding counseling is not relevant. The fact is that these studies served to confirm the conventional wisdom on counseling, rather than to disclose any new or unexpected revelations.

Prior to going on to examine HUD's Information Advice and Assistance Program, HUD's 1974 homeownership counseling program, a brief assessment of the role of the Housing Counselor at HUD will help to round out the picture of HUD's posture vis a vis counseling.

²⁸San Francisco Development Fund, "Preliminary Results of the Buyer's Agent Demonstration" Report and Recommendations. February, 1975 p. 3.

²⁹Ibid. p. 5.

c. The HUD Housing Counselor:

Besides contracting with private, voluntary agencies to provide homeownership counseling services, HUD also has had the option to provide the services itself. The OSTI Final report observed that:

The creation of the HUD Housing Counselor role at the Area/Insuring offices initially enabled HUD offices to undertake direct provision of counseling services to prospective purchasers. However, the Housing Counselor role, in which the central responsibility for direct provision of counseling services resided, proved to be an unpopular one in a predominantly production-oriented organization.³⁰

Indeed, the Housing Counselor was also viewed as a relatively low man on the HUD totem pole by Central Office. According to William Feingold, Assistant Director of Homeownership at HUD:

The Housing Counselor is very low in the HUD bureaucracy...It's not even considered a high role in relation to such positions as Property Disposition Officer or Loan Management Specialist within the Division of Housing Management.³¹

HUD's lack of interest or intent to provide direct counseling services was clearly stated by Under Secretary Richard Van Dusen before a Subcommittee of the Senate Appropriations Committee:

We never assumed...that the Department would do counseling as a Federal function. It just isn't organized in that manner, and doesn't have the field establishment to do that. But if there were in each of our field offices somebody who had the responsibility to see that counseling services were available, and that an applicant for subsidy needing counseling were referred to a local counseling agency, and there was that followup, this we think, would be very useful.³²

³⁰OSTI Final op. cit. p. 40-41.

³¹Interview, William Feingold, Assistant Director of Homeownership, HUD Central Office, February 20, 1974 (telephone).

³²Senate FY 1972 op. cit. p. 352. But although the official policy at HUD discouraged in-house counseling, some Area and Insuring offices undertook their own counseling programs. Lawrence Katz, a former HUD director in Milwaukee initiated a widely acclaimed counseling program for ADC mothers. See, for example, "Defaults on FHA-Insured Mortgages (Part 2)" op. cit. p. 143-174.

Based upon this view of counseling, the HUD Housing Counselor emerged as a certifier, monitor and evaluator of counseling agency efforts, but not as a counselor. The job description of the HUD Housing Counselor outlined his tasks.

The HUD Housing Counselor:

...provides leadership, assistance, and training to local housing authorities, sponsors, HUD-approved counseling agencies, local Insuring offices and others on homeownership counseling...He recruits counseling agencies and monitors and evaluates their counseling programs. He establishes and maintains liaison with public and private agencies on the State and local levels to enlist their participation on a voluntary basis, in counseling programs. He reviews and make recommendations on counseling and training proposals submitted to the Area Office by local housing authorities and HUD-assisted sponsors.³³

Further, according to Mr. Feingold:

The Housing Counselor is the only advocate of the homebuyer within HUD...Others may be sympathetic, but without a Housing Counselor, there is no advocate.³⁴

Yet, in spite of the seemingly important function of the Housing Counselor, as of late February 1974 less than one-half of these positions were filled in the Area/Insuring offices.³⁵

In the absence of a Housing Counselor, other HUD personnel often carried out the former's most rudimentary tasks. For example, in Philadelphia as of January 1973, there had been no Housing Counselor for six months. An interview with the Community Services Advisor, the Housing Counselor stand-in, revealed that only 3-4 hours per week were devoted to carrying out the normal functions of the Housing Counselor,

³³Area Office Organization, A HUD Handbook 1171.1A, November 1971, p. 32.

³⁴Interview, William Feingold, op. cit.

³⁵Ibid.

including answering telephone calls, responding to letters, and filing an occasional report. Moreover, to his embarrassment, the Community Services Advisor did not know anything about the more substantive tasks of a Housing Counselor.³⁶

Similarly, the Hartford Insuring office had been without a Housing Counselor for one month as of February 1974.³⁷ In that office, the Housing Counselor's tasks fell on a secretary in the Housing Management section. An interview with this individual revealed that she simply answered calls from people who were seeking information about how to go about purchasing an FHA-insured home.

For example:

The first thing I tell them is that they must find a house and the bank finances it. If their homes qualify, I'll refer them to the Connecticut Housing Finance Agency, where they can get a lower interest mortgage.³⁸

While this type of information giving is, indeed, useful, it represents only one facet of the tasks that are supposed to be carried out by the Housing Counselor. Thus, HUD's willingness to "ax" its most consumer-oriented position, is further evidence that HUD does not yet put a high premium on serving consumer needs.

³⁶Interview, Charles Morgan, Community Services Advisor, HUD Area Office, Philadelphia, Pa. January 11, 1973.

³⁷In Insuring Offices, the Housing Management Representative carries out the functions of the Housing Counselor. There is usually no Housing Counselor, per se.

³⁸Interview, Sarah Comber, Secretary, Housing Management Section, FHA Insuring Office, Hartford Conn. February 7, 1974. (telephone)

d. The Homeownership Information, Advice and Assistance Program:

In January 1974 HUD launched a new homeownership counseling program, attendance at which was a requirement for any family wishing to purchase a HUD-owned property. But, surprisingly, within the atmosphere of a frequently weak or nonexistent Housing Counselor, HUD chose to place the bulk of the responsibility for implementing the new program on the Housing Counselor:

The Housing Counselor...shall have lead responsibility for directing, organizing, planning, preparing and participating in the (program)...³⁹

Moreover, the program was specifically required to be executed "in house":

The sessions...are to be conducted on specific days and at specific times in the local HUD offices.⁴⁰

The Homeownership Information, Advice and Assistance Program (HIAAP) was created to give new purchasers of HUD acquired properties, under Sections 235 and 221(d)(2), access to information related to homeownership. The guidebook stated the following as its key objective:

By preparing prospective purchasers for homeownership, its responsibilities and obligations, incidences of chronic delinquencies, defaults, and foreclosures will be eliminated or substantially reduced resulting in a corresponding reduction in losses to HUD.⁴¹

There are several aspects of the HIAAP that warrant discussion. First, the way in which HIAAP emerged within HUD is interesting.

³⁹"Homeownership Information, Advice and Assistance Program" A HUD Handbook, Program Participant and HUD Staff. January 1974, p. 2 (referred to as HIAAP Guidebook).

⁴⁰Ibid. p. 4-5.

⁴¹Ibid. p. 1.

William Feingold related the following story:

With the production programs in a state of decline, Sheldon Lubar was looking around for new programs with which the production people could become involved. He spoke to Assistant Secretary for Housing Management Crawford about the possibility of HPMC setting up a counseling program that could be offered in conjunction with the disposition of HUD-foreclosed homes. Crawford, upset about Lubar's threat to undertake a counseling program, responded: "You can't do counseling...it's a management thing."

And, according to Feingold -- "the next day we had a counseling program."⁴²

Whether or not it was the rivalry within HUD, that provided the real push for the HIAAP, the fact is that the HIAAP was not a well-thought-out homebuyer-oriented counseling plan.

A second important aspect of the HIAAP is that by placing the responsibility for implementing the program on HUD staff (Housing Counselor in conjunction with Chief Property Officer and Loan Management Specialist),⁴³ HUD was shifting back to the earlier conceptualization of the Housing Counselor's role. But, ironically, as noted above, this shift occurred at a time when many areas lacked the personnel to carry out the program.

Third, the program itself -- objectives, format and content -- was based upon assumptions that were not supported by the then-available information on the role of counseling. The HIAAP offered one group session lasting a minimum of one hour, with an additional half hour for questions.⁴⁴ The content of the session was to include the following:

⁴²Interview, William Feingold, op. cit.

⁴³HIAAP Guidebook, op. cit. p. 1-2.

⁴⁴Ibid. p. 5-6.

purchase procedures; property care and maintenance; financing home-ownership; home management; budget and debt management; referral services; resale; recertification; and alternatives to foreclosure.⁴⁵

Chart 6 examines the structure of the HIAAP and presents the evidence that contradicts the assumptions on which it was based.

CHART 6

Assumptions on Which the HIAAP was Based Compared with the Then-Available Knowledge on Homeownership Counseling

Assumptions

Evidence

a. Group information sessions are appropriate to assist prospective mortgagors.

None. Based upon the OSTI telephone census of counseling agencies, HUD should have known that the great majority of agencies offering pre-purchase counseling used the one-to-one counseling format and felt that this was considerably more effective than group sessions.⁴⁶

b. A family can be adequately prepared to undertake the responsibilities of homeownership by being provided with an hour of information, and that this information will be sufficient to substantially reduce the incidence of defaults and foreclosures.

None. It had been widely acknowledged that one of the causes of defaults and foreclosures in the 235, 237 and 221(d)(2) programs was that families were ill-prepared for their new obligations. Simple logic would suggest that one hour could not alter this situation substantially.⁴⁷

In addition, again based upon the OSTI telephone census, the great majority of agencies that offered pre-purchase counseling services spent several hours with each client.⁴⁸

⁴⁵Ibid. p. 7-8.

⁴⁶OSTI Working Paper on Telephone Census, December, 1973 (unpublished report).

⁴⁷See, for example, "Fifteenth Report by the Committee on Government Operations," op. cit. p. 16-17.

⁴⁸OSTI Working Paper, op. cit.

Assumptions

Evidence

c. HUD-foreclosed properties will be suitable for new 235 and 221(d)(2) mortgagors.

Furthermore, studies on the causes of defaults and foreclosures point to the fact that most people having difficulties with their mortgage payments are in this position for reasons beyond their control. (See Chapter 10 Section 2) In addition, the OSTI study found that the economic character of a particular area was also a contributor to default and foreclosure rates.⁴⁹ Thus, information alone would not appear to be the solution to defaults and foreclosures.

None. HUD-foreclosed properties are frequently in bad repair.⁵⁰ Moreover, the cause of the foreclosure often related to the poor condition of the property or an undesirable location, with falling market values.⁵¹ Unless HUD ensures that the re-sold homes have good values and are in good repair, the new purchasers could end up in foreclosure also. It must be remembered that 235 and 221(d)(2) purchasers have low incomes and, most likely, do not have the resources to deal with costly repairs.

And, a fourth and final aspect of the HIAAP that warrants attention is that the requirement that the HIAAP be administered within the local HUD office undermined the efforts of the scores of private agencies that had managed to offer counseling services to homebuyers. The HUD Guidebook

⁴⁹OSTI Final op. cit. p. 227-232.

⁵⁰See, for example, "Fifteenth Report by the Committee on Government Operations," op. cit. p. 6 and p. 23-24.

⁵¹See, for example, Ibid. p. 5 and 13-17 and OSTI Final p. 233.

specifically relegated counseling agencies to a secondary or nonexistent role within the HIAAP:

The Housing Counselor...may call upon HUD-approved counseling agencies to assist him in providing the necessary information, advice and assistance for homebuyers. HUD-approved counseling agencies shall not participate in this program until their staffs have been thoroughly trained in this program...⁵²

Some HUD field office personnel registered strong disagreement with the reduced role of the counseling agencies and argued that counseling could best be achieved through a liaison between the Housing Counselor and the counseling agency. This view was expressed in an interview with the Region IX Community Services Advisor, Janet Miller.

The HIAAP undermined everything we were trying to do. I wanted to sit down and cry. We wanted to get money for the counseling agencies to do counseling. We simply don't have the in-house capacity to do it.⁵³

And, in a February 25, 1974 memo to the Assistant Regional Administrator for Housing Management, Region IX, Robert E. Boldt, Ms. Miller noted that:

Recent developments indicate a complete lack of support for the former counseling agency approach. In fact, the word counseling has such a negative connotation in Washington that organizational and title changes are in the works to "consumer" terminology. Semantics rather than substance are the order of the day.

⁵²HIAAP Guidebook, op. cit. p. 9.

⁵³Interview, Janet Miller, Community Services Advisor, San Francisco Regional Office, March 22, 1974. (The Community Services Advisor is in charge of consumer oriented activities at the regional level. As mentioned previously, there may also be Community Services Advisors in Area offices and, in such cases, these individuals often perform the Housing Counselor's responsibilities.)

Yet, we in Region IX are still committed to this approach, have exerted substantial efforts in gearing up for it, and have over thirty local agencies struggling to serve potential homebuyers' interests. We have every reason to feel that if well-developed, this will be the most effective way of preparing low-income families for successful homeownership and of reducing default and acquisition rates.⁵⁴

Ms. Miller's conviction that counseling should be performed by private agencies, not HUD, was so firm that she issued a set options to Area/Insuring offices within Region IX, in which she interpreted HUD Guidelines to conform to her own beliefs. (See Exhibit 3)

The story on HUD's pre-purchase counseling efforts ends here. The conclusion that must be reached from the above discussion points to the fact that HUD has not played a strong or consistent role in promoting pre-purchase homeownership counseling. Of all the ways in which HUD might intervene to protect the consumer and to minimize its own risk, counseling appears to be among the most direct and potentially beneficial. Clear explanations that would account for this behavior have not been found.

⁵⁴Memorandum: "Position Paper on Housing Counseling" from Janet Miller, Community Services Advisor to Robert E. Boldt, Assistant Regional Administrator for Housing Management, Region IX, February 25, 1974.

EXHIBIT 3:

II. OPTIONS FOR IMPLEMENTATION

It is our interpretation that the counseling agency approach is not only consistent with, but extends well beyond, the Homeownership Information Program. We also recognize that the circumstances in each office differ and will dictate variations in the program. Therefore, in implementing the HIAPP, it is proposed that field offices choose one of three basic options as best suits the circumstances of that office. OPTION 1 represents the most ideal alternative.

OPTION 1. All 235 and 221(d)(2) buyers participate in a comprehensive counseling program conducted by a HUD-certified counseling agency.

In those offices where it is feasible (e.g., where there exists a sufficient number of counseling agencies, with adequate geographic distribution, with adequate funding resources and the expressed interest), purchasers can be required to participate in the program of a HUD-certified counseling agency. The agency would screen the buyer, provide the scope of services as outlined in 7610.2, make a judgment on his suitability for homeownership, and certify to his eligibility. Under these circumstances, HIAAP sessions would not be necessary. A system involving these elements is currently being implemented in the SAN FRANCISCO Office.

OPTION 2. All 235 and 221(d)(2) buyers participate in an HIAAP session conducted by a HUD-certified counseling agency.

Where it is infeasible to implement OPTION 1, but where counseling agencies exist who are interested in assisting with the program, the counseling agency can be assigned full responsibility for conducting the sessions, monitored by the CSA.

OPTION 3. All 235 and 221(d)(2) buyers participate in an HIAAP session conducted by HUD Counseling, Property Disposition and Single-Family Mortgage Servicing staff.

Where the first two options are infeasible, the office shall implement the program entirely with HUD staff resources. This is being actively done in SACRAMENTO, where no counseling agency presently exists.

A fourth option is mailing the information and requiring a response indicating that the buyer has read the material. This is highly discouraged, but may be necessary in the case of buyers too distant from the office or a participating counseling agency.

CHAPTER 9: DEFAULT: HUD'S INTERNAL PROCEDURES, GUIDELINES FOR MORTGAGEES AND COUNSELING EFFORTS

1. RELATIONSHIP OF DEFAULT TO FORECLOSURE:

According to HUD a mortgagor is considered to be in "default" thirty days after a mortgage payment is missed. He continues in default until his payments have been brought current or until the house is disposed either through sale or foreclosure. A mortgagor is considered "delinquent" anytime a payment is due and not paid -- both during the first thirty days of non payment and anytime thereafter.¹ Sixty days in default means that three payments have not been made and that the first of these payments is ninety days overdue.

During the period of default, mortgagees are supposed to make every effort to assist mortgagors to become current; and mortgagors are supposed to notify mortgagees whenever payment difficulties arise. Yet, in many instances, mortgagees have not provided the HUD-mandated assistance to mortgagors during the default period and many mortgagors have been faulted by mortgagees for their lack of cooperation. The increasing problems between mortgagor and mortgagee points to a significant breakdown in the home finance system. (See Chart 7).

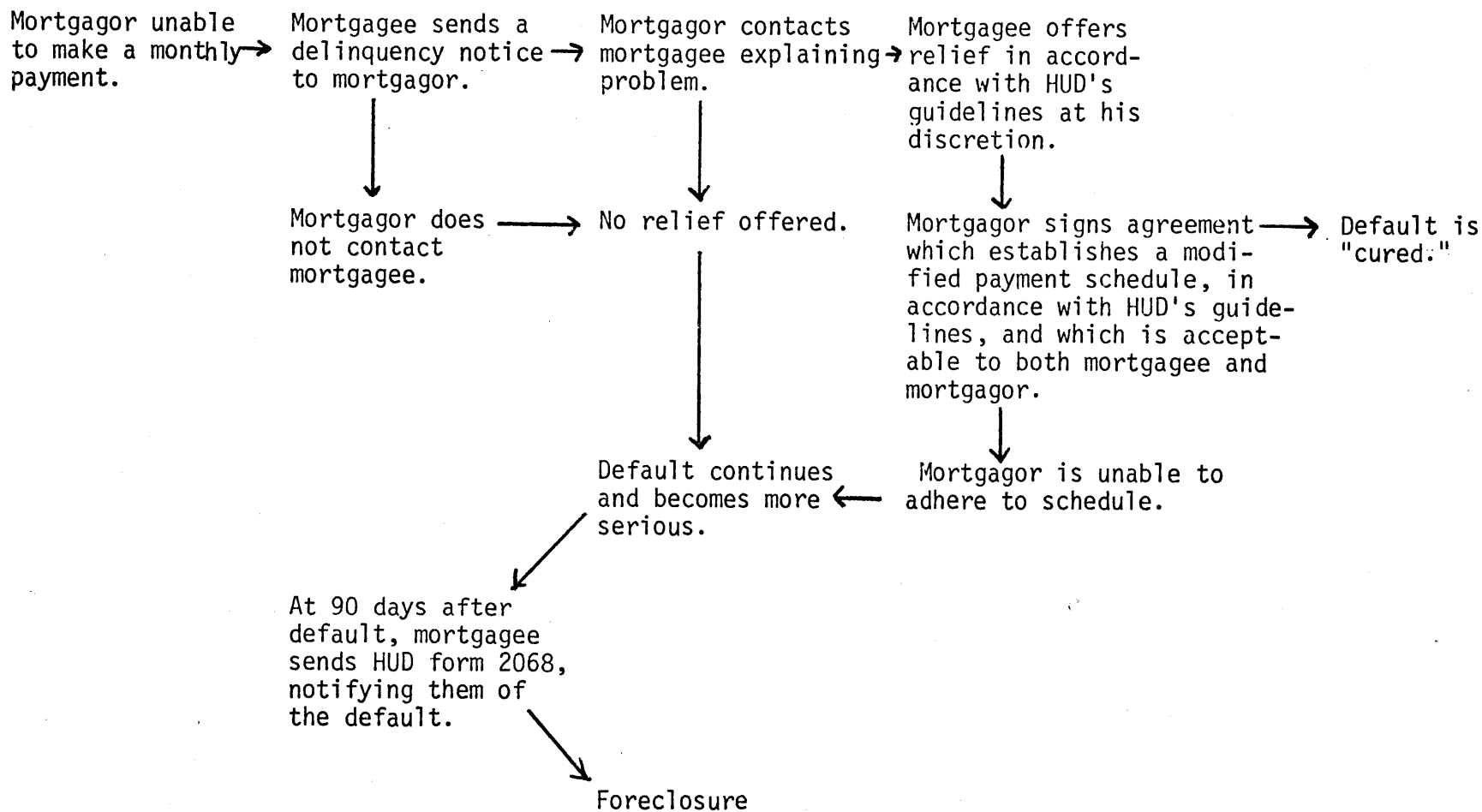
Simply stated, the default situation is critical since, all too often, it leads to foreclosure. It has been estimated that a high percentage of families who are in default will eventually lose their homes. For example, using data from Detroit, Baltas Birkle of the U.S. General Accounting Office estimated in 1971, that at least

¹HUD Handbook 4191.1, op. cit. p. 39.

CHART 7

Model of the Delinquency, Default, Foreclosure

Process: Roles of Key Actors



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75 percent of all homes one to three months in default would be eventually acquired by HUD.² Since Detroit was harder hit by defaults and foreclosures than most other cities, this number may be an exaggeration of the situation nationwide.

Evidence that, at least in the short-run, the relationship between default and foreclosure may be somewhat less severe than 75 percent comes from the OSTI research. Based upon a sample of 145 defaulting 235/237 mortgagors in eleven cities, in various parts of the country, the OSTI researchers found that over a 10 month period slightly less than half the defaulting mortgagors had either lost their homes, (19.3%), or had fallen into more serious default, (28.2%), which seemed to be heading toward foreclosure.³ But however many defaulting families do eventually end up in foreclosure, default is always an intermediate and critical stage in the process.

Unfortunately, the number of people going into default in the 235 program has been climbing steadily, reaching 7.77 percent of the total number of mortgages in force in 1973. And, while there was a slight decrease in the default rates in the 203 and 221 programs in 1973, the trend in recent years has been on the upswing. By the end of 1973, 134,086 FHA

²"Defaults on FHA-Insured Mortgages -- Detroit" (Part 1) op. cit. p. 15.

³OSTI D & D #2 op. cit. p. 49-51. However, it should be added that the OSTI researchers calculated that taking into account some "soft assumptions" a slightly higher percentage than 47.5% would fall into foreclosure -- 53.5% (p. 55).

homeowners were in default -- an increase of 41,000 from just three years earlier -- and with only slightly more mortgages in force during the latter year. (See Table 15).

Before going on to an examination of the default process, the impacts of foreclosure on HUD and the homeowner will be assessed to underscore the importance of giving adequate attention to default.

TABLE 15

Defaults, FHA-Insured Home Mortgages, Selected Years, 1950-1973

	Number of Defaults	No. Insured Mortgages In Force	Percent of Defaults Out of Insurance in Force
1950			
Section 203	9,480	1,119,967	.85%
All home programs*	17,058	1,511,402	1.13
1955			
Section 203	8,866	1,760,905	.50
All home programs*	14,988	2,140,936	.70
1960			
Section 203	22,490	2,697,106	.83
Section 221	835	21,448	3.89
All home programs*	26,850	3,093,034	.87
1965			
Section 203	55,343	3,584,655	1.54
Section 221	4,154	167,003	2.49
All home programs*	64,018	4,090,458	1.57
1970			
Section 203	72,097	4,270,264	1.69
Section 221	15,919	373,239	4.27
Section 235	2,536	129,608	1.96
Section 237	756	1,248	60.58
All home programs*	93,005	5,067,933	1.84
1971			
Section 203	82,858	4,329,935	1.91
Section 221	23,430	450,829	5.20
Section 235	12,300	266,807	4.61
Section 237	127	2,040	6.23
All home programs*	120,818	5,339,974	2.26
1972			
Section 203	91,426	4,248,267	2.15
Section 221	30,491	498,840	6.11
Section 235	23,921	368,313	6.49
Section 237	282	2,733	10.32
All home programs*	148,614	5,396,288	2.75
1973			
Section 203	73,858	4,026,849	1.83
Section 221	26,295	514,390	5.11
Section 235	31,315	403,077	7.77
Section 237	357	3,222	11.08
All home programs*	134,086	5,194,953	2.58

*Totals of "All home programs" include other programs in addition to those listed in the table.

Source: 1973 HUD Statistical Yearbook, p. 185

2. IMPACTS OF FORECLOSURE ON HUD-FHA AND HOMEOWNERS:

a) HUD-FHA:

Whenever an FHA-insured home is foreclosed, HUD becomes the owner of the property. The mortgagee is usually responsible for all the legal aspects of foreclosure and, upon presenting HUD with clear title to the home, and a guarantee that it is vacant, HUD reimburses the mortgagee for the outstanding principal balance of the mortgage, less one-third the amount of foreclosure costs. HUD then becomes responsible for the maintenance and the disposition of the property. Unfortunately, HUD has become the owner of an increasing number of homes.

As evident from Table 16, the percent of foreclosures in all the FHA-insured home programs, but particularly in the 221, 235, and 237 programs, has been rising steadily since 1970. In 1973, a record 63,113 FHA-insured homes were foreclosed -- more than double the number of homes foreclosed only three years earlier.

Emphasizing the seriousness of this situation, Rep. William T. Randall, Chairman of the Legal and Monetary Affairs Subcommittee of the House Committee on Government Operations, reported that:

During the first three months of 1973...HUD had acquired almost as many homes due to foreclosure as in the first twenty years of its history. In May of (1973), HUD acquired 5,624 homes, the largest number of acquisitions in a single month in the entire thirty-nine years in which FHA has been in existence.¹

Moreover, the costs of foreclosure to HUD have been sky-rocketing. Figures from the General Accounting Office revealed that the average

¹Review of FHA Part 1, Hearings. op. cit. p. 32.

TABLE 16

Foreclosures, FHA-Insured Home Mortgages, Selected Years, 1950-1973

	Number of Foreclosures	Percent of Fore-closures Out of Insurance in Force	Cumulative No. Through End of Year	Percent of Total Insured
<u>1950</u>				
Section 203	453	0.05%	6,018	0.30%
All home programs*	2,467	.19	15,351	.58
<u>1955</u>				
Section 203	1,053	.07	10,306	.33
All home programs*	4,585	.23	27,063	.69
<u>1960</u>				
Section 203	5,763	.23	23,879	.51
Section 221	400	3.17	446	2.04
All home programs*	7,914	.28	50,909	.91
<u>1965</u>				
Section 203	37,759	1.11	169,563	2.54
Section 221	3,547	3.05	10,861	6.05
All home programs*	46,033	1.19	226,961	2.91
<u>1970</u>				
Section 203	21,783	.52	316,137	3.78
Section 221	6,710	2.17	36,835	8.44
Section 235	1,171	4.58	1,212	.93
Section 237	23	5.08	25	1.96
All home programs*	31,095	.65	415,841	4.17
<u>1971</u>				
Section 203	25,655	.60	341,792	3.94
Section 221	10,256	2.75	47,091	8.81
Section 235	6,849	5.28	8,061	2.93
Section 237	96	7.69	121	5.58
All home programs*	43,840	.87	459,681	4.37
<u>1972</u>				
Section 203	20,554	.47	362,346	4.07
Section 221	16,184	3.59	63,275	10.36
Section 235	16,637	6.24	24,698	6.26
Section 237	134	6.61	255	8.50
All home programs*	54,453	1.02	514,134	4.69
<u>1973</u>				
Section 203	24,792	.58	387,138	4.29
Section 221	18,025	3.61	81,300	12.33
Section 235	18,931	5.14	43,629	9.65
Section 237	170	6.22	425	11.58
All home programs*	63,113	1.17	577,247	5.15

*Totals of "All home programs" include other programs in addition to those listed in the table

cost of disposing of an acquired home ranged from \$4,318 for a 235 home to \$7,767 for a 223(e) homes. (See Table 17)

In Detroit, the losses have been even more substantial. In some sections of that city, the average loss per property has been close to \$10,000.²

There are several explanations which account for the increase in costs. First, since many HUD inspections on homes insured after 1968 were inadequately performed, some of HUD's post-foreclosure repair costs have stemmed from this early negligence.³ Second, since many homes insured after 1968, particularly homes insured under Sections 221(d)(2) and 223(e) were in declining neighborhoods, the high incidence of vandalism in these areas has boosted HUD's repair costs.⁴ Third, since many homes that had been "rehabilitated" prior to the original sale, had received only cosmetic repairs, but had nevertheless commanded high prices, HUD has had to sell properties for considerably less than its payment in the insurance settlement.⁵ Along with this, the market for many of the homes that flooded the post-1968 real estate market has diminished, further frustrating the ease of HUD's sale.⁶

²"Defaults on FHA-Insured Mortgages"- Detroit"(Part 1) op. cit. p. 8.

³See Chapter 8 Section 1a and Fifteenth Report by the Committee on Government Operations,"op. cit. p. 22.

⁴Ibid. p. 5-6.

⁵Ibid. p. 13-14.

⁶Review of FHA, Part 2 op. cit. p. 142.

TABLE 17

Average Losses* to HUD Per FHA-Insured Acquired
Home Property - Fiscal Years 1972-1973

	Average Losses: FY 1972	Average Losses: FY 1973
235	\$3,876	\$4,318
203(b)	5,004	5,659
221(d)(2)	6,031	7,162
223(e)	7,367	7,767

Source: Review of Federal Housing Administration (Part I)
p. 29

And, since many homeowners were ill-prepared for homeownership some of HUD's repair costs can be attributed to mortgagor neglect or financial inability to maintain the property adequately.⁷

HUD reimburses mortgagees from one of FHA's four insurance funds, depending upon the section of the National Housing Act through which the loan is insured. Section 203 is covered by the Mutual Mortgage Insurance Fund (MMIF), Section 221 is covered by the General Insurance Fund (GIF), and Sections 235 and 223 are covered by the Special Risk Insurance Fund (SRIF). (See Appendix 9-1 for a description of each insurance fund.)

As of June 30, 1973, the reserves in the MMIF amounted to about \$1.72 billion and, based on FHA's estimate, were in excess of reserve requirements by about \$338 million.⁸ However, both the General and the Special Risk Insurance Funds had, as of that date, reserve deficits which totalled \$2.34 billion. (See Table 18)

The net reserve deficit of all funds combined is close to \$2 billion. However, the excesses of the MMIF (and the fourth fund, the Cooperative Management Housing Insurance Fund) cannot be used to reduce the deficits of the other funds. "Each fund is an individual financial entity and, by law, the excess reserves in one fund cannot be used to cover a reserve deficiency in another fund."⁹

⁷"Fifteenth Report by the Committee on Government Operations," op. cit. p. 16-17.

⁸Review of FHA, Part 2 op. cit. p. 150.

⁹Review of FHA, Part 1 op. cit. p. 3.

TABLE 18

Reserves and Reserve Requirements in the Insurance
Funds of FHA as of June 30, 1973
 (in thousands of dollars)

	Insurance Reserves	Estimated Reserve Requirements	Excess of Insurance Reserves Over Estimated Reserve Requirements	Outstanding Balance Insurance In Force (in millions)
Mutual Mortgage Insurance Fund - 203(b)	\$1,718,973	\$1,330,777	\$ 388,196	\$50,385
General Insurance Fund - 221(d)(2)	- 315,641	441,690	- 757,331	NA
Other Programs	151,760	596,673	- 444,913	NA
TOTAL	- 163,881	1,038,363	-1,202,244	22,796
Special Risk Insurance Fund 223(e)	- 134,060	59,931	- 193,991	1,323
235	- 186,304	321,450	- 507,754	6,805
237	- 3,026	2,741	- 5,767	41
Other Programs	- 30,308	401,606	- 431,914	6,024
TOTAL	- 353,698	785,728	-1,139,426	14,193
Cooperative Management Housing Insurance Fund	22,839	11,096	11,743	780
TOTAL ALL FUNDS	\$1,224,233	\$3,165,964	-\$1,941,731	\$88,155

Source: Review of FHA, Part 2 , p. 167

In order to make up deficits, the Secretary of HUD may borrow funds from the Treasury.¹⁰ In addition, since Congress never intended the SRIF to be actuarially sound it "provided specific authority for HUD to seek appropriations to cover fund deficiencies."¹¹ As of June 30, 1973 HUD had requested an appropriation of \$92 million to cover realized losses. And, to cover the deficits in the GIF a total of \$831 million had been borrowed from the Treasury as of June 30, 1973.¹²

Clearly, the financial consequences of foreclosure indicate that it is not in HUD's best interest. In addition to the costs, as described above, there are also several other negative aspects of foreclosure, from HUD's point of view. First, the paperwork and mechanics of foreclosing a home are time-consuming and unwieldy. Second, the process of boarding up, rehabilitating and selling a property is not HUD's forte. HUD has never been, nor meant to be, directly involved with the management or sale of real estate. And, third, with HUD's mandate to help achieve the national goal of "a decent home...for every American family" having to repossess a home and thereby evict a family forces HUD to take at least one step backward in achieving this goal.

Yet, in spite of these strong disincentives to foreclose, HUD has not played a major role in deterring foreclosures, during default, as discussed in subsequent sections.

¹⁰Ibid. p. 34.

¹¹ Review of FHA, Part 2 op. cit. p. 152.

¹²Ibid. p. 151-152.

b. Homeowners:

While HUD stands a great deal to lose in foreclosure, by far the greatest loss is to the ex-homeowner. Foreshadowing the present situation, Secretary Weaver declared it would be a "cruel hoax" if large number of low-income families were frustrated in achieving or maintaining homeownership, when offered to them by the government. Due to the problems of contacting families whose homes have been foreclosed, no data exist describing the explicit feelings of these families. But it is reasonable to infer that they feel bitterly disappointed.

From a practical perspective, the family loses at least some or all of its downpayment and whatever equity it has managed to build up. Foreclosure also seriously hurts a family's credit record making it difficult, if not impossible, for them to be approved for a loan in the future. And, last, once a family has lost its home the issue of where to move next must be confronted.

Thus, to both HUD and the homeowner foreclosure is an anathema. Yet, HUD has not moved aggressively to prevent foreclosure. Similar to the pre-purchase situation HUD has, in the default situation, a variety of opportunities to play a strong and significant pro-homeowner role and, in turn, to reduce its own risk. The following three sections will examine HUD's internal guidelines and activities related to default; HUD's guidelines for mortgagees who are dealing with defaulting mortgagors; and HUD's default counseling program.

3. HUD'S INTERNAL PROCEDURES DURING DEFAULT:

Mortgagees are required by HUD to fill out a default notice (See Exhibit 4) when the mortgagor is sixty days in default or, 3 payments overdue. However, upon receiving the 2068, HUD field office personnel are required only to file it and to stamp and return one copy to the mortgagee. Aside from using this information to prepare quarterly reports on defaults for the Research and Statistics Office in HUD Central Office, the 2068's have no further required use.¹

A recent report by the Comptroller General of the U. S. confirmed that most field offices do only what Central HUD requires. They neither use the 2068's to monitor mortgagees' servicing nor to intervene on behalf of mortgagors. But, in spite of HUD's minimal requirements, two of the eight field offices which were visited by the research team were actually using the information in FHA form 2068 to monitor mortgagees' servicing activities.²

And, going another step beyond HUD's requirements, these two offices chose to make direct contacts with defaulting mortgagors. These contacts were made in an attempt to cure the defaults or, when necessary, they served to alert the mortgagor that foreclosure had started.³

But, in spite of these consumer-oriented innovations, an untouched, out-of-date 2068 field office card file appears to be more common.⁴

¹ Report of the Task Force on Improving the Operation of Federally Insured or Financed Housing Programs, Volume 1, "Single Family Housing", National Center for Housing Management Inc. Washington, D.C. 1974, p. 211.

² Non Supervised Mortgagee Report, op. cit. p. 39.

³ Ibid. p. 39.

⁴ In fairness to HUD field offices, it should be added that one reason for an outdated 2068 file is due to mortgagee neglect. The OSTI D & D #2 report stated that "...not all mortgagees were conscientious in submitting 2068 reports. op. cit. p. 47.

EXHIBIT 4:

ADMINISTRATION OF
INSURED HOME MORTGAGES

4191.1

APPENDIX 5

FHA FORM NO. 2068 Rev. 4/66

U. S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
FEDERAL HOUSING ADMINISTRATION

HOME MORTGAGE DEFAULT NOTICE

THIS NOTICE MAY BE SUBMITTED BY EITHER THE MORTGAGEE OR ITS SERVICER, BUT NOT BY BOTH. Detach the first 2 copies and mail to FHA. Retain the third copy for your files. We recommend that the last copy be mailed to the Mortgagor at the same time; however, its use is optional.

- | | |
|---|--|
| <ol style="list-style-type: none"> 1. Send report to the FHA office having jurisdiction on or before the date on which three installments are in default. When an installment due Sept. 1 is not paid by Oct. 1, the mortgage is in default on October 1, and if payment is not made in the meantime, a report is required by Dec. 1. 2. After the first report is filed, reports are not required unless: <ol style="list-style-type: none"> a. The account is reinstated. b. Six installments are delinquent in which event a report must be submitted immediately and | <ol style="list-style-type: none"> c. Foreclosure becomes imminent regardless of the number of installments delinquent. d. Foreclosure is started. e. Foreclosure is completed. <ol style="list-style-type: none"> 3. No report is required between the start of foreclosure and the report of completion unless in the meantime the default is cured or the foreclosure is suspended. |
|---|--|

FHA FORM NO. 2068 Rev. 4/66

Form Approved Budget Bureau No. 63-R0734

FHA Case No.		U. S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT FEDERAL HOUSING ADMINISTRATION		Date of this report
HOME MORTGAGE DEFAULT NOTICE				
Section of National Housing Act	Mortgagee's Reference No.	Number of payments past due		
Mortgagors (Last Name First)		<input type="checkbox"/> Mortgage is reinstated and current.		
Property Address		<input type="checkbox"/> Foreclosure is imminent. <input type="checkbox"/> Foreclosure is started.		
City State		<input type="checkbox"/> Foreclosure is completed		
MORTGAGEE'S NAME, ADDRESS AND ZIP CODE		FIELD OFFICE INSTRUCTION PLACE OFFICE RECEIVING STAMP ON REVERSE AND RETURN TO MORTGAGEE IN WINDOW ENVELOPE.		

4/74

For example, this writer had the opportunity to observe such a file in the Philadelphia HUD Area Office in early, 1973.⁵ In addition, interviews with HUD personnel in several other cities disclosed a widespread lack of concern for the 2068's.⁶

In contrast to HUD's standard regulations concerning the 2068 forms, in those cities in which a Concentrated Delinquency and Default Counseling Program (D+D Program; See Chapter 9 Section 6) had been set up, the 2068's were required to be used by field office staff to refer defaulting mortgagors to counseling agencies. But since the D+D program was created specifically to assist 235 mortgagors in default, most cities participating in the D+D program followed the normal procedure for handling the 2068 notices for non-235 mortgagors -- they simply filed them.⁷

⁵Field visit to Philadelphia HUD Area Office, Office of James Rolen, Supervisor of Single Family Mortgage Servicing, January, 1973.

⁶For example, interviews with Katie Washington, Little Rock, Arkansas, op. cit. Kenneth Anderson, Chief Single Family Servicing, HUD Area Office, San Francisco, California, and Rose Strickland, Phoenix, Arizona. op. cit.

⁷For example, interviews with, William Bonner, Shreveport, Louisiana, op. cit. Lucille Henderson, Kansas City, Missouri, op. cit. and John Fortson, Community Services Advisor, HUD Area Office, Los Angeles, California.

However, in at least one city, HUD personnel were using the D+D program idea as a vehicle for making counseling services available to non-235 mortgagors who were also in default. In Louisville, in late 1973, Thomas Clendenon, the HUD Housing Counselor, began his own default counseling program. Rather than simply filing the 2068's that came into the office, he sent out a letter to all defaulting mortgagors, offering them the option of discussing their problem with a HUD representative. While admitting that when the 2068 came in, he didn't automatically send out the letter, and that this effort depended on his workload, he reported enthusiastically that direct HUD involvement with defaulting mortgagors could be extremely successful. He stated that:

When I go to a defaulting family's home with a man from the mortgage company, we never get invited into the house. But I do when I go alone...people trust me while they don't trust the mortgage company. The only people who don't want to see me are those who have made promises to me that they haven't kept.⁸

In a report on his efforts to the Director of the Housing Management Division, Dominic Schuler, Mr. Clendenon concluded that:

I am elated with the results of this project at this date. The "letter" is, if nothing else, working as a collection tool. It is not a permanent solution to a very complex problem. I am also very happy with the results of my counseling. I am willing to bet we can save three of the five mortgages with continued effort.⁹

⁸Interview, Thomas Clendenon, op. cit.

⁹Report by Thomas Clendenon, Housing Counselor, to Dominic Schuler, Housing Management Division. "November, 1973 Report on the Counseling of Defaulted Mortgagors in the Louisville Area." December 6, 1973.

Thus, unlike the problems in HUD's pre-purchase activities, HUD's internal procedures related to mortgagors in default are problematic due to faulty regulations, rather than because of deficiencies in administration. The ordinary HUD way of doing business around default was reflected in the passive role required of field office staff for dealing with the 2068 default notices. The form, which could be used by an aggressive HUD as a warning and regulatory device -- to monitor mortgagee servicing activities or to intervene on behalf of the defaulting mortgagor to offer counseling -- was, instead, used as a filing and information piece. For mortgagees to simply let HUD know the problem was deemed sufficient. But the fact that a few field offices have departed from the regulations to directly intervene on behalf of the consumer is noteworthy.

If HUD regulations were to change to require field staff intervention upon receipt of the 2068's, it would also be desirable for HUD to require that mortgagees file the forms much earlier than 60 days in default. By the time a mortgagor has missed 3 payments, his financial troubles are serious and becoming current on his payments becomes more difficult.

Unlike HUD's espoused role vis a vis the consumer at the point the home is purchased, HUD does not even define a theoretically active role for itself at the point of its maximum liability and at a critical point for the consumer -- default. Instead, HUD has relied upon the activities of mortgagees and, to a lesser extent, on private counseling agencies, to assist mortgagors in becoming current. Thus, even in HUD's "final hour" to reduce its own risk and protect its own interests, it has chosen to play a passive role, refusing to acknowledge the extent of its own liability.

4. HUD'S GUIDELINES FOR MORTGAGEES WHO ARE SERVICING MORTGAGES IN DEFAULT:

The mortgagee is the key actor involved in mortgagor default. Whereas HUD's guidelines on its own role in default are almost non-existent, HUD's servicing guidelines for mortgagees are more detailed.¹

HUD guidelines carefully explain that foreclosure is supposed to be viewed by mortgagees as a last resort -- to be initiated only after all other efforts have failed:

Foreclosure of a mortgage shall be undertaken only after the mortgagee or servicer has assured itself that the case has been handled in full accordance with the servicing practices outlined herein.²

And, further,

In cases where the default is caused by a hardship beyond the mortgagor's control, this decision (to acquire the property) shall be made only after all of the relief measures...have been considered, and the mortgagee has determined that none of them is likely to be effective in making it possible for the mortgagor to retain the property. Once the decision has been made, however, such action shall not be delayed.³

The relief measures referred to above were authorized in the Housing Act of 1964. Section 104(a) of that Act states that:

With respect to any mortgage covering a one -, two -, three -, or four -, family residence insured under this Act, if the Secretary finds, after notice of default, that the default was due to circumstances beyond the control of the mortgagor, he may, upon such terms and conditions as he may prescribe, (1) approve the request of the mortgagee for an extension of the time for the curing of the default and of the time for commencing foreclosure proceedings or for otherwise acquiring title to the mortgaged property to such time as the Secretary may determine is necessary and desirable to

¹Yet, it must be recalled from Chapter 6, Section 3a that HUD's guidelines for mortgage servicers are, by no means, as explicit as they could be. See Appendix 9-2 for a brief look at the Phoenix Insuring Offices' attempts to initiate its own better defined set of servicing standards.

²HUD Guidebook 4191.1 op. cit. p. 44.

³Ibid. p. 55.

enable the mortgagor to complete the mortgage payments, including an extension of time beyond the stated maturity of the mortgage and in the event of a subsequent foreclosure or acquisition of the property by other means the Secretary is authorized to include in the debentures an amount equal to any unpaid mortgage interest, or (2) approve a modification of the terms of the mortgage for the purpose of changing the amortization provisions by recasting, over the remaining term of the mortgage or over such longer period as may be approved by the Secretary...⁴ (underline added)

Thus, Congress was explicit about the type of relief, or assistance, that mortgagees could offer mortgagors who were in default for reasons beyond their control. Furthermore, the relief measures provided mortgagees with a guarantee that they would be fully protected against any loss of interest, even if the mortgage should subsequently foreclose. Following the Congressional mandate, HUD issued a set of detailed relief measures which are available to defaulting mortgagors.

a. Special Forbearance:

Special forbearance is a written agreement worked out between mortgagee and mortgagor at the suggestion of the mortgagee and generally does not require prior approval by HUD. However, while the offering of relief is only a voluntary gesture on the part of the mortgagee, HUD expects mortgagees "to make a concerted effort to avoid the foreclosure or assignment of HUD insured mortgages and to utilize acceptable methods of forbearance relief, wherever feasible."⁵ Special forbearance consists of two basic components:

⁴Housing Act of 1964. Public Law 88-560, approved September 2, 1964, Stat. 769 Section 104(a) Section 204(a) National Housing Act.

⁵HUD Guidebook 4191.1 op. cit. p. 47.

- (1) Reduction or suspension of regular mortgage payments for a period not exceeding 18 months; (unless a longer period is approved by HUD) and,
- (2) Resumption of regular payments no more than 18 months after the date of the special forbearance agreement (unless a longer period is approved by HUD.)⁶

In addition, the special forbearance agreement allows for the maturity date of the mortgage to be extended by the period of reduced or suspended payments, (up to 18 months, unless a longer period has been approved by HUD). The agreement must also include the specific dates on which the additional payments are due to repay the reduced or suspended payments.⁷

While the HUD guidelines do not include an example, and only supply an unfilled-in "Sample Forbearance Agreement" (See Exhibit 5) the following example, which follows HUD's guidelines, demonstrates the usefulness and potential benefit of this relief measure when it is used to suspend payments for the maximum period allowed. Reduced payments or suspended payments for a shorter period would also yield substantial, although not as dramatic, benefits.

Special Forbearance Example:

Original Amount of Mortgage	\$20,000
Interest Rate	7 1/2%
Original Term	20 years
Date of First Payment	October 1, 1972
Original Maturity Date	September 1, 1992
Monthly Payments	\$161.12

⁶Ibid. p. 48.

⁷Ibid. p. 48.

EXHIBIT 5:

4191.1

ADMINISTRATION OF
INSURED HOME MORTGAGES

APPENDIX 8

SAMPLE FORBEARANCE AGREEMENT

Mr. and Mrs. John Doe
129 S. W. Avenue
Topeka, Kansas

Re: Forbearance Agreement
FHA Case No. _____

Dear Mr. and Mrs. Doe:

The indebtedness in the captioned case is in default and, in consideration of the (name of mortgagee) extending forbearance for a period of time, it is necessary that you indicate, by signing this letter agreement, your acceptance of the following conditions:

Beginning on the _____ day of _____, 19____, you will remit a monthly payment of \$ _____* for a period of _____** months. On _____, it is agreed that you will resume the regular monthly payments required under your note and security instrument. In addition, you shall add _____ Dollars (\$ _____) each month to such regular monthly payment for the period of _____ months. Such additional payment shall commence on _____ .*** The debt, if not sooner paid, shall be due and payable on the first day of _____, 19____.**** All of the provisions of the note and security instrument, except as herein provided, shall remain in full force and effect. Upon the breach of any provision of this agreement, the (name of mortgagee) may terminate this agreement, and, at the option of the (name of mortgagee), institute foreclosure proceedings according to the terms of the note and security instrument without regard to this instrument.

Please execute the original and first copy of this agreement and return them immediately.

Very truly yours,
(name of mortgagee)

By: _____

Accepted and agreed _____ day of _____, 19____:

John Doe

Mary Doe

*Less than regular payment
**18 months or less
***This date must be simultaneous with or later than date for resumption of regular payments
****18 months or less beyond present maturity

Suspended Payments

November 1, 1974 - April 30, 1976

Total Amount Suspended = \$2,900.16

(161.12 X 18 = 2900.12)

No. years remaining until maturity date as of April 30, 1976 =

16 yrs., 5 mos. (197 mos.)

Alternative (1)

Divide amount due
(2900.6) by the
total no. of payments
until end of maturity and
add this amount to regular
monthly payments.

Alternative (2)

Extend the original maturity date by
18 months, thereby making up the lost
payments. New maturity would then be
March 1, 1994. Monthly payments would
remain \$161.12.

$\frac{2900.16}{197} = 14.62$ = Additional payment
+161.12 -- Regular monthly payment
\$175.74 -- New monthly payment. Same maturity date.

In addition to being an enormous aid to mortgagors, it must be emphasized that forbearance should also be attractive to mortgagees.

When the mortgagee extends forbearance...it will receive, as part of its insurance settlement, unpaid mortgage interest, including all amounts accrued prior to the execution of the forbearance agreement...⁸

Thus, if the mortgage ends in foreclosure, the mortgagee becomes fully protected against any loss of interest, once an agreement has been executed.

b. Recasting:

Recasting is another important HUD-approved relief measure. As mentioned above, recasting may be done when a mortgagor is in default due to a reason

⁸Ibid. p. 48.

beyond his control and, similar to special forbearance, may be processed without prior approval from HUD. Recasting may accomplish one or both of the following:

(1) Increase the unpaid principal balance of the mortgage to include all the sums due and payable except late charges,

(2) Extend the term of the mortgage for not more than 10 years.⁹

(See Exhibit 6)

Exhibit 7, from HUD Guidebook 4191.1, combines both (1) and (2) above.

While the recasting example in Exhibit 7 assumes that the default occurred after 10 years and, by extending the term another 10 years, resulted in decreased payments, the following example assumes that the default occurred in the second year of the loan and does not assume an increase in term.

Recasting Example Number 2

Original Amount of Mortgage	\$15,000.00
Interest Rate	8 1/2%
Original Term	30 years
Date of First Payment	January 1, 1973
Original Maturity Date	December 1, 2003
Monthly Payments	\$ 115.34
Period of Default	February 1, 1974 -- June 1, 1974 (5 paymen
Total Amout Past Due	\$ 576.70
Approximate Interest Amount Past Due	\$ 531.70
Approximate Principal Amount Paid Between January 1, 1973 and February 1, 1974	\$ 115.00
Principal Amount Owed	\$14,885.00
+ Interest Past Due	\$ 532.00
New Prinicipal Amount	<u>\$15,417.00</u>

Approximate New Monthly Payment as of July 1, 1974 = \$120.00

(\$120.00 is the approximate monthly amount needed to amortize the new principal amount at 8 1/2% interest over 28 1/2 years.)

⁹ HUD Guidebook 4191.1 op. cit. p. 50.

EXHIBIT 6:

ADMINISTRATION OF
INSURED HOME MORTGAGES

4191.1

APPENDIX 9

SAMPLE RECASTING AGREEMENT

FHA Case # _____

This Agreement, made this _____ day of _____, 19____, between _____, hereinafter referred to as Lender, and _____, hereinafter referred to as the Borrowers, and _____, as Trustee (if applicable);

WITNESSETH:

Whereas the Borrowers are now indebted to the Lender in the sum of Dollars (\$ _____) (hereinafter called "new principal amount"), consisting of Dollars (\$ _____) unpaid principal, and _____ Dollars (\$ _____) unpaid installments of ground rents, hazard insurance premiums, taxes, assessments, and mortgage insurance premiums, the payment of which is secured by a note and security instrument owned and held by the Lender, dated _____, 19____, and recorded in the office for the recording of deeds in _____ County and State of _____, in book _____ of mortgages, page _____, and

Whereas the parties mutually desire to modify the terms of payment of said indebtedness by changing the amount of monthly payments required on said note and security instrument;

NOW, THEREFORE, in consideration of the covenants hereinafter contained, it is mutually agreed as follows:

The Borrowers agree to pay the "new principal amount" with interest at the rate specified in said note on the unpaid balance in monthly installments of _____ Dollars (\$ _____) commencing on the first day of _____ 19____, and on the first day of each month thereafter until the "new principal amount" and interest thereon are fully paid, except that the final payment of the "new principal amount" and interest, if not sooner paid, shall be due and payable on the first day of _____, 19____.*

It is mutually agreed that said security instrument shall continue a first lien upon the premises and that neither the obligation evidencing the aforesaid indebtedness nor the security instrument securing the same shall in any way be prejudiced by this agreement, but said obligation and security instrument and all the covenants and agreements thereof and the rights of the parties thereunder shall remain in full force and effect except as herein expressly modified.

IN WITNESS WHEREOF, the parties have signed, sealed, and delivered this agreement on the date above written.

Lender (SEAL)

Borrower (SEAL)

By

Borrower

DEEDS OF TRUST

(If the security instrument is a deed of trust and it is necessary that the Trustee execute recasting agreements, the following acknowledgment shall be signed by the Trustee.)

THE TRUSTEE has executed this instrument to acknowledge his (its) assent thereto and agrees to continue to act in such capacity under the terms as modified herein.

TRUSTEE:

*This date cannot exceed by more than 10 years the maturity date of the original note.

(Add acknowledgment, if required)

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APPENDIX 10

The first monthly installment based on the above figure will be due November 1, 1973, and the final payment to principal and interest will be due March 1, 2003 (Original Maturity Date plus 10 years).

New Monthly Payment Based on New Maturity Date and "New Original Principal Balance"

To amortize \$13,070.75, the number of monthly payments in the new term must first be computed. To the original term of 360 months is added 120 months (the extension period of 10 years) for a total of 480 months. From the total of 480 months, subtract 121 months (the total number of payments due prior to 11-1-73) for a remaining term of 359 months or 29 years and 11 months.

The new payment to principal and interest is reached by multiplying the new balance by the monthly installment per \$1,000 for 29 years and 11 months (\$13,070.75 x \$5.53 + \$1,000 = \$72.30). The monthly installment per \$1,000 may be found under "Amortization Tables" in FHA Form 2025. The new monthly installment will be:

Principal and Interest	\$72.30
MIP	5.26 (Based on Original Amortization Schedule)
Taxes	14.58
Insurance	5.83
	<u>\$97.97</u>

Based upon the above calculations, it is clear that recasting can be an extremely useful tool in helping a defaulting mortgagor renew his payments with "a clean slate," and without a substantial increase in his original monthly payments. Psychologically, the sense of being given another chance could be of considerable benefit to a mortgagor who had been unable to get out of a serious default.

But, clearly, there could also be some negative side effects of the leniency provided by special forbearance and recasting. Most obvious and drastic is the possibility that some families might go through the 18 month period without having to pay anything and then simply abandon the property. However, there are also several deterrants to this type of behavior. First, the family would lose its home -- an extremely undesirable situation to most people. Second, the family would lose whatever equity it had built up. And, third, the foreclosure would be a serious problem to the family in future credit transactions. Thus, the drawbacks to simply leaving after the payment suspension period are substantial and would probably deter most people from such actions.

TABLE 19

Status of FHA-Insured, FNMA-Owned Mortgages - January 1, 1973

<u>FHA Section</u>	(1)	(2)		(3)	(4)	(5)	(6)	
	Total Portfolio No.	Special Forbearance No.	(% of 5)	Delinquent 2 Months No.	Delinquent 3 Months No.	Total Delinquent 2 + 3 Months (3)+(4) No.	*Total Delinquent No.	(% of 1)
203	543,898	306	2.8	7,278	3,346	10,624	41,397	7.7
221	135,192	237	4.6	3,327	1,841	5,168	14,698	11.2
235	167,820	324	3.2	6,539	3,511	10,050	26,305	16.1
All Other FHA	51,604	11	1.5	487	246	733	2,898	5.6
TOTAL	898,514	878	3.3	17,631	8,944	26,575	85,298	9.4

*This includes loans 1 month, 2 months, and 3 months past due. One month delinquencies are not presented in this table.

Source: Federal National Mortgage Association, Delinquency Reporting System; Monthly Summary of Delinquent Mortgages, Run Date, March 2, 1973.

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5. USE OF RELIEF MEASURES BY MORTGAGEES:

In spite of the apparent usefulness of special forbearance and recasting agreements, they have been used only infrequently. FNMA provides the only aggregated data on the frequency of use of special forbearance. HUD does not compile any data on the use of its prescribed relief measures.

As shown in Table 19, special forbearance is used for only a small percentage of delinquent FHA-insured loans owned by FNMA. Out of a total 26,575 loans that might be considered eligible for special forbearance -- two or more months delinquent -- only 878, or 3.3% were receiving special forbearance.

Interviews with mortgagees confirmed the infrequent use of special forbearance and recasting. The following comments sum up the mortgagee attitude on this point.

We don't give formal forbearance. About 10 percent of our loans are receiving informal forbearance. That is, no written agreement. Formal forbearance is very rare. There's practically no recasting.¹

The maximum we allow is six months to repay...We don't allow a suspension of payments unless the mortgagor is in the military...we don't do recasting now.²

Recasting? I had to find out how to do it. I called the mortgage bankers in the area and they didn't know what I was talking about. I've done about seven recastings in my career -- never lost one -- other mortgage companies have now called me for information on how to do it.³

¹Interview, Donald A. Luff, op. cit.

²Interview Bill Salyer, op. cit.

³Interview Harold Dickson, op. cit.

We may have had one or two forbearance agreements -- that is, reducing payments -- over the years. We're very lenient about foreclosure. We don't want to foreclose. We'll carry loans that are two-four months delinquent...Recasting is very seldom used -- like forbearance.⁴

We're reluctant to give forbearance...We're reluctant to recast. We try to work with mortgagors and bring the loan current. It's an informal procedure; we feel sure that our servicers do about the same. Rarely are we asked by a servicer for forbearance. Maybe one time out of five-hundred defaults.⁵

Off the record, I think you have a point about mortgage companies not doing the servicing they should. The philosophy has been Bang 'em in the head -- get the money from the government. Years ago our company was like that. Now we're using more of the conciliation approach.⁶

Comments by HUD Area and Insuring Office personnel echoed those of the mortgagees. For example, Rose Strickland observed:

Forbearance? Mortgagees don't do it -- or recasting. Mortgagees don't like to hear the word forbearance -- it makes them shiver and quiver.⁷

Kenneth Anderson, Chief of Single Family Servicing, summed up his experience with mortgagees on a semi-optimistic note.

By and large, mortgagees are doing a better job now than twenty-four months ago. For the past two years I've been talking forbearance and recasting all the time. Two years ago none of the mortgagees knew about these things...Recasting is simple. The Bank of America, will use it if it's suggested to them...Lomas and Nettleton have also improved over the last six or seven months. They hadn't been doing any servicing at all. They were foreclosing without even communicating with the mortgagor. But there is still a great variation in servicing practices -- still alot of lip service and no action.⁸

⁴Interview, P.P. Flynn, Assistant Vice President for Servicing, Provident Institution for Savings, Boston, Massachusetts, January 28, 1974.

⁵Interview, Vera Iannello, Vice President, Servicing, Northeast Federal Savings and Loan Association, Watertown, Massachusetts, February 1, 1974.

⁶Interview, Stan Goodrow, J.I. Kislak Mortgage Company, Miami, Florida, November 6, 1974 (telephone).

⁷Interview, Rose Strickland, op. cit. Also, interview, Janet Miller, op. cit.

⁸Interview, Kenneth Anderson, op. cit.

Similarly, personnel of HUD-certified counseling agencies that have attempted to assist defaulting mortgagors have found resistance on the part of mortgagees to use the relief measures. For example, Barbara Southwick, a Housing Counselor for the Spokane Community Action Council complained that:

Mortgagees simply refuse to follow HUD's relief measures. They've never heard of forbearance or recasting. I keep showing them the guidebook but they pay no attention. I can't even get our FHA Insuring Office to stand behind their own guidelines. If they would, I think the mortgagees would cooperate. I think I could really help alot of these families to become current if only the mortgagees would do what they're supposed to.⁹

Further, OSTI, in its study of the HUD Concentrated Default Counseling Program, reported that:

Another indication that mortgagees retained the upper hand in restricting the use of relief measures was that agencies tended to request the kinds of mortgage relief which fell within the accepted limits set by mortgagees. Formal forbearance agreements were rarely used because mortgagees were reluctant to use them. And only one agency counselor mentioned making an effort to get mortgagees to recast some of her clients' mortgages; most of the others never mentioned recasting at all, and a sixth had never heard of it.¹⁰

The type of relief, alluded to above, that is acceptable to most mortgagees is known as "informal forbearance" or a repayment schedule. A typical repayment schedule would work as follows: Suppose a mortgagor had missed three payments of two-hundred dollars each -- mortgagee and mortgagor would work out an agreement whereby the mortgagor would pay anywhere between a payment and a quarter to two full payments per month until the six-hundred dollars were repaid. This would mean required

⁹Interview, Barbara Southwick, Housing Counselor, Spokane Community Action Council, Spokane, Washington, December, 1972.

¹⁰OSTI D+D #2 op. cit. p. 43-44.

monthly payments of between two-hundred - fifty dollars and four-hundred dollars, instead of the normal two-hundred dollars.¹¹ This is a very different type of arrangement from HUD's special forbearance and recasting. For the mortgagor trying to recover from a default, it is reasonable to assume that this type of repayment schedule could put an enormous strain on a family's budget.

Indeed, it would be interesting to know how many foreclosures have resulted from a second default following the negotiation of a repayment schedule.¹²

While forbearance and recasting are, as discussed above, only rare occurrences, they have often publicly been touted as the best approach both for the mortgagor and HUD.

¹¹Information on repayment schedules were gathered in many interviews. For example: Val Garcia, Mortgage Servicing Specialist, HUD Area Office, Los Angeles, California, March, 1974; Arnold Schultz, Origination Officer, Home Owners Federal Savings and Loan Association, Boston, Massachusetts January 28, 1974; Stuart Blanton, op. cit.; Stan Goodrow, op. cit.; and Thomas Wilmore, Loan Officer, Cambridge Savings Bank, Cambridge, Massachusetts, January, 1974.

¹²This writer observed a repayment schedule being set up by the Association for Better Housing (now called the Association for Better Living) in Boston, the only HUD-Certified Counseling Agency in that city. The housing counselor developed a budget, based on the maximum that the family could pay, and then telephoned the mortgagee, to read him the agreement, thereby verbally binding the mortgagor. The payment schedule in question required the mortgagor to make a payment and a half per month, with the half payment due on the fifteenth of the month. While these comments are clearly subjective, this writer vividly recalls the fear on the mortgagor's face as the counselor read off the schedule to the mortgagee.

In the early 1960's, during a period of rising defaults and foreclosures in the FHA and VA programs, Sen. Tower questioned FHA Commissioner Brownstein about "specific recommendations...for mitigating [the] foreclosure rate." Brownstein's response emphasized the need for forbearance to be made more attractive to lenders by ensuring them that leniency would not involve any financial loss.¹³

However, even though leniency no longer involves any financial loss, HUD officials have still had to urge the greater use of forbearance. Testifying over ten years after Brownstein, former FHA Commissioner Sheldon Lubar stated that: "Certainly the most desirable cure for foreclosure is not to let it happen, to work out some forbearance arrangement if that is possible..."¹⁴

Echoing this statement, Kenneth A. Duncan, a Regional Vice-President of FNMA, testified that recasting is the best method to assist a defaulting mortgagor, in the following exchange with the Assistant Counsel of the

¹³Until 1964, lenders only received interest as of the date of foreclosure, rather than as of the date of default. Brownstein was arguing for the need "to date back the debentures as of the date of default, in which event the mortgagor then will be able to approach his lender, and say that it will not result in a financial loss to extend forbearance." Hearings Before a Subcommittee of the Committee on Banking and Currency, "FHA Mortgage Foreclosures" U.S. Senate, 88th Cong. 2nd. Sess. January, 1964. p. 38.

¹⁴ Review of FHA, Part 1 op. cit. p. 77.

Senate Subcommittee on Antitrust and Monopoly:

Mr. Blum: (Assistant Counsel) In your statement you say that when a mortgage goes into arrears, the mortgage servicer is encouraged to find ways of reinstating an owner of the property. Is refinancing an acceptable way out?

Mr. Duncan: Refinancing, as such, generally would require the pay-off of the whole mortgage and a new mortgage. And this, generally, is not a feasible method of doing it because of the cost of obtaining the new mortgage.

The best method, I think, is to recast the mortgage within its terms and amortize the remaining portion of the loan over the remaining term of the mortgage. (Underline added.)

Mr. Blum: Has that been done successfully with any frequency in New York? Do you know? Do you have any feel for it?

Mr. Duncan: I don't recall that we've had very many cases of that kind. In fact, I don't recall any off hand.

Mr. Blum: Well, with such a high delinquency rate, wouldn't you expect much more activity in such things as recasting and reworking the terms of the mortgages?

Mr. Duncan: Of course, this has to be coordinated with the borrower. If the borrower doesn't want to recast it, there's not much use in trying to force it on him.

Most of the time, I think the borrower is more interested in getting the back payments caught up, rather than to recast his mortgage.

Mr. Blum: Can he do that with a settlement plan, some sort of agreement to pay back? What would the usual procedure be?

Mr. Duncan: Normally, in a case of that nature, the servicer would enter into an agreement with him where he could pay a full installment and a portion of another installment each month in order to catch up the arrears.¹⁵

The above exchange is revealing in several ways. First, it is an indication that defaulting FNMA-held mortgages are only infrequently recast. And, second, according to Duncan, those mortgagors that are aware of recasting do not seem to understand how it could help them to wipe out arrears.

¹⁵New York Antitrust Hearings, op. cit. p. 545-546.

Indeed, Mr. Duncan's own testimony suggests that he, too, may be somewhat confused about the advantages of recasting. In view of the above recasting examples, it is hard to imagine how a repayment schedule, that includes a full payment, plus a portion of a past due payment, could possibly be more appealing to defaulting mortgagors than a recasting agreement.

It is ironic that in spite of Brownstein's and Lubar's apparent enthusiasm for relief measures, individuals who have worked closely with HUD claim that the agency is partly responsible for the infrequent use of relief measures, as suggested by the statement by Barbara Southwick quoted above.

Even more striking is the fact that some HUD Area Office personnel expressed no concern over the lack of mortgagee adherence to HUD guidelines on mortgage relief. For example, in spite of his aggressive role in trying to help defaulting mortgagors, Thomas Clendenon stated that:

I don't know how many loans have been recast. I very seldom try to get a loan recast. The most effective, efficient and easiest way is to go the two payments per month route. This is the minimum that mortgage companies will accept. They won't accept partial payments because they say it messes up their computer...I often get in touch with the mortgage company to see if they'll set up this type of repayment schedule. It's not the easiest route for the mortgagor but it's a good thing for them to get on a strict budget.¹⁶

But, according to Mr. Clendenon it's not only the mortgage companies that insist on repayment schedules in preference to the HUD approved

¹⁶Interview, Thomas Clendenon, op. cit.

relief measures. Continuing, he said:

What is allowed and what will be done are two different things. And it's not just the mortgage companies. The HUD Area Office Director wouldn't go for it. (i.e. special forbearance and recasting.) He comes from a mortgage company himself.¹⁷

Thus, even some HUD personnel have resigned themselves to the non-use of their own guidelines. Furthermore, Gene Prosnitz, a New York Legal Services attorney, also faulted FHA's attitude toward its relief measures:

Now, when we have spoken to Fannie Mae's lawyers, they say they will do whatever the FHA tells them to do.

And here, Fannie Mae is...in the same position as the banks, and they are just following the lead of the FHA. That's why we feel the solution is with the FHA.

In other words, for example, if the FHA tells the bank to give forbearance relief and to allow a certain homeowner to make deferred payments on his mortgage because maybe the homeowner was injured and has to stay out of work for a while, and as a result could not keep up with his payments, and if this man applies to the FHA for forbearance relief, then they will go along. I think the main way to attack the problem is through the FHA.¹⁸

Yet, as we have seen, HUD does not become involved with relief decisions. Forbearance, according to HUD guidelines, is an option of the mortgagee and HUD does not use default notices for any purpose other than data collection.

But the other stumbling block to the greater use of HUD-approved relief measures is the mortgage servicer. Investors, such as FNMA, feel that it is up to the servicer to make recommendations for relief.¹⁹

¹⁷Ibid.

¹⁸New York Antitrust Hearings, op. cit. p. 122.

¹⁹FNMA Servicer's Guide, op. cit. p. 27-28.

Servicers agree. One mortgage banker stated:

This is our job -- this is what we're paid for -- to make recommendations to investors.²⁰

Mortgage servicers also acknowledge that once a relief measure has been worked out and a recommendation made to the investor, approval from the investor is virtually automatic.²¹ Kenneth A. Duncan, stated that:

Fannie Mae encourages servicers to use every possible method to assist the borrower in avoiding the loss of his home. Fannie Mae will accept any agreements with the borrower to forbear, recast, reamortize, extend, or modify the terms of the mortgage in hardship cases where the servicer recommends such agreement, provided it is approved by the FHA insuring office. The conditions that support the use of such relief include illness, death, temporary suspension or reduction of income, and other conditions which create a hardship on the borrower. (Underline added)²²

Thus, the servicer is in a critical position and is responsible for suggesting and working out relief measures with defaulting mortgagors. Since servicers are in a position to grant relief, the question then becomes: Why are they reluctant to do so? Before going on to answer this question -- the subject of chapter 10 -- this chapter will conclude with an assessment of HUD's third way of intervening on behalf of defaulting mortgagors -- counseling.

²⁰Interview, Stan Goodrow, op. cit.

²¹Interviews. For example, Stuart Blanton, op. cit. and Donald A. Luff, op. cit.

²²New York Antitrust Hearings, op. cit. p. 525.

6. HUD'S DEFAULT COUNSELING PROGRAM: ACTIVE INTERVENTION:

Prior to the creation of the Concentrated Delinquency and Default Counseling Program (D+D) in 1972, HUD had never considered counseling as a form of intervention in mortgagor default. While some HUD and non-HUD certified voluntary counseling agencies provided mortgagors with post-purchase assistance, default counseling, per se, had been scarce, if not totally absent.¹

Based upon the belief that counseling could cut down on defaults, HUD chose to channel approximately three-quarters of Congress' \$3.25 million FY 1972 appropriation for homeownership counseling toward funding a new program aimed at assisting Section 235 and 237 mortgagors who were in mortgage default. The HUD-implemented D+D Program marked the first time, and still the only time, that Congress has directly funded homeownership counseling efforts.²

It is important to recall the context of the D+D program and to understand why HUD diverted funds which had been earmarked for pre-purchase counseling to default counseling. First, beginning in 1971, HUD personnel, including Secretary of HUD George Romney, were questioned

¹In OSTI's telephone survey of over 300 HUD-certified and non-certified counseling agencies, the question of whether default counseling was ever offered was not asked. However, the survey did disclose that: "Most agencies offered services to a family only before the family purchased a home. Although nearly half of the agencies reported that they assisted some families after purchase, the degree of such service provision was apparently minimal..." OSTI Final, op. cit. p. 58.

²However, as discussed in Chapter 8, the Congressional intent of this appropriation was not to supply counseling assistance to defaulters. Rather, the intent was to help fund existing voluntary counseling agencies in their on-going efforts in counseling prospective home buyers.

extensively by various House Committees on the rising default and foreclosure rates that were occurring nationally, but were particularly troublesome in Romney's home state, Michigan. In conjunction with this, Congress began to articulate considerable concern over the rapid depletion of the reserves in the FHA insurance funds.³

Second, following the various Congressional hearings disclosing problems with the homeownership programs, HUD's official direction became more consumer oriented. As quoted previously, HUD's own Office of Audit, in reviewing the 235 program, pointed out that "consumer protection...is inextricably interwoven with other program objectives."

Thus, the D+D program was launched by HUD as a desperate attempt to reverse the mounting foreclosure rate by assisting the homeowner to keep his home and, in the process, cutting down the costs to HUD of foreclosure. The stated objective of the D+D program reflected these dual concerns -- for the consumer's well-being as well as HUD's.

...(to) provide concentrated counseling for delinquent or defaulting mortgagors to alleviate the incidence of delinquencies, defaults and foreclosures under the Section 235 and 237 programs. This shall be accomplished by assisting mortgagors, through financial management and homeownership counseling, to bring and maintain mortgage payments to a current status, thus reducing the social and financial costs to mortgagors who would otherwise face foreclosure, and the financial loss and administrative costs incurred by HUD when default terminations occur.⁴

³See, for example, "Interim Report on HUD, Investigation of Low- and Moderate-Income Housing Programs" op. cit. "Defaults on FHA-Insured Mortgages..." Parts 1 and 2, op.cit.

⁴Concentrated Default and Delinquency Counseling Program, HUD-RFP H-23-72, April, 1972.

In July 1972, HUD contracted 31 private agencies in 19 cities to provide counseling services to families who had brought homes under the Section 235 and 237 programs and who were currently in default. (See Exhibit 8)

The expected operation of the D+D program, though relatively straightforward, (See Exhibit 9) required a number of modifications in the normal mortgagee/HUD relationship at the point of mortgagor default. The OSTI D+D #2 report noted that:

Mortgagees were asked to send notification of mortgagor delinquency after just 30 days directly to the HUD Housing Counselor, whereas in the past notification was required by the Mortgage Servicing Branch only after 90 days of default. Moreover, mortgagees were requested to give special attention to defaulting mortgagors, and to grant relief on the strength of a recommendation from a third party to the affair, the Default Counseling Agency.⁵

Not surprisingly, some of the most severe problems in the implementation of the D+D program revolved around these new relationships, with mortgagees playing a pivotal role. The OSTI researchers found that many mortgagees sent HUD names of defaulting 235/237 mortgagors irregularly or only after the mortgagor had been in default for many months; other mortgagees screened the referrals using unknown criteria; while still others refused to participate in the D+D program at all.⁶

Although the Government Technical Representatives (GTRs)⁷ found it hard to generalize about mortgagees as a group and claimed that each mortgagee had "its own personality," the reasons generally cited for

⁵OSTI D+D #2 op. cit. p. 8.

⁶Ibid. p. 18-27.

⁷The HUD official in charge of the D+D program. In most cases, the Housing Counselor filled this role.

SCHEDULE OF DEFAULT COUNSELING CONTRACTS

<u>Contract No.</u>	<u>Name & Location of Contractor</u>	<u>Contract Amount</u>
H-1868	Economic & Youth Opportunity Agency Los Angeles, California	\$ 16,500
H-1865	Family Home Counseling Los Angeles California	12,000
H-1919	Pasadena Area Housing Development Corp. Los Angeles, California	14,755
H-1861	Center for Civic Initiative Milwaukee, Wisconsin	33,306
H-1854	Urban League of Oklahoma City, Inc. Oklahoma City, Oklahoma	76,517
H-1848	Andrews & Associates San Antonio, Texas	97,658
H-1850	Ella Austin Community Center San Antonio, Texas	112,700
H-1853	Seattle Housing Development Seattle, Washington	177,053
H-1849	Consumer Credit Counseling Service of Shreveport, La. (Retail Merchants Assn, Inc) Shreveport, Louisiana	83,000
H-1920	Spokane Community Action Council Spokane, Washington	21,000
H-1852	Spokane Retail Credit Association Spokane, Washington	21,000
H-1870	GMUL, Inc. Orlando, Florida	22,500
H-1871	Metropolitan Development Agency Tampa, Florida	38,000
H-1864	Tulsa Urban League, Inc. Tulsa, Oklahoma	81,306
H-1847	Housing Counseling Service of Urban Rehabilitation I Corp. Washington, D. C.	110,358
H-1867	Atlanta Urban League Housing Center Atlanta, Georgia	79,346

SCHEDULE OF DEFAULT COUNSELING CONTRACTS

<u>Contract No.</u>	<u>Name & Location of Contractor</u>	<u>Contract Amount</u>
H-1856	Consumer Credit Counseling Service Atlanta, Georgia	\$ 69,743
H-1860	Midlands Community Action Agency Columbia, South Carolina	310,000
H-1851	Dallas Urban League Dallas, Texas	89,453
H-1862	Credit Counseling Centers, Inc. Southfield, Michigan	193,311
H-1855	Detroit Non Profit Housing Corp. Detroit, Michigan	198,250
H-1858	Mayor's Committee for Human Resources Dev. Detroit, Michigan	136,500
H-1857	TULC Housing Corporation Detroit, Michigan	146,250
H-1863	Credit Counseling Centers, Inc. Southfield, Michigan	46,962
H-1844	Community Inter-Faith Housing, Inc. Indianapolis, Indiana	32,000
H-1874	GMUL, Inc. Jacksonville, Florida	21,000
H-1873	Jacksonville Urban League Jacksonville Florida	74,750
H-1872	The Urban Jacksonville, Inc. Jacksonville, Florida	44,000
H-1866	Urban League of Greater Little Rock Little Rock, Arkansas	78,000
H-1859	Housing Opportunity Centers, Inc. Louisville, Kentucky	48,200
H-1869	MACBET, a Division of Sonia, Corp. Los Angeles, California	16,200

EXPECTED OPERATION OF THE DEFAULT COUNSELING PROGRAM*

In assessing the actual operation of the D&D program, it is useful to establish, as a frame of reference, the way in which the program was expected to operate at its inception. In general, the expected D&D scenario involves the following steps:

- HUD Area/Insuring office contacts HUD-approved mortgagees who are involved in the 235 and 237 programs to explain the D&D program and to encourage their participation.
- Mortgagees are to send the names of defaulting 235 and 237 mortgagors as well as chronically delinquent mortgagors to HUD, once a month. Mortgagees are also to make these referrals when a mortgagor is only one month in default.
- The HUD Housing Counselor refers defaulting mortgagors to the Default Counseling Agency in that area.
- The agency contacts the defaulting mortgagor by telephone, if possible, and by mail and notifies him of the possibility of free financial management and homeownership counseling services available from HUD-approved counseling agencies. The agency urges the mortgagor to accept a screening interview with a housing counselor as soon as possible.
- If the mortgagor refuses counseling assistance, the agency notifies the HUD Housing Counselor and the mortgagee, in writing.
- At the screening interview the agency determines the extent of and basic causes of the mortgagor's default; current financial status of the mortgagor; potential effectiveness of counseling to cure the delinquency and default and willingness of the mortgagor to accept counseling.

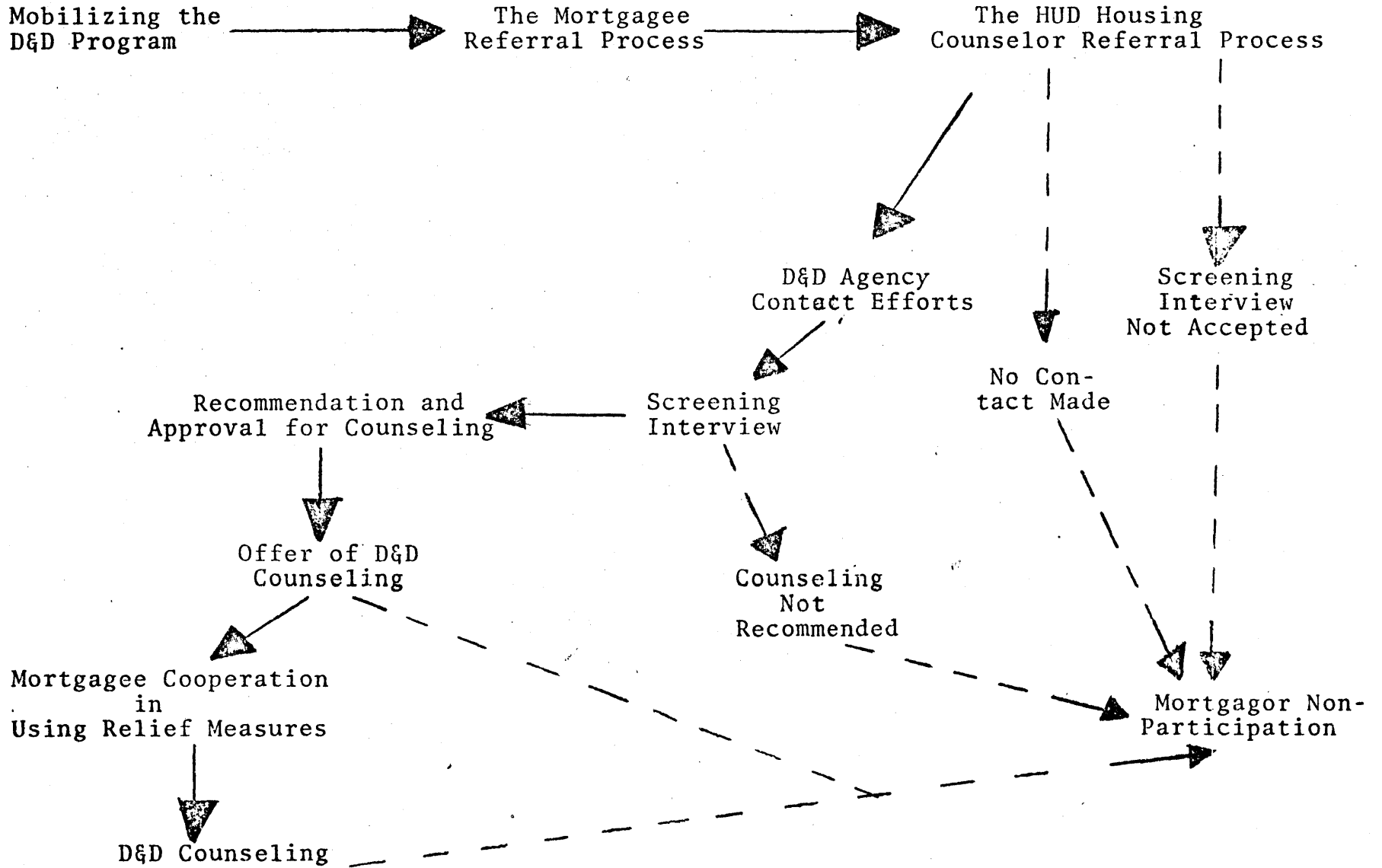
* Taken primarily from Request for Proposal No.H-23-72, for Concentrated Counseling of Delinquent or Default Mortgagors under HUD Section 235 and 237 Programs.
(OSTI D+D #1, p.3-5)

- The D&D agency communicates the findings from the screening interview to the HUD Housing Counselor. If it is determined that counseling cannot cure the default, the agency advises the mortgagor of this decision, what is involved in foreclosure, and assists the mortgagor to locate other housing.
- If counseling is in order, the agency submits to HUD a counseling plan to meet the needs of the mortgagor.
- If counseling is recommended by the agency and approved by the Housing Counselor, counseling is promptly offered to the mortgagor.
- The D&D agency notifies mortgagees of each mortgagor's participation in the counseling program. Mortgagees are requested to use the appropriate relief measures.
- The agency provides counseling on an individual basis, tailored to the needs of the mortgagor. Referrals to other public and private resources take place when necessary. Counseling is given weekly or biweekly for the first month or two until the mortgagor has demonstrated his ability to meet the objectives of the program proposed by the agency. Counseling does not exceed 12 sessions.

On the following page, a model of the D&D counseling program is presented.

MODEL OF THE D&D COUNSELING PROGRAM

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non-participation of mortgagees in the referral process were, according to the OSTI researchers:

- general conservatism and lack of sympathy in the program;
- hard-nosed, inflexible mortgage servicing practices;
- mortgagee resentment of governmental and third-party (D+D agency) intervention into servicing practices;
- mortgagee objection to increased reporting requirements;
- lack of feedback from HUD and the D+D agency to the mortgagee on progress with defaulting mortgagors;
- lack of HUD leverage or pressure to assure broader participation of mortgagees.⁸

On this point, while all the GTRs seemed to be expending a great deal of effort to gain more effective participation by mortgagees,⁹ the voluntary nature of the D+D program, compounded by the unwillingness of HUD to put any "teeth" in the program, hindered program operation. The OSTI D+D #2 report noted that:

A recurring theme throughout many of the agency (D+D counseling agency) interviews was the frustration counselors felt in dealing with mortgage companies in the absence of any significant pressure from HUD to cooperate in the accomplishment of D+D program goals.¹⁰

HUD, in the course of its own evaluation of the D+D program, found that GTRs and counseling agencies were slightly more positive about mortgagees, although problems in this area were also noted.

⁸OSTI D+D #2, p. 21.

⁹Ibid. p. 21.

¹⁰Ibid. p. 40.

Most GTRs believe, that after a slow start, the mortgagees have demonstrated their willingness to participate in the program. (However) in some areas of the country, it appears that various mortgagees are "hard nose"...especially on the West Coast. It was also found that certain mortgagees' mortgage servicing departments have yet to fully cooperate with the program.¹¹

And, similarly,

A majority of the contractors indicate that the mortgagees are cooperating in the program. It was discovered that on the West Coast, however, certain lending institutions have not given the program the attention it deserves (e.g. lack of cooperation in providing relief measures for mortgagors).¹²

And further, the report stated that:

...no legal authorization was given to HUD to enforce mortgagee cooperation in the program. What this meant was that D+D agencies were constantly in the position of requesting that the mortgagees grant relief measures by convincing them in each case that relief was both necessary and appropriate. Some mortgagees were willing to accede to the agencies' views, but others often were not. When mortgagees were not, there was very little the agency or HUD could do toward reinstating a client's mortgage...once agencies became aware of how much cooperation they could expect from the mortgagees they dealt with, they tended to accept the mortgagees' policy limits on servicing rather than run the risk of losing significant sources of D+D referrals by repeated confrontation.¹³

The HUD report went on to note that:

Some contractors feel that mortgagees are constrained in affecting relief to mortgagors due to Area/Insuring office policies.¹⁴

Unfortunately, the report did not detail exactly what field office policies were problematic. Nevertheless, the HUD and OSTI research present

¹¹HUD D+D report op. cit. p. 7.

¹²Ibid. p. 8.

¹³OSTI D+D #2 op. cit. p. 42-43.

¹⁴HUD D+D op. cit. p. 8.

convincing evidence that HUD's lack of authority over mortgagees, compounded by the unwillingness of some Area/Insuring Offices to give the D+D program a high priority, have worked against the needs of defaulting mortgagors and have increased HUD's risk.

Thus, the OSTI researchers found that the lack of authority vested in HUD personnel to make demands on mortgagees worked against the goals of the program.

Furthermore, the HUD report also disclosed that the policies of certain Area/Insuring Offices thwarted optimal program effectiveness:

In a few instances, some GTRs felt that the program was not being given the priority which is warranted by their respective offices. Further, some have reported that a certain division (e.g. loan servicing) of their offices has not yet fully utilized its resources in helping make the default counseling program as effective as it could be.¹⁵

In spite of the problems, the D+D program was evaluated positively by OSTI. The OSTI D+D #2 report concluded that:

Many, probably a majority, of local D+D programs have presently achieved a modest degree of success in providing effective assistance toward the remedy of mortgage delinquency/default and in lessening the incidence of mortgage failure. Given the severe problems encountered in local program operation...these results tend to be fairly impressive...In brief, the D+D program generally succeeded in delivering useful resources and services to many defaulting mortgagors who were most in need of them.¹⁶

Based upon their overall evaluation, OSTI recommended that:

HUD give serious consideration to expanding its funded counseling efforts to include the provision of broad, preventive post-purchase counseling resources, rather than retain its exclusive concern with remedial counseling intervention upon default.¹⁷

¹⁵Ibid. p. 7.

¹⁶OSTI D+D #2 op. cit. p. 84-85. HUD's report did not evaluate the success or failure of the D+D program per se. Rather, its only concern was to assess the way in which the program was being implemented.

¹⁷OSTI D+D #2 op. cit. p. 110.

In spite of this recommendation, HUD neither continued the D+D program beyond the two-year experimental period,¹⁸ nor has it worked toward setting up a comprehensive post-purchase counseling program. Similar to pre-purchase counseling, post-purchase counseling and default counseling have been left to the whims and minimal resources of HUD-approved counseling agencies that "choose to do so" on a non-funded basis.¹⁹ (See Exhibit 10)

In spite of the fact that default is a critical point both for HUD and the homeowner, HUD has neither taken an active role in its internal procedures, nor has it continued to support counseling efforts. Furthermore, while HUD has specific guidelines for mortgagees to follow who are servicing loans of defaulting mortgagors, these relief measures are rarely used. Thus, in the default situation, HUD has not acted in a consistent manner with its risk-taking position and, as such, has also not supported the interests of consumers.

¹⁸ HUD Handbook 4191.1 op. cit. Appendix 1, p. 1.

¹⁹ Ibid. However, a long-term positive outcome of the D+D program is that with the issuance of HUD Handbook 4191.1, Delinquency Counseling was cited for the first time as an acceptable "Mortgage Collection Technique": Delinquency Counseling. When normal collection techniques are not effective consideration may be given to professional homeownership counseling for the delinquent mortgagor by a HUD approved counseling agency." p. 43 .

EXHIBIT 10:

4191.1

ADMINISTRATION OF
INSURED HOME MORTGAGES

APPENDIX 1

DEFAULT AND DELINQUENCY COUNSELING PROGRAM

Under the funded demonstration aspects of this program, selected HUD-approved counseling agencies, in designated communities, provide concentrated counseling for chronically delinquent or defaulting mortgagors, without cost to such mortgagors, to alleviate the incidence of delinquencies, defaults, and foreclosures under the Sections 235 and 237 programs. Such agencies assist mortgagors through financial management and homeownership counseling, to bring and maintain mortgage payments to a current status, thus reducing the financial costs to mortgagors who would otherwise face foreclosure, and the financial loss and administrative costs by HUD when default terminations occur.

The non-funded portion of the program is implemented by HUD-approved homeownership counseling agencies that choose to do so, and covers all HUD-insured home mortgage programs.

Mortgagee cooperation and assistance should be extended to HUD approved counseling agencies under the funded delinquent and default counseling program and under the nonfunded delinquent and default counseling program. This point is emphasized especially when the funded demonstration portion of the program is ended and delinquent and default counseling continues as a nonfunded program.

The mortgagee, upon request of the default and delinquency counseling agency, should submit copies to the counseling agency of the following records of the mortgagor for whom the agency is providing assistance:

- a. Form 2004-F, Request for Verification of Deposits
- b. Form 2004-G, Request for Verification of Employment
- c. Form 2900, Mortgagee's Application for Mortgage Approval and Commitment for Mortgage Insurance under the National Housing Act.
- d. Form 3100, Application for Homeownership Assistance under Section 235 of the National Housing Act (where applicable)
- e. Form HUD-9905, Mortgage Applicant Profile (where applicable)

4191.1

APPENDIX 1

ADMINISTRATION OF
INSURED HOME MORTGAGES

- f. Purchase Agreement
- g. Any other pertinent documents

These records may assist the counseling agency in determining the extent of and basic causes of mortgagor's delinquency and default, current financial status of mortgagor, potential effectiveness of counseling to cure delinquency or default, types of counseling needed to assist the mortgagor, and willingness of the mortgagor to accept counseling.

When a counseling agency and HUD determine that a delinquency or default may be cured with appropriate counseling, and the mortgagor indicates his willingness to accept such counseling, the counseling agency will so inform the mortgagee of these facts in writing. In such cases, the mortgagee is requested to withhold the initiation of foreclosure proceedings for at least 60 days from the date of receipt of the above-mentioned written notice.

CHAPTER 10: ANALYSIS OF WHY HUD-APPROVED RELIEF MEASURES ARE NOT USED
AND OVERVIEW OF EFFORTS AT REGULATING MORTGAGEES

1. INTRODUCTION:

In the previous chapter, HUD's guidelines for mortgagees servicing FHA-insured mortgages in default were discussed and substantial evidence was presented that mortgagees do not generally follow these regulations. Keeping in mind that the HUD-approved relief measures safeguard mortgagees against any loss of interest during the period of relief if the loan is eventually foreclosed, the question is: why are mortgagees unwilling to follow HUD's guidelines?

There are several possible reasons why the HUD-approved relief measures are not frequently used. This chapter will explore the explanations for why there is such widespread non-compliance with HUD guidelines relating to forbearance and recasting.

But without digging too deeply for reasons, a basic disparity exists between the way the Mortgage Bankers Association and HUD view foreclosure on FHA-insured mortgages. While the MBA views foreclosure as a last resort, they advise a double standard for loans depending on whether or not they are FHA-insured. The MBA Manual on Collection Procedures states:

The decision to foreclose should be made on an individual case basis. Working with the conclusions drawn from the preforeclosure analysis, the servicer must weigh the alternatives and evaluate the consequences of foreclosure. If the loan truly fits a classical default pattern, the foreclosure decision is easy. However, no two defaulted loans are identical, and it is best to be certain that no item of consequence is overlooked. This is particularly important with respect to the possibilities for large losses. An alternative that would be unacceptable on the usual FHA or VA loan might become very acceptable if

something had happened to invalidate the VA guaranty or FHA insurance, leaving the lender no recourse other than taking the property.
(underline added)¹

This language is in sharp contrast to HUD's guidelines. The "Mortgagees' Handbook -- Application Through Insurance" states that:

In general terms, HUD-FHA requires that the holders of insured mortgages service them in accordance with the accepted practices of prudent lending institutions. This should be done in the same manner as if the loan were not insured and the mortgagee were dependent entirely on the property as security to protect its investment.²

Thus, while HUD implores mortgagees to service FHA-insured loans as though they carried a full amount of risk, the MBA advises members to "bend over backwards" to prevent a foreclosure only if the property is the investor's only protection against loss.

But beyond this basic and important difference in outlook, other reasons exist which account for mortgagees' unwillingness to extend HUD-approved relief to defaulting mortgagors.

¹MBA Collection Procedures, op. cit. p. 34.

²HUD Handbook 4000.2 op. cit. p. 3-5.

2. ACTUAL AND SERVICER-PERCEIVED CAUSES OF DEFAULT:

The cause of default is critical to the use of HUD's relief measures. For a family to be eligible for special forbearance or recasting HUD guidelines require that the cause of default be due to "circumstances beyond the mortgagor's control."¹ Such circumstances include "death, illness, curtailment of income and uninsured damage to the mortgaged property."²

Thus, the first reason why servicers do not extend relief may be that the cause of default is not beyond the mortgagor's control. Or, second, the cause of default may actually be beyond the mortgagor's control but the servicer may have a conflicting perception.

There is substantial evidence which suggests that most reasons for mortgagor default would, in fact, make a majority of mortgagors eligible for relief. For example, testifying before the House Subcommittee on Housing, HUD Secretary Romney stated that:

In September 1970, we did a limited survey in Detroit's inner city area of homeowners who were in default or had had their homes foreclosed. This survey indicated that illness, loss of jobs, and family problems accounted for seventy percent of the defaults. These basic problems were compounded by excessive maintenance cost on properties generally more than thirty-five years old, and occupied by lower income purchasers with too many other bills to pay and little ability to accumulate reserves to cover unexpected expenses.³

HUD's findings were confirmed by OSTI, in the course of their evaluation of the Concentrated Delinquency and Default Counseling Program.

¹ HUD Handbook 4191.1, op. cit. p. 48.

² Ibid.

³ "Real Estate Settlement Costs..." op. cit. p. 34.

Here, too, the most frequent causes of default were due to reasons which were clearly beyond the mortgagor's control. Based upon information on 124 defaulting Section 235 mortgagors, OSTI found that "unemployment, illness in family, repair and maintenance problems and family problems... together accounted for almost 60% of the reasons for default."⁴ The single most frequent reason cited for default was budget or credit problems -- difficulties which, depending upon circumstances, may or may not also be beyond a person's control. (See Table 20)

Another study conducted by OSTI also indicated that default is, most often due to reasons beyond the mortgagor's control. In a survey of 261 Section 235 homeowners, slightly over one-third of those interviewed indicated that they had been in default at least once. Table 21 presents the major reasons for default according to these mortgagors. In summarizing their findings, the OSTI report stated that there was an underlying pattern behind most default episodes. This pattern is characterized by a:

temporary family crisis which presents itself as a problem in maintaining employment, in maintaining the health of the family, and in maintaining the household on a limited budget, and which cuts off the normal flow of cash to monthly mortgage payments.⁵

Another recent study performed by the University of Southern California Law School also indicated that most reasons for mortgagor default are due to events "beyond the mortgagor's control" and, moreover, that there are discrepancies between mortgage servicer and mortgagor perceptions concerning

⁴D+D #1, op. cit. p. 12.

⁵OSTI Final, op. cit. p. 217-218.

TABLE 20

Major Reasons for Default Among Section 235 Mortgagors
(As Diagnosed by D+D Counseling Agency Counselors)

	<u>No.</u>	<u>%</u>
Budget/Credit Problems	56	36
Unemployment	44	29
Illness	28	18
Maintenance/Repair Problems	11	7
Family Problems	8	5
Problems with a Public Agency (i.e., VA, public assistance, for lack of appropriate payments, etc.)	6	4
Other	<u>1</u>	<u>1</u>
TOTAL	154*	100%

*More than one major reason for default given in thirty clients' cases

Source: OSTI D+D #1 p. 20.

TABLE 21

Major Reasons for Most Recent Default Episode

	<u>No.</u>	<u>%</u>
Unemployment	21	24
Income	8	9
Budget Management	20	22
Medical	20	22
Family	4	4
Housing-related	4	4
Happenstance	6	7
Other	<u>6</u>	<u>7</u>
TOTAL	89	100%

Source: OSTI Final p. 215.

the causes of default.⁶

As evident from Table 22 the majority of the "mortgagor" reasons for default appear to be due to unexpected and uncontrollable hardships. Fifty-five percent of the mortgagors listed death, illness, accidents, and curtailment of income as the major causes of default. And, again, depending upon how the servicer interprets "marital difficulties" and "excessive obligations," and the particular circumstances of each case, considerably more mortgagors may also be in default for "reasons beyond their control."

The discrepancy between mortgagor and mortgage servicer reasons for default is striking. The major reason for default according to the latter was "excessive obligations," 41%, while mortgagors listed this in only 14% of the cases. Equally striking is that mortgage servicers found death, illness, or curtailment of income to account for only 17% of the defaults, while these reasons were cited by mortgagors as the causes of default in 48% of the cases.

The USC report stated that:

The significance of the divergences may be twofold: first, they may indicate that mortgagees are not reporting the causes and factors of mortgage defaults in a meaningful way; second, and related but also of independent significance, mortgagees may not have accurate information to report because they are not doing a proper job of servicing mortgage defaults.⁷

⁶George Lefcoe et. al. Univeristy of Southern California Default Study, Preliminary Data, March, 1974 p. 1.

⁷Ibid. p. 6.

TABLE 22

Primary Causes of Default According to Mortgagors and Mortgagees;
Sections 203(b); 221(d)(2); and 235*

	<u>Mortgagor Reason</u>		<u>Mortgagee Reason</u>	
	<u>No.</u>	<u>%</u>	<u>No.</u>	<u>%</u>
Death or illness of principal mortgagor or family member	47	21	7	3
Marital difficulties	7	3	24	10
Curtailment of income	61	27	32	14
Excessive obligations	31	14	92	41
Accident to head of household	16	7	0	0
Lender returned partial payments	15	6	0	0
Increase in housing costs/repair costs	11	5	0	0
Mortgagor has abandoned property	0	0	21	9
Inability to sell or rent property	0	0	8	4
Other	<u>39</u>	<u>17</u>	<u>43</u>	<u>19</u>
TOTAL	227*	100%	227*	100%

*203(b) = 121
 235 = 28
 221(d)(2) = 78

Source: University of Southern California Default Study, Preliminary Data (Data presented in Table 22 calculated from material presented on p. 2-4.)

Based upon interviews with defaulting mortgagors, the USC study found many instances of poor mortgage servicing. They learned that:

Mortgage servicing involves little more than an attempt to collect payments. Not only do mortgagees offer no assistance in helping mortgagors cure defaults, their mechanistic behavior actually increases the chance of default and magnifies the chance of recurrent defaults once the first breach occurs. Lenders disregard HUD regulations which are designed to cure breaches and prevent defaults...If certain mortgage [servicing] practices were changed, there would be a lower mortgagor default rate and quite possibly a lower acquisition rate for HUD.⁸

More specifically, the report went on to note that HUD guidelines on special forbearance "would lead one to expect a fair number of forbearance arrangements among those whose defaults were caused by illness, accidents, or job layoffs..."⁹

In spite of this, forbearance was only an extremely rare occurrence. Only seventeen forbearance agreements were found in the entire USC sample and, significantly, "in each of these seventeen cases the mortgagor was living up to the agreement at the time of the interview."¹⁰

The USC study then went on to estimate the number of defaults in their sample eligible for forbearance. Using guidelines, that far sur-

⁸Ibid. p. 1.

⁹Ibid. p. 11.

¹⁰Ibid.

passed HUD guidelines in terms of strictness,¹¹ the USC researchers concluded that about one-quarter of the defaulters should have been eligible for forbearance.¹²

Two earlier studies also found that the causes for mortgagor default were, most often, due to reasons beyond their control. In addition, according to one of the studies, conducted by the Veterans Administration in December 1960, there was again a wide disparity between the reasons that mortgage holders gave for default and the reasons obtained by VA directly from mortgagors. The VA gave several explanations for these disparities:

To some extent, differences in reasons may be attributable to changes in the circumstances of obligors (mortgagors) between the time the default was reported (and the holder's reason given) and the time when reasons were given by the VA obligor.

The largest shift, however, occurs from the category classified by holders as "Improper Regard for Obligations." This shift appears more likely to reflect a difference in attitudes between holders and obligors, than to reflect changed circumstances.¹³

For example, the VA report points out that a family that suffers a curtailment of income may offer this as the reason for default. Yet, they may still have had sufficient resources to meet their payments if they

¹¹The USC Guidelines for forbearance eligibility:
1. Illness, accident, unemployment, or curtailment of income were counted only if experienced directly by the head of the household.
2. The mortgagor indicated that this was the first time that he/she had been in default.
3. Forbearance was requested and not granted.

¹²Ibid.

¹³Office of Appraisal and Department of Veterans Benefits, Veterans Administration Report of Loan Service and Claims Study, April 30, 1962, p. 187. In Hearings Before A Subcommittee of the Committee on Banking and Currency, "FHA Mortgage Foreclosures" U.S. Senate, 88th Cong., 2nd. Sess. January, 1964.

had managed their finances better, thereby displaying an "improper regard for obligations."¹⁴

But, the report goes on to note that:

At the same time, the facts lead to an assumption that a considerable body of cases may have been arbitrarily classified by holders as "Improper Regard for Obligations" with little real knowledge as to the circumstances of the obligors.¹⁵

Moreover, it adds that:

This impression is strengthened by the fact that in 41% of all cases in the study (87,155) holders had reported no personal contact with obligors.¹⁶

In contrast to the above, in 2900 cases there was agreement between the reasons for default as reported by mortgagees and mortgagors. (See Table 24) Thus, at least one-third of the VA mortgagors were in default for reasons "beyond their control" -- according to the most conservative estimate, by mortgagees (Table 23) -- and about two-thirds were in default for "reasons beyond their control" based upon either the data in Table 24, or the mortgagors' reasons for their own defaults, as presented in Table 23.

And, adding fuel to the argument that many more defaulting families are eligible for relief than are being offered it, the VA report further

¹⁴Ibid.

¹⁵Ibid.

¹⁶Ibid. p. 188.

TABLE 23

Reasons for Default According to Mortgagees and VA Mortgagors - I
(Based Upon a Sample of 7964 Mortgagors)

	<u>Mortgage Holder</u>	<u>Mortgagor</u>
	<u>%</u>	<u>%</u>
Improper regard for obligations	51	12
Extensive Obligations	9	11
Curtailment of Income	22	37
Death or Illness	6	24
Marital Difficulties	4	8
Other	<u>8</u>	<u>8</u>
TOTAL	100%	100%

Source: Veterans Administration Report of Loan Service and Claims Study, p. 187.

TABLE 24

Reasons for Default According to Mortgagees and VA Mortgagors - II
(Based Upon 2900 Cases in Which the Reasons Coincided)

	<u>%</u>
Improper Regard for Obligations	26
Extensive Obligations	7
Curtailement of Income	39
Death or Illness	16
Marital Difficulties	9
Other	<u>3</u>
TOTAL	100%

Source: Veterans Administration Report of Loan Service
and Claims Study, p. 189.

points out that:

Of all the cases in the study, only... 2%, had been previously extended by holders, although sixty percent of the cases involving the filing of claims could have been extended.¹⁷

And, finally, a survey of lenders conducted by the Mortgage Bankers Association in June, 1963 disclosed the causes of default for almost 20,000 loans -- FHA, VA, and conventional. Table 25 lists the principal reasons for default, as viewed by the lender.

Once again, it is evident that a minimum of one-third of the mortgagors would seem to be in default for reasons beyond their control -- reduced income and death/illness.

The MBA survey also questioned lenders about the "nature of forbearance on loans in serious default." The fact that the question was unanswered for about half of the loans led MBA to suggest that, in part, this "reflects a lack of records that indicate the nature of past forbearance actions."¹⁸

Further, the MBA report notes that:

Apparently, mortgage lenders have not seriously attempted to determine what effect different forbearance practices may or may not have on saving the loan and avoiding risks of loss through foreclosure.¹⁹

These data suggest that many servicers are not adequately carrying out one of their major responsibilities -- that of finding out why mortgagors

¹⁷Ibid. p. 195. An extension, according to VA Guidelines is a type of forbearance. See "Lenders Handbook" Guaranty or Insurance of Loans to Veterans ...GI Loan Program, Veterans Administration, December, 1969, p. I-40 para. 6040.

¹⁸Mortgage Bankers Association of America, "Characteristics of Delinquent Mortgage Loans" Research Delinquency Report No. 1, 1962. p. 14.

¹⁹Ibid.

TABLE 25

Reasons for Default According to Mortgagees

	<u>No.</u>	<u>%</u>
Improper Regard for Obligations	4,469	23
Reduced Primary Income	4,148	21
Death or Illness	2,631	13
Marital Problems	2,328	12
Over-Obligated	2,205	11
Unable to Sell or Rent	1,543	8
Property Abandoned	1,067	5
Other	997	5
Not Reported	<u>359</u>	<u>2</u>
TOTAL	19,647	100%

Source: MBA Delinquency Report, p. 41.

are in default.²⁰ It seems clear that many more mortgagors are eligible for relief than are currently receiving it. The above data disclose that one possible reason for this may be inaccurate assessments of the causes of default by servicers. But other reasons may also exist. These will continue to be assessed below.

²⁰Mortgage Bankers Association of America, "Collection Department -- Responsibilities and Operations" -- A Manual, October, 1972 p. 13.

3. VARYING NOTIONS ON THE MEANING OF FORBEARANCE AND CONFLICTS WITH NORMAL MORTGAGEE OPERATIONS:

The Mortgage Bankers Association interprets forbearance in a unique fashion that conflicts with HUD's guidelines. The MBA Manual entitled "Collection Department -- Responsibilities and Operations" describes a very different "special forbearance" than HUD's. First, while HUD's "special forbearance" may extend up to eighteen months, the MBA manual states that, "Usually, forbearance arrangements should not extend beyond six months..."¹ Second, in direct violation of the HUD guidelines, the MBA sample forbearance agreement does not specify when or how the deficit resulting from the reduced payments will be repaid. (See Exhibits 11 and 12) And, third, the MBA Manual does not mention that forbearance can allow the length of a mortgage to be extended beyond its normal maturity.

Thus, the official trade organization of mortgage bankers does not advocate the same relief measure as put forth in the HUD guidelines. Similarly, FNMA's Guide to Servicers outlines a forbearance procedure that also does not exactly coincide with HUD's. Most important in this regard is FNMA's requirement that:

Each forbearance should provide for the reduction or suspension of regular mortgage payments for a specified period of time not to exceed six months and for the resumption of regular monthly payments upon expiration of the forbearance period. (Underline added)²

Moreover, once the mortgagor is ready to liquidate his past due installments, he must do so "within a period not to exceed six months" unless approval is obtained from FNMA. (Underline added)³

¹Ibid. p. 29.

²Federal National Mortgage Association, "Servicer's Guide" September, 1973, Sec. 128.07 (a) p. 31.

³Ibid. Sec. 128.07 (b) p. 31.

EXHIBIT II:

Mortgage Bankers Association of America

APPLICATION FOR FORBEARANCE

MBA MORTGAGE COMPANY

To: MBA Mortgage Company

Date: June, 1971

We own the property located at 26 South West Eighth Street, Miami, Florida on which you hold or service a mortgage loan, Number 80836

We are hereby making application to have our house payments reduced temporarily.

1. Personal Information: Residence address (If different)

Name of Husband James W. Cunningham Age 30 Tel. Nos. Home 731-0171 Business
Name of Wife Mary R. Cunningham Age 28 Other Dependents: No. 2 Ages 5, 8
Husband's Employer Unemployed for three months Position How Long
Business Address Type of Business
Wife's Employer Position How Long
Business Address
Previous Employer ABC Manufacturing

2. Our Income:

Table with columns for income source and Net Per Month. Includes Husband's current base pay, commissions, overtime, Wife's current base pay, overtime, and other sources. Total current monthly income is \$300.00.

3. Our outgo (show average monthly costs):

Table with columns for expense category and Per Month. Includes Food, Medical, House Payment, Utilities, Transportation, Insurance, Other Expenses, and Loans. Total monthly expenses is \$300.00.

4. Our mortgage is past due because (explain fully if 30 days or more past due. I have been unemployed for three months.

5. If accident, sickness, or unemployment, we have received or will receive the following compensation or aid: I am receiving unemployment compensation of \$300 per month.

6. In view of the above facts, we request your temporary forbearance and offer the following payment schedule, each payment to be made promptly: Reduced payment for a period of time until employment is located.

We certify that all statement herein are true and are made to induce you to grant us forbearance. We agree that any rights now or hereafter possessed by the mortgage holder shall in no way be prejudiced by accepting payment, or granting forbearance. You may request our employers or others to confirm our statements.

Supplemental data should be attached if the foregoing does not supply the mortgage holder with all information which might be helpful in considering this request.

James W. Cunningham
Signature of Husband

Mary R. Cunningham
Signature of Wife

EXHIBIT 12:

FORBEARANCE AGREEMENT

LOAN NUMBER TF 80836

The indebtedness in the captioned loan is in default. In consideration of the forbearance extended for a period of time by MBA Mortgage Company, it is necessary that you indicate acceptance of the following conditions by signing this letter of agreement:

1. Beginning on the first day of July, 1971, you will remit a monthly payment of \$60.00 for a period of six months.
2. MBA Mortgage Company agrees to make a further review of your loan at the end of the above six month period provided the above payments are made as scheduled.
3. It is understood that the term and provisions of the note and security instrument securing the captioned loan, shall remain in full force and effect. MBA Mortgage Company reserves the right to institute foreclosure proceedings according to the terms of said note and security instrument in the event of either your breach of the term of this agreement to forbear, or your failure to pay the note and security instrument, according to its tenor upon the termination of this agreement to forbear.

Please execute the original and first copy hereof, and return them immediately.

Sincerely yours,

MBA MORTGAGE COMPANY

BY: A. G. Smith

Accepted and Agreed this 1st day of July, 1971.

James W. Cunningham

Mary R. Cunningham

Similar to forbearance, the MBA Manual describes a recasting agreement which is different from HUD's. While the HUD recasting examples are explicit and readily understandable, MBA's sample recasting agreement is obscure at best, and misleading at worst. (See Exhibit 13)

Looking again to FNMA's Servicer's Guide discloses another discrepancy between HUD's guidelines and FNMA's. FNMA is considerably more strict when it comes to modifying (i.e. recasting) a mortgage. Also, extending the term of a mortgage, permitted by HUD's forbearance procedure, is not encouraged by FNMA. The FNMA Servicer's Guide states that:

Modifications or extensions are neither a privilege of the mortgagor nor a device for eliminating delinquencies. Such actions should be confined to cases in which modification of the mortgage terms will enable the mortgagor to maintain his account in current condition rather than lose his home because of inability to meet the existing mortgage terms due to an adverse change in his circumstances. (underline added)⁴

This language is in sharp contrast to that of Congress when it specifically stated that recasting is a viable option when the default is due to circumstances beyond the control of the mortgagor. Instead, FNMA authorizes recasting only if the reason for default represents a permanent change in the mortgagor's financial position.

SAMPLE RECASTING AGREEMENT

FHA Case #561-195220-235

This Agreement, made this 1st day of January 1973, between MBA Mortgage Company hereinafter referred to as Lender, and James W. Cunningham, and Mary R. Cunningham, hereinafter referred to as Borrowers, and Approved Trust Company, as Trustee (if applicable);

WITNESSETH:

Whereas the Borrowers are now indebted to the Lender in the sum of \$18,500 (hereinafter called "new principal amount"), consisting of \$17,302 unpaid principal, and \$1,198 unpaid installments of ground rents, hazard insurance premiums, taxes, assessments, and mortgage insurance premiums, the payment of which is secured by a note and security instrument owned and held by the Lender, dated May 15, 1969, and recorded in the office for the recording of deeds in Dade County and State of Florida, in Book 302 of mortgages, page 1097, and

Whereas the parties mutually desire to modify the terms of payment of said indebtedness by changing the amount of monthly payments required on said note and security instrument;

NOW, THEREFORE, in consideration of the covenants hereinafter contained, it is mutually agreed as follows:

The Borrowers agree to pay the "new principal amount" with interest at the rate specified in said note on the unpaid balance in monthly installments of \$177.00 Dollars (\$177.00), commencing on the first day of January 1973, and on the first day of each month thereafter, until the "new principal amount" and interest thereon are fully paid, except that the final payment of the "new principal amount" and interest, if not sooner paid, shall be due and payable on the first day of May, 1974.¹

It is mutually agreed that said security instrument shall continue a first lien upon the premises and that neither the obligation evidencing the aforesaid indebtedness nor the security instrument securing the same shall in any way be prejudiced by this agreement, but said obligation and security instrument and all the covenants and agreements thereof and the rights of the parties thereunder shall remain in full force and effect except as herein expressly modified.

IN WITNESS WHEREOF, the parties have signed, sealed, and delivered this agreement on the date above written.

MBA Mortgage Company (SEAL) James W. Cunningham (SEAL)
Lender Borrower
By Mary R. Cunningham
Borrower

DEEDS OF TRUST

(If the security instrument is a deed of trust, and it is necessary that the Trustee execute recasting agreements, the following acknowledgment shall be signed by the Trustee.)

THE TRUSTEE has executed this instrument to acknowledge his (its) assent thereto and agrees to continue to act in such capacity under the terms as modified herein.

TRUSTEE:

Approved Trust Company

1 Note to Reader
This date cannot exceed by more than 10 years the maturity date of the original note.

Further, while HUD does not require approval of a recasting agreement, FNMA does (See Exhibit 14) -- and rightfully so. Since any modification in the terms of the mortgage will affect the yield, the owner of the mortgage would clearly want to be aware of any such changes.

Thus, while HUD lists recasting as an option of the mortgagee to cure a default, the realities of the mortgage finance system make recasting a slightly more complicated procedure, than the guidelines portray. And, the issue of recasting aside, whenever a loan goes into default, the cash flow to the investor is disrupted. For example, Stan Goodrow, a Vice President of Kislak Mortgage Company pointed out that:

Since forbearance entails a decreased cash flow it is still unattractive to most investors, even though the interest is guaranteed by HUD.⁵

Thus, most mortgagees are acutely aware of cash flows and are concerned about how any changes in the terms of the mortgage would affect them. Yet, it would appear that the mortgagee confronted with a defaulting loan, which automatically means a disruption in the cash flow, would prefer an option such as special forbearance that seems to offer the best alternative in a difficult situation.

But, in addition, while a mortgagee is assured of receiving all his money back if a loan that has received HUD-approved relief later forecloses, he may still suffer a reduced yield -- in addition to the disrupted cash flow -- if the loan is eventually brought current. This, then, may be another reason why mortgagees may be opposed to granting relief.

⁵Interview, Stan Goodrow, op. cit.

EXHIBIT 14:

PART IV

FNMA SERVICER'S GUIDE

FNMA FORM 181

FORMS INSTRUCTIONS

FNMA FORM 181

(Revised 3-71)

APPLICATION FOR MODIFICATION OR EXTENSION OF MORTGAGE

- Purpose:** To be used by Servicer in applying for a modification or extension of a mortgage.
- Prepared by:** Servicer.
- Prepared in:** Original plus four copies.
- Distribution:** Original and four copies to FNMA Regional Office for consideration. If approved, FNMA will retain two copies, and forward three copies to the Servicer; one copy should be delivered to VA or FHA, as applicable; one copy should be retained in the Servicer's records; one copy should be delivered to the mortgagor. (FNMA Regional Office will forward one of its copies to Loan Accounting Division - Washington Office.)

INSTRUCTIONS

The amount of the total sum shown in paragraph numbered (2) less the amounts deposited with the Servicer for application as of the effective date of the modification or extension as shown in paragraph numbered (3), if any, shall equal the balance of the loan to be modified or extended as shown in paragraph numbered (4). The effective date of the modification or extension shall be entered in paragraph (4) as well as the proposed monthly principal and interest installment and the maturity date.

FNMA/GNMA FORM 181
Revised 3-71

Date _____

**APPLICATION FOR MODIFICATION
OR
EXTENSION OF MORTGAGE**

FNMA/GNMA NUMBER	VA OR FHA NUMBER
MORTGAGOR (OR TRUSTOR)	
ADDRESS OF PROPERTY	

**TO: FEDERAL NATIONAL MORTGAGE
ASSOCIATION (FNMA)
or
GOVERNMENT NATIONAL
MORTGAGE ASSOCIATION (GNMA)**

The undersigned, (hereinafter referred to as the "Applicant") does hereby apply for a _____ of the time for payment of the above-captioned account covering an indebtedness owing from the Applicant to _____ ("Modification" or "Extension") (hereinafter referred to as the "Mortgagee"), the Mortgagee evidenced by a note (or bond) and secured by a real property mortgage (or trust deed) (said note or bond and real property Mortgage or trust deed are hereinafter referred to as the "Mortgage") and the Applicant represents as follows:

(1) Applicant is now the owner and holder of the real property encumbered by said Mortgage, recorded in the public records in the County of _____, State of _____, in _____ book _____ page _____, or document or file number _____.

(2) Under the terms of said Mortgage, there remains unpaid as of the first day of the month in which this Application is made, the sum of \$ _____ for principal, \$ _____ for interest thereon, \$ _____ for advances made by FNMA thereunder, and \$ _____ for interest on such advances, aggregating a total sum of \$ _____, for which amount the Applicant is indebted to the Mortgagee under said Mortgage, which is a valid first lien, to which Applicant has no defenses, off-sets, or counterclaims.

(3) Applicant hereby deposits with the Mortgagee the sum of \$ _____, which is to be applied upon the present balance due on the principal of said Mortgage, (including advances, if any), and the sum of \$ _____ which is to be applied upon the delinquent interest due upon said principal (and advances, if any); application of said deposited amounts is to be made as of the effective date of the proposed modification or extension, which if not consummated, shall be returned to the Applicant.

(4) Applicant requests the terms of said Mortgage be modified or extended relative to the payment of said indebtedness by providing for payment of the balance of the principal, including any unpaid interest due thereon, (after the deposits aforementioned have been applied thereto), as follows: Said total balance of \$ _____ is to be paid, with interest at the same rate per annum stipulated in the Mortgage, on the unpaid balance, in equal monthly installments of \$ _____ (exclusive of sums required to be deposited for the payment of taxes, insurance, etc.), the first of said installments shall become due and payable on the first day of _____, 19____, and the remaining installments, successively, on the first day of each and every month thereafter, until said mortgage indebtedness is fully paid, except that if not sooner paid, the final payment of principal and interest shall be due and payable on the first day of _____, 19____ which is the present or extended maturity date.

(5) Applicant agrees to make the payments as specified in paragraph (4) hereof and understands and agrees that:

(a) All the rights and remedies, stipulations, and conditions contained in said Mortgage relating to default in the making of payments under the Mortgage shall also apply to default in the making of said modified payments hereunder.

(b) All covenants, agreements, stipulations, and conditions in said Mortgage shall be and remain in full force and effect, except as herein modified, and none of the Applicant's obligations or liabilities under said Mortgage shall be diminished or released by any provisions hereof; nor shall this Application in any way impair, diminish, or affect any of the Mortgagee's rights under or remedies on the Mortgage, whether such rights or remedies arise thereunder or by operation of law. Also, all rights of recourse to which the Mortgagee is presently entitled against any property or any other persons in any way obligated for or liable on the Mortgage, are expressly reserved by the Mortgagee.

(c) All costs and expenses incurred in connection with the processing of this Application, including recording fees, title examination, and attorneys' fees, shall be paid by Applicant and shall be secured by said Mortgage.

(d) Applicant agrees to make and execute such other documents or papers as may be necessary or required to effectuate the terms and conditions of this Application which, if approved and accepted by the Mortgagee, shall bind and inure to the heirs, executors, administrators, and assigns of the Applicant.

(6) For the purpose of inducing and influencing the Mortgagee to grant this Application, the undersigned represents of his own knowledge that the names, and marital status, of all owners or other persons having an interest in the mortgaged property and the name of his or her spouse are as follows:

<u>Name</u>	<u>Marital Status</u>	<u>Name of Spouse</u>
_____	_____	_____
_____	_____	_____
_____	_____	_____

All such persons are of legal age, and none is under any legal disability, except as follows:

*Witnessed by: _____ (SEAL)

_____ (SEAL)

_____ (SEAL)

Applicant

***ACKNOWLEDGMENT**

Accepted: Date _____, 19____.

_____ NATIONAL MORTGAGE ASSOCIATION

By _____

The undersigned, being obligated for the payment of the above-described Mortgage indebtedness, hereby consents to the execution of the foregoing Application between the Applicant therein described and the Mortgagee, and further consents to any modification or extension of the Mortgage by the Mortgagee under said Application.

*Witnessed By: _____

Co-Makers or Endorsers

*THE EXECUTION OF THIS APPLICATION SHOULD BE WITNESSED AND THE APPROPRIATE ACKNOWLEDGMENT CLAUSE SHOULD BE ADDED. IF THESE ARE REQUIREMENTS UNDER LOCAL LAW; ALSO, THIS APPLICATION SHOULD BE FILED FOR RECORD, IF REQUIRED UNDER LOCAL LAW OR PRACTICE.

4. COSTS AND TIME INVOLVED IN PROCESSING HUD-APPROVED RELIEF MEASURES:

Another possible reason why HUD's relief measures are not used by mortgagees is that HUD does not consider the costs involved in extending relief. Thus, if the costs to the mortgagee of forbearance or recasting are high, this would be a deterrent to granting relief.

However, this does not seem to be the case. Interviews with mortgagees consistently pointed to the fact that the costs involved in extending relief are not substantial. For example, one mortgagee said that:

HUD forbearance or recasting is not difficult to do. It would only take a couple of hours -- not a big deal.¹

Another mortgagee said that it would cost \$10-15 to recast a loan -- "\$25 at the outside -- not more than that."²

Several mortgagees indicated that it may take as much as a day's work, or about \$100, to execute a forbearance or recasting agreement.² However, when one mortgagee was asked what his attitude would be if HUD allowed a new 1% payment to the mortgagee for recasting a loan, he indicated that he doubted it that would change their willingness to get involved with this type of procedure.⁴

Two HUD Area Office mortgage servicing specialists also had impressions about the time and costs involved. Val Garcia, in the Los Angeles Area

¹Interview, Stan Goodrow, op. cit.

²Interview, Harold Dickson, op. cit.

³Interviews, Stuart Blanton, op. cit. and Bill Salyer, op. cit.

⁴Ibid. Interview, Bill Salyer.

Office, stated that:

Recasting is not used very much because of the amount of work involved. It's almost like writing a new loan.⁵

But, he went on to contradict himself when he added that recasting a loan would take about two hours!⁶ Kenneth Anderson of the San Francisco Area Office bluntly stated:

Recasting is simple. You use just one form. But you must inform the investor to set up a new computer program.⁷

Based upon the above comments, and with the lack of any evidence to the contrary, it appears that HUD-approved forbearance and recasting are neither time-consuming nor costly procedures for mortgagees. Thus, this does not appear to be a viable explanation for why HUD-approved relief measures are used so infrequently. However, the perception that the paperwork involved with granting relief is substantial, may be another explanation for the non-use of forbearance and recasting.

⁵Interview, Val Garcia, op. cit.

⁶Ibid.

⁷Interview, Kenneth Anderson, op. cit.

5. LACK OF MORTGAGOR INFORMATION CONCERNING DEFAULT:

Another plausible reason why the HUD-approved relief measures are so seldom used is that mortgagors have, or are given, very little information on the types of relief for which they may be eligible.

Even when the Mortgage Bankers Association has an opportunity to encourage its members to consider the HUD relief measures as a means to assist mortgagors in default, it chooses not to do so. For example, the MBA Manual on collection procedures devotes twenty-five pages to sample letters to be sent to delinquent and defaulting mortgagors, but not a single letter makes any reference to the fact that the mortgagor may be eligible for HUD-approved relief measures.¹ Rather, the tone of nearly all the letters is extremely cold, angry, and threatening. (See Exhibit 15)

The overriding attitude of reluctance, on the part of mortgagees, to offer information about available relief measures was cited by Ronald G. Yelenik, a New York Legal Services Attorney:

Even in cases of extreme emergencies, such as unemployment or serious illness, he (the mortgagor) is not informed of his right to relief, which is available under HUD regulations. The fact is that if a homeowner is ill or has encountered some emergency he can be extended a deferred payment schedule in reference to his mortgage. The homeowner never learns of this right and is never educated as to this fact.

I would say that this withholding of information is almost tantamount to fraud, in that the failure to provide this information can result in a very serious situation and eventually in the foreclosure of the mortgage due to the homeowner's inability to keep up his mortgage payments.²

¹ MBA Collections Manual, op. cit. p. 63-88.

² New York Antitrust Hearings, op. cit., p. 109.

FIRST MONTH SERIES – PART I

INTERRELATED LETTERS TO BORROWER PAYING AFTER 25th OF MONTH

August 20

Dear Mr. Smith:

Your loan is now 20 days delinquent.

We have had no word from you regarding your intentions for taking care of this payment. Please call me immediately.

It is imperative that your loan be brought up to date within the next five days and that future mortgage payments are received in our office on or before the first day of each month.

August 25

Dear Mr. Smith:

On August 20, we wrote to you requesting that you contact us regarding your delinquent mortgage loan. We also asked that you send your August 1st payment immediately. Thus far, we have not received your payment, nor have we heard from you. Unless we hear from you, we assume you are not experiencing any difficulty. Therefore, you should be making your payment on or before the first day of the month, as outlined in the Deed of Trust.

This letter is to advise you we must receive your payment in our office not later than August 31. If you wish to protect your interest in this property, we suggest you give this matter your immediate attention.

Mortgage Bankers Association of America _____

THIRTY DAY LETTERS

First two letters are examples for use on 32nd day of delinquency

Your home loan with us is now in default. When your loan was made, the monthly payments were set up to be due on the first day of each month. The payments are due in our office on that date.

Our records show that your payment for last month is still due, in addition to the payment for this month. Also, a late charge for last month's payment is due, as authorized under the terms of your Deed of Trust. The total amount due at this time is shown above.

It is not our policy to accept less than the full amount due.

Unless we receive your remittance in the full amount, or unless other arrangements are made immediately, your loan could be referred to the holder of your mortgage for further recommendations resulting in additional expense to you.

We urge you to give prompt attention to this matter.

FINAL NOTICE

PLEASE READ CAREFULLY:

1. Two payments are now past due on your mortgage and legally the entire balance is now subject to payment on demand.
2. The amount now required to reinstate your mortgage includes a late charge for last month.
3. Your failure to contact us immediately may have serious consequences.
4. Your cooperation is urgently needed now to safeguard your equity in your home.

THIRTY-FIVE DAY LETTERS

September 7

Dear Mr. Smith:

Your loan on the subject property is still in default.

Because we do not have your residence telephone number, any communication concerning your loan must be initiated by you.

In order to protect your interest in this property, it is necessary that you contact this office not later than 4:30 p.m., September 12.

September 9

Dear Mr. Williams:

Your mortgage loan is still outstanding for the August 1st and September 1st installments.

We must advise you that we have a legal right to start proceedings to protect our interest in the property. If you have concern for keeping your property, it is urgent that the loan be brought to a current basis.

We will expect your full remittance in this office not later than 4:30 p.m., September 15.

The urgency of this matter demands immediate action on your part.

FORTY-FIVE DAY LETTERS

We sincerely regret that you have made no effort to do anything about your loan, as we requested on a number of occasions last month.

We use the words "sincerely regret" because they best express our feelings. There is nothing in connection with our business that we value so highly as friendly relations with our customers.

It's possible that you have been sick or away from home and have been unable to reply to our previous letters. If that is the case, to avoid any steps that would further injure your credit, we will wait five more days before taking any other action.

At that time, however, we shall feel justified in considering that we have done all in our power to settle the matter as one between friends.

We earnestly hope that you will avoid possible legal action by paying the above amount.

Your mortgage on the subject property is now in default for the September 1st and October 1st installments.

Must we remind you that this is a very serious matter?

All payments are due and payable on or before the first day of each month.

We have a legal right to start proceedings to protect our interest when a loan is in default. It is in your interest that we urge you to make immediate arrangements to bring your loan current.

If the delinquency is not paid promptly, it is our intention to forward a recommendation to our investor which could adversely affect your interest in this property.

FIFTY-FIVE DAY LETTERS

Although we mailed a letter to you earlier this month, you have now allowed your mortgage loan to become seriously delinquent.

The amount shown above represents two payments and two late charges. To avoid additional expense including attorney's fees, we urge you to pay immediately.

If the entire amount due at this time is not paid within four days of the date of this letter, it is our intention to take further steps which could adversely affect your interest in this property.

Your attitude concerning this obligation will be an important determining factor in which action we take.

The loan on your property remains in default with the installments for September and October past due.

Despite our recent letters to you we have received no word from you. Our field representative visited your property and found no one at home. We still do not know your residence telephone number nor your place of employment.

We have made every effort to contact you and have not been successful. It is, therefore, up to you to contact us. We urge you not to jeopardize your interest in your property by inaction and continued silence.

According to our records, your loan is now delinquent for the September 1st and October 1st installments, plus two late charges. The total amount due is \$208.00, and another payment becomes due on November 1.

Unless funds are received in our office by October 31, it is our intention to recommend that your property be posted for foreclosure sale. Payment must be in the form of a cashier's check, money order or cash.

We suggest that if you are successful in saving your home this time, that you will not jeopardize it again by making your mortgage payments late.

SIXTY AND SEVENTY-FIVE DAY LETTERS

Your loan is three months delinquent and in serious trouble.

FORECLOSURE is imminent. If you wish to save your property, you must act now.

The amount shown above represents three payments and two late charges. To avoid foreclosure of your mortgage, certified funds (no personal checks), representing the full amount of the delinquency, must be forthcoming at once.

This is the kind of letter we'd rather not write. In previous letters, we've done everything we could think of, to urge you to bring your loan current and save your equity in this property.

We've told you what action has been taken, and tried to do it in a way that didn't sound threatening. We've now been directed to forward your loan to our attorneys, so that they can start a foreclosure action. This we are doing and we've told them that the total amount needed in certified funds is now \$303.00, including applicable late charges.

Legal fees will be added to this figure, when the attorneys begin their paper work. The fees are costly and the foreclosure notice will be published in your local newspapers. This doesn't make good sense, does it? We don't think so. We need your help to avoid this, and we need it now.

You are about to lose your property through your failure to pay the past due mortgage payments on your loan.

We must receive at once either a cashier's check or money order, covering the full amount of the delinquency. The amount shown above represents three payments and three late charges. Additional expense will be incurred shortly, if the account is not paid current.

If funds to cover these payments are not forthcoming immediately, it is our intention to turn your file over to our attorney for foreclosure proceedings.

This is our last written communication with you prior to foreclosure.

And, adding further weight behind Mr. Yelenik's statement the USC Default Study also found that mortgagees do not generally initiate discussions on forbearance when dealing with defaulting mortgagors.

Conversations with individual mortgagee employees indicate that at present only the mortgagor who seeks relief receives it. Mortgagors could be informed of this option but few mortgagors have the skill and determination required to negotiate a forbearance, especially when the mortgagee is out-of-town and disinterested.³

Thus, in summary, based upon the preceding analysis, there are several reasons why mortgage servicers do not use HUD's relief measures.

- Inability of mortgagors to push for relief measures, since they are not supplied with information;
- Servicers not accurately determining the reason for default and therefore fewer mortgagors are thought to be in default for reasons beyond their control than is actually the case;
- Disruption of cash flow and change in yield;
- Perception by servicers that it is costly to execute a forbearance or recasting agreement;
- MBA and FNMA defining forbearance and recasting in a different way than HUD.

However, these provide only a partial explanation concerning why HUD-approved relief measures are not used more often.

³U.S.C. Default Study, op. cit. p. 13.

6. ABSENCE OF POSITIVE INCENTIVES TO GRANT RELIEF; EXISTENCE OF POSITIVE INCENTIVES TO NOT GRANT RELIEF; AND ABSENCE OF NEGATIVE SANCTIONS IF RELIEF IS NOT GRANTED:

While this reads like a tongue-twister, these are the key reasons why mortgagees do not jump at every opportunity to grant relief to defaulting mortgagors. As a background to this discussion, the work of Kenneth Arrow on Risklessness and Motives is relevant.

a) Risklessness and Motives: Kenneth Arrow's Analysis:

If a person has little at stake in a given venture, he may have a tendency to work for success with less conviction than if he had a great deal at stake. Kenneth Arrow has explored the relationship between risk and probable success in relation to various economic activities. In an essay entitled "Insurance, Risk and Resource Allocation" he writes:

In a capitalist world...the owner of a business typically is supposed to assume all the risks of uncertainty, paying out the unexpected losses and enjoying the unexpected gains. But society has long recognized the need for permitting him to shed some of the risks. A man's capacity for running a business well need not be accompanied by a desire or ability for bearing the accompanying risks, and a series of institutions for shifting risks has evolved. Insurance itself is an early and important example of such an institution...

The possibility of shifting risk, of insurance in the broadest sense, permits individuals to engage in risky activities which they would not otherwise undertake.¹

¹Kenneth I. Arrow, Essays in the Theory of Risk Bearing. (Chicago: Markham Publishing Co., 1971) p. 135, 137.

According to Arrow, this is a positive function of insurance, since it enables and encourages innovation.

If risks cannot be shifted then very possibly none of the projects (i.e. risky and innovative) will be undertaken; if they can be, then each individual investor, by diversification, can be fairly sure of a positive outcome, and society will be better off by the increased production.²

Given the productivity that can result from this ability to shift and share risks, why aren't more economic activities subject to insurance.

Arrow poses the question:

Suppose that we could introduce into the economic system any institutions we wish for shifting risk instead of being confined to those developed historically. Why has the economic system not developed a more completely adequate set of markets for risk bearing?³

He goes on to answer his own question with the following explanation, noting that while there are several reasons:

...the factor known as the "moral hazard" is perhaps the most important. The insurance policy might itself change incentives and therefore the probabilities upon which the insurance company has relied. Thus, a fire insurance policy for more than the value of the premises might be an inducement to arson or at least to carelessness.⁴

Arrow further explains that if the motives of the insured are to reduce loss, then the insurance company is out of danger. However, by not knowing what the human motives are, the insurance company is left

²Ibid.

³Ibid. p. 141.

⁴Ibid. p. 142.

in a position of having incomplete information on which it must assess its risks. As a result:

Either he will refrain from insuring or he will resort to direct inspection and control, to make as certain as he can that the insured is minimizing all losses under the latter's control.⁵

Summary of Arrow's Argument on Risk:

- 1) No risk by insured = possibility of negative behavior depending upon motives of insured.
- 2) No risk by insured + motive of insured to minimize loss = consistency between motives of insurer and insured.
- 3) No risk by insured + motive of insured not to minimize loss = inconsistency between motives of insurer and insured.

But: Motives of Insured cannot always be known by insurer.

Therefore insurer will:

- A) Not insure, or
- B) Exert close control over the situation which has been insured.

Several important questions emerge from Arrow's analysis that are relevant to this discussion:

- (1) Does FHA insurance provide mortgagees with a totally risk-free investment? If so, what are the effects of this risklessness on mortgage lending decisions and servicing?

⁵Ibid. p. 143.

(2) What are the motives of mortgagees and servicers? Do they have consistent interests with FHA? (i.e. to avoid foreclosure)

Thus, two independent variables must be considered: Risklessness and Motives. By itself, risklessness is not, according to Arrow, detrimental to the goals of the insuring agency. Only when risklessness is accompanied by conflicting motives does a potentially dangerous situation arise. After briefly assessing the risk to mortgagees and servicers using FHA insurance, the issue of mortgagee motives and their desire to avoid foreclosure will be analyzed.

b) Risk of Foreclosure to Mortgagees and Servicers:

The FHA-insured mortgage provides the mortgagee with a virtually risk-free investment. First, since 1964 FHA has had the option of making claims on foreclosures in cash. Previously, FHA had made settlements only with debentures, a note which carried an interest rate which was somewhat lower than the interest rate of the mortgage. Second, while FHA pays only two-thirds of foreclosure costs, it is possible for mortgagees to inflate their real costs thereby making certain that FHA reimburses them for all, rather than only two-thirds, of the costs of foreclosure. However, this writer found no evidence that this, in fact, was a common or widespread practice.⁶

⁶For example, Kenneth Anderson noted that: "While it is possible for mortgagees to blow up their foreclosure costs, most don't." Interview, Kenneth Anderson, op. cit.

In addition to the possibility of incurring some foreclosure costs, mortgagees claim to detest foreclosure because of the red-tape involved, bad public relations and simply not having any desire to be in the real estate business.

Thus, while there does appear to be some tangible risk to the mortgagee, it is also clear that this risk is minimal. Similarly, the mortgage servicer also has a minimal risk. The MBA claims that while a majority of mortgage companies lose money on originations, almost all firms make money on servicing. A 1972 survey of mortgage companies disclosed that:

To offset the losses on originating single-family loans, it is fortunate that almost all mortgage banking firms report a net income on servicing these loans - 163 out of the 166 firms in this study. The 96 firms reporting an origination loss require 5.4 years on average to recover the loss.⁷

Thus, for those servicers who lose money on origination, the fees collected through servicing are critical to their survival. However, it is important to point out that a HUD study on origination costs did not agree with the findings of the MBA study. In contrast, HUD found that:

Origination losses were reported by only 23 of the 98 firms we audited. We found an average net gain of \$102 per loan

⁷Mortgage Bankers Association of America, Research Committee Operations Report No. 3, "Mortgage-Banking Survey of Single-Family Loan Operations 1972: Income and Costs for Origination and Servicing of Single Family Loans" 1974, p. 6.

for all firms instead of a loss; and only a \$56 average loss per loan for the 23 firms reporting losses.⁸

Thus, there is a basic disagreement whether servicing is needed to offset origination losses. But even if no loss occurs at origination, servicing fees are still an important source of the mortgage companies' operating income and a foreclosed loan results in a reduced cash flow. In addition, if a given investor's servicing portfolio is consistently running a high foreclosure rate, a mortgage company may have difficulty placing future loans with that investor. Yet, in spite of this, the risks to both servicers and mortgagees of foreclosure are minimal.

Extending Arrow's analysis to the present discussion, it is clear that by enabling the mortgagee to assume almost no risk, HUD-FHA has opened the possibility of negative behavior on the part of mortgagees. Logically, and according to prudent mortgage lending practice, it has generally been assumed that the motives of the insured, the mortgagee, are consistent with those of HUD-FHA -- to avoid foreclosure. Based on this assumption, HUD-FHA has neither refused to insure, nor exerted close control over the situation which has been insured, as Arrow's theory suggests. However, while the motives to avoid foreclosure may not be terribly strong, the motives to foreclose can be tempting.

⁸ HUD Office of Audit, "Review and Analyses of Mortgagees' Costs of Origination Services" 05-2-3001-0000, March 23, 1973, p. 27.

c) Mortgagees and Motives:

The FHA insurance mechanism was intended to help Depression-scared lenders regain confidence in mortgage investments. As discussed in Chapter 3, this goal was realized. However, there is now evidence that points to the fact that some mortgagees look to FHA insurance for more than protection against risk: FHA insurance has enabled certain unscrupulous lenders to originate loans that are destined for an early foreclosure. In addition, some lenders, either directly or through their servicers, have been reluctant to assist defaulting mortgagors because of the possibility of a windfall profit at the time of foreclosure.

Since most FHA insured loans are originated at a discount, the mortgagee has less than the face value of the mortgage note invested. Thus, if a \$20,000 mortgage is originated at a five point discount, the lender has only advanced \$19,000. However, the FHA has insured that loan at the time of origination for the full \$20,000. Thus, similar to Arrow's mythical man who insures his home against fire for more than the home is worth, the lender is able to obtain insurance for more than the mortgage is worth.

The negative implications of this incentive -- which run counter to the motives of the insurer, HUD-FHA,-- was spelled out in an interview with a high HUD Central Office official:

The investor wants to foreclose. Within the first year he can make a lot of money. That's why they don't forbear, re-cast or anything else. Investors give originators the direc-

tions to foreclose as soon as it's legally possible. No forbearance is offered or anything. We're all against this system, but we can't do anything about it. If the buyer wants services such as forbearance and lenient servicing and so forth, he has to be willing to pay for it -- in terms of the market interest rate -- rather than the lowered rate that he gets through FHA. FHA people aren't paying for the services that conventional home buyers are paying for.⁹

But, in contrast to this sense of resignation, others have tried to change the system. For example, Jack Blum, Assistant Counsel to the Senate Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, exposed the negative incentives built into the discount system. Throughout over a thousand pages of testimony taken during hearings in New York City, Mr. Blum questioned witness after witness on the practices of originating bad loans in the hopes of gaining windfall profits on early foreclosures.

The following is a sampling of the types of dialogues between Mr. Blum and various witnesses before the Subcommittee. While the theme in the following excerpts is repetitive it is, nevertheless, useful to underscore the fact that the lucrative nature of early foreclosure is widely acknowledged.

- 1) Mr. Blum: There is one point I would like to go over with you, and that is the question of how it is possible, on a quick foreclosure where there is enough of a discount for somebody to make quite a bit of money, might it be profitable for someone to originate a bad loan or enough points to make money on

⁹Interview, Walter J. Stuart, Director, Policy Analysis and Development Division, Housing Production and Mortgage Credit, HUD Central Office, Washington, D.C., September 19, 1973.

the yield to maturity? Is that something you have heard of happening?

Mr. Lasurdo: (Executive Vice President, Green Point Savings Bank, Brooklyn, N.Y.) Yes.

Mr. Blum: And the way that works is the quick recapture of the discount. FHA pays off the loan at par and the loan is originated at 90 or 92, is that correct?

Mr. Lasurdo: That is the way it works.¹⁰

- 2) Mr. Blum: If the loan is foreclosed very quickly...the yield to maturity increases sharply.

Mr. Katz (former Chairman of the Board, United Institutional Servicing Corp., a mortgage co., New York, N.Y.). If the loan is foreclosed in 1 year and it is a 7-percent loan and they bought it at a 6-percent discount, the yield to maturity is 13 percent, less expenses and there are expenses. There is a loss of interest and the loss on foreclosure.¹¹

Mr. Blum: There are expenses, but it is still a significantly greater yield than perhaps could be obtained if the mortgage ran through its term.

Mr. Katz: That depends on the price they pay for it. If they bought it at 98, the answer would be no.

Mr. Blum: But, if the discount is deep enough, there is considerable profit possibility.¹²

And, further,

Mr. Blum: Are there any financial institutions that participate in this secondary market who have reputations for looking for paper which is likely to be foreclosed?

Mr. Katz: I know of none.

¹⁰New York Antitrust Hearings, p. 765.

¹¹By way of clarification, HUD pays two-thirds of the costs of foreclosure. Thus, unless the real costs of foreclosure have been inflated by the investor to recapture the lost one-third, there can be costs of foreclosure. However, according to HUD no interest should be lost.

¹²New York Antitrust Hearings, op. cit., p. 308.

Mr. Blum: Are there any paper buyers looking for the highest possible yield with no regard for quality whatsoever?

Mr. Katz: This was true in the past, not so true now, because of the problems with foreclosures in the State of New York... The cost of foreclosure now, on some of the ghetto-type properties is so high that if you have foreclosure, there will be a loss. This did not occur 5 or 6 years ago.

Mr. Blum: At that time, there were institutions that would go into these areas looking for highest possible yields.

Mr. Katz: Right.¹³

- 3) Mr. Blum: Would that seven- or eight-point discount have been sufficient to insure that you would not lose money on a foreclosure? That is, if you would recapture that discount and other expenses of foreclosure?

Mr. Duncan: (Regional Vice-President, Northeastern Region, FNMA). On that particular mortgage, with a 7- or 8-percent discount, my assumption would be that we could recover, through the discount, sufficient to offset all the losses that we would incur otherwise...the fact that we have a discount does not, in itself, mean that we make a profit on the mortgages that go into foreclosure.

I would say overall, on an average, we probably come out fairly close to even when we consider the various types of mortgages in foreclosure.

Mr. Blum: Is it true, that if legal costs escalate sharply, they eat up the amount that you capture on yield to maturity, and possibly put you in a loss position?

Mr. Duncan: Yes. Legal costs, foreclosure costs, add to the question of whether we do or do not make any profit.

Mr. Blum: Do you think on balance that Fannie Mae will make or lose money on the New York situation?

Mr. Duncan: I think on balance we would probably come out at least even, or better. This is purely a guess. I do not have any basis for it. It is only a guess.¹⁴

¹³Ibid. p. 323-324.

¹⁴Ibid. p. 541-542.

And, further,

...we have tried to ascertain what our position is concerning gains and losses on foreclosure. And we conducted two studies. One assumption shows we made a little bit of money; one showed that we lost a little bit of money.

We have concluded, overall, we do not lose money on foreclosures. We break about even on total.¹⁵

The following example is illustrative of how a highly suspect deal could end up being extremely lucrative for the mortgagee.

Mr. Blum: In your statement you mentioned that you required United to buy back 12 loans that went into foreclosure without a single payment being made. Would that not indicate that there were serious problems with those loans, and at least the possibility of fraud?

Mr. Duncan: I did not consider it fraud. I considered it either that they had not done a good job of underwriting or they had not done a good job of servicing...

Mr. Blum: Is the line between good job of underwriting and the possibility of fraud rather a thin one?

Mr. Duncan: Well, I have never really been experienced in fraud enough to know what the difference is. By my judgment was that there was nothing wrong with the underwriting on these loans...

Mr. Blum: Were those loans repurchased by United at a discount?

Mr. Duncan: Yes, sir; at the same price that we paid for them.

Mr. Blum: Is it possible that the amount of the discount recovered by United more than paid whatever expenses they might have incurred in foreclosure.

Mr. Duncan: It is possible, yes, sir.

Mr. Blum: So they might very well have come out ahead on that transaction?

Mr. Duncan: It is possible, yes, sir.¹⁶

¹⁵Ibid. p. 555-556.

¹⁶Ibid. p. 550.

In addition to the above testimony which reveals how mortgagees can make substantial profits on discounted loans which go into early foreclosure, many HUD employees interviewed had also heard of "bad" mortgages being originated.

For example, Thomas Clendenon of the Louisville HUD Area Office stated that:

I know that mortgage companies originate bad loans. There's also a possibility that some investors like buying bad loans. I've heard that it happens.¹⁷

Also talking about Louisville, David Goss noted:

I'm quite certain that mortgage companies do originate bad loans and that there are bad investors who buy them. Some mortgage companies have a failure rate that's so high that they couldn't have done it unintentionally.¹⁸

And, Val Garcia of the Los Angeles HUD Area Office said that:

There have been two or three mortgagees who were making money on foreclosure and purposely originating bad loans.¹⁹

Lucille Henderson, of the Kansas City HUD Area Office, remarked that:

I've heard that mortgagees originate bad loans just for the points. But I haven't come across this in my own experience.²⁰

Similarly, many mortgagees interviewed were familiar with the practice of originating "bad" loans and of foreclosing quickly in order to cash in on

¹⁷Interview, Thomas Clendenon op. cit.

¹⁸Interview, David Goss, Loan Management Officer, HUD Area Office, Louisville, Ky., February 11, 1974 (telephone).

¹⁹Interview, Val Garcia, op. cit.

²⁰Interview, Lucille Henderson, op. cit.

the points. A Louisville mortgage banker noted that:

I don't think we would follow the practice of originating bad stuff on purpose. I suspect that the GNMA auction is for that purpose. If an investor buys a loan that is in default, he won't let it be reinstated, no matter what. On cases where we do make money on foreclosures, we make a little bit -- not alot. Just a couple of hundred dollars -- particularly if it's foreclosed within a reasonable length of time.²¹

Particularly striking on this point were the comments of a Richmond, Virginia, mortgage banker:

We had once thought of getting together the worst VA mortgages that we could -- hoping that at least half would foreclose.²²

The above comments suggest that forbearance would be less likely to be used on deep-discounted loans. More explicitly, Eric Brestrup, a FNMA official in Washington, observed that:

FNMA tries to instill a willingness on the part of its servicers to forbear on deserving cases. However, on a foreclosure, an investor can make money. There is no incentive to go the forbearance route either by the investor or the seller-servicer.²³

And, John Waner, Director of the Chicago Area Office of HUD, in testimony before the Illinois Legislative Investigating Commission went so far as to state that:

...Under FHA, let me say that the average lender, because he knows his mortgage is insured by the Government, which will reimburse his losses, he is more inclined to speed up foreclosure. He is less inclined to be tolerant with this individual who, through one circumstance or another, may be delinquent on his mortgage payments.

²¹ Interview, Harold Dickson, op. cit.

²² Interview, Stuart Blanton, op. cit.

²³ Interview, Eric Brestrup, FNMA Central Office, Washington, D.C., September 19, 1973.

In a recent study by my office, instituted by me, I have seen that invariably the lender who utilizes FHA for the purpose of guaranteeing his bank against any losses, he accelerates, putting it into legal processes where if it is a conventional loan, he will exercise more tolerance and spend more time with the individual to try to make his loan more current.

But if this party came in and said, "Look I can't pay July's but I can pay June's" they say it is just too bad. You are Federally insured and we are going to get our dough from Uncle Sam. And they don't give him a break. But if it is conventional, they will go along with him, carry him for a month or two or eight or ten. But they don't do that with FHA. They take it and unload it.²⁴

Director Waner further observed in recent newspaper articles:

Some cash-hungry lending institutions are going out of their way to foreclose their government-backed mortgages and force families from their homes so they can collect the money from the United States Treasury immediately and loan it out again.²⁵

In addition to there being an opportunity to make money on a foreclosure by getting a reimbursement from HUD for the face value, rather than the discounted value of the loan, Stan Goodrow of the Kislak mortgage company pointed out that forbearance would be unattractive for another reason:

On a low interest rate loan, we would not be inclined to go into forbearance...I won't say that investors haven't pushed for foreclosure.²⁶

Thus, a low interest loan is particularly unattractive to an investor when current interest rates have increased and the foreclosure proceeds can be channeled into new, higher yielding investments.

Fortunately, however, many investors and mortgage bankers would not tolerate these kinds of practices, as typified by the response of a Boston area Savings and Loan officer:

²⁴Illinois Mortgage Practices Commission Report, Chicago, Illinois, 1974.

²⁵Ibid. p. 55. Quoted from Chicago Tribune, September 26, 1974, p.1.

²⁶Interview, Stan Goodrow, op. cit.

A broker called me saying, "I've got some bad stuff -- they're sure to foreclose within a few months. Do you want any?" I told him to go fuck himself.²⁷

But the general lack of willingness to forbear because of the possibility of a lucrative foreclosure was identified as early as 1967 in HUD's report on mortgage discounts.

Large discounts may offer a temptation to some lenders to initiate foreclosure during the early life of a mortgage when forbearance might preserve an owner's home and avoid a loss to be absorbed by FHA or VA. Where discounts are small or non-existent, this incentive is absent because there is no windfall to be captured.

We are confident that this is not a widespread problem, and our outstanding instructions admonish our field offices to do everything possible to help save the home of a mortgagor who is in temporary financial straits. The overwhelming majority of responsible lenders are equally concerned that this approach be applied.²⁸

Nevertheless, the report went on to note that it was "drafting legislative language that would authorize the removal of the 'windfall' temptations in the event such action appears desirable in the future." Unfortunately, however, no legislation to this effect has ever been passed.²⁹

More recently, another HUD report echoed the findings of the report quoted above.

...the discount system results in the mortgagee investing less than the full face amount of the mortgage. The discount represents additional interest to the mortgagee amortized over the term of the mortgage. When a mortgage is foreclosed and HUD reimburses the mortgagee for the outstanding mortgage indebtedness,

²⁷Interview, C.L. Gildroy, - Northeast Federal Savings and Loan Association, Watertown, Mass.

²⁸A Report by the Department of Housing and Urban Development "Mortgage Discounts" February, 1967, p. 22.

²⁹Ibid.

the mortgagee collects for the discount which has not been earned (amortized). Under these circumstances, we believe that the discount system works counter to HUD-FHA's efforts to encourage mortgagees to avoid foreclosure by trying to work out a plan with the mortgagor to bring the mortgage to a current status.³⁰

Based upon this finding, the report recommended legislation to correct the possibility of abuse. The report went on:

The Secretary has recently established more realistic maximum interest rates on insured mortgages to approximate money market conditions. If the adjusted rates do not substantially eliminate discount points, we recommend that the Secretary establishes regulations or, if necessary, propose legislation to permit HUD to reduce its payment of early foreclosure claims by the amount of loan discount (points) that remains unamortized on any mortgage foreclosed within, say, three years of loan origination.³¹

Yet, at this writing, three years after the issuance of HUD's second report, the situation remains unchanged. Positive incentives for mortgagees to foreclose still exist and neither positive incentives for compliance nor negative sanctions for non-compliance with HUD's relief measures have been instituted on a widespread basis. Yet, HUD has been making some efforts toward controlling problematic mortgagee behavior in the default as well as during the pre-purchase period. After a brief review of HUD's and FNMA's regulatory authority over mortgagees, HUD's recent efforts at curbing mortgagee activities will be examined.

³⁰All Homes Audit op. cit. p. 54-55.

³¹Ibid.

7) HUD'S REGULATION OF MORTGAGEES:

As mentioned in Chapter 6 HUD is the only agency with major regulatory powers over mortgage companies, the major lender in the HUD-FHA home programs. In view of the non-compliance with HUD guidelines among mortgagees, particularly related to the default situation, but also during the pre-purchase period (as discussed in Chapter 8, Section 1c) it is important to review how HUD has supervised mortgagees.

Briefly, a mortgagee must receive HUD approval before it may either originate or purchase an FHA-insured mortgage. In the case of financial institutions that are supervised by another Federal body, such as the Federal Home Loan Bank Board, approval is virtually automatic. However, in the case of non-supervised institutions, such as mortgage companies, HUD requires documentation pertaining to the mortgagees' financial soundness and has the prime responsibility for overseeing its activities.

Accompanying HUD's authority to approve mortgagees, it also has power to withdraw approval, thereby prohibiting mortgagees from either originating, holding, or servicing FHA-insured mortgages. (See Appendix 10-1 for detailed information on HUD's approval and dis-approval criteria and requirements.)

While HUD's supervision of non-supervised mortgagees appears to have reached a low point by 1973-1974, there is evidence that by 1975, HUD had begun to take some positive and aggressive steps toward controlling problematic mortgagee behavior. This section will briefly review how

HUD supervised mortgagees during the early 1970's and Section 9 will then go on to discuss some of the recent steps that HUD has taken to try to correct the various problems in mortgagee procedures.

HUD's Supervision of Mortgagees -- Early 1970's:

During late 1973 two independent reports disclosed severe problems in HUD's monitoring procedures of mortgagees. One was prepared by HUD's own audit department (All Homes Audit) and the other was the result of an investigation launched by the Comptroller General of the U.S. (Non Supervised Mortgagee Report).

The All Homes Audit concluded that there was a nationwide problem of deficiencies and irregularities in FHA loan processing activities by HUD-FHA approved mortgagees due, primarily, to a laxity in HUD's supervision. Specifically:

The problem (mortgagee deficiencies) has developed due to rapid growth in the mortgage banking industry while the loan origination and mortgage servicing activities of mortgagees concurrently have been subjected to less and less supervision by the insuring and investing segments of the industry...supervision by HUD/FHA, FNMA and private segments of the mortgage banking industry has substantially declined over the past years.¹

Organizationally, the HUD field offices have been responsible for making recommendations for mortgagee approval to Central Office and for monitoring mortgagee servicing. However, the Comptroller General's Report found that criteria for mortgagee approval were inconsistent among the eight field offices examined.

¹All Homes Audit, op. cit. p. 43-44.

HUD's careful review and appraisal of its three basic requirements for prospective mortgagees -- assess quality, capital adequacy, and the ability of the applicants to administer a mortgage operation -- are of paramount importance.

Although HUD field offices were not consistently verifying these requirements, the Mortgagee Approval Officer was basing his recommendation for approving or disapproving a prospective mortgagee's application on an assumption that the offices had verified the requirements. The field offices failed because HUD headquarters had not issued detailed procedures specifying how the offices were to verify the information supplied by mortgagees applying for approval status.²

And, concerning the monitoring of servicing, field office reviews have not been a common procedure. On-site reviews of mortgagees' loan servicing practices have generally been in response to a specific problem, such as a mortgagor complaint, rather than as a routine control mechanism.³

HUD Central Office has been in charge of overseeing mortgagee origination activities and has final authority for approving and disapproving mortgagees. The Mortgagee Approval Officer in the Central Office is the major contact person for mortgagees. His duties include approving mortgage applications; processing changes in any mortgagees' status, such as change of address; and analyzing annual audits of non-supervised mortgagees. However, the All Homes Audit concluded that these activities:

²Non Supervised Mortgagee Report, op. cit. p. 14.

³All Homes Audit, op. cit. p. 88.

Do not provide adequate surveillance of mortgagees' activities since they do not provide on-site evaluations of the primary functions of loan processing and loan servicing practices of the HUD-approved mortgagees...(Furthermore) the Mortgage Approval Office has not been performing this limited surveillance on a current basis because of a shortage in staff. On March 1, 1973, the Mortgage Approval Office had a backlog of about 1,370 unanalyzed financial statements. This backlog consisted of practically all statements received since January, 1972.⁴

Interviews with staff of the Mortgage Approval Office in late 1973 and early 1974 also disclosed that seemingly basic record keeping on mortgagees was not being performed. For example, no precise data existed on mortgagees -- either supervised or non-supervised. Estimates by HUD personnel on the number of HUD approved mortgagees ranged from 1700-1800 non-supervised institutions to 25,000-30,000 - supervised institutions. Furthermore, that office kept no records on mortgagee approvals or disapprovals. J.M. Hurtt, the Mortgage Approval Officer as of September 1973, estimated that there had been over 100 terminations in the past year and perhaps between 100 and 900 cumulative. However, he added that he really had "no idea" about the total number of mortgagee terminations and the reasons, he said, varied greatly.⁵

⁴Ibid. p. 90.

⁵Interviews, J.M Hurtt, Mortgage Approval Officer September 19, 1973. Washington D.C. and Mr. Hall, Management Analyst, May, 1974, Washington, D.C. The estimated 1700-1800 non-supervised mortgagees does not include the over 4300 related branches of these institutions. (Non Supervised Mortgagee Report p. 6). In addition, the Non Supervised Mortgagee Report stated that there were 1,587 non supervised mortgagees' main offices and 11,593 supervised mortgagees' main offices and 14,775 related branches as of August, 1972 p. 6.

Although a mortgagee may lose its HUD approval for "failure to conduct its business in accordance with good business practices and accepted standards of conduct"⁶ the "All Homes Audit" found that:

HUD applies adverse actions against mortgagees primarily in accordance with the suspension and debarment procedures... of the Code of Federal Regulations. These procedures state that suspension is a drastic action taken when there is suspicion of fraud or other criminal conduct... HUD has not established a readily enforceable procedure for taking adverse action against mortgagees which perform inadequate processing or inadequate loan servicing but have not committed violations that can be proven in court to be criminal.⁷

Evidence that HUD is reluctant to use suspension as a penalty comes from the Comptroller General's Report, which found that for the 5 months ending July 1972, out of 53 mortgagees who were not complying with HUD rules and regulations, less than half (22) had lost their status as approved mortgagees, while only another 18 were even threatened with suspension or termination.⁸

Thus, the report concluded that:

HUD should have been more forceful and consistent in exercising its authority for suspending or terminating the approval status of HUD-approved mortgagees for non-compliance with HUD rules and regulations.

It is interesting to note that while the Comptroller General's Report lists a variety of reasons for the threatened or actual suspensions, none of the reasons cited dealt with mortgage non-compliance with HUD's

⁶HUD Handbook 4000.2 op. cit. p. 3-6.

⁷All Homes Audit op. cit. p. 89.

⁸Non Supervised Mortgagee Report op. cit. p. 45-47.

guidelines for dealing with mortgagors in default.⁹

Further evidence of the infrequent use of suspension as a disciplinary action comes from the Office of Loan Management. Fred W. Pfaender, Director of that office, stated that between 1969 and mid-May 1975, 78 mortgagees had been suspended, with 69 still suspended but, of those, he did not know how many had been suspended because of servicing.¹⁰

Thus, up until the mid-1970's suspension was used only as a drastic measure, perhaps not even for non-compliance with servicing guidelines. The latter half of this decade may, however, see a change in HUD's willingness to discipline uncooperative mortgagees. Before going on to examine HUD's recent efforts at supervising mortgagees, it is appropriate to briefly review FNMA's regulatory responsibilities in relation to mortgagees.

⁹Non Supervised Mortgagee Report, op. cit. p. 45-48. Reasons for suspensions or threats included: failure to submit the required annual certified financial statements; failure to pay mortgage insurance premiums; misrepresentations in sales transactions, and net worth deficits.

¹⁰Hearings Before a Subcommittee of the Committee on Government Operations, "Mortgage Servicing and HUD Property Management" House of Representatives, 94th. Cong. 1st. Sess. July, September and October, 1975. p. 22.

8. FNMA'S REGULATION OF MORTGAGEES:

Similar to HUD, FNMA retains the right to suspend or terminate servicers that do not comply with its servicing standards or that are in violation of the servicing contract. However, rather than suspension or termination, a common path for FNMA to take with a problematic servicer is to impose "close supervision."¹ In this way, FNMA has an opportunity to closely monitor the servicer's activities, particularly those which may be the basis for termination of the Servicing Agreement.²

Oakley Hunter, President and Chairman of the Board of FNMA has emphasized FNMA's rights with regard to suspension or termination of servicers. In April of 1972 he warned that:

FNMA customers who abuse the (Government housing) programs may lose the right to do business with FNMA.³

Thus, while FNMA's official policy is to take harsh steps with any servicer found to be in non-compliance with FNMA's servicing standards, similar to HUD, it has generally chosen not to do so.

The Fifteenth Report by the Committee on Government Operations found that:

In Detroit...despite the high rate of defaults experienced by many mortgagees, neither FHA nor FNMA has acted to suspend mortgagees for building up excessive numbers of defaulted mortgages in their portfolios.⁴

¹ FNMA Servicer's Guide, op. cit. p. 3.

² Ibid. p. 2.

³ FNMA Press Release, April 13, 1972. Fifteenth Report By the Committee on Government Operations, op. cit. p. 19.

⁴ Ibid.

Similar to the findings of the Committee on Government Operations, the All Homes Audit found that supervision of mortgagees by FNMA had declined markedly:

Up to about eight years ago mortgagees which participated as permanent mortgage investors, including the Federal National Mortgage Association (FNMA), involved themselves in assuring that originating mortgagees determined the mortgagor's credit to be sound and the underlying property to provide good security...

For example, FNMA has eliminated its internal underwriting review of FHA insured mortgages and reduced its audits of mortgagees.⁸

Further evidence of FNMA's laxity in supervision and reluctance to act in a hard nosed way toward servicers is found in the testimony of Kenneth A. Duncan, before the Senate Subcommittee on Antitrust and Monopoly. While Mr. Duncan acknowledged that several problem laden mortgage companies in his region had recently been suspended from making further sales to FNMA, his testimony demonstrates a willingness on the part of FNMA to cajole even the most suspect servicer.

⁸All Homes Audit, op. cit. p. 87. The audit also noted that: "Private investors have continued to reduce their supervision through audits and on-site reviews of originating mortgagees because of the risk-free reliance they place upon FHA mortgage insurance." Furthermore other Federal financial regulatory agencies have also been abdicating their supervisory responsibilities. "Officials of the Comptroller of the Currency and of the Home Loan Bank Board informed us that their audits of banks and savings and loan institutions (supervised mortgagees) limit their review of mortgage origination practices to a determination of institutional policies because FHA insurance covers all of the risk involved." The problem of Federal regulatory agencies not using their powers to their maximum extent was discussed in Chapter 3. This issue is also relevant to the problem of discrimination in mortgage lending, such as red-lining.

Mr. Blum: As I understand your statement, Fannie Mae has had a history of problems with United Institutional servicing dating back to 1968; is that correct?

Mr. Duncan: Yes, sir; I think that's correct.

Mr. Blum: And Mr. Katz, the chairman of United, told you as early as October 1969, that United felt it had no responsibility for quality of the loans that originated? Is that correct?

Mr. Duncan: Yes, sir.

Mr. Blum: Did you report any of the ongoing difficulties with United to the Washington office of Fannie Mae?

Mr. Duncan: I don't recall making any special reports to them; no sir...⁹

Mr. Blum: When was United's bidding privilege suspended?

Mr. Duncan: We never did suspend United's bidding privilege.

Mr. Blum: Perhaps I'm a little confused here. Did they voluntarily withdraw? Was that it? Did they agree not to bid at a certain point in time?

Mr. Duncan: Actually, when they asked for the last 60 days extended time, they said they would refrain from bidding in the auction system on their own. My understanding of this - and this is an assumption - was that Mr. Katz preferred not to have a suspension of the company when he was trying to sell, because this might have impaired his capability of selling.

Mr. Blum: Technically, there was no suspension, and you knew that the company was bound to be sold and that would have simply scrambled up the ability to sell?

Mr. Duncan: That's right, sir.

Mr. Blum: They were put on probation, however, is that correct?

Mr. Duncan: Yes, sir...

Mr. Blum: Was the servicing taken away by Fannie Mae?...

⁹New York Antitrust Hearings, op. cit. p. 547.

Mr. Duncan: No, sir...

Mr. Blum: In other words, the situation was that you had repeatedly said to United, "Look, this servicing record is not very good. You are going to have to improve it." And the response was, "If we cannot improve it, we will sell it."
Is this correct?

Mr. Duncan: Yes, this is correct.

Mr. Blum: Finally, it was sold; is that correct?

Mr. Duncan: Yes...

Mr. Blum: Could you have suspended the servicing contract with United and transferred it to another company without paying United anything?

Mr. Duncan: It is possible. But I could not have. It is possible that Fannie Mae could have. I do not recall, after about 12 years of being with Fannie Mae, that we have involuntarily taken a portfolio away from anybody and then sold it.¹⁰

While FNMA requires that servicers will not foreclose "until every reasonable effort has been made to arrive at some other solution,¹¹ as of July, 1975 FNMA had never suspended a servicer solely for failure to undertake proper forbearance action.¹²

Yet, Oakley Hunter openly admitted before the Manpower and Housing Subcommittee that "there probably have been from time to time cases where our servicers have moved rather rapidly"¹³ and that overall, "the supervision of servicers can be stepped up."¹⁴

¹⁰Ibid. p. 548-549.

¹¹FNMA Servicer's Guide Sec. 129.01, op. cit. p. 35.

¹²"Mortgage Servicing and HUD Property Management" op. cit. p.65.

¹³Ibid. p. 68.

¹⁴Ibid. p. 79.

One way that FNMA might be able to improve its supervision would be to spot-check the servicers' recommendations for foreclosure. FNMA's almost automatic acceptance of a servicer's recommendation to foreclose is a key way in which FNMA could improve its procedures.

Joseph C. Luman, Staff Director on the Manpower and Housing Subcommittee noted that:

Some of those (forms sent in by servicers recommending foreclosure) I looked at had brief comment sections. It was pretty hard to tell whether the loan had been serviced. There would be a statement that the mortgagor had overextended and couldn't make his payments, but you couldn't tell from the comments in the brief section of the form whether he had been hustling or if the servicer was really trying.¹⁵

While Oakley Hunter acknowledged that spot-checking on a case by case basis would be costly, he also agreed that "it should be done even if it is going to cost more money."¹⁶

A final critique of FNMA's regulatory activities comes from a massive study of mortgage lending in Illinois. The Illinois Mortgage Practices Commission found that FNMA has not been carrying out its regulatory responsibilities to its maximum capacity:

It is apparent that despite the information regularly reported to FNMA about delinquencies and abandonments, FNMA has not chosen to either make such information public or to promulgate and enforce standards for the FHA mortgage servicers it does business with. Contrasting the sanctions against servicers that FNMA has, with the lack of effective sanctions against servicers that FHA possesses, it is apparent to the Commission that FNMA has failed to effectively deal with FHA servicing problems, which are beyond the regulatory authority of FHA, as it is presently defined. Therefore, much of the blame for the poor administration of the FHA insured housing programs must fall on FNMA.¹⁷

¹⁵ Ibid. p. 75.

¹⁶ Ibid. p. 78.

¹⁷ Illinois Mortgage Practices Commission Report, Chapter V, "Report on FHA-Insured Lending in Illinois." 1975, p. 67.

Based upon the above findings, the Commission asked:

FNMA to assume the regulatory responsibilities that it has failed to exercise for several years.¹⁸

More specifically, the Commission urged the Governor of Illinois to request that FNMA begin to:

a) make available to the public the future foreclosure rates of every FHA approved mortgagee with which it does business.

b) refuse to buy FHA mortgages from any FHA seller/servicer with an unreasonable rate of foreclosure among its FHA loans.

c) promulgate detailed servicing standards for FHA servicers and strictly monitor such standards for compliance.¹⁹

Clearly, FNMA is in a pivotal position vis a vis servicers. It has an enormous amount of power and should be able to wield it to require tighter compliance with its servicing standards.

¹⁸Ibid. p. 72.

¹⁹Ibid. p. 72.

9. 1975-1976: HUD EFFORTS AT REGULATING MORTGAGEES: RHETORIC OR ACTION?

During the spring and summer of 1975 HUD officials not only began acknowledging the mortgagee abuses and non-compliance with HUD guidelines, but also began to take steps toward correcting the problems. HUD's actions were, probably to a large extent, prompted by the pressure of citizens groups¹ and Congress.² In addition, several court cases have revolved around mortgagee unwillingness to follow HUD's guidelines related to default. (See Appendix 10-2)

In a recent court-case in Chicago (Johnnie D. Brown vs. Lynn and Mortgage Associates) HUD was even named as a co-defendant along with the mortgage company. U.S. District Court Judge Herbert L. Will, in charge of hearing the case, faulted HUD for catering to mortgage companies rather than to low-income homeowners. Judge Will further stated that:

Contrary to its statutory obligation, HUD has forced foreclosures rather than taking action to prevent them...If HUD had consciously and deliberately set out to frustrate the Congressional purpose and sabotage the program, (235 program) it could have hardly done so more effectively -- short of simply refusing to carry it out.³

In the wake of these criticisms, Secretary of HUD Carla A. Hills launched a program to sharpen the monitoring of mortgagees. The first

¹See, for example, 1975-1976 issues of Disclosure, published by the National Training and Information Center, Chicago. (Formerly known as the Housing Training and Information Center.)

²See, for example, "Mortgage Servicing and HUD Property Management," op. cit. and Hearings Before the Committee on Banking, Housing and Urban Affairs, "Housing Management, Foreclosures and Abandonments" U.S. Senate, 94th. Cong. 1st. Sess., July, 1975, Chicago, Illinois.

³Statement reprinted in Community Planning Report Vol. 1, No. 14, October 31, 1974, Washington, D.C. (See Appendix 10-3 for various materials relating to Brown vs. Lynn et. al. and for HUD's new approach to relief for defaulting mortgagors.)

step the Secretary took was to establish a four-member "Mortgage Review Board" with the power to revoke the approval status of mortgagees. (Prior to this the FHA Commissioner had the ultimate authority for suspensions and terminations -- See Appendix 10-4.)

Less than two months after its creation, on October 31, 1975, the Mortgage Review Board suspended Advance Mortgage Company (AMC), the nation's second largest mortgage banker, for 30 days. Basing their decision on data collected in an investigation which has still not been released by HUD, the board cited "widespread violations of HUD's policies and procedures regarding the origination, servicing, and post-foreclosure treatment of FHA-insured mortgages."⁴

In what has been called a "precedent setting action"⁵ HUD not only ordered a 30-day suspension of all origination activities; placed the mortgage company on probation for 180 days; ordered a reimbursement of \$145,000 for excessive charges in connection with the servicing of FHA-insured loans; but also cancelled FHA insurance on all loans on which false information had been give by AMC between January 1, 1974 and December 31, 1975 and which had either been foreclosed or would go into foreclosure by December 31, 1979.

⁴Housing and Development Reporter - Vol. 3, No. 12, November 3, 1975, p. 537. The report citing these mortgagee abuses is known as the "Moss Report."

⁵Ibid. Vol. 3, No. 16, December 29, 1975, p. 723.

Voiding the insurance on an FHA insured mortgage, thereby shifting the responsibility for the worth of the property back to the mortgagee and forcing him to assume a full measure of risk, is a powerful "stick" that HUD has at its disposal for forcing mortgagees to comply with its regulations and requirements. It is encouraging that HUD is willing to use this important and potent disciplinary action -- although it is clearly a "last resort" response to what must have been major irregularities in AMC's activities. It is still too early to judge whether the new Mortgagee Review Board's powers will be used often, thereby creating an effective punishment for non-complying mortgagees, or whether they will be used only as a means for HUD to periodically display that it is doing something to force mortgagees to follow its guidelines. Thus, the Mortgagee Review Board may become a real watchdog over mortgagees, keeping the consumer's and HUD's interests paramount, or it may only be used as a political device.

In addition to the creation of the Mortgagee Review Board, HUD has also taken a series of other steps to improve the operating procedures of mortgagees. But, similar to the Mortgagee Review Board, these actions are still too recent to provide any insight into how broadly they will be used or how effective they will be. HUD has, within the past year, instituted several measures that, if enforced, would seem to be strongly pro-consumer.

Testifying before the Manpower and Housing Subcommittee of the House Committee on Government Operations in July, 1975, Robert C. Odle, Jr.,

HUD Deputy Assistant Secretary for Housing Management stated that HUD was requiring the following immediate steps:

A. Submission by each field office of a monthly report advising of significant potential problem areas.

B. Spot-checking of credit and employment checks, required at the mortgage origination stage.

C. Spot-checking of insured property condition at time of transfer to HUD.

D. Spot-checking of claims submitted by mortgagees for reimbursement of property preservation.

In addition, Odle testified that, on a longer term basis, various insurance and servicing activities would undergo scrutiny and, where appropriate, revisions to existing procedures would be undertaken.

Among the areas to be studied included:

1. Clarification of standards for FHA-insured mortgage servicing.

2. Clarification of underwriting and inspection standards for originators of FHA mortgages.

3. Clarification of the responsibility of mortgagees to preserve and protect FHA-insured properties during foreclosure proceedings.

4. Clarification of the sanctions applicable to mortgagees who fail to meet HUD standards for servicing, property maintenance, and origination.

5. Improvement of HUD's capacities and procedures for monitoring mortgagee compliance with HUD regulations and procedures.

6. Consideration of means to minimize the length of time during which properties in foreclosure and HUD-acquired properties remain vacant.

7. Establishment of better lines of communication between borrowers and lenders, including the possibility of requiring mortgagees to maintain a toll-free telephone number or to accept collect calls from borrowers.

8. Finalizing a nationwide computer network which will provide data on each FHA-insured mortgage and on the default rates of each FHA-approved mortgagee.⁶

While HUD has begun to implement some of the above measures, it is both too early and beyond the scope of this thesis to assess how effectively HUD will institute and monitor the new requirements. It is encouraging that high HUD officials are trying to reverse problematic origination and servicing procedures. But, on the other hand, HUD's past record of acting on recommendations to improve its internal and monitoring activities has been subject to criticism. A March,

⁶"Mortgage Servicing and HUD Property Management" *op. cit.* p. 12-13, In addition to the above nationally oriented efforts, in Chicago, every property transferred to HUD is to be inspected and photographed by an area manager or by HUD personnel within 5 days after the claim for FHA insurance benefits.

1976 report by the Committee on Government operations faulted HUD for its "seeming unwillingness in the past to take corrective action."⁷

Further, the Committee found that:

Recommendations for improvement from internal and external sources such as the Congress, the General Accounting Office, HUD's Inspector General, and HUD field offices often have not been given the attention they deserve. Consequently, reports critical of HUD seem to have a quality of timeliness even when they are several years old.⁸

There is no single reason which accounts for HUD's inaction. The late 1960's reorganization of HUD;⁹ inadequate staffing;¹⁰ fraud and abuses by HUD personnel;¹¹ the inexperience of HUD staff in dealing with a new type of mortgagor -- one with a lower income;¹² and a sensitivity to the problems of mortgage servicers which is for greater than its sensitivity to the problems of other groups¹³ provide plausible explanations for HUD's unwillingness or inability to change and correct its defective procedures. Whether or not HUD is now prepared to act on its own recommendations for improving its internal and monitoring operations of mortgagees is open to question. The issue deserves close scrutiny.

⁷Nineteenth Report by the Committee on Government Operations, op. cit. p. 4.

⁸Ibid. p. 7.

⁹See, for example, Ibid. p. 4 and Horace B. Bazan, op. cit.

¹⁰Nineteenth Report by the Committee on Government Operations. op. cit. p. 13-14, see also Fifteenth Report by the Committee on Government Operations. op. cit. p. 22-24.

¹¹Housing and Development Reporter Vol. 2, No. 24, p. 1185, April 21, 1975.

¹²Fifteenth Report by the Committee on Government Operations. op. cit. p.19.

¹³Nineteenth Report by the Committee on Government Operations, op. cit. p. 18.

CHAPTER 11

CONCLUSIONS AND RECOMMENDATIONS:

The first part of this thesis explored the ways in which the government has encouraged the participation of financial institutions in mortgage lending by creating mechanisms that have reduced risk. Specifically, Sections I and II assessed how the post-Depression recovery measures -- HOLC, FHLBS, FNMA and, most important, the FHA, encouraged financial institutions to become re-involved in mortgage lending by shifting risk away from lenders by providing liquidity and minimizing the possibility of losses due to foreclosure. Furthermore, the unique characteristics of mortgage companies, the dominant lender in the HUD-FHA home finance system, when combined with the riskless lending situation that the government has created, have encouraged irresponsible decisions on the part of some lenders. In addition, the multiple goals of the homeownership programs -- to involve lenders and to achieve an array of other social, political and economic objectives -- have also presented some difficulties for consumers.

The multiple goals embodied in the Housing and Urban Development Act of 1968 have also caused some problems. The political struggles which prevented the creation of a new agency, the NHOF, to implement the socially oriented homeownership programs may, in fact, have been more successful than HUD has been. Furthermore, HUD Secretary Romney's intense desire to prove that his agency could implement the programs certainly contributed to the confusion over whether the emphasis in the homeownership programs should be on insuring good quality homes or a large quantity of units;

and this, in turn, contributed to a variety of problems in HUD's pre-purchase procedures.

The second part of this thesis examined how, in the course of the government's efforts at shifting risk away from lenders, it has shifted the risk of mortgage lending onto itself. Section III analyzed the numerous ways in which HUD has neglected to accept the responsibility which is inherent in its risk taking position. Faulty appraisal and inspection procedures; inadequate checks on the buyer's credit' almost no controls at closing, insufficient monitoring of mortgagees; and a total abdication of responsibility during mortgagor default -- all point to the fact that HUD must be harshly criticized for not dealing with the risk that is the critical element of its being a mortgage insurer.

In understanding what happened after 1968, the following analogy is helpful:

Prior to 1968, HUD was dealing with "swimmers" that could have made it to shore without life jackets. Thus, the pre-1968 FHA home buyer was a reasonably safe risk, by virtue of his middle class, middle income status. Whether HUD was exerting tighter controls prior to 1968, or whether they were just dealing with good "swimmers," a situation was created in which relatively few people drowned. However, after 1968, suddenly HUD was forced to deal with people who had never even been in the water! Everyone expected the life-jacket -- HUD-FHA -- to work. But, to everyone's disappointment, the life jacket had holes in it and thousands of people drowned. Thus, HUD neither accepted the risk

inherent in its position as an insurer nor did it accept the responsibility of a public agency -- to safeguard the consumer through more direct channels, such as counseling.

In contrast to the "swimmers," not only did the mortgage lenders have one life jacket but they had two good ones, that fully protected them against risk -- FHA and FNMA.

Furthermore, while many home buyers have managed to get "to shore" -- even with their faulty life jackets, many others have drowned because of a sudden tidal wave -- default. During default, HUD's risk intensifies but, once again, they have turned their backs on their responsibilities. The financial institutions, on the other hand, who have also been hit by the tidal wave, have been able to ride through the storm without any major difficulties and have been so preoccupied with getting to shore and have been so well protected from the problems all around them because of their double life jackets, that they have paid no attention to the fast-sinking homeowners. Thus, many of the swimmers who managed to plug the holes of their faulty life jackets, finally succumb. The life jackets disintegrate and the swimmers drown. The homeowner in default is, literally, "at sea" and foreclosure is a frequent outcome.

But in spite of the fact that the drowning people never claimed to be swimmers in the first place, the Administration has concluded that in order to prevent anyone else from drowning, that the appropriate policy is not to let anyone else in the water, rather than to fix the life jackets and to teach the people to swim.

Thus, in summary, the major conclusion of this thesis is that the policy of homeownership for low-moderate income families has not yet been given a fair test at the national level. The thesis has demonstrated that the HUD-FHA home finance system has not been oriented toward the needs of the low-moderate income consumer for several complex and important reasons.

- 1) The government has shifted risk in mortgage lending away from financial institutions and onto itself, through a series of complex institutions.
- 2) This shifting of risk has been done in order to ensure a good flow of mortgage credit, by encouraging the participation of lenders.
- 3) In addition to the government's efforts at enhancing credit flows and encouraging lender participation, the government has also addressed a variety of other political, economic and social goals through its homeownership policies. Thus, the needs of the consumer have never been the primary concern of Federal homeownership legislation and the consumer has suffered some adverse impacts.
- 4) The complexity of the resulting homeownership/home finance system has made it less able to deal with consumers on a one-to-one basis. The system is particularly unresponsive around mortgagor default.
- 5) The system is problematic for the consumer in default, not only because of its unwieldiness, but because there are positive incentives to foreclose; there are no positive incentives to grant forbearance; and there are no negative sanctions if forbearance is not granted.

6) While HUD has shifted the risk onto itself it has not accepted the responsibilities interwoven with this position, in numerous ways. A key point at which it has not accepted responsibility has been during default. HUD has not lived up to its role as a public agency and not protected the interests of consumers, which are consistent with its own self-interest.

7) The cushions and supports that the government has supplied to the financial institutions to produce a risk-free lending environment have not been matched by either equal or ample supports for the consumer, by way of consumer protection and counseling services.

Beyond these basic conclusions loom a series of issues which should be addressed.

- 1) Is homeownership for low-moderate income families still a viable policy?
- 2) Could HUD be the implementing agency for such a program?
- 3) In what other ways could the homeownership/home finance system be made more consumer oriented?
- 4) How could the default situation be improved?
- 5) Who should be the lender in the government's homeownership programs?
(With particular emphasis on the inner city.)
- 6) How can mortgagees be made more responsible?

1. IS HOMEOWNERSHIP FOR LOW-MODERATE INCOME FAMILIES STILL A VIABLE POLICY?

There are three reasons why this policy should be revived.

First, many participants in the homeownership programs are probably having at least satisfactory experiences. One of the drawbacks with an investigation into problems in program operation is that it is very easy to lose sight of the fact that the program was not 100% bad. If the present foreclosure rates continue in the low-moderate income homeownership programs, somewhere between 87-90% of all program participants will not lose their homes. And, of these families, it is probably reasonable to assume that a majority will be happier than with their previous housing situation.

Based upon a survey of 260 Section 235 homeowners, OSTI researchers found that 75% of the families claimed that their present condition was an improvement.¹ Furthermore,

...on balance, fewer families mention deficits at all in comparison with the benefits they feel they have had as homeowners. Their satisfactions are greater than their dissatisfactions, and the benefits outweigh the deficits...Whatever they had to do (to maintain ownership) was worth it to most of them. The opportunity to own a home thus emerges as one of the most important values for the lower-income families who purchased under the 235 program... over 90% of...the families would become homeowners again. With all the problems they have had, only a few of the families are thinking of moving. Most of them expect to remain in the houses they bought for at least the next ten years; some, for the rest of their lives.²

¹OSTI Final, op. cit. p. 203.

²Ibid. p. 205.

This, then, is fuel for the argument that the low-moderate income family is not, per se, incapable of homeownership. The lower income homeownership programs have, by no means, been a total failure and the Administration's and Congress' disenchantment with the policy is unfounded.

However, there have certainly been an abundance of problems, as discussed throughout this thesis. These problems are, in fact, the second and most important reason why the policy of homeownership for low-moderate income families should not be abandoned. Even with all the problems -- ranging from inadequate property appraisals and inspections by HUD; to a disinterest on the part of mortgage companies in either the person or the property; to a dearth of supports for the consumer -- many homeowners appear to be succeeding. Reiterating the major conclusion of the thesis, the policy of homeownership for low-moderate income families has not yet been adequately tested, given the widespread problems that have pervaded the implementation of the homeownership programs.

The third reason why the policy is still viable relates to the successes that small-scale lower income homeownership programs have reported. In 1970, Bernard Frieden and JoAnn Newman found that four pilot lower income homeownership programs have achieved a high degree of success.³ More recently, the Buyer's Agent Program (BAP) in San Francisco has demonstrated that lower income purchasers, using Section 235 subsidies were, unqualifiedly, capable of homeownership. However, both Frieden and Newman

³Bernard Frieden and JoAnn Newman, "Home Ownership for the Poor?" Trans-Action, October 1970. p. 47-53.

and analysts of the BAP agree that counseling and consumer protection, on the part of the implementing agency, are critical ingredients for success.

The Final Report on the BAP concluded that:

The BAP constitutes a provocative lesson in the provision of a service to consumers that can make housing subsidy delivery service more effective...The government must begin treating low and moderate income families as consumers of housing rather than seeing them merely as consumers of subsidies. The BAP approach must now be carefully evaluated in terms of subsidy delivery and consumer protection.⁴

Thus, the material presented in this thesis, when combined with the positive findings of other lower income homeownership programs, provide a strong case for the policy of homeownership for low-moderate income families being given a second chance at the national level. But, a key question would be, who would implement the program?

⁴Edward W. Moose, "Final Report, The Buyer's Agent Program" Prepared for the San Francisco Development Fund, March 1975 p. 74-75. On the Buyer's Agent Program also see: Raymond H. Lapin and Elizabeth Eudey, "Section 235 Can Work: Findings of San Francisco Demonstration Indicate 235 Subsidized Homeownership Deserves Second Try" Journal of Housing, June 1975, p. 287-289. For another story of a successful lower income homeownership program see: Charles Abrams (with Robert Kolodny) Home Ownership for the Poor: A Program for Philadelphia (New York: Praeger, 1970).

2. SHOULD HUD BE THE IMPLEMENTING AGENCY FOR A HOMEOWNERSHIP PROGRAM FOR LOW-MODERATE INCOME FAMILIES?

HUD's record in implementing the post-1968 homeownership programs casts a dark shadow on whether it would be able to manage a homeownership program for low-moderate income families. But in view of the enormous difficulties inherent in creating a totally new agency, and taking into account the certain strong opposition by HUD to such a proposal, the likelihood is that HUD would be charged with the implementation of any new homeownership program.

However, whether the implementing agency were HUD or another agency, there are three well-defined alternatives that would dictate its basic mode of operation. Assuming that all major aspects of the homeownership/home finance system remain unchanged, HUD could either:

- 1) Accept no risk, shifting it back onto the lender;
- 2) Accept full risk, but carry out the responsibilities inherent in this position; or,
- 3) Accept less risk, but still carry out the responsibilities of a partial risk-taker.

Clearly, if HUD were to follow Option 1, there is a strong possibility that the pre-1968 situation would re-occur: exclusion of the very families that are supposed to be assisted through a lower income homeownership policy. Thus, if the government were to remove itself from a risk-taking position, the availability of funds for socially oriented homeownership programs would be reduced. As a result, Option 1 must be ruled out.

Whether or not the government chose Option 2 or 3, HUD would still have to greatly improve its functions so that it would carry out its tasks in a manner consistent with a risk-taking position -- whether the risk would be total, as in the present situation, or whether it would be shared with the lender.

There are, of course, some different implications on how HUD would operate depending upon whether it chose Option 2 or 3. For example, as long as HUD accepts full risk, it is probably legitimate for them to require all participants in the homeownership programs to go through a counseling program. On the other hand, if HUD shifted some risk onto either the lender, the buyer, or both, the decision of counseling would probably be a joint decision, at the discretion of all the parties who are bearing the risk.

The point that is important to this discussion is that, as long as HUD bears total risk, it must both act in a manner consistent with its highly vulnerable position and it has the right to make certain requirements of participants to protect them as well as itself.

Whether or not a new low-moderate income homeownership program re-emerges, there are still a variety of things that HUD could do that would reduce its risk and could benefit all housing consumers, whether or not they have lower incomes.

The major change that is needed is attitudinal and goes against HUD's historical outlook. HUD must redefine its mission to serve people. HUD

must come to realize that its clients are the homebuyers not the mortgage lenders, builders, or real estate brokers.¹ It must become a consumer protection agency.²

During the course of visits to HUD Area Offices and interviews with HUD personnel, this writer was impressed by the number of dedicated people who had already defined their role in this way. Most of these people were relatively young and had joined HUD, not FHA. If, for no other reason than

¹Horace B. Bazan, for example, has defined mortgagees as the clients of FHA. op. cit. p. 30. In addition, William B. Traxler Jr. et al. have noted that "It is clear that HUD's dealings and concerns are with the mortgage companies and builders and that little attention is given the homeowner (in the 235 program)." "The 235 Housing Program in Action: An Empirical Examination of its Administration and Effect on the Homeowner-Participant in the Columbia, South Carolina Area," South Carolina Law Review, Vol 24, No. 1, 1973, p. 131.

²Other analyses of HUD-FHA have come to the same conclusion. One study concluded that: "The FHA must be redirected as an agency that once again is concerned with people and serving their needs -- helping them acquire the home of their choice. Citizens Planning and Housing Association, "FHA: An Unsatisfactory Status Quo" Baltimore, Maryland, November, 1973 p. 55. Similarly, Vicent diPentima has written that "Fundamental to the success of these (homeownership) programs is an active administration by a concerned, social-oriented agency which engages in both safeguarding purchasers and providing increased homeownership...A new initiative and a new effort can be mounted in the FHA by restructuring it in so far as it would assume features similar to a consumer protection agency. "Abuses in the Low Income Homeownership Programs -- The Need For a Consumer-Protection Response by the FHA" Temple Law Quarterly, Vol. 45, No. 3. Spring, 1972, p. 472, 475. See also Conclusions of the BAP, Moose, op. cit. To provide a balanced view, it should be noted that while some analysts have similarly faulted HUD for its lack of a consumer orientation they have concluded that, rather than HUD try to change, new agencies should be created. See, for example, Chester W. Hartman, Housing and Social Policy (Englewood Cliffs, N.J.: Prentice-Hall, 1975) p. 161.

attrition of old FHA personnel, HUD could change its orientation. But high HUD officials must become more responsive to innovation and suggestions for improvement from HUD Area Office personnel than they have been in the past. This thesis has discussed instances in which HUD personnel have indicated an awareness of problems which they have communicated to their superiors, but to no avail.³

Of a more technical, procedural nature, HUD should undertake the following, to further the objective of accepting its responsibility and inbecoming a more consumer-oriented agency.

- 1) HUD should make sure that its own guidelines concerning pre-purchase processing are enforced. For example, HUD should rigorously spot-check appraisals, mortgagor employment and bank deposits. In addition, HUD should play an active role at closing and should withhold issuance of the insurance certificate until everything meets with their approval.
- 2) HUD should make sure that the property to be insured is in good condition and should take responsibility for such inspection.
- 3) The position of the Housing Counselor should be upgraded within an expanded section dealing solely with individual consumers and counseling agencies.
- 4) HUD should be a strong advocate of a comprehensive counseling program that would include pre-purchase, post-purchase and default counseling services.

³See Chapter 10 and Appendix 9-1. Also see "HUD's Responsiveness to Previous Recommendations for Corrective Action" *op. cit.* This report faulted HUD for a "lack of responsiveness to proposed changes...some HUD field officials were aware of problems long before they became news items or subjects of...investigations. Among those officials who recognized what was happening were some who proposed corrections." p. 4.

- 5) HUD should devise rigorous certification procedures for counseling agencies and should develop a monitoring procedure.
 - 6) HUD should improve its monitoring of approved mortgagees, particularly the non-supervised mortgagees. The newly created Mortgagee Review Board should play an active role in taking strong, punitive actions against non-complying mortgagees. Mortgagee suspensions and even terminations should be used more frequently for violations with HUD guidelines. HUD should also not hesitate to revoke the insurance on specific mortgages whenever it has established that a mortgagee has violated a procedure or guideline.
 - 7) HUD should investigate the possibility of requiring mortgagees to have servicing offices within a reasonable distance from the property.
 - 8) HUD should act as a watchdog in the home finance system. Investigative teams should delve into all aspects of the private market and monitor the activities of private actors.
 - 9) HUD should play a more aggressive role in the default situation.⁴
- Thus, even if no new low-moderate income homeownership program is enacted, that might either keep HUD's risk at the same or a lesser level, for as long as HUD is in the business of being a mortgage insurer, it must come to accept the responsibility inherent in this role.

⁴Specific suggestions on how HUD should respond in the default situation will be discussed in Section 4, below.

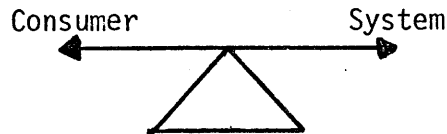
In addition to the above internal improvements that HUD must make if it is to accept the responsibility inherent in its risk-taking position, several changes in other aspects of the homeownership/home finance system are needed to make the system more consumer-oriented.

3. IN WHAT OTHER WAYS COULD THE HOMEOWNERSHIP/HOME FINANCE SYSTEM BE MADE MORE CONSUMER ORIENTED?

An image that comes to mind that describes the post-1968 homeownership/home finance system is a scale, with the supports and cushions heavily weighed on the system's side without comparable supports for the consumer: Prior to 1968, however, the scale was reasonably balanced since the consumer came equipped with his own cushions, in view of his middle income status. After 1968, however, the new consumer's lack of education, experience and resources, combined with a lack of any real government supports to replace these deficiencies, caused an unbalanced scale.

Pre-1968

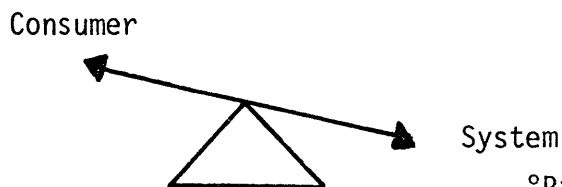
- °Middle income
- °Safe, suburban property



- °Risk free lending environment
- °Conservative FHA

Post-1968

- °Lower income
- °No counseling
- °HUD abdicating responsibility
- °No incentives to assist consumer in default



- °Risk free lending environment
- °Liberal insuring policy

While the homeownership programs may have given a new group of people an "equal opportunity" to achieve homeownership this was not enough. More "affirmative action" on behalf of the consumer, is required for the low-moderate income homeownership programs to be completely successful.

Using Charles Abrams' image, the government has, once again, created "socialism for the rich and laissez-faire for the poor."¹ More aids to the consumer

¹Charles Abrams, The City is the Frontier op. cit. p. 255.

are clearly required if the low-moderate income family is to be given a chance at homeownership.

Some of the needed changes directly related to HUD's activities were outlined above. In addition, other changes in the home finance system would be necessary to put the consumer at a greater advantage and to help re-balance the scale.

Congress should play a stronger role in requiring a consumer orientation in the home finance system. Specifically, Congress should, in any future low-moderate income homeownership program, make explicit the fact that the goal is to assist families to attain better housing. Other goals of housing legislation, such as improving the overall housing stock; increasing the level of construction; encouraging lender participation by providing them with protection; and enhancing the flow of capital, must be clearly placed in subsidiary positions.

Congress should also undertake the following:

- 1) Investigate the impacts of removing the FHA interest rate ceiling and the abolition of points on the primary and secondary mortgage markets. Direct research efforts to the question of how points could be eliminated.
- 2) Appropriate funds for homeownership counseling services.
- 3) Direct HUD to require counseling of all low-moderate income home buyers.

In addition to a need for Congress and HUD to shift their priorities more in the direction of the consumer, there is also room for mortgagees to play a more responsible, consumer-oriented role. While it is easy to point to HUD as the cause of the problems in the homeownership programs, since HUD is the public agency vested with safeguarding the public interest,

HUD should not take the blame alone. One cannot say that mortgagees that don't perform properly are solely HUD's responsibility, since HUD is supposed to regulate them. Mortgagees, too, must be criticized for their deficient procedures. That the system does not provide incentives for them to act in a consumer-oriented fashion is a short-coming of the system. But the failure of mortgagees to act as responsibly as possible, is a failing for which they, alone, must be blamed.

Mortgagees must play a more responsible role in the lending decision. By providing them with either "carrots" or "sticks," they must come to realize that there are real risks in irresponsible underwriting and servicing. Ways in which this could be achieved will be discussed in following sections.

4. HOW COULD THE DEFAULT SITUATION BE IMPROVED?

Much of this thesis has been involved with an examination of the default situation. The following are some key changes that should be made to make HUD a more responsible bearer of risk and to enhance the consumer's position in default.

- 1) Regardless of whether or not the FHA interest rate ceiling can be removed, the ability of mortgagees to make money of foreclosure must be eliminated.
- 2) HUD guidelines for servicing mortgages in default -- relief measures -- should be given the weight of law.
- 3) HUD and FNMA should work together to devise a standard set of relief measures. The MBA should be requested to adopt them.
- 4) HUD should require all mortgage servicers to notify defaulters of the availability of specific relief measures.
- 5) HUD should send out a letter to defaulters asking their cooperation upon their receipt of the 2068 form.
- 6) HUD and/or its designated counseling agency should be available to assist mortgagors in default or to mediate between them and mortgagees.
- 7) FNMA should improve its monitoring of mortgagees, particularly with respect to the extension of relief.
- 8) Strong sanctions -- both by HUD and FNMA -- such as fines, suspensions or terminations should be brought against mortgagees who do not comply with the relief measures.

Thus, there are a number of ways in which the defaulting consumer could be treated that would improve his position, thereby diminishing the likelihood of foreclosure and decreasing HUD's own risk.

In addition, the Emergency Housing Act of 1975¹ gives HUD standby authority to make loans to defaulting homeowners or to co-insure lender advances of up to \$250 per month for 12 months to help homeowners meet their mortgage obligations. However, this is not as advantageous for the consumer as are the existing HUD relief measures. Forbearance allows non-payment for a longer period and allows the term of the mortgage to be extended. In contrast to these lenient provisions, payment on the loan principal, authorized by the Act, must begin 12 months after the assistance has ended. This could easily place a severe burden on the mortgagor recovering from a default and trying to resume his regular mortgage payments.

HUD should direct its energies toward putting real "teeth" into its guidelines for relief rather than diverting them into a loan or co-insurance program that seems to primarily benefit the mortgagee. However, if this program is ever implemented and, at the present, HUD has decided to wait until the delinquency/foreclosure rate becomes more serious,² it will be important to follow the results carefully.

¹Emergency Housing Act of 1975, P.L. 94-50, 94th. Cong. July 2, 1975.

²Housing and Development Reporter, February 9, 1976, Vol. 3, No. 19, p. 856-857.

5. WHO SHOULD BE THE LENDER IN THE GOVERNMENT'S HOMEOWNERSHIP PROGRAMS
(WITH PARTICULAR EMPHASIS ON THE INNER CITY)

While this writer has been critical of mortgage companies, and would like to see thrift institutions re-enter the HUD-FHA homeownership programs, as a matter of reality, mortgage companies are here to stay and HUD-FHA will continue to work with them. Mortgage companies, whose business is so heavily intertwined with HUD-FHA, are a formidable group whose interests would not be snubbed by the government. However, it is important to briefly underscore the up-side-down nature of our home finance system and the need and mechanisms for conventional lenders to re-enter the government's homeownership programs and inner city areas.

As discussed at length in Chapter 6, the mortgage banker operates in a national, rather than local, mortgage market. Contrary to thrift institutions, such as savings and loan associations, which have historically prided themselves on their expert knowledge of local real estate markets, mortgage bankers have become experts in national investment markets. Since HUD performs (or is supposed to perform) the property appraisals and underwriting function, the mortgage banker has usually been more of an expediter or broker in mortgage transactions than a mortgage lender in the traditional sense.

This distinction between the local orientation of thrift institutions and the nationwide orientation of mortgage bankers is an important one. It suggests that mortgage bankers, who dominate many, if not most, inner-city areas, may, in fact, be much less equipped to perform the complex market analyses than the thrift institutions.

Thus, it appears that we may have developed a "topsy-turvy" home finance system. Thrift institutions have abdicated their role in the inner city -- a role which, by virtue of their training and orientation, they could probably fill comfortably and more easily become inner city lending specialists. Instead, in their place, the nationally-oriented mortgage company dominates the inner city markets.

How could this be changed -- how could conventional lenders be encouraged to re-enter the government's homeownership programs and inner city areas?

First, it is interesting to note that it seems that we have come full-circle in recognizing the importance and need for local lenders who know their territory.

As early as 1934, concern was voiced over the importance of local institutions originating and servicing loans during the early years of the mortgage. Testifying during the hearings which preceded passage of the National Housing Act of 1934 John Fahey, Chairman of the Federal Home Loan Bank Board, stated that:

Mortgages on owner-occupied homes are of necessity small in individual amount, and preferably should be originated and serviced during the first years by local institutions thoroughly familiar with local conditions and in a position to keep close watch on the condition of the property and the responsibility of the borrower. After these mortgages have been amortized to a conservative figure, however, they will constitute safe and acceptable investments for mortgage associations operating over a larger field, which will be able to obtain cheaply the funds used to purchase such insured mortgages from local institutions at a favorable price and thus release fresh funds for local investment.¹

¹National Housing Act Hearings 1934, op. cit. p. 17.

And, in 1974, 40 years after Fahey's remarks, Sheldon Lubar pinpointed the need for localized institutions taking greater responsibility, particularly because of the problems related to default. Lubar noted that a key component of a new neighborhood preservation program is to:

have banks and savings and loans recognize their responsibility to the city -- and as primary lenders put some portion of their assets there, and give these loans a higher level of service than they receive now when they are merely FHA insured and sold on the secondary market...

...Right now...most of the FHA activity is in the central city and we are the only participant there and all of those loans get sold into the secondary mortgage markets...When there is a default those loans are immediately foreclosed and there isn't a great attempt at forbearance or working the problem out.

What I want to do is to have the FHLBB and, hopefully a regulatory agency for the commercial banks, emphasize to them their responsibility to put some portion of their assets in home loans in the central city where they are located...As primary investors, they would hold those loans for their own portfolio. If there would be a default they would do their best to work it out. Most loans can be worked out if enough time and effort is put into it. ²

Thus, in addition to the data presented in this thesis concerning the more careful procedures of some financial institutions compared to mortgage companies, "conventional wisdom" says that local lenders should be more involved in inner city areas. Lenders would probably come back to the government programs and inner city areas if they could be convinced that there is money to be made there.

²Review of FHA, Part 2, p. 175.

A small group of researchers has begun to investigate the conditions under which inner city areas are viable investments.

Basing his comments on research carried out in three California cities, Frederick E. Case stated that:

If there is any single overriding conclusion to be drawn, it is that there is a viable mortgage lending market in inner city areas, but it is a market with special characteristics and problems which must be recognized if the market potential is to be exploited successfully. ³

In a subsequent study, which analyzed inner city housing markets in five cities in different parts of the country, as well as four California cities, Case again found the above statement to hold true:

...if lenders take time to examine territories and examine them on a direct basis, they can undoubtedly find a great many more areas to place loans in the inner city. And they can do this without an appreciable loss of profit or appreciable differences from accustomed results of suburban lending. ⁴

Case offers a number of hints which lenders should follow, if their inner city lending programs are to be successful. For example, he advises that for inner city areas, normal lending policies and risk analyses should be supplemented by: 1) provisions for dealing with various social, health, and employment problems; 2) in-depth credit evaluations; 3) credit collection flexibility; 4) working with public officials to reduce the constant threat of land-use changes; 5) education and training programs on inner-city housing and lending markets for loan officers. ⁵

³Frederick E. Case, et al. "Housing the Underhoused: Two California Studies," Housing, Real Estate and Urban Land Studies Program, Graduate School of Business Administration, University of California, Los Angeles, May 1971, p. 2.

⁴Frederick E. Case, ed., Inner City Housing and Private Enterprise (New York: Praeger, 1972), pp. 74-75.

⁵Ibid., pp. 10-11.

Thus, it is critical that lenders and insurers of inner city properties become better able to understand market forces in those areas. Just as it is probably true that some families should not own homes, it is also likely that some properties are not viable homes. But again, it is difficult for investors not to red-line areas while still being sufficiently cautious.

This discussion re-raises the dilemma presented in Chapter 8 concerning the hair-line difference between over-caution and over-lenieny in lending decisions. How, then, can lenders be assisted in making lending decisions in addition to becoming more familiar with market forces, as discussed above?

A 1968 doctoral dissertation suggested the need for a tool which could:

be used by lenders as a sieve to screen out the borrowers who are least likely to represent good credit risks...This (would) hopefully result in turning away those potential house buyers who should wait a few more years before they undertake the financial obligations that go with homeownership. The turning away of marginal accounts is as much a service to the lender as to the potential borrower.⁶

In this writer's opinion, the necessary tool for making this type of determination would involve counselors able to gauge a prospective mortgagor's readiness for ownership as well as the basic and more easily definable ability to pay. In addition, an assessment of a person's ability to own a home should also consider which home. It might be wise to discourage a "borderline" family from purchasing a house needing major repairs while a different house, one in better condition, may permit the

⁶Frank Earl Dotson, "The Development of a Numerical Scoring System for Evaluating Mortgage Loan Delinquency Risk," Dissertation, Graduate School of Business Administration, University of Southern California, June, 1968.

the family to become a homeowner.

Thus, while it is not a simple issue to become involved with homeownership programs for lower income people and inner city areas, it also appears that there are ways in which lenders and insurers could both minimize losses while opening participation to all eligible people, while barring participation only to those people and properties which are clearly ineligible.

Before going on to the last question, it is important to add that community groups, have been trying to force conventional lenders back into the cities and the government programs for several years. One approach, spear-headed by the National Training and Information Center, has been to demand that lenders disclose the geographic areas of both savings accounts and mortgage loans in their portfolio. These efforts have resulted in the Home Mortgage Disclosure Act of 1975. However, it is still too early to know how much success this legislation will have in encouraging lenders back into the cities. The legislation does not require lending in any specific area, it merely requests that information on the location of loans be made public.

Other community groups have been working with consortia of conventional lending institutions and, when their own resources have been combined with commitments for services from the municipal government, lenders have been willing to re-enter an area by pooling mortgage funds. This has proven to be a particularly successful approach in several cities.

In Pittsburgh, for example, the Neighborhood Housing Service Program has been widely acclaimed for "bringing back" a declining area with the

cooperation of local lenders.⁷ The high degree of success attributed to this program spurred a joint effort by HUD and the Federal Home Loan Bank Board -- The Urban Reinvestment Task Force -- to try to duplicate the Pittsburgh model in other cities. This type of shared-risk program may be one answer for encouraging lenders back into the cities.

⁷See, for example, Roger S. Ahlbrandt, Jr. and Paul C. Brophy, "An Evaluation of Pittsburgh's Neighborhood Housing Services Program" (Pittsburgh: ACTION Housing, Inc.), March, 1975 (Prepared for HUD). It must also be added, however, that some mortgage pools have not worked. For example, the Boston Banks Urban Renewal Group Program has been faulted for encouraging unscrupulous real estate and banking activities and hastening the decline of an urban area rather than preventing it. See Boston Antitrust Hearings op. cit. and Rachel G. Bratt, A Homeownership Survey, prepared for the Boston Model City Administration, January, 1972.

6. HOW CAN MORTGAGEES BE MADE MORE RESPONSIBLE?

First, there is a need for increased regulation of mortgage companies by HUD. In the long run, Congress should make a thorough investigation into this issue and consider the possibility of creating a separate regulatory body that would supervise mortgage companies in the same way that the FHLBB supervises savings and loan associations.

Second, all lenders using FHA insurance could be made to share some risk through a coinsurance program or through some other means. (This would be Option 3, discussed above). Section 244 of the Housing and Community Development Act of 1974 established a coinsurance program. Under this section a mortgagee may choose to assume at least 10 percent of any loss on an FHA-insured mortgage. The mortgagee must agree to "carry out...such credit approval, appraisal, inspection, commitment, property disposition or other functions..." And, in exchange for this new responsibility and risk, the mortgagee will share with HUD the FHA insurance premium.

However, it is not at all clear that coinsurance will do away with irresponsible mortgage lending. First, since coinsurance is optional, at the discretion of the lender, it is uncertain whether it will be used at all. Lender participation will certainly depend, in part, upon how great an incentive the sharing of the insurance premium will provide.

Second, even if lenders were willing to participate in the program, the likelihood is that they will choose coinsurance only in those cases that are deemed safest, or risk-free -- in the spite of the language of the legislation: "The Secretary shall exercise his authority under

this section only to the extent that he finds that the continued exercise of such authority will not adversely affect the flow of mortgage credit to older and declining neighborhoods and to the purchasers of older and lower cost housing."

More skeptically, it is not clear that all mortgage lenders that participate in the FHA programs are even capable of performing the necessary underwriting functions, whether or not there is risk involved. The well-formed habit of being unconcerned about underwriting, that many mortgage companies have lapsed into, prompted one high HUD official to note that "Most small mortgage companies don't know anything about underwriting. They don't have to with FHA."¹

And, fourth, even if mortgage companies were able to do good underwriting jobs on the coinsured loans, there is still nothing to encourage them to take similar care on the 100 percent FHA-insured loans. Thus, it is unlikely that a mortgage company that carefully underwrites a low-risk coinsured loan will expend much effort screening a totally risk-free loan.

In view of the above, it is unlikely that the present coinsurance program will go far toward increasing the responsibility of mortgagees. Yet, the need for mortgagees to assume some responsibility for the lending decision is clear and some type of coinsurance scheme appears to be the most likely alternative. The next step is for the government to carefully assess the present coinsurance plan and to experiment with modifications, as necessary.

¹ Interview, Walter Stuart, op. cit.

It is critical that the whole area of risklessness in mortgage lending be studied carefully and that there be both positive incentives for good underwriting and clear and enforceable sanctions against irresponsible actions.

A FINAL NOTE:

Thus, there are a number of improvements that can be made and studies to be undertaken. With these changes and added information the homeowner-ship/home finance system would be more consumer-oriented and a revived national effort at providing homeownership opportunities for low-moderate income families would be in order.

But, even these improvements to the HUD-FHA home finance system may still not result in the desired end: Provision of decent housing and the choice of homeownership to a wide range of families.

Critics of the housing system point out that with its present fundamental characteristics, there may be no way of meeting the nation's housing goal.

As Chester Hartman has stated:

At the government level expenditure levels are miniscule compared with need, and the required degree of public intervention in and control over the housing system has not been accepted. The private sector's need for profit from new housing production -- in land speculation, money lending, materials production, and development -- as well as from ownership and operation of existing housing conflicts frequently and drastically with the human right to live decently. Establishment and implementation of a right to decent housing is essentially a political question...Failure to face the fundamental issues of resource distribution and political control will consign millions of American families to substandard living conditions and excessive housing costs for decades to come.²

Yet, in spite of the persuasiveness of Hartman's argument, housing policy makers still need a direction in lieu of -- or until -- more massive changes in our society occur. Thus, it is still fruitful to try to create and implement policies that are directed at attaining the nation's housing goal. Homeownership for low and moderate income people is still a viable housing strategy and awaits a better planned and better executed trial.

²Chester Hartman, Housing and Social Policy, op. cit. p. 176.

APPENDICES

APPENDIX 1-1
DETAILED DESCRIPTION
OF HOMEOWNERSHIP
PROGRAMS

From: HUD Handbook 4000.2
"Mortgagees' Handbook--
Application Through
Insurance" (Single
Family) March, 1975

CHAPTER 1. INTRODUCTION

- 1-1. THE NATIONAL HOUSING ACT of 1934 established a federal program to foster home ownership. The Federal Housing Administration, created to administer the program, provides insurance protection to private lenders who provide mortgage financing to home buyers.
- 1-2. EVOLUTION OF HOUSING PROGRAMS. As the housing needs of America have changed over the years, so have the organizations designed to meet those needs.
- a. The Department of Housing and Urban Development (HUD) was established to provide cohesive control over those governmental programs designed primarily to provide housing and the services and facilities essential to the improvement of housing standards and conditions.
 - b. The Federal Housing Administration (FHA) was made a part of this Department, with responsibility for administering its mortgage insurance programs for the Secretary. In most of its programs, HUD-FHA is an insurer whose ability to pay claims is guaranteed by the United States Government. Its income from fees, mortgage insurance premiums, proceeds from the sale of acquired properties, and investments has enabled HUD-FHA to pay its operating expenses and claims under the unsubsidized programs while accumulating substantial reserves. The expenses of operating the unsubsidized mortgage insurance programs of HUD-FHA are borne by the beneficiaries of these programs. More recently, the Department has been given responsibility for the administration of several newer programs designed to provide much needed housing for families of low and moderate income, financed in part by appropriate funds. While some of these programs are administered by HUD-FHA as mortgage insurance programs, mortgages originated under them become risks of the Special Risk Insurance Fund created for this purpose, and they have no effect on the older insurance funds, which continue to be self-supporting.
- 1-3. HUD-FHA's BASIC HOME MORTGAGE INSURANCE PROGRAM was established in Section 203(b) of the National Housing Act, and the descriptions in the basic text of this handbook are based on it. Since 1934, several additional programs have been enacted to meet the specific needs of special classes of home buyers. While the processing of applications and the insurance of mortgages under

4000.2

these newer programs follow the same general pattern prescribed for Section 203(b), there are some differences. Chapter 2 contains a summary of the provisions of each of the home mortgage insurance programs and an explanation of any specific processing requirements.

- 1-4. THE CONTRACT OF MORTGAGE INSURANCE. The Secretary and the mortgagee are bound by the HUD-FHA Regulations with the same force and to the same extent as if a separate contract of insurance had been executed relating to each insured mortgage. The mortgagee's submission of closing documents and HUD-FHA endorsement of the Mortgage Insurance Certificate in each case creates a contract of mortgage insurance which embodies as its provisions the HUD-FHA Regulations in force at the time of endorsement relating to the section of the National Housing Act under which the mortgage is insured. The HUD-FHA commitment is an assurance that, subject to the terms and conditions of the commitment, the mortgage will be insured.

- 1-5. THE ENCOURAGEMENT OF BETTER HOUSING IN SMALL TOWNS and outlying areas is a stated policy of the Department of Housing and Urban Development. To further this policy, the Department in September, 1969, revised outstanding instructions to make all of its home mortgage insurance programs available for use in all areas, provided a market exists for the properties and the properties themselves meet the objectives of HUD-FHA's Minimum Property Standards. Houses to be constructed, however, must meet all applicable standards of the MPS's.
 - a. When determining whether a market exists, the local market conditions of the small town or outlying area in which the property is located, are utilized by the HUD-FHA field office.
 - b. Likewise, the Department recognizes that real estate patterns in small towns and outlying areas include social and economic preferences which are dissimilar to those encountered in larger towns and cities. On existing houses, if a condition is acceptable to the typical market in the area, the appraiser adapts to the point of view of that market and renders his judgments accordingly. Outstanding instructions emphasize that comparisons to standards of the "big city" are to be avoided.

CHAPTER 2. HOME MORTGAGE INSURANCE PROGRAMS

- 2-1. GENERAL. HUD-FHA's home mortgage insurance programs are established by the National Housing Act, and the common method of reference to each program is by the section of the Act which established it. Thus, the basic home mortgage program is normally referred to as "203(b)" and the program which provides insured mortgages for servicemen is referred to as "222." The provisions of the Act are expanded in the HUD-FHA Regulations, which have the effect of law. Each program differs from all others in some respect. For some, there are specific eligibility requirements. For others, the loan-to-value ratio or the maximum insurable mortgage of each home mortgage amount is unique. This chapter presents a capsule summary of each home mortgage insurance program and its peculiarities and explains any specific restrictions or processing requirements.

SECTION 1. HOME MORTGAGE INSURANCE SECTION 203(b)

- 2-2. SECTION 203(b) - GENERAL. This is the basic home mortgage program on which the processing instructions in Chapters 5, 6, and 8 are based. It is designed to provide insurance of mortgages to finance the acquisition of one- to four-family housing for mortgagors having no special qualifications. (Examples of mortgagors having special qualifications are servicemen, disaster victims, and displacees.) If there is doubt as to the section of the Act under which an application should be submitted, the mortgagee should choose Section 203(b). If, in its processing, HUD-FHA determines that the mortgage can more appropriately be insured under another program, the local field office will make the change before issuing a commitment. Similarly, if the mortgagee decides that another section would be more appropriate, the change can be requested when the application for firm commitment (FHA Form 2900) is submitted.
- 2-3. AMOUNT INSURABLE. The maximum insurable mortgage is based on the lower of the statutory dollar limit or the appropriate loan-to-value ratio which applies to the circumstances of the given case.
- a. Statutory Limits.
- (1) Single-family structures: \$45,000.
 - (2) Two-or three-family structures: \$48,750.
 - (3) Four-family structures: \$56,000.
- b. Loan-to-Value Ratios.
- (1) Occupant Mortgagors Who Are Not Veterans:
 - (a) Properties approved for mortgage insurance before the beginning of construction or completed more than one year on the date of application:
 - 1 97% of the first \$25,000 of value and closing costs, plus
 - 2 90% of the next \$10,000 of value and closing costs, plus
 - 3 80% of all value and closing costs over \$35,000.

-
- (2-3) (b) Properties under construction or completed less than one year on the date of application:
- 1 90% of the first \$35,000 of value and closing costs, plus
 - 2 80% of all value and closing costs over \$35,000.
- (2) Occupant Mortgagors Who Are Veterans: (a person who has served on active duty in the Armed Forces for more than 90 consecutive days and was discharged under conditions other than dishonorable) Only single-family structures are eligible.
- (a) Properties approved for mortgage insurance before the beginning of construction or completed more than one year on the date of application:
- 1 100% of the first \$25,000 of value and closing costs, or \$25,000 plus prepaid expenses less \$200, whichever is less, plus
 - 2 90% of the next \$10,000 of value and closing costs, plus
 - 3 85% of all value and closing costs over \$35,000.
- (b) Properties under construction or completed less than one year on the date of application:
- 1 90% of the first \$35,000 of value and closing costs, plus
 - 2 85% of all value and closing costs over \$35,000.
- (3) The ratios discussed in 2-3b.(1) and (2) are available only to mortgagors who can be expected to occupy the property on a long-term basis. Under this section, if the mortgagor's employment is such that he is subject to frequent transfer and can reasonably be expected to move from the area before living in the property

for at least four years, he is considered a short-term occupant, and the maximum mortgage available to him may be reduced accordingly.

(4) Non-Occupant Mortgagors:

- (a) 85% of the amount calculated under paragraph 2-3b.(1), or
- (b) 100% of the amount calculated under paragraph 2-3b.(1) if, under HUD-FHA's Escrow Commitment Procedure, the mortgagor and mortgagee jointly assume responsibility for reducing the unpaid principal by not less than 15% if the property is not sold and the mortgage is assumed by an acceptable occupant mortgagor by the due date of the 18th amortization installment.

1 Under this procedure, the mortgage is insured for 100% of the amount available to an owner-occupant mortgagor who is not a veteran. 15% of this amount is placed in escrow with the mortgagee until the property is sold to a buyer acceptable to HUD-FHA under its FHA Form 2210 procedure (See Reference (1) of the Foreword). If the property is not sold in 18 months, the 15% in escrow is applied to reduce the principal.

2 This provision is available and of principal interest to builders who require insured mortgages to finance construction (Chapter 4), builders or real estate brokers engaged in trade-in transactions, or home owners who require funds to purchase new homes. FHA Form 314, Escrow Commitment Certificate, must accompany the application.

- 2-4. MINIMUM INVESTMENT BY MORTGAGOR. The mortgagor's investment in the property must be equal to the difference between the total cost of acquisition and the amount of the mortgage to be insured, but at least 3% of the cost of acquisition. In no instance may his investment be less than the difference between the cost of acquisition (the total cost including repairs, alterations or additions, plus closing costs, but

exclusive of non-realty items or prepaid expenses) and the amount calculated by applying the appropriate formula from paragraph 2-3b. to the acquisition cost. If the mortgagor is 60 years of age or older, this investment may be made with funds borrowed from a corporation or individual approved by HUD-FHA. In all other transactions, secondary financing is prohibited.

- 2-5. MORTGAGE TERM. 30 years, except that a mortgage on new construction may have a term up to 35 years if the mortgagor is unacceptable for a 30-year term and can qualify under the longer term. Operative builders qualify for no more than 20-year mortgages. The term is further limited to 3/4 of the remaining economic life of the property, if it is less than the maximum term otherwise allowable, but this limitation is waived in cases insured pursuant to Section 223(e), when remaining physical life of the property is substituted for 3/4 of remaining economic life.
- 2-6. INTEREST RATE. Current interest rate as determined by the Secretary of Housing and Urban Development (See Appendix 1).
- 2-7. HUD-FHA STATEMENT OF VALUE. For mortgages on one-to four-family structures, the seller must certify in the application for appraisal (FHA Form 2800-1) that the HUD-FHA Statement of Value (FHA Form 2800-6) will be delivered to the purchaser, and the purchaser must certify (on FHA Form 2900-1 or a separate statement attached to it) that he received either the HUD-FHA Statement of Value or a VA Certificate of Reasonable Value before he signed the application and, at closing (on FHA Form 2900-4), either that the HUD-FHA Statement of Value was delivered to him before the sale contract was signed or that the contract included a provision allowing him to withdraw if the HUD-FHA appraised value (excluding closing costs) is less than a specified amount (which must be large enough when added to the estimated closing costs to support the mortgage applied for).
- 2-8. REFINANCING. An existing mortgage, insured or uninsured, may be refinanced with a new mortgage insured under this section. The maximum mortgage amount and loan-to-value ratio is the same as if it were a new mortgage, further limited to the

larger of 85% of the amount of a new mortgage available to an owner-occupant, or the existing indebtedness related to the property plus the cost of repairs and refinancing. A statement of the purpose of the loan must accompany the application.

- 2-9. OPEN-END ADVANCES are an increase in the outstanding balance of an insured mortgage to provide funds for improvement of the property. They are authorized in those states in which local statutes permit.
- a. Proceeds must be used for repairs or improvements which materially protect or improve the basic livability of the property and for which no obligation has yet been incurred at the time of the advance.
 - b. Applications are submitted on FHA Form 2004-OE, accompanied by:
 - (1) Description of proposed improvements or drawings, and Description of Materials, FHA Form 2005, in duplicate, whichever is sufficient to permit an estimate of cost and determine compliance with the HUD Minimum Property Standards.
 - (2) Copy of contractor's bid or itemized estimate of costs.
 - (3) FHA Form 2900, Application for Mortgagor Approval.
 - (4) Application fee (Appendix 2). This is the only case in which the fee accompanies the application to HUD-FHA.
 - c. Commitments are issued on FHA Form 2007-OE.
 - d. Insurance is evidenced by FHA Form 2576-OE. When the repairs or improvements have been completed and all inspections required by the commitment have been made, the mortgagee returns the commitment with the mortgagor's and mortgagee's certificates completed.
- 2-10. SPECIAL REQUIREMENTS.
- a. If the Mortgagor is a Veteran requesting the higher loan-to-value ratios described in paragraph 2-3b.(1), the application must be accompanied by a Certificate of Veterans

(2-10) Status, VA Form 26-8261, which the mortgagor can request from any office of the Veterans Administration.

b. For Mortgagors Sixty Years of Age or Older, if all or any part of the mortgagor's required investment is borrowed, the application should be accompanied by evidence that:

- (1) The lender or donor is a relative, employer, or humanitarian institution (See paragraph 2-4 of this handbook);
- (2) The amount borrowed, when added to the mortgage amount, does not exceed the total of HUD-FHA value plus prepaid expenses;
- (3) The interest rate on the loan does not exceed the mortgage interest rate; and
- (4) The mortgaged property is not security for the loan.

SECTION 8. HOME MORTGAGE INSURANCE -
LOW AND MODERATE INCOME -
SECTION 221(d)(2)

2-23. SECTION 221(d)(2) - GENERAL. This program provides insured mortgage financing for the purchase or rehabilitation of low-cost housing in one- to four-family units for families displaced by urban renewal or other governmental action and for other low- or moderate-income families.

2-24. AMOUNT INSURABLE. The amount insurable is the lesser of the statutory limit or the appropriate loan-to-value ratio.

a. Statutory Limits.

(1) Occupant Mortgagors:

(a) Families of Less Than Five Persons.

- 1 Single-family structures: \$21,600 (may be increased up to \$25,200 in specified high-cost areas.)
- 2 Two-family structures: \$28,000 (may be increased up to \$36,000 in specified high-cost areas.)
- 3 Three-family structures: \$38,850 (may be increased up to \$46,050 in specified high-cost areas.)
- 4 Four-family structures: \$47,500 (may be increased up to \$54,700 in specified high-cost areas.)

(b) Families of Five or More Persons. Only single-family structures with four or more bedrooms are eligible for increased limits of \$25,200 (up to \$28,800 in specified high-cost areas.) Approval is limited to areas in which suitable housing for larger families cannot be made available within the lower limits prescribed for smaller families.

(2) Operative Builders: 85% of the amount available to a family of less than five persons as occupant-mortgagors of a single-family structure. Commitments may be issued to operative builders for ultimate sale to occupant mortgagors (see also paragraph 2-27). Other non-occupant mortgagors are not eligible.

(2-24) b. Loan-to-Value Ratios.

(1) Occupant Mortgagors:

(a) Displaced Families (also see paragraph 2-27):

- 1 Properties approved for mortgage insurance before the beginning of construction or completed more than one year on the date of application, the lesser of:
 - a Value and closing costs, or
 - b Value, closing costs, and prepaid expenses, less \$200 per family dwelling unit.
- 2 Properties under construction or completed less than one year on the date of application - 90% of value and closing costs.
- 3 Rehabilitation: The least of:
 - a Value before rehabilitation, plus estimated cost of rehabilitation, and closing costs, or
 - b Value and closing costs after rehabilitation, plus prepaid expenses, less \$200 per family dwelling unit.
 - c Value and closing costs after rehabilitation.

(b) Other Occupant Mortgagors:

- 1 One unit properties approved for mortgage insurance before the beginning of construction or completed more than one year on the date of application - the lesser of:
 - a Value and closing costs, or
 - b 97% of the sum of value, closing costs, and prepaid expenses.

(2-24)

- 2 One unit properties under construction or completed less than one year on the date of application - 90% of value and closing costs.
- 3 Rehabilitation: The least of:
 - a Value before rehabilitation, plus rehabilitation cost and closing costs, or
 - b Value after rehabilitation and closing costs, or
 - c 97% of the sum of value after rehabilitation, closing costs, and prepaid expenses.
- 4 2-to 4-unit properties approved for mortgage insurance before the beginning of construction or completed more than one year on the date of application - same as 203(b), (paragraph 2-3b(1)(a)).
- 5 2-to 4-unit properties under construction or completed less than one year on the date of the application - same as 203(b), (paragraph 2-3b(1)(b)).

(2) Operative Builders:

- (a) Properties approved for mortgage insurance before the beginning of construction: the least of:
 - 1 85% of value and closing costs, or
 - 2 85% of the amounts prescribed in paragraph 2-24b(1)(a)1.
- (b) Rehabilitation: the least of:
 - 1 85% of value after rehabilitation and closing costs, or
 - 2 Five times the estimated cost of improvements, or

4000.2

3 The least of:

- a 85% of the sum of the purchase price and estimated cost of rehabilitation, or
- b 85% of the sum of value before rehabilitation and the estimated cost of rehabilitation, and closing costs, or
- c 85% of the amounts prescribed in paragraph 2-24b(1)(a)3.

2-25. MINIMUM INVESTMENT BY MORTGAGOR. This minimum investment may include amounts covering settlement costs, initial payments for taxes, hazard insurance premiums, mortgage insurance premiums, and other prepaid expenses. It need not be in cash but may be represented by the fair market value of the mortgagor's labor in constructing the house. The minimum investment should be:

- a. Displaced Families: At least \$200 per family unit.
- b. All Other Mortgagors: At least 3% of acquisition cost.

2-26. ADDITIONAL PROGRAM SUMMARY INFORMATION.

a. Mortgage Term. The mortgage term is the lesser of:

- (1) Three quarters (3/4) of the remaining economic life of the property (this may be waived if the mortgage is insured pursuant to Section 223(e)), or
- (2) For displaced families: 30 years (35 to 40 years under special credit conditions), or
- (3) For other occupant mortgagors:
 - (a) Housing built subject to inspection by HUD-FHA or VA: 30 years (35 to 40 years under special credit conditions).
 - (b) All other housing: 30 years.
- (4) For non-occupant mortgagors: 30 years.

-
- b. Interest Rate: Same as Section 203(b) (paragraph 2-6).
 - c. HUD-FHA Statement of Value. Same as Section 203(b) (paragraph 2-7).
 - d. Refinancing. Same as Section 203(b) (paragraph 2-8).
 - e. Open-End Advances. Same as Section 203(b) (paragraph 2-9).

2-27. SPECIAL REQUIREMENTS.

- a. Applications from families displaced by urban renewal or other governmental action who qualify for higher loan-to-value ratios or purchase under equity accumulation contracts must be accompanied by FHA Form 3476, Certificate of Eligibility (Figure 2-2), from the appropriate local government agency. These certificates need not be used in the area in which they were issued, but may be used to support applications for mortgage insurance anywhere in the United States.
- b. Operative Builders may sell single-family dwellings to displaced families on a deferred basis through the use of an installment contract or contract for deed not exceeding 18 months. Such an arrangement must be approved in advance by HUD-FHA.
- c. Certification by appropriate local government officials that the property meets or exceeds local code requirements in all areas where a local code exists, is required.

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SECTION 9. MORTGAGE INSURANCE FOR LOW INCOME REHABILITATION HOUSING - SECTION 221(h) AND MORTGAGE INSURANCE FOR LOW AND MODERATE INCOME CONDOMINIUM FAMILY UNITS - SECTION 221(i)

2-28. SECTION 221(h) and (i). Section 221(h) is a combination multi-family - single-family mortgage insurance program described in detail in Reference (2) of the Foreword. It provides for insured project mortgages to permit non-profit sponsors to purchase and rehabilitate projects for eventual resale as individual dwellings or condominium units to low-income purchasers. The purchaser of an individual unit is charged interest at one, two, or three percent, depending on his income. All mortgages at these rates are held by the Government National Mortgage Association under its special assistance function. Section 221(i) is a similar program providing for the sale as condominium units in a project with a mortgage insured under Section 221(d)(3). No new program commitments are being issued by HUD-FHA under these two programs.

SECTION 11. MISCELLANEOUS HOUSING INSURANCE -
SECTION 223(e)

- 2-33. SECTION 223(e) - GENERAL. Under this program, properties which do not qualify under any other programs solely because of locational factors may be insured. Mortgagees may not submit applications under this program. The determination of the use of Section 223(e) is at the discretion of HUD-FHA.
- a. HUD-FHA will first consider applications on the basis of the requirements for insurance under the Section of Title II specified in the application. If the application would not be eligible because of locational factors but the property is in a location which is judged to be reasonably viable, considering the need for housing for low- and moderate-income families and the objective of upgrading older, declining neighborhoods, the mortgage may be insured under the Section of Title II applied for, "Pursuant to Section 223(e)."
 - b. The Suffix of the Case Number will be changed by HUD-FHA (see Reference (3) of the Foreword, also see Appendix 3 and Appendix 4 of this handbook).
 - c. Mortgages insured pursuant to Section 223(e) are not subject to restrictions on mortgage term based on the remaining economic life of the property.

SECTION 14. HOMEOWNERSHIP FOR LOWER INCOME FAMILIES -
SECTION 235

- 2-36. SECTION 235. This program is designed to provide insured mortgage financing for the purchase of homes by low-income families. While the income of the mortgagor family remains below certain income limits, a portion of the monthly mortgage payment is made by the Secretary of Housing and Urban Development directly to the mortgagee. This program is designed primarily to help low-income families buy single-family homes and is administered by the Office of Underwriting Standards. The Assistant Secretary for Housing Management also administers the program from a servicing standpoint. No new program commitments are being issued by HUD-FHA under this program. Further information is available in Reference (4) of the Foreword.

SECTION 15. HOME MORTGAGE INSURANCE, SPECIAL CREDIT RISKS -
SECTION 237

- 2-37. SECTION 237. Under this program, an applicant, who would not qualify for an insured mortgage under one of several other home mortgage programs because of his credit or income history or characteristics, may be eligible if it is determined that he would be an acceptable risk if provided with credit and debt management counselling. This program is administered by the Assistant Secretary for Housing Management.

APPENDIX 1-2

HOMEOWNERSHIP: A BASIC INGREDIENT OF AMERICAN LIFE:

Homeownership, it has been noted, is an ideal "almost as sacrosanct as motherhood or apple pie."¹ Consistent with some of the most basic traditions in this country, homeownership has won widespread and enthusiastic support throughout American history. The homeowner was clearly in step with Thomas Jefferson's "rugged individual" and the Protestant ethic lauded the self-sufficiency and hard work which are still associated with the meaning of owning a home.

Whether or not "a nation of homeowners is unconquerable"² as Franklin Roosevelt claimed, it is certainly likely that most Americans would agree with Lyndon Johnson's view of the homeowner:

Homeownership is a cherished dream and achievement of most Americans...Owning a home can increase responsibility and stake out a man's place in his community. The man who owns a home has something to be proud of and good reason to protect and preserve it.³

This type of sentiment is, perhaps, at the heart of why homeownership is the preferred form of tenure of the majority of people in this country. Numerous surveys have confirmed that most people prefer homeownership over rental situations.

For example, in a study done by the Joint Center for Urban Studies of MIT and Harvard, "America's Housing Needs: 1970-1980" it was found that

¹Bernard J. Frieden and Joann Newman, op. cit.

²Speech before the United States Savings and Loan League, quoted in the New York Times, November 17, 1972.

³Lyndon B. Johnson, "The Crisis of the Cities", The President's Message to the Congress on Urban Problems, February 12, 1968.

homeownership is a goal among all socio-economic groups.⁴

The ruling ideal among working-class men and women under forty-five years of age in both Boston and Kansas City is to have "a place of our own", meaning...a single-family home that they own, not rent -- with a "piece of ground and grass around us" in a neighborhood where "we can have piece of mind -- we can leave the house and not worry about it."⁵

Among families of the middle class a propelling goal is to attain housing of "pleasantly good" status. At the present time this is typified by a home of at least seven rooms...⁶

Among families of solidly upper-middle-class status, it is expected that by the time the household head is in his thirties and approaching the years of his prime earning powers, the family should have acquired a home of at least eight rooms...⁷

Surveys done in the late 1930's also produced similar findings. John Dean, in his book Homeownership: Is It Sound? noted that:

One study, involving over a thousand face-to-face interviews, found more answers to the question "Why do you prefer to own?" falling into the category "like the feeling of ownership" than into any other. Another study of 253 new home owners gave as their primary reason why these

⁴Except perhaps the lowest class, where such fantasies may frequently be left unspoken. Joint Center for Urban Studies of MIT and Harvard, "America's Housing Needs: 1970-1980", p. 5-34. However, on this point Michael Stegman found, in a recent survey of lower income families in Baltimore, that there was "an overall interest in homeownership among 87% of the low-income inner city renter population". Housing Investment in the Inner City, (Cambridge, Mass.: MIT Press, 1973), p. 193.

⁵"America's Housing Needs", op. cit. p. 5-22.

⁶Ibid. p. 5-12.

⁷Ibid. p. 5-8.

families bought homes "Belief in home ownership." These results suggest that home ownership is not merely a means by which one achieves other values; it is also an end in itself..."⁸

Indeed, tenure statistics bear out this preference for homeownership.

A majority of family have managed to satisfy their desires to own their own homes (see Table 1).

⁸ John P. Dean, Homeownership: Is It Sound? (New York: Harper and Row, 1945), p. 13. Also on this point, Meyerson et. al. have written that: "Surveys taken since the early thirties show that 70 percent of the country's population desire homeownership for themselves." Martin Meyerson, Barbara Terrett, William L.C. Wheaton, Housing, People and Cities (New York: McGraw-Hill, 1962) p. 84. However, these writers also point out that many of these studies have examined the housing preferences of husband-wife families, who are most likely to prefer the single family home (p. 93). Similarly, Herbert Gans in "Urbanism and Suburbanism as Ways of Life" has observed that: "As soon as they can afford to do so, most Americans head for the single-family house and the quasi-primary way of life of the low-density neighborhood, in the outer city or the suburbs." (P. 48). And earlier in the same essay, he noted that "the quasi-primary way of life is associated with the family stage of the life cycle and the norms of child-rearing and parental role..." (p. 45). It is also important to point out that fewer families might prefer homeownership if more suitable rental alternatives were available. In a survey of homeowners in Boston it was found that the respondents fell into two groups: "Those who were always interested in homeownership and those who were more or less forced to become homeowners due to an apparently unsatisfactory rental stock...The quest for space was a significant determinant in steering families out of the rental market and into the house-buying market." Rachel G. Bratt, "A Homeownership Survey: A Report on the Boston Banks Urban Renewal Group" prepared for the Boston Model City Administration, January, 1972. Thus, it is possible that it is not really the actual ownership that appeals to families, but rather that families desire the improved quality which is associated with ownership. Michael Stegman has found that there is a prevailing investor view that: "Many low-income renters indicating an interest in owner-occupancy are really expressing a desire for better neighborhoods and improved housing quality, and not simply a fee interest in their dwellings. Owner-occupancy, they assert, is an instrumental variable in the improved housing equation, but not the real preference." Thus, Stegman proposes that "a simple change in tenure would produce less improvement in consumer satisfaction than many would like to believe." (Michael Stegman, op. cit. p. 194-195)

TABLE 26
 Occupied Housing Units, By Tenure
 1890 to 1970

	Owner-occupied units		Renter-occupied units		Total-occupied units
	Number (000)	Percent	Number (000)	Percent	Number (000)
1890	6,066	47.8	6,624	52.2	12,690
1900	7,455	46.7	8,509	53.3	15,964
1910	9,301	45.9	10,954	54.1	20,256
1920	11,114	45.6	13,238	54.4	24,352
1930	14,280	47.8	15,624	52.2	29,905
1940	15,196	43.6	19,659	56.4	34,855
1950	23,560	55.0	19,266	45.0	42,826
1960	32,797	61.9	20,227	38.1	53,024
1970	39,885	62.9	23,565	37.1	63,450

Source: Department of Commerce, Bureau of the Census, 1960 Census of Housing and 1970 Census of Housing, Vol I. Compiled in 1973 HUD Statistical Yearbook, p. 317.

APPENDIX 1-3

QUALITATIVE APPROACH

The approach of the research has been qualitative. Data have been gathered from over eighty interviews with, for example, HUD employees, mortgage lenders and homeownership counseling agency personnel located all across the country. Another key primary source of information has been Congressional hearings and Government Audit Reports.

At no point during the thesis has any attempt been made to develop causal relationships between the problematic procedures of the homeownership system and default and foreclosure rates.

APPENDIX 1-4

INDIVIDUALS CONSULTED:

1) Mortgage companies and other lending institutions:

Thomas Wilmore - Cambridge Savings Bank
P. Flynn - Provident Institution for Savings, Boston
Arnold Schultz - Homeowners Federal Savings & Loan Association, Boston
Donald J. McLaughlin - Provident Institution for Savings, Boston
Thomas H. Leahy - Beacon Mortgage Co., Boston
*George Silva - Old Stone Bank, Providence
*Robert Evans - Old Stone Bank, Providence
*C. Crocker - Citizens Savings Bank, Providence
Stanley Goodrow - Kislak Mortgage Co., Miami
Robert R. Jordan - Kislak Mortgage Co., New Jersey
William Salyer - Louisville Mortgage Company
Sharon Bolton - Jay F. Zook Mortgage Co., Cleveland
Donald Luff - Jay F. Zook Mortgage Co., Cleveland
Stuart Blanton - First Mortgage Corp., Richmond, Va.
William Sawyer - Northeast Federal Savings & Loan Assoc., Watertown, Mass.
Vera Iannello - Northeast Federal Savings & Loan Assoc., Watertown, Mass.
C. L. Gildroy - Northeast Federal Savings & Loan Assoc., Watertown, Mass.
Harold Dickson - Pence Mortgage Co., Louisville
Michael Aguirre - Gibraltar Savings and Loan Association, Los Angeles
Gladys Zumwall - Western Mortgage Co., Los Angeles
Marie Greenwood - Gibraltar Savings and Loan Association, Los Angeles
*F. McCafferty - Bogley Mortgage Company, Philadelphia
*Romeo Valentino - Colonial Mortgage Company, Philadelphia
*Robert Schimony - Colonial Mortgage Company, Philadelphia

2) Department of Housing and Urban Development:

John C. Fortson - Los Angeles
David Goss - Louisville
Katie Washington - Little Rock
Val Garcia - Los Angeles
*John Andrews - Boston
Lucille Henderson - Kansas City, Kansas
Rose Strickland - Phoenix
Thomas Clendenon - Louisville
Kenneth Anderson - San Francisco
*William Bonner - Shreveport
Janet Miller - San Francisco
Sarah Comber - Hartford
William Feingold - Washington
D. Hall - Washington
J. M. Hurtt - Washington
*Wallace St. Angelo - Providence
*Douglas Chaffen - Philadelphia

*James Rolen - Philadelphia
*Michael Cosantino - Philadelphia
*Charles Morgan - Philadelphia
*R. Merrell - Philadelphia
*Robert O'Connor - Philadelphia
Water J. Stuart - Washington

3) Federal National Mortgage Association:

Oakley Hunter - Washington, D.C.
Norman Camber - Los Angeles
Ellen Allison - Los Angeles
Oliver McCarron - Philadelphia
Betty Brouwer-Ancher - Philadelphia
Harry S. Schwartz - Washington
Loretta Wing - Philadelphia
Allan E. Arneson - Los Angeles
Fred Mowatt - Washington
John Kuhnle - Washington
Robert Kahn - Washington
John Blakistone - Washington
Eric Brestrup - Washington

4) Miscellaneous:

Carl Freeman - Association for Better Living/Surburban Housing Project,
Boston
Clark Prichard - Mortgage Bankers Assoc., Washington
Gavin Brown - Mortgage Bankers Assoc., Washington
John Wetmore - Mortgage Bankers Assoc., Washington
Eugene Toten - University of Southern California
George Lefcoe - University of Southern California
Hilbert Fefferman - Consultant to FNMA
Victor Bach - Project Director, OSTI
*Welton Myers - Better Rochester Living
David Madway - National Housing and Law Project, Berkeley
Seymour Mansfield - Legal Assistance Foundation of Chicago
Meg Frisbee - FHLB of Boston
*Garfield Harris - Maple Corporation, Philadelphia
*Harry Reno - Maple Corporation, Philadelphia
Tom Jones - NHS Program, Pittsburgh
Barbara Dingfield - Assoc. for Better Housing, Boston
*Barbara Southwick - Spokane Community Action Council
*Sadelle Sachs - Fair Housing Inc., Boston
Jack Blum - Senate Subcommittee on Antitrust and Monopoly
Bill Whiteside - Urban Reinvestment Task Force, Washington
*Shreveport Consumer Credit Agency
*Louisville Urban League (Counseling Agency)
Kenneth Plant - Federal Home Loan Mortgage Corp.
*B. Ormes - Philadelphia Urban League Housing Information Center
Don Kaplan - FHLBB, Washington
Margaret Drury - Urban Institute, Washington
Mort Isler - Urban Institute, Washington

*Individuals interviewed while working at OSTI.

APPENDIX 1-5

AN IMAGE OF A "CONSUMER-ORIENTED" HOMEOWNERSHIP/HOME FINANCE SYSTEM:

It is valuable to briefly describe some of the key aspects of a homeownership/home finance system that would be oriented toward the needs of consumers. The following image of a consumer-oriented system points to many mis-matches between it and the actual practices and procedures of the present HUD-FHA home finance system, as discussed throughout this thesis.

A consumer oriented homeownership/home finance system would be based on a set of consumer rights. In the first major address by a President on protecting the consumer interest, President Kennedy suggested that consumer rights include the following:

1. The right to safety - to be protected against the marketing of goods which are hazardous to health or life.
2. The right to be informed - to be protected against fraudulent, deceitful, or grossly misleading information, advertising, labeling, or other practices, and to be given the facts he needs to make an informed choice.
3. The right to choose - to be assured, wherever possible, access to a variety of products and services at competitive prices and in those industries in which competition is not workable and Government regulation is substituted, to be assured satisfactory quality and service at fair prices.
4. The right to be heard - to be assured that consumer interests will receive full and sympathetic consideration in the formulation of Government policy, and fair and expeditious treatment in its administrative tribunals.

¹Executive Office of the President "Consumer Advisory Council, First Report", October 1963. This report contains the text of President Kennedy's March 15, 1962 "Special Message on Protecting the Consumer Interest."

Translating these "rights" into the present context--the homeownership/home finance system--the following is a list of the types of expectations that a consumer should reasonably expect to be fulfilled in purchasing and maintaining a home:

1. Being in a position to understand the home purchase process, particularly the roles and goals of each actor and institution.
2. Being able to articulate and answer the key questions related to buying a home.
3. Having access to a source of information--such as a homeownership counseling agency--which is able to provide advice and advocate on the consumer's behalf.
4. Being assured that the Government agency involved in the home purchase process--in this case HUD-FHA--will protect his interests and will act as a watchdog over the other actors and institutions in the system.
5. Understanding the implications of default and foreclosure and knowing how to act if mortgage payment difficulties arise. Also, being assured that the mortgage lender will assist him to the fullest extent and will comply with the Government's guidelines concerning default.
6. Being able to file a complaint about any aspect of the home purchase process in which the consumer feels he has been wronged. And, being assured that this complaint will receive prompt attention and that the problem will be rectified if the complaint is justified.

APPENDIX 2-1

THE FHLBS AND ITS ADJUNCTS: FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION (FSLIC) AND THE FEDERAL HOME LOAN MORTGAGE CORPORATION (FHLMC):

FSLIC

Just as the FHLBS's credit advance mechanism addressed itself to the liquidity problem that lenders faced during the Depression, the Federal Deposit Insurance Corporation (FDIC) and later the FSLIC, helped depositors to overcome the mistrust in financial institutions which had been so widespread in the 1930's.

Using the Federal Reserve System as the model, Congress created the FSLIC in 1934. The FDIC, established earlier that year, was set up to insure savings accounts in commercial and mutual savings banks. Through this new mechanism, depositors were assured that if, for any reason, a bank were forced to close down, the money on deposit in each account could be recouped through the FDIC.

Writing about the success of the FDIC, Hoagland and Stone have observed that:

Immediately after provision by Congress for the insurance of bank accounts, the old boot, the clock, and the tin can buried in the backyard began to disgorge their currency contents. Public confidence in our commercial banking system was miraculously restored. The about-face was immediate and complete.¹

But, in order to restore confidence in savings and loan associations, a comparable insurance mechanism was needed. Thus, the creation of FSLIC² was critical to the S and L's if they were to continue to be able to attract deposits and be competitive with the insured savings institutions.

¹ Hoagland and Stone, op. cit. p 461.

² Title IV. National Housing Act of 1934, op. cit.

FHLMC, or "FREDDIE MAC"

The FHLMC, a subsidiary of the FHLBS, is the last link of the FHLBS, as well as the newest member of the Federal credit family.³ FHLMC was created by Title III of the Emergency Home Finance Act of 1970 and serves as a secondary mortgage market facility, primarily for savings and loan associations. It is part of the Federal Government's continuing effort at decreasing risk for lenders by providing them with an additional source of liquidity. As a purchaser of conventional mortgage loans, FHLMC duplicates FNMA's recently granted authority to purchase non-insured loans.

³For a good summary of FHLMC's functions see Richard W. Bartke, "Home Financing at the Crossroads". A Study of the Federal Home Loan Mortgage Corporation; FHLMC Monographs: No. 1. February, 1973.

APPENDIX 3-1: HISTORY OF RISK
CONCEPTS IN HOME MORTGAGE
INSURANCE LEGISLATION

From: Fifteenth Report by the
Committee on Government
Operations, "Defaults on
FHA--Insured Home Mort-
gages--Detroit, Mich."
June 20, 1972

APPENDIXES

APPENDIX A.—HISTORY OF RISK CONCEPTS IN HOME MORTGAGE INSURANCE LEGISLATION

The National Housing Act of 1934, as amended, provides for insurance of home mortgage loans by the Secretary of HUD. Originally, the authority to insure mortgage loans was vested in the Administrator of the Federal Housing Administration. Although the authority was transferred to the Secretary of Housing and Urban Development when the Department was created by the Department of Housing and Urban Development Act of 1965, mortgage loans insured under various sections of the National Housing Act have continued to be identified as FHA-insured mortgage loans.

Section 203

Section 203, enacted in 1934, provided authority for insurance of mortgage loans to finance the purchase of one- to four-family new or existing homes. Designed to restore the confidence of lenders in residential mortgage loans, it insured them against losses from default, except for a part of foreclosure costs. To stimulate residential construction in a depressed economy, it authorized the insurance of mortgages with relatively low downpayments on the purchase price and extended loan maturities. In addition to those provisions to keep monthly principal and interest payments low, the interest rate was not to exceed a regulatory ceiling that could be established below a statutory ceiling. Administrative expenses and insurance claims were to be paid from proceeds of annual mortgage insurance premiums collected from the homeowner mortgagors. The premium has been one-half of 1 percent of the outstanding loan balance except for a short period in the early years of the program.

The mortgage insurance program, thus, was to be self-sufficient. In 35 years, after insurance of some 8.4 million home mortgages under section 203, an accumulation of \$1.3 billion in insurance fund reserves was built up through an excess of insurance premium income over administrative expenses, claim payments and mutual fund participation payments to mortgagors. To reinforce the prudent character of the operation, section 203 provides that "no mortgage shall be accepted for insurance under this section unless the Secretary finds that the project with respect to which the mortgage is executed is economically sound." Under this mandate, the FHA mortgage insurance program was administered in such a way as to avoid the risks of mortgages on properties in declining inner-city neighborhoods, or of mortgagors whose income was considered too low to assure loan repayments without excessive risk.

In 1954, the urban renewal program, which had been enacted in 1949, was revised and expanded in the Omnibus Housing Act of 1954. Related to the urban renewal legislation, in the same act, new mortgage insurance legislation was enacted to meet some of the special problems engendered by the urban renewal program.

One of the new housing provisions enacted was section 221(d)(2) of the National Housing Act. The section "is designed to assist private industry in providing housing for low- and moderate-income families and displaced families." The words "displaced families" were substituted in 1961 for the original clause: "families displaced from urban renewal areas or as a result of governmental actions."

Many of the families being displaced from housing to be rehabilitated or demolished for redevelopment on urban renewal sites had limited incomes. The 1954 legislation, therefore, permitted home purchases with a \$200 minimum down payment to be financed with an FHA-insured section 221(d)(2) mortgage. Such a mortgage also could have a maturity of up to 40 years, instead of the 30-year maximum then permitted under section 203. Most important of all, there was no "economic soundness" criterion in the section 221 statute. There is a provision (in sec. 221(f)) that "The property shall comply with such standards and conditions as the Secretary may prescribe to establish the acceptability of such property for mortgage insurance." This approaches the "acceptable risk" concept which is to become more explicit in subsequent legislation; it apparently was intended to be a relaxation from the "economic soundness" concept and certainly came to be interpreted as a less rigid criterion.

On the other hand, it should also be noted that section 221(d)(2) requires that the property shall be one which meets "the requirements of all State laws, or local ordinances or regulations, relating to the public health or safety, zoning or otherwise, which may be applicable thereto."

Section 203(1)

A more explicit exemption from the "economic soundness" criterion was enacted by the Congress in 1966. In the general context of the Demonstration Cities and Metropolitan Development Act of 1966, approved November 3, 1966, which was aimed at the improvement of conditions in the inner city, section 302 added section 203(1) of the National Housing Act:

(1) The Secretary is authorized to insure under this section any mortgage meeting the requirements of this section, other than the requirement in subsection (c) relating to economic soundness, if he determines that (1) the dwelling covered by the mortgage is situated in an area in which rioting or other civil disorders have occurred or are threatened, (2) as a result of such actual or threatened rioting or other disorders the property with respect to which the mortgage is executed cannot meet the normal requirements with respect to economic soundness, and (3) such property is an acceptable risk giving due consideration to the need for providing adequate housing for families of low and moderate income in such area.

This section was repealed by the Housing and Urban Development Act of 1968 in which sections 223(e) and 237 were enacted to serve the same purpose with less limitations as to the applicable geographic areas. The two latter sections are discussed below. Section 203(1) was significant, however, since it apparently was the basis for mortgage insurance policy changes that were made in 1967. -462-

Section 235

Section 235, enacted in 1968, authorized a mortgage interest rate subsidy program to support homeownership by low- and moderate-income families, generally those with incomes below 135 percent of local public housing limits. In addition to an interest rate subsidy, in the form of monthly assistance payments to cover part of the regular monthly debt service, the section 235 mortgage loan could cover all of the purchase transaction price except a \$200 downpayment and could have a maturity of up to 40 years.

There is no "economic soundness" requirement for Section 235 mortgage insurance. The statute provides that "to be eligible for insurance under this subsection, a mortgage shall meet the requirements of Section 221(d)(2) or 234(c)." Section 234(c) refers to condominiums and cooperatives. By cross reference, therefore, the concept of the "acceptable risk" becomes applicable to section 235. Also applicable by reference would be the section 221(d)(2) requirement for compliance with State and local code regulations.

The term "acceptable risk" also appears specifically in section 235 (b)(1) in a proviso that a section 235 mortgage may be insured, pursuant to Section 237 provisions, for a mortgagor who is determined to be not an acceptable risk but would otherwise be eligible to receive a mortgage loan insured under 235(j) (that is, a home rehabilitated under the special 235(j) financing program), 221(d)(2) or 234(c) and is accepted as "a reasonably satisfactory" risk under Section 237.

Section 237

Section 237, also included in the Housing and Urban Development Act of 1968, states that:

The purpose of this section is to help provide adequate housing for families of low and moderate income, including those who, for reasons of credit history, irregular income patterns caused by seasonal employment, or other factors, are unable to meet the credit requirements of the Secretary for the purchase of a single-family home financed by a mortgage insured under section 203, 220, 221, 234, or 235(j)(4), but who, through the incentive of homeownership and counseling assistance, appear to be able to achieve homeownership.

Subsection (c)(3) provides that the Secretary must determine that a mortgagor whose loan is being insured pursuant to section 237 would be "a reasonably satisfactory credit risk, consistent with the objectives stated in subsection (2), if he were to receive budget, debt management and related counseling".

A subsequent amendment to section 237 (in sec. 110 of the Housing and Urban Development Act of 1969) included families eligible for assistance payments under section 235—not only 235(j)—among ap-

plicants who are to be given a preference for mortgage insurance and counseling services.

Another significant subsection is section 237(e) which reads:

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(e) The Secretary is authorized to provide, or contract with public or private organizations to provide, such budget, debt management, and related counseling services to mortgagors whose mortgages are insured under this section as he determines to be necessary to meet the objectives of this section. The Secretary may also provide such counseling to otherwise eligible families who lack sufficient funds to supply a downpayment to help them to save an amount necessary for that purpose.

In the HUD budget requests submitted to the Congress by the Executive, an appropriation to fund activities authorized under section 237 was requested for fiscal years 1970 and 1971 (as part of "salaries and expenses") but disapproved by the Congress. For fiscal 1972, HUD did not include such a request in its budget, but the Congress, on its own initiative appropriated \$3,250,000 for counseling services that had been authorized under Section 237. HUD, according to its budget summary for fiscal year 1973, is using the funds "to assist public and private voluntary agencies in bringing additional and more effective counseling services to low-income families, and to evaluate the effectiveness of providing counseling services."⁸⁶ The HUD 1973 budget contains no appropriation request for additional section 237 funding. It states that "additional funding" required to complete the demonstration program will be provided through the Department's research program.⁸⁷

The section 237 funds, thus, generally have not been used for counseling of individual home purchasers. In mid-January 1972, HUD did initiate a program, however, under which counseling is provided to purchasers of homes under the section 235 program, or under other programs but pursuant to the provisions of section 237. In instances of such purchases when the HUD or FHA office reviewing the application determines that the home purchaser requires counseling, it is made a prerequisite to the closing of an FHA-insured loan to finance the purchase. The seller is required to pay the counseling fee of up to \$100 to a HUD-approved counseling agency from the mortgage proceeds disbursed at time of the loan closing.

Section 223(e)

Another section of the Housing and Urban Development Act of 1968, approved August 1, 1968, added section 223(e) to the National Housing Act, which reads as follows:

Notwithstanding any of the provisions of this act except section 212, and without regard to limitations upon eligibility contained in any section of this title or title XI, the Secretary is authorized, upon application by the mortgagee, to insure under any section of this title or title XI a mortgage executed in connection with the repair, rehabilitation, construction, or

⁸⁶ HUD Budget Justification, pt. 3, p. C-1.

⁸⁷ *Ibid.*

purchase of property located in an older, declining urban area in which the conditions are such that one or more of the eligibility requirements applicable to the section or title under which insurance is sought could not be met, if the Secretary finds that (1) the area is reasonably viable, giving consideration to the need for providing adequate housing or group practice facilities for families of low and moderate income in such area, and (2) the property is an acceptable risk in view of such consideration. The insurance of a mortgage pursuant to this subsection shall be the obligation of the Special Risk Insurance Fund.

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Legislative Intent and Implementation

The history of legislative amendments with respect to mortgage insurance risks to be assumed by HUD, especially in 1966 and 1968 amendments, indicates an intent that greater risks were to be assumed in order to aid low income, inner city residents to acquire homes. A significant policy change toward implementation of this intent was made by the then FHA Commissioner Brownstein within a year after the enactment of section 203(1). At a conference of FHA insuring office directors on October 23, 1967, he said:

* * * Risks are inherent in an insurance program (otherwise there would be no justification or need for insurance)
* * * This does not by any means require the elimination of prudence and common sense. * * * I want us to develop and support projects which give reasonable promise of success, which give reasonable promise of improving the housing conditions of low- and moderate-income families, and improving the inner city. A project should be rejected if it does not appear to give reasonable promise of accomplishing these objectives. It should not be rejected simply because it involves poor people, or because it is in a portion of the city you have been accustomed to rejecting or redlining for old fashioned, arbitrary reasons.

In testimony before the Housing Subcommittee of the House Banking and Currency Committee on February 22, 1972, HUD Secretary Romney, in discussing the recent marked increase in FHA foreclosures, defaults and abandonments, traced the legislative history of the "acceptable risk" concept in lieu of "economic soundness". He also placed in the record the above quoted 1967 statement by former FHA Commissioner Brownstein.

In a public statement in January 1972, Secretary Romney had said that there was graft, corruption and kickback and that thousands of families who bought homes with FHA-insured mortgage loans had been victimized.

With reference to Secretary Romney's January statement and February testimony, at a hearing of the Legal and Monetary Affairs Subcommittee on February 24, 1972, Subcommittee Chairman Monagan said:

Unfortunately, this belated recognition of the seriousness of today's crisis in subsidized housing has been accompanied by a tendency to affix blame in an oversimplified manner, vir-

tually ignoring administrative responsibility for the past 3 years. There may be defects in the basic statute involved, as has been stated.

-465- The distinguished Senator from Alabama, John Sparkman, chairman of the Senate Banking and Currency Committee, because of this apparent finger-pointing attitude, stated in his address to the home-builders on January 25:

To keep the record straight, there was never any congressional intent to authorize local FHA offices to insure substandard housing or to accept as mortgagors the poor whose financial condition did not justify homeownership. The strong language in the 1968 Housing Act and subsequent administrative rulings were intended to eliminate "redlining" in older declining urban areas, but not to blanket in as insurable risks all units in such areas regardless of their condition or otherwise insurable qualifications.

An objective reading of the statute, the legislative history, and a review of subsequent administrative rulings support Chairman Sparkman's interpretation. It is disturbing, therefore, to learn that the impression left by the Secretary in response to questioning before the Housing Subcommittee of the House Banking and Currency Committee was that Congress was the principal villain in the piece.

Former FHA Commissioner Brownstein, in response to the Secretary's testimony, submitted for the record of the Housing Subcommittee hearing a letter to Chairman Barrett, which included the following:

You will note that throughout all of the directives there is a common theme—the revision of criteria relating to property location. In no way does it relax the requirement that the house itself meet minimum property standards. There is no suggestion whatever that appraisers "throw away the book" in establishing their valuation.⁸⁸

He also said that waiving "economic soundness" for "acceptable risk" analysis carries with it the necessity of a sound appraisal and a structurally sound dwelling unit.

⁸⁸ Hearings before the Subcommittee on Housing of the House Committee on Banking and Currency, Feb. 22, 24, 1972, p. 269.

APPENDIX 5-1

ATTEMPTS TO CONTROL OR BAN DISCOUNTS

By the end of World II, the various types of problems associated with discounts began to be acknowledged.¹ In 1950, and then again in 1957, Congress passed legislation which attempted to control discounts. However, both bills were repealed. (See Chart 8). In both cases the repeal had to do with the notion that the ban on discounts was imposing unnatural constraints on the market.

In the earlier legislation, lenders were having difficulty selling undiscounted loans to secondary investors without accruing losses and this, in turn, resulted in mortgage capital drying up. Similarly, in the later legislation, discounts were blamed as one reason why lenders were simply not making mortgage credit available, thereby contributing to the declining home building industry.

In arguing for the repeal of the 1957 legislation the FHA Commissioner stated that:

FHA has made every effort to administer the provisions of this section (Discount Control) in a manner that would cause as little disruption of the normal practices of the homebuilding and financing industries as possible, while at the same time preventing any charges to home buyers. In spite of these efforts this provision has created confusion and reluctance on the part of lenders toward using FHA-insured financing.²

¹"Mortgage Discounts" op. cit.

²Ibid. p. 33

Keeping in mind that the 1957 law was repealed less than nine months after its enactment, the Commissioner's remarks lack credibility. First, it is hard to imagine the FHA being able to make "every effort" in such a short period. And, second, nine months would hardly seem to be a sufficient amount of time to ascertain that the control on discounts was the cause of the decreasing amount of mortgage capital. It would appear, then, that the discount control law was not given a fair chance.

CHART 8

Summary of Legislative History of Discount Control Laws

<u>Legislation</u>	<u>Provision</u>	<u>Outcome</u>
Section 504 Housing Act of 1950	Gave authority to VA Administrator and FHA Commissioner to limit the charges and fees imposed upon builders, veterans or other purchasers of VA or FHA housing. No loan shall be insured or guaranteed unless the mortgagee certifies that it has adhered to these regulations.	<ol style="list-style-type: none">1. Amended by Housing Amendments of 1953 (Sec. 23) to the effect that the regulations which limited charges and fees of mortgagees should not be construed to include any loss suffered by an originating lender in the sale of mortgages to secondary investors. It appears that this amendment was added because Section 504 was cutting off involvement among secondary mortgage market investors who had been purchasing FHA and VA loans at par. Capital scarce areas were hardest hit by Section 504.2. Section 504, repealed by Section 813 of the Housing Act of 1954. Determined that Section 504, was no longer needed since control of fees is otherwise available. While this was not detailed, it was the intent of Congress that FHA and VA would continue to protect purchasers against excessive fees.

Summary of Legislative History of Discount Control Laws, cont'd.

<u>Legislation</u>	<u>Provision</u>	<u>Outcome</u>
Housing Act of 1957 Section 605	Gave authority to the FHA Commissioner and the VA Administrator to fix reasonable limits on the charges, fees, and discounts imposed upon the builder, seller or purchaser in connection with any housing insured or guaranteed by these agencies. No loan shall be insured or guaranteed unless the lender certifies that it has adhered to these regulations. While the language of this and the 1950 legislation is almost identical, the 1957 law did not intend to eliminate discounts entirely, as did the earlier legislation.	Repealed by Emergency Housing Act of 1958, Section 6. Following President Eisenhower's suggestion, less than a year after the discount control law went into effect, it was repealed by Congress. The apparent reason was that the home-building industry was in a serious slump and the ban on discounts was blamed as one reason why lenders were moving away from FHA and VA programs, thereby making mortgage money scarce.

Source: Gathered from information presented in "Mortgage Discounts" pp. 25-34.

APPENDIX 6-1

EARLY MORTGAGE COMPANIES:

While the mortgage company has grown considerably under the FHA, a variety of mortgage banking firms have operated since the late eighteenth century. Before the emergence of the "modern mortgage company", following the creation of the FHA, four distinct types of specialized mortgage lending institutions had developed:

(1) Mortgage banks originated mortgages, and held them in their own portfolio. In order to raise the funds to convert into mortgage loans, they issued their own obligations, secured by these mortgages, for sale to the public.

(2) Mortgage guarantee companies originated mortgages and either sold them to investors or issued bonds which were backed by these mortgages. These companies guaranteed the payment of principal and interest on the bonds to the investors.

(3) Mortgage loan companies originated and sold mortgages directly to investors.

(4) Mortgage brokers arranged transactions between borrowers and lenders without any direct ownership of the mortgages.¹

The modern mortgage company most resembles the mortgage loan company. As intermediates between borrower and investor, they are free of any direct obligations upon the sale of the mortgage. In a legal sense, they have no interest in the mortgage following its sale. An overriding difference between the four mortgage entities described above and modern mortgage

¹Typology developed by Klamann, op. cit.; p. 5.

companies is that the latter sell the overwhelming proportion of the mortgages which they originate to institutional investors, while the earlier mortgage banking firms sold most of their mortgages of individuals.²

²Ibid

APPENDIX 8-1

HUD'S HANDLING OF MORTGAGORS' COMPLAINTS

Information on how HUD has handled mortgagors' complaints is skimpy. However, the 235 Audit and the All Homes Audit present some data on HUD's procedures related to both existing and new Section 235 homes.

New Homes

The 235 Audit found that although:

The prescribed procedures for the handling of mortgagors' complaints on new housing..(was) generally adequate...better implementation by field offices (was) needed.¹

Based upon the findings of new 235 Audit, Central Office developed precise procedures for handling complaints on new housing. However, the All Homes Audit found that in five of the nine field offices reviewed, the implementation of the new homes complaint procedure was still not adequate. The major deficiency was the lack of prompt advice on the availability of HUD assistance provided to dissatisfied mortgagors.² One reason given by HUD officials for inactivity and/or delays was the inability to obtain the FHA case files.³

It is a disconcerting fact that once the FHA insurance certificate has been issued, the entire case file is shipped from the Area or Insuring Office to Central Office in Washington. Moreover, the only way for field office personnel to obtain a specific case file is by knowing the FHA case number.

¹235 Audit op. cit. p. 43

²All Homes Audit op. cit. p. 62

³Ibid.

However, the 235 Audit found that:

No records are required to be maintained in the field office that permit access to any information it might have in its files, or in the case file that is stored in Washington, D.C.⁴

If the complaining mortgagor knows his case number, or if this can be obtained from the mortgagee, the file can be sent for in Washington. However, there is no certainty that the file will be readily found. For example, part of the field research by OSTI, under contract to HUD, included pulling a sample of 235 case files from specific locales. Upon visiting the file room in Washington, OSTI researchers learned that many files were missing, particularly because of the variety of investigations that were then underway. For some locales, 235 mortgagor case files were almost totally absent, and the person in charge only could offer that they had been "borrowed"--not even sure by whom.⁵ Thus, access to any one of these mortgagors' case files was virtually impossible.

In such a situation, or if the field office wanted to try to handle the case without dealing with Central Office, case information is frequently obtained from the mortgagee, who usually keeps a copy of most, if not all, of the information contained in the FHA case file. However, there are shortcomings with this approach. The 235 Audit reported that:

We observed a number of cases in which mortgagors' complaints were handled without access to the data in the case file. In a good percentage of such cases, the field offices requested data from the mortgagees' files about the certifications of, for example, plumbing, roofing or heating, in order to evaluate the likelihood of an inaccurate certification by a trades-

⁴235 Audit op. cit. p 45

⁵Writer's experience while employed by OSTI.

man. Often, the mortgagee had certified to the satisfactory completion of repairs about which the mortgagor was complaining. Accordingly, we do not consider the mortgagees' files to be a proper continuing reference source which substitutes for access to information contained in HUD files.⁶

The All-Homes Audit also found that:

In four field offices, complaints covered by builders' warranties were not being processed promptly and insufficient or untimely action was taken against builders who failed to correct defective conditions for which they were responsible.⁷

Further:

Four of the offices failed to act on a number of referrals...some field office took from six months to more than one year to obtain corrective action. One field official told us that he did not act on referrals until the mortgagors filed a written complaint, which no one advised the mortgagor to do.⁸

Existing Homes

Until April 1971, HUD had no prescribed procedures or policies for the handling of mortgagors' complaints on existing Section 235 housing.

The December 1971 235 Audit found that:

The policies, procedures, and controls for handling of mortgagors' complaints on existing housing as well as the field offices' implementation thereof were substantially deficient. Many mortgagors' legitimate complaints about serious problems were not resolved promptly, if at all.⁹

But, in April 1971, HUD implemented the Section 518(b) program, which attempted to make amends to Section 235 mortgagors with legitimate complaints. As discussed in Chapter 8, this program authorizes the Secretary of HUD to compensate 235 mortgagors and, since 1974, mortgagors under

⁶235 Audit, op. cit. p. 45-46

⁷All-Homes Audit, op. cit. p. 66

⁸Ibid. p 64

⁹235 Audit, op. cit. p. 42

the other home insurance programs, for structural or other defects which seriously effect the use and livability of the dwelling.

As a result of the slow processing of complaints on both new and existing housing, some families have been forced to abandon their homes and foreclosure has resulted.

For example, in one existing housing case:

A complainant sought assistance to repair leaky rusted-out water pipes that had caused ten inches of water to stand under his house. After about three months the complainant advised the field office that he intended to abandon the house because of "red tape" and the unlivable condition of the house.¹⁰

In addition, the Audit noted that some owners of new homes:

Have defaulted on their mortgages due to dissatisfaction with their property and frustration in obtaining the needed corrective action.¹¹

This is, in part, due to HUD's procedures for closing complaint cases.

In compliance with HUD policy as stated in Handbook 4070.1:

The field offices closed complaint cases without taking any action to assure that the work was done. When the work was not done as promised, which was not uncommon, the mortgagor again had to notify HUD of his complaint, which further irritated the mortgagor.¹²

Thus, while it seems that HUD has become more responsive to consumers' complaints, the fact remains that during the early years of the low-moderate income families' participation in the homeownership programs, HUD's procedures were problematic. HUD's failure to institute good procedures for handling mortgagors' complaints early in the homeownership programs

¹⁰All Homes Audit, op. cit. p. 64

¹¹Ibid. p. 66

¹²Ibid.

is further indication of HUD's unwillingness to accept a full measure of responsibility and, as a result, the interests of consumers have not been served.

APPENDIX 9-1:
THE FOUR INSURANCE FUNDS
AUTHORIZED BY THE
NATIONAL HOUSING ACT

From: Twenty-Third Report by the
Committee on Government
Operations, "Alarming
Deterioration of Reserves
of FHA Mortgage Insurance
Funds." December 18, 1974

II. THE FOUR INSURANCE FUNDS AUTHORIZED BY THE NATIONAL HOUSING ACT

The Federal Housing Administration, Department of Housing and Urban Development, administers mortgage insurance programs under which lending institutions (mortgagees) that have financed first mortgages on various types of housing are insured against loss on these mortgages as well as on loans which finance property alterations, repairs and/or improvements.

Most of the insurance written by the FHA covers mortgages on small homes—one to four families—and on multifamily housing properties. From its inception on June 27, 1934, through June 30, 1973, the FHA wrote approximately \$180 billion in insurance, of which about \$88 billion was in force as of the latter date.⁴

Originally, the system of mortgage insurance was designed to create a sound debt structure to support residential construction activity. The National Housing Act of 1934 provided for a single amortized mortgage with relatively low downpayments and for a self-supporting insurance fund. Since its inception, Government mortgage insurance has provided access to the housing market for millions of families on an economically sound basis, not only through FHA programs, but also by demonstrating to conventional mortgage lenders the soundness of low downpayment, long-term mortgage lending.

FHA insurance programs, as a result of the Housing and Urban Development Act of 1965 and subsequent amendments, are now conducted under four insurance funds authorized by the National Housing Act. These are revolving funds which are used for carrying out the insurance operations of specific sections of the enabling legislation. The funds are credited with fees, premiums, and investment income and are charged with debenture interest, administrative expenses, and insurance losses.

These funds include the mutual mortgage insurance fund, the general insurance fund, the cooperative management housing insurance fund, and the special risk insurance fund.

MUTUAL MORTGAGE INSURANCE FUND

The mutual mortgage insurance (MMI) fund, established by the original National Housing Act in 1934, was to be used as a revolving fund for the insurance of home mortgages under section 203 and low-cost housing projects under section 207. Since 1938, the MMI fund has been utilized solely in connection with FHA operations under section 203 to insure one-to-four family homes with loan-to-value ratios of 80 to 96 percent. The mortgage term can now be as long as 35 years, although most are for 30 years or less. This insurance fund is a mutual one because mortgagors (homeowners) who have fully

⁴ Hearings, pt. 1, p. 2; pt. 2, p. 118.

repaid their mortgages may receive a share of funds accumulated in a participating reserve account established for the purpose of making such payments.

As of June 30, 1973, this fund had about \$50 billion of outstanding insurance in force.⁵ The assets of this insurance fund are, for the most part, invested in the public debt of the United States.⁶

GENERAL INSURANCE FUND

The general insurance fund was established on August 10, 1965, by the Housing and Urban Development Act of 1965 to consolidate a number of previously established insurance funds authorized by the National Housing Act. Included were the assets and liabilities of all insurance accounts and funds, and all previously issued outstanding commitments, except those resulting from operations under section 203 (the MMI fund) or section 213 to the extent they involved mortgage insurance under the cooperative management housing insurance fund, which was also established in 1965.

The general insurance fund insures a wide variety of mortgages and notes of varying risk which finance the purchase, construction, and/or improvement of small homes, multifamily property, nonresidential property, and commercial or farm structures. Among the programs insured are title I home improvement and mobile home loans, section 207 multifamily housing, title VI war housing, section 220 urban renewal housing, and section 221 multifamily and single-family insurance for displaced families and families of low and moderate income.

As of June 30, 1973, the general fund had about \$23 billion of outstanding insurance in force.⁷ Most of the dollar volume of insurance outstanding in this fund is for insuring mortgages on section 221(d)(2) low downpayment, homeownership property and market and below-market interest-rate multifamily rental property.⁸

COOPERATIVE MANAGEMENT HOUSING INSURANCE FUND

The cooperative management housing insurance (CMHI) fund, also established by the Housing and Urban Development Act of 1965, was designed to serve as a revolving fund for mortgages, loans, and commitments transferred to it from the general insurance fund, or those covered by insurance written after that date, on section 213 management-type cooperative projects. In a manner similar to that of the MMI fund, section 213(l) provides that "Upon termination of the insurance obligation * * * by payment of any mortgage or loan insured under this section, and at such time or times prior to such termination as the Secretary may determine, the Secretary is authorized to distribute to the mortgagor or borrower a share of the Participating Reserve Amount in such manner and amount as the Secretary shall determine to be equitable and in accordance with sound actuarial and accounting practice * * *." These provisions for mutuality payments to mortgagors or borrowers distinguish the MMI

⁵ Hearings, pt. 2, p. 150.

⁶ See app. A for a detailed listing of investments.

⁷ Hearings, pt. 2, p. 151.

⁸ Hearings, pt. 1, p. 6.

and CMHI funds from other insurance funds established under the National Housing Act.⁹

Outstanding insurance in force under this fund totaled about \$780 million as of June 30, 1973.¹⁰

SPECIAL RISK INSURANCE FUND

The special risk insurance (SRI) fund was established on August 1, 1968, pursuant to the Housing and Urban Development Act of 1968. Under this fund, mortgages are insured which finance (1) homes purchased by low income families who are assisted with their mortgage payments by the FHA; (2) homes purchased by low and moderate income families who, because of the nature of their credit histories or irregular income patterns, could not qualify for mortgage insurance under other FHA insurance programs; and (3) the repair, rehabilitation, construction, or purchase of property located in older, declining urban areas in which conditions are such that eligibility requirements for mortgage insurance could not be satisfied under other FHA insurance programs.

As of June 30, 1973, this fund had about \$14 billion in insurance in force, nearly all of which covered the subsidized section 235 homeownership and section 236 rental assistance programs and the section 223(e) insurance in declining neighborhoods.¹¹

⁹ Ibid., p. 34.

¹⁰ Hearings, pt. 2, p. 151.

¹¹ Hearings, pt. 1, p. 4; pt. 2, p. 152.

APPENDIX 9-2

CASE STUDY OF ATTEMPT BY LOCAL HUD OFFICE TO INSTITUTE DETAILED, CONSUMER-ORIENTED MORTGAGE SERVICING STANDARDS

In spite of an apparent concern for defining mortgagee responsibility during default, the HUD guidelines leave some key words open to interpretation. For example, HUD Guidebook 4191.1 advises that: "Approved mortgagees are required to service their insured mortgage accounts in accordance with the accepted practices or prudent lending institutions"¹ thus turning the responsibility for judgment back on the mortgagee (underline added).

In view of the above, the "Report of the Task Force on Improving the Operation of Federally Insured or Financed Housing Programs", stated that there was still a need for "a set of detailed servicing requirements to be observed by all mortgage servicers with respect to FHA-insured single family mortgages".²

The Single Family Mortgage Servicing Specialist of the Phoenix Insuring Office concurred with this recommendation. In an attempt to make HUD's servicing guidelines more specific, he encouraged the Phoenix Insuring Office Director to issue a set of "Minimum Servicing Standards" to all approved mortgagees in his area.³ These new guidelines went beyond HUD servicing guidelines in the following ways: (See Exhibit 16)

¹ HUD Guidebook 4191.1 op. cit. p. 2.

² Volume 1 "Single Family Housing", op cit. p 275.

³ Interview, Rose Strickland, op. cit.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
FEDERAL HOUSING ADMINISTRATION
Phoenix Insuring Office
244 West Osborn Road, P.O. Box 13468
Phoenix, Arizona 85002

EXHIBIT 16:

November 29, 1973

OFFICE OF THE DIRECTOR

CIRCULAR LETTER NO. 73-13 1

TO : ALL APPROVED MORTGAGEES

RE : MINIMUM SINGLE FAMILY MORTGAGE SERVICING STANDARDS

The Phoenix Insuring Office of the Department of Housing and Urban Development is continuously receiving inquiries from borrowers involving mortgage servicing matters which are within the purview of the lending institutions. In order to assure that mortgagors have an opportunity to work out their problems and have their questions answered promptly, this office has developed minimum standards of prudent mortgage servicing.

Every FHA approved mortgagee having an investment or servicing portfolio of FHA insured mortgages encumbering properties situated within the State of Arizona must meet the minimum servicing standards enunciated below:

Minimum Servicing Standards


1. Every mortgagee shall have a home office, a branch office, or an FHA approved servicing agent within the State of Arizona. The office or agent shall provide the full range of mortgage servicing activities. In the case of a mortgagee using a servicing agent, there must be a formal, written contract delegating to the agent the authority to perform all duties required to meet these minimum servicing standards. We ask each lender to submit a copy of the original and any subsequent contracts to this office for review and retention in the file. HUD approval of the servicing contract will constitute approval of the servicing agent.
2. The local office or agent shall respond to mortgagor requests for information and complaints from mortgagors about payment procedures within 24 hours of initial contact. The office or agent must also agree to accept collect call from mortgagors. Under no circumstances may a borrower, his representative, or an official of HUD be asked or required to write or call an office outside the State of Arizona for any type of information, advice, or assistance pertaining to an FHA insured mortgage. Every approved mortgagee whose home office or servicing office is outside the State of Arizona must inform every mortgagor in writing of the address and telephone number of the office in Arizona to which he can write or call for information, advice, or assistance. We will need a sample copy of the letter for the files in this office.
3. It is recommended that correspondence with borrowers be under a letterhead prominently displaying the address and telephone number of the lender's Arizona office or agent.
4. The office of the local representative shall provide answers to all borrower inquiries including but not limited to analysis of impound accounts, questions relating to payment of taxes and insurance premiums, payment changes, assumptions, pay off information, Section 235 recertifications, and defaults and repayment plans.

5. The local office or agent shall have a full time servicing representative who is knowledgeable in servicing practices and FHA home mortgage regulations. The local office or agent must have someone who is authorized to bind the mortgagee in matters involving all aspects of servicing of insured mortgages. This authority is to include but is not limited to adjustment of impound accounts, acceptance of partial payments, and negotiations of repayment plans in cases of default. One of the touchstones of competent servicing is the ability to analyze financial data, determine causes of default, and work out repayment plans. The local representative must be authorized to meet this responsibility.
6. Prudent servicing makes it essential that there be maintained within the State of Arizona a documented collection file that contains copies of letters from borrowers; replies to such letters; a record of the results of each telephone call, office visit, or field visit; financial data or a statement as to why the data was not obtained; the payment history of the case; a statement of the cause of default; and the terms of any repayment plan negotiated.
7. Every borrower shall receive telephone contact, if possible, on or before the 30th day of delinquency.
8. If a personal meeting is necessary, the borrower should be asked to come to the lender's office. In cases in which telephone contact cannot be made and in cases in which distance or hardship preclude a visit to the office, it is the responsibility of the lender to make a field servicing visit to the property on or before the 45th day of delinquency (15th day of default). This visit will be a servicing visit, not merely a foreclosure inspection. Lenders are not required to make continuous field servicing visits to recalcitrant mortgagors. Lenders are expected to make a sincere effort to cure defaults, assist borrowers in hardship cases, and correct the bad paying habits of chronic delinquents. If the lender does not make a field visit within the prescribed time, the servicing file must contain documented evidence of past prudent servicing efforts.

Every FHA approved mortgagee is asked to notify this office in writing within 90 days whether it is in full compliance with these minimum servicing standards or has disposed of its portfolio to a lender who is in full compliance.

HUD Assistance

The Single Family Mortgage Servicing Specialist of the Phoenix Office has already begun a program of visiting FHA approved mortgagees in Arizona to assist them with servicing problems and to review their servicing policies and procedures. We urge all lenders to inform their local representatives that servicing personnel of the Phoenix Office are prepared to meet with them and to provide any type of assistance possible under outstanding HUD regulations and policies. Please call 261-4923 when requesting assistance.


MERRITT R. SMITH
Director

- Required each FHA approved mortgagee doing business with Arizona to have an office or representative within the state. (1)⁴
- Set a time limit within which mortgagees were required to respond to mortgagor questions and prescribed other specific requirements for dealing with mortgagors. (2,3,4)
- Required mortgagees to have a full-time servicing representative who was to be knowledgeable in all aspects of servicing -- including dealing with mortgagors in default and record-keeping. (5,6,7,8)⁵

While this writer was unable to learn the details of Central HUD's reaction to this circular, it is fair to say that it was not favorable: Assistant Secretary Crawford ordered that it be rescinded.⁶ However, the Phoenix Insuring Office Director issued a new circular which said most of the same things as the earlier one, but referred more directly to HUD guidelines and regulations as the basis for its specific recommendations.⁷ (See Exhibit 17)

This circular was also not received favorably by Central Office⁸ and on February 8, 1974 it, too, was rescinded with the following brief and weak explanation (See Exhibit 18)

⁴Numbers in parentheses refer to the specific paragraphs in Circular 73-13M.

⁵Circular Letter No. 73-13M; From the Office of the Director, Phoenix HUD/FHA Insuring Office, To All Approved Mortgagees Re: Minimum Single Family Mortgage Servicing Standards, November 29, 1973.

⁶Interview, Rose Strickland, op. cit.

⁷Circular Letter No. 74-2M; From the Office of the Director, Phoenix HUD/FHA Insuring Office, To all Approved Mortgagees, Re: Single Family Mortgage Servicing, Jan. 31, 1974.

⁸Interview, Rose Strickland, op. cit.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
FEDERAL HOUSING ADMINISTRATION
Phoenix Insuring Office
241 West Osborn Road, P. O. Box 13468
Phoenix, Arizona 85002

EXHIBIT 17:

January 31, 1974

OFFICE OF THE DIRECTOR

CIRCULAR LETTER NO. 74-2 M

TO : ALL APPROVED MORTGAGEES
RE : Single Family Mortgage Servicing

The Phoenix Insuring Office Circular Letter 73-13 M, dated November 29, 1973 is rescinded.

In this letter we remind all mortgagees of the requirements of HUD-FHA regulations and guides pertaining to the servicing of mortgages. The comments herein apply to all lenders who have an investment or servicing portfolio of FHA insured mortgages encumbering properties situated within the State of Arizona.

HUD-FHA Regulation 203.9 requires: "All approved mortgagees are required to service insured loans in accordance with acceptable mortgage practices of prudent lending institutions. In the event of default, the mortgagee should be able to contact the mortgagor and otherwise exercise diligence in collecting the amounts due." Paragraph 3-7 of the Mortgagees Guide - Application Through Commitment requires: "Mortgagees are expected to insure that adequate facilities are available in the area in which the property is located to enable the mortgagor to get timely information concerning his account and to enable the mortgagee to take adequate steps to protect the security for its loan."

The term "adequate facilities" means local servicing representation. The term "in the area in which the property is located" means within the State of Arizona. Therefore, every lender must have a home office, a branch office, or a servicing agent within the State of Arizona. The office or agent must provide the full range of mortgage servicing activities. In order to assure that the facility will be adequate, mortgagees using a servicing agent must have a formal, written contract delegating to the agent the authority to meet HUD requirements. Each lender shall submit a copy of the original and any subsequent contracts to this office for review and retention in the file. HUD approval of the servicing contract will constitute approval of the servicing agent.

The local representative must provide timely information to the mortgagor (Paragraph 3-7 of the Guide). To assure that every borrower is aware of this service, every mortgagee whose home office or servicing office is outside the State of Arizona must inform every borrower in writing of the name and address of the local representative.

The local representative must be competent to protect the security for the loan (HUD-FHA Regulation 203.9 and paragraph 3-7 of the Guide). He will be expected to make field visits to borrowers, obtain financial information, determine causes of default, and negotiate repayment plans. Lenders are urged to grant local representatives authority to bind the corporation in all servicing matters including repayment agreements. If the home office wishes to reserve to itself approval authority of repayment plans, the local representative should make an immediate report to the home office, including a statement of the borrower's repayment offer. If the offer is accepted, no further action would be necessary other than routine notification to the borrower. If the offer is rejected, the home office should take the following action. Within 72 hours of receipt of the local representative's report, an official of the home office who is authorized to accept repayment plans should establish telephone contact with the mortgagor. After an explanation of the rejection, the borrower should be given an opportunity to present his side of the story and to make further repayment offers. Upon completion of the interview, a full resume of the contact must be sent to the local representative for retention in his collection file.

Generally, communication expenses relating to servicing inquiries and negotiations shall be borne by the lender. In any unusual instance in which a lender refuses to bear such expense, we advise a thorough explanation be forwarded to this office to assure such action is prudent and reasonable. However, we would expect such instances to be extremely rare, recognizing that many mortgagors are completely uninformed about mortgage matters.

In the Form 2001 series, the mortgagee agrees it will submit at any time to such examination of its records and accounts as the Secretary may require. The Phoenix office of HUD is primarily concerned with collection records. Prudent servicing makes it essential that there be maintained within the State of Arizona a documented collection file that contains copies of letters from borrowers; replies to such letters; a record of the results of each telephone call, office visit, or field visit; financial data or a statement as to why the data was not obtained; the payment history of the case; a statement of the cause of default; and the terms of any repayment plan negotiated.

Prudent servicing of HUD-FHA insured mortgages in Arizona must be in effect on or before April 1, 1974. Every HUD-FHA approved mortgagee is asked to notify this office on or before that date whether it is in full compliance with the contents of this letter. The letter of compliance is to be accompanied by a copy of the servicing contract if applicable.

Those lenders who responded to Circular Letter 73-13 M and who indicated full compliance therewith, need not respond to this letter.

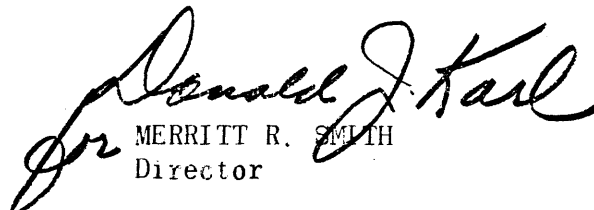

MERRITT R. SMITH
Director

EXHIBIT 18:

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DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
FEDERAL HOUSING ADMINISTRATION
Phoenix Insuring Office
244 West Osborn Road, P. O. Box 13468
Phoenix, Arizona 85002

February 8, 1974

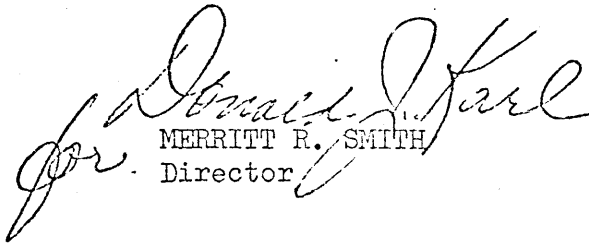
OFFICE OF THE DIRECTOR

CIRCULAR LETTER NO. 74-4 M

TO : ALL APPROVED MORTGAGEES
RE : SINGLE FAMILY MORTGAGE SERVICING

The Phoenix Insuring Office Circular Letters No. 73-13 M, dated November 29, 1973, and No. 74-2 M, dated January 31, 1974, are rescinded.

This action is necessitated in order to minimize and/or eliminate variations in local servicing practices policy and assure compliance with National policy which is currently under discussion at the HUD Central Office.


MERRITT R. SMITH
Director

This action is necessitated in order to minimize and/or eliminate variations in local servicing practices policy and assure compliance with National policy which is currently under discussion at the HUD Central Office.⁹

This incident is important for several reasons. First, it points out that at least some Area Office personnel have tried to deal with mortgagee servicing issues in a hard-nosed, consumer oriented fashion. Not only have they identified serious deficiencies in mortgagee servicing activities but they have been willing to take steps to try to correct them.

Second, HUD chose to act in a mortgagee-oriented rather than consumer-oriented fashion, even though it appears that it would have been easy and straight-forward to follow the latter course.

And, third, Central HUD's requests to rescind the circulars could only serve to weaken the Phoenix Insuring Office in terms of its dealings with mortgagees. Imagine the reaction of a mortgagee who receives a succession of firm circulars that he is later told to ignore by Central HUD. Clearly, this could result in the local office having an even more difficult time persuading mortgagees to follow their requests or recommendations. Rather than helping local personnel to deal with mortgagees with authority, HUD chose to diminish their power.

⁹Circular Letter No. 74-4M; From the Office of the Director, Phoenix HUD / FHA Insuring Office, To All Approved Mortgagees, Re: Single Family Mortgage Servicing, Feb. 8, 1974.

APPENDIX 10-1:
HUD CRITERIA FOR
APPROVAL AND DISAPPROVAL
OF MORTGAGEES

From: HUD Handbook 4000.2
Mortgagees' Handbook--
Application Through
Insurance" (Single
Family) March, 1975

CHAPTER 3. APPROVAL OF MORTGAGEES

- 3-1. RESTRICTIONS. A mortgage insured by the Secretary may not be originated or purchased by a lender which has not first been approved as a mortgagee by the Secretary, except under special conditions described in Section 203.433 of the FHA Regulations. Similarly, an insured mortgage may not be sold to other than an approved mortgagee except as provided in Section 203.433 of the FHA Regulations. The authority to grant and withdraw approval of mortgagees has been delegated to the Director, Participant Control and Supervision Division, Office of Management Systems, HPMC, Department of Housing and Urban Development, Washington, D. C. 20411. Approval permits the approved mortgagee to participate in all mortgage insurance programs administered by HUD-FHA, and is not restricted to home mortgage programs.
- 3-2. AUTOMATIC APPROVAL. The Federal National Mortgage Association, Government National Mortgage Association, Federal Reserve Banks, Federal Home Loan Banks, and all other Federal, State, or municipal government agencies empowered by law to hold insured mortgages are approved as mortgagees. For accounting purposes only, such agencies should file FHA Form 2001, Application for Approval as Mortgagee, with the local HUD field office and obtain a mortgagee code number before dealing in insured mortgages.
- 3-3. APPROVAL REQUIREMENTS. Chartered institutions, permanent institutions having succession, or trusts may be approved as mortgagees on application to the local HUD field office. An approved mortgagee must have sound capital funds (used herein synonymously with "acceptable net worth") properly proportioned to its liabilities and to the character and extent of its operation.
- a. Approved Mortgagees are divided into six groups, and the requirements for approval vary from group to group.
- (1) Group 1. Members of the Federal Reserve System and institutions whose deposits are insured by the Federal Savings and Loan Insurance Corporation or the Federal Deposit Insurance Corporation need only submit FHA Forms 2001, Application for Approval as Mortgagee, and 2001-b, Resolution of Authority (Figures 3-1 and 3-2, respectively).
 - (2) Group 2. Supervised Institutions.
 - (a) Supervision. A mortgagee in this group must be subject to the supervision of a governmental agency which is required by law to make regular examinations of its books and accounts.

-
- (3-3) (b) Available Funds. A mortgagee in this group must have sound capital funds of not less than \$100,000, or if it is a mutual company or association without capital funds, it must have an acceptable net worth of not less than \$100,000.
- (c) Application. FHA Form 2001, Application for Approval as Mortgagee and FHA Form 2001-B, Resolution of Authority (Figures 3-1 and 3-2), accompanied by the applicant's latest published financial statement; a list of branch offices, if any, and their addresses; a list of the directors and officers of the corporation; and a list identifying each holder of ten percent or more of the corporate stock.
- (3) Group 3, Non-supervised Institutions. Mortgagees in this group are subject to supervision by HUD-FHA, but not by any other governmental agency (in contrast to Groups 1 and 2).
- (a) Activity. A mortgagee in this group must have as its principal activity the lending or investing of funds under its own control in real estate mortgages.
- (b) Available Funds. Sound capital funds of not less than \$100,000.
- (c) Application. FHA Form 2001-B, Resolution of Authority and FHA Form 2001-C, Application for Approval as Mortgagee (Figures 3-2 and 3-3), accompanied by letters from banks setting forth available lines of credit; and a current, detailed audit of the company's books by an independent accountant, satisfactory to the Commissioner, including his unqualified opinion of the firm's financial condition.
- (4) Group 4, Loan Correspondents.
- (a) Activity. Approval must be requested by an approved mortgagee in Group 1 or 2, above. The sponsoring mortgagee must be investing in insured mortgages for its own portfolio in a volume sufficient to enable the correspondent to operate successfully. The loan correspondent is limited to originating or purchasing insured mortgages for its sponsor.

-
- (3-3) (b) Available Funds. Sound capital funds of at least \$5,000.
- (c) Application. The sponsor and correspondent must file a joint FHA Form 2001-D, Application for Approval of Loan Correspondent (Figure 3-4). The loan correspondent must file FHA Form 2001-B, Resolution of Authority; a detailed, current audit of the company's books and accounts by an independent accountant, as in Group 3; and letters from banks setting forth lines of credit available.
- (5) Group 5, Charitable or Non-Profit Institutions, Pension Funds, or Trust.
- (a) Activity. A mortgagee in this group must have investment experience and ability. It may invest in insured mortgages but may neither originate nor service them.
- (b) Available Funds. Permanent funds of not less than \$100,000.
- (c) Application. FHA Form 2001-E, Application for Approval as Mortgagee (Figure 3-5).
- (6) Group 6, Investing Mortgagees.
- (a) Experience. A mortgagee in this group must have experience in investing in real estate mortgages. Insured mortgages may not be originated or serviced, but may be acquired by purchase from other approved mortgagees and held as investments.
- (b) Available Funds. Sufficient capital to support a projected investment of at least \$1,000,000 in real estate mortgages.
- (c) Application. FHA Form 2001-G, Application for Approval as Investing Mortgagee (Figure 3-7), accompanied by a current, detailed audit of the company's books by an independent accountant, as in Group 3.

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- b. Mortgagee Application Forms FHA 2001, 2001-B, 2001-C, 2001-D, 2001-E, 2001-F, and 2001-G are available from HUD field offices.
- c. Reports, Audits, and Examinations. Any approved mortgagee may, at any time, be required to furnish the Secretary or his representative with a copy of its current financial statement or report. In addition, a mortgagee in Group 3, 4, or 6 must submit a detailed audit of its books by an independent accountant at least once in each calendar year. Any mortgagee must submit to examination of its books whenever requested by the Secretary.
- 3-4. AUTHORIZED AGENTS. Authorized agents are not approved as mortgagees. Any corporate entity, partnership, firm, or individual may be appointed by an approved mortgagee in Groups 1 or 2 to act in its name in originating and servicing insured mortgages. Two copies of the resolution by which the principal grants this authority must be forwarded to the local HUD field office, with a letter from the principal requesting approval of the agent. The resolution must describe the nature and scope of the agent's authority. The Department has no liability or responsibility to the mortgagee for actions by an authorized agent outside the scope of his authority.
- 3-5. BRANCH OFFICES. Any approved mortgagee in Group 3 may request HUD-FHA approval to establish branch offices through which it originates and services insured mortgages.
- a. Mortgagees in Groups 1 and 2 need not request approval, but, if bills for fees or mortgage insurance premiums are to be directed to a branch office, a request for assignment of a branch code number must be forwarded in letter form to the Director, Participant Control and Supervision Division, Office of Management Systems, HPMC, Department of Housing and Urban Development, Washington, D. C. 20411.
- b. Standards for Approval are set forth in FHA Form 2001-F, Application for Approval of Branch Office (Figure 3-6). There are no financial requirements for approval if the branch office is located in the mortgagee's home state or in a contiguous state. However, to establish a branch office in a non-contiguous state, the Group 3 mortgagee must have acceptable net worth of at least \$150,000. For each non-

contiguous state to that of its main office, in which it establishes a branch office or offices, Group 3 mortgagees must have an additional \$50,000 in net worth until net worth reaches \$250,000. Upon reaching this level, no further increase in net worth will be required if branches are opened in additional non-contiguous states.

- 3-6. MORTGAGEE CODE NUMBERS. HUD-FHA's accounting system is completely automated, and billing for fees and mortgage insurance premiums is included in this system. In addition, many of HUD-FHA's statistical and administrative activities, although not automated, are coordinated with the accounting system. Therefore, each mortgagee and, in some cases, each branch office, is assigned a code number. This number, along with the mortgagee's complete name and address, must appear on all processing documents, applications, commitments, servicing report forms, claims for insurance benefits, and the like. The mortgagee number appears in its letter of approval from HUD-FHA.
- 3-7. LOAN ORIGINATION RESPONSIBILITY. HUD requires the originators of insured mortgages to develop such loans in accordance with accepted practices of prudent lending institutions and HUD-FHA requirements. They must obtain and verify information with at least the same care that would be exercised in originating a loan in which the mortgagee would be entirely dependent on the property as security to protect its investment.
- 3-8. SERVICING RESPONSIBILITY. Even though servicing of an insured mortgage may be done under contract by a mortgagee other than the mortgagee on record, HUD-FHA holds the owning mortgagee responsible for the adequate administration of each insured mortgage in its portfolio. HUD-FHA will look to the owning mortgagee for the correction of any errors or omissions. Mortgagees are expected to insure that adequate facilities are available in the area in which the property is located to enable the mortgagor to get timely information concerning his account and to enable the mortgagee to take adequate steps to protect the security for its loan. In general terms, HUD-FHA requires that the holders of insured mortgages service them in accordance with the accepted practices of prudent lending institutions. This should be done in the same manner as if the loan were not insured and the mortgagee were dependent entirely on the property as security to protect its investment.

3-9. WITHDRAWAL OF APPROVAL. Any mortgagee's approval may be withdrawn at any time for any reason which the Secretary determines justifies the withdrawal. Like the authority to approve mortgagees, authority to withdraw approval has been delegated to the Director, Participant Control and Supervision Division, Office of Management Systems, HPMC, Department of Housing and Urban Development, Washington, D. C. 20411.

a. Some Specific Reasons for Withdrawal of approval are:

- (1) Transfer of an insured mortgage to a mortgagee not approved by the Secretary, except as permitted by Section 203.433 of the FHA Regulations.
- (2) Failure on the part of a mortgagee in Groups 3 and 6 to segregate escrow deposits and deposit them in a special account or accounts with a banking institution whose accounts are insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation.
- (3) The use of escrow funds for any purpose other than that for which they were received.
- (4) Failure of any mortgagee to conduct its business in accordance with good business practices and accepted standards of conduct.
- (5) Termination of a Group 2 mortgagee's supervision by a governmental agency.
- (6) The payment by the mortgagee of any fee, kickback, or other consideration (directly or indirectly) in connection with any insured mortgage transaction (or transactions) to any person including an attorney, escrow agent, title company, consultant, mortgage broker, seller, builder, or real estate agent if such person has received any other payment (or other consideration) from the mortgagor, the seller, the builder, or any other person for services related to such transaction (or transactions) or from, or related to, the purchase or sale of the mortgaged property. However, compensation may be paid for the actual performance of such services as may be approved by the Commissioner. (See Chapter 8 of this Handbook).

(3-9) b. Withdrawal of Approval does not affect the insurance on mortgages held in the lender's portfolio or commitments outstanding in the name of the lender at the time of withdrawal.

APPENDIX 10-2

CASE STUDY OF COURT CASE INVOLVING FORBEARANCE AGREEMENT:

First National City Bank, Plaintiff vs. Geneav Moncrief, Defendant March-May, 1973, Indianapolis

Mr. and Ms. McNeil and Geneav Moncrief were mortgagors on an FHA-insured 203(b) 20 year loan. By the time of the case, ten of these years had passed with an apparently good payment record. Mr. and Ms. Moncrief had been separated for five of these years, but Mr. Moncrief continued to make the monthly mortgage payments of \$115.00 for the house in which his wife and three children still lived.

About a year before the case, Mr. Moncrief stopped making the monthly mortgage payments. However, because Mr. Moncrief had, from time to time, been late in making payments, Ms. Moncrief did not, at first, become overly concerned. As Ms. Moncrief realized that this situation was not about to change she sought and found employment which, both she and her attorney felt was sufficient to meet the mortgage payments. Moreover, while Ms. Moncrief claimed that she would no longer be dependent upon Mr. Moncrief for the mortgage payments, the latter had agreed to resume payments.

Advance Mortgage Company (AMC), servicer for the mortgagee and Plaintiff, First National City Bank, did not offer Ms. Moncrief any form or relief, in spite of the fact that the default was apparently for a reason beyond her control. Instead, they initiated foreclosure proceedings. While ignoring requests for forbearance from Ms. Moncrief's attorneys, AMC finally agreed to dismiss its suit for foreclosure only if the following terms were met:

- 1 - Immediate payment of \$262.50 as reimbursement for accrued fees;

2 - Payment of \$162.00 per month for the next 30 months so as to amortize the delinquent amount;

3 - No extension of the original maturity date of the mortgage.¹

Moreover, Ms. Moncrief's attorney, Davis S. Walker, wrote in a letter to the Indianapolis Area Office of HUD that:

The Attorney for AMC was unfamiliar with the FHA regulations providing such relief (i.e. forbearance) and asked for my consent to a foreclosure decree in late December of 1972. When I again requested special forbearance he was unfamiliar with such relief and, in any event, did not believe that his client (i.e. First National City Bank) would accept it. The only reason he stated was that the money could be loaned at a higher rate of interest now.²

Based upon AMC's response to requests for relief for Ms. Moncrief, Mr. Walker concluded that:

AMC is not servicing this mortgage beyond the bare minimum of collecting payments. The regulations (HUD) plainly envision that it will do more, and at the very least mean that the mortgagee will devote earnest attention and consideration to a request for special forbearance. In the circumstances of the present case....I believe that the mortgagee is required by the regulations to grant the relief.³

HUD responded to Walker's argument by putting pressure on AMC to grant relief. In a letter to the Assistant Vice President of AMC, the Deputy Director of the Indianapolis HUD Area Office, Choice Edwards stated that:

In view of the remedies available to deserving mortgagors under our insurance programs, we cannot help but feel that your offer (as described above) is unnecessarily harsh for

¹The above description is condensed from information presented in a letter from David S. Walker to Mr. Thomas McNally, Area Counsel, Department of HUD, Indianapolis, Indiana. February 15, 1973. (Cause No. S572-716)

²Ibid.

³Ibid.

a homebuyer who has paid one-half of her mortgage, who is 47 years of age, has three children living with her, who became delinquent through no apparent fault of her own, who has made a determined effort to find employment to continue her payments and through her past payment record would normally be considered a good risk.⁴

After reminding AMC of their responsibility to service loans in accordance with acceptable mortgage practices of prudent lending institutions and of the array of relief measures available, Mr. Edwards concluded with the following:

HUD-FHA is more than willing to approve Ms. Moncrief's proposal that the mortgage term be extended one year in order to maintain her payments at \$115.00 per month. In the event Ms. Moncrief again defaults and the property is foreclosed, you will be reimbursed for all of the interest during the year the mortgage was in default, no matter when that foreclosure should occur. Since the government bears all the risk of loss, we do not understand your reluctance to reinstate the mortgage and hope that this letter will convince you to review your course of action.⁵

While HUD's response was good, it lacked promptness. Almost three weeks had passed from the time of Mr. Walker's February letter to HUD.

Meanwhile, Ms. Moncrief's attorneys continued their case through the courts. It is an interesting coincidence that Mr. Edwards' letter bears the same data as Ms. Moncrief's "Answer and Counterclaim" against the Plaintiff. In this document the attorneys charged that the plaintiff:

- a. failed to visit the mortgaged property, telephone and meet with the defendants, and inquire into the circumstances of the default;

⁴Letter from Choice Edwards, Deputy Director, Indianapolis Area Office, HUD, to Mr. John Heitkamp, Asst. Vice Pres. Advance Mortgage Corp., Detroit, Mich. March 6, 1973.

⁵Ibid.

- b. refused to accept partial payments and insisted upon full payment of the delinquent amount, including all late charges;
- c. failed to inform the defendant of special relief in lieu of foreclosure authorized by the FHA and available to mortgagors whose default occurs under circumstances beyond the control of the mortgagor;
- d. failed to give good faith consideration to the defendant's request for special forbearance relief, as authorized by regulations of the FHA;
- e. failed to make all reasonable efforts to avoid foreclosure of a mortgage that is in default due to circumstances beyond the mortgagor's control.⁶

The clear and undeniably sound arguments of Ms. Moncrief's case combined with the pressure from HUD and the court, finally compelled AMC to execute a forbearance agreement with Ms. Moncrief 14 months after the date of her default. The case was dismissed and Ms. Moncrief continued making payments of \$115.00 per month and the date of maturity of the loan was simply extended one year. The ease with which the matter was finally resolved would be comical were it not for the energy, money and anguish expended on what should have been a routine procedure. To underscore the simple nature of a forbearance agreement, even following such a prolonged problem, the actual agreement, along with the "Stipulation of Dismissal" is included. (See Exhibit 19).

⁶Superior Court of Marion County, State of Indiana: Cause no. S572-716. "Answer and Counterclaim of Geneav Moncrief", Filed March 6, 1973.

FORFEITURE AGREEMENT

THIS AGREEMENT, made and entered into this _____ day of April, 1973, by and between FIRST NATIONAL CITY BANK (hereinafter referred to as "Mortgagee") and GENEAV MONCRIEF (hereinafter referred to as "Mortgagor"), WITNESSETH THAT:

WHEREAS Mortgagee is the holder, by virtue of an assignment, of a promissory note and real estate mortgage executed by the Mortgagor and her husband on October 2, 1962; which mortgage (1) was given as security for the repayment of the debt evidenced by the aforesaid note, (2) is a first and prior lien upon certain real estate located in Marion County, Indianapolis, Indiana, which real estate is legally described as follows:

Lot 4 in Northeastern, an Addition to the City of Indianapolis, the plat of which is recorded in Plat Book 18, page 163, in the office of the Recorder of Marion County, Indiana,

and (3) is insured by the Federal Housing Administration (FHA Case No. 151-007265-203); and

WHEREAS the Mortgagor, due to circumstances beyond her control, failed to make monthly mortgage payments required under the aforesaid note and real estate mortgage from March 1, 1972 through February 28, 1973;

NOW THEREFORE, in consideration of the mutual promises contained herein, it is agreed by and between the Mortgagor and Mortgagee:

1. That the Mortgagor has been and is now in default under the terms of the aforesaid note and real estate mortgage for the period commencing March 1, 1972 and extending through February 28, 1973.

2. That pursuant to 12 U.S.C. §§1709 - 1710 and 24 C.F.R. §203.340 the Mortgagee is willing to and hereby does extend to the Mortgagor a special forbearance suspending the monthly mortgage payments during the aforesaid period of default.

3. That as of March 1, 1973 Mortgagor will resume and thereafter continue to make the regular monthly payments required under the aforesaid note and real estate mortgage.

4. That the original mortgage term shall be and hereby is extended one (1) year, and that the debt, if not sooner paid, shall be due and payable on the 1st day of October, 1983.

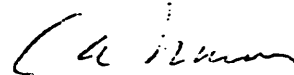
5. That all of the provisions of the note and real estate mortgage, except as herein provided, shall remain in full force and effect.

6. That upon the breach of any provision of this agreement, the Mortgagee may terminate the same, and, at the option of the Mortgagee, institute foreclosure proceedings according to the terms of the note and real estate mortgage without regard to this agreement.

WITNESS OUR HANDS, this April 24, 1973:


Geneav Moncrief

FIRST NATIONAL CITY BANK

By:  Vice Presi
~~Irwin J. Prince~~ C. R. Munoz
Eskenazi, Mitchell & Yosha
Attorneys at Law
220 N. Meridian Street
Indianapolis, Indiana 46206

FIRST NATIONAL CITY BANK,)
) Plaintiff,)
))
) VS.)
))
McNEIL MONCRIEF,)
GENEAV MONCRIEF,)
) and)
THE STATE OF INDIANA)
GROSS INCOME TAX DIVISION,)
) Defendants,)

CAUSE NO. S572-716

FILED

MAY 2 1973

E. Allen Hensley
CLERK

STIPULATION OF DISMISSAL

Plaintiff First National City Bank by its attorney Irwin J. Prince, and defendant Geneav Moncrief, by her attorney David S. Walker, hereby stipulate that the above-entitled civil action be discontinued and dismissed, without prejudice, pursuant to Trial Rule 41 (a) (1), Indiana Rules of Procedure, and as grounds therefor state that said parties have agreed to a settlement of the plaintiff's claim for relief.

Irwin J. Prince

Irwin J. Prince
Eskenazi, Mitchell & Yosha
Attorneys for Plaintiff
2220 North Meridian Street
Indianapolis, Indiana 46205
925-9011

RECEIVED
MAY 14 1973
NATIONAL CLEARINGHOUSE
FOR LEGAL SERVICES

David S. Walker

David S. Walker
Attorney for Defendant Geneav Moncrief
Legal Services Organization
of Indianapolis, Inc.
1955 Central Avenue

APPENDIX 10-3:

- MATERIAL RELATING TO BROWN VS. LYNN ET. AL.
- HUD'S NEW APPROACH TO RELIEF FOR DEFAULTING
MORTGAGORS.

64 East Jackson Boulevard, Chicago, Illinois 60604 (312) 922-5625

Legal Assistance Foundation of Chicago

March 14, 1975

Western Legal
Assistance Clinic
1 Superior Street
6

Services
1111 Broadway Street
5

East
Services
1111 North Avenue
0

West Austin
Services
1111 Cicero Avenue
0

West
Services
1111 Kedzie Avenue
3

South Court
Services
1111 South Oakley Avenue
1

North Street
Services
1111 East 18th Street
0

South Boulevard
Services
1111 West 47th Street
5

South
Services
1111 West 63rd Street
0

South
Services
1111 South Halsted Street
0

West
Clinic
1111 South University Street
81

Ms. Rachel G. Bratt
Worcester Road
Princeton, Massachusetts 01541

Dear Rachel:

I very much enjoyed our phone conversation of yesterday. It is a refreshing coincidence for me to find other people working in depth to solve FHA quick-foreclosure problems, especially so in this case since the information you have compiled seems so helpful to Brown v. Lynn.

I give you my firm assurance that if you were to send us the draft of your thesis, it would only be shown to and used by counsel in the Brown case. You would be advised before any part of your thesis would be introduced in evidence or otherwise released, and if you declined to approve such release, we would not proceed. Hopefully, you would be available to testify at trial in lieu of the introduction of your thesis, if we thought your input was probative to the case.

I have enclosed copies of the following documents:

- (1) Chapter 2, Report of Illinois Mortgage Practices Commission;
- (2) Testimony of John Waner, HUD area director, before the Illinois Legislative Investigating Commission;
- (3) MBA National Delinquency Survey, June 30, 1974.

I am awaiting receipt from you of a copy of the first draft of the OSTI report. Hopefully, Mr. Bach will send us the

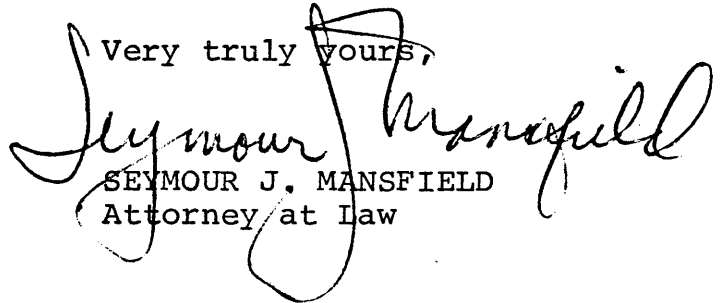
Ms. Rachel Bratt
Page Two

March 14, 1975

final report.

Thank you for your help.

Very truly yours,

A handwritten signature in cursive script that reads "Seymour J. Mansfield". The signature is written in black ink and is positioned above the typed name and title.

SEYMOUR J. MANSFIELD
Attorney at Law

SJM:cd

enclosures

P.S. Rachel, are you aware of two "studies of mortgage default" (dated Dec., 1974 and Feb., 1975) supposedly done by HUD Office of Program Development? An attorney from D.C. asked if I had seen them but had no further description.

54 East Jackson Boulevard, Chicago, Illinois 60604 (312) 922-5625

Legal Assistance Foundation of Chicago

July 25, 1975

Western Legal
Assistance Clinic
1 Superior Street
6

Services
North Broadway Street
5

West
Services
East North Avenue
10

1/1 Austin
Services
Cicero Avenue
10

1/1
Services
1/1th Kedzie Avenue
13

1/1
Services
South Oakley Avenue
31

1/1th Street
Services
West 18th Street
30

Boulevard
Services
East 47th Street
35

1/1
Services
East 63rd Street
30

1/1
Services
South Halsted Street
30

1/1 Clinic
South University Street
181

Ms. Rachel G. Bratt
Worcester Road
Princeton, Mass. 01541

Dear Rachel:

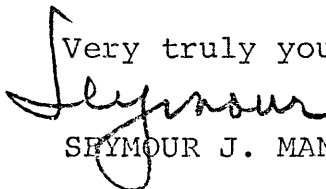
Please accept my apologies for not writing sooner. Your thesis draft has been very, very useful. We have used the information in it (but not the physical text itself) in the depositions of John Waner, the Chicago Area Office Director, and William Miller, local head of Housing Management; and we intend to use the draft in the upcoming depositions of Washington HUD officials.

We have now compiled probably the most complete (and incriminating) documentary-discovery library on FHA single-family mortgagee servicing available. I am sure you would be interested in perusing our material before you finalize your thesis. Besides, I would love to talk to you - so why not plan to come to Chicago during the summer.

In the meantime, do you have an updated version of the thesis? Do you have any background material on Philip Forrest, Chief, Mortgage Servicing Evaluation Branch; Julius Williams, Director, Single Family Housing Division; Fred Pfeander, Director, Office of Loan Management; H.R. Crawford, Assistant Secretary, Housing Management, all in D.C.? We will be taking some or all their depositions in September.

I hope to hear from you soon.

Very truly yours,



SEYMOUR J. MANSFIELD

SJM:eg

P.S. Rachel, I would still like to talk to you about being an expert witness or affiant in Brown - now probably going to trial in October or November, 1975. - SJM

**LEGAL
ASSISTANCE
FOUNDATION of
CHICAGO**

343 South Dearborn Street Chicago, Illinois 60604 (312) 341-1070

**EIGHTEENTH STREET LEGAL
SERVICES**

1413 West 18th Street
Chicago, Illinois 60608
421-1900

ENGLEWOOD LEGAL SERVICES

6401 South Halsted St.
Chicago, Illinois 60621
651-3100

F.A.C.T. PROJECT

4 North Cicero Avenue
Chicago, Illinois 60644
379-7800

**GARFIELD/AUSTIN LEGAL
SERVICES**

4 North Cicero Avenue
Chicago, Illinois 60644
379-7800

**JUVENILE COURT LEGAL
SERVICES**

1114 South Oakley Boulevard
Chicago, Illinois 60612
421-2061

LAWNDALE LEGAL SERVICES

911 South Kedzie Avenue
Chicago, Illinois 60612
638-2343

**MENTAL HEALTH ADVOCACY
PROJECT**

343 South Dearborn St.
Chicago, Illinois 60604
341-1307

**MID-SOUTH SIDE LEGAL
SERVICES**

4655 South Michigan Ave.
Chicago, Illinois 60653
538-0733

MIGRANT LEGAL SERVICES

1212 North Ashland Ave.
Chicago, Illinois 60622
489-6797

NORTHWEST LEGAL SERVICES

1212 North Ashland Ave.
Chicago, Illinois 60622
489-6800

**PRISONERS LEGAL
ASSISTANCE**

343 South Dearborn St.
Chicago, Illinois 60604
896-5540

UPTOWN LEGAL SERVICES

4564 North Broadway
Chicago, Illinois 60640
789-1015

August 3, 1976

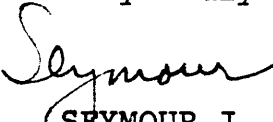
Ms. Rachel G. Bratt
Worcester Road
Princeton, MA 01541

Dear Rachel,

Just a note on Brown (now called Ferrell vs. Hills). As you can see from the enclosed regulations, the settlement stipulation, final order, and our descriptive memo, the Brown case has been settled. We are happy with the settlement - indeed we think it's the best thing HUD has done in the last 40 years to help save distressed homeowners from foreclosure. However, we are receiving a lot of complaints around the country from Legal Service attorneys and community organizations that HUD is violating the settlement. Thus, we seem only to be biding our time until we go marching back into court to obtain an injunction requiring HUD on pain of contempt to earnestly implement and enforce the assignment program.

I look forward to hearing your comments.

Very truly yours,


SEYMOUR J. MANSFIELD

SJM:cd

P.S. How are you enjoying motherhood?

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JAMES and JOYCE FERRELL, et al.,)	
)	
Plaintiffs,)	
)	
v.)	Case No. 73 C 334
)	
CARLA HILLS, et al.,)	
)	
Defendants.)	

S T I P U L A T I O N

WHEREAS, on February 13, 1973, plaintiffs filed, on behalf of Johnnie D. Brown and others, their complaint against George Romney, Secretary of the Department of Housing and Urban Development (hereinafter "HUD"), and John Waner, Director of the Chicago Area Office of HUD, and Mortgage Associates, Inc.; and

WHEREAS, on May 3, 1973, plaintiffs filed an amended complaint on behalf of the above-named plaintiffs and others against James Lynn, Secretary of HUD; John Waner, Director of the Chicago Area Office of HUD; Mortgage Associates, Inc.; L.E. Lay and Company; Simmons First National Bank of Pine Bluff, Arkansas; First Federal Savings and Loan Association of Gary, Indiana; Elmira Savings and Loan Association; Charleroi Federal Savings and Loan Association; James F. Messenger; Unity Savings and Loan Association; Federal National Mortgage Association and First Federal Savings and Loan Association of South Holland; and

WHEREAS, on October 11, 1974, the Court dismissed the

Handwritten initials/signature

defendant mortgagees on the ground that plaintiffs' amended complaint failed to state a cause of action as to those defendants, but did, part, state a valid cause of action against the federal defendants, Brown v. Lynn, 385 F. Supp. 986 (N.D. Ill. 1974); and

WHEREAS, on March 17, 1975, the Court determined that plaintiffs' cause of action could proceed as a nationwide class action on behalf of the named plaintiffs and on behalf of all other persons who (a) have purchased a home pursuant to three programs of homeownership for low and moderate-income families established by the National Housing Act: Section 203, 12 U.S.C. §1709; Section 221(d)(2); 12 U.S.C. §17151(d)(2); and Section 235, 12 U.S.C. §1715z; and (b) are currently or in the future become in default on mortgages insured under said programs; and

WHEREAS the plaintiffs, James and Joyce Ferrell, et al., filed a second amended complaint on October 20, 1975, seeking, inter alia, declaratory and injunctive relief against defendants, Carla H. and John Waner, and to require said defendants to (a) promulgate and enforce a continuing, binding and effective regulatory scheme and establish procedures to prevent holders and servicers of HUD-insured mortgages from prematurely and precipitously foreclosing on said mortgages and (b) require relief in the alternative to foreclosure to distressed homeowners such as forbearance relief, recasting of the mortgage or the taking of an assignment of the mortgage by HUD to avoid foreclosure; and

WHEREAS, on May 17, 1976, the defendant, Secretary of HUD issued HUD Notice HM 76-43 and Mortgagee Letter 76-9, which notice

and mortgagee letter incorporate the Department's revised policy regarding acceptance of assignments of insured mortgages in default; and

WHEREAS, in order to avoid further costly and time-consuming litigation, the parties have agreed to compromise and settle their disputes;

NOW, THEREFORE, IT IS HEREBY STIPULATED AND AGREED BY THE PARTIES HEREIN THROUGH THEIR ATTORNEYS, PURSUANT TO RULE 41(a) OF THE FEDERAL RULES OF CIVIL PROCEDURE, THAT:

1. Nothing in this Stipulation shall constitute an admission by the defendants of any of the facts alleged in plaintiffs' complaints or that those facts are sufficient to state a cause of action, nor shall this Stipulation constitute an admission by plaintiffs that their complaints, or any parts thereof, fail to state a sufficient and provable cause of action. Nor shall any provision of this Stipulation be deemed an adjudication by the Court of the merits of this cause.

2. On May 17, 1976, HUD issued Notice HM 76-43 and HM Mortgagee Letter 76-9, copies of which are attached hereto as Exhibits A and B, and explicitly made a part of this Stipulation. HUD will take appropriate measures, within its regulatory authority, to require HUD-approved mortgagees to process, request and execute assignments to avoid foreclosure of HUD-insured, single family home mortgages, and HUD will process and act upon requests for assignment, and thereafter service said mortgages substantially in accordance

with said HUD Notice 76-43 and HM Mortgagee Letter 76-9, as amended to comply with paragraph 9 of this Stipulation.

3. The aforesaid Notice and Mortgagee Letter incorporate the terms and conditions of HUD's policy respecting assignments of HUD-insured mortgages in default.

4. HUD will promptly submit for publication in the Federal Register HM Notice 76-43 and HM Mortgagee Letter 76-9 for informational purposes.

5. HUD will proceed expeditiously to revise FHA Form No. 2068F (Rev. 10/69) so as to be substantially similar to the attached Exhibit C, and subject to necessary clearance by the Office of Management and Budget, will issue said Form for use in connection with said assignment program.

6. Within a reasonable time, HUD will modify paragraph 9 of HUD Notice 76-43 by substituting explicit and expeditious time limits within which Area/Insuring Offices will be expected to process assignments.

7. Within a reasonable time, HUD will develop a statistical reporting system concerning the assignment program hereby established which information will be made available upon written request.

8. HUD Handbook 4155.1, Mortgage Credit Analysis Handbook paragraphs 2-8(e) will be promptly modified by adding a new subparagraph (3) as follows:



- (3) The term "extenuating circumstances beyond the mortgagor's control" may include:
- (a) Curtailment of family income, such as unemployment; loss, reduction or delay in receipt of federal, state, municipal benefits (e.g., Social Security, Supplemental Security Income, Public Assistance, government pensions) or of private benefit payments (e.g., pensions, annuities, retirement plans); loss of support payments; or other loss of income due to divorce or separation;
 - (b) Uninsured damage to the mortgaged property, affecting its livability, of a type which is commonly insured against but which was not covered or not fully covered by insurance because adequate insurance coverage was not available;
 - (c) Death or illness in the mortgagor's household and expenses attributable thereto;
 - (d) Unanticipated increase of payments to mortgage escrow account to compensate for past underestimates of requirements.

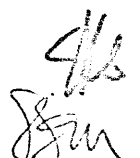
Such circumstances must have resulted directly in the mortgagor's default and the foreclosure. In no case shall the foreclosure action or deed in lieu of foreclosure by itself be deemed to make the defaulting mortgagor ineligible for an insured mortgage if, when given an opportunity, the mortgagor demonstrates that it was caused by extenuating circumstances beyond the mortgagor's control.

9. HUD will proceed expeditiously to amend said Notice, paragraph 10(c), the second sentence, to read as follows:

"... In any case, however, the mortgage payments during the reinstatement period, including all escrows, must be no more than the highest payment obtainable under one of the following three alternatives:

* * * *

(2) The amount obtained by adding all outstanding arrearages to the unpaid principal balance and recasting the mortgage to allow for completion of its payment as amortized



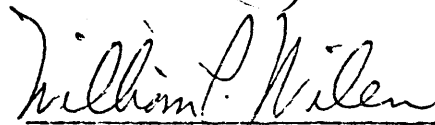
over its remaining term, plus current escrow requirements. The term may be extended by up to 10 years if, on the date of assignment, 10 years or more had elapsed since the due date of the first payment under the mortgage. (See Appendix 4); or . . .

10. Whenever the term "HUD" is used in this Stipulation, it shall refer collectively to the United States Department of HUD, the defendants, their successors in office, and their agents, subordinates and employees.

In consideration of the above agreements, the plaintiffs and the plaintiff class members, by and through their attorneys, agree to the entry of an order dismissing their complaint without prejudice, subject to the approval of the Court pursuant to Rule 23(e) of the Federal Rules of Civil Procedure.

Plaintiffs James and
Joyce Ferrell, et al.


SEYMOUR J. MANSFIELD
Attorney for Plaintiffs


WILLIAM P. WILLEN
Attorney for Plaintiffs

Defendants Carla Hills
and John Waner


SAMUEL K. SKINNER
United States Attorney

Dated: July 2, 1976.

Office of HUD; and certain HUD-insured mortgagees.

4. On October 11, 1974, the Court dismissed the defendant mortgagees on the ground that plaintiffs' amended complaint failed to state a cause of action as to those defendants, but denied federal defendants' motion to dismiss, ruling that plaintiffs' amended complaint did, in part, state a valid cause of action against said federal defendants, Brown v. Lynn, 385 F. Supp. 986 (N.D. Ill. 1974).

5. On March 17, 1975, the Court determined that plaintiffs' cause of action could proceed as a nationwide class action on behalf of the named plaintiffs and on behalf of all other persons who (a) have purchased a home pursuant to three programs of homeownership for low and moderate-income families established by the National Housing Act: Section 203, 12 U.S.C. §1709; Section 221(d) (2); 12 U.S.C. §17151(d) (2); and Section 235, 12 U.S.C. §1715z; and (b) are currently or in the future become in default on mortgages insured under said programs.

6. On October 20, 1975, to more specifically comport with the Court's rulings of October 11, 1974 and March 17, 1975, plaintiffs, James and Joyce Ferrell, et al., filed a second amended complaint, seeking, inter alia, declaratory and injunctive relief against defendants, Carla Hills and John Waner, and to require said defendants to (a) promulgate and enforce a continuing, binding and effective regulatory scheme and establish procedures to prevent holders and servicers of HUD-insured mortgages from prematurely

and precipitously foreclosing on said mortgages, and (b) require relief in the alternative to foreclosure to distressed homeowners such as forbearance relief, recasting of the mortgage or the taking of an assignment of the mortgage by HUD to avoid foreclosure.

7. Commencing on about January 28, 1976, the parties entered into negotiations regarding settlement of this case. Those negotiations began after discovery procedures had been initiated. The Court was advised of the pendency of those negotiations. Based upon the information so received and the record in these proceedings, the Court is satisfied that the conflicting positions of the various parties were ably represented, and that the eventual settlement agreement was negotiated in good faith.

8. On May 17, 1976, the defendant, Secretary of HUD, issued HUD Notice HM 76-43 and Mortgagee Letter 76-9, which notice and mortgagee letter incorporate the Department's revised policy regarding acceptance of assignments of insured mortgages in default (hereinafter, "assignment program").

9. On July 2, 1976, the parties, by and through their attorneys, voluntarily entered into and filed with the Court a Stipulation containing the entire agreements of the parties to compromise and settle their disputes. Said Stipulation is incorporated herein by reference. At that time, the plaintiffs orally moved this Court to enter an order approving said Stipulation and the dismissal of this action without prejudice in accordance with Rule 23(e), Federal Rules of Civil Procedure.

10. During the pendency of the settlement negotiations and at the time of the filing of the Stipulation with the Court, on July 2, 1976, the defendants represented to the plaintiffs and to this Court their intention to modify or amend, at some future time, the assignment program which is by reference incorporated in the aforesaid Stipulation. The plaintiffs advised the defendants and this Court that they understood defendants had such intention, but irrespective thereof, plaintiffs did not waive their right to challenge or acquiesce to the contents of any such amendment or modification, nor did they waive any rights created under said Stipulation.

11. Pursuant to Rule 23(e) of the Federal Rules of Civil Procedure, notice of the settlement of this action is waived and excused for good cause shown and this Court's findings that the settlement and dismissal of this action cannot prejudice the rights of members of the plaintiff class.

12. In assessing the fairness and reasonableness of the proposed settlement, the Court considered that this case raised substantial, complex, and contested issues of law and fact and that the public interest was significantly involved herein. This Court considered the likely eventual rewards of litigation to members of the plaintiff class as compared with the benefits offered by the Stipulation and the assignment program incorporated by reference therein.

13. This Court is of the opinion that the settlement represents a fair resolution of the competing interests of

the plaintiff class and the defendants. The Court concludes that the settlement is fair, reasonable and adequate. The Stipulation accordingly will be approved.

14. Moreover, there is pending before the Court in this case plaintiffs' motion for contempt, fees, and per diem fine. The administrative costs which defendants may be required to bear or expend in connection with resolution of the aforesaid application may be substantial, and in order to avoid such costs and time consuming litigation, the parties have settled their disputes by the plaintiffs' agreement to withdraw the motion for contempt, fees and per diem fine, and the defendant's agreement to make a payment of \$4,587.00.

IT IS THEREFORE ORDERED THAT:

A. The Stipulation filed July 2, 1976, is hereby approved pursuant to Rule 23(e) of the Federal Rules of Civil Procedure as fair and reasonable. Notice of settlement is waived and excused as the settlement and dismissal of this action in no way can prejudice the rights of the members of the plaintiff class.

B. The rule to show cause why defendants should not be held in contempt is hereby discharged and plaintiffs' motion for a finding of contempt, fees and per diem fine is hereby withdrawn.

C. A judgment in the amount of \$4,587.00 is hereby entered against the defendants in favor of the Legal Assistance Foundation of Chicago.

D. This action be and the same is hereby dismissed without prejudice.

E. The terms and conditions of said dismissal are contained in the Stipulation executed by the parties, by and through their attorneys, on July 2, 1976, which Stipulation is incorporated herein by reference.

ENTER:

UNITED STATES DISTRICT JUDGE

Dated:



DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D. C. 20413

May 17, 1976

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING MANAGEMENT

IN REPLY REFER TO:

HM Mortgagee Letter 76-9

TO : ALL APPROVED MORTGAGEES

SUBJECT: Acceptance of Assignment of Home Mortgages in Default

1. PURPOSE: The purpose of this letter is to announce the Department's policy in connection with the acceptance of home mortgages in default in order to avoid foreclosure and to promulgate procedures for the implementation of that policy. The following instructions are effective immediately and, pending revision of Handbook 4191.1, Administration of Insured Home Mortgages, supersede the instructions in paragraph 126 of that Handbook.

2. GENERAL. Effective immediately, HUD will accept assignment of any fully insured mortgage if all the criteria in paragraph 3 below are met. Any mortgagor owning a home subject to a fully insured mortgage, regardless of the section of the National Housing Act under which the mortgage is insured, is entitled to a conference with a responsible representative of HUD before the mortgage is foreclosed, unless the Department agrees to accept assignment of the mortgage without such a conference. This Mortgagee Letter applies to all HUD-insured single family mortgages, except single family mortgages coinsured by HUD pursuant to Section 244 of the National Housing Act.

In any case where the mortgagor has voluntarily abandoned the mortgaged property, the mortgagee may initiate foreclosure without adhering to the procedures for assignment set forth in this Mortgagee Letter.

The requirements of this Letter shall be applicable to each mortgagee's HUD-insured portfolio. If servicing functions are performed by a contract servicer, it is the responsibility of the mortgagee to insure that the servicer meets these requirements.

3. ELIGIBILITY CRITERIA. All of the following criteria must be met in order for the mortgage to be eligible for assignment. If the criteria are met, the mortgagee shall request that the Secretary accept assignment of the mortgage.

- a. The mortgagee must have indicated to the mortgagor its intention to foreclose the mortgage.

- b. At least three full monthly installments must be due and unpaid under the mortgage.
- c. The mortgaged property must be the principal residence of the mortgagor, unless this criterion is waived by HUD.
- d. The mortgagor must not own other property subject to a mortgage insured or held by HUD, unless this criterion is waived by HUD.
- e. The default must have been caused by a circumstance or set of circumstances beyond the mortgagor's control which temporarily renders the family financially unable to cure the delinquency within a reasonable time or make full mortgage payments. Examples of qualifying reasons for default include, but are not limited to:
 - (1) Curtailment of family income, such as unemployment or underemployment; loss, reduction or delay in receipt of federal, state, municipal benefits (e.g. Social Security, Supplemental Security Income, Public Assistance, government pensions) or of private benefit payments (e.g. pensions, annuities, retirement plans); loss of support payments, or other loss of income due to divorce or separation.
 - (2) Uninsured damage to the mortgaged property, affecting its livability, of a type which is commonly insured against but which was not covered or not fully covered by insurance because adequate insurance coverage was not available.
 - (3) Death or illness in the mortgagor's household or expenses attributable thereto.
 - (4) Unanticipated increase of payments to mortgage escrow account to compensate for past underestimates of requirements.
- f. There must be a reasonable prospect that the mortgagor will be able to resume full mortgage payments after a temporary period of reduced or suspended payments not exceeding 36 months, and will be able to pay the mortgage in full by its maturity date, extended, if necessary, by up to ten years if, on the date of assignment, ten years or more have elapsed since the due date of the first payment under the mortgage.
- g. The mortgagee must have done everything it might reasonably be expected to do to avoid foreclosure.

4. MORTGAGEE DECISIONS. In every case in which the mortgagee decides to foreclose, it must decide prior to initiating foreclosure whether or not to request that HUD accept assignment of the mortgage to avoid the foreclosure. If all of the criteria listed in paragraph 3 above are met, HUD must be requested to accept assignment and, if such a request is made, must have rejected it, before foreclosure is started.

5. NOTICE TO MORTGAGORS.

a. When the Mortgagee is Considering Foreclosure.

- (1) Time of Notice. No sooner than five days after the date three full monthly installments are due and unpaid under the mortgage, but in any event prior to instituting foreclosure or acquisition of the mortgaged premises, the mortgagee shall send to the mortgagor a notice as below prescribed.
- (2) Content of Notice. The notice shall advise the mortgagor of the following:
 - (a) He is now in default, and the mortgagee intends to foreclose unless he cures the default or alternative relief is afforded.
 - (b) If the default is due to circumstances beyond his control, he may be eligible for relief in lieu of foreclosure by assignment of the mortgage to HUD.
 - (c) The mortgagee is currently considering whether or not to apply to HUD for assignment of the mortgage.
 - (d) He will be advised shortly of the mortgagee's decision in writing.
 - (e) If he wishes to contact the mortgagee concerning his eligibility for assignment, he may write, call or visit the mortgagee.
 - (f) If he does not understand his rights, he is admonished to secure assistance from an attorney or HUD-approved counseling agency.

An acceptable form of notice is attached hereto as Exhibit 1, and its use is suggested, although it may be modified to suit the mortgagee if it still includes the items above designated.

- b. When the Mortgagee Decides to Request that HUD Accept Assignment. The mortgagor shall be notified of the request by a letter including the substance of Exhibit 2. The letter must include a statement that HUD has been requested to accept assignment of the mortgage and it must enclose Form 2068F with item 14 completed. Instead of asking the mortgagor to mail the completed Form 2068F to it, the mortgagee may give the mortgagor the option of visiting its office for the purpose of completing the form.
- c. When the Mortgagee Decides Not to Request that HUD Accept Assignment. The mortgagor shall be notified of the decision by a letter including the substance of Exhibit 3. The letter must include a statement that the mortgagee has decided to foreclose and has decided not to request that HUD accept the assignment, and it must identify the specific criteria for assignment identified in paragraph 3, above, which were not met. The letter must describe the mortgagor's right to request that HUD accept the assignment, with a brief explanation of the effect of assignment, specify the fifteen day time limit within which the mortgagor must act, and admonish him to seek legal or professional assistance if he does not understand his rights and obligations.
- d. Spanish Language Warning. The letter required by paragraph 5b and the notice of decision required by paragraph 5c shall contain at the bottom thereof a warning to Spanish-speaking mortgagors to have the notice translated, as follows:
- "ESTES ES UN AVISO MUY IMPORTANTE QUE AFECTORA SU DERECHO A CONTINUAR VIVENDO EN SU CASA. SI NO PUEDE LEERLO, HABALO TRADUCIR IMMEDIATAMENTE. A MEMOS QUE RESPONDA DENTRO DE QUINCE (15) DIAS A PARTIR DE LA FECHA QUE TENGA EL AVISO, UD. PUEDE PERDIR SU CASA EN FUTURO."
- e. Time Limits. All time limits for the sending of notices required by this Mortgagee Letter, and for mortgagors required responses shall be deemed to be calendar days, unless otherwise expressly stated. If the last day for sending any notice, performing any act or making any response falls on a Saturday, Sunday or legal holiday, the last day for sending such notice, doing such act or making such response shall be the next following regular working day.

6. NOTICE TO HUD.

- a. Negative Decisions. If the mortgagee decides not to request that HUD accept assignment of the mortgage, HUD need not be notified of that decision, although the mortgagor must be notified as prescribed in paragraph 5c, above.

b. Positive Decisions. When the mortgagee decides to request that HUD accept assignment of the mortgage, it must notify the mortgagor and HUD simultaneously. The notification to HUD shall be in the form of a letter requesting that assignment be accepted and accompanied by the following:

- (1) A copy of the notice to the mortgagor required by paragraph 5b, above.
- (2) A copy of the related ledger record or payment record card reflecting the payment history on the account since inception of the loan or, if the indebtedness was assumed by the present mortgagor, since the assumption.
- (3) Copies of all related collection records documenting the efforts of the mortgagee's staff to collect the debt and the mortgagor's reactions to those efforts.
- (4) Copies of FNMA Forms 145 or similar reports to the investor recommending any action requiring approval of the investor. If no such formal reports or recommendations were made, substitute a brief narrative description of the reasons for the default, as seen by the mortgagee, and the basis on which the decision to foreclose was made.
- (5) A brief statement of mortgagee's opinion as to the probability of restoring the mortgage to good standing and the reasons for that opinion.
- (6) A completed Form 2068F. Pending revision of this form, item 14 shall be completed by the mortgagee before it is given to the mortgagor.

7. PROVIDING MATERIAL TO HUD. When a mortgagee has notified a mortgagor that it intends to foreclose the mortgage and does not intend to request that HUD accept assignment of the mortgage, the mortgagor has fifteen days in which to request that HUD accept assignment of the mortgage during which the mortgagee must withhold foreclosure. If the mortgagor responds within this time period, HUD will direct the mortgagee to delay the initiation of foreclosure. HUD also will ask that the mortgagee provide the documentary information described in paragraph 6, above, except the completed Form 2068F. Mortgagees shall respond promptly to such requests and should remember that delays in responding will only serve to delay the date on which the mortgage can either be foreclosed or assigned to HUD.

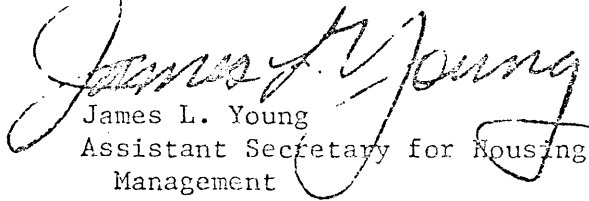
8. MORTGAGEE ACTIONS

- a. General. Mortgagees must take, or refrain from taking, actions as indicated below. Deviations from these requirements shall cause HUD to consider suspending or withdrawing the mortgagee's approval to participate in the Department's programs of mortgage insurance.
- b. Mortgagee Actions. Mortgagees shall not initiate any action leading to foreclosure of the mortgage, acquisition of the mortgaged property without the consent of the mortgagor, or dispossession of the mortgagor until HUD's consideration of whether or not to accept an assignment is completed. Mortgagees must also honor, immediately, directions from HUD that mortgages be assigned. Whenever any mortgagee refuses to honor HUD's direction to assign, or refuses to refrain from foreclosure, acquisition, or dispossession as above described pending HUD's determination on accepting assignments, the circumstances will be reported to the Director, Single Family Housing Division, Office of Loan Management, who shall take appropriate action, including, if warranted, recommending suspension or withdrawal of the mortgagee's approval to the Mortgagee Review Board. HUD field office Directors are instructed to process requests that assignment be considered as rapidly as possible, and the mortgagee will be notified, by telephone and by mail, as soon as any decision has been reached.
- c. Granting Additional Relief. When the mortgagee is advised by HUD that assignment of a mortgage will not be accepted because the criterion described in paragraph 3g above has not been met, specific additional relief measures deemed reasonable by the Director will be prescribed. Mortgagees are expected to grant such relief.

9. MORTGAGES NOW IN FORECLOSURE. With regard to all fully insured single family mortgages in the process of foreclosure or acquisition on the effective date of this Mortgagee Letter, where no final court judgment has been entered pursuant to judicial foreclosure, or where no sale of the mortgaged property has taken place under a power of sale, mortgagees shall stay any foreclosure suit, seeking leave of court where necessary, or shall defer any sale until after such mortgagees have considered whether mortgagors are eligible for assignment and have afforded mortgagors an opportunity for review and final determination by HUD in accordance with the provisions of this Mortgagee Letter. Field office Directors are to give priority to processing requests involving cases already in foreclosure.

10. EFFECT OF ASSIGNMENT. Mortgagees are reminded that assignment of a mortgage to the Secretary has advantages over completion of foreclosure to all parties. The mortgagor is provided an added opportunity to prevent foreclosure permanently, and HUD gains the potential for recovering all or a significant part of the amount paid in the mortgage insurance claim to the mortgagee. The mortgagee, however, benefits most. If the mortgage is foreclosed and a claim for mortgage insurance benefits is paid, the mortgagee loses two months' interest completely and is paid interest at the lower debenture rate from the date of default to the date of settlement of the claim. Further, it is reimbursed for only two thirds of the cost of completing the foreclosure. If, on the other hand, the mortgage is assigned, the claim includes all unpaid mortgage interest to the date of assignment, as well as all costs of completing the assignment. Mortgagees should consider these facts carefully in determining whether to request that HUD accept assignments of mortgages.

Sincerely,


James L. Young
Assistant Secretary for Housing
Management

[LETTERHEAD OF MORTGAGEE]

Dear _____:

Your mortgage is in default in the amount of \$ _____ covering the months of _____ and late charges. Unless you are able to cure this default by promptly remitting the above amount to this office, we intend to commence foreclosure of your mortgage.

However, if the default was caused by circumstances beyond your control, you may be eligible for an assignment of your mortgage to the Department of Housing and Urban Development (HUD) to avoid foreclosure. If HUD were to accept assignment of your mortgage, it would become your lender and might be able to work out a more favorable payment plan whereby your mortgage payments might be reduced or suspended for a period of time or you might be allowed to cure the default by making only small additional payments with your monthly mortgage payments.

We are currently considering whether you meet the criteria for assignment specified in the HUD regulations. If we find that you do, we will request HUD to accept an assignment of your mortgage. If we decide that you do not, we will proceed with foreclosure, unless you seek further review of that decision by HUD. In either case, you will be advised shortly of our decision.

If you have any questions or wish to give us information concerning your eligibility for an assignment, please call _____ at (____) ____-____ or visit him/her at our office. If you do not understand what this means to you, you might want to contact one of the agencies listed in the HUD booklet we sent you recently or seek legal advice.

Sincerely,

[LETTERHEAD OF MORTGAGEE]

Dear _____:

Your mortgage is in serious default and we have decided that we are unable to provide any additional assistance to you in your attempts to save your home. We have, however, decided to ask that the Department of Housing and Urban Development (HUD) accept assignment of your mortgage to avoid foreclosure.

If HUD agrees to our request, HUD will become your lender and your future payments will be made directly to HUD. You may be able to work out some arrangement which will make it possible for you to bring your mortgage account current and save your home.

We are including a copy of Form 2068F. This asks several questions about your financial situation and your plans for the future. Answers to those questions are needed if HUD is to make a decision in your case. You must complete the form as fully as possible and return it to us WITHIN 15 DAYS OF THE DATE OF THIS LETTER. If you do not do this, we must assume that you are not interested in saving your home, and we will proceed with foreclosure. If you need help completing the form, please call _____ at () ____-____ or visit him/her at our office.

If HUD decides for any reason that it will not accept assignment of your mortgage, unless you seek further review, we plan to start foreclosure as soon as we have been advised of that decision.

Spanish Language Warning: ESTE ES UN AVISO MUY IMPORTANTE QUE AFECTORA SU DERECHO A CONTINUAR VIVENDO EN SU CASA. SI NO PUEDE LEERLO, HAGALO TRANducir IMMEDIATAMENTE. A MENOS QUE RESPONDA DETRO DE QUINCE (15) DIAS A PARTIR DE LA FECHA QUE TENGA EL AVISO, UD. PUEDE PERDIR SU CASA EN EL FUTURO.

Sincerely,

[LETTERHEAD OF MORTGAGEE]

Dear _____:

Your mortgage is in serious default and we have decided that we are unable to provide any additional assistance to you in your attempts to save your home. Under certain circumstances, the Department of Housing and Urban Development (HUD) might be able to accept assignment of your mortgage from us and offer additional help. This would mean that HUD would become your lender and you would make future payments to HUD. We have decided that you are not eligible for an assignment and we will not ask HUD to do this because: HERE LIST THE SPECIFIC ELIGIBILITY CRITERION OR CRITERIA FROM PARAGRAPH 3 WHICH MAKE THE CASE INELIGIBLE FOR ASSIGNMENT.

You have the right to go directly to HUD to ask that they consider your case, and we will not start foreclosure of your mortgage until you have had an opportunity to do so. If you wish to be sure that foreclosure will be delayed while HUD is considering acceptance of assignment of your mortgage, you must contact HUD WITHIN 15 DAYS OF THE DATE OF THIS LETTER. We intend to proceed automatically with foreclosure of your mortgage unless we have heard from HUD within that time.

If you want to ask HUD to consider accepting assignment of your mortgage, you should call or write them at ADDRESS OF LOCAL HUD OFFICE, () - , immediately. If you do not understand what this means to you, you might want to seek help. You may call the HUD office identified above or you might want to contact one of the agencies listed in the HUD booklet we sent you recently or seek legal advice.

Spanish Language Warning: ESTE ES UN AVISO MUY IMPORTANTE QUE AFECTORA SU DERECHO A CONTINUAR VIVENDO EN SU CASA. SI NO PUEDE LEERLO, HAGALO TRANUDICIR IMMEDIATAMENTE. A MENOS QUE RESPONDA DETRO DE QUINCE (15) DIAS A PARTIR DE LA FECHA QUE TENGA EL AVISO, UD. PUEDE PERDIR SU CASA EN EL FUTURO.

Sincerely,

APPENDIX 10-4:
MORTGAGEE REVIEW BOARD

HUD'S REGULATIONS ESTABLISHING A MORTGAGEE REVIEW BOARD

Title 24—Housing and Urban Development SUBTITLE A—OFFICE OF THE SECRETARY DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. R-75-352]

PART 25—MORTGAGEE REVIEW BOARD

Subpart A—Department of Housing and Urban Development Mortgagee Review Board

The Department is establishing a Mortgagee Review Board to act for the Secretary in determining whether or not to withdraw approval of a mortgagee under HUD programs.

The establishment of this Board and creation of a new Part 25 are matters of internal management and operation not subject to the requirements of 5 U.S.C. 553 or 24 CFR 10.5. Moreover, inasmuch as the part sets forth duties, functions, and final authority that is not regulatory in nature, this document is effective as of September 12, 1975.

Accordingly, Title 24 is amended by adding a new Part 25, Mortgagee Review Board, to read as follows:

Subpart A—Department of Housing and Urban Development Mortgagee Review Board

Sec.

25.1 Establishment of the Board.

25.2 Members.

25.3 Functions, duties and powers.

25.4 Withdrawal determinations.

25.5 Grounds for withdrawal.

25.6 Effective date of withdrawal.

AUTHORITY: Sec. 7(d), Department of Housing and Urban Development Act; 42 U.S.C. 3535(d).

Subpart A—Department of Housing and Urban Development Mortgagee Review Board

§ 25.1 Establishment of the Board.

There is hereby established in the Office of the Secretary a Mortgagee Review Board.

§ 25.2 Members.

The Mortgagee Review Board is composed of the following members: Assistant Secretary for Housing Production and Mortgage Credit—Federal Housing Commissioner, Chairman; General Counsel; Assistant Secretary for Housing Management; Inspector General, or their designees.

§ 25.3 Functions, duties and powers.

Except as limited by this part, the Mortgagee Review Board shall exercise all of the authority and perform all of the functions of the Secretary with respect to withdrawal of mortgagee approval. The Board shall have all powers necessary and incident to the proper performance of these functions and duties.

§ 25.4 Withdrawal determinations.

(a) *Determinations by the Board.* If the Board unanimously determines that a mortgagee's approval be continued, the mortgagee's approval shall be continued. If the Board unanimously de-

termines that a mortgagee's approval be withdrawn, the geographical extent of such withdrawal, the duration of such withdrawal, and whether the withdrawal shall be partial or total, the mortgagee's approval shall be withdrawn pursuant to the Board's determination. If the Board's determination is not unanimous concerning withdrawal, the geographical extent of such withdrawal, the duration of such withdrawal, or the nature of such withdrawal, the Under Secretary shall determine those matters as to which the Board's determination is not unanimous, and the mortgagee's approval shall be withdrawn pursuant to the Board's unanimous determination and the determination of the Under Secretary. As used in this Part, "duration of withdrawal" shall include permanent withdrawal, withdrawal for a specific length of time or withdrawal for an indeterminate period pending satisfaction by the mortgagee of conditions specified by the Board or the Under Secretary.

(b) *Notification of mortgagee.* Whenever the Board or the Under Secretary determines pursuant to paragraph (a) of this section that a mortgagee's approval be withdrawn, the Chairman shall in writing notify, or cause to be notified, the mortgagee of such determination and the extent, duration and nature of such withdrawal. Such notice shall specify the reasons for the determination and the facts upon which the determination is based and shall further specify the name and address of the designated Departmental hearing officer to whom the mortgagee should address a request for a hearing pursuant to paragraph (c) of this section.

(c) *Hearings.* Whenever the Board or the Under Secretary determines that a mortgagee's approval be withdrawn in accordance with paragraph (a) of this section, the mortgagee shall have a period of 30 days in which to request in writing a hearing on such withdrawal action before the designated Departmental hearing officer.

(d) *Conduct of hearing.* Upon receipt of a request for a hearing, the hearing officer shall arrange a timely hearing. Notice of the time and place of such hearing shall be in writing, transmitted by registered or certified mail, return receipt requested. It shall be within the discretion of the hearing officer to determine the hearing place.

(1) The hearing officer shall be responsible for the fair and expeditious conduct of proceedings. The Department shall be represented by the General Counsel or his designee. A record shall be made of the proceedings and shall be made available to the parties upon request. After the mortgagee against whom action is proposed has been afforded an opportunity to be heard, the hearing officer shall make an initial written determination on the evidence presented. The hearing officer's determination shall be final unless reversed or modified within 30 days by the Secretary. Each determination shall become a part of the record.

Notice of the final determination shall be given in writing, signed by the hearing officer and transmitted by registered or certified mail, return receipt requested. The final determination shall be conclusive.

(e) *Failure to request a hearing.* If the mortgagee does not request a hearing before the Departmental hearing officer for a review of the Board's or the Under Secretary's withdrawal determination within the period prescribed in paragraph (c) of this section, the determination shall become final.

§ 25.5 Grounds for withdrawal.

Any withdrawal or proposed withdrawal of approval under § 25.4 shall be upon one or more of the following grounds:

(a) The transfer of an insured mortgage to a non-approved mortgagee, except pursuant to §§ 203.433 or 203.435 of Part 203.

(b) The failure of a nonsupervised mortgagee to segregate all escrow funds received from mortgagors on account of ground rents, taxes, assessments and insurance premiums, and to deposit such funds to a special account or accounts with a financial institution whose accounts are insured by the Federal Deposit Insurance Corporation or by the Federal Savings and Loan Insurance Corporation;

(c) The use of escrow funds for any person other than that for which they were received;

(d) The failure of a nonsupervised mortgagee to conduct its business in accordance with the plan indicated by its application for approval;

(e) The termination of a mortgagee's supervision by a governmental agency;

(f) The failure of a nonsupervised mortgagee or an investing mortgagee to submit the required annual audit report of its financial condition within 75 days of the close of its fiscal year or such longer period as the Assistant Secretary for Housing Production and Mortgage Credit—Federal Housing Commissioner may determine;

(g) The payment by the mortgagee of any fee, kickback, or other consideration, directly or indirectly, in connection with any insured mortgage transaction or transactions to any person including an attorney, escrow agent, title company, consultant, mortgage broker, seller, builder, or real estate agent if such person has received any other payment or other consideration from the mortgagor, the seller, the builder, or any other person for services related to such transaction or transactions or from or related to the purchase or sale of the mortgaged property, except that compensation may be paid for the actual performance of such services as may be approved by the Assistant Secretary for Housing Production and Mortgage Credit—Federal Housing Commissioner;

(h) Such other reason as the Board, Secretary, Under Secretary or hearing officer, as appropriate, determines to be justified.

§ 25.6 Effective date of withdrawal.

Withdrawal of a mortgagee's approval pursuant to this part shall be effective:

(a) Immediately if the Board unanimously determines that continuation of the mortgagee's approval pending a request of the mortgagee for a hearing pursuant to § 25.4(c) would not be in

the public interest or in the best interests of the Department;

(b) At the expiration of the 30 day period specified in § 25.4(c) if the mortgagee has not requested a hearing; or

(c) 30 days after the hearing officer's written determination pursuant to § 25.4 (d).

Effective date. This regulation is effective as of September 12, 1975.

CARLA A. HILLS,
*Secretary of Housing and
Urban Development.*

[FR Doc.75-24840 Filed 9-17-75;8:45 am]

Federal Register
Sept. 18, 1975

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