A New Initiative in the Federal Housing Administration's Office of Multifamily Housing Programs: An Assessment of Small Projects Processing

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Abstract

This article critiques the Federal Housing Administration's (FHA's) new processing option for small, multifamily mortgage insurance—small projects processing (SPP). The authors review some of the motivations behind reforms at FHA multifamily and highlight how the SPP initiative is designed to serve some of HUD's broader affordable housing goals. The authors summarize the research to specify certain aspects of the SPP initiative, highlighting the discussions that took place with FHA, its consultants, lenders, developers, and other government representatives. They identify the aspects of traditional multifamily finance programs that make them difficult to use in serving the small loan market, and contrast these aspects against the actual reforms adopted as part of the SPP initiative. Finally, the authors propose additional steps in the further development of SPP and the ongoing reforms of FHA multifamily and the industry at large.

A longstanding goal of HUD has been to increase the provision of affordable housing. Efforts to increase the supply of decent and affordable multifamily housing have been important to achieving this goal, because multifamily housing tends to be smaller and less expensive than single-family housing and, as a result, is often better suited for households in the lower portions of the income distribution. The Federal Housing Administration (FHA) plays an important role in these efforts by offering mortgage insurance for loans that are often targeted to affordable multifamily housing. Unfortunately, some multifamily insurance programs have been unsuccessful and imposed substantial costs on FHA reserves. For example, it has been estimated that FHA lost more than $10 billion due to problems with coinsurance programs of the 1980s (Coopers and Lybrand, 1993). The failure of the coinsurance program is one factor that led HUD and FHA to reevaluate their approach to multifamily lending.[1]

Two options for major reform of multifamily lending exist: to implement new large and highly centralized programs or to reduce the role of the Federal Government and rely more on the private sector to provide affordable housing with Low-Income Housing Tax Credit (LIHTC) incentives. Many additional possibilities have been proposed to launch HUD/FHA programs and initiatives to improve the private sector's ability to produce more affordable housing.

The primary purpose of this article is to examine one initiative for improving HUD/FHA's delivery of affordable multifamily housing. Initially referred to as the small projects program and later small projects processing (SPP), this initiative calls for expanding FHA's largest multifamily programs into project sizes not typically served by FHA multifamily mortgage insurance programs. The project is experimental and more flexible than most previous programs. It calls for FHA to play a monitoring and evaluating role rather than its traditional function as primary underwriter and producer of multifamily loans. The second purpose of the article is to highlight some broader issues of the program and some related lessons for future program development at HUD.

The bulk of the article discusses the development process for this new program. The final section explains fundamental features of the program that are relevant to broader, ongoing discussions about the future of FHA and HUD.

Developing a New FHA Program: Small Projects Processing

The Federal Housing Administration's Office of Multifamily Housing Programs launched a new product development effort in February 1996 (Price Waterhouse, n.d.). Among the many product lines and initiatives considered was an insurance program designed to facilitate the development, rehabilitation, and refinancing of small multifamily rental projects. After 1 year in development, this program—FHA's SPP—was announced at the Mortgage Bankers Association of America's commercial/multifamily conference in February 1997 in Orlando, Florida.

The following section provides an overview of the research and development process that led to the creation of SPP. It includes policy reasoning that fostered the development initiative, a summary of market research underlying SPP's development, and important design elements for products aimed at the small project market that were developed through this research effort. The section concludes by highlighting SPP in the context of these design elements.

Policy Justification for a Small Projects Initiative

In its preliminary research of national housing data, FHA found that the private housing market provides the majority of the country's affordable rental housing and that most multifamily rental properties are small projects, ranging from 5 to 49 units. According to the Bureau of the Census' 1990 residential finance survey, 557,000 of the 633,000 multifamily properties in the United States contain 5 to 49 units. The median rent per unit for small mortgaged projects is $354 compared with $421 per unit for larger mortgaged properties. These data indicate that a significant portion of the Nation's affordable rental stock is located in small multifamily projects. The data also suggest that maintaining this housing stock is central to FHA's mission of retaining and expanding affordable housing opportunities.[2]

FHA also identified that long-term sources of financing for this rental housing stock are not readily available. In addition, financing costs for existing mortgage products are high relative to financing for single-family homes and large multifamily developments. This situation has created problems for owners of small multifamily housing projects who are trying to raise funds to rehabilitate properties, and it probably has caused properties that might otherwise have been adequately maintained to fall into disrepair. Scarcity of capital—particularly of long-term, fixed-rate debt—among small projects also may have contributed to higher default risk, insufficient maintenance, and less affordable rents.

FHA's small projects initiative emanated from its decision to take a leadership role in encouraging stable investment in the small projects market. This decision led to its developing a mortgage insurance program tailored to the needs and financial means of small project owners, while providing incentives for lenders and investors to originate and service small project loans needed to serve the small project market.

Small Project Market Research

FHA launched its small project initiative with market research aimed at acquiring a deeper understanding of current and past activities in the small project market as well as the extent of conventional market participation in financing small projects. This market research, conducted by FHA and its independent contractor, Price Waterhouse LLP, consisted of literature reviews, meetings, conference calls, conversations with multifamily professionals, and a market review of current financing opportunities for small projects. The effort involved discussions with more than 100 industry representatives.

Initiated with a symposium in Washington, D.C., the market research process involved a series of focus group meetings held using teleconferencing. Prior to each meeting, a new product description was drafted and sent to participants to help generate specific responses to possible features. Ten focus group discussions were conducted over approximately 16 hours in June 1996. A total of 24 industry members participated from across the country, including representatives from mortgage and commercial banks; thrift and secondary market institutions, such as Freddie Mac and Fannie Mae; small project owners; loan service officials; property managers; and trade associations.

At the same time, FHA investigated conventional mortgage market offerings for small multifamily projects. Researchers identified initial contacts and obtained referrals during the industry meeting in June, through teleconferencing research, and from HUD field office staff. To gain information from lenders in a variety of geographic locations, researchers contacted Federal Home Loan Bank offices in Boston and San Francisco to obtain additional names of institutions actively lending to small projects.

Researchers asked about personal experiences related to small project lending, especially as compared with that for other multifamily properties. In particular, questions focused on the areas of underwriting, property valuation, loan volume, borrower type, loan terms, and secondary market activity, as well as general market trends. Interviewers asked lenders to explain their views of the market, its shortcomings, and its strengths in meeting the needs

Exhibit 1

Small Multifamily Financial Products of Selected Lenders

Financial Institution	Property Size[a]	Max. Mort. Amt.	Uses[b]	Rates[c]	LTV[d] %	DSC[e]	Recourse	Loan Term/ Amortization term (in yrs.)	Loan Borrower Type[f]	Average Annual Term Volume	Use of Secondary Market	Servicing
Riley Mortgage Corp., Fort Worth, TX	Small	$1.5 million	RF, A	FR	70–75	1.2	No	35/35	Mostly O-Ms	$5 million	Yes	Inhouse
Seattle Mortgage Corp., Seattle, WA	Small	$1 million	RF, A	FR	70	1.25	Partial	10/25	MPOs	$2.7 million	Yes	Inhouse
Crestar Bank, Washington, DC	Small	$1 million	RF, A	FR	70–75	1.25	Yes	5–7/20	MPOs	$30 million	No	Inhouse
Tucker Federal, Atlanta, GA	Small	$3 million	60% RF, 40% NC	FR	70	1.2	Yes	5–10/ 25–30	O-Ms	$10–12 million	No	Inhouse
Guaranty Financial, Inc., Columbus, GA	Small	$1.5 million	RF, A	FR	70–75	1.25	No	10/25	O-Ms	$1.5–2 million	Yes	Inhouse
P/R Mortgage Corp., Indianapolis, IN	Small	$2 million	RF, A	FR	85	1.175	No	35/35	O-Ms, MPOs	$5 million	Yes	Inhouse
MA Housing Investment Corp., Boston, MA	Mostly small, some very small	$1.5 million	NC	FR	85–90	1.15	Yes	Up to 1/ Up to 1	Nonprofits	$10 million	No	Inhouse
NationsBank, Community Development Group, Washington, DC	Small	$1 million	A, RH	FR	80	1.15	Yes	5/25	MPOs, nonprofits	$5 million	No	Inhouse
First Nationwide Bank, San Francisco, CA	Small	$2.5 million	NC, A, RH	FR	75	1.15	No	30/30	Nonprofits	$4 million	No	Inhouse
World Savings Bank, Oakland, CA	Mostly very small, some small	$2.5 million	RF, A	ARM	65–70	1.15–1.20	Yes	20–30/ 0–30 20–30	Very small O-Ms; small MPOs	NA	No	Inhouse

Financial Institution	Max. Property Size[a]	Mort. Amt.	Uses[b]	Rates[c]	LTV[d] %	DSC[e]	Recourse	Loan Term/ Amortization term (in yrs.)	Loan Borrower Type[f]	Average Annual Term Volume	Use of Secondary Market	Servicing
Brookline Savings Bank, Brookline, MA	Mostly very small, some small	$2 million	RF, A, RH	ARM, FR	75	1.3	Yes	7–10/25	Very small O-Ms; small MPOs	$24 million	FR: Yes ARM: No	Inhouse
South Shore Bank, Chicago, IL	Mostly small, some very small	$2.5 million	A, RH	ARM	A: 80 RH: 100	Varies	Yes	20/20	O-Ms	$12 million	No	Inhouse
Greystone Lending, New York, NY	Small	$2.5 million	RF, A	FR	80	1.15	No	70%: 5–10/25 30%: 15–25/ 15–25	O-Ms	$70 million	Yes	Inhouse
GMAC Commercial Mortgage Corp., Philadelphia, PA	Small	$1 million	A, RH	FR	75	1.25	Yes	5–10/25	O-Ms	NA	Yes	Inhouse
Citibank, Economic Development Banking Center, Washington, DC	Small	$2.5 million	A, RF, mod RH	Most FR, some ARM	75	1.1–1.15	Nonprofits, no; others, yes	FR: 20–30/ 20–30 ARM: 5–10/ 10–15	Nonprofits, MPOs	$5 million	No	Inhouse
Daiwa Finance Corporation, National group of correspondents	Very small or small	$1.5 million	A	Both	75	1.25	Yes or no	7–10/25	Small MPOs; partnerships; corps.	$25 million expected	Yes	Inhouse by Daiwa correspondents

[a] Property Size: Lenders were asked if they targeted small properties (13–50 units) or very small properties (5–12 units) for their small project lending.
[b] Uses: A = acquisition, NC = new construction, RF = refinancing, RH = rehabilitation.
[c] Rates: ARM = adjustable rate mortgage, FR = fixed rate mortgage.
[d] LVT: Loan-to-value ratio.
[e] DSC: Debt service coverage.
[f] Borrower types: MPO = multiple project owners, O-M = owner-managers.

of small project owners. The small project loan products of lenders that provided the most complete information are summarized in exhibit 1.

Overall, market research provided the design team with a detailed understanding of current product offerings for small project financing. It also shed light on desirable features of finance products and credit enhancement tools for this market segment, along with industry views on the role of conventional lenders and FHA in providing financing to small projects. A summary of the discussions and findings is provided below.

Supply and Demand Factors. Originators indicated a fairly large demand for small project loan products. Banks, mortgage companies, thrifts, and other lending institutions are currently meeting some of the demand for financing small projects. Yet national lenders, especially Fannie Mae and Freddie Mac, are still reluctant to become active in financing smaller projects because they believe they could be unprofitable. Lenders agreed that the high administrative costs and low fees generated from this market compared with those received from larger loans discourage typical commission-based originators. These lenders favored loans to larger multifamily projects, where each transaction produced higher fees. Institutions significantly involved in making small loans typically have a small, specialized staff dedicated to that effort; those employees are paid a salary rather than on a commission basis. Some lenders forecasted, however, that the conventional market's interest in making smaller loans could increase if spreads on larger transactions continue to tighten (that is, the difference between the comparable U.S. Department of the Treasury rate and mortgage interest rates).

Both small project owners and lenders surveyed generally agreed that the costs and processing requirements involved in applying for FHA's standard multifamily mortgage insurance programs are prohibitive for financing small projects. Participants concurred almost universally with the projection that streamlined, less time-consuming processing procedures and servicing requirements for FHA mortgage insurance programs would reduce lenders' costs and could facilitate FHA's expansion into the small project mortgage market.

Geographic Differences in Coverage. Most currently available financing for small projects restricts lending to refinancing and acquisition of existing structures. However, the availability of financing for different uses varies by geographic region. For example, in rapidly growing urban areas such as Atlanta or rural areas as in parts of North Dakota there is typically great demand for new construction financing for small multifamily projects, and it is generally more readily available. In well-developed urban areas, such as cities in the northeast, demand is focused more on acquisition and rehabilitation. Communities like Boston, which have a high concentration of nonprofit developers of affordable housing, also have sources of financing specifically for lending to nonprofit agencies or for affordable housing purposes.

Most financial institutions that currently originate a significant volume of small project mortgage loans are located in urban areas where the majority of the country's multifamily housing stock is located. Nonetheless, financing costs typically are high and products generally are characterized by shorter loan terms and adjustable interest rates. This pattern tends to be even more pronounced in rural and suburban areas, where affordable short-time financing for existing projects and permanent financing for new construction are scarce. In these areas lenders reportedly are originating a nominal loan volume for regular customers through traditional multifamily lending channels.

General Terms. Lenders surveyed generally restrict loan-to-value (LTV) ratios to a maximum of 70 to 85 percent and required minimum debt service coverage (DSC) of at least 1.15 to 1.25. Terms vary depending on recourse provisions and maturity. Whereas specific product terms differed substantially among institutions and geographic areas, lenders cited some common trends in financing small projects. Underwriting guidelines for small projects were commonly more flexible than for traditional multifamily lending. These guidelines considered more dimensions than LTV and debt service coverage ratios. For example, most lenders agreed that the financial strength and creditworthiness of the borrower, in addition to the projected cash flow of the project, are important determinants of credit risk. In fact, underwriting for smaller projects was often compared to single-family lending more than that for traditional larger multifamily projects, especially in cases where owner-managers or landlords occupy one or more units of the mortgaged property. Lenders considered flexibility in underwriting terms a critical element for ensuring thorough coverage of the small project market because of the many unusual capabilities and circumstances of the borrowers.

Risk and Pricing. The majority of lenders surveyed reported that small projects were comparable to larger multifamily properties in historical loan performance. Several reasons were offered to support these claims, including a history of more active loan servicing and a perceived tenacity by owners to make their projects succeed. Apart from these assertions, research indicates that small project loans are usually priced higher than are mortgages on larger projects. In some cases, small project loans carry a spread of more than 300 basis points above treasury securities of comparable maturity. While the pricing discrepancy is attributed in part to lenders' fixed origination and servicing costs, it probably also reflects the industry's uncertainty about credit risks inherent in the small project market as well as the market's lack of access to public capital sources. However, very little performance data exist to verify or refute these claims.

Secondary Market. Most lenders perceived small project loans as having limited access to secondary mortgage markets. Lenders cited the inability of these project loans to originate sufficient volume for pooling and the lack of standardized loan documents and loan terms as major impediments. Most lenders currently active in the market are portfolio lenders. Industry representatives also indicated that it is difficult for small project loans to enter the secondary market since Fannie Mae, the primary agency involved in multifamily debt transactions, requires standards that often are not economical or are too restrictive for smaller borrowers. In addition, they viewed the Ginnie Mae's dollar-volume constraints and single loan pool restrictions as impediments to securitizing small project debt.

However, small projects were beginning to stimulate conventional market attention at the time research was conducted; this activity was primarily due to the large spreads that characterize the market. Two new products (one by Daiwa Finance Corporation, another by Donaldson, Lufkin & Jenrette, Inc.) focus on purchasing small multifamily project loans originated by selected lenders. Fannie Mae was also expected to introduce a small projects product during late summer 1996 with revised underwriting and streamlined applications to address concerns about its ability to serve this market.

Conclusions. FHA concluded that a concentrated effort to finance small project loans was justified. From our perspective, research indicates that small projects make up a niche market that is difficult and uneconomical to serve through standard multifamily lending practices. Although a single-family model might appear to be more appropriate, research suggests that small projects are too complex to underwrite exclusively through single-family techniques. In our opinion, the market calls for adoption of a new "blended" technique, incorporating principles of income property lending with the borrower credit assessment more commonly associated with residential lending.

In addition, financing costs seem high for many products discovered through the survey effort. While no data exist to empirically assess the servicing costs and credit risks that characterize small project lending, FHA's decision to continue development of a small project initiative seems due in part to the belief that the large spreads indicate inefficiencies in the market and a failure to accurately price risk in the small project market. Better data on servicing requirements and costs, as well as on loan performance histories, would facilitate a more thorough assessment of marketable pricing for small project loans.

Critical Elements of Small Project Financing Products

Several critical elements for designing effective finance products were identified as a result of the small projects market research.

Upfront Costs. Upfront costs are a major impediment to traditional multifamily lending for smaller projects. Typical multifamily financing arrangements include, but are not limited to, origination and placement fees, environmental reviews, architectural certifications in the case of new construction and rehabilitation, inspections, attorney opinions and certifications, credit reviews, appraisals, and market surveys. The combined effect of these requirements can be prohibitively costly for smaller projects, particularly for fixed aspects of upfront costs—that is, when they are not scaled according to unit size or mortgage amount. To reach the small project market, upfront costs of loans must be streamlined or, if possible, financed into the mortgage and settled through periodic debt service payments.

Each element of the application and approval process should be reviewed for its relevance to smaller projects and smaller mortgages. In addition, exchanging lenders' upfront compensation for higher servicing fees can make transactions more feasible and place a premium on the quality of underwriting to secure long-term returns.

Reducing Ongoing Costs. Other common obstacles that prevent small projects from obtaining financing are traditional servicing requirements and other ongoing provisions that can impose high ongoing costs on both lenders and borrowers. Whereas periodic audited financial statements and property inspections are prudent for larger projects, a smaller project is often unable to afford an annual certified public accountant's opinion on the project's financial condition, and lenders may find regular onsite inspection of small properties uneconomical. Replacing some of these requirements with additional borrower certifications and commensurate liability coverage may increase lending opportunities for the small project market.

Standardization. The lack of standardized loan terms and documents for small projects is a major impediment to reaching public capital through secondary mortgage markets. The costs to investors of due diligence on nonstandardized loan pools of small project mortgages eliminate many pricing advantages of a structured transaction. Efforts to increase standardization could secure more access to efficient sources of long-term capital. However, standardization may prove difficult to accomplish because of the heterogeneity of small project borrowers and the flexibility required to underwrite small project loans.[3]

Underwriting. Underwriting perhaps offers the most definitive area for innovation in small project lending. To reach borrowers and developers in the small project niche effectively, lenders must tailor blends of income property underwriting to that of single-family residential lending. Small project lending requires underwriting the borrower's personal income and real estate income. However, most programs focus disproportionately on only one of these elements. When addressing this issue, a fundamental question arises: How was the limit of four-dwelling units for most single-family programs derived? Most likely this unit limitation resulted from the capacity of borrowers to make up shortfalls in rental income through personal wealth or income. Extending this principle to a greater number of units or to a proportion of units in a larger property may again expand lenders' willingness to cover smaller projects. In addition, lenders often cite the creditworthiness of the borrower as an important determinant of a project's success. With the expansion and application of credit-scoring techniques tailored to small multifamily lending, underwriting practices that consider borrower creditworthiness could be efficiently adopted.

Many programs designed to finance small projects involve some form of borrower recourse in the case of loan default and foreclosure. The ownership structure of many small project ventures is one of several aspects that make the small project market well suited to incorporating a recourse element. Larger projects provide limited recourse opportunities because they are commonly developed, owned, and/or managed by a corporate entity or partnership. Smaller projects, by contrast, are often owned by an individual who owns and manages the project as a source of personal income and, in some cases, as a personal residence as well. In these cases, recourse is much simpler and more straightforward. It may be used as an additional form of credit enhancement in a flexible underwriting regime. For example, a loan with direct recourse to a person with sufficient assets could allow more flexibility in the maximum LTV requirement or debt service coverage limit. Consideration also should be given under a recourse financing provision to the impact of tax credit projects on a borrower's eligibility.

Replacement Reserve Accounts. Another area often cited as creating difficulties for small project owners and lenders is replacement reserve requirements. Many owners find traditional multifamily program upfront-reserve deposits to be onerous, particularly when additional upfront fixed costs are required. Lenders have also suggested that substantial servicing costs can be added by agency programs dictating that reserves be held in escrow accounts. Suggestions for improvements or innovations in small project financing include provisions to replace initial reserve deposits with larger annual or periodic account installment payments. This would eliminate reserve requirements for low LTV financing or recourse financing while permitting lenders to maintain borrower reserve balances in traditional savings accounts. Careful consideration during mortgage origination of a borrower's history with property management and the project's physical state should contribute to defining reserve requirements. Clearly, less structured and costly provisions could enhance a lender's prospects for penetrating the market more effectively.

Pooling. Among several aspects of small project financing that make it difficult for lenders to resell small project debt in public capital markets, including lack of loan standardization and perceptions of high credit risk levels, the lack of pooling capacity or warehousing of small loans remains one of the largest impediments. Efficient access to secondary mortgage markets will require a more thorough and empirical assessment of small project risks, standardization of small project mortgage documents and terms, and an institutional willingness to warehouse or pool small project loans.

One reason for the infrequency of pooling or warehousing of small project loans has been the types of lenders generally active in that market. Sources of financing for small projects typically have come from commercial banks, thrift institutions, and community development or nonprofit lenders that hold loans in portfolio. The agencies and their national network of originators and servicers have not developed the capacity or interest in small project debt. The conduits, while expressing some recent interest, have focused on larger project loans that compete directly with agency programs. Active participation by larger, national lenders and agency programs should stimulate more secondary market participation through existing capital channels. In the interim, lenders may develop a warehousing program through partnerships or with the agencies to foster more efficient access to public capital.

Agency/Originator Partnerships. For Fannie Mae, Freddie Mac, FHA, and the conduits to become more active in financing the small project market niche, relationships and partnerships between agencies and the originators will need to develop, as in Fannie Mae's delegated underwriting and servicing (DUS) program or a properly structured and monitored FHA-coinsured model. The flexibility necessary for small project underwriting will require the discretion and judgment of a lender with knowledge of the local market, community, or neighborhood. National lenders will need to rely heavily on regional offices or correspondent discretion. In addition, agencies purchasing, securitizing, or insuring small project loans must design appropriate controls and incentives, such as risk-sharing agreements, to maintain credit quality in loan portfolios produced through origination networks. Although FHA and Freddie Mac's experience in the late 1980s may have hindered progress in this area, underwriting discretion must be exercised by the lender to serve this market effectively.

New Construction. Many traditional multifamily construction programs, particularly FHA's 221(d)(4) program, are difficult to use for financing the development or rehabilitation of small projects. Several requirements, such as periodic inspections and procedures to administrate construction draws, can be too costly for small projects but could be streamlined to accommodate the small project market. In addition, wage-rate requirements associated with FHA development programs can be prohibitive for owners. Pioneering a new forward commitment product for small project loans could be one way to avoid the overwhelming costs to small project owners of existing development finance programs.

Nonprofit Lenders. Nonprofit lenders are often involved in brokering transactions that have an affordable housing mission. They experience special constraints when working in traditional multifamily finance programs, particularly with small project loans that constitute a substantial amount of the Nation's affordable stock. Special requirements for LTV, reserve, and debt service coverage requirements may generate more financing opportunities for these small projects, although the risks also must be mitigated through subsidies or sources of credit enhancement.

FHA's Small Projects Processing

One result of 12 months of research and development is that SPP insures mortgages of up to $1 million that are secured by rental properties with 5 to 20 residential units. SPP is derived from FHA's 221(d)(4) and 223(f) programs with processing modifications intended to adapt the products for smaller mortgage loans. SPP has been structured to follow the critical design elements highlighted above and described below.

Upfront Costs. Some upfront cost reductions adopted by FHA include streamlining environmental reviews, limiting origination and financing fees scaled to the mortgage amount, waiving the opinion of the borrower's attorney, and delegating the required upfront reserve account deposits to the discretion of lenders. The effect of these efforts may be marginal in some cases, depending on reserve account requirements that likely will vary by lender.

Reducing Ongoing Costs. Two related components of servicing costs have been addressed. Costs to the borrower are reduced by waiving requirements for the borrower to submit annual audited financial statements. Lenders are given flexibility to maintain replacement reserves in traditional savings accounts, thus eliminating the costs of administering escrowed reserves. Some additional costs are shifted to lenders in the servicing area, including property inspections and financial statement review. These additional costs can be covered through a higher servicing spread than that of standard FHA processing programs (see pooling below).

Standardization. The need for standardized documentation is greater for existing sources of small project capital, primarily commercial banks, thrift institutions, and community development corporation lenders. If FHA develops a large portfolio through SPP, the existing FHA documentation is sufficiently standardized to facilitate pooling. The ability to further analyze the data will depend, in part, on the extent to which information is sorted electronically and made available to research professionals.

Underwriting. SPP blends aspects of underwriting for single-family structures and small businesses with criteria appropriate to multifamily rental projects. In general, underwriting under SPP procedures involves evaluating each borrower's personal credit history, income potential, personal assets, and overall business activity, in addition to the project cash flow. In an early model of SPP, the program provided limited duration recourse to the borrower in exchange for even more flexible underwriting criteria. However, due to conflicts with LIHTC projects, recourse was removed entirely from the program.

In addition to thorough credit reviews of borrowers, debt coverage guidelines are set at a minimum of 1.2, and the DSC ratio is determined assuming an occupancy rate of 90 percent. Maximum LTV ratios of 80 percent for refinancing and acquisition and 85 percent for rehabilitation and new construction allow the product to compete with the current market offerings while ensuring a substantial equity contribution by the borrower.

Replacement Reserve Accounts. To promote lender autonomy and flexibility for using this product, FHA encourages, but does not mandate, lenders to require that borrowers fund reserve accounts. FHA rejected mandating reserve maintenance because of the cost to lenders and the fact that some borrowers may have sufficient funds to cover emergencies. FHA also eliminated the requirement that reserves be held in escrow accounts, enabling borrowers to maintain reserves in standard savings accounts. This change offers several advantages: Funds are accessible without consent of the servicer, the servicer's costs of oversight are reduced, and the owner is able to earn interest on the funds. If required by the lender, reserve amounts can be defined according to FHA guidelines for the age and condition of the project as well as the experience and net worth of the borrower.

Pooling. In conjunction with FHA, Ginnie Mae designed a mortgage-backed security (MBS) product to facilitate pooling of SPP loans. In contrast to Ginnie Mae programs, the SPP pooling program allows lenders to package multiple loans into a single pool, allowing more efficient MBS placement. Ginnie Mae SPP MBS will be required to carry a minimum servicing fee of 37 basis points, in addition to Ginnie Mae's 13-basis point guarantee fee. This differs from the current minimum 12-basis point servicing fees on traditional Ginnie Mae multifamily securities. Ginnie Mae's servicing fee floor is designed to protect the value of servicing rights if they are acquired by Ginnie Mae. It can also provide compensation to lenders for fixed servicing costs beyond the standard servicing fee rate for larger multifamily transactions.

Agency-Originator Partnerships. To administer the program, FHA requires mortgagees to follow a flexible set of guidelines for processing applications, underwriting loans, and servicing mortgages. In return for this discretion, lenders identify their approaches to small project underwriting and overall operations management in quality control plans. After submitting these plans to FHA for approval, lenders are responsible for adhering to the plans. Because of the increased flexibility allowed to the lender, FHA increases its monitoring and oversight but decreases its micromanagement of individual loans. If, through active monitoring, FHA detects a pattern of poor underwriting judgments, it may take action to bar the lender from further use of the product and, if necessary, from FHA products entirely. The program does not require existing lenders to implement SPP-specific quality control plans as part of the approval process. Such a requirement would have subjected SPP to a formal review by the Office of Management and Budget (OMB) under the Paperwork Reduction Act and, as a result, could have stalled the release of SPP by up to 18 months.

In the preliminary version of the program, lenders shared credit risk with FHA for the first 5 years of amortization. The lender's share decreased each year, and its highest exposure was linked to the period when negligent underwriting would most likely produce loan defaults. Ultimately, the risk-sharing model was discarded due to statutory and regulatory restrictions.

Introduction of this product reflects FHA's evolution into an agency that builds partnerships with private-sector businesses to harness their knowledge, expertise, and capabilities to continue to provide the strength and financial benefits of Federal insurance. This new direction suggests that FHA staff will need to shift from an environment focused on retail production toward one emphasizing performance monitoring and industry leadership. This change in outlook undoubtedly will take time to complete, in the same way as will the establishment of necessary monitoring and enforcement skills.

New Construction. Several participants in the market research phase of SPP development urged FHA to explore waiving the requirements for Davis Bacon wage rates. These participants explained that the prohibitive costs of Davis Bacon wages in many regions and the logistical complexity of complying with wage-rate provisions would marginalize the product's effectiveness as a new construction or rehabilitation financing tool for small projects. In addition, many participants expressed the opinion that waiving Davis Bacon for small project construction or rehabilitation could establish a legislative precedent. Despite the industry's reservation, FHA did not attempt to waive the Davis Bacon requirements for SPP.

Lessons for HUD and FHA Reform

The Small Projects Program is one example of ongoing attempts to reinvent HUD and improve its ability to meet goals. A valuable guide to this debate, the HUD Management Reform Plan, can be found at HUD's Web site (http://www.hud.gov). Here we seek to draw attention to the connections between the SPP initiative and the broader goal to improve HUD.

Need for Regulatory Relief

As mentioned above, several aspects of SPP considered by FHA management during the development phase were later ruled out because of regulatory restrictions, statutory conflicts, or recognition that program components would require review by OMB and other regulators, potentially prolonging the program's release by up to 18 months. Without genuine reform and relief from constraining regulations and statutory interpretations, coherent and significant program development at FHA will be hampered. Currently, FHA cannot act as a sophisticated financial institution and cannot react and intervene in a timely manner to influence the dynamic functioning of multifamily credit markets. In addition, regulatory restrictions can lead to weakness in program design since program elements are complementary and a single change can significantly affect the cohesiveness of the overall product design.

Need for Multifamily Housing Information

Well-designed programs require accurate information. Unfortunately, this information is rarely available in multifamily finance program development. The primary source of information for the new program is based on interviews with people in the field. Although informative and insightful, it is at best labelled anecdotal. No systematic or rigorous attempt has been made to document the private sector's failure in the multifamily mortgage market or the comparative advantage of the Federal Government. This broader theme on the need for better data has been highlighted in work by James R. Follain and Edward J. Szymanoski (1995) and Amy Bogdon and Follain (1996).

One example of the absence of accurate data is our lack of knowledge about the causes and consequences of multifamily default. Much study has been done in recent years relating to single-family default. However, the same cannot be said of multifamily default. Exceptions include the work of Lawrence Goldberg (1997) and that of Wall Street practitioners reported in part in Frank J. Fabozzi and his colleagues (1997). A paucity of high-quality and lengthy time-series data on the performance of FHA multifamily mortgages and the characteristics of multifamily mortgages thought to influence default is part of the information-gap problem.

Another problem is the lack of reliable time-series information about the price of multifamily housing in various markets. Follain and Charles Calhoun (1997) discuss available data and provide an index using the residential finance survey. In addition, the complexities of the default and foreclosure process are relevant to the incidence of multifamily mortgage default and the size of loss from foreclosure. These complexities include reserve requirements (whether for recourse or nonrecourse loans), the incentives facing the lender to act promptly, and a host of other seemingly minor "institutional" details. Unfortunately, little systematic information exists about the likely impact of these details. Consequently, attempts to design program features to illicit timely action by lenders in the case of default are hindered.

The establishment of the Multifamily Housing Institute (MHI) and HUD's support of it are steps in the right direction. Other steps include the new landlord survey by HUD, the Bureau of the Census, and U.S. Department of Commerce, as well as HUD's ongoing effort to develop a multifamily data warehouse. Nonetheless, HUD and FHA would be well served by further efforts to increase knowledge about the dynamics of multifamily mortgage markets. Programs based on anecdotal and hastily compiled information cannot substitute for long-term observation of trends in the market. Indeed, this activity is more familiar to the Federal Government than to the private sector, because the collection of such information is a public good that benefits many.

Importance of an Evaluation Component

The new SPP program does not include a formal evaluation component. The reason, as for many HUD/FHA programs, is that formal evaluation can be expensive and, in these days of tight budgets, has been left out in favor of additional funding for the program. Nonetheless, evaluation can contribute to efficient use of these scarce resources. The first application of such an effort would be a well-designed data collection effort focusing on loan applications and approvals. All application information should be computerized and made available for analysis, subject to confidentiality. Finding out about other options available to the borrower and the reasons for choosing the SPP program would be particularly interesting. As noted above, loan performance information is particularly crucial as a measurement of the length of time between default and final mortgage resolution.

Ideally, an evaluation component would include analysis of a control group. For example, efforts might focus on one metropolitan market with basic information collected about a sample of multifamily lending. This would include information about lending terms, loan purpose, lender, project size, and loan performance. The objective would determine whether FHA participants in the sample are different from other borrowers. More specifically, it is important to determine whether the risk of adverse selection is particularly high. Perhaps a joint effort could be undertaken with Freddie Mac and Fannie Mae to collect such information.

A Different Type of HUD

The new program includes a call for emphasis on multifamily mortgage lending by HUD. SPP charges HUD to increase its monitoring role and decrease its activity as primary underwriter or direct producer, according to incentives within the program for private participation. The experiences of Fannie Mae and Freddie Mac have been mixed with respect to this style of program management. Fannie Mae appears to have a highly successful delegated underwriting system for its multifamily lending program; criteria for selection as a delegated underwriter appear to be the key ingredient. Conversely, Freddie Mac encountered far more difficulty with its multifamily lending programs and curtailed this activity in the early 1990s to review its plans. Its new approach calls for concentrating more on primary underwriting and less on delegated underwriting, at least until it gathers sufficient data on multifamily lending to design a successful delegated underwriting process. HUD could learn from both approaches.

SPP highlights a long-heralded role for FHA as an innovator in the mortgage market. This is an appropriate and longstanding role for the Federal Government, a tradition that includes the introduction of insurance for the 30-year fixed-rate mortgage in the 1930s. Nonetheless, financial markets are much more complex than they were in the 1930s. The SPP project can serve to demonstrate the potential viability of a needed new product and potential profitability of a new product.

Two points are relevant regarding the private sector’s receptivity to mortgages for small projects. First, some of the perceived underprovision of such loans by the private sector may be due to lingering perceptions of small multifamily loans that were formed as a result of loan defaults in the late 1980s. It is well known that this market was just returning to full capacity in the mid-1990s. Second, the private sector is well positioned to adopt new and profitable ideas. Indeed, anecdotal information obtained since the launching of SPP suggests it is well received. If this is true, ways for shifting responsibility for the program from FHA to the private sector should be considered.

Complexity of Providing Affordable Housing

The process of developing the SPP program underscores the complexity of providing decent shelter for low-income households. Part of this difficulty is due to the variety of different existing programs. For example, FHA still administers a large number of insurance products. At the Federal level, there are housing vouchers, public housing, and LIHTC. A variety of financing mechanisms and subsidies also operate at the State and local levels. In addition, numerous factors contribute to insufficient shelter for the poor, many outside the housing market.

As a result of this complexity, designing new programs and evaluating their impact are difficult. HUD can simplify this undertaking by using a more targeted approach through clearer statements about its priorities and more specific ways to improve the private sector's performance in providing affordable housing. While the new management plan, ongoing discussions about ways to reinvent HUD, and SPP are excellent steps in this direction, much more can be done.

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Notes

1. James R. Follain and Edward J. Szymanoski (1995) and William Segal and Szymanoski (1997) discuss some issues surrounding the reform of FHA multifamily programs. Kerry Vandell (1995) and responses to his paper by Nicholas Retsinas and John Weicher in the same volume of *Journal of Housing Research* provide an overview of the process surrounding reform proposals for FHA and specific insights about the need for reform of multifamily insurance programs.

2. Amy Bogdon and Follain (1996) provide more information about multifamily housing finance based on the residential finance survey.

3. Denise DiPasquale and Jean L.Cummings (1992), Follain and Szymanoski (1995), and Segal and Szymanoski (1997) provide background and support for issues related to the securitization of multifamily loans.

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