The original documents are located in Box 54, folder "1975/12/02 - Dr. John Dempsey and David Froh" of the James M. Cannon Files at the Gerald R. Ford Presidential Library.

MEETING WITH DR. JOHN DEMPSEY
DAVID FROH
Tuesday, December 2, 1975
11:30 a.m.

Mr. Cannon's Office

Dist
Todd to
follow up

THE WHITE HOUSE
WASHINGTON

December 2, 1975

JMC:

Dr. Dempsey's office called to say that the following people will accompany him on his visit with you today at 11:30:

Isaac Green
Mr. Fox
Dave Froh

p

THE WHITE HOUSE

WASHINGTON

REQUEST

December 1, 1975

MEMORANDUM FOR JIM CANNON

FROM TOD HULLIN

SUBJECT MEETING WITH GOVERNOR MILLIKEN, DR. JOHN DEMPSEY TUESDAY, DECEMBER 2, 1975, 11:30 a.m.

I. PROBLEM

Many housing finance agencies (the Michigan State Housing Finance Agency included) are facing severe financial difficulty, primarily because of their inability to raise capital on reasonable terms.

II. PROPOSAL

The Governor will urge you to expedite a proposal that is being developed by Secretary Hills which authorizes a co-insurance program of multi-family mortgages with State and local housing agencies.

III. BACKGROUND

The Housing and Community Development Act of 1974 contained two provisions (Section 802) which could benefit State housing agencies. One authorized the Secretary to guarantee obligations issued by State agencies and subsidize one-third of the interest on this type of obligation. The other authorized the Secretary to coinsure (with any mortgagee) single- and multi-family mortgages where:

- The mortgagee assumed at least 10 percent of the loss on a mortgage;
- The mortgagee carried out the underwriting functions;
- Coinsurance volume could not exceed 20 percent of either FHA single-family or multi-family insurance for each fiscal year until October 1, 1977.

Since enactment, the Administration has strongly opposed the use of the State bond guarantees and interest subsidy authorities. Congress appropriated $15 million of contract authority ($600 million budget authority) for interest grant payments. The President has proposed a rescission of this authority.

The Senate Banking, Housing and Urban Affairs Committee has developed amendments to the mobile home bill which amend the existing coinsurance authorities by:

-- Authorizing coinsurance where the mortgagee would take an initial percentage (unspecified) of the losses plus a share (not less than 10 percent) of the remaining losses;
-- Removing mortgages coinsured with public housing agencies from the 20 percent limitations.

Secretary Hills has proposed that the Administration accept these amendments. OMB has concurred and the Secretary should communicate our position to the Senate later this week.

The proposed amendments will probably be passed by the Senate and will probably be accepted by the House in conference. This legislation should be to the President before Christmas and the program could be in operation by mid-February.

RECOMMENDED RESPONSE

I suggest that you listen and indicate that you will do whatever you can to expedite HUD's proposal.

The announcement of Administration support for these amendments should be done by the Secretary.

PROBLEMS CAUSED BY AN INABILITY OF STATE HOUSING FINANCE AGENCIES TO RAISE CAPITAL THROUGH THE SALE OF SECURITIES

POSSIBLE CONSEQUENCES AND A PROPOSED SOLUTION

Prepared by:
Michigan State Housing Development Authority
December 1, 1975

The Problem

The state housing finance agencies (SHFA's) are the only presently operational entities producing subsidized housing under the provisions of the 1974 housing act. They face an immediate and critical problem caused by an inability to sell the notes and bonds which finance their operations because of an erosion of confidence on the part of security buyers. Investors have stopped buying, or are buying in grossly inadequate amounts, because of generally unsettled economic conditions intensified by a growth in the demand for capital at a rate substantially in excess of the rate of expansion in the supply of capital, and compounded by investor concerns about a New York City default and the UDC difficulties. A rundown of specific state agency financing difficulties is attached.

It must be emphasized that this problem did not result from a recognition by the security market of a weakness in the statutory, financial or organizational structure of state housing finance agencies, or from a discovery that the heretofore favorable investors' and rating agencies' analyses of HFA security offerings had been faulty. Contrary to the HUD/FHA experience, the states have consistently produced subsidized housing which works. These successful developments are the underlying security and source of repayment for SHFA securities, which therefore remain sound.

If a resolution does not occur quickly, many state agencies will face default on the repayment of their share of one and three quarters billion dollars of presently outstanding bond anticipation notes. Default could occur because of an inability to roll these notes over, or replace them with long term bonds. In addition, new capital is required if new starts are to take place. If new capital is not available and the production pipeline is turned off, a rapid winding down would occur. Competent, experienced staff will leave. It would take years to rebuild the development capabilities of SHFA's so that housing starts can again take place. If there is widespread default on current agency obligations, SHFAs may never be resurrected as a means of producing housing.

Rationale for Assisting the SHFAs

The 1974 Housing Community Development Act specifically assigned a role to the state housing finance agencies in the delivery of subsidized housing. HUD, which does not presently appear capable of sustained program activity, gave the states the major role in implementing the housing component of the 1974 Act. In many instances it assigned more subsidies to state agencies than to its own area offices. The state agencies are geared up and able to produce substantial amounts of housing if the flow of capital is assured. If however, the state agencies become inoperative, no present feasible alternative is available to fulfill the Administration's and Congress' goal of producing subsidized new housing. Additionally, the cessation of housing construction would negatively affect the economy of the country with immediate consequences in terms of significant increases in unemployment for construction workers and others dependent on the shelter industry.

Proposed Solution

It would be unrealistic to rely on a spontaneous resolution in the near future of the factors which have negatively affected the SHFA's ability to sell notes and bonds. Since the financing difficulties preventing the sale of securities are due to a lack of market acceptance caused by factors unrelated to the financial integrity of the SHFAs, the appropriate solution would be a method of bolstering buyer confidence. Conversations toward an implementation of this objective have already begun with HUD. A proposal has been formulated by a group of state agencies. It calls for federal assistance within the framework of existing fiscal and budgetary policies. The devices recommended do not require any net cost to any federal agency, will not increase the total demands for capital, and will in fact reduce federal outlays almost immediately. It is not a subsidy or a bail-out. The proposal is attached as Exhibit I. It consists of the following two basic components:

1. FHA Co-Insurance. State agencies would continue to finance housing production and would have the ability to underwrite FHA insurance for this housing on a shared risk basis. This concept is not new. It is presently authorized by legislation and has been in the discussion stage for at least two or three years.

2. Issuance of Government National Mortgage Association (GNMA) Mortgage Back Securities. This is a procedure which would allow the state agencies to utilize existing GNMA procedures and guarantees. GNMA backing would provide a security instrument which is well known and accepted in the securities market and would thus enable state agencies to successfully market their issues. In addition, it would open a large new capital market to the state agencies. GNMA would have no financial exposure since the underlying mortgages would be insured by both FHA and the states. The state portion would obviously have to be funded in an actuarially sound basis so that no possibility of GNMA exposure would result.

   The federal Treasury has traditionally resisted the piggy-backing of federal guarantees and tax exempt financing. To avoid this situation which would occur with a GNMA guarantee on tax exempt bonds, it would be feasible to issue taxable bonds under this proposal, since the GNMA guarantee by itself would produce an attractive and workable interest rate estimated at 8 3/4% today.

Conclusion

If the Administration intends to produce subsidized housing within the next year and wishes to do so at the least possible expense to the federal treasury, then speedy adoption of this proposal is necessary.

FINANCING DIFFICULTIES OF STATE HOUSING FINANCE AGENCIES

New Jersey Housing Finance Agency: Recently able to sell $60 Million of bonds at approximately 9% only after resorting to extraordinary measures including committing State funds to purchase a portion of the issue. Several hundred million of notes outstanding. Agency has ceased new housing production activity.

Massachusetts Housing Finance Agency: Recently able to sell bonds, but only in the amount of $12 Million. Were able to roll over notes only through emergency action of State Legislature. About $500 Million of bond anticipation notes outstanding.

Virginia Housing Finance Agency: Paid 8.78% to sell $30 Million bond issue. Were able to renew only $15 Million of bond anticipation notes at 8.70%. Stopped applications and commitments.

Pennsylvania: Presently trying to sell $18 Million of a planned issue of $30 Million. No new commitments being issued.

Wisconsin: No construction financing. Long term financing in small cities subject to the sale of bonds. No big city lending. Bond sale in October, 1975 for $11 Million at 8.40%.

Minnesota: Processing commitments subject to financing. Closing with money already available. November bond sale of $18 Million at 8.67%. Hope to sell $31 Million two-year notes at 7.00% in December.

Illinois: Processing at developers risk. No assurance of commitment. $130 Million short term debt due beginning September, 1976. Sold $29 Million notes on November 4, 1975 at 6.25%.

New York - UDC: Problems well publicized. Attempting to build-out developments already started.

New York - HFA: Mammoth note overhang. Going from financial crisis to financial crisis.

Michigan: Withdrew a $25 Million bond sale because of no market response. If another bond sale attempt fails, processing new commitments will be suspended.

EXHIBIT I

COUNCIL OF STATE HOUSING AGENCIES

RECOMMENDATIONS

TO

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

CONCERNING IMPLEMENTATION OF EXISTING

FEDERAL ASSISTANCE AUTHORITY NEEDED

TO ENHANCE MARKETABILITY OF

HFA NOTE & BOND ISSUES

1025 CONNECTICUT AVENUE, NORTHWEST / SUITE 707-A / WASHINGTON, D. C. 20036 / PHONE: (202) 785-2146

SUMMARY

The State housing finance agencies are facing an immediate, critical problem in selling the necessary volume of notes and bonds at reasonable interest rates. If they do not succeed in doing so, they will very soon be out of business as effective delivery mechanisms for the production of low and moderate income housing.

The Council of State Housing Agencies, therefore, urgently recommends that HUD implement two programs to assist the HFAs in solving this problem:

(1) Co-insurance (or partial insurance) by HUD/FHA of HFA multifamily mortgages under Section 244, and
(2) Use of GNMA mortgage-backed securities for HFA bond issues.

These two programs can be implemented quickly, under existing legislation, at no cost to the Federal government, and with great benefit to both the HFAs and HUD.

We have made various specific suggestions for how to implement these two programs, but we would be willing to discuss other specifics for these programs or to explore other alternative programs.

In addition, we have identified several other possible alternatives for Federal action, including the Section 802 bond option. These alternatives each have drawbacks which make them less desirable or effective for immediate implementation. However, the only significant negative element involved in the Section 802 interest differential payments concept is that, notwithstanding the inherent fiscal efficiency of the concept, the continued use of this program implies continued Federal budget appropriations. CSHA remains extremely interested in working with HUD to implement the Section 802 program, and believes that it can be employed effectively in conjunction with our major proposals outlined above; however, we wish to direct HUD's attention first to our two primary recommendations.

We have requested a meeting with the Secretary of HUD to present our proposal, and ask to begin working with HUD immediately to implement our two major recommendations or other suitable programs as soon as possible.

CSHA PROPOSAL TO HUD

Table of Contents

I. INTRODUCTION

Because of conditions which have developed in the municipal bond market over the last several months, State housing finance agencies are now in serious danger of losing their ability to stimulate and finance the development of low and moderate income housing. At its recent annual meeting in Chicago, the Council of State Housing Agencies appointed a special task force to prepare and present recommendations for prompt Federal action which could assist in solving this critical problem. Consequently, we submit for your urgent consideration our proposal to utilize existing authorities of the Department of Housing and Urban Development in order to restore the access of State housing agencies to the capital markets at reasonable interest rates.

A. Statement of the Problem

The basic problem which HFAs face today is the inability to sell their long-term bonds at reasonable interest rates; in addition, the market has been unwilling to accept more than small amounts of bonds at any one time, almost regardless of rate. This situation has engendered serious investor doubts about the ultimate ability of the HFAs to sell all the bonds needed to meet even their present obligations (represented primarily by bond anticipation notes presently outstanding in an aggregate principal amount of more than $1-3/4 billion, together with additional loan commitments of more than $1/2 billion). As a consequence of these doubts, the market place has begun to resist even short-term issues of bond anticipation notes, and many HFAs are now wondering whether they can responsibly issue notes for <u>new</u> projects, when they do not know whether, or at least at what pace and volume, they can "roll over" or "take out" their presently outstanding notes for projects already under construction.

Bluntly, the confidence of investors in the ability of HFAs to market their bonds, in the volumes needed to pay off their existing notes and at interest rates that keep the underlying developments economically feasible, must be restored as quickly as possible. Until that happens, it will be extremely difficult, if not impossible, for most HFAs to undertake any new developments, including particularly the many thousand units of Section 8-assisted housing as contemplated both by the HFAs and by HUD. In the meantime, the risk that one or more agencies may default on its notes, thereby becoming impotent for future development activities and imposing an additional negative influence of potentially disastrous proportions on the market for <u>all</u> HFA debt obligations, continues to increase.

It should be emphasized that the problems which this proposal addresses do <u>not</u> result from a sudden recognition of any intrinsic weakness in the statutory, financial or organizational structure of the housing finance agency concept, or a discovery that investors' and rating agencies' analyses of HFA debt offerings have been faulty. These problems are, in reality, a product of the general economic conditions at the present time, intensified by a growth in the demand for capital at a rate substantially in excess of the rate of expansion in the supply of capital. These general conditions have obviously been compounded by investor concerns about a possible default by New York City and other recent difficulties in the municipal bond market.

This situation has developed in spite of the fact that the security being offered by the housing finance agencies has not weakened during the past year. There still are not defaults on housing developments underwritten and financed by HFAs. Established reserves remain intact. There is no evidence that States will not meet the moral obligation being pledged; in fact, the obligation has been met whenever and wherever called upon, and there are additional examples of direct State support in the absence of even a "moral" obligation. Nevertheless, investors have not been willing to continue the purchase of the previous volume of housing finance agency obligations. Furthermore, the number of new issues being offered to purchasers of tax-exempt bonds has increased substantially, resulting in a much greater interest rate differential than previously existed between the various grades of municipal securities. This is evidenced by the fact that reasonably sized issues of top grade tax-exempt bonds are still being sold at interest rates under 6%, while lower-rated HFA bonds are selling at 8½% or more.

In this environment, State housing agencies are having relatively similar experiences as they approach the capital markets.

Most agencies, offering sound real estate investments, reasonable reserves, capable professional management and a State moral obligation pledge as security for their bonds, are not able to attract enough capital at a reasonable rate to carry out the substantial production volumes of which they are capable and which they have found to be necessary and desirable in their States. Moreover, the conditions which have brought housing finance agencies to their current status are not likely to be resolved by an improvement in general economic conditions. Projections of long-term capital needs indicate that relatively lower-grade securities will continue to have difficulty in attracting investors. The continued operations of State housing finance agencies, therefore, will require an improvement in the perceived quality of the security being offered. Fortunately, existing Federal legislation provides several alternative mechanisms to accomplish this objective.

B. <u>Rationale for Federal Action</u>

The Federal government, acting through HUD, should utilize these mechanisms in order to preserve State housing agencies as effective participants in the process of developing low and moderate income housing. Federal involvement is necessary in order to raise HFA debt obligations to a significantly higher level of security in the eyes of investors. The issue, we suggest, is not the soundness of the underlying mortgage loans or the ability of the agencies to work out any difficulties which may be encountered in specific developments. Rather, the question is one of persuading the investor that his investment is safe. With the wide range of alternative investments available to him today, the bond buyer simply does not want or need to take the time to analyze the underlying security for an HFA bond issue. But the mechanisms we are proposing will give him a readily identifiable security which in his mind is substantially above that which HFAs presently can offer.

Federal involvement in preserving HFA capabilities is also feasible within the framework of existing fiscal and budgetary policies. The devices we are recommending do not require any Federal budgetary outlays, will not produce any net cost to any Federal agency, will not increase the total demands for capital, and will in fact reduce Federal outlays almost immediately. <u>We are not seeking a subsidy or a bail-out</u>. The use of the mechanisms we are proposing will not cost the Federal government anything.

Federal involvement in solving this problem is warranted, because State HFAs perform a vital role in the planning and development of lower income housing needed to accomplish various public purposes. These agencies have proven their capability to initiate, complete and monitor high-quality multi-family housing developments; they are a proven and effective delivery mechanism, both for production of housing and for such "software" activities as planning, coordination, technical assistance, and experimental programs. Also, these State-level entities provide a more local and flexible means of implementing housing policies than is possible at the Federal level. The HFA mechanism is a valuable, functional part of the balance of Federal and State responsibilities under our system of government, and appropriate action by the Federal government to preserve this mechanism is wholly consistent with current Administration policies.

C. Possible Consequences of Inaction

It is not an overstatement to say that the very existence of HFAs as functional agencies is being seriously threatened today. Unless State agencies receive assistance soon along the lines we are proposing, the result is likely to be an increasing risk of inability to meet outstanding obligations, the discontinuance of processing of applications for future multi-family mortgage loans, and the loss of agency production capability. Most HFAs are already anticipating severe difficulties in obtaining permanent financing at feasible interest rates for their Section 236 and mixed-income developments which are under construction or completed. It is absolutely clear that, under current circumstances, State agencies will not be able to provide the capital necessary to finance any significant portion of the housing needed to utilize Section 8 new construction funds. This will cause a further deepening of the housing recession with its direct and significant impact on employment, put inflationary pressures on the existing supply of housing, and generally serve to impede any overall economic recovery.

The terrible aspect of this critical situation is that, if the present opportunity to provide no-cost Federal assistance and preserve the HFA vehicle is allowed to go by, the decision may well be irreversible. Once the production pipeline is turned off and competent, experienced staff is lost, it will be extremely difficult, if not impossible, to rebuild the development capability of State agencies; at best, it will literally take years before housing starts occur again. And if there is any widespread default on current agency obligations because of the inability to sell bonds at acceptable interest rates, HFAs will never be resurrected as a means of raising capital for the production of housing.

On the other hand, prompt implementation of the available options for Federal action will allow State housing finance agencies to continue production at reasonable levels which can be supported in local housing markets, with confidence that they will be able to compete effectively for capital.

We respectfully urge your immediate efforts to effectuate the recommendations which follow.

II. MAJOR RECOMMENDATIONS FOR FEDERAL ACTION

Of the many and varied alternative methods of Federal action to assist the HFAs in raising capital which have been put forward, we wish to recommend most strongly a combination of two programs: (1) co-insurance by HUD-FHA of HFA mortgage loans under the new Section 244, and (2) adaptation of the existing GNMA "mortgage-backed securities" (MBS) program for use by HFAs.

Both of these options should have a substantial beneficial impact on the marketability of HFA debt issues, while having only a moderate restrictive impact on HFA program administration.

At the same time, the impact on the Federal government in terms of risk, cost and other Federal policies would be modest, and the potential volume under each option or a combination of the two would appear to be of manageable proportions. Several other options which do not measure up on all these points, but which may still be desirable--perhaps for limited applications--are discussed in section III of this report.

A. Co-Insurance of HFA Mortgages Under Section 244

The most basic and urgent recommendation we submit is for immediate development and implementation of a program of "co-insurance" (or, perhaps more accurately, partial insurance) by HUD-FHA of HFA mortgage loans pursuant to Section 244 of the National Housing Act. We believe that such insurance, covering a maximum of approximately 85% of the possible loss pursuant to each of an agency's mortgage loans, would be of substantial assistance by itself and also is the necessary prerequisite to several of the other alternatives, especially the GNMA mortgage-backed securities program.

Technically, § 244 authorizes the Secretary to insure under any provision of Title II of the National Housing Act, "pursuant to a co-insurance contract", mortgages which would be eligible for regular FHA insurance under such provision. Because of the replacement cost approach to value used by most HFAs, it is assumed that such mortgages normally would be insured under either Section 220 (urban renewal and declining areas) or Section 221 (other areas). The statutory provisions of these sections (or other appropriate insurance sections) would have to be met, of course, but some of the regulatory requirements might have to be modified. For now, we will leave the specifics of this matter to a later submission. Suffice it to say that we believe this question is, with rare if any exception, solvable.

1. Eligible Agencies

HFAs wishing to utilize the co-insurance program would submit a request for participation to HUD-FHA, and would also request a total amount of co-insurance authorization. HUD-FHA would review the agency's qualifications in terms of program-related criteria, and notify the agency of its approval, if it qualified, and its authorization amount. Upon approval of the agency by HUD-FHA, the agency would continue to be authorized to make mortgage loans eligible for co-insurance, up to the dollar amount of its authorization.

The basic criteria for agency participation would be considerations such as: (1) the ability of the agency to perform mortgage loan underwriting; (2) the soundness of the agency's underwriting in the past, to the extent applicable; and (3) the significance of the financial risk to the agency if losses are in fact experienced, so that the agency will have a strong incentive to do careful underwriting. On the other hand, an ability on the part of the agency to fully cover the uninsured part of any loss should not be a requirement for program participation, since HUD-FHA will not be liable for this portion of the loss in any event. Practically speaking, the market place will require sufficient assurances on this score, and HUD need not become involved in this judgment as a condition of eligibility for Section 244.

Once approved for Section 244 purposes, an agency would function much like an FHA Title I lender. The HFA and HUD-FHA would enter into a master co-insurance contract, pursuant to which the HFA would originate, process, and close the co-insured mortgage loans in its own name. Shortly prior to closing of each loan, however, it would deliver to HUD a certificate of compliance with the appropriate statutory criteria and a request for execution by HUD-FHA of a certificate of co-insurance. (In projects receiving Section 8 assistance this could be done simultaneously with submission of the Proposal.) The individual project need not be underwritten at all by HUD-FHA and the co-insurance certificate issued by HUD-FHA would be conclusive evidence of the HUD-FHA's insurance obligation, once the loan was actually closed.

2. Eligible Mortgages

All multi-family mortgage loans made or purchased by an eligible agency would be eligible for co-insurance under Section 244, except of course any loans already insured under other sections of the National Housing Act. Subject to the comments on page fifteen, advances on construction loans also would be eligible for co-insurance. Co-insurance could be applied to mortgage loans for projects that are not yet started, that are in construction, or are already completed; projects that are already "bonded out" would not be eligible, however, since the HFAs have no need to raise further capital for such projects. As discussed above, HUD-FHA could issue certificates to provide co-insurance for specific project loans subject to closing of those loans within the period of the commitments.

Under this approach, the maximum potential volume of HFA mortgage loans which HUD might be asked to co-insure is probably less than $5 billion. This includes the possibility of co-insuring all of the HFA loans presently on BANs (sometimes referred to as the "note overhang") and also co-insuring HFA mortgages for new construction Section 8 projects (based on the HFAs' estimated allocation of the FY75 and FY76 contract authority), most of which projects are not yet committed by the HFAs. The breakdown of the maximum potential volume is approximately as follows:

Outstanding BANs as of 10/1/75	$1.757 billion
Commitments not on BANs	.658
Subtotal - ("Note Overhang")	$2.415 billion
FY75 Sec. 8 Projects Not Yet Committed (est. at 20,000 units)	.500
FY76 Sec. 8 Projects (est. at 60,000 units)	1.500
Subtotal-Sec. 8 New Construction	2.000
TOTAL	$4.415 billion

(Note - Outstanding BANs and commitments from HDR of 10/6/75.)

This is almost certainly the maximum potential volume through the life of the present statutory authority which expires June 30, 1977. A statutory amendment will almost certainly be needed very soon, however, to exempt HFA mortgages from the 20% ceiling on co-insured vs. "fully" insured mortgages presently contained in Section 244(d)(2); however, an HFA co-insurance program could be developed and implemented for at least a few months before this ceiling became a problem.

3. Sharing of Risk Between HUD and HFAs

We are proposing a formula under which the agencies first must absorb all of the initial loss in connection with any project, up to 5% of the original principal amount of the mortgage loan. Only if the loss exceeded this amount would HUD-FHA have any liability under its co-insurance contract, and even then the excess of the loss over the 5% level would be shared 90-10 between HUD and the HFA. In addition, HUD's liability could never exceed 85% of the original principal amount of the mortgage loan. These rather stringent provisions, we believe, give HUD very definite limits on its liability and also give the agency a real incentive to do careful underwriting. In order to give the agencies an incentive to try to work out problems, rather than just collect on their co-insurance, we are also proposing that they be given a dollar-for-dollar credit toward their top 5% liability for any expenditures they make trying to keep the project out of foreclosure.

Several examples are presented in Table I below showing how this formula would work. In each case it is assumed that the project has been sold at foreclosure for the amount indicated to an arm's length purchaser who has paid cash for the project.

TABLE I

EXAMPLES OF EFFECT OF HFA CO-INSURANCE PROGRAM

	A	B	C
Original Principal Amount of Mortgage	$ 2,000,000	$ 2,000,000	$ 2,000,000
Pre-Foreclosure Expenditures by HFA	-0-	100,000	-0-
Plus			
Mortgage Balance At Date of Foreclosure	2,000,000	1,500,000	1,950,000
Plus			
Foreclosure Expenses	50,000	50,000	50,000
Subtotal Less	2,050,000	1,650,000	2,000,000
Proceeds of Sale	-0-	750,000	-0-
"Insured Loss"	2,050,000	900,000	2,000,000
Less			
HFA's Top 5%	100,000	100,000	100,000
Leaves			
Co-insured Amount	1,950,000	800,000	1,900,000
Less Lower of 95% of Co-insured Amount			
or	1,755,000	720,000	1,710,000
85.5% of Original Mortgage Amount	1,710,000	1,710,000	1,710,000
Additional HFA Share	195,000	80,000	90,000
Total HFA Share of Loss	340,000 (16.6%)	180,000 (20%)	290,000 (14.5%)
HUD Share of Loss	$ 1,710,000 (83.4%)	$ 720,000 (80%)	$ 1,710,000 (85.5%)

As can be seen, the HFA always will absorb at least 14.5% of the actual loss and in some cases could absorb 20% or more of the loss. HUD-FHA, on the other hand, will never have to pay more than 85.5% of the loss or 85.5% of the original mortgage amount, whichever is less. In addition, the agency is always better off to spend dollars to try to prevent a foreclosure, up to the point where it has spent the full 5% or has concluded that the project cannot be saved by spending the 5%.

In summary, we wish to emphasize two specific points:

a. We believe that the inclusion within our proposal of the concept that an HFA will "participate" to the extent of 10% in any loss in excess of the top 5% (with the HFA assuming the <u>entire</u> responsibility for such initial 5%) creates a continuing incentive to the HFA to perform the most professional job of underwriting possible in order to minimize any loss, rather than an incentive to "write off" a project once the possible loss exceeds 5%.

b. We are proposing that the foregoing risk-sharing formula be applicable to <u>all</u> co-insured HFA mortgage loans, without any dollar limitation on the HFA's exposure as to its overall loan portfolio. We suggest that this intentional exclusion of any "stop-loss" provision establishes a <u>continuing</u> incentive to the HFA to apply the same professional standards of underwriting, portfolio administration and program management to <u>each</u> proposed mortgage loan <u>and</u> to its aggregate portfolio.

(It <u>may</u> be necessary to amend the statute, by exempting HFAs or co-insured HFA loans from the "direct proportion" language of Section 244(a)(1), in order to allow HFAs to take the top 5% of any loss as we are proposing; if it is concluded that such an amendment is needed for this purpose, we will cooperate with HUD in seeking the necessary Congressional action.)

4. Method of Determining "Loss"

We are proposing that HUD-FHA would make no insurance payments unless a project was foreclosed upon or a deed given in lieu of foreclosure. The total "insured loss" could then be calculated, with all expenditures by the HFA up to the date a foreclosure action was filed or an "in-lieu" deed was received counting toward the HFA's top 5%. As discussed above, the HFA would have an economic incentive not to go to foreclosure, as long as it thought the project could be reinstated.

If the agency concludes the project cannot be saved without a substantial reduction in the project's debt but still wants to utilize the housing, it should be allowed to accept a deed in lieu of foreclosure or to bid in itself at the foreclosure sale. The difficulty which arises here is that there is no sure method to determine the market value of the property at the date of sale. In order to protect HUD-FHA's interest in this case, we would suggest that a public auction sale take place in every case, even where an "in-lieu" deed is accepted, with the project going to the highest bidder. If the HFA submitted the highest bid, it would keep the project; if not, the project would be conveyed to the highest bidder and the sale proceeds credited against the mortgage balance and costs in arriving at the "insured loss."

5. Co-Insurance Effective Upon Completion

It would be necessary to have a co-insurance certificate in hand before the initial loan closing, in order to assure the bondability of the project and thereby make the bond anticipation notes (BANs) saleable. It may be possible, however, to provide that HUD-FHA's insurance liability would not begin until the project was physically complete (and free of all construction-related liens or claims). Most of the HFAs believe they are capable of protecting themselves against and solving any construction-related problems, and many have already satisfactorily resolved difficult problems of this type. Removing the construction risk would significantly reduce the exposure of HUD-FHA under its co-insurance obligation and would probably be acceptable to most HFAs. We cannot yet judge whether the note market will accept non-co-insured BANs without imposing a substantial interest rate differential, and so we cannot recommend at the present time a delayed effective date, contingent upon project completion. We suggest further joint exploration of this possibility, if it is of interest to HUD.

6. <u>Administration of Defaulted or Foreclosed Properties</u>

It is our specific intention that the responsibility for working with projects that get into difficulty be solely that of the HFA, as it is now with non-insured projects. Because of the risk-sharing formula described above, the HFA would have a positive incentive to advance its own funds to keep a project out of foreclosure, as long as this was remotely possible. It would be necessary, therefore, to ensure that the agency was not in any risk of losing its co-insurance claim by trying to work with the project and delaying the filing of its claim. On the other hand, it would be specifically provided that, if it became necessary, the HFA would be fully responsible for accepting a deed in lieu of foreclosure, going through foreclosure proceedings, auctioning the property, and undertaking any other actions that may be needed. We expect that this feature of our proposed co-insurance program will be particularly attractive to HUD, as well as being preferred by the HFAs.

7. <u>Payment and Use of Co-Insurance Premiums</u>

The HFA would, of course, pay a premium for the co-insurance of its mortgages by FHA. (We would suggest, for example, an initial fee of ½ of 1% of the insured portion of the loan plus an annual fee of 1/8 of 1% of the insured portion of the declining principal balance.) The intention in establishing the premium should be to make the program self-sustaining. After sufficient experience had been obtained, it might be possible to determine that the program would be actuarially sound with a lower premium, and any premiums already collected in excess of the level needed would then be refunded to the HFAs. The agency would be responsible to FHA for the payment of the premium, although it would be allowed to include the cost of the premium in determining its interest and service charges to its borrowers.

Because the agency would be taking such a substantial portion of the risk itself, and in order to minimize the increased cost to the borrower, we believe that every effort should be made to keep the co-insurance premiums as low as possible. We are confident that an appropriate fee schedule can be worked out with HUD-FHA staff once the basic structure of the program is agreed upon.

B. <u>HFA Use of GNMA Mortgage-Backed Securities</u>

The second major component of our recommendation is that the existing GNMA mortgage-backed securities (MBS) program for multi-family mortgage loans be adapted for immediate use by qualified HFAs. Under our proposal, HFAs would continue to issue their own tax-exempt bonds backed by pools of mortgages as they traditionally have done, but the bonds would now be backed also by a GNMA guarantee of the timely payment of principal and interest. The major effect of adding the GNMA guarantee to the HFA bonds would be to significantly lower the interest cost on long-term capital - capital that will have to be raised for lower-income housing development in one way or another even if the GNMA backing were not to be available. Under the procedure we are suggesting, GNMA would be fully protected against loss in the event of default, partially by FHA co-insurance on the underlying mortgages and for the balance of any loss by guaranty fees and other assurances provided by the HFAs.

There should be absolutely no net cost to GNMA or the Federal government for this use of the MBS program. This is so for the following reasons:

(1) The same amount of long-term capital would have to be raised from the nation's total capital supply anyway in order, first, to convert the agencies' existing and committed short-term debt into long-term amortized bonds and, second, to build the new construction Section 8 units which have already been authorized by HUD or have recently been authorized by Congress. Thus, the HFA MBSs would not be increasing capital demands and would not raise the cost of borrowing by the Treasury or other Federal government agencies.

(2) There would be no cost to GNMA if any defaults occurred because of the co-insurance and HFA assurances to GNMA. The co-insurance program itself, as discussed above, should be self-sustaining through premiums, and the HFA guaranty fees and assurances would have to be determined by GNMA as adequate each time a bond issue was sold.

(3) The cost of administration of the program, which should be relatively low, would be covered by an application fee paid by the HFA at the time of each issue.

In fact, use of the MBS program in this way should save money for HUD, since it would be the chief beneficiary of the reduction in HFA borrowing costs. The vast majority of the dwelling units for which permanent financing must be obtained are assisted by HUD under either Section 236 or Section 8, and under the Regulations for these programs a reduction in the permanent interest cost will directly lower the subsidy cost per unit to HUD.

1. Statutory Authority

Section 206(g) of the National Housing Act, added in 1968, authorizes GNMA to guarantee the timely payment of principal and interest on securities which are (1) issued by any issuer approved by GNMA for this purpose and (2) based on and backed by a trust or pool composed of mortgages insured under the National Housing Act. The statute further provides that GNMA shall collect from the issuer a reasonable fee for any such guaranty and shall make reasonable charges for the analysis of any trust or other security arrangement proposed by the issuer.

This statutory authority has been used to implement a sizeable and very successful program of mortgage-backed securities issued by mortgage bankers for FHA-or VA-insured single family loans. In addition, a somewhat smaller program has been implemented for multi-family project loans, where there is usually a separate issue of securities for each FHA-insured project mortgage loan. Basically, we are proposing an adaptation of the existing multi-family MBS program, to recognize the HFAs as eligible issuers and to make it more feasible to use pools of multi-family loans.

2. Rationale for Use of GNMA Guaranty

The basic reason for the use of the GNMA guaranty on HFA bonds, via the mortgage-backed securities route, is to improve investor confidence in HFA notes and bonds. In theory, the same combination of underlying protections (FHA co-insurance with HFA reserves and the State moral obligation) could be offered directly to the investors, and their security would be the same as GNMA's. We believe that such a combination of security elements would serve to improve the competitive position of FHA debt obligations in the capital markets and increase the volume of such obligations which could be absorbed; however, in light of current market conditions, we believe that such a combination, without a more readily apparent security device, would not achieve any significant improvement in the interest rate at which such obligations could be marketed. The addition of the GNMA guaranty to the HFA bonds should produce a very significant decrease in interest rate, because investors would immediately recognize the increased security level. Also, an advance commitment by GNMA to guarantee the take-out bonds should substantially reduce the interest rate on the interim bond anticipation notes, since doubts as to the agency's ability to market the ultimate bonds would be greatly alleviated.

As explained above, this guaranty would produce no net cost to the Federal government. Using it would produce a much lower interest cost on bonds which simply must be sold in one way or another. If the State agencies are not able to convert the existing $1.75 billion in outstanding BANs into definitive bonds, it will destroy absolutely their ability to raise any further capital for housing development. But in view of the severe restrictions that the market is presently imposing on the size of any one bond issue, it could take literally years to work off this "overhang" and continuous brushes with the brink of default are likely to occur. Use of the GNMA guaranty would at least remove the risk of inability to sell bonds at all, while greatly lowering interest costs, and it may also help to some degree with the volume problem.

3. Requirements for Agency Eligibility

GNMA would define certain minimum requirements for HFAs to participate in the MBS program. In addition, each time an agency wished to use GNMA backing for a particular bond issue, it would have to satisfy GNMA that each mortgage loan to be included was co-insured by FHA and that the HFA had sufficient reserves or other means of covering the uninsured portion of the particular bond issue. Alternatively, part or all of the uninsured portion of the issue might be secured by a funded State insurance program or as general obligations of the State itself, where such authority exists.

In brief, the intention of this proposal is to protect GNMA completely against any risk of loss; the HFAs recognize that they will have to provide GNMA with adequate guaranty fees and other assurances against loss. The specific mechanisms to accomplish this goal would probably vary from State to State and would best be worked out in discussions with GNMA.

4. <u>"Pass-through" vs. "Bond-type" Securities</u>

The MBS program permits the securities sold to the investors to take either of two forms: (1) a mortgage-like security in which the monthly payment of principal and interest (less the servicing fee and the GNMA guaranty fee) is "passed through" to the investor each month; or (2) a "bond-type" security on which interest only is paid semi-annually and the full principal is paid at a specified maturity date. So far, all multi-family MBSs issued by private mortgagees have been "pass-through" securities, while FNMA and FHLMC have issued "bond-type" securities.

The "pass-through" securities are considered to have a distinct marketing disadvantage in the taxable market, because of the monthly payment feature; and such an instrument is completely unknown in the tax-exempt market. Use of the "bond-type" security by HFAs, therefore, would be far preferable; it would be feasible, because HFAs traditionally have combined several mortgages, each making monthly payments of principal and interest, into a single bond issue under which semi-annual payments are made to the bondholders. The present administratively-set restrictions on the use of "bond-type" securities would have to be appropriately modified, but there does not seem to be any statutory obstacle to using this route for HFAs.

5. <u>Potential for Project "Work-outs"</u>

One of the serious disadvantages of the present multi-family MBS program is that it leaves the mortgagee/issuers virtually no flexibility to enter into forebearance or modification agreements with their borrowers if the underlying mortgage loans experience difficulty. The program requires, for economic reasons, that any defaulted loans be assigned to FHA for insurance purposes as soon as permissible.

In our proposed HFA version of the MBS program, however, we believe that this problem can and should be avoided. The underlying mortgages will be co-insured, rather than fully insured by FHA, so that the HFAs will have a continuing loss exposure and, under the co-insurance format we are proposing, they will also have an incentive to advance cash to keep the projects out of foreclosure. There should be no need, therefore, for any requirement in either the Section 244 regulations or the MBS regulations that the co-insurance be called upon at the earliest permissible date. It will be important to coordinate the regulations and procedures under the two programs on this point, but we believe this is possible and that the flexibility needed to reinstate defaulted mortgages, wherever feasible, can be maintained in an HFA-MBS program.

6. <u>Advance Commitments for GNMA Bond Guaranty</u>

We are proposing that the GNMA backing be applicable only to definitive bonds issued by HFAs, and we believe that this will be of great assistance in enhancing the marketability of, and thereby lowering the interest cost on, State agency bond issues. We are not proposing to use the MBS vehicle for notes issued to cover the construction period, because this would involve GNMA in evaluating the construction risks and the adequacy of the agency's coverage thereof, and also because this does not seem to be necessary in the marketplace today. (In addition, it is possible the FHA co-insurance might not be in effect during the construction period, as discussed above.)

But there clearly has been a marketplace problem in issuing BANs where the ability of the agency to sell the bonds needed to ultimately pay off the notes is uncertain. In order to alleviate this problem in cases where the ultimate take-out is intended to be GNMA-backed bonds, we propose that GNMA issue conditional commitments (or certificates of eligibility) to HFAs for specific projects before the notes for those projects are sold. These advance commitments, of course, would be conditioned on the agency's continuing to meet the GNMA eligibility requirements at the time of the bond sale and its providing at that time the agreed-upon guaranty fees and other assurances required by GNMA. Again, we believe that a mutually satisfactory mechanism of this type can be worked out with GNMA staff based on similar procedures in other programs. (It may also be necessary, for mechanical reasons relating to the customary method of selling bonds, to use GNMA "construction loan securities"; we are not requesting this and would work with GNMA staff to avoid this route, if at all possible.

7. <u>Combination with Other Alternatives</u>

As mentioned previously, the Section 244 co-insurance program is an absolute prerequisite to use of the MBS program, since by statute MBSs must be backed by mortgages which are FHA-insured, FmHA-insured or VA-guaranteed. In addition, the multi-family

MBS program could, at the option of HUD, be combined with one of the other alternatives discussed in the next section. For example, the MBSs issued by the HFAs could be taxable bonds receiving an interest subsidy under Section 802(c)(2), in order to give the HFAs access to the corporate bond market. Or FNMA could purchase the GNMA-backed HFA bonds and raise the funds needed to do so in the corporate market. Either of these combination routes would make additional capital sources available to HFAs, while also serving to reduce the volume of tax-exempt borrowings.

The obvious disadvantage of such combinations is further complexity in designing and implementing a new program. We are not enthusiastic, therefore, about such further combinations, but we do think they could be made workable with a sufficient effort. We would be most willing to develop them further, if this is of substantial interest to HUD.

III. OTHER POSSIBLE ALTERNATIVES FOR FEDERAL ACTION

The following possibilities for Federal action are also of interest to us, particularly the use of taxable HFA bonds coupled with interest differential payments by HUD under Section 802(c)(2) of the Housing and Community Development Act of 1974. At this point in our investigations, however, they appear either to present significant potential delays in implementation or to raise major policy questions on which opinion is likely to be strongly divided. Therefore, we are not including them in our major recommendations at this time. We are most willing, however, to explore any of these alternatives further (especially the Section 802 taxable bond option), if they are of substantial interest and appear workable to HUD.

A. Taxable Bond Option under Section 802(c)(2)

The principal benefit of using taxable HFA bonds with HUD grants to cover the higher interest cost would be to give HFAs access to the corporate bond market. This should provide some relief from the oversupply problem in the municipal bond market, where the number of debt issues has been increasing while some traditional investors have withdrawn from the market. Because of the much larger amounts of capital which are generally available in the corporate market, the severe limitation presently existing on the volume of HFA issues would be alleviated. Also, because of the narrowing differential between taxable and tax-exempt securities of similar quality and term, use of the full 33-1/3% interest grant might actually produce a slightly lower net interest cost to the HFA than a tax-exempt issuance. Even on this basis, however, interest costs to the HFA would still be high (probably between 7.5 and 9%), because there would be no perceived improvement in the security of the investment.

We would strongly recommend that HUD take action to implement the interest grant portion of Section 802 as soon as possible, at least on an experimental basis. Ideally, it should be coupled with the use of FHA co-insurance under Section 244 and GNMA mortgaged-backed securities. In this event, of course, the MBSs issued by the agencies would be taxable, but because they would also be fully secured in the hands of the investors, the net interest cost to the HFAs should be much lower. We believe this combination approach could be particularly useful in times such as the present, when the municipal market is at its capacity, because it takes the basic top-grade security recommended above and makes it saleable also in the taxable market.

We have not included Section 802(c)(2) as part of our two basic recommendations, however, for three reasons:

(1) We are concerned that it will take much longer to implement than the co-insurance and MBS programs, because there is no programmatic precedent which can be adapted;

(2) It requires direct budgetary outlays, on a continuing basis, and will therefore increase Treasury borrowings; and

(3) Even if implemented right away, it would solve only a small part of the present HFA "overhang" problem, since the recent $15 million appropriation is probably sufficient for only about $400 million of bonds.

Despite these drawbacks, we urge you to implement taxable bond interest grants as quickly as possible, and we volunteer to assist you in this effort. We simply do not want to have the co-insurance and MBS proposals in any way delayed while Section 802(c)(2) is being analyzed and implemented.

B. Guarantee of HFA Bonds under Section 802(c)(1)

Obviously, a direct guarantee of HFA bonds by HUD would be of major assistance with both the interest rate and the volume problems. CSHA strongly supported the passage of this legislation and still believes in this concept. We recognize, however, the likely resistance of HUD and the Treasury Department to use of this route. Also, Section 802(h)(2) appears to require that any bonds receiving guarantees must be taxable, which would presumably offset the advantage of the guarantee in terms of interest rate. Therefore, use of the Section 802 (c)(1) guarantee as a practical matter would also require the use of Section 802(c)(2) interest grants, which adds another level of complexity and raises the policy concerns discussed above relative to Section 802(c)(2).

C. GNMA Purchase of HFA Mortgages ("Tandem Plan")

The Emergency Housing Act of 1975 added Section 313(h) to the National Housing Act, which authorizes GNMA to purchase "conventional" multi-family mortgages which either have a loan-to-value ratio not in excess of 75% or are insured by a qualified private mortgage insurer or a state insurance corporation approved by GNMA. Few if any HFA mortgage loans could meet these requirements at the present time (and to modify significantly the loan-to-value ratio on such mortgage loans would have severe programmatic drawbacks) and therefore this possible vehicle does not seem to us to be of any general help to HFAs in the near future. Creation of more State insurance programs could change this situation.

Both Section 313(b) (part of the 1974 "Brooke-Cranston" legislation) and Section 302(b)(1) (the older and more general "Tandem Plan" authority) authorize GNMA to purchase mortgages insured under the National Housing Act, which would include mortgages co-insured under Section 244. The recent HUD appropriations act includes $5 billion for purchase by GNMA of mortgages under any part of Section 313. Conceivably, therefore, state agencies could insure their mortgages under Section 244 and then sell them to GNMA under the Section 313(b) version of the Tandem Plan for permanent financing.

But there are several serious problems in trying to use any form of the Tandem Plan for HFAs:

(1) Section 302(b)(1) prohibits GNMA from purchasing mortgages offered by a State instrumentality. (Perhaps this problem could be solved by having the HFA sell its mortgages to a third party, who would then re-sell them to GNMA, if this process has some substance to it.)

(2) GNMA would then have to raise the necessary capital to buy the mortgages. If it did so by issuing MBSs in its own name, the interest rate could not exceed approximately 7.25%, under Section 313(d)(1); if sold on the open market, this would mean the MBSs would sell at a very great discount. A similar discount problem would be caused if GNMA re-sold the mortgages to FNMA. Alternatively, GNMA could borrow from the Treasury or the Federal Financing Bank, but this would increase Treasury's need for capital. Another alternative would be for HFAs

to sell their own bonds, use the proceeds to purchase GNMA-issued MBSs and pledge the MBSs to secure their bonds; but, as the statute presently stands, this would require the agencies to sell their bonds at 7.25%, less their own spread.

(3) Because there are many other calls on the $5 billion in Tandem Plan funds, this would at best be only a partial solution for HFAs.

(4) The basic statutory authorization in Section 313 expires on July 1, 1976, except as to commitments to purchase entered into before that date.

(5) Sale of HFA mortgages to GNMA would eventually remove HFAs from the servicing of these mortgages. This would reduce both their income and their ability to effectively regulate and monitor the management of their developments. Again, we are not recommending this route at this time, but would be willing to explore it further with HUD and GNMA staff.

IV. CONCLUSION

State housing agencies are at a crossroads. Either they will continue to be effective, responsive public bodies initiating and financing the development of housing, or they will shortly become relics of a bygone era. Which course they will take is not entirely in their power to decide - HUD's action or inaction in the very near future will in all probability decide this issue for them.

We respectfully, but urgently, request immediate favorable action by HUD. We have put considerable time and effort into exploring all possible vehicles for Federal action, and we sincerely believe that the combination of FHA co-insurance and GNMA mortgage-backed securities is the best route, considered from all points of view. We are more than willing, however, to consider any changes in these two programs you may wish to propose from the format presented above, or to explore any other alternatives. We ask only that you respond to this proposal as quickly as possible. We stand ready and willing to begin working with you at the earliest possible moment.