

# ***Managing Federal Credit Programs in the Information Age: Opportunities and Risks***

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The private sector is adopting new information technologies at a rapid pace. By contrast, most federal credit agencies tend to use information that may not be as timely, detailed, or validated. Advances in private sector information systems offer the opportunity for federal agencies to purchase high-quality systems at reasonable cost. These private sector advances also create risk to federal credit agencies, especially if the government becomes the major provider of credit in a market that lacks good information about its business such as the home mortgage market. This article assesses the state of federal credit information and suggests possible improvements in program design and management.

## **I. INTRODUCTION: INFORMATION-BASED MANAGEMENT SYSTEMS AND THE GROWING DISPARITY BETWEEN THE PUBLIC AND PRIVATE SECTORS**

The management of federal credit programs, always a demanding task, is further complicated by today's rapid developments in technologies and markets and by a continuing debate over the role of government generally and some credit programs in particular. This article presents a review of emerging issues regarding information about credit portfolios, incentives of participants in the delivery system for federal credit, and the impact of those issues upon federal credit management.<sup>1</sup>

The research for this paper included interviews with federal credit managers and policymakers and private sector financial services firms. Participants in the Federal Credit Institute's 1996 Workshop on Promising

Practices for federal credit programs also contributed numerous insights.

The research reveals increasing disparities between the public and private sectors. These disparities relate to (1) effective utilization of information-based systems; (2) creation and implementation of constructive relationships that give partners performance-based incentives to provide credit or other financial services properly and efficiently; and (3) development of learning-based management to provide credit in the forms most appropriate to program purposes.

Conclusions of this article may be summarized as follows:

- The private sector is developing new information-based systems at a rapid pace. These systems offer opportunity to federal credit managers, who now have access to new information management capacity, often at low cost.
- An increasing number of lenders and financial

services companies use high-quality information systems. This creates risk to federal credit programs in areas where the government may be the only major provider of credit that lacks good information about its business.

- Risk to federal credit programs can take a number of forms. For example, the new systems may permit private lenders greater opportunity to attract creditworthy borrowers away from federal programs, thereby leaving the government with an unexpected volume of losses from less creditworthy borrowers. Also, to the extent that disparities in capacity between private and public sectors become more pronounced, constituencies may begin to question the value of particular programs.

- New technologies have forced private financial services firms into a continuing process of reconfiguration of activities and products; to keep up with these technologies and the marketplace, the government too must become more flexible. Pilot tests of alternative credit products and delivery systems can generate information that leads to continuing improvement in program performance.

- Today, federal managers may be impeded by law from designing effective incentives and relationships with the third parties whose performance determines success of credit programs. New information-based systems and well-designed pilot tests can help to demonstrate to policymakers the benefits of considering new ways of doing business.

## II. INFORMATION ABOUT CREDIT PORTFOLIOS

### A. The Need for High-Quality Information

Federal credit agencies need high-quality information about their portfolios for three basic reasons: (1) to avoid costly program failures; (2) to facilitate cost-effective management strategies; and (3) to provide better service to borrowers.

#### 1. Avoiding Program Failures

A major responsibility for federal managers is to avoid costly program failures. Financial losses waste taxpayers' money. Through a variety of processes such as the annual reestimation of credit subsidies for the federal budget, unexpected program failures also can result in constriction of program resources in future years.

Information is key to avoiding program failures. Managers need to know which parts of their programs can or will cause financial losses. High-quality information can help managers to anticipate potential risks and can help them to manage unavoidable problems. Perhaps most important for some programs, high-quality information can help to prevent unnecessary

compounding of losses.

Ginnie Mae maybe the leading federal credit agency today with respect to quality of information about its portfolio. That portfolio consists of over half a *trillion* dollars of mortgages that are pooled and used to back securities that Ginnie Mae guarantees. In 1989 Ginnie Mae recognized billions of dollars of losses from mortgage defaults. The agency then moved promptly to build two management information systems, to track the performance of servicers, i.e., issuers, of its mortgage pools and the lenders who originated the mortgages in those pools. These are known as the Issuer Portfolio Analysis Database System (IPADS) and the Correspondent Portfolio Analysis Database System (CPADS).

IPADS provides Ginnie Mae with information about the state of the portfolio of mortgages in each pool that Ginnie Mae guarantees. Ginnie Mae updates pool information monthly, including delinquency and default rates, and loan-level information quarterly. Through use of financial ratios, Ginnie Mae is able to use IPADS to identify performance of issuers and their servicing of mortgage pools that falls outside expected parameters.<sup>2</sup>

CPADS helps Ginnie Mae monitor the originators and sellers of mortgages into Ginnie Mae pools. The system tracks loans that originators may sell to correspondent lenders and provides a continuing report on delinquency and default rates of each loan originator. These rates are compared with normal rates for lenders of similar size and loans of similar age and location.<sup>3</sup>

Agency officials believe these systems have been extremely cost-effective. The payoffs come in terms of potential losses avoided through early intervention with issuers and originators of mortgages for pools that show troublesome characteristics.<sup>4</sup>

The U.S. Department of Education is also working with Coopers & Lybrand, the private contractor that developed IPADS and CPADS with Ginnie Mae. ED would use its new system to monitor the performance of the post-secondary educational institutions whose students are eligible to receive federal financial assistance, including guaranteed student loans.

The private sector is adopting new information technologies at a more rapid pace than the government. While this creates opportunities for agencies to purchase quality systems, if the government does not keep up, growing disparities may create new forms of financial vulnerability. For example, consider the single-family mortgage insurance program of the Federal Housing Administration (FHA). The residential mortgage market is undergoing profound transformation. New information technologies are driving a consolidation of mortgage lenders as mortgage originators and servicers continue to realize economies of scale.<sup>5</sup>

New information technologies also have facilitated the development of automated underwriting systems that permit the conventional mortgage market to serve an increasing number of borrowers of a type previously served by FHA. Credit scoring models, validated on the basis of literally millions of mortgages in some cases, permit the conventional market to distinguish clearly between creditworthy lower-income borrowers and those who are unlikely to be able to handle the burdens of their mortgage loans.<sup>6</sup>

The FHA single-family program is likely to lose creditworthy borrowers to the extent that the conventional market offers them attractive mortgage products. The FHA program currently lacks sufficient information to determine whether and to what extent the dynamic conventional market is likely to saddle the government with an unacceptably high proportion of borrowers who show a propensity to default on their mortgage loans. The FHA also lacks real-time information that might help credit managers detect deterioration in performance of previously responsible lenders who have come under stress as a result of competition in the mortgage banking industry.

Thus, new information technologies provide significant new opportunities for federal managers to detect financial risk in their portfolios and deal with it in a timely fashion. At the same time, some programs could run substantial new risks when their level of information management lags substantially behind private lenders using new systems as a way to compete for the business of creditworthy borrowers who once found themselves confined to the market for government loans.

## **2. Facilitating Cost-Effective Management Strategies**

High-quality information is necessary to implement legal requirements. The U.S. Department of Education, for example, receives some 10 million applications each year through its guaranteed and direct student loan programs. The department matches these applications internally, both to check if a borrower earlier defaulted on a student loan and to enforce statutory limits upon the annual and cumulative total amount of loans that an individual student may receive.

The department also matches applications against other government data bases, including the Credit Alert Interactive Voice Response System (CAIVRS), to determine whether applicants have defaulted on other federal loans. ED matches applications against data bases of the Social Security Administration (to verify accuracy of Social Security numbers and citizenship status of applicants) and the Immigration and Naturalization Service (to verify the status of non-citizen applicants).

The department has found computerized matching systems to be cost-effective. Internal matching for prior defaults enables the department to avoid an estimated \$230 million annually in probable future defaults. It is not possible to quantify some of the benefits, such as the number of defaulted student loans that are matched annually through CAIVRS and then repaid by borrowers who seek to participate in other federal credit programs.

High-quality information also is the necessary precondition for performance-based management systems. In this regard, the federal bank regulatory agencies appear to have developed significantly more advanced systems than most federal credit agencies. Federal bank regulators have developed a risk-based rating system, that depends on information gleaned from examinations of financial institutions and report information. They use this information to categorize the institutions according to the risk of financial failure and to allocate scarce supervisory resources to supervision of the most risky institutions.<sup>7</sup>

The Federal Deposit Insurance Corporation, insurer of the deposits of most banks and thrifts in the United States, has a Division of Insurance that is charged with responsibility for anticipating forms of risks and their possible impact upon the financial soundness of insured institutions. Such financial early warning systems would be especially appropriate for federal credit programs that need to detect concentrations of risk, such as might be posed by lenders or borrowers in a particular geographic area or segment of the economy and that could precipitate multiple losses at the same time.

An increasing number of federal credit agencies are beginning to develop information and systems that could be used as the foundation for performance-based management systems. For example, the U.S. Department of Education is implementing a system to monitor the financial capability of some 7,500 educational institutions that are eligible to participate in the guaranteed or direct student loan programs. The department has developed regulations that measure five elements of financial health: financial viability, profitability, liquidity, ability to assume additional debt, and capital resources. The department ranks the schools into categories ranging from exemplary to immediate problem institutions. It can then allocate its supervisory resources according to the classification of a school.<sup>8</sup>

The Small Business Administration is contracting with Fair, Isaac and Company to provide credit scores for small business borrowers that apply for an SBA-guaranteed loan through the agency's new low-documentation program. Such credit scores can help the SBA monitor and supervise lenders who originate a disproportionate share of loans with low credit scores. Conceptually at

least, the SBA eventually might be able to use credit scores to detect changes between creditworthiness of applicants that a lender serves through its conventional loan portfolio and those that it serves with SBA-guaranteed loans.

The absence of high-quality information can impede the ability of a federal credit agency to adopt performance-based management systems for program participants. The U.S. Department of Housing and Urban Development, for example, has adopted an innovative Special Workout Assistance Team (SWAT) approach to deal with the most troubled multifamily projects.<sup>9</sup> The variable nature of information about the actual condition of projects, however, has meant that a high proportion of those screened are not selected for assignment to SWAT for action.

### **3. Using Information to Provide Better Service to Borrowers**

High-quality information might help federal managers serve their borrowers better. Federal managers can use information to monitor program participants whose loan origination and servicing practices result in inordinate defaults for a particular program.

The U.S. Department of Veterans Affairs applies Ginnie Mae's CPADS to identify mortgage lenders who generate unsound loans because of poor underwriting. The VA uses the monitoring process to help protect veterans against unnecessary defaults and foreclosures on their VA-financed homes. Using CPADS, VA can compare lender performance to other lenders in the same locality and thus target its scarce audit resources.<sup>10</sup>

Starting in May 1998, the VA began working with Fannie Mae and four servicers of VA mortgages to test Fannie Mae's loss mitigation system, known as Risk Profiler. This system permits a lender to score loans and identify delinquent loans with low scores where early intervention is most likely to help avert default.

The four servicers, ranging in size from one of the largest to one of more modest size, will apply the system to some 500,000 loans, out of roughly 3 million VA-guaranteed loans outstanding. The servicers will service half of the loans in their usual manner and the other half using Risk Profiler. The experiment is hoped to produce savings in managing delinquencies of high-score loans (i.e., those that tend to reinstate with no or little intervention) and in reducing defaults that otherwise would require costly attention. If it proves successful, then borrowers also will benefit, because of the ability of improved servicing to mitigate losses and reduce the likelihood of a foreclosure.

Such examples of the application of high-quality information systems to enhance service to borrowers are

not easy to find in federal credit programs. It is private lenders who use information technologies extensively, to screen loan applicants, enhance servicing, and to build relationships with customers.

The design of federal credit programs may in fact preclude extensive federal application of technologies to enhance customer service. First, the government credit agency may lack a direct link to borrowers; programs are frequently designed to deliver credit through intermediaries such as lenders who originate and service federally guaranteed loans. Direct federal loan programs also may rely upon intermediaries, such as the schools that originate federal direct student loans or contract servicers.

Second, the enabling legislation for a credit program may not let government managers adjust underwriting standards to protect against financial loss. Indeed, most major federal credit programs are directed toward classes of borrowers or activities or offer loan terms that may not otherwise be available through the commercial market.

Borrowers from the Small Business Administration's Section 7(a) program or programs of the U.S. Department of Agriculture are eligible for federal loans or loan guarantees only when they have been denied similar credit by private commercial lenders. Some programs are structured legally to be an entitlement: the federal student loan program (Title IV of the Higher Education Act) for example, requires the government to extend credit to any eligible student attending an eligible educational institution. As a result of such public policies, some federal agencies do not place a priority on the use of the types of information-based systems that the private sector uses to enhance borrower service.

### **B. Information Based Systems: Possible Next Steps**

For several agencies, developments in the private sector offer an easy opportunity to gain important program-related information. The FHA single-family program and, to a lesser extent, the VA mortgage loan guaranty program would benefit from collection and analysis of credit scores for each borrower or loan. These scores are readily available in the market. They can be obtained inexpensively at origination of the loan or applied retrospectively.<sup>11</sup>

The most immediate purpose of analyzing credit scores is to create a simple financial early warning system. If the FHA can monitor the average level of credit scores on a real-time basis, it can detect unexpected drops in average credit scores that might signal an increase in financial risk to the insured portfolio. This could occur if private lenders are using credit scores in their financial analysis to attract creditworthy borrowers away from the FHA program.

Other benefits of credit scores might occur in the future. The FHA could assess the average credit scores of borrowers who obtain their loans through particular lenders. It might then increase the review of such lenders to assure that prepurchase disclosures and counseling have been available, for example. At some point, as the FHA learns from the financial performance of borrowers with differing credit scores, the agency may be in a position to recommend or require special services for those groups with the highest propensity to default.

The Small Business Administration is another agency that would benefit from application of credit scores. While the agency has begun to use credit scores in some areas, it could expand this use to the entire Section 7(a) program at little cost.

Again, the most immediate program need may be defensive. Commercial banks that make small business loans are increasingly applying credit scoring to their loan origination activities. They may thus identify more creditworthy small business borrowers and send fewer creditworthy borrowers into the SBA program. The SBA can use credit scores as an inexpensive early warning signal in case the financial quality of the portfolio begins to decline.

Later, the SBA may also be able to use credit scores to enhance service to borrowers, for example, by identifying those that may have most need of technical assistance to handle their loans. Because credit scores of small businesspeople correlate with their propensity to repay debt, the SBA also may be able to use credit scores as information for managers who are responsible for supervision of the performance of lenders in the three major categories: SBA's preferred, certified, and guaranteed lender programs.

The Department of Education already is taking important steps to enhance the quality of program information. Implementation of an IPADS system will help the department allocate its scarce supervisory resources more effectively. A subsequent step might be to integrate analysis of lender performance through development of a CPADS-type system. ED could track performance of all of the loans that each lender originates, in much the same way that Ginnie Mae and VA track the loan performance of lenders who originate and sell loans to other lenders.

### **III. THE DELIVERY SYSTEM FOR FEDERAL CREDIT: INCENTIVES AND RELATIONSHIPS**

Effective management of a federal loan or loan guarantee program depends upon the quality of the relationships among federal managers, participants in the delivery system, and the borrowers themselves. One

critical element affecting the quality of relationships is the legal framework—laws, regulations, and contracts—in which the parties operate. Another critical element involves the extent to which incentives of the parties are aligned with the public purposes of the program. Misaligned incentives often require application of “command-and-control” regulation to curb abuses; this approach is likely to be a poor substitute for program design based upon constructive use of incentives to carry out public purposes.

#### **A. The Legal Framework for Federal Credit Programs**

The legal framework for a government program consists of a descending series of rules, from the Constitution to statutory law enacted by the Congress to regulations enacted by the agency to the contracts prescribed by an agency for use in the program or signed by the agency with program participants or borrowers.<sup>12</sup> In many agencies the formal rules are supplemented by handbooks, informal practices, and written guidance such as ED's “dear colleague” letters and FHA's mortgagee letters. Judicial review is available to aggrieved parties; judicial decisions have resulted in significant changes to the implementation of many programs.

##### **1. The Constitution and Statutory Law**

The law shapes government credit programs so that they are different in significant respects from completely private lending transactions. Government managers may not make arbitrary distinctions among similar classes of borrowers, lenders, or other program participants. The potential that an aggrieved party will challenge government action means that an agency must be ready to provide clear justification for its decisions.

The requirement that the government provide due process means that a program agency faces the prospect of litigation if it attempts to apply sanctions or terminate a lender or other participant without adhering to fair procedure. In practice, federal agencies have tended to structure cumbersome processes that can consume large amounts of agency resources and sometimes require years of building a case before sanctions may be applied against a lender or other program participant who performs poorly.

The most difficult cases to enforce involve complicated patterns of fact or disputes about ambiguous or conflicting regulations. Poor performers gain special benefit from systems of dispute resolution that permit continuing participation in a program until they have exhausted all appeals have been exhausted. Examples of potentially resource-intensive and time-consuming



processes are those involving FHA's Mortgagee Review Board<sup>13</sup> and the procedures for limitation, suspension, or termination established by the U.S. Department of Education for the guaranteed student loan program.<sup>14</sup> A private lender may terminate or adjust a commercial business relationship for any of a number of business reasons, without engaging in extensive procedures.

The result of these legal requirements can be that a federal credit agency lacks access to the flexible incentives that are associated with market discipline in the commercial world. Evidence is found in Price Waterhouse's report on the failed HUD multifamily coinsurance program of the 1980s. The report finds that HUD used sanctions that were time-consuming to apply while ultimately offering little financial protection to the government. The department lacked "the power to immediately impose corrective measures on coinsurers who, through their actions, may prejudice the interests of FHA and GNMA."<sup>15</sup>

Government managers are tied to the law in a fundamental way. Unlike the ordinary private company, a federal program agency may not take action unless specifically authorized by law.<sup>16</sup> The enabling laws of a federal credit program may reflect a variety of economic and non-economic values. Moreover, the mix of values may change from time to time as new legislation is enacted. Federal agencies may have difficulty trying to manage the tension in their programs between doing good (i.e., supplying credit through or to particular constituencies) and doing well (i.e., administering a credit program without taking unacceptable losses).

Contradictions among laws governing a program may undercut the ability of a federal agency to enforce its financial interests through legal rights that otherwise would seem to be unambiguous. One federal judge reviewed the various laws enacted in the 1970s for HUD multifamily programs and concluded that HUD could not foreclose on a defaulted mortgage without taking account of other housing policy goals:

"While the project undoubtedly lacks financial promise, this alone is not enough to justify foreclosure. In exercising its admitted discretion, HUD must show more than a legal right to foreclose. HUD is not simply a banker. Before it acts because of default on a project...it must consider national housing policy and decide what further steps authorized by Congress it will take to assure continuity of the decent, safe, sanitary, low-cost housing then being provided." *Kent Farm Co. v. Hills*, 417 F. Supp. 297 at 301 (DC District Court, 1976).

Laws may be enacted without concern for the resources that are available for implementation. A panel of the National Academy of Public Administration reported that between 1980 and 1992, the Congress

broadened HUD's statutory mandates from 54 to just over 200 programs. In the same period, field staff decreased by 1,664 staff-years (13%) and headquarters staff by 932 staff-years (21%).<sup>17</sup> The gap between the law and the agency's capacity for implementation in this case was exacerbated by the multiplicity of statutory programs as well as their size.

Sometimes the appropriations process may emphasize values and activities that are not part of an agency's statutory mission. Federal credit programs in agencies as diverse as the U.S. Department of Agriculture and the U.S. Department of Veterans Affairs have found congressional policymakers to be reluctant to curtail some field office functions even when they could be more efficiently performed on a centralized basis. By contrast, the profit orientation of the usual commercial lender tends to create a direct correlation between the volume of financial services and the availability of resources to sustain them.

A number of laws help many credit programs work more efficiently. These include cross-cutting laws such as the Credit Reform Act of 1990, the Chief Financial Officers Act of 1990, and the Federal Debt Collection Improvements Act of 1996.

Other helpful laws permit credit agencies to establish limits with respect to the performance of lenders or other participants and to take effective action with respect to those who exceed the limits. Such laws include the 1990 amendments that require HUD to suspend mortgagees whose default rates exceed twice the standard deviation above default rates of loans originated by other mortgagees in the same market area<sup>18</sup> and the law that permits HUD to recover double damages in the case of diversion of multifamily project funds from authorized purposes.<sup>19</sup> The two HUD laws have two salient features: (1) They are directed to the poorest performers in the program, and (2) they permit an agency to ascertain violations and prove them relatively easily and quickly.

Changes in the law can have a dramatic impact upon the ability of a federal credit agency to manage its programs. Changes in the Higher Education Act have permitted the Department of Education to make remarkable progress in reducing the default rates of the federal guaranteed student loan program. By one measure, the Department reports that the default rate on guaranteed student loans dropped from 21.4% on loans originated in fiscal year 1989 to 10.4% on loans originated in FY 1995. The department's strengthened oversight led to removal of about 1,000 institutions from the program.<sup>20</sup> This halving of the default rate will have substantial positive effects for students who otherwise might be enticed to take on federal loans that they can't handle.<sup>21</sup>

## 2. Regulations

Agencies use regulations to help implement the laws that govern their programs. A number of agencies have used the regulatory process to shape relationships with the lenders or other participants in their programs.

An admirable example is the Small Business Administration's use of the regulatory process to create a three-tiered performance-based system of classification for lenders who participate in the Section 7(a) small business loan program.<sup>22</sup> Lenders with the best track records are permitted to join the Preferred Lender Program and originate loans up to a set volume each quarter, subject to later review by SBA. To become preferred lenders, they must have demonstrated lending ability and a record of relatively low loan defaults and losses to the program. Lenders at the next level may elect to join the Certified Lender Program. Certified lenders face slightly greater loan-by-loan scrutiny but again are monitored primarily on the performance of the loans they originate. Finally, lenders in the regular Section 7(a) loan program must submit individual loans for the SBA to evaluate on a loan-by-loan basis. The SBA can then monitor the performance of preferred and certified lenders and reclassify the lenders whose track records do not meet SBA standards.<sup>23</sup>

Agencies can use the regulatory process to mandate reporting requirements that help to indicate performance or capacity of a lender or other participant. The Department of Education, for example, requires participating educational institutions to submit regular reports on their financial responsibility to administer the department's programs for student financial aid.<sup>24</sup>

Agencies also can use the regulatory process to implement laws that permit the setting of standards for performance by program participants. A U.S. Department of Housing and Urban Development regulation permits termination of the approved status of a mortgagee that has a rate of defaults and claims in an area that exceeds 200% of the normal rate for that area, without resorting to the cumbersome procedures of the Mortgagee Review Board. If the mortgagee has a default and claims rate above 150% of the normal rate, HUD may place the lender on a credit watch list and will subject its activities to more intensive scrutiny.<sup>25</sup>

Implementation of such helpful regulations depends upon the availability both of appropriate authorizing legislation and of sufficiently supportive constituencies. Some agencies may perceive that their program constituencies consist more of lenders and other program partners than of the ultimate borrowers. For example, Elisabeth Rhyne conducted extensive research and interviews with respect to the SBA Section 7(a) business

loan program. She found that all her respondents placed lenders ahead of small businesses as beneficiaries of the program.<sup>26</sup>

This perception of beneficiary may make it difficult for federal managers to impose financial discipline on program partners, even when the result would be favorable to borrowers and taxpayers alike. Again, this is quite different from marketplace circumstances. The usual business corporation adopts a customer orientation, and its officers and directors have a formal fiduciary responsibility to serve the financial interests of the company and its owners.

## 3. Contracts

The final basic element of the legal framework is the written contract that governs the relationship between the federal agency and program participants or borrowers. Federal contracts tend to incorporate by reference the laws and regulations that govern the program. Along the way, the effect of rapidly changing laws may be an array of relationships with program participants and borrowers who are subject to differing contractual terms.

Like contracts in the private sector, federal contracts may include many detailed provisions. Available information may not be adequate, however, to determine whether a contract partner is complying with all the terms; even when and if violations can be detected, the agency may not have sufficient resources or even a mandate to enforce compliance. The problem of contract enforcement highlights the general proposition that command-and-control relationships are a poor substitute for properly aligned incentives between a credit agency and its program partners and borrowers.

Thus, Helen Dunlap, HUD Deputy Assistant Secretary for Housing Operations, reported on a HUD survey of single-family borrowers showing that many borrowers had excellent credit reports except for payments on their FHA-insured mortgage. Similarly, landlords may default on their FHA-insured apartment mortgages. They might even "have the money in the bank for the monthly payment, but they just simply haven't made it."

Ms. Dunlap concludes that borrowers are responding to expectations created by poor government supervision: "If nobody ever asks you for a monthly payment, you don't [necessarily] make a monthly payment after a certain point."

Part of this problem can be traced to HUD's relationship with mortgage lenders and the lack of incentive for lenders, especially with respect to multifamily mortgages, to manage loans as if their own

money were at stake. Because private firms would enforce contract terms on loans that they own, Ms. Dunlap viewed loan asset sales as one way for HUD to add value to defaulted loans and to the FHA fund.<sup>27</sup>

If the government fails to enforce covenants over a period of time, difficulties may arise in later efforts at enforcement. Thus, a prospectus for a sale of securities backed by a pool of federal loans include the warning:

“Past servicing of the Loans by ED and other Federal agencies has concentrated almost exclusively on the collection of principal and interest payments rather than the enforcement of other covenants contained in the Loan documents. . . . [A] significant number of those borrowers whose loans or financial statements were examined are not in compliance with such covenants. Although the Servicer intends to employ commercial servicing standards, no assurance can be given that failure by ED to enforce such covenants in the past has not. . . impaired the Servicer’s ability to enforce such covenants in the future.”<sup>28</sup>

## **B. The Incentives of Participants in Federal Credit Programs**

### **1. Program Design and the Government’s Reliance Upon Prescriptive Requirements**

The legal framework for government programs establishes quite different relationships from those found in the private sector. In the private sector, market discipline is enforced by rewarding good performers with valuable relationships, imposing more onerous terms on adequate performers, and ceasing to do business with poor performers.<sup>29</sup>

Private firms tend to specify clearly the rights and remedies of parties to a contract and provide for efficient means of resolving disputes. Continuing competition for business provides continuing motivation for partners and prospective partners to improve their performance. By contrast, government often lacks authority to reward good performers with more favorable relationships; enforcement of an agency’s legal rights or termination of poor performers also can be a protracted and costly exercise.

Instead of structuring and applying flexible incentives, the government often imposes prescriptive requirements upon program participants, which are expensive to administer and hard to enforce. Reliance upon detailed specification of tasks tends to penalize potential high performers who might achieve better results through more flexible approaches.

One such example is the regulation of the U.S. Department of Education that specifies detailed servicing requirements for lenders that participate in the

guaranteed student loan program.<sup>30</sup> Many of its prescriptions relate to requirements that the lender document that it actually engaged in servicing activities in the prescribed manner. None of the requirements relate to standards of performance in terms of the actual value added by diligent loan servicing.

Often the design of a credit program can prevent the federal credit agency from improving the form of its relationship with program participants. The most important feature in this regard is risk-sharing with private participants. When a private lender has its own money at stake in originating or servicing a loan, a government agency may be able to align the incentives of that lender or other participant so that the government’s financial interests are protected as well.

Here again, private sector models are instructive. Private lenders want to structure their relationships with their contract servicers to maximize cash flows from the serviced portfolio. They often accomplish this by providing that the servicer is paid a fixed percentage of all the cash flows that the lender collects from the portfolio. This incentive, essentially giving the servicer an equity stake in the performance of the portfolio, helps to align the servicer’s incentives to maximize the portfolio’s performance with those of the lender who owns the loans.

By contrast, if a lender originates or holds a loan that is completely or nearly completely guaranteed by the government, it may have little financial stake in the quality of its underwriting or servicing or collecting on that loan. The federal guaranteed student loan (GSL) program is a case in point. As one study observes:

“Although the GSL program makes heavy use of the nation’s private credit system, the private banks in the program act not as sellers in a market system but as administrative agents in a centralized bureaucracy.”<sup>31</sup>

In short, when the government establishes the relationship between a program and a lender or other partner, it must be sensitive to the incentives that it creates for that partner.

### **2. Lessons About Capacity and Incentives From the Experience of the Resolution Trust Corporation**

The Resolution Trust Corporation (RTC), although it was in a business different from the typical federal credit agency, was required to address familiar issues of great demands upon a limited institutional capacity. The experience of the RTC offers some valuable lessons, especially about the trade-off between the incentives of private parties who participate in government programs and the institutional capacity that the government requires for effective supervision of those parties.



At first, the RTC attempted to hire asset managers and compensate them according to the volume of assets that they managed or sold. This incentive structure required direct supervision by RTC officials and imposed great demands upon the agency's limited institutional capacity. Moreover, government officials often were tempted to substitute their own judgments for those of the private asset managers.

By contrast, when the RTC developed securitization or joint-venture approaches, these could be structured to reduce demands upon the government's own resources. The RTC entered into contracts with private partners that helped create a win-win outcome; the private partners could make money, but only when they acted to promote the government's interests as well. The RTC's securitization and joint-venture structures were able to align incentives of the private partners and the government, mitigating the oversight and control of individual asset managers. The contracts also helped to protect the private partners from long deliberations of government officials who might have been tempted to second-guess any of a myriad of decisions.<sup>32</sup>

Consider the difference between (1) placing assets into the hands of private contractors under a Standard Asset Management and Disposition Agreement (SAMDA), and (2) use of joint-venture partnerships.

*Contractors:* The RTC used over 100 so-called SAMDA contractors, and some 2,000 subcontractors, under three year agreements to manage and dispose of some \$40 billion of assets through individual asset sales, workouts, and settlements. These contractors and subcontractors received fees both for managing and disposing of properties. Their incentives did not necessarily coincide with the mission of the RTC.

RTC officials found that it was difficult to structure sufficiently strong and clear incentives for each of the private contractors. Fear of possible financial abuses meant that the RTC could not delegate asset management and disposition decisions freely to contractors. Supervision of SAMDA contractors and approval and supervision of their activities imposed significant burdens upon RTC in-house staff.

*Joint-venture partnerships:* The RTC developed joint-venture partnerships as a larger-scale way to deal with many of the more troubled assets, including multifamily and commercial properties and mortgages. The joint-venture partnerships provided for risk-sharing between the government and the private party in the form of equity-sharing. The winning qualified bidder became the general partner and holder of a specified equity interest in the partnership. The winning bidder, not the RTC, managed the partnership.

The winning bidder was compensated primarily

through its share of returns from the sale of assets or income from assets. The RTC was the limited partner with the right to receive a stated percentage of cash flows. The RTC developed contract terms to prohibit self-dealing and exceptional tax benefits and that helped to align the interests of the private joint-venture partner and those of the government.

The joint-venture partnership thus assured the private partner a significant share of net cash flows, but removed other interests of the private partner that could complicate the incentive structure. The RTC joint-venture partnerships were successful financially for the RTC, were easy to monitor, and imposed minimal burdens upon the institutional capacity of the agency.

For example, the RTC used a staff of five plus a contractor to oversee over 40 partnerships that disposed of about \$16 billion of assets. In some partnerships, the RTC structured the transaction so that a small part of the proceeds could be used to hire an accounting firm to monitor that the private partners were living up to the terms of their contractual agreements with the government.

The RTC experience shows how sound program design can greatly reduce the demands upon scarce supervisory resources. In other words, a federal agency can improve its programs and delivery systems if managers explore alternatives and learn lessons from each transaction.

### **C. The Incentives of Federal Program Managers and Program Constituencies and the Problem of Government Inertia**

One of the most powerful strategic tools available to a private firm is the ability to define and redefine its business to take account of changing opportunities and constraints.<sup>33</sup> The redefinition of a telephone company as a telecommunications firm or a bank as a financial services company may be essential to the institution's long-term survival. Yet few government agencies have seized upon changing technologies and public needs to transform their programs.

In part, this inertia seems to stem from incentives relating to government programs. Once the government begins a program and creates relationships with borrowers and lenders and other partners, then each of these parties accommodates to the pattern of relationships. Harold Seidman cautions:

"Difficulties occur when agencies and their clienteles develop a vested interest in the way things are done. New approaches are resisted for no other reason than that they require major modifications in existing administrative patterns or complicate constituency relationships."<sup>34</sup>

Seidman observes that modification of organizational behavior requires a form of leadership, exercised over a sufficient period of time, that may have been lacking in some agencies. As was revealed by several dozen remarkable innovations showcased recently at the conference on promising practices of the Federal Credit Institute, many federal credit agencies have begun to overcome such inertia. Many times the driver has been increased pressure to provide more services with fewer resources. Many of the better credit agencies have been led by first-rate officials who have been able to provide the needed leadership.

Despite the enthusiasm for reinventing government, federal credit agencies have only begun to consider the impact of changing technologies and new financial services upon the definition of the purpose of their programs and the available policy tools. One agency to begin this process is the U.S. Department of Housing and Urban Development, with its proposals to reengineer its multifamily programs and improve its capacity to deliver all mortgage insurance products.<sup>35</sup> At least for the moment, only the multifamily proposal has gone through the legislative process in some form; the recommendation to transform the FHA into a wholly owned government corporation, a more capable and flexible organizational form, failed to meet with acceptance by the necessary constituencies.

#### **D. Improved Design of Incentives: Possible Next Steps**

Effective management of incentives requires an agency to pilot alternatives and see how they work. The RTC was especially impressive as an organization that experimented, studied the results, and evolved continuing improvements in relationships with private partners. The loan guaranty program of the Department of Veterans Affairs also has devised a number of experiments, especially in the area of loan servicing.

For other federal credit agencies as well, servicing may be a good place to begin such pilot testing and experimentation. Also important is the need to institutionalize a process of continuing benchmarking against the rapid progress that private lenders are making in credit management.

One potential source of benchmarking information might be the credit rating services such as Standard & Poor's or FitchICBA. These companies have developed protocols and procedures for evaluating the quality of servicing of particular kinds of loans, such as single-family mortgages or student loans.<sup>36</sup> At reasonable cost, a federal credit agency may be able to commission an evaluation of direct loan servicing or may be able to recommend such an evaluation as a diagnostic device for

private servicers of guaranteed loans whose performance appears substandard and whose volume of serviced loans may represent an unacceptable concentration of risk.

In some cases the Congress itself has mandated that an agency experiment with alternative approaches. The Congress has required, for example, that the Small Business Administration conduct a pilot private sector loan servicing demonstration program and evaluate its costs and benefits compared to in-house servicing of such loans by SBA.<sup>37</sup>

Other aspects of the loan administration process also may lend themselves to pilot testing. The Department of Housing and Urban Development faces continuing questions with respect to the most appropriate means of dealing with its troubled portfolio of multifamily housing supported both by Section 8 rental assistance and by federal mortgage insurance. In 1996 and 1997 the Congress authorized two limited forms of demonstration; it may be appropriate to revisit this issue and propose testing and evaluation of a wider range of options. It may be that one approach is not appropriate for all types of multifamily properties. The key is to learn lessons from pilot programs so that the department can evolve increasingly valuable incentive structures for its program partners.

Finally, the Export-Import Bank of the United States may want to pilot proposed new forms of risk-sharing. Given the lessons of other credit agencies, ExIm needs to be sure that any standardized approach in fact leads to significant sharing of financial risk with private parties and that performance is thereby improved.

### **IV. EFFECTIVE MANAGEMENT OF FEDERAL CREDIT PROGRAMS**

Effective management of federal credit programs depends both upon timely access to high-quality information and upon a well-designed program that involves a mutually beneficial and effective structure for the relationships among the government agency, program participants, and borrowers. It is not easy to supervise a federal loan or loan guarantee to protect against unnecessary financial losses.

The burdens on effective federal management are especially great because of the long maturities that characterize the loans or guarantees provided through many programs. FHA single-family mortgage insurance remains in force for up to 30 years and multifamily insurance for 20 or even 40 years. The student loans or loan guarantees of the Department of Education may average up to 13 years in maturity, and student loan guarantees of the Department of Health and Human Services for health professionals may average 18 years.

Loans guaranteed by the Small Business Administration may have maturities that average up to 20 years.<sup>38</sup>

Federal agencies have had experience with several approaches to effective management: open competition to provide financial services for a federal credit program, performance-based classification of lenders or other program participants, financial-risk sharing, competition to select joint-venture partners, and—less often but especially useful in the current environment—changing or redefining the purposes of a credit program or the organizational structure of the program agency.

#### **A. The Benefits of Competition to Select High Performers**

Management can be complicated if the design of a federal credit program combines government assumption of financial risk and delegation of financial decisions to private parties. Such a combination can bring to play the worst of both the public and private worlds. While private partners may lack direct economic incentives to protect the financial interests of the government, they will also have other interests that make them unresponsive to direction from government program managers.

One solution to this problem is to inject competition into the relationship. The program agency might be authorized to select private companies to provide specified services such as loan servicing, collections, auditing, lender and loan tracking, and asset disposition. The term of the contract should be long enough to permit vendors to offer a reasonable price, but short enough to permit the agency to from time to time select new vendors whose performance may be better than the performance of the incumbent.

The Department of Education has evolved a performance-based relationship with private loan collection services. As with any good performance-based system, the measure of performance includes qualitative as well as financial factors. The contract with collection services provides incentives both to collect loans effectively and to treat borrowers with respect. The department oversees performance by each contractor and uses the relative performance of the contractors to help decide upon allocation of the flow of new business.

The department has found that a substantial majority of student loan defaults occur when the borrower misses the first payment. Thus, much of the work of collection services involves contact with the borrower at the point just before the first payment becomes due. The borrower then has an opportunity to clarify issues concerning the obligation to repay the loan, and also has a sense that loan payments are being monitored. Contact with potentially high-risk borrowers can be especially fruitful.

#### **B. Performance-Based Classification of Lenders or Other Program Participants**

Another approach to effective management might be based upon the three-tier system for lenders developed by the Small Business Administration. As program participants gain experience and a favorable track record, they might graduate from a process of tight restrictions and close supervision to a more flexible relationship with the federal credit agency.

The growing availability of performance information to federal managers can enhance the utility of this approach. A two- or three-tier system is especially attractive because of options other than cumbersome suspension or termination actions; lenders or other participants are merely stratified and supervised according to the extent that they protect the financial interests of the government.

Once the available information is timely and accurate, federal credit managers can gain assurance that a measured relaxation of prescriptive controls will not result in unacceptable financial losses for the program. In some programs, the Congress might even want to authorize federal agencies to set lower premiums for high performers such as lenders who originate and service loans that exhibit below-average default rates.<sup>39</sup> Innovative programs such as risk-sharing or low documentation loans or new servicing arrangements might begin as options for lenders and other partners who are classified as high performers.

From the perspective of the constituents of a credit program, classification of lenders or other participants by financial performance can have an added benefit. If the incentives created by stratification help to improve the performance of the majority of lenders, then the gains can be reflected in lower credit subsidy rates. The result can be an increased ability to serve borrowers at a time when appropriated funds are increasingly scarce for many credit programs.

#### **C. Risk-Sharing With Lenders or Other Partners**

Another approach to improved management involves the use of risk-sharing to help align incentives of private partners with those of the government. As noted above, the Export-Import Bank of the United States has begun to explore the possibility of reducing regulatory prescriptions and relaxing oversight of lenders in return for risk-sharing by those lenders.

Properly designed risk-sharing can enhance service to borrowers by reducing the incidence of loan defaults. Reduced defaults protect borrowers who otherwise would default on credit that they can't handle and whose

financial failures would damage both their reputations and their credit ratings.

It is important to understand the limitations upon risk-sharing, both financially and from the perspective of public policy. The financial limitations relate to the capacity of the government to handle the remaining financial risk on a loan or pool of loans. In the case of HUD, poor design and administration of its multifamily coinsurance program led to billions of dollars of losses.

Flaws in design included (1) ability of undercapitalized partners to obtain fees that exceeded their financial stake, and (2) a relationship between FHA and Ginnie Mae guarantees that resulted in ultimate assumption of 100% of the financial risk on coinsured loans by the government. Administrative failures included (1) lack of reliable information about the financial soundness of partners or the quality of their underwriting or servicing, (2) lack of appropriate standards of financial responsibility of partners, (3) concentration of risk in a limited number of large coinsurers, and (4) lack of adequate reporting by coinsurers and monitoring of their performance.<sup>40</sup>

In short, risk-sharing can compound the problem rather than improve the government's ability to deal with adverse incentives of private parties. This can happen because of design flaws that create concentrate the risk in the wrong place. Risk-sharing is also financially dangerous if it creates a false sense of complacency among government managers that a shared-risk program can run successfully by itself.

A related issue involves the need to design risk-sharing so that the private partner actually bears significant risk. Congress modified the guaranteed student loan program in 1993 to provide for reimbursement of lenders and other program partners for 98% of the guaranteed loan rather than 100%. Given the income to lenders when they hold student loans, especially in the years before the student graduates and begins repayment, it is unlikely that this modification caused a significant change in lender behavior.

The utility of risk-sharing also may be limited by the public purposes of particular programs. The guaranteed student loan program is an entitlement for eligible students who attend eligible schools. If Congress were to increase risk-sharing significantly, so that the lender, for example, would bear financial risk up to 20% of the loan amount, the market would quickly exclude some students and some schools from access to guaranteed student loans.

The lending industry understands which schools and types of borrowers are correlated with likelihood of default. The private sector is willing to extend credit for such schools and borrowers only when lenders bear little

of the financial risk. For this particular program, the Congress has made the policy judgment that low-income and proprietary school students deserve access to subsidized federal credit even if they tend to default in larger numbers than other students.<sup>41</sup>

#### **D. Use of Joint Venture Partnerships**

The experiences of the Resolution Trust Corporation with joint-venture partnerships are an interesting model for the administration of some credit programs. The structuring of relationships between the government and private financial firms on the basis of shared cash flows offers a useful way to align incentives of the parties and to maximize the financial value of a loan portfolio, servicing portfolio, or other pool of federally supported credit.<sup>42</sup>

Once again, however, this management approach is limited by public policy considerations that the Congress may intend to trade off against the maximization of financial value. One interesting variant upon the RTC's use of joint-ventures is the use of contractual terms in the partnership agreement to help assure that non-financial public policies will be implemented.

For example, when lenders put defaulted insured multifamily mortgages to HUD, the department is required to maintain the low-income occupancy of the multifamily properties. In June 1996, the department sold a pool of 158 mortgages on partially assisted multifamily properties, i.e., apartment buildings in which up to half of the units received federal rent subsidies. The equity partner, selected competitively, is required by the terms of its agreement to maintain the rental assistance contracts and enforce tenant protections after the sale.<sup>43</sup> Federal agencies that engaged in loan asset sales in the 1980s similarly used contractual agreements to assure that private parties would respect non-financial public policies such as special servicing requirements or borrower rights.

#### **E. Changing the Form of Federal Credit Support**

Federal direct loans and loan guarantees are tools of government with strengths and limitations compared to other tools. Budget scoring rules have provided the impetus for program changes between direct loans and guarantees. As constraints increase upon available appropriated funds, especially with respect to permitted staff levels, policymakers and program managers may want to explore other ways to transform programs to provide cost-effective financial support to their constituencies.



At some point, budget constraints may combine with changing markets, technologies and public priorities to make it worthwhile for federal credit agencies to work with their congressional committees and their own constituencies to ask even more basic questions like those that are transforming the commercial banking industry.<sup>44</sup> For example, what is the best way for a federal credit agency to serve its mission of enhancing the flow of credit to favored constituencies such as students, home buyers, or farmers? Do new information technologies offer the opportunity for an agency to support the flow of credit cost-effectively without actually originating or servicing or collecting on loans?

One idea along these lines is included in OMB's FY1996 passback concerning the FHA single-family mortgage insurance program. OMB proposed that FHA supplement its traditional single-family mortgage insurance with a program of credit enhancements:

"The Administration will propose legislation to change the mechanism for ensuring access to credit by buyers who cannot obtain traditional financing. Under the proposal, FHA will no longer insure individual mortgages. Instead, FHA will provide credit enhancement for pools of high LTV [loan-to-value] and other high-risk mortgages securitized by Fannie Mae, Freddie Mac or other securitizers. The enhancement, in the form of a loss reserve, will ensure that the cash flow to investors is not interrupted by defaults. FHA will continue to charge borrowers a fee to fully fund the loss reserves and cover its administrative costs."<sup>45</sup>

This proposal did not advance to the point where policymakers had an opportunity to consider related issues such as possible roles for Ginnie Mae if FHA adopted the new process. The idea was not included in the final version of the Administration's FY 1996 budget. While strategic rethinking has been essential to the continuing success of private lenders, policymakers have not yet reached consensus about comparable challenges or opportunities for government credit programs.

#### **F. Changing the Organizational Form of a Federal Credit Agency**

To some extent, government program agencies themselves suffer from a lack of appropriate incentives. Trade-offs are not evaluated and properly rewarded. Thus, an agency may face obstacles rather than encouragement if it seeks to increase spending on improved information systems to reduce default rates, or if it seeks to privatize certain functions to enhance servicing or collections or other performance. Unlike the

private marketplace, the government agency often lacks feedback loops to reward superior performance and discourage wasteful or counterproductive activities.

The performance-based organization is a recent concept that may be a useful tool for enhancing the incentives of program managers. If performance standards are in place, then the Congress may be willing to relax some of the rigid input controls that can inhibit trade-offs and innovation.

For example, a program might be designed so that the Congress appropriates a fixed amount of money equal to the credit subsidy plus administrative expenses. The agency might be authorized to experiment with various forms of credit support, including direct loans, guarantees, or credit enhancements, that will serve designated numbers and types of borrowers. To the extent that the agency becomes more efficient, it will be authorized to serve additional borrowers, up to the limits of its budget authority for the year.

Such a performance-based approach can assist the Congress as well. At a time of reduced budget resources, congressional policymakers could see clearly the trade-offs between enhanced collections or superior servicing, for example, and thus the increased availability of funds for origination of new loans or guarantees. While this management concept flies in the face of Harold Seidman's warnings, quoted above, it offers a vision of how a federal credit agency could create a systematic process for increasing constituent services at a time of fewer resources.

#### **G. Enhancing the Management Capacity of Federal Credit Agencies: Possible Next Steps**

Enhanced management in the near term might be seen as a three-pronged approach: (1) systematic reinforcement of relationships with high-performing partners, (2) across-the-board actions to deal with the poorest performers who pose the greatest financial risk to the government; and (3) use of provisions of existing law that facilitate or authorize new ways to provide credit support to constituencies.

The creation of a two- or three-tier performance-based classification of lenders and other partners is an excellent first step for many programs. Thus, the FHA single-family mortgage insurance program today permits the huge majority of participating lenders to underwrite FHA loans themselves. Such wholesale assignment of lenders to a single category defeats the purpose of performance-based incentives and rewards. If lenders or other partners must earn their preferred status, they have an incentive to perform.

Unlike the FHA, the SBA selects perhaps the top 350

lenders out of a total of 8,000 to do business in the Section 7(a) program through the SBA's Preferred Lenders Program. They are selected on the basis of past performance and their commitment to the program. They originate and service about 40% of all Section 7(a) loans each year; this dependence upon a high volume of SBA business gives them a stake in performing so that they maintain eligibility as a preferred lender. Needed now is increased high-quality information about SBA lender performance to provide early warning about changes in lender activity that could pose financial risk to the SBA.

Virtually any guaranteed loan program may find it worthwhile to experiment with a tiered classification of lenders and other partners. An agency is likely to find any number of positive incentives, that are consistent with the relevant authorizing legislation, such as expedited approvals or increased access to program waivers. Preferred lenders should receive the best service from the agency, commensurate with their service to the program and its public purposes; the poorest performers should systematically find themselves behind the high performers in the queue to receive discretionary benefits and at the head of the line for careful supervision.

It is time to consider the problem of high defaults in a way that cuts across program lines. Significant evidence exists that easy credit can harm both borrowers who default and, in the case of credit for housing or agriculture, their communities. Building upon the favorable experience of the Department of Education, policymakers may want to consider legislation that precludes lenders from participating in federal credit programs if their default rate in any one program exceeds some high number, say, 25%. To avoid such a high default rate, lenders would then have an incentive to counsel borrowers, structure loans so as to reduce the likelihood of default, or otherwise try to protect people or firms with low prospects for repaying their federally supported loans.

Finally, program agencies ought to review their current statutory authority to determine whether they may be able to experiment with alternative ways of providing credit. The FHA, for example, has the authority to experiment with reinsurance with respect to single-family mortgages and risk-sharing with respect to multifamily mortgages. Successful pilot programs might offer the agency increased options for future credit activity, especially in the event that current programs eventually need to be changed. The search by the ExIm Bank for new forms for lenders to assume some financial risk is another good example. Here, too, the agency will benefit from pilot testing and analysis before making large-scale program changes.

## V. CONCLUSION

New information technologies are forcing the private credit markets to engage in continuing change and improvement. These information technologies also offer the federal government an opportunity to enhance performance and remove impediments to the flow of credit to intended constituencies.

The government can purchase many different kinds of information-based systems, whether to track loans, score borrowers in some programs for creditworthiness, monitor performance of lenders and other partners, enhance servicing and collections, or reduce the incidence and costs of default. Each year of progress in the private sector provides government agencies with the opportunity to purchase better systems at lower cost.

Information is essential to effective program management. The mere availability of systematic information about lender performance, for example, is likely to clarify trade-offs between the budgeted cost of a program and the need for enhanced standards of performance.

The new private information technologies also pose new risks to many government programs. Problems of adverse selection can be compounded for loan guarantee programs when the lender has access to information that predicts likely default rates, but the government does not. One can imagine that lenders with such information will become quite effective at deciding which small business or mortgage loans to fund through the private sector and which to sell with a government guarantee.

Similarly, the new information systems help the private market to distinguish attractive business partners from those with poor performance. One could envision some markets where the government does business with an increasing number of lenders or other program partners that the private market would reject or else penalize through deliberately onerous terms. In many programs, poor performing lenders or partners can create concentrations of financial risk. Again, the government may be at a disadvantage if it is the only major player in the market without timely access to high-quality information.

The new information-based systems have made the private sector quite nimble. This permits experimentation with forms of incentives and application of incentives that achieve the most effective results. Here the government lags. Variations in incentive between program managers and private partners and dysfunctional incentives within federal agencies help to confine programs to the old ways. Yet, new technologies are taking apart old functions and reconfiguring them in new ways. Unless government too becomes more nimble,

organizations risk becoming irrelevant to the performance of large parts of their public missions.

Some federal agencies are becoming increasingly skilled at adopting new information systems. Ginnie Mae's IPADS and VA's use of Ginnie Mae's CPADS are perhaps the best examples. Other agencies have new systems scheduled to come on line.

Much more difficult is the process of aligning incentives between a federal agency and its partners. The Congress needs to be convinced either to enact enabling legislation or to acquiesce in an agency's development of new enabling regulations and contract forms. Again, information is the key to clarifying the costs of keeping to the old ways.

More thorough process reengineering and redefinition of programs lies yet farther in the future. Yet the benefits of rethinking the means of serving public purposes and of creating performance-based organizational structures cannot be underestimated. In the end, government credit managers cannot do more with less unless they have the necessary political mandate and the tools, performance-based incentives, and capacity to do the job.

## END NOTES

<sup>1</sup>The author is grateful to Justine Rodriguez, Deputy Associate Director for Economic Policy of the Office of Management and Budget (OMB), for the idea of linking the discussion of (1) information, (2) incentives, and (3) management of federal credit programs.

<sup>2</sup>See, Ginnie Mae, "Overview of the Issuer Portfolio Analysis Database System (IPADS)," (undated); and Coopers & Lybrand, Risk Analysis Group, "GNMA: IPADS (Issuer Portfolio Analysis Database System) Training Manual," (undated).

<sup>3</sup>Ginnie Mae, "GNMA: CPADS (Correspondent Portfolio Analysis Database System) Training Manual," May 1, 1994.

<sup>4</sup>Remarks of Ted Foster, Ginnie Mae, at the Workshop on Promising Practices, transcribed proceedings, Financial Management Service, U.S. Department of the Treasury, October 1, 1996, pp. III-IV-9 to III-IV-12, and remarks of Gerald Ference, U.S. Department of Veterans Affairs, *Ibid.*, pp. III-IV-12 to III-IV-14.

<sup>5</sup>See, Office of Federal Housing Enterprise Oversight, "Major Trends in Single-Family Mortgage Lending," *1996 Annual Report to Congress*, 1996, pp. 7-20.

<sup>6</sup>See, Office of Federal Housing Enterprise Oversight, "Major Trends in Single-Family Mortgage Lending," *1996 Annual Report to Congress*, 1996, pp. 16-29; and "Enterprises Introduce Automated Underwriting Systems," *1995 Annual Report to Congress*, 1995, pp. 1-7.

<sup>7</sup>See, e.g., Rebel A. Cole and Barbara G. Cornyn, "FIMS: A New Monitoring System for Banking Institutions," *Federal Reserve Bulletin*, January 1995, pp. 1-15; and Rebel A. Cole and Jeffrey W. Gunther, "A CAMEL Rating's shelf-life," *Financial Industry Studies*, Federal Reserve Bank of Dallas, December 1995, pp. 13-20.

<sup>8</sup>U.S. Department of Education, "Student Assistance General Provisions," notice of proposed rulemaking, 34 CFR part 668, *Federal Register*, Vol. 61, No. 184, September 20, 1996, pp. 49551-49574; and KPMG Peat Marwick LLP, *Financial Ratio Analysis Project: Final Report*, August 1, 1996.

<sup>9</sup>The Kerry Company, "SWAT Briefing: Assistant Secretary for

Housing - Federal Housing Commissioner Nicolas P. Retsinas," December 7, 1995 (updated March 1, 1996); and Thomas H. Stanton, *Institutional Capacity to Manage Financial Risk: An Essential Consideration for the Future of the HUD Multifamily Assisted Housing Loan Portfolio*, April 2, 1996.

<sup>10</sup>Dick Fyne and Frank Kesterman, "VA's Lender Surveillance Improved by GNMA "C-PADS" Data," *The Financial Connection*, Financial Management Service, March 1995, p. 2.

<sup>11</sup>See, generally, Robert B. Avery, Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner, "Credit Risk, Credit Scoring, and Performance of Home Mortgages," *Federal Reserve Bulletin*, July 1996, pp. 621-648.

<sup>12</sup>Ronald C. Moe and Robert S. Gilmour, "Rediscovering Principles of Public Administration: The Neglected Foundations of Public Law," *Public Administration Review*, Vol. 55 (1995), pp. 135-146.

<sup>13</sup>24 CFR Part 25, "Mortgage Review Board"

<sup>14</sup>34 CFR Part 682, "Federal Family Education Loan (FFEL) Program," Subpart G, "Limitation, Suspension or Termination of Lender or Third-Party Servicer Eligibility and Disqualification of Lenders and Schools"

<sup>15</sup>Price Waterhouse, *Multifamily Coinsurance Programs*, January 18, 1990, at p. 51.

<sup>16</sup>See, Ronald C. Moe and Robert S. Gilmour, "Rediscovering Principles of Public Administration: The Neglected Foundation of Public Law," *Public Administration Review*, March/April 1995, Vol. 55, No. 2, pp. 135-146.

<sup>17</sup>National Academy of Public Administration, *Renewing HUD: A Long-Term Agenda for Effective Performance*, July 1994, pp. 29-30.

<sup>18</sup>12 U.S.C. Sec. 1709(t), "Accountability of mortgage lenders"

<sup>19</sup>12 U.S.C. Sec. 1715z-4a, "Double damages remedy for unauthorized use of multifamily housing project assets and income"

<sup>20</sup>U.S. Department of Education, "Fiscal Year 1999 Justifications of Appropriations Estimates to the Congress," Volume II, undated, 1998, pp. O-15 to O-16.

<sup>21</sup>Especially low-income students in the past seem to have been prey to excessively available federal credit to subsidize schools that failed to offer a useful education. See, e.g. Michael Winerip, "Billions for School are Lost in Fraud, Waste and Abuse," *The New York Times*, February 2, 1994, p. 1.

<sup>22</sup>See, 13 CFR Part 120, "Business Loans," Subpart D, "Lenders."

<sup>23</sup>Of course, such a system requires a federal credit agency to monitor actively the performance of participating lenders. See, U.S. General Accounting Office, *Small Business Administration: Few Reviews of Guaranteed Lenders Have Been Conducted*, GGD-98-85, June 11, 1998.

<sup>24</sup>34 CFR Sec. 668.15, "Factors of financial responsibility." See also, 34 CFR Sec. 668.16, "Standards of administrative capability."

<sup>25</sup>24 CFR Sec. 202.11, "Approval, recertification, withdrawal of approval and termination of approval agreement."

<sup>26</sup>Elisabeth Rhyne, *Small Business, Banks and Loan Guarantees*, (New York, NY: Quorum Books, 1988), p. 26.

<sup>27</sup>Remarks of Helen Dunlap, HUD Deputy Assistant Secretary for Housing Operations, at the Workshop on Promising Practices, transcribed proceedings, Financial Management Service, U.S. Department of the Treasury, October 3, 1996, pp. IX-3 to IX-4.

<sup>28</sup>Salamon Brothers Inc, The First Boston Corporation, Shearson Lehman Hutton Inc., Prospectus, "College and University Facility Loan Trust Two Sequential Pay Bonds," May 3, 1988, pp. 14-15.

<sup>29</sup>See, e.g., David A. Smith and Kimberly Vermeer, Recapitalization Advisors, *Report: HUD Multifamily Property Management Fee Study*, prepared for the Department of Housing and Urban Development, May 1, 1994.

<sup>30</sup>34 CFR 682.411, "Due diligence by lenders in the collection of guaranty agency loans"

<sup>31</sup>Michael S. McPherson and Morton Owen Schapiro, *Keeping*

*College Affordable*, (Washington, DC: Brookings Institution, 1991), pp. 159-60. Since that statement was written, the GSL program has increased risk sharing by lenders to two percent of the amount of the loan—a modest change that adds only marginally to a lender’s incentives to originate only sound loans or to service them well.

<sup>32</sup>See, Thomas H. Stanton, “Using Loan Asset Sales to Improve the Management of Federal Credit Portfolios,” *The Financier: Analyses of Capital and Money market Transactions*, Vol. 5, No. 1, Spring 1998, pp. 5-16, for a more detailed discussion of the RTC experience.

<sup>33</sup>See e.g., Derek F. Abell, *Defining the Business: The Starting Point of Strategic Planning*, (Englewood Cliffs, NJ: Prentice Hall, Inc., 1980); Michael E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance*, (New York, NY: The Free Press, 1985); James Brian Quinn, *Intelligent Enterprise: A Knowledge and Service Based Paradigm For Industry*, (New York, NY: The Free Press, 1992); and Michael Hammer, *Beyond Reengineering: How the Process-Centered Organization is Changing Our Work and Our Lives*, (New York, NY: HarperBusiness, 1996).

<sup>34</sup>Harold Seidman, *Politics, Position and Power: The Dynamics of Federal Organization*, fifth edition (New York, NY: Oxford University Press, 1998), p. 136.

<sup>35</sup>U.S. Department of Housing and Urban Development, *HUD Reinvention: From Blueprint to Action*, chapter 3, “Federal Housing Administration,” (Washington, DC: March 1995).

<sup>36</sup>See, e.g., Standard & Poor’s, *Servicer Evaluation: Criteria Summary and Description*, August 1997.

<sup>37</sup>See Section 104 of “The Small Business Programs Improvement Act of 1996,” PL 104-208, reprinted in the *Congressional Record*, September 28, 1996, at p. H11835.

<sup>38</sup>See, generally, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1999: Federal Credit Supplement*, (Washington, DC: 1998).

<sup>39</sup>For example, the ExIm Bank charges exposure fees based upon the credit risk of each loan for which it provides a guarantee. This helps to level the playing field so that ExIm can afford to serve borrowers and transactions that involve a range of financial risk. See, Export-Import Bank of the United States, “Exposure Fee Advice,” EBD-M-20, April 1996.

<sup>40</sup>Price Waterhouse, *Review of Capital and Administrative Requirements: Multifamily Coinsurance Programs*, January 18, 1990.

<sup>41</sup>As the Department of Education has increased its oversight of high-default schools, proprietary schools have left the program. Also, the average default rate of the remaining proprietary schools has dropped substantially.

<sup>42</sup>One interesting application of the joint venture structure was the RTC’s use of joint ventures to collect on judgments, deficiencies, charge-offs, and small-balance assets. See, e.g. Resolution Trust

Corporation, “Revised Bid Offering to Become a Partner in the Collection of RTC Judgments, Deficiencies, Charge-Offs & Small-Balance Assets,” July 23, 1993.

<sup>43</sup>With respect to the protection, even after sale of HUD-held mortgages, of the rights of tenants who receive HUD rental assistance, see, Office of Assistant Secretary for Housing - Federal Housing Commissioner, “Sale of HUD-Held Multifamily Mortgages,” *Federal Register*, Vol. 61, No. 25, February 6, 1996, pp. 4580-4584.

<sup>44</sup>See, e.g. The Boston Consulting Group, *The Information Superhighway and Retail Banking*, Bank Administration Institute, 1995 (two volumes).

<sup>45</sup>The Office of Management and Budget, “FY 1996 Passback: Department of Housing and Urban Development,” November 21, 1994, pp. 21-22.

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