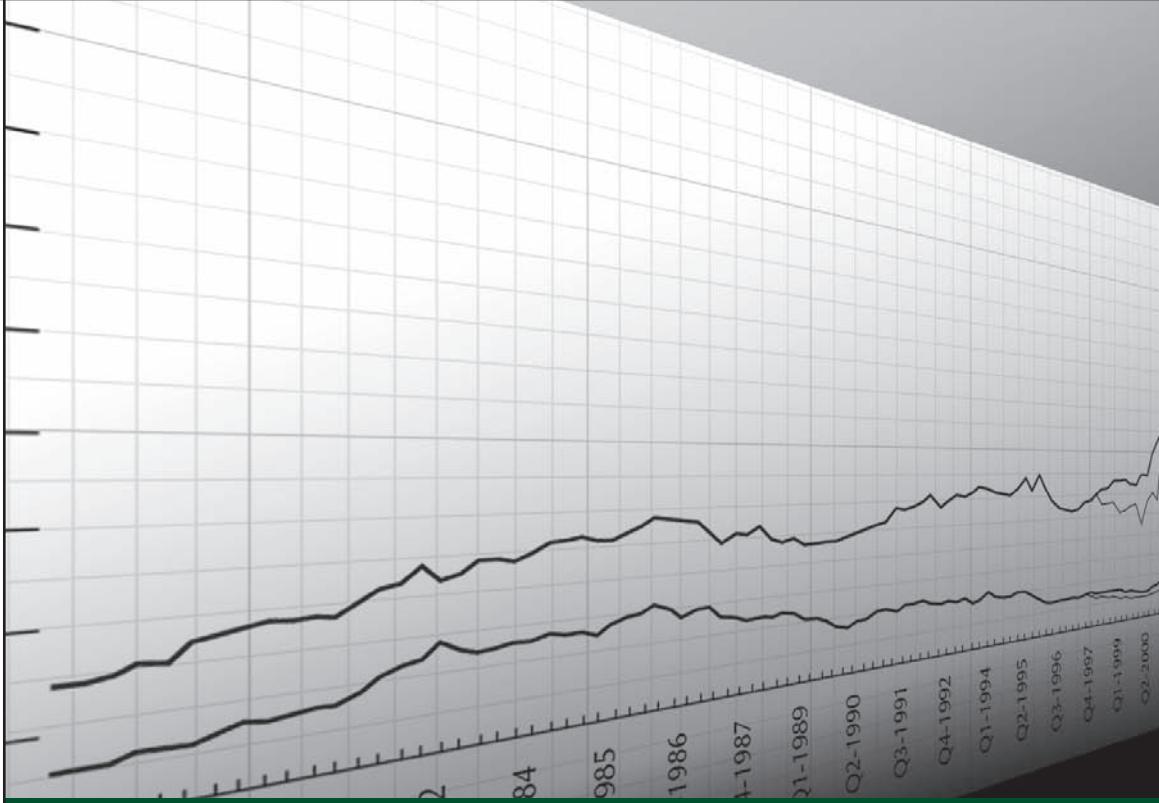


# Federal Credit Programs: Managing Risk in the Information Age



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FINANCIAL MANAGEMENT SERIES

# **Federal Credit Programs:**

## Managing Risk in the Information Age

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IBM Center for  
**The Business  
of Government**

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## FOREWORD

April 2005

On behalf of the IBM Center for The Business of Government, we are pleased to present this report, "Federal Credit Programs: Managing Risk in the Information Age," by Thomas H. Stanton.

Credit programs (direct loans and loan guarantees) are one of the "tools" that governments can use to achieve public purposes. The federal government extends credit for a broad range of purposes, from overseas activities to the needs of people caught in a disaster. In FY 2004, the government had \$250 billion of direct loans and over \$1.2 trillion of loan guarantees outstanding. Home buyers, farmers, and students are the most frequent recipients of government loans.

The last 10 years have seen a remarkable expansion of information technologies and their application. For government credit programs, these developments bring both opportunities and challenges. Opportunities occur as federal credit agencies can now develop new risk management systems that might have been unavailable or unaffordable in the past. New technologies also bring challenges because the private sector can now increasingly apply its information capability to compete effectively to attract the more creditworthy borrowers from government programs.

This report highlights the fundamental tensions that federal credit programs face between doing good and doing well. On the one hand, the government provides support through loans and loan guarantees to borrowers who are not considered adequately served by commercial credit markets. On the other hand, the government cannot afford to lose large amounts of money by paying for an unacceptable number of defaults on federal loans.

The report concludes with 10 recommendations for federal credit agencies, as well as several core lessons from research conducted for the study: (1) federal credit agencies must establish management information systems and risk monitoring systems; (2) the availability of positive models shows that this can be done; (3) effective risk management also requires processes to allow senior managers to review relevant information and take action to deal with emerging risks; and (4) a sound statutory framework is needed to help many credit programs succeed. The report also includes case studies of promising practices in risk management. Stanton concludes that federal credit programs have much to teach one another.

We trust that this report will be informative and useful to all public managers grappling to improve their credit programs and the risk management of those programs.

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## EXECUTIVE SUMMARY

The past 10 years have brought a remarkable expansion of information technologies and their applications. Each stage of the credit management cycle has benefited from the development of a broad array of approaches that are applied based on analysis of information databases. Competitive superiority is increasingly derived from the quality of information management.

For government credit programs, these developments bring both opportunities and challenges. Opportunities occur as federal credit agencies develop risk management systems that might have been unavailable or unaffordable in the past. These risk management systems are based on improved business processes as well as the application of new technologies to those processes. New technologies also bring challenges because the private sector increasingly can apply its information superiority to compete effectively against government programs and to attract the more creditworthy borrowers from those programs.

Credit is one in a range of tools that government may use to achieve public purposes. The U.S. government extends credit for a broad range of purposes, from overseas activities to the needs of people caught in a disaster. The federal government in FY 2004 had \$250 billion of direct loans and over \$1.2 trillion of loan guarantees outstanding, especially to home buyers, farmers, and students. Over the past 20 to 30 years, the volume of federal loan guarantees has grown significantly, while the volume of direct loans outstanding has remained at a more constant level. With its emphasis upon up-front disclosure of the likely costs of credit, the Credit Reform Act has increased the financial accountability of credit programs.

Several types of risk particularly affect federal credit programs. Two of the most important are operational risk and credit risk. Operational risk is the risk that the government agency may lose control over part or all of its program. The other major risk factor is credit risk—that is, the chance that borrowers in a particular credit program will default in large numbers and thereby cause unacceptable losses. The third kind of risk is market risk, such as competition from a private sector that is increasingly able to apply information-based processes and technologies to attract the most creditworthy borrowers away from a government program.

Perhaps the most important opportunities presented by information systems relate to the ability of federal credit managers to manage the operational risks in their programs. Promising practices here are the Executive Dashboard and Project Scorecards of the Office of Federal Student Aid (FSA) of the U.S. Department of Education, and the Asset Management System of the Export-Import Bank of the United States.

Increasing, widespread use of the Internet has helped to foster electronic processes for loan applications and loan origination. Here a promising practice is the E-Tran loan guaranty origination system of the Small Business Administration (SBA).

Information-based systems, utilizing reports from lenders and other information, allow federal credit agencies to monitor the state of their portfolios of guaranteed loans and to obtain early warning about lenders whose performance merits special attention. The SBA has developed a lender monitoring system that uses commercially available information to assess the agency's portfolio of guaranteed business loans and to monitor lenders that participate in the program. The SBA's Office of Lender Oversight provides a promising practice in the way that it uses the infor-

mation from its monitoring system to decide the frequency with which lenders will be subject to reviews and to inform senior management about portfolio risks.

For many years, many federal credit agencies, especially those serving housing, were unable to obtain significant recoveries from defaulted loans. A promising practice with considerable evidence of success is the Loss Mitigation Program of the Federal Housing Administration (FHA) Single Family Program. This program helps borrowers to avoid foreclosure and keep their homes and also saves money for the government.

At some point, a federal agency must ensure that defaulted loans are sent to collection. A promising practice is the Collections Group of the Department of Education's Office of Federal Student Aid. Some federal programs may involve government loans or loan guarantees based on collateral such as a home or small business. When a borrower defaults, the collateral may come into government hands. An interagency promising practice is theHomeSales.gov common portal for sales of homes owned by the Department of Housing and Urban Development (HUD), Department of Veterans Affairs (VA), and Rural Housing Service (RHS) of the Department of Agriculture (USDA).

The application of new technologies also poses a serious challenge to some federal credit programs, particularly to the single-family mortgage programs of the FHA and VA. In recent years, the conventional mortgage market has attracted creditworthy borrowers who earlier might have sought an FHA or VA mortgage. Just 3.3 percent of home buyers took out an FHA-insured mortgage in 2004, down from almost 10 percent of mortgage originations in 1999. At the same time, the private mortgage market has been able to use new information-based systems to improve the credit quality of conventional mortgages compared to those insured by FHA. In 1986, FHA mortgages were 1.9 times more likely than conventional mortgages to become 90 days past due. By 2000, FHA mortgages were five times more likely than conventional mortgages to become 90 days past due. This trend is unsustainable.

Each credit program is different, with different risks, risk management practices, and management structures. However, some recommendations arise from

this survey of risk management and promising practices that credit agencies might wish to consider adopting and adapting to the particular needs of their programs. The report contains the following recommendations:

1. Develop a process to analyze pertinent information about the nature and dimensions of risks of each loan program.
2. Create a risk management office responsible for creating and overseeing effective risk management systems and for reporting important risk issues to top agency management.
3. After consultation with other federal agencies and the private sector, develop and maintain an effective portfolio risk-monitoring system.
4. Require the risk management office to prepare regular and special reports concerning significant risk factors and the state of the program and portfolio.
5. Establish a credit committee or similar body, chaired by a top agency official, to review risk-related information regularly and on special occasions.
6. Review the ability of the agency to address major forms of risk that potentially could emerge.
7. Develop internal documents that spell out appropriate responses to different types and severity of risk problems.
8. Make recommendations to the agency's leadership about new or amended regulations to deal with risk problems.
9. Make recommendations to Congress about legislation that could help to fill gaps in the statutory framework.
10. Keep a continuing eye on market risk and consider recommending to Congress appropriate changes in law and program structure.

Finally, a lesson of the promising practices in this report is that federal credit agencies have much to teach one another.

# Introduction

The past 10 years have brought a remarkable expansion of information technologies and their applications. Each stage of the credit management cycle—loan origination, servicing, monitoring of lenders or other private parties, loss mitigation, and default management—has benefited from the development of a broad array of approaches that are applied based on analysis of information databases. Competitive superiority is increasingly derived from the quality of information management rather than other traditional factors such as the cost of funds.

For government credit programs, these developments bring both opportunities and challenges. Opportunities occur as federal credit agencies increasingly develop risk management systems that might have been unavailable or unaffordable in the past. These risk management systems often are based on improved business processes as well as the application of new technologies to those processes. New technologies also bring challenges because the private sector increasingly can apply its information superiority to compete effectively against government programs and to attract the more creditworthy borrowers from those programs.

This report begins with a discussion of federal credit programs as tools of government, the establishment of credit budgeting, and the developments that have followed. This is followed by a discussion of risk management and the types of risk that a federal program must manage. The next six sections review examples of promising practices and the kinds of major improvements made by federal credit agencies in the application of information-based business processes to the management of their programs.

Following that is an examination of the challenges posed by new information technologies and their applications, especially to federal programs in the residential mortgage market. The report concludes with lessons derived from the review of the challenges and opportunities, and provides policy recommendations.

Several core lessons emerge from this survey:

- To continue to succeed in the information age, federal credit agencies must establish management information and risk monitoring systems.
- The availability of positive models among federal credit programs shows that this can be done effectively.
- Effective risk management also requires the establishment of processes to allow senior managers to review the relevant information and take action to deal with emerging risks.
- A sound statutory framework is needed to help many credit programs succeed. Credit agencies can use the information they gather from their systems and processes to make a good case for statutory improvements.

## Guide to Acronyms and Abbreviations

<b>AMR group:</b>	The Asset Monitoring and Restructuring group of the Export-Import Bank of the United States	<b>MBA:</b>	Mortgage Bankers Association of America
<b>CCC:</b>	Commodity Credit Corporation	<b>NHR:</b>	A loss mitigation technique that does not involve retaining the borrower's home
<b>CFO:</b>	Chief Financial Officer	<b>OLO:</b>	Office of Lender Oversight of the Small Business Administration
<b>ExIm Bank:</b>	The Export-Import Bank of the United States	<b>OMB:</b>	Office of Management and Budget
<b>FHA:</b>	Federal Housing Administration	<b>RHS:</b>	Rural Housing Service of the U.S. Department of Agriculture
<b>FSA:</b>	Office of Federal Student Aid of the U.S. Department of Education	<b>SBA:</b>	Small Business Administration
<b>FY:</b>	Federal Fiscal Year, which runs from October 1 to the following September 30	<b>TRS:</b>	Tier Ranking System of the FHA's Loss Mitigation Program
<b>HR:</b>	A loss mitigation technique that involves retaining the borrower's home	<b>VA:</b>	Department of Veterans Affairs
<b>HUD:</b>	Department of Housing and Urban Development	<b>USDA:</b>	U.S. Department of Agriculture
<b>LM:</b>	FHA's Loss Mitigation program	<b>XML:</b>	eXtensible Markup Language
<b>LMPA:</b>	Loss Mitigation Performance Analysis score of the FHA's Loss Mitigation Program		

## Acknowledgments

This research involved a review of literature on risk management and a series of interviews with executives and managers in private firms and the federal government. The author was able to draw on his background doing research for a number of federal credit agencies, including some discussed in this report, and the deeper knowledge that that experience provided. In one case, for example, the author was able to spend an entire day interviewing the top management of a major private financial institution about its risk management practices. The author submitted the draft of this report, or key sections, to knowledgeable people, who provided valuable additional comments.

The author would like to express gratitude to the many people who made this work possible, especially Mark Abramson and Jonathan Breul of the IBM Center for The Business of Government. The author has learned much from Steve Redburn, Kathryn B. Stack, Courtney Timberlake, J. Anthony Curico, and Erin McNeece, of the Office of Management and Budget; Theresa S. Shaw, John Fare, Kay Jacks, Gerald Schubert, Sue Szabo, Harry Feeley, Jeanne Saunders, Gary Hopkins, and Richard Galloway of the Office of Federal Student Aid of the Department of Education; James K. Hess and Frances I. Nwachukwu of the Export-Import Bank of the United States; John Weicher, Joe McCloskey, Michael O'Donnell, and Eric Stout of the Department of Housing and Urban Development; Janet Tasker, Stephen Kucharski, and Glenn Hannon of the Small Business Administration; William B. Shear of the Government Accountability Office; Eric S. Belsky of the Harvard Joint Center for Housing Studies; Jay Brinkmann of the Mortgage Bankers Association of America; and Alex Pollock, former CEO of the Federal Home Loan Bank of Chicago. However, all statements and views in this report are solely those of the author and not necessarily those of people who kindly provided background information.

# Credit as a “Tool” of Government

## The Size and Scope of Federal Credit Programs

The federal government provides loans or loan guarantees as a way to encourage funding for borrowers or activities that are considered important. Credit is one of a range of tools that government may use to achieve public purposes.<sup>1</sup> As with the other tools of government, credit programs must be carefully matched with the public purposes that they are supposed to serve. The U.S. government extends credit for a broad range of purposes, from overseas activities to the needs of people caught in a disaster. In appropriate circumstances, it can be extremely effective to extend government credit to borrowers who are capable of using the funds and then repaying their debt obligations; by contrast, provision of credit to borrowers who are not creditworthy can be costly both to the government that must take the losses on the defaulted loans and to the borrowers themselves.

Table 1 on page 10 presents an overview of federal direct loan and loan guarantee programs for fiscal years 1999 and 2004. As can be seen from the table, the bulk of credit programs serve constituencies in housing (Federal Housing Administration [FHA], Department of Veterans Affairs [VA], and rural housing), education (direct and guaranteed student loans), and agriculture (Farm Service Agency and rural programs).

The federal government borrows money to fund direct loans and provides loan guarantees that are backed by the full faith and credit of the U.S. Treasury. Given the financial strength of the U.S. government, the federal government thus can maintain very large direct loan and loan guarantee pro-

grams. Table 1 shows that the federal government in FY 2004 had \$250 billion of direct loans and over \$1.2 trillion of loan guarantees outstanding, especially to home buyers, farmers, and students.

Figure 1 on page 11 shows the volume of federal direct loans and loan guarantees outstanding in recent decades. Over the past 20 to 30 years, the volume of federal loan guarantees has grown significantly, while the volume of direct loans outstanding has remained at a more constant level.

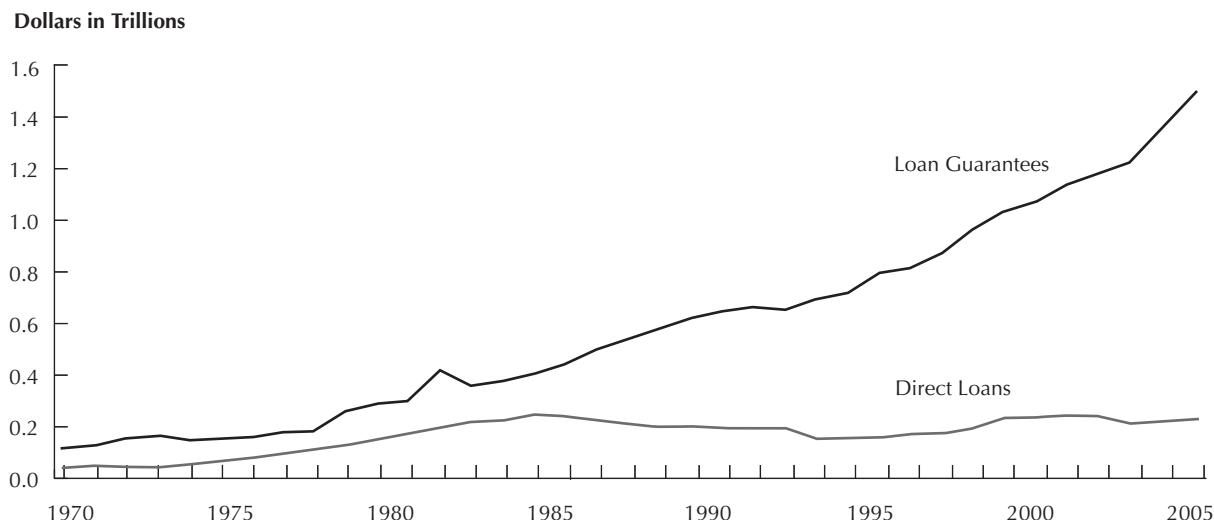
Figure 1 captures several trends. First, starting in the late 1960s, the government greatly expanded federal credit programs. The federal government responded to urban unrest with new FHA mortgage insurance programs, both for single-family homes and for apartment buildings. Many of these programs involved heavily subsidized interest rates, as a way of helping to lower housing costs for low-income home buyers and renters. The government created the guaranteed student loan program in 1965 and greatly expanded its coverage in subsequent years. Credit programs of the Farmers Home Administration (now succeeded by the Rural Housing Service) multiplied sixfold in outstanding volume between 1973 and 1984, to \$61 billion. This resulted from more generous loan terms and also from an expansion of the types of loan program that the agency offered.

With the advent of the Reagan administration, the federal government began a serious effort to curtail domestic budget resources. Figure 1 shows how, for federal credit programs, budget constraints caused a shift to loan guarantees rather than a constriction in the actual volume of credit outstanding.

**Table 1: Federal Credit Programs (Outstanding Loans and Loan Guarantees, in Billions of Dollars)**

<b>Program</b>	<b>Outstanding FY 1999</b>	<b>Outstanding FY 2004</b>
<b>DIRECT LOANS</b>		
Federal Student Loan Programs	65	107
Farm Service Agency (excluding CCC), Rural Development, Rural Housing	45	43
Rural Utilities Service and Rural Telephone Bank	29	32
Housing and Urban Development	14	13
Agency for International Development	11	8
Public Law 480	11	9
Export-Import Bank	12	11
Commodity Credit Corporation	7	7
Federal Communications Commission	8	4
Disaster Assistance	7	3
Other Direct Loans	22	13
<b>Subtotal: Direct Loans</b>	<b>234</b>	<b>250</b>
<b>LOAN GUARANTEES</b>		
FHA Mutual Mortgage Insurance Fund	411	384
VA Mortgage	221	351
Federal Family Education Loan Program	127	245
FHA General/Special Risk Insurance Fund	93	91
Small Business	39	57
Export-Import Bank	25	36
International Assistance	19	21
Farm Service Agency and Rural Housing	17	24
Other Loan Guarantees	23	23
<b>Subtotal: Loan Guarantees</b>	<b>976</b>	<b>1,232</b>
<b>TOTAL LOANS AND LOAN GUARANTEES</b>	<b>1,210</b>	<b>1,482</b>

Source: Office of Management and Budget, Executive Office of the President, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2001, Table 8-1, p. 208 (February 2000), and Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006, Table 7-1, p. 109 (February 2005). The totals exclude double counting such as when Ginnie Mae guarantees securities backed by pools of FHA, VA, or RHS loans.

**Figure 1: Face Value of Federal Credit Outstanding (FY 1970 to FY 2005)**

Source: Budget of the United States Government: Analytical Perspectives, Fiscal Year 2006, Chart 7-2, p. 108 (February 2005)

## The Importance of Credit Budgeting

Before the enactment and implementation of the Credit Reform Act of 1990, the government budgeted for direct loans as if they were cash outlays for the full loan amount in the year that the loan was disbursed. The government then scored loan repayments as budget receipts in the year that the government received them.

By contrast, loan guarantees were virtually unchecked by the budget process. The government did not score loan guarantees when they were issued; rather, the government scored the amount of a claim on the guarantee in the year that an agency actually paid off a lender in response to a default on the guaranteed loan.

In this distorted budget context, budget constraints in the mid-1980s led congressional policy makers simply to shift the form of federal credit from direct loans to loan guarantees. The volume of outstanding loan guarantees rose while the volume of direct loans declined.

The Credit Reform Act changed budget scoring for credit programs. The government now accounts for both direct and guaranteed loans by calculating the present value of expected future outlays to pay for all of the direct or guaranteed loans that are originated under a particular federal program for each fiscal year. In general terms, for a direct loan

program, the present value calculation is the outlay of federal funds to make the loans in a fiscal year minus the present value of repayments of that cohort of loans and any program fees or other returns to the government, including recoveries on any of those loans that default. For a guaranteed loan program, the present value calculation is the amount of money the government pays out for claims for defaulted loans minus any program fees or other returns to the government on the cohort.

In other words, if a credit program makes \$1,000 in direct loans in a fiscal year and later receives repayments, fees, and recoveries amounting to \$900 (on a present-value basis), then the program has a credit subsidy of 10 percent. For a guaranteed loan program, the calculation is similar. If a credit program guarantees \$1,000 of loans in a fiscal year and claims from defaults, net of any fees the government may collect, amount to \$100, then the credit subsidy is 10 percent. To extend that \$1,000 in direct loans or loan guarantees, a program with a 10 percent subsidy rate requires an appropriation for the \$100 that will not be returned when those loans have been paid off or defaulted, as the case may be.

The major costs for any federal credit program involve the costs of defaulted loans and the costs of any interest rate subsidies that the government may provide to reduce the borrowing costs for a federal loan program. Interest rate subsidies turn out to be especially expensive for some programs. Also

expensive are favorable loan terms such as the loan deferral or loan forgiveness features of federal student loan programs.

Credit budgeting has helped to place direct loan programs and loan guarantees on a more equal footing. However, the budget treatment is not completely equal. The credit subsidy does not include the costs of administering a credit program; those costs are budgeted separately each year. Because it costs a government agency more to administer a direct loan program than a guaranteed loan program, guaranteed loans often may be favored in their budget treatment.

With some exceptions such as the direct student loan program, Congress has tended to use direct loan programs to serve less creditworthy borrowers and to authorize guaranteed loan programs for the more creditworthy eligible borrowers. Figure 1 shows how loan guarantees have continued to expand, compared to federal direct loans, despite the establishment of credit budgeting.

With its emphasis upon up-front disclosure of the likely costs of credit, the Credit Reform Act has increased the financial accountability of credit programs. The new budget treatment creates an incentive for policy makers to avoid program elements that could cause high default rates. Another consequence is the creation of an incentive to provide unsubsidized credit so that scarce budget resources can serve a greater number of constituents than could be served through heavily subsidized credit. To take the example used above, if a federal agency can reduce its credit subsidy from 10 percent to 5 percent, then a given level of appropriations will fund twice as many loans or loan guarantees.

Thus, in the past the federal government often provided subsidized interest rates to borrowers. Today the government provides an increasing proportion of its credit at unsubsidized, that is, near-market, rates of interest, thereby allowing limited budget dollars to extend much farther. Also, increased federal attention to reducing the incidence of defaults—for example, by excluding schools with high default rates from eligibility to participate in the student loan program—also reduces the amount of subsidy involved in providing these increasing volumes of federal credit.

Loan guarantees rather than direct loans have tended to benefit from these trends. Private financial institutions are a powerful constituency that favors loan guarantees because of the fees and interest income that a lender can earn from a federally guaranteed loan and the way that a lender can use the federal loan to nurture a borrower relationship (for example, a student who later may take out a consumer loan or home mortgage from the bank). Lenders have welcomed the increase in volume of outstanding federal loan guarantees and also may welcome the growth in borrowing at less subsidized interest rates.

Indeed, some of the most successful federal programs have involved extensions of unsubsidized credit for new types of loans. FHA single-family mortgage insurance originally involved the creation of the 30-year self-amortizing mortgage to allow borrowers to obtain long-term funding for their homes. The 30-year FHA mortgage replaced the earlier form of financing, through a balloon mortgage that the homeowner was required to refinance every few years. The successful experience of FHA mortgage insurance over several decades permitted the development of a private mortgage insurance industry to take similar kinds of risks with 30-year mortgages. The Export-Import Bank and Overseas Private Investment Corporation similarly tend to lead the private market by providing longer-term financing, compared to the private commercial market, for exports and investments, respectively, for borrowers in particular countries. The expectation is that the private sector may follow as those countries become more developed economically.

# Risk Management as the Key to a Successful Credit Program

## The Tension in Federal Credit Programs

It is not easy for government to provide credit effectively. Programs must be carefully managed to limit risk. Credit programs have an inherent tension between the initial provision of credit to borrowers, which can be very automatic, and the much greater effort that may be required to collect on loans once they have been made or guaranteed. Credit programs must manage the tension between doing good—providing funds for favored constituencies and purposes—and doing well—avoiding unacceptably high costs from defaults.

The provision of credit tends to occur quite automatically once borrowers establish their eligibility. When a credit program is an entitlement, borrowers merely need to establish their eligibility to receive the loans for which they qualify. Thus, eligible students at eligible educational institutions, as the law defines *eligibility*, can receive federal direct student loans from their schools or federal guaranteed student loans from an eligible lender, as the case may be. Veterans may apply to a mortgage lender to receive VA guaranteed home loans once they establish their eligibility. When a credit program is an entitlement, Congress has created a permanent indefinite appropriation to ensure the government will in fact fund all direct or guaranteed loans for eligible borrowers.

When a credit program is not an entitlement, eligible borrowers will receive direct or guaranteed loans only if money has been appropriated to fund the particular program for which they are applying. This can create queues in some programs toward

the end of a fiscal year, in the event that Congress has not appropriated enough money to provide the volume of direct loans or loan guarantees that the market demands during the fiscal year.

Thus, so long as the funding is available, the provision of credit through direct loans or loan guarantees is fairly easy to implement. By contrast, the collecting on loans and avoidance of defaults on direct loans or loan guarantees is far less automatic, and can be difficult for a federal credit agency. The government has had to make a substantial effort to collect on defaulted direct and guaranteed loans.

The world of finance is filled with water metaphors, such as the term *insolvency*, and a water metaphor is appropriate here. In providing direct or guaranteed loans, the government finds that credit flows easily downhill from the federal source to lenders and borrowers. By contrast, much more effort is required to make the water flow back uphill and to ensure that borrowers replenish the federal supply by making complete repayments on their loans.

Credit budgeting has had a salutary effect on risk management for many federal loan guarantee programs. Lenders may be concerned that limited federal appropriations may limit the number of loans that may be originated under some loan guarantee programs. The arithmetic of credit budgeting means that a reduction in the default rate on government-guaranteed loans can reduce the credit-subsidy estimate for that program. Conversely, an increase in loan defaults can increase the credit subsidy, thereby reducing the number of loans that can be supported by a given level of appropriated funds. To expand the number of guaranteed loans they can

make, lenders have an interest in limiting program losses from defaults that could have been avoided with improved financial management.

For example, the Small Business Administration (SBA) met with a range of lender representatives before it created the Office of Lender Oversight (for a more detailed discussion, see the section “Risk Management: Lender Monitoring,” beginning on page 22). These people generally were pleased that the office would help monitor lenders who had exceptionally high rates of default on their SBA loans. By eliminating high-default lenders, SBA would be helping to reduce the subsidy estimates for its business loan programs so that average lenders with more reasonable default rates would not be penalized in their access to the SBA to make their loans. The lender community had no objection to the creation of SBA’s Office of Lender Oversight, as long as it was concentrating its efforts on the minority of low-performing lenders that otherwise might make the program more expensive and less accessible for everyone else.

## **Limiting the Risk in Federal Credit Programs**

Three types of risk particularly affect federal credit programs: *operational risk*, *credit risk*, and *market risk*. Two of the most important are *operational risk* and *credit risk*. *Operational risk* is the risk that the government agency may lose control over part or all of its program. For direct loan programs, operational risk involves the risk of improperly originating, servicing, or collecting on a federal loan. For guaranteed loan programs, operational risk involves the risk that lenders who originate and service guaranteed loans do so poorly. Operational risk also involves the chance that either a lender or the government, as the case may be, will fail to collect properly on loans that may default. Limitations in a program’s statutory framework sometimes can increase the likelihood of operational risk in a federal program.

Operational risk is a factor in any loan program, whether for lending in the private sector or in a government program. However, operational risk may be more difficult to manage for government. Often the government program involves extending credit to borrowers who are not as demonstrably creditwor-

thy as borrowers who take out private consumer or commercial loans. For example, one of the justifications for the federal student loan program is the fact that students may need to borrow thousands of dollars for their schooling before they have established the credit history that allows the private market to score its borrowers so effectively. Similarly, many small businesses may need start-up loans before they have established themselves and their creditworthiness. Such a lack of information can reduce the benefits of credit scoring and loan scoring that have been so effective for private lenders. Instead, the government must also use other operational measures to limit the risk of its programs.

The other major risk factor is *credit risk*, namely, the chance that borrowers in a particular credit program will default in large numbers and thereby cause unacceptable losses. Again, government agencies face greater difficulties in this regard than private lenders do.

Government programs usually are intended to complement, rather than compete directly with, the private sector. That means that programs such as the SBA’s section 7(a) business loan program require that their borrowers be turned down for nongovernment loans before they become eligible to take out a government loan. Alternatively, government programs such as the FHA single-family mortgage program may involve greater fees or longer processing times than borrowers face if they take out a conventional loan instead.

It is much harder to underwrite a loan to borrowers who cannot or do not wish to avail themselves of a private sector loan than it is to underwrite a comparable loan in the private sector. This is especially true if the borrowers in the government program cannot provide adequate information about their creditworthiness.

Despite these difficulties, the record of federal credit agencies in recent years generally has been one of increasing success at managing both the operational and credit risks inherent in their programs. A major reason, besides the changed incentives created by credit reform, has been the increased availability of information-based practices and technology systems that federal agencies have been able to apply to management of their programs.

The third kind of risk might be called *market risk*.<sup>2</sup> This can be difficult for credit agencies to detect and address because it involves factors beyond their direct control. One form of market risk is competition from a private sector that is increasingly able to apply information-based processes and technologies to attract the most creditworthy borrowers away from a government program. Another form is a change in the economy that reduces the number of eligible borrowers for a federal program or otherwise limits the public purposes that a program is supposed to serve. A number of rural credit programs come to mind in this regard. Often the only remedy for market risk, if it is detected and addressed in time, is a change to the statutory structure of a federal credit program to enable managers to limit their losses or otherwise adjust the nature of their programs.

The next six sections offer promising practices, culled from a large number of agency practices that are worthy of recognition, that show how federal agencies have used information-based systems and processes to address both operational risk and credit risk in their programs.<sup>3</sup>

# Risk Management: Management Oversight

Perhaps the most important opportunities presented by information systems relate to the ability of federal credit managers to manage the risks in their programs. In the private sector, lenders or financial guarantee firms establish an appropriate risk management environment through use of a credit committee of senior management to ensure that appropriate policies are in place and that the institution is following those policies. One leading private mortgage insurance company, for example, utilizes a senior management committee, backed up by quarterly reviews to ensure that (1) the company's portfolio performance reflects the anticipated parameters, or (2) corrective actions have been taken to address unforeseen problems. Managers understand that they must act to deal with problems as soon as possible because the state of the relevant portfolio or product performance indicators will be reviewed as a part of the quarterly review.

Technology is an important tool in management's oversight of its risk exposure. An increasing number of firms maintain a "digital cockpit," also called an electronic dashboard, to allow access by senior managers at any time to screens that indicate credit quality and other metrics, both by customer and by product. It is the combination of a sound process for management oversight, backed by appropriate information technologies, that makes these companies effective at managing their credit and operations risks.

In the federal government, at least two federal agencies display useful examples of this approach. One, the Office of Federal Student Aid (FSA) of the U.S. Department of Education, involves an immense program, including oversight of some \$107 billion of direct and \$245 billion of guaranteed student loans in FY 2004. The other, the Export-Import Bank of the United States (ExIm Bank), involves outstanding loans

or loan guarantees totaling \$47 billion in FY 2004. While individual student loans are smaller in amount and tend to fall into fairly standard patterns, ExIm Bank loans tend to be large and to differ in significant respects from one another. The application of effective management information systems for two such different programs shows that this is indeed a promising practice for federal credit agencies generally.

## Promising Practice: The Executive Dashboard and Project Scorecards of the Office of Federal Student Aid of the U.S. Department of Education

**The practice.** FSA inaugurated its Executive Dashboard in the summer of 2003. The FSA group that administers the dashboard, the Enterprise Performance Management Services Group, took perhaps two to three months to get the project started. The group began with a one-page summary of key program performance indicators, which soon grew into a several-page report as managers sought to be informed about additional indicators.

The dashboard report appears weekly. The group publishes the dashboard each Thursday on the agency's internal website as the basis for discussion at the Monday meeting of the FSA's Management Council, which includes the chief operating officer and her top managers. If all indicators seem to be moving in expected and positive directions, the discussion might last only 15 minutes or so, to hit some of the highlights. If the indicators reveal disturbing or unexplained trends, the discussion can go much longer, and may result in requests for more information. FSA officials in each of the agency's operating areas, or business units, also utilize the reports.

Key dashboard performance indicators relate to loan applications (for example, the percentage of applications that are submitted electronically rather than on paper), program disbursements, direct loan servicing (for example, the percentage delinquent more than 31 days), loan consolidation activity, collections, accounting and program management, budget, project status (a summary of the number in each status category, for example, those coded green, yellow, or red), overdue control mail, call-center performance, and status of internal audits.

FSA reports that producing the dashboard has required refinement of data elements and standardization of definitions. Each business unit produces the data for the part of the dashboard report that relates to its performance. The compilation of the data each week helps program managers to detect issues of performance quality or data quality in each of the sub-areas that they aggregate for the report. Program managers also add notes to explain anomalies in their reported information. The head of the FSA Enterprise Performance Management Services Group reports that, in addition to the time spent by managers in the separate business units, his office spends perhaps one person-day a week preparing the dashboard report, plus clerical help.

One other FSA performance report also deserves mention. This is the monthly project scorecard, which provides management with easy-to-read indicators of schedule, cost, quality, scope, and the elapsed time compared to the period of performance specified in a contract. (FSA administers most of its work through contractors.) Each performance category is scored with a green, yellow, or red indicator of the degree of risk in terms of schedule to completion, cost, and other issues. A second page of the scorecard goes into more detail, including major issues, corrective actions taken, needed management support, accomplishments over the past month, and activities upcoming over the next month, along with information about the responsible officials, business unit, and contractor.

Similar to the Executive Dashboard, FSA managers actively use the project scorecard as a management tool. Project scorecards are considered as part of the weekly meetings of the FSA Investment Committee, which is also chaired by the chief operating officer and attended by senior FSA managers. The Investment

Committee hears requests for approval to spend money that has already been budgeted for the fiscal year. The committee also reserves time at each meeting to review scorecards of approved projects and review the status of each ongoing project at least quarterly. As a result of the review, the committee may allocate support to a troubled project or otherwise help project managers to deal with problems. The committee's meetings are open to FSA managers generally. Project managers gain an incentive to report accurately on their scorecards because of the likelihood that senior FSA managers will ask questions and raise issues that could reveal inaccuracies.

**Next steps.** FSA has just created a risk analysis unit within the Enterprise Performance Management Services Group. This group will identify areas of risk and investigate data anomalies, with a special focus on identifying areas of fraud, waste, or abuse in the program. The risk analysis unit is not yet looking at issues of program design or external factors affecting the success of FSA programs, although these may become areas of interest in future years. One likely result of the activities of the new group may be the addition of data elements to the Executive Dashboard that better highlight relevant risk factors. One wonders whether FSA would find it useful to add a one-page cover sheet to each weekly report that flags the most important information, as a way to return to the original concept of the dashboard.

## Promising Practice: The Asset Management System of the Export-Import Bank of the United States

**The practice.** The ExIm Bank's Asset Management System tracks all loan activity starting once the ExIm Board of Directors approves a loan. The system is managed by the Asset Monitoring and Restructuring group (AMR group) of the Asset Management Division of the bank. Members of the division add information to the loan file on any analyses they perform, any contacts with the borrowers, any trips overseas to inspect the status of funded projects, any change in risk rating of a loan or borrower, changes in loan terms negotiated with the borrower, and virtually any other changing circumstances with respect to an outstanding loan. The group makes these additions promptly after the activity or change in status occurs.

The critical importance of the Asset Management System is that it maintains all portfolio data in a single place. The system interfaces with other bank systems such as the document management system (where the legal documents on a loan are maintained) and the bank's systems that record the payment history of loans and loan guarantees.

The AMR group adds all information to the Asset Management System starting with information from the documents backing an approved loan. The system is available throughout the ExIm Bank so that people in other units—for example, senior management or the people who originated a loan—can follow changes in the portfolio or in a single loan's status over time. Initially the system produced quarterly risk assessment reports on the entire loan portfolio. However, the system now produces portfolio reports twice a year, which seems to represent a more appropriate interval.

Loans that exhibit declining credit quality—for example, because of a drop in the risk rating of a particular borrower or of the country where the loan has been made—may be placed on credit watch status. Credit risk is assessed by reviewing expected future cash flows from a loan, with a 12-month time horizon, and issues of credit quality such as the emergence of new competition for a borrower. Any downgrade or upgrade of a loan triggers an e-mail report to the chief financial officer (CFO), deputy CFO, and the person who originated the loan for the bank. The system generates exception reports on loans falling outside of expected parameters as well as quarterly reports to the CFO.

One of the benefits of the system is the richness of insight that it can provide about why a loan is facing a decline in credit quality. An ExIm Bank official reports that the experience of generating a composite portfolio report has helped to catch problem loans earlier and generally to ask more of the right questions about potential issues.

The Asset Management Division began working on the system in 2000 and took delivery in March 2002. As occurred with the Executive Dashboard of the Office of Federal Student Aid, the issue of data definition was important in helping to ensure the quality of the ExIm Bank system and its reports.

Here the key questions revolved around factors relating to the credit quality of loans. The people who originated loans at the bank did not want to be surprised by a credit downgrade that might occur as early as six months after the board approved a loan. This led to a process of collaboration between the unit of the bank that originates loans and the AMR group, so that both offices could come to agreement about the likely credit quality of the loan at the time of origination. The result of this collaboration is that ExIm Bank officials who originate loans now apply the definitions that are used for the Asset Management System when they rate the risk on their new loans and generally come to the same risk assessments. That means that loans can be structured appropriately to address risk concerns at the time of origination rather than only afterwards.

**Next steps.** The Asset Monitoring and Restructuring group is considering establishing a brief report, perhaps one or two pages in length, which summarizes the status of the loan portfolio for ExIm Bank senior managers. This would accompany the longer semi-annual portfolio report that the group currently generates. Another question is whether the inputting of data could be made easier by performing more of the task at the time the loan is being developed rather than only after board approval. These issues are currently under consideration.

## Lessons Learned

While the FSA Executive Dashboard and project scorecard, and the ExIm Bank Asset Management System all are different in their purposes, they provide useful insights about the development of management information systems:

1. *These systems are management tools. Each of these systems is responsible for generating information that top management needs.* They add considerable value compared to the cost of building and maintaining the system.
2. *Information quality is important.* Management will use the information to make decisions. Because the information will be used in actual business decisions, prompt feedback is available from a variety of users to help detect inaccuracies, to correct them, and to improve the processes that generated the information.

3. *One office is responsible for maintaining a system and ensuring its quality.* On the other hand, that office does not work alone. Collaboration with other business units ensures that the system continues to evolve to meet the agency's needs.
4. *These systems interface with those of other business units.* The Executive Dashboard depends on data generated by other FSA units. The ExIm Bank Asset Management System accesses data from a number of other systems of the bank. Yet, it was possible in each case to build a new system without disrupting the other systems.
5. *These are simple systems.* In FSA, management determined that its information needs were not being adequately met and devised the new dashboard and scorecards to meet those needs. In the case of the ExIm Bank, an official coming from the private sector determined that there was a gap among the existing ExIm Bank systems and knew how that gap could be filled with minimal disruption.

# Risk Management: Loan Origination

Increasing widespread use of the Internet has helped to foster electronic processes for loan applications and loan origination. In particular, large lenders have developed electronic systems to manage their loan portfolios from the time of origination to the end of a loan. Federal agencies such as the Small Business Administration need to make their processes electronic and compatible with the electronic processes of their participating lenders, both to keep transaction costs down and to encourage participation in their credit programs. Electronic loan origination also improves the quality of the data that SBA uses to manage the risk in the agency's portfolio of loan guarantees.

## Promising Practice: The E-Tran Loan Guaranty Origination System of the Small Business Administration

The business loan programs of the Small Business Administration have been evolving over time. Today, over half of all SBA-guaranteed business loans—the so-called Section 7(a) program, named after the section of the Small Business Act that authorizes the program—are processed through a channel known as SBA Express. SBA Express reduces the documentation that otherwise would be required for a Section 7(a) lender and, in return, requires the lender to accept a 50 percent share of the risk on the guaranteed loan. This is a much higher percentage of risk than lenders take on the traditional Section 7(a) program.

**The practice.** The SBA traditionally has received loan origination requests by fax. Lenders fax the borrower's information to the SBA, and a clerk enters the information into a database and requests a loan number. The SBA then faxes a loan number back out to the lender. This process takes approximately 24

hours to complete. Although SBA performs limited validation checks on the information, it is possible for the SBA to generate a loan number to permit a lender to obtain the SBA's guarantee even if the application contains incorrect information.

E-Tran greatly streamlines this process. Lenders enter information electronically. Edit checks help to catch erroneous information at an early stage. Once SBA receives the application, the E-Tran system checks for completeness and accuracy, checks for availability of the guarantee within the SBA's credit budget, and allows the SBA to respond in minutes with an SBA loan number that signifies approval of the request for the agency's guarantee. Information from approved loans is transmitted to SBA's mainframe systems.

E-Tran is also a lender reporting system. It allows lenders to use E-Tran documentation to extract the information from their systems that is required to be reported to SBA. SBA staff use this information both to monitor the portfolio of SBA loans of each lender and to monitor the SBA Express guaranteed loan portfolio as a whole.

SBA provides lenders with several electronic options:

- A web page where lenders can enter loan information for single loans
- A secure website capable of accepting multiple applications simultaneously via an XML (eXtensible Markup Language) file transfer
- Access to software intermediaries that include E-Tran loan submission capability in the services that they provide to lenders

These alternatives allow each type of lender, small or large, to select the form of E-Tran access that is most appropriate for its business needs. The provision of E-Tran's specifications to software vendors has allowed them to include E-Tran in the suite of products and services they offer to lenders. Vendors have produced software that contains the necessary forms that lenders need to originate SBA loans. This documentation software resides on lenders' desktop computers and facilitates standardized document preparation and transmission to the SBA. This is helpful because it allows E-Tran applications to be integrated into the processes that the lender uses to manage its larger loan portfolio, including loans that may not be SBA guaranteed.

SBA officials note several advantages to using vendors to facilitate the E-Tran loan origination process. Because many lenders use the services of such vendors, SBA can use them as a channel to help disseminate changes in documentation or policies so that lenders remain current on any SBA-mandated changes. This saves the SBA time and money in notifying its large pool of lenders.

One hundred and fifty-five lenders currently have signed on to originate loans via E-Tran. Many of these lenders have reported enthusiastically back to SBA on the benefits of the new process, especially because of the ability they gain from E-Tran to originate SBA loans quickly and to increase their volume of SBA lending without increasing labor costs.

**Next steps.** SBA worked with lenders for over two years to develop E-Tran, first as a pilot and now as a full-fledged program. SBA is expanding the scope of E-Tran and plans to make it available for applications from lenders participating in the traditional Section 7(a) business loan program and, eventually, to participants in the SBA's Section 504 program, which permits small businesses to finance major assets such as land and buildings.

The SBA also has embarked on a multi-year project to standardize the data elements associated with E-Tran. Standardizing of data elements allows the SBA to publish a single XML data dictionary for E-Tran, which helps the SBA maintain strict guidelines regarding how lenders define terms and report them. SBA has done this in close collaboration with industry users. The benefit of the XML language is that it

permits documents to be shared on the Internet in a manner that allows for data exchange across platforms and applications. It is likely that the financial industry will widely adopt XML as a means to format data for exchange. The SBA's largest lenders would potentially realize the greatest benefit from using XML technology, because XML facilitates economies of scale and a significant increase in the volume of file transfers between lenders and the SBA.

Because of the SBA focus on promoting lender participation in SBA programs and the large number of lenders who originate only a handful of SBA loans, the SBA has no plans to require lenders to adopt electronic filing.

## Lessons Learned

The SBA's E-Tran system provides a number of useful lessons for other agencies:

1. *Users can make an important contribution to the design of a system.* In the E-Tran case, SBA was careful to work with the lending community to determine what kind of system would best fit with the lenders' own systems.
2. *Systems are easier to adopt if they accommodate user needs.* The SBA is not ready to require that lenders use an electronic system for obtaining their loan guarantees. Instead, SBA has provided three different options for lenders to use the system, including making the E-Tran software available to vendors who serve the community of lenders who make SBA loans.
3. *Piloting can be an important aspect of system development.* SBA used the pilot phase not only to work out kinks in E-Tran, but also to establish a track record that it could use to show SBA lenders the benefits and ease of use of the system.
4. *Data definitions should be standardized.* This is a recurring theme across federal agencies' information systems. Standardizing the data definitions for E-Tran will allow SBA to use XML to pull lender data from E-Tran into its larger portfolio monitoring system without suffering a degradation of data quality because of the input from many different users.

# Risk Management: Lender Monitoring

When a federal agency provides a government guarantee of a loan, this changes the incentives of the lender that makes that loan. Economists call this phenomenon “moral hazard.” Because the government bears some or all of the risk of default, the lender loses the incentive to originate and service the loan with the same care that it would use if its own money were entirely at stake. In the first year or two after originating a loan, the lender may gain enough income from fees and interest charges that it becomes indifferent to the risk of later default. After taking losses in many programs, federal credit agencies are devoting increased resources to monitoring the performance of lenders who participate in their programs. Ginnie Mae has been a leader in developing lender monitoring systems, starting in the early 1990s and continuing today with its Ginnie Mae Portfolio Analysis Database System (GPADS).<sup>4</sup> Other federal credit agencies have also developed lender monitoring systems tailored to the laws that define their particular programs.

## Promising Practice: The Lender Monitoring System of the Small Business Administration’s Office of Lender Oversight

The Small Business Administration makes loans to small businesses that are unable to obtain credit on comparable terms from the private financial market. In order to maintain its lending program within the limits of the subsidy estimates of the agency’s credit budget, the SBA must be proactive in monitoring its guaranteed loan portfolio and the performance of the lenders participating in SBA’s business loan programs. This is especially important for the main SBA loan guarantee program—the section 7(a) program, which has been budgeted for a zero credit subsidy starting in FY 2005.

**The practice.** In 1999, the SBA created its Office of Lender Oversight (OLO) to institutionalize the risk management function within the agency. OLO is responsible for overseeing lenders that participate in SBA section 7(a) and 504 loan guaranty programs and also for monitoring and analyzing the condition of the agency’s outstanding portfolios of section 7(a) and 504 loans.

OLO monitors lender performance with systems at its headquarters and also conducts reviews that involve visits to lenders. The office has retained the services of a contractor to provide a commercial off-the-shelf package to monitor the financial risk of individual SBA loans and to score lenders according to the credit quality of the SBA loans that they have originated. OLO ranks the lenders on a five-part scale according to the credit quality of their loans. Lenders in the top three tiers are overseen by the SBA’s Office of Financial Assistance, which is responsible for promoting SBA services and loan programs to lenders. Lenders in the bottom two tiers—about 10 percent of the total—are shifted to direct oversight by OLO. These lenders are subject to more intensive reviews. The two SBA offices are working together to try to grant additional discretion and expedited processing to the highest-performing lenders in the two top tiers.

Using its headquarters system, OLO monitors lenders quarterly. The review process allows OLO to identify those lenders whose risk profiles have changed significantly since the last quarter and to identify lenders that merit special attention. The OLO system generates exception reports to flag lenders whose origination of SBA loans has greatly increased in a short period of time or to flag where the credit quality of its SBA loans shows signs of deterioration.

A particular measure of concern involves an increase in early defaults, that is, loans that default within 18 months of the first dispersal.

When its monitoring identifies issues or concerns, OLO staff follow up directly with the lender to ascertain the basis and implications of the lender's changed performance. OLO may request that the lender provide additional information such as the business profile of its SBA-guaranteed loans and any plans for growth or contraction of its SBA business. OLO also may compile additional information from public annual reports or regulatory reports concerning the lender.

Although the SBA's monitoring relies to a significant extent on information provided by the lender, the agency is able, as the Government Accountability Office points out, to use the combination of a reconciliation process, lender incentives, and the SBA's program of loan asset sales, to help ensure data quality. Lenders have an incentive to report section 7(a) loan data accurately because of SBA's policy of denying partial or full payment of a claim for payment under the section 7(a) guarantee on a defaulted loan if the reported loan data were not correct.<sup>5</sup>

Besides monitoring lenders, OLO is responsible for conducting analyses of the SBA's portfolios of section 7(a) and 504 loans and for detecting trends. OLO accesses six different SBA databases to compile its portfolio analyses.

OLO has determined, for example, that lenders who have originated less than 10 SBA loans do not pose a concentration of risk for the agency. Of some 5,000 lenders, 7 percent, or 350 institutions, are responsible for originating 84 percent of outstanding SBA loans, amounting to about \$25 billion. The remaining 4,792 lenders are responsible for only \$4.9 billion of outstanding SBA loans. Of these, 3,443 lenders originated just over \$1 billion of SBA loans. OLO can factor this assessment into its allocation of the office's scarce resources. It has decided, for example, to concentrate on conducting more frequent reviews of the small number of lenders who have the greatest participation in the SBA's loan programs and whose activities therefore pose a potential concentration of risk.

The SBA has institutionalized its processes to review the portfolio analysis and trends. The SBA's Portfolio

Analysis Committee, chaired by the SBA's chief operating officer and including the heads of OLO and the Office of Financial Assistance, plus the associate deputy administrator for capital access (who supervises both offices) and his or her deputy, meets monthly to review the portfolio analyses that OLO generates. In addition, the SBA's Lender Oversight Committee, also chaired by the SBA's chief operating officer, meets bimonthly and as needed to review OLO enforcement recommendations as well as OLO's budget, staffing, and operations.

The institutionalization of the process for top management, backed by analysis from OLO, to review periodically the SBA's credit exposure and portfolio trends is very important if the agency is to keep risk within intended limits. Early detection of issues can permit SBA to respond with a range of tools that would not be nearly as effective if the agency waited until problems turned into greater or more widespread losses. The SBA also may have time to turn to Congress for additional tools if trends indicate the need.

**Next steps.** GAO has called upon SBA to define its enforcement powers and the array of tools that it will apply to deal with problem lenders. SBA has requested Congress to provide added enforcement powers. OLO meanwhile is working to refine its lender scoring and the application of lender scorecards to lenders so that OLO can apply SBA's scarce oversight resources most effectively.

## Lessons Learned

The SBA's experience with lender monitoring reveals a number of important lessons:

1. Proven technology now exists, either in available products or through commercially available data services, to help federal credit agencies *deploy effective portfolio monitoring systems*.
2. Effective risk monitoring requires an agency to *institutionalize processes for receiving risk-related information and acting on it*. Stakeholders in that process include both the parts of the agency that try to encourage lenders to use the agency's programs and those parts responsible for alerting top management about the emergence of serious risk issues.

3. Federal credit agencies are well served by *creating offices with the responsibility for developing and deploying risk management systems and for analyzing risk problems as they are detected.* Regular reporting from the risk management office to a risk management committee that meets regularly and is chaired by a senior agency official can help to focus top management on emerging problems before they potentially grow out of control.
4. Risk management systems and processes alone are not enough. Agencies also need to have the *enforcement tools and other statutory authority* to address problems they detect.

# Risk Management: Loan Servicing

For many years, many federal credit agencies, and especially those serving housing, were unable to obtain significant recoveries from defaulted loans. Agencies such as the Federal Housing Administration and the Small Business Administration engaged in loan asset sales programs that helped to increase returns from defaulted loans or the seized collateral from such loans. Mortgage loans pose special difficulties because of the many different state laws and procedures relating to foreclosure and the time and substantial cost that is often involved in actually foreclosing on a home that secures a defaulted mortgage. In addition, of course, federal credit agencies are reluctant to have lenders foreclose on people's homes because of the human toll that this takes on borrowers who had tried to benefit from a federal loan program.

## Promising Practice: Loss Mitigation by Lenders in the Federal Housing Administration Single Family Program

As the administrator of the nation's largest federal credit program, the FHA was especially sensitive to the costs of mortgage foreclosure both to the borrowers involved and to the program. An early attempt to reduce foreclosures, the assignment program permitted a lender to assign a defaulted mortgage to FHA with a forbearance plan that offered reduced or suspended payments for up to three years. FHA concluded that the program generated substantial losses without curing a sufficient number of mortgage defaults.

**The practice.** In 1996, FHA terminated the assignment program and began to implement the Loss Mitigation Program. Under the Loss Mitigation Program, FHA scores the performance of lenders who use loss mitigation techniques to reduce default rates and the cost to FHA of claims made. Loss mitigation

tools are of two kinds: those that offer some form of temporary or long-term debt relief to a borrower so that he or she can come back into repayment status and those that result in the borrower giving up the home without going through the foreclosure process.

Loss mitigation includes a range of home retention tools. Partial reinstatement provides for a borrower to resume regular payments and to catch up on missed payments through a repayment plan for the following 12 months. Special forbearance allows for the lender to suspend or reduce payments and for the borrower to make up the forbearance up to 12 months later. These two approaches would be suitable for a borrower, for example, who lost his or her job and defaulted on the mortgage but who found new employment and was able to resume payments. A loan modification allows for the negotiation of new, less burdensome monthly payments for borrowers who may not qualify for refinancing of the mortgage. A partial claim workout provides for a lender to advance funds on behalf of the borrower for up to 12 months so that the loan can become current. The borrower then signs a subordinate mortgage to FHA. Currently such subordinate mortgages carry no interest due and are payable only when the borrower pays off the first mortgage or sells the property. This last approach would seem appropriate where a borrower has had a medical or other financial emergency and can resume paying on the mortgage but cannot afford to make up the missed payments by adding to the monthly payments due.

Loss mitigation that involves sale of the home includes a range of approaches (non-home retention tools) that permit a borrower to give up title to the home or to sell it without going through foreclosure. A workout mortgage assumption allows a new owner

to take over the property from a borrower who is currently delinquent or in danger of default because of some involuntary inability to pay, such as a medical emergency. Giving up title to the home would occur when the borrower has little or no equity in the property; otherwise, one assumes that a troubled borrower could simply sell the home and recoup any equity from the property.<sup>6</sup>

Thanks to scoring-based technology systems that allow lenders statistically to test the likelihood that a particular form of loss mitigation will be successful for a particular type of borrower, lenders have become quite adept in recent years at applying loss mitigation.<sup>7</sup> The Loss Mitigation Program recognizes this and, within broad limitations, leaves considerable discretion to the loan servicers as to whether or what kind of loss mitigation they will apply in particular circumstances.

In support of the Loss Mitigation Program, FHA provides quarterly loss mitigation training for lenders and housing counselors. In the five years from FY 2000 through FY 2004, the FHA provided training to over 9,000 people.

FHA provides both positive rewards and the possibility of sanctions to lenders to promote their participation in the Loss Mitigation Program. The agency uses one lender performance score, the Loss Mitigation Performance Analysis (LMPA), to determine which lenders will receive annual incentive awards.

The LMPA performance score measures the lender's success in keeping its rate of mortgage defaults low and in keeping the costs of those defaults low, relative to comparable types of lenders with comparable types of loan portfolios. FHA divides its participating lenders into peer groupings (high, medium high, medium low, and low volume). It calculates each lender's performance score, standardizes it, and makes adjustments based on the extent that the lender services riskier loans, that is, loans for first-time home buyers and minority borrowers, and in underserved areas. Then FHA determines for each category of lender the best performers who service up to 25 percent of the loans in each lender category. These lenders receive the annual incentive awards. FHA publishes the annual list of lenders who achieve the best performance scores.

In addition, FHA has available strong sanctions to apply against lenders who fail to apply loss mitigation to their defaulted loans. The law provides that such lenders may be subject to damages in an amount equal to three times the amount of claims they make with respect to any FHA-insured mortgage where they failed to engage in loss mitigation.<sup>8</sup> To implement the law, FHA began the Tier Ranking System (TRS) in 2000 to determine which lenders were using FHA loss mitigation tools.

Essentially, the TRS performance score measures the number of loans where the lender exercises loss mitigation divided by the number of the lender's loss mitigation loans plus the lender's loans that went into foreclosure. FHA then separates lenders into four tiers according to their TRS performance scores. Lenders who rank in the lowest two tiers are subject to training, investigation, or audit. FHA also flags those lenders that rely on one loss mitigation approach exclusively or that use a particular approach more than three times the national average or less than one-third the national average. The agency believes that lenders with numbers far outside the national average may indicate servicer abuse or lack of training. FHA releases TRS performance scores to lenders quarterly, based on data from a rolling 12-month rating period. FHA does not publish the TRS performance scores.

The Loss Mitigation Program has shown dramatic success in reducing the number of defaults that turn into claims on the FHA fund and in reducing the cost of those that do turn into claims. Table 2 shows that in FY 1999, for example, FHA had almost 26,000 mortgage loans in loss mitigation ("Total LM Claims") and over 73,000 foreclosures. In other words, only 26 percent of defaulted loans were resolved through workouts rather than foreclosure ("Workout Ratio"). The numbers steadily improved over the subsequent years until in 2004 (the last year for which complete data are available) there were over 84,000 mortgage loans in loss mitigation and over 71,000 foreclosures, for a workout ratio of 54 percent—over twice as high as six years earlier. (As will be discussed in the section "Adverse Selection and the FHA Single Family Program," beginning on page 34, these numbers also reveal a significant increase in defaults of FHA loans).

**Table 2: Loss Mitigation Claims Paid Annually, FY 1999–2004**

Fiscal Year	HR Claims	NHR Claims	Total LM Claims	Foreclosures	Total Claims (LM and Foreclosures)	Workout Ratio
<b>FY1999</b>	20,815	4,961	25,776	73,371	99,146	26.00%
<b>FY2000</b>	31,120	4,306	35,426	68,668	104,094	34.03%
<b>FY2001</b>	50,385	3,347	53,732	60,204	113,936	47.16%
<b>FY2002</b>	68,755	4,361	73,116	64,218	137,334	53.24%
<b>FY2003</b>	68,003	4,300	72,303	73,215	145,518	49.69%
<b>FY2004</b>	78,528	5,694	84,222	71,273	155,495	54.16%

Source: FHA

Note: "HR" means those home-retention loss mitigation techniques that allow a borrower to keep the home. "NHR" means those non-home-retention loss mitigation techniques that do not allow a borrower to keep the home.

What is especially heartening about these numbers is that home-retention workouts account for the bulk of the growth in loss mitigation over the six years. Home-retention claims rose from almost 21,000 in FY 1999 to almost 79,000 in FY 2004. Taking the six-year total, almost 418,000 people who had defaulted on their mortgages and who in prior years probably would have lost their homes instead were able to keep their homes and come back into repayment status.

Each federal credit agency operates with a dual mission: (1) to serve borrowers by providing credit that they might not otherwise obtain on the same terms from the private market, and (2) to protect taxpayers against unacceptable losses, especially from loan defaults. The FHA Loss Mitigation Program, by helping defaulted borrowers to keep their homes—or at least to sell their homes with minimal loss—and by protecting the FHA insurance fund against the cost of claims, provides an excellent example of service to both of those objectives.

**Next steps.** Since the inception of the Loss Mitigation program, FHA officials have worked actively to refine the scoring of lender performance. A number of further improvements to the LMPA and TRS performance scores would seem to suggest themselves. First, it would seem useful to combine the two sets of performance scores into a single score that would be used both to make incentive awards and as the basis to recommend training or apply sanctions. Second, it would seem that the score should be set quarterly. This conforms

to the practices of lenders, which provide incentive bonuses to their managers and employees on a quarterly basis. Finally, because loss mitigation works best in a market with stable or appreciating house prices, it would seem prudent for FHA officials to consider the program implications if home prices were to decline, as is discussed in the section "Adverse Selection and the FHA Single Family Program."

## Lessons Learned

The FHA loss mitigation program is building on a record of demonstrable success. Among the lessons:

1. *Working with stakeholders* can help an agency avoid dilemmas that otherwise could beset its programs. FHA's loss mitigation program works well because the incentives of the agency—to save money lost from foreclosures—overlap with those of participating mortgage lenders who can profit more if FHA shares the gains from loss avoidance with them. This is a superior approach to the earlier loan assignment program that failed to work with the common interests of lenders.
2. A federal credit agency requires *prompt, accurate, and verifiable information* to administer its programs. To succeed, FHA needed to develop lender reporting requirements and systems to compile and digest the reported information. FHA also needed to be able to verify reported information, which it does at the time a lender files a claim.

3. For broad-based approaches such as loss mitigation, an agency needs to *experiment with a variety of approaches*. FHA started loss mitigation by creating incentives for high-performing lenders. It moved to a complementary program of supporting or sanctioning low-performing lenders.
4. Once again, the FHA experience shows the *importance of having a well-crafted law in place*. Here the law allows FHA to assess treble damages against lenders that make claims against the FHA fund but fail to engage in loss mitigation.

# Risk Management: Collection

At some point a federal agency must ensure that defaulted loans are sent to collection. This is needed because of the problem of moral hazard. If borrowers came to believe that the federal government never collects on its loans, then many could lose the incentive to stay current in their payments. Also, agencies need to address the recovery rate on their defaulted loans in order to keep their credit subsidy amounts within reasonable bounds. The credit subsidy calculation for a program depends not only on the default rate, but also on the amount that the agency recovers from each defaulted loan.

Federal credit agencies have adopted several different approaches to collection. Under a law that took effect in 1997, the Small Business Administration now requires lenders to resolve defaulted business loans and to make a claim on the SBA's guarantee only once the lenders have the recovered amounts in hand. This can be much more efficient than turning a defaulted loan over to the government to collect. A second very effective approach is for a federal credit agency to sell nonperforming loans and recovered property through a carefully structured loan asset sale program. The SBA was able to sell 187,000 older nonperforming loans, amounting to over \$5 billion in unpaid principal balance, in a loan asset sales program that freed up SBA staff to be able to support a significant increase in the volume of SBA loans outstanding.<sup>9</sup> Another example of an asset sales program, the Department of Housing and Urban Development's HomeSales.gov, is discussed in the next section, "Sales of Acquired Properties."

When neither of these two options is attractive, a federal credit agency may need to supervise collection of defaulted loans itself. That can occur, for

example, if the federal government has more effective collection tools at its disposal, such as the federal Treasury Offset Program, than are available to collectors on privately owned debts. In such cases, a critical issue is the way that the agency rewards its contractors and ensures that the collectors' incentives are aligned with those of the agency.

## Promising Practice: The Collections Group of the Department of Education's Office of Federal Student Aid

The FSA Collections Group oversees a portfolio of 2.4 million in defaulted student loans, amounting to \$18 billion of outstanding principal balance. Fifty-five percent of these are defaulted guaranteed student loans that have been put back to the agency and another 41.4 percent are defaulted direct student loans. In FY 2004 the group collected \$1.8 billion on its portfolio of defaulted loans.

**The practice.** As with most federal credit agencies, FSA relies heavily on contractors to perform tasks such as collections. The Collections Group began to apply performance-based contracting in 1979 and has been refining its approach ever since. Performance-based contracting is needed to avoid counterproductive activities that might result from a contract system that misaligned the contractor's incentives and the interests of the agency. Some federal agencies, for example, have found themselves paying contractors according to the size of the loan portfolio that they manage; this can create an incentive for the contractor to hold and churn the portfolio rather than actively collect on it.

FSA wants to do business only with the best collectors in the business. For FY 2005, FSA has selected 17 private collection agencies, including five small businesses, to receive task orders. Collection contractors are paid a percentage of the accounts that they recover. FSA must receive payments on a collected account before the contractor is paid out of the proceeds. The solicitation provides a schedule of commissions and fees for different types of collection activity. FSA has set these based on close study of the collection industry as to appropriate remuneration.

With the compensation schedule essentially set, the competition for contract award consists of a demonstration of the contractor's past experience. If a contractor is already serving FSA, it must be one of the top performers to obtain a new award; if it is not an incumbent, it must have performed well compared to other collectors working for a company that similarly creates a competitive environment for its collection contractors.

The FY 2005 contract is for a base period of 30 months with renewals at the option of FSA for up to a total of five years. FSA begins the contract period by allocating 20,000 defaulted student loans to each successful collection agency and 5,000 to each successful small-business collection agency.

Starting with the first allocation of loans, FSA applies a balanced scorecard to assess its contractors' performance. Currently it assesses contractor performance according to three measures: total dollars collected in the quarter (70 percent), percentage of accounts serviced (20 percent), and percentage of accounts resolved administratively (10 percent). In addition, FSA may award bonus points (up to 10 percent) from time to time for outstanding customer service. Each quarter, FSA calculates both a quarterly performance scorecard and a long-term scorecard that measures each contractor's performance over the life of the contract.

FSA pays each contractor a specified percentage of the dollars that it collects. Based on long-term performance, FSA awards bonuses each quarter to the top three performers, plus bonuses based on performance in that quarter. FSA has experimented with different performance incentives. For example, it now caps at 6 percent per quarter the total bonus

that high-performing contractors may receive for their performance in any quarter.

In addition to bonus payments, high-performing contractors are rewarded with increased allocations of loans to collect. By contrast, FSA reserves the right to recall accounts from low-performing contractors. FSA also can and will cancel the task order with low performers. The contract solicitation itself warns that the task order for a contractor is likely to be canceled if it scores poorly and is within the lowest two performing collectors for three consecutive quarters.

FSA monitors the collections process closely. The Collections Group includes a small headquarters staff and staff in three regional offices. These include about 55 people in the Atlanta Regional Office who oversee the private collection agency contractors. About the same number of people in the Chicago Regional Office maintains the Department of Education's (ED) call center operations. ED maintains a complaint tracking system based on calls to the call center. The contract with each collection agency specifies that if ED receives two or more complaints that raise concerns about an individual working for the collection agency, then the collection agency shall immediately remove that person from working for ED on the task order. The quality of collector contacts with borrowers is important to FSA. The agency would like to collect money from defaulted loans, but also wants to ensure that all borrowers are treated fairly and with respect.

FSA makes the process as transparent as possible. The agency is determined to maintain credibility with its contractors. Thus, while it maintains close communications with its own contractors, FSA makes clear that a contractor will not get a special advantage because of such discussions. The agency closely monitors practices of the collections industry and seeks feedback on whether its performance measures create the best incentives. For the Collections Group, collections are the subject of continuous process improvement.

**Next steps.** The FSA Collections Group uses an old legacy system to monitor the FSA collections portfolio. This system has limitations in terms of functionality as well as the number of years of data that

it can store. FSA plans to replace this system with a new integrated data system, which is intended to consolidate the FSA's direct loan servicing functions and loan consolidation processes with information concerning collection activities. A contract for the new system was let in early FY 2004, and the system is scheduled to be complete in FY 2006.

## Lessons Learned

The FSA collections experience is another case where good results have been demonstrated over many years. Among the lessons:

1. *Learn from the private sector.* Starting with its predecessor organization, FSA has actively solicited lessons from the private sector about the best practices of companies that need to collect on a large volume of consumer loans.
2. *Competition is a key part of performance-based contracting.* FSA not only structures its contracts to reward performance, but also fosters competition among the contractors it employs. High-performing contractors thrive in such an environment. FSA weeds out low performers.
3. *Ensure information about performance is verified.* FSA has structured collections so that collected funds are paid by the borrower to a separate contractor. This allows FSA to pay its collectors on the basis of actual funds collected rather than on the basis of unverified reports.
4. *Keep learning.* FSA communicates frequently with its contractors and others in the industry, and changes its rules according to lessons learned.
5. With adequate oversight, an agency can *apply a balanced performance scorecard.* FSA wants to collect as much as it can from defaulted student loans, but not at the cost of mistreating borrowers. While encouraging collections, the collection contract also seeks to prevent abuses. FSA maintains an office that oversees the collection contractors and ensures their performance according to this balanced set of measures.

# Asset Management: Sales of Acquired Properties

Unlike student loans, other federal programs may involve government loans or loan guarantees based on collateral such as a home or small business. If a loan moves to foreclosure and if the lender has the right to put the defaulted loan and foreclosed property back to the agency, then the agency must sell it. As was noted earlier, federal agencies have taken a variety of approaches to carrying out this function.

## Promising Practice: The [www.HomeSales.gov](http://www.HomeSales.gov) Common Portal

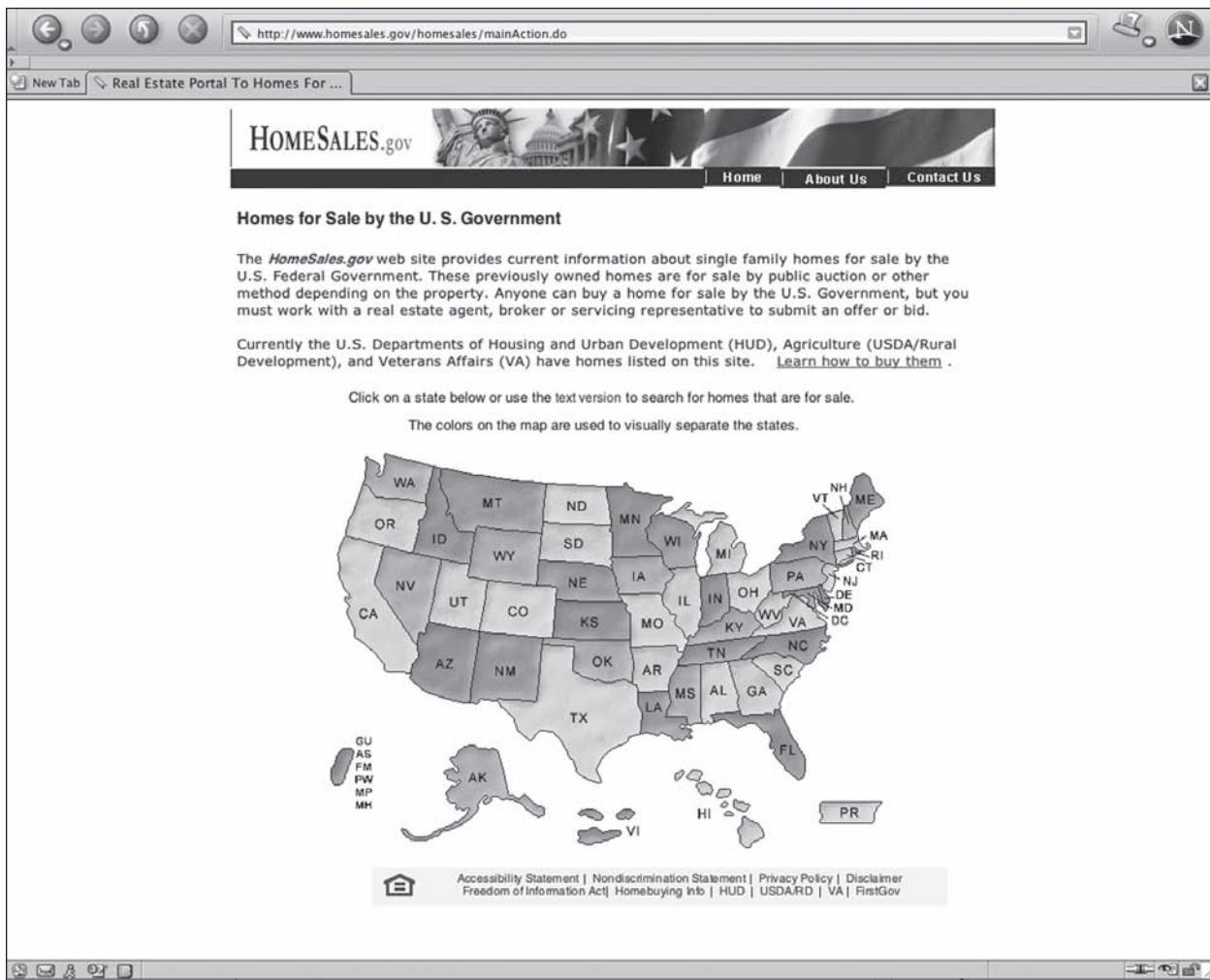
The three housing credit agencies—the Federal Housing Administration at the Department of Housing and Urban Development (HUD), the Department of Veterans Affairs (VA) Loan Guaranty Service, and the Rural Housing Service (RHS) of the Department of Agriculture (USDA)—together hold some 10,000 homes in their ready-for-sale inventories. This amounts to about 99 percent of all single-family homes that the government holds. Until 2004, each of the three agencies simply listed the homes that it holds on the agency's own website. However, this reduced the economies of scale that normally make a property listing system effective.

**The practice.** The three agencies met and decided to create a common portal to allow potential home buyers to visit one website and have access to properties held by all three agencies. Working together, the three agencies soon produced the common portal. RHS and HUD IT staff mocked up the initial web page design with working links to the three agencies' web pages. RHS then offered to create

and host a professional website for the portal. HUD IT staff completed the process by tapping the data sources of the three agencies, transforming the data to XML and then testing the site for functionality, stability, and accuracy.

The website was opened to the public in late 2004. A visit to the site (see Figure 2) reveals how a prospective home buyer can select first the state and then the locality where homes are located. Thanks to the common XML for the datafeeds from all three agencies, property listings are properly distributed so that all of the three agencies' homes in a locality appear together. If the prospective buyer is interested in pursuing a property, the website provides the information needed to contact the agency field office or contractor that has the property available for sale. Creating and implementing the portal (including interagency coordination) required only about 500 staff-hours total from a dozen HUD, USDA, and VA federal employees, plus another 500 hours from various contractor staff who support the agencies' back-end and web-based systems.<sup>10</sup>

**Next steps.** Now that the website is operational, the three participating agencies plan to offer access to the properties of other federal agencies that hold smaller numbers of single-family homes, including the Federal Deposit Insurance Corporation, General Services Administration (GSA), Internal Revenue Service, U.S Army Corps of Engineers, Customs, and the U.S. Marshals Service. HUD is also exploring with GSA the possibility of creating a similar new website, RealEstate.gov, to help sell some 200 commercial and multifamily properties now held by over a dozen federal agencies.

**Figure 2: Homepage of www.HomeSales.gov**

## Lessons Learned

The portal [www.HomeSales.gov](http://www.HomeSales.gov) provides a number of lessons:

1. With careful thought about business processes, even a *small systems change can make a difference*.
2. A new, very useful system need not cost a huge amount. While the experience of a number of federal credit agencies suggests that acquisition of off-the-shelf systems can avoid pitfalls, it sometimes can be useful for an agency just to build a system in-house, especially if it is not a large system.

3. In the world of e-government, *interagency cooperation is more valuable than ever before*. The three major housing agencies worked closely together to make HomeSales.gov a success. Because the agencies worked in a collaborative mode, they could build the new system in a way that bridged differences in the way each agency conducts its home-sale business.

# Challenges Posed by Developments in the Application of Information Systems by the Private Sector

Return again to the fundamental tension that federal credit programs face between doing good and doing well. On the one hand, the government provides support through loans and loan guarantees to borrowers who are not considered adequately served by the commercial credit markets. On the other hand, the government cannot afford to lose large amounts of money paying for an unacceptable number of defaults on federal loans.

For many years, major federal credit programs, and especially the unsubsidized single-family mortgage insurance program of the FHA and the home loan guaranty program of the VA, together were able to provide hundreds of billions of credit without incurring budget costs. They were able to perform this budgetary feat because they helped to overcome market imperfections: They provided funding for creditworthy individuals, including disadvantaged minorities and borrowers in disadvantaged communities, who were underserved by the conventional mortgage market.

The growing conventional mortgage market, now backed by the implementation of automated information-based underwriting systems, has changed this. Through more accurate assessment of the creditworthiness of borrowers and mortgages, the conventional mortgage market has been able to attract an increasing proportion of creditworthy borrowers and to leave FHA and VA with an increasingly concentrated pool of less-creditworthy borrowers.

This process, called “adverse selection,” has been happening over many years. However, it appears that the balance may be tipping, especially for FHA. In metaphorical terms, the conventional mortgage market has been skimming the cream of mortgage loans for years; with automated underwriting and improved information, the conventional market is also taking

the milk and, indeed, some of the better skim milk as well. That process, ultimately unsustainable for FHA, provides a valuable case study of the increasing difficulty that many federal credit programs face when carrying out their missions in today’s increasingly efficient information- and technology-driven credit markets.

## Adverse Selection and the FHA Single Family Program

The FHA unsubsidized single-family mortgage insurance program dates back to the Great Depression and the need for the federal government to intervene to restore the confidence that investors had lost. By providing federal mortgage insurance, the government could reassure investors that, regardless of the possibility that borrowers might default on their mortgages because of hard times, the investment would be safe because it was backed by the federal government. The paradox was that the government was able to do this on a financially self-sustaining basis: The program relied on strict underwriting to make loans predominantly to creditworthy borrowers and recouped from fees sufficient amounts to pay for losses from defaults as well as resale of properties securing any defaulted mortgage loans. Over the years, the financial soundness of the program rested heavily on the fact that, from their depths around the time that the FHA came into being, home prices appreciated substantially over subsequent decades. That meant that the collateral backing FHA mortgage insurance was of very high quality.

At the time that the FHA began, the private mortgage insurance (PMI) industry had completely failed. It was only in 1957 that the private market again ventured to re-create private mortgage insurance. The private market began cautiously by insuring only the best credit risks. (The market for privately insured mortgages, and mortgages without insurance, is known

as the conventional mortgage market.) As private mortgage insurance companies found they could emulate the FHA and be financially self-sustaining, the industry offered PMI to an increasing share of the home mortgage market.

For many years, this process of adverse selection posed no threat to the fundamental viability of the FHA program. Indeed, the FHA was considered a pioneer whose experience helped to encourage the re-emergence of a private mortgage insurance industry.

In recent years, the conventional mortgage market attracted more creditworthy borrowers who earlier might have sought an FHA or VA mortgage. The conventional mortgage market made steady incursions into the market share of federal mortgage programs, and especially the market traditionally served by FHA. Using one measure of market share, *Inside Mortgage Finance* reported that just 3.3 percent of home buyers took out an FHA-insured mortgage in 2004, down from almost 10 percent of mortgage originations in 1999.<sup>11</sup>

At the same time, the private mortgage market has been able to use new information-based systems to improve the credit quality of conventional mortgages compared to those insured by FHA. There has been a pattern of generally increasing 90-day delinquency rates for FHA and VA mortgages and generally declining 90-day delinquency rates for conventional mortgages. In 1986, FHA mortgages were 1.9 times more likely than conventional mortgages to become 90 days past due, and were 1.7 times more likely to begin foreclosure. By 1996, these ratios had jumped to 4.4 times and 2.3 times higher, respectively, for FHA compared to conventional mortgages. Credit quality of VA mortgages compared to conventional mortgages also declined, but not as starkly.

These changes occurred before the widespread private use of credit-scoring and mortgage-scoring systems for origination of new loans. Starting in the mid-1990s, the mortgage industry adopted scoring and automated underwriting systems.<sup>12</sup> Tables 3 and 4 show how electronic adverse selection has continued the trend. By 2000, FHA mortgages were five times more likely

**Table 3: 90-day Delinquencies for FHA, VA, and Conventional Mortgages (1986–2000)**

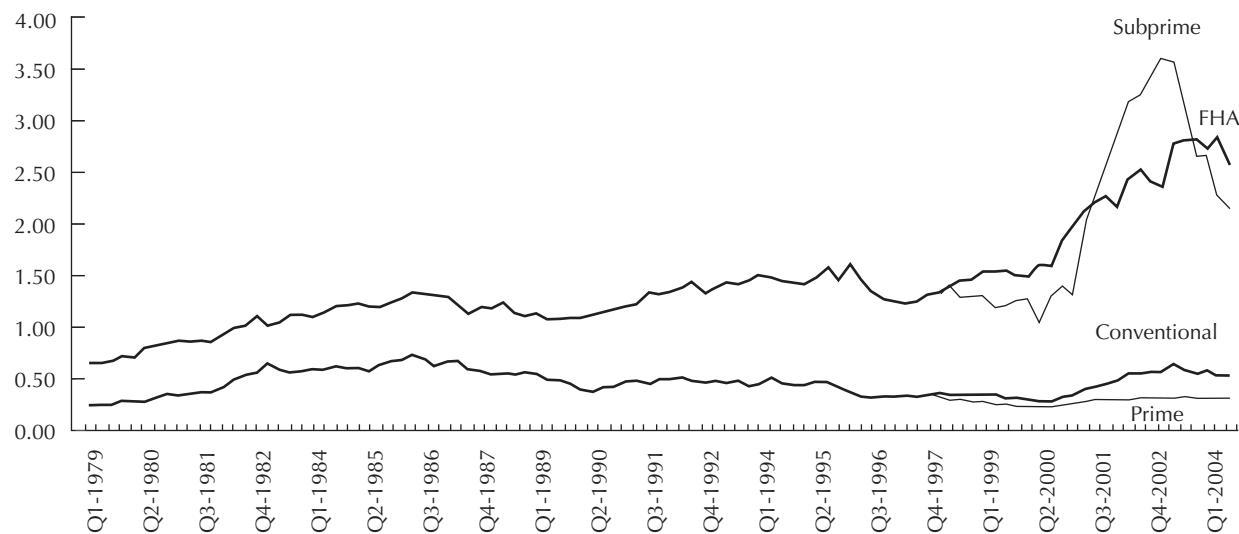
	FHA	VA	Conventional Mortgages	Ratio FHA/Conventional
<b>1986</b>	1.29%	1.24%	0.67%	1.9 times
<b>1991</b>	1.25%	1.11%	0.46%	2.7 times
<b>1996</b>	1.40%	1.10%	0.32%	4.4 times
<b>2000</b>	1.61%	1.22%	0.32%	5.0 times

Source: MBA National Delinquency Survey, reproduced in HUD Office of Policy Development and Research, U.S. Housing Market Conditions, Table 18, November 2004.

**Table 4: 90-day Delinquencies for FHA, VA, and Prime Conventional Mortgages (1998–2003)**

	FHA	VA	Conventional Prime	Ratio FHA/Prime Conventional
<b>1998</b>	1.50%	1.23%	0.28%	5.40 times
<b>1999</b>	1.50%	1.23%	0.24%	6.25 times
<b>2000</b>	1.61%	1.22%	0.22%	7.30 times
<b>2001</b>	2.12%	1.47%	0.27%	7.80 times
<b>2002</b>	2.36%	1.61%	0.29%	8.10 times
<b>2003</b>	2.64%	1.75%	0.30%	8.80 times

Source: MBA National Delinquency Survey, reproduced in HUD Office of Policy Development and Research, U.S. Housing Market Conditions, Table 18, November 2004.

**Figure 3: 90+ Days Delinquency (1979–Present, SA)**

Source: Mortgage Bankers Association of America, Department of Research and Economics.

Note: "SA" means that the numbers are seasonally adjusted.

than conventional mortgages to become 90 days past due. One can see from Table 3 a substantial acceleration in FHA delinquencies compared to the conventional market, which accelerates around 1996, when Fannie Mae and Freddie Mac deployed their automated underwriting systems to process increasingly large volumes of mortgage originations.

Indeed, the trend is even stronger than it appears from these numbers. This is seen in Table 4. Starting in 1998, the Mortgage Bankers Association began separating the conventional market into its prime and subprime components, to reflect the increased willingness of the conventional market to serve borrowers whose mortgage loans were below traditional credit standards. Looking at the comparison of the prime conventional segment of the mortgage market and the FHA and VA segments shows how the process of adverse selection has played out in recent years as the more-creditworthy FHA and VA borrowers turned to the conventional prime market instead.

It is not clear how the FHA program can sustain a 90-day delinquency rate that is approaching 10 times that of the conventional prime market. Figure 3, prepared by the Mortgage Bankers Association, shows how FHA's mortgage delinquencies of 90-plus days have grown since 1979. As the

subprime market develops further, it remains to be seen whether, as the graph shows, FHA delinquencies will remain above those of conventional subprime as well as prime mortgages.

The application of new technologies thus poses a serious challenge to federal mortgage programs of the FHA and VA, as well as to other programs that may face increasing adverse selection from the private sector. There is a good argument that the form of the FHA program should change to adapt to the new reality rather than continuing current trends.

## Dealing with Market Risk

Cases of serious market risk sometimes can be slow to emerge. On the other hand, they can be particularly hard to address because they seem to be outside the purview of the agency's management responsibilities. In the FHA single-family program, for example, Congress might want to consider changing the form of some or all of the FHA program.

At some point, to diminish the potential impact of adverse selection, policy makers may want to explore options for changing the form of some credit programs. The Office of Management and Budget (OMB) already raised this idea many years ago. In OMB's FY 1996 budget passback concerning the FHA single-family

mortgage insurance program, OMB proposed that FHA replace 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>13</sup>

This proposal met with opposition from stakeholders, and the idea was not included in any subsequent budget document. Some have expressed concern, for example, that FHA serves its subprime borrowers differently from the way conventional subprime lenders serve them. Moving to a private guarantee program would lose the special treatment that FHA provides for such borrowers and also end the market channel that has developed to serve FHA. Nonetheless, the proposed change provides a useful model of how the transformation of the form of a credit program, here from a loan guarantee to a grant, can improve the ability of government to manage and budget for credit programs in today's environment. The proposal's demise also provides an illustration of the fact that stakeholder issues may prevent policy makers from adapting programs until the status quo for some of them becomes untenable.

# Recommendations for Federal Credit Agencies

Each credit program is different, with different risks, risk management practices, and management structures. However, some recommendations arise from this survey of risk management and promising practices that credit agencies might wish to consider adopting and adapting to the particular needs of their programs.

**1. Develop a process to analyze pertinent information about the nature and dimensions of risks of each loan program.**

The first step in effective risk management is to be able to assess program risks systematically and on a continuing basis. This requires development of an ongoing process to gather, quantify, and evaluate information about risks.

**2. Create a risk management office responsible for creating and overseeing effective risk management systems and for reporting important risk issues to top agency management.**

In most agencies, effective risk detection and assessment is likely to require the work of a small office. An important part of the responsibilities of this office is to ensure that top managers always have a clear picture of the risks inherent in the programs they manage. On the other hand, more important than whether an agency has a special office or not is to ensure that processes are in place so that risk information flows to top management.

**3. After consultation with other federal agencies and the private sector, develop and maintain an effective portfolio risk-monitoring system.**

Good risk management requires that good processes be supported by effective systems. Fortunately, in

many cases the private sector may have developed systems that can be adapted to the somewhat different needs of federal credit programs. One lesson that emerges from many different parts of government is that it is much easier to develop small systems that focus on a single function such as risk monitoring, compared to large systems that attempt to serve a multiplicity of different functions. Once an agency has established a focused risk monitoring system, it may be able to integrate that system with others. FSA currently is undertaking the integration of multiple operating systems on a major scale. While the process is not yet complete, the preliminary results are promising.

**4. Require the risk management office to prepare regular and special reports concerning significant risk factors and the state of the program and portfolio.**

As in the examples of FSA and the ExIm Bank, top management needs access to regular reports on the nature and level of program risks as well as special reports when risks emerge at higher levels or in new forms.

**5. Establish a credit committee or similar body, chaired by a top agency official, to review risk-related information regularly and on special occasions.**

In some agencies, the program offices responsible for outreach and program development may not welcome the risk management function. The problem with risk assessment in this view is that it may bring bad news; the best that risk assessment can do is provide assurance that nothing serious has been detected. It is important for agencies to master the tension between program development and risk monitoring. A useful way to contain and utilize the tension is to create a credit committee that grapples

with the trade-offs that must be made between program development, on the one hand, and protection of the program from unacceptable risks and surprises, on the other.

#### **6. Review the ability of the agency to address major forms of risk that potentially could emerge.**

A risk management system has little value if the credit agency does not have the tools available to address the risks that are detected. In some cases, enforcement tools may be needed to address program partners that create unacceptable risks. In other cases, an agency may need backup systems or procedures to ensure an effective response to operational risks.

#### **7. Develop internal documents that spell out appropriate responses to different types and severity of risk problems.**

Once an agency has identified the major risks that it faces, it can be helpful to consider scenarios for addressing those risks. If an agency does face a challenge, it helps to have a game plan available that can be adapted to provide an effective response.

#### **8. Make recommendations to the agency's leadership about new or amended regulations to deal with risk problems.**

One of the most important functions of scenario analysis is to identify gaps in an agency's ability to deal with potentially serious problems. In those cases, it may be necessary to issue new regulations or amend guaranty agreements with lenders or take other steps to improve the agency's position in case serious risk problems do emerge.

#### **9. Make recommendations to Congress about legislation that could help to fill gaps in the statutory framework.**

Sometimes, as in the case of GAO's recommendation that the SBA clarify its supervisory and enforcement powers over Section 7(a) lenders, an agency may need to go to Congress to obtain improvements in the laws that authorize its programs. FHA, for example, obtained strong enforcement authority from Congress that has helped to create incentives for lenders to participate more actively in its Loss Mitigation Program.

#### **10. Keep a continuing eye on market risk and consider recommending to Congress appropriate changes in law and program structure.**

Market risk causes problems that are especially difficult for federal agencies to handle proactively. This is because market changes may take a long time to emerge fully. Market risks often are also a matter of probabilities rather than certainties. On the other hand, once market risk does build up to the point that it is clearly perceptible, it may cause significant harm. Preemptive changes in program structure can help to deal with market risk while it is still at a point where it can be addressed more easily.

Finally, a lesson of the promising practices in this report is that federal credit agencies have much to teach one another. The advent of new technology systems has allowed credit agencies to make improvements in program management systems that might not have been possible, or at least affordable, in earlier years. The Office of Management and Budget has just created a new federal Credit Council, composed of representatives from the federal credit agencies. It appears that the new council will be able to provide a supportive forum that fosters the ability of federal credit agencies to learn from one another and, where useful, to collaborate with one another to develop and manage systems that provide mutual benefits. This is a very positive step that can help federal credit agencies to improve not only their risk management practices but also many other aspects of program management.

# Endnotes

1. Lester M. Salamon, editor, *Tools of Government: A Guide to the New Governance*, Oxford University Press, 2002. Other tools of government include grants, regulation, tax expenditures, insurance, and direct provision of services by a federal department or agency.

2. For private financial institutions, *market risk* is the risk of losses in on- and off-balance-sheet positions arising from movements in market prices. Here, the term is used to encompass a variety of exogenous risks that arise from a change in the markets that federal credit programs serve.

3. Note that this review does not explore the equally important issues concerning the mission of an agency and the extent that a federal credit program effectively carries out important public purposes. For a discussion of such issues, see, e.g., Thomas H. Stanton, "Loans and Loan Guarantees," chapter 12 in *Tools of Government: A Guide to the New Governance*, Lester M. Salamon, editor, Oxford University Press.

4. The Ginnie Mae lender monitoring system is discussed in Thomas H. Stanton, "Opportunities for Reducing Delinquencies and Defaults in Federal Mortgage Credit Programs: A Review of New Technologies and Promising Practices," *Journal of Public Budgeting, Accounting & Financial Management*, summer 2001, pp. 157–192.

5. Government Accountability Office, "Small Business Administration: New Service for Lender Oversight Reflects Some Best Practices, but Strategy for Use Lags Behind," GAO-04-610, June 2004, pp. 31–32.

6. These loss mitigation approaches are discussed more fully in, Amy Crews Cutts and Richard K. Green, "Innovative Servicing Technology: Smart Enough to Keep People in Their Houses?" Freddie Mac Working Paper Series, No. 04-03, July 2004.

7. Ibid. An early discussion of the application of scoring-based systems to the servicing of federal loans is, Thomas H. Stanton, "Credit Scoring and Loan Scoring:

Tools for Improved Management of Federal Credit Programs," IBM Center for The Business of Government, July 1999, p. 24.

8. Codified at 12 U.S.C. § 1735f-14.

9. See, Thomas H. Stanton, "Lessons Learned: Obtaining Value From Federal Asset Sales," *Public Budgeting & Finance*, Spring 2003, pp. 22–44.

10. For further information visit the website or see, Eric Stout, "www.HomeSales.gov (a partnership by HUD, USDA, and VA): History and Documentation of our 'one-stop' web portal for public sale of Federally owned/held homes," draft, April 22, 2004; and U.S. Department of Agriculture, "Homes.gov: Software Requirements Specification," draft, version 0.1, March 23, 2004.

11. "Lenders and Dealers Search for Ways to Rebuild Market for Government-Insured Mortgages," *Inside Mortgage Finance*, March 11, 2005.

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## A B O U T T H E A U T H O R

**Thomas H. Stanton** is a Washington, D.C., attorney. He is a Fellow of the Center for the Study of American Government at the Johns Hopkins University, where he teaches graduate seminars on the law of public institutions, government and the American economy, government and the credit markets, and administering homeland security.

Mr. Stanton's academic, legal, and policy experience relates to the capacity of public institutions to deliver services effectively, with specialties relating to design and implementation of federal programs, federal credit and benefits programs, government enterprises, and regulatory oversight. Mr. Stanton has provided support to some of the agencies and programs mentioned in this report. He is a member of the Board of Directors of the National Academy of Public Administration (NAPA) and a former member of the Senior Executive Service. Until recently, he served as chair of the NAPA Standing Panel on Executive Organization and Management.

Mr. Stanton's writings on government and financial organizations include a book, *Government-Sponsored Enterprises: Mercantilist Companies in the Modern World* (AEI Press, 2002). The concerns expressed in his earlier book on government-sponsored enterprises, *A State of Risk* (HarperCollins, 1991), helped lead to enactment of several pieces of legislation and the creation of a new federal financial regulator in 1992. Mr. Stanton is coeditor with Benjamin Ginsberg of *Making Government Manageable: Executive Organization and Management in the 21st Century* (Johns Hopkins University Press, 2004).

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Mr. Stanton earned his B.A. degree from the University of California at Davis, M.A. from Yale University, and J.D. from the Harvard Law School. The National Association of Counties awarded him its Distinguished Service Award for his advocacy on behalf of the intergovernmental partnership.



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