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REVITALIZING THE FHA

THE REPORT OF THE TASK FORCE ON THE FUTURE OF FHA

REVITALIZING THE FHA - EXECUTIVE SUMMARY

During the month of June 1977, a twenty-three member Task Force chaired by Dr. Robert C. Weaver, former Secretary of the Department of Housing and Urban Development, and consisting of representatives from Federal and State housing departments, builders and the lending industry, met to discuss the future of the Federal Housing Administration (FHA). This Task Force was charged by HUD Secretary Patricia Roberts Harris to review and make recommendations on the role that FHA should play in a Federal housing strategy. After a series of meetings in Washington, the Task Force concluded the following:

. The Task Force agreed that the FHA must take an active role in the credit markets in order to provide for subsidized and unsubsidized housing. In the 1960's and early 1970's, the FHA's role in providing mortgage insurance for unsubsidized housing declined, but provided substantial assistance for an unprecedented volume of low-and moderate-income subsidized housing built during those years. If continued progress is to be made in solving the Nation's housing problems, the Task Force felt that phasing out or reducing the role of FHA would severely hamper meeting the Nation's housing needs.

. The FHA is an excellent vehicle to provide for innovation and leadership in housing and housing finance.

The FHA can provide for a greater availability of mortgage capital to a wider range of individuals by providing financing to those who might otherwise find it difficult to obtain that financing. The FHA, through its role in the secondary market, also can provide mortgage capital to areas where capital is generally limited and can promote the movement of capital from other sectors into housing.

The Task Force provided the Secretary with six recommended objectives for the FHA. These include:

1. Reinvestment in urban neighborhoods

The FHA, through provision of mortgage insurance, did much to promote the development of this Nation's suburbs. FHA should now turn its attention to the provision of mortgage credit in the inner city by providing mortgage insurance directly or through serving as a catalyst and coordinator for private investment. The FHA can promote the preservation of the existing housing stock and through the revitalization of urban neighborhoods, the redevelopment of our cities, thereby encouraging people to return to the cities and enabling current residents to remain.

2. Multifamily rental housing

While the FHA has played a role in the past in providing for rental housing, its importance in that area is growing. The Task Force believed that the FHA is an appropriate vehicle to provide governmental assistance to overcome the severe shortage of rental housing for low-and middle-income families in the Nation's cities.

This assistance to multifamily rental housing should be both through the provision of mortgage insurance and through an active GNMA tandem program. The Task Force emphasized the need for aggressive FHA monitoring in order to ensure sound project management. Further, the concern over effective management should begin during preconstruction planning and provisions for effective management should be permitted in the budget planning process.

3. Single Family housing

The FHA has done much to make this a nation of homeowners. While its role in the production of single family housing should continue, the FHA role should focus on expanding the range of potential homeowners through innovative financing techniques and working to reduce housing costs by expediting processing, eliminating red tape and establishing reasonable property standards.

4. Subsidized housing

The Task Force expressed great concern over the problems of providing subsidized housing for the Nation's lower-income families and agreed that the FHA must continue to serve these families through the coordination of insurance programs with other federally and locally provided subsidies. The Task Force noted that, in their opinion, entirely too much attention has been focused on the failures of previous subsidized programs; the true test should be the recognition of their substantial record of success.

In the production of subsidized housing, the FHA also should take an aggressive role in promoting housing opportunities for minorities outside of urban areas of minority concentration, but prohibition of the construction of new housing in urban areas solely because of current racial composition is open to question.

The Task Force made three other specific recommendations with regard to subsidized housing.

A. The Task Force supported the concept of experimentation with prototype cost--the establishment of rents based on prototype costs rather than the rent comparability test as is currently used in the Section 8 program.

B. Subsidy contracts, such as the Housing Assistance Payments contract in Section 8, should be coterminous with the term of the FHA insured mortgages, i.e. forty years.

C. The FHA should expand and promote an aggressive counseling and referral service for low-income tenants and should consider the costs of providing such services in the allowable operating budget for a rental project.

5. Other specific recommendations

There should be an analysis of the Title I and Section 223(f) programs.

Similar attention should be directed to the premium interest rate structures of the FHA insurance.

Coinsurance should be continued as an additional tool to provide mortgage credit, and consideration should be given to permitting conventional lenders to process FHA applications on a contract basis. However, these alternatives are not a viable substitute for the basic FHA insurance program.

6. Administrative structure

One of the major discussions during Task Force meetings and one of the Task Force's major recommendations is the implementation of administrative changes directed at improving the efficiency and delivery of the FHA programs. The Task Force recommended there be direct line authority between the Assistant Secretary and field offices of the Department.

Summary

The Task Force believed that an active and aggressive FHA is essential to the provision of decent housing in this country, particularly for low-income families. While the major portion of FHA efforts should continue to focus on subsidized housing, the FHA should play a continuing role in the provision of unsubsidized housing by providing for the general availability of capital for housing and through innovative uses of new financing mechanisms. By focusing on housing needs of the inner city, assisting in the development of rental housing, providing expanded counseling and referral services and ensuring sound project management, the FHA can make significant in-roads on the Nation's housing problems.

TASK FORCE ON THE FUTURE OF FHA

This Task Force was authorized on June 1, 1977, by the Secretary of Housing and Urban Development. It was asked to recommend the future role of the Federal Housing Administration. The first meeting was held on June 15, 1977, and the substance of this report was approved by the Task Force on June 30, 1977.

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PREFACE

For thirty-five years following its establishment in 1934, the Federal Housing Administration (FHA) was a vital force in American housing. It shored up the mortgage credit market, revived the homebuilding industry, greatly accelerated homeownership, and provided the basis for an effective national secondary mortgage market. In the process, FHA encouraged many innovations such as the widespread acceptance of low down-payment, long-term and fully amortizing level payment mortgages. Its principal tool was mortgage insurance. These innovations brought homeownership within the reach of millions of Americans, who, prior to the advent of FHA, could not afford to purchase a home. These and other new approaches of FHA were emulated by private sources of mortgage credit, leading most recently to the rise of the private mortgage insurance industry.

While this notable record of achievement was occurring, there was a great change in the form and structure of a rapidly urbanizing America. The most dramatic characteristic of this change was the unprecedented growth of the suburbs and the decline of the central cities, with the familiar economic, social and physical consequences so apparent today. FHA facilitated this process, since its mortgage insurance had from the start been a significant factor in assisting the financing of suburban housing.

In the mid 1950's, government policy first began to focus on using FHA as a way to counteract the growing decline of the inner cities. From 1954, when the first mortgage insurance program for rental housing in urban renewal areas was developed, through the 1960's, a series of programs was devised which enabled FHA to work more aggressively to facilitate the financing of urban housing. Part of this effort to supply mortgage credit to hard pressed urban areas was an effort to provide new housing at lower cost to the residents of these areas. The first instrument for this was the subsidized interest rate, developed in 1961. Subsequently, the rent supplement program was enacted. The first enabled moderate-income and the second enabled low-income people to afford the housing FHA insured. Finally, in 1968, two new and by now familiar programs were enacted as a further response to the growing difficulty low-and moderate-income people were having in obtaining decent housing in urban areas, namely Sections 235 and 236. It should be noted that these programs were also used outside the inner cities.

From 1969 through 1972, FHA experienced a series of three major reorganizations at the very time it was developing and administering these new and complex programs. The consequence was operational chaos and lowered morale. Additionally, the skills of technically proficient employees often were wasted by using them at lower skill levels, and it became increasingly

difficult to obtain adequate staff to administer the programs. The impact of this was accentuated by the increasing complexity of FHA's new programs and the rise of new elements in their processing.

Despite these problems, the new FHA programs were so needed that an unprecedented volume of low and moderate income housing was financed through them during the early 1970's. The faulty organization combined with maladministration of FHA (under HUD's direction), and unanticipated high rates of increases in project operating expenses led to higher levels of failure than might otherwise have been experienced. The scandals which occurred, involving subsidized and unsubsidized programs and resulting in hundreds of criminal convictions, seriously damaged the image of FHA. Both the then current Administration and the media stressed the failures and ignored the much more numerous successes of the subsidized programs in meeting the urgent housing needs of large numbers of low-income families.

At the same time, the traditional FHA programs were being less widely used, primarily because their great success caused their techniques and principles to be widely adopted by the private market. The result was that FHA was left with a greatly reduced, though still potentially significant, impact on the private market.

The years of reorganization and high production were followed by the moratorium, an abrupt total cut-off of all subsidized programs. No housing program can succeed in an on-again, off-again environment, and this development and its consequences were devastating, contributing significantly to the declining image and impact of FHA.

This is the situation which confronted the Task Force, although it should be noted that recent FHA activity is beginning to increase and efforts are underway to improve FHA's product and administration. In this context, the Task Force considered the questions of whether FHA should be allowed to phase out, attempt to revert to its earlier role, become solely the mortgage insurer of last resort, or aggressively participate in both the non-subsidized and subsidized lending markets while continuing to innovate. The Task Force quickly agreed on the last alternative.

FUNCTIONS FOR FHA

The Task Force believed that FHA is an excellent vehicle for the government to provide innovation and leadership in the housing field; producing creative financing instruments, expanding involvement in urban areas, introducing flexibility in standards and lot sizes and reexamining the basis of Minimum Property Standards and neighborhood and site standards.

In short, FHA can provide aggressive leadership for the problems of the Seventies, reevaluating standards to fit today's needs. In those situations where FHA cannot lead the way, it should serve as a catalyst, thereby encouraging others to make innovations in taking leadership positions. In the areas of finance and housing standards, FHA's existence provides competitive stimulation to the private sector.

In addition to concerns for the general availability of capital, FHA should provide access to the mortgage market for a wide range of individuals. Task Force members agreed that one of FHA's goals should be to provide insurance for qualified home purchasers and multifamily developers, who otherwise might find difficulty obtaining financing.

FHA is a prime insurer of mortgages traded in the secondary mortgage market. The Task Force members agreed that a primary role for FHA must be to continue, through this secondary mortgage market, to provide access to mortgage funds for those individuals and properties in specific areas which are generally capital short. Also, during periods of general capital stringency, FHA stimulates the movement of money from other capital sectors into mortgage markets by making investment in the mortgage market more attractive to private sources of capital, both directly and through the secondary mortgage market. In these ways, FHA generates substantial funding for new housing opportunities. The Task Force believed that these functions of FHA are vital and must be continued.

OBJECTIVES FOR FHA

Inner Cities

The Task Force concluded that the devastated areas of our Nation's cities represent the most disgraceful waste of resources in our society that are associated with dramatic consequences affecting the quality of life. Thus, our cities should be given the highest priority by HUD and FHA.

Given FHA's general role of mortgage insurance for lenders on behalf of individuals and developers, and the significant impact that FHA has had on housing generally, Task Force members agreed that FHA must take an active leadership role in the provision of credit in the Nation's cities, playing a major role in their development, redevelopment, and rehabilitation.

The Task Force recognized, however, that FHA mortgage insurance alone is inadequate to solve the problems of central cities. Commitment is essential from many groups, financial and non-financial, both private and public, and HUD and FHA should take a leadership role in organizing and coordinating these commitments.

The Task Force believed that the capital, to which FHA insurance gives access, must be available on a continuing and broad basis so that residents, state and city officials, community groups, builders and lenders may undertake the planning and participation so vital to the provision of housing.

All of the resources of HUD should be made available to assure a supply of adequate housing, new or rehabilitated, for families who may be displaced.

Recommendation:

FHA should actively assist in the provision of housing in older, declining neighborhoods in order to arrest their decline, help to stabilize them, and to be a tool for those who are working to improve and upgrade them.

The Task Force believed that FHA has a major role to play in encouraging reinvestment in urban neighborhoods, thereby reducing redlining. This role does not require FHA to assume a posture as an insurer against unduly high risks. FHA can provide access to mortgage credit to a wider range of individuals within declining areas who would not otherwise have such access. In the process, marginal but potentially viable areas in the central cities can be saved from decay, thereby preserving the housing stock and improving the economic base of the involved cities.

Mortgage Insurance for Multifamily Rental Properties

FHA should play a major role in the provision of multifamily rental housing in all areas. The Task Force was concerned that we are approaching an acute shortage of rental housing and an effective FHA is a logical vehicle of government assistance to deal with this problem. In the administration of this program, the growing middle class among minority groups

in our urban areas must be recognized. Moreover, in the development of an adequate tax base for the cities, FHA may be needed to prime a flow of mortgage credit into these areas.

In all rental property, management is of vital importance. During the last decade, problems in this area have increased in volume and complexity. The Task Force emphasized the impact of the quality of management upon the economic viability of such properties and the quality of life enjoyed by the residents.

Recommendation:

Effective management is essential for the success of all FHA insured rental developments, and FHA must monitor management to ensure its quality. There should be pre-construction planning for implementation of effective management and budgetary provision for same.

The Task Force noted that much of the new non-luxury rental housing now under construction is FHA insured. It must be understood, however, that all new FHA insured rental housing built without subsidies requires rental levels that only middle-income families can afford. Without FHA insurance, the volume of luxury rental housing built in today's market would decline. This is true despite years of under-production and the consequent current shortage of rental units.

GNMA Tandem Plans

The Task Force also noted that the most effective way currently available to help reduce the rental cost of FHA insured rental housing, without overt direct subsidies, is through the GNMA tandem plans, and without these plans, only upper-middle-income families would be able to afford to live in newly constructed FHA insured rental projects. Aside from the resulting problem of failing to serve many lower-and moderate-income families, projects face a hard time remaining occupied due to the limited number of families which can afford them.

Recommendation:

There is a current need for the continuation of active GNMA tandem plans of the type described above.

Mortgage Insurance for Single-Family Housing

American housing policy for many years has been based on the single-family home for a variety of social and economic reasons. To implement this policy, substantial economic benefits are directed at homeowners. Nevertheless, a lesser proportion of this Nation's people currently are able to purchase a single-family house than in recent decades, and FHA must work to help reduce costs by expediting processing, reviewing and revising regulations, introducing innovative techniques, and making credit available on more reasonable terms.

Recommendation:

FHA must administer its single-family programs more efficiently and design financing mechanisms which will assist a wide range of prospective homeowners. While the continued development of the private mortgage insurance industry is desirable, FHA must continue to provide an effective alternative, which serves all sectors of the homeownership market. Also, it must work to facilitate the opportunity people have to enjoy the benefits of ownership in multifamily buildings through cooperatives and condominiums.

Subsidized Programs

The Task Force agreed that the needs of lower-income families should be met by a combination of FHA programs and the public housing program. During the Task Force's discussions on FHA participation in multifamily housing, the question of the use of FHA insurance in conjunction with subsidy programs was raised. Although direct loan programs are actually less expensive than interest or rent subsidy programs, nevertheless, in terms of budget authority, the immediate impact of direct loan programs is substantial. Thus, other types of subsidy programs are essential for providing lower-income housing and FHA mortgage insurance is important to help make available the necessary private capital.

The Task Force spent considerable time discussing recent problems in the subsidized programs to determine where the true problem lies. The Task Force believed entirely too much attention has been focused upon the failures, and that the true test of the programs was the substantial record of successes they produced. The Task Force discussed also whether a mortgage, which meets all underwriting tests, except for the fact that the income of the homeowner or renter is too low to support the full debt service or rental, should be considered an actuarially sound risk. The Task Force concluded that recent experience demonstrated that such loans are sound investments where rental income and the amount of subsidy are adequate. Nevertheless, the Task Force repeatedly emphasized that such programs must be carefully and competently administered and must include counseling for low-income homeowners and careful monitoring of rental project management.

Most members concluded that FHA should provide a financing vehicle to be used with subsidy programs, but that the subsidy itself should be tied to the underwriting function since the major adjustments involved in insuring subsidized loans are of an underwriting nature.

The Task Force noted that private capital will not currently finance subsidized housing without FHA insurance or some other device to assure debt service. For example, the Section 8 program, which was designed to be primarily a subsidy program

using non-FHA financing, has not turned out as planned. Nearly one-half of the projects currently under construction are insured by FHA, while most of the other half are being financed by State Housing Finance Agencies. Even in this situation, it was felt that FHA is not currently able to meet the financing needed for Section 8 projects that other vehicles have not provided.

Recommendations:

FHA should be fully and actively involved in subsidized programs. In addition, there should be a mechanism to administer these programs and to ensure that individuals receive the appropriate subsidy and type of housing assistance necessary to fit family needs at given income levels.

The Task Force urged continuation of site selection criteria to the extent they promote housing opportunities for minorities outside of urban areas of minority concentration. However, the Task Force stressed careful review of the policy where site selection criteria prohibit construction of new housing in urban areas solely on account of the racial composition of the neighborhood.

The following sub-issues related to subsidized housing also were discussed:

A. Section 8 Prototype Costs

The Task Force discussed using prototype costs in lieu of rent comparability calculations in the Section 8 new construction and substantial rehabilitation programs. Purportedly, the lack

of adequate "comparables" or the stringent implementation of the rent comparability test by FHA has caused programmatic problems.

Recommendations:

The Task Force supported experimentation with cost prototypes, and the establishment of rents based on prototypes rather than rent comparability in a manner similar to that authorized for public housing.

B. Financing

One of the impediments to using Section 8 for new construction and substantial rehabilitation has been the limitation of the term of the Housing Assistance Payments contract to 20 years in the case of projects financed with an FHA insured mortgage. This greatly reduces the attractiveness to potential lenders of 40-year mortgages, and increases FHA's risk of acquiring the property at the end of 20 years.

Recommendation:

In Section 8, all Housing Assistance Payments contracts should have the same duration as the mortgages involved. This would mean that, if the loan were kept current, the mortgage would be paid off by the end of the subsidy period.

C. Counseling

The Task Force discussed in some detail the need for counseling in FHA programs. While homeownership cannot and should not be provided to all low-income families, it should be made available for those who are able and prepared, with assistance of a subsidy, to meet their financial obligations. Counseling should be aimed at assuring that low-income families can assume and maintain their financial obligations and should assist them in this. The absence of counseling greatly reduces the likelihood of success on the part of the buyer and greatly increases the risk to FHA.

Recommendation:

Homeownership for lower-income families should not be provided without effective counseling and adequate funds should be available for this purpose. Counseling and referral programs should be extended to low-income renters, as it is an integral element in the management of lower-income rental housing and FHA should consider including its costs as part of the operating expenses.

OTHER EXISTING PROGRAMS AND COINSURANCE

Other Existing Programs

The Task Force concluded that the basic single-family and multifamily mortgage insurance programs should continue. It recommended, too, in connection with its concern for urban revitalization, that there be an analysis and evaluation of the Title I program and the Section 223(f) program, in particular. Similar attention should be directed to the premium and interest rate structures of FHA. The emphasis should be on achieving greater utilization of FHA to broaden housing markets and on identifying potential changes in programs to achieve this goal.

Coinsurance

The Task Force discussed coinsurance as one approach to increasing housing production and providing faster processing and sounder underwriting decisions. Under coinsurance, basic underwriting decisions and processing responsibilities are delegated to the mortgagee, with the mortgagee bearing a percentage of any loss from default and providing some assurance to HUD that the mortgagee will carry out underwriting and loan management in a sound manner.

Several Task Force members suggested that by sharing the underwriting responsibilities, underwriting might be improved. Other members, however, pointed out that many loan originators do not hold a portfolio of mortgages, but originate loans for

sale in the secondary market and it is doubtful that secondary market investors would assume the liability imposed by the contract of coinsurance. Therefore, the loan originators who serve them would not find coinsurance attractive.

Generally, the Task Force believed coinsurance is not a viable substitute for the current form of FHA insurance.

Recommendations:

It was recommended that coinsurance be available as an additional tool to mortgagees who originate mortgages for their own portfolio, e.g., mutual savings banks and savings and loan associations as well as other qualified lenders willing to assume the risk. Also, it is recommended that FHA study the feasibility of permitting conventional lenders to process applications for insurance on a contract basis.

STRENGTHENING THE ADMINISTRATIVE STRUCTURE OF FHA

A continuous theme throughout the discussions emphasized the need for FHA to implement administrative changes directed at improving the efficiency and delivery of its programs, and the need for instituting aggressive leadership and innovation in the field of housing. FHA programs themselves are essential and serve a vital function; however, they must be improved administratively. The organization, the processing, and the systems must be reviewed and upgraded.

Much of the discussions of the Task Force centered on difficulties FHA's clients have had in receiving timely answers and decisions. The Task Force was fully aware of the increasing complexity of FHA's programs, and the competing demands upon its staff. One example of the latter is the requirement of Environmental Impact Statements for use in housing production. FHA should support the objective of protecting the Nation's environment. However, this objective has occasioned new and time-consuming processes which have complicated the operation of FHA. In order to satisfy and balance its several social goals, such as environmental protection, affirmative action and equal opportunity, considerable coordination of different aspects of processing must be achieved at the field office level.

Recommendation:

In order to achieve timely and efficient processing, the Task Force recommended that the present FHA administrative structure be refined in order to establish line authority from the Assistant Secretary for Housing-Federal Housing Commissioner directly to the field. There should be at least one qualified official in each field office empowered to make a final determination on all credit, economic worthiness and management criteria. Line authority implies line of communication to and from the field offices on the part of those involved in these phases of processing.

Where an Area Office Director believes the FHA field person's underwriting determination to reject a project is erroneous, the Director should be empowered to forward the issue to Washington with adequate documentation to be resolved by the Federal Housing Commissioner. On the other hand, where the top FHA field person approves a project, but other disciplines such as the equal opportunity staff or the environmental staff, believe a project should be rejected, the Area Office Director should resolve these differences. Where he is unable to do so, applicants should have clear procedures for appealing to Washington and HUD needs to establish administrative machinery for prompt review and determination on such appeals.¹

CONCLUSION

The Task Force believes that this report is responsive to the charge given to it. We have avoided detailed analyses of FHA operations or formulation of regulations, recognizing that such issues could not be treated adequately within the time limits imposed; nor were we asked to deal with these matters. Our concern has been with the mission of FHA, broad approaches it must pursue to achieve this mission, and the major administrative changes that are necessary for its effective operation.

FHA long served as a vital force in the mortgage and housing markets. While we realize that recent demographic, cultural, social, institutional, and economic changes have created new and varied needs, FHA can and should be responsive

to them, and the specific program recommendations in this report are designed to accomplish this. The administrative reforms proposed by the Task Force do not mandate restitution of an agency or a structure of several decades ago. Rather, they call for coordination of FHA within HUD, line authority for the Federal Housing Commissioner involving all underwriting matters and coordination of FHA's other responsibilities within the field offices.

FOOTNOTE

¹The following footnote is attributed to Dr. Oliver H. Jones in relation to the recommendation on page 18:

"This proposal goes a long way in improving FHA's organization and thereby its ability to deliver its product. However, neither the Commissioner nor the Area Office Director can be expected to resolve differences when field personnel working outside of the underwriting function, i.e., equal opportunity or environmental staff, are not directly responsible to the Commissioner for their product. The result will be further delays and added burdens as far too many cases will be sent to Washington for resolution. To complete the line authority concept, policies should be established in Washington at the staff level. This would include all policy subjects, underwriting, environment, affirmative marketing. Then, the Commissioner should be given the necessary personnel, under his direction and line of responsibility, to carry out those policies in the field. As both staff and line officer, he, then, would be responsible to the Secretary for results."