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U. S. DEPARTMENT
OF AGRICULTURE

Centralized Servicing
for FmHA
Single-Family Housing
Loans



150099

**Resources, Community, and
Economic Development Division**

B-254849

September 23, 1993

The Honorable Patrick J. Leahy
ChairmanThe Honorable Richard G. Lugar
Ranking Minority Member
Committee on Agriculture,
Nutrition, and Forestry
United States SenateThe Honorable Gary A. Condit
Chairman, Information, Justice, Transportation,
and Agriculture Subcommittee
Committee on Government Operations
House of Representatives

As part of our continuing work on evaluating the structure and effectiveness of the U.S. Department of Agriculture's (USDA) management, we testified in July 1993 that USDA needs to be fundamentally restructured, or "reinvented," in the context of the newer management concepts that guide private sector corporations, state governments, and governments in other countries.¹ These concepts emphasize, among other things, competition, flattened hierarchies, and the achievement of results.

Following that testimony, by examining the Farmers Home Administration's (FmHA) studies that discuss centralized servicing of the agency's single-family housing loans, we identified such servicing as the type of new effort that USDA should strongly consider. As you know, FmHA makes housing and farm loans to rural Americans who cannot otherwise obtain the loans on reasonable terms. Centralized servicing of loans is widely and successfully used by private sector companies, including mortgage firms that typically consolidate and centralize loan servicing functions. Such functions include loan collections, escrow accounting for taxes and insurance, and delinquency management.

As you requested, this briefing report serves to formalize the information we presented to you on August 18 and 19. Our objectives were to describe the status of FmHA's loan portfolio for single-family homes, the history of FmHA's efforts to centralize servicing operations for direct housing loans, the benefits and disadvantages of centralization, and the options for moving forward with centralization. In our briefing, we explained that (1)

¹Revitalizing USDA: A Challenge for the 21st Century (GAO/T-RCED-93-62, July 21, 1993).

FmHA's single-family housing loan portfolio is far larger than the agency's farm loan portfolio, (2) FmHA's efforts over the past 5 years to centralize servicing operations for direct housing loans have not been fruitful, (3) the benefits of centralization outweigh the disadvantages, and (4) options for moving forward with centralization would be consistent with USDA's efforts to reinvent itself.

In summary, we found the following:

- As of June 30, 1993, FmHA held \$18.8 billion in loans that were made to over 690,000 single-family direct housing borrowers. During the last 5 fiscal years, funding obligated for these loans has remained fairly constant at approximately \$1.2 billion annually. These loans are serviced by FmHA in about 1,700 county offices. In addition, approximately 95,000 former FmHA single-family housing loans sold by the agency in 1987 are serviced by a private company in a central office. (See sec. 1.)
- Although FmHA has pursued the centralized servicing concept since 1988 in order to improve its program management and streamline its field office operations, it has yet to make a final determination on adopting the practice. Over the past 5 years, FmHA has spent about \$1.6 million for an unsuccessful pilot project to establish federally mandated escrow accounting and for one external study. FmHA has also devoted an unknown amount of staff resources toward preparing two internal studies and three plans for implementing centralized loan servicing. (See sec. 2.)
- FmHA's studies and our analysis show that the benefits of centralized servicing outweigh the disadvantages. For example, a contracted study for FmHA estimated that implementing centralized servicing would mean an operating cost savings of \$106 million annually. Moreover, we identified 700 of FmHA's county offices that have more than 75 percent of their loans in single-family housing. With centralized servicing, these offices could be studied for possible consolidation or closure. Other benefits of centralized servicing—which are currently experienced by the private company that centrally services the former FmHA single-family housing loans—are an appreciably lower delinquency rate and reduced loan losses. The private company credits this increased efficiency (as compared with FmHA's servicing) to its (1) computer system that flags delinquent borrowers and allows the company to question early on why payments were missed, (2) escrow accounting system that helps borrowers budget for taxes and insurance, and (3) high degree of specialization among staff members who service loans. The potential disadvantages of centralized servicing are the loss of face-to-face contact between the borrower and the loan servicer and the costs of redeveloping existing automated systems, which would be

incurred if centralized servicing were carried out by FmHA rather than by a private company already using centralized servicing. (See sec. 3.)

- Options for pursuing centralization include (1) establishing an in-house loan servicing center at FmHA, (2) contracting with the private sector, or (3) implementing a combination of the previous two options that allows the public and private sectors to compete for loan servicing. We believe all three options would support recent efforts to flatten hierarchies and improve efficiency. The second and third options would also support the reinventing government theme of increased competition. Contracting with the private sector or allowing the public and private sectors to compete could mean that the benefits of a competitive marketplace would be reaped—greater efficiency, increased focus on customers' needs, increased innovation, and improved morale. (See sec. 4.)

To determine the status of FmHA's loan portfolio and of the mix of loans at approximately 1,700 FmHA county offices, we analyzed files and records as of June 30, 1993, from FmHA's Finance Office in St. Louis, Missouri. To determine the history of FmHA's efforts to centralize the agency's direct single-family housing loan operations, we reviewed FmHA's internal and external plans and studies and interviewed personnel from FmHA's National Office and Finance Office. To determine the benefits and disadvantages of centralization and to present options for moving forward with centralization, we examined USDA's internal and external studies and current literature on reinventing government. We also met with personnel from the private sector company that is currently centrally servicing the former FmHA single-family housing loans sold in 1987.

Our review was performed between July and September 1993 in accordance with generally accepted government auditing standards. As requested, we discussed the information in this briefing report with USDA's Under Secretary for Small Community and Rural Development. He said he would be spending a great deal of time on the issue in upcoming weeks and would decide whether to include centralized servicing in a report on reinventing USDA that is to be issued in October. As requested, we did not obtain written agency comments on a draft of this briefing report.

As arranged with your office, unless you publicly announce its contents earlier, we will make no further distribution of this report until 7 days after the date of this letter. At that time, we will send copies of this briefing report to the Secretary of Agriculture; the Director, Office of Management

and Budget; and interested congressional committees and Members of Congress. We will also make copies available to others upon request.

Please contact me on (202) 512-5138 or Robert A. Robinson on (202) 254-6100 if you or your staff have any questions. Major contributors to this briefing report are listed in appendix I.



John W. Harman
Director, Food
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Contents

Letter		1
Section 1		8
Status of	What Is Centralized Servicing?	8
Single-Family Housing	FmHA's Single-Family Housing Loan Portfolio	8
Loan Portfolio		
Section 2		10
History of FmHA's		
Efforts to Centralize		
Section 3		12
Benefits and	Benefits Expected From Centralization	12
Disadvantages of	County Office Consolidation Potential	13
Centralization	Disadvantages of Centralization	15
Section 4		17
Options for Moving		
Forward With		
Centralization		
Appendix	Appendix I: Major Contributors to This Briefing Report	20
Figure	Figure 3.1: High Percentage Single-Family Housing Loan Offices (Relative to Farm Loans)	14

Abbreviations

FmHA	Farmers Home Administration
SFH	single family housing
USDA	U.S. Department of Agriculture

Status of Single-Family Housing Loan Portfolio

What Is Centralized Servicing?

- Providing all servicing actions after a loan closes—i.e., escrowing, reviewing interest credit, applying and collecting late payment fees, counseling on credit issues, handling delinquency cases—at one central location.

The private sector has used centralized servicing of housing loans for many years. Under centralized servicing, an individual who wishes to buy a home obtains a loan from a lending institution. After the loan is closed, the lending institution often sells the servicing rights to another organization. It is this centralized servicing organization that provides services such as collecting monthly payments, escrowing for property taxes and insurance, managing delinquencies, and providing credit counseling. The borrower communicates with the servicing organization over the telephone or through the mail.

FmHA's in-house centralized servicing for FmHA borrowers would work in much the same way as private sector servicing. Borrowers could obtain their loans from FmHA's local offices, regional offices, or from a central office, but all services would be performed at a separate, central location. The borrower would receive the same services provided by the private sector loan servicing industry as well as services unique to FmHA such as periodic review of interest credit agreements, application of moratoriums, and appeals.

FmHA's Single-Family Housing Loan Portfolio

- Value of single-family housing (SFH) loan portfolio = \$18.8 billion.
- Value of farm portfolio = \$16 billion.
- Ratio of SFH borrowers to farm borrowers = 3:1 (approximately 690,893 SFH to 232,663 farm).
- SFH loan payments are made on a monthly basis.
- Farm loan payments are made on a yearly basis.
- More than 100,000 SFH loans that were sold in 1987 are now serviced centrally in the private sector.

FmHA has a large single family housing (SFH) portfolio. As of June 30, 1993, the outstanding principle due on SFH loans was \$18.8 billion (compared to about \$14.4 billion for farm loans) and the ratio of direct SFH borrowers to farm program borrowers was 3-to-1. Moreover, since the program was first authorized in the Housing Act of 1949, FmHA has made over 2 million SFH loans for over \$45 billion.

Section 1
Status of Single-Family Housing Loan
Portfolio

SFH loans account for about 35 percent of the work load in an FmHA county office. SFH loans require more servicing than farm loans primarily because the payments on the former are more frequent (monthly) than on the latter (annually).

In 1987, over 100,000 loans were sold as part of the Omnibus Budget Reconciliation Act of 1986. These loans are being administered by a loan servicing company from a central location.

History of FmHA's Efforts to Centralize

- 5-year escrow requirement.
- 1 unsuccessful pilot project.
- 2 internal studies.
- 1 external study.
- 3 FmHA plans.
- More than \$1.6 million spent.
- \$62 million and \$106 million in estimated annual savings.
- No USDA decision to date.

FmHA has pursued the concept of centralized servicing beginning with the attempt to escrow in 1988. It has participated in one pilot project, performed two internal studies, contracted for one external study, and developed three plans of action. The pilot project and external studies alone cost about \$1.6 million.

1988

The Congress enacted Public Law 100-242 requiring FmHA to offer escrow accounting for its SFH borrowers (Sec. 303). The principle rationale for this requirement was that low-income homeowners would be more likely to stay current on their mortgages and less likely to lose their homes to foreclosure if they were required to establish escrow accounts for property taxes and insurance payments.

To begin implementing this statute in 1988, FmHA entered into a contractual agreement with a private firm to provide escrowing for the agency's SFH borrowers in Wisconsin. This effort is known as the "Wisconsin Pilot." The pilot study did not succeed because the contractor was not able to integrate its automated system with FmHA's loan accounting system. FmHA settled its contractual obligation in December 1992 for \$1,247,751.

1990

In early 1990, FmHA had not determined how to implement escrow accounting. At the same time, it had a project underway for a pilot study on the servicing of SFH loans from a centralized location. FmHA had viewed the two projects as separate initiatives. An internal study was done to determine whether these two projects should be combined and what actions ought to be taken to synchronize their development.

The study was completed in late 1990 and recommendations were made which identified the steps FmHA would take to combine escrowing and centralized servicing for SFH. This plan was approved by the FmHA Administrator in November 1990.

1991

In 1991, FmHA completed a second study that described the operational structure, cost estimates, and impacts of centralized servicing. This study concluded that FmHA could save as much as \$62 million annually in operating costs alone if it implemented centralized servicing. The study also established an October 1993 target date for implementation.

The study was never officially approved by the Under Secretary for Small Community and Rural Development. Instead, the Under Secretary ordered FmHA to obtain independent verification of the cost estimates, savings, and proposed operating structure.

1992

In March 1992, FmHA contracted with a consulting firm for an independent study of centralized servicing options. The study, completed in September 1992, described six options that FmHA could take and concluded that FmHA could save \$106 million annually in operating costs by implementing centralized servicing. The study cost \$322,000.

In June, FmHA issued its Strategic Business Plan which stated that the agency would implement centralized servicing and escrowing by fiscal year 1994.

In October, FmHA's Assistant Administrator for Housing Programs recommended to FmHA's Administrator that servicing of SFH loans be centralized in one location and that the agency purchase a mortgage servicing system to carry out centralization.

1993

FmHA's Acting Administrator for Housing Programs told us in August 1993 that she does not know the status of the agency's plans to centralize servicing for its SFH portfolio. No action has been taken since October 1992.

Benefits and Disadvantages of Centralization

Benefits Expected From Centralization

- Lower delinquency rate.
- Reduced loan losses.
- Escrow accounting ability.
- Lower operating costs.
- Greater productivity and efficiency gained through staff specialization.

As of June 30, 1993, the delinquency rate for FmHA's single-family housing borrowers was 13 percent, with a total unpaid principal on delinquent loans of over \$2.8 billion. In a 1991 internal study, FmHA concluded that a delinquency rate of 10 percent was a realistic expectation for its single family housing borrowers using centralized servicing. The private company that centrally services the remaining 95,000 SFH loans that were purchased from FmHA in 1987 is experiencing a 7.8-percent delinquency rate. According to FmHA, the lower delinquency rate expected from centralized servicing would save millions of dollars in reduced loan losses by reducing foreclosures and associated costs.

Escrow accounting is widely used in the private sector. Housing advocacy groups see escrow accounting as an effective household budgeting tool. It would also help protect the government interest in the properties by ensuring taxes and insurance are paid.

Centralized servicing would also save operating costs. As mentioned earlier, two USDA studies, one internal and one by a private contractor, estimated annual operating cost savings of \$62 million and \$106 million, respectively. These studies estimated that the savings would result from reduced staffing, reduced office space, and increased automation.

The private sector has shown that using highly specialized personnel to perform loan servicing functions results in greater productivity and efficiency. The input of data by fewer individuals should permit better quality control and thus dramatically improve the integrity and reliability of the system data. FmHA found that compared to its present decentralized loan servicing system, training costs could be reduced by not having to train field office personnel in all aspects of servicing single-family housing loans. Also, many of the reports now distributed to FmHA's county field offices would be eliminated, as would any inconsistencies in interpretation and compliance with regulations and policies due to the dispersion of field staffs.

County Office Consolidation Potential

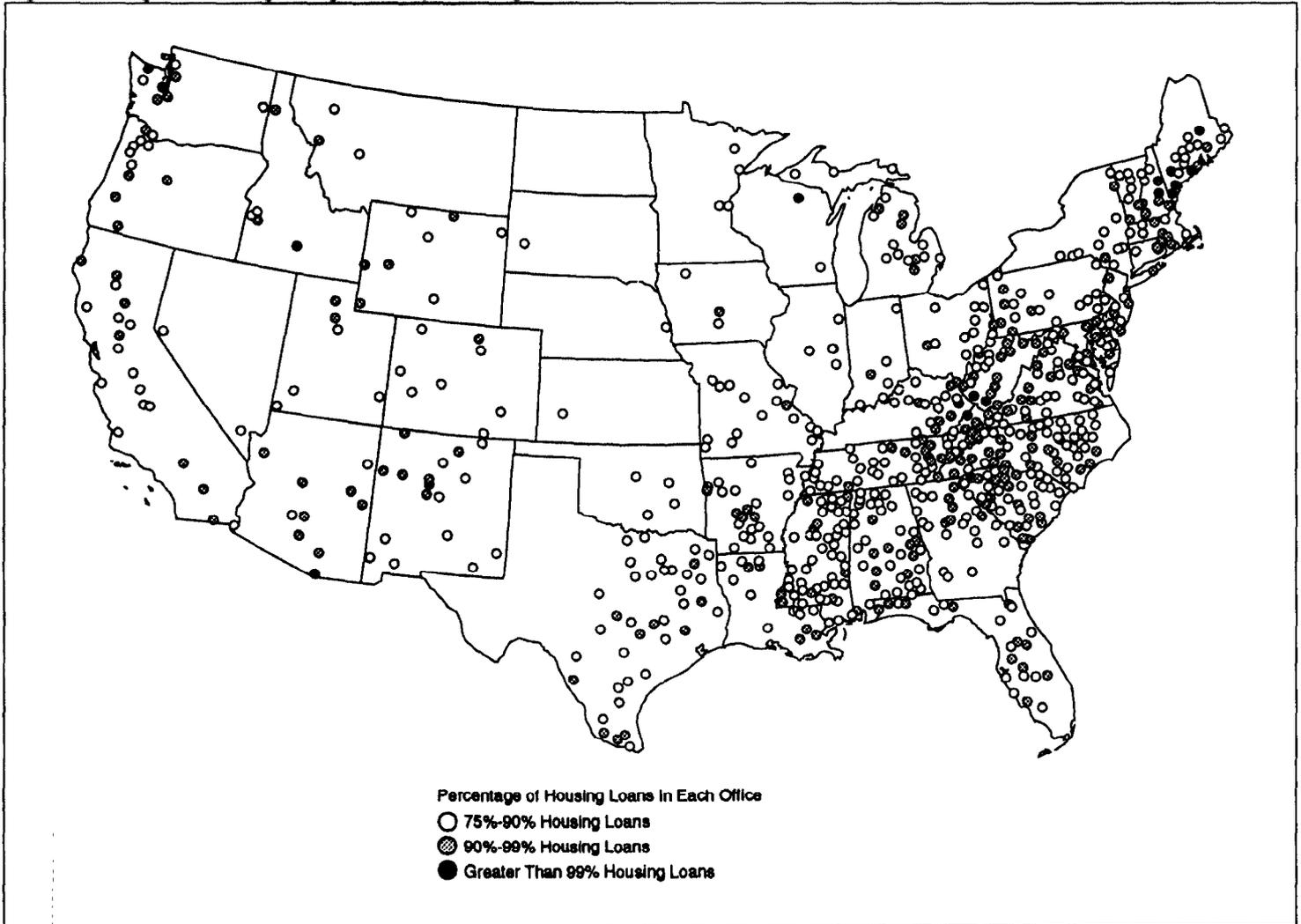
- Opportunities to consolidate FmHA's over 1,700 county offices.
- 1991 FmHA study identified 742 county offices with low work loads.
- GAO analysis identified 700 county offices with high percentage of SFH loan activity.

According to FmHA, centralized servicing would have a significant impact on the existing field office structure. A 1991 internal FmHA study found that since the servicing of SFH loans accounts for about one-third of the workload in county offices nationwide, it would be feasible to close some county offices in the transition to centralized servicing. The study estimated that after full implementation of centralization, about 742 county offices would no longer have a sufficient workload to justify 2 full-time staff. These offices could be closed and their farmer program responsibilities and single-family loan-making activities would be consolidated with remaining county offices. The net result would be fewer county offices serving a greater geographic area.

The following map of the results of our analyses of the mix of farmer program loans versus single-family housing loans as of June 30, 1993, complements USDA's analysis. Where USDA focused on low staff offices, our analysis focused on high housing loan offices. We believe that both criteria should be used in identifying offices to be closed.

Section 3
Benefits and Disadvantages of
Centralization

Figure 3.1: High Percentage Single-Family Housing Loan Offices (Relative to Farm Loans)



The map shows that our analyses confirms FmHA's 1991 findings. As the map illustrates, there are 700 FmHA county offices in the continental 48 states in which SFH loans represent over 75 percent of the total farm and SFH mix. Included in this amount are 459 offices in which over 75 percent but less than 90 percent of the loans are housing loans; 223 offices in which over 90 percent but less than 99 percent of the loans are housing loans; and 18 offices in which over 99 percent of the loans are housing loans, including 8 county offices that only handle housing loans. An

additional 30 high percentage single family housing FmHA offices are located in Alaska, Hawaii, Puerto Rico, and the trust territories.

Disadvantages of Centralization

- Decrease in face-to-face contact between borrower and lender.
- Major redevelopment and redesign of existing automated systems (including purchase of mortgage servicing software and hardware) may be necessary.

While the benefits of a centralized servicing environment for SFH are numerous, some disadvantages have been articulated. One is the belief that the reduction in face-to-face contact between the borrower and lender would adversely affect the borrower. It is true that under centralized servicing, physical contact would be essentially eliminated. However, the primary concern is the quality of service, not how it is provided. Improved service from such offerings as a toll-free number to obtain assistance, immediate response to problems without the necessity of an appointment, and the anonymity that some borrowers prefer may outweigh the perceived advantage of face-to-face contact. Moreover, FmHA's own internal studies and the contractor's study all call for contact with borrowers, primarily by phone and through the mail. Many private sector loan servicing organizations report that clients are very satisfied with business conducted over the phone or through the mail.

Another disadvantage would be the need to redesign and redevelop existing automated systems. If FmHA provides the servicing instead of a contractor, FmHA would need to purchase additional hardware and mortgage servicing software or undertake major redesign and redevelopment efforts because its current systems cannot do the job. If the servicing were contracted, the contractor would provide the hardware and software.

If contracted out, these developmental costs may be appreciably less if FmHA contracts with a company that has already developed these automated systems for use in centralized servicing.

History has shown that USDA's information technology investments have not always provided the expected improvements. For example, system design problems were the primary reason for FmHA's inability to provide escrowing service for its borrowers. FmHA's own study concluded that it is very likely that the agency would have to rely on either the purchase of

**Section 3
Benefits and Disadvantages of
Centralization**

such a system, estimated at costing about \$18 million, or contracting out the entire centralized servicing function.

Options for Moving Forward With Centralization

- In-house loan servicing by FmHA.
- Contracting for services with the private sector.
- A combination of the above two that allows the public and private sectors to compete for loan servicing.

Three basic options for moving forward with centralization include in-house loan servicing by FmHA, private sector contracting, or a combination of the two that allows the public and private sectors to compete for the loan servicing. At least to some extent, the option selected depends on one's view of the government's role and whether it can and should be carrying out functions the private sector can do.

Although this is an age-old debate, recent literature and efforts by the Administration's National Performance Review team have emphasized the benefits of private sector and public/private competition. For example, the National Performance Review states that

"reinventing government is not just about trimming programs; it's about fundamentally changing the way government does business. Forcing public agencies to compete...will create a permanent pressure to streamline programs, abandon the obsolete, and improve what's left."¹

Allowing the public and private sectors to compete for centralized servicing of the 690,000 borrowers currently serviced locally will fundamentally change the way FmHA does business. It also could mean reaping the benefits of the competitive marketplace—greater efficiency, increased focus on customer needs, increased innovation, and improved morale.

For example, while FmHA has unsuccessfully attempted to develop an escrow accounting system for the loans it services, a private company has established escrow accounts for each of its 95,000 loans. If forced to compete, FmHA will have to develop escrow accounts and a computer system that meets the needs of the loan holders and computer operators. Without a system comparable to the one developed by private industry, FmHA would not be competitive. Yet, the literature states that once forced to compete, government employees enjoy the challenge of competition if job security is not at stake.

¹David Osborne and Ted Gaebler, *Reinventing Government—How the Entrepreneurial Spirit Is Transforming the Public Sector*, (Redding, Mass.: Addison-Wesley Publishing Company, Inc., 1992).

Section 4
Options for Moving Forward With
Centralization

If properly planned, time can work to FmHA's advantage. Each of the three options could be implemented over a period of years. This would allow USDA to rely on attrition and retirements to minimize work force reductions resulting from office consolidations.

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