NAHB
National Association of Home Builders

Testimony of Kevin Kelly

On Behalf of the

National Association of Home Builders

Before the

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Introduction

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee on Housing and Insurance, I am pleased to appear before you today on behalf of the National Association of Home Builders (NAHB) to share our views on improving and modernizing the Federal Housing Administration (FHA). We appreciate the invitation to appear before the subcommittee on this important issue. My name is Kevin Kelly, and I am NAHB's 2013 First Vice Chairman of the Board, and a builder and developer from Wilmington, Delaware. NAHB represents over 140,000 members who are involved in building single family and multifamily housing, remodeling, and other aspects of residential and light commercial construction. NAHB's builder members construct approximately 80 percent of all new housing in America each year, and many of our builders rely on the use of the programs of the Department of Housing and Urban Development (HUD) (largely FHA's) in order to help provide decent, safe, and affordable housing to many of our fellow citizens.

NAHB supports efforts to improve FHA, and we understand that this is not a simple undertaking, yet we want reform to be approached with a certain degree of caution. Changes to FHA's programs cannot be separated from the larger discussion of reforming the complex housing finance system, including future reforms to Fannie Mae and Freddie Mac. While the recent FHA actuarial report is troubling, and certainly deserving of congressional oversight, NAHB urges Congress to proceed cautiously and not significantly alter the role of FHA programs.

The FHA was created in 1934 during the Great Depression to promote stability in the housing marketplace and has been viewed as a housing finance innovator by insuring millions of mortgage loans since its inception. In its nearly 80 year history, the agency has successfully achieved its mission at no cost to taxpayers. The fact that the FHA finds itself in this position now, as opposed to four years ago during the height of the financial meltdown, is testament to its ability to meet its mission in these difficult economic times.

While there is no doubt that the housing finance system needs to be reformed, the contributions that the FHA has made during this economic downturn underscore the need for a government backstop for both the primary and secondary mortgage markets. In times of crisis, private financial institutions have been unable or unwilling to meet housing capital needs. Without government support for home purchasing and refinancing, the nation's mortgage markets will grind to a halt in times of economic stress and uncertainty, throwing the economy back into recession.

Given the significant role that housing plays in the economy, Congress needs to take a long-term, holistic approach to housing finance reform. NAHB stands ready to work with the House Financial Services Committee to achieve such reforms and provide much-needed stability for this critical sector of the economy.

Importance of the Federal Housing Administration for Single Family and Multifamily Mortgage Financing

Since the creation of the FHA, it has had a long track record of achievement in insuring loans for over 37 million American families, many of whom would not otherwise have been able to own a home. FHA pioneered the concept of a 30 year fixed-rate mortgage and low down payments, and the nation still benefits from that program today. FHA maintains strong underwriting criteria to protect the tax payers and is intended to be self-funded through the upfront and annual mortgage insurance premiums that borrowers pay.

Contrary to the belief of some, FHA is not a subprime lender and has never required a federal bailout. Although the single family mortgage insurance program is experiencing shortfalls in its excess reserves due to the effects of the worst economic downturn since the Great Depression, FHA remains an integral part of our nation's economic recovery. Housing has led America out of every economic downturn and can do so again if the future policies regarding housing finance reform are addressed in a manner that provides liquidity for the entire housing sector in all markets.

Looking at the dramatic increase of FHA's market share of single-family mortgages over the past few years, it is clear how essential the program is for our nation's economic recovery. Since the downturn in the housing market, FHA has become the primary source of mortgage credit for first-time home buyers, minorities and those with limited downpayment capabilities as other sources of mortgage credit have disappeared. During this time, FHA's share of the market jumped from 3 percent during the housing boom to a high of almost 30 percent early in the crisis. Nearly 80 percent of FHA's purchase loans have been to first-time home buyers. This dramatic shift is evidence that FHA is performing its mission of providing the federal backstop to ensure that every American has access to a stable mortgage product. NAHB believes that the private market should be the primary source of mortgage financing, but that market is extremely limited. While these circumstances prevail, it is entirely appropriate for FHA and other federally backed programs to continue to have a larger than historical market share.

FHA historically also has played an important role in the financing of multifamily rental housing, and it is especially important now during the current economic crisis. In 2008, FHA endorsed just over $2 billion in multifamily loans (excluding health care programs), which grew to $14.6 billion in FY2012. This unprecedented increase in FHA multifamily loan volume occurred as other private market sources of multifamily financing withdrew from the market as economic conditions worsened. FHA, along with Fannie Mae and Freddie Mac, are the primary sources of multifamily financing today. Like in the single family market, the FHA multifamily mortgage insurance programs are fulfilling the function and mission for which Congress originally intended.

FHA Single Family Mortgage Insurance Programs

The FHA single-family mortgage programs are a unique and vital component of the housing finance system, providing access to homeownership for underserved communities, primarily first-time homebuyers, minorities and those with limited downpayment capabilities. During the recent mortgage crisis FHA demonstrated how invaluable their counter-cyclical role was in providing mortgage market liquidity during the country's unstable housing market system. This role has not been without costs to the FHA program as evidenced by the recent actuarial studies of the FHA's Mutual Mortgage Insurance Fund (MMIF).

Since 2010, FHA has implemented a series of policy changes, including higher mortgage insurance premiums, tighter underwriting requirements, stricter mortgage lender enforcement, and improved risk assessment all intended to strengthen the performance of the MMIF and rebuild the capital reserve ratio. These changes are the most sweeping combination of reforms to credit policy, risk management, and lender enforcement in FHA history. FHA's 2012 Actuarial Report estimates that the changes in credit policy and pricing have added more than $20 billion in economic value to the fund from 2010 through 2012.

Just this year HUD announced even more steps it will take to improve the health of the fund and expects that these measures, coupled with an estimated additional $11 billion in capital from new business in FY 2013, will return FHA's capital reserves to a positive position within the year. Some of the measures HUD has announced include:

- Continued improvements to loss mitigation programs, including targeting deeper relief to struggling borrowers, expanded use of short sales and streamlined policies for sales of foreclosed properties.
- Elimination of the policy that allows borrowers to stop paying mortgage insurance premiums (MIP) after their loan reaches 78 percent of its original value. This policy, which went into effect in 2001, has left FHA without premiums to cover losses on loans held beyond the period after the borrower stopped paying MIP. This change will apply to new loans only, effective June 3, 2013.
- Increasing the annual MIP by 10 basis points on new FHA loans, effective April 1, 2013.
- Requiring borrowers with credit scores below 620 to have a maximum total debt-to-income (DTI) ratio no greater than 43 percent in order for loans to be approved through FHA's automated underwriting system. Loans with DTI above 43 percent will have to be manually underwritten. This is effective for new case numbers assigned on or after April 1, 2013.
- Increasing downpayment requirements on loans above $625,500 (up to $729,750) to five percent from 3.5 percent. FHA is reviewing public comments on this proposed change, no effective date has been announced. (The current high cost loan limit of $729,750 will expire at the end of 2013 and revert back to $625,500, the same as the high cost limit for Fannie Mae and Freddie Mac.)

NAHB generally has been supportive of FHA's changes to bolster the MMIF. However, NAHB strongly believes that such changes must be balanced to ensure the ability of FHA to maintain its critical mission of providing support for homebuyers. For example, we note that FHA has increased the annual MIP five times since 2010, raising the annual MIP to the highest levels in FHA's history. As of April 1, the annual MIP on a typical FHA loan (LTV less than 95 percent and loan amount below $625,500) is 130 basis points compared to 50 basis points in April 2010. Further, the upfront MIP has increased to 175 basis points. There has not been adequate time to evaluate the impact that these pricing and other FHA policy changes have had on FHA borrowers. In the meantime, Congress is also considering additional changes to FHA.

<u>Past Legislative Proposals</u>

Over the past couple of years Congress has taken a hard look at the FHA and its policies in an effort to ensure the program is on a sound financial footing. While NAHB has cautioned against a piecemeal approach to address housing finance reform, we have nevertheless supported individual reforms aimed at providing the FHA with immediate tools to better manage risk and protect the insurance fund without disenfranchising responsible homebuyers.

The following legislative reforms were included in bi-partisan legislation passed by the House of Representatives last Congress, and supported fully by NAHB:

<u>Flexibility in Mortgage Insurance Premiums:</u> NAHB has supported the ability to provide FHA with more flexibility in setting annual mortgage insurance premiums. While the aim of such flexibility would be to ensure a fiscally solvent insurance program, NAHB supports a ceiling on these premiums as a way to maintain FHA as a viable option for homeownership.

Lender Indemnification: NAHB has supported strengthening and broadening HUD's ability to ensure that mortgage lenders are required to repay the Department for losses on loans they originate or underwrite regardless of when the FHA insurance claim is paid. Under such a proposal, HUD would be given the ability to terminate lender participation in the program (for those that have a high rate of early defaults) on a nationwide basis in addition to specified local areas. Since HUD currently may only terminate a lender's authority in a specific HUD field office jurisdiction, this would help HUD effectively mitigate risks to the MMIF.

Origination of FHA-Insured Loans: NAHB has supported improving FHA's flexibility by providing authority for small loan originators to originate FHA insured loans in partnership with larger lenders, thereby enabling mortgage brokers to continue doing FHA business without having to alter their business practices or state licensing.

Early Term Delinquencies: NAHB supported requiring HUD to develop a program that analyzes all early period delinquencies and states that HUD must seek repayment by the lender for any early term delinquency that did not meet FHA's underwriting guidelines and requirements.

Risk Officers: NAHB supported the creation of a Chief Risk Officer for the Government National Mortgage Association (Ginnie Mae) in order to have financial oversight on a daily basis, rather than wait for the annual audit. Further, proposals have also codified HUD's existing practice by establishing a Deputy Assistant Secretary for Risk within FHA to mitigate mortgage risk and protect the FHA single family fund.

Annual Actuarial Reports: NAHB supported requiring HUD to provide a semi-annual independent actuarial report on the MMIF and conduct an evaluation of the feasibility of doing quarterly reviews.

Streamlining of Programs: NAHB has supported language that HUD shall conduct a study identifying unused or underused FHA insurance programs and methods to streamline, consolidate, simplify, and reduce the number of these insurance programs.

Emergency Capital Plan: NAHB supported language that required HUD to provide an emergency capital plan for the restoration of the FHA's fiscal solvency and directs the Government Accountability Office to provide for an independent third party to conduct a one-time safety and soundness review of the FHA's mortgage insurance programs and report on its findings.

FHA Multifamily Mortgage Insurance Programs

NAHB has long-supported the FHA multifamily mortgage insurance programs. These programs, notably Section 221(d)(4) and Section 223(f), have enabled the construction of needed affordable and market rate rental housing units over the years, as well as contributed to the ability of property owners to acquire, refinance, rehabilitate and preserve the nation's existing stock of rental housing. Of importance, FHA financing is often used in smaller markets where Fannie Mae, Freddie Mac and other market participants are less active, and FHA has filled the niche that local banks and thrifts have retreated from in recent years.

It is important to note that over the last two years, HUD has instituted new risk management protocols for the FHA multifamily mortgage insurance programs. The new protocols tightened underwriting requirements and created a national loan review committee. New policies were implemented for large loans, including higher standards for sponsor creditworthiness and experience. Processes and procedures throughout the field offices have been strengthened and standardized. There is closer scrutiny on market strength and FHA presence than before the economic crisis struck.

In addition, HUD revised and tightened lender capitalization, licensing and monitoring requirements, made significant changes as part of the update of the loan closing documents, and finalized several changes to the multifamily mortgage insurance program regulations. The most recent step taken was raising the mortgage insurance premiums for programs in the General Insurance/Special Risk Insurance (GI/SRI) fund. This was the first premium increase in 10 years for these programs.

Most recently, a new Concentration of Principal Risk policy was issued describing the procedures lenders must follow to obtain prior approval for borrowers (principals) with greater than $250 million of outstanding FHA-insured debt who plan to submit applications for new loans. Under the new policy, lenders are required to conduct a complete mortgage credit review of principals who meet the threshold.

All of these actions were intended to strengthen risk management practices related to the FHA multifamily mortgage insurance programs, ensure the health of the GI/SRI fund, and attract high quality borrowers, without taking market share from the private sector or endangering taxpayers. NAHB has been actively engaged in working with the department as these requirements have been implemented. Although NAHB has not agreed with every action taken, overall we have supported HUD's objectives and have worked to ensure that borrowers and lenders understand the changes.

As important as these steps have been towards increasing risk management, the FHA multifamily field offices continue to struggle because of inadequate staffing and resources. The Office of Multifamily Housing is in the process of testing "workload sharing" among the Multifamily Hubs and Program Centers to address imbalances among staffing levels and to compensate for absences of specialized staff (such as appraisers or construction experts) needed to complete a loan review. This involves the sharing of staff resources among different offices, as well as shifting some loans from one office to another (generally in the same geographic area). The department's objective is to alleviate staff burden, improve operational efficiency and respond more effectively to customers.

Further stressing the multifamily programs at this time is that commitment authority is being used at a significantly faster pace than last year, and it is very possible that there will be a disruption in the programs early this summer unless Congress acts to authorize additional commitment authority. HUD estimates it will need $5 billion in additional commitment authority for the remainder of FY2013. Lenders and borrowers may be faced with no avenue to obtain construction financing or to refinance existing properties if FHA's authorized level of commitment authority is exhausted before the end of the fiscal year.

NAHB believes that staffing and resource issues must be addressed to ensure that the FHA multifamily mortgage insurance programs remain strong and viable. In addition, the uncertainty related to the availability of commitment authority has the potential to create great disruptions in financing important affordable and market-rate rental properties, as well as health care facilities, which are also included under the GI/SRI fund. NAHB also notes that the Federal Housing Finance Agency's (FHFA) recent announcement that Fannie Mae and Freddie Mac must reduce their respective multifamily businesses by 10 percent over the next year, together with the FHA commitment authority situation, is close to representing a "perfect storm" in that financing for multifamily properties could become severely constrained quite quickly, for no reason related to market conditions.

Modernization of the FHA

FHA's operations must be modernized to allow the agency to operate more efficiently and effectively. In its current framework, governed by federal budget constraints and rigid statutory and regulatory requirements, FHA is sluggish and inefficient. FHA has little capacity to implement adequate operating processes, respond promptly to mortgage market developments, or pursue program and product innovations. FHA lacks experienced personnel, is unable to provide adequate staff training, and is constrained in human resources management. FHA has lagged in implementing technological improvements. The Government Accountability Office (GAO) and HUD Office of Inspector General (OIG) have identified the department's outdated financial management system as a serious impediment to the proper oversight of FHA's portfolio. Both GAO and the OIG report the need to update technology and integrate systems to enhance HUD's ability to perform required financial management functions and efficiently manage financial operations of the department.

Constraints have been placed upon FHA, by Congress and internally via HUD, which inhibit FHA's ability to operate in a manner that recognizes, complements and evolves with developments by the private sector. To continue its vital role in the housing finance arena, FHA must be afforded greater freedom from external micromanagement and political influence while developing a professional, responsive, results-oriented organizational culture and remaining accountable for achievement of its mission.

NAHB believes that this can best be accomplished by restructuring FHA as an independent government corporation within HUD, separate from Ginnie Mae, which would continue its current mission of supporting liquidity, innovation and continuity in the housing finance markets by providing mortgage insurance backed by the full faith and credit of the U.S. government. The restructured FHA would be led by a chief executive officer, appointed by the President, who would report to a presidentially appointed board, chaired by the HUD Secretary.

The Bipartisan Millennial Housing Commission (MHC) recommended that FHA be restructured as a wholly owned government corporation within HUD in its 2002 Report to Congress. The key differences between the MHC and NAHB recommendations are that MHC would combine FHA and Ginnie Mae and would have the FHA CEO report directly to the HUD Secretary. (See: Report of the Bipartisan Millennial Housing Commission, May 30, 2002, p. 45.)

While under general Congressional oversight, FHA should have the authority, without further Congressional action, to create or alter specific insurance programs in order to have the flexibility to react promptly to changes in market and other conditions. Hiring, salaries, personnel management, and procurement would be freed from current, confining federal government constraints in order to be more consistent and competitive with the private sector. FHA would be operated in a manner that does not require a federal subsidy and would allow FHA to retain revenues generated in excess of expenses to be used for mission purposes.

Additional Proposed Changes to FHA Single Family Programs

In addition to the structural, operational and programmatic changes discussed so far in this statement, a number of other changes to FHA single family mortgage insurance programs have been proposed. NAHB recognizes that additional changes to FHA programs may be necessary as the housing finance system continues to evolve and wants to participate in the dialogue on such changes. NAHB believes that in evaluating proposals for further change in FHA programs, the modifications should be analyzed in the context of other changes that have occurred or may occur both within FHA and in the broader housing finance system. Assessing the cumulative impact of all components of housing finance system restructuring, including the interplay among housing finance sectors, should be standard protocol for accurately determining the ultimate outcome of any proposed change on FHA's mission, effectiveness and financial condition.

NAHB has not yet established policy positions on FHA program proposals beyond those discussed in the preceding sections of this statement and cannot do so until sufficient explanations and details on the additional proposals are available. Some of the single family program proposals merit exploration, including those involving risk-based pricing, risk-sharing and reduction in the current portion of the loan insured by FHA. While such changes could offer benefits to FHA and the mortgage marketplace, they also raise a number of questions and concerns, which are identified below.

Risk-Based Pricing – Calibrating mortgage insurance premiums to the risk profile of the borrower would allow FHA to better align its revenues with potential claims and thus bolster reserves. However, it would also place FHA in the position of raising the mortgage financing costs of the individuals it has the mission to serve. A key consideration in designing a system of risk-based pricing for FHA is the range and weighting of risk-factors used in determining the schedule of premiums.

Risk Sharing – Dividing the risk with private companies would reduce FHA's loss exposure and could have other operational advantages. However, it would also raise the question of FHA's exposure to adverse selection if the private companies limited their participation to the lowest risk portion of FHA's business. This concept also could reduce or eliminate participation by smaller mortgage lenders, particularly community banks, who would have difficulty meeting the eligibility criteria for the program. A change of this nature would also impact the Ginnie Mae mortgage-backed securities (MBS) program by raising Ginnie Mae's exposure to counterparty risk and would likely require significant changes at that end as a result.

Reduced Degree of FHA Insurance – FHA could also shift risk exposure to the private sector by reducing the percentage of a loan that it insures. The Department of Veterans Affairs (VA) has operated its Loan Guaranty Program in this manner with positive results. However, the VA program is restricted to a specific portion of the population, the military, and has operating features that may not be replicable at FHA. In addition, as in the case of risk-sharing, Ginnie Mae's counterparty risk exposure would increase, necessitating changes in that program as well.

Conclusion

Few things are more important to Americans than their homes. Whether they rent or own, Americans want to choose where they live and the type of home that best meets their needs. Rental housing is the choice for millions, from all ages and walks of life. For many others, the opportunity to own a home is the cherished ideal. Today, even though the housing market is still recovering from the effects of the worst housing market downturn since the Great Depression, Americans still believe in homeownership, which is why NAHB appreciates the key role FHA has played in keeping our housing market liquid, stable and affordable.

Given the significant role that housing plays in the economy, we urge Congress to take a long-term, holistic approach to housing finance reform. NAHB stands ready to work with you to achieve such reforms and provide much-needed stability for this critical sector of the economy.