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BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

April 24, 2002

Thank you for the opportunity to testify on behalf of the Department of Housing and Urban Development and the Office of Housing-Federal Housing Administration (FHA), concerning the "Housing Affordability for America Act of 2002." The bill covers a very wide range of programs and activities across the Department, including many different programs within the Office of Housing. We have carefully reviewed each provision contained in the bill, and I am grateful for this opportunity to provide you with our thoughts on the sections of this important piece of legislation. Because you have also addressed a number of specific questions about FHA programs in your letter of invitation, I will combine my answers to those questions with comments on the corresponding sections of the bill. I have organized my comments by program area.

FHA Single-Family Insurance Programs

To begin with FHA's basic Section 203(b) home mortgage insurance program and the Mutual Mortgage Insurance (MMI) Fund: as you know, the President and the Secretary have made promoting homeownership, especially for minority households, a cornerstone of domestic policy. We are very proud of FHA's success in promoting homeownership. About 80 percent of our home purchase mortgages serve first-time homebuyers and about 35 percent serve minority households. The national homeownership rate, and the minority homeownership rate, both set new records last year.

The MMI Fund was determined to have an economic value of $18.5 billion at the end of FY2001, with a capital ratio of 3.75%. FHA's volume of business this year is running substantially in excess of expectations. Indeed, through the first six months of the year we have insured over $81 billion of single-family mortgages. We are assessing the need to seek an increase in our current commitment limitation of $160 billion for the MMI Fund for the current fiscal year. Having been personally involved in developing the legislation that put FHA on an actuarially sound basis some 12 years ago – as was Chairwoman Roukema and Ranking Member Frank - I am very pleased to report this information to you.

Of course, the MMI Fund has attracted a number of proposals to spend the reserves, for example to divert funds into a new "National Housing Trust Fund" for purposes well beyond the homeownership goals of the Mutual Mortgage Insurance Fund. We think these proposals are ill-advised, and they misconstrue the nature of the MMI Fund's net worth. Net worth includes the estimated present value of future losses and future premium income, as well as current reserves.

Establishing the MMI Fund on an actuarially sound basis was a fundamental goal of the Cranston-Gonzalez National Affordable Housing Act of 1990. That was intended to forestall the need for any taxpayer bailout of the FHA, as had just been required for the savings and loan industry. The MMI Fund was specifically required to operate with a separate reserve against potential losses. The Cranston-Gonzalez legislation provided that funds would be available to meet any contingency, so that general revenues in the

Treasury would never be needed to meet FHA obligations. To achieve this objective, FHA suspended the payment of distributive shares to borrowers and raised insurance premiums substantially.

Since 1990, FHA has gradually built up its reserves year by year. This annual surplus has been counted in the overall Federal budget as an offsetting receipt, and has helped reduce the deficit. Because this revenue was previously counted as a receipt, any legislation that proposes to expend it will be counted as new spending, just as if funds were being appropriated directly out of the Treasury. Using these funds for other purposes will result in a substantial budget outlay. Moreover, using the MMI Fund reserves will vitiate FHA's ability to meet the basic goal of the Cranston-Gonzalez Act of making the MMI Fund actuarially sound.

FHA was able to reduce single-family premiums substantially last year, and make homeownership more affordable for more families, in line with our fundamental public policy purpose. The "Housing Affordability for America Act of 2002" contains several provisions that would improve FHA's ability to operate our core single-family home mortgage insurance programs. Section 221 would make permanent a pilot designed to streamline and simplify the FHA downpayment program. Secretary Martinez supported this proposal during his testimony before the House Appropriations Subcommittee last month. This downpayment simplification calculation has proven to be a successful program modification. The procedure reduces the number of steps involved in the calculation of the FHA single-family mortgage amounts, and thereby has eliminated the confusion experienced by many buyers, brokers, and lenders. Further, this existing statutory authority has reduced the costs associated with closing an FHA insured mortgage. Ultimately, the simplification has increased homeownership opportunities for low- and moderate-income families. The Department appreciates the efforts by Rep. Bob Ney and other Members of this Committee in supporting the permanent extension of this provision.

Similarly, Section 227 should facilitate the Department's ability to effectuate another legislative priority. During the FY2002 budget process, the Department requested and received authority to insure hybrid Adjustable Rate Mortgages (ARMs). Our work to implement that authority is continuing. The Department's position is that FHA's hybrid ARM should approximate the conventional hybrid ARM and its benefits as closely as possible, subject to preserving sound underwriting policies and protections for FHA borrowers and the MMI Fund. Section 227 supports that end by allowing the Department greater flexibility in the design of regulations that will govern the initial rate adjustment at the end of the fixed rate period.

Sections 229-231 are consistent with recent Department actions to strengthen our Section 203(k) rehabilitation mortgage insurance program and our nonprofit partnerships. In 1996, the Office of Housing issued Mortgagee Letter 96-59, placing a moratorium on investor participation in the 203(k) program. Investors have not been allowed to participate in the program since the issuance of this Mortgagee Letter. The moratorium still stands. We have no plans to modify the Letter and have no objection to Section 229.

Similarly, Section 230 regarding rehabilitation loan advances is also consistent with Departmental action. FHA Mortgagee Letter 00-25 states, "mortgagees are fully responsible for authorizing draw inspections, managing the rehabilitation escrow account, and approving the associated draws for the account." The Letter also requires consultants to be chosen from the FHA 203(k) Consultant Roster and permits consultants to perform the inspections on the mortgagee's behalf. The Department has a number of technical questions regarding this provision and looks forward to working with the Committee to ensure that mortgagees are held appropriately responsible.

Section 231 would require participating nonprofits to be approved 501(c)(3) organizations and certify annually to the Department its understanding of HUD guidelines. In January 2002, the Office of Housing issued Mortgagee Letter 02-01, establishing new requirements for nonprofits seeking FHA-approval. Nonprofits must now have, among other requirements, two years 501(c)(3) IRS tax-exempt status and a minimum of two consecutive years – within the last 5 years – of housing development experience. Approved nonprofits have until September 30, 2002 to demonstrate their compliance with the new requirements. The Office of Housing supports Section 231 to strengthen its existing guidance. It will help us prevent a recurrence of the 1998-1999 Section 203(k) fraud problem in New York City, where a number of nonprofits purchased small multi-unit buildings in Harlem and Brooklyn, intending to have them rehabilitated for owner-occupancy. The knowledgeable and experienced Commissioner of New York City's Department of Housing Preservation and Development said that she had never heard of 25 of the nonprofits that bought these homes; she had only heard of two. This fraud will cost U.S. taxpayers some $268 million and will cost the citizens of New York City another $125 million.

Sections 222-224 contain proposals to provide special opportunities for teachers and public safety officers. Section 223 would give the Secretary authority to discount HUD-owned, single-family properties by 50% to qualified teachers and public safety officers. The Department certainly does not object to such a program; indeed, the Secretary already has this authority and has exercised it. The Department's Officer/Teacher Next Door Program currently allows teachers and police officers to purchase homes at a 50% discount in designated revitalization areas, subject to a three-year owner occupancy requirement. In connection with such programs, however, we do want to highlight for the Committee the management challenges and program administration difficulties inherent in these efforts. During a Fiscal Year 2001 audit of the program, the Office of the Inspector General uncovered a significant number of violations of the program rules by officer participants. In May 2001, the Department temporarily suspended sales under the program and instituted enhanced management controls. A recent IG audit of sales closed after the program resumed in August 2001 did not identify any new program violations. The Department is currently working on a proposed rule to include these program controls.

Sections 222 and 224 both aim to reduce downpayment requirements for public safety officers, while Section 222 also includes teachers among those who will benefit.

In regard to both provisions, it is important to note that the Office of Housing has recently made significant changes to its programs to reduce downpayment costs substantially for all buyers of FHA insured properties. These changes include the reduction of upfront insurance premium rates by 33 percent, along with the Downpayment Simplification previously mentioned. One observation the Department would make with regard to Sections 222-224 is that a number of other occupational groups have expressed a similar interest in reduced downpayments.

I would also mention that the Department's Office of Policy Development and Research is in the process of studying the impact of programs that reduce downpayment requirements for selected populations, as required by Congress. We believe that it would be prudent to wait until the results of this study are available before making any commitment to such an initiative.

The Administration appreciates the importance of providing opportunities for low-income families to receive downpayment assistance. We are committed to expanding homeownership opportunities. The Department is prepared to implement the American Dream Downpayment Fund proposed by the President and funded by Congress last year. The American Dream Downpayment Fund will reduce the barrier that downpayments frequently pose to homeownership, for all low- and moderate-income families. On behalf of the Administration, I want to thank Rep. Mike Rogers and other Members of Congress for introducing H.R. 4446 to authorize this program.

Section 228, which would establish a uniform national loan limit for Home Equity Conversion Mortgages (HECMs), also concerns an issue that is currently part of an internal analysis by the Office of Policy Development and Research. As mandated by the "American Homeownership and Economic Opportunity Act of 2000," the Department is conducting an actuarial analysis on the impact of this provision. We will provide the Subcommittee with comments and recommendations when this study has been finalized.

FHA Single-Family REO

The bill also contains several provisions concerning FHA's single-family inventory of foreclosed homes, and the Committee has asked about our Real Estate Owned (REO) activities. Since the introduction of the Management and Marketing contracts in March of 1999, the Department has greatly improved its REO disposition. As of March 2002, the inventory of HUD-owned homes is at its lowest level since 1996 - 28,270, compared to a March 1999 inventory of 41,747. Moreover, the inventory has been stable during the recession, instead of rising as has been typical in the past. Currently, properties remain in inventory an average of 183 days, compared to 221 days in March 1999, and losses per claim have been reduced from 39 cents to 29 cents on the dollar. The loss rate is at its lowest point in at least 20 years.

FHA sold 66,415 single-family homes during FY 2001. About 60 percent of these sales were to owner-occupants, helping serve FHA's basic purpose of promoting

homeownership. Another 30 percent are sales to investors, and the remainder – slightly less than 10 percent - goes to local governments and nonprofit organizations.

FHA currently offers discounts to HUD-approved nonprofit organizations on the purchase of REO. Properties newly acquired by HUD are offered initially to governmental entities and nonprofits organizations on a limited competitive basis, which excludes investors and owner occupants, for up to 5 days. For specific properties on which governmental entities and nonprofits organizations express an interest to purchase, HUD offers them these properties on a limited competitive basis for up to another 10 days. After these periods, FHA opens bids on properties to the general public, but nonprofit groups and governmental entities may bid and still receive sales discounts. These discounts are factored into a sale after the highest bids are calculated.

HUD properties are appraised and initially listed for sale on the Internet and through multiple listing services at the "as-is" value established by the appraiser. Properties sold to a nonprofit are discounted by 10%, unless the property is located in a FHA-designated "revitalization area," in which case the discount is 30%.

FHA has two primary initiatives underway associated with its property disposition program. We have begun a major review of our Asset Control Area (ACA) program, following a report of program deficiencies by the HUD Office of Inspector General in a recent audit. We are planning to build stronger controls into the ACA program. During that review, which will take four to six months, we will let current ACA agreements expire. Our ACA partners can, however, continue to rehabilitate and sell the properties they have already acquired from HUD, and we believe that most, if not all, ACA partners have an inventory of properties that will not be exhausted during the review.

A second initiative is HUD's Accelerated Claims Demonstration Program. This program, created by Section 601 of the FY1999 Appropriations Act and announced in a Federal Register Notice on February 5th, will enable HUD to buy seriously defaulted loans that cannot be addressed through FHA's loss mitigation program and sell these loans to the private sector for management, including more extensive mitigation than FHA can provide. This program is expected to begin in the fourth quarter of this fiscal year. Considering both of these initiatives, it does not appear that additional statutory authority related to property disposition is required at this time.

Partly for these reasons, we see no need for Section 225 of this bill, which would require HUD to use the Department of Agriculture's Rural Housing Services Center as an additional resource for servicing single-family, HUD-held mortgages. We believe that this requirement is unnecessary and indeed would be counterproductive. Presently, HUD's National Servicing Center (NSC) in Oklahoma services four types of secretary-held loans, each with unique characteristics and servicing requirements. In particular, NSC services 963 reverse equity loans. For this loan type, the Department makes monthly payments to the borrowers rather than receiving income from them. The daily payment process is complex and time sensitive. Additionally, NSC services second mortgages generated through loss mitigation advances and discounted sales to officers and teachers in HUD's Officer/Teacher Next Door programs. Because these mortgages

carry no interest and require no monthly payments, servicing activity is generally limited to processing subordinations and payoffs. All of these mortgage types are unique to HUD. The Rural Housing Service has no similar programs and no experience in servicing such loans. NSC is doing an excellent job managing their unique mortgage servicing requirements. It is unclear that there is a benefit or need to outsource the servicing of these loans.

FHA Multifamily Insurance Programs

As the members of this Subcommittee know, FHA's basic multifamily insurance program is Section 221(d)(4). This program has required a credit subsidy since Federal Credit Reform was enacted in 1990. Three times in the last eight years, the program was closed down because the available credit subsidy was exhausted. To prevent further closures and place the program on a break-even basis, the Department raised the premium from 50 basis points to 80 basis points for FY 2002. Many in the industry, and some Members of Congress, were concerned that the program would be hamstrung by this increase. That has not happened. Already in this fiscal year, FHA has insured over $1.5 billion worth of Section 221(d)(4) projects – more than we insured in all of last year. Moreover, with the 25 percent increase in mortgage limits that was proposed by the Secretary and enacted by Congress, we are seeing applications from high-cost metropolitan area that have not participated in the program in years – Philadelphia, Newark, Baltimore, here in Washington, the Twin Cities, and Seattle.

In addition, we have conducted the first systematic re-analysis of the premium and credit subsidy since Credit Reform was enacted. We have concluded that Section 221(d)(4) can be operated on a break-even basis at a much lower premium – 57 basis points. The President's Budget contains an announcement of this premium reduction, effective in October, at the beginning of FY 2003. We are also reducing either the premium or the credit subsidy for nearly every other multifamily program.

This summary of FHA's multifamily mortgage insurance programs provides background for consideration of Sections 201 and 202 in the legislation. They address the question of who should be served by the programs. FHA multifamily mortgage insurance generally serves moderate-income renters. Most of the projects that FHA insures are affordable to families in the lower half of the income distribution, and almost half are in underserved areas. These are important markets; these families and these communities need FHA.

Section 201 proposes to index the FHA multifamily mortgage limits. As members of this Subcommittee certainly know, Congress approved indexing the mortgage limits in the Section 203(b) single-family mortgage insurance program several years ago. This provision has enabled FHA to keep pace with inflation and changing economic conditions as it serves young, first-time homebuyers. Indexing the multifamily limits should likewise prove to be more responsive to market conditions and to the needs of families seeking moderately priced rental housing. Clearly, annual adjustments

provide a better way to compensate for increased costs than by providing periodic dollar increases. When Congress raised the limits last year by 25 percent, at the request of Secretary Martinez, this was the first increase since 1992, and represented a delayed catch-up for the inflation that occurred between 1992 and 2001; during those years, FHA was progressively less able to serve moderate-income renters.

Section 202 proposes to increase the maximum mortgage limits in areas with very high housing costs by 30 percent above the amounts allowed under current law. It also proposes to increase the amount by which the Secretary, on a case-by-case basis, may increase the maximum mortgage amount. The Department would prefer to analyze the data resulting from our experience with the new limits that Congress enacted last year and the future effects of the indexing contained in Section 201 before evaluating the need for additional high housing cost authority.

FHA Insurance for Nursing Homes and Hospitals

The Housing Affordability for America Act of 2002 contains several provisions relating to FHA's insurance programs for nursing homes and hospitals. Section 206 seeks to provide a more flexible procedure with respect to the Certificate of Need (CON) for hospitals, which is somewhat similar to an Administration proposal that was not enacted last year. There is a technical problem with the language of Section 206 as drafted. The Section states that HUD should work "in conjunction with" the Department of Health and Human Services (HHS). HUD currently has a contractual agreement with HHS with respect to Section 242, the hospital mortgage insurance program. Under this agreement, both HHS salaries and expenses are paid from the FHA General Insurance Fund. This agreement has worked well for several years. Because of the agreement, the language should be modified to read "in consultation with," to avoid any contractual disputes between HUD and HHS in the future. There is no similar agreement between HUD and HHS with respect to the Section 232 nursing homes mortgage insurance program, and we do not believe that the language is necessary or desirable for that program. HUD operates the nursing home program effectively without formal participation by HHS.

Sections 203-205 amend the definition of the FHA health care and assisted living programs so as to take FHA into new lines of business. Sections 203 and 204 change the definitions in Section 232 and Section 242, respectively, to include community health centers, medical practice facilities, and group practice facilities, and Section 205 permits insurance to refinance these facilities. These provisions raise a number of questions and require additional analysis before the Department can provide a definitive position. The language creates an overlap between Section 232 and Section 242, as well as Title XI, so that these new lines of business can be insured under either program. The programs are now managed separately within the Office of Housing, and the overlap could possibly complicate our ability to run both programs. More fundamentally, these proposals would appear to require FHA to undertake new insurance activities on unfamiliar products, beyond our current expertise and capacity. FHA primarily insures financing for housing.

To expand our portfolio to include businesses that provide no shelter could have long-term consequences to the FHA General Insurance (GI) Fund. We are now experiencing an increasing number of claims in the Section 232 nursing home program, and we have some 17 hospitals on our "Problem Watch List." It is particularly relevant that the expansion of nursing homes into new business activities during the 1990s led to a significant number of defaults and bankruptcies.

Programs for the Elderly and Disabled

Section 301 addresses part of a well-known policy concern. It would authorize the use of uncommitted, unobligated Assisted Living Conversion Program funds in the Section 202 program for use in a modernization demonstration program for Section 236 elderly housing. The Section 236 elderly housing portfolio is a fraction of the Section 236 program - about 90,000 units, less than one-third of the units in the entire Section 236 portfolio of over 330,000 units nationwide. The elderly housing projects are generally in good physical condition; only 25 projects out of 556 have REAC physical inspection scores of less than 60, less than 5 percent of the inventory. We certainly recognize that there is some need for capital improvements among the entire older insured subsidized FHA multifamily portfolio. We have been working with the multifamily industry over the last two years, in an effort to modernize and restructure the Section 236 housing portfolio. The work is being conducted within the framework of preserving these projects for continued use within the affordable multifamily housing stock. The general restructuring technique involves a sale of the project to a new owner who physically modernizes the project and maintains its affordability for the term of the mortgage plus five years, generally a total of 15 years. In most cases, the financing technique utilizes new mortgages supported by the continuation of Section 8 rental assistance and the remaining Section 236 interest reduction payments. The owner's capital is provided through the Low Income Housing Tax Credit (LIHTC). To date, we have succeeded in restructuring over 100 of these projects. We do not believe that Section 301 is necessary for this effort. We also are concerned that the Section 202 Assisted Living Conversion program might be adversely affected. The program has not yet reached the scale envisioned in past appropriations, and the unexpended funds have been carried forward. But it is our experience that new programs do take time to get underway, and we do not believe it is prudent to anticipate that Section 202 Assisted Living Conversion funds would be available.

With regard to Section 303, as you know, the President and the Secretary are strongly committed to ensuring that religious organizations have the same opportunities as any other participant in the Section 202/811 programs, which are our largest programs in terms of participation by faith-based organizations. These organizations now can be sponsors of these projects, and certainly religious organizations have been very active in the Section 202 program since its creation in 1959. In recent years, they have accounted for approximately 40% of the funding that Congress appropriates for these programs. We therefore applaud the purposes of Section 303 and will work with the Committee in consideration of issues that relate to HUD's current practices in this area.

Other Provisions

The Housing Impact Analysis proposed in Title VIII was proposed by President Bush during the campaign two years ago. It is an effort to create a system to monitor the aggregate effects of all rules on the cost and availability of housing. We believe that it is in the interest of consumers, especially moderate-income families seeking to become homeowners or to find decent affordable rental housing, to ensure that regulations are demonstrably required to protect health and safety, and that the costs and consequences of regulation for affordable housing are recognized and balanced against other important public purposes.

Section 902 establishes a single office within the Department to coordinate counseling activities. This sounds desirable, but may be counterproductive, in our judgment. It might undermine the ability of the various offices to establish requirements, standards, and performance measures that meet the unique needs of their programs and clients. HUD's various program areas each provide counseling, generally for different purposes and typically to different clienteles. Recently, FHA revised the standards and performance measures related to the 1,400 HUD-approved housing counseling agencies participating in this program. We see no need for another office within the Department to repeat this process. As you know, the Administration has requested $35 million for a new categorical counseling program, nearly doubling the current level of funding and removing the program from the HOME block grant. We urge you to support that proposal, and we believe it will be easier and quicker to provide the funds to counseling agencies if we can operate the new program on the basis of the standards we have recently established.

Finally, the Administration supports Section 908 to simplify current law pertaining to subsidy layering. The provision permits housing credit agencies to certify to compliance with the Department's subsidy layering requirements concerning the combination of HUD and other governmental assistance with the Low Income Housing Tax Credit. The housing credit agency will simply certify that it has made the subsidy layering determination already required by Section 42 of the Tax Code. This provision is consistent with the Secretary's efforts to streamline the delivery of HUD's programs and support the production of affordable housing through the use of FHA mortgage insurance and the Low Income Housing Tax Credit Program.

Conclusion

Thank you again for the opportunity to testify on the "Housing Affordability for America Act of 2002." I would be happy to answer any questions that the Subcommittee may have.