NAHB

National Association of Home Builders

Testimony of Robert F. Nielsen
On Behalf of the
National Association of Home Builders

Before the
House Financial Services Subcommittee on Insurance, Housing and Community Opportunity

Hearing on
“Oversight of the Federal Housing Administration’s Multifamily Insurance Programs”

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Introduction

Chairman Biggert, Ranking Member Gutierrez and Members of the Subcommittee on Insurance, Housing and Community Opportunity, I am pleased to appear before you today on behalf of the National Association of Home Builders (NAHB) to share our views on the importance and the oversight of the Federal Housing Administration's (FHA) multifamily mortgage insurance programs. We appreciate the invitation to appear before the Subcommittee on this important issue.

My name is Bob Nielsen. I am a multifamily builder from Reno, Nevada, and I am the Immediate Past Chairman of the Board of NAHB. NAHB represents over 140,000 members who are involved in building both 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 multifamily builders rely on the use of FHA's multifamily programs to help provide decent, safe, affordable rental housing to many of our fellow citizens.

We want to commend the Subcommittee for its work on housing policy this Congress, and we appreciate this hearing to discuss the importance of multifamily rental housing and the federal programs that support this segment of the housing market. We also want to take a moment to recognize the U.S Department of Housing and Urban Development (HUD) for its work during the economic crisis with all multifamily stakeholders, many of whom are at this table, to ensure that credit remained available and affordable.

As we have testified in other committees, NAHB believes that a stable, effective and efficient housing finance system is critical to the housing industry's important contribution to the nation's economic performance and to the achievement of America's social goals. Residential construction - including the building of new structures as well as the remodeling of existing ones - has direct, positive impacts on the U.S. economy. The most obvious impacts are the work opportunities created in the housing industry, as well as in other industries that provide products or services to home builders and buyers. Workers are employed to directly engage in the construction activity. Jobs are generated in the industries where lumber, concrete, lighting fixtures, heating equipment, and other products that go into a home are produced. More jobs are created when real estate agents, lawyers, brokers and property managers provide services to home builders, home buyers and renters. NAHB estimates that the impacts include the following:

- 3.05 jobs from building an average new single family home.
- 1.16 jobs from building an average new multifamily rental unit.
- 1.11 jobs from $100,000 spent on residential remodeling.

As members of Congress and the administration move forward on restructuring the nation's housing finance system, NAHB would like to reiterate its longstanding belief that it is crucial for the federal government to continue to provide a backstop to ensure a reliable and adequate flow of affordable housing credit. A federal backstop must be a permanent fixture to guarantee a consistent supply of mortgage liquidity, as well as to allow rapid and effective responses to market dislocation and crises. That being said, NAHB looks forward to a continued dialogue with the members of this Subcommittee.

NAHB's testimony focuses on the Section 221(d)(4) and 223(f) programs, which provide mortgage insurance for new construction/substantial rehabilitation and the acquisition and refinancing of existing multifamily properties. These two programs are of critical importance to NAHB multifamily members. They are often used in tandem with the Low Income Housing Tax Credit (LIHTC) program to provide affordable housing. Indeed, HUD has been working to streamline the use of FHA insurance with the LIHTC program, as well as with other federal housing programs, such as HOME.

Our testimony includes an assessment of the department's risk management efforts; NAHB's concern regarding the administration's proposal to increase the mortgage insurance premiums; potential changes to the Guaranteed Insurance/Special Risk Insurance (GI/SRI) fund; recommendations regarding several appropriations issues that affect the FHA multifamily portfolio; and NAHB's policy direction regarding the future of FHA.

Background

Our members have long-supported the FHA multifamily mortgage insurance programs. These programs, most notably Section 221(d)(4) and 223(f), have enabled the construction and substantial rehabilitation of needed affordable rental housing units over the years, and as well as contributed to the ability of property owners to acquire, refinance, rehabilitate and preserve the existing stock of affordable housing. FHA historically has played an important role in the financing of multifamily rental housing, and it is especially important now during the current economic crisis. In FY2008, FHA issued firm commitments for just over $2 billion in multifamily loans (excluding health care), which grew to $5.8 billion in FY2009, $11.8 billion in 2010 and $13 billion in FY2011. This unprecedented increase in loan volume occurred as other sources of multifamily financing withdrew from the market as economic conditions worsened. FHA, along with Fannie Mae and Freddie Mac (the enterprises), are the primary sources of multifamily financing today.

However, the role of FHA during this economic crisis has been particularly important because private market sources of capital (banks, life insurance companies, and pension funds) for multifamily financing have not been available for all segments of the multifamily market. Life insurance companies tend to focus on large projects in the strongest markets and typically serve the highest income households. Once they meet their own portfolio investment targets, life insurance companies retract their lending. Banks do not provide 30-year term financing (as FHA does) and are subject to significant restrictions in terms of capital requirements. While the commercial mortgage backed securities (CMBS) market was significant at one time, it has not recovered from the financial crisis and is not expected to resume its past levels of volume. In addition, while the enterprises have been and remain critical sources for multifamily financing, they do not insure construction loans and have a poor record of addressing the financing needs for small multifamily rental properties.

Thus, while other lenders have started to return to the market, FHA continues to perform one of its critical roles - providing sufficient liquidity to meet market demand for financing both affordable and market rate rental housing in all geographic areas of the country during all economic cycles.

FHA's Risk Management Practices for Multifamily Programs

Early in the current housing crisis, HUD reassured NAHB that FHA would continue to provide liquidity to the market and quickly took steps to provide support for multifamily by instituting a waiver of the three-year rule for refinancings and extended that waiver twice. HUD also instituted a waiver to allow projects already under construction, with certain conditions, to apply for FHA financing.

As overall market conditions deteriorated, the department announced its intentions to institute a new risk management protocol for the multifamily insurance programs. In June 2010, a Mortgagee Letter was issued announcing significant tightening of the underwriting requirements for the Section 221(d)(4) new construction/substantial rehabilitation and Section 223(f) acquisition and refinancing programs. In addition to the underwriting changes, a national loan review committee was established, delegation to the field was modified, and FHA began a process of substantial credit policy and work flow management changes. The department also established a strong credit approach to application processing. 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 regulations governing the FHA multifamily mortgage insurance programs.

The department also took steps to mitigate risk related to large multifamily loans. In late December 2011, HUD issued a Mortgagee Letter regarding the underwriting of large loans, defined as those at or above $40 million. While only a small number of loans overall, HUD was concerned that a few defaults of large loans could have an overwhelming impact on the portfolio. Debt service coverage, loan-to-cost and reserve requirements were tightened considerably for large loans (over and above the tightening already put into place). Also included in the new policy is additional scrutiny of sponsors asking for loans of $25 million or larger. Sponsors' creditworthiness, experience with large developments and past performance on FHA-insured properties will be examined much more closely before any loan applications are accepted.

All of these actions were intended to strengthen risk management practices related to the FHA multifamily mortgage insurance programs, ensure the health of the FHA multifamily portfolio and attract high quality borrowers. 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. Working with our industry colleagues, we have offered suggestions for improvements in a number of areas. Of particular concern has been avoiding an overcorrection; that is, ensuring that credit is not tightened unnecessarily. Also of continuing concern is that processing of FHA-insured loans remains slow, impeding access to needed credit.

Proposed Increases for the Multifamily Mortgage Insurance Premiums

As the department implemented the new risk management protocols discussed above, it did not propose an increase in the mortgage insurance premiums (MIPs) through FY2012. However, reversing this trend, the Administration's proposed FY2013 budget included an increase in the mortgage insurance premiums (MIPs) for most of the FHA multifamily mortgage insurance programs financing market rate loans. The department states in its Federal Register Notice (FR-5634-N-01) that, "These MIP increases will not only provide additional protection for the Guaranteed Insurance/Special Risk Insurance fund (GI/SRI) and increase receipts to the Treasury, but will also encourage private lending to return to the market by ensuring FHA is not under-pricing its risk."

The department proposes to increase the MIPs for the Section 221(d)(4) new construction/substantial rehab by 20 basis points (bps) from 45 to 65 and increase the MIPs for the Section 223(f) acquisition and refinance program by 15 bps, from 45 to 60. The increases do not affect affordable/assisted properties, that is, properties financed with Low Income Housing Tax Credits (LIHTCs) or that have Section 8 project-based or other types of rental assistance.

NAHB is opposed to these increases. We do not believe that HUD has provided compelling justification for them. The purpose of the MIPs is not to increase receipts to the Treasury, nor to adjust FHA's pricing of credit risk relative to current private market pricing. Increasing the MIPs will not serve to build a buffer against future losses, because there is no segregated fund and excess income is returned to the Treasury each year. These higher MIPs will only add to property owners' costs, thereby affecting rents. In the current economic environment, where rents are increasing, higher MIPs will only speed the upward trending of rents.

We believe it is extremely important that any increase in the mortgage insurance premium be supported and preceded by a careful analysis of the need and impact of the change. HUD's Notice provides no analysis of the need and impact of the proposed increase on borrowers, lenders or renters who live in properties insured under the programs.

NAHB believes that HUD's basis for these increases is a deviation of past practices and current policy. Historically, HUD has not raised the MIP to generate revenue beyond that needed to cover expected credit losses and associated program costs. Currently, the MIP is set at a level where the programs will break even (i.e., no credit subsidy is required) providing only a minimal amount of excess income. This level is established based on an economic model, as required under the Federal Credit Reform Act of 1990 (FCRA), that takes into account the risks and costs of the program. The HUD proposal makes no mention of any technical or actuarial defects of the model. If such defects exist, the Department should be transparent and indicate such as a reason for increasing the MIPs. Absent any information to this effect, we would presume that the Department believes the risk model is working appropriately.

It is our understanding that Congress did not intend the FHA MIP to be based on what the market would bear. Rather, Congress, in FCRA, set out a framework for federal insurance and guarantee programs "that would assure the government accounted for these guarantees in an appropriate manner." Originally, this calculation resulted in the need for an appropriation by Congress for the FHA multifamily programs. However, the credit subsidy calculation which has been used by HUD for the last 10 years has set the MIP for most of the multifamily programs at a level that would allow them to break even and not require an appropriation of credit subsidy. In fact, the multifamily programs have generated substantial negative credit subsidy for HUD over the years. As noted earlier, the current MIP increase runs counter to the Credit Reform Act, as it sets the MIP at what the Administration considers a rate more in line with the private sector. We believe it is more appropriate to set the FHA MIP based on FHA's costs and experience with FHA's portfolio of loans.

It is extremely important to note that, in the most recent past, the default rate used by HUD in the credit subsidy calculation has, in fact, **gone down**. In the case of the new construction program, according to the Federal Credit Supplement of the recently released FY2013 Budget Proposal, the FY2012 budget had a default rate of 19.11 percent, while the FY2013 budget saw that rate fall to 13.18 percent — a significant decrease. Similarly, the default rate for the multifamily refinance program dropped from 12.64 percent to 4.22 percent — a stunning decrease.

NAHB believes that should HUD impose higher MIPs on these loans, it would discourage market rate housing. Congress intended the FHA multifamily insurance programs to have a broad scope. The legislation authorizing the multifamily programs nowhere indicates a requirement or even a preference for assisted housing. In fact, Congress has repeatedly increased the maximum loan limits for the programs which are the only targeting mechanism for the multifamily insurance programs.

Moreover, rental housing in general — whether market rate or otherwise — is inherently affordable in character, and many of the properties financed and refinanced under the FHA multifamily programs are affordable to families at 60 to 80 percent of area median income without any type of direct federal or state subsidy. These types of properties are routinely financed by FHA-insured loans, particularly in the 223(f) programs, and these properties will be disadvantaged by the imposition of higher MIPs.

In addition, the proposed increases will disproportionately affect market rental properties in secondary and tertiary markets. Private capital (banks, pension funds and insurance companies) currently is focusing lending activities in the strongest markets and for the most well-capitalized large developers. Access to capital in the secondary and tertiary markets is much more limited, and FHA has always played a significant role in providing liquidity in these areas. HUD does not differentiate among markets in setting the MIPs, thus the increases penalize the borrowers who need HUD financing the most.

The need for an MIP increase in the face of reduced defaults has not been demonstrated and sets a precedent for poor public policy making, creating a de facto tax on rental housing.

FHA and the Private Market

Although the role of FHA has increased significantly in the multifamily market during this recession, NAHB believes that this has not been a direct effort to push out the private market; it has only done so because other market participants have pulled back. The volume of multifamily loan originations by CMBS issuers, banks, life insurance companies and other lenders reached their peaks in 2007 and dramatically decreased in 2008 and 2009. Many capital providers began reentering the market in 2009 and have steadily increased in 2010 and 2011. On the other hand, Fannie Mae, Freddie Mac and FHA stayed in the markets and even increased their volumes in 2008, 2009, 2010 and 2011.

FHA financing is often used in smaller markets where the enterprises and other market participants are less active and has filled the niche that local banks and thrifts have retreated from in recent years. Without FHA, many of the rental housing properties that need rehabilitation would not be able to achieve the necessary capital, and new rental housing would not be able to be built.

As conventional lenders have returned to the market, FHA's market share has declined because these financing sources are more flexible and less costly to pursue. This is occurring naturally without the need to unnecessarily increase costs through an increase in the MIP.

The Guaranteed Insurance/Special Risk Insurance (GI/SRI) Fund

NAHB recognizes there have been discussions on the establishment of capital ratios for the GI/SRI funds as a way of strengthening the risk management practices for the FHA programs. NAHB does not believe it is appropriate to apply the concept of capital ratios as used with the Mutual Mortgage Insurance Fund (MMIF) to the GI/SRI fund. The nature of the multifamily portfolio is significantly different from the single family portfolio insured under the MMIF.

Currently, there is no statutory requirement for capital ratios for the GI/SRI fund. If Congress must consider whether or not to establish capital ratios, it should be preceded by an in-depth analysis to determine the likely impact on the MIPs for the FHA multifamily programs. Until the FY2013 budget was proposed, implementation of the new risk management protocol did not include an increase in the MIP for any of the FHA multifamily mortgage insurance programs. Any proposal to implement a capital ratio on the GI/SRI funds could have a significant impact on MIPs. Higher MIPs will lead to higher costs for borrowers and renters who are served by the FHA multifamily programs. A key example is the Section 221(d)(4) program where a higher MIP will raise the required borrower debt service and/or equity contribution, resulting in a lower mortgage amount at a higher rate of interest. These higher costs would be passed along to the low- and moderate-income families who use the program in the form of higher rents or could result in properties not being built or rehabilitated because of the higher equity contribution required.

NAHB urges members of Congress to carefully consider the range of issues before proceeding to consider whether minimum capital ratios should be required of the GI/SRI fund. First and foremost, an in-depth analysis, conducted by a qualified third party, should be undertaken before any legislative proposals are moved forward.

Other Issues Impacting the Multifamily Portfolio

Section 8 Project Based Rental Assistance

The Administration’s FY2013 budget includes a proposal to short-fund renewals of Section 8 Project Based Rental Assistance (PBRA) contracts. That is, instead of asking for sufficient appropriations to renew the funding of all expiring contracts for a full 12 months, funding would be provided only for the remainder of the fiscal year in which the contract is renewed. HUD believes that this is a cost-saving measure, but in fact, short funding in one fiscal year only exacerbates the problem for the next fiscal year.

Property owners and managers will need to make contingency plans for paying their mortgages and operating expenses if HUD does not have funding available to renew the contracts or make housing assistance payments. In addition, uncertainty about the budgets for PBRA raises concerns about the reliability of federal funding commitments among owners, managers, lenders and residents and could stall or prevent the preservation of FHA-insured multifamily properties that provide affordable housing through PBRA.

We strongly support the Senate Appropriations Transportation, Housing and Urban Development (THUD) bill as passed by the Full Committee, which provides full 12-month funding for PBRA contracts. We would urge this Committee to work with their counterparts in Appropriations to ensure spending levels which enable property owners to properly administer the programs that serve those in need.

HUD's Legislative Proposal for Small Multifamily Financing

HUD is interested in finding new financing options for the refinancing, rehabilitation and/or acquisition of small multifamily rental properties (defined as five to 50 units). Small properties are an important source of affordable housing – nearly a third of the nation's renters live in small, unsubsidized housing. Typically such properties are owned as "Mom and Pop" investments or by other small business entities, which often have difficulty obtaining financing for capital improvements or to acquire these properties.

The HUD budget for FY2013 includes a proposal to amend Section 542(b) of the Housing and Community Development Act of 1992. Under the Section 542(b) risk share legislation, HUD provides reinsurance on multifamily housing projects whose mortgage loans are originated, underwritten, and serviced by Qualified Participating Entities (QPEs). QPEs include eligible lenders, such as state housing finance agencies (HFAs), government sponsored enterprises (GSEs) or other approved entities.

Under this proposal, a greater number of experienced affordable housing lenders would be allowed to make risk share loans to refinance, rehabilitate and recapitalize small properties. The proposal would amend Section 542(b) to allow Ginnie Mae to securitize risk share loans. Thus, lenders approved by Ginnie Mae for the program could securitize these loans on the secondary market, reducing the costs of financing such properties and freeing up capital for additional multifamily lending.

HUD also proposes to amend Section 542(c) of the Housing and Community Development Act of 1992, which allows FHA to enter into risk sharing programs with HFAs only. HUD's proposed amendment would permit Ginnie Mae to securitize loans made under Section 542(c).

NAHB supports HUD's efforts to expand the availability of financing for small multifamily rental properties and to provide a secondary market outlet for such loans. These two legislative proposals are an important step in the right direction, and we urge the Committee to work with HUD on its proposed amendments to Sections 542(b) and (c).

H.R. 4253 Preservation Enhancement and Savings Opportunity Act

NAHB would like to express its support for H.R. 4253. The bill was introduced to address an issue affecting properties originally financed in the early 1970s with a subsidized mortgage loan under Section 236 of the National Housing Act. In 1994, to encourage the continued availability of the property for affordable housing, the financing for the property was restructured under the Low-Income Housing Preservation and Resident Homeownership Act of 1990 (LIHPRHA).

Under the LIHPRHA agreements, the owner became obligated to operate the property as low income housing for the remaining useful life of the property. The restructured financing imposed a fixed maximum amount on annual cash distributions to the equity owners of the property. These distribution limits, while initially quite workable, over time have developed adverse and unexpected impacts relating to the federal income tax liabilities of the owners. Initially, the net income from the property was in reasonable balance with the depreciation and mortgage interest deductions, with the result that the permitted fixed cash distribution was at least sufficient to permit the equity owners to satisfy their federal income tax liability relating to the property.

With the passage of time, deductible mortgage interest has been an ever-declining portion of the constant mortgage loan payments, and depreciation deductions have also declined. Thus, the annual federal taxable income of the owner has increased substantially, while the permitted distribution under the LIHPRHA Agreements has remained at the constant dollar amount fixed in 1994.

The bill would address this situation by removing contractual limits on distributions of surplus cash, permitting the owner to take an annual distribution of any project income that remains after all project operating expenses and maintenance costs have been provided for, in accordance with HUD standards, and all debt service obligations have been paid. In essence, the bill simply accelerates the owners' access to their own funds. The proposed legislation would ameliorate a burdensome and unintended result of LIHPRHA, at no budgetary or tax cost to the Federal government (as the funds are project funds and do not belong to HUD) and without threatening the physical or financial well-being of the property.

The Future of FHA Multifamily Financing

The focus of the discussion on the future of housing finance reform largely has been on single family homeownership. Less attention has been paid to the multifamily rental housing segment of the housing finance system, even though almost one-third of Americans live in rental housing, and demand for rental housing in the future is expected to increase.

In particular, NAHB estimates that the aging of the "echo boom" generation will result in demand for between 300,000 and 400,000 multifamily housing units on average per year over the next ten years. The timing of this demand will depend on the pace of economic recovery, but the housing needs of these households will not be postponed indefinitely. In 2011, the 178,000 multifamily housing starts were roughly half of the 300,000 to 400,000 units needed to keep pace with demographic factors over the next 10 years. Production of multifamily housing will undoubtedly increase above the current low levels. It is important that the financing mechanisms to support that production are available.

The administration, in its 2011 report, *Reforming America's Housing Finance Market,* emphasizes that Americans must have access to a range of affordable housing options, whether they own or rent. The report notes that renters face significant affordability challenges and says that the housing finance system must promote liquidity and capital to support affordable rental options that alleviate high rent burdens on low-income households.

The report states that, in the near term, the administration will begin to strengthen and expand FHA's capacity to support both lending to the multifamily market and for affordable properties that are underserved by the private market. Options include risk-sharing with private lenders and development of programs dedicated to hard-to-reach segments, such as small rental properties, underserved markets and rural areas.

While NAHB strongly supports such activities as appropriate for FHA, the current structure, staffing levels and resources available may not be sufficient to take on such additional responsibilities, nor does FHA have the institutional flexibility to respond to the range of market needs quickly and efficiently. FHA continues to struggle to improve loan processing times, and staffing levels are at all-time lows. Consideration must be given as to how to implement the structural and budgetary changes that would be needed for expanded responsibilities.

NAHB also believes that more thought needs to be given to a future financing system that will meet the needs of moderate and middle income renters. Fannie Mae and Freddie Mac have developed expertise in providing financing to the middle of the rental market, where housing is generally affordable to moderate income families. However, FHA has a role to play in this segment of the market as well, particularly if the enterprises' eventual dissolution leaves a void that will not be filled by other entities.

Conclusion

The FHA multifamily mortgage insurance programs play a critical role in the nation's housing finance system. These programs provide access to credit in all geographic areas of the country and under all economic conditions. NAHB strongly supports HUD's efforts to strengthen the programs and to implement changes that improve their efficiency and effectiveness without impeding access to credit.

NAHB also strongly believes that the programs must be protected from being used as sources of income for non-housing uses. Raising the MIPs to provide revenue to the federal government is poor public policy and only increases the cost of housing. Similarly, instituting minimum capital ratios without a thorough study and justifiable need is not an action supported by NAHB.

The future of the nation's housing finance system remains in flux; the future of the FHA multifamily mortgage insurance programs must be part of the discussion. NAHB believes that the FHA mission should remain broad, that the programs should encompass market rate and affordable housing, and that more effort should be directed towards increasing program flexibility and staff resources.

Thank you again for this opportunity for the National Association of Home Builders to share our views on the FHA multifamily mortgage insurance programs.