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HEARING BEFORE THE

SENATE APPROPRIATIONS COMMITTEE
SUBCOMMITTEE ON TRANSPORTATION, HOUSING AND URBAN DEVELOPMENT AND RELATED AGENCIES

ENTITLED

SOLVENCY AND REFORM PROPOSAL FOR THE FEDERAL HOUSING ADMINISTRATION

WRITTEN TESTIMONY OF
JOANNE POOLE, CRS, GRI, LTG
2007 LIAISON

NATIONAL ASSOCIATION OF REALTORS®
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EQUAL HOUSING OPPORTUNITY

Introduction

Madam Chairman, Ranking Member Bond, thank you for this opportunity to testify before you. My name is JoAnne Poole and I am the broker/owner of Poole Realty in Glen Burnie, Maryland. I have been a REALTOR® for 21 years, and am currently part of NAR's Enlarged Leadership Team, and serve as a 2007 Liaison.

I am here to testify on behalf of 1.3 million members of the National Association of REALTORS®. We thank you for the opportunity to present our view on the FHA program and the need for reform. NAR represents a wide variety of housing industry professionals committed to the development and preservation of the nation's housing stock and making it available to the widest range of potential homebuyers. The Association has a long tradition of support for innovative and effective federal housing programs and we have worked diligently with the Congress to fashion housing policies that ensure federal housing programs meet their mission responsibly and efficiently.

Need for FHA

The current increase in foreclosures is troubling to all of us. In 2006, 1.2 million families entered into foreclosure, 42 percent more than in 2005[1]. Predatory lending, exotic mortgages and a dramatic rise in sub-prime lending – coupled with slowing home price appreciation - have all contributed to this crisis.

In 1934 the Federal Housing Administration was established to provide consumers an alternative during a similar lending crisis. At that time, short-term, interest-only and balloon loans were prevalent. Since its inception, FHA has insured more than 34 million properties. However, because it hasn't evolved, FHA's market share has been dropping. In the 1990s FHA loans were about 12 percent of the market. Today, that rate is less than 3 percent. This statistic is unfortunate given that FHA is needed now as much as it was in 1934. At the same time, the sub-prime market has skyrocketed. In 2003, the sub-prime market share was 8.5 percent by 2005 it was at 20 percent. In 2006, FHA/VA market share dropped 37.8 percent; conventional loans dropped 9.8 percent; while sub-prime loans increased another 15.7 percent.

When formed, FHA was a pioneer of mortgage products. FHA was the first to offer thirty-year fixed-rate financing in a time when loans were generally for less than five years. Unfortunately, FHA has not changed with the times. Where they were once the innovator, FHA has become the lender of last resort. As conventional and sub-prime lenders have expanded their repertoire of loan products, FHA has remained stagnant. As a result, a growing number of homebuyers are deciding to use one of several new types of non-traditional mortgages that let them "stretch" their income so they can qualify for a larger loan.

Non-traditional mortgages often begin with a low introductory interest rate and payment—a "teaser"—but the monthly mortgage payments are likely to increase significantly in the future. Some of these loans are "low documentation" mortgages that provide easier standards for qualifying, but also feature higher interest rates or higher fees. Mortgages such as interest-only

[1] *A Flood of Foreclosures, But Should You Invest?,* Market Watch, February 18, 2007.

and option ARMs can often be risky propositions for some borrowers. These products pose severe risk for consumers who may be unable to afford their mortgage payments when monthly payments increase by as much as 50 percent or more when the introductory periods end, or when their loan balances get larger each month instead of smaller. Mortgage experts estimate that approximately $1.5 trillion worth of adjustable mortgages will reset by the end of 2007[2]. While some borrowers may be able to make the new higher payments, many will find it difficult, if not impossible.

As the market has changed, FHA must also change to reflect consumer needs and demands. If FHA is enhanced to conform to today's mortgage environment, many borrowers would have available to them a safer alternative to the riskier products that are currently marketed to them.

FHA Reform Proposals

To enhance FHA's viability, the Administration has proposed a number of important reforms to the FHA single-family insurance program that NAR believes will greatly benefit homebuyers by improving access to FHA's safe and affordable credit. By way of an example, NAR projects that in Washington State, where less than 6,500 homeowners used FHA for financing in 2005, the reforms proposed could increase the number of FHA homebuyers by more than 62 percent, saving those borrowers $20.9 million over what they would pay for a sub-prime loan.

FHA is proposing to eliminate the statutory 3 percent minimum cash investment and downpayment calculation, allow FHA flexibility to provide risk-based pricing, move the condo program into the 203(b) fund, and increase the loan limits. The National Association of REALTORS® strongly supports these reform provisions.

Down Payment Flexibility. The ability to afford the downpayment and settlement costs associated with buying a home remains the most challenging hurdle for many homebuyers. Eliminating the statutory 3-percent minimum downpayment will provide FHA flexibility to offer varying downpayment terms to different borrowers. Although housing remains strong in our nation's economy and has helped to increase our nation's homeownership rate to a record 69 percent, many deserving American families continue to face obstacles in their quest for the American dream of owning a home. Providing flexible downpayment products for FHA will go a long way to addressing this problem.

In 2005, 43 percent of first-time homebuyers financed 100 percent of their home. NAR research indicates that if FHA were allowed to offer this option, 1.6 million families could benefit. According to NAR's Profile of Homebuyers, 55 percent of homebuyers who financed with a zero-downpayment loan in 2005, had incomes less than $65,000; 24 percent of those who used a zero-downpayment product were minorities; and 52 percent of people who financed 100 percent of their home purchased homes priced at less than $150,000. It is important to note that FHA will require borrowers to have some cash investment in the home. This investment can be in the form of payment of the up-front premium or closing costs. No loan will be made for more than 103 percent the value of the home.

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[2] *Homeowners Brace For ARMs' New Rates*, The Seattle Times, February 17, 2007.

Loan Limits. FHA mortgages are used most often by first-time homebuyers, minority buyers, and other buyers who cannot qualify for conventional mortgages because they are unable to meet the lender's stringent underwriting standards. Despite its successes as a homeownership tool, FHA is not a useful product in high cost areas of the country because its maximum mortgage limits have lagged far behind the median home price in many communities. As a result, working families such as teachers, police officers and firefighters are unable to buy a home in the communities where they work. Even in your home state of Washington, Madam Chairman, the median home price exceeds FHA's current limit of $200,160.

This is why NAR strongly supports proposals to change the FHA loan limits. Under the Administration's plan, FHA's limits for single unit homes in high cost areas would increase from $362,790 to the 2006 conforming loan limit of $417,000. In non-high cost areas, the FHA limit (floor) would increase from $200,160 to $271,050 for single unit homes. This increase will enhance FHA's ability to assist homebuyers in areas not defined as high-cost, but where home prices still exceed the current maximum of $200,160. This includes states like Arizona, Colorado, Florida, Georgia, Illinois, Maine, Minnesota, Nevada, North Carolina, Ohio, Oregon, Pennsylvania, Utah, Vermont, and Washington. While none of these states is generally considered "high cost", all have median home prices higher than the current FHA loan limit.

Risk-based Pricing. Another key component of the Administration's proposal is to provide FHA with the ability to charge borrowers different premiums based on differing credit scores and payment histories. Risk-based pricing of the interest rate, fees and/or mortgage insurance is used in the conventional and sub-prime markets to manage risk and appropriately price products based on an individual's financial circumstances. Currently, all FHA borrowers, regardless of risk, pay virtually the same premiums and receive the same interest rate.

The legislation will allow FHA to differentiate premiums based on the risk of the product (e.g. amount of cash investment) and the credit profile of the borrower. These changes will enable FHA to offer all borrowers choices in the type of premium charged (e.g. annual, upfront or a hybrid). In addition it will permit FHA to reach higher risk borrowers (by charging them a premium amount commensurate with risk), while continuing to attract the better credit risks, by charging them less. FHA financing, with risk-based premium pricing, will still be a much better deal for borrowers with higher risk characteristics than is currently available in the "near prime" or sub-prime markets. Risk-based pricing makes total sense to the private market, and should for FHA as well.

It is also important to note that, while FHA has had the authority to charge premiums up to 2.25 percent, they have not done so. FHA currently charges 1.5 percent. The FHA Fund is strong and has continued to have excess revenue, so there has not been a need to increase the premiums. However, due to its markedly decreased market share, FHA may have to increase premiums on borrowers in 2007 and in future years. Unless the program is reformed to make it more consumer-friendly, FHA will need to generate more revenue to cover its losses.

Giving FHA the flexibility to charge different borrowers different premiums based on risk will allow FHA to increase their pool of borrowers. If FHA is also given authority to provide lower

downpayment mortgages, premium levels will need to reflect the added risk of such loans (as is done in the private market) to protect the FHA fund.

Changes to the Fund Structures. The Administration also proposes to combine all single-family programs into the Mutual Mortgage Insurance Fund. The FHA program has four funds with which it insures its mortgages. The Mutual Mortgage Insurance (MMI) Fund is the principal funding account that insures traditional Section 203b single-family mortgages. The Fund receives upfront and annual premiums collected from borrowers as well as net proceeds from the sale of foreclosed homes. It is self-sufficient and has not required taxpayer bailouts.

The Cooperative Management Housing Insurance Fund (CMHI), which is linked to the MMI Fund, finances the Cooperative Housing Insurance program (Section 213) which provides mortgage insurance for cooperative housing projects of more than five units that are occupied by members of a cooperative housing corporation.

FHA also operates Special Risk Insurance (SRI) and General Insurance (GI) Funds, insuring loans used for the development, construction, rehabilitation, purchase, and refinancing of multifamily housing and healthcare facilities as well as loans for disaster victims, cooperatives and seniors housing. Currently, the FHA condominium loan guarantee program and 203k purchase/rehabilitation loan guarantee program are operated under the GI/SRI Fund.

NAR strongly supports inclusion of the FHA condominium loan guarantee program and the 203k purchase/rehabilitation loan guarantee program in the MMIF. Both of these programs provide financings for single family units and have little in common with multifamily and health facilitates programs covered by the SRI and GI funds. In recent years programs operating under the GI/SRI funds have experienced disruptions and suspensions due to funding commitment limitations. Maintaining the single family condo and purchase/rehabilitation programs under the GI/SRI funds exposes these programs to possible future disruptions. Thus, from a conceptual an accounting standpoint, it makes sound business sense to place all single-family programs under the MMIF.

Program Enhancements. As well as combining the 203(k) and condominium programs under the MMIF, NAR also recommends key enhancements to increase the programs' appeal and viability. Specifically, NAR recommends that HUD be directed to restore investor participation in the 203(k) program. In blighted areas, homeowners are often wary of the burdens associated with buying and rehabilitating a home themselves. However, investors are often better equipped and prepared to handle the responsibilities related to renovating and repairing homes. Investors can be very helpful in revitalizing areas where homeowners are nervous about taking on such a project.

We also recommend that HUD lift the current owner-occupied requirement of 51 percent before individual condominium units can qualify for FHA-insured mortgages. The policy is too restrictive because it limits sales and homeownership opportunities, particularly in market areas comprised of significant condominium developments and first-time homebuyers. In addition, the inspection requirements on condominiums are burdensome. HUD has indicated that it would provide more flexibility to the condo program under the MMIF. We strongly support loosening

restrictions on FHA condo sales and 203k loans to provide more housing opportunities to homebuyers nationwide.

Borrower Benefits of FHA

The universal and consistent availability of FHA loan products is the principal hallmark of the program that has made mortgage insurance available to individuals regardless of their racial, ethnic, or social characteristics during periods of economic prosperity *and* economic depression.

The FHA program makes it possible for higher-risk, yet credit-worthy borrowers to get prime financing. According to a recent Federal Reserve Bank review,[3] the average credit score for sub-prime borrowers was 651. This is higher than FHA's median credit score borrower, which demonstrates that these borrowers are likely paying more than they need to pay. By offering access to prime rate financing, FHA provides borrowers a means to achieve lower monthly payments – without relying to interest-only or "optional" payment schemes. FHA products are safe, thanks to appropriate underwriting and loss-mitigation programs, and fairly priced without resorting to teaser rates or negative amortization.

When the housing market was in turmoil during the 1980s, FHA continued to insure loans when others left the market; following 9/11, FHA devised a special loan forbearance program for those who temporarily lost their jobs due to the attack; after Hurricanes Katrina and Rita, FHA provided a foreclosure moratorium for borrowers who were unable to pay their mortgages while recovering from the disaster. FHA's universal availability has helped to stabilize housing markets when private mortgage insurance has been nonexistent or regional economies have faltered. FHA is the only national mortgage insurance program that provides financing to all markets at all times. Simply put, FHA has been there for borrowers.

Now, more than ever, FHA needs to be strengthened to continue to be available to borrowers. In just the past few months, at least 25 sub-prime lenders have exited the business, declared bankruptcy, announced significant losses, or put themselves up for sale.[4] After making record profits, these lenders are simply bailing as the bad loans they made begin to fail. FHA, who is more careful with its underwriting standards, can be a safe alternative for buyers who have been lured into unnecessary sub-prime loans.

FHA is a leader in preventing foreclosures. FHA's loss mitigation program authorizes lenders to assist borrowers in default. The program includes mortgage modification and partial claim options. Mortgage modification allows borrowers to change the terms of their mortgage so that they can afford to stay in the home. Changes can include extension of the length of the mortgage or changes in the interest rate. Under the partial claim program, FHA lends the borrower money to cure the loan default. This no-interest loan is not due until the property is sold or paid off. In the year 2004 alone, more than 78,000 borrowers were able to retain their home through FHA's loss mitigation program; and two years later, nearly 90 percent of these borrowers are still in their homes. By encouraging lenders to participate in these loss mitigation efforts and penalizing

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[3] Federal Reserve Bank of St. Louis Review - January-February 2006
[4] *The Mortgage Mess Spreads*, BusinessWeek.com, March 7, 2007.

those who don't, FHA has successfully helped homeowners keep their homes and reduced the level of losses to the FHA fund.

Solvency and Strength of FHA

Critics of the reform proposals have argued that FHA isn't positioned to handle changes to the program. We respectfully disagree. Despite FHA's falling market share, the FHA fund is healthy and strong. Congress has mandated that FHA have a capitalization ratio of 2 percent to insure fiscal solvency. In 2006, the FHA cap ratio was far above that figure at 6.82 percent -- despite being the lender of last resort in today's marketplace. FHA's current economic value is over $22 billion. In simple terms, this indicates that if the MMIF stopped operations today, the current portfolio would be expected to generate $22 billion dollars over the remaining life of the loans in the portfolio above what it would pay out in claims. Since its inception in 1934, FHA has never needed a federal bailout, and has been completely self-sufficient. In fact, FHA has contributed a significant amount of money to the Federal Treasury each year. However, due to the dramatic loss in volume, FHA has estimated that it will need to increase premiums if reforms are not implemented that increase usage of FHA.

If FHA is allowed to adjust premiums based on risk, it will operate even more soundly than it does today. If FHA is to thrive and fully perform its intended function, a change to risk-based pricing is necessary. Average pricing in the portion of the credit spectrum where FHA operates is crucial if FHA is to sustain its operations in a financially solvent manner. Absent risk-based premiums, the risk profile FHA borrowers can decrease, causing either an increase in the average price or an ultimate shortfall in the insurance fund. This is why FHA has estimated that it will need to increase premiums if reforms are not implemented that increase usage of FHA.

FHA is often criticized for its default and foreclosure rate. That criticism is unwarranted, as FHA's mission is to serve people that aren't served by the conventional market, and therefore are more risky. However, FHA's foreclosure rate is substantially better than the sub-prime market, where many FHA-eligible borrowers currently have loans. A recent study by the Center for Responsible Lender reported that "FHA and sub-prime loans have quite different foreclosure rates. For example, sub-prime loans originated in 2000 in our sample had a 12.9% foreclosure rate within five years. In contrast,... FHA loans originated in 2000 had a 6.29% foreclosure rate by year-end 2005."[5]

When FHA has seen problems with their default rates, they have tried to remedy them. FHA noticed that loans which utilized a gift downpayment had a higher default rate. These gifts included seller-funded downpayment assistance. FHA attempted to eliminate this program and faced legal challenges. At that time Congress supported downpayment gift providers, and challenged HUD's attempt to shut them down. Studies done by Government Accountability Office and others determined that this form of downpayment assistance in fact drove up the costs of homeownership, and generally made the loan a bigger risk. Although the IRS recently ruled that many seller-funded downpayment programs would lose their charitable tax status, they have yet to change the status of any organization. To avoid further delay, FHA announced plans to

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[5] *Losing Ground:Foreclosures in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending, December 2006, page 26.

publish a notice prohibiting gift downpayment loans from FHA eligibility. Such a prohibition should greatly improve FHA's default rate. It has been estimated that 29 percent of FHA borrowers in 2005 used seller-funded downpayment assistance.

Instead, by providing FHA the ability to offer flexible downpayments, homeowners won't bear the increased home price costs and the loans will be safer. Allowing FHA to price low downpayment loans according to risk, they would be more in line with the conventional market. This will greatly decrease FHA's default rate.

Furthermore, FHA's operations have improved dramatically in the last several years. In 1994, HUD was designated as "high risk" by the Government Accountability Office, a longtime critic of the Department. Last month, that designation was removed. GAO said that "HUD had improved its oversight of lenders and appraisers and issues or proposed regulations to strengthen lender accountability and combat predatory lending practices."[6] HUD has also demonstrated their ability to estimate program costs and oversight for mortgage underwriting.

Conclusion

Thank you again for the opportunity to testify on this important issue. Now is the time when the country needs FHA. As sub-prime loans reset and real estate markets are no longer experiencing double digit appreciation; a reformed FHA would be perfectly positioned to offer borrowers a safer mortgage alternative and bring stability to local markets and local economies. The National Association of REALTORS® stands ready to work with the Congress on passage of FHA reform.

[6] GAO, *High Risk Series: An Update*, GAO-07-310 (Washington, D.C.: January, 2007)