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TESTIMONY OF

GARY THOMAS
2013 PRESIDENT
NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING, & URBAN AFFAIRS

HEARING TITLED

ADDRESSING FHA'S FINANCIAL CONDITION AND PROGRAM CHALLENGES, PART II

FEBRUARY 28, 2013

Introduction

Chairman Johnson, Ranking Member Crapo, and members of the Committee; my name is Gary Thomas. I am a second generation real estate professional in Villa Park, California. I have been in the business for more than 35 years and have served the industry in countless roles. I currently serve as the 2013 President of the National Association of REALTORS® (NAR).

I am here to testify on behalf of the 1 million members of the National Association of REALTORS®. We thank you for the opportunity to present our views on the importance of the Federal Housing Administration's (FHA) mortgage insurance program. 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 American households. 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 missions responsibly and efficiently.

FHA is an insurance entity within the Department of Housing and Urban Development (HUD) that ensures that American homeowners have access to safe and stable financing in all markets. FHA has insured home loans for more than 37 million American families since its inception in 1934 and has never required a federal bailout. While many so-called experts have questioned the program's recent performance, NAR would argue that FHA has demonstrated its considerable importance during the significant housing and economic crisis our country is still experiencing.

History of FHA

When FHA was created by the 1934 National Housing Act, the primary goal of the Administration was to insure loans for home improvements[1]. In the wake of the Great Depression, the nation's housing stock was crumbling. Houses were not being maintained or modernized and the result was a negative feedback loop of deteriorating living conditions and falling home prices. At the same time, painters, carpenters, landscapers, workers in the dozens of trades involved in making home improvements were without work. By creating an agency to insure small, private capital loans for home improvements, the federal government hoped to address these issues simultaneously.

While home improvement loans were the first listed aim of the National Housing Act of 1934 and the subject of the Act's first Title, the full scope of the law went further. According to the Report of the House Committee, the intent of the National Housing Act of 1934 was:

[1] 13 Wayne L. R. 651, 652 (1967)

> "to improve Nation-wide housing standards, provide employment, and stimulate industry ; to improve conditions with respect to home mortgage financing, to prevent speculative excess in new-mortgage investment, and to eliminate the necessity for costly second-mortgage financing, by creating a system of mutual mortgage insurance and by making provision for the organization of additional institutions to handle home financing . . ."[2]

These goals were achieved not through small loans for home improvements, but through what would become the Act's more enduring legacy: mutual mortgage insurance. Authorized by Title II of the National Housing Act, FHA's mutual mortgage insurance sought to insure loans up to $16,000 for the purchase of new and existing homes and spread the loan amortization period over a 20-year period. Up to this point, most home loans were balloon loans that had to be refinanced every few years, subjecting consumers and the market to massive volatility. By spreading out the amortization, the government hoped to make the market more stable, and create predictability for both homeowners and the financial industry.[3]

A common misconception exists that FHA was originally intended to benefit low-income borrowers who could not afford a large down payment on a new home. While an upper limit of $16,000 for a home loan may seem exceptionally small today, in 1930, the national median home value was $4,778.[4] Only 3.2 percent of homes were valued between $15,000 and $20,000.[5] The majority of homes were valued between $2,000 and $7,500, with the largest number between $3,000 and $5,000.[6] So an upper limit of $16,000 in 1934 was more than 300 times the value of the median American home at that time.

Of course, a $16,000 loan limit does not paint the entire picture of FHA's target demographic. To better understand this, we should look at how the program was used by borrowers. In its third annual report to Congress in 1936, FHA's statistics showed that most of the homes insured were valued in the $3,000 to $6,000 range and the average single-family home value for an insured mortgage was $5,497, more or less reflecting the average costs of homes at the time.[7] Only 2.8 percent of FHA-insured homes were valued below $2,000, and only 2.1 percent above $15,000.[8] This is strong evidence that FHA was not originally targeted to any income group, but rather to help families across the income spectrum get financing to purchase homes. These statistics varied slightly from year to year, with the size of insured mortgages somewhat lower in 1937 (median $4,288), and then higher in 1938

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[2] H.R. Rep. No. 1922, 73d Cong., 2d Sess. 1 (1934).
[3] First Annual Report of the Federal Housing Administration for the Year Ending December 31, 1934. U.S. Government Printing Office. 1935. p. 4
[4] Id. at 18
[5] 15th Census of the United States, Population, Volume VI: Families, U.S. Census Bureau, 1930, P. 17
[6] Id.
[7] Third Annual Report of the Federal Housing Administration for the Year Ending December 31, 1936. U.S. Government Printing Office. 1937. P.35
[8] Id.

(median $4,491).[9] [10] In general, these percentages have mirrored the distribution of incomes of FHA-insured borrowers.[11] [12] A study on FHA recently reported that "The Section 203(b) program was clearly intended to deal with the vast bulk of the homeownership market, excepting only the wealthiest few…Thus initially, FHA was narrowly targeted to the promotion of single-family homeownership but broadly targeted to all but the lowest and highest income markets.[13]

In a similar vein, the original loan-to-value ratio (LTV) limit for FHA mutual mortgage insurance was set at 80 percent. This sounds like a high down payment requirement today, but it was considerably less than what lenders had previously required. Home loans prior to FHA had downpayment requirements as high as half the value of the home, and as a result the American homeownership rate in 1930 was below 50 percent.[14] Because FHA-insured loans were amortizing and thus inherently less risky for both borrower and lender, a lower down payment requirement was justifiable. When the last payment on the loan was made, the loan was paid off. These changes proved very popular: nearly 60 percent of FHA-insured borrowers in 1937 had LTVs between 76 and 80 percent, a jump from 47 percent in the preceding year.[15] Indeed, the loosening of the down payment requirement proved successful enough for FHA to raise the loan to value ratio again in 1938 to 90 percent for some loans.

Over the next few decades, FHA continued to update a number of its core policies. In 1934, the loan term for FHA-insured loans was 20 years. By 1954, FHA had changed its loan term to 30 years, a term that is still in place today. While the original downpayment for FHA loans was 20 percent, it was lowered to 5 percent by 1950 and to 3 percent in 1961. This downpayment stayed in place for 47 years, until Congress increased it to 3.5 percent in 2008.

<u>Role of FHA During the Recent Housing Crisis</u>

FHA has sustained housing markets nationwide during the worst economic crisis of our lifetime. As private lenders fled and financial institutions went out of business, FHA remained in the market and has provided insurance to more than 4 million families since

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[9] Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937. U.S. Government Printing Office. 1938. P.58

[10] Fifth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1938. U.S. Government Printing Office. 1939. P.85

[11] Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937. U.S. Government Printing Office. 1938. P.61

[12] Fifth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1938. U.S. Government Printing Office. 1939. P.91

[13] Vandell, Kerry D. FHA Restructuring Proposals: Alternatives and Implications. *Housing Policy Debate*, Volume 6, Issue 2, Fannie Mae, 1995.

[14] 15th Census of the United States, Population, Volume VI: Families. U.S. Census Bureau, 1930. P. 12

[15] Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937. U.S. Government Printing Office. 1938. P.60

2008. In a time when many of the large private banks, investment firms, and other financial institutions have needed bailouts or have even collapsed, FHA has weathered the storm very well. FHA continues to have significant resources to pay 30 years' worth of expected claims on its portfolio, an amount 30 times more than that required of banks, which are only required by the Financial Accounting Standards Board (FASB) to hold one year of reserves. In addition, FHA continues to have additional reserves in the MMI Fund of more than $2.5 billion. This is truly an achievement; FHA should be lauded for its financial stability in a most challenging environment and held up as a standard for strong underwriting and risk avoidance.

This recent period is not the first time FHA has played a counter-cyclical role. The FHA helped stabilize falling home prices and made it possible for potential homebuyers to get the financing they needed when recession prompted private mortgage insurers to pull out of oil producing states in the 1980s. According to FHA Commissioner Shaun Donovan, "FHA picked up private market slack in Texas, Oklahoma and Louisiana during the Oil Patch bust in the late 1980s and in Southern California during the early 1990s, and it is playing this role again today."[16] Between 1986 and 1990, FHA's market share increased dramatically, as private lending tightened up or left. A GAO report said of the time, "private mortgage insurance (PMI) companies change the conditions under which they will provide new insurance in a particular geographic area to reflect the increased risk of loss in an area experiencing economic hardship. By tightening up the terms of the insurance they would provide, PMIs may have decreased its share of the market in economically stressed regions of the country."[17] However, FHA continued to provide insurance to these areas, stabilizing housing prices.

As private lending constricted (and in some markets, disappeared altogether), FHA's role in the market grew. As recently as 2006, FHA's share of the home mortgage market was down to 3 percent, as unscrupulous lenders lured FHA's traditional constituent to risky exotic mortgages with teaser rates and little to no underwriting criteria. As the housing market began to collapse, private lenders fled or went out of business. As is seen in Figure 1, FHA's share of the market began to grow, as the private market's share plummeted. This demonstrates the counter-cyclical role FHA plays in the market.

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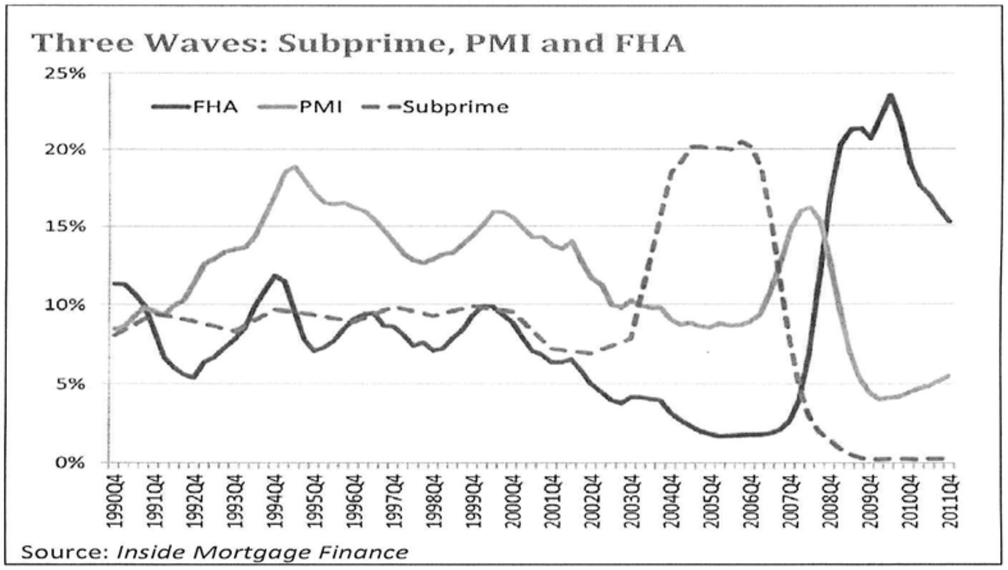
[16] Written Statement of Secretary Shaun Donovan U.S. Department of Housing and Urban Development Hearing before the Subcommittee on Transportation, Housing and Urban Development, and Related Agencies Committee on Appropriations United States Senate, **"**The Role of the Federal Housing Administration (FHA) in Addressing the Housing Crisis," Thursday, April 2, 2009.

[17] GAO, FHA's Role in Helping People Obtain Home Mortgages, August 1996, GAO/RCED-96-123.

Figure 1



[18]

Mark Zandi of Moody's Analytics has pointed out that "If FHA lending had not expanded after private mortgage lending collapsed, the housing market would have cratered, taking the economy with it."[19] Moody's has estimated that without FHA, housing prices would have dropped an additional 25 percent, and American families would have lost more than $3 trillion of home wealth.

Instead, FHA continued to lend. From 2007-2009, FHA helped more than 1.8 million Americans become homeowners. Even more importantly, FHA helped stabilize housing prices in thousands of communities by providing access to home financing when few others would. A recent University of North Carolina study noted that "Private mortgage insurers implemented 'distressed area' policies making it almost impossible to obtain conventional mortgages with LTV ratios greater than 90 percent in some regions of the country. In contrast, FHA does not vary its insurance premiums by region, creating an automatic regional stabilization policy."[20] This counter-cyclical role of FHA helped stabilize markets and slowed the downward spiral of housing prices and economic decline (see Figure 2).

[18] Quercia, Roberto G. and Park, Kevin A, Sustaining and Expanding the Market: The Public Purpose of the Federal Housing Administration, UNC Center for Community Capital, December 2012.
[19] Zandi, Mark, Obama Policies Ended Housing Free Fall, *The Washington Post*, September 28, 2012.
[20] Quercia, Roberto G. and Park, Kevin A, Sustaining and Expanding the Market: The Public Purpose of the Federal Housing Administration, UNC Center for Community Capital, December 2012.

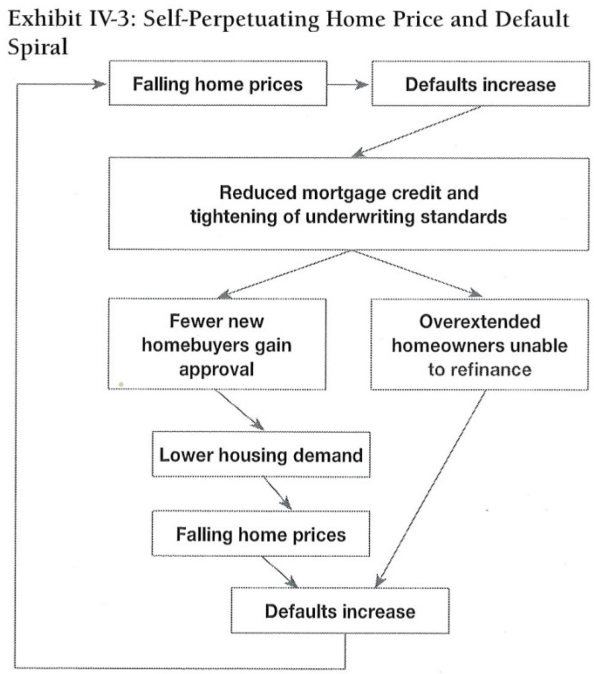


Figure 2[21]

Had FHA not stepped in and filled this mortgage insurance void, many neighborhoods would have been devastated and our economy will still be in a recession.

Some have criticized FHA for the high foreclosure rate on loans it insured during the period of the crisis. It is true that these loans have had a serious impact on the health of the Mutual Mortgage Insurance Fund (MMIF). More than $70 billion in claims that FHA has filed can be attributed to the books of business made in 2007-2009. Housing prices continued to decline through 2009. Lending in declining markets raises risk. FHA and private insurance and lenders that remained during that time period were all impacted. This was not a result of lax underwriting or inappropriate lending. FHA's most recent survey of the drivers of default showed that for the past 4 years, the overwhelming reason for delinquency has been reduced employment and reduced income – accounting for nearly 50 percent of all delinquencies for the past 10 quarters (see Figure 3).

21 Szymanoski, Edward; Reeder, William; Raman, Padmasini; and Comeau, John "The FHA Single-Family Insurance Program: Performaing a Needed Role in the Housing Finance Market", PD&R Working Paper No. HF-019, December 2012.

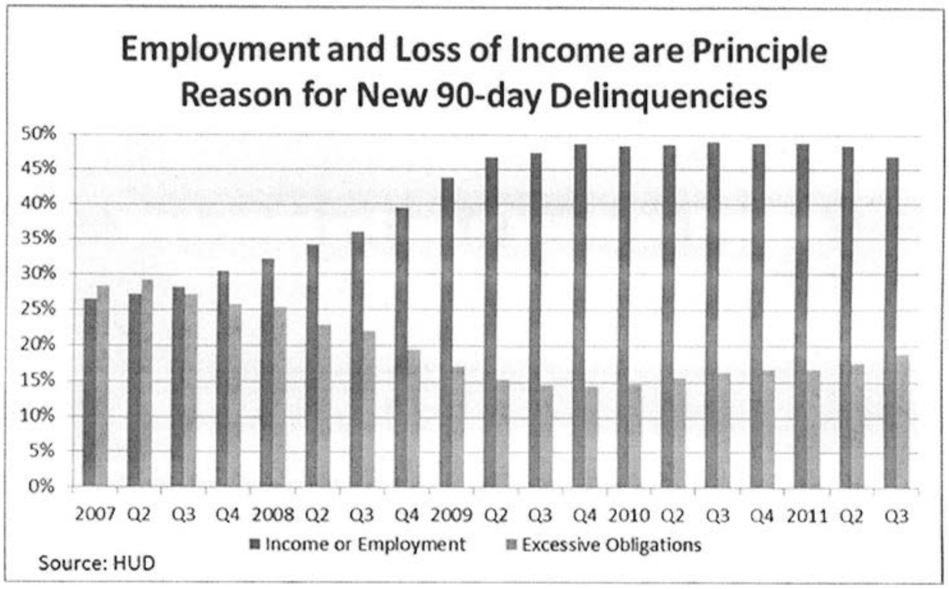


Figure 3

No one can be expected to predict the job loss and other fallout a household may suffer from a recession. Federal Reserve Chairman Ben Bernanke has said that, "an increasing share of losses have arisen from prime mortgages that were originally fully documented with significant down payments, but have defaulted due to the weak economy and housing markets."[22] In 2009, even the Congressional Research Service cleared FHA from blame noting, "FHA would not be able to prevent defaults arising from deteriorating financial and macroeconomic conditions."[23] Home prices have fallen 33 percent since 2006, causing much of FHA's financial decline. On a very basic level, the actuarial report analyzes the value of FHA's outstanding mortgages as compared to the value of the homes. As housing prices have fallen, so has the value of FHA's books. As a participant in the home mortgage process, FHA cannot be immune to the pitfalls of the housing crisis. Solid underwriting policies and safe lending practices have protected it from the biggest failures.

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[22] Speech by Federal Reserve Chairman Ben Bernanke at the At the 2012 National Association of Homebuilders International Builders' Show, Orlando, Florida, February 10, 2012.

[23] CRS Report R40937, *The Federal Housing Administration (FHA) and Risky Lending*, coordinated by Darryl E. Getter.

FHA Today

Loans insured by FHA require full documentation of income and assets. During the height of the real estate bubble, FHA was marginalized while exotic mortgages such as stated-income loans and payment option adjustable rate mortgages became common practice. When the bubble burst, these subprime and often predatory loans were prohibited by the regulators, leaving the industry searching for a stable mortgage product. Lenders using FHA must examine an applicant's financial status including income, debts and obligations. Generally, the monthly mortgage payment may not exceed 31 percent of a borrower's gross income and 43 percent of all debt payments.[24] Borrowers are required to have a 3.5 percent downpayment and closing costs may not be considered part of this financial contribution.

Recognizing the impact foreclosure has on communities and homeowners, FHA offers several programs to minimize risk to the MMIF and help families facing financial hardship stay in their homes. FHA may offer a loan modification, special forbearance, a partial claim, or foreclose on the property. Loss mitigation programs are available for both forward and reverse mortgages insured by FHA. Payments by FHA to a lender through loss mitigation do not impact taxpayers or the federal budget because they are derived from insurance payments made by FHA borrowers.

FHA continues to play a significant role for first-time buyers and minorities. In 2012, 78 percent of the 700,000 purchase loans FHA insured were for first-time buyers. Since 2009, FHA has insured mortgages for more than 2.8 million first-time buyers. Were it not for FHA, these buyers would not be homeowners, and 2.8 million homes would still be on the market. This would have been devastating on our nation's economy. Half of African-American homebuyers and nearly the same percentage of Hispanic and Latino buyers who purchased in 2011 used FHA financing. Even in 2001, before the crisis, more than twice as many minority first–time buyers used FHA than a loan that was guaranteed by Freddie Mac or Fannie Mae.

Since the crisis, the quality of FHA borrowers has skyrocketed. The average FICO score of an FHA borrower in 2012 was 699. The average FICO score on denied FHA applications was 670. Less than 4 percent of all FHA borrowers in the first half of 2012 had credit scores below 620. Figure 4 illustrates that FHA's denials in 2012 are higher than loans accepted in prior years. This figure also demonstrates that private lending has constricted to the degree that borrowers with credit scores over 730 are now being denied access to conventional credit. This draws more borrowers to FHA.

Some have criticized FHA for lending to borrowers with such high credit scores. But if they are denied a loan in the private marketplace, where else can they turn? That is exactly FHA's

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[24] HUD 4155.1 4.F.2.B and HUD 4155.1 4.F.2.C

role – to lend to the underserved. As hard as it is to believe, borrowers with credit scores below 760 may be underserved by the private market.

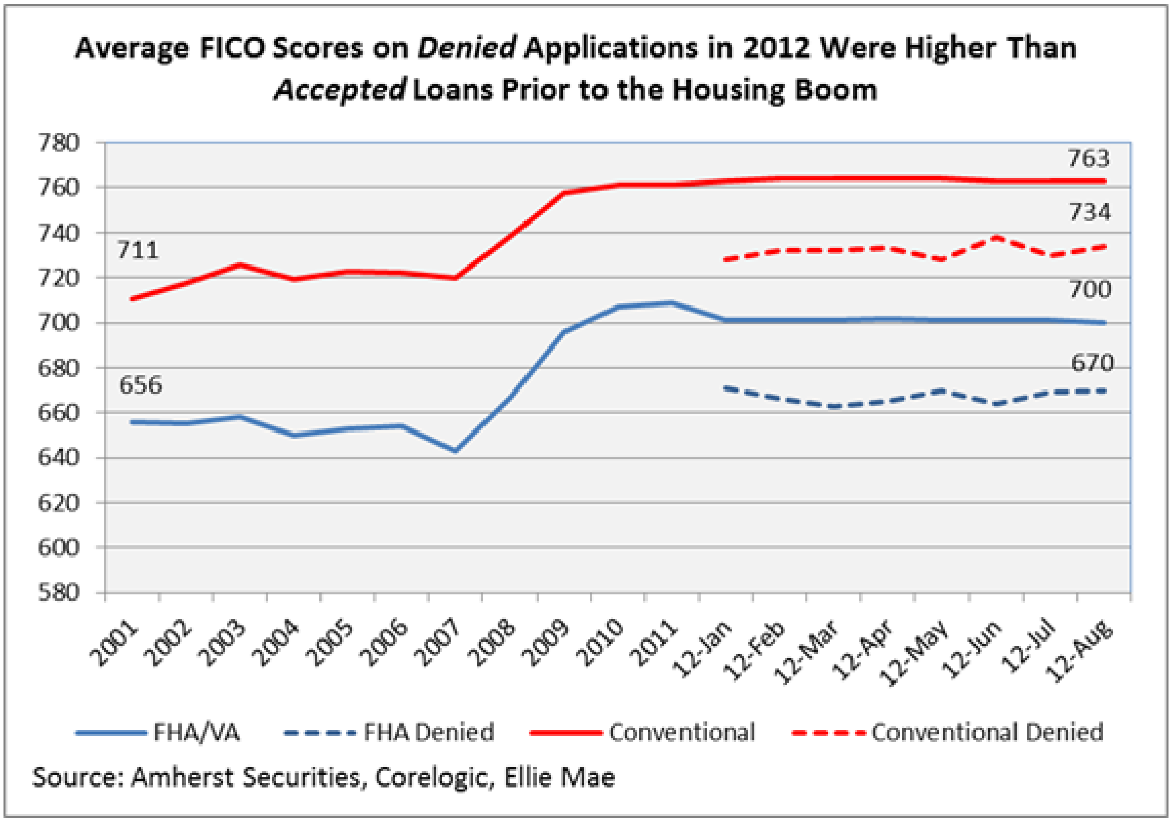

Figure 4

The private market is returning, albeit slowly. As Figure 1 demonstrated, FHA's market share is declining, as private lending tentatively re-enters the marketplace. PMI's business has increased by 60 percent over where it was in 2011, but only 40 percent higher than in 2010 (Figure 5).

While economic conditions have limited private market participation, the regulatory and oversight landscape also has made lenders very wary of making home loans. Upfront charges for loans financed by the GSEs (called loan level pricing adjustments) and representation and warranty risks are significant factors. While lenders received clarity on new origination standards with the release of the qualified mortgage rule (QM) in January; fundamental changes to the structure of the secondary mortgage market are necessary before the role of the private market can be fully restored. Both the government and private sector issue mortgage-backed securities (MBS), which are bundles of mortgages sold to investors. Investors in privately-issued mortgage backed securities (PLS) experienced severe losses during the housing bust and questions have been raised about the quality of loans in the securities. As a result, since the housing downturn investors have favored MBS backed by Ginnie Mae, Fannie Mae or Freddie Mac because of the government guarantee and stronger underwriting and transparency. This need to restore investor confidence is critical to strengthen the private sector.

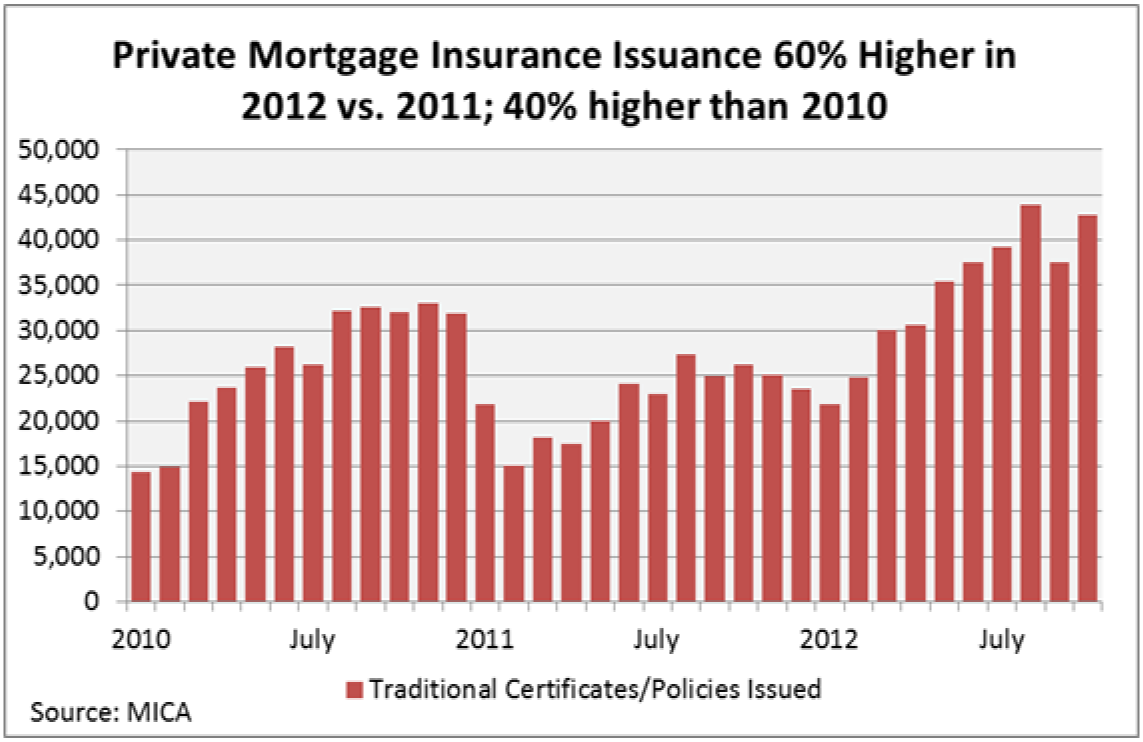

Figure 5

There has been much said about FHA's market share. To clarify, 15.8 percent of all people who purchase a home use FHA-insured financing. In recent years, the number of people paying cash for a home has increased. So when looking at all the people who use a mortgage to purchase a home, 26 percent of those buyers use FHA-insured financing. Most private lenders today require a 20 percent downpayment. For those who allow a smaller downpayment along with some kind of mortgage insurance, 44.6 percent of those loans are FHA-insured.

The National Association of REALTORS® welcomes a return of a robust private market. But we are not there yet. One needs only to look to markets not well-served by FHA – such as loans above $729,750 or the condominium market. Credit in those markets is very tight, requires significant cash down payments, or is simply unattainable. We strongly caution against actions to precipitously lower FHA's share of the market. We believe such changes at this time will simply lower the overall pool of mortgage credit available – keeping more credit-worthy borrowers from being able to own a home of their own. When regulatory uncertainty is resolved, and there is a known future of secondary mortgage credit, private lenders will return.

Mutual Mortgage Insurance Fund (MMIF)

It is likely that FHA will need to borrow money from the Treasury this year, but it is important to look at why. FHA did not offer risky mortgage products. FHA did not engage in exotic underwriting. FHA did not have accounting problems or other unscrupulous behavior. Instead, FHA stepped in during our housing crisis, and provided access to mortgage credit to millions of responsible Americans who wanted to purchase homes. Many of the mortgages FHA entered into during the crisis were in declining markets. Lending in declining markets increases risk. However, had FHA not stepped in to fill that market void, our economy would still be far from recovered.

Although the Federal Credit Reform Act (FCRA) and FHA's 2 percent capitalization ratio may require FHA to borrow from the Treasury, that money will not actually be spent to pay claims. The actuarial study predicts that FHA has sufficient resources to pay 7-10 years' worth of claims right now – with no future business. But the Treasury draw may be necessary to hold a reserve able to fully fund all claims over a 30-year period. So FHA will simply be holding this money in reserve. This is money that the actuarial report says will be unnecessary by FY2014, when the FHA fund will return to self-sufficiency. Some have argued that such a requirement is a misuse of taxpayer money, when it is not needed to pay debts.

Another factor that has had a significant negative impact on FHA's losses is the use of seller-funded down payment assistance. Downpayment assistance from the seller was never permitted by FHA, but in the 1990s, some organizations formed schemes to circumvent the widely accepted prohibition on seller-provided down payments by forming middle-man "charitable" organizations that funneled seller monies through to the buyer. As early as 1999, FHA proposed eliminating these loans. But FHA was unable to do so because of successful litigation to prohibit the ban. Finally, in 2008, FHA received legislative relief to prohibit these loans. However, the damage had been done. These loans reached a record default rate of 28 percent, and account for more than $15 billion of FHA's current deficit.

Looking forward, the more recent books of business are of the highest quality in FHA history. The projected performance of the recent books of business (FY10-FY12) has improved steadily in the last three audits. Even the FY12 Actuarial Review shows FHA will be fully capitalized again in FY2014, and will reach the desired 2 percent capital reserves ratio by 2017, which is above and beyond the required 30 years' worth of reserves.

Response from FHA

Over the past four years, FHA has made many administrative changes to mitigate risk. FHA has increased mortgage insurance premiums (MIP), hired the agency's first Credit Risk Officer, implemented a credit score floor, required a greater downpayment for borrowers with lower credit scores, and adopted a series of measures to increase lender responsibility and enforcement.

FHA has increased its premiums five times in the last 4 years, to a now historic high level. Beginning on April 1, 2013, the annual premium for new mortgages less than or equal to $625,500 and LTVs greater than 95 percent will be 1.35 percent. The annual premium for new mortgages greater than $625,500 with LTVs greater than 95 percent will be 1.55 percent. FHA also removed the automatic cancellation of the annual MIP for fixed-rate mortgages with LTVs greater than 90 percent at origination. These borrowers will have to pay the annual MIP for the life of the loan beginning June 3, 2013. While these changes may be necessary in the short-term, we encourage FHA to reconsider the need for these charges, when mortgage markets stabilize and the FHA fund returns to full capitalization.

FHA has also instituted changes to low credit score borrowers. Borrowers with a credit score below 500 are not eligible for FHA-insured mortgage financing, and those borrowers with credit scores between 500 and 579 are required to make a 10 percent downpayment. FHA has also increased the downpayment (as well as imposed an additional premium increase) for borrowers with loans above $625,500 from 3.5 percent to 5 percent. NAR strongly opposes this increase, as the actuarial report has repeatedly shown that the higher limit loans perform better than the rest of the portfolio, and thus are helping the financial standing of the FHA fund.

NAR Recommendations

NAR advocates for some additional changes to FHA with respect to condominiums, to ensure its continued strength and availability to homeowners.

Condominiums are often the only affordable option for first time home buyers. FHA updated the condominium rules in September of 2012, but we recommend additional changes that will provide greater liquidity to this sector of the real estate market without causing additional risk to the MMIF. We support enhancements to the rules and limits relating to owner-occupancy, investor ownership, and delinquent home owner association (HOA) assessments.

NAR recommends elimination of the owner-occupancy ratio requirement for FHA condo mortgages. The GSEs do not have an occupancy ratio for condominium projects if the borrower is going to occupy the unit, which is the case for all FHA borrowers. Eliminating this requirement will allow more households looking for a principal residence to purchase condominiums, which are often more affordable, raise occupancy levels, and stabilize these developments and their communities.

FHA should continue to provide additional flexibility on condominium recertification requirements and fidelity insurance coverage requirements. The existing rules place significant data and liability burdens on often-volunteer boards of condominium and homeowners associations and limit the stock of housing units available to FHA buyers.

Conclusion

The National Association of REALTORS® strongly believes in the importance of the FHA mortgage insurance program and believes FHA has shown tremendous leadership and strength during the recent crisis. Due to solid underwriting requirements and responsible lending practices, FHA has avoided the brunt of defaults and foreclosures facing the private mortgage lending industry. We applaud FHA for continuing to serve the needs of hardworking American families who wish to purchase a home; and we stand in support of its mission, its purpose, and its performance, particularly in times of a national housing crisis.