Statement of the National Association of Home Builders

Hearing on

"The State of the Housing Market"

United States Senate Committee on Banking, Housing, and Urban Affairs

March 9, 2011

The National Association of Home Builders (NAHB) appreciates the opportunity to submit this statement to the Senate Committee on Banking, Housing, and Urban Affairs on the current state of the nation's housing markets, prospects for the future, and housing policy implications. NAHB represents over 160,000 member firms involved in home building, remodeling, multifamily construction, property management, housing finance, building product manufacturing and other aspects of residential and light commercial construction.

The state of the nation's housing markets is improving but fragile. While the bottom of the market in terms of housing production and significant price declines is behind us, the road to a robust recovery for housing remains a long and difficult path. High unemployment, housing policy uncertainty in terms of buyer and builder finance, and long-term fiscal issues are challenges for the housing construction sector as it struggles to return to its long run trend, with the job and economic benefits that such a development would bring. NAHB estimates that the construction of each single-family home creates three jobs, $90,000 in federal, state and local tax revenue, $145,000 in wage income, and $86,000 in net business income.

NAHB urges Congress to agree to definite solutions regarding the future of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac that ensure a functioning housing finance system that provides credit to homebuyers on reasonable terms, protect the housing tax incentives, including the deduction for home mortgage interest, and unblock the obstacles to acquisition, development and construction (AD&C) lending for builders.

In normal times, housing's total contribution to Gross Domestic Product (GDP) is approximately 18%. Today it stands at a diminished 15%, with home building's direct component down from a normal of 5% of GDP to 2.4% of GDP. In the first year of all post-World War II economic recoveries, except for the most recent cycle, housing averaged a 28% increase in production. In this recovery, housing construction has grown less than 5%. As a result, unemployment in the construction sector remains the highest of any major area of the economy.

General Economic Conditions

A recovery in the housing market is dependent on strong economic performance by the economy as a whole. The Commerce Department's second estimate of growth in real GDP for the final quarter of last year, released on February 25, showed a downward revision from 3.2% to 2.8%; a revision that dropped growth for 2010 as a whole from 2.9% to 2.8%. This surprising development primarily reflected downward revisions to spending by consumers and state and local governments, along with a reduction in net exports.

Last week's job market data suggested an improving labor market. Total non-farm payroll employment increased by 192,000 in February, a marked improvement after the weak performance in January. Job gains occurred broadly across sectors of the economy. Year-over-year, total payroll employment has grown by 1.3 million, or an average of 106,000 per month. The unemployment rate decreased to 8.9%, but the number of unemployed is still high at 13.7 million.

Residential construction employment increased slightly in February**,** up 0.66% (13,200 jobs) to 2.024 million. Conditions are improving in the sector, as this is the fourth consecutive month of growth. However, year-over-year, the sector is still down 65,800 jobs (-3.15%). Total construction unemployment continued to improve, falling to 16.39% on a seasonally adjusted basis, from 18.65% in January. Nonetheless, total loss in residential construction employment since its peak in April 2006 is 1.426 million (-41.3%).

While it is positive that overall job creation is occurring, the economy in general, and the housing markets in particular with respect to the demand side of the market, require much more robust employment growth. In the 1990's, the labor force grew at a rate 139,000 a month, and in the pre-recession 2000's this rate was 122,000. To accommodate population growth and replace the more than 8 million jobs lost in the Great Recession, the economy needs to generate at least 300,000 jobs a month.

With respect to regional economic conditions, unemployment rates are declining and jobs are being created, but there remains significant variation across states. Nevada's total job losses exceed 14% of its employment force, and Michigan, Florida and Arizona have recorded job losses of more than 10% of their labor forces. Nevada has the top unemployment rate, as of December 2010, at 14.5%, with the states of California, Florida, Michigan, Rhode Island, South Carolina, Oregon, Kentucky, Georgia and Mississippi possessing rates greater than 10%. Nonetheless, all states have posted reductions in unemployment rates since their respective maximum rates, with the largest point declines reported in Michigan, Illinois, Washington, D.C., and Alabama.

Credit conditions remain tight. The Federal Reserve's January Senior Loan Officer Opinion Survey indicated that, after easing slightly in the third quarter of 2010, banks resumed tightening their lending standards in the fourth quarter and the tightening continued in January 2011. Over the past three years the major banks have ratcheted up their credit standards to a point that it is very difficult for homeowners without superior credit standards to access loans for housing.

Further, builders are finding access to credit even more difficult, with very few banks willing to provide AD&C loans. In the fourth quarter of 2010, NAHB survey data confirmed that few builders are even seeking loans given existing tight credit conditions. Only 17% of builders sought land acquisition loans in the fourth quarter, down 92% in the final quarter of 2005. Similarly, only 20% attempted to secure land development loans, down from 89% in 2005. For the single-family market, 40% of builders sought construction financing in the fourth quarter of 2011, down from 96% for the same period of 2005. Multifamily tells a similar story as well, with 19% of surveyed membership seeking construction financing, down from 82% in 2005.

Data from the fourth quarter of 2010 indicates that of those builders reporting tighter conditions 77% noted lenders require lower loan-to-value ratios, 76% indicated that lenders were not making new loans at all, 69% reported reduced lending amounts, 59% responded that lenders required personal guarantees or collateral not connected to the project, and 51% indicated higher interest rate requirements. Overall, these very tight credit standards are holding back housing demand and restricting supply.

Taken together, NAHB expects above-trend growth of GDP over the 2011-2012 period, with a modest slowdown in 2012 as fiscal stimulus to the economy fades away. NAHB is forecasting year-over-year GDP growth of 3.1% and 3.5% in 2011 and 2012, respectively. With respect to home construction, NAHB expects year-over-year growth in residential fixed investment to reach 12% in 2011 and 26% in 2012, performances that will contribute about 0.3 and 0.7 percentage points to GDP growth in these two years.

Current Housing Market Conditions

House prices have declined in recent months, falling with the end of the home buyer tax credit program. All major house price measures turned down in the third and fourth quarter of 2010, taking back some but not all of the gains achieved since early 2009. However, some of the price decline was related to the elevated share of the existing home sales market that was attributable to distressed sales. Data from RealtyTrac indicates that for 2010, 26% of home sales were distressed sales, and that homes in the foreclosure process on average sold for a 28% price discount. Bank-owned homes sold for an even deeper discount, a 36% reduction on average.

Despite these recent declines, NAHB expects house prices to stabilize in the near term and to post slow growth later this year and in 2012 as economic growth produces jobs and improves consumer confidence. In many areas, house price-to-income ratios have returned to historical levels. On a national basis, the home price to income ratio has reached 3.2 (the level it approximately tracked from 1991 to 1999) after peaking at 4.7 in late 2005.

As of January 2011, private housing starts totaled 596,000 at an annualized rate. This is well below the long run-trend of approximately 1.7 million new homes that are necessary to accommodate population growth and replacement of older housing stock. The gap between current production and potential

housing construction is a result of multiple factors, including builders dealing with excess housing inventory, deferred household formations, and lack of AD&C financing.

Inventories of new and existing homes continue to fall as a result of significant declines in housing construction. The National Association of Realtors estimates that the national inventory of existing homes for January 2011 stands at 3.38 million homes, a 7.9 month supply of homes at current sales rates. This is significantly lower than the 12.5 months-supply that was recorded in July 2010. In contrast to existing homes, newly-constructed inventories represent a very small share of total housing inventory. As of January 2011, the Census reports 188,000 newly-constructed homes for sale, a 7.9 months-supply. This is also much reduced from the 11.2 months-supply level reported in 2008. Such inventory numbers reflect homes that are completed, are underway, or not yet under construction. Inventories of completed constructed for-sale homes stand at an all-time low: 78,000 in January 2011, down from 199,000 in January 2009. The homebuyer tax credit program was effective in reducing these inventories, and we thank the Congress for its support of this important program during the Great Recession.

On the negative side, the inventory of foreclosed homes rose in the fourth quarter of 2010, matching the peak level set at the start of the year. The foreclosure crisis is unlikely to fade in the near-term, with delinquency rates remaining high, providing a steady flow of foreclosure starts. While the rate of foreclosures declined in the fourth quarter of 2010 to 1.27% of all loans outstanding, it was only a modest improvement from the peak level of 1.42% in third quarter of 2009. The foreclosure problem is concentrated however, with very high rates of foreclosures started in Nevada (2.95% of loans outstanding in Q4 2010), Arizona (2.29%), Florida (2.21%), Illinois (1.55%), Michigan (1.55%) and California (1.41%). These six states also hold almost half of the foreclosure inventory. The large number of foreclosed properties on the market will continue to exert downward pressure on house prices and stifle demand in these states through 2012. In other states less burdened by foreclosures, the housing market is likely to be more responsive to the improvement in economic activity and declines in the unemployment rate that is expected in the near term.

While much has been made of the excess supply of homes, the demand side of the housing market has also contributed to recent weakness. Due to high unemployment rates and economic uncertainty associated with the aftermath of the Great Recession, many households that were expected to form due to simple population growth have not in fact materialized. Such individuals may represent children living with parents, roommates doubling up, or even divorce-related. NAHB estimates that approximately 2.1 million household formations have been delayed as a result of recent economic conditions. These potential households constitute a “shadow demand” for the nation’s housing markets. As the economic picture improves, we expect this demand to be unlocked, helping to reduce housing vacancy rates.

Finally and most importantly in terms of the long-term health of the home building industry, low levels of housing construction activity, and its spillover economic benefits and job creation, are also due to lack of financing available to small- and medium-sized builders across the nation.

Small businesses are the heart of the residential construction sector, which includes single-family and multifamily construction, land development and home remodeling. Overall, approximately one-third of NAHB's membership is made up of dedicated builders. The remaining share of its membership consists of associate members who also work within the residential construction sector.

As measured by workers, 80% of NAHB builder members have less than 10 employees, with the average member having approximately 11 employees. Only 1% of NAHB builder members have more than 100 employees. For NAHB's associate members, nearly 90% have less than 50 employees.

Approximately 50% of NAHB builder members have less than $1 million in gross receipts, and 86% have less than $5 million in gross receipts. Approximately 80% of NAHB builder members built 10 or fewer homes in 2010. NAHB's associate members are very similar to its builder members with respect to dollar size of business, with 77% having less than $5 million in gross receipts.

These kinds of small businesses typically rely on debt financing, often from regional and community banks. For such businesses, the credit crunch persists, and lending conditions are as tight as ever. Builders who have local demand to build often cannot access AD&C financing, thereby preventing business activity and job creation.

Housing Market Outlook

The near-term outlook for new housing demand remains sluggish, with the NAHB / Wells Fargo Housing Market Index (HMI) for February failing to gain ground. The HMI remains at a level of 16, with any reporting less than 50 indicating ongoing weakness on the demand side of the new-home market and suggesting low levels of single-family production for some time.

These sobering signals have persisted despite record-high readings regarding the affordability of home purchases. NAHB's housing opportunity index (HOI) reached a new high in the fourth quarter of 2010. Similarly, consumers' view of the buying conditions for homes from the University of Michigan consumer sentiment survey is also very high. However, while consumers are aware of the very favorable affordability conditions and continued low interest rates (30-year, fixed-rate mortgage rates have hovered around 5% since mid-December 2010), other factors, such as concerns over their employment situation and income growth, tight buyer credit conditions and inaccurate appraisals, are holding back prospective home buyers.

Despite some recent downward revisions, NAHB expects slowly improving economic and financial market conditions, along with great affordability conditions, to support moderate increases in new single-family home sales and housing production in 2011-2012.

New single-family home sales and housing production are expected to remain weak in the first half of 2011, but will pick up in the second half of the year, with momentum building through 2012. NAHB's forecast of new home sales shows a modest gain of 8% in 2011, before a more substantial 49% increase in 2012.

After recent gains, the rate of increase in existing single-family home sales is expected to slow in the first quarter of 2011. However, we expect that it will return to its strong rate of growth in the second quarter, which will carry through to the end of 2012. This will return existing single-family home sales to their long term sustainable trend level by the end of 2012.

Single-family housing starts will follow a similar trend to new single-family home sales with an increase of 15% in 2011 and 47% in 2012. This will raise the level of single-family starts to 900,000 units by the end of 2012. While a substantial gain over current depressed levels, this is still 40% below NAHB's estimate of the long-term sustainable trend, based on demographics, replacement needs and second-home demand.

Multifamily housing starts have experienced great volatility in recent months, rising from 89,000 in June 2010 to 182,000 in August, back down to 93,000 in November then up to 183,000 in January 2011. This variation is expected to continue, with a sharp rise in multifamily housing starts expected in the first quarter of 2011, a modest decline in the second quarter, before resuming steady growth through the end of 2012. Overall multifamily housing starts are projected to increase 21% in 2011 and 40% in 2012, rising to 210,000 units in the fourth quarter of 2012, which is still 38% below NAHB's estimate of the long-term sustainable level.

Residential fixed investment (RFI) experienced only moderate growth in the fourth quarter of 2010, with the gains in existing home sales (i.e. increase in brokers' commission) countered by weak housing production (single-family and multifamily housing starts). Increases are expected over the next few years, with the forecasts for housing production and home sales generating year-over-year growth in real RFI of 12% in 2011 and 26% in 2012. However, coming from an extremely low level in 2010, these gains in RFI will provide only a modest contribution to GDP growth, about 0.3 and 0.6 percentage points respectively, in those two years.

Policy Implications

Given housing's ongoing weakness in the economy, NAHB urges Congress to approach housing policy with due caution. Several housing policies loom on the horizon, and if treated inappropriately, they have the potential to harm the housing sector, thereby hurting the savings of the nation's 75 million homeowners, as well as the ability of the residential construction and real estate industry to contribute to the economic recovery.

First, NAHB urges Congress to agree to definite solutions to the issue of the GSEs that ensure a functioning housing finance system that provides credit to home buyers on reasonable terms. The housing market faces a strong possibility of a double dip characterized by strong price declines and significant declines in sales volumes if homebuyers do not have reasonable access to credit. In the short-term, the conforming loan price limits for mortgages will adjust downward, which could place downward price pressure on affected, high-cost markets. It is useful to remember that FHA and GSE guarantees currently cover approximately 90% of mortgages issued today.

Second, there has been increased attention paid to the federal government's budget situation. The state of the nation's public finances is critical for homebuyers and home builders. A large federal deficit can absorb savings that might be used for investment in housing, thereby leading to higher interest rates, increasing borrowing costs for small businesses and crowding out potential homebuyers. However, most economists believe the state of the federal government's fiscal path is unsustainable, prompting cries of reform, both for government spending and tax policy. And a target for some within this debate is the mortgage interest deduction (MID), arguably the most important tax rule for homebuyer and homeowners in the U.S.

It is important to keep in mind that the deduction for mortgage interest is solidly a middle class tax break. Nearly 70% of the benefits of the MID is collected by homeowners with less than $200,000 in income. In 2012, the tax expenditure for the MID – roughly its budget size – is estimated by the Joint Committee on Taxation as $94 billion. While a large number – not surprisingly as more than 35 million homeowners will benefit from the MID directly in 2012 – this amount totals to only 3.7% of expected tax collections in that year. Under realistic policy estimates, a total repeal of the MID would likely collect $75 million or less, as homeowners restructure their finances, increasing tax collections by only about 3% (or half a percentage point of GDP). This is not responsible for, nor can it fix, the nation's fiscal challenges.

Other housing tax rules, such as the capital gain exclusion, the real estate tax deduction, and the Low-Income Housing Tax Credit (LIHTC), are well-established housing policies, which if eliminated or weakened would result in wealth losses for homeowners (in the case of the gain exclusion) or the abandoning of a successful policy that facilitates the production of affordable housing (in the case of the LIHTC).

Regulators should also proceed with caution as they implement last year's financial reform legislation (Dodd-Frank). A determination needs to be made regarding what constitute a qualified residential mortgage (QRM) that would be exempt from the law's risk retention rules. An excessive downpayment requirement, such as 20%, would squeeze first-time homebuyers out of the housing market for years to come, preventing household formations and producing economic damage to the overall economy.

Finally, and most importantly for the nation's small home builders, Congress, regulators and financial institutions must work to unblock the AD&C lending channels, to permit home builders to contribute to the economy where and when housing demand emerges as the economy improves. Without access to credit, the residential construction industry will lose more small businesses and experience more job losses, with these impacts being widely spread across the nation.

With this in mind, NAHB has presented banking regulators with specific instances of credit restrictions; provided data showing no difference in credit access across market conditions and requested specific changes to current regulatory guidance. To date, these efforts have not produced any tangible results. With the spigot for housing production loans cut off, and threat that the uncertainty from Dodd-Frank rule-making will further affect the ability of small community lenders to service the credit needs of the home building industry, it is clear that Congressional action is needed to help open the flow of credit to

home builders. Without such action, there can be no housing recovery, which has major implications for our nation's ability to recover from the current economic downturn. NAHB has outlined a formal legislative blueprint to Congress detailing key legislative elements critical to help ensure adequate credit availability to home builders. Three of these key elements focus on fixing specific instances of regulatory excess, while the final element aims to address the ability of the Small Business Administration (SBA) to meet the credit needs of small home builders. In the coming weeks and months, NAHB will be working with Congress to address these critical issues and seek congressional action to address each specific concern.