Written Statement

of the

NATIONAL ASSOCIATION OF REALTORS®

submitted to the

Senate Banking, Housing and Urban Affairs Committee
Subcommittee on Housing and Transportation

On

“FHA: Issues for the Future”

June 20, 2006

Senator Allard, Senator Reed and the Members of the Subcommittee, My name is Tom Stevens, and I am the former President of Coldwell Banker Stevens (now known as Coldwell Banker Residential Brokerage Mid-Atlantic) – a full-service realty firm specializing in residential sales and brokerage. Since 2004, I have served as senior vice president for NRT Inc., the largest residential real estate brokerage company in the nation.

As the 2006 President of the National Association of REALTORS®, I am here to testify on behalf of our nearly 1.3 million REALTOR® members. We thank you for the opportunity to present our view of 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 work diligently with the Subcommittee and the Congress to fashion housing policies that ensure Federal housing programs meet their mission responsibly and efficiently.

FHA's single-family mortgage insurance program is a valuable government program that has proved highly beneficial in helping low-, moderate-, and middle-income people achieve the dream of homeownership. FHA insurance is available to individuals regardless of their racial, ethnic or social characteristics and its universal availability helps stabilize housing markets when private mortgage insurance is nonexistent or regional economies encounter disruptions. FHA's underwriting standards are more flexible than the conventional market, allowing more borrowers to qualify for mortgages. We believe that the FHA program can be empowered with tools to close the minority homeownership gap and provide homebuyers with alternatives to risky loan products currently being provided by the conventional and sub-prime markets.

FHA was established in 1934 to provide an alternative to homebuyers. At that time in our history short-term, interest-only and balloon loans were prevalent. FHA was created to provide long-term, fixed-rate financing. These same conditions exist today, warranting the continued existence and viability of FHA.

FHA's market share has dwindled because its loan limits, inflexible downpayment requirement, and fee structure have not kept pace with the current mortgage marketplace. As a result, a growing number of homebuyers are deciding to use one of several new types of specialty mortgages that let them "stretch" their income so they can qualify for a larger loan. Specialty mortgages often begin with a low introductory interest rate or payment plan—a "teaser"—but the monthly mortgage payments are likely to increase significantly in the future. Some are "low documentation" mortgages that provide easier standards for qualifying, but also feature higher interest rates or higher fees. Mortgages such as interest-only and option ARMs can often be risky propositions to borrowers. These pose severe risk burdens to consumers who may be unable to afford the mortgage payment in the future because monthly payments may increase by as much as 50% or more when the introductory period ends, or cause their loan balance (the amount you still owe) to get larger each month instead of smaller. According to Moody's, more than a quarter of all existing mortgages come up for interest rate resets in 2006 and 2007.[1] While some borrowers may be able to make the new higher payments, many will find it difficult, if not impossible.

[1] "Millions are Facing Monthly Squeeze on House Payments", *Wall Street Journal*, March 11, 2006, page 1.

For many of these potential homebuyers, FHA can play a major role in meeting their homeownership aspirations without adverse consequences. FHA typically serves borrowers who have lower annual incomes, make smaller down payments, and purchase less expensive homes. However, FHA's market share has been dropping in recent years. In the 1990s FHA loans were about 12% of the market. Today, that rate is closer to 3%. As the market has changed, FHA must also change to reflect consumer needs and demands. Conventional and sub-prime lenders have been expanding their products and offering more types of loans to more types of borrowers. However, not all of these loans are in the best interest of the borrower. If FHA is enhanced to conform to today's mortgage environment, many borrowers would have available to them a viable alternative to the riskier products that are marketed to them.

In recent years the subprime mortgage market has exploded. In 2003, subprime loans accounted for 8.5% of the market. In 2005, their share was 20%. Subprime loans are not inherently bad. The subprime market has a very important role to play for many borrowers. Subprime loans allow many homebuyers who could not otherwise get into a home achieve the dream of homeownership. But, as FHA has declined to be a player in the mortgage market, more and more borrowers have taken out a subprime loan, when they would have qualified for FHA at a lower overall cost. In the first quarter of this year, FHA lost almost 38% of its market share, the conventional market lost almost 10%, while the subprime market gained nearly 16%. American homebuyers need to have affordable alternatives, such as FHA available to them.

While the homeownership rate continues to rise, there are still many hard-working families that simply cannot qualify for a conventional mortgage. Minority homeownership rates are significantly lower than the national average—around 50%, compared with nearly 70% for the nation as a whole. The homeownership rate for African American households in the first quarter of 2005 was 48.8 percent, while Hispanic households were at 49.7 percent. The homeownership rate for Asian, Native Americans, and Pacific Islanders was 59.4 percent. By comparison, 76.0 percent of non-Hispanic whites were homeowners.

Recently the Center for Responsible Lending released a study[2] that demonstrated that minorities are 30 percent more likely to receive a higher-priced loan than white borrowers, even after accounting for risk. African-Americans were more likely to receive higher-rate home purchase and refinance loans than similarly-situated white borrowers, particularly for loans with prepayment penalties. For Latinos it was even worse. According to the study, Latinos were 29 to 142 percent more likely to receive a higher cost loan than whites of similar risk.

A study by the National Community Reinvestment Coalition[3] found similar results. Its study found that of all the conventional loans made to African Americans, 54.5% were high cost loans, while only 23.3% of whites had high cost loans. FHA insurance is available to individuals regardless of their racial, ethnic or social characteristics. Nearly 30% of FHA's market is minority homebuyers, compared to only 17% of the conventional market.

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[2] *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages,* Center for Responsible Lending, May 31, 2006.

[3] *The 2005 Fair Lending Disparities: Stubborn and Persistent II,* National Community Reinvestment Coalition, May 23, 2006.

Finally, a report by the Consumer Federation of America[4] determined that African American and Latinos are more likely to obtain payment option mortgages. Latinos were twice as likely to obtain payment option mortgages as non-Latinos and African Americans were 30 percent more likely to obtain payment option mortgages than non-African Americans. With regard to borrower income levels, CFA discovered that 37 percent of interest only borrowers and 35 percent of option payment borrowers had incomes below $70,000. If revitalized, FHA can help bridge the gap in minority homeownership and provide alternative options that help fight against predatory or discriminatory loans.

To enhance FHA's viability, the Administration is proposing a number of important reforms to the FHA single-family insurance program that will greatly benefit homebuyers nationwide. FHA is proposing to eliminate the statutory 3 percent minimum cash investment and downpayment calculation, allow for extended loan terms from 30 to 40 years, allowing 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.

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% of first-time homebuyers financed 100% 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% of homebuyers who financed with a zero-downpayment loan in 2005, had incomes less than $65,000; 24% of those who used a zero-downpayment product were minorities; and 52% of people who financed 100% of their home purchased homes priced at less than $150,000.

FHA has allowed borrowers to receive their downpayment assistance through an approved gifting source. However, the IRS recently ruled that many seller-funded downpayment programs would lose their charitable tax status, making them ineligible for FHA usage. It has been estimated that 29% of FHA borrowers in 2005 used seller-funded downpayment assistance. 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. Instead, by providing FHA the ability to offer flexible downpayments, homeowners won't bear this increased cost, and, along with the flexibly pricing proposal, FHA could price such a product according to risk, as is done in the conventional market.

FHA mortgages are used most often by first-time homebuyers, minority buyers, low- and moderate-income buyers, and other buyers who cannot qualify for conventional mortgages

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[4] *Exotic or Toxic? An Examination of the Non-traditional Mortgage Market for Consumers and Lenders,* Consumer Federation of America, May, 2006.

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.

Under the Administration's proposal, 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. Research conducted by the National Association of REALTORS® indicates that this will result in 28% more FHA originations in California and 19% more originations in Massachusetts.

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 the states of 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.

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 and fees and/or mortgage insurance is used in the conventional and subprime 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 that includes both an upfront and annual premium structure) and will permit FHA to reach higher risk borrowers (by charging them a premium amount commensurate with risk), and continue to accommodate 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 subprime 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%, they have not done so. FHA currently charges 1.5%. The FHA Fund is strong and has continued to have excess revenue, so there has not been a need to increase the premiums. Opponents argue that FHA is seeking to increase premiums to make money, gouging lower-income borrowers. Giving FHA the flexibility to charge different borrowers different premiums based on risk will simply 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.

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 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.

For accounting purposes, the MMI Fund is linked with the Cooperative Management Housing Insurance Fund (CMHI). The CMHI 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 these programs in the MMIF. In recent years programs operating under the GI/SRI funds have experienced disruptions and suspensions due to funding commitment limitations. Because the multifamily housing programs are under the GI/SRI funds and thus susceptible to future funding expirations, maintaining the single family programs under the GI/SRI funds would expose these programs to possible future disruptions. Thus, from an accounting standpoint, it makes sound business sense to place all the single-family programs under the MMIF.

Besides 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.

In today's market, interest rates are low, home prices are rising, and lenders have expanded their pool of tools to offer borrowers. But will these options still be available during periods of economic uncertainty? FHA has been there for borrowers. When the housing market was in turmoil during the 1980s, FHA continued to insure loans when other left the market. Following

Hurricanes Katrina and Rita, FHA provided a foreclosure moratorium for borrowers who were unable to pay their mortgages while they recover from the disaster.

The universal and consistent availability of FHA 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. FHA's universal availability helps stabilize housing markets when private mortgage insurance is nonexistent or regional economies encounter disruptions. FHA is the only national mortgage insurance program that provides financing to all markets at all times.

FHA also works to protect borrowers against foreclosure. FHA provides financial incentives to lenders who use HUD's loss mitigation program to help homeowners keep their homes. FHA's loss mitigation program authorizes lenders to assist borrowers in default and reduce losses to the FHA fund. These programs include mortgage modification and partial claim. Mortgage modification allows borrowers to change the terms of their mortgage so that they can afford to stay in the home. Changes 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.

The NATIONAL ASSOCIATION OF REALTORS® recognizes that homeownership is a primary goal of American families. Housing has always been and continues to be one of the highest personal and social priorities in America with study after study affirming that a large proportion of Americans would rather own than rent a home. Homeownership directly benefits society by fostering pride and participation in one's community, encouraging savings and promoting social and political stability. Homeownership has been emulated on television, romanticized in literature, and coveted in the popular social consciousness. It is advocated by private enterprise and encouraged by government policy. Clearly, it is the proud achievement of most American families, the ultimate assimilation for generations of immigrants to this country, and the pinnacle for Americans generally as they climb the ladder of economic success.

The NATIONAL ASSOCIATION OF REALTORS® applauds the private sector for the recent development of innovative and affordable housing products that are providing housing opportunities for many deserving families. However, not all needs are being met, and some homeowners may not be in a loan that is appropriate for them. Consequently, the NATIONAL ASSOCIATION OF REALTORS® steadfastly maintains that government mortgage programs in general and the Federal Housing Administration in particular represent the most important source of homeownership for many American families. FHA is currently a lender of last resort. Without reforms to the program, first time homebuyers, minorities, and homebuyers with less than perfect credit are left with fewer and fewer safe, affordable options. FHA is a safe product at a fair price. We need reforms to the program that make FHA a viable mortgage product for today's homebuyers. We urge you to seriously consider these reforms to the FHA single-family home loan guarantee program to ensure all homeowners are afforded the true dream of homeownership.

In conclusion, the National Association of REALTORS® commends you, Ranking Member Reed, Chairman Allard, and the Subcommittee for its leadership in fashioning housing policies that stimulate housing opportunities for deserving families. The NAR stands ready to work with you in crafting legislation that furthers the mission of the FHA single-family mortgage insurance program.