NATIONAL ASSOCIATION OF REALTORS®
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HEARING BEFORE THE
UNITED STATE HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

ENTITLED

"THE FHA REFORM ACT OF 2010"

WRITTEN TESTIMONY OF
CHARLES MCMILLAN, CIPS, GRI
ON BEHALF OF
THE NATIONAL ASSOCIATION OF REALTORS®

MARCH 11, 2010

Madam Chairwoman, Ranking Member Capito, and members of the Subcommittee, my name is Charles McMillan, and I am the immediate Past President of the National Association of REALTORS®. I have been a REALTOR® for more than 20 years, and am Director of Realty Relations and Broker of Record for Coldwell Banker Residential Brokerage, Dallas-Fort Worth. Along with being a REALTOR®, I have been active in my community, serving as past chairman of the Community Development Council of Fort Worth, the Tarrant County Affordable Housing Task Force, the Housing Subcommittee of Fort Worth, and a past director of the United Way of Tarrant County and of the Fort Worth Chamber of Commerce.

I am here to testify on behalf of 1.2 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 (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 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.

FHA was created in 1934, and since then has provided more than 37 million American homeowners with safe, stable, financing in all markets. FHA is not a subprime lender, has strong underwriting criteria to protect American taxpayers, and has never required a federal bailout. FHA borrowers are not subsidized, and pay both upfront and annual premiums. While the program is experiencing shortfalls in its excess reserves due to our economic crisis, FHA remains financially strong and a critical part of our nation's economic recovery. Without FHA, our economy could not be on the verge of recovery.

In fact, the dramatic increase in FHA's market share demonstrates how critical the program is to our nation's economic recovery. In 2009, FHA insured nearly 30 percent of the single family mortgage market, compared to a low of nearly 3 percent just three years ago. In 2009 more than 50 percent of first-time buyers used FHA; and nearly 80 percent of FHA's purchase loans were to first-time homebuyers. In addition, FHA is serving a need for those who need to refinance out of risky nontraditional ARMs or subprime loans with high interest rates. In 2009, approximately 835,000 borrowers refinanced into lower interest rate FHA insured loans, saving them an estimated $1.3 billion.

It can be argued that FHA's market share is a good indicator of the state of housing markets. Back when FHA was at 3 percent of the market, that should have been a warning sign that we were in a troubled mortgage market, with abusive lenders wooing homebuyers away from safer, stable mortgage products. Now, with FHA at nearly 1/3 of the market, it is clear that the private market has yet to rebound. Historically, FHA's market share has hovered between 10 and 15 percent of the market. We believe this is an appropriate share for the FHA program. FHA was created to serve the needs of all homebuyers who lacked access to mortgage financing. However, the private market should be the primary source of mortgage financing. Today, that market is extremely limited, so FHA is meeting its role to fill that gap. When the private market is strong enough to return, we will welcome FHA's reduction in market share, as that will indicate a return to a healthy housing market.

FHA 2009 Audit

We have testified previously before this committee about the reasons that the FHA audit showed reserves had fallen below the 2% capitalization ratio. We believe the bulk of FHA's excess reserves loss can be explained in large part by the unprecedented declines in housing prices coupled with rising unemployment that this nation has experienced in the last few years. Many borrowers are underwater on the value of their homes, and many families have members that have lost jobs. These two factors lead to increased defaults. No level of underwriting standards or equity requirements could have avoided that. As a Congressional Research Service (CRS) report, published November 23, 2009, stated "FHA would not be able to prevent defaults arising from deteriorating financial and macroeconomic conditions."[1]

FHA has continued to require prudent underwriting and has sufficient controls against risk. In fact the FHA reserves requirement is by far greater than any requirement placed on private banks or lenders. FHA's fully capitalized cash reserves account for paying all claims over a 30 year period. By comparison, the Financial Accounting Standards Board only requires financial institutions to hold reserves for losses over the next 12 months. FHA has 30 times that amount in their cash reserves, with another $2.7 billion in the excess capital reserves. We do not dispute the findings that the reserves have fallen, but believe FHA has sufficient reserves to cover losses, and sufficient controls in place to control risk.

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

Since being confirmed, FHA Commissioner Dave Stevens has instituted changes to ensure that FHA remains safe and sound and serves the needs of its borrowers without burdening American taxpayers. For the first time in the history of FHA, Commissioner Stevens hired a Chief Risk Officer to oversee FHA's efforts to mitigate risk. He has also taken action against abusive and unscrupulous lenders. In 2009, more than 590 cases were brought before FHA's Mortgagee Review Board – which is more than was brought in the previous 8 years combined. FHA terminated FHA approval of 268 lenders in 2009 – compared to 101 in the previous 8 years combined. We believe FHA's management is committed to increasing oversight and dealing with abusive lenders.

Today, FHA borrowers' credit profile has never been stronger. The Federal Reserve report shows that FHA is not the new subprime lender - its FICO scores have increased, and its Loan-to-Value ratios (LTVs) have decreased. The average credit score for FHA's current customer has grown to 693, and only 13 percent of their purchase borrowers this year had FICO scores below 620. Forty four percent of FY2009 loans have FICO scores above 680, and 30 percent had scores above 720. And those numbers are only improving, according to HUD's recent Report to Congress. In September of this year 45 percent of FHA loans had FICO scores above 700, and less than 5 percent had scores below 620. Borrowers also have more equity, as the percentage of FHA's LTV ratios above 95 percent fell from 72 percent in 2007 to 62 percent in 2008. In fact, the audit shows a record $4.9 billion positive adjustment due to the high credit quality of FHA's recent originations.

FHA's New Initiatives

In an effort to replenish the capital reserves, FHA has implemented (or proposed) a number of changes to the program. While we are not convinced that all of these changes are necessary, we generally support FHA's efforts to strengthen the program. We urge caution in making changes that will make it hard for credit-worthy borrowers to become homeowners.

Mortgage Insurance Premiums

FHA has increased the upfront mortgage insurance premium (UFMIP) to 2.25 percent up from 1.75 percent. In addition, FHA will seek legislative authority to increase the annual premium (currently capped at 0.55 percent). Increasing the upfront premium dramatically increases closing costs for borrowers. The average closing costs to borrowers can range anywhere between 3 and 6 percent of the loan. This increase of 0.50 percent places a high burden on FHA borrowers. Homebuyers are already facing increased fees from appraisals and other closing services. Increasing the upfront premium for FHA loans just adds to this problem.

We understand that FHA intends to lower the upfront premium when it is granted authority to increase the annual premium. We support legislation to reasonably increase the annual premium in order to replenish FHA's capital reserves. We also strongly support decreasing the upfront premium to help borrowers at the closing table. In addition, we would urge the Department to use discretion to insure borrowers are not paying too high a fee. Years ago, FHA had a distributive shares program that provided rebates to FHA borrowers who paid excess fees into the MMIF. While we are not asking to reinstate this program at this time, we encourage FHA to monitor MMIF level and premium levels, and adjust them – both up and down, appropriately.

Credit Score Changes

FHA has proposed that borrowers with a credit score below 580 be required to make at least a 10 percent down payment. The minimum down payment will remain at 3.5 percent for all other borrowers. FHA's mission is to serve those underserved by the private market. The National Association of REALTORS® does not condone making loans to borrowers who are unable to repay the loan, or are at significant risk to not repay the loan. However, we do not believe that credit scores are a perfect indicator of risk. And in fact, credit scores have a disparate impact on minorities over other borrowers.

A Federal Reserve study completed in 2007 found that "different demographic groups have substantially different credit scores, on average. For example, on average, blacks and Hispanics have lower credit scores than non-Hispanic whites and Asians, and individuals younger than age 30 have lower credit scores than older individuals. Also, for given credit scores, credit outcomes—including measures of loan performance, availability, and affordability—differ for different demographic groups."[2] A Federal Trade Commission report in the same year found that "non-Hispanic whites and Asians are distributed relatively evenly over the range of scores, while African Americans and Hispanics are substantially overrepresented among consumers with the lowest scores (the scores associated with the highest predicted risk) and substantially under-represented among those with the highest scores."[3] The disparate impact

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[2] *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit,* Board of Governors of the Federal Reserve System, August 2007.

[3] *Credit-Based Insurance Scores: Impacts On Consumers Of Automobile Insurance,* A Report to Congress by the Federal Trade Commission, July 2007.

of credit scores on minority groups flies in the face of the mission of FHA to serve underserved markets.

Seller Concessions

FHA intends to propose a rule to decrease seller-paid concessions to 3 percent from 6 percent. FHA requires borrowers to provide a cash downpayment of 3.5%. The LTV on an FHA purchase loan cannot be more than 96.5%. So even with seller concessions, borrowers still have "skin in the game." Closing costs for loans differ greatly from state to state, irrespective of housing costs. Texas is surprisingly the state with the highest closing costs, followed by New York, and then Florida[4]. In states where closing costs are high, our members report that seller concessions are often higher than 3%, and are critical to allowing the borrowers to purchase the home without depleting all of their savings.

Lender Enforcement

FHA is proposing a number of changes to facilitate stronger oversight over FHA lenders and further protection for the Mutual Mortgage Insurance Fund (MMIF) and American taxpayers. To date, FHA Commissioner Stevens has shown a commitment to eliminating problematic lenders and taking all necessary enforcement measures to insure the safety and soundness of FHA and protection of borrowers.

As was discussed earlier, FHA is taking serious steps to assure FHA lenders are not abusing the program. They have stepped up oversight and enforcement, removing approval of or suspending 274 lenders in 2009. We applaud the efforts of Commissioner Stevens in this area, and support adding more tools to FHA's arsenal to protect FHA borrowers and taxpayers.

<u>Other FHA Issues</u>

Some members of Congress have introduced legislative proposals that react hastily and, we believe inappropriately to FHA's audit findings. We urge Congress to exercise caution before considering proposals that may have a profound adverse impact on our economic recovery and diminish programs that serve such a critical role to our nation's families. Rep. Scott Garrett (R-NJ) has introduced H.R. 3706, the "FHA Taxpayer Protection Act of 2009", which would increase the FHA downpayment to 5 percent and would prevent financing of the MIP or any other costs. We strongly oppose this legislation. Increasing FHA's downpayment

[4] Bankrate.com analysis, found on http://www.bankrate.com/finance/mortgages/state-by-state-closing-costs8-131404.aspx

would not add a penny to FHA's reserves. While it would increase an individual borrower's investment in the home, it would disenfranchise many FHA borrowers. Closing costs average 3-5 percent of the cost of a home. Those costs combined with the current 3.5 percent downpayment requirement are sufficient to insure a borrower's commitment to homeownership, and already represent a significant financial commitment. Requiring a larger downpayment will make homeownership out of reach for many families and for others could deplete their cash reserves for home and other emergencies.

FHA Loan Limits

We strongly support making permanent the FHA mortgage loan limits that are currently in effect. FHA has played a critical role in providing mortgage liquidity as private financing has dried up. We applaud Congress for extending the current loan limits through 2010, but they need to be made permanent.

Many argue that the loan limit increases help only the higher cost areas, but this is not the case. According to a recent HUD report, only 3 percent of FHA loans are above $362,750, and less than 2 percent are above $417,000. But decreasing the current loan limits would reduce the availability of mortgage loans in 612 counties in 40 states plus the District of Columbia. The resulting average reduction in limits would be more than $50,000. This decline would have a dramatic impact on liquidity in these markets, and could halt the housing recovery.

In addition, such a move could result in a greater risk to the stability of the FHA program since higher balance FHA loans perform better than lower balance ones. According to the FY 2009 audit, "FHA experience indicates that larger houses tend to perform better compared with smaller houses in the same geographical area, all else being equal."[5] So despite arguments that FHA higher limits put taxpayers at risk, these loans actually add strength to the program, and reduce risk to the fund.

Others argue that high FHA loan limits restricts private market activity. We strongly dispute this argument. FHA is currently acting in its role to fill the gap when the private market cannot or will not. If the current limits were restricting the development or resurgence of a private market, we would expect to see private lenders providing more new "jumbo" loans – above $729,750 since there is certainly demand for these loans in high cost areas. But in fact, we

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[5] *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund (Excluding HECMs)for Fiscal Year 2009,* by Integrated Financial Engineering Inc., November 6, 2009, pg 45.

find that there are few lenders willing to make these loans. When the private market returns, FHA will still have an important role in helping to serve the underserved in all parts of the country – even in high cost areas.

We strongly support the legislation introduced by Committee members Brad Sherman (D-CA) and Gary Miller (R-CA), H.R. 2483, the "Increasing Homeownership Opportunities Act," to make the current loan limits permanent. We urge the Committee to quickly consider this important legislation to ensure that FHA's role can continue in all markets for all credit-worthy consumers.

Condominium Rules

NAR has also been working closely with FHA on their new condominium approval process. As originally published in Mortgagee Letter 2009-19, we have concerns that some components of the new policy may lengthen the real estate crisis, just as some markets are seeing positive growth. We applaud the Department for delaying implementation of this letter and making temporary enhancements to the policy. While FHA has made some positive changes to their policy, we believe more can be done.

NAR recommends elimination of the owner-occupancy 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 of course would be the case for all FHA borrowers. Eliminating this requirement will allow buyers to purchase condominiums (which are often more affordable), raise condominium owner-occupancy levels, and stabilize these developments and the community. If FHA retains the owner-occupancy ratio, NAR recommends amending the rules so that bank-owned REOs are not counted for the purposes of calculating the occupancy ratio. FHA amended the rules in this manner in their temporary condominium guidance (ML 2009-46 A), but we believe this should be included as a permanent part of the owner-occupancy calculation. Again, this will align FHA with the industry practices in this area.

Condominiums are often the only affordable option for first time home buyers or borrowers with good credit, but small downpayments. NAR recommends amending the FHA concentration requirement. Currently, no more than 30 percent of the total units in a project may have an FHA mortgage. While FHA has temporarily increased this limit to 50 percent, we believe that making the 50 percent cap permanent or increasing it further, will result in a greater owner-occupied ratio in and given project because more borrowers will be able to use FHA to purchase a primary residence.

Many new condominiums remain largely vacant because of our real estate crisis. But FHA requires that at least 50 percent of the units be sold prior to FHA's endorsement of a unit. This eliminates condominiums as an option for many FHA borrowers. FHA has temporarily reduced the requirement to 30 percent. Again, we believe that this reduction should be made permanent or eliminated so that the borrower has greater choice of available units.

NAR recommends reinstituting the Spot Loan Approval Process. Effective February 1, 2010, FHA no longer permits Spot Loans for condominiums in projects that do not have FHA approval. Elimination of the Spot Loan Approval Process reduces consumer choice significantly and does nothing to stabilize condominium projects in down markets. We understand that there were incidents of abuse with the Spot Loan Approval Process; however, eliminating this as an option for borrowers is an extreme response. NAR believes that FHA could develop appropriate measures to ensure Spot Loans are available to borrowers while protecting their risk.

Conclusion

The National Association of REALTORS® believes in the importance of the FHA mortgage insurance program and believes FHA has shown tremendous leadership and strength during the current 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.

We urge the Administration and Congress to move cautiously before making changes to a program that has served the needs of millions of American families for more than 80 years without needing a federal appropriation. FHA's recent audit shows that if FHA makes no changes to the way they do business today, the reserves will go back above 2 percent in the next several years. We urge caution in making changes to a critical part of our nation's economic recovery, and disenfranchising American families.