TESTIMONY

H.R. 4110
The FHA Single Family Loan Limit Adjustment Act of 2004

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Committee on Financial Services
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It is an honor to appear today before this Subcommittee to discuss H.R. 4110, the FHA Single Family Loan Limit Adjustment Act of 2004. I am managing partner of Federal Financial Analytics, a consulting firm that advises on U.S. legislative, regulatory and policy issues affecting financial institution strategic planning. We thus advise a variety of companies on the implications of legislation and regulation in the mortgage and housing markets. Clients in this practice include trade associations, mortgage insurers, and mortgage lenders.

There are a few key points I would like to make regarding the proposal to have FHA insure loans equal to as much as 100% of an area's median house price:

- Higher FHA area loan limits do not help low- and moderate-income families obtain mortgages. If anything, they may well act to push up area home prices, making home ownership even further out of reach for moderate-income borrowers.
- Uncapping the FHA loan limit will, in some metropolitan areas, effectively open this vital federal program to high-income households who cannot or who choose not to make a downpayment large enough to qualify for a conventional mortgage. With median house prices of over $400,000 to $650,000 in some areas an uncapped FHA program would target borrowers earning $130,000 to over $200,000 a year. Legislating 100% Federal insurance coverage for mortgage borrowers at these high-income levels poses significant questions about the nation's housing priorities.
- Evidence from previous regional house price contractions indicates that opening the FHA single-family insurance program to low-downpayment

mortgage borrowers acquiring very large loans could jeopardize the financial health of the program during a period of regional house price stress.

- In my opinion, it is time that FHA became an income-targeted – rather than a loan amount targeted – housing program. The current system for setting FHA area loan limits is skewed toward raising these limits above the true median house price for an area and never lowering them, even if house prices fall. Income targeting FHA's single-family program will assure that low, moderate and middle-income borrowers become the primary focus of the program, and should also help make housing more affordable for these targeted borrowers.

Higher FHA Loan Limits Do Not Raise Borrower Income.

Discussion of FHA loan limits usually fail to address a key fact: the FHA is an insurance program that allows a borrower to qualify for a federally-insured low downpayment mortgage if, and only if, that borrower has sufficient income otherwise to qualify for the loan. The FHA income ratios and debt ratio requirements are slightly more generous than most conventional mortgage programs, but not by enough to allow a low- or moderate-income borrower to qualify for a large loan amount. Raising the FHA loan limits only serves those borrowers who already have the high income necessary to otherwise qualify for the loan. Uncapping the FHA loan limit will not allow a borrower with a $50,000 income to qualify for a $300,000 FHA-insured 30 year fixed rate mortgage —even at today's low interest rates. If interest rates rise, the larger FHA loan is placed that much further out of the reach of the moderate-income borrower.

Which Borrowers Will Benefit From an Uncapped FHA Loan Limit?

The current FHA single-family loan limit structure is set within a band tied to the Freddie Mac nationwide loan limit that is reset every year according to statute. The basic standard FHA loan limit nationwide is set at 48% of the Freddie Mac national loan limit. Today, this is equivalent to a mortgage of $160,176. Thus, even if the median house price in an area is only $80,000, $100,000 or $150,000 the FHA will insure loans in that area up to $160,176. On the other hand, the ceiling on the maximum FHA loan amount is set at 87% of the Freddie Mac loan limit. Today, this is equivalent to $290,319. This means that, if the FHA process determines that 95% of the median house price in an area is greater than $160,176, then that amount will be the FHA limit for that area up to a maximum ceiling of $290,319.

H.R. 4110 would change the FHA area limits in two ways. First, it would raise the calculation from 95% to 100% of area median house price. Second, it would keep the basic standard limit at 48% of the Freddie Mac limit but uncap the high-end limit. Thus, in areas where today FHA calculates area median house price to be above $290,319, it would insure mortgages up to 100% of that median house price – no matter how far above $290,319 the calculation would take FHA.

Here are two examples of what this would mean. The California Realtors reported in a May 25, 2004 press release that the median house price in Orange county for the month of April was $645,590, up from $605,560 in the previous month. Similarly, the

National Association of Realtors reported the median existing house price in the Boston MSA for 2003 was $412,800.[1] Under H.R. 4110 the FHA loan limits in these areas could jump from $290,319 to $646,000 in Orange county and likely over $412,800 in the Boston MSA. Not only are these sizable increases in two populated areas, but the incomes required to qualify for loans of this size are well beyond the reach of what most people would consider should be the target borrower for a Federal insurance program—a low, moderate or middle income, first-time home buyer. Moreover, borrowers with the high incomes necessary to qualify for these larger loan amounts appear to be well served by the conventional conforming mortgage market as well as the nonconforming market.[2]

If we assume the borrower fully qualifies for the FHA loan on an income basis and has no other debt that would act to limit the loan amount for which they would qualify, then, assuming current FHA mortgage rates and average property taxes and property insurance[3] the minimum borrower income needed to qualify for the current $290,319 FHA loan is $95,000. For a $412,800 FHA loan, the minimum borrower income jumps to $135,000 while, for a $646,000 FHA loan, the minimum income would be at least $211,000. Consumer debt and other factors would further raise these minimum qualifying borrower incomes.

No matter how one looks at these income requirements, they target the very top of individual income taxpayers. IRS data for 2001 shows that only the top 8.5% of all individual income tax returns had adjusted gross income of over $100,000 and only the

[1] *Real Estate Outlook*, publication of the National Association of Realtors, April 2004.
[2] A review of HMDA data for recent years shows that borrowers reporting income above 120% of area median income – the category where borrowers with incomes above $100,000 are likely classified – comprised a significant portion of both the conventional purchase and refinance markets. See generally HMDA data available on FFIEC website.
[3] Interest rate of 6.33% for a 30 year fixed rate FHA loan. Annual property taxes and insurance were assumed at a combined 2% of house price.

top 2% of individual returns were above $200,000[4]. What holds true nationwide is pretty representative of what exists even in so-called "high-cost" areas. The 2000 census data shows that 15% of Orange county households had incomes above $125,000 and only 5% had income above the $200,000 income needed to meet a $646,000 FHA loan limit for that area. [5] Furthermore, looking only at individual income tax returns with adjusted gross income between $100,000 and $200,000 we find that 77% of these returns reported a deduction for home mortgage interest – indicating that the filer already owned a residence. In short, if FHA starts targeting loan amounts where borrowers are required to have incomes from $100,000 to $200,000 or more, then, it can safely be said that these borrowers are at the very top income categories and are almost assuredly not first-time homebuyers. In my view, this is not and was never meant to be the target market for FHA single-family mortgage insurance.

In addition to targeting the upper income segment of the mortgage market, uncapping FHA limits in high cost areas may act to push some housing further out of the reach of low- and moderate-income borrowers seeking a house in that market. There is some evidence from previous FHA loan limit debates that higher FHA limits may serve to raise the cost of new housing that is made available to FHA-eligible borrowers in an area subject to the higher limits. That is, builders of new housing may change their pricing structure on some new units targeted to the higher end of the FHA market to reflect the availability of government insurance on larger loan amounts within an area.

Since the FHA insurance allows the borrower with a certain income but little or no downpayment to qualify for a slightly larger loan amount than would otherwise be the

[4] See Individual Income Tax Returns, 2001, article by David Campbell and Michael Parisi , available on IRS website.

case, it should come as no surprise that new home prices will reflect the availability of the larger loan amount for the borrower at the upper limits. Again, however, the higher FHA loan limit does nothing for the moderate- income borrower you qualifies for a loan amount below the old FHA limit. While that borrower gains nothing, he or she may well suffer as the market focuses on the new availability of FHA insurance at the high end.

Redefining Median House Price

Implicit in H.R. 4110 is the assumption that the current way FHA area loan limits are set falls short of matching the area's true median house price. In fact, just the opposite is the case. The current structure for setting FHA loan limits for high cost areas is skewed toward setting them at a level above the true area median house price. Beginning in 1999, as a result of legislation, the current system ties the calculation of the median house price for an MSA to the median house price in the highest cost county within the MSA.[6] The result is that the FHA loan limit for the MSA is clearly not reflective of the true median house price for the entire MSA – it is higher. Moreover, anyone can request a higher limit for the MSA by presenting data to HUD that house prices within a single county within the MSA have gone up to a level above that reflected in the current FHA area loan limit. Further aggravating the bias toward an artificially high MSA median house price is that, when data are compiled to show recent house price sales, new house sales are over-weighted. That is, if new house sales comprise less than 25% of all house sales in the county and the value of existing home prices is static or declining, then the median price

[5] See State and County Datasets 2000 Census on U.S. census website.

[6] For FHA limit setting process see HUD Mortgagee Letters 2003-23 and 95-27. As evidence of how quickly real estate brokers and others took advantage of the new law to seek higher area FHA limits see "HUD Raises Limits for FHA-Insured Mortgages in 1999, Numerous Appeals Are in the Works." *Inside Mortgage Finance*, January 8, 1999, page 9.

for new houses is calculated separately but given equal weight to the median sales price for existing house sales. Since new home prices are generally higher than existing home sales prices this acts to raise the FHA limit above what would be the true area median house price. Shifting the FHA area limit calculation from 95% to 100% of "median house price" as calculated under the existing formula will simply aggravate the current distortion in the calculation.

Uncapping FHA Loan Limits Will Add to FHA Risk

It is commonly assumed that borrowers with higher incomes are, for some reason, safer credits than low and moderate-income borrowers. Evidence from the private mortgage insurance industry shows that this is not the case when considering low downpayment borrowers during periods of regional economic stress and falling home prices.[7] It is one thing to have a relatively high income and owe a large mortgage on a home with borrower equity of 20% or more. It is quite another issue to have a large mortgage with very little or no equity at all in the house during a period of falling house values. When borrowers start the ownership process with little or no downpayment using an FHA-insured mortgage loan, they are extremely dependent on a continuing advance in home prices to build their equity. Any reversal in personal fortunes will find them underwater on their mortgage – owing more than the house is worth after broker and other fees have been paid. This is especially the case for zero downpayment mortgages recently approved for FHA by this Committee.[8]

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[7] See testimony of Charles Reid, President of the Mortgage Insurance Companies of America, before the Subcommittee in Housing and Community Development, on FHA's Mutual Mortgage Insurance Fund, July 27, 1993, Attachment A, Incremental Risk of Higher Mortgage Amounts, 1981-1989.
[8] See my testimony before this subcommittee on the FHA zero downpayment mortgage of March 24,2004.

The nature of the residential real estate market in the past decade has been very good to most risk takers. Home prices have appreciated across the board – although with wide geographic variations. Unfortunately, there is no assurance that rapid house price appreciation will continue. Furthermore, past experience with regional downturns in house prices has shown that houses at the upper end of the house price distribution scale are likely to suffer more serious declines in property values than more moderately priced houses. This is not surprising. By definition, there are fewer people with the wherewithal to purchase higher priced homes than there are available to purchase more moderately priced homes. During a period of economic stress and falling home prices, the lack of liquidity at the higher end of the house price market will be felt to the detriment of the holder of these mortgages.[9] Since FHA insures 100% of the loan amount, the FHA stands to lose a great deal in this situation.

The potential loss for FHA from uncapping the high-end limits may be significant during a period of falling regional house prices. A 30% loss on a foreclosed $100,000 FHA insured loan costs the single family fund $30,000. A 30% loss on a $400,000 FHA-insured loan would cost the fund $120,000. If, as is the case in the private sector, larger FHA loan amounts that go to foreclosure during periods of severe economic stress suffer larger percentage reductions in value, then the fund may suffer even greater unanticipated losses. In any case, the new low- and moderate- income borrowers who will be seeking to qualify for a moderate FHA loan during this period of economic stress will feel the impact of these losses. Just as new borrowers paid the higher FHA loan premiums needed to return the single family fund to economic solvency in the early 1990s, so too will these

[9] In this regard it is interesting to note that the FHA loan limits that existed in the late 1980s and early 1990s may well have protected the MMI Fund from the severe losses that were incurred in the private

moderate income borrowers bear the higher costs associated with the losses resulting from defaults on larger loans in the event of a future house price decline.

Will there be a regional house price decline that will result in heavy losses to FHA? We don't know. But we do know that low- and moderate-income borrowers gain nothing and may well lose from retargeting FHA to higher income borrowers. Why would Congress want to run that risk when so much more needs to be done to provide affordable housing for minorities and low and moderate-income borrowers and renters?

Finding A New Path

Let me conclude by saying what I think government could do to effectively use the FHA single-family fund to promote home ownership for more low- and moderate-income borrowers. Fundamentally, I think the federal government should act when the private market isn't efficient because of poor information or other impediments to credit availability. That was the genius of the FHA when it was created in 1934 and it's the role it should continue to serve.

Income targeting would ensure that the FHA promotes home ownership for those borrowers whose needs remain unmet by private markets.[10] It would enhance home ownership even in high-cost areas without creating a subsidy for higher-income borrowers or an incentive for higher home prices that may cut lower-income borrowers out of home ownership – the opposite, of course, of what the FHA should do.

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sector by the house price declines in New England and Southern California during these years.

[10] The concept of retargeting FHA subsidies to needy borrowers is not new and was made by the Chicago Fair Housing Alliance in a March, 1998 policy paper entitled *The Two Faces of FHA.* The paper concluded, in part, that FHA lending should be targeted to "those who cannot be served by the conventional markets and to programs designed to experiment with expanding the mortgage markets."(p.12).

Income targeting doesn't mean that every area of the country has the same target—be it 80%, 100% or 120% of area median household income. To support home ownership in changing inner city neighborhoods, for example, the targets could be set at a higher percentage of median household income than would be the case in other neighborhoods. However, it is critical to set them in a way that puts taxpayer-supported programs to work for those potential borrowers in the neighborhood who need them the most.

Income targeting the FHA single-family program also assures that the insurance subsidy remains with targeted borrowers during periods of rising interest rates. I noted earlier that the FHA's current high cost area limit of $290,319 requires a borrower income of at least $95,000. But that calculation assumes current mortgage interest rates. If 30-year FHA mortgage interest rates were to increase to 8% -- where they were only four years ago -- then the minimum borrower income needed to qualify for the same FHA loan would rise by 14% to $108,000. In other words, the FHA loan limit approach of targeting borrowers leaves low- and moderate-income families behind during periods of rising interest rates. In my opinion the FHA program should do just the opposite—during periods of rising rates it should assure that its subsidy remains targeted to the low-and moderate-income borrower. Income targeting the FHA single-family program will assure that this happens.

We in this country support home ownership with an array of government support – tax deductibility for mortgage interest, the manifold benefits afforded to the housing GSEs and so much else. If we increase the scope of FHA without focusing it on the real needs of underserved borrowers, we run the risk of undercutting the program and its ability to serve those who need it and at the time when they may need it the most.