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BEFORE THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

OF THE

HOUSE OF REPRESENTATIVES

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Thank you, Chairman Ney, Ranking Member Waters, and members of the Subcommittee. I am Frank Nothaft, Vice President and Chief Economist of Freddie Mac. In this position, I am responsible for primary and secondary mortgage market analysis and research, as well as macroeconomic analysis and forecasting. I am also involved in the analysis of affordable lending activities and policy issues affecting the housing industry. I have more than 20 years experience applying economic analysis to domestic housing and mortgage market issues, accumulated both at Freddie Mac and at my previous employer, the Federal Reserve Board.

I welcome the opportunity to be here today to discuss H.R. 4110, the "FHA Single Family Loan Limit Adjustment Act of 2004." Freddie Mac supports efforts by Chairman Ney, Congressmen Miller and Frank, Congresswoman Waters, and other members of the Subcommittee to help meet affordable housing needs in all neighborhoods, and especially in high-cost markets. We believe that these needs are best served by a higher loan limit for FHA, coupled with a higher loan limit for Freddie Mac and Fannie Mae, in high-cost markets. This will expand the market and provide more access to credit and lower homeownership costs. Before I begin, however, I would like to briefly touch on Freddie Mac's mission as well as the accomplishments of the FHA.

Freddie Mac's Mission

At Freddie Mac we recognize our special responsibility to homebuyers, the public, the Congress and investors. Our Congressional charter stipulates that we should assist in the creation and maintenance of stable, liquid and broadly accessible markets for residential mortgage finance. Simply put, Freddie Mac's mission is to ensure a stable supply of low-cost mortgages for America's families – whenever and wherever they need them.

We have made tremendous strides in providing stability and liquidity to the US mortgage finance system – playing a major role in helping to increase the number of American families living in their own homes. For more than 30 years, Freddie Mac has helped meet the home financing needs of families at all income levels, in all communities, and in all parts of the country. For example, last year, Freddie Mac financed homes for 5.8 million families—23,000 homes each business day, and we contributed to a housing sector that continues to power our economy.

Looking ahead, Freddie Mac is dedicated to our mission to expand homeownership. Under the leadership of our Chairman and CEO Dick Syron, Freddie Mac has renewed our commitment to America's homebuyers, with an emphasis on reaching more minority families and underserved borrowers than ever before.

The Accomplishments of the FHA

This month marks the 70th anniversary of the FHA, and over this period the FHA has insured 33 million loans. Congress has modified and updated the FHA program many times, to reflect changing mortgage market conditions, the needs of America's families, and the rising cost of housing.

By statute, FHA's single-family loan limit is equal to 95 percent of the median house price of the local area, subject to a maximum and a minimum loan limit. Since 1994, FHA's maximum and minimum single-family loan limit has been linked to Freddie Mac's single-family loan limit.[1] Freddie Mac's loan limit generally adjusts once a year, effective January 1, reflecting the rise in national average house prices. This linkage enables the FHA loan limit to change automatically as the conforming limit changes, eliminating the periodic need for Congress to debate the increase in FHA loan limits.[2] FHA's maximum loan limit is set at 87 percent of Freddie Mac's loan limit, and FHA's lowest loan limit is set at 48 percent of Freddie Mac's loan limit.[3] For 2004, Freddie Mac's one-family loan limit is $333,700; thus, FHA's limit varies from $160,176 to $290,319 in the highest-cost markets.[4]

Housing affordability is an issue in all high-cost markets across the nation. As an example, the median price of a single-family home in March in California was $428,000 and $560,000 in San Francisco.[5] In 2003, the median price of a home in Boston was $413,000.[6] In these and other high-cost markets around the nation, a higher FHA loan limit, and a higher loan limit for Freddie Mac and Fannie Mae, would be vehicles for bringing low-cost, accessible mortgage credit to more families.

Today, in my comments to this Subcommittee, I will first discuss general effects of an FHA loan limit increase upon the overall mortgage market, and then provide some specific comments on H.R. 4110.

General Effects of an FHA Loan Limit Increase

There are two effects of raising the FHA loan limit on the overall mortgage market. First, a higher limit will draw some additional borrowers into the market, expanding the overall size of the home-purchase origination market. Second, by providing an alternative source of mortgage insurance, it will draw some borrowers away from the conventional market.

We have conducted analysis at Freddie Mac to parse out both effects with market data.[7] Our analysis was focused on the previous large jump in FHA loan limits that was enacted October 21, 1998, that increased the maximum high-cost limit from 75 percent of Freddie

[1] Public Law 103-327, signed into law on September 28, 1994. Pub. L. No. 103-327, 108 Stat. 2298 (1994).
[2] 140 Cong. Rec. H 6025 (1994).
[3] Public Law 105-276, approved October 21, 1998, placed the maximum and minimum FHA loan limit at 87 percent and 48 percent, respectively, of Freddie Mac's loan limit.
[4] The first mortgage loan limit is 50 percent higher in Alaska, Hawaii, Guam, and the U.S. Virgin Islands. Higher loan limits apply for 2- to 4-family properties.
[5] California Association of Realtors, *Trends in California Real Estate*, 25:54 (May 2004).
[6] National Association of Realtors®, *Real Estate Outlook*, 11:4 (April 2004).
[7] We used the public loan-level files released by the Federal Financial Institutions Examination Council collected pursuant to Regulation C (Home Mortgage Disclosure) as well as the loan level data submitted by the mortgage insurers who are members of the Mortgage Insurance Companies of America. We looked at what happened to private mortgage insurance volume, and FHA insurance volume, immediately after a hike in the FHA loan limit.

Mac's loan limit to 87 percent of our limit, that is, an increase that placed the maximum FHA limit $28,800 higher than it otherwise would have been in 1999.[8]

What we found was that the higher FHA limits increased overall home-purchase for the population of loans that fell within the new, higher FHA loan limits. In the 41 highest-cost counties, the increase in FHA limits increased the number of home-purchase loans by 5,000 to 8,000, or an average of 130 to 200 loans per high-cost county in the first full year after enactment.

In contrast, the number of conventional home-purchase loans, and the number of privately insured loans, was reduced. The number of conventional loans was 2,000 to 5,000 lower, indicating that the higher limits attracted some borrowers who would otherwise have taken out a conventional loan. We estimated that the "overlap" with the conventional market was between 22 percent and 49 percent of the new volume of FHA loans.

The midpoint of this range, or 35 percent, is very close to the estimate of the "overlap" computed by the General Accounting Office (GAO) in a 1996 report.[9] GAO found that 34 percent of FHA-insured loans qualified within the Freddie Mac, Fannie Mae, and private mortgage insurance underwriting guidelines, with LTV ratios at or below 97 percent, expense-to-income ratios at or below 33 percent and total debt-to-income ratios at or below 38 percent.

Thus, based on our analysis of the market increase we saw in 1998 and the "overlap" with the conventional market, any increase in FHA loan limits will have two effects: It will expand the overall lending market, and it will also draw some borrowers away from the conventional market.

I will now describe some observations I have on H.R. 4110.

<u>Specific Comments on H.R. 4110</u>

H.R. 4110 alters the FHA loan limit in two respects. First, it eliminates a maximum loan limit by decoupling the link to the Freddie Mac loan limit. Second, it sets the FHA loan limit at 100 percent of the median house price, up from 95 percent.

Eliminating the maximum loan limit means that the FHA limit will exceed the Freddie Mac and Fannie Mae loan limit of $333,700 in a number of markets. By statute, HUD evaluates the median house price in the most expensive county within a metropolitan area to establish the FHA loan limit for that area. In Manhattan, the median value of owner-occupied single-family homes – almost entirely condominiums and cooperatives – was over $1 million as of the 2000 decennial census. Factoring in home-value appreciation over the past four years in the New York market would place the median value in the

[8] Pub. L. No. 105-276, 112 Stat. 2461 (1998).
[9] U.S. General Accounting Office, *Homeownership: FHA's Role in Helping People Obtain Home Mortgages*, GAO/RCED-96-123 (Washington, D.C. August 13, 1996).

neighborhood of $1,500,000, placing the FHA loan limit at that level throughout the New York metropolitan area. Likewise, the FHA loan limit in San Francisco would be set equal to the median price in the most expensive county within the metropolitan area, which is Marin county; using the median home value from the 2000 census and home-value growth over the four years since would place the FHA loan limit for the San Francisco metropolitan area near $750,000. In essence, FHA loans will be competing with the jumbo market and the inevitable news stories of mansions with FHA mortgages will appear.

Further, the "overlap" with the jumbo market will be far more substantive that the estimates I cited earlier for one simple reason: FHA fixed-rate loans will still carry the lower rates enjoyed by borrowers in the conforming market, compared with the higher level of interest rates on fixed-rate jumbo loans, that is, loans that exceed the statutory loan limits of Freddie Mac and Fannie Mae. While that rate differential varies over time, the interest rate savings in the conforming market can be upwards of one-half of a percentage point on 30-year fixed-rate loans. With such a large financial incentive, many borrowers will opt for an FHA loan over a jumbo loan.

Congress should consider very carefully what it wants the FHA program to accomplish and how best to achieve its policy objectives. Currently there are 82 counties that are at the FHA maximum loan limit, including the New York, San Francisco, and Boston metropolitan areas. Setting the FHA loan limit at such levels will assist very few, if any, lower-income borrowers, as low-income borrowers are unlikely to qualify for mortgages for the large amounts required to purchase in these areas. Maintaining the link with the Freddie Mac loan limit, perhaps in concert with an increase in that limit, would assure that FHA continues to serve its intended borrower population, while assuring families greater access to a wider alternative of housing finance options.

A second part of H.R. 4110 increases the loan limit for those areas where it is currently set at 95 percent of the median house price. The proposed increase to 100 percent of the median house price will affect 539 counties in the nation. The families who will benefit from FHA's lower down payment requirements and higher payment-to-income ratios will tend to be lower-income and have less savings. However, many of these borrowers would also have qualified for a conventional, privately insured loan. We estimate that several thousand lower-income and minority home buyers, who otherwise would have qualified for and taken out a conventional mortgage, will opt for an FHA-insured loan.

Because the FHA program touches so many aspects of the mortgage market, it is also important to look at how the overall strength of the FHA fund would be impacted by the legislation and other developments in the mortgage market, such as lower down payments, higher loan limits, and possible affordable housing goal changes for Freddie Mac and Fannie Mae. As you know, HUD has issued a proposed rule that would set new affordable housing goal requirements for Freddie Mac and Fannie Mae, effective in 2005. HUD's market analysis was completed months ago and does not factor in an FHA loan limit increase. Thus, the FHA loan limit increase will make it even more difficult for us to make the proposed goal levels. Due to the market impacts of a FHA loan limit increase, Congress should consider requesting that HUD take into account the effect of higher FHA loan limits on the size of the conventional market that meets the proposed goal levels.

Conclusion

As I mentioned earlier, Dick Syron, Freddie Mac's new CEO, has defined a mission-centric focus to our activities. Included within that is new product development to help meet the affordable housing needs in all neighborhoods. Congressional action to support affordable housing throughout the nation, and especially in high-cost markets, is well justified, and we support efforts by Chairman Ney, Congressmen Miller and Frank, Congresswoman Waters, and other members of the Committee to ensure that America's families have affordable housing in the cities in which they work. As I have stated, we believe that these families are best served by a higher loan limit for FHA, as set forth in the bill, coupled with a higher loan limit for Freddie Mac and Fannie Mae, in high-cost markets. This will expand the market, provide more access to credit and lower homeownership costs and make home possible for more of America's families.

Thank you for the opportunity to appear before the Subcommittee today. I look forward to answering whatever questions you may have.