Testimony of

Robert Mitchell

On Behalf of:

The National Association of Home Builders

To The

United States Senate
Small Business Committee

Hearing On

"Impacts of the Credit Crunch on Small Firms"

April 16, 2008

Introduction

On behalf of the almost 250,000 members of the National Association of Home Builders (NAHB), we appreciate the opportunity to participate in this Senate Small Business Committee hearing on "Impacts of the Credit Crunch on Small Firms." My name is Bob Mitchell and I am a home builder from Rockville, MD. I served as President of the National Association of Home Builders in 2000, and have been involved in the home building industry for over 35 years.

The majority of NAHB's builder members are small businesses, building less than 25 homes per year. These builders typically get their financing from depository institutions. Many borrow from small, community-based banks and thrifts and have established strong ties to these institutions over time. NAHB's members have been significantly impacted by the credit crunch and there is deep concern that the dislocations in the financing markets will increase the depth and length of the housing downturn.

Housing Credit Market Conditions

The mortgage credit crunch, which began in the summer of 2007, will continue to be the most significant factor impacting the home building industry into the foreseeable future. The U.S. housing market now is in the contraction phase of the most pronounced housing cycle since the Great Depression. This dramatic contraction has exacted a heavy toll on economic growth and employment during the past two years, and now has pushed the U.S. economy into recession according to NAHB macroeconomic analysis.

The adverse economic impacts of the housing contraction involve not only sharp declines in home sales and housing production, but also depressing effects of falling home prices on household wealth and mortgage credit quality. These events have provoked an alarming surge in mortgage foreclosures that have cut into the homeownership rate. Further, events have seriously damaged financial institutions holding mortgage assets, as well as companies that provide mortgage credit enhancement.

The pronounced decline in mortgage credit quality first became evident in the subprime mortgage sector last year, and that debacle triggered a stampede toward credit quality in national and global credit markets. This process has essentially shut down or seriously damaged a wide range of securities markets, including major components of the mortgage securities markets in the U.S. The freezing-up of private securities markets, both here and abroad, has shifted credit demands to government-related securities markets and to depository institutions – resulting in higher loan volume and pressures on capital positions at the depositories. The banking system, in turn, has been aggressively tightening lending standards in order to control volume, maintain asset quality and shepherd capital.

With private securities markets in disarray and banks retrenching, a bona fide credit crunch is underway. This credit crunch actually appears to be worsening despite the concerted efforts of central banks here and abroad. The Federal Reserve has been easing monetary policy aggressively since last fall, and probably will do more in the near future. These actions have improved the functioning of short-term money markets, including the interbank markets, but the Fed has not been able to relieve strains in longer-term credit markets.

With the deterioration of housing demand, exacerbated by the credit crisis and the fear and uncertainty concerning future housing price declines, for-sale housing market inventories are at historic levels. For example, the new homes inventory stands at a 9.8 months supply. The record volume of vacant homes on the for-sale market inevitably will put persistent downward pressure on home prices for some time. These interrelated factors of inventories and home price decline are central to the outlook for the economy and the financial markets.

Continued downward pressure on home prices also further saps the quality of outstanding mortgage credit, making it even more difficult to refinance or restructure adjustable-rate mortgages that have encountered or are facing payment resets. These effects, in turn, will worsen the alarming upsurge in mortgage foreclosures; move even more homes onto the for-sale market, put even more downward pressure on house prices and mortgage quality; and stretch out the contraction in new housing production even further. This represents quite a feedback loop, with ominous potential consequences for the U.S. economy and the financial markets.

Housing Production Credit

The tightening of credit standards and sharp reduction in credit availability that emerged and spread in the consumer mortgage arena has leapt to the housing production loan market. Builders are reporting an adverse shift in terms and availability on loans for land acquisition, land development and home construction (AD&C) and builders with outstanding loans are facing mounting challenges. Lenders are receiving current appraisals reflecting lower values on lots and homes, as well as market studies significantly scaling back absorption estimates. As a result, lenders are seeking additional equity for outstanding credits and balking at loan extensions. Defaults on AD&C loans are rising. The bank regulators have raised concerns about real estate lending and are reviewing the methodology utilized by banks in determining loan loss reserves and levels of delinquent and non-accrual loans for AD&C commitments. In this environment, banks are actively reducing exposure levels to home building credit.

Market Conditions

Residential AD&C loans are used to purchase land; develop lots; build a project's infrastructure such as streets, curbs, sidewalks, lighting, and sewer and utility connections; and construct homes. The vast majority of residential AD&C loans are made by depository institutions. NAHB's surveys of home builder and developer financing found that commercial banks and thrifts account for more than 90 percent of residential land acquisition, development and construction (AD&C) lending, and that commercial banks alone account for more than 80 percent of such activity.

Loans extended to builder/developers are short-term obligations lent as progress payments, i.e., portions of the loan commitment are advanced as stages of the construction project are completed. The advances, or draws, are generally made over a 6-to-18 month period. The principal and interest on the loans is repaid to the lender when the home is sold. Builders typically secure this financing through personal guarantees and/or offering other assets as collateral.

The deterioration in the mortgage credit markets and in home sales and inventories is spilling over into the markets for AD&C loans. Data from the OTS' Thrift Financial Report shows a marked increase in charge-offs on one-to four-family residential construction loans in 2007, as charge-offs as a percent of average loan balance jumped from 23 basis points in the first quarter to 170 basis points

in the fourth quarter. For all of 2007, the average charge-off rate was 82 basis points, the highest since 1991 during the last credit crunch.

Bank Call Report data reflect a similar trend at commercial banks. Non-current rates on residential construction loans rose sharply in the fourth quarter, hitting 4.11 percent, which is an increase of 76 percent from the third quarter and 142 percent from the first quarter. (Unfortunately, prior comparisons are not available since banks just started reporting disaggregated residential and non-residential construction loan data in March 2007.)

Regulatory Perspective

These trends have caught the attention of banking regulators who over the past year have been raising concerns about large concentrations of commercial real estate (CRE) loans, which include residential AD&C loans. In particular, regulators are focusing on problems arising from significant community bank concentrations in CRE at a time of significant market disruptions and the declining quality of these loans, especially those related to residential construction and development.

Financial institutions have been reminded to adhere to the December 2006 CRE Exposure Guidance on understanding and managing CRE risks. While this guidance does not include specific limits on CRE lending, it does emphasize that banks with higher CRE concentrations have higher levels of risk and therefore must have risk management and capital commensurate with the higher level of risk. Consistent with this guidance, regulators have stated that in stressed markets, institutions will likely need to downgrade assets, increase loan-loss provisions, conduct fresh appraisals, and reassess the adequacy of bank capital.

The FDIC issued a Financial Institution Letter (FIL) on March 17 which re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management for institutions with high CRE exposure. The letter stressed that institutions should follow the 2006 CRE Exposure Guidance. Importantly, the letter also encouraged institutions to continue to make CRE and construction and development loans in their communities using prudent and strong underwriting standards and loan administration practices.

At present, regulators are addressing these concerns through increased bank examinations and forcing some lenders to bolster reserves. Unlike the last credit crunch, when there was wholesale ban on CRE lending, regulators are working with lenders through the supervisory process to address CRE problems early. Nevertheless, the heightened regulatory scrutiny is having an impact on borrowers. Some builders are rapidly drawing down interest reserves and many have had to put up additional equity as appraised values have declined.

Impact on Builders

The upheaval in the housing credit markets has had a significant impact on NAHB's builder members. Tighter mortgage lending terms have made it difficult for home buyers to obtain financing to purchase new homes. Likewise, stricter credit standards for AD&C loans have adversely impacted the cost and availability of builder financing.

Tighter Mortgage Lending Standards

In a national survey conducted this month by NAHB, 64 percent of builders reported that more restrictive mortgage lending standards have adversely impacted their sales. By comparison, in April 2007, only 45 percent of builders were noting sales problems due to financing stresses. In terms of the degree of impact on sales, builders citing buyer financing troubles reported an average sales decline of 15 percent. A third of the builders reported sales declines of 10 to 24 percent, 30 percent said their sales were down 25 to 49 percent, and 31 percent experienced a drop in sales of more than 50 percent.

The constriction in mortgage credit also has contributed to sales cancellations. Overall, 33 percent of the builders surveyed in December said they had contracts cancelled because buyers were unable to qualify for a mortgage. This was up from 28 percent in March 2007. Regarding the scale of cancellations, 44 percent of the builders surveyed said their sales pipeline shrunk by 10 to 24 percent.

Builders have used a variety of techniques to bolster sales and/or limit cancellations, including price reductions, no-cost options or upgrades and financing incentives. The two most widely used incentives are including optional items at no-cost and reducing home prices. NAHB's March builder survey found that 56 percent of respondents had included no-cost options, while 49 percent had reduced prices from the preceding month, with an average price reduction of 3.7 percent. Price reductions as a sales incentive seem to have peaked last fall when 59 percent of builders surveyed in October reported lowering their prices. This in part reflects the waning effectiveness of price reductions, as only 55 percent of respondents rated these as somewhat or very effective in the March 2008 survey, compared to 67 percent in the June 2007 survey. By comparison, 73 percent of the respondents to the March 2008 survey rated no-cost options as somewhat or very effective.

Availability of Housing Production Credit

Weakening AD&C loan performance and stricter regulation has translated into tighter AD&C credit availability and underwriting terms. NAHB's builder financing survey for the fourth quarter of 2007 shows that thirty-five percent of respondents stated that the availability of credit worsened in the fourth quarter relative to the third for single family construction loans. This continued a progressive rise over the past year in the proportion making such an assessment. Thirty-six percent of those seeking land acquisition loans reported worse credit availability; this reading was 30 percent for those seeking land development credit and 24 percent for those trying to line up construction funds for multifamily housing. Of those reporting deterioration of credit availability, 81 percent noted lower loan-to-value limits and approximately two-thirds said lenders are reducing the amount they are willing to lend.

NAHB's April builder survey shows continued tightening in the availability of AD&C credit. Thirty-three percent of respondents reported that the availability of credit for single family construction loans worsened in the first quarter of 2008, compared to the final quarter of 2007. Similarly, 30 percent of those seeking land acquisition loans reported worse credit availability; this reading was 29 percent for those seeking land development credit and 21 percent for those trying to line up construction funds for multifamily housing.

In addition to stricter standards for new AD&C loans, lenders also are tightening requirements for outstanding loans. Roughly a third of respondents to NAHB's April survey

reported that lenders had reappraised some or most of their single family construction loans. Three-quarters of those with reappraisals were asked to pay down the original amount, and 13 percent had to put down additional assets. For land acquisition loans, 26 percent of respondents were asked to pay down part of the loan due to possible declines in the value of the land.

NAHB Recommendations

Broader Sources of AD&C Credit

The current financing quagmire for home builders vividly illustrates the importance of developing additional sources of AD&C credit. Presently, funding for viable residential development and construction projects is severely limited or blocked entirely by credit, concentration, capital and other regulatory restrictions on federally insured depository institutions, which are the sole source of housing production credit for the small businesses that comprise most of the home building industry. Furthermore, there is no secondary market for residential AD&C loans where community banks and thrifts could turn to help manage their balance sheets and obtain liquidity for additional lending.

A viable secondary market for AD&C loans would directly benefit builders and lenders by: (1) transferring risk away from lenders; (2) increasing availability of funds so that projects can be more reliably completed; and (3) mitigating the devastating impact of equity calls on builders, or transfers of partially completed projects to banks under capital and/or regulatory pressure.

Government Sponsored Enterprises

One potential source of relief is through a program Fannie Mae has developed to purchase participation interests in AD&C loans made by banks and other qualified lenders. This program was tested successfully for more than a decade as a pilot and has been cleared for permanent operation by the Office of Federal Housing Enterprise Oversight and the Department of Housing and Urban Development. The program was designed as an outlet for banks to sell originated AD&C loans so these institutions could recycle funds into other viable AD&C projects, much like the workings of the very liquid and successful Agency mortgage-backed securities market. Fannie Mae, which has moved very cautiously in launching the permanent AD&C loan purchase program, should be encouraged to ramp up to higher activity levels to provide a much-needed outlet for portfolio AD&C lenders. In addition, Freddie Mac should seek approval to operate a similar program.

The Federal Home Loan Banks (FHLBanks) can also provide support to the AD&C loan market. Over the longer-term they could develop loan purchase programs to support housing production lending efforts in their districts. Immediately, however, the FHLBanks can improve AD&C liquidity by accepting housing production loans as collateral for the secured advances they make to member institutions. Currently these loans are secured mainly by the home mortgage portfolios of borrowing banks and thrifts, and advance activity has risen dramatically as these portfolio lenders sought liquidity support amidst credit market turmoil. The FHLBank of Des Moines received approval from the Federal Housing Finance Board on September 10, 2007 to accept one-to-four family construction loans as part of a basket of other real estate collateral that may back the Bank's advances to member financial institutions in its district. This step will improve balance sheet flexibility for members of the Des Moines FHLBank and improve stability in the region's housing production credit market. Other FHLBanks should be encouraged to follow suit.

Federal Housing Administration

NAHB also believes the Federal Housing Administration (FHA) should play a role in supporting the AD&C credit market. FHA insurance would help increase competition in the AD&C market by attracting new originators such as mortgage banking companies. In addition, FHA-insured construction loans could be packaged in Ginnie Mae-guaranteed securities to allow capital to flow from investors in that market. These benefits would translate into improved credit availability for home builders and home buyers and reduced home buying costs.

FHA already has authority to insure permanent mortgages that are converted from construction loans in construction-to-permanent mortgage programs, which have been growing in popularity. NAHB has obtained a legal opinion that confirms that FHA also has authority currently to insure the construction portion of these loans. NAHB has urged FHA to utilize this authority and we have developed legislative language that would provide FHA the additional authority of insuring stand-alone construction loans. As in the case of the end-loan mortgage market, FHA could be a crucial stabilizing force in AD&C lending in turbulent times such as these.

Privately Issued AD&C Securities

NAHB is also pursuing initiatives with key capital market players to develop a prototype private security instrument for AD&C loans. Discussions have included major financial institutions, including several insurance companies, and we are broadening our search to include other Wall Street specialists. NAHB is pursuing several of the tax changes recommended by the New York State Bar Association to facilitate development of securities backed by AD&C loans. In particular, recommended changes to tax provisions relating to REMICs and Taxable Mortgage Pools (TMPs) could be helpful in securitizing construction loans. NAHB also has met with Congressional staff and members on AD&C tax issues and is seeking legislative vehicles to obtain changes to the REMIC and TMP rules that would facilitate securitized pools of AD&C loans.

Balanced Regulation

The approach of the regulators in overseeing institutions involved in AD&C lending will be an important factor determining the length and severity of the current housing and economic recession as well as the vigor of the subsequent recovery. It is crucial for the banking regulators to take a balanced approach when evaluating bank lending, especially in regard to AD&C loans. The regulators should continue to encourage institutions to pursue sound loans on viable projects. In addition, the regulators should provide additional guidance to lenders on dealing with outstanding AD&C loans to ensure that losses are minimized through flexible and prudent loan accommodations. Such actions are just as critical in a nascent recovery as in the current downswing.

While we recognize the importance of the safety and soundness of the banking system, NAHB urges banking regulators to exercise extreme care in order not to produce unnecessary restrictions on credit. Overly pessimistic assumptions about future home sales and values will result in an unnecessary extension of the credit crunch and housing recession. Draconian restrictions on lending or forced reductions in AD&C concentrations will only serve to exacerbate the present crisis and delay, or even prevent, future recovery. Small businesses, including small builders, are vital to the economy and arbitrary or unreasonable regulatory restrictions would only serve to harm many builders, and potentially many banks. It would be ironic and tragic to have the positive work of the

Fed undone by bank regulators taking a totally different vision and approach when it comes to lending matters.

Federal Home Loan Bank Guarantees of Municipal Bonds

A lesser discussed aspect of the credit crunch is the increasing difficulties experienced by local governments in funding infrastructure projects such as water treatment facilities. Impediments to such financing often have blocked residential development and have sometimes resulted in additional charges being imposed on home builders to pay for improvements that benefit existing residents as well as residents of newly built homes. The financial strength of the Federal Home Loan Banks (FHLBanks) allows them to provide stand-by letters of credit to facilitate municipal bond issues for infrastructure projects. However, under current law, municipal bonds that are guaranteed by FHLBanks cannot qualify for tax-exempt status and, therefore, carry higher interest costs.

S. 1963, introduced in the Senate by Senators Rockefeller, Crapo, Stabenow and Carper, would address this impediment. The bill would amend Section 149(b) of the Internal Revenue Code by adding FHLBanks to the list of government agencies and government-sponsored enterprises (GSEs) authorized to provide credit enhancement for tax-exempt municipal bonds. Fannie Mae, Freddie Mac, Ginnie Mae, the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA) have been permitted since 1984 to provide such credit support. A similar provision was included in the Housing Assistance Tax Act of 2008 (H.R. 5720) that was recently approved by the House Ways and Means Committee. Enactment of this measure would help to significantly lower financing costs on public infrastructure and other projects that are the foundation for meeting community housing and economic development needs.

Home Buyer Tax Credit

Two causal factors in the current housing downturn and the related credit crunch are declining house prices and excess inventory. These elements are equally central to the outlook for the broader economy and the financial markets. Policies that stimulate home purchases in the immediate future can pay huge dividends. The biggest bang for the buck most likely would be provided by a temporary homebuyer tax credit, such as the credits approved recently by the Senate in the *Foreclosure Prevention Act of 2008* and by the House Ways and Means Committee in the *Housing Assistance Tax Act of 2008*. Indeed, the recent revival of interest among prospective buyers suggests that temporary credits could stimulate a wave of home buying that could quickly reduce excess supply in housing markets and halt the dangerous erosion of house prices and mortgage credit quality. NAHB applauds the Congress for its efforts to create a homebuyer tax credit, and stand ready to work with Congress in crafting the most effective credit to help solve the current economic crisis.

Tax credits for the purchase of a home would be very effective economic stimulus tool. They are a means of eliminating excess inventory, relieving some of the pressure on falling housing prices, and ending the waiting-on-the-sideline strategy some potential buyers have adopted in response to overly negative media stories concerning the future of the housing market. As Alan Greenspan noted in November of 2007, reducing inventory is critical for the health of the economy, and a tax credit would be the easiest and most cost effective way to achieve this goal.

What is common amongst all of the various models of a tax credit for the purchase of a home is that they represent policies that increase housing demand, thereby enabling home purchases for

families and fight falling housing prices, which threatens the economy as a whole. We recommend a targeted homebuyer tax incentive in order to maximize induced purchases. An effective temporary home buyer tax credit would restore confidence in the housing market for homeowners, homebuyers, builders and financial institutions, thereby reducing some of the factors responsible for the current credit crunch.

Expand the Net Operating Loss Deduction Carryback

Home builders, like many businesses, are now reporting financial losses when a few years ago they were generating jobs, providing local development and paying taxes. For home builders large and small the importance of the ability to claim and carry back net operating losses (NOL) deductions to years when significant taxes were paid cannot be overstated. The inability to do so will result in the need to either increase high-cost borrowing or further liquidate land and homes, which will only compound the existing inventory problem. The additional supply of homes and land on market for sale, of course, will put even more downward pressure on prices and further add to the housing crisis. Ultimately, the result of this will be more layoffs of workers and reduced development of communities.

Current law allows for a two-year carryback of NOLs, however, home builder losses began in 2006. Expanding the carryback of NOLs beyond two to years when significant taxes were paid provides financial resources to the home building sector as well as all businesses to weather the economic downturn. Further, this will help all businesses, including financial institutions and manufacturers, facing difficult economic decisions concerning employment. Finally, an expansion of the NOL carryback simply allows businesses to accelerate their claim of NOL deductions that under present law would be claimed in the future. The need for these deductions today is critical. NAHB thanks the Senate for approving a temporary expansion of the NOL carryback period to four years for tax years 2008 and 2009 as part of the *Foreclosure Prevention Act of 2008*. NAHB applauds Senators Snowe, Kerry, Coleman and Landrieu (R-ME) for their work on S. 2552, the *Small Business Stimulus Act of 2008*, which includes an expanded NOL carryback provision. These provisions will help all businesses with losses weather the economic downturn and emerge from this recession in a position to grow.

Expand the Mortgage Revenue Bond Program

The existing Mortgage Revenue Bond (MRB) program also offers a method of increasing housing demand. A special allocation of bonds to be used for either purchase or refinancing would be beneficial for housing. The MRB program allows state and local governments to issue tax-exempt debt that may be used to finance mortgages at below-market interest rates. Certain technical restrictions concerning the MRB program could also be made more flexible to enhance its use as an economic stimulus tool. These include the house price limits and the first-time home buyer requirement. Expanding the reach of the MRB program would allow it to have the largest effect, particularly for communities experiencing the possibility of a wave of foreclosures or an extreme excess of inventory. Such positive results will help reduce pressure on housing prices, thereby restoring financial institutions' confidence in the housing market and reducing the effects of the current credit crunch. NAHB thanks the Senate and the House Ways and Means Committee in approving a temporary $10 billion expansion of the MRB program. The industry looks forward to seeing it enacted into law in the near future.

Expand Small Business Expensing

Section 179 of the tax code allows small business to expense the cost of investment for business property. The Economic Stimulus Act of 2008 temporarily expanded the rules so that small businesses may expense up to $250,000 of qualified investment for tax year 2008 ($128,000 would have otherwise applied in 2008, with that amount indexed for inflation through 2011). The expensing benefit is phased-out for business incurring more than $800,000 in qualified investments in 2008 ($510,000 would have otherwise applied in 2008, with that amount indexed for inflation through 2011).

Home builders in general appreciate the opportunity that Section 179 expensing offers small businesses from both the tax policy perspective, as well as the administrative burden reduction that such rules offer. However, it is useful to remember that many builders currently have no taxable income to offset, so such investment incentives offer no effective relief. These incentives will be more important when the housing market rebounds in the future.

Conclusion

NAHB appreciates the opportunity to testify on behalf of our 235,000 members on critical issues related to small businesses impacted by the credit crunch and economic downturn. We look forward to working with the Committee, the Senate and the Congress to develop effective responses to these issues and policies to help ensure the continued viability of our nation's small businesses.