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Proposed Changes to the Conforming Loan Limit

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Summary

Two government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, buy residential mortgages from the original lenders, package them, and sell the resultant mortgage-backed securities to investors (or hold them in their own portfolios). Current law includes a conforming loan limit that puts a ceiling on the size of the mortgages that the GSEs can buy. Securitization of mortgages that exceed the limit – called jumbo loans – is performed by private financial institutions. GSE status allows Fannie and Freddie to issue debt at lower cost than other private firms; part of this subsidy is passed on to home buyers in the form of lower interest rates. Interest rates on jumbo mortgages are slightly higher than those on the conforming loans that the GSEs can purchase, although the differential is not constant over time, and reflects other factors besides the GSE subsidy.

Section 123 of H.R. 1461, the GSE regulatory reform bill, proposes to raise the conforming loan limit by up to 50% in areas with high housing prices, which would allow Fannie and Freddie to expand their operations into markets now served by private (non-GSE) institutions. If the GSEs supplant the existing securitizers of jumbo mortgage loans, some home buyers in expensive areas may experience a small reduction in their mortgage rates. Some would argue, however, that (1) the secondary market for jumbo mortgages works well without GSE participation, and that (2) because the size of GSE operations already poses a potential risk to financial stability, it would be imprudent to permit a significant expansion of their activities. This report analyzes the proposal to raise the conforming loan limit. It will be updated as legislative developments warrant.

Background

Congress set the conforming loan limit into law with the Housing and Community Development Act of 1980 (P.L. 96-399). The initial limit was set at $93,750 for a single-family home (39% above the FHA ceiling at the time), and the law provides for annual increases in the loan limit to adjust for rising prices (as reflected in a housing price index published by the Federal Housing Finance Board).[1] The loan limit was initially set at a level significantly higher than the national average home price, and with indexation it has remained higher. In 2004, the conforming loan limit stood at 116% of the average new home price, and 139% of the average resale price of an existing home.[2] For 2005, the conforming loan limit is $359,650.

P.L. 96-399 set a higher limit for mortgages on residences in Alaska, Hawaii, and Guam, all thought at the time to have higher than normal costs of building and lower than normal access to credit because of their remoteness. In those areas, the conforming loan limit was set at 150% of the limit that applied to the rest of the nation. In 1992, the Virgin Islands was added to the list of areas where the 150% limit applied.[3] In 2005, the limit for these four states and territories is $539,475.

How H.R. 1461 Would Raise the Loan Limits

Section 123 of H.R. 1461 (as reported by the House Financial Services Committee) would abandon the single conforming loan limit for the contiguous 48 states. The loan limit would be allowed to rise in metropolitan statistical areas that met the definition of "high-cost." A high-cost area would be one where the median home sale price exceeded the current conforming loan limit. That median home price would become the conforming loan limit for that metropolitan area. Increases would be capped at 150% of the statutory loan limit – the same limit that now applies to Alaska, Hawaii, and the two island territories.

A look at median prices in various metropolitan areas of the country shows that the conforming limit would rise in several places. The available data are for existing single-family home prices, collected by the National Association of Realtors, covering 134 metropolitan areas. Based on data for the first quarter of 2005, the limit would rise in 12 of the 134 areas, mainly in California and the New York City area. The 12 areas and the extent of the increase are shown in **Table 1** below.

This picture probably understates the number of areas where the conforming loan limit would rise (if H.R. 1461 were enacted in its current form), for at least two reasons. First, the data in **Table 1** reflect median prices for existing homes, while the medians for new homes are generally higher, and the designation of "high-cost area" would be based on the median of all prices in an area.

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[1] Higher limits were set for home mortgages covering 2-, 3- and 4-unit dwellings. See 12 U.S.C. 1454 for Freddie Mac and 12 U.S.C. 1717 for Fannie Mae.

[2] *The 2005 Mortgage Market Statistical Annual*, Bethesda, MD, Inside Mortgage Finance Publications, 2005, v. 1, p. 185.

[3] By Sec. 1382(k) of P.L. 102-550.

Second, the list of high-cost areas reflects only first quarter price data, while annual adjustments to the limit are based on October-to-October price changes. Thus, by the fourth quarter of 2005, the number of high-cost areas may well increase; median prices in at least three metropolitan areas fell only about 10% short of the national threshold in the first quarter.

Table 1. Metropolitan Areas Where the Conforming Loan Limit Would Rise Under H.R. 1461

Metropolitan Area	Median price as % of limit	New limit
Anaheim/Santa Ana (Orange County), CA	183%	$539,450*
Boston, MA	111%	$398,300
Los Angeles, CA	132%	$474,700
New York/N. New Jersey/Long Island, NY/NJ/CN	121%	$435,200
Bergen/Passaic, NJ	125%	$448,100
Middlesex/Somerset/Hunterdon, NJ	106%	$381,400
Nassau/Suffolk, NY	124%	$446,700
Newark, NJ	106%	$379,700
San Diego, CA	162%	$539,450*
San Francisco Bay Area, CA	192%	$539,450*
Washington, DC/MD/VA	103%	$369,000
West Palm Beach/Boca Raton/Delray Beach, FL	101%	$362,800

* mortgage amounts are rounded to the next lower $50
Source: National Association of Realtors.

The Impact of Raising the Conforming Loan Limit

The data in **Table 1** suggest the regional variation in housing prices: nationally, the conforming loan limit exceeds the average house price, but in these high-cost areas, the median home price is higher than the limit. GSE status allows Fannie and Freddie to borrow at lower interest rates than non-GSE financial institutions.[4] A portion of this subsidy is passed on to home buyers whose mortgage loans are purchased and securitized by the GSEs. The existence of high-cost housing areas implies that the benefits of that subsidy are not distributed uniformly. In 2003, Fannie and Freddie purchased 35.1% of all mortgages (by dollar value) originated nationwide. This percentage varied from state to state. In three states and the District of Columbia, the GSEs purchased less than 30% of new mortgages, and all three states (and the District) appear in **table 1** – California,

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[4] The chief financial advantage conveyed to Fannie and Freddie by GSE status is the "implicit guarantee." Although GSE debt is not explicitly backed by the full faith and credit of the Treasury, market participants believe that the government will not allow either GSE to become insolvent. Thus, GSE debt is perceived as less risky than debt issued by other firms with similar balance sheets, and investors will accept a lower interest rate. This funding advantage is effectively a subsidy, although no expenditure of taxpayer funds is involved.

New York, and Connecticut. In 15 states, on the other hand, the two GSEs purchased over 40% of new mortgages.[5]

In high-cost areas, in other words, the GSEs' mortgage purchase and securitization operations are constrained by the conforming loan limit. Loans that exceed the conforming loan limits can only be securitized by non-GSE issuers, and there is a large secondary market for jumbo mortgage loans. In 2004, total jumbo loan originations were estimated at $548 billion, while $233 billion in jumbo MBS were issued, implying a securitization rate for jumbo mortgages of 42.6%.[6] By contrast, Fannie and Freddie securitized 80.2% of loans originated in 2004 in the conventional, conforming mortgage markets where they are allowed to operate.[7]

In contrast to the secondary market for conforming loans, where the GSEs are completely dominant, dozens of issuers are active in the jumbo market. The top five issuers accounted for only 42.4% of the market in 2004.[8]

Conforming mortgage loans tend to carry lower interest rates than nonconforming loans. A number of studies have attempted to measure the spread between conforming mortgage and jumbo loan rates and the extent to which the rate differential can be attributed to the subsidy contained in GSE status.[9] Most estimates of the spread between conforming and jumbo loans fall into the range of 18-25 basis points. (A basis point is 1/100th of a percent.) All researchers assume that at least part of this spread is due to the GSE subsidy, but other factors are involved. For example, as properties become more expensive, lenders worry more about price volatility. That is, as the risk of a significant drop in the market value of the house – the loan's collateral – increases, lenders raise rates to compensate for that risk.[10] Second, the existing jumbo secondary market cannot realize certain economies of scale because market participants are generally frozen out of the conforming loan market (due to their inability to compete with the funding advantages of the GSEs). These and other factors suggest that allowing the GSEs into the jumbo

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[5] *The 2005 Mortgage Market Statistical Annual*, v. 1, p. 25.

[6] ibid., v. 2, p. 6.

[7] ibid. In addition to the jumbo market, there is a very large subprime mortgage market where GSE securitization is restricted.

[8] ibid., v. 2, p. 25. (The top five jumbo MBS issuers are Countrywide Financial, Bear Stearns, Lehman Brothers, Bank of America, and Wells Fargo.)

[9] See U.S. Congressional Budget Office, *Updated Estimates of the Subsidies to the Housing GSEs*, Apr. 8, 2004; Wayne Passmore, Shane Sherlund, and Gillian Burgess, "The Effect of Government Sponsored Enterprises on Mortgage Rates," *Real Estate Economics*, forthcoming (2005); Wayne Passmore, Roger Sparks, and Jamie Ingpen, "GSEs, Mortgage Rates, and the Long-Run Effects of Mortgage Securitization," *Journal of Real Estate Finance and Economics*, v. 25, Sep.-Dec. 2002, p. 215; Joseph A. McKenzie, :A Reconsideration of the Jumbo/Non-Jumbo Mortgage Rate Differential," *Journal of Real Estate Finance and Economics*, v. 25, Sep.-Dec. 2002, p. 197; and Brent Ambrose, Michael LaCour-Little, and Anthony Sanders, "The Effect of Conforming Loan Status on Mortgage Yield Spreads: A Loan Level Analysis," *Real Estate Economics*, v. 32, Winter 2004, p. 541.

[10] The issue of volatility is particularly important in areas where many observers believe that home prices are artificially high due to a speculative bubble.

market would not cause the entire spread to disappear. There is no consensus as to how much of the 18-25 basis point spread is due to the GSE subsidy – estimates range as low as seven basis points.[11]

Thus, it is uncertain how much benefit homebuyers would receive if the conforming loan limit were increased according to H.R. 1461. An upper bound estimate may be obtained by assuming that the interest rate on a 30-year, 6.25% mortgage of $539,450[12] is reduced to 6%. The home buyer's monthly mortgage payment of $3,324 (at 6.25%) would be reduced by about $87. Over 30 years, this reduction yields interest savings of about $31,000. Of course, this projected saving shrinks if one assumes that some portion of the rate spread will persist. If the interest rate paid by the hypothetical home buyer in the example above falls by only seven basis points, the monthly payments are lower by about $25 a month, and interest savings are about $9,000 over 30 years.

It should also be remembered that under H.R. 1461 not all mortgages in high-cost areas would become conforming loans. Loans for amounts greater than the area median house price (capped at 150% of the statutory limit) would still be treated as nonconforming. In other words, the very top end of the housing market would be unaffected by the bill's provisions.

Policy Issues

The case for raising the conforming loan limit, as H.R. 1461 would do, is based on equity concerns. Home buyers in the conforming mortgage market receive part of the GSE subsidy in the form of lower interest rates. Since housing prices vary across the nation, the geographical distribution of this benefit is uneven. The current loan limit is $359,650; in many parts of the country, this amount covers all but the top end of the housing market. In high cost areas like San Francisco or New York City, on the other hand, a large proportion of real estate transactions take place over that limit. Since current law sets a higher limit for Alaska, Hawaii, Guam, and the Virgin Islands, where housing costs are assumed to be high, why not raise the limit in other areas where prices are measurably higher?

A counter-argument is that the additional subsidy created by raising the loan limit would go overwhelmingly to mortgage holders with high incomes. If the purpose of the GSEs is to foster home ownership, the impact of raising the limit is likely to be minor: those who would benefit from the change already have high homeownership rates.

Arguments in favor of retaining the current limit are based on other concerns as well. First, there are questions involving Congress's rationale for creating the GSEs in the first place. The GSEs were intended to foster and develop a secondary market for home mortgages. That market is now well-established and does not depend on the GSEs for its continuance, despite their dominance in the parts of the housing market where they are allowed to operate. Raising the loan limit would not result in the creation of a new secondary market; it would simply allow Fannie and Freddie to expand their business at

[11] See Passmore, Sherlund, and Burgess, op. cit.

[12] Mortgages are in multiples of $50; thus, the limit is rounded to the next lower $50.

the expense of the numerous private (non-GSE) firms that now make up a competitive market.

Second, there are macroeconomic objections to increasing the government subsidy to the residential mortgage market. Any policy that directs investment to a favored sector incurs a cost: investment funds for other uses become more scarce or expensive. There is some concern – not shared by all observers – that a bubble in housing prices may be distorting investment patterns and could slow economic growth if it bursts. To the extent that a higher conforming loan limit made mortgages cheaper in the jumbo market, it would put even more upward pressure on home prices in those markets where evidence of a bubble is clearest. Of course, given the many federal programs and policies that subsidize housing, the increase in the GSE subsidy implied by a partial takeover of the jumbo market by Fannie and Freddie is not likely to bring about a major shift in investment.

The loan limit proposal raises basic economic questions about the role of GSEs. Subsidizing mortgages through GSE status creates a distortion in the market outcome. The conforming loan limit places another distortion on top of the first, by driving a wedge between market outcomes in the conforming and nonconforming markets. Raising the conforming limit reduces the second distortion but increases the size of the first distortion.[13] If one believes that the first distortion is socially desirable, then reducing the second is also desirable. However, if the first distortion – the basic GSE subsidy – is undesirable (or desirable only at the low end of the market), then reducing the second distortion (and thereby expanding the first) is economically inefficient.

Finally, there is the issue of systemic risk posed by the rapid growth of the GSEs in recent years. Financial trouble in either GSE could spill over into the many institutions that hold large quantities of GSE debt (as well as into the mortgage market). The consequences of such a crisis are unpredictable, but they include the possibility of a costly bailout by the taxpayers. As the scale of GSE operations expands, the potential for systemic disruption also increases.

In this context, Federal Reserve Chairman Alan Greenspan has often advocated a reduction in the size of the GSEs' investment portfolios. H.R. 1461 recognizes this concern by stipulating that the higher loan limit will apply only to mortgages that the GSEs securitize and sell, rather than hold in their own portfolios. However, it is not clear that this provision will prevent the GSEs from increasing their portfolios if they choose to do so: at the end of 2003, Fannie Mae held $31 billion in Freddie Mac securities, while Freddie held $75 billion in Fannie Mae obligations.[14] The language of H.R. 1461 appears to permit either GSE to hold in portfolio jumbo mortgage-backed bonds issued by the other.

[13] That is, as the scope of GSE activities is allowed to expand, the amount of the subsidy to home mortgage markets expands automatically.

[14] *The 2005 Mortgage Market Statistical Annual*, v. 2, p. 129.