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Fannie Mae and Freddie Mac: Proposals to Regulate Their Mortgage Portfolio Size in the 110th Congress

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Summary

Rising interest rates and interest rate resets on subprime adjustable rate mortgages combined with stagnant or falling home prices threaten increasing numbers of homeowners with foreclosure. Members of Congress have responded to this situation by proposing legislation that would use the congressionally chartered, stockholder-owned government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, to prod the market to provide more affordable mortgages. The GSEs have retained mortgage portfolios with a combined value of $1.4 trillion. In the 110th Congress, H.R. 1427 and S. 1100 propose changes in the rules governing the activities and regulation of Fannie Mae and Freddie Mac. H.R. 3777, H.R. 3838, and S. 2169, 110th Congress, focus on allowing the GSEs to increase their retained mortgage portfolios. S. 2036 is similar, but would also increase the maximum size of a mortgage that the GSEs can purchase.

The GSEs agreed to restrictions on their retained portfolios in 2006, following discovery of accounting and management problems. In 2007, the Office of Federal Housing Enterprise Oversight (OFHEO) denied requests from both Fannie and Freddie to raise or eliminate the caps.

The GSEs' portfolios include mortgages and mortgage-backed securities (MBS) that are subject to several types of financial risk. If these risks are not managed properly, or if market movements turn dramatically against the GSEs, the government may face two unsatisfactory alternatives: either let the GSE go into default and hope that the financial repercussions can be controlled, or step in and assume payments on the GSE debt at a significant cost to taxpayers. The GSEs and their supporters argue, on the other hand, that the profits generated by the investment portfolios enhance the GSEs' ability to support affordable housing programs and reduce mortgage interest rates.

Proponents of raising the portfolio limits or the $417,000 conforming loan limit believe that the GSEs could bring more capital to these mortgage market segments and compensate for what many analysts see as a sudden increase in the interest rate premium charge for more risky loans.

This report analyzes the advantages and disadvantages of proposals to limit portfolio size. It will be updated as warranted by significant developments.

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Background

Rising interest rates and interest rate resets on subprime adjustable rate mortgages combined with stagnant or falling home prices threaten increasing numbers of homeowners with foreclosure. Members of Congress have responded to this situation by proposing legislation that would increase the mortgage portfolios of Fannie Mae and Freddie Mac, two congressionally chartered, stockholder-owned businesses.[1] The intent is to help these homeowners by making available affordable refinancing and, in some proposed legislation, to increase the conforming loan limit (the size of mortgages that the GSEs are authorized to purchase).

Congressional — as opposed to regulatory — action to increase GSE portfolios is being considered because accounting and management problems at the GSEs led the Office of Federal Housing Enterprise Oversight (OFHEO) to limit their mortgage portfolios. The formula for the conforming loan limit (presently $417,000) is established in their charters and so legislation would be required to change it. The GSEs, which are prohibited by law from directly making mortgage loans to homeowners, purchase mortgages from the original lenders, which can make more loans. The intent of the bills is to encourage GSEs to purchase mortgages that refinance homeowners out of subprime mortgages. The GSEs would assume the risk of default by the homeowner. **Table 1** summarizes the provisions of the bills.

[1] Rep. Melissa L. Bean introduced H.R. 3777, the Protecting Access to Safe Mortgages Act, on October 9, 2007. Rep. Barney Frank introduced H.R. 3838, To temporarily increase the portfolio caps applicable to Freddie Mac and Fannie Mae, to provide the necessary financing to curb foreclosures by facilitating the refinancing of at-risk subprime borrowers into safe, affordable loans, and for other purposes, on October 16, 2007. Sen. Charles E. Schumer introduced S. 2036, the Protecting Access to Safe Mortgages Act, on September 9, 2007. Sen. Schumer introduce S. 2169, Promoting Refinancing Opportunities for Mortgages Impacted by the Subprime Emergency Act of 2007, on October 16, 2007. Unless stated otherwise, all bills in this report were introduced in the 110th Congress. Fannie Mae and Freddie Mac are known as government-sponsored enterprises (GSEs). This report will refer to them as GSEs.

Table 1. Proposed Legislation

Bill	Portfolio Increase	Conforming Loan Limit Increase
H.R. 3777	Not less than 10%. One year sunset. OFHEO may override if the increase would create a safety and soundness issue.	No provision.
H.R. 3838	Not less than 10%. 85% for subprime mortgages at risk of foreclosure. Six month sunset. No OFHEO discretion.	No provision.
S. 2036	Not less than 10% portfolio increase. 50% for subprime mortgages with reset between June 2005 and December 2009. One year sunset. OFHEO may override if the increase would create a safety and soundness issue.	Increases conforming loan limit in high cost areas for one year.
S. 2169	Not less than 10% increase. 85% refinancing subprime mortgages at risk of foreclosure. Six month sunset. No OFHEO discretion.	No provision

The conforming loan limit increases in H.R. 3777 and S. 2036 would not go into effect if the director of OFHEO certifies in writing that the increase would create an unsafe and unsound condition or significantly deplete core capital. Supporters of these bills fear that the interest rate resets will increase monthly payments beyond what borrowers can maintain. The backers also argue that there is a lack of liquidity for subprime adjustable rate mortgages, and that the GSEs would supply this liquidity if they could increase their portfolios.

This is in contrast to the debate over GSE regulatory reform legislation (H.R. 1427 and S. 1100), which would give a new regulator more authority to restrict GSE portfolios.[2] H.R. 1427 and S. 2036 would increase the maximum mortgage size that Fannie Mae and Freddie Mac can purchase in high-cost areas.

This report analyzes the issues behind these proposals.

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[2] Rep. Barney Frank introduced H.R. 1427, the Federal Housing Finance Reform Act of 2007, on March 9, 2007. Sen. Chuck Hagel introduced S. 1100, the Federal Housing Enterprise Regulatory Reform Act of 2007, on April 12, 2007. CRS Report RL33940, *H.R. 1427 and S. 1100: Reforming the Regulation of Government-Sponsored Enterprises*, by Mark Jickling, Edward Vincent Murphy, and N. Eric Weiss discusses these bills in detail.

Current Restrictions on Fannie Mae and Freddie Mac Portfolios

Fannie Mae's and Freddie Mac's charters give the government the right to regulate the GSEs in exchange for special benefits such as exemptions from state and local income taxes and a $2.25 billion "line of credit" with the U.S. Treasury. OFHEO, an independent agency within the Department of Housing and Urban Development (HUD), regulates the GSEs for safety and soundness. The Financial Institutions Regulatory Division, also a part of HUD, provides mission regulation to insure that the GSEs fulfill their public purposes.

In January 2003, Freddie Mac announced that it had understated its earnings and began the process of revising its financial statements and installing management controls to insure accurate financial reporting in the future.[3] In a restatement issued November 2003, Freddie Mac increased its net income for 2002 and earlier years by a total of $5.0 billion. As of October 2007, Freddie Mac continued to work on changes to enable it to file timely and accurate reports with the Securities and Exchange Commission (SEC). Freddie Mac has paid $125 million in civil fines, and $50 million to settle SEC charges that it fraudulently misstated earnings. In addition, Freddie Mac has paid more than $410 million to settle investor lawsuits.

In September 2004, OFHEO charged that Fannie Mae had failed to follow Generally Accepted Accounting Principles (GAAP).[4] Fannie Mae responded that its disagreement with OFHEO involved differences in interpretation of very technical rules, not improprieties. After investigating, the SEC announced that Fannie Mae's financial reports and management were inadequate and directed the GSE to restate its earnings for the previous five years. In December 2006, Fannie Mae released restated financials for 2001-2005 that reduced its earnings by $6.3 billion, and Fannie Mae subsequently paid $400 million in civil penalties.

As part of its continuing investigation and increased scrutiny, OFHEO proposed in 2006 that Fannie Mae should not increase its retained mortgage-related portfolio to more than the amount held on December 31, 2005 ($727 billion). Fannie Mae agreed. Separately, Freddie Mac agreed in a letter to OFHEO to limit its portfolio growth to 2% or approximately $28 billion annually. Without these agreements, the GSEs would be able to increase their retained portfolios as desired.

Although the GSEs' charters exempt them from filing financial statements with the SEC, both have voluntarily agreed to register one class of common stock.[5] This makes them subject to requirements to file reports with the SEC on its finances and changes in insider stock holdings. Fannie Mae, registered its common stock with the

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[3] CRS Report RS21567, *Accounting and Management Problems at Freddie Mac* by Mark Jickling contains more details.

[4] See CRS Report RS21949, *Accounting Problems at Fannie Mae*, by Mark Jickling for more details.

[5] 12 U.S.C. 1717(c)(1) exempts Fannie Mae from registering with the SEC, and 12 U.S.C. 155(g) exempts Freddie Mac.

SEC on March 31, 2003, and thus became subject to SEC reporting requirements. Fannie Mae's accounting problems have prevented it from timely filing of financial statements. For example, Fannie Mae's submitted its annual Form 10-K (a detailed annual financial report) for 2004 on December 6, 2007. By comparison, Countrywide Financial Corporation, a large mortgage lender, filed its 10-K for 2004 on March 15, 2005, almost 21 months earlier. Fannie Mae's website contains no financial reports since the second quarter of 2004. Freddie Mac voluntarily agreed to register its common stock in October 2000, but has been prevented from filing because of its accounting problems. It has never filed a 10-K with the SEC.[6]

On August 11, 2007, OFHEO denied requests from the GSEs to relax the limitations on their portfolios. OFHEO stated that sufficient progress had not been made to resume timely financial reporting (including annual 10-K and quarterly 10-Q filings with the SEC) and that management controls were not adequate for more growth.

Approximately one month later (on September 19, 2007), OFHEO announced that it was making several changes that would have the effect of allowing the GSEs to increase their retained mortgage holdings to $735 billion each and to grow beyond this.[7] First, it gave each GSE the same portfolio cap as of July 1, 2007.[8] Second, it agreed that Fannie Mae could increase its portfolio at the same rate as Freddie Mac — not more than 2% per year and not more than 0.5% per quarter. This would allow each GSE to increase its portfolio by $14.7 billion annually, or $3.7 billion quarterly. Third, for the fourth quarter of 2007 (October-December 2007), each GSE's portfolio could grow by up to 1%, but the 2% annual cap would still apply. This would allow each GSE to increase its portfolios by $7.4 billion in the last quarter of 2007. Fourth, OFHEO imposed additional reporting requirements on both GSEs.

GSE Risks

The major cost to the federal government of the GSEs is the risk of a serious financial problem that could require a government rescue of one or both GSEs. Although the GSEs' bonds are required to inform lenders that the securities are not backed by the United States government, many think there is an implied guarantee that the federal government will back the GSEs, if necessary. Since tax laws were revised to help Fannie Mae avoid becoming insolvent, there is some basis for this belief.[9]

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[6] Fannie Mae last filed a quarterly financial statement, Form 10-Q, with the SEC on August 9, 2004. Freddie Mac has never filed a Form 10-Q.

[7] Office of Federal Housing Enterprise Oversight, "OFHEO Provides Flexibility on Fannie Mae, Freddie Mac Mortgage Portfolios" September 19, 2007, available at [http://www.ofheo.gov/newsroom.aspx?ID=388&q1=0&q2=0].

[8] Historically, Fannie Mae's retained mortgage portfolio has been larger than Freddie Mac's. The difference has narrowed since the agreements on portfolio size with OFHEO.

[9] P.L. 97-372, 96 Stat.1726 et seq., "The Miscellaneous Revenue Act of 1982." See Section (continued...)

Following standard financial risk analysis, GSE risks are broken down into credit risk, prepayment risk, interest rate risk, and operational risk. These risks are discussed as they apply to the GSEs. How various legislative options would affect these risks is discussed in the analysis section, which follows.

Credit Risk. Credit risk is the risk that the borrowers (mortgagors) will not repay their loan on time. When Fannie and Freddie buy mortgages and combine them into mortgage-backed securities (MBS), they add their guarantee that the loans will be repaid on time. They charge an annual fee of about 20 basis points (0.20%) for this guarantee. In 2005, Standard & Poor's and most other major observers conclude that because of the different maturity dates, loan-to-value ratios, private mortgage insurance, and geographic diversification, credit risk was not a serious problem.[10]

Prepayment Risk. Prepayment risk is potentially more serious. This is the risk to an investor that a mortgage will be paid before its full term is concluded, leaving the investor to find another investment — perhaps when interest rates have decreased. Homeowners prepay for two major reasons: moving, and to obtain more favorable terms. Most subprime borrowers took out their mortgages anticipating prepaying. Prepayment risk falls on the ultimate holder of a mortgage or MBS. Since 1986, the GSEs have offered multiclass MBSs, which divide prepayment risk among the different classes. They are customized for investors to match their tolerance and preference for prepayment risk versus anticipated yield. When GSEs keep the MBS, they also keep this risk.

Interest Rate Risk. Interest rate risk comes from financing the MBS portfolios by borrowing money (issuing bonds), and is related to prepayment risk. In 2005, the GSEs had total debt outstanding of $1.513 trillion: Fannie had $764 billion of debt outstanding; Freddie had $749 billion. Fannie and Freddie use short-term bonds and financial derivatives to finance long-term loans. When interest rates increase, the GSEs must roll over their bonds with higher-rate ones. When interest rates decrease, homeowners prepay their mortgages, and the GSEs buy new ones at lower rates.

Interest rate risk can be very serious. Many savings and loan associations became insolvent in the early 1980s because of it. During that time, Fannie Mae's portfolio was poorly hedged. According to then-Treasury Secretary John W. Snow, "Fannie Mae became insolvent on a mark-to-market basis. Only a combination of legislative tax relief, regulatory forbearance, and a decline in interest rates allowed

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[9] (...continued)
102, titled "Adjustment to Net Operating Loss Carryback and Carryforward Rules for Federal National Mortgage Association."

[10] James R. Haggerty, "Mortgage-Securities Drop Will Depend on Economy," *Wall Street Journal*, September 17, 2005, p. B7.

Fannie Mae to grow out of its problem."[11] Despite state-of-the-art hedging today, the GSEs' portfolios continue to have significant interest rate risk.

If the GSEs have to make large adjustments to their portfolios, only very large financial institutions will be able to handle the other side of the financial transactions. If these financial institutions are unwilling or unable to take the other side of the financial transaction, the GSEs could be unable to refinance or adjust their retained mortgage portfolios.[12]

Operational Risk. Operational risk is the risk of loss due to inadequate or failed internal procedures and systems. Fannie Mae's and Freddie Mac's accounting and management problems raise questions about internal controls. Accounting systems provide the basis for portfolio adjustment decisions. If the accounting system is providing inaccurate information, the resulting portfolio adjustment decisions are likely to be incorrect.

Analysis

This section analyzes the benefits and costs of the various proposals to increase the GSEs' portfolios and to increase the conforming loan limit.

Increasing GSE Mortgage Portfolios

Some current legislative proposals would direct OFHEO to increase the ceilings on the GSEs' portfolios by at least 10%. Under H.R. 3777 and S. 2036, the director of OFHEO could certify in writing to the House Financial Services Committee and the Senate Banking, Housing, and Urban Affairs Committee that such an increase would significantly deplete capital or create an unsafe and unsound condition and reduce or eliminate the increase. H.R. 3838 and S. 2169 have no such provision.

Benefits. Proposals to increase in the GSEs' mortgage portfolios contain a requirement that a large percentage (which varies depending on the bill) would be devoted to providing subprime borrowers with a way to refinance out of their high

[11] U.S. Department of Treasury, Testimony of Secretary John W. Snow Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, "Proposals for Housing GSE Reform," press release, April 7, 2005, p. 4, available at [http://www.treas.gov/press/releases/js2362.htm].

[12] In a letter from Alan Greenspan, then-Chairman of the Federal Reserve, to the Honorable Robert F. Bennett, U.S. Senate, September 2, 2005, p. 1, available at [http://online.wsj.com/public/resources/documents/Greenspan091505.pdf]. Greenspan wrote: "Moreover, the success of interest-rate-risk management, especially the exceptionally rapid timing necessitated by dynamic risk adjustments, requires that the ultimate counterparties to the GSEs' transactions provide sufficient liquidity to finance an interest-rate-risk transfer that counters the risk. Otherwise, large and destabilizing adjustments will result in sharp changes in the interest rates required to rebalance and hedge a portfolio."

interest rate mortgages into more affordable ones.[13] The homeowners would benefit because they would keep their homes and refinance into a mortgage with lower monthly payments. Some investors holding the subprime mortgages could benefit as they get out of subprime mortgages that have a higher probability of defaulting and causing losses. Other investors, such as those expecting interest payments in later years, would suffer loses because of the prepayments. The GSEs could benefit because the new mortgages would be profitable, and the increase in their mortgage portfolio would provide additional profit.

A subprime mortgage can have a fixed rate or an adjustable rate. A fixed rate subprime can have an introductory reduced payment before becoming fully amortizing at the agreed upon fixed rate. An adjustable-rate subprime mortgage also can have an introductory teaser period (typically two or three years), before becoming fully amortizing and adjusting based on some interest rate on a stated schedule. A recent news story highlighted the case of a subprime borrower whose mortgage interest rate will increase in 2008 from 8.2% to 14%; the monthly payment will increase from $3,700 to $8,000.[14] The idea is that many subprime homeowners who cannot afford the subprime mortgage after the reset could afford the monthly payments of a traditional 30-year mortgage.

For calendar year 2007, even before OFHEO's policy changes, the GSEs could purchase and retain in portfolio approximately $320 billion in mortgages to replace those being paid off by borrowers. Fannie Mae could purchase and retain in portfolio $124 billion in mortgages and MBS.[15] Likewise, for calendar year 2007, Freddie Mac could purchase and retain in portfolio $196 billion of mortgages and MBS; $168 billion would replace those being paid off by borrowers, and $28 billion would be allowed by the 2% growth.[16] In addition, Fannie Mae and Freddie Mac can purchase without limit mortgages that they assemble in mortgage-backed securities (MBS), add their guarantees of timely payment of principal and interest, and sell to investors.

The GSEs historically have kept some types of affordable nontraditional housing loans in their portfolio because they apparently are hard to package and to sell in MBS at a price that the GSEs find attractive. Perhaps potential investors are unfamiliar with the prepayment characteristics of subprime mortgages and undervalue them out of ignorance, but the GSEs with their experience find them a

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[13] CRS reports on subprime mortgages include CRS Report RL33930, *Subprime Mortgages: Primer on Current Lending and Foreclosure Issues*, by Edward Vincent Murphy; and CRS Report RL33775, *Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets*, by Edward Vincent Murphy.

[14] Rick Brooks and Constance Mitchell Ford, "The United States of Subprime," *Wall Street Journal*, October 11, 2007, p. A1, A16.

[15] In the first half of 2007, Fannie Mae's retained mortgage portfolio experienced nearly $62 billion in liquidations. Fannie Mae's annualized liquidation rate was 17%. See, Fannie Mae, *Monthly Summary*, July 28, 2007, available at [http://www.fanniemae.com/ir/pdf/monthly/2007/063007.pdf].

[16] Freddie Mac experienced almost $84 million and its annualized liquidation rate was 24% in the first half of 2007. See, Freddie Mac, *Monthly Volume and Summary: June 2007*, available at [http://www.freddiemac.com/investors/volsum/pdf/0607mvs.pdf].

profitable investment to retain. Allowing the GSEs to retain subprime mortgages in their portfolios then would result in lower interest rates to borrowers.[17]

Supporters of relaxing the GSEs' portfolio restrictions imply that adding $320 billion to the GSEs' portfolio is insufficient without targeting subprime borrowers. To date, the GSEs have been very cautious about purchasing subprime mortgages or private-sector subprime MBS. This implies that the GSEs have analyzed the potential profit and risks of subprime loans and find them too risky to purchase and guarantee at current prices.

The GSEs might be willing to purchase subprime mortgages if there were other provisions that would make the overall change profitable after adjusting for risk and increased goodwill. For example, a statistical analysis of combined enterprise profitability reveals that between 1983 and 2001, each $1 million of MBS outstanding added $2,200 to net income (profit), but each $1 million in retained mortgages or MBS added $5,300 to net income.[18] In other words, a dollar in their retained portfolios generated more than twice as much profit as a dollar of MBS sold to other investors. This increased profit from retaining a mortgage in portfolio might be sufficient to induce the GSEs to buy risky mortgages, but only if the risky mortgages can be retained in portfolio.

In summary, if the GSEs thought that buying subprime mortgages would be profitable in their current financial and regulatory situation, they would be doing it now. Their absence from the market suggests that the GSEs do not find the profit worth the risks. A combination of raising the cap and requiring that a certain percentage of mortgages be subprime could work, but the percentage required to make profits outweigh the risk cannot be known without access to proprietary GSE data.

Allowing the GSEs to retain these mortgages would benefit subprime borrowers who are able to refinance into the new mortgages. The GSEs would either expand existing subprime affordable lending programs or create new programs. The interest rates on these loans would be higher than on prime mortgages — the higher rate would compensate for the higher risk of default — but the rates would be less than on today's subprime loans once they reset. Not every subprime borrower would qualify under the GSEs' underwriting standards.

H.R. 3777 and S. 2036 propose a temporary 10% increase in the retained portfolio caps; it is not clear what would happen at the end of the temporary period. Would the GSEs have to sell some of their portfolio to get back under their lower

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[17] In the secondary market, investors bid on mortgages taking the contracted interest rates as given. If investors want a higher yield, they offer a lower price for mortgages. Investors might demand a higher yield because the interest rates on alternative investments have increased, or because risk has increased.

[18] This relationship breaks down after 2001. It appears that the reason appears to be in part due to the restatement of earnings by the GSEs, and in part to net interest income almost doubling between 2001 and 2002. Data source: Office of Federal Housing Enterprise Oversight, *Mortgage Markets and The Enterprises in 2006*.

caps? Would the temporary caps form the basis of any future limits? Would OFHEO remove the portfolio caps altogether? OFHEO is reported to be considering removing the temporary caps in 2008 if the GSEs resume timely financial reporting, get clean audit opinions, and are found to have no material weaknesses.

Costs. The costs of increasing the GSE portfolio caps are mainly the costs of increased risk to the financial system.[19] Like all risks, these can be difficult to measure and to weigh against concrete benefits. The GSEs share many risks with all business. These risks can affect the companies, stockholders, employees, bondholders, and business partners, and because of their size, the GSEs' risks can also affect the nation's financial system and the economy. These risks can be analyzed using the four categories discussed previously.

- **Credit Risk.** By definition, subprime borrowers present lenders with higher credit risks than prime borrowers. To induce lenders to make subprime loans, a higher interest rate is required. Even with this higher interest rate, the risk of significantly higher default and loss rates is greater than for prime loans. As long as subprime loans remain a relatively small portion of the GSEs portfolios, and as long as the remainder of the GSEs business does not experience unusually high losses, there would be little risk to the federal government, but many stockholders could find the losses undesirable and sell their stock.

- **Prepayment Risk.** Little is known about subprime borrowers' propensity to prepay mortgages. Subprime loans originally were made with the hope that either borrowers would improve their credit scores, or that house prices would appreciate enough to allow them to be refinanced on more favorable terms. Since July/August 2007, refinancings have been more difficult. Investors, many of whom are Alt-A borrowers with credit between prime and subprime categories, are more likely to prepay, as many seek to hold property only for a short time. The recent mortgage market turmoil has made this strategy more difficult.

- **Interest Rate Risk.** Interest rate risk might be made more serious because the GSEs would hold the subprime mortgages in portfolio.

- **Operational Risk.** Operation risk could be increased because increasing the size of the GSEs' portfolios makes them more difficult to manage and control. This increased risk would be reduced by the GSEs ongoing efforts to improve their accounting and management controls. Subprime delinquency, default, and foreclosure could present them with new challenges as they attempt to mitigate their losses.

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[19] CRS Report RS22307, *Limiting Fannie Mae's and Freddie Mac's Portfolio Size*, by N. Eric Weiss covers the risks from the GSEs' portfolios in more detail.

Increasing the Conforming Loan Limit

Several bills would increase the conforming loan limit in high cost areas. A permanent increase would help increase homeownership in areas where housing costs are greater than the national average. Temporary increases are designed to provide temporary help to counter the recent increase in the interest rate premium on jumbo mortgages, as compared to conforming mortgages.

Benefits. H.R. 1427 would permanently increase the conforming loan limit ($417,000 in 2007 and 2008) in high cost areas, and S. 2036 would also increase it, but for one year. Both would increase the limit to the lesser of median home price in an area or 150% of the conforming loan limit ($625,500 in 2007 and 2008). CRS Report RS22172, *Proposed Changes to the Conforming Loan Limit*, by Mark Jickling finds it likely that the limit would rise in 11 of the 156 metropolitan areas, mainly in California and the New York City area.

Congress enacted the modern conforming loan limit in the Housing and Community Development Act of 1980 (P.L. 96-399, 94 Stat. 1614). The initial limit was $93,750 for a single-family home (39% above the FHA ceiling at the time), and the law provided 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 [FHFB]).[20] 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 2005, the conforming loan limit stood at 121% of the average new home price, and 135% of the average resale price of an existing home.[21]

Research has found that the spread or interest rate differential between conforming and jumbo mortgages usually is 16-40 basis points (0.16% to 0.40%).[22] Starting with the problems with subprime mortgages that occurred in August 2007, this spread widened to approximately 100 basis points (1%), and has since narrowed to a little more than half that. Allowing the GSEs to purchase these loans is likely to reduce, or perhaps eliminate, the jumbo-conforming spread on the loans that would become conforming.

Costs. One cost of raising the conforming loan limit would fall on the financial intermediaries that securitize jumbo mortgages in the geographic areas where the GSEs could become active. These financial intermediaries are likely to be unable to compete with the GSEs because they do not have the advantages of GSE status. If the increase in the conforming loan limit were to be temporary, the impact on the non-GSE mortgage securitizers would be temporary.

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[20] 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.

[21] *The 2006 Mortgage Market Statistical Annual*, Bethesda, MD, Inside Mortgage Finance Publications, 2006, vol. 1, p. 225, and the National Association of Realtors.

[22] Joseph A. McKenzie, "A Reconsideration of the Jumbo/Non-Jumbo Mortgage Rate Differential," *Journal of Real Estate Finance and Economics*, vol. 25, no.2-3 (September 2002) pp. 197-213.

Another cost comes from interfering with the normal functioning of markets. Some argue that financial markets have overreacted to problems that are confined to the subprime market and that the jumbo market for prime credit borrowers should not be affected. Be that as it may be, investors in financial markets are demonstrating that they believe jumbo mortgages are more risky. The question remains for policy makers to decide if the cost of higher jumbo rates is worth the risk to the federal government through the implicit federal guarantee supporting the GSEs. Moreover, in the normal course of economic cycles, there are variations in the spread between conforming and jumbo mortgages. Some might argue that if the spread is presently unjustified, it will quickly narrow and that no congressional action is warranted.