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 and resell them as mortgage-backed securities to investors (or hold them in their own portfolios). The law includes a conforming loan limit, a ceiling on the size of loans the GSEs can buy. Since 2006, the standard limit has been $417,000, and on November 7, 2008, the Federal Housing Finance Agency (FHFA) announced that the national conforming loan limit in 2009 would continue to be $417,000. In 2008, the Economic Stimulus Act of 2008 (P.L. 110-185) and the Housing and Economic Recovery Act of 2008 enacted higher limits in "high cost" areas. Securitization of mortgages that exceed the limit—called jumbo loans—is done 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. The spread between jumbo and conforming loan rates has been higher than normal since mid-2007.

The Economic Stimulus Act of 2008 enacted a temporary increase in the conforming loan limit. For mortgages originated between July 1, 2007, and December 31, 2008, the limit was capped at 175% of the statutory limit, or $729,750, in certain high-cost areas. The GSEs are able to purchase these conforming loans after December 31, 2008. The Housing and Economic Recovery Act of 2008 raised the limit permanently by up to 50% (that is, to $625,500) in high-cost housing areas, allowing the GSEs to expand into markets previously served by non-GSE institutions. If the GSEs supplant the existing securitizers of jumbo mortgage loans, there is likely to be some reduction of mortgage rates in high-cost areas, which will enable more prospective buyers to qualify for (or refinance) loans. Some would argue, however, that 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 implications of raising the conforming loan limit in high-cost areas. It will be updated as legislative developments warrant.

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Background[1]

Congress enacted the modern conforming loan limit in the Housing and Community Development Act of 1980 (P.L. 96-399). 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).[2] 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 2007, the conforming loan limit stood at 145% of the average new home price, and 162% of the average resale price of an existing home. Since 2006, the basic conforming loan limit has held steady at $417,000.[3]

Proposals to Raise the Loan Limits

The Economic Stimulus Act of 2008 (P.L. 110-185) enacted a temporary increase in the conforming loan limit. For mortgages originated between July 1, 2007, and December 31, 2008, the loan limit for an area was the greater of (1) the existing limit of $417,000 or (2) 125% of the area median home price, *not to exceed* a ceiling of 175% of the statutory limit, or $729,750. The list of affected areas is available at http://www.ofheo.gov/media/hpi/AREA_LIST.pdf. A total of 71 metropolitan and micropolitan statistical areas had higher 2008 conforming loan limits, including 224 counties and cities not in counties. There are 21 counties outside of metropolitan or micropolitan areas with increases.

The Housing and Economic Recovery Act of 2008 (H.R. 3221, P.L. 110-289) permanently removes the single conforming loan limit for the contiguous 48 states. The loan limit will be allowed to rise in metropolitan statistical areas—defined as "high-cost"—where the median home sale price exceeds the current conforming loan limit. The conforming loan limit for that area will be 115% of the median home price in the area, except that increases would be capped at 150% of the statutory loan limit (the limit that now applies to Alaska, Hawaii, and the two island territories). This system for determining the limit took effect when the temporary limits set by the stimulus act expired on December 31, 2008. The GSEs are able to purchase high-cost conforming loans after December 31, 2008, subject to the requirement in their charters that loans purchased be no more than one year old.

A look at median prices in various metropolitan areas of the country shows that the conforming limit is rising in several localities under P.L. 110-185, and (in fewer areas) has risen under P.L. 110-289. The available data are for existing single-family home prices, collected by the National

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[1] Barbara Miles, former Specialist in Financial Institutions, contributed to this report.

[2] 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.

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

Association of Realtors, covering 156 metropolitan areas. Based on data for the third quarter of 2007, the impact on several areas is shown in **Table 1** below.

Table 1. Selected Areas Where Conforming Loan Limit Would Rise

High-Cost Housing Area	New Loan Limit	
	P.L. 110-185	P.L. 110-289
Barnstable Town, MA	$462,500	$417,000
Boston/Quincy/Cambridge, MA	$523,750	$465,750
Boulder, CO	$460,000	$417,000
Bridgeport/Stamford/Norwalk, CT	$708,750	$511,750
Los Angeles/Long Beach/Santa Ana, CA	$729,750	$625,500
Miami/Ft. Lauderdale, FL	$423,750	$417,000
New York City/N. NJ/Long Island, NY/NJ	$729,750	$625,500
Newark/Union, NJ	$729,750	$625,500
Riverside/San Bernardino, CA	$500,000	$417,000
Sacramento/Arden/Arcade/Rosedale, CA	$580,000	$474,950
San Diego/Carlsbad/San Marcos, CA	$697,500	$546,250
San Francisco/Oakland, CA	$729,750	$625,500
San Jose/Sunnyvale/Santa Clara, CA	$729,750	$625,500
Seattle/Tacoma/Bellevue, WA	$567,500	$506,000
Washington, DC/MD/VA	$729,750	$625,500

Source: Loan limits (P.L. 110-185) are from Office of Federal Housing Enterprise Oversight, *Metropolitan Statistical Areas, Micropolitan Statistical Areas and Rural Counties where Loan Limits are Set Based on High-Cost Area Provisions of HERA*, available at http://www.ofheo.gov/media/hpi/AREA_LIST.pdf.

The Impact of Raising the Conforming Loan Limit

The existence of high-cost housing areas implies that the benefits of the GSE subsidy are not distributed uniformly. 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. 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 (and the District) appear in **Table 1**—California, New York, and Connecticut. In 15 states, on the other hand, the two GSEs purchased over 40% of new mortgages.[5]

[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.

[5] *The 2006 Mortgage Market Statistical Annual*, vol. 1, p. 25.

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 2006, total prime jumbo loan originations were estimated at $480 billion, while $219 billion in prime jumbo mortgage-backed securities (MBS) were issued, implying a securitization rate for jumbo mortgages of 45.6%.[6] By contrast, Fannie and Freddie securitized 83% of loans originated in 2006 in the conventional, conforming mortgage markets where they are allowed to operate.[7]

Unlike the secondary market for conforming loans, where the two GSEs are dominant, dozens of private issuers are active in the "non-agency" market. The top ten issuers accounted for only 59.0% of the market in 2007.[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 18-60 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. Second, the existing jumbo secondary market cannot realize certain economies of scale because market participants are largely frozen out of the conforming loan market (due to their inability to compete with the GSEs). These and other factors suggest that allowing the GSEs into the jumbo market would not cause the entire spread to disappear. There is no consensus as to how much of the 18-60 basis point spread is due to the GSE subsidy—estimates range as low as four basis points.[10]

Thus, it is uncertain how significant the benefits would be if the conforming loan limit were increased during normal times. As a rough guide to the size of potential savings, assume that the interest rate on a 30-year, 6.25% mortgage of $625,500 is reduced to 6%. The home buyer's monthly mortgage payment of $3,851 (at 6.25%) would be reduced by about $100. Over the 10-year average life of a loan, this reduction yields interest savings of about $15,500. Of course, this figure shrinks if some portion of the rate spread persists, if, that is, not all the savings are passed through to borrowers. If the interest rate paid by the hypothetical home buyer in the example

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[6] *The 2008 Mortgage Market Statistical Annual*, vol. 2, p. 3.

[7] Ibid.

[8] Ibid., vol. 2, p. 16. (The top five non-GSE MBS issuers in 2007 were Countrywide Financial, Lehman Brothers, Wells Fargo, Washington Mutual, and Bear Stearns. At the end of 2008, only Wells Fargo was an independent company.)

[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,* vol. 33, fall 2005; Joseph A. McKenzie, "A Reconsideration of the Jumbo/Non-Jumbo Mortgage Rate Differential," *Journal of Real Estate Finance and Economics*, vol. 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*, vol. 32, winter 2004, p. 541.

[10] See Passmore, Sherlund, and Burgess, op. cit., and Lehnert, Passmore, and Sherlund, *GSEs, Mortgage Rates, and Secondary Market Activities*, Finance and Economics Discussion Series, Federal Reserve, 2006-30. The latter paper found no significant effect on mortgage rate spreads.

above falls by only seven basis points, the monthly payments are lower by about $28 a month, and interest savings would be about $4,400 over 10 years.[11]

With the housing market downturn that began in 2006, there is a new rationale for raising the conforming loan limit: to stimulate the jumbo mortgage market, which would in turn provide stimulus for the housing sector and the economy. Credit conditions in the jumbo market are said to be unusually tight—the spread between jumbo and conforming loan rates has widened, exceeding 150 basis points at the end of 2008. High rates price many would-be buyers out of the market: in an environment of falling prices, lenders are less willing to make loans, especially the kinds of interest-only and negative amortization mortgages that sustained the boom.

Pressure on lenders is intensified by weakened demand for mortgage-backed securities (MBS) in the secondary market. Investors have seen many subprime MBS lose much of their value, and are reluctant to purchase bonds, with the exception of those issued by Fannie or Freddie, who guarantee timely payment of interest and principal, and are backed by the "implicit guarantee"[12] of their GSE status, which was underlined by the provisions in P.L. 110-289 that authorized the Treasury to purchase any amount of GSE debt or equity securities. It is hoped that allowing the GSEs to securitize some jumbo loans will restore liquidity to the secondary market, enable lenders to transfer the risk of holding jumbo mortgages, and make loans more affordable and available. The GSEs' conservatorship would appear to provide Treasury backing for GSE debt, but not for stockholders. For more information on the GSEs' conservatorship, see CRS Report RS22950, *Fannie Mae and Freddie Mac in Conservatorship*, by Mark Jickling.

Policy Issues

The case for raising the conforming loan limit is based partly on equity concerns. Home buyers in the conforming mortgage market may 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. Before the recent increases, the loan limit was $417,000; 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 well 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 high-price areas?

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

[11] Note also that under P.L. 110-185 not all mortgages in high-cost areas would become conforming loans. Loans for amounts greater than 150% or 175% of the statutory limit would still be treated as nonconforming. In other words, the top end of the housing market would be unaffected by the bills' provisions. Also, during the mortgage market turmoil of 2008, the difference in interest rates for conforming loans and jumbo loans that were not GSE-purchasable frequently was more than one percentage point. There was some evidence that there was no difference in rates on jumbos that the GSEs could purchase (e.g., $500,000 in the Washington, D.C., area) and jumbos that the GSEs could not purchase (e.g., $800,000).

[12] GSE debt is not explicitly backed by the full faith and credit of the government, but bond buyers do not believe that the Treasury will allow either GSE to default. This is called the "implicit guarantee." As a result, investors view GSE-issued MBS as less risky than debt issued by other firms, even when the credit quality of the underlying mortgages is no better.

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.

Another key issue is risk. As noted above, the jumbo home market is in trouble because perceptions of risk are sharply higher than they were during the boom. Lenders are more cautious because the value of their collateral—the house—may drop significantly. MBS investors have the same fear, making it harder for lenders to transfer price and credit risk to the secondary market. GSE entry into the jumbo market would appear to meet the needs of both lenders and investors: the GSE (and the implicit Treasury) guarantee would reassure MBS buyers, leading to a resumption of securitization, in turn encouraging lenders to make loans at more affordable rates.

But GSE participation would not reduce overall risk in the market. If house prices continue to fall, and delinquencies and foreclosures continue to rise, the kinds of multi-billion dollar losses that have been reported in recent months could fall upon the GSEs. Could they withstand those losses, or would the Treasury be forced to engineer a bailout to prevent a default that could be highly destabilizing to the global financial system? What is the potential cost of such an intervention to the taxpayers?

These questions cannot be answered with certainty, but it is worth noting that the systemic risk posed by the rapid growth of the GSEs in recent years has been a major issue in the debate over GSE reform. Former Federal Reserve Chairman Alan Greenspan and others have called for a reduction in size of the GSEs' investment portfolios (currently about $1.4 trillion) on the grounds that they represent an unacceptable concentration of financial risk in two companies whose financial controls have been shown to be weak. As director of OFHEO, FHFA director James Lockhart has argued against raising the conforming loan limit unless the GSE regulator also receives enhanced safety and soundness powers.[13]

If the current tightness in the jumbo loan market reflects an over-reaction on the part of market participants in the grip of panic, some argue that an increase in the conforming loan limit may be a useful corrective and avert unnecessary damage to housing markets and the economy. On the other hand, if market fundamentals dictate that home prices still have a long way to fall, the assumption of more risk by the GSEs (and, more or less implicitly, by the Treasury) could arguably slow the market adjustment process and foster an unwelcome expectation in financial markets that they will always be rescued from the consequences of their own mistakes.

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[13] "Statement on Conforming Loan Limit Increase," Jan. 28, 2008, at http://www.ofheo.gov.