Policy Briefs

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Conforming Loan Limits

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Abstract

The Conforming Loan Limit (CLL) and the government-sponsored enterprises bound by the CLL experienced significant changes in 2008 as a result of the mortgage market turmoil and the resultant legislation passed by Congress and signed by President George W. Bush. This policy brief outlines the changes to the CLL and the debate that surrounded those changes.

Introduction

Mortgage markets were extremely volatile in 2007 and 2008. The turmoil began in the summer of 2007 as subprime mortgage delinquency and default rates increased to historic levels. In the spring of 2008, as house prices in many markets continued to decline and mortgage lenders absorbed unprecedented losses, Congress passed and President George W. Bush signed the Economic Stimulus Act of 2008, granting tax rebates to U.S. households and establishing a temporary Conforming Loan Limit (CLL) in high-cost areas through the end of 2008 of 175 percent of the 2008 CLL. The CLL is the maximum principal balance that Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation) may purchase. A main objective of the increase in the CLL was to increase the availability of credit because the market for jumbo mortgages had severely tightened.

In the summer of 2008, Congress passed and the President signed the Housing and Economic Recovery Act of 2008 to create a new, stronger regulator for Fannie Mae and Freddie Mac and to permanently increase the ceiling on conforming mortgages for 2009 to 150 percent above the 2006–08 CLL. In the fall of 2008, as economic and housing market conditions continued to deteriorate, the federal government placed Fannie Mae and Freddie Mac into conservatorship.

The events of 2007 and 2008 have highlighted the role that Fannie Mae, Freddie Mac, and the CLL play in U.S. mortgage and housing markets. The events also raise questions surrounding the CLL. What motivated the increase in the CLL? What were the arguments for and against raising the CLL? What benefits were expected from the higher CLL? This policy brief will present the history of the CLL and the pros and cons of raising the CLL.

Background and History of Fannie Mae, Freddie Mac, and the Conforming Loan Limit

The Federal National Mortgage Association Act and the Federal Home Loan Mortgage Corporation Act, and subsequent amendments, created Fannie Mae and Freddie Mac, respectively, as corporations chartered by Congress to do, among other things, the following:

- Provide stability in the secondary market for residential mortgages.
- Provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.
- Promote access to mortgage credit throughout the nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.[1]

Since Congress's authorization in 1970 of Fannie Mae and Freddie Mac to purchase conforming mortgages Fannie Mae and Freddie Mac have played a critical role in U.S. mortgage markets by purchasing mortgage loans; packaging them into mortgage-backed securities (MBS), which are enhanced with their credit guarantee of timely payment of principal and interest; and selling them to investors in the capital markets. By purchasing and securitizing mortgages, Fannie Mae and Freddie Mac replenish the money used to fund the original mortgages so that originators can fund additional mortgages. As government-sponsored enterprises, Fannie Mae and Freddie Mac have been able to access funds at lower cost than other private entities, which allows them to purchase mortgages from loan originators at terms more favorable than those offered by private entities. Thus, mortgage originators prefer to sell conforming mortgages to Fannie Mae and Freddie Mac and generally offer more attractive terms to conforming borrowers.

Before the events of 2008, mortgage markets in the United States could be broken down into conventional (nongovernment-guaranteed) and government-guaranteed (Federal Housing Administra-

[1] See the Federal National Mortgage Association Act (12 U.S.C. 1716 to 12 U.S.C. 1723i) and the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1451 to 12 U.S.C. 1459).

tion [FHA], Department of Veterans Affairs, and Rural Housing Service) mortgage markets. Fannie Mae and Freddie Mac operated within the conventional mortgage market, where they purchased mortgages with principal balances less than or equal to the Conforming Loan Limit from loan originators in secondary mortgage markets for securitization and sale. Conventional mortgage loans with a principal balance above the CLL and known as “jumbo loans” or “jumbo mortgages” were either held in portfolio by the mortgage originator or sold to a private securitizer to pool with other jumbo loans for sale to investors as private-label MBS.

In 1970, the maximum loan amount that the Federal Housing Administration (FHA) could insure or a federally insured savings and loan association (thrift) could grant was $33,000. Fannie Mae and Freddie Mac were subject to the same maximum loan purchase limit.[2] The Housing and Community Development Act of 1974 increased Fannie Mae and Freddie Mac’s CLL to $55,000—the ceiling on loans federally insured by thrifts. In an effort to accommodate lending in higher cost areas, the Housing and Community Development Act of 1977 reset the CLL to 125 percent of the ceiling on thrifts, or $75,000. In 1979, the ceiling on thrifts was increased to $75,000, increasing the CLL to $93,750.[3] In 1980, Congress deregulated the thrift industry and repealed the loan ceiling on thrifts, inadvertently eliminating the CLL. Several months later, Congress amended the Housing and Community Development Act of 1980 to reestablish the CLL and allow for annual adjustments reflecting changes in average single-family home purchase prices.[4] The CLLs for single-unit, single-family homes for 1980 through the beginning of 2008 are shown in exhibit 1.[5]

Recent Regulatory Changes

In the first 9 months of 2008, the federal government took three significant regulatory actions regarding Fannie Mae, Freddie Mac, and the CLL.

First, on February 13, 2008, President Bush signed H.R. 5140, the Economic Stimulus Act of 2008, into law. The law temporarily increased the CLL above the national limit of $417,000 to as high as $729,750 in the highest cost areas through December 31, 2008.[6]

[2] Although the Economic Stimulus Act of 2008 and the Housing and Economic Recovery Act of 2008 raised the maximum FHA loan limit to parity with Fannie Mae and Freddie Mac’s CLL, historically, the maximum FHA loan limit and the Fannie Mae and Freddie Mac CLL have differed. From 1998 until enactment of the Economic Stimulus Act of 2008, the maximum FHA loan limit was set at 87 percent of the CLL. Before 1998, the FHA loan limit equaled a lower percentage of Fannie Mae and Freddie Mac’s CLL or was set independent of the CLL.

[3] At the same time, the maximum loan limit for FHA loans in high-cost areas was also raised to the lesser of 95 percent of the local median home sales price or $90,000. The statutory dollar maximum was raised in 1987 and again in 1992 before becoming indexed at 75 percent of the CLL in 1994 and subsequently increased to 87 percent of the CLL in 1998. The Economic Stimulus Act of 2008 and the Housing and Economic Recovery Act of 2008 raised the maximum FHA loan limit to parity with Fannie Mae and Freddie Mac’s CLL.

[4] For more information about the history of the CLL, see ICF Incorporated (1990).

[5] In addition, CLLs exist for two-, three-, and four-unit single-family loans. The two-, three-, and four-unit single-family CLLs are 28.0, 54.7, and 92.2 percent, respectively, above the single-unit CLL in any given year.

[6] In metroplitan statistical areas where 125 percent of the local median house price was between the national limit of $417,000 and the highest limit of $729,750, the CLL was set to 125 percent of local median value.

Exhibit 1

Historical Conforming Loan Limits (Single Unit)

Single-Family Conforming Loan Limits					
Year	Limit ($)	Year	Limit ($)	Year	Limit ($)
2008*	417,000	1999	240,000	1989	187,600
2007	417,000	1998	227,150	1988	168,700
2006	417,000	1997	214,600	1987	153,100
2005	359,650	1996	207,000	1986	133,250
2004	333,700	1995	203,150	1985	115,300
2003	322,700	1994	203,150	1984	114,000
2002	300,700	1993	203,150	1983	108,300
2001	275,000	1992	202,300	1982	107,000
2000	252,700	1991	191,250	1981	98,500
		1990	187,450	1980	93,750

** The 2008 Conforming Loan Limit (CLL) was established at $417,000; however, the Economic Stimulus Act of 2008, signed into law on February 13, 2008, established a temporary CLL of up to $729,750 through December 31, 2008. The CLL in Alaska, Guam, Hawaii, and the U.S. Virgin Islands is 50 percent higher than the standard CLL.*

Second, on July 30, 2008, President Bush signed H.R. 3221, the Housing and Economic Recovery Act of 2008, into law. The new law provided a permanent authorization for a CLL of 115 percent of the local median house price if in excess of the standard national limit of $417,000 up to a maximum of 150 percent of the standard national limit, or $625,500, in high-cost areas, effective January 1, 2009, when the temporary loan limits enacted by the Economic Stimulus Act of 2008 expire.[7]

Finally, on September 7, 2008, Treasury Secretary Henry M. Paulson, Jr., and Federal Housing Finance Agency Director James B. Lockhart III announced that, in order to help restore confidence in Fannie Mae and Freddie Mac, enhance their capacity to fulfill their mission, and mitigate systemic risk, the government was placing Fannie Mae and Freddie Mac into conservatorship of its new regulator, the Federal Housing Finance Agency. In this case, conservatorship is defined as "the legal process in which a person or entity is appointed to establish control and oversight of a Company to put it in a sound and solvent condition. In a conservatorship, the powers of Company directors, officers, and shareholders are transferred to the designated Conservator," the Federal Housing Finance Agency.[8]

These three events have brought significant attention to Fannie Mae, Freddie Mac, and the CLL. As previously noted, the CLL increased from $33,000 in 1970 to $417,000 at the beginning of 2008, to a temporary high of $729,750 in some high-cost areas through the end of 2008, and then to a new permanent loan limit of up to $625,500 in the highest cost areas beginning January 1, 2009. Some observers suggest the need for a higher CLL, while others contend that a higher CLL would unnecessarily increase Fannie Mae's and Freddie Mac's risk and cause Fannie Mae and Freddie Mac

[7] The standard national loan limit, of course, remained indexed for year-to-year general house price increases.

[8] See Federal Housing Finance Agency (2008).

to move further away from their mission of increasing availability of affordable housing. The next two sections present arguments advanced for and against higher CLLs.

Arguments for a Higher Conforming Loan Limit

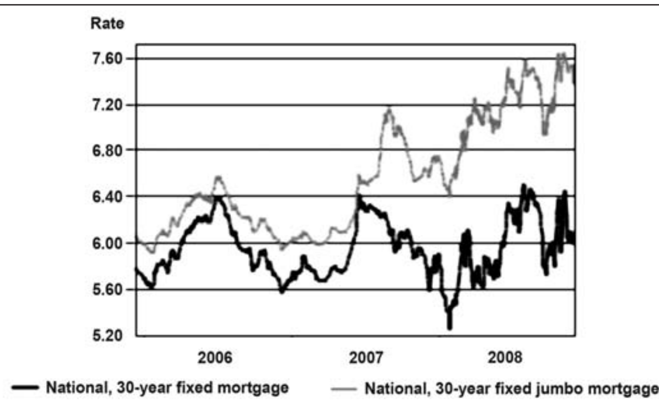
Home builders, mortgage originators, consumer advocates, and others have argued that the CLL should be higher in order to increase access to the benefits of borrowing in the conforming market. Three of the main arguments are presented below.

Higher CLL Lowers Borrowing Costs

Interest rates on 30-year, fixed-rate conforming mortgages have traditionally been lower than interest rates on 30-year, fixed-rate jumbo mortgages, and numerous studies have verified existence of a jumbo-conforming differential, which has been estimated at 10 to 60 basis points.[9] Starting in the summer of 2007, the jumbo-conforming differential widened from its traditional range of 10 to 60 basis points to approximately 100 basis points, as shown in exhibit 2. This widening was more than a 10-fold increase from the jumbo-conforming differential experienced just a few months earlier, and the persistence of that widened differential throughout the remainder of 2007 and into 2008 prompted Congress and the President in early 2008 to enact the Economic Stimulus Act of 2008. The Act temporarily increased the CLL with the aim of restoring access to affordable interest rates for borrowers in high-cost housing markets. Thus, a primary reason for raising the CLL was to ameliorate the weakening confidence in the jumbo loan market and restore the traditional near parity with Fannie Mae and Freddie Mac interest rates for homebuyers requiring mortgages between $417,000 and $729,750.

Exhibit 2

Conforming and Jumbo Mortgage Rates



Source: Bankrate, Inc. (2008)

[9] For more information about jumbo-conforming interest rate differentials, see Congressional Budget Office (2001).

Higher CLL Increases Liquidity

In the first quarter of 2008, federal agency (Fannie Mae, Freddie Mac, and Ginnie Mae[10]) MBS issuance accounted for more than 80 percent of total U.S. MBS issuance.[11] Because the conforming market is characterized by high-volume, fairly standardized, agency-backed mortgages, its MBS are easily tradable and very liquid, resulting in lower costs to originators and borrowers of conforming mortgages. Therefore, allowing mortgages that were formerly jumbo loans to be pooled into MBS with other conforming mortgages under a higher CLL should be expected to increase liquidity and reduce costs for borrowers in higher cost areas.

Higher CLL Increases Affordability and Equity in High-Cost Areas

Borrowers in high-cost housing markets, such as San Francisco and New York City, are generally excluded from the conforming mortgage market because of the uniformly high home prices in these markets. Proponents of a higher CLL have argued that this results in unfair treatment of borrowers in high-cost markets, because only a small percentage of borrowers in these markets qualify for conforming mortgages and their associated lower interest rates, while an overwhelming majority of borrowers qualify for conforming mortgages in lower cost housing markets, such as Memphis or Pittsburgh. Thus, politicians and interest groups in high-cost markets have argued that the CLL should be raised to reflect higher home values in higher cost metropolitan statistical areas (MSAs) to improve affordability (in terms of lower interest rates) and equity (in the form of equal mortgage terms for relative equals) across U.S. housing markets.

Arguments Against a Higher Conforming Loan Limit

Although the merits of a higher CLL have been argued, significant arguments have been made against a higher CLL. Arguments against a higher CLL, including that a higher CLL would shift Fannie Mae's and Freddie Mac's focus away from their affordable housing mission and that a higher CLL would expose Fannie Mae and Freddie Mac to additional and uncertain risks, are presented below.

Higher CLL Does Not Support Affordable Housing Mission

Congress created Fannie Mae and Freddie Mac to expand homeownership opportunities and affordability for low- and moderate-income families. Government sponsorship allows Fannie Mae and Freddie Mac to borrow funds and sell securities at more favorable interest rates than nongovernment-sponsored entities, thereby allowing them to accept lower yields (bid higher prices) on mortgages and still remain profitable. Thus, originators can offer lower rates to attract borrowers and profitably sell the mortgages to Fannie Mae and Freddie Mac. Critics contend that the lower interest rates represent a government subsidy that is available only because of perceived

[10] Ginnie Mae (the Government National Mortgage Association) is a government-owned corporation within the U.S. Department of Housing and Urban Development.

[11] See "Inside Mortgage Finance," cited in Securities Industry and Financial Markets Association (SIFMA) testimony, May 22, 2008.

government backing of Fannie Mae and Freddie Mac with its associated contingent liability borne by the U.S. government. Moreover, critics argue that federal subsidies should be reserved for households with low and moderate incomes (on a national rather than area-specific basis) so that raising the CLL in higher cost MSAs would be equivalent to granting a federal subsidy to higher income households who should not be receiving a subsidy.

Higher CLL Has a Negative Effect on Secondary Market Competition

Critics also argue against raising the CLL because broadening the scope of Fannie Mae and Freddie Mac would further preempt secondary market activity by private conduits. That is, Fannie Mae and Freddie Mac's government backing gives them unfair competitive advantages, as outlined above, that prevent development of private conduits in the secondary mortgage market except for jumbo market lending, above the CLL, or subprime and Alt-A lending, in which underwriting practices prevent Fannie Mae's and Freddie Mac's participation. Thus, raising the CLL would shrink the size of the nongovernment-sponsored mortgage market, further reducing incentives for private conduit participation in secondary mortgage markets. Of course, the current nonprime mortgage credit meltdown and the breakdown of the market for nonagency MBS has made the issue moot.

Higher CLL's Jumbo Loans Pose Unknown Risks

Fannie Mae and Freddie Mac have substantial experience with conforming loans but little experience with nonconforming loans. History has shown higher balance loans respond differently than lower balance loans to changes in interest rates; that is, for a given decrease in interest rates, higher balance loans are more likely to prepay.[12] Similarly, borrowers with higher balance adjustable rate loans may be more likely to default when rates increase compared with lower balance borrowers because of the larger dollar value of payment increases on higher balance loans.[13] Jumbo mortgages have different prepayment and credit risks, as well as differing geographic concentrations from traditional conforming loans; for example, roughly half of all jumbo mortgages are in California.[14] The higher volatility, different behavior, and different borrower characteristics of higher balance loans may pose unknown risks to the safety and soundness of Fannie Mae and Freddie Mac. Opponents of higher CLLs claim that current mortgage market conditions and the troubled status of Fannie Mae and Freddie Mac make it a bad time to expand Fannie Mae's and Freddie Mac's exposure to new mortgage products.

Higher CLL's Jumbo Loans May Distort Secondary Mortgage Pricing

Many of Fannie Mae's and Freddie Mac's MBS are sold into the To Be Announced (TBA) market. In the TBA market, contracts are signed for the exchange of MBS at a future date. The identities of the specific mortgage pools, however, remain unknown at the time of the agreement. The TBA market operates on the assumption of homogeneity of the underlying mortgage assets. One argument

[12] See SIFMA testimony, May 22, 2008.

[13] See Congressional Budget Office (2001).

[14] See "Reforming the Regulation of the Government Sponsored Enterprises," Office of Federal Housing Enterprise Oversight (OFHEO) Director James B. Lockhart III testimony, February 7, 2008.

against higher CLLs is that they could introduce mortgages into the TBA market with materially different risk and prepayment characteristics from current conforming mortgages. Thus, increasing the CLL would introduce more uncertainty to the TBA secondary mortgage market, which could reduce investor appetite for Fannie Mae and Freddie Mac MBS and both increase the cost and reduce the availability of funds for current conforming borrowers. One way to address this concern would be to limit the volume of jumbo-conforming mortgages that can be included in TBA pools, which is indeed what happened following enactment of the Economic Stimulus Act of 2008.[15]

Higher CLL Increases Interest Rates on Current Conforming Loan Borrowers

A main argument for a higher CLL is that it would reduce borrowing costs to the former jumbo-loan borrowers brought under the new CLL. Opponents contend that, although the former jumbo-loan borrowers would benefit, their benefit would come at the expense of higher rates for existing conforming borrowers. Critics say the higher risk and uncertainty associated with the new jumbo-conforming loans will necessitate an increase in conforming interest rates to compensate for the new, higher risk profile of the average conforming loan. Thus, the affordability of lower principal balance loans, presumably to lower income borrowers, would deteriorate. Opponents of a higher CLL contend that this tradeoff is not worth making.

Expected Effects and Effects to Date From Higher Conforming Loan Limits

The temporary higher CLLs in high-cost areas that expired December 31, 2008, and the permanent higher CLLs in high-cost areas that took effect January 1, 2009, were expected to achieve multiple objectives. Higher CLLs were expected to increase liquidity, reduce interest rates, and increase availability of credit for jumbo loans. The market turmoil, placement of Fannie Mae and Freddie Mac into conservatorship, credit tightening, and numerous bank failures and mergers since the passage of the Economic Stimulus Act of 2008 have made it difficult to assess the effect of the higher CLLs in the short run. As shown in exhibit 2, the interest-rate spread between 30-year conforming and 30-year jumbo mortgages, although stable through the middle of 2007, widened outside its traditional range in the middle of 2007 and has remained in its new range through the third quarter of 2008. Borrowers recently brought under the CLL as a result of the Economic Stimulus Act of 2008 appear to be benefiting from lower conforming interest rates, whereas borrowers above the new CLL have faced higher rates over the 12 months ending the third quarter of 2008.

[15] Good Delivery Guidelines, which are published by SIFMA for the TBA market, outline criteria for inclusion of individual loans in mortgage pools sold in the TBA market. Following passage of the Economic Stimulus Act of 2008, SIFMA's updated guidelines restricted eligible original loan balances to $417,000 due to the temporary nature of the higher temporary CLLs enacted by the Act. Following passage of the Housing and Economic Recovery Act of 2008, SIFMA updated the Good Delivery Guidelines to make higher balance loans eligible in TBA pools but limited their inclusion to 10 percent of the total balance of the pool submitted for TBA delivery.

Conclusion

On February 13, 2008, a temporary higher CLL in high-cost areas was established through December 31, 2008, and on July 30, 2008, a permanent higher CLL in high-cost areas was established to begin January 1, 2009. Short-run effects of the higher CLL in 2008 have been lower borrowing costs for borrowers seeking "conforming jumbo"[16] mortgages. Long-run effects of the higher CLL on conforming borrowers, conforming jumbo borrowers, U.S. housing and mortgage markets, the U.S. economy, and Fannie Mae and Freddie Mac will be determined over the coming years. Although exhibit 2 indicates that the higher CLL has not raised borrowing costs for traditional conforming borrowers through the third quarter of 2008, future research on the effect of the higher CLL, with controls for other relevant variables, would be valuable.

Acknowledgments

The author thanks Bill Reeder, Mark Shroder, and Kurt Usowski for valuable comments and suggestions.

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[16] Mortgages with principal balances above the 2008 CLL of $417,000 and less than or equal to the temporary higher CLL of $729,750 are often referred to as "conforming jumbo" loans.