Another Kick in the Teeth: Loan Limits and the Housing Market

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For weeks, August 2—the date on which the U.S. Treasury might have defaulted on its debts—was the deadline that drove policymakers toward a deal on raising the debt ceiling and lowering the nation's spiraling debt and deficits.

Another pending deadline—October 1—has won far less attention. But it too could have far-reaching impacts on the U.S. economy if Congress allows it to expire.

This date is when the maximum size of a mortgage loan (the "loan limit") that can be insured by the Federal Housing Administration (FHA) or bought by government-sponsored mortgage giants Fannie Mae and Freddie Mac (the GSE's) drops significantly. On October 1, these loan limits will fall in 669 counties in 42 states and the District of Columbia, with an average reduction of more than $50,000 and in some cases by more than $100,000.[1] In these areas, many prospective homebuyers once eligible for an FHA loan would no longer qualify, while others may face the prospect of a higher-cost "jumbo" loan.

The result could be the potential sidelining of a key segment of homebuyers, which in turn would further weaken demand, depress home prices and drop another wet blanket on consumer confidence as Americans continue to watch their home equity evaporate. Needless to say, this is the last thing the housing market or the economy needs as it struggles toward recovery.

Without question, government should ultimately pare back its involvement in the housing market and let private capital play the leading role. But this should also happen when the markets are ready, not according to an arbitrary timetable. Unfortunately, the initial conditions that warranted the current loan limits in the first place have not improved substantially. Nor does it seem private sources are ready to jump in if government support were to end.

By further weakening the housing market, a premature drop in the current FHA and GSE loan limits could also dampen the outlook for the broader economy. This policy brief makes the case for continuing these limits at their current levels past October 1.

FHA, Fannie and Freddie: Crutches for an Ailing Market

There are two reasons why a pullback in government support—which a drop in loan limits would be—could be destructive to the market and the economy.

First, the nation's housing market is still far from healthy and vulnerable to potential shocks:

- Through July, seasonally adjusted new home sales for the year have totaled just 298,000—less than half of the 700,000 annual sales that economists say are typical of a healthy market. The pace of sales is below even that of 2010, the worst year since 1963.[2]
- Home prices are now close to pre-bubble levels. The current median price of an existing home is $174,800—almost exactly where it was in 2004 before the run-up in prices and almost $90,000 below their peak. At the height of the bubble in March 2007, median existing home values soared to $262,600.[3]

Congress first raised the FHA and GSE loan limits in 2008 to mitigate the "credit crunch" resulting from the loss of private capital—a role these agencies are still performing two years later.

Second, the FHA and GSEs are so deeply intertwined in the market's health that any major change in policy could have wide impact:

- In the first quarter of 2011, the GSEs accounted for fully *97 percent* of all mortgage-backed securities issued into the secondary market.[4]
- From January to May 2011, federal lending through the FHA accounted for 15 percent of all single-family home purchase activity, including 24 percent of all new home sales.[5]
- FHA lending also accounts for between about half to 90 percent of the loans made to borrowers with less-than-perfect credit (i.e., credit scores of between 620 and 740).[6]
- FHA loans have become an especially important gateway to homeownership for first-time buyers. Eighty percent of the more than 2 million FHA loans made since 2008 have gone to first-time buyers, many of them from lower and middle-income families.[7]

The current outsized role of the FHA and GSEs are a direct result of the financial crisis, when private money evaporated virtually overnight. In fact, Congress first raised the FHA and GSE loan limits in 2008 to mitigate the "credit crunch" resulting from the loss of private capital—a role these agencies are still performing two years later.

The FHA's mortgage insurance program, for example, provides a government guarantee for qualified loans. This encourages banks that otherwise wouldn't lend by protecting them in case of a default. Fannie and Freddie also provide a prop to private banks by buying mortgages from banks, thereby providing them with the cash to make more loans to more people rather than tying up capital by keeping all their loans on the books. Fannie and Freddie use the mortgages they buy to create mortgage-backed securities, which because of their implicit (and now explicit) government guarantee have historically proven to be an important source of investment and market stability.

What Could Happen October 1

While no one knows for certain what the impact of lower loan FHA and GSE loan limits would be, the fragile state of the housing market and the agencies' current footprint argue that the effects won't be trivial. Lower loan limits could in fact set off a chain reaction of impacts that could seriously damage both the housing market and the broader economy:

1. Fewer Loans at Higher Prices

The most immediate effects of an increase in loan limits will be a drop in the number of loans available to prospective homebuyers and a rise in the interest rates at which those homebuyers can borrow. In fact, some banks have already stopped taking applications for lower-cost FHA loans. Wells Fargo, for example, announced an August 15 cut-off for new mortgage applications above what the new limits will be.[8]

Borrowers who might have expected to get an FHA or conforming loan can now expect the following:

Higher down payments. Borrowers no longer eligible for an FHA loan will likely face a much higher down payment requirement than the 3.5 percent now required by the FHA. Nationally, the median down payment today is 22 percent[9]—a potentially prohibitive high sum for many borrowers (e.g. $38,456 for a house at the current median existing home price of $174,800).[10]

Higher interest rates. Borrowers who can no longer get "conforming loans" that can be securitized by Fannie and Freddie will now need "jumbo" loans at higher rates. While the difference in interest rates ("spread") between a conforming and jumbo loan is currently lower than it has been—on occasion, the difference has been upwards of 2 percentage points—the Federal Housing Finance Administration predicts the difference could still be between 1/2 and 3/4 of a percentage point.[11] For a $650,000 mortgage, the difference between 5 percent and 5.5 percent interest over 30 years is $72,360 in additional interest.

2. Widespread pain

While much of the attention on loan limits has focused on the upper strata of the current FHA and GSE programs, the actual impact of the pending changes will be much more widespread—both geographically and across all price levels.[12]

What will change on October 1 is the underlying statutory formula for determining the maximum FHA and GSE loan limits in any given area of the country. For FHA in particular, this means that as many as 669 counties across 42 states and the District of Columbia will see a reduction in loan limits. The following map from the Department of Housing and Urban Development shows the geographic distribution of the affected counties.

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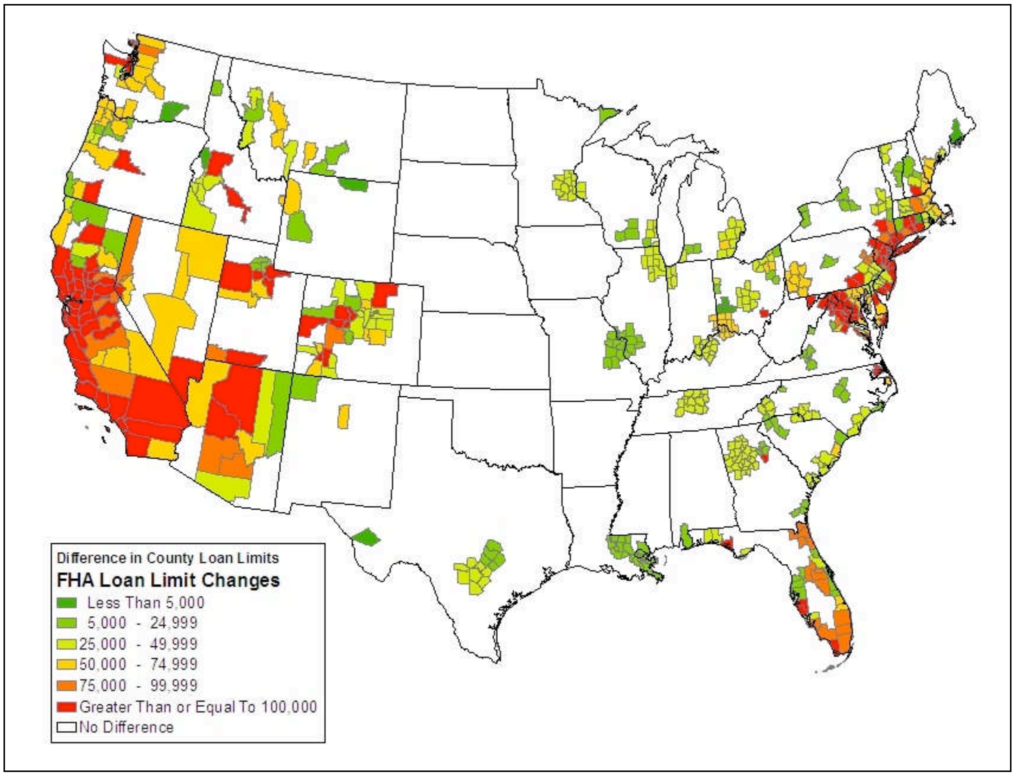

Source: Department of Housing and Urban Development

Moreover, many of these counties include moderately-priced areas in addition to the so-called "high-cost" regions such as Washington, D.C. The following chart shows some of the sample impacts:

	Current FHA Loan Limit	Limit as of October 1	Difference
Los Angeles County, CA	$729,750	$625,500	-$104,250
Fresno County, CA	$381,250	$281,750	-$99,500
Mesa County, CO	$371,250	$271,050	-$100,200
Fairfield County, CT	$708,750	$575,000	-$133,750

Charlotte County, FL	$296,250	$271,050	-$25,200
Cook County, IL	$410,000	$365,700	-$44,300
District of Columbia	$729,250	$625,500	-$104,250
Camden County, NJ	$420,000	$379,500	-$40,500
Elko County, NV	$325,000	$271,050	-$53,950
Lancaster County, PA	$383,750	$271,050	-$112,700

Source: National Association of Realtors

In terms of loan dollar volume, HUD says that 23 states would have seen a more than 5 percent drop in the dollar amount of FHA loans made had the loan limits been dropped in 2010, including eight states that would have seen declines of greater than 10 percent.[13] According to HUD, roughly $76 billion in FHA loans would not have been made in 2010 had the limits already been lower.[14]

3. Another blow for first-time homebuyers

As noted previously, FHA lending has become a key lifeline for many first-time homebuyers, particularly among minorities and lower-income households. Because of this, a drop in loan limits would have particular impact on these buyers—and at a time when they are already facing more roadblocks to homeownership.

In typical times, first-time buyers make up 40 percent of the housing market. In January 2011, however, they accounted for just 29 percent of sales.[15] Some of this is due to much tighter credit standards in the wake of the crash, as well as the much bigger down payment requirements mentioned above.

Moreover, regulators implementing new “risk retention” rules in the Dodd-Frank financial reform legislation are contemplating making 20 percent down payments the new norm.

Maintaining strong first-time buyer demand is pivotal to a healthy housing market; first-time buyers are the “first link” in a chain of demand that generates broad economic activity. The seller to the first-time buyer “trades up,” and both buyers may undertake renovations, buy new furniture and so on. According to the Washington Research Council, 12,000 additional first-time buyers could generate enough construction, resale and renovation activity to create as many as 8,500 jobs and as much as $1.35 billion in additional economic activity.[16]

As a consequence, any change that would dampen first-time demand is a concern. Not only would fewer people attain the middle-class goal of homeownership, the downstream impacts on the overall market and economy could be significant.

4. A Continuing Downward Spiral in Home Prices

Moreover, any decline in demand would in turn further weaken home prices, which are central to both the market's stability and consumer confidence.

As noted, home prices are already at pre-bubble levels, and they still may not have hit bottom. According to the latest numbers from the closely watched Standard & Poor's/Case-Shiller index, home prices as of June 30 were down 5.9 percent from a year ago, despite gains in the second quarter.[17]

Now that the bubble is long past, falling home prices are fast becoming yet another liability for the market. For one thing, falling prices will push more and more mortgages underwater, which in turn encourages defaults and foreclosures. Even as defaults have begun to slow, the number of pending foreclosures and loans that were more than 90 days delinquent totaled 4.1 million in June 2011.[18] In February 2011, approximately 40 percent of sales were foreclosures or so-called "short sales" where the lender takes less than the amount owed on the mortgage.

The higher-cost areas that would be especially affected by a drop in loan limits are the few bright spots in the housing market that are stable or doing relatively well—such as Washington, D.C., Los Angeles, New York, San Francisco and San Diego.

Falling home prices deal a heavy blow to consumer confidence. Since the crash, Americans have lost $6.6 trillion in equity.

A slide in these markets would have a palpably negative impact on such leading measures of confidence in the housing market as the Case-Shiller index, which many look to as the "Dow" of real estate. A close look at Case-Shiller shows that the slight downward slide in this index in the past year would have been much worse had it not been for the performance of these five markets.

Falling home prices deal a heavy blow to consumer confidence. Since the crash, Americans have lost $6.6 trillion in equity.[19] While this undoubtedly includes paper gains, Americans who might have looked to their houses as a nest egg are now undoubtedly much more anxious about their circumstances.

5. An Even Less Attractive Environment for Private Capital

Falling prices and continued instability will only make the market that much less attractive for private capital to return—which is the opposite of what proponents of lower loan limits want to see.

Supporters of lower loan limits argue that current FHA and GSE support for the market is “crowding out” private sources of capital. By withdrawing this support, they argue, private money will flow in. However, there’s little evidence of pent-up capacity for private capital.

Since the crash in 2008, only one company—Redwood Capital—has securitized newly originated residential mortgage loans without any government support (i.e. without the backing of Fannie and Freddie). The size of that transaction was $295 million.

In Senate testimony this May, Redwood’s CEO, Martin Hughes, said his company planned on two more securitizations in 2011 to the tune of $800 million or $1 billion for the year[20]—a relative drop in the bucket compared to the $125 *billion* securitized in just the first quarter of 2011 by Fannie and Freddie.[21] It’s also worth noting that the quality of the mortgages securitized by Redwood was exceptionally high. Redwood’s sole focus is on the “jumbo market” from borrowers who put 20 percent down, pay higher interest rates and have perfect credit.

Experts such as David Stevens, the former head of the Federal Housing Administration and now chief executive of the Mortgage Bankers Association, warn against what he calls "an irrational belief that says private capital will emerge" if government support drops away.[22]

In addition to broad structural reforms that build confidence, many experts say that stable housing prices, above all, will be what lure private capital back into the marketplace. Dropping the loan limits will not, however, help make that happen.

6. A Continuing Drag on the Economy

Finally, the potential damage done by a drop in loan limits and government support could have broad ramifications for the overall economy.

Undoubtedly, the bubble years overinflated housing’s economy impact. Today, however, it’s at the opposite extreme: housing is a lead weight dragging down both jobs and consumer confidence.

Housing traditionally accounts for 17 percent to 18 percent of America’s economy[23]—a figure that outstrips even health care as a major pillar of the nation’s total economic output. Economic activity related to housing includes not just construction but a host of related industries including manufacturing (furniture, construction equipment, etc.), retail (from furnishings, plumbing supplies, paint, etc.) and a variety of services (real estate sales, mortgage banking and brokering, lawn care, etc.).

As of 2010, housing and its directly related industries employed more than 2 million Americans at all levels of the wage spectrum from construction workers to high-end realtors.[24]

Moreover, housing accounts for a significant portion of Americans' total wealth. Even after the post-crash loss of equity, housing accounts for $22.7 trillion in assets held directly by middle-class Americans.[25] For most Americans, their home is still their biggest asset.

Conclusion: A Market-Based Drawdown

Keeping the loan limits where they are won't solve the nation's housing problems or stimulate a recovery—but dropping them could make things worse.

October 1 is too soon for the federal government to suddenly kick the legs out from under the market with a precipitous—and arbitrary—drop in the loan limits for the FHA and GSE programs, even though the Obama Administration has stated its desire to let the limits expire as part of its plan to wind down Fannie and Freddie.[26] There are not yet adequate sources of private capital that are ready to step in, and the sudden loss of liquidity will severely cripple the availability of credit and contribute to the downward spiral of home prices. As Thomas Hamilton of Barclays Capital testified in August, "[b]eing able to withdraw the government from mortgage markets will require a carefully planned and sequenced transition which should take a number of years." Private capital, he continued, "will not simply appear because we want them to. They must be drawn back into, and made comfortable with, private label securitization and its regulatory environment."[27]

What Congress should do is to work out a process for the "orderly" transition to private capital—including the future modification of loan limits—in a way that makes sense for a particular area's market and will not cause sudden and undue disruptions

Certainly, the federal government cannot and should not support the housing market forever. Nor should it do so at the expense and the exclusion of private capital. What Congress should do is to work out a process for the "orderly" transition to private capital—including the future modification of loan limits—in a way that makes sense for a particular area's market and will not cause sudden and undue disruptions.

First, Congress should extend the loan limits past the arbitrary October 1 deadline. Some in Congress have already called for another extension of the current FHA and GSE loan limits past the October deadline; this is an excellent first step.[28] In addition, as some have already proposed, the director of the FHFA should be granted the discretion to suspend a change in loan limits if the impact on median prices were too severe. This is a potentially important reform that could help better connect regulators with real-world impacts. This provision could also serve as a failsafe to protect the housing market from needless disruption in the event Congress can't or won't act before future deadlines pass.

As Congress contemplates new steps to kick-start the economy, it must first avoid shooting itself in the foot. Extending the current FHA and GSE loan limits is a simple and relatively cost-free step to prop up the economy until a recovery can take further hold.

Endnotes

[1] National Association of Realtors, Estimate of October 1, 2011 Loan Limits, available at http://www.realtor.org/wps/wcm/connect/3ace760047433b5fb9cabf0e6e9f088e/oct1+limits+-+fha++gse.pdf?MOD=AJPERES&CACHEID=3ace760047433b5fb9cabf0e6e9f088e

[2] Derek Kravitz, Associated Press, "New Home Sales Fall, 2011 Could Be Worst Year Yet," Aug. 23, 2011, http://finance.yahoo.com/news/Newhome-sales-fall-2011-could-apf-3845011766.html?x=0&sec=topStories&pos=6&asset=&ccode=

[3] National Association of Homebuilders, New and Existing Single Family Home Prices, http://www.nahb.org/fileUpload_details.aspx?contentID=55764

[4] Federal Housing Finance Administration, Conservator's Report of the Enterprises' FInancial Performance, First Quarter 2011, http://www.fhfa.gov/webfiles/21616/Conservator%27s_Report_1Q 2011final.pdf

[5] Federal Housing Administration, FHA Single Family Activity in the Home-Purchase Market Through May 2011, available at http://portal.hud.gov/hudportal/documents/huddoc?id=fhamkt0511.pdf. This is a marked contrast from the bubble years when the housing market was flush (perhaps too flush) with private sources of lending. During that period, the role of the FHA and the GSEs receded significantly. In 2005 and 2006, the FHA's market share of home loans dropped to just 3 percent, down from about 10 percent in 2000.[5] From 2001 to 2006, the GSEs, including Ginnie Mae, experienced a parallel decline from 80 percent of the entire mortgage securities market to 44 percent. Federal Reserve Bank of Philadelphia, FHA Lending Activity in the Past Decade: A National Overview, available at http://www.philadelphiafed.org/community-development/publications/special-reports/FHA-lending-activity/; http://www.fhfa.gov/webfiles/21616/Conservator%27s_Report_1Q2011final.pdf (p.5)

[6] Dan Immergluck, "From Minor to Major Player: The Geography of FHA Lending During the U.S. Mortgage Crisis," Journal of Urban Affairs, Feb. 2011, Vol. 2. 33, Issue 1.

As the following chart shows, the FHA and GSE's accounted for fully 100 percent of mortgage activity in the market for loans under the FHA loan limits, particularly for Americans whose credit scores were not absolutely sterling.

GSE and FHA Home Purchase Loans under FHA Loan Limits by FICO Score, Fourth Quarter 2008

FICO Score	GSE	FHA	Total	Percent GSE	Percent FHA
740 or higher	42,741	12,975	55,716	76.7%	23.3%
680 to 739	19,058	17,535	36,593	52.1%	47.9%
640 to 679	3,719	14,697	18,416	20.2%	79.8%
620 to 639	663	7,159	7,822	8.5%	91.5%
Less than 620	349	11,832	12,181	2.9%	97.1%
Total	**66,530**	**64,198**	**130,728**	**50.9%**	**49.1%**

Data Source: LPS Applied Analytics; U.S. Department of Housing and Urban Development.

[7] Written testimony of David H. Stevens, Assistant Secretary of Housing, Federal Housing Administration, Commissioner, U.S. Department of Housing and Urban Development, Hearing before the House Financial Services Committee on Insurance, Housing and Community Opportunity, Feb. 16, 2011, http://portal.hud.gov/hudportal/HUD?src=/press/testimonies/2010/2011-02-16a

[8] Diana Olick, Wells Fargo Lowers Conforming Loan Limits, August 17, 2011, www.cnbc.com, available at http://www.cnbc.com/id/44178578/Wells_Fargo_Lowers_Conforming_Loan_Limits

[9] S. Mitra Kalita, "Banks Push Home Buyers to Put Down More Cash", *The Wall Street Journal*, February 16, 2011, Accessed February 17, 2011. Available at: http://online.wsj.com/article/SB10001424052748703312904576146532935600542.html

[10] National Association of Homebuilders, New and Existing Single Family Home Prices, http://www.nahb.org/fileUpload_details.aspx?contentID=55764

[11] FHFA Mortgage Market Note 11-01, "Possible Declines in Conforming Loan Limits." March 29, 2011, available at http://www.fhfa.gov/webfiles/20671/MMNote_2011-01_LoanLimit.pdf

[12] Under current law, the maximum for a GSE conforming loan is $417,000 (or $729,750 in certain high-cost areas), while the current maximum FHA loan is $729,750 (again depending on the area). On October 1, the overall GSE conforming loan limit will stay at $417,000 but will drop to $625,500 for high-cost areas. The FHA loan limit will also drop to $625,500 for the same high cost areas.

[13] U.S. Department of Housing and Urban Development, Office of Housing, Risk Management and Regulatory Affairs, Evaluation, "Potential Changes to FHA Single-Family Loan Limits beginning October 1, 2011 from Implementation of the Housing and Economic Recovery Act of 2008: A Market Analysis Brief," May 26, 2011, available at http://portal.hud.gov/hudportal/documents/huddoc?id=FHA_Loan_Limits_HERA.pdf

[14] States Most Affected by a Hypothetical Drop in FHA Loan Limits in 2010

State	Share of dollar volume of loans not covered by FHA (2010 hypothetical)	Dollar volume of loans not covered by FHA (2010 hypothetical)
Alaska	6%	$639,129,288
Arizona	12%	$5,209,663,831
California	12%	$4,233,459,000
Colorado	10%	$624,557,679
Connecticut	15%	$467,535,308
Delaware	7%	$986,153,035
D.C.	15%	$135,425,939
Florida	8%	$9,907,127,919
Hawaii	7%	$694,974,989
Illinois	6%	$6,695,810,708
Maine	9%	$583,099,841
Maryland	7%	$7,857,744,389
Massachusetts	11%	$500,799,090
Maine	9%	$54,454,639
Minnesota	7%	$4,341,923,245
New Hampshire	10%	$107,409,628
New Jersey	6%	$7,767,804,460
New York	6%	$8,801,357,218
Nevada	10%	$286,015,822
Oregon	9%	$272,472,402
Puerto Rico	11%	$145,779,388
Virginia	6%	$9,501,371,050
Washington	8%	$6,745,007,728

Source: Department of Housing and Urban Development

[15] John Gittelsohn, "Cash-Paying Vultures Pick Bones of U.S. Housing Market as Mortgages Dry Up," Bloomberg, March 29, 2011, Accessed March 30, 2011. Available at: http://www. bloomberg.com/news/2011-03-29/cash-paying-vultures-feast-on-u-s-housing-as-mortgages-dry-up.html

16 Washington Research Council, The Economic and Fiscal Impacts of First-Time Home Buyers, February 2, 2009, available at:

http://www.researchcouncil.org/docs/PDF/WRCEconomics/TheEconAndFiscalImpacts.pdf

[17] Jason Philyaw, "S&P/Case-Shiller up 3.6 percent in 2Q, down 5.9 percent from year ago," HousingWire, August 30, 2011, available at http://www.housingwire.com/2011/08/30/spcase-shiller-up-3-6-in-2q-down-5-9-from-year-ago

[18]Lender Processing Services, LPS Mortgage Monitor, July 2011 Mortgage Performance Observations, xviiihttp://www.lpsvcs.com/LPSCorporateInformation/ResourceCenter/PressRe

sources/MortgageMonitor/201106MortgageMonitor/LPS_Mortgage_Monito

r_June_2011.pdf

[19] New York Times Editorial, "Homeowners Need Help," Aug. 21, 2011, http://www.nytimes.com/2011/08/22/opinion/homeowners-need-help.html

[20] Ibid.

[21] Federal Housing Finance Administration, Conservator's Report of the Enterprises' FInancial Performance, First Quarter 2011, http://www.fhfa.gov/webfiles/21616/Conservator%27s_Report_1Q

2011final.pdf

[22] Nick Timiraos, "Government Stays Glued to Mortgage Market," The Wall Street Journal, June 20, 2011, http://online.wsj.com/article/SB100014240527023041864045763

89863819100854.html

[23] "Housing's Contribution to Gross Domestic Product", National Association of Homebuilders, GDP statistics published by the United States Bureau of Economic Analysis. Available at: http://www.nahb.org/generic.aspx?sectionID=784&genericContentID=66226

[24] U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Products Table 6.4D, http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTabl

e=193&Freq=Year&FirstYear=2009&LastYear=2010

[25] Yeng Bun, U.S. Homes Set to Lose $1.7 Trillion in Value During 2010, Dec. 9, 2010, http://www.zillow.com/blog/research/2010/12/09/u-s-homes-set-to-lose-1-7-trillion-in-value-during-2010/

[26] Testimony of Timothy F. Geithner, Secretary of the Treasury before the House Committee on Financial Services, March 1, 2011, available at http://financialservices.house.gov/media/pdf/030111geithner.pdf

[27] Written Statement of Thomas Hamilton, Managing Director, Barclays Capital, Hearing before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Securities, Insurance and Investment, Aug. 3, 2011, www.sifma.org/workarea/downloadasset.aspx?id=8589934926

[28] See, e.g. HR 1754, Preserving Equal Access to Mortgage Finance Programs Act; HR 2508, Conforming Loan Limits Extension Act; and S 1508, the Homeownership Affordability Act of 2011.

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