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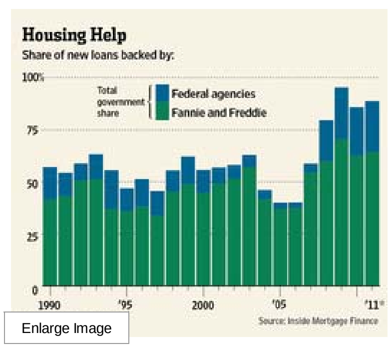
U.S. Gambles With Mortgage Retreat

By NICK TIMIRAOS

Three years after virtually nationalizing the U.S. mortgage market, the government has embarked on a pullback to see whether private industry picks up the slack.

Some people in the housing industry worry that Washington's move will cause fresh pain in many regions where demand has yet to recover amid the sluggish economy.



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At issue are the loan limits that Congress expanded in 2008, allowing Fannie Mae and Freddie Mac to buy mortgages that exceeded the national cap of $417,000.

When the mortgage market melted down four years ago and sent private mortgage investors fleeing, interest rates rose sharply on "jumbo" mortgages—those too large for backing by Fannie, Freddie or agencies such as the Federal Housing Administration. That accelerated home-price declines in high-end markets throughout California and the Northeast, where many pricey homes couldn't be bought with a government-backed loan.

To stem the fallout in prices, Congress raised the loan caps to as high as $729,750 in markets such as Los Angeles and New York. It then passed a series of one-year extensions to keep the higher limits in place. But this year, Congress and the Obama administration opted against an extension.

As a result, the limits in hundreds of counties fell by 10% or more on Oct. 1. For loans backed by Fannie and Freddie, the limits declined to between $417,000 and $625,500 in about 200 counties.

More worrisome to real-estate agents are declines in the FHA limits, which fell to between $271,050 and $625,500 in 600 counties. Those changes are causing heartburn because the FHA allows buyers to make down payments of just 3.5%, and it has financed as many as half of all home purchases in recent quarters.

Policy makers allowed the limits to fall because they want private companies to hold more mortgage risk, and dialing down loan limits is one way to carve out space for those investors. Fannie, Freddie, and the FHA currently back nine in 10 new mortgages. Taxpayers already are on the hook for $141 billion in losses at Fannie and Freddie, and the FHA's reserves have plunged to razor-thin levels.

Mortgages that don't qualify for government backing typically have higher borrowing costs, including interest rates around 0.75 percentage point above conforming loans. Mortgage rates currently are very low, but jumbo loans also require bigger down payments—at least 20%—and can have tougher qualification rules.

"The net-net here is that the available pool of credit for housing is shrinking. Prices will have to decline," said Christopher Whalen, co-founder of risk-management consultant Institutional Risk Analytics.

On one side of the debate are mortgage investors who say the government needs to give the private sector more room to compete if a vibrant market for nongovernment-backed loans is to re-emerge. "The banking industry, flush with excess deposits, will fund those loans," said Mike McMahon of Redwood Trust, a real-estate investment firm in Mill Valley, Calif.

Assuming a 20% down payment, the new limits still allow homeowners in parts of California to qualify for a government-backed mortgage on a $780,000 home. Critics say there's little public policy rationale to subsidize loans for those borrowers, who need substantial incomes.

On the other side are real-estate agents and some economists who say sellers are in for a nasty surprise when they find that fewer potential buyers qualify to purchase their properties. They say the changes also could hamstring "trade-up" buyers who typically used home equity, which has plunged during the bust, as their down payment to move to a bigger residence.

Gisella Olivares closed on a home in Upland, Calif., on the day before the new loan limits went into effect. Without the FHA-backed mortgage, "there would be no way I could afford to get the house," said Dr. Olivares, who qualified for a $448,000 mortgage. In California's Inland Empire region, the metropolitan area an hour east of Los Angeles, the FHA loan limit fell to $355,350 from $500,000.

If Dr. Olivares, a 42-year-old physician, had to make the $100,000 down payment for a jumbo mortgage, she said she would have waited at least two years to buy a home. The seller, meanwhile, was able to avoid foreclosure by completing a short sale, where the bank allowed the house to sell for less than the amount owed.

The loan limits wouldn't appear to have much of an impact on the overall housing market. In 2009, about 1.5% of home-purchase loans backed by government entities wouldn't have been eligible under the new limits, according to a study by the Furman Center for Real Estate and Urban Policy at New York University.

But the same study emphasized the outsize local impact. Some 9% of purchases would have been affected in San Jose, Calif., and 5% in San Diego.

Meanwhile, banks would have to increase the number of jumbo loan originations by 56% to make up the gap, "which the private sector could be hard pressed to fill," said Mark Willis, one of the study's authors. "If you want to get the market moving, why would you decrease the availability of credit for any part of it?"

Ultimately, the loan-limit issue shows the broader challenge in bringing back private capital and reducing taxpayer exposure: Housing markets are shaky, and the government is still offering better terms than private lenders.

Steps that raise borrowing costs could attract private investors, but if that pushes home prices down in the process, it may do more harm to the economy and to individual housing markets still reeling from the real estate bust.

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