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## 'Do no harm' on conforming loan limits

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Unless Congress acts, we will soon embark on an ill-timed test of the strength of the nation's housing market and private mortgage finance system.

On Oct. 1, government support for mortgage lending is scheduled to drop in dozens of metropolitan areas containing more than two-thirds of the U.S. population. Although our research indicates this change will affect only a very small segment of the overall housing market and is consistent with longer-term policy goals, efforts to revive the economy would be better served by maintaining current support for mortgage lending.

This looming change in mortgage policy is due to the scheduled expiration of legislation first enacted in 2008 to temporarily shield more of the housing market from the shrinking availability of private mortgage credit during the then-unfolding foreclosure and financial crises.

That legislation, which has been extended by Congress three times, increased the maximum size of loans that can be guaranteed by **Fannie Mae** and **Freddie Mac** or insured by the **Federal Housing Administration**.

Now, in several of the most expensive housing markets, the GSE loan limits are set to fall in parallel. In New York City, Los Angeles and Washington, for example, the maximum loan size for both types of support will drop to $625,000 from $729,750, leaving households seeking new loans in this range completely reliant on privately financed loans called jumbo mortgages.

In many other, less-expensive metropolitan areas, only the FHA loan limit will drop, leaving many prospective borrowers — who today would normally take out an FHA loan — dependent on Fannie and Freddie instead.

Our analysis of 2009 mortgage originations (the most recent year comprehensive data are publicly available) suggests that less than 2% of the U.S. mortgage market will be affected by the scheduled reduction in Fannie, Freddie, and FHA eligibility.

Most of the borrowers who took out these loans earned substantially more than the typical U.S. family. Ideally, we would not continue putting scarce public dollars at risk or distort the market to help households that should be able to obtain financing on their own if they choose to be homeowners.

Yet, these loan-limit changes will likely add additional downward pressure on prices for, at least, a small part of the housing market.

Not every prospective homebuyer or refinancer seeking a loan who would be ineligible for FHA insurance or a Fannie or Freddie guarantee will be able to obtain a loan of equivalent size from an alternative financing source.

This is because loans financed by Fannie and Freddie generally require higher down payments than FHA, and because jumbo mortgages have higher interest rates and often require higher down payments than loans financed by Fannie and Freddie.

By reducing demand, these loan-limit changes could lower the value of many homes, sinking more homeowners underwater and making it more difficult for many borrowers to refinance into today’s lower rates, the same conditions the federal government has sought to address with other recent policies.

In addition, the pending changes will place more pressure on the jumbo mortgage market than it may be able to absorb. There is no large-scale secondary market for jumbo mortgages, or even a final set of rules for how it will operate.

Instead, jumbo lending is almost completely financed out of bank portfolios, so any constraints on balance sheet capacity in the troubled banking sector could hinder the ability of private lenders to meet additional demand for jumbo loans.

By our estimates, based on 2009 mortgage lending patterns, the private sector will have to ramp up jumbo lending by some 56% in the number of originations and by some 38% in dollars loaned to make up for the scheduled pullback by Fannie and Freddie.

The negative effects of the scheduled decrease in federal mortgage support will be particularly acute in certain metropolitan areas hit especially hard by the foreclosure crisis. In the greater San Jose, Calif., area, nearly 9% of all purchase mortgages in 2009 were backed by Fannie, Freddie, or FHA and were large enough that they would not have been eligible for support if made after this policy change.

In several other areas, the share of the mortgage market losing federal support is between 3% and 7%, so a significant slice of their housing markets will be affected.

Reducing the role of the federal government from the nation's mortgage finance system is an important long-term policy goal.

At some point the loan limits should be reduced. However, the top priority now is nurturing the broader economy, which is being weighed down by a weak housing market.

Relying on an uncertain private mortgage finance system to ramp up lending to the extent our research shows would be needed to maintain today's credit supply is a gamble.

Furthermore, revised pricing and underwriting at the FHA and Fannie and Freddie have helped reduce the exposure of the **Treasury** to their support of the housing market and mean current policies are not an immediate drain on public tax dollars.

Accordingly, Congress and the White House should follow a "do no harm" approach for the time being and support legislative proposals to defer the reductions of the loan limits one more time.

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