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Committee on Financial Services

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Hearing on

"Impact on Homebuyers and Housing Market of Conforming Loan Limit"

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Chairman Frank, Ranking Member Bachus and Members of the Committee, my name is Jay Brinkman, and I am Vice President of the Economics and Research Department at the Mortgage Bankers Association (MBA).[1] Thank you for the opportunity to testify today as you explore how Fannie Mae and Freddie Mac (government sponsored enterprises or GSEs) have responded to their temporary authority to purchase loans with higher balances than would otherwise be permitted under their statutory charters.

My career in the capital markets and housing finance industry spans decades. I have been an economist with MBA for the past seven years, and prior to that I was with Fannie Mae, the University of Houston and a commercial bank.

Before I begin, please let me say, Mr. Chairman, MBA particularly appreciates your dedication to holding the GSEs accountable for their congressional mandate to facilitate affordability, stability and liquidity not only during this time of duress in the mortgage industry, but throughout the business cycle. We recognize you as a champion of GSE regulatory reform, and we urge you to remain steadfast in your fervor. Over the past few days, your colleagues in the Senate have made considerable headway in developing a reasonable legislative solution to many of the obstacles impeding successful completion of this task in prior years. We encourage this committee to reach consensus with the Senate in a conscientious and expedited manner. GSE regulatory reform legislation is a top priority for MBA and the mortgage industry. MBA will do all it can to assist your work.

Background

It is a basic tenet of safe and sound lending but it bears repeating in the context of today's hearing: The larger the mortgage, the riskier the loan. The riskier the loan, the tougher it is for a homebuyer to get a mortgage approved – and the tougher it is to securitize and sell a loan in the secondary market. This rule of thumb is so basic to financing concepts that it appears even federal government intervention can do little to quickly change it.

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[1] **The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 370,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.**

For example, the Economic Stimulus Act of 2008,[2] which became law on February 13, 2008, increased the maximum allowable loan limits for Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA) from $417,000 to a variable upper limit based on area median incomes in metropolitan statistical areas (MSAs), but not to exceed $729,750. The increase in loan limits was an admirable attempt by Congress to jumpstart the market for large balance or jumbo loans.

The seizing of the secondary market beginning in August of 2007 had the effect of limiting the origination of loans with balances higher than the conforming limit of $417,000 to institutions that could hold loans in their portfolios or place loans with private investors outside the securitized market. The result was that interest rates on 30-year fixed-rate jumbo loans increased from their usual spread of roughly 25 basis points over equivalent credit risk conforming loans to as much as 125 basis points.

The higher rates on these high-dollar loans had an immediate and negative sustained impact on mortgage originations for home purchases and refinances in high-cost areas such as California, and portions of Florida, mid-Atlantic and Northeast states, but eventually all parts of the country were affected. As a result, the jumbo share of mortgage applications captured in MBA's Weekly Applications Survey fell from a high of 12.1 percent of all applications in March of 2007 to a low of 4.4 percent of applications in March of 2008.

Industry Response to Higher Conforming Loan Limit

The mortgage industry faced several hurdles in figuring out how to bring the maximum benefit of the higher GSE loan limits to borrowers. The first hurdle was the complexity of the limits themselves. Up until the Economic Stimulus Act was passed, the industry had dealt with only a single national limit for loans sold to or guaranteed by Fannie Mae and Freddie Mac. While loan limits in automated underwriting systems had heretofore been adjusted by changing a single number, mortgage lenders and the GSEs became encumbered with the task of reprogramming underwriting systems to account for different limits for different metropolitan areas. Moreover, reprogramming errors could be quite costly. For example, if a loan is priced based on the expectation that it can be delivered into a GSE or Ginnie Mae security, but it turns out that the loan is not eligible due to a mistake in the system, the costs of that mistake are very large because the loan will have to be sold at a large loss. That was one of the reasons MBA had recommended going with a single national standard for the new GSE loan limits.

The second and bigger hurdle was how these loans would price in the secondary market. While these so-called jumbo conforming loans would carry a GSE credit guarantee, their prepayment behavior and liquidity was and is very much in question. One effect of the law setting different loan limits in different areas was

[2] Public Law 110-185.

that secondary market pricing would likely differ from city to city. Large balance loans prepay faster and are therefore worth less to investors. Thus the lack of a single, nationwide loan limit made investors fearful of a balkanization of the secondary market with a series of separate prices based on the maximum loan limits in each area, reducing the overall liquidity and thus value of the jumbo conforming loan backed securities. To some extent, the establishment of multi-lender pools has assuaged investors' fears, but the problem lingers.

Another factor impacting potential secondary market pricing was the uncertainty surrounding the terms of the loan limits. Investors in mortgage-backed securities are fearful of being stuck with an orphaned security, that is, a security where no new, similar ones are being issued. The reason is that in markets where little secondary trading takes place, prices are determined by trading in the most recently issued securities. Without new issues, it is difficult to determine a price and, as a result, investors are less able to liquidate their holdings if needed.

A fourth issue with establishing a price for these securities, and thus the rate on the mortgages, was the timing of the collapse of Bear Stearns and the problems with the Carlyle Fund. When the new loan limits were announced in early March, the broker/dealers on Wall Street were suddenly hoarding cash so as not to become the next victim. Mortgage companies calling around to their usual contacts for selling GSE-backed mortgage securities could find no buyers for these new jumbo securities.

The logjam appears to be breaking with very recent announcements by the GSEs about their commitment to participate in the new jumbo conforming market. Freddie Mac recently announced that it would purchase at least $10 billion in jumbo conforming mortgages from several financial institutions. Fannie Mae also announced that it would buy jumbo conforming loans at prices equivalent to the TBA market[3] for conventional conforming loans. After taking into account delivery fees, Fannie Mae's decision alone should result in rates to borrowers of around an eighth to a quarter point over loans below $417,000 with comparable risk characteristics. These recent actions have effectuated an immediate pick-up in applications for jumbo loans and a reduction in borrower interest rates. The establishment of a GSE price point in the market has increased investor confidence and is likely to whet the secondary market's appetite for these securities.

Fifth, it is important to remember that the jumbo market was not historically a fixed-rate market. Based on MBA's Weekly Mortgage Applications Survey, in May of 2006 only 30 percent of jumbo loan applications were for fixed-rate 30-year loans versus 63 percent for conforming loans. In May of 2007, the fixed-rate 30-year share of jumbo applications increased to 51 percent, but was still

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[3] The TBA market facilitates the forward trading of MBS issued by GSEs and Ginnie Mae by creating parameters under which mortgage pools can be considered fungible and thus do not need to be explicitly known at the time a trade is initiated – hence the name "To Be Announced."

below the 70 percent share for conforming loans that month. While only partial data exists for this month, the 30-year fixed rate share of jumbo applications has increased to 62 percent in May, very close to the conforming share of 70 percent. Those numbers are based on applications, but according to First American CoreLogic, for loans actually originated, 76 percent of jumbo loans were adjustable rate mortgages (ARMs) in 2004, 65 percent in 2005, 46 percent in 2006 and 31 percent in 2007. The point is that the jumbo market historically was neither a GSE market nor a fixed rate market. Consequently, it has taken time for the GSEs and other investors who normally dealt only in GSE paper to become comfortable with these new loans.

The final point on pricing is that some have questioned why the industry opposed including jumbo conforming loans in conforming TBA pools. The simple reason is that once the credit risk is taken on by the GSEs, the remaining risk is that of prepayment. Since most borrowers have the option of prepaying their loans at any time, investors can never be sure they are paying the correct price for the loans. If an investor pays a price that assumes receiving payments for five years and the loan prepays in two years, the investor loses money.

Pricing of prepayment risk is a sophisticated multivariate process with one of the most important variables being the size of the loan. Because borrowers with large loan balances can recoup the cost of refinancing their loans faster than borrowers with small balances, they tend to prepay with only slight reductions in interest rates. Low balance loans, therefore, are worth more to investors, other factors being equal. Mixing high balance loans newly eligible for GSE guarantees in with the smaller balance TBA pools would have created uncertainty around the performance of these pools at a time when this was the only part of the market still functioning. The result would have been a narrowing of the jumbo/conforming spread by lowering jumbo rates and increasing conforming rates, a solution no one should want.

MBA analysis shows that the intended effects of the Economic Stimulus Act, combined with the GSEs' most recent focus on the jumbo conforming market segment, are beginning to show. The share of jumbo loans applications in MBA's Weekly Survey of Mortgage Applications was a little over four percent in March, but during the first few weeks of May we have seen the jumbo share climb to almost six percent.

How long will it be until jumbo loan pricing returns to levels seen before last August? As vital as the GSE contribution is to the return of portions of the jumbo market, it should be understood that the GSEs are limited in what they can do. Since the MSA-level loan limits exclude many areas, it is likely that slightly less than half of the jumbo loans originated for home purchases in 2006 would qualify for GSE purchase under the new loan limits. In addition, GSE underwriting standards are tighter than what existed in the non-GSE jumbo market so perhaps only about a quarter of the 2006 prime jumbo purchase originations would qualify, along with perhaps 15 percent of the Alt-A originations and only about 5 percent of the jumbo subprime originations. As for refinancing jumbo loans, only about 15 percent of 2006 and 2007 originations are likely to qualify under the GSE guidelines and the geographic limitations of where the loan limits apply, whereas roughly 35 percent to 45 percent of 2002 to 2005 originations would likely qualify, with very few Alt-A or subprime loans originated in the last few years qualifying.

The credit requirements put in place by the GSEs are likely a reaction to their lack of experience in the jumbo loan market because they were prohibited by law from expanding into this territory. That is where FHA is playing an important role. The market demand for Ginnie Mae securities has also been there and one apparent side effect of the announcement of the price at which the GSEs would purchase jumbo loans is that the demand for Ginne Mae jumbo loan securities has picked up. However, for loans that qualify for neither a Fannie/Freddie program or the FHA program, little price relief is in sight for 30-year fixed rate loan, with spreads likely to remain in excess of 100 basis points over conforming rates. However, pricing is very competitive for loans with adjustable rate features, such as a 3/1 hybrid or a 5/1 hybrid.

For mortgage originators, the search for the right loan has become an exercise in balancing loan amounts, down payments and credit scores. For some combinations and therefore for some borrowers, FHA is the better, lower cost choice. For other combinations, a loan that can be sold to Fannie Mae or Freddie Mac costs less. As announcements have been made over the last month and new underwriting and fee structures have been rolled out, lenders have worked hard to present the best option to their customers.

Conclusion

All of the signs are there for a recovery of a major piece of the jumbo market. Post-recovery, the trend in underwriting practices will be to require higher credit scores, larger down payments, and more robust documentation. Nevertheless, based on current analysis, it is likely that more jumbo loans will be made even before the secondary market fully recovers.

In conclusion, MBA reiterates its request for Congress to enact comprehensive GSE reform legislation this year. Notwithstanding the positive impact of the Economic Stimulus Act of 2008, attributable to higher GSE and FHA loan limits, MBA believes comprehensive GSE regulatory reform will assist in the recovery from the current crisis, as well as minimize the likelihood of future crises. Thank you again for the opportunity to share MBA's views, and we look forward to working with the committee on this very important issue.