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Raising the FHA Loan Limit: A Step in the Wrong Direction

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In one spectacularly misguided move, a House–Senate conference committee has taken a step that will expand the federal presence in the housing markets, preserve Fannie Mae and Freddie Mac, and damage the near-bankrupt Federal Housing Administration (FHA) in the name of helping the housing sector to recover. One small provision of a massive appropriations bill[1] covering the Departments of Housing and Urban Development, Agriculture, Commerce, and Justice enables the FHA to insure mortgages of up to $729,750 instead of the current ceiling of $625,000. The move came on the same day that the FHA reported its capital had dropped and was close to zero, raising the specter of another government bailout of a mortgage finance entity.

The conference committee's action will short-circuit efforts to create a private-sector guarantee of home mortgages and to restart private mortgage-backed securities, an essential step in phasing out Fannie Mae and Freddie Mac. Rather than privately insuring mortgages larger than $625,000 against default—a move supported by key lawmakers on Capitol Hill such as Representative Jeb Hensarling (R–TX) and Representative Scott Garrett (R–NJ) and even the Obama Administration—these mortgages will instead be insured by the FHA.

Short-Circuiting Efforts to Phase Out Fannie Mae and Freddie Mac. The issue arose after the Senate added a provision to the appropriations package that would restore the conforming loan limit, the maximum amount of a mortgage that can be purchased by Fannie Mae, Freddie Mac, and the FHA, to the temporary level of $729,750 that expired on October 1. In an effort to compromise, the conference committee limited the restoration to mortgages insured by FHA by taking out references to Fannie Mae and Freddie Mac.

Unfortunately, this "solution" is certain to backfire. As noted, the move will make it very difficult to establish private-sector mortgage insurance, since most jumbo mortgages will be insured by the FHA. In addition, it will become much more difficult to restore private-label mortgage-backed securities, which in the past have used mainly private-sector risk protections rather than FHA insurance. It is conceivable that private-label mortgage-backed securities could be structured to include FHA-insured mortgages, but this would stunt the growth of a fully private alternative and leave those securities vulnerable to the side effects of a taxpayer bailout of the FHA.

The net result of the conference committee provision is to make it much harder to phase out Fannie Mae and Freddie Mac and their huge taxpayer-fund-

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ed bailouts. It becomes much more likely that both entities will be converted to government-owned utilities or restored to their old presence. And time is running out. As acting Federal Housing Finance Agency (FHFA) Director Ed DeMarco pointed out to the Senate Banking Committee, "Conservatorship is not designed to be a multi-year holding state."[2] Every day that Congress fails to establish a modern private housing finance system, the task becomes more difficult. By essentially voiding the first step in the transition, the conference committee is setting the stage for future housing crises and taxpayer bailouts.

An FHA Already on the Brink of Bailout. The appropriations provision would greatly increase the FHA's presence in the housing market at a time when it is almost out of capital. The agency's latest annual report[3] shows that it has about $2.6 billion in capital to pay for possible losses in its $1.1 trillion mortgage portfolio. This equals about $1 for every $400 of insured mortgages and is far below the legally required $1 of capital for every $50 of insured mortgages. In the past year alone, the report notes that the agency saw its capital drop by $2.1 billion, and there is a 50 percent likelihood that the agency will need as much as a $43 billion bailout as soon as next year.

Since it was created in 1934, the FHA has focused on assisting moderate-income and low-income home buyers by providing them with insured mortgages and allowing them to make down payments as low as 3.5 percent of the purchase price. However, since 2007, the FHA has moved from insuring about 5 percent of new mortgages to about one-third of all new mortgages, as the size of its insurance portfolio tripled. Although the agency's leadership confidently predicts that a recovering housing market will keep it from needing a taxpayer bailout, other experts[4] make a convincing case that the agency is already underestimating the amount of risk in its portfolio, and a bailout is all but certain.

The conference committee's move will see the FHA move beyond its supposed focus on low-income to moderate-income home buyers and become a major player in upper-income mortgages. It will result in using taxpayer dollars to provide subsidies to wealthy home buyers who really have no need of this assistance. Further, by boosting the FHA's market share to even greater levels, it will speed up the probable taxpayer bailout and make it larger. A recent study[5] shows that owners of "jumbo" mortgages are more likely to walk away from their mortgages than other income groups.

Time for a New Mortgage Finance System. The conference committee's action is a serious policy blunder that will only destabilize the FHA and make it harder to create the kind of mortgage finance system needed to assist the economy in recovery. As the mortgage crash of 2007–2008 showed, the current housing finance system is both dangerous and inadequate. Efforts to retain a massive federal presence in housing will result in additional bailouts, federal subsidies that distort housing prices, and a continuing temptation to use the system to implement social goals. It is time for Congress to end the current FHFA receivership and to begin the task of

1. "Hill Bargainers Agree to Boost Size of FHA-backed Mortgages but not Fannie's, Freddie's," Associated Press, November 15, 2011, at *http://www.washingtonpost.com/business/hill-bargainers-agree-to-boost-size-of-fha-backed-mortgages-but-not-fannies-freddies/2011/11/15/gIQAVlYbPN_story.html* (November 17, 2011).
2. Donna Borak, "FHFA's DeMarco Defends Exec Pay for Fannie, Freddie Execs," *American Banker*, November 15, 2011, at *http://www.americanbanker.com/issues/176_222/fhfa-demarco-exec-pay-compensation-freddie-mac-fannie-mae-1044092-1.html* (November 17, 2011).
3. Annie Lowrey, "F.H.A. Audit Sees Possible Bailout Need," *The New York Times*, November 15, 2011, at *http://www.nytimes.com/2011/11/16/business/economy/auditor-says-fha-could-need-bailout.html?_r=1* (November 17, 2011).
4. Joseph Gyourko, "Is FHA the Next Housing Bailout?" American Enterprise Institute, November 11, 2011, at *http://www.aei.org/papers/economics/financial-services/housing-finance/is-fha-the-next-housing-bailout* (November 17, 2011).
5. Kenneth R. Harney, "Jumbo Mortgage Holders Pose Highest Risk of Strategic Default," *Los Angeles Times*, November 13, 2011, at *http://articles.latimes.com/2011/nov/13/business/la-fi-harney-20111113* (November 17, 2011).

moving to a privately financed mortgage market. This task must be handled carefully, because the housing market is still very weak, but further delay will only increase the price for both taxpayers and homeowners.

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