Mortgage Market Note

Portfolio Caps and Conforming Loan Limits

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Mortgage Market Note 07-1

There has been confusing commentary on Fannie Mae's and Freddie Mac's role in the secondary mortgage market and how they might contribute to easing the current disruptions. As the regulator of these companies, one role of the Office of Federal Housing Enterprise Oversight (OFHEO) is to enhance public understanding of the secondary mortgage market. To that end, this Note explains the conforming loan limit and the portfolio caps currently in place for Fannie Mae and Freddie Mac.

Specifically, the **conforming loan limit** refers to the maximum principal balance of individual mortgages that Fannie Mae and Freddie Mac may purchase. Set forth in their charters by the Congress, the loan limit is based on year-over-year changes in a house price series published by the Federal Housing Finance Board based on its Mortgage Interest Rate Survey. OFHEO then calculates the maximum amount the conforming loan limit may be based on the increase or decrease calculated by the Finance Board. After OFHEO announces the new maximum amount, Fannie Mae and Freddie Mac then announce whether they will set the conforming loan limit at or below the new maximum. OFHEO does not have the authority to increase the conforming loan limit above that resulting from the calculation.

Portfolio caps refer to limits on the total dollar amount of mortgage assets Fannie Mae and Freddie Mac may hold on their balance sheets. Portfolio caps were put in place in separate agreements between OFHEO and each Enterprise due to safety and soundness concerns. The agreements were established to limit the size of the portfolios (but not to limit Enterprise securitization of mortgages) as the Enterprises remediate existing accounting and internal control issues.
The portfolios are not static. Each month, borrowers make principal payments that reduce their loan balances and some borrowers prepay their mortgages. At the same time, each month the Enterprises are adding new mortgages to their portfolios, within the cap limits.

The following discussion elaborates on these two important topics. Definitions of mortgage terms and an index to relevant documents appear at the end.

Background on Fannie Mae, Freddie Mac, and Their Role in the Mortgage Market

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are government-sponsored enterprises (GSEs or Enterprises) – shareholder-owned companies chartered by the Congress to fulfill a public mission. They operate with certain benefits unavailable to other private firms, but are limited by their federal charters to certain business activities described below. Their charters also include limits on the dollar size of mortgages eligible for Enterprise purchase or guarantee, the minimum down payment required (or alternative credit enhancement), and general guidance with respect to credit quality and underwriting. The Congress created OFHEO in 1992 to oversee Fannie Mae's and Freddie Mac's safety and soundness.

Today, Fannie Mae and Freddie Mac are supporting the liquidity and stability of the mortgage markets by buying, selling, and securitizing more than $100 billion of mortgages per month. Fannie Mae and Freddie Mac report annualized growth rates through July of 12.1 percent and 12.9 percent, respectively, in their total books of business. At the same time, mortgage originations have been declining significantly over the past several quarters; in the second quarter of 2007, single-family originations averaged about $243 billion per month, down 8.8 percent from the second quarter of 2006.

Conforming Loan Limit

Fannie Mae and Freddie Mac are not allowed by their charters to purchase loans above the conforming loan limit ($417,000 for most single-family properties in both 2006 and 2007). Under present law, the conforming loan limit may only be increased if the average house price goes up from October to October as measured by a Federal Housing Finance Board survey. OFHEO independently calculates the conforming loan limit and assures that changes to the limit made by the Enterprises accord with the statute and are implemented in a safe and sound manner. OFHEO recently issued proposed revisions to its existing guidance on the subject, detailing procedures it will use to provide certainty to the mortgage markets regarding the limit should house prices decline. Under this proposal, no decrease would be required in the conforming loan limit for 2008, regardless of what happens to house prices this year.

In the GSE reform legislation that passed the House of Representatives in May, the conforming loan limit would be increased in some areas where house prices are especially high.

Securitization, Retained Portfolios, and Portfolio Caps

The primary way Fannie Mae and Freddie Mac support the conforming loan market is by guaranteeing mortgage-backed securities (MBS). In a process called securitization, the Enterprises create MBS, securities that are backed by a pool of mortgages, and guarantee payment to MBS investors. The MBS pay principal and interest to investors based on payments made by borrowers on the underlying pool of mortgages. The Enterprises bear and manage the credit risk that borrowers may default on these mortgages; for that risk, the GSEs collect a fee. Thus, payments to investors in Enterprises' MBS are secured, first, by the underlying mortgages and, second, by a corporate guarantee of payment from the issuing Enterprise. The corporate guarantee of payment to MBS investors is the same as the corporate guarantee of repayment to the Enterprises' debt holders.

These MBS, which total over $3.5 trillion today, are actively trading at reasonable prices based on historical norms, despite increased new issue volumes and the present turmoil in other segments of the mortgage market. In recent years, the Enterprises' share of MBS issuance declined as private-label securities, often backed by subprime, Alt-A, and jumbo mortgages, grew rapidly. Most recently, the Enterprises' market share has been increasing and now exceeds 50 percent (Table 1). In July, the Enterprises' share was greater than 60 percent.

Table 1. Gross Issuance of Mortgage-Backed Securities (MBS)					
Date	Total MBS ($ in billions)	Percent of Total		Alt-A and Subprime as Percent of Total	
		Agency	Non-Agency	Alt-A	Subprime
2001	$1,355	80.3	19.7	0.8	6.4
2002	$1,857	77.7	22.3	2.9	6.6
2003	$2,717	78.4	21.6	2.7	7.2
2004	$1,884	54.1	45.9	8.4	19.2
2005	$2,156	44.7	55.3	15.4	21.6
2006	$2,050	44.1	55.9	17.8	21.9
2007 Q1	$537	49.4	50.6	18.0	16.5
2007 Q2	$547	52.8	47.2	18.4	13.7

Source: OFHEO based on data from Inside Mortgage Finance Publications.

The second way the Enterprises support the conforming loan market is through buying mortgages and MBS, holding them in their own portfolios and funding them by issuing debt. These retained portfolios represent 31.1 percent of their book of business. Portfolio holdings chiefly comprise the Enterprise's own MBS, other issuers' private-label MBS, and whole loans. Table 2 shows the Enterprises' retained mortgage portfolios as of July 31, 2007. Actual mortgage loans (whole loans) compose 40 percent of Fannie Mae's retained mortgage portfolio and 10 percent of Freddie Mac's. Thus, 60 percent of Fannie Mae's retained mortgage portfolio, and 90 percent of Freddie Mac's retained mortgage portfolio are comprised of mortgage-backed securities. Combined, the Enterprises own about 18 percent of their own MBS. Almost 50 percent of their portfolios are in liquid agency securities, which are issued by Fannie Mae, Freddie Mac and Ginnie Mae.

Table 2. Enterprises Retained Mortgage Portfolios as of July 31, 2007 (dollars in millions)					
	Own MBS	**Other Agency MBS**	**Non-Agency MBS**	**Whole Loans**	**Total**
Fannie Mae	$277,468	$33,136	$123,922	$295,314	$729,840
Freddie Mac	$365,332	$44,271	$241,780	$69,246	$720,629
Combined	$642,800	$77,407	$365,702	$364,560	$1,450,469
Combined %	44.3%	5.3%	25.2%	25.1%	100%

Sources: Fannie Mae, Monthly Summary, July 2007 and Freddie Mac, Monthly Volume Summary: July 2007.
Notes: Amounts are unpaid principal balances. Other agency MBS includes MBS issued or guaranteed by another Enterprise or by the Government National Mortgage Association (Ginnie Mae). Non-agency MBS are "private-label securities."

As these purchases entail not only credit risk but significant interest rate and operational risks and as Fannie Mae and Freddie Mac still have significant systems, operational, control, and risk management challenges, OFHEO entered into separate agreements last year with Fannie Mae and Freddie Mac to cap their retained mortgage portfolios. The Freddie Mac cap, established by a voluntary agreement between Freddie Mac and OFHEO, allows 2 percent annual growth (0.5 percent quarterly). For the third quarter, the Freddie Mac cap is $728.1 billion.

The fourth quarter's cap will increase to $731.8 billion. Fannie Mae's portfolio cap, established by the May 2006 consent order, is fixed at $727.7 billion. The totals for the two Enterprises' retained portfolios in Table 1 reflect unpaid principal balances and, thus, differ slightly from the actual portfolio balance numbers used to assess compliance with the portfolio caps. Each Enterprise's actual balance reflects its unpaid principal balance adjusted, in accordance with Generally Accepted Accounting Principles (GAAP), to reflect market value adjustments, impairments, the Enterprise's allowance for loan losses, and other such adjustments. Each Enterprise remains in compliance with its respective portfolio cap requirement.

As balances on the whole loans and mortgages underlying MBS held in the portfolios of Fannie Mae and Freddie Mac decline through prepayments and normal loan amortization, the Enterprises in combination have the ability to make $20-30 billion in new portfolio investments each month. Importantly, the portfolio caps do not apply to the Enterprises' off-balance sheet securitization activities except that purchases of those MBS for their own retained portfolios are affected by the cap. Also, the caps apply only to the mortgage portfolios, not to the Enterprises' other assets.

Recent Market Disturbances

Key sources of the current market difficulties have been poor underwriting by lenders, excessive reliance on continued house price appreciation by investors, and highly leveraged borrowing by some homebuyers. Most of these problems have centered in the subprime and "Alt-A" mortgage markets and involve mortgages made to borrowers with impaired credit histories or with limited or no documentation of borrower income. Bank and thrift regulators have issued guidances on non-traditional mortgages and subprime lending to curb these practices, and OFHEO has supported these efforts by requiring the Enterprises to limit their mortgage purchases and guarantees to loans and securities that are consistent with these guidances. At the same time, OFHEO has encouraged the Enterprises to develop and implement safe and sound mortgage products for homeowners currently in unsuitable mortgages.

Mortgage Terminology

Credit Quality

Prime Loan – A conventional single-family mortgage made to a borrower with strong credit. Also known as an A loan.

A- (A-Minus) Loan – A conventional single-family mortgage made to a borrower with slightly impaired credit.

Alternative-A (Alt-A) Loan - A conventional single-family mortgage made to a borrower who typically provides limited income or asset verification or no evidence of an employer. Such loans may have other non-standard underwriting.

Subprime Loan - A conventional single-family mortgage made to a borrower with impaired credit.

Loan Type/Size

Conventional Mortgage – A loan that is neither insured nor guaranteed by the federal government (such as by the Federal Housing Administration or the Department of Veterans Affairs).

Conforming Loan – A conventional single-family mortgage with a principal balance eligible for purchase by Fannie Mae and Freddie Mac (in 2007 that limit is $417,000) and that otherwise meets the credit quality standards of the Enterprises.

Jumbo or Non-Conforming Loan – A conventional single-family mortgage with a principal balance exceeding the conforming loan limit (in 2007 that limit is $417,000).

Type of Property Financed

Affordable Housing Loan – A single- or multifamily mortgage that finances units that count toward goals established by the Department of Housing and Urban Development. These goals require each Enterprise to devote specific percentages of their purchases to units in properties that are affordable by low- and moderate-income households or located in targeted geographic areas.

Single-Family Mortgage – A loan secured by a property with 1 to 4 units.

Multi-family Mortgage – A loan secured by a property with 5 or more units. Fannie Mae and Freddie Mac may purchase multi-family mortgages of any size.

Securities

Mortgage-Backed Security (MBS) - A security that represents an undivided interest in a group of mortgages. MBS investors receive pro rata shares of principal and interest payments on the loans backing the securities.

Agency MBS – A MBS guaranteed by Fannie Mae, Freddie Mac, or the Government National Mortgage Association (Ginnie Mae), a government corporation that is part of the U.S. Department of Housing and Urban Development. Unlike MBS guaranteed by Fannie Mae and Freddie Mac, MBS guaranteed by Ginnie Mae are backed by the full faith and credit of the United States.

Private-Label Mortgage-Backed Security (PLS) - A MBS issued by a private entity other than Fannie Mae, Freddie Mac, or Ginnie Mae – a non-Agency MBS.

Residential Mortgage-Backed Security (RMBS, also known as Private-Label or Non-Agency MBS) – A MBS issued by a private entity other than Fannie Mae, Freddie Mac, or Ginnie Mae – a non-Agency MBS.

Commercial Mortgage-Backed Security (CMBS) – A MBS that represents an undivided interest in mortgages made to finance retail, office, industrial, hotel and resort, or multi-family properties.

Real Estate Mortgage Investment Conduit (REMIC) - An investment vehicle that holds residential or commercial mortgages in trust and issues multiple classes of securities representing undivided interests in those mortgages. The securities in each class entitle investors to cash flows structured differently from the payments on the underlying mortgages.

Index to Relevant Documents

Conforming Loan Limit

Current OFHEO Guidance on the Conforming Loan Limit:
http://www.fhfa.gov/SupervisionRegulation/Rules/Pages/Examination-Guidance.aspx

Proposed Changes to the Conforming Loan Limit Guidance:
http://www.fhfa.gov/SupervisionRegulation/Rules/Pages/OFHEO-Conforming-Loan-Limit-Calculations-Proposed-Guidance-June-20-2007-Revising-SG0401-February-20-2004.aspx

Public Comments Received on Proposed Changes to Conforming Loan Limit Guidance:
http://www.fhfa.gov/SupervisionRegulation/Rules/Pages/Comment-List.aspx?RuleID=39

Portfolio Caps

Consent Order with Fannie Mae:
http://www.fhfa.gov/Media/PublicAffairs/Pages/Fannie-Mae-Facade-Fannie-Mae-Criticized-for-Earnings-Manipulation.aspx

http://www.fhfa.gov/Media/PublicAffairs/Pages/OFHEO-SEC-Reach-Settlement-with-Fannie-Mae-Penalty-Imposed.aspx

Voluntary Agreement with Freddie Mac:
http://www.freddiemac.com/news/pdf/ofheoltr_073106.pdf

August 10, 2007 Statement of OFHEO Director Lockhart on Portfolio Caps:
http://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-James-B-Lockhart-on-Liquidity-of-Mortgage-Market-and-Role-of-Fannie-Mae-and-Freddie-Mac.aspx

Nontraditional Mortgages and Subprime Guidance

Statement of Director Lockhart:
http://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-on-Issuance-of-Letters-by-Fannie-Mae-and-Freddie-Mac-Regarding-Nontraditional-and-Subprime-Mortgage-Products.aspx