The Honorable Melvin L. Watt
Federal Housing Finance Agency
Constitution Center
400 7th Street, SW
Washington, DC 20024

July 17, 2015

Re: May 21, 2015 Request for Input on House Price Index Measure for Conforming Loan Limits for Fannie Mae and Freddie Mac

Dear Director Watt,

On May 21, 2015 the FHFA requested input on a method for assessing the national average single-family house price for use in setting the conforming loan limits of Fannie Mae and Freddie Mac. The Housing and Economic Recovery Act of 2008 requires that FHFA "establish and maintain" a house price index for adjusting the conforming loan limits of the Enterprises. We are pleased to provide our input on this.

We strongly support the FHFA's proposal to use the FHFA "expanded-data" house price Index as the basis for adjusting the GSE's conforming loan limits. This index is done internally, giving the FHFA total control, which allows the FHFA to make changes to enhance the index. And it avoids the risk that an outside vendor will discontinue the index or alter it in an undesirable manner. Moreover, this well established index uses more comprehensive data than any of the FHFA's other indices.

Included with this letter is an article we prepared on the topic, which contains our comments and summarizes our views on using the "expanded-data" house price index for adjusting GSE conforming loan limits.

I sincerely appreciate your consideration of our input on this important issue, and would be happy to discuss this further at your convenience. I have included my contact information below.

Sincerely,

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Use the Expanded-Data Index to Set Mortgage Loan Limits

Laurie Goodman

June 2015

The government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, can guarantee loans only up to a maximum amount. These size limitations, or conforming loan limits, are established by the Federal Housing Finance Agency (FHFA), the GSEs' conservator.

On May 21, 2015, the FHFA issued a request for input on which house price index should be used to adjust the conforming loan limits, noting its intent to use the FHFA "expanded-data" house price index (HPI). For the reasons discussed below, I agree that the expanded-data HPI is the right choice.

Background

The Housing and Economic Recovery Act of 2008 (HERA) establishes a formula for determining the conforming loan limits that relies upon an index of home prices maintained by the FHFA. As home prices increase according to the index, so too do the conforming loan limits, allowing the outer limit of the GSEs' market coverage to capture roughly the same share of the market. Notably, loan limits only adjust upward: if prices decline under the index, then the limits remain unchanged. The limits do not adjust upward until the index regains all its prior losses.

The FHFA determines both a single nationwide limit (now set at $417,000) and a set of upward adjustments for communities in which home prices are considerably higher than average. High cost areas are those in which 115 percent of the local median home values exceeds the baseline. For these areas, the loan limit is set at 115 percent of the median value. The single-family loan limit cannot be more than 150 percent of the baseline level except in Alaska, Hawaii, Guam, and the US Virgin Islands.

Home prices declined considerably between 2007 and 2011, and they have since risen substantially. As a result, values on many indices are close to where they were in 2007; this is a critical level for determining whether the limit can rise again, owing to HERA's no decline rule. As the index rises above the level in effect when HERA was passed, the conforming loan limit will be raised.

The "Expanded-Data" House Price Index

The FHFA is requesting comment on its choice of the FHFA "expanded-data" price index to be used to set conforming loan limits. This index is referred to as "expanded-data" because it contains more than just GSE loans; it also includes loans insured by the FHA and loans held in portfolio by originating lenders. The expanded-data index is now 7.3 percent below the level that would command an upward adjustment in the conforming loan limit.

I believe that the "expanded-data" price index is the logical choice for FHFA. The FHFA believes it must control the index to allow for total transparency on index construction and weightings and to allow the agency to make changes to enhance the index. Indices developed by outside vendors do not offer this control, though the FHFA did consider them. Without control, the FHFA runs the risk that the outside vendor will discontinue the index or make changes that the FHFA believes compromises quality.

Of the several repeat-sales indices the FHFA produces, the expanded-data index is the best on many levels, including the following:

- **The index uses more comprehensive data.** Other FHFA indices are based just on GSE data. The expanded-data price index includes transactions with FHA-endorsed loans, as well as transactions that have been logged at county recorder's offices throughout the country. (The FHFA currently receives these latter data through CoreLogic.) Because the county recorders' transactions contain homes with GSE or FHA mortgages, the duplicate sources of information must be eliminated.

- **The FHFA has already corrected for variations in transaction volume, as it does for all its indices.** If the index were constructed by simply pooling transactions data and directly estimating the change, a bias would likely be introduced: transaction activity is generally higher in areas where prices are rising and lower in areas where prices are falling. The expanded-data index computes the change for each state plus Washington, DC, then weights the change by the relative number of homes in that area.

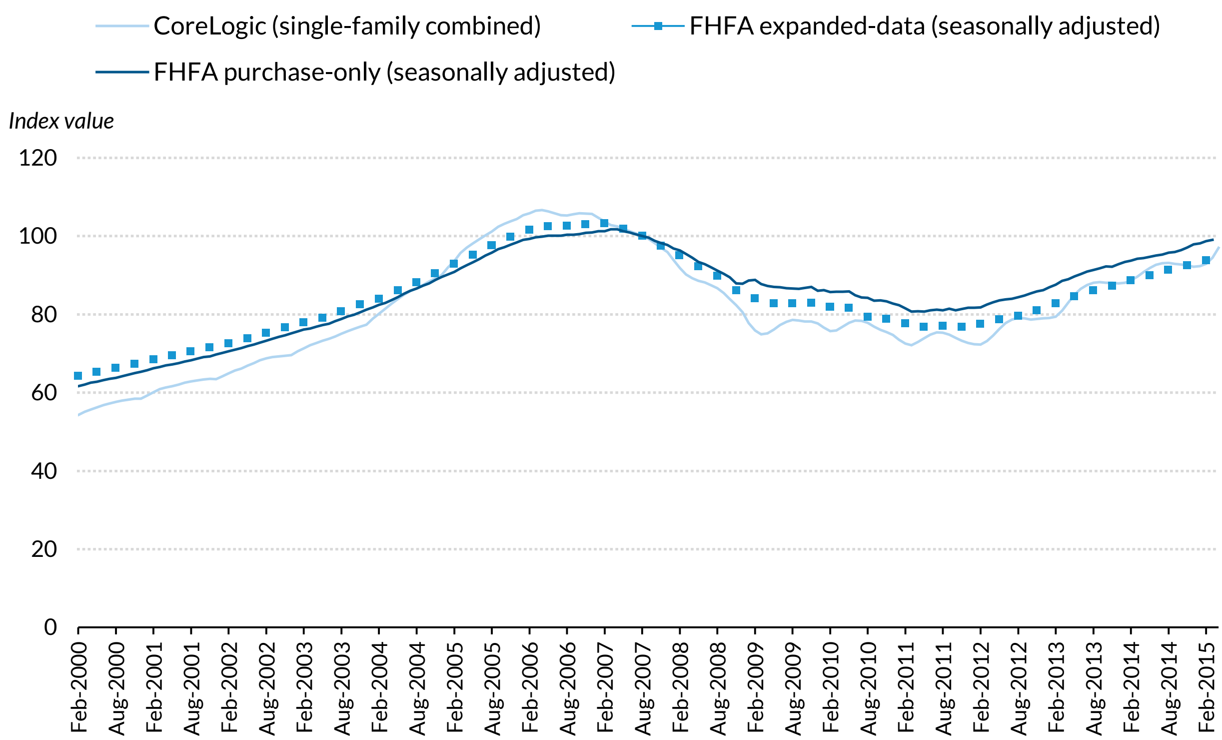
- **The index uses only purchase loans.** Appraisal values from refinance mortgages are excluded, as this information is less reliable. The FHFA's purchase-only index includes only purchase mortgages, while its "all transactions" index includes refinances.

- **The index includes distressed sales, as do all national FHFA indices.** Experts have long debated whether home price indexes should include distressed sales, which include short sales, sales of bank real estate–owned properties, and deeds-in-lieu of foreclosure. These properties often sell for a lower price than non-distressed sales for two reasons: because the property is in worse shape, and because the party responsible for the sale is often not the party taking the economic loss and is hence less motivated to expend the additional effort for a slightly higher price. However, distressed sales are transactions, and they often provide indications of market value. Home price measures that exclude distressed sales could be misleading. In areas where prices are declining, for example, borrowers could be holding homes off the market and the sales price would be too high, as it is based on only a few non-distressed transactions.

Figure 1 compares the FHFA expanded-data HPI with the FHFA purchase-only HPI and the CoreLogic HPI. The expanded-data index is more volatile than the purchase-only index because the dataset is larger and incorporates a broader range of homes—including more lower-priced homes, which depreciated more during the Great Recession than higher-priced homes. It is less volatile than the CoreLogic HPI because of the weighting scheme. I believe this index is a reasonable choice.

FIGURE 1

A Comparison of House Price Indices, February 2000–February 2015



Sources: FHFA, CoreLogic, and Urban Institute.
Note: All indexes are rebased to equal 100 in August 2007.

Using the "expanded-data" index does raise the broader question of the purpose of conforming loan limits, whether the base level is reasonable, and whether the high cost adjustments should be continued. Those questions, however, are beyond the scope of the request for input.

About the Author

Laurie Goodman is the director of the Housing Finance Policy Center at the Urban Institute. The center is dedicated to providing policymakers with data-driven analysis of housing finance policy issues that they can depend on for relevance, accuracy, and independence.

Before joining Urban in 2013, Goodman spent 30 years as an analyst and research department manager at a number of Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group, LP, a boutique broker/dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of Global Fixed Income Research and Manager of US Securitized Products Research at UBS and predecessor firms, which was ranked first by *Institutional Investor* for 11 straight years. She has also held positions as a senior fixed income analyst, a mortgage portfolio manager, and a senior economist at the Federal Reserve Bank of New York.

Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. She serves on the board of directors of MFA Financial and is a member of the Bipartisan Policy Center's Housing Commission, the Federal Reserve Bank of New York's Financial Advisory Roundtable, and the New York State Mortgage Relief Incentive Fund Advisory Committee. She has published more than 200 articles in professional and academic journals, and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and a MA and PhD in economics from Stanford University.

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