

Lessons from the Jumbo Market

Absent Freddie Mac, borrower costs and risks would rise

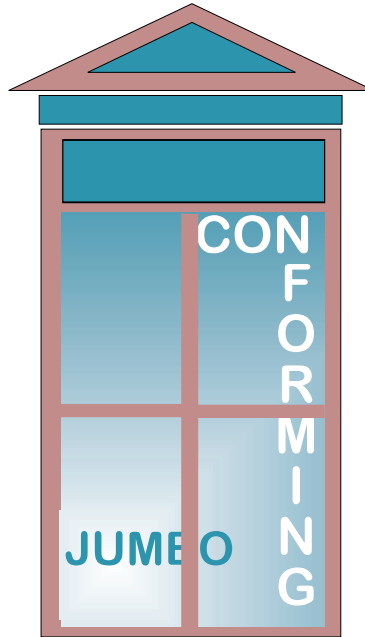
by Frank E. Nothaft

PICTURE A WORLD IN WHICH Freddie Mac and Fannie Mae—no longer operating under the congressional charters by which they were formed—lose both their housing-specific missions and the tools that enable them to accomplish their public purpose.

Actually, it does not take much imagination to envision how the mortgage market would change. A window on such a world already exists in the form of today's jumbo mortgage market. This niche, about one-fifth the size of the conventional market in the United States, supplies capital to fund the larger mortgages that the pair, by charter, are prevented from purchasing. The current loan ceiling, which may change annually, limits the two companies to investing in one-family mortgages of up to \$207,000¹, thereby setting the bounds of what is often referred to as the "conforming" mortgage market.

If Freddie Mac and Fannie Mae were to begin operating as fully private entities, the conforming loan market would quickly come to resemble the existing jumbo mortgage market.

Compared with the conforming loan market, today's jumbo



market is encumbered by several undesirable characteristics, including higher borrowing costs, greater borrower risk and regional disparities. The typically higher interest rates charged for jumbo mortgages account for much of the \$10 billion annually

that conforming loan borrowers save due to the presence of Freddie Mac and Fannie Mae.

The Jumbo Market Today

At the primary mortgage-market level, the jumbo and conforming segments share many lenders. Banks, including their mortgage-banking subsidiaries, dominate in both markets, accounting for 47 percent of conventional conforming originations and 58 percent of jumbo loans², based on 1995 Home Mortgage Disclosure Act (HMDA) data. Independently owned mortgage companies and thrifts also accounted for 28-percent and 25-percent shares, respectively, of the conforming market and 16 percent and 27 percent of the jumbo market in 1995.

More acute differences emerge between the jumbo and conforming players at the

¹Higher limits apply in Alaska, Hawaii, Guam and the U.S. Virgin Islands. Higher limits also apply to mortgages for two-, three- and four-unit properties.

²The HMDA data do not distinguish between conforming and jumbo loans for mortgage originations falling between \$203,150 (the 1995 conforming loan limit for one-unit properties) and \$390,400 (the 1995 conforming loan limit for four-unit properties). Freddie Mac erred on the side of caution by counting as conforming mortgages only those at or below \$203,150 and counting as jumbo loans those above \$390,400.

This article, focusing on the weaknesses of the jumbo mortgage market, is drawn from a more wide-ranging report, *Financing America's Housing: The Vital Role of Freddie Mac*, prepared earlier this year by Freddie Mac. The report more fully explores the feasibility and desirability of repealing the federal charters under which Freddie Mac and Fannie Mae operate. To obtain a copy of the report, call (800) FREDDIE. It should also become available shortly through the Internet at www.freddiemac.com.

Frank E. Nothaft is deputy chief economist in Freddie Mac's housing economics department.

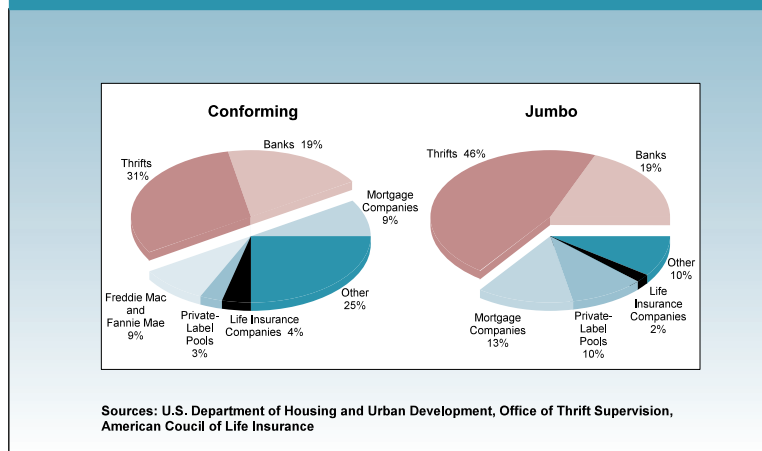
secondary-market level. While Freddie Mac and Fannie Mae play a critical role in ensuring the availability of low-cost mortgages on the conforming side, no comparable organizing structure exists for the jumbo market. As a result, a far greater share of jumbo mortgages is retained in the portfolios of depositories and a far smaller share is sold into the secondary market. Moreover, the base of investors that purchase securities backed by jumbo mortgages is far more narrow.

The relatively disparate sizes of the two secondary markets is reflected in the fact that 2.5 million conventional conforming loans were sold in 1995, compared with 0.1 million jumbo loans, according to HMDA data reports. At the primary-market level, jumbo mortgage originations totaled approximately \$110 billion in 1995, or one-fifth of all conventional loan originations.

Drawbacks of the Jumbo Market

The jumbo market suffers from a host of inherent weaknesses. It is incapable of offering the same market standardization, business volume and investor guarantees that Freddie Mac and Fannie Mae bring to the mortgage arena. These jumbo-market flaws, if overlaid against the much larger sector of mortgages that currently conform to Freddie Mac and Fannie Mae standards, would grow in magnitude, not disappear.

EXHIBIT 1: Holders of New Conventional Single-Family Originations



What's more, many of the efficiencies found in the jumbo market stem indirectly from the charter-driven advantages of the conforming loan market. For example, jumbo lenders protect their mortgage production pipelines against interest-rate fluctuations by investing in Freddie Mac securities, which provide a less expensive and more effective hedge than other means available.

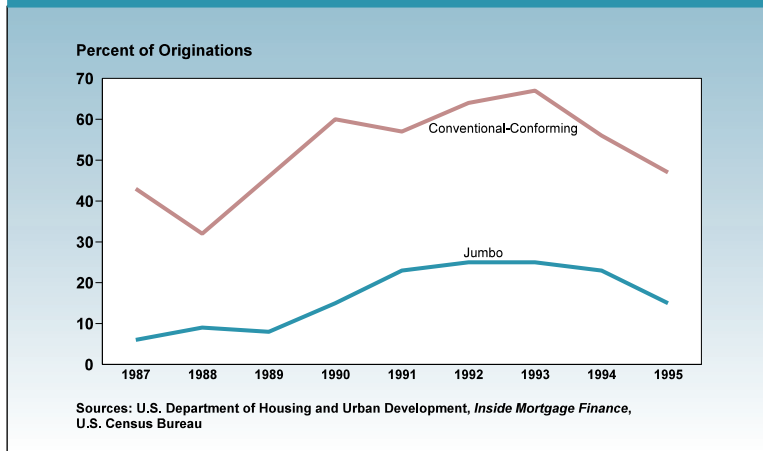
Without the presence of a Freddie Mac-Fannie Mae equivalent, the jumbo market relies more heavily on the deposits generated by banks and thrifts to replenish the working capital necessary to originate jumbo loans. According to the most recent data available, depository banks and thrifts in 1991 held 65 percent of newly made jumbo whole loans (*Exhibit 1*) but only 50 percent of conforming whole loans. When investments in Freddie Mac and Fannie Mae mortgage-

backed securities are excluded, the depositories' share of conforming loans drops to 41 percent.

The notable lack of diversity within the jumbo investor base makes this market more susceptible to rises in mortgage rates during periods of stress. During an economic downturn, for example, the thrift industry might well act to offset losses by conserving the capital that otherwise would go into mortgage purchases, thereby depriving the jumbo market of one of its dominant investors.

The depositories, in a charterless housing-finance system, likely would assume an even larger investor role than now, given that they would continue to benefit from the borrowing advantages that flow from federal deposit insurance and low-cost Federal Home Loan Bank advances. Yet, they are in no position today to meet the surge in demand the conforming

EXHIBIT 2: Issuance of Mortgage-Backed Securities



market would bring. Deposits at these institutions, which also support other business- and consumer-credit needs besides mortgages, have grown only by a factor of six to \$3.4 trillion today from \$0.6 trillion in 1970. Over the same period, though, single-family conventional mortgage debt shot up 15-fold, increasing to \$3.1 trillion from \$0.2 trillion. To cope, banks and thrifts would need to pay higher interest rates to attract more deposits, which would show up in higher mortgage prices. Ultimately, that forces yet another cost on borrowers from which they are spared in today's conforming loan market.

When not held in portfolio, the remaining jumbo loans are funded primarily through mortgage-backed-security sales, but to a much lesser extent than in the conforming market, as shown in *Exhibit 2*. An average 19 percent of jumbo loans were issued by a private-label conduit

between 1987 and 1995, peaking at 25 percent in 1993. By comparison, securitization of conventional conforming loans by Freddie Mac and Fannie Mae averaged 55 percent during the same years.

Private-label securities built on jumbo loans not only fail to convert as quickly and easily into cash as those based on conforming mortgages, but the number of securities issued is small and the underlying mortgages are less homogenous. In contrast, the superior liquidity of conforming securities arises from the greater issuance volume, standardization across securities and the strength of the guarantees by the two companies to pass along timely principal and interest payments to securities investors.

The jumbo-mortgage security deficiencies make trading in the private-label market highly cumbersome. Investors must analyze the structure of each security and the composition of

the pool of mortgages. Further, they must evaluate the type and extent of the credit enhancement that support jumbo securities. Private-label securitizers rarely provide corporate guarantees to back their issues against late payments and defaults because they are not adequately capitalized to do so. Instead, they must reduce investor exposure through more expensive means. This might include isolating the riskiest payments within a mortgage pool into securities separate from those composed of the most reliable payments preferred by jumbo investors. The complexity of compensating for risk through such a structure adds to the unwieldy nature and costs of jumbo trading.

The prospect of higher yields does not offset the lack of an easy-to-understand corporate guarantee and the scarcity of readily accessible information about the mortgages forming a private-label security. Many investors, therefore, remain reluctant to enter this market. The result is a much narrower investor base for jumbo mortgages.

Interest among many capital-market investors in holding Freddie Mac and Fannie Mae securities would wane in the event the companies would operate without government-sponsored charters. Investors would sell off their mortgage-backed securities because the instruments would no longer

qualify for special investment treatment similar to that accorded U.S. Treasury securities. As capital-market investors left the market, government agencies and federally insured depositories, both of which bear full faith and credit guarantees by the federal government, would assume noticeably larger loan-funding roles.

What's more, without a federally chartered secondary-market system in place, doing business in the jumbo market would become even more expensive for borrowers. Private-label securitizers and investors could no longer keep their costs down by piggy-backing on the standardization that Freddie Mac and Fannie Mae have brought to mortgage securities and the underlying mortgages themselves. The jumbo market also reduces its research costs by capitalizing on innovations coming out of the conforming sector. Furthermore, jumbo-market lenders rely heavily on Freddie Mac and Fannie Mae securities to hedge their loan pipelines against interest-rate risk.

Market Flaws Add Up to Higher Borrower Costs

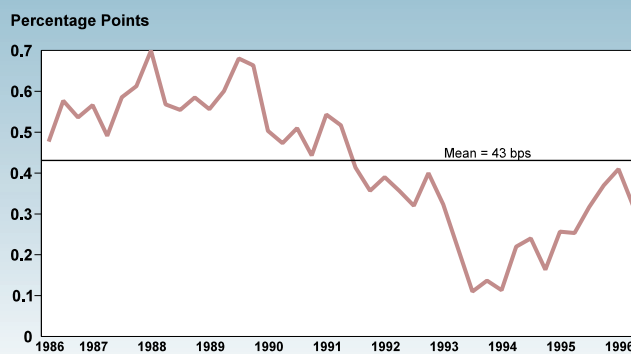
Because the jumbo market is less liquid and functions from a narrower investor base, it is rife with many undesirable characteristics that likely would spread to the conforming market in the event Freddie Mac and Fannie Mae were to operate without their charters. When

added together, borrower costs attributable to weaknesses of the jumbo market raise the interest rate on these loans by one-half of a percentage point. The flaws include:

Stiffer interest rates, particularly for fixed-rate mortgages. The interest rates on jumbo mortgages are generally higher than they are on conforming mortgages. Over the past decade, the rate spread between jumbo and conforming loans made at a

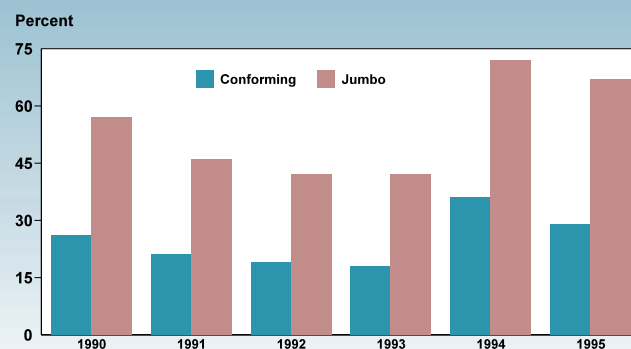
fixed rate of interest for 30 years has averaged 0.43 percentage points (*Exhibit 3*). Many studies have found that interest rates generally decline as loan amounts increase. Consequently, the 0.43-percentage-point difference understates the extent to which Freddie Mac and Fannie Mae have succeeded in lowering conforming rates. After adjusting for the discrepancy, the interest-rate savings come to about 0.5 percentage points, according to Freddie Mac's calculations.

EXHIBIT 3: Jumbo-Conforming 30-Year Spread



Sources: Freddie Mac, HSH Associates Inc.

EXHIBIT 4: ARM Share of Conventional Purchase Loans

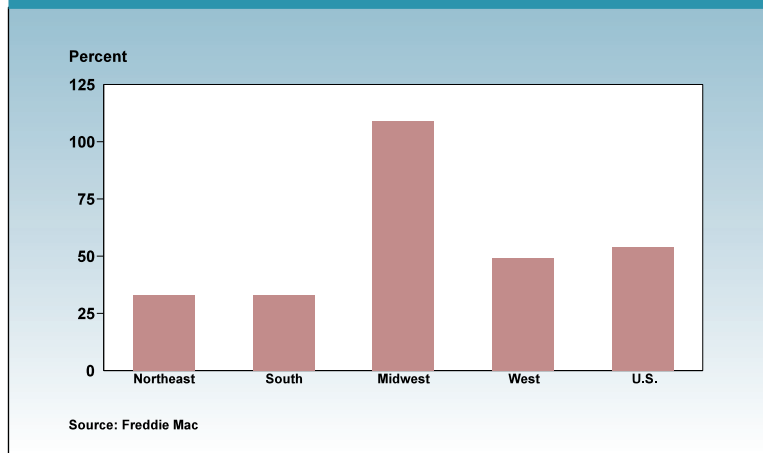


Source: Federal Housing Finance Board

Moreover, borrowers would pay even higher mortgage rates during the chaotic transition to a jumbo-like mortgage market because of the limited capacity of jumbo investors to absorb dramatically higher loan volume.

Heavy reliance on riskier adjustable-rate lending. The adjustable-rate mortgage (ARM) share of the jumbo market is typically more than double that of the conforming market (*Exhibit 4*). This is a direct result of the fact that the interest rate

EXHIBIT 5: Relative Jumbo Mortgage Rate Variability by Region



for fixed loans is about 0.5 percentage points higher in the jumbo market. To illustrate, the first-year starting rate on a jumbo ARM in January 1996 was 2 percentage points lower than on a 30-year, fixed-rate jumbo loan. At the same time, the adjustable-fixed difference in the starting rates for conforming loans was a much smaller 1.5 percentage points. Given that this pattern of interest-rate relationships is likely to persist in the future, fewer borrowers in the conforming market will tend to choose ARMs than those on the jumbo side.

By choosing the ARM option, jumbo borrowers are accepting the risk of potentially sharp upward increases in their monthly loan payments. ARM foreclosure rates are generally double that for fixed-rate mortgages. On the fixed-rate side, much of the risk of rising interest rates remains with the institutional investors, who are arguably better equipped to protect themselves against interest-rate risk.

Regional disparities. Conforming mortgage rates today are highly uniform across different regions of the country, largely due to the national scope of Freddie Mac and Fannie Mae activities. Jumbo rates, though, vary significantly within and among regions. Across the United States, jumbo fixed-rate mortgage prices fluctuate with 54 percent more variability within

regions than do conforming rates, based on a nationwide sample of lenders offering both products (*Exhibit 5*). In the Midwest, in particular, jumbo rate quotes are more than twice as variable as conforming rate quotes.

More erratic interest rates. A heightened sensitivity to regional economic downturns creates the greater rate variability in the jumbo loan market across different areas of the country. During a regional recession, the depositories that serve as the prime investors in jumbo loans—and often double as jumbo lenders—incur losses on a variety of fronts. With their reserves straining to cover these losses, depositories often reduce their portfolio mortgage lending as a means of freeing up more capital. The resulting contraction in credit availability affects borrowers as a combination of higher loan rates and stricter loan-qualifying standards.

In early 1990, for example, housing values fell sharply in Massachusetts as the New England economy sank into recession. Mortgage rates on jumbo fixed-rate loans in Boston alone spiked 0.2 percentage points relative to the national average jumbo rate. That means that a borrower there, by accident of geography, would pay about \$15,000 more in mortgage costs over the life of a 30-year, fixed-rate mortgage than someone living elsewhere.

The rate bump on jumbo loans undoubtedly caused some Boston-area borrowers to forestall their homebuying plans until rates dropped, to settle for less expensive homes, to agree to riskier but lower-cost adjustable-rate mortgages or to come up with higher down payments to keep monthly loan payments in check. In contrast, conforming mortgage rates there averaged slightly less than the national average rate, giving conforming-loan borrowers continued access to lower-cost mortgage money.

In terms of conforming lending, a charter-less system would feature higher mortgage rates and reduced availability of low-down-payment loans. Yet the government-backed mortgage programs—Federal Housing Administration (FHA), Department of Veterans Affairs (VA) and Rural Housing Service (RHS)—and their secondary market facility, known as Ginnie Mae, would remain virtually untouched by the changes. Consequently, the uninterrupted availability of relatively lower interest rates and low down payments on FHA, VA and RHS mortgages would pull many families away from the conventional market and into the government market. As a result, lending activity by FHA, VA and RHS, as well as Ginnie Mae pool guarantee volume, would increase, but so would taxpayer exposure.

A charter-less marketplace would increase government involvement, thereby increasing taxpayer risk.

Avoiding Jumbo-Sized Headaches

Without access to Freddie Mac and Fannie Mae, the secondary market for jumbo loans is hampered by a lack of geographic diversification, resulting in higher capital costs, a shallow investor base, a thin securities market, cumbersome trading, high research costs and greater risk.

America's vast housing-finance system is critical to both the economy and individual homeowners. Because the housing-finance system is just that—a system—the removal of the charter identities of Freddie Mac and Fannie Mae would reverberate throughout the mortgage market. Moreover, elimination of the pair's charters would not dislodge the government's extensive role in mortgage markets. In fact, a

charter-less mortgage marketplace would tend to increase government involvement, thereby increasing taxpayer risk, as the federally insured depositories, FHA and VA assume larger roles.

The weaknesses in the jumbo market emanate from the lack of a government-chartered secondary market as an organizing structure. Consequently, the costs are higher and the risks greater for lenders and investors participating in the jumbo market. Ultimately, though, it is borrowers who suffer the consequences, for they are the ones who must pay the higher mortgage rates dictated by a less efficient market. **SMM**