

October 1994

HOUSING FINANCE

Implications of Alternative Methods of Adjusting the Conforming Loan Limit



**Resources, Community, and
Economic Development Division**

B-257364

October 5, 1994

Congressional Addressees

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)—federally chartered corporations—channel funds between mortgage lenders and capital market investors. While these organizations do not originate mortgage loans, by purchasing mortgages from lenders, Fannie Mae and Freddie Mac provide liquidity to lenders, thereby making additional credit available to qualified borrowers.

The Housing and Community Development Act of 1980 requires a limit (conforming loan limit) on the size of mortgages that can be purchased by either Fannie Mae or Freddie Mac. Fannie Mae and Freddie Mac may not purchase mortgages that exceed the conforming loan limit—called “jumbo” loans. Rather, lenders either hold these loans in their portfolio or sell them to private investors.¹ For borrowers, recent studies have found that conforming loans carry somewhat lower interest rates than jumbo loans. The act provides that the conforming loan limit be adjusted annually so that Fannie Mae and Freddie Mac can respond to changing conditions. For 1994, the conforming loan limit is \$203,150.

To adjust the conforming loan limit, Fannie Mae and Freddie Mac are required to use data on home sales prices published by the Federal Housing Finance Board (Finance Board) in its “Monthly Interest Rate Survey.” The Finance Board’s survey is based on the average price of homes sold in the last 5 days of the month.² To calculate the new loan limit, the percentage change in the average price of homes sold is determined using data from the Finance Board’s survey for the month of October versus the previous October. Then, the previous loan limit is increased by this percentage change. Some critics of the loan limit have suggested alternatives to this method of adjusting the conforming loan limit.

This report, mandated by the Housing and Community Development Act of 1992, reviews the methodology used to adjust the conforming loan limit. Specifically, the report (1) assesses the effect on the loan limit of using

¹Lenders can originate both conforming and jumbo loans. According to data from the Federal Housing Finance Board, in 1993 about 47 percent of jumbo loans were originated by mortgage companies, 32 percent by savings and loan institutions, and about 20 percent by commercial banks.

²Actually, the data are based on the sales price of homes sold that closed during the last 5 days of the month. For this report, we refer to homes sold.

alternative adjustment methods, (2) determines the implications of Fannie Mae's and Freddie Mac's decisions not to adjust the loan limit for 1994, and (3) provides information on how users of the Finance Board's data view the data's accuracy.

Results in Brief

In comparison with the current method of adjusting the loan limit, alternative methods do not substantially change the resulting 1993 loan limit or the share of the conventional mortgage market that would be below the conforming loan limit. For three of the four alternatives we tested, the 1993 conforming loan limit would be within 7 percent of the actual conforming loan limit. The greatest difference in the loan limit—over 14 percent—would occur if the change in home prices, rather than the percentage change in home prices, is simply added to the previous conforming loan limit. With regard to the share of the conventional mortgage market that would fall below the conforming loan limit, 93 percent of all conventional loans were at or below the actual conforming loan limit in 1993. In comparison, between 87 and 91 percent of all conventional loans were at or below the loan limits derived from alternative methods.

Fannie Mae's and Freddie Mac's decision to maintain the same loan limit in 1994 as in 1993, while the index of home prices declined 3 percent, is authorized by law. This decision should allow both companies to, at a minimum, serve the same segment of the mortgage market that they had served the previous year and ease any potential disruption to lenders. For some borrowers, maintaining the same conforming loan limit in 1994 could mean lower interest rates associated with conforming loans.

However, because the law also requires that adjustments to the conforming loan limit be based upon increases in home prices over a 1-year period, the 1995 loan limit may be adjusted upward without reflecting the percentage change in home prices that occurred during the entire 2 years since the limit was last adjusted. This would result in the loan limit no longer following the long-term pattern of growth in home prices, thus imparting a permanent upward bias in the conforming loan limit. Furthermore, should similar circumstances arise in the future, the conforming loan limit would be further biased upward.

While for some borrowers, a higher loan limit could provide the benefits of the lower interest rate associated with conforming loans, the permanent upward bias in the loan limit could increase the number of loans that

would be eligible for Freddie Mac and Fannie Mae to purchase, while reducing the number of jumbo loans. This would particularly affect those lenders that specialize in originating and holding jumbo loans. Similarly, an upward bias in the limits for home loans insured by the Federal Housing Administration (FHA) may occur should the FHA loan limits be indexed to the conforming loan limit, as has been proposed in recent legislation.

Finally, from a national perspective, users of the Finance Board's survey find the data to be generally accurate. Some users did question the accuracy of data for local areas—which is used for purposes other than setting the national conforming loan limit. Furthermore, the Finance Board's data remain as the only comprehensive source of national data on housing price changes for both new and existing homes.³

Background

The conforming loan limit is a legislative restriction on the size of loans that Fannie Mae and Freddie Mac may purchase from lenders. Specifically, the Housing and Community Development Act of 1980 requires that the maximum loan limit be adjusted annually by a percentage equal to the percentage increase in the national average price of houses as measured by the Finance Board. The legislation also specifies that the time period for which an increase in average home prices is measured is the 12-month period ending with the previous October. This adjustment mechanism was provided to allow Fannie Mae and Freddie Mac the capacity to respond to changing conditions over time—presumably including the changing price of homes sold over time.

Between 1980 and 1993, the conforming loan limit rose from \$93,750 to \$203,150, as Fannie Mae and Freddie Mac adjusted the loan limit annually on the basis of the Finance Board's index. For all but one year, the loan limit increased—by as little as less than 1 percent to as much as 15.6 percent. The loan limit declined by one-tenth of 1 percent in 1990—the only year the loan limit has declined. In November 1993, the Finance Board reported that the national average price of homes sold in October 1993 was 3 percent lower than the national average price of homes sold the previous October. However, because of concerns over the potential impact lowering the limit may have on home buyers and lenders, and because the act only specifies that the conforming loan limit be

³Home price data on existing homes are available from the National Association of Realtors, and data on new homes are available from the Bureau of the Census' Current Construction Reports.

increased according to the Finance Board's index, Fannie Mae and Freddie Mac decided not to change the loan limit for 1994.

Alternative Methods for Adjusting the Conforming Loan Limit Yield Similar Results

A 1990 study prepared for the Department of Housing and Urban Development (HUD) assessed several criticisms of the current method for setting the conforming loan limit.⁴ Among these criticisms were that the current method results in the limit (1) being volatile from year to year, (2) rising more rapidly than home prices, (3) not reflecting regional differences in home prices, and (4) not accounting for the changing quality of homes sold.⁵

However, according to the Finance Board, its survey remains the only comprehensive home price data for both new and existing homes. Also, despite the volatility of this index, over the long term, the conforming loan limit is in line with other house price indexes, according to the Congressional Research Service.⁶ The 1990 HUD study also recognized this fact. Finally, the 1990 study also found that adjusting limits for regional differences in home prices and accounting for the changing quality of homes require more detailed data than are now available.

While some critics of the current method believe that the limit has risen more rapidly than home prices, the alternative methods that they suggest would result in similar limits for 1993. In addition, while one might expect that an inflated conforming loan limit would, over time, result in proportionately more loans falling under the limit, the share of loans under the limit has been fairly stable for the past 13 years.

To test the effect of using alternative methods for setting the conforming loan limit, we compared the actual 1993 conforming loan limit with the loan limits derived from alternative methods contained in the 1990 study. These alternative methods included using the same Finance Board data in different ways—median and 3-month averages of home sales prices and a simple addition of the absolute change in home prices—and using alternative data from the National Association of Realtors (NAR) and the

⁴Effects of the Conforming Loan Limit on Mortgage Markets (Mar. 1990), prepared for HUD by ICF, Inc.

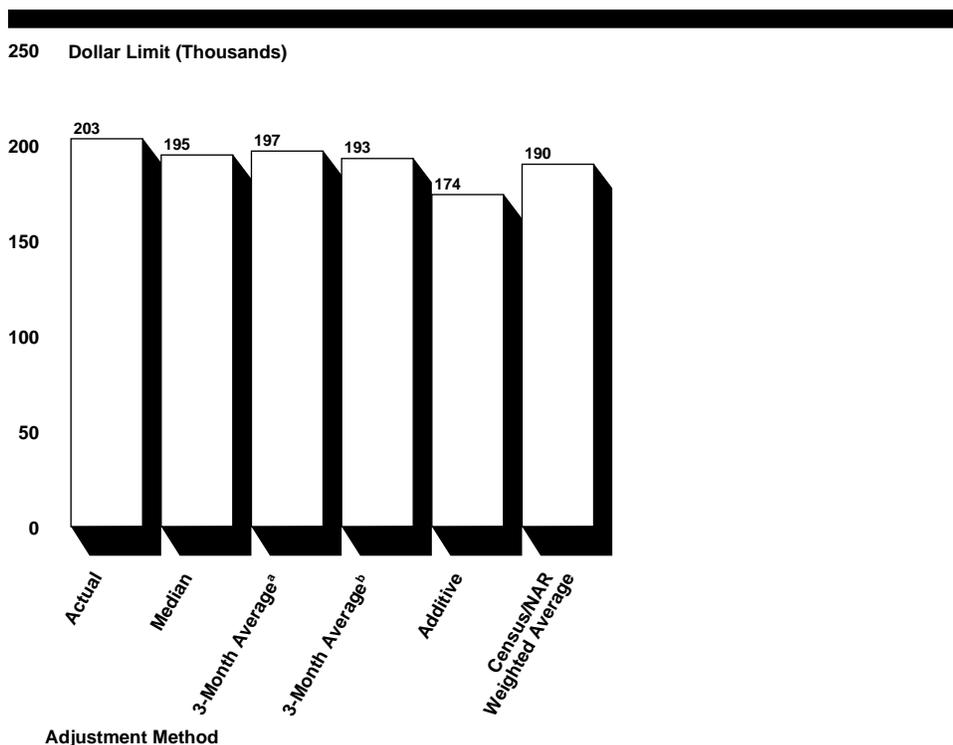
⁵The survey used to adjust the conforming loan limit includes data on fully amortized, purchase money, conventional, first mortgage loans. The survey does not include data on balloon loans, refinancings, or FHA/Veterans Administration loans. Also, the survey does not include data on some other loans, such as those secured by structures with more than one unit.

⁶Housing Finance Debates: The "Conforming Loan" Limits of FNMA and FHLMC, Congressional Research Service, (IB 87094, updated Jan. 1988).

Department of Commerce's Bureau of the Census.⁷ For all alternatives, we estimated the 1993 loan limit using data for all years from 1980 through 1992. Using the median or 3-month averages of the Finance Board's home price data does not significantly affect the amount of the conforming loan limit—between \$192,800 and \$196,700 versus \$203,150. The substitution of alternative data, such as from the Bureau of the Census and the NAR, for the Finance Board's data results in a somewhat larger change but still is within 7 percent of the actual conforming loan limit. As expected, the greatest difference in the loan limit—over 14 percent—would occur if the average change in home prices is simply added to the previous conforming loan limit. (See fig. 1.)

⁷Freddie Mac advocates the use of an alternative methodology that would be based upon an index of weighted repeat sales. Such an index measures the sales price of the same homes over time. Fannie Mae advocates the use of an index of transaction prices for adjusting the loan limit, as is done now. In June 1994, Freddie Mac and Fannie Mae introduced an index of weighted repeat sales, combining data from both companies. According to Freddie Mac, this is the only such index prepared on a national level but does not include data on new homes sold. For this report, we did not compute the conforming loan limit using a repeat-sales index. Rather, we limited our analysis to those alternatives found in HUD's 1990 study.

Figure 1: 1993 Conforming Loan Limit—Actual and Using Alternate Methods



^aOctober, November, and December.

^bAugust, September, and October.

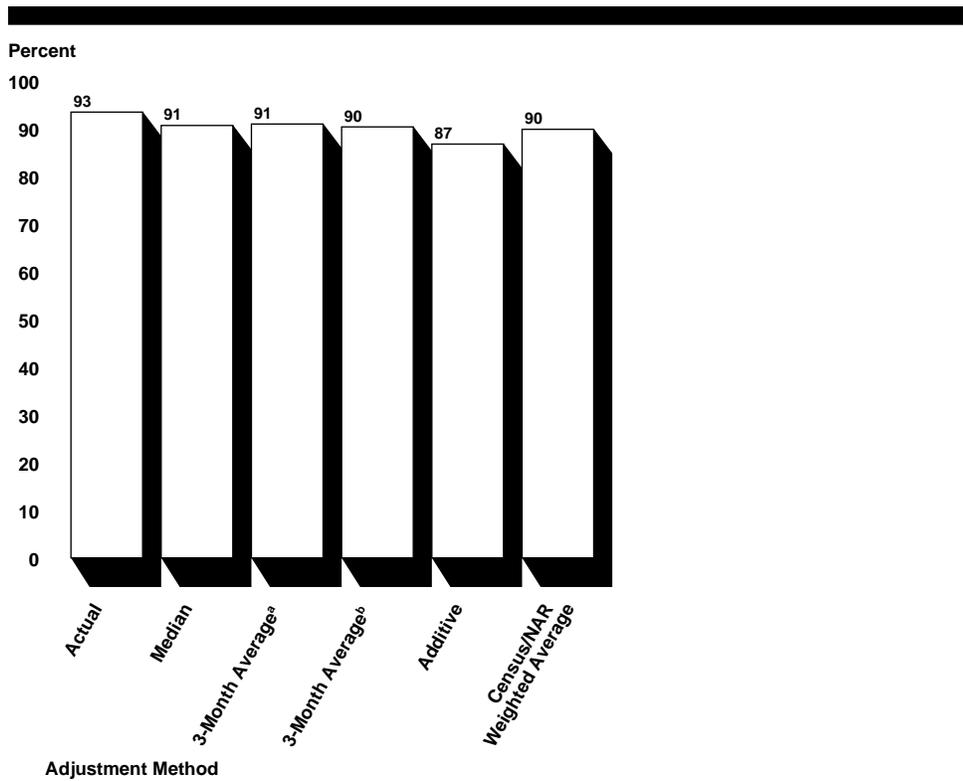
Source: GAO's analysis of data provided by the Finance Board, Bureau of the Census, and NAR.

The effect on the share of conventional loans below the loan limit—and therefore eligible for purchase by Fannie Mae and Freddie Mac—was relatively small for each of the alternative methods we tested. For example, while about 93 percent of conventional loans were below the conforming loan limit in 1993, 91 percent of conventional loans were below the loan limits that would be set if the median home price or a 3-month average method of adjusting the loan limit were used instead. Even using alternative data from the NAR and the Census Bureau results in

⁷Freddie Mac advocates the use of an alternative methodology that would be based upon an index of weighted repeat sales. Such an index measures the sales price of the same homes over time. Fannie Mae advocates the use of an index of transaction prices for adjusting the loan limit, as is done now. In June 1994, Freddie Mac and Fannie Mae introduced an index of weighted repeat sales, combining data from both companies. According to Freddie Mac, this is the only such index prepared on a national level but does not include data on new homes sold. For this report, we did not compute the conforming loan limit using a repeat-sales index. Rather, we limited our analysis to those alternatives found in HUD's 1990 study.

about 90 percent of conventional loans falling under the alternate loan limit in 1993. Again, the greatest effect on the share of conventional loans below the loan limit occurs if the loan limit is set by simply adding the average change in home prices to the previous limit. (See fig. 2.)

Figure 2: 1993 Share of All Conventional Loans at or Below the Actual and Alternative Conforming Loan Limits



^aOctober, November, and December.

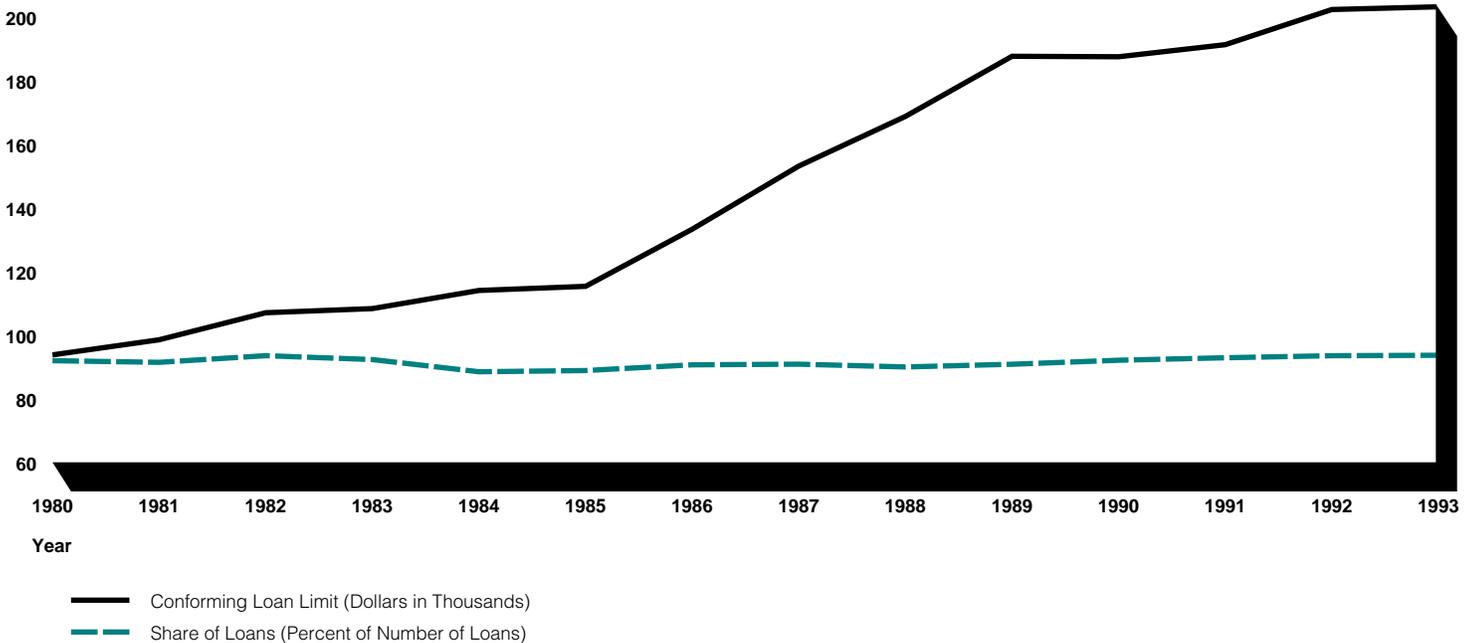
^bAugust, September, and October.

Source: GAO's analysis of data provided by the Finance Board, Bureau of the Census, and NAR.

To assess the criticism that the Finance Board's index had risen faster than actual home prices, we reviewed the share of conventional loans that were below the conforming loan limit for the 1980 through 1993 period. If the conforming loan limit were rising faster than the overall value of homes purchased with conventional mortgages, then a growing share of the loans originated would fall below the limit each year. The result would be an increase in the conforming share of the market. In fact, we found

that the share of conventional loans below the conforming loan limit has been relatively stable between 1980 and 1993. Specifically, the share of loans below the conforming loan limit averaged about 91 percent for the period and ranged from a low of 88 percent to a high of 94 percent. During the same period, the conforming loan limit rose from \$93,750 in 1980 to \$203,150 in 1993. (See fig. 3.)

Figure 3: Conforming Loan Limit and Share of Conventional Loans Below Loan Limit (1980 Through 1993)



Source: GAO's analysis of data provided by the Finance Board.

Implications of Not Adjusting Downward the 1994 Loan Limit

For 1981 through 1993, Fannie Mae and Freddie Mac adjusted the conforming loan limit annually according to the Finance Board's index. For all but one year, the index caused the conforming loan limit to increase—by as little as less than 1 percent and as much as 15.6 percent. The loan limit declined by one-tenth of 1 percent in 1990—the only year the loan limit has declined. In November 1993, the Finance Board reported that the price of homes sold in October 1993 was 3 percent lower than the

price of homes sold the previous October. However, Fannie Mae and Freddie Mac decided for the first time to make no changes to the limit for 1994. Among the reasons cited by Fannie Mae and/or Freddie Mac were that (1) the act only specifies that the conforming loan limit be increased according to the Finance Board's index, (2) it was not clear that there was a real decline in house prices in 1993, and (3) there was the need to provide stability in the secondary market.

The Housing and Community Development Act of 1980 provides that the conforming loan limit be adjusted annually using data on home prices from the Finance Board. Specifically, in order to provide Fannie Mae and Freddie Mac with the capacity to respond to changing conditions over time, the act requires that the maximum loan limit be adjusted each year by a percentage equal to the percentage increase in the national average price of houses as measured by the Finance Board.⁸ The act also specifies that the time period for which an increase in average home prices is measured is the 12-month period ending with the previous October. However, the act is silent on adjusting the loan limit when there is a decline in the average sales price of homes. Neither does the act's history explain whether Fannie Mae and Freddie Mac are required to make adjustments to the loan limit when the average price of homes declines. Like the act, its legislative history speaks of adjusting the maximum allowable loan limit by adding to the existing limit a percentage equal to the percentage of increase, during the 12-month period ending with the previous October, in the national average home price as measured by the Finance Board. Accordingly, in this instance, the act does not require Fannie Mae and Freddie Mac to lower the loan limit when the price declines.

We do not address here whether or not Fannie Mae and Freddie Mac have authority to maintain the conforming loan limit regardless of the extent or duration of housing price declines. According to the Senate report that accompanied the legislation which originally instituted maximum loan limits, the purposes of the conforming loan limit are "to reduce risk to [Fannie Mae and Freddie Mac] and to encourage the flow of mortgage credit to low- and moderate-priced housing." In the event housing prices declined drastically or declined continuously over a period of years, a decision by Fannie Mae and Freddie Mac to maintain the conforming loan limit at a level equal to its highest level could contravene these purposes. It

⁸Freddie Mac commented that it and Fannie Mae have the ability to set a loan limit below the maximum allowable loan limit. Historically, however, both have adjusted the limit according to the percentage increase in the Finance Board's index.

might also result in an inappropriate increase in the share of the secondary market held by the two organizations.

Fannie Mae and Freddie Mac also cited other reasons for their decision—including a concern that a reduction in the limit would hurt many middle-class home buyers, especially in high-cost markets such as California. These borrowers would either have to come up with a larger downpayment or seek a jumbo loan, which recent studies find carry higher interest rates. Both Fannie Mae and Freddie Mac also believe that a reduction in the loan limit would impose operational burdens on lenders, as they would have to operate with two different sets of loan limits for a period of time and have controls in place to ensure that mortgages originated at the previous higher limits are delivered within specified deadlines. For lenders with insufficient volumes to make jumbo loans, a reduction in the loan limit could mean a direct loss of business, according to Fannie Mae.

In terms of the number of loans affected, we found that in 1993, only about 2.4 percent of conventional loans were for amounts that were within 3 percent below the 1993 loan limit—the equivalent of the reduction in the limit that might have been made for 1994 based on the reduction in the average sales price. The impact on the dollar volume of loans is greater. For example, Fannie Mae estimates that about 6 percent of its and Freddie Mac's total 1993 business was within 3 percent below the conforming loan limit. Also, Fannie Mae reports that borrowers in central cities and high-cost areas, such as California, as well as minorities would be disproportionately affected by a reduction in the conforming loan limit.⁹ For example, Fannie Mae estimates that more than 23 percent of the families affected are in central cities, and 8 percent of the entire California market would be affected. Also, 17 percent of the loans in this range were made to minorities in 1993.¹⁰

While not lowering the loan limit in 1994 is allowed by the law, and should ease disruption to certain borrowers and lenders, the method by which subsequent adjustments to the loan limit are made could result in a continuing impact on the share of conventional mortgages below the conforming loan limit. That is, should the loan limit be adjusted upward in

⁹Every metropolitan statistical area has at least one central city, which is usually its largest city.

¹⁰According to HUD, about 25 percent of Fannie Mae's single-family 1993 purchases were on properties located in central cities. Thus, the proportion of central city borrowers that might be affected by a decline in the loan limit is roughly equal to the proportion of central city borrowers that Fannie Mae serves.

1995 to reflect an increase in the average price of homes sold between 1993 and 1994 as currently required by law, regardless of whether there was an increase in the average price of homes sold between 1992 and 1994, the resulting loan limit will be biased upward, and a greater proportion of conventional loans would fall below the conforming loan limit. For example, assuming that average house prices rise by 5 percent this year, the 1995 conforming loan limit would increase by 5 percent if only one year's data were used as a basis for adjusting the limit. However, the 1995 limit would increase by only 2 percent if two year's data were used—reflecting the last point in time that the loan limit was adjusted. Thus, the 1995 loan limit would be 3 percent higher than the loan limit if the adjustment period reflected the entire period since the loan limit was last adjusted—2 years. Consequently, we believe that a greater number of conventional loans would fall under this loan limit in 1995 and in all subsequent years. That is, the number of conventional loans that Fannie Mae and Freddie Mac could purchase could be greater, while the number of conventional loans above the loan limit—jumbo loans—could be lower than otherwise might be the case. Furthermore, if similar circumstances arose in the future, the gap between what could be the loan limit would widen. For some borrowers, a higher conforming loan limit would bring the benefit of lower interest rates associated with conforming loans. Finally, recently proposed legislation would provide for indexing the loan limits for loans insured by FHA to the conforming loan limit. Should the FHA limits be so indexed, any upward bias in the conforming loan limit would result in a similar upward bias in the FHA loan limits.

Comments From Users on the Reliability of the Finance Board's Data on Average Home Prices

In response to the Finance Board's May 1990 request for comments on proposed changes to its Monthly Interest Rate Survey, respondents typically did not question how accurately data were input or how reliably the data were processed. Some respondents did question the accuracy of local data that are used for purposes other than adjusting the conforming loan limit. Specifically, the respondents most often suggested that the sample size be expanded so that regional, state, and local data would be more reliable. Some respondents suggested alternative methods of increasing sample size, such as using more days of the month or the last days of the month. Other respondents suggested adjustments to better reflect the mix of lenders reporting and the geographic and size mix of homes included in the sample.

In response to respondents' concerns, the Finance Board made several technical modifications to its method for calculating the average home

sales price. To increase the sample size, in November 1991, the Finance Board started using data for the last 5 days of the month, instead of the first 5 days of the month, because more loans are closed at the end of the month than at the beginning. In addition, the Finance Board, in January 1992, implemented a new weighting scheme that, according to the Finance Board, would allow for the share of mortgages represented in the survey for each type of lender to comport with aggregate lending patterns.¹¹ The principal effect of this change, according to the Finance Board, is to increase the statistical importance of loans originated by mortgage companies and commercial banks and decrease the statistical importance of loans originated by savings and loan associations.

While these changes address some of the respondents' concerns, we have not evaluated their statistical significance. Regardless, the Mortgage Interest Rate Survey remains the only comprehensive source of home price data for both new and existing homes.

Conclusions

Alternative methods of adjusting the conforming loan limit have little effect on what the loan limit would be and the share of conventional loans that would be conforming. Also, while the data used to adjust the limit do not include data on all house sales, they remain the only source for national data on both new and existing homes.

The Housing and Community Development Act of 1980 provides that the conforming loan limit be adjusted annually to reflect the percentage increase in the national average price of homes purchased. The act also specifically requires that adjustments be based on the 12-month period preceding the adjustment. Given that Fannie Mae and Freddie Mac decided not to adjust the conforming loan limit for 1994, adjusting the limit next year on the basis of a 1-year increase in the average home prices between 1993 and 1994 as currently required by law will introduce an upward bias in the conforming loan limit. This upward bias could result in a greater proportion of conventional loans falling below the loan limit and being available for purchase by Fannie Mae and Freddie Mac. Conversely, such an increase in the loan limit could result in fewer jumbo loans, which would particularly affect lenders that specialize in originating and holding such loans. Moreover, should the index of home prices decline again in the future, and subsequent adjustments be based on only a 1-year change in home prices, the resulting loan limit would be further biased upward. Each

¹¹The Finance Board uses data from HUD's Survey of Mortgage Lending Activity to adjust the weights it gives to different types of lenders. However, the Finance Board questions the representation of commercial lenders in the survey. Currently, HUD is evaluating the reliability of its survey.

such event would further increase the share of the mortgage market in which Fannie Mae and Freddie Mac can operate. For borrowers that would have to obtain a jumbo loan if the conforming loan limit was not increased, a higher limit could provide the benefit of the lower interest rates associated with conforming loans.

Matter for Congressional Consideration

If the Congress intends that the conforming loan limit follow the long-term pattern of growth in average home prices, it should amend the legislation to require that adjustments be made on the basis of the time period since the limit had last been changed rather than the 12-month period preceding the adjustment, as mandated now. For example, given that the loan limit was not adjusted for 1994, the loan limit for 1995 should be based upon the change in the average home price between October 1992 and October 1994 rather than the change in price between October 1993 and October 1994.

Agency Comments and Our Evaluation

We received written comments from the Finance Board, HUD, Fannie Mae, Freddie Mac, and the Mortgage Bankers Association of America (see apps. I through V). In addition, the Savings and Community Bankers of America opted to provide oral comments. Overall, the Finance Board, HUD, and the Savings and Community Bankers of America generally agreed with our conclusions; Fannie Mae, Freddie Mac, and the Mortgage Bankers Association agreed with our finding that Fannie Mae's and Freddie Mac's decision to maintain the same loan limit in 1994 is authorized by the statute.

Three organizations commented on our matter for congressional consideration. HUD agreed that the matter for congressional consideration could eliminate the potential upward bias in the loan limit described in the report. HUD also suggested an alternative method that uses a cumulative index to remedy the upward bias. The official from the Savings and Community Bankers of America said that the loan limit should adjust downward as well as upward, but agreed that our matter for congressional consideration, over the long term, would result in the same loan limit. The Mortgage Bankers Association said that the matter for congressional consideration was inappropriate because it appeared to be based on the belief that thrifts would be adversely impacted, that the limit should not be used as a market allocation tool, and that the adverse affect is overstated. Freddie Mac also said that the draft incorrectly stated that thrifts would be particularly affected by loan limit increases and that the loan limit was not intended to be a market allocation device.

In response to HUD's suggestion of using a cumulative index, we agree with HUD's assessment that it would produce outcomes identical to those obtained with the procedure described in our matter for congressional consideration. HUD officials described this cumulative index as an index that would be set at 100 to correspond with the Finance Board's data for October 1992. Such a cumulative index would be increased by the percentage increase in the Finance Board's index from October 1992, but in years when the Finance Board's index had an annual decline, the cumulative index would remain at its previous level. In effect, this suggestion is one way to adjust the conforming loan limit consistent with our matter for congressional consideration—on the basis of the time period since the loan limit had last been adjusted.

With regard to the Savings and Community Bankers' suggestion of following the Finance Board's index regardless of whether the index rises or falls, while we agree that this would allow the loan limit to follow the long-term pattern of growth in average home prices, it might impose operational burdens on lenders when the loan limit declines, as cited by Fannie Mae and Freddie Mac. Also, given that declines in the Finance Board's index have been infrequent and that the law is silent on declines in the index, we believe that our matter for congressional consideration would not only ensure that the limit follows the long-term pattern of home price appreciation but also would alleviate any short-term disruption to lenders and borrowers.

In response to the comments concerning the impact on thrifts, we have deleted the specific reference to savings institutions' being particularly affected by an increase in the conforming loan limit and refer instead to those lenders that specialize in originating and holding jumbo loans. In addition, we have added data to show that mortgage companies originated 47 percent of the dollar volume of jumbo loans in 1993 and savings and loan institutions originated about 32 percent. In addition, we recognize that lenders may originate both jumbo and conforming loans.

With regard to concerns that the loan limit not be used as a tool to allocate market share, we note that the loan limit does, in effect, define the market in which Fannie Mae and Freddie Mac may operate. However, the basis for our matter for congressional consideration is not to employ a market allocation tool but continues to be solely the desire for the conforming loan limit to follow the long-term pattern of changes in average home prices.

In its comments, Freddie Mac suggested that we consider whether it is appropriate for the Finance Board to administer the survey or index used to determine the maximum conforming loan limit because the Finance Board is an advocate for the Federal Home Loan Banks and suggested that other agencies perform this function. We did not address the independence of the Finance Board because this was not part of our mandate. In addition, while we did not assess the reliability of the Finance Board's data, in reviewing comments to the Finance Board on its proposed changes to the index, we found no indication that users of the data believed that the Finance Board was in any way manipulating the data to the advantage of the Federal Home Loan Banks.

Finally, in response to these and other comments, we have added information about the recently announced Freddie Mac/Fannie Mae home price appreciation index, clarified our description of how the limit is adjusted, added data on who particularly originates jumbo loans, and added further detail of what data are included in the Finance Board's index. Where appropriate, we have incorporated other suggested clarifications to the report.

Scope and Methodology

To assess the methodology used to adjust the conforming loan limit, we examined both the effect that using alternative methods of adjusting the loan limit would have on the limit and market share and the historical share of conventional loans that are below the conforming loan limit. We limited the alternative methods we used for comparison to those that were previously reported in the 1990 study on loan limits prepared for HUD. In comparing the current method for determining the conforming loan limit with alternate methods, we used the Federal Housing Finance Board's data for 1979 through 1992, as well as Census data on new home prices and NAR's data on existing home prices. To assess the requirements for adjusting the conforming loan limit, we reviewed the legislative history of conforming loan limits and obtained the views of Fannie Mae and Freddie Mac officials. We examined comments received by the Finance Board in response to its 1990 request for comment on improving the Monthly Interest Rate Survey. We did not assess the reliability of the Federal Housing Finance Board's data. Our work was conducted between April and September 1994 in accordance with generally accepted government auditing standards.

We are providing copies of this report to the Secretary of Housing and Urban Development, the Director of the Office of Management and Budget, and other interested parties. We will also make copies available to others upon request. In response to the mandate, we have also provided in a separate report information on how the income, age, and race of borrowers of FHA-insured loans and the location of their homes has changed since the 1970s.¹²

Please contact me on (202) 512-7631 if you or your staff have any questions about this report. Major contributors to this report are listed in appendix VI.

Sincerely yours,

A handwritten signature in black ink that reads "Judy A. England-Joseph". The signature is written in a cursive, flowing style.

Judy A. England-Joseph
Director, Housing and Community
Development Issues

¹²Housing Finance: Characteristics of Borrowers of FHA-Insured Mortgages (GAO/RCED-94-135BR, Apr. 6, 1994).

List of Addressees

The Honorable Paul S. Sarbanes
Chairman
The Honorable Christopher S. Bond
Ranking Minority Member
Subcommittee on Housing and
Urban Affairs
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Barbara A. Mikulski
Chair
The Honorable Phil Gramm
Ranking Minority Member
Subcommittee on VA, HUD,
and Independent Agencies
Committee on Appropriations
United States Senate

The Honorable Henry B. Gonzalez
Chairman
The Honorable Marge Roukema
Ranking Minority Member
Subcommittee on Housing and
Community Development
Committee on Banking, Finance and
Urban Affairs
House of Representatives

The Honorable Louis Stokes
Chairman
The Honorable Jerry Lewis
Ranking Minority Member
Subcommittee on VA, HUD,
and Independent Agencies
Committee on Appropriations
House of Representatives

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Abbreviations

FHA	Federal Housing Administration
GAO	General Accounting Office
HUD	U.S. Department of Housing and Urban Development
NAR	National Association of Realtors

Comments From the Federal Housing Finance Board



Federal Housing Finance Board

1777 F Street, N.W., Washington, D.C. 20006
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August 23, 1994

Ms. Judy A. England-Joseph
Director, Housing and Community
Development Issues
General Accounting Office
441 G Street, NW
Room 1842
Washington, D.C. 20548

Dear Ms. England-Joseph:

The Federal Housing Finance Board (Housing Finance Board) appreciates the opportunity to comment on the draft report entitled Housing Finance: Implications of Alternative Methods of Adjusting the Conforming Loan Limit. (GAO/RCED-94-225)

In general, the Housing Finance Board agrees with the conclusions in the report and has only one minor clarification regarding a statement on page 16, footnote 6, which reads:

"The Finance Board uses data from the Department of Housing and Urban Development's Survey of Mortgage Lending Activity to adjust the weights it gives to different types of lenders. However, the Finance Board questions the accuracy of this survey. Currently the Department is evaluating the reliability of its survey."

The Housing Finance Board cannot comment on the overall accuracy of the survey of Mortgage Lending Activity. Rather, the Housing Finance Board has questioned the share of mortgage originations by commercial banks in this survey. This issue is discussed in greater detail in a letter sent by Sylvia Martinez, Director of the Housing Finance Directorate, to Assistant Secretary Michael Stegman. I am enclosing a copy of the letter.

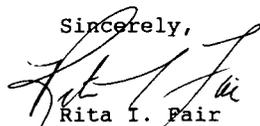
Now on p. 11.
Now footnote 11.

**Appendix I
Comments From the Federal Housing
Finance Board**

Ms. J.A. England-Joseph
Page 2

Again, we appreciate the opportunity to comment.

Sincerely,



Rita I. Fair
Acting Managing Director

Enclosure

cc: Sylvia Martinez
Chuck Chamness

**Appendix I
Comments From the Federal Housing
Finance Board**



Federal Housing Finance Board

1777 F Street, N.W., Washington, D.C. 20006
Telephone: (202) 408-2500 Facsimile: (202) 408-1435

October 29, 1993

Mr. Michael A. Stegman
Assistant Secretary for Policy Development
and Research
U.S. Department of Housing and Urban Development
451 7th Street, S.W.
Washington, D.C. 20410-6000

Dear Mr. Stegman:

Thank you for the opportunity to participate in the evaluation of the HUD's Survey of Mortgage Lending Activity. The Federal Housing Finance Board (FHFB) uses data from the HUD survey as a component for calculations in the FHFB's Monthly Interest Rate Survey (MIRS). The MIRS is the nation's most comprehensive source of information on conventional mortgages and house prices, especially for states and metropolitan areas.

Each month the Finance Board compiles the MIRS data by asking a sample of major mortgage lenders to report the terms and conditions on all conventional, single-family, purchase-money loans closed during the last five working days of the month. By law, the data from the MIRS is used by Fannie Mae and Freddie Mac each year as the basis of the adjustment of the "conforming loan" limit. In addition, the MIRS data is used to adjust a number of federal and state programs, including the "safe-harbor" limits for mortgage revenue bonds and, indirectly, the FHA high-cost area limits.

In the MIRS weighting procedure, the data is "balanced" each month so that the shares of weighted loans by lender type (savings and loan association, commercial bank, savings bank, and mortgage company) reflect the shares of mortgage originations by lender type reported in the HUD survey. The Finance Board also uses the annual data on mortgage originations by state reported in the HUD survey to balance the data by region.

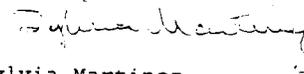
The item of most concern to the Finance Board is that the shares of mortgage originations by lender type be accurate. While there is little specific data available on mortgage originations by commercial banks, the share of commercial bank originations may be overstated in the HUD data. This is based on the observation that few commercial banks have major portfolio concentrations of single-family mortgage loans, and most large commercial banks do not originate mortgages, rather they rely upon their mortgage banking subsidiaries.

**Appendix I
Comments From the Federal Housing
Finance Board**

The accuracy of this data is important because the mortgage loans reported in the MIRS by commercial banks consistently are smaller and on lower-priced properties than for the other three types of lenders. The weight applied to commercial bank loans will thus affect the reported national averages.

I appreciate the opportunity to offer the Finance Board's views on this issue. Joseph McKenzie, Associate Director of the Housing Finance Directorate, has the overall responsibility for the survey. He can answer any technical questions your staff may have about how the HUD survey affects the Finance Board's data, and he can be reached at (202) 408-2845.

Sincerely yours,



Sylvia Martinez
Director
Housing Finance Directorate

Enclosure

Comments From the U.S. Department of Housing and Urban Development



U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000
August 31, 1994

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Ms. Judy A. England-Joseph
Director, Housing and Community Development Issues
U.S. General Accounting Office
441 G Street, N.W. - Room 1842
Washington, DC 20548

Re: GAO Draft Report--Housing Finance:
Implications of Alternative Methods of
Adjusting the Conforming Loan Limit
(GAO/RCED-94-225)

Dear Ms. England-Joseph:

Thank you for the opportunity to comment on the above draft report.

The report concisely lays out the relevant issues and concerns about both the effect on the conforming loan limit of alternative adjustment methods other than the use of the Federal Housing Finance Board's Mortgage Interest Rate Survey and also the implications of Fannie Mae's and Freddie Mac's decisions to not adjust the loan limit for 1994. HUD has only one major comment on the substance of this report and several minor comments, detailed in the attachment.

HUD agrees with the report's finding that the 1993 decisions by Fannie Mae and Freddie Mac to not adjust the loan limit for 1994 will bias the limit upward when home price increases follow price declines for which the loan limit was not adjusted. HUD further agrees that this bias problem could be eliminated with the adoption of GAO's recommendation that future adjustments be made on the basis of the time period since the limit had last been changed rather than the preceding twelve-month period.

HUD would suggest that GAO consider an alternative method that standardizes the period of time over which future adjustments are made. The method for changing the loan limit outlined on page 18 could be systematized by linking a FHFB cumulative home sales price level index to the conforming loan limit. October 1992 could serve as the base year price where the cumulative price level index is set to 100 and would correspond to the base conforming loan limit of January 1993. This approach produces outcomes identical to those

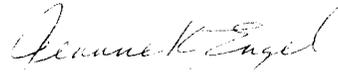
Now on p. 12.

Appendix II
Comments From the U.S. Department of
Housing and Urban Development

obtained with the procedure described in the draft report. It has the advantage, however, of using an annual adjustment rather than requiring FHFB staff to formulate varying adjustment periods depending on when the last loan limit adjustment was made.

Additional, non-substantive comments on the report are contained in an attachment to this letter.

Sincerely,



Nicolas P. Retsinas
Assistant Secretary for Housing - Federal Housing
Commissioner

Comments From Fannie Mae

3900 Wisconsin Avenue, NW
Washington, DC 20016 2899
202 752 6675

Annette Fribourg
Vice President for
Regulatory Activities

August 23, 1994



Ms. Judy A. England-Joseph
Director, Housing and Community
Development Issues
Resources, Community and Economic
Development Division
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Ms. England-Joseph:

Thank you for the opportunity to review and comment on your report, "Housing Finance: Implications of Alternative Methods of Adjusting the Conforming Loan Limit" (GAO/RCED-94-225).

We are pleased that the report confirms our own assessment that the methodology used to calculate the conforming limits has performed well over time. The report finds that the index has maintained the proportion of the conforming market relative to the non-conforming market. As a result, Fannie Mae has been able to continue to serve the same broad segment of the market we were intended to serve, providing greater availability of financing, choice of loan products, and as the report indicates, lower mortgage interest rates for homebuyers.

The index embodies several principles which we believe are fundamental. It covers new and existing home sales. Its publication can be relied upon, as it is required by law. It is transaction based. This is key because measurement of actual market prices is most directly responsive to our mission of serving the broad market. Other measurements are useful for certain applications, but do not get as close to the basic purpose of the mortgage limits themselves.

We are also pleased that the report supports our conclusion that the statute does not require us to decrease the conforming limits when the index shows a decline. Indeed, such decreases would cause disruption throughout the market.

Sincerely,

A handwritten signature in cursive script that reads 'Annette Fribourg'.

Fannie Mae The USA's Housing Partner

Comments From Freddie Mac

1101 Pennsylvania Ave., NW, Suite 950
PO Box 37347
Washington, DC 20077-7347

August 30, 1994

**Freddie
Mac**

Ms. Judy A. England-Joseph
Director, Financial Issues
Resources, Economic, and Community Development Division
U.S. General Accounting Office
Washington, DC 20548

Dear Ms. England-Joseph:

The Federal Home Loan Mortgage Corporation ("Freddie Mac") appreciates the opportunity to comment on the GAO's draft study on the methodology for adjusting the maximum conforming loan limit.

Our comments will focus on three issues: the weaknesses in the current methodology for calculating the maximum conforming loan limit and whether viable alternatives exist; which agency should administer the index used for determining annual house price changes; and GAO's discussion of this issue as it relates to thrifts.

Problems with the current methodology

We believe that GAO's draft study could consider more fully both the weaknesses in the current methodology for adjusting the maximum conforming loan limit and whether alternative methodologies could provide a more accurate measure of average house price changes.

The current methodology, established by Congress in the Housing and Community Development Act of 1980, involves use of the Federal Housing Finance Board's (FHFB) Mortgage Interest Rate Survey (MIRS), which measures changes in one-unit house prices by aggregating data on conventional purchase-money closings during the last five days of each month. FHFB determines the maximum annual increase to the conforming loan limit by comparing the percentage change in such prices from October of the previous year to October of the current year. The actual adjustment in the limit is subsequently determined by Freddie Mac and Fannie Mae.

While the MIRS for years was the most sophisticated survey available, it no longer provides the best possible measurement of house price appreciation. Indeed, relative to other methodologies now available it is overly simple. In effect, it computes a weighted

Ms. Judy A. England-Joseph
August 30, 1994
Page 2

average transaction purchase price in the U.S., where the weights reflect transaction volume differences across four census regions and four lender types. It does not otherwise account for variations in location, nor does it account for variations in the composition of the housing stock traded. We believe this, combined with the very narrow time period examined (only five days in one month), creates a level of volatility in the series that raises questions about how accurately it measures annual changes in housing prices.

An examination of the fluctuations in the MIRS' reported average national purchase prices during 1994 illustrates just how volatile the series is. The reported price for January was \$141,400. In February, it rose to \$144,600 (+2.3 percent). In March it dropped steeply to \$140,900 (-2.6 percent). It then rose to \$143,700 in April (+2.0 percent), fell again to \$140,200 in May (-2.4 percent), and rose sharply yet again to \$144,200 in June (+2.9 percent). Such volatility does not provide an accurate picture of actual conditions in the real estate market. While prices certainly change over time -- and sometimes quickly in local markets -- on a national level they do so much more gradually than the survey suggests. Additionally, real estate prices do not sharply change direction from month to month.

Another problem with the MIRS deserving attention is that it excludes a substantial number of mortgages. The MIRS includes only fully amortizing mortgages, thus leaving out balloon mortgages, which in recent years have accounted for a significant share of originations. It also does not include mortgages on two-to-four unit properties. This further brings into question its adequacy as a tool for measuring price appreciation on conventionally-financed homes.

The GAO's analysis should both address these questions and consider whether alternative methodologies could provide a more accurate and useful measure. We believe one viable alternative GAO should consider is an index based on a weighted repeat sales methodology, an example of which is the Conventional Mortgage Home Price Index jointly published by Freddie Mac and Fannie Mae. This methodology has been widely embraced by the research community and is being used by the Office of Federal Housing Enterprise Oversight (OFHEO), the safety and soundness regulator of Freddie Mac and Fannie Mae, for the purpose of monitoring both companies' capital adequacy. While we do not believe our particular index should replace the MIRS -- it does not include sales of new homes, homes with two-to-four units, or homes with mortgages above the conforming loan limit -- a weighted repeat sales methodology more completely weighs housing composition and location than does the MIRS.

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Alternative agencies

Another question GAO might consider is whether it is appropriate for FHFB to administer the survey or index used to determine the maximum conforming loan limit for Freddie Mac and Fannie Mae. As GAO's December 1993 study on the Federal Home Loan Bank System noted, FHFB plays a dual role as both the regulator of and advocate for the Federal Home Loan Banks. It thus is not an entity operating at arms-length from the housing finance industry.

We believe GAO also should consider whether other agencies are better suited to administer the index. Viable alternatives include OFHEO, the Department of Housing and Urban Development (HUD), which collects a vast amount of housing data and is the mission regulator of Freddie Mac and Fannie Mae, and the Federal Reserve Board, which also collects a substantial amount of financial and housing data.

The conforming loan limit and the thrifts

GAO agrees that Freddie Mac and Fannie Mae acted within the law in deciding to maintain their 1994 loan limits at their 1993 level. At the same time, GAO expresses concern that the 1995 loan limit could be adjusted upward on the basis of a one-year increase in the index in 1994, without accounting for the decline of the index in 1993. This, GAO suggests, could increase the conforming market's share of total mortgage originations. GAO's concern appears to be based on the impact this could have on thrifts: if the conforming market's share of the mortgage market increases, this could reduce the number of "jumbo" mortgages (i.e., those with an amount above the conforming limit) that thrifts can originate and hold in portfolio. GAO thus recommends Congress consider modifying the statutory provisions for the loan limit to require Freddie Mac and Fannie Mae to make adjustments not on a one-year basis but on the basis of the time period since the last increase in the loan limit.

GAO's discussion appears to be based in part on an assumption that jumbo loans are typically made by savings institutions. However, according to the MIRS, in 1992 and 1993 thrifts accounted for only one-third of total purchase-money originations of jumbo mortgages, while mortgage bankers originated nearly one-half of them. Additionally, the share of jumbo mortgages originated by thrifts has been in decline in recent years, while the share originated by mortgage bankers has been increasing. The respective market

Ms. Judy A. England-Joseph
August 30, 1994
Page 4

shares and market share trends are similar to those taking place in the mortgage market as a whole. This, combined with GAO's findings that the conforming market's share of total originations has remained stable since 1980, suggests that while thrifts do have reason to worry about the numbers of jumbo loans available to them, the chief source of their concern should be competitive pressures from other players in the jumbo market, not the conforming market.

GAO's concerns about the thrifts also suggests an implicit belief that one purpose of the conforming loan limit is to allocate market shares between thrifts and the conforming secondary market. In fact, in none of the statutes that established and subsequently modified the conforming loan limit, nor in any of the legislative histories of those statutes, did Congress ever state or imply such a purpose.

Many organizations and individuals besides thrifts are impacted by the level of the conforming loan limit. One group particularly worth mentioning is homebuyers. Any increases in the conforming market's share of total originations means that a commensurately larger portion of the homebuying population will receive access to less expensive conforming mortgage credit. This tangible benefit to homebuyers should be considered in any recommendations GAO makes on the conforming loan limit.

Conclusion

We again appreciate the opportunity to provide GAO with our input on this issue. Please do not hesitate to contact us if we may be of further assistance in this matter.

Sincerely,



John Gibbons
Senior Vice President
Corporate Relations

Comments From Mortgage Bankers Association of America

Mortgage Bankers Association of America

Robert M. O'Toole
Senior Staff Vice President
Residential Finance & Government
Agency Relations
Tel. (202) 861-6534, Fax (202) 822-6320
1126 15th Street, N.W.
Washington, D.C. 20005-2766

The National Association
of Real Estate Finance

August 25, 1994



Ms. Judy A. England-Joseph
Director, Financial Issues
Resources, Economic and Community Development
U.S. General Accounting Office
Washington, D.C. 20548

Dear Ms. England-Joseph:

Thank you very much for giving the Mortgage Bankers Association of America (MBA) the opportunity to comment on your office's draft report entitled, *Housing Finance: Implications of Alternative Methods of Adjusting the Conforming Loan Limit* (GAO/RCED-94-225) (the "Draft"). We commend the GAO for another thorough exploration of an important issue to mortgage bankers. Our comments focus on the three major concerns of the Draft--the methodology for calculating the loan limits governing Fannie Mae and Freddie Mac (the "conforming loan limits"), the need for downward adjustments, and the issue of "upward bias" that the Draft raises.

Survey Methodology

MBA has been very interested in the methodology for adjusting the conforming loan limits. In 1990, we urged the Federal Housing Finance Board to take steps to increase the reliability of its "Monthly Interest Rate Survey," which is used to derive the conforming loan limits. Our recommendations included looking at closing data for the last five days of the month to capture the bulk of loan closings and adding more lenders to the sample to capture more loans and increase geographic dispersion. Since these changes were implemented, we believe that the survey provides reasonably acceptable data for calculating housing price changes, although reliability could be enhanced by the coverage of additional product types; e.g., balloon loans given the relatively recent rise in popularity of 5- and 7-year balloon loans, loans on 2-4 family properties, and refinance loans, which, according to the MBA Economics Department, accounted for 55% of the total of \$1,009 trillion in mortgages originated in 1993.

Maintaining Current Loan Limits When the Index Declines

We also share the GAO's conclusion that the Housing and Community Development Act of 1980 authorizes Fannie Mae and Freddie Mac (the GSEs) to maintain the current conforming loan limits when the index of home prices declines. The statute and its legislative history speak

exclusively in terms of upward adjustments. Under well-established case law, the lack of any ambiguity in the statute requires that its plain terms govern. At the very least, the statute does not require downward adjustments; a literal interpretation would argue that downward adjustments are precluded.

Upward Bias in Loan Limits

We do differ with the conclusions of the GAO in one important respect. We disagree with the recommendation that if the GSEs are not required to make downward adjustments in the conforming loan limits, they should be required, by means of a statutory amendment, to make subsequent upward adjustments "on the basis of the time period since the limit had last been changed, rather than the 12-month period preceding the adjustment as mandated now." Draft at p. 18. The premise of this recommendation is the belief that the current statutory formula for adjustments introduces "an upward bias" in the conforming loan limits. Draft at p. 17.

We believe that the Draft's recommendation is inappropriate for several reasons. First, it appears to assume that the current statutory approach would have an adverse impact on thrifts by expanding the conforming market to reduce the number of jumbo loans that thrifts may originate. This assumption presupposes that thrifts are the primary players in the jumbo market. This is not the case. According to the Federal Housing Finance Board, in 1992 and 1993, thrifts made only one-third of jumbo loan originations whereas jumbo originations by mortgage bankers for private conduits and other investors approached nearly one-half of the total. Moreover, the Draft presumes that all thrifts are strictly portfolio lenders. However, according to the Savings and Community Bankers Association, as quoted in the *American Banker* on August 10, 1994, thrifts in 1993 sold 45% of their originations into the secondary market. The article describes how most thrifts have some type of secondary market strategy, selling off at least a portion of their production and earning servicing fees. Therefore, thrifts do not necessarily suffer a disadvantage from an increase in the conforming loan limits.

Second, the Draft appears to regard the loan limits statute as a market allocation tool for mortgage bankers and thrifts. However, nothing in either the legislation or its statutory history suggests any such intent. Therefore, it is logical to conclude that Congress was merely recognizing that i) property values generally tend to increase, and ii) the greater efficiency of enacting a formula for establishing the conforming loan limits over enacting fixed limits that could not adjust absent legislation.

Using the conforming loan limits statute for allocating market share between the conforming market and thrifts not only is inappropriate but unnecessary-- true market factors should be allowed to operate. In the current interest rate environment, for example, the market share of thrifts is increasing, independent of any legislation, because of the appetite of today's borrowers for certain adjustable rate mortgages which, basically, only thrifts are willing to provide.

Third, the Draft overstates any "adverse" impact of the application of the existing statute. First of all, between 1980 and 1993, the national average home purchase, as calculated according to the Monthly Interest Rate Survey, declined only twice and then only by one-tenth of one percent and 3 percent in 1990 and 1993, respectively. In addition, the Draft does not adequately

Now on p. 12.
Now on p. 11.

Appendix V
Comments From Mortgage Bankers
Association of America

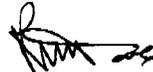
address the positive effects of increases in the conforming loan limits. The increases make housing more available and affordable, especially for those Americans who live in high cost areas. When rates and points are considered, jumbo loans originated for private conduits are more expensive than conventional loans and 95 percent LTV loans are generally less available so that higher down payments are required.

Affordable housing also is made more available indirectly by the current statutory approach-- the Draft's approach would divert loans away from the GSEs, reducing the base amount of business against which the affordable housing goals are calculated. To the extent that application of the existing statute would result in a "windfall" increase in the conforming loan limits, any increase in the business of the GSEs would increase their affordable housing obligations.

Last, any "windfall" gain in the conforming loan limits would tend to help consumer spending and stimulate the economy. After a decline in the index, it would be unlikely under reasonably foreseeable economic conditions for any upward trend in property values to reflect, on average, a dramatic improvement in the economic situation of the borrower. Accordingly, borrowers as a group would tend to benefit from the cost savings that could be obtained from conforming versus jumbo loans and the cumulative effect could be beneficial for the economy.

MBA believes the legislative change that the Draft proposes needs to be carefully re-assessed in light of the adverse impacts such a change could have. We hope that the GAO will ultimately delete this proposal from its final report. If you would like to discuss this issue with us further, we are available at your convenience. Again, we appreciate the opportunity to comment on the Draft.

Sincerely,



Robert M. O'Toole

Major Contributors to This Report

Housing and
Community
Development Issue
Area

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