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Sellers Brace for New Mortgage Caps

October Change Is Meant to Reduce the Government Footprint in Housing, but Industry Fears It Could Lead to Lower Prices

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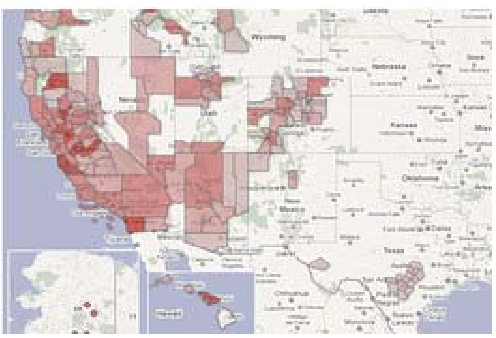
The federal government is readying its first retreat from the mortgage market, with the size of loans eligible for government backing set to decline in October.

As an emergency measure three years ago, Congress raised to as high as $729,750 the maximum loan amount that Fannie Mae, Freddie Mac and federal agencies could guarantee.

That made it easier—and cheaper—for borrowers in pricey housing markets to obtain mortgages, because the government guarantees that investors receive payments on those mortgages even if homeowners default.

Jumbo Declines

Mapping declines in FHA-backed loans by metro areas



Sortable chart: Declines for Fannie, Freddie loans

Sortable chart: Declines for FHA loans

Now those limits are set to decline modestly in hundreds of counties across the U.S. as the government attempts to reduce its outsized footprint in the mortgage market and create room for private investors to compete. Government-related entities stand behind more than nine of 10 new mortgages, and taxpayers have sunk $138 billion into Fannie and Freddie, underscoring the eagerness to dial down the government's share.

The new limits will vary widely by location, but will drop to $625,500 in top-tier markets such as New York, Los Angeles and Washington, D.C.

Even though the new limits won't take effect until Oct. 1, some lenders are already warning borrowers that they will stop accepting applications for loans that exceed the new limits much sooner, to ensure the loans are funded before the cutoff date.

Industry groups are making the case on Capitol Hill that reducing current limits in some of the largest markets is "the exact wrong way to go," said Jerry Howard, president of the National Association of Home Builders. But Obama administration officials say the limits should fall as scheduled, and Republican lawmakers have introduced measures to shrink the Federal Housing Administration's reach more aggressively.

Had the lower limits been in place last year, Fannie and Freddie would have backed 50,000 fewer loans, according to the Federal Housing Finance Agency. The bulk of the affected loans —about 60%—are in California, with another 20% in Massachusetts, New York and New Jersey.

Parts of the country with less expensive homes also would be affected; their limits are scheduled to fall as low as

$417,000 for Fannie and Freddie loans and as low as $271,050 for FHA loans.

Limits for Fannie and Freddie-eligible mortgages will fall in 250 counties, and FHA limits will drop in about 600 counties. While that is a fraction of the nation's 3,000 counties, economists at the National Association of Home Builders say those densely populated areas account for 27% and 59% of the nation's housing stock, respectively.

The possibility of lower loan limits is causing considerable anxiety in coastal California and other high-end housing markets that will serve as test cases for how the government's withdrawal from housing will affect the market and local economies.

Homeowners whose mortgages are too big to qualify for a government-backed mortgage must seek a so-called jumbo loan, which often carry higher interest rates as well as larger down-payment requirements, sometimes more than 20%.

"Sellers are going to have to reduce their prices if borrowing costs rise," said Scott Sheldon, a loan officer with First Cal Mortgage in Petaluma, Calif.

One of Mr. Sheldon's clients, Ed Barr, has been pre-approved for a $662,000 loan backed by the FHA, the largest mortgage the agency can insure in Sonoma County, Calif. He is racing to close a sale before the limit drops to $520,950.

Mr. Barr, who owns a wine-making machinery company, said he has excellent credit but a recent divorce left him with little cash for such a purchase. "I don't have any other alternative," the 48-year-old said. Without the loan backed by the FHA, which allows for down payments as low as 3.5%, "the sale won't happen."

Developments

Rebound or Retreat After Mortgage-Cap Declines?

Scaling back loan limits underscores a broader challenge facing the government: It wants more private players to hold mortgage risk, but it doesn't want to destabilize fragile housing markets.

Craig Van Sant is looking to pay $500,000 for a home with a $20,000 down payment in Rancho Cucamonga, Calif. Once the FHA limit drops to $335,000, he would need to more than double his down payment. The only upside, he said, is that "home values slide even more, allowing us to buy more house, if we can pull together all the cash."

Investors and some academics say the government needs to shrink its footprint if private markets are to re-emerge, and that big loans for pricey homes are a reasonable place to start. "Credit unions, small banks, and hedge funds are all eager to buy these loans," said Brian Brady, a mortgage banker at World Wide Credit Corp. in San Diego.

For now, interest rates for jumbo loans are relatively low, which could cushion the impact of changing loan limits. Rates on 30-year fixed-rate jumbos averaged 5.07% last week, compared with 4.62% on government-backed loans, according to financial publisher HSH Associates. The jumbo rates are near the lowest mark since HSH began its count in 1986, and the spread is the lowest since mortgage markets seized up four years ago.

But rates are only part of the equation. Because jumbos aren't being securitized, banks must keep them on their balance sheets and are generally requiring larger down payments and stringent income qualifications."It'll be a real test of private lenders and their ability to fill the void," said Mark Zandi, chief economist of Moody's Analytics.

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