

Prepayment Update – March '08

The Conforming Loan Limit Increase: What it Means for Borrowers and Investors

By Dan Szakallas

There has been much discussion over the last couple months regarding the increase in the conforming loan limits as part of the 2008 Economic Stimulus bill that eventually passed through the House and Senate and was signed into law by President Bush on February 13th. There was much speculation on what the new limit would be, how different parts of the country would be affected, and ultimately when it would go into effect. Now that the law has been passed, we can answer those questions and discuss what the impact might be on the Agency MBS arena.

The increase in the conforming loan limit for 2008 is defined as the lesser of \$729,750 or 125% of the average home value within a given metropolitan statistical area (MSA). The increase has been introduced as temporary, but there is no timetable for a reduction. Fannie Mae and Freddie Mac are now allowed to purchase these loans for securitization into their mortgage-backed security pools that are sold to investors. Fannie Mae will only securitize these loans with other similar loans, meaning they will most likely receive their own pool type, and not be packaged into standard FNCL TBA deals.

From the borrower's perspective, this change greatly benefits those in top MSA areas, such as New York, Chicago, Los Angeles, etc., where the median home price can fall above that of the former conforming limit of \$417,000. For example, according to HousingTracker.net, the median asking price for a single family or condominium home in the NY-White Plains-Wayne metropolitan division of the NY-NJ-Long Island MSA was \$435,000. With the expanded limit, potential buyers in this market can now qualify for an interest rate on a mortgage that should be less than before, when they could only qualify for a jumbo mortgage. The typical spread between conforming and jumbo loans has historically been around 50bps, but in the last 6 months we have seen it widen to an average of about 125 bps. If lenders offer these potential borrowers the same rates that are offered on loans that currently fall under \$417,000, then this will be a great benefit to homebuyers/homeowners that live in the expensive MSA's. What remains to be seen is how welcoming the banks are to this new limit. On the one hand, many investors have been burned in the last 18 months by bad loans, and are still calculating losses on their mortgage portfolios; on the other hand is the liquidity issue for borrowers of prime jumbo loans. If these jumbo loans can now be sold to the agencies and are therefore guaranteed, mortgage pipelines could start flowing again.

From the investor's perspective, the big question is how to model prepayments for these new "conforming jumbos." We have observed prepayments for many years on jumbo loans, and it seems likely that underlying borrower behavior will not change simply because of lower interest rate availability. From a modeling perspective, it would be acceptable to use a jumbo model for the new pools, but with a slight tuning adjustment of the slide factor. By "sliding" the underlying refinancing thresholds to account for the new rate benchmark for the conforming jumbos, models should give accurate results. These loans will still be prime quality, so all of the concerns after the sub-prime fallout will be minimized here, since only credit-worthy borrowers will qualify for these loans. One behavior that might be observed is in the current jumbo market. How many borrowers will look to refi their jumbo loans into these new conforming jumbos in order to take advantage of the lower interest rates? Also, since there is no timetable given for these temporary limits to be changed, what happens to the non-agency jumbo market through 2008? What will

new origination volume levels be? Also, will lenders offer the same rates for a \$300,000 loan as they will for a \$650,000 loan?

While we know more today than we did three months ago, there are still several questions that remain unanswered. We will be monitoring this issue closely over the next several months and will offer more insight as our research continues.



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