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OFHEO Requires Enterprises to Follow Formal Procedures for Calculating Conforming Loan Limits

WASHINGTON, D.C. — Armando Falcon, Jr., Director of the Office of Federal Housing Enterprise Oversight (OFHEO), has issued a Supervisory Guidance establishing a regulatory process for annual adjustments to the Enterprises conforming loan limit. The guidance, which lays out procedures to be applied to computations of future conforming loan limits, follows a review of concerns raised by the 2004 loan limit calculation.

In that review, OFHEO determined that the 2004 limit adopted by Fannie Mae and Freddie Mac failed to incorporate a necessary adjustment factor brought on by methodological changes in the Federal Housing Finance Board's (FHFB) Monthly Interest Rate Survey (MIRS). The improper calculation resulted in a conforming loan limit of \$333,700 dollars, which is \$2,300 higher than it would have been if this adjustment had been made.

In a letter and the guidance to the Enterprises, Falcon said the adjustment that should have been made in 2004 will be incorporated into the 2005 calculation. From now on, OFHEO will announce its annual calculation of the maximum conforming loan limit based on the MIRS survey. OFHEO will consider the purchase by Fannie Mae or Freddie Mac of any mortgage above that amount to be an unsafe and unsound practice.

"It is now clear that the informal procedure currently used for annually adjusting the conforming loan limit is inadequate and a new, formal supervisory process is warranted," said Falcon. "It is my feeling that these steps will minimize future risk and ensure a fair and accurate calculation that will benefit the nation's consumers and housing finance markets."

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OFHEO Advisory

Supervisory Guidance

Issuance Date: February 20, 2004 Doc. #: SG-04-001

Subject: Conforming Loan Limit Calculations

TO: Chief Executive Officers of Fannie Mae and Freddie Mac
All OFHEO Employees

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I. Introduction

a. Scope

This guidance document addresses the annual establishment of the conforming loan limit amount for mortgages purchased by Fannie Mae and Freddie Mac ("the Enterprises") and OFHEO supervisory procedures related to such activity.

(1) OFHEO Supervisory Authority.

OFHEO oversees the housing government sponsored enterprises-- Fannie Mae and Freddie Mac-- to assure they operate in a safe and sound manner and maintain adequate capital; 12 USC 4501, 4511, 4513. OFHEO has indicated that its oversight responsibilities include avoiding situations that would present safety and soundness problems; 12 CFR 1720, Appendices A and B and 1777. In addressing areas where this could arise, OFHEO has highlighted corporate governance and financial disclosures; 12 CFR 1730 and 1710. In its regulation on disclosure, OFHEO noted key areas of concern - access to markets and potential damages to the firm from incurring reputation risk. Therefore, OFHEO has set forth this guidance to ensure that the conforming loan limit is established in a manner consistent with safe and sound operations and with statutory requirements.

(2) Conforming Loan Limit.

The Enterprises are authorized by their charters to purchase mortgages up to a specified limit as adjusted annually; 12 USC 302(b)(2) and 305(a)(2).

The Enterprises make this adjustment based on a survey conducted by the Federal Housing Finance Board (FHFB). The FHFB monthly conducts and publishes the results of a survey of mortgage interest rates, the Monthly Interest Rate Survey (MIRS). The Enterprises, under their charters, use the percentage increase during the twelve-month period ending with the previous October in the national average one-family house price as determined by the FHFB in its survey. The Enterprises apply the percentage increase to the prior year's conforming loan limit to establish the next year's limit. This is a closely watched number in mortgage and financial markets.

OFHEO as safety and soundness regulator has responsibility to oversee safe and sound operations and may act to redress violations of law by the Enterprises. In this situation, OFHEO has determined a more formalized process for establishing the conforming loan limit is needed.

(3) Overview of Loan Limit Adjustment Factor Determinations and Conforming Loan Limit Determinations.

Since 1981, the Enterprises have adjusted the conforming mortgage loan limit as allowed under the Housing and Community Development Act of 1980. During this time frame, two types of occurrences have transpired that raise the need for a more formal process-- the Enterprises have adjusted their loan limits in a manner that is different from the survey results and cases where the Federal Housing Finance Board has made technical changes to its methodology for determining housing price.

There have been three occasions when the average house price declined from October to October (in 1990, 1994, and 1995).¹ There have been three occasions when the Federal Housing Finance Board made methodological changes to the Monthly Mortgage Interest Rate Survey that required an adjustment to one or both of the reference years (in 1992, 1998, and 2003).² Additionally, in November 1997, the Enterprises took another course, setting a lower number than the adjustment produced. They determined that the 1998 conforming loan limit would increase by only 3.67 percent, even though the percentage change in house prices using FHFB data for 1996-1997 was 8.44 percent.

This guidance is prompted by the most recent incident regarding the conforming loan limit adjustment. In 2003, the Enterprises adopted a conforming loan limit that disregarded communications from the FHFB staff regarding a change in the methodology for estimating house prices. The Enterprises determined that the 2004 conforming loan limit would increase by 3.41 percent based on unadjusted national average house prices for October 2002 and October 2003 that were published by the FHFB. During 2003, FHFB staff indicated that the October 2003 national average house price would need to be adjusted downward by \$1,647 when the Enterprises determined the 2004 conforming loan limit. If the Enterprises had used the adjustment as requested by the FHFB staff, the percentage change in house prices from October 2002 to October 2003 would have been 2.71 percent instead of 3.41 percent.

In sum, for twenty-three years of practice, the Enterprises announced a conforming loan limit. However, in seven of those years adjustments or decisions were made that raise safety and soundness concerns about the annual adjustment to the conforming loan limit. OFHEO believes that the situation may be addressed through appropriate

¹ In November 1989, the Enterprises determined that the 1990 conforming loan limit would decline \$150 from the 1989 level based on a house price decline of .07 percent. In November 1993 and November 1994, however, the Enterprises announced that the conforming mortgage loan limit would remain constant at \$203,150, despite two declines in house prices of 2.96 percent in 1993 and 1.46 percent in 1994 from the prior years. Once housing prices increased from October 1994 to October 1995, the Enterprises raised the limit for 1996 without any adjustment for the previous years' declines.

² In December 1992, the Enterprises determined that the 1993 conforming loan limit would increase .42 percent based on adjusted FHFB numbers for October 1991 and October 1992 national average one-family house price published on December 1, 1992. In November 1998, the Enterprises determined that the 1999 conforming mortgage loan limit would increase by 5.66 percent based on an adjusted October 1997 house price survey. In 1992 and again in 1998, the Enterprises used the adjusted national average one-family house price(s) provided by the FHFB.

guidance, setting a more regularized process of oversight and control for this matter of significant national importance.

b. Preservation of Existing Authority

Nothing contained in this guidance prevents OFHEO from undertaking such supervisory or enforcement actions as may be necessary to meet its statutory obligations to oversee maintenance of safety and soundness and adequate capital.

II. Calculation of Conforming Loan Limit

a. Procedures

(i) Consistent with current practice, OFHEO will utilize the October MIRS survey data (routinely released in November) to calculate the conforming loan limit for the following calendar year.

(ii) Under the terms of an inter-agency agreement, the FHFB will provide OFHEO with the confidential October survey data prior to its public release.

(iii) OFHEO will run the adjustment factor therein against the prior year's figures to determine the new conforming loan limit for the following year.

(iv) Concurrent with the FHFB's October MIRS announcement, OFHEO will announce its calculation of the new conforming loan limit.

(v) OFHEO will promptly issue a letter to the Enterprises confirming the new limit. The purchase of any mortgage above this limit by Fannie Mae or Freddie Mac will be considered an unsafe and unsound practice.

(vi) OFHEO shall inform the Enterprises of such procedures as it determines appropriate to carry forward the terms of this section.

b. Adjustments/Technical Changes

(i) At any time during the year after a calculation has been made and the conforming loan limit set, if the Enterprises ask FHFB for revisions, receive notice of revisions from FHFB or other developments occur relevant to the calculation of the loan limit adjustment factors, then the Enterprises shall provide such information on a contemporaneous basis to OFHEO.

(ii) OFHEO shall inform the Enterprises of such procedures as it determines appropriate to carry forward the terms of this section.



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800
Office of the Director

February 20, 2004

Franklin D. Raines
Chairman and CEO
Fannie Mae
3900 Wisconsin Avenue, NW
Washington, DC 20016-2892

Dear Mr. Raines:


OFHEO has concluded a review of concerns raised by the Federal Housing Finance Board regarding the 2004 conforming loan limit (see attached correspondence). After considering information provided by the FHFB, Fannie Mae, and Freddie Mac, I have concluded that the limit adopted by Fannie Mae improperly failed to incorporate a necessary adjustment factor. This omission occurred despite notification by the FHFB of the need for the adjustment months before the new loan limit was announced. Given the safety and soundness implications that arise, OFHEO, with the assistance of the FHFB, is taking the following two actions.

First, the adjustment that should have been incorporated in 2004 will be incorporated into the 2005 conforming loan limit. The FHFB's October 2004 survey announcement will provide the necessary information on the proper adjustment. Other less practical options, such as reducing the 2004 limit already in place, could result in a disruption of the mortgage markets. Therefore, consider this letter as confirmation that the maximum 2004 conforming loan limit for one-unit single family loans is \$333,700, with the exception of Alaska, Hawaii, Guam, and the U.S. Virgin Islands.

Second, OFHEO is issuing the attached Supervisory Guidance that will govern future adjustments to the conforming loan limit. The current informal procedure for annually adjusting the conforming loan limit is inadequate. Under the terms of this Guidance, OFHEO will annually announce its calculation of the maximum conforming loan limit and will consider the purchase by Fannie Mae or Freddie Mac of any mortgage above this amount to be an unsafe and unsound practice.

These prudential steps will minimize operation and reputation risk associated with the annual adjustment to the conforming loan limit.

Sincerely,



Armando Falcon, Jr.
Director



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800
Office of the Director

February 20, 2004

Richard F. Syron
Chairman and CEO
Freddie Mac
8200 Jones Branch Drive
McLean, VA 22101-3107

Dear Mr. Syron:


OFHEO has concluded a review of concerns raised by the Federal Housing Finance Board regarding the 2004 conforming loan limit (see attached correspondence). After considering information provided by the FHFB, Fannie Mae, and Freddie Mac, I have concluded that the limit adopted by Freddie Mac improperly failed to incorporate a necessary adjustment factor. This omission occurred despite notification by the FHFB of the need for the adjustment months before the new loan limit was announced. Given the safety and soundness implications that arise, OFHEO, with the assistance of the FHFB, is taking the following two actions.

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These prudential steps will minimize operation and reputation risk associated with the annual adjustment to the conforming loan limit.

Sincerely,



Armando Falcon, Jr.
Director



Federal Housing Finance Board

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December 23, 2003

Note: This letter is scanned and blurry.
For copy or assistance, please contact
FHFAinfo@fhfa.gov

Via Facsimile Transmission and Regular Mail

Ms. Ann M. Kappler
Senior Vice President and General Counsel
Fannie Mae
3900 Wisconsin Avenue, N.W.
Washington, DC 20016-2892

Dear Ms. Kappler:

Thank you for your letter of November 25, 2003 regarding Fannie Mae's calculation of its 2004 conforming loan limit.

In a monthly Press Release dated November 25, 2003, the Federal Housing Finance Board ("Finance Board") reported that the October 2003 average house price was \$243,756. The Press Release went on to state that the \$243,756 October 2003 average house price compared with an average house price in October 2002 of \$235,717. This resulted in a 3.4% increase over the twelve-month period.

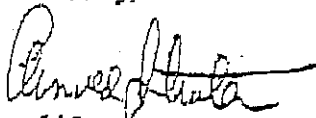
Your letter noted that the Finance Board had adopted a new survey methodology to calculate monthly average home prices in 2003. That methodological change was adopted by the Finance Board in December 2002 and published in the *Federal Register* on December 27, 2002 (See 67 Fed. Reg. 79100). The methodological change was the culmination of a process that began several years earlier, and the planned revisions were the subject of a *Federal Register* notice that sought public comment (See 65 Fed. Reg. 58813, September 26, 2000). The final paragraph of the Finance Board's November 25, 2003 Press Release confirmed that the October 2003 average house price was calculated according to the new methodology.

On several occasions in 2003, beginning in February and culminating in the days prior to the public release of the October 2003 average home price on November 25, 2003, Finance Board staff informed Fannie Mae that the estimated net effect of the methodological changes was to increase reported average house prices by \$1,647. Finance Board staff also informed Fannie Mae that calculating a percentage change in

house prices by directly comparing October-over-October averages without adjustment for the methodological changes incorporated in 2003 would overstate the true change in average house prices. Thus, for the purposes of determining an accurate percentage increase in average housing prices in this transition year to the Finance Board's new methodology, it is necessary to compare the October 2002 average one-family house purchase price of \$235,717 with the October 2003 average house price adjusted for the \$1,647 increase that results solely from the new methodology. The adjusted October 2003 average house price is \$242,109. The adjustment reduces the October 2002 to October 2003 percentage increase in the national average one-family house price in the monthly survey of all major lenders conducted by the Finance Board from 3.4 % to 2.7%.

Other than providing Fannie Mae with information on average one-family house purchase prices that is a component of the Finance Board's Monthly Interest Rate Survey, the Finance Board has no input into Fannie Mae's conforming loan limit calculations. My purpose in responding to your letter is simply to restate that Finance Board Staff provided Fannie Mae with information on the Finance Board's new methodology of calculating average one-family house purchase prices well in advance of the November 25, 2003 release of the October 2003 average home prices. The Finance Board also provided information regarding the appropriate steps for Fannie Mae to take to ensure comparability between the 2003 and 2002 average home price data. If additional information is needed, please feel free to contact me at 202-408-2536 or Joseph McKenzie the Deputy Chief Economist of the Finance Board's Office of Supervision at 202-408-2845.

Yours Truly,



Arnold Intrater
General Counsel
Federal Housing Finance Board

cc. Ms. Joan Donoghue
Acting General Counsel
Freddie Mac

Mr. Armando Falcon, Jr.
Director
Office of Federal Housing Enterprise Oversight

Mr. John C. Weicher
Assistant Secretary for Housing
U.S. Department of Housing and Urban Development