

A Jumbo Opportunity

The Motley Fool

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Lately, we've become all too aware that some mortgage borrowers aren't as creditworthy as others. Yet even for those with good credit, prospective homeowners in some high-priced areas of the country are increasingly having trouble dealing with higher interest rates on the big mortgages they need.

The key lies in so-called jumbo mortgages, a term that applies to mortgage loans above a certain amount. Currently, if you need to borrow more than \$417,000 to buy a home, you'll have to get a jumbo mortgage. And the bad news is that according to Money magazine, interest rates on jumbo mortgages rose nearly half a percentage point in August - even as regular mortgage rates were mostly coming down.

The magic number

So what's so special about \$417,000? The answer has to do with the way mortgages are bought and sold among financial institutions. In many cases, the lender you work with directly while you're going through the mortgage process chooses not to hold onto your mortgage over the ensuing years. Instead, it sells your mortgage on to the secondary market.

The biggest entities that purchase mortgages like yours are **Fannie Mae** (NYSE: FNM) and **Freddie Mac** (NYSE: FRE). However, they set guidelines for the mortgages they choose to purchase, and one guideline is the maximum amount they're willing to finance for any one borrower. The number is based on average loan amounts, and since the beginning of 2006, it has been set at \$417,000.

Falling behind

Unfortunately, the jumbo amount didn't keep up with the booming real estate market in recent years. One theory behind jumbo mortgages is that they would normally only be necessary for luxury properties, whose values are more prone to changing economic conditions than homes in more typical price ranges and, therefore, involve more risk for a lender.

Yet where prices have risen the most, it can be hard to find even a starter home that doesn't require a jumbo mortgage. Even modest-sized condos in some areas of Los Angeles and San Francisco often cost upwards of \$500,000. It's hard to argue that every single home in an entire metropolitan area could be a luxury property.

Are higher limits smart?

Meanwhile, Congressional debate has focused on a different limit: the \$362,000 cap on the amount the Federal Housing Administration can guarantee on certain mortgages. By raising that cap to match or exceed the jumbo loan amount, more troubled homeowners could get refinancing. Without FHA assistance, lenders probably won't take on the risk of default.

Yet for lending institutions, Fannie Mae and Freddie Mac limits are likely more important, as the spreads between regular and jumbo rates show. Currently, **Wells Fargo** (NYSE: WFC) charges 0.5% more on jumbo loans than conforming loans, while **Fifth Third** (Nasdaq: FITB) jumbo rates are nearly a full percentage point higher.

Fed Chair Ben Bernanke has argued that increasing those limits “would expand this implied guarantee [as a government-sponsored entities] to another portion of the mortgage market, reducing market discipline further.” Yet financial companies and regulators need to determine the most efficient way for the mortgage market to function in a way that balances the needs of borrowers and lenders.

Historically, banks retained responsibility for loans, giving them more incentive to make good lending decisions. The more recent practice of selling mortgages has removed much of that incentive. And while increasing the jumbo limit may allow more homeowners to take advantage of lower rates, it still leaves the question of how to get lenders to care about the quality of the loans they make. In the end, that's the only way to avoid a much larger crisis.

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