Redwood Trust, Inc.

Perspectives on GSE Conforming Loan Limits

December 2021

Redwood Trust has continuously led the private sector resurgence in housing finance, issuing the first post-crisis securitization in 2010 and the first securitization backed by residential loans originated since the onset of the COVID-19 pandemic in 2020. Each year, we adapt to changes in GSE conforming loan limits and continue innovating to address the needs of both GSE eligible borrowers and those not eligible for, or well-served by, government-sponsored loan programs. In particular, we have credit enhanced more securitizations of high balance "jumbo" residential loans than any issuer in the country, and we specialize in underwriting the unique borrower profiles and properties backing these loans.

A few years ago, we published a presentation that provided perspectives on private capital in the mortgage market[(1)], providing evidence at the time that policymakers focused on affordable homeownership no longer need to subsidize high-cost mortgages, as the private sector has consistently offered similar if not more competitive rates to conforming mortgages for a number of years with substantial liquidity. Reflecting on the significant growth of the private sector since that time, this whitepaper offers commentary on the record conforming loan limit increases for 2022.

(1) https://s23.q4cdn.com/859201575/files/doc_presentations/d6b9569a-4e95-ff04-2bdb-b42f1a0e1073.PDF

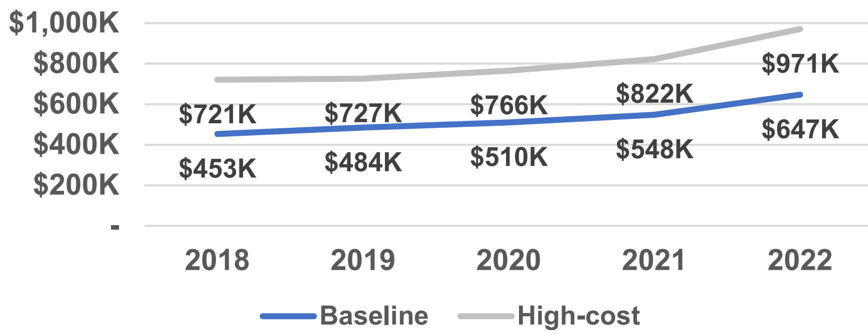
Taxpayers Are Now Expected to Backstop Mortgages of Close to $1 Million

Last week, the Federal Housing Finance Agency (FHFA) published updates to the conforming loan limits. These caps – inclusive of so-called "high-balance" limits applicable to higher-cost areas across the country – govern the maximum loan sizes eligible for securities backed by Fannie Mae and Freddie Mac (the GSEs).

Since 2008, these conforming loan limits have been set by the FHFA using the "HERA formula" established under the Housing and Economic Recovery Act of 2008. The formula is based upon a House Price Index Report that is updated during the third quarter of each year, with new limits for the following calendar year published in late November. FHFA uses the HPI Report's data and applies a statistical analysis to determine the new conforming limits. For higher-cost areas in which the local median home value exceeds a specified amount, loan limits can be up to 150% of the baseline cap.

After a 7.4% increase for 2021 – in keeping with the FHFA's home price appreciation data for last year – the 2022 base loan limit was increased by approximately 18%, reflecting record home price appreciation over the past 12 months. In most markets, the maximum GSE-eligible loan size is now $647,200, with limits as high as $970,800 in certain high-cost areas. These limits are now more than two and three times, respectively, the average size of a newly originated GSE loan.

Baseline and top high-balance loan limits, since 2018



Despite Popular Thinking, the FHFA is not Required to Implement the Maximum Conforming Limits

The maximum limits represent just that – a maximum, not a mandate. Prior to the financial crisis, the executives at Fannie Mae and Freddie Mac maintained discretion to reduce those limits for risk-based or other business reasons. However, since the GSEs entered conservatorship in 2008, that discretion transitioned to the GSE regulator, FHFA.

We believe there are important factors the FHFA should consider in evaluating the maximum limits – which at current levels will result in taxpayers backstopping loans for homes valued well in excess of $1 million.

1. The GSEs could more effectively support their affordable housing mission with a reduced focus on high balance loans. High balance loans divert capital and other resources to activity that does nothing to promote affordable housing. In particular, the new limits appear at odds with the recently-published GSE goal scorecard, which leans heavily on mission-driven outcomes – most notably supporting access to affordable housing. This includes loans for first-time or low-to-moderate income homebuyers. These goals come as GSE purchases have migrated increasingly toward higher balance loans, as the average size of loans purchased has increased 21% since 2018. At the new higher limits, Fannie and Freddie will be assuming risk on mortgages to homebuyers with incomes well in excess of the national median, and in many cases well above the median in their own neighborhoods.

2. The new limits unnecessarily expand the GSE footprint and represent further government subsidization of the mortgage market. As many readers recall, the GSEs were placed in conservatorship in 2008 after a massive taxpayer funded bailout. That bailout was in part due to excessive and unnecessary risk taking at the time by the GSEs, particularly in aspects of the market that were not well understood or consistent with the bulk of the production they had underwritten in the past.

Continuing to Raise the High-Balance Loan Limits Appears at Odds with the GSEs' Affordability Goals

The widening gap between median income in high-cost areas and the associated loan limits indicates that the original policy justification for high-balance loan limits has likely run its course. The path of home prices has migrated high-balance loan limits to the point where there is now a significant gap between the new limits and what a household earning the median income can afford.

The table below considers three counties with higher-balance limits and their most recently reported median household income. In each case, a household income of two times the area median is required to support debt payments on these higher-balance loans (assuming a reasonable debt-to-income ratio of 40%). The median income in these areas supports a mortgage balance substantially below the new prevailing limits.

Estimated Household Income Required for 40% DTI in Select High-Balance Counties

County	State	2022 GSE Limit	Required Household Income @ 40% DTI	County Median Household Income	Required Multiple of Median Household Income	Affordable Loan Size based on County Median Household Income
Ventura	CA	$851,000	$186,120	$91,446	2.0x	$415,000
King	WA	$891,250	$206,340	$102,338	2.0x	$440,000
Fairfax	VA	$970,800	$231,780	$127,898	1.8x	$575,000

Sources: FHFA, USDA Economic Research Service, Bureau of Labor Statistics. DTI calculation assumes 3.25% 30-year fixed mortgage rate and monthly real estate tax, insurance, and other debt obligations of $2,500-$3,500 per month.

The Private Sector Has Efficiently Served Consumers Requiring Higher Balance Loans for Decades

Firms such as Redwood specialize in high balance consumer mortgages, and already offer consumers mortgage rates at or better than similar loans purchased by the GSEs. The chart below evidences the relationship between conforming and jumbo rates over the past several years, along with annual jumbo volumes. As the data shows, the jumbo mortgage market has continued to offer competitive financing rates while witnessing a meaningful increase in scale.

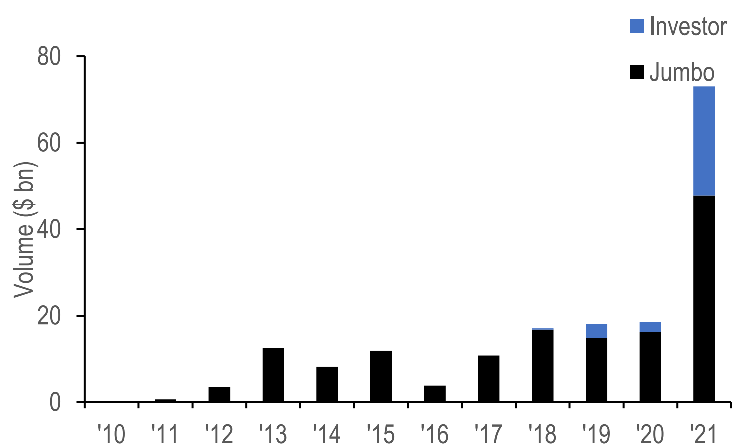
Average Conforming & Jumbo Rates; Estimated Jumbo Origination Volume (2017-2021)

	2017	2018	2019	2020	2021
Avg. Conforming Rate	4.28%	4.84%	4.21%	3.18%	3.12%
Avg. Jumbo Rate	4.18%	4.69%	4.23%	3.34%	3.10%
Jumbo Origination Volume	$320 B	$281 B	$392 B	$435 B	$569 B

Sources: Inside Mortgage Finance, Bloomberg

Part and parcel with this has been a steady increase in private sector securitization issuance over the past several years, which still speaks for only a fraction of the jumbo market's overall volume. Unlike the private market before the Great Financial Crisis of 2008, today the substantial majority of jumbo mortgages are owned in whole-loan form by large depositories, insurance companies, and other institutional investors. Redwood continues to actively serve both the private-label securitization market and whole loan investors, with sales almost evenly split between these two very important sources of liquidity for homebuyers.

Aggregate Jumbo and Investor Loan-Backed Securitization Volume, 2010 through YTD 2021



Source: JPMorgan

In keeping with this expansion, our year-to-date loan purchase volume in 2021 shows increased diversity across geographies and associated loan limits, reaffirming that capital from the private sector remains critical even as loan limits continue to increase. While our business continues to grow in the country's highest-cost areas, it now represents the lowest percentage of our total volume (less than 25%) in our history, reflecting the substantial number of borrowers who rely on access to the private markets for home loans.

The Private Markets Continue to Innovate to Serve Borrowers More Efficiently

Private capital has demonstrated the ability to fill gaps when the GSE footprint is reduced and do so with no discernible impact in borrower interest rate or process efficiency. A telling example of private capital absorbing GSE borrower demand is in the non-owner occupied (NOO) mortgage market. This market primarily includes investor properties and second homes owned by borrowers who qualify under GSE guidelines. For much of 2021, the GSEs, operating under various caps set under the prior Administration, limited NOO loans to 7% of all production sold to the GSEs by a single counterparty. In response, loan sellers increasingly relied on private capital to help them manage distribution of NOO loans away from the GSEs. The result was a substantial increase in NOO-backed private-label securities (PLS), which was easily absorbed by the market. In many cases, this allowed loan originators to offer better rates to borrowers while distributing the loans efficiently as they do with the GSEs.

Continued process improvements in the private sector have made it an increasingly efficient alternative to the GSEs. Speed to closing, highly competitive mortgage rates, and reliable execution are how Redwood has always operated. Specific innovations we have pioneered (including Rapid Funding and the use of Blockchain technology in securitization) have been important advances for the private markets as greater automation takes hold.

High Balance Loans Present Unique and Additional Risks Relative to Typical Conforming Products

The process efficiencies discussed above are not a substitute for much of the traditional diligence work done by private investors prior to purchasing bonds or loans. This underwriting rigor reflects the fact that the cohort of borrowers purchasing homes at prices well in excess of $1 million – versus those seeking mortgages in the $300,000 range (the recent average GSE loan size) – tends to produce a wider array of underwriting considerations (for example, a higher percentage of self-employed borrowers). This bears close watching, particularly given the cross-subsidy that drives guarantee fees across loan cohorts.