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Housing Finance: A Long-Term Perspective

By David Lereah*

The 1990s were good years for the housing finance business. Home buying surged, and financing shifted to new mortgage originators. Industry consolidation, advances in technology and narrowing profit margins characterized the changes. Although the outlook is favorable, challenges remain. The survivors in this mature industry will be the low-cost producers with a heavy investment in technology.

THE 1990s HAVE PROVIDED a favorable backdrop for the housing finance business. With an environment of steady economic growth and historically low mortgage rates, households exhibited a healthy appetite for home buying throughout this period, generating relatively high levels of residential mortgage originations for mortgage lending companies. Perhaps equally as important, the process of financing home buyers has shifted from individual mortgage issues by commercial banks and savings and loans (the portfolio lenders) to a host of new mortgage originators (mortgage banking companies and a securitization process led by Fannie Mae and Freddie Mac) that has expanded the mortgage market considerably in the 1990s. At year-end 1996, mortgage banking companies held a 56 percent market share of total industry originations, compared with only a 35 percent market share in 1990. And of the estimated $809 billion in total originations in 1996, $458 billion were secondary market transactions, compared with $276 billion of secondary market transactions in 1990.

The housing finance business also experienced other profound and rapid changes during this past decade, impacting mortgage lending companies and households in meaningful ways. Industry consolidation, advances in technology and narrow profit margins are just some of the developments that characterize the changes and challenges facing the housing finance marketplace of the 1990s.

Looking forward, the longer run prospects for the nation's housing finance business are favorable, promising to provide households with a varied menu of mortgage products and mortgage lenders with plenty of business. However, the obstacles and challenges that face the housing finance business today are clearly lined in the path of tomorrow. It is becoming increasingly clear that the housing finance industry has entered the "maturity" phase of the industry's life cycle. Excess capacity, industry consolidation and narrow profit margins are the observable residuals of this type of business environment. As in most mature industries, the surviving companies will be the low-cost producers, and a heavy investment in technology may help companies accomplish this objective.

The remainder of this paper will offer a long-run perspective of prospects for the housing finance marketplace. We first offer a review of this past year in the housing/housing finance markets to provide a benchmark for the longer-term prospects. We will then focus attention on the seminal/recurring forces that are expected to influence the nation's future housing finance needs and some selected business/policy issues that are expected to have a direct impact in the housing finance marketplace in the years ahead.

YEAR IN REVIEW

Looking back, mortgage lending flourished in 1996, beginning with a mini-refinancing boom early in the year, a surge in purchase originations in the middle of the year, and another mini-refinancing boom towards the end of the year. Although the economy and the housing markets provided a solid operating environment for mortgage banking companies, the operat-

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ing environment remained fiercely competitive, exerting downward pressure on operating margins.

Thirty-year mortgage rates that began the year averaging 7.03 percent in January rose to 8.32 percent by July, only to fall to 7.7 percent in November. For the year, existing home sales totaled a record 4.09 million units, 7.6 percent above the 3.80 million existing homes sold in 1995 and exceeding the previous record of 3.98 million homes sold in 1978. Similarly, new home sales totaled 756,000 units in 1996, 13 percent above the 669,000 new homes sold in 1995, and the highest number of new homes sold since 816,000 new homes were sold in 1978.

With the demand for housing strong and the inventories of existing and new homes kept relatively lean, builders kept building homes during 1996. For the year, housing starts totaled 1.47 million units, 7.9 percent above the 1.36 million units started in 1995 and the highest level of starts since 1.49 million units were started in 1988.

The housing markets enjoyed a banner year in a year of rising and then falling mortgage rates. People bought homes in record numbers and builders built homes at near record numbers, while the housing pundits scratched their heads. The popular notion that the housing markets have become less vulnerable to interest rate increases because homeowners can dull the adverse impact of higher mortgage rates with adjustable-rate loans is an appealing explanation. However, surging consumer confidence supported by strong job and income gains is also an equally appealing notion for explaining the steady strength in housing demand throughout 1996.

The housing sector's robust performance in 1996 directly affected the mortgage lending business. Mortgage originations are now estimated to have totaled $809 billion, 29 percent above the $639 billion in originations in 1995 and the third best year ever. Further, purchase originations set a record, totaling a projected $574 billion, easily exceeding the $522 billion in purchase originations posted in 1994. Moreover, the industry also experienced two mini-refinancing booms, one early in the year and one towards the end of the year. In total, refinancings comprised about 29 percent of total originations, totaling about $240 billion, the third best refinancing year ever (tied with 1994). With fixed-rate/adjustable-rate spreads widening throughout the first seven months of the year (to about 215 basis points from an average of 188 basis points in 1995), the markets shifted emphasis away from fixed-rate mortgages and toward adjustable-rate mortgages (ARM). ARMs claimed an estimated 26 percent market share of total originations for the year.

Translating increased business volume into profitability was not a trivial task for mortgage banking companies. The mortgage banking industry is projected to post only a 10 percent profit margin (net income/gross income) for 1996, slightly better than the 8.8 percent margin posted in 1995 and greater than the dismal 4.6 percent margin recorded in 1994. However, excluding gains from sales of servicing, operating margins continued to be thin. Excluding servicing sales, the operating profit margin projected for 1996 is about 5 percent, only half of the gross profit margin.

Responding to a fiercely competitive marketplace, some mortgage lenders turned to the subprime lending business in an effort to offset lackluster margins in the "A" market. According to the Mortgage Bankers Association's (MBA) numbers, subprime lending (excluding home equity loans) totaled about $90 billion and accounted for about 11 percent of all mortgage originations in 1996, compared to only $60 billion and a 9 percent share of originations in 1995. Securitization of "B & C" products and the increased participation from the agencies (i.e., Fannie Mae and Freddie Mac) in purchasing subprime loans, suggest that more mortgage banking companies may begin to contemplate life in the subprime lending markets.

Home equity loans and second mortgages (sometimes considered "B & C" lending) are other lending products that mortgage lenders are turning to for additional business volume. According to MBA's numbers, home equity lending totaled about $60 billion and accounted for about 7.5 percent of all mortgage originations in 1996, compared to only $40 billion and a 6 percent share of originations in 1995.

The credit quality of mortgage portfolios improved throughout 1996 in spite of lenders easing credit standards somewhat, as evidenced by rising loan-to-quality ratios in 1995, greater penetration of nontraditional borrowers (i.e., low income and minority borrowers) and entry into the subprime lending business. Delinquency rates dropped steadily throughout the year, dropping 32 basis points to 4.16 percent in the third quarter of 1996 (most recent number) from a cyclical high of 4.48 percent posted in the fourth quarter of 1995.

And finally, consolidation activity continued in 1996 with some of the largest mortgage lenders combining in efforts to reduce staff, achieve economies of scale, buy into retail markets and gain market share.

LONG-TERM FORCES INFLUENCING HOUSING FINANCE

The long-term prospects for housing finance are heavily influenced by five seminal and/or recurring forces: (1) the economy's boom/bust interest rate cycle; (2) demographic trends; (3) technological innovations; (4) changes in the business environment; and (5) changes in government policy. Each of these forces will be evaluated separately below.

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Boom/Bust Interest Rate Cycle

According to recent history, interest-rate volatility has been the single most important factor affecting the housing finance business. The economy inevitably experiences all phases of the business cycle: downturn, trough, recovery, expansion, and peak. Consequently, interest rates, responding to changes in the economy, also exhibit a boom/bust cycle, which in turn influences the business prospects of interest-sensitive industries such as housing finance.

It is not overstatement to say that the availability and affordability of mortgage credit are highly dependent upon movements in mortgage rates. Total mortgage origination volumes averaged about $97 billion annually during the 1981-82 period when thirty-year mortgage rates peaked at around 16 percent. Conversely, total mortgage originations volumes averaged around $900 billion during the 1992-93 period due to mortgage rates falling to a cyclically low 7.3 percent. With mortgage rates hovering around 8 percent during the 1996-97 period, industry originations are running between $750-$800 billion. Simply stated, lower mortgage rates improve affordability conditions as well as stimulating refinancing transactions, while higher mortgage rates dampen a household's appetite and ability to purchase a home.

Looking forward, we are assuming that the interest-rate environment will remain relatively low and stable towards the year 2000. At present, inflationary pressures are at bay, the economy is projected to grow along a noninflationary trend line, and the Federal Reserve has demonstrated a willingness to take a preemptive strike against the threat of inflation. Furthermore, the federal budget deficit is shrinking and a credible balanced budget package could be in the offing, suggesting that long-term rates could fall even further from their current levels.

Demographic Trends

Perhaps the most telling story of why our nation's housing markets are overachieving and may continue to prosper is in the demographic numbers. A significant portion of baby boomers have now entered the "high consumption" years for housing, feeding the nation's appetite for housing. Further, the percent of two-income families has steadily increased to almost 80 percent of households today from only registering 63 percent in 1980, providing families with greater financial flexibility to purchase homes. Also, the percent of single households has increased by over 5 percentage points to 19.5 percent today versus only 14.1 percent in 1990, increasing the pool of potential homebuyers. Similarly, the percent of divorced households has risen by 4 percentage points to 11.2 percent today from 7.2 percent in 1990. And finally, there has been a surge of immigration into this country during the past decade, helping boost the Asian and Hispanic population growth rates to 44 percent and 22 percent, respectively. And with each new year, there are increasing numbers of immigrants entering the home-buying marketplace.

A closer inspection of population growth, household formation rates, and age composition demonstrates the favorable demographic trends for the remainder of this decade. According to the U.S. Bureau of Census's recently (March 1996) revised population projections for the 1990-2000 period, the United States is projected to add 24 million people during this period, 2 million more than the 22 million people that were added to the population during the 1980-90 period. Similarly, the U.S. census now projects that 1.3 million new households will be formed every year during the 1990-2000 period, up from the 1.2 million households formed per year during the 1980-90 period. Both of these revised projections are encouraging, because both population growth and household formation are the fuel for future housing demand.

Evaluating the trends in age composition for different population groups reveals that the notion of aging baby boomers inhibiting future housing activity may be misguided. It is true that the "baby bust" generation, replacing the baby boomer generation aging out of the 25-34 age group, is quite smaller. According to the Census Bureau projections, the 25-34 age group will lose 728,000 persons per year during the 1995-2000 period. This groups represents the bulk of first-time home buyers, suggesting a drop in first-time home buying demand. However, several countertrends may more than offset the baby bust effect:

1. The recent surge in immigration (particularly the Hispanic and Asian groups) has created a new group of potential first time home buyers.
2. The under twenty-five age group is projected to add 674,000 people per year during this same time period. Some percentage of this group will also be first-time home buyers.
3. The aging baby boomers are now in the 35-44 and 45-54 age groups, adding 1.5 million people per year to these groups. These two middle-age groups are in the peak home-buying years, because income and wealth levels are peaking during these years. Both the housing and lending markets can expect a rise in trade-up home buying, renovations, jumbo lending, and home equity lending as well.
4. The 55-64 age group is projected to add 566,000 people per year during the second half of this decade, spurring demand for second homes as well as renovations, trade ups, and home equity lending.
5. The 65 + age group is projected to add 235,000 people per year, which portends favorably for retirement housing.

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Technological Advances

Recent advances in technology are making it possible to integrate and improve loan origination, underwriting, and servicing systems. Looking forward, the technology impact on the housing finance industry could be enormous. And as mentioned elsewhere, advances in technology can help companies become low-cost producers, which may mean survival in a maturing industry.

For consumers, advances in technology promise to accelerate the loan approval process and lower the price of obtaining a mortgage. For mortgage lenders, technological advances have a more profound impact on their businesses. Keeping up with technology means investing substantial capital and resources, and also assuming some risk. Advances in technology are so frequent that many systems more than two years old may already be outdated and behind the curve when contrasted to a competitor's newly added system.

The advent of automated underwriting systems and investment in electronic connectivity (i.e., connecting the underwriting process to appraisers, title companies, etc.) will significantly accelerate the underwriting process for most loans. Some loans will be able to be underwritten in a matter of hours rather than weeks. Both consumers and lenders are and will continue to benefit from technological advances on the origination side of the business. Application of technology to improving delivery channels of mortgage products to consumers is also beginning to dominate the business. Database marketing, use of the Internet and the implementation of wide-area networks for establishing controlled business arrangement (i.e., strategic alliances with realtors and/or builders) will all improve the mortgage lending process. And finally, advances in systems on the servicing side has helped give birth to the mega-servicer (servicing companies whose portfolios far exceed $20 billion) in an attempt to achieve economies of scale in servicing.

Changing Business Environment

The business operating environment for the housing finance business is expected to be extremely active for the remainder of this decade. While mortgage companies are expected to continue to post positive and improving returns on their capital; the lending markets will remain fiercely competitive; operating spreads will remain narrow; companies will continue to increase their focus on niche markets; and the industry is likely to experience further consolidation. The following discussion focuses on some selected areas that are considered business-related issues.

Consolidation. The increasingly competitive business environment and narrowing profit margins will require companies to be cost conscious on the loan production side of the business, either by reducing origination capacity or altering origination strategy in such a way to reduce loan production costs. In recent years, the reduction in origination capacity has taken place through industry consolidation. Furthermore, there has been a push towards becoming mega-servicers in an attempt to achieve economies of scale on the servicing side of the business.

At year-end 1996 the twenty-five largest servicers and the twenty-five largest originators held about 42 percent of their respective markets. This consolidation has primarily been driven by economies of scale on the servicing side of the business. This has allowed these companies to pass the lower costs through and reduce rates to borrowers, increasing market share of originations.

Credit Quality. Credit quality of mortgage portfolios may become an increasing problem during 1997 and beyond. Although the U.S. economy experienced solid growth during the past twelve months, rising consumer debt is beginning to place strains on household balance sheets. Total debt service payments as a percentage of disposable income for 1996 registered the highest level since 1990. Rising debt burdens combined with the historically high loan-to-value loans originated during the past three years are possible contributors to a less-than-favorable delinquency situation.

Subprime Lending. Subprime lending has played an important role in increasing profit opportunities for mortgage companies in the past year. This impact of subprime lending is likely responsible for a portion of the increased profit margins of mortgage companies in the first half of 1996. While the average firm registered a net profit margin of 11.8 percent and a net operating margin of 13.3 percent in the first half of 1996, the average firm posted a net profit margin of 2.6 percent and a net operating margin of negative 1.5 percent in the first half of 1995. Further evidence of the increasing interest in this market includes the nearly 50 percent increase in "B & C" originations to $96.5 billion in 1996 from $65 billion in 1995. Also, "B & C" securitizations posted the largest increase in mortgage securitizations to $38 billion in 1996 from $18 billion in 1995. The "B & C" securitization rate of 39.4 percent in 1996 was not far behind the overall mortgage (excluding "B & C" activity) securitization rate of 50.6 percent. Interest in this area continues to grow, and this business is expected to post solid growth gains for the remainder of the decade.

Home Equity Lending. An expanding market for home equity securitizations is providing increasing opportunities for mortgage bankers to become involved in home equity lending (HEL). The growth of securitization in this area has been phenomenal in the

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past two years. HEL security issuance doubled to $38 billion in 1996 from $19 billion in 1995 and just $11 billion in 1994. Indeed, mortgage companies directly issued $11 billion in HELs in 1996, up from $6 billion in 1995 and $2.4 billion in 1994.

It has also been reported that Fannie Mae may be considering adding a home equity line of credit (HELOCs) product to its offerings. This would open up the market for "A" credit quality borrowers to mortgage bankers; currently the "A" market is dominated by large commercial banks. Further, as interest rates remain stable or increase, demand for home equity loans should rise.

Profit Performance. Consolidation and slower prepayments in the "A" market in 1994 and 1995 paved the way for increases in company profits in 1995 and 1996. The average firm reported a profit margin of only 4.6 percent in 1994 before rebounding to 8.8 percent in 1995. The industry profit margin for 1996 is expected to be in the 10 to 12 percent range.

The combined upward profit impact of the forces of consolidation (in both origination and servicing), increased "B & C" market activity, slower prepayments, and cost reduction through outsourcing will likely overcome the downward push from reduced "A" market origination volume and likely credit quality deterioration in 1997 and 1998. Profit margins are expected to continue in the 10 percent to 15 percent range over the remainder of the decade.

BUSINESS/POLICY ISSUES

Flat Tax/Mortgage Interest Deduction

Perhaps of all the issues that could potentially influence the housing finance business, the implementation of a flat-tax system would be the most disruptive. While the flat tax initially appeals to most taxpayers on the grounds of simplicity, replacing today's comprehensive tax code with a single tax rate would generate a severe reallocation of resources within the economy. Currently, individuals and businesses alike are playing by today's tax rules and incentives, and to change the rules in the middle of the game would cause a significant reallocation of resources among the players.

A flat tax eliminates all deductions, including the mortgage interest expense, state and local income and property taxes, charitable contributions, medical expenses and investment interest expense. However, it is clear that a flat-tax system favors businesses over individuals. While a flat tax would compensate businesses for the loss of their interest expense deduction by allowing them to expense new equipment and other business purchases in the year of acquisition, no such compensation exists on the individual side for the loss of the mortgage interest deduction.

Owning residential real estate becomes more expensive relative to other investments in a flat-tax world, inhibiting residential investment while favoring business investment. Over time, resources would be pulled out of the housing sector and put elsewhere. According to a Congressional Budget Office (CBO) report, eliminating the mortgage interest deduction would increase homeownership costs so sharply that current homeowners may not be able to afford their homes. Elimination would raise the taxes of about 28 million homeowners by an average of about $2,100 in 1996. The greatest impact would be on home prices. A taxpayer in the 28 percent tax bracket owning a median price home could expect his home value to decline by as much as 21.5 percent. Our estimates demonstrate that a 20 percent drop in home values would cause default rates to increase by approximately 3 to 4 percentage points, threatening the viability of mortgage lending companies, including commercial banks, thrift institutions and mortgage banking companies.

Fair Lending Policies

In addition to operating in a more fiercely competitive environment, mortgage lenders also operate in a fair lending environment that promises to continue throughout this decade. Intense focus continues on the part of regulators, community groups and the media on mortgage lending and underwriting practices and their impact on minority and low-income borrowers and communities. The implications of this has been and will continue to be dramatic. Basically, companies have to satisfy certain numerical quotas (acceptance and application ratios) serving the low/moderate income and minority borrowers. Business strategies in mortgage lending have changed dramatically during the past several years and will continue to evolve to satisfy the fair lending/CRA (i.e., commercial bank) guidelines. Mortgage lenders are experiencing (and will continue to experience) both business opportunities (e.g., identifying untapped borrowers) resulting in greater profits and business losses (e.g., making unprofitable loans in order to satisfy regulatory quota requirements).

Capital Gains Tax Exclusion

Just recently President Clinton submitted his budget of the United States government for fiscal year 1998. In his budget was a proposal to provide capital gains exclusion on sale of principal residence.

Under current law, gains on the sale of a taxpayer's principal residence are subject to the capital gains tax; however, taxes on the gain can be deferred through the purchase of a new home of equal or greater value within a specified period of time. Taxpayers over 55

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may elect to take a one-time exclusion of up to $125,000 of gain from the sale of their home. The Administration proposes to exclude up to $500,000 of gain from the sale of taxpayer's principal residence ($250,000 for single taxpayer), effective for sales on or after January 1, 1997. This proposal would have a serious impact on housing activity, influencing the demand for tradeup homes, lower priced homes, relative prices of homes, and the demand for rental properties.

RESPA/TILA Reform

The mortgage lending industry over the past several years has faced the threat of widespread class action litigation brought on behalf of consumers. The courts have liberally construed the basic consumer protection statutes and regulations in favor of consumers with hypertechnical interpretations of the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA). Congress appears to see a need to simplify these and other consumer protection statutes to reduce any undue compliance burden on the lending industry and to consolidate and simplify disclosures, so that they can be more readily understood by consumers. Looking forward, this issue will be on the front burner for both consumers and lenders. It could have significant implications for the costs of doing business for lenders and the simplification of the closing process for consumers.

IRA-First-Time Homebuyers

During the past decade, federal tax policy has eliminated and/or restricted several important incentives for individual savings. Included among these are the provisions permitting the creation of individual retirement accounts. Congress is now considering expanding existing rules governing these savings vehicles or, in the alternative, creating a new form of IRA to encourage individuals to save for their retirements or other essential purchases, such as a first home.

Efforts to expand IRA provisions to allow for first-time homebuyers to withdraw funds for a purchase of a home looks ever more likely this coming year. More than 15 million first-time home buyers have entered the housing market during the 1990s, yet the surge of immigrants into the United States over the past two decades provides further growth opportunities for the first-time home-buyer market. The expanded IRA could be expected to add 45,000 additional households to the homeownership ranks each year.

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