Mortgage Outlook 2H 2016: As Interest Rates Fall, Non-Bank Share of Lending Volumes Rise

The financial troubles in Europe and larger concerns about China's economy continue to put a downward bias on interest rates, part of a secular deflationary trend now in its eighth year following the 2008 financial crisis. A number of investors have asked Kroll Bond Rating Agency (KBRA) how falling rates will impact origination volumes for 1-4 family mortgages in the US, and how these trends will affect financial results for banks and non-banks alike.

The short answer is that falling interest rates will probably boost refinancing volumes less than expected, but continued strong growth in mortgage loans for new home purchases will probably offset at least some of the difference. Of note, the Mortgage Bankers Association (MBA) is estimating $1.7 trillion in mortgage originations for 2016, up slightly from 2015. Overall, KBRA expects strong origination volumes in the second half of 2016 as lenders expand the credit box and take more underwriting risk than at any time since 2008. But this increase in lending volumes will also carry potential hazards down the road.

Mortgage Rates Trail Treasury Yields

The first observation to make is that mortgage rates historically have lagged the benchmark 10-year Treasury security, even as yields have hit an all-time low. As usual, prices for residential mortgage backed securities (RMBS) have trailed the upward move in Treasury bonds. But KBRA notes that this is consistent with the move in mortgage rates in 2012, when the all-time low was set. Mortgage industry veteran Rob Chrisman notes:

> "If you look at the 2012 period, one can see that the 10-year yield bottomed out in July, and started rising into the end of the year. Mortgage rates kept falling throughout the year, bottoming out in December. So, in 2012 mortgage rates didn't bottom out until 5 months after Treasuries did. Sure enough, looking at this year, if you plot the difference between the two rates (basically a proxy for MBS spreads), you can see that the current difference is approaching a high again. If this is a truly mean-reverting series, you should expect that gap to close over time, and that will either happen through higher Treasury yields or lower mortgage rates - probably the latter."

Origination Volumes Rise on Non-Bank Share Gains

Of course, predicting mean reversion in the global bond market at a time when government intervention by central banks has all but extinguished free market dynamics is a risky proposition for analysts and investors alike. That said, the results so far in the US mortgage market point to a bullish year for purchase mortgages and the possibility of a better year in refinancing volumes, albeit from a lower base. The MBA, for example, has been predicting a steady decline in refinancing volumes each year through 2018.

Added to the analysis is the changing composition of the lending universe. Loan volumes by banks continue to fall, but lending by non-banks has increased more than proportionately especially to lower quality borrowers. The International Center on Housing Risk in Washington notes that lending to borrowers with FICO scores below 700 has increased dramatically, with the GSEs such as Fannie Mae and Freddie Mac up 27% year-over-year (YOY) through May and Ginnie Mae up 21% YOY.

Mortgage lending by depositories continues to fall, with loans securitized with servicing retained down 14% YOY to just $704 billion, according to data from the FDIC. Net securitization income for all FDIC insured banks fell to $203 million, down 32% YOY and just 10% of the level of bank securitization income in 2008. Given the increased propensity of banks to retain what mortgage production they are willing to underwrite, KBRA expects that securitization of 1-4 family mortgages by depositories to continue to decline.

Indeed, mortgage banking profits tumbled in 1Q16, dropping 27% from 4Q and hitting the lowest levels in five years, according to *Inside Mortgage Finance*. Net servicing fees fell almost 50% to $864 million in Q1 2016 vs $1.6 billion a year before. Adding insult to injury, non-cash losses due to model-driven mark-downs of mortgage servicing rights (MSRs) have been a significant drag on the reported profitability of all mortgage originators.

Warehouse Lending Increases with Non-bank Originations

While commercial banks are making fewer 1-4 family loans, the banking industry's commitment to the market is increasing via warehouse lending to non-banks. As KBRA has noted in past research notes, the 1998 changes to SEC Rule 2a-7 make it impossible for non-banks to fund themselves via short-term debt issuance for purchase by money market funds. These changes made by the SEC under Chairman Arthur Levitt have not only given commercial banks a monopoly on short-term funding in the United States, but arguably led to the near-catastrophic failure of Long Term Capital Management later that same year. KBRA believes that the financial crisis of 2008, including the failure of non-banks such as Bear, Stearns & Co, Countrywide and Lehman Brothers, to name just three, was made far worse because of the changes made to Rule 2a-7 a decade earlier.[1]

In credit terms, all non-banks that engage in liability transformation, from mortgage lenders to marketplace lenders to auto finance companies, are now effectively subordinated to commercial banks that provide them with liquidity and hold the related collateral. Non-banks are now entirely dependent upon commercial banks to fund new mortgage originations, advance lines and other fully-secured short-term liabilities. As a result, as commercial banks withdraw from mortgage lending, the only way for non-banks to make up the difference and maintain or even increase new loan origination volumes is for banks to increase warehouse lines. The most recent survey by *Inside Mortgage Finance* shows that the total market for warehouse lending was $50 billion at the end of Q1 2016, as shown in the table below.

Warehouse Lender	1Q16 ($M)	1Q15-16 (Δ)	KBRA Rating
JPMorgan Chase Bank	$6,000	38.4%	nr
Texas Capital	$4,981	-7.9%	nr
Wells Fargo Bank	**$4,700**	**-5.0%**	**AA-**
Comerica Bank	$3,300	3.1%	nr
Customers Bank	**$3,284**	**46.6%**	**BBB**
BB&T	$2,800	-2.6%	nr
U.S. Bancorp	$2,522	11.6%	nr
Flagstar Bank, FSB	**$2,360**	**42.0%**	**BBB+**
Santander Bank	$2,350	20.2%	nr
First Tennessee	$2,330	39.4%	nr
People's United	$1,600	14.3%	nr
EverBank	**$1,340**	**148.1%**	**A-**
Fidelity Bank	$645	21.7%	nr
Southwest Bank	$597	17.3%	nr
NattyMac (ND)	$564	40.0%	nr
Group Total:	**$29,947**		
Market Total:	***$50,000***		**11.1%**

Source: Inside Mortgage Finance, KBRA nr=not rated

[1] Countrywide Financial was technically a bank, but the firm was primarily funded via short-term borrowings from its primary warehouse lender, Bank of America (NYSE:BAC).

Purchase Mortgages vs. Refinancing

As noted above, the MBA is expecting a slight increase in mortgage originations in 2016, including $880 billion in purchase mortgages and $749 billion or 46% percent share for mortgage refinance transactions. With a larger share of the market attributed to non-banks, however, it remains to be seen whether the US mortgage market can expand significantly from current levels. Non-banks simply lack the balance sheet and access to sufficient funding to make up the difference as commercial lenders migrate toward more profitable and less risky lending products. The table below shows the composition of bank and non-bank lenders in the conforming and government markets as of Q1 2016. Depositories are shown in bold.

Rank	Conforming Market	Market Share	Rank	Government Market	Market Share
1	**Wells Fargo & Co**	11.7%	1	**Wells Fargo & Co**	8.4%
2	Quicken Loans	6.3%	2	Freedom Mortgage	7.8%
3	**Chase Bank**	4.8%	3	PennyMac	7.5%
4	**U.S. Bank**	2.4%	4	Quicken Loans	5.8%
5	**Flagstar Bank**	2.1%	5	**U.S. Bank**	3.8%
6	loanDepot.com	2.1%	6	Amerihome Mortgage	2.8%
7	**Bank of America**	2.1%	7	Caliber Home Loans	2.7%
8	Amerihome Mortgage	1.8%	8	loanDepot.com	2.2%
9	United Wholesale	1.8%	9	Pacific Union Financial	2.1%
10	PennyMac	1.7%	10	Stearns Lending	2.0%
11	Caliber Home Loans	1.6%	11	Ditech Financial	1.9%
12	Franklin American	1.6%	12	**Flagstar Bank**	1.9%
13	Stearns Lending	1.6%	13	Plaza Home Mortgage	1.8%
14	**Citibank**	1.6%	14	**Chase Bank**	1.7%
15	Ditech Financial	1.5%	15	Sun West Mortgage	1.7%
16	Nationstar Mortgage	1.4%	16	USAA Federal Savings	1.6%
17	**SunTrust**	1.3%	17	The Money Source	1.5%
18	**BB&T**	1.2%	18	Nationstar Mortgage	1.4%
19	Guaranteed Rate	1.2%	19	**Navy Federal CU**	1.3%
20	Impac Mortgage	0.9%	20	Carrington Mortgage	1.3%
21	PrimeLending	0.9%	21	Mortgage Research	1.3%
22	Provident Funding	0.9%	22	Guild Mortgage Co	1.1%
23	Fairway Mortgage	0.8%	23	Stonegate Mortgage	1.1%
24	Freedom Mortgage	0.8%	24	CMG Mortgage	1.1%
25	Finance of America	0.8%	25	Fairway Mortgage	1.0%

Source: Inside Mortgage Finance

With interest rates falling under the inexorable pull of debt-deflation, KBRA believes that there is reason to believe that in the near term mortgage refinance volume will rebound to half of total originations. A strong increase in prepayment rates for jumbo and agency RMBS also supports this analysis. The expansion of the credit box particularly by non-bank lenders is another positive factor that may push mortgage refinancing volumes higher.

Balanced against this bullish picture, however, is the fact that commercial banks continue to retreat from mortgage lending under the relentless bombardment of prudential and consumer regulators, who have collectively made 1-4 family mortgages the most problematic asset that a bank can originate and hold. On a risk adjusted basis, at best originating and servicing a residential mortgage is a single-digit return proposition. No surprisingly, many banks have decided that this asset class is simply too dicey to include in their mix of lending products, especially if the loans are sold into the conforming or conforming markets.

Notice, for example, that today there are only five depositories in the top-25 lenders operating in the FHA market. Indeed, more than half of the banks in KBRA's rated universe have either scaled back or eliminated residential mortgage lending entirely. Meanwhile, the largest bank players in the residential market such as **Wells Fargo (NYSE:WFC)** and **JPMorgan Chase (NYSE:JPM)** have refocused their origination activities on high FICO lending so that roughly 40% of the originations by the top four US commercial banks are now in low-risk jumbo mortgages.

Meanwhile, KBRA notes, smaller non-bank lenders are originating loans in the conforming (Fannie Mae & Freddie Mac) and government (FHA/VA), with the emphasis on the latter. While the market for private label mortgages has not and likely will not be revived, the FHA market has become the default market for below-prime, low-FICO loans originated predominantly by smaller non-bank lenders.

Conclusion

Analysts at JPM expect home prices in the US to rise at low single digits in 2016. "At a national level, home price gains moderated slightly, but still coming in at above 5% pace," writes analyst John Sim et al. "Supply in the market is still relatively limited given the demand. We maintain our view that home prices should continue to moderate to a 3-4% level by year end." Cash buyers from nations such as China and the UK also may continue to push up US home prices as they seek to flee economic troubles at home.

The continued positive lift in home prices provides an upward bias to home mortgage origination volumes, largely driven by a continued dearth of supply of homes. That said, home prices have been rising in the US at multiples of GDP growth for the past five years, forcing LTV ratios lower. KBRA notes that borrowers with troubled credit histories are also seeing improved FICO scores as foreclosures and default events recede into the past.

From 2010 through 2014, US home prices appreciated at a double digit rate. While the rise in purchase mortgages was until recently predominantly driven by first-time home buyers, the easing of credit standards has seen an increase in repeat buyers, a sign that the home price cycle is maturing and the speculative component of the market is expanding.

"Fueled by solid job gains, low mortgage rates, and high and growing leverage, the national seller's market is now in its 45th month," notes Ed Pinto of the The International Center on Housing Risk. "Contrary to the prevailing view, post-crisis underwriting/regulatory changes promote rather than constrain a boom. The current pattern is similar to the full-blown sellers' market that began in 1998. If this trend continues, the risk of a serious house price correction will become even larger."

KBRA believes that 1) the growing supply of credit – even from liquidity constrained non-banks selling into the conforming and agency markets – and 2) the increasing proportion of repeat buyers are becoming the more important factor behind rising US home prices. Accordingly, we believe that lenders, investors, and policy makers need be cautious as the US home market ends its sixth year of price increases at rates of appreciation that remain a multiple of underlying GDP growth.

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