Housing finance in the USA in the 1990s

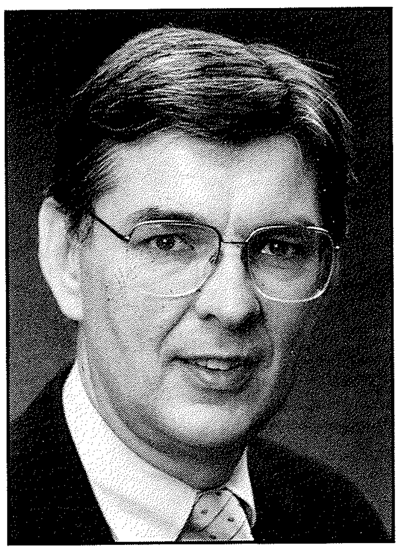
By Warren Lasko

IN recent years, the American mortgage market has been beset by high and volatile interest rates, the fallout effects of deregulation, excess capacity, huge default and foreclosure losses, intense price competition and the evaporation of profits. There has been a shift from fixed rate financing towards adjustable rate and other forms of "creative" financing, and there has been a sweeping trend towards securitisation and increased reliance on the secondary market.

Taking the longer, broader view, we recognise we now have a well-developed secondary market that assures the availability of mortgages in bad times as well as good. The secondary market, through Fannie Mae, Freddie Mac and Ginnie Mae, and through a number of private conduits, has proven a remarkably efficient engine for channelling capital for housing from the national and global credit markets into local housing markets.

The marvels of near instant worldwide communications and the ability with computers to transform mortgages into a wide variety of rateable-tradable high grade securities has made the mortgage market one of the most efficient and competitive marketplaces in existence. Housing consumers have been the beneficiaries as they can compete for housing finance on nearly equal terms with giant corporations and obtain credit at rates only 150 basis points or so above the U.S. Government's costs of borrowing.

Yet housing affordability has suffered even as the mortgage market has become more efficient. House



THIS paper sets out ranges of possibilities for the future of the housing finance market. It points out that while there will be a growing market for real estate finance for the forseeable future, the housing finance business will be leaner in the 1990s than it has been in the 1980s.

prices in much of the country have risen faster than incomes and faster than consumer prices. Young people trying to buy their first home are most affected, as they struggle to accumulate a down payment and to achieve sufficient income to make a monthly mortgage payment that requires an income out of reach to increasing numbers of them.

Among households headed by persons aged 25 to 34, the home ownership rate has dropped to about 45%, an eight percentage point drop from a decade earlier. The typical home in the late 1980s absorbs half again as much family income as it did two decades earlier.

The affordability of rental housing is similarly distressing. Higher financing and other costs of owning and operating rental housing have pulled rents up faster than the modest incomes of most renters.

As we look towards the future in our capitalist, free market system, the ultimate driving forces, as in the past, will be profits and returns on investments. The future of real estate finance will be shaped by the traditional interwoven forces of entrepreneurship, human ingenuity, and technology; armed with capital; in pursuit of material gain; guided and restrained by public policy and regulation.

The way we finance housing and other real estate in the 21st century will almost certainly provide better mortgage products, more efficiently, at lower real costs. The competitive forces of the free marketplace over the long term work inexorably toward innovation and greater efficiency. Our business, like most, will do thousands of little things a little bit better, and once in a while a very few things a whole lot better.

Basic demand for mortgage finance

There will be a large and growing market for real estate finance for as far into the future as we can imagine. But it will be leaner, less ebullient business than in the 1980s.

There will always be a need, and therefore demand, for housing, office and other commercial space, and for the financing of it. But the rate of growth in demand has reached a plateau and will even slacken during the 1990s. Chart 1 shows net new household formations declining from an annual average of 1.6 million in the 1980s to 1.2 million in the 1990s. This will translate into an average annual need for some 1.4 million housing unit starts, which in turn suggests fewer new home sales and sharply lower multifamily construction.

Interestingly, existing home sales will rise gradually. Though the absolute number of additional homes will be declining, the total stock of housing will be rising and so too will the number of existing units sold each year.

This less than effervescent housing market and related employment and commercial activity will in turn generate only slowly growing and still cyclical needs for mortgage credit. We anticipate that home mortgage originations during the 1990s will average a bit over $500 billion a year. Thus we will indeed see the day when the phenomenal lending levels of 1986-87 are reached again. But it will take until the middle of the decade to reach such levels.

In contrast, loan servicing grows year in and year out. By the year 2000, home mortgage debt will likely reach $6 trillion. This is far more than double its level at the start of the 1990s (Chart 2).

Demographics could play a beneficial role in lowering mortgage and other interest rates in the 1990s. As the bulge in the U.S. population grows older, it will shift over the next decade from credit-using, non-saving young people to credit-supplying net savers. This could prove a powerful shift that lowers demand for consumer durables and housing, slows credit growth relative to employment and income, and raises the national savings rate. Federal policy success in containing inflation through reduced budget deficits and lower international imbalance will, of course, also play a vital role in determining interest rates.

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Chart 1

Housing Markets in the 1990s

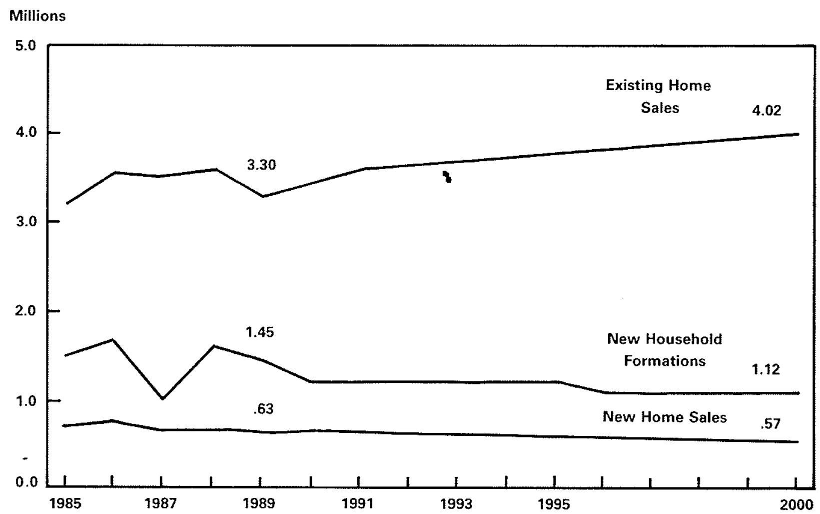
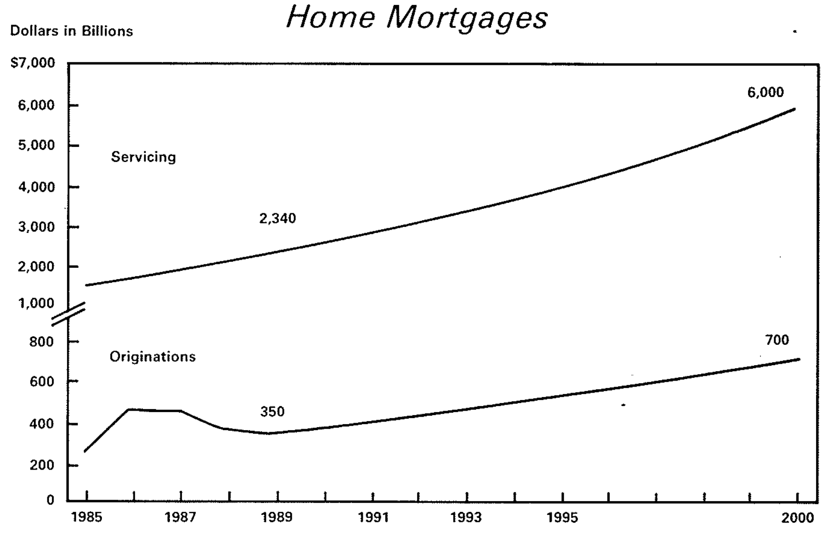


Chart 2

Mortgage Finance in the 1990s

Home Mortgages



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This population shift almost certainly will be accompanied by diminished market share for first-time home buyers and the use of low down payment, conventional, government-insured mortgages. The move up-market for housing and mortgages will grow in importance, suggesting comparatively strong demand for high balance conventional nonconforming financing.

Taken together, these demographic and market phenomena could well also weaken the political support for pro-housing issues.

Structure of the real estate finance industry

Who will make, service and hold mortgage debt? As we enter the 1990s, the entire financial services industry, and especially the mortgage delivery system, is going through a period of fundamental restructuring.

Consider first who will hold mortgages as the ultimate investors. Where will mortgage money come from? It used to be, at the beginning of the 1980s, that savings institutions and banks provided most of it. Indeed, the thrift industry alone held about half of all mortgage debt then. But, as the decade ends, thrifts hold a much lower portion of the total, and their share is declining (Table 1).

Meanwhile, banks, pension and insurance funds and foreign institutions are becoming far more important as ultimate sources of mortgage funds, and this trend will accelerate. Pension funds will without doubt grow in importance. As our population ages, a growing proportion of its financial assets will be held in "forced savings" in retirement funds. Pension funds also benefit from low operating costs, hence ability to survive on lower spreads over their cost of funds, and greater predictability of liabilities compared with thrifts.

How will these funds, these savings, find their way into the mortgage market? Just because the resources are held in big banks, thrifts and retirement funds does not mean those institutions will necessarily create and service the assets — the mortgages — that they hold. Large institutional investors become essentially asset managers, handlers of huge portfolios, with their top management trained and skilled at optimising yields. This is a very different set of skills and orientation compared with that of a producer of a product.

Table 1
Who Makes, Services and Holds Home Mortgage Debt?

(Dollars in billions)

	1980		1988	
	Amount	*Per cent*	*Amount*	*Per cent*
Mortgage Originations				
Thrifts	$ 66.5	49.7%	$ 186.2	49.7%
Mortgage companies	29.4	22.0	85.3	22.8
Commercial banks	28.8	21.5	95.5	22.5
All others	9.1	6.8	7.4	2.0
Total	$133.8	100.0%	$ 374.4	100.0%
Mortgage Servicing				
Thrifts	$482.0	50.4%	$ 823.8	38.9%
Mortgage companies	195.0	20.4	748.8	35.4
Commercial banks	179.1	18.7	402.2	19.0
All others	100.2	10.5	140.4	6.7
Total	$956.3	100.0%	$2,115.2	100.0%
*Mortgage Holdings**				
Thrifts	$512.0	53.5%	$ 924.8	43.7%
Commercial banks	196.6	20.6	482.5	22.8
Pension and retirement funds	27.3	2.9	135.9	6.4
Federally-chartered agencies	38.0	4.0	131.8	6.2
Insurance companies	28.2	2.9	143.0	6.8
All others	154.2	16.1	297.2	14.1
Total	$956.3	100.0%	$2,115.2	100.0%

*Including mortgage-backed securities.

In terms of who does what in the mortgage market in the years ahead, there is a paradox evolving. At one time there is underway an homogenisation of institutions on a global scale, but also a growing specialisation of functions within firms. If we can look beyond the day-to-day vagaries, crises and pitfalls, the long-term trend is inexorably towards a global and more level playing field.

Borrowers of all sorts will gain increasing access to capital more efficiently, through more firms, more quickly across the continent and around the world. At the same time, within the mortgage delivery business, market forces are shaping and will continue to shape more efficient and more specialised ways to finance housing and commercial facilities.

In the centuries-old process of progress through specialisation and division of labour, we envisage the mortgage business becoming divided into separate, more efficient entities, specialising in:

Originating (or making) mortgages, including underwriting and quality control.

Aggregating (or pooling) and warehousing mortgages, making them ready for delivery into the secondary market.

Marketing and risk management prior to delivery to investors.

Wholesale distribution to the investment community, and subsequent trading, along with the reconfiguration of cash flows into derivative products.

Mortgage loan administration.

Mortgage insurance and other credit enhancement functions.
Holding mortgages and related securities as investors.

These functions will often be carried out within the same firm, but they need not be. Banks and thrifts that hold uninsured conventional loans in their portfolios carry out all of these activities in-house. But low-cost/high-efficiency specialists will increasingly take on the individual functions.

The making and servicing of mortgages will continue to be the province of mortgage companies, banks and "thrift" institutions. Mortgage companies will succeed when they can take advantage of their absolute specialisation in mortgages, their agility and their ingenuity to be the low-cost providers and servicers of mortgage products.

It is likely that thrifts and banks will converge, and will fall into two — perhaps three — categories. Some will remain small scale, essentially consumer lenders. These will have a special role emphasising mortgages in towns and communities where personal relationships remain important and price is not the most determining factor in consumer decisions.

Other thrifts and banks will look more like the mid-sized commercial banks looked in the late 1980s. They will make mortgages, but also provide a full range of commercial and business loan functions, offer a range of deposit and other liability services, and provide access to mutual funds, annuities, trusts, credit card and other financial services.

At the extreme, some institutions will be so huge as to be almost impossible to define: Citicorp and American Express come to mind. They will have large market shares in the mortgage arena, but also in investment banking, credit cards, foreign exchange trading and in other services. Their success in the mortgage arena will be augmented by their name, scale and corporate presence, but a more vital ingredient will be whether they can muster the ability to motivate and maintain entrepreneurial autonomy in a separate, mortgage-specialised subsidiary within the overall corporate structure.

Consider now the possibilities in the key traditional functions of mortgage finance — making, marketing and servicing mortgages.

The origination function

Nowhere in the mortgage market is competition keener than in loan production. It will remain so. The business of producing mortgages will face the continuing challenges of: gaining access efficiently to the consumer — the borrower — both directly and through real estate agents, a very labour-intensive person-to-person business, while at the same time controlling costs and adapting automation and other new technology to speed and simplify mortgage lending, a capital intensive process. Coupled with the ease of entry into the business and tendency towards over-capacity, these forces will keep pressure on loan pricing for the foreseeable future.

In the 1980s the most successful firms were those which controlled costs most effectively. With demographics weakening and capacity excessive, intense price competition will mean that successful firms will be leaner and still more tightly managed in the years ahead.

Economies of scale exist to a far lesser extent in loan production than in loan servicing. The annual volume of loan production needed for profitability in a well-run firm is likely to remain low. Indeed, diseconomies may set above fairly modest production levels. So, relatively small, well-managed firms can prosper, particularly in so-called niche markets with niche products. For all originations, though, there will be continuing moves toward reduced branch office overhead, "shirt-sleeve" rather than "managerial" employees, controls on excessive compensation packages, and consistently sound underwriting and overall quality controls.

The 1990s could well witness the emergence of the loan originating correspondent firm, rather than the branch office network, as the predominant organ of loan originations. Independent correspondents can be so efficient, move so fast, operate with such low overheads and enter or leave a volatile market so easily ("they pop up like mushrooms after a rain-storm") that they may render traditional branch offices competitively obsolete in cost-price competitive markets. Risk management and quality control will be keys to long-term success among wholesale purchasers from such correspondents.

Expect at the same time in the decade ahead a trend towards global standardisation in mortgage products. Consumer desires and preferences all over the world are becoming more homogeneous. In new industries, such as compact discs and fibre optics, we have global standards from day one. In older industries we are moving towards global standards in consumer goods ranging from cars to televisions to watches and soft drinks. We can expect similar conformity in the mortgage market.

The marketing function

The heart of mortgage banking is the process of delivering, or marketing, mortgages into the secondary market. This function almost without doubt will become even more integral to the business of mortgage lending in the decade ahead.

And at the heart of the marketing function is profit optimisation in a framework of risk management. This will be as true in the future as in the past; we may not be able to forecast the level of interest rates, but we know they will be volatile.

We can anticipate a continued search for better hedging vehicles — with both futures and options pro-

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ducts, and attempts to shorten further the period from loan application to delivery. There will almost certainly be advances in securitising adjustable rate loans, and these will become more readily accepted in the investor community. Other new products will probably involve securities with global appeal — LIBOR (and other indexes)-based floaters, with strip features and advances in reducing exchange rate risk.

Whilst there well may be some further refinement in mortgage securities structures, there is only a limited likelihood of any further quantum leaps in the technology of rearranging mortgage cash flows. Certainly the marketing function, more than any other part of the mortgage business, will be heavily dependent on computers, information processing and electronic communications. And it will be driven by intense competition based on price, not on personal relationships. Indeed, this may be the single biggest revolution over the past two decades in the way the mortgage business is conducted.

Loan originators and servicers will relate to the marketing function in different ways, based mainly on their size. Small firms will deliver to wholesalers, which in turn will aggregate loans and perform most of the risk management and marketing functions. The very largest servicers will increasingly issue securities directly, while most firms will continue to rely on the federal agencies and private conduits for the securitisation of their loans. Even the large private issuers will be constrained by the capacity of their corporate parents to carry the contingent liability of huge volumes of mortgage-backed securities.

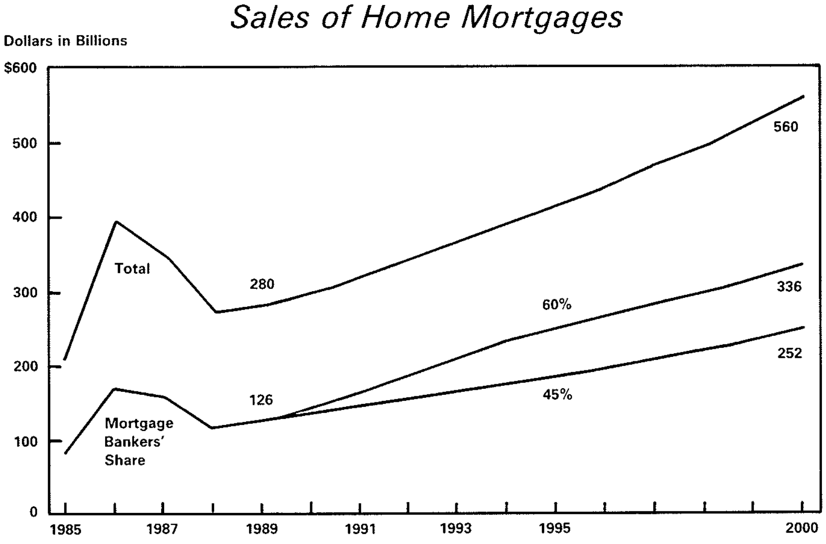
Chart 3 shows our projection that by the year 2000 home mortgage sales into the secondary market will reach about $560 billion. This will represent about 80% of loan originations. Mortgage bankers can be expected to be the principal players in delivering new mortgages into the secondary market.

If they do no more than maintain their current market share of 45%, they will be selling over $250 billion in loans by the beginning of the 21st century. It is not unreasonable, however, to project a 60% market share — or annual sales exceeding $300 billion.

Chart 3

Secondary Market Activity in the 1990s

Sales of Home Mortgages



The servicing function

In loan administration, technological advances coupled with competitive forces will move the break-even level of real costs ever lower. The minimum volume of residential servicing needed for sustained profitability, probably in the 30,000 to 50,000 loan range in the late 1980s, will continue to rise.

Hence the minimally optimal servicing operation is likely to be far larger than the concomitant scale of an efficient production operation. As a result, various forms of bulk servicing purchases will become a routine, institutionalised part of the mortgage business.

Over the course of the 1980s, the point at which most dramatic economies of scale set in shifted from perhaps as low as 10,000 loans early in the decade to the 50,000 loan range late in the decade. Though we can never know in advance what technical marvels will arise in the future, history leads us to expect that progress will continue to be made.

As direct servicing costs — people, data processing and the like — are brought down to their technically feasible limits, the 1990s will see a growing emphasis on controlling credit losses and contingent liabilities that are becoming more and more a part of the mortgage business. ■

WARREN LASKO is executive vice-president of the Mortgage Bankers Association of America. This article is extracted from a long report which will be published by the Association later this year.