Declining Mortgage Lending Volumes Ahead

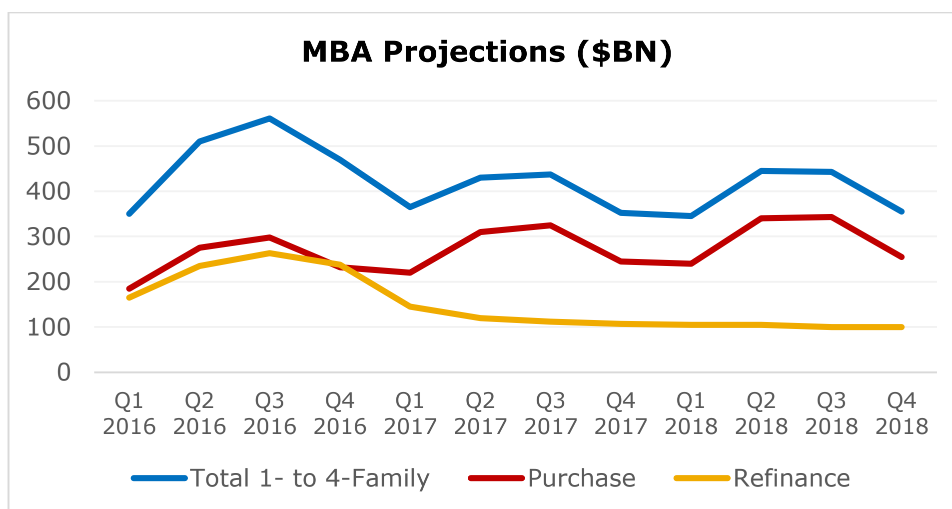
The Federal Housing Finance Agency's (FHA) decision to raise conforming loan limits for the first time in a decade is being met with enthusiasm from the mortgage industry. Kroll Bond Rating Agency (KBRA) disagrees with the consensus view that this modest move by the Federal Housing Finance Agency will prove to be a meaningfully positive factor for future residential mortgage loan origination volumes. Indeed, while 2016 has been an excellent year for the U.S. mortgage industry with almost $2 trillion in new loan originations, we believe that this year is also likely to be the peak in terms of lending volumes for years to come. There are several factors in KBRA's outlook for the residential mortgage market as 2016 comes to a close:

- First, the change in the conforming loan limit is insignificant compared with the double-digit home price appreciation (HPA) seen over the past decade, especially in high priced markets such as East and West coasts and South Florida. Affordability is an issue in all of these markets.

- Second, the impact of rising interest rates and widening credit spreads is a far larger negative influence on prospective mortgage origination volumes than the relatively small increase in the conforming loan limit. Mortgage lending volume is about interest rates first and foremost.

- Third, the negative regulatory environment and low (or zero) risk adjusted returns in the residential mortgage sector will likely encourage the continued exodus of insured depository institutions from the 1-4 family loan market, reducing overall mortgage lending capacity.

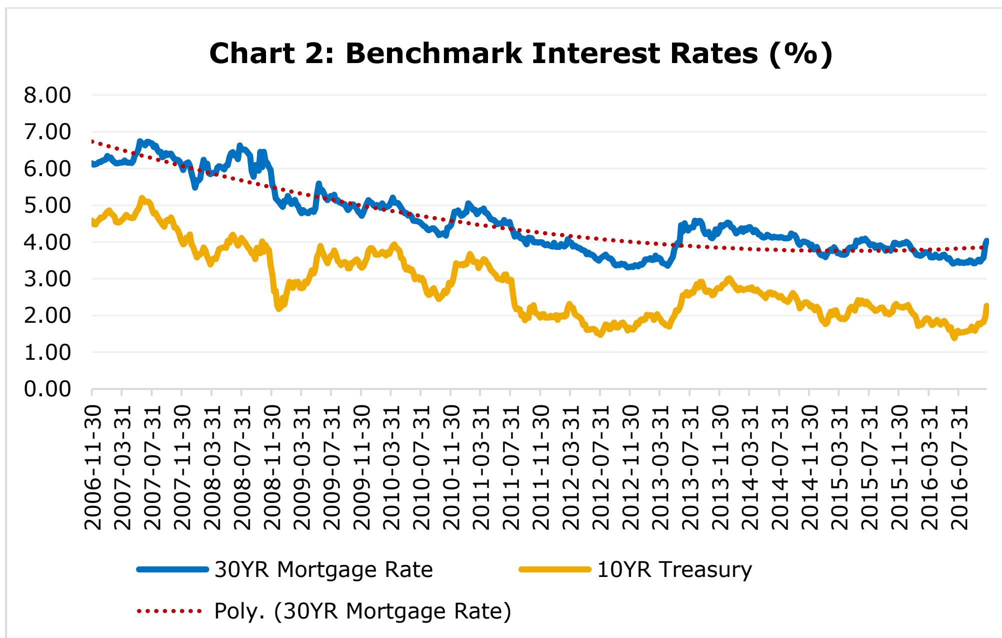
Chart 1 below illustrates the forward projections for 1-4 family loan originations from the Mortgage Bankers Association (MBA) through 2018, which are reproduced with permission.



Source: Mortgage Bankers Association

The MBA is projecting total originations for 2016 to reach about $1.9 trillion, including roughly equal volumes of purchase mortgages and refinancing transactions. In 2017, however, the MBA is projecting a sharp decline in refinancing volumes to just $145 billion in Q1 2017, down from $263 billion in Q4 2016. Purchase mortgages are projected by the MBA to rise to $1.1 trillion in 2017, but refinancing volumes will be cut in half for the full year, leading to an overall decline in mortgage origination volumes of 20% next year compared with 2016. Significantly, the MBA sees the coupon on a 30-year fixed rate mortgage going from 3.9% in Q4 2016 to 4.4% by Q4 2017 and almost 5% by the end of 2018.

With interest rates rising, the economic and financial environment for the U.S. housing market is going to become progressively less hospitable. After nearly a decade-long recovery in both HPA and mortgage lending volumes thanks to the Federal Open Market Committee, KBRA believes that the U.S. housing sector is in the process of normalizing—albeit from rate levels that are, in historical terms, still extremely low. Chart 2 below displays the 10-year Treasury and 30-year mortgage rate over the past decade.



Mortgage rates have not yet come close to the levels seen in 2013 much less the far higher rates seen in the 2000s or before. Going back over the past half century starting in the early 1970s, the average 30-year mortgage rate was 8.26%—double current coupon levels. The high was 18% in early 1981 and the low 3.31% in November 2012. The standard deviation over those four plus decades was over 3.1%. Yet the recent market moves do represent, in relative terms, a significant change for both issuers operating in the mortgage markets and fixed income investors.

Given the regulatory environment and rising trend in interest rates, KBRA believes that lending volumes for both insured depositories and non-bank lenders are likely to fall in 2017 and beyond as relatively lucrative refinancing volumes dry up. This downward trend in mortgage volumes could be a negative factor on earnings in Q4 2016 and beyond for banks and non-banks alike. Acquiring purchase mortgage customers is a more complex and expensive process than refinancing an existing mortgage. This is especially true for risk-averse depositories that must deal with both the Consumer Financial Protection Bureau and prudential regulators who are actively discouraging below-prime residential lending and loan servicing by banks.

It is no mystery that 1-4 family residential mortgages are the slowest growing bank loan category at +4.3% after farm loans (+3.6%) and home equity lines (-5.4%), and well below the 6% rate of bank asset growth overall. Sales of 1-4s by commercial banks also continue to fall and totaled just $684 billion in Q2 2016, down almost 9% year-over year. Non-bank lenders will pick up the slack to some degree, with much of the below-prime volumes going to the government-guaranteed FHA market. But no amount of prospective regulatory relief or changes in the rules for loan guarantees in Washington can fully offset the dampening effect of rising interest rates on the home finance sector.

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