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"2014 In a Blink"

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As a way to say "thanks" to our Lender, Realtor, and Non-Profit partners in homeownership, WHEDA presents this briefing of news, notes, and trends that will dominate the mortgage banking landscape in 2014 and beyond.

We looked into our crystal ball to discover mortgage industry prophesy. Instead, we saw storm clouds swirling. The regulatory cloud was dark and moving briskly. The mortgage production cloud was changing shapes, shrinking as interest rates rose. And the government-sponsored enterprise (GSE) reform cloud seemed to be stagnant, if not immovable.

But as we all know, in every storm there is opportunity; behind every cloud, there is sunlight. Those who find the rays of light – the new markets, the new relationships, the new business sources, the strategic technologies, the more efficient ways of doing business, the ability to deliver better customer service, the optimal methods for managing regulatory and credit risk – will be able to profitably grow their business despite suspect growing conditions.

We've called this briefing "2014 in a Blink" for two reasons. First, it's a reference to Malcolm Gladwell's best-seller *Blink* in which Mr. Gladwell poignantly introduces us to "the power of thinking without thinking." Second, we literally wrote it in a blink. So without further ado here's a closer look into the crystal ball, a glance ahead to 2014 in just one blink.

Mortgage interest rates will rise … Tapering has already begun. And with every favorable domestic economic report, tapering will gain steam. But how high will rates go? Housing industry economists project rates on 30-year fixed-rate mortgages (FRMs) will increase to between 5.15% and 5.50% by the end of 2014. The comparable Freddie Mac Average Commitment Rate ended 2013 at 4.48% after ending 2012 at 3.35%.

Refinancing will fall off a cliff … The drop already has been steep. The base jump will be complete in 2014 as rates rise. Refis were 72% of the market in 2012, an estimated 62% in 2013, and a projected 39% in 2014. Refis were about half of all originations in the rate-rising second-half of 2013. The continued drop in refis is expected to contribute to a 30% drop in overall single-family loan originations, from an estimated $1.85 trillion in 2013 to $1.30 trillion in 2014.

A healthy purchase-money market … Purchase originations are projected to ramp up to $800 billion. That would be a 14% increase over 2013 purchase volume and a 31% increase over 2012. It looks like 2014 will be the first year since the start of The Great Recession that lenders originate more purchase-money mortgages than refinance loans.

Competing forces will shape production in 2014 … Higher rates, lenders' grappling with Dodd-Frank reforms, and the industry's never-ending operational preparation for Consumer Finance Protection Bureau (CFPB) audits will tap the brakes on volume. But an expanding economy, reduced joblessness, increasing consumer confidence and positive real estate market trends – such as rising home prices and borrowers' improving equity positions – will stoke the home buying market.

Some markets will continue to deal with foreclosure backlogs … The issue of unwinding foreclosure inventories is largely concentrated in judicial foreclosure states. Irvine, CA-based RealtyTrac says foreclosure starts in November 2013 fell to their lowest level in eight years – a sign that we've reached the tail of the dragon, so to speak. But judicial foreclosure states are having more difficulty slaying the dragon and are still winding through foreclosures started in 2007-08. In Wisconsin, the courts have largely been able to keep up, however it is not uncommon for some 2011 starts to remain unresolved.

Vampire REOs and Zombie Foreclosures are slowing the recovery … RealtyTrac reports that approximately 47% of bank-owned homes are still occupied by the previous owner. These are called "Vampire REOs." On the other end of the spectrum are so-called "Zombie Foreclosures" in which the property has been left vacant and is subject to decay and vandalism. RealtyTrac says these comprise 20% of active foreclosures nationwide.

This will make 2014 another good year for investor-buyers … As long as there is an inordinate amount of REO, there will be a higher percentage of short sales involving investors trolling for opportunities to rent or flip. Sticking with RealtyTrac, the firm reports that all-cash buyers accounted for 49% of home sales in September, up from 30% a year earlier. And institutional purchases, which it defines as transactions involving buyers of more than 10 properties in a year, accounted for a record high 14% of September sales.

Single family rental is hot and could stick around awhile … Investors who gobble up REO in short sales or bulk purchases either rent the homes or repair them and remarket them, looking for a gain on the flip. Or they do both – buy low, rent for a few years, and sell high when the market has rebounded. Either way, most experts believe single family rental is a niche that is here to stay. With down payment and credit underwriting standards having tightened in recent years, there will be a larger share of households that will have to wait before they qualify for a home loan. In the meantime, single family rental gives these families all the benefits of owning a home.

REO-to-Rental securitizations will occur … This will give the sector a systematic way to attract capital and have some liquidity. Fitch Ratings, however, reports that the initial securitizations will likely grade out no higher than an "A" credit rating due to the lack of performance history for the REO-to-Rental market and some structural concerns. Rent payments would presumably cash flow the periodic obligation to bondholders. However, if properties need to be sold at bond maturity, there is concern that a large-scale listing could affect market-clearing prices, Fitch notes. The exit strategy will be critical to a successful securitization.

Investor purchases are driving home prices, for now … The Federal Housing Finance Agency (FHFA) Home Price Index (HPI) rose 5.5% in 2012, an estimated 8.4% in 2013, and is projected to rise between 5% and 6% in 2014, according to housing industry economists. The run up in prices is more pronounced in markets dominated by REO and all-cash sales, experts note. Year-over-year price gains in Las Vegas, California and Arizona, for instance, are 25%, 23% and 15%, respectively, according to FHFA.

Wisconsin is middle of the pack … The Zombie Foreclosure and Vampire REO trends exist here, they're just not dominant. Pure cash buyers are active in Wisconsin, just not as active as elsewhere. The reason? Wisconsin's single family foreclosure problem, while historically bad, never reached the catastrophic levels of other states. As a result, home prices never plummeted to the degree they did elsewhere. Consequently, while home prices have rebounded at a healthy clip in Wisconsin, they have not surged as dramatically as other markets. According to the FHFA HPI, Wisconsin home prices are up 4.6% year-over-year versus 8.4% nationally. That ranks the Badger State 34th in annual home price growth. Comparatively, Wisconsin is 31st in foreclosure rate at 1.3%, according to CoreLogic.

More homeowners will be "in the money" … As home prices rebound, some households are rising above the water line. According to Zillow, the national negative equity rate is falling. Zillow says 21% of mortgaged households remain "underwater" versus the first quarter of 2012 when 31% of borrowers had negative equity. Zillow estimates the negative equity rate will fall to 18% in 2014 and more than half of those borrowers will be underwater by 20% or more. Very few that deeply under water will be here in Wisconsin.

Wisconsin home values not yet back to peak … CoreLogic reports that home prices in Wisconsin peaked in September 2006. Since then, home prices fell and have risen, gaining back some lost ground. Still, according to CoreLogic, Wisconsin home prices remain 11.15% below the September 2006 peak, ranking Wisconsin 26th among states by percent decline from peak. Only 11 states have gained back all the home value lost during The Great Recession, CoreLogic reports.

A good year for builders, new home sales … 2014 should be a good year for home sales, fueled by new home construction. Fannie Mae projects a 24% increase in single-family housing starts and a corresponding 23% increase in the sales of new single-family homes for 2014. Overall, however, home sales are expected to increase just 4.1% as existing home sales figure to advance at a meager clip of 2.5%, according to Fannie Mae. The issue for existing home sales remains one of inventory. More non-distressed sellers are needed to boost inventory and existing home sales. This will eventually come as household stability and equity continue to improve over the next couple of years.

Looking long-term, foreign-born households will drive homeownership … The Mortgage Bankers Association (MBA) reports that foreign-born buyers will account for 35% of the first-time homebuyer market by 2020. Over half of the net new household formations in 2012 were Hispanic. Asian household formations are also growing rapidly.

Reaching these buyers effectively will require homebuyer education … There are approximately 2,400 HUD-approved counseling agencies nationally, and these agencies serve an estimated 1.6 million people each year. Homebuyer education can help foreign-born families build credit and budget management skills in addition to helping them understand the home buying process and the responsibilities of owning a home. FHA's new program – Homeowners Armed With Knowledge, or HAWK – is attempting to seamlessly incorporate counseling into the FHA origination process.

Regulatory compliance versus production … Mortgage bankers will be challenged with two huge tasks in 2014 – implementing policies and procedures to assure compliance with the new Ability to Repay (ATR) and Qualified Mortgage (QM) rules taking effect January 10, and finding enough purchase volume to replace the lost refi production. These two priorities will likely butt heads as loan officers lose deals to Appendix Q requirements for determining ability to repay. Lenders will wade as close to shore as possible, staying in the safe harbor for most of their transactions.

ATR/QM will tip the scales even more dramatically to the GSEs … Lenders will focus production on Fannie Mae, Freddie Mac, and Ginnie Mae products, following the GSEs' guidance on ATR Covered Loans. As they grow more comfortable with their ability to underwrite to Appendix Q, lenders will be more willing to originate loans outside the ATR safe harbor but within the rebuttable presumption. These loans will go into portfolio or private-label mortgage-backed securities (PL MBS), eventually. HFAs, such as WHEDA, could also benefit as their loans are ATR/QM exempt.

PL MBS will stall before gaining its footing … This includes the jumbo market, which is essentially the only PL MBS sector alive right now. ATR/QM will cause a pause for the PL MBS market, but it could be a boon down the road. By defining safe harbor, rebuttable presumption, and unprotected loans, ATR/QM has given the rating agencies clear guidance on the regulatory risk composition of PL MBS. But before PL MBS can emerge, other stars must align – higher g-fees, lower loan limits, affordable credit enhancement, and the formation of large sums of capital are among them.

Mel Watt's FHFA confirmation could signal a change in direction … Under Edward DeMarco, FHFA was systematically taking steps to reduce the roles of Fannie and Freddie, toward the goal of eventually winding them down. Higher g-fees, tighter credit underwriting, and promotion of a common securitization platform that would ultimately be accessible by PL MBS were setting the stage for a reduced role for the GSEs. Even before his first day on the job, Watt last week said he will delay implementation of DeMarco's last moves – a 10-bp g-fee increase and large increases in Fannie Mae's loan-level pricing adjustments (LLPAs).

Time will tell if Watt will redefine FHFA's expectations of the GSEs … But it is widely believed that he will be less inclined to lower the conforming loan limit, raise g-fees, and take other measures that would hasten the emergence of PL MBS. DeMarco also prohibited the GSEs from forgiving principal on delinquent loans as a workout option. Some lawmakers and industry observers believe Watt may change that directive, as well. Time will tell.

GSE Reform will not happen in 2014 … Of course it won't. But should it happen at all? What problem still needs correcting? These are questions some policymakers are asking now that what ailed Fannie and Freddie has been corrected and the GSEs have effectively paid back all of the losses that taxpayers absorbed for them during the bailout years. No longer publicly traded, the GSEs don't have a profit-minded incentive to stray from their secondary mortgage market mission. And in FHFA, they now have a much stronger safety and soundness regulator than they had in the Office of Federal Housing Enterprise Oversight (OFHEO). GSE reform bills, however, will continue to gain attention in the first half of 2014 before the mid-term election cycle gears up.

ATR/QM is fueling the Mini-Correspondent surge … As the 3% cap on points and fees looms, more and more brokers are becoming bankers. This allows the lender to close loans in its name and on its warehouse line while maintaining full pricing flexibility. The 3% cap limits what the lender can earn originating the loan, but the lender can then turn around and sell the loan to a wholesaler at a premium. Moreover, they can have the wholesaler underwrite and approve the loan prior to closing, thus leaving the risk of repurchase due to underwriting negligence with the wholesaler. The barriers for many brokers making the switch to a "mini-corr" business model, however, are capital and securing a warehouse line with favorable terms.

Profitability will be harder to manage in 2014 … For mortgage bankers, it will be all about expense control in a declining production environment. According to the MBA's Quarterly Mortgage Bankers Performance Report, loan production expenses rose every quarter in 2013 as refi share fell. In Q1, refis totaled 73% of originations and per-loan production expenses average 249 bps, according to the MBA. In Q3, the refi share had fallen to 56% and per-loan production expenses soared to 280 bps. Driving the higher expense load was an 11% increase in personnel expense. Expect this trend to continue as lenders grapple with Dodd-Frank …

This will place greater emphasis on cost-saving technologies … Specifically, lenders will pay more attention to technologies that can automate certain aspect of compliance. They'll also continue to strive to wring paper from the process. Lenders will need to improve their operating income/loss line; and those who can't will be forced to seek higher gains in the secondary market. The MBA reports that per-loan secondary marketing gains shrank 18% between the first and third quarters as refis dropped. The confluence of higher expenses and smaller gains resulted in a 56% drop in net production income per loan, from 87 bps to 38 bps, from the first to the third quarter. This is a glimpse of what 2014 has to offer.

What to expect from WHEDA in 2014 … We'll continue to broaden our product set while focusing our attention on minimizing turn times and providing lenders top-notch customer service. We'll introduce our own Mini-Corr Channel, and we'll roll out a B2B portal through which lenders can register and lock loans, submit data (DU 3.2

or Calyx Point), submit documents, and check loan statuses. We'll finalize and release the WHEDA Advantage Policies and Procedures Manual, clarifying our policies and making it easier for lenders to understand and implement procedures relating to WHEDA programs. We'll also introduce grid pricing, enabling Correspondent and Mini-Corr Channel lenders to pick their price and rate.

Thank you for a successful 2013, and we look forward to serving you in 2014 … WHEDA strives to be Wisconsin's Affordable Home Loan Wholesaler. We can't do it without excellent lender partners, a committed and knowledgeable real estate community, and the good work of non-profit homebuyer education and counseling agencies statewide. We look forward to seeing you May 12-13 at the 3rd Annual Wisconsin Home Ownership Conference, which will be held at the Kalahari in the Wisconsin Dells.

We hope you enjoyed this briefing on trends that will define our mutual business world in 2014. Don't blink. Before you know it we'll be closing the book on 2014 and ringing in 2015.

Sincerely,

WHEDA Single Family

WHEDA's Single Family Team
