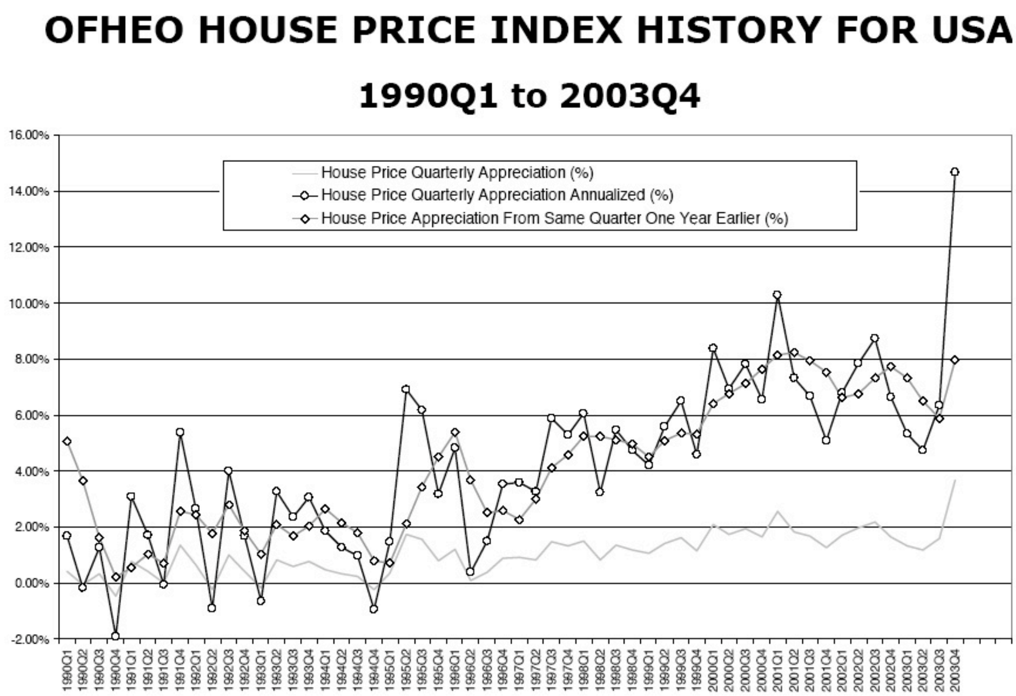
Housing Prices, Mortgages, and Asset/Liability Management

An early March press release from the Office of Federal Housing Enterprise Oversight (OFHEO), reported that housing price increases in the United States have accelerated. There are two troubling aspects to this story. First, the government is apparently spending so much money creating agencies for this and that, that we have been reduced to scrounging names from the random word generator. “Housing Enterprise Oversight”?

Second, and more importantly, there are some serious implications for community banks in the skyrocketing prices for housing. Having no expertise in credit, I will try to address the issue from the perspective of asset/liability management.

<u>Housing Prices on the Rise</u>

OFHEO reported that national housing prices had increased by 3.67% in the fourth quarter, annualizing to 14.67%. On a year-over-year basis, prices increased 7.97%. See chart.



It’s not surprising that housing prices began to rise in 1995 and beyond. That is when the economy was recovering from the early 1990’s recession and beginning the longest expansion in its history. What is surprising is that the recession of 2001 did not slow the increase, and even from the elevated levels of that time, price increases have held and are now accelerating to the upside.

Perhaps, the increase in housing prices is reflecting those areas of the country that are experiencing population growth. Problem is, that if we look at the states and the District of Columbia, it turns out that fourteen had double digit price increases during 2003. Of these fourteen, seven are in the northeast and ten are clustered from DC north to Maine. I hardly need to point out that this geographic area is not adding population at anywhere near the pace that the southern or the western states are. We need to look at a different driver besides income and population growth to explain the recent housing price movement.

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Interest Rates Matter

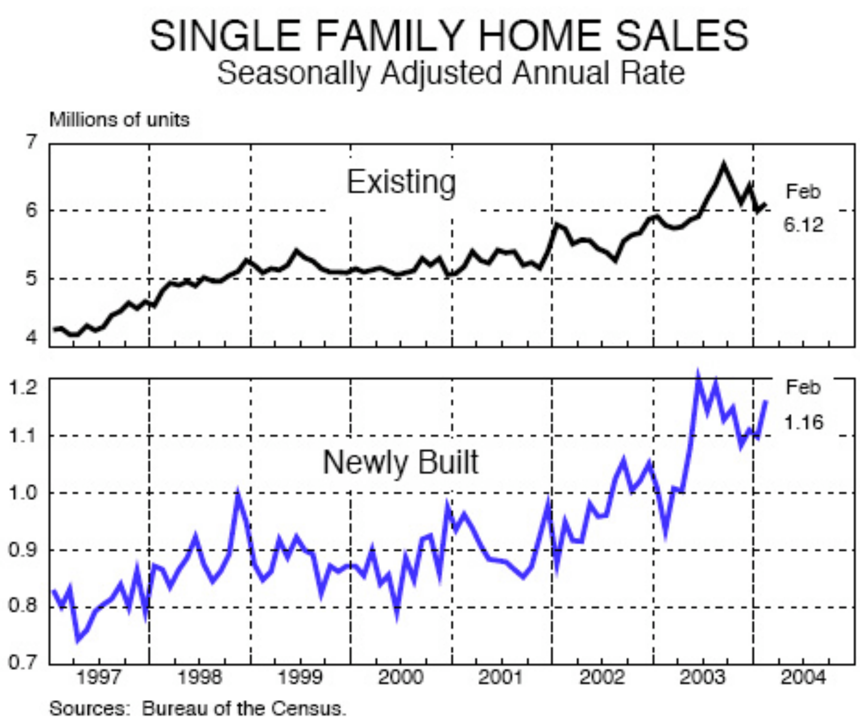
Since the recession began in early 2001, housing prices have posted an annualized increase of over 7%. I think it is hardly a coincidence that the long-term mortgage rate began this period at about 7.50% and is now near 5.50%. This dramatic decline has provided the homeowner with a significant boost to his ability to finance a higher purchase price. The following chart shows the 30-year mortgage balance than can be supported on a $1,000 per month payment at different interest rates:

Mortgage Rate	Mortgage Balance
7.50%	$143,000
5.50%	$176,000

Note that the mortgage that can be supported at current rates is about 23% larger than that at the rates that prevailed three years ago at the beginning of the recession. Further note that a 7% per year appreciation over that period is remarkably close to 23%.

It is also to be noted that median household income over the last three years has barely budged. In fact, wage and salary income is lower today than it was when the recession began. It appears to me that a strong case can be made that the recent housing price appreciation is due to lower rates rather than increased income and demand.

From an asset/liability perspective the decline in mortgage rates over the last three years has created a surge of prepayment activity. Loans and MBS that we expected to be with us for a decade were paying off in years if not months. Few homeowners that have lived in their house for five years or more have not refinanced at least once. Furthermore, trading up in housing gained momentum as apartment dwellers purchased starter homes and those occupants sought larger abodes. This chart shows the surge in houses sold over the last few years.



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Note that existing sales increased from roughly 5 million per year in 2001 to 6 million per year in 2003. New home sales increased from roughly 900,000 to 1.1 million over the same period of time. It is likely that virtually all of these transactions create a mortgage prepayment. On an existing house, the seller will be paying off borrowings unless she is a retiree who is moving south. On a new home, most of the buyers are trading up. This means that the increase in sales has created prepayments that have to be added on to those created by stay-in-place refinances.

Commercial banks have ridden the wave. Last year, they captured 30% of the net increase in mortgage loans. As recently as 2001, they garnered only 10%. This fact is very important. Banks in general have bet heavily on the residential mortgage market in the past few years. IBANYS banks are no exception. Total 1-4 family mortgages increased by $1 billion or 15% in 2003. Since total loans increased by $1.7 billion or 9%, it is obvious what the main driver has been. Any volume declines will have a real impact on revenues.

<u>Future Trends</u>

Although there were mortgage originations of over $3.6 billion in the twelve months ending September 2003, net mortgage outstandings increased by only $850 billion. This suggests just how important refinance and trade-up volume is to the total. I estimate that about half of the net increase in outstandings is due to cash-out refinances, one-quarter is due to trade-ups and one quarter is due to net new purchases.

Current projections from the Mortgage Bankers Association (MBA) indicate mortgage originations will fall by one-third in 2004 from 2003 levels. All of the decline is expected to occur in refinance volume. This is because you need constantly lower rates to keep refinance volumes steady. Were rates to rise back to 2001 levels, the declines could be much more substantial. The reason: I believe the potential impact on volume from reduced sales if rates rise is not being captured.

If rates rise, will home sellers reduce their price or simply hold their houses off the market? Based on the OFHEO chart and on human nature, it is likely volume will slow rather than prices fall to clear the market. This means sales could easily drop from 7 million total to 6 million or a decline of 14%. Much of this volume is what has been captured by banks.

The asset/liability implications fall into three areas. First, prepayments, second, net loan volumes, and third, originations for sale.

Current prepayment assumptions on mortgage portfolios suggest an average life of 3 years. An increase in rates could easily double the average life to 6 years. Coupled with a slowdown in net new volume, the net impact would be longer assets on the books at lower yields. Far from offsetting the earnings drain in a rising rate environment, the expected gains from sales of mortgage loans (and booking originated mortgage servicing rights) would compound the problem. Since community banks do not generally have a large portfolio of serviced loans like large banks or mortgage companies have, there is no natural hedge. Net impact: declining net revenues.

Stable or falling rates don't offer the offsetting opportunity for gain. Continued prepayments at current levels will erode asset yields while net new volume will be stable at best (and at lower replacement yields). Originations for sale could hold, but are unlikely to grow from present levels. Net impact: no gains in revenues.

The bottom line is that rising rates could easily crush the income contribution from mortgage-related products. The recent increase in sales volumes could reverse, and community banks would bear a good deal of the decline in expected new loan originations. Unfortunately, the option risk embedded in mortgages suggests there will not be an offsetting benefit if rates hold steady or fall. Community banks should review just how important the lubricant of low interest rates is to mortgage loan and overall revenue growth. It would be wise to quantify the impact from a sharp falloff in volume.

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