In the Year 2016…

BY PATRICK STONE AND J. WILLIAM MOODY

Five bold predictions for the mortgage industry in the not-too-distant future.

Predicting the future of the mortgage industry is a dicey proposition at best. There are an endless confluence of factors: market trends and shifts; market and regulatory reaction to the events of the past several years; adjustments to these events by industry participants; fundamental changes to the way the industry is regulated; and even basic demographics. ▲ The variables are seemingly endless. Then there is the economy. There is, and can be, no truly accurate roadmap to suggest what our industry will look like by 2016. There are too many actors and too many actions yet to happen. ▲ Nonetheless, there are several striking changes we think are very likely to take hold in our industry. Although 2016 is, in some ways, an arbitrary number for this article, it represents one point well enough—that some of the transformation likely to take place is not really that far off.

Prediction One

The United States will actually face regional housing shortages as well as increased housing demand.

Analysts and pundits today are focused on the staggering amounts of unoccupied inventory. The numbers are, indeed, sobering. The Census Bureau's four main vacancy surveys—the *Housing Vacancy Survey, American Community Survey, American Housing Survey* and *Decennial Census*—estimate that the number of unoccupied homes ranges from a low of 1.5 million units to a high of 3.5 million units.

At current household formation rates, that amounts to a range of from 2.2 to 5.1 years of supply. Additionally, the Census Bureau's Housing and Household Economic Statistics Division reported that homeowner vacancy rates approached 3 million in 2009. The same source suggested that in the first quarter of 2010, there were more than 700,000 excess unsold homes on the market.

Further, Santa Ana, California–based CoreLogic estimates that the shadow inventory (comprised of homes in default or approaching lengthy periods of delinquency) neared 2.1 million units in August 2011.

It's clear: There are tremendous quantities of housing units on, or about to enter, the market. It is reasonable to argue that true market recovery will require that a hefty percentage of those units be sold or rented.

Let us go a step beyond this analysis. While the "when" may be a variable open to debate, "what" will likely happen, after the abatement of the default and real estate–owned (REO) surge, in large part, is not. Demand will rebound faster than the available inventory.

Recently, home builders have slashed new starts to a minuscule number. This trend will likely continue for some time. The debt crisis (United States and Europe) and unemployment have made renters out of many former and would-be homeowners. Consumer confidence, in 2011, is low. Ergo, home builders have reacted in predictable fashion: Cut inventory, decrease supply.

Simultaneously, investors and businesses have predictably hunkered down to await rock bottom (purchase opportunities) and/or greater market stability. This has amounted to a tremendous amount of sidelined cash.

At some point, there will be a rock bottom, as well as some predictability in the residential real estate market. When that happens, demand always moves faster than supply—especially when the supply side is dependent on the time- and labor-intensive process of home building, and the regulatory hurdles inherent in property development.

Another variable is the very real potential for exponentially increased demand. Add to the equation a larger number of Americans seeking real estate and mortgages. In particular, let us consider new Americans and the likely impact of immigration.

The Census Bureau projects that almost one-third of our current population growth is caused by net immigration. The Census Bureau notes that, in 2000, the nation's population was 8 million larger than if there had been no net immigration.

It further projects that, by 2050, this difference will increase to 82 million, with as much as 86 percent of the population growth at that time dependent upon post-1992 net immigration.

So what's the bottom line? There are large numbers of people coming to America, with more on the way. Whether they prefer multifamily/rental or single-family units, they still will need some kind of housing.

The shortages will be regional. Many have made the argument that there is no such thing as a national real estate market. Increased population and demand will

bear this out. In cities and regions where home starts have been cut the deepest, and in areas most prone to an influx of new homeowners, the shortages will be most dramatic. In some areas, restrictive land-use policies will compound the problem.

Prediction Two

There will be a breathtaking change in who participates in the industry, caused by dramatic consolidation and improvement of efficiency in production.

The industry last saw truly dramatic change from a perspective of participation from 1990 into 2002. The impetus was clear. Historically low interest rates and highly available credit and an insatiable demand for mortgage-backed securities (MBS) spurred historic origination volume.

New players rushed to fill the void, and expansion was the rule of the day. Firms flush with cash and easy credit swallowed their less-efficient cohorts. The result is the industry we see, for the most part, in 2011.

However, just as an industry expands to meet demand, so too will it contract as demand declines.

We believe there is still a tremendous amount of slack or variation between industry production capacity and demand. The law of the jungle, therefore, suggests that many more will go.

Down markets can be excellent periods of opportunity for efficient actors with cash on hand. We believe this will play out in the next two to four years. Mortgage and real estate industry capacity will be dramatically reduced in an effort to take in the slack caused by the historic expansion followed by the historic contraction.

A slow and bumpy market recovery, hindered by market and regulatory uncertainty, will bring about the untimely demise of many of the less-efficient or less-prepared actors. There will be no "hockey stick" recovery, which means that only the prepared will be able to make it through the rest of the current cycle.

In fact, we would argue that the next several years, of necessity, will see an industry that shifts its focus to efficiency on the production side. The mortgage industry has slogged for years through an inefficient process, and a tremendous amount of "siloization." The result is an eye-opening number of players touching a single mortgage transaction.

Compounding the problem is a lack of universal data standards; poor or antiquated workflow and communications processes; and an unwillingness to devote resources to updating a sales and production process that has evolved *ad hoc* over the past two decades. The result is a transaction that is too costly.

We predict this will finally be analyzed, and corrected. We would not be surprised if entire industry segments disappear, with their roles being absorbed by more efficient actors and new uses of technology.

This process will be accelerated by a number of factors. Our industry is now, and will continue to be, subject to an increased level of scrutiny driven by public and political demand. The "bailout" mentality of the past four years (real or perceived) will give way to a different mentality, constrained by political hostility.

Mortgage lenders will increasingly be expected to sink or swim, as will their partners. Consumer-focused innovation (e.g., an easier, faster, cheaper and better underwritten mortgage) will increasingly be rewarded by the market—or at least by those overseeing its regulation.

Bottom line? Expect change in the way we do business. It may start slowly, but it will accelerate exponentially, leading to a very different way of selling homes and mortgages in the next several years.

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Prediction Three

The government-sponsored enterprises (GSEs) will live on, in one form or another.

Admittedly, the cynic could view this prediction as a concession to political inertia. It would be difficult to find many to dispute the fact that the federal government, one way or another, amounts to the bulk of our secondary market. Nor would many argue with the premise that removing such presence overnight could be beyond catastrophic in the short term.

However, our prediction is there will remain some form of federal guarantee in our market, even if it were possible to devise a way to wind down its presence without unpalatable short-term consequences.

The primary reason for this is political. Although "affordable homeownership" has, temporarily, taken a back seat in public discourse to such terms as "poor underwriting," "predatory lending" and "risk retention," these are terms that do not win many elections.

Already, politicians and interest groups on both sides of the aisle are aware that Qualified Residential Mortgage (QRM), GSE wind-down and other similar concepts would do absolutely nothing to improve homeownership in the short run. And while restoring some stability to the mortgage industry may be long overdue, it will not come at the expense of reasonably affordable homeownership. The political appetite for this will quickly fizzle.

The public has repeatedly demonstrated a short memory when it comes to basic wants and needs, and four years of policy reversal will not undo decades of messaging that the American dream is homeownership. Even if leadership begins to believe it is not, it will have a very, very difficult time convincing the public of the same.

The second reason the GSEs will remain with us in the long term (although they likely will be given new names, different constraints and new levels of accountability) revolves around private-label securitization. We will not, here, argue for or against the concept.

It is well known that those in favor of a more robust private-label securitization market believe that government involvement in the market leads to inefficiencies, and that the events of 2007–2011 aptly demonstrated those shortcomings. These proponents believe that GSEs

in any form lack the incentive or wherewithal to manage and price their products to account for risk, whereas a private-label securitization market lives and dies by such ability.

Others support the continued existence of the GSEs. Their arguments range from the egalitarian (too much market power will inevitably settle into the hands of the few) to the practical (the housing market is unique, and requires a steady flow of GSE-/federally guaranteed cash to ensure a consistent home-building process and, therefore, a steady market). These proponents believe that institutional investors will only invest in American mortgages if they are backed by some kind of federal guarantee.

They may both be right, to some extent. But both agree there is little to no private-label securitization market right now, and that it would take dramatic and risky action to create one.

We believe, however, that the American public and its appointed government representatives do not have the desire to go through such a fundamental transformation and the inevitable short-term chaos likely to go with it.

Expect the GSEs to be given a makeover—largely cosmetic—designed, in theory, to appear to address the perceived causes of the mortgage market meltdown.

Perhaps there will be more or tighter oversight by Congress and/or the appropriate agency or bureau. Perhaps we will see clearly defined or even statutory limits on risk and debt. Perhaps there will be a requirement for more transparency in the way mortgages become derivatives. But make no mistake: The GSEs will be with us for quite some time.

Prediction Four

The "vanilla" mortgage loan will not prevail for long.

Talk of risk retention and the removal of a federal risk guaranty from the secondary market have led many to suggest that our industry is entering the era of the "vanilla" loan. This may be true. But we do not believe this will last long. Within a few years, we will see the return of more creative mortgage products to meet the demand for them.

We have already discussed briefly the contention that demand for affordable homeownership will not simply disappear into thin air. Although discussion of the financial crisis, and the belief by some that it was aided by irresponsible lending (or, more appropriately, underwriting) is fresh on the minds of many, this will fade with time. We do not believe it will take long. In fact, we believe it will take about as long as it takes for the same demographics we seek to protect, with the new emphasis on vanilla lending, to be rejected in their bids for new mortgages under those tightened standards.

We believe that, eventually, the mortgage industry and its regulators will come to accept that subprime or alternative-A lending is not inherently irresponsible.

There seems to be an axiom growing on Main Street that only A-paper borrowers should be able to own homes. This assertion, in our view, is preposterous, and is proven wrong every day by the millions of subprime homeowners making regular payments on their alternative mortgage products.

Furthermore, as discussed, the American housing market will look a bit different very soon. Its demand for mortgages may begin to vary as well, allowing for some creativity.

Where demand begins to change in any market, so too will supply. For example, we've discussed the trends of immigration leading to a potential boom in demand for multifamily housing. Non-traditional families will be growing as well, with new and unique housing needs.

Consider, also, that the rapidly maturing Generation Y (the "Millennials") will have dramatically different expectations for fulfilling their housing needs. Renting will not be taboo for successful young Americans. They may need additional, albeit legal and ethical, incentive to take on mortgage loans. The trend is to carry less debt and more savings. Should this continue, demand may swing to shorter-term fixed-rate loan products. We are already seeing a rise in demand for the 15-year fixed-rate mortgage (FRM).

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The bottom line is that the vanilla mortgage loan will not meet American demand fully. The face of the borrower is changing, as are his or her needs. When we accept that it wasn't the distribution of non-traditional loans, but instead the sloppy execution and underwriting of such loans that facilitated the crisis, our industry will flock to meet growing demand in the way the market requires.

Prediction Five

Regulatory and market pressure will force our industry to finally streamline, modernize and make more efficient the real estate transaction.

As of 2008, the typical real estate transaction in the United States cost 9.07 percent of the property's value, according to Global Property Guide (www.globalpropertyguide.com), a site for residential property investors seeking to buy houses or apartments in other countries. By comparison, costs in the United Kingdom approached 5.03 percent. In Canada, they were 6.97 percent.

Although the cost per transaction in the United States is not the highest rate in the world, it is high enough to examine more thoroughly as our market changes. We believe it could be reduced dramatically.

Let's face it: The transaction process in the United States is cumbersome. Even in the best of markets, the time from purchase agreement to closing and recording of the deed takes from weeks to months. Why?

Ours is a silo-focused industry that does not communicate well or integrate seamlessly during the typical transaction. The result? Higher cost, more time. Ours is an industry that has not always embraced technology as a means to correct these deficiencies. Where it has, the approach has been *ad hoc* and often poorly executed.

As a result, even where some vendors to the real estate transaction may well be using a newer technology,

the benefit is minimal if other necessary vendors do not. We believe this finally will begin to change, driven by outside forces.

Clearly, increased regulation and enforcement will only mean increased cost to every company in the mortgage and real estate industry. While origination volume will likely remain lower in the short term, compliance and operational costs will spike, squeezing already thin margins.

Nothing spurs introspection and reflection like fiscal pressure. It is difficult to believe that actors in the real estate transaction will review the process, as profits decline, and come away from that examination confident there are no further costs that can be driven out of the transaction. We are already beginning to see this. It will likely only accelerate in the short term.

We believe that many lenders will seek to eliminate touch points to the transaction. Additionally, they will look to consolidate seemingly redundant or overlapping processes under the fewest number of proverbial "roofs" possible. They will probably do so using new management and production technologies, from the vendor management and selection process right down to compliance and delivery.

In short, there will soon be a forced march toward improved communication and collaboration across the board.

We also cannot overlook the fact that market expectations will be changing. Young Americans who are beginning to consider new homes have already been among the first to take on student loans in an online process. This is a generation very comfortable swiping credit or debit cards for even the smallest transactions, and one unwilling to wait long for the transaction to be processed.

Americans will increasingly expect to be in newly purchased homes in a matter of days or weeks rather than weeks or months. Although that may seem a pipe dream today, the market will push our industry in that direction and we will be forced to make it happen.

There are still many who believe that our industry will simply weather the storm of regulatory and market pressures that continue to buffet it today.

Although we have lived through a lengthy period of relative stability in terms of the way we do business, we believe that how it has been done for the past 10 to 15 years will no longer be the way it is done—at least, not for successful businesses.

Regulatory pressure—no matter which party dominates our nation's capital after 2012—will not simply disappear. More importantly, our market—with its changing demographics, needs and perceptions of the industry as a whole—is not going away, either. This is good news, but only for those willing to adapt. Some fairly dramatic changes are just beginning as a result. After all, 2016 is coming. . . . **MB**

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