Deconsolidation in the Primary Mortgage Market: A Temporary or Structural Trend?

Fannie Mae Housing Insights, Volume 3, Issue 10

December 5, 2013

Between 1998 and 2010, the share of the market held by the top ten originators grew from just below 40 percent to nearly 80 percent.

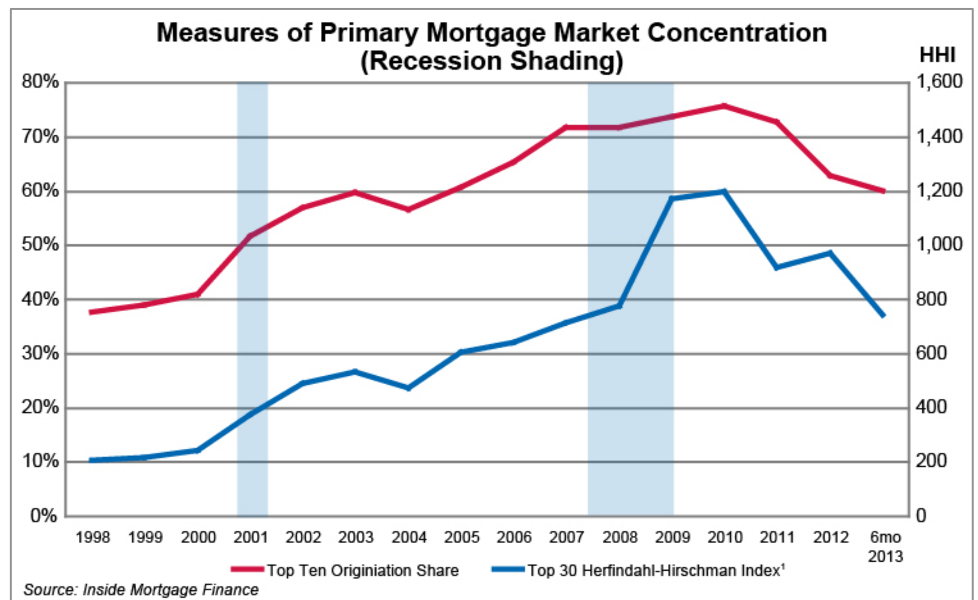
However, since 2010, top ten lender share of originations has fallen below trend and retreated to slightly more than 60 percent in the first half of 2013.

"Increasing [primary market] concentration by one standard deviation reduces the overall impact of a decline in MBS yields by approximately 50 percent."

--*Concentration in Mortgage Lending, Refinancing Activity and Mortgage Rates,* National Bureau of Economic Research Working Paper Series

Introduction

For many years, concentration in the U.S. primary mortgage market was on an inexorable increasing trend. Between 1998 and 2010, the share of the market held by the top ten originators grew from just below 40 percent to nearly 80 percent. However, over the last three years, the market has experienced significant deconsolidation as top lender share retreated to slightly more than 60 percent in the first half of 2013. Market deconsolidation was driven largely by the withdrawal of large lenders, with only 5 of the top 20 single-family mortgage originators in 2006 remaining active in the market today.



This begs the question: To what extent is the recent decline in top lender share of market originations more likely a function of cyclical or structural market factors?

Factors Favoring Large Mortgage Lenders

1. Economies of Scale and Scope: Large lenders are able to spread fixed costs (e.g., technology expenses) across a high volume of mortgage transactions, reducing average costs relative to smaller competitors. The mortgage servicing business provides perhaps the clearest example of the benefits of scale economies in the primary mortgage market. Based on data published by the Mortgage Bankers Association for the period between Q2 2012 and Q2 2013, direct servicing expenses for servicers of fewer than 2,500 mortgage loans were 13 percent higher per loan than direct servicing expenses for servicers of more than 50,000 loans.

[1] A commonly accepted measure of market concentration calculated by summing the squares of the market share of market leaders.

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In addition, larger lenders offer a wider array of products and services to consumers, enabling them to distribute certain other fixed costs (e.g., staff functions) across a broader set of lending and service lines of business.

Also, because larger banks have established relationships with customers in more non-mortgage lines of business, they have greater opportunity to cross-sell mortgage products than smaller lenders.

Lending Lines of Business

Bank Size	Count	Average Number of Lending Lines of Business
Mega Banks (>$1T in assets)	4	18.5
Large Banks (<$1T, >$100B in assets)	21	14.0
Medium Banks (<$100B, >$1B in assets)	606	13.5
Community Banks (<$1B in assets)	5956	12.4

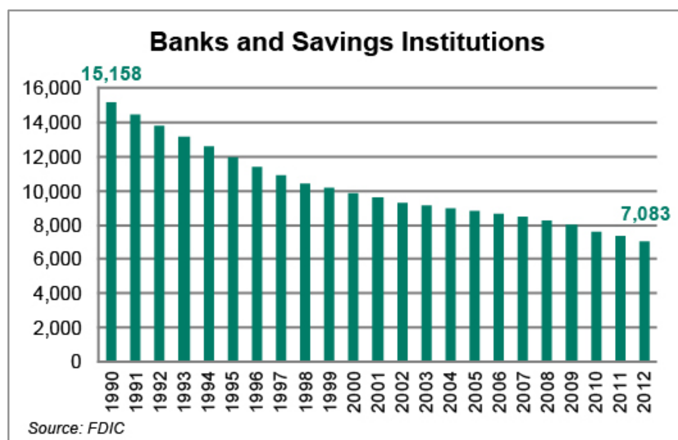
Source: SNL Financial

2. Cost of Debt: Larger banks generally have a lower cost of debt and broader access to funding in the bond markets than small lenders. According to a recent paper from Goldman Sachs, large banks have enjoyed an average 31 basis point cost of debt advantage compared to smaller banks since 1999. During the crisis period, the authors found the large bank advantage expanded to nearly 800 basis points. Today, large banks have an apparent 10 basis point cost of funds disadvantage; however, the average tangible common equity ratio (TCER)[2] for small banks is also meaningfully higher than the TCER for the largest U.S. banks.[3]

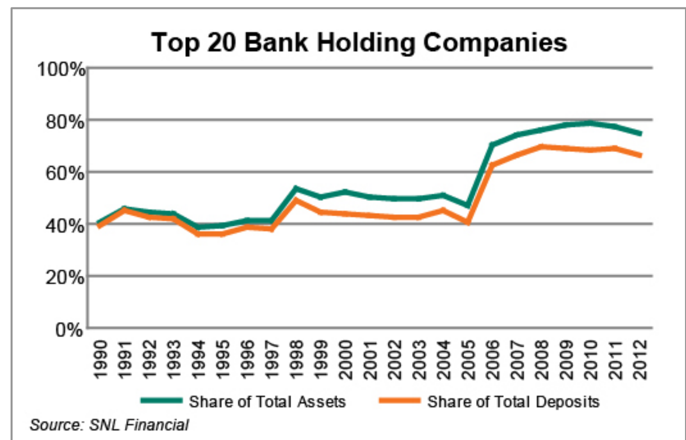
3. Shift to More Commoditized Market: The combination of tighter credit standards and legislative and regulatory responses to the market crisis is leading to a more standardized and commoditized mortgage market. A more commoditized market will likely reduce the value of product and service differentiation, and operating costs will likely become a stronger driver of competitive position, favoring large lenders.

4. Access to Subject Matter Experts: Large lenders are better positioned than smaller competitors to employ subject matter experts in increasingly complex disciplines such as regulatory compliance and financial modeling.

5. M&A not Motivated by the Mortgage Business: Between 1990 and 2012, the number of U.S. banks and saving institutions has declined by more than 50 percent. Also, the top 20 bank holding companies' share of assets and deposits nearly doubled during this period.



Source: FDIC



Source: SNL Financial

[2] Tangible common equity ratio = tangible common equity (total equity less intangible assets, goodwill and preferred equity) / tangible assets (total assets less goodwill and intangible assets). Tangible common equity ratio compares a firm's liquidation value to the liquidation value of its assets.

[3] Tangible common equity ratio calculated using Q2 2013 SNL Financial data.

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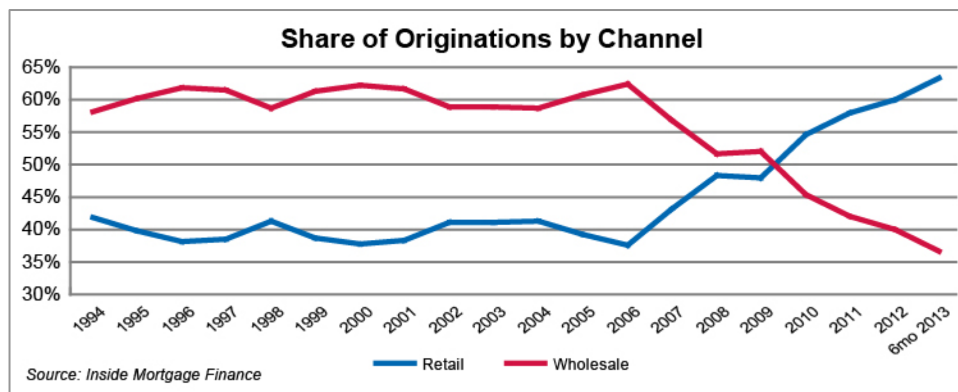
6. Absence of Private Label Securities (PLS) Market for Conforming Loans: Prior to the crisis, the PLS market was a significant avenue for attracting private capital to mortgage credit risk investment. However, the PLS market for conforming loans has been essentially dormant since the crisis. A resurgence in PLS issuance, particularly for agency eligible products, would signal a return of private capital and could be favorable to large lenders with the ability to gather the required collateral and to perform the securitization and master servicing functions.

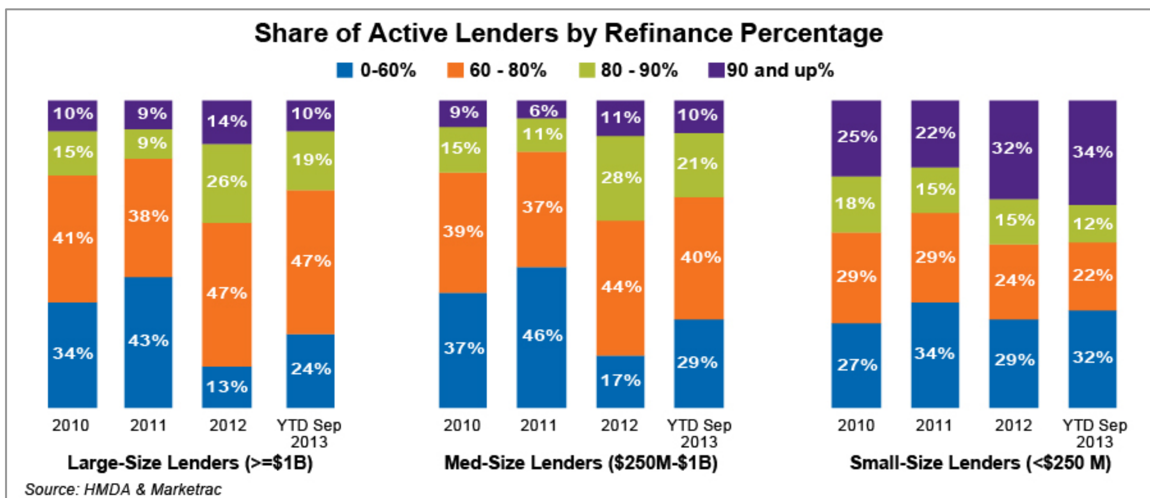
Factors Favoring Less Consolidation

1. Shift to Retail Origination: A sustained shift to retail origination would signal a future landscape with a more diversified group of originators because larger lenders tend to have greater capacity for wholesale origination. We believe that the shift to retail originations since the crisis came from lender desire to have tighter control of underwriting and production, driven by comparatively weak performance and high manufacturing defect rates for wholesale originations during the crisis period.



However, we believe the sustainability of the shift to retail is uncertain. Lender concerns about poor loan performance and repurchase risk are expected to decline as the housing market outlook and manufacturing processes improve, but some smaller lenders are expected to be less willing to sell their mortgage production to larger lenders in the future.

2. Nimbleness of Smaller Lenders: Smaller institutions by their very nature may have more ability to react to market changes. In a refinance-driven mortgage market (2012 and 2013), a large share of small lenders focused on refinance originations. Recently, mortgage rates have risen and a shift from a refinance dominated originations market to a purchase dominated market could test the nimbleness of many small lenders.



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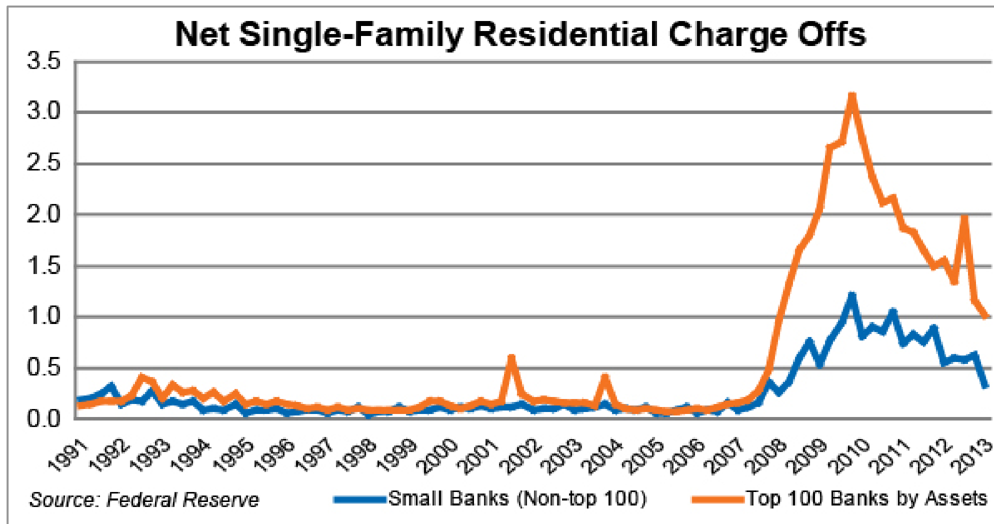
3. Local Market Expertise: Many advocates of community banks assert that smaller banks have a fundamental advantage because they have in-depth knowledge of their local market. In regards to single-family credit losses, small banks outperformed their larger competitors in the recent crisis and have done so consistently since 1992. However, it is not clear whether this outperformance is due to local knowledge or other factors, such as a different risk appetite.



4. Capital Requirements: The largest U.S. bank holding companies are subject to a variety of enhanced prudential supervisory requirements compared to smaller regulated institutions, including increased capital standards and stress test regimes. In addition, the Dodd-Frank Act requires the largest banks to hold capital at the higher of the "standard" or "advanced" approaches to determining capital requirements. The advanced approach is not applicable to smaller banks. Under the Basel III capital standards, the capital requirements for MSRs will increase. The heightened requirement may be one factor among others that will discourage banks, particularly those looking to enhance their capital position, from holding MSR assets.

5. Legacy Issues: Following the financial crisis, large and small lenders received loan repurchase requests from the GSEs and other secondary market participants. A significant volume of legacy repurchase issues have been resolved recently through settlements with many lenders, suggesting that these repurchase requests will recede as a business issue for mortgage lenders. The volume of outstanding Fannie Mae repurchase requests for the top 5 lenders as of year-end 2012 declined by more than 90 percent by September 2013. In addition, the volume of outstanding repurchase requests for the top 5 lenders declined from more than 90 percent to less than 60 percent of total outstanding Fannie Mae repurchase requests over the same period. Also, as of September 2013, less than 0.25 percent of the loans in Fannie Mae's single-family book of business acquired between 2009 and 2012 have been subject to a repurchase request, compared with approximately 3.6 percent of the single-family loans acquired between 2005 and 2008.

Probability that Consolidation Returns in the Primary Mortgage Market

Large and small lenders enjoy advantages over each other in the mortgage marketplace. However, we believe large lenders benefit from more significant and potentially more sustainable advantages relative to small lenders. Consequently, our assessment indicates that the recent decline in large lender share of the primary market is temporary, and principally a result of cyclical factors that caused larger lenders to pull back from the market. Absent a meaningful restructuring of the mortgage market (our analysis did not contemplate changes that may come from reform of the housing finance system, as we do not yet know the timing and shape of reform), we believe there is a significant probability that in the long-term large lender share of the primary market will increase compared to current levels.

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Relative advantages by size of institution

	Factor	Mid-Term Outlook
Favors Consolidation ↑	Economies of Scale and Scope	Sustainable
	Cost of Debt	Sustainable
	Shift to Commoditized Market	Sustainable
	Access to Subject Matter Experts	Sustainable
	Banking M&A Not Motivated by Mortgage Business	Sustainable
	Absence of PLS Market for Conforming Loans	Sustainable
	Other Benefits of High Volume	Sustainable
	Added Capital and Regulatory Requirements for Large Institutions	Sustainable
	Capacity Limits for Large Lenders	Temporary
	Legacy Issues	Temporary
	Shift to Retail Market	Temporary
	Local Market Expertise	Sustainable
	Customer Loyalty/Preference	Sustainable
Favors Deconsolidation ↓	Nimbleness	Sustainable

Source: Fannie Mae, Economic & Strategic Research Group

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The authors thank Orawin Velz, Pat Simmons, Tom Seidenstein, Mark Palim, Doug Duncan, Pete Bakel, Noel Fahey, Michael Vangeloff, and Paul Mahler for valuable comments in the creation of this analysis. Of course, all errors and omissions remain the responsibility of the authors.

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