The Economy

PUTTING SKIN IN THE GAME

WILL RISING INTEREST RATES LOOSEN LENDING STANDARDS AS BANKS TRY TO WOO BUSINESS FROM LESS-CONVENTIONAL BORROWERS? WELL FIRST, RATES HAVE TO RISE....

ACCORDING TO FANNIE MAE'S National Housing Survey for August, lenders anticipate interest rates rising steadily in the coming months and expect an even bigger and concurrent reduction in mortgage loan demand. Will that reduced demand drive lenders to loosen credit standards?

Well, it could, particularly given increasing concerns on the part of regulators and lawmakers over the lack of credit access due, in significant degree, to new and stringent standards for both consumers seeking loans and banks worried about future buyback demands.

New Department of Housing and Urban Development Secretary Julian Castro told the Bipartisan Policy Center Forum Sept. 16 that he will promote easing credit access and fostering increased homeownership. Reportedly, home lending across the nation stands at a 17-year low.

Among the steps Castro is pushing is revising the Federal Housing Administration's handbook for lenders to make it more clear when financial institutions can be forced to buy back defaulted loans.

Castro hopes he can ease banks' reluctance to lend outside qualified mortgage rule terms by making them less fearful of potential repurchase demands.

If all this comes into play, consumers could see easier access to credit in the coming months, and there is some evidence it's happening already.

MORTGAGE DEMAND DROPS, CREDIT ACCESS EXPANDS

According to Fannie Mae's third-quarter Mortgage Lender Sentiment Survey, large lenders expect mortgage demand to drop in the next three months with the largest drop in demand occurring for government-sponsored enterprise eligible loans.

However, large lenders also expect credit standards to ease, particularly for non-GSE loans. In a Sept 17 news release, Fannie Mae Chief Economist Doug Duncan said, "Historically, as lenders face a more competitive market for loan volume, it's not uncommon to see some loosening in the lending standards."

The survey showed as well that big lenders are increasingly more likely to go after business that does not meet the standards of the new qualified mortgage rule. Smaller banks seem less inclined…so far.

"Larger lenders are expecting to tap into the non-GSE-eligible and government loan market to maintain or grow their market share and offset their anticipated slowing mortgage demand as the peak spring/summer selling seasons are coming to an end," Duncan added.

The third quarter showed no significant loosening in credit standards, and the fourth quarter is unlikely to show significant movement either, but the pendulum has swung even since last year.

The average credit score for mortgages closed in August was 727, according to Ellie Mae's latest insight report, and while that score is still pretty high, it's a notable drop from the average of 750 seen two years ago. In August 2013, the average credit score for closed mortgages was 734.

FHA-backed loans are seeing loosening credit score standards as well. The average score for loans closed in August was 682 compared to 697 a year earlier.

Ellie Mae President and Chief Operating Officer Jonathan Corr noted, "The numbers have been going down pretty consistently through most of 2013 and the first half of 2014. We are definitely not going to go back to the '06 timeframe, but we'll go back to a normal market."

And with significantly reduced volume in refinancing applications, lenders will have to do something to attract borrowers in the coming months.

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The Mortgage Bankers Association expects the 30-year fixed rate to rise to 4.5% this quarter and to continue to go up gradually, probably hitting 5% by the middle of next year. Without the deep dips in interest rates seen the last few years, banks will have to do more to urge borrowers in their doors.

It will be a welcome change for borrowers, particularly those whose loan needs don't fit conventional mortgages as well as the self-employed, who have faced stringent underwriting standards that have often locked them out of qualifying for mortgages.

Even former Federal Reserve Chairman Ben Bernanke, who reportedly has assets in excess of $1.1. million, could not qualify for refinancing when he attempted to refinance his home, assessed at $880,700, in Washington, D.C. in September, according to a blog post from Vincent Asset Management.

At a conference in Chicago hosted by the National Investment Center for Senior Housing and Care in early October, Bernanke said current tight lending standards are "probably excessive" and then added, "The housing area is one where regulation has not yet got it right."

Not everyone agrees that tight lending standards are the problem, however.

Anthony Sanders, an economics professor at George Mason University, said recently he thinks it's borrowers' income that's the problem, not strict underwriting. He notes that the 2008 collapse damaged the finances of many borrowers, and incomes since then have been largely stagnant.

Sanders claims that even if lenders loosen standards, there still won't be borrowers with sufficient enough income to step up to the plate. To lower credit standards to the degree necessary to bring a lot of borrowers back to the table would be risky to the economy, he believes, and perhaps launch another default crisis.

The failure of borrowers to meet debt-to-income and loan-to-income ratios as well as rising home prices and decreased incomes are, some believe, the real problems holding back housing recovery, not new credit rules.

WILL BANK BAITING WORK?

However, the MBA's Weekly Mortgage Applications Survey shows loan applications on the rise. They increased 3.8% the week ending Oct. 3 compared to a week earlier. Meanwhile the Refinance Index increased 5% from the week prior, and the seasonally adjusted Purchase Index rose 2% from the previous week and to the highest level since the beginning of July.

This trend will likely continue despite the Fed's end to quantitative easing at the close of October. Thus far, the Fed has promised to keep interest rates at or near zero for the immediate future.

It's unlikely the Fed will raise short-term interest rates before the close of 2014. But once the Fed moves or states an intent to move, long-term rates will rise, perhaps by as much as half a percentage point.

This could happen in early 2015, just as it did in 2013, when Bernanke announced the Fed's plans to reduce QE3. There are economists who think, however, that long-term rates may not follow pace with short-term ones, particularly if a significant enough number of depressive forces remain in the economy.

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Thirty-year fixed mortgage rates will follow the 10-year Treasury rate, which will probably hover around 3.3% by year's end. The 30-year fixed rate will follow, probably rising to around 4.4% by the close of 2014, continuing to follow Treasury bond rates through 2015, ending next year at around 5%, which, by historical standards, is still low.

As rates rise, the result could be a slight depressive effect in the opinion of some economists, though given the likely slow rise (which is anticipated to be in intervals of a quarter or half percentage point in the coming months), the impact on gross domestic product with likely be almost imperceptible, according to the U.S. Department of Commerce.

The latest report to clients from Western Asset's Portfolio Manager John Bellows, indicates long-term interest rates will continue to be low.

He points to private credit creation in the U.S. as on the rise of late, and if credit standards ease, it could pick up even more. Bellows is unconcerned about any Fed interest rate hike, noting "The historical record of Fed hiking is mixed: in some instances a rise in interest rates corresponded with tighter financial conditions, but in others, financial conditions remained accommodative throughout the Fed hiking cycle." He reminds clients that longer term interest rates are more important for markets and the economy.

"Financing decisions facing corporate treasurers and prospective homebuyers are usually based on longer-term interest rates, not on overnight interest rates."

Job growth is up, too, if only slightly. The month of September picked up 248,000 jobs, according to the Department of Labor, putting employment growth back on track at over 200,000 job gains a month in every month of 2014 save two. New hiring rates are the highest they've been since 2000, and, as of September, unemployment stood at 5.9%.

Wages are still stagnant and will probably continue so for a number of months, but economists predict growth in income does lie in the foreseeable future, which will also increase interest in home buying.

And while interest rate hikes could ultimately benefit borrowers by leading banks to ease credit standards, banks may not necessarily see any substantial benefit in doing so.

According to a September 2014 note to clients from PMA Financial Network, while "higher rates would result in high interest income on banks' securities and loan portfolios," seemingly boosting margins by boosting interest income, the higher rates could actually "elevate banks' funding costs, which could initially negate the positive effects of the interest rates rise."

More loans could also, PMA points out, increase liquidity pressure on banks. JPMorgan Chase Chief Financial Officer Marianne Lake told a recent Morgan Stanley Financials Conference that higher interest rates could cause the industry to experience liquidity losses in the range of $1 trillion, as banks look to meet new regulatory liquidity requirements.

Nevertheless, Western Asset Management projects inflation will remain moderate, meaning interest rates should not spike too much. In fact, Bellows suspects any hike in overnight rates to go largely unnoticed given that 10-year bond yields are and will likely remain low.

"The implications of longer-term bond yields remaining low are straightforward: low borrowing costs will be supportive of corporate investment and residential construction, low discount rates will provide a tailwind to equity and real estate valuations, and demand will remain elevated for fixed-income spread sectors," Bellows says.

"In this favorable environment, the impact of higher overnight rates could very well go unnoticed."

And given the Fed will likely continue purchasing assets on a regular basis through 2015, its balance sheet won't shrink slowly in the coming years, particularly since the regulatory agency has no plans to sell assets but rather to let them mature.

And while the Fed's balance sheet has often been linked to overall market liquidity, Bellows says that ignores the role of private credit creation, which he sees as increasingly central to the liquidity of the overall U.S. economy.

Bellows' outlook is promising, as he points to loans and leases held by commercial banks rising at an annual rate of 7.5% so far in 2014, three times the pace of last year.

His long view is one of expanding credit access and an expanding, economy, though he cautions the success of QE3 ending will depend very much on the ability of the private sector and private lending to step in.

In an about-face from previous Federal Housing Finance Agency policies, however, new Director Mel Watt is preparing to unveil a program that would ideally encourage banks to ease lending standards even for Fannie Mae and Freddie Mac backed loans.

In fact, some borrowers may be able to obtain such loans in the coming months with down payments of as little as 3%. Critics could call such expansion of credit access foolhardy and reminiscent of the lax standards that led to the Great Recession.

But whether or not banks will pick up the bait remains to be seen. ■