Market Focus

Mortgage Banker Consolidation Means Structurally Faster Refinancings

The mortgage origination business is consolidating rapidly because of economies of scale as well as the significant cost differences among originators. In the last five years, the five largest originators' market share has grown to 21% from 12% (see table below). Consolidation should increase the refinanceability of mortgages (at any given market level) and make prepayments more sensitive to interest rates. Historically, the originators with the fastest growth have refinanced the mortgages they originated more quickly than the industry averages. The reason for the speed of their refinancing cannot be fully explained by the geographic mix of their mortgages, by demographics, or by product specialization. Instead, we believe that the low costs of these fastest-growing originators have enabled them to pursue refinancing origination more actively than their competitors. We also believe that the process of consolidation is far from over and will continue until the cost differences among major competitors even out.

Mortgage Originator Market Shares

	All Originators		GNMA MBS Issuers	
	1990	**1995***	**1990**	**Oct. 1995***
Top 2	2%	15%	17%	39%
Top 5	12%	21%	30%	53%
Top 10	17%	28%	39%	68%

* Includes Pru-Norwest and Chase-Chemical combinations

Major Difference in Costs

Many originators we have spoken with agree that the difference in costs between the lowest-cost and highest-cost of the major nationwide originators is about a factor of two. (The difference is probably largely attributable to technology investments and sales costs.) This is a highly unusual situation for a major nationwide industry, indicating that further consolidation among today's hundreds of originators is very likely. Moreover, significant economies of scale in the origination and associated servicing businesses also point to the eventual emergence of a relatively small number of very large mortgage origination and servicing companies. The cost divergence supports our projection that the average cost of originating a mortgage should fall by about half in the next three to five years. This should happen both because of further technological improvements and because of consolidation to a lower average cost structure.

GNMAs Ahead of Conventionals

The GNMA sector could be an indicator of what the future might hold for the overall mortgage origination business (see table above). The two largest GNMA MBS issuers now account for almost 40% of the market, up from 17% in 1990. In the GNMA business, mortgage brokers and nationwide mortgage bankers have been more important for longer, while thrifts and savings banks have remained more significant in conventional originations. Consolidation has been faster and more far-reaching in GNMAs, and recent GNMA versus conventional prepayment trends could reflect the temporary head start of GNMA consolidation.

Norwest-Pru Acquisition Is Symptomatic

The recent acquisition by Norwest Corp of Prudential Home Mortgage Corp.'s conforming origination and servicing business is symptomatic and significant in the context of overall consolidation. Mortgage pools originated by Prudential (about 2-3% of the agency market) have consistently refinanced at rates that are among the slowest of the major originator-servicers; meanwhile, pools originated by Norwest (about 5-6% of the agency market) have consistently been among the fastest (see graph and table on the next page). The reason for the difference goes well beyond geographic mix, any demographic explanation, or product specialization. Instead, in our view it reflects the aggressiveness of the originator in seeking out refinancings on the mortgages it originated. Any such aggressiveness is probably traceable to a cost advantage in originations. While we have no specific information about the cost structures or technology investments of these two institutions, it's interesting to note that according to *Mortgage Technology* magazine (yes, such a publication exists!), Norwest Mortgage Corp uses more laptop computers for mortgage originations than do its closest five competitors combined.

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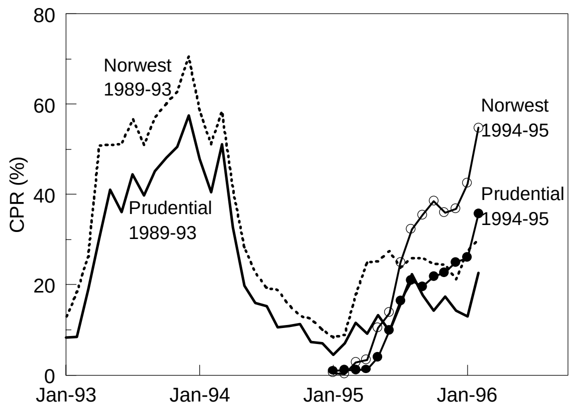
Norwest Pools Have Refinanced Consistently Faster Than Prudential Pools

(Example: GNMA 9s)



Historical Prepayment Comparison: Norwest vs. Prudential (% CPR)

	FNMA				GNMA			
	1993 Average		Latest 6-Mo		1993 Average		Latest 6-Mo	
	Norw	Pru	Norw	Pru	Norw	Pru	Norw	Pru
30-Yr 8.5 (94-95)	—	—	30	25	—	—	30	20
(89-93)	55	44	20	16	44	28	22	14
30-Yr 9.0 (94-95)	—	—	35	31	—	—	41	26
(89-93)	59	42	26	18	50	37	26	17
30-Yr 9.5 (94-95)	—	—	38	21	—	—	44	26
(89-93)	56	34	24	16	54	39	29	20

Prepayment Impact Is Significant

The specific details of the prepayment differences are persuasive. For both new and seasoned premiums, GNMAs and conventionals, Norwest agency pools have consistently registered monthly prepayment rates averaging about 50% faster than those of Prudential agency pools. (This is five times our standard measure of refi sensitivity.) These differences are highly significant for the value of refinanceable premiums — or indeed for any mortgage security with call risk either in the money or out of the money. For GNMA 9s priced at 105, the difference between 25% CPR and 35% CPR amounts to 2/32nds of carry per month, or more than 70 bp of yield and annual return. In a 1993-style environment, priced at 107, the difference between 40% CPR and 55% CPR amounts to nearly 6/32nds of carry per month, or almost 200 bp of yield and annual return.

Fast Pools Stay Fast

It is impractical to stipulate the originator or servicer in mortgage trades, but the impact of the originator or servicer on prepayments suggests that pools with a fast prepayment history will remain fast in the future. In contrast, slow pools might either stay slow or speed up as their originator or servicer starts refinancing more aggressively or is acquired.

Norwest’s strategy for expanding market share through the aggressive pursuit of refinancing business and origination technology is clearly succeeding; the company has become the country’s largest mortgage originator and largest mortgage servicer. In fact, as technology-driven consolidation and economies of scale foster “survival of the fittest” in the home mortgage business, refinancing efficiencies inevitably rise. Ultimately, those originators whose refinancing speeds are below the industry averages must either catch up or face the threat of decreasing market share. Either way, refinancings become faster for any given level of interest rates.