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# Mortgage lending: Don't bet the house on mortgage market recovery

by Helen Avery

**Banks profit on originate and hold; Expectations 'ahead of themselves'**

Mortgage lending **boosted earnings for many of the largest banks in the US in the third quarter of the year**, prompting bullish sentiment that the market is in a full-blown recovery.

Bank of America reported that mortgage-lending revenues rose 18% to $21 billion from the same period a year ago, while revenues from the same business soared by more than 50% for JP Morgan Chase and Wells Fargo.

Opinion on the housing market seems to have turned positive since mortgages are now cited as the clear way for banks to be profitable.

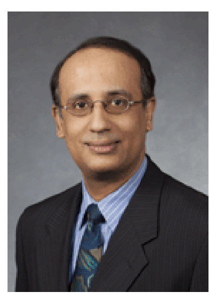
The CEOs of Wells Fargo and JP Morgan Chase said in earnings calls that the housing market had turned a corner.

Some observers even link **Vikram Pandit's exit as chief executive of Citi** to the bank having failed to capitalize on the mortgage business as well as its rivals.

That there is money to be made is certain, and not just in banking.

Tilden Park Capital Management, the hedge fund of former Goldman Sachs trader Josh Birnbaum, was reported to have made a 30% gain in October thanks largely to bets on residential mortgage-backed securities.

However, the future of the mortgage market and indeed a US housing recovery is much more blurry than some would like to believe, according to investors and economists.



**Srinivas Thiruvadanthai, director of research at the Jerome Levy Forecasting Center**

"Because **the Federal Reserve** has been buying up Fannie Mae and Freddie Mac mortgage-backed bonds, agency spreads between those and treasuries have compressed," says Srinivas Thiruvadanthai, director of research at the Jerome Levy Forecasting Center. "Mortgage rates however have not, so it has become more profitable for banks to originate mortgages and hold on to them. Those spreads will also come down, but for now they are relatively high."

Thiruvadanthai adds that new mortgage lending is not, in fact, surging in the way it might appear: "Applications for home purchases remain much as they have done for the past two years. Refinancings may be up, but approvals are still low."

Indeed, some 75% of JPMorgan's mortgage loans in the third quarter were refinancings.

Banks, still suffering the financial pain of **lax mortgage lending** in the boom times, are clearly still very nervous about who they make loans to and have retained tight lending standards.

Bank of America, for example, said in October that investor claims that the bank should buy back mortgages it sold before the crisis were $25 billion in the third quarter, up from $10 billion in the same period a year before.

Bruce Thompson, BofA chief financial officer, was cautious in his outlook for mortgages during an analyst call.

He said: "We’ve clearly begun to turn the corner", but added that he remained "a little bit cautious because there are headwinds out there".

Some analysts say there is a lot to consider before becoming bullish on the housing market and forecasting continued profits from banks’ mortgage-lending businesses.

"There are so many contradictions in the housing market at present," says one hedge fund manager that invests in residential mortgage-backed securities.

"The population has increased yet new housing has stopped, so there is demand from a demographic standpoint. And there is money out there to invest; some new companies offering mortgages or servicing mortgages are beginning to crop up. Yet the banks are wary with good reason. The messages they are getting are mixed because of the large penalties they have received for bad mortgages. And the economy does not look sound enough to say for certain there will be a housing recovery. People want to write the ending and say we are done and recovering, but the hurricane has not gone back out to sea yet."

He points out that banks’ wariness about a housing recovery or even a broader economic recovery is evident in that they are doing more business in shorter-term loans for autos, for example.

"They are deliberately keeping their bets shorter," says the hedge fund manager.

In a report from Standard & Poor’s in October, analyst Matthew Albrecht made the point that the US government’s continued involvement in the housing market shows just how precarious it is.

It is almost two years since the US Treasury released a white paper stating that it wanted to wind down the government-sponsored enterprises.

Yet Fannie Mae, Freddie Mac and the Federal Housing Administration hold, manage or back around 90% of the US housing market.

"Despite recent signs that home prices are stabilizing in some areas, the housing market is still dealing with an overhang of inventory, high non-performing loan rates, and few qualified new borrowers [thus preventing the US government from stepping away]," says Albrecht.

In addition some analysts point out that housing is a political football and so in an election year is garnering more attention than usual.

Thiruvadanthai says that the mindset of the purchaser has also changed, and that may affect the US housing market’s future.

"Expectations have run ahead of themselves. We think the housing recovery will be much slower and less exciting than people are hoping and it will be more vulnerable to broader economic developments," says Thiruvadanthai.

"Because, let’s not forget, individuals now realize that property prices do not go solely upwards. You could justify paying a premium to purchase a property back in the day, but why would you do it now if an increase in home price is not a sure thing?"

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