BANKS AND THE MORTGAGE BUSINESS

by Steve Brown

As most of our clients know, we are not fans of the origination and portfolio model of residential mortgages on community bank balance sheets. This opinion has been largely driven by the fact that if you look at the 10Ys prior to 2008, the low volume mortgage business seen at most community banks was just barely profitable on a risk-adjusted basis. Worse, the mortgage business is somewhat correlated to size, so the majority of bank operations were actually unprofitable. It is a volatile, transaction-driven, competitive business; where success depends on scale or the exploitation of a particular niche (such as super-jumbo origination in a less competitive area). The business model profile of the mortgage business is the domain of large banks, so our recommendation is for community banks to generally look elsewhere to deploy capital in order to garner an above average return and long-run competitive advantage.

Of note, our opinion did change slightly in 2008, when market dislocations allowed mortgage originators and warehouse lenders to increase pricing and bring the risk/reward profile closer to other business lines. Since 2008, our recommendation has been to exploit the sector over the next several years, but then look to get out, as liquidity floods back and pricing compresses. However, since last Friday, when we saw the Obama Administration's quasi-proposal on FNMA and FHLMC, our updated take is that banks can most likely enjoy profitability in this sector for longer than first assumed. Better pricing and less competition has shifted things so the average bank goes from making a negative risk-adjusted return, to a positive one over the next 5Ys.

We believe underwriting will be tighter for a longer-than-first-assumed period of time. Lower LTVs, higher credit scores, larger downpayments and more complete documentation has reduced the expected probability of default. For 2011, the bottom quartile of FICO score being booked for a conforming mortgage is 716, a vast improvement from the 680 score found in 2007. Our 5Y projection has this standard staying above 705.

Better underwriting will be supported by the move to privatize much of GSE non-FHA production. Here, the long term reduction in guarantees will create less of a homogenous market and place more production at the doorstep of banks. As such, banks are more sensitive to their use of capital and will deploy their mortgage resources more efficiently. This lower production will also be supported by the fact that Fannie and Freddie will both have to increase their guarantee fees. The net result will be higher pricing and less capital deployed in the mortgage market by the Gov't. Less origination also means a reduction of refinancing activity. This dramatically alters profitability, as the number one killer of profitability, negative convexity, is reduced by what we estimate to be speeds that are 15% lower than where traditional mortgage models currently predict.

These trends will be combined with lower loan limits for conventional mortgages, greater consumer regulation, the establishment of a national standard for servicing and a volatile economy. This will keep downward pressure on supply, thus keeping risk-adjusted spreads positive for a longer period of time. Other ramifications of these trends will be a lower percentage of homeownership, a more transient population and a more robust rental market (good for multifamily lending).

While we are not sure where the industry eventually shakes out, the way it is heading now bodes well for the profitability of community banks over the next 5Ys. While we still don't "love" the business line, we do believe banks with solid operations can drive positive shareholder value for years to come.

BANK NEWS

M&A

Ocean Shore Holding Co. ($840mm, NJ) will buy the holding company of Select Bank ($135mm, NJ) for $11.9mm in cash, or 1.3x book.

More Branches

Countering the branch closure trend of BofA and Citi, JPMorgan Chase announced it will open 225 branches this year and more than 2k over the next 5Ys. The Bank is seeking to increase its presence in FL, CA, NY and IL.

Good Sign

The FDIC announced its West Coast Temporary Satellite Office will be closing down after its initial 3Y authorization expires. The office was set up in Nov 2008 to handle asset liquidations from banks in the western states and the official sunset date of the office will be Jan 13, 2012.

Mortgage Servicing

FRB Governor Raskin said the regulatory review of mortgage servicing standards (slated for release later this month) will show widespread weakness in the servicing industry and that the deficiencies "pose significant risk to mortgage servicing and foreclosure processes, impair the functioning of mortgage markets and diminish overall accountability to homeowners." Expect tighter regulations down the road as a result.