

A man in a dark suit, light blue shirt, and blue tie is shown in profile, looking out a window. The background is a blurred office interior with a window showing a view of a city at night. The lighting is dramatic, with strong highlights on the man's face and suit.

**HW**

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# THE COMEBACK TRAIL

WELLS FARGO'S **MICHAEL HEID**

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By Christopher Whalen

## 2011: A year of lost opportunities for housing



### QUICK FACTS

Banks reported the strongest first quarter in four years.

As we close out the year, the economy is flat and employers are cautious about hiring.

*As 2011 began, there was a good deal of talk about residential housing prices bottoming out by midyear. The U.S. banking industry had its best quarter in four years in the first quarter. The public relations flaks in the Obama White House were even starting to talk about an economic recovery before the November 2012 election.*

Now it's December and we all know better. The economy is flat to down, especially, as contrarian investor Marc Faber notes, when you subtract the true underlying inflation rate seen by business and consumers. The public sector is shedding jobs and private employers are cautious about adding permanent workers to payrolls. Home prices continue to decline, pushed lower by the twin evils of shrinking credit availability and government intervention.

Most Washington agencies are making the problems in the housing sector worse. The Obama administration stood by in almost Republican fashion in October and allowed the Federal Housing Administration's conforming loan limit to fall by about \$150,000 in major metro markets such as Washington, New York and Los Angeles. The reduction will force housing price compression from jumbos down through the entire housing market, says Alan Boyce of The Absalon Project. "My guess is that the conforming limit

change will be worth 5% to 10% on HPI in the higher priced MSAs. The refinance blockage could be worth 10% nationwide, and probably results in an extra 1 million Americans unemployed as labor mobility has fallen," he said.

Yet conservatives in Congress welcomed the conforming loan change — even though it will almost certainly reduce the supply of credit for home financing. Part of the problem is conservative's well-intentioned efforts to roll back 80 years of government support for the housing market. Prior to the 1930s, no national market in housing finance existed and through the 1970s, the mortgage market wasn't even securitized. Investors in residential mortgage-backed securities backed by Fannie Mae and Freddie Mac have not been asked to take first-loss exposure post-World War II.

With banks writing 90% of new loans for government-sponsored enterprise guarantees, the notion that the private sector is ready to carry the load on home finance

seems absurd — except in Washington. Rep. Scott Garrett (R-N.J.) has introduced legislation to begin the process of creating a private secondary market for housing loans, something we have written about in HousingWire for years now.

The latest Garrett bill does some good things, like repealing the idiotic risk-retention provisions of Dodd-Frank and requiring the Federal Finance Housing Agency, the regulator of the GSEs, to set national standards for loan underwriting.

Anybody following the RMBS litigation against Countrywide and Bank America understands that we already have "risk retention." But while we ought to support efforts by Garrett and others to restructure the U.S. housing market, we also need to focus on maintaining current market liquidity as we make important structural changes. But the fact is that neither investors nor banks are willing to write 30-year mortgages without government coverage against principal loss.

### THE FED'S NEGATIVE FACTOR

"This whole experiment in removing the GSEs from the mortgage market to give 'room' for the private sector will end in tears," predicts Boyce, who worked at Countrywide Financial prior to the Bank America acquisition and is one of the nation's leading authorities on the secondary market. But in addition to the actions of the Obama administration and Congress to constrict the role of the GSEs in supporting housing finance, the Federal Reserve is a major negative factor of the housing equation.

In almost every economic slump since WWII, the Fed has used housing as the primary channel for monetary policy. Unfortunately in the latest cycle of boom and bust, interest rates were already so low that only the most attractive borrowers have been able to refinance. Not only is most of the business currently being written by banks and the GSEs related to refinancing, but the vast bulk of the loans



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are being written against relatively new, lower coupon loans.

Since two of every three mortgage refinancing transactions done by banks and guaranteed by the GSEs since 2008 have gone to higher-income households, low-income families who need lower rates are mostly locked out. Look at the prepayment rates of older, high-coupon mortgages. They are half that of current mortgages. In the latest prepayment data from Fannie Mae, the discrimination against middle- and low-income borrowers is obvious. The average loan size of the older, high-coupon loans is almost half that of new loans. Thank former Treasury Secretary Larry Summers and current Secretary Timothy Geithner for the “do nothing” policy when it comes to home refinancing.

#### SHRINKING THE BALANCE SHEET

Banks and GSEs alike are reluctant to refinance these older loans with high spreads at time of origination because of the huge drop in yield compared to current production loans. Loans today have some of the lowest effective returns for lenders and investors in generations, going back to WWII when the Fed pegged interest rates at artificially low levels.

Ronald E. Hermance Jr., CEO of Hudson City Bancorp, commented on the difficult environment for portfolio lenders when the bank reported third-quarter results:

“With mortgage rates hitting all-time lows and reinvestment rates for mortgage securities below 3%, we believe balance sheet growth does not make sense in this environment. We anticipate continuing to restrain our balance sheet growth while the Federal Reserve and U.S. Treasury department continue their on-going attempts to spur economic growth by, among other things, keeping interest rates at historical lows. This quarter, the rate on 10-year Treasury notes fell below 2% — a rate even lower than during the Great Depression. As a result of the decrease in rates during the

quarter, we had \$2 billion of investment securities called during the third quarter, including \$1.2 billion during the month of September. This resulted in a large cash balance at Sept. 30, 2011, which will be redeployed during the fourth quarter.”

Notice that an acceleration in prepayments of the portfolio of mortgage securities is forcing Hudson City to buy new-issue RMBS, which have lower yields than seasoned paper. Note, too, that Hudson City has net prepayments on both the securities and lending books, an illustration of the deflationary situation today found at lenders large and small. A deflating economy is translating into shrinking lending volumes and bank revenue, suggesting that the Fed’s zero interest rate policy may be doing more harm than good.

As political efforts to accelerate refinanc-

ment believe is going to take up the role of the GSEs in the U.S. housing market?

We also made little progress this year in settling the legacy claims against the remaining mortgage securitization and servicing houses. Lehman Brothers and Washington Mutual are bankrupt. Bear Stearns festers inside JPMorgan Chase and Countrywide remains unresolved within Bank of America, which also owns Merrill Lynch, care of former Treasury Secretary Hank Paulson.

I have been arguing for months that Bank of America needs to be restructured to deal with many tens of billions in unliquidated claims by investors, insurers and government agencies. The settlement of put-back claims from hundreds of RMBS trusts against Countrywide announced this summer is now effectively dead. More claims are likely to be filed in the coming

#### QUICK FACTS

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**“Most Washington agencies are making the problems in the housing sector worse.”**

ing take hold, the prepayment rates on all existing RMBS will rise and margins among all FDIC-insured banks will be under increasing pressure. Because Hudson City has relatively high credit standards for lending, it also has one of the lowest default rates in its peer group. But that also means most of today’s consumers are not bankable at regional lending institutions like Hudson City.

PNC Financial, another bank we rate at Institutional Risk Analytics, is likewise shrinking its balance sheet. Most lenders today are only making loans for FHA cover and most of these for existing first liens held by higher income borrowers. With ZIRP discouraging American lenders from taking risk in markets from residential mortgages to overnight REPO transactions with European Union banks, it is reasonable to ask where exactly is this private-sector lending capacity that my friends in the conservative move-

weeks and months. But the Obama administration, following the advice of Summers and Geithner, has chosen to do nothing.

“In 2011 we got a glimpse of just how deep the flaws in underwriting and mortgage servicing have been over the past several decades,” notes Graham Fisher & Co. housing analyst Josh Rosner. “Rather than really investigating these flaws and supporting mechanisms for investors in MBS and borrowers to privately negotiate resolutions, the government has sought to prevent the full recognition of bank exposures to first and second lien losses by seeking to craft piecemeal programs and unjust settlements, which only slow the fundamental clearing and recovery of the housing market,” Rosner said. “As a result we have pushed the chances of a fundamental bottoming of housing prices further out into the future.” ■