The American Mortgage Market

Over the past 10 years, the mortgage market moved from the conventional 20% down, 30-year fixed-rate mortgage into a mortgage market that featured affordability-based products, flexible terms, and interest rates that often appeared "too good to be true". Today, with banks increasingly careful about the capital they extend to risk and with the secularization market largely closed, the only mortgages available to today's potential home buyer are those "conforming" mortgages - the old fashioned 20% down, 30-year mortgages - that are funded by Freddie Mac and Fannie Mae or mortgages available through the FHA to first time home buyers.

Each time a bank makes a loan, it has to carve out a part of its capital based on rules set by the Basel Accords (international banking standards). Just like anytime a bank makes an investment - and a loan to a bank is an investment asset - a standard amount of capital is used. The idea for the bank is to make the best return on that capital and a 30-year mortgage is hardly a high-yield product. So, banks are almost exclusively turning to Fannie and Freddie to fund any new mortgages they make, but because Fannie and Freddie got into trouble taking too much mortgage risk themselves, Fannie and Freddie are only interested in conforming mortgages. Fannie and Freddie pay the bank for the mortgage and the bank has funds to make another loan. So, if you are a borrower with special needs or have the income to afford a home that requires a mortgage larger than the conforming standards (the upper limit varies by locality based on the prevailing housing markets), you have virtually no options.

As the stronger banks emerge – particularly the local community banks – there will be a return to “portfolio” lending or mortgages made by a bank that are designed to be funded by the bank’s internal funding (primarily deposits) and that are designed to stay on the bank’s balance sheet in the form of debt consolidation. These are loans that pay the bank a spread (the mortgage coupon minus the bank’s cost of funds) over time.

The profit prospect of such a mortgage is a long term one and again, not overly attractive for many institutions, particularly those needing to make money to cover previous losses. The number of banks in this market niche are likely to be small. In the meantime, what can a non-conforming borrower do? Wait.

About the Author

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