Loan Repurchases Are a $10 Billion Problem for Big Banks

by Alistair Barr

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Just when they thought the worst of the mortgage crisis was behind them, billions of dollars in bad loans from the debacle may be rising from the dead and creeping back on the balance sheets of the largest U.S. banks.

Big lenders including **Bank of America** (BAC), **J.P. Morgan Chase** (JPM) and **Wells Fargo** (WFC) may be forced to repurchase troubled home loans from insurers and mortgage-finance giants like **Freddie Mac** (FRE) that had agreed to take on risks associated with those assets during the real estate boom.

The banks are setting aside more reserves to cover the potential costs of such repurchases, cutting into earnings.

The trend is also pitting big lenders, insurers and mortgage-finance institutions against each other. That's a big change from the previous decade, when they worked together to fuel the housing boom by originating, insuring and securitizing mortgages in record amounts.

Christopher Whalen, managing director of research firm Institutional Risk Analytics, offered up a colorful metaphor for the unfolding situation.

"The wave of loan repurchase demands on securitization sponsors is the next area of fun in the zombie dance party, namely the part where different zombies start to eat each other," Whalen wrote in a note to clients Tuesday.

Mortgage insurers such as **MGIC Investment** (MTG) have rescinded, or refused to pay, roughly $6 billion in claims from delinquent home loans since January 2008, rating agency Moody's Investors Service estimated in a December report. That could leave banks that originated the loans on the hook for losses.

Bond insurers are expecting to recover more than $4 billion from banks for breaches of representations and warranties on residential mortgage-backed securities they guaranteed, Moody's also noted.

"Depending on how things go it certainly could go much higher than $10 billion," said James Eck, a senior analyst in Moody's Specialty Insurance team.

Meanwhile, government-controlled mortgage-finance giants **Fannie Mae** (FNM) and Freddie Mac are also getting in on the act, potentially forcing banks to repurchase billions of dollars more in bad loans.

In the first nine months of 2009, firms that collect payments on mortgages guaranteed by Freddie Mac repurchased home loans with a total unpaid balance of $2.7 billion. That was up from $1.2 billion in the same period of 2008, Moody's noted.

Vulnerable to Potential Exposures

Bank of America and Wells Fargo may be particularly exposed on this front, according to Institutional Risk's Whalen.

Fannie and Freddie "are going to tear 50-100 basis points easy out of the flesh of the banking industry in the form of loan returns," he wrote.

Wells Fargo said last month that $1.2 billion in fourth-quarter income from mortgage loan originations and sales included a $316 million increase in reserves to cover loan repurchases. The bank disclosed no such reserves in its third-quarter earnings release.

It's a similar situation at Bank of America. Joe Price, the company's head of consumer banking, told analysts last month that the company has billions of dollars in reserves lined up to cover loan repurchases and related disputes with Fannie, Freddie and insurers.

"I would be disingenuous if I didn't say people were throwing everything over the wall then can, because they are," Price said during a January conference call with analysts.

Bank of America books "hundreds of millions of dollars" in reserves for these risks each quarter, he added.

At J.P. Morgan Chase, the company's retail division reported its first quarterly loss in nearly two years in January, partly because it had to set aside more reserves for loan repurchases.

"Obviously it's picked up," Michael Cavanagh, J.P. Morgan Chase's chief financial officer, said recently.

"All parties in the mortgage chain are taking a look at their rights and looking to bring claims," he said during a conference call with analysts. Cavanagh didn't disclose details of the company's reserves covering these risks.

The process takes a long time because each disputed loan has to be scrutinized to see if the originator should buy it back or whether the risk should stay with the insurer or Fannie and Freddie.

Legacy of Countrywide

Bank of America's Price said the company is still resolving similar disputes from a business that it exited in 2001.

A lot of Bank of America's more-recent exposure comes from its 2007 acquisition of mortgage lender Countrywide Financial.

In September, **MBIA** (MBI) sued Countrywide, alleging that the lender "fraudulently induced" the bond insurer to guarantee securities backed by home-equity lines of credit and second-liens.

MBIA claims Countrywide didn't underwrite the home loans properly because it was trying to gain more market share during the real estate boom. The bond insurer said that it already paid out $1.5 billion on these guarantees and that it remains exposed to "several hundred million dollars more," according to the suit.

Bank of America is fighting back on some of these claims. Countrywide sued MGIC Investment in December, on the grounds that the mortgage insurer is improperly denying millions of dollars in valid claims on defaulted home loans.

Countrywide said that MGIC knew much about the lender's underwriting policies and that it only questioned them after the real estate market collapsed and claims spiked.

"As long as the real estate market remained relatively strong, and claims levels remained moderate, MGIC was happy to collect premiums on loans that were made based on existing underwriting practices, about which it was fully aware," Countrywide said in the suit.

From Allies to Adversaries

Disputes such as these are sparking increased tensions between companies that previously worked closely together during the real estate boom.

For mortgage insurers, this means that customer relationships may be damaged and that the perceived value of their coverage may fall, Moody's warned back in December.

"This remains a source of tension in the industry," said Michael Fraizer, chief executive of**Genworth Financial** (GNW), which owns one of the largest mortgage insurers. "No one can be happy, but you have to approach the issue professionally. We wanted to make sure we were paying all appropriate claims, not inappropriate claims."

Genworth saved $847 million in 2009 from loss-mitigation efforts, including mortgage insurance policy recissions and loan modifications. Recissions accounted for roughly two-thirds of these savings, the insurer noted.

In 2010, Genworth expects loss mitigation to generate the same level of savings, or more. Recissions will make up less of the total, while mortgage modifications are set to pick up.

Battles like these may be more important for bond insurers and their mortgage counterparts than the big banks, according to Moody's.

"For a large bank, it could be an earnings event for a quarter, rather than something that really depletes capital," said David Fanger, a senior vice president on Moody's banking team.

http://finance.yahoo.com/banking-budgeting/article/108762/loan-repurchases-are-a-10-billion-problem-for-big-banks