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Growing Divergence in Bank Mortgage Risks

Following a robust recovery after the Global Financial Crisis, operating profits at banks have flattened over the past year (See Chart 1 below). Headwinds from a flat yield curve and weakness in mortgage profitability have acted as a counterbalance to more favorable trends related to strong labor markets and low credit losses. We have recently documented how weakness in the mortgage market has led to an increased risk profile overall in mortgage lending[1], and how this is very likely a material factor in the recently-announced merger between BB&T and SunTrust[2].

Chart 1. All FDIC-Insured Institutions Quarterly Net Income

An interesting question for bank analysts is how this increased risk is distributed across individual institutions. This note looks at this question for four large banks from the perspective of their activity in the mortgage servicing business.

Mortgage servicing is a risky business. Participants are subject to prepayment risk if mortgage rates fall. They are also subject to credit risk as they bear the costs associated with working with delinquent borrowers. As a consequence, banks have to reserve substantial capital against holdings of these assets on their balance sheets[3]. But during times of steady interest rates and low unemployment, this can be a profitable enterprise.

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[1] https://agency.recursionco.com/documents/CredigCrumbles.pdf
[2] https://agency.recursionco.com/documents/BB&T_Merger.pdf
[3] https://www.federalreserve.gov/publications/other-reports/files/effect-capital-rules-mortgage-servicing-assets-201606.pdf

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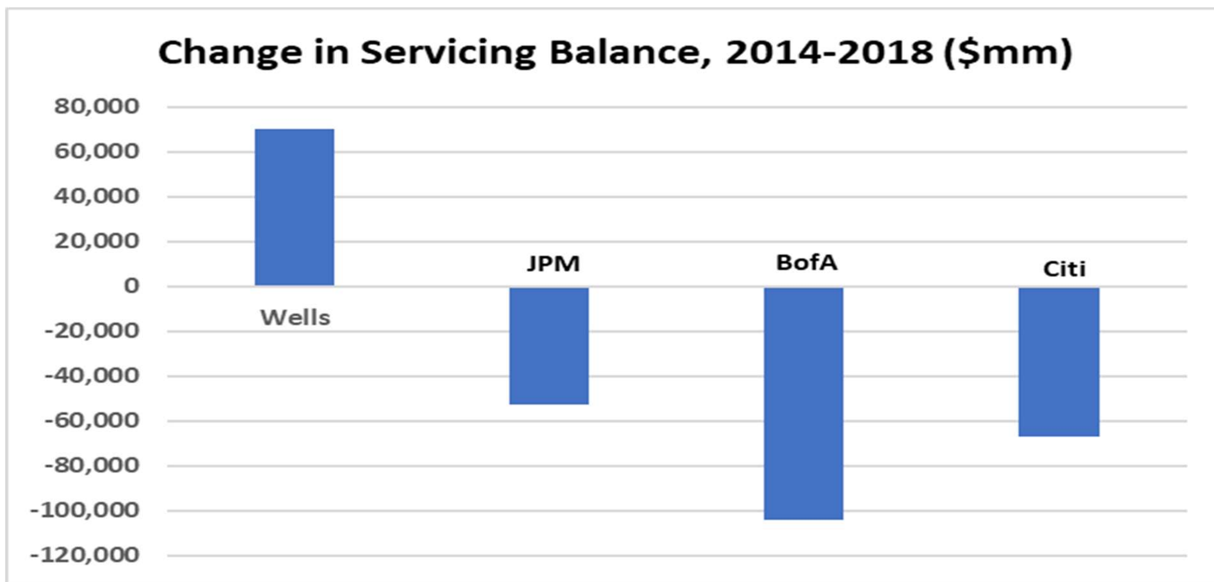
Using Recursion loan-level data from agency pools, we can look at trends and the composition of MSR holdings for individual banks. Chart 1 shows the change in the magnitude of MSR portfolios for Wells Fargo, JP Morgan, Bank of America and Citibank from 2014-2018.

Chart 2. Change in Servicing Balance for Selected Banks



Source: Recursion Co

Clearly Wells Fargo stands out. To gain a clearer picture about these developments, Table 1 shows the year by year evolution of the balance, along with data regarding direct purchases and sales of servicing rights.

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Table 1. Mortgage Servicing Portfolio Balance By Bank($mm)

	Wells Fargo		Bank of America		JP Morgan		Citi Bank	
As Of	Agency Servicing Balance	Servicing Purchase	Agency Servicing Balance	Servicing Purchase	Agency Servicing Balance	Servicing Purchase	Agency Servicing Balance	Servicing Purchase
201903	967,065	-197	116,991	-150	326,109	133	40,385	0
2018	933,897	43,144	111,053	-12,437	321,981	4,869	66,007	-7,811
2017	923,424	-288	143,865	-9,276	334,764	-4,517	73,568	-45,923
2016	899,231	0	164,885	-906	325,947	-4,496	99,843	-4,116
2015	897,923	2	195,428	-40,436	346,555	-20,684	108,663	-2,024
2014	903,983	0	215,067	-6,844	390,887	-6,174	107,737	-1,846

While JP Morgan, BoA and Citi all were active sellers of servicing rights over the 2014-2018 period, Wells Fargo maintained its portfolio for the first four years and then purchased $43 billion of servicing rights last year, mostly from Seneca Mortgage Services, as the latter exited the space. Of course, 2018 was a notable year for Wells Fargo as the Federal Reserve levied sanctions that preclude them from expanding their balance sheet[4]. The precise considerations which led Wells to institute its unusual strategy towards servicing rights remains unclear. Recursion data shows that, during the past two years, Citi sold $52B of its conforming servicing book to New Residential Mortgage, making New Residential a significant player in the GSE servicing landscape. Notable purchasers of servicing rights from Bank of America include Carrington ($32B) and NationStar($20B) during the 2015-2018 period.

Then, there is the natural question as to whether the composition of the servicing books contributes to their risk profile. Table 2 indicates the share of the servicing portfolio that consists of loans issued into Ginnie Mae pools.

[4] https://www.federalreserve.gov/newsevents/pressreleases/enforcement20180202a.htm

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Table 2. Ginnie Mae Share of Servicing Book (%) for Selected Banks

As Of Year	Wells	JPM	BofA	Citi
2018	29.3	20.2	11.6	16.8
2017	34.2	25.2	20.3	18.7
2016	38.3	29.9	26.2	10.9
2015	42.7	32.7	28.7	12.3
2014	45.9	37.6	48.6	14.2

Once again Wells is the standout with almost 30% of its servicing comprised of Ginnie Mae loans , nearly 10% greater than JP Morgan, the next largest among the large borrowers.

Table 3. Credit Characteristics of Selected Bank Servicing Portfolios, 2018

		Wells	JPM	BofA	Citi
Government					
	CS	712	701	722	684
	DTI	38	38	39	40
	LTV	94	95	93	93
Conventional	CS	752	751	751	745
	DTI	34	34	34	34
	LTV	76	75	72	71

As can be seen, the credit characteristics for servicing rights for Government program loans are uniformly looser than for conventional mortgages. Wells' greater share in GNM eligible mortgages implies a distinctly riskier portfolio.

This exercise serves to point out the utility of big data tools to monitor the risk profiles of banks. Whether Wells Fargo will post superior performance compared to its peers or not remains to be seen, but the ultimate outcome will depend to no small extent on future developments in the mortgage market.

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