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EXCLUSIVE

Fed rate cuts offer relief, refi's, but no free lunch for lenders

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By Lauren Keyson

Recent rate cuts by the Federal Reserve might prompt a wave of refinancing applications but they are unlikely to bail out the most troubled borrowers or their lenders.

As the Fed began easing rates last summer, loan applications jumped during the months of August and September, but it turned out to be a false measure of how many people received loans. Borrowers' credit scores "were much weaker than required to qualify," Doug Duncan, chief economist at the Mortgage Bankers Association, said.

Loan applications have again accelerated following the most recent Fed cuts, with the MBA's weekly mortgage applications survey for the week ending Feb. 1 showing an increase of 3.0% on a seasonally adjusted basis from one week earlier and a jump of 73.2% on unadjusted basis from the same week one year ago.

A large portion of new applications, 68% to 70%, are refinancings, Wells Fargo senior economist Scott Anderson said.

"The Fed Rate cut did increase the number of applications — refi's being up 160% year over year for all banks — yet you have to be a little suspect of that number because there are probably a number of people taking out multiple applications," he told SNL.

Jim Wiener, managing director and head of finance and risk practice in North America for Oliver Wyman, said that the likelihood of many of those applications leading to a refi boom is not probable since credit standards are tighter.

"I think you will still see an increase in closed loans, but relative to prior refi booms I think there will be a much lower pull-through rate," Wiener told SNL.

In addition to tightening lending through pricing, Duncan said that banks put ceilings on loan-to-value ratios in markets where home prices have fallen the most and reduced their reliance on third-party lending.

"Borrowers are being denied," Duncan told SNL. "Just because the Fed cuts rates doesn't mean people are going to be able to qualify easier if they don't have a mortgage."

The rate cuts are not necessarily helping struggling borrowers either. Richard Pratt, chairman of mortgage finance consulting firm Richard Pratt Associates, said the cuts are not bailing out the most troubled borrowers — those with subprime loans.

"The people that need to be bailed out are those who, by definition, are not the best credits," Pratt told SNL.

The Treasury Department's "Hope Now" initiative is in part aimed at addressing this issue, aiming to help as many as 1.2 million households either through loan modifications or temporary interest rate freezes. Wells Fargo's Anderson, whose company is part of the Hope Now alliance, said that the initiative will help people who can afford their payments now, but will not be able to do so when their loans reset.

"The problem is many people don't even realize they are in trouble," Anderson said. "Half the people who are in trouble, or are in danger of defaulting, don't even contact their mortgage bankers."

And with the subprime market completely evaporated, FHA loans are now rising, according to National Association of Realtors spokesman Walter Molony. "We're projecting that they will be about 8% of the market this year," Molony told SNL.

The Fed rate cuts have lowered the cost of credit for all borrowers and thus made "circumstances somewhat better for people that are in trouble," Robert Davis, executive vice president of American Bankers' Association, said.

"The cuts are also helping lenders who in the past had more sound practices to have the liquidity to make new loans and to encourage confidence in the markets. But the Fed's actions do not eliminate the embedded losses and bad credit judgments that were made in 2006 and 2007," Davis told SNL.

Pain will be felt by banks holding '06 and '07 vintages, but cash flow from some refinancing activity, even if it is muted, will help offset those losses. Any level of refi activity has not yet translated into higher home sales, but Molony believes that the rate cuts in January and higher loan limits announced Feb. 12 will eventually lead to higher sales in second half of 2008.

"We'll see the pace of sales rise from a 4.9 million annual rate in the first half of the year to 5.8 million in the second half of the year — with pace of activity continuing to improve in 2009," Molony said.