Bauerle's Bank Notes

Fresh Air

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The world of high finance, American-style, has been turbulent this last decade. Truth has been stranger than fiction, as they say. Consider the new words and phrases that have entered the lexicon. The "Great Recession" began with the collapse of the "Bear Stearns High Grade Structured Finance Fund" and the "Bear Stearns High Grade Structured Finance Enhanced Leverage Fund," gibberish only Wall Street could coin. The funds were filled with "toxic assets," consisting of "CDO-Squared" bonds and other "sub-prime" obligations whose makers lived in places like Stockton, California, but whose credit defaults, and the failure of associated "credit default swaps," rippled through Europe, Asia and everywhere in between. Only massive intervention by the Federal Reserve and other central banks, the U.S. Congress, two Presidents and savvy investors like Warren Buffett prevented a decade of Japanese-style deflation.

To those with their fingers on the pulse of local economies, the crisis was predictable if not inevitable. In 2006, we visited with a bank CEO in the Allegheny Mountains who marveled at the mortgage loans Countrywide, Washington Mutual and their ilk were making to customers well known in his community to be poor risks. "Everyone within 50 miles knows these people are bad paper," he said. "I can't imagine what the lenders are thinking." Turns out they weren't. In 2005, when speaking to the Financial Managers Society of New York and New Jersey, I asked the audience what problems they saw on the horizon. "Inflated residential real estate values," answered a New Jersey banker without hesitation.

The backlash that has ensued has brought us the Consumer Financial Protection Bureau, departure of most major banks from mortgage lending business, emergence of unregulated mortgage servicing companies like Ocwen Financial Corporation (NYSE: OCN), whose practices have been successfully challenged by attorneys general in 49 states, and news accounts of wealthy homeowners who have traded the income tax benefits of mortgage financing for the borrowing simplicity of using investment accounts as collateral for personal loans. So it came as a breath of fresh air that one Western Pennsylvania regional bank, First Commonwealth, announced last week its systematic reengagement in residential mortgage financing. The bank's move in our view is salutatory from multiple points of view.

- For the two-thirds of Americans who own their homes, mortgages represent the bedrock of their financial relationship with the world. The bank that owns their mortgage has first claim on their hearts and minds. "Home is where the heart is," goes another old saw.
- Western Pennsylvania homeowners are a conservative lot. Most have at least 50% equity in their residences. Property values are not volatile. That makes mortgage lending a safe bet, provided interest rate risk and other dynamics are managed effectively. The calamity of the last decade in mortgage financing occurred because trading culture and speculation invaded a market sector that usually has all the excitement of watching paint dry.
- "Hit 'em where they ain't," was Wee Willie Keeler's explanation for his prodigious batting average in the early years of professional baseball. First Commonwealth's embrace of what others are avoiding is a thoughtful tactic that defies financial markets' propensity to follow the crowd, which created the problem a decade ago.
- Aftershocks of the Panic of 2008 have delayed household formation among the so-called Millennial Generation. This demographic group is sizeable, as children of the Baby Boom generation. Inevitably, they will need mortgage financing. First Commonwealth and those that provide it stand to gain not just for the moment, but a generation.
- As the centerpiece of household finance, residential mortgage lending is the gateway to serve every other life-event driven financial need. Included here are life insurance, higher education financing, retirement planning, elder-care and special-needs trust funding, and installment lending to support purchases of automobiles, white goods, home improvements and other consumer durable goods.

Our steadfast belief is that regional banks are here to stay. Consumers need them. Communities do too. Most Congressional districts have one, which makes them a force to be reckoned with, even if regional banks don't always exercise their political franchise effectively. Mortgage banking is, to use a business cliché, a core competency for regional banks. Here is hoping First Commonwealth's strategy succeeds brilliantly, and others follow suit.