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Third-party originations: What the future may hold

By David Walden

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When offering my opinions on the subject of the future prognosis for the mortgage broker industry, I have only one agenda and that is how to save the mortgage broker industry. I certainly do not speak for the Mortgage Bankers Association (MBA) as a trade group spokesperson, but I am offering uncensored straight talk from real experience. I'm entering my 39th year in this business, and until eight months ago, I co-owned a third-party wholesale operation that was also a division of a federally-chartered thrift. I am a mortgage banker, and I exchange knowledge and ideas almost exclusively within mortgage banking circles from board rooms, management retreats, and lounges at industry trade shows, the office water cooler, telephone, e-mails, and inner-industry trade publications.

It is a complete mistake born of misunderstanding to believe mortgage bankers want to completely re-assume the responsibilities of meeting the total demand for mortgage originations. In the late 1980s and early 90s, mortgage bankers basically gave birth to the mortgage broker industry of today because the business cycles of originations, coupled with almost uncontrollable losses in other business units of bank-owned mortgage banks, forced the reductions of overhead associated with the mortgage origination platforms. We avoided incremental overhead (on the balance sheet) by using outsourced overhead (off balance sheet) thanks to the brokers.

When we come out of this "meltdown" there is very possibly going to be a fairly rapid ramp-up of business demand for real estate financing, especially because the downside has been so protracted. Realtors are tired of starving and pent up demand from consumers previously frozen with fear will give them the opportunity to get back on the road to prosperity. The same holds true for homebuilders. Everyone in this business, and all allied business groups, are going to be even more hungry than today! There will be pressure on new product development to assure that the American dream will again be within reach for most Americans who wish to own a home. Five major banks will own in excess of 65 percent of all mortgage servicing rights and while Troubled Asset Relief Program (TARP) funds have mitigated the effects of their shrinking net worth resulting from runoff, those lenders will need to stem the tide of rapid runoffs as quickly as possible for their stockholders. There will be limited servicing available to purchase at cost-effective prices. Therefore, it must come from production. Their own existing production operations will soon prove to be insufficiently staffed and trained to meet this demand. This industry has lost a lot of its trained, seasoned human resources from the production side of the business. We will absolutely need the surviving community of mortgage brokers to help generate the volume required to stem the servicing portfolio runoff once this cycle turns upward!

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Yet today, their very survival is being threatened by program eliminations, closings of wholesale lenders, mortgage insurance restrictions and new legislation. Why? Over the past three years, mortgage bankers have been perpetually analyzing what went wrong in each file that began failing our performance expectations, including the "what/why/who" of each file. The analysis of data across the total industry indicts the broker more than any other origination group.

In my opinion, the compensation structure of most mortgage brokerages is the number one factor that compromises the ethical focus of the originators. Number two is poor or non-existent supervision, and number three is the absence and/or enforcement of traditional quality control practices, both of which are prevalent at the significant number of poorly-managed mortgage brokerages when compared to the more structured, rules-based culture typical of a mortgage bank. Not at the trade association level, but within the individual businesses themselves. Servicing mortgage bankers conduct the origination business for the servicing rights of the loans. They don't want to put defective business on their books because it doesn't perform and contaminates their portfolio or securities. They certainly don't incent their originators to break the rules and will not hesitate to terminate production personnel found to be involved in fraudulent activity. That includes fraud by omission or commission. They typically pay the lowest commission rates of all origination platforms. If one of their originators seeks to achieve gross earning levels comparable to those working in other origination platforms, they must create that opportunity through higher volume. Non-servic-

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ing mortgage bankers often pay a slightly more generous commission rate than servicing mortgage banks because their profit and loss (P&Ls) margins are totally fee income-driven, yet still discourage the origination of defective products. They too will terminate any production employee found to be practicing unethical origination tactics of any kind because they are obligated under strictly enforced correspondent lending contracts to repurchase loans determined to be defective, in addition to first pay and early pay default liabilities. Mortgage brokers typically pay the highest per unit commission rate of all origination platforms. They too are totally fee-driven, with commission rates that have ranged from 60 to 90 percent of total fee revenue, including yield spread premiums (YSPs). This is often rationalized due to the lack of benefits offered by the employer and the "harder sell" scenario created by discriminating disclosure requirements that limit those originators from achieving the unit volume enjoyed by servicing and non-servicing mortgage banks, banks and credit unions. If the originator is a valuable contributor to the bottom line of the brokerage, there is a predictable reluctance to take decisive action against the guilty originators by the owner/broker. The wholesale agreements with the lenders have been too weakly worded or passively enforced, and those who were enforced were ignored by the brokers or they simply closed up and re-opened under another name. This author is definitely not for limiting or capping origination income for loan officers. However, I am not an advocate for low volume/high commission incentive programs.

But what about the sub-prime and Alt-a programs? Let's be clear about this. It is not so much the liberal terms of programs and/or underwriting that caused the majority of the losses driving the meltdown. It is the misuse of those programs and the documentation trickery and counterfeiting that drives a majority of the losses. The analysis also demonstrated that, by early 2008, approximately 60 percent of mortgage fraud was "fraud for shelter," but only represented approximately five percent of the losses. That's right … liberal programs only represent five cents of the dollars lost in the meltdown! The explosion of foreclosures skews that figure after the beginning of 2008 due to short sales and rapidly deteriorating property values. But the meltdown was seeded way in advance of 2008! On the other hand, approximately 40 percent of mortgage fraud was "fraud for profit" and represented approximately 95 percent of the losses. That indicates it is not the programs themselves but the abuse of the programs that are the root of the real problem, as well as this disagreement of where we are! Arguably nine out of 10 of the fraudulent loans were broker-originated! Mortgage bankers know it. Banks know it. And equally as important, the regulators know it. That's why modifications of business and risk models used by lenders and insurers are not the principal threat to the survival of the brokers, but rather the eliminations, delivery channel closings, mortgage insurance restrictions and new legislation, much of it directed against brokers who are the principal threat.

The fix to this problem is both simple and complicated. First, modify the compensation structure to more closely resemble that of mortgage bankers. Paying a higher rate to offset the lack of a benefits program is fair, but it should be kept at a reasonable level. Reallocating some of the excessive commission rates to payroll to strengthen supervision and quality control systems would improve the business model significantly, and would go a long way to meeting the next objective. Next, push to change some of the laws requiring brokers to disclose their earnings in a manner other origination platforms are not required to do. In other words, level the playing field so brokers can better focus their efforts on unit volume, rather than income per unit. It's in the mortgage banker's interest to do whatever it takes to preserve the mortgage broker business. They will need the production, and wholesale platforms are typically less expensive to operate and maintain than retail platforms, especially in stagnant or down cycles. In addition, and at least as important as any other step, mortgage brokers must defeat the reputation that is creating so much fear that the lenders to whom brokers were their best customers are turning their backs on the third-party originator industry? At the trade association level all the way down to the individual broker level, they must become more active and visible in their efforts to clean up their own backyard. They must stop prioritizing fear of litigation over the survival of the more intense threat to your business and industry. They know who the bad guys are. Their own loan officers tell them daily when they report that another broker got a loan approved and closed … that experience tells the honest and prudent broker would absolutely not qualify within the stated and intended terms of any known program. We, as third-party lenders, need the brokers to rebound and survive, but they must take the lead to make that happen from this point on.

David Walden is a 39-year veteran of the mortgage banking industry, specializing in the mortgage production management of retail, wholesale, correspondent and affiliate branch origination strategies, and currently owns Production Solutions, outsourced production management and staffing. In addition, David also owns Risk & Recovery Solutions, conducting mortgage fraud detection, investigation, prosecution and asset recovery. He may be reached by e-mail at david@randrsolutions.biz.