

The Future of Mortgage Warehouse Lending
A Leadership Imperative for Independent Mortgage Bankers
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Restoring the productivity of the U.S. mortgage marketplace is a critical, perhaps linchpin, element of both domestic and global economic recovery. Despite conditions ripe for our industry to experience resurgent and restorative volume, independent mortgage bankers have been restrained by a massive retreat from warehouse line lending. Some warehouse lenders succumbed to insurmountable losses on subprime and non-performing loans of defunct mortgage bankers, while others made hard choices on balance sheet allocation and the “perceived” risk of warehouse lending before exiting the market.

As a by-product of a shrinking pool of warehouse line funds, independent mortgage bankers are being competitively marginalized. This marginalization translates into borrowers not having access to competitively priced loan options. “Big Bank” lenders saved by TARP allocations are gaining market share, which poses a dangerous imbalance to our recovery and long-term financial sustainability.

Grave Consequences Misunderstood

As the result of its relationships with independent mortgage bankers and its role as an expert in mortgage back office operations and fulfillment processes, Titan Lenders Corp recognized the gravity of the situation as it emerged in earnest during Q4 of 2008. Titan has been on the front line with independent mortgage bankers as they experience the diminishing capacity to fund loans.

The warehouse line lending paradigm shift triggered our decision to take an active, outspoken role in educating Wall Street business media and public policy representatives. We were concerned that the consequences of the problem were inadequately understood. Due to the efforts of the MBA and organizations like ours, the issue is finally being addressed and becoming a topic of active debate and discussion.

Based on our close analysis of the withering warehouse lending capacity, we have concluded that independent mortgage bankers must seize the debate, identify solutions, and collaborate to ensure a multifaceted resolution that better meets their needs is brought to bear. Like the true entrepreneurs they are, independent mortgage bankers must come together and create their own solutions. Think outside the box. They do not have the luxury of waiting for the GSEs to move or TARP funds to come along to bail them out.

How Did We Get Here?

Over the last four to five years, the number of financial institutions offering warehouse lines of credit to independent mortgage bankers declined from nearly 115 at its peak to fewer than 25

today, representing an 80 percent reduction in warehouse lending facilities for the industry. Lenders that utilize warehouse lines of credit originate approximately 41 percent of all U.S. residential mortgage loan originations and nearly 55 percent of FHA loans. By the end of Q1, it was clear from discussions we were having with lenders nationally that they were deeply concerned about the dwindling availability of warehouse lines and the possibility that a lack of liquidity would curtail or close their business. The loss of a warehouse line for an independent mortgage banker time is a business-ending event in many cases.

As of May 2009, less than \$25 billion in warehouse line capacity was available to independent mortgage bankers, a figure that stood in stark contrast with the MBA estimates for anticipated demand of \$2.78 trillion in originations for 2009, up from a \$1.6 trillion in 2008. It is conceivable that there will be a \$630 billion shortfall in home mortgage financing availability caused by a lack of warehouse lending capacity.

As dictated by the rules of economics, scarcity in warehouse line liquidity is driving up costs for non-depository lenders and borrowers. During the MBA Secondary Conference in April, we encountered several lenders who were actively renegotiating renewal of their warehouse line at previously unheard of terms defined as note rate plus 300 bps with a penalty of 50 bps for every dollar not utilized at least once within a 30 day timeframe up to the line limit. Nonrefundable application fees in the amount of \$1,500 have been the norm, but some lines have been trending upwards to around \$5,000 and correspondents have been paying in the hope of getting a line to meet rising origination demand.

Recovery Stymied at Origination

Fueled simultaneously by growth in first-time residential purchases and refinance activity due to historically low interest rates, mortgage demand has swelled in the first and second quarters of 2009. From a demand standpoint, public policy of low rates and tax credits seems to be having the intended effect. However for the small business arm of mortgage banking, there is evidence that a portion of that demand is being stymied at origination due to severely limited liquidity.

In combination, these circumstances threaten the survival of independent, community-based mortgage businesses. The risks inherent to a shrinking marketplace of independent mortgage bankers will have a ripple effect, creating a less cost competitive environment for purchase borrowers of all kinds, dangerously limiting refinance opportunities for troubled homeowner households, and further eroding local economic vitality.

Unfortunately and because warehouse lending is a more arcane facet of how the industry performs, it has been an “elephant in the room” as regulators and politicians try to hammer out stimulus policy focused largely on “reactionary” measures related to toxic mortgage-securitized assets at the highest levels of finance. Arguably because of the virtual invisibility of this enormously important contributor to mortgage finance liquidity, opportunities to compress the duration of economic malaise at the local community level are being squandered and misspent.

Situation Plays Well for "Big Bank" Lenders

There is simply not enough money in the system to allow both independent mortgage bankers and correspondent lenders to service consumer demand in their communities. They must pick and choose which loans to fund at the end of the month. Liquidity issues have even moved some remaining warehouse lines providers to suspend refinance transaction funding in favor of purchase money business at the end of the month, which can be disastrous for FHA streamline refinances.

Independent mortgage bankers are finding themselves less competitive to the Big Banks, as they extend locks and absorb the increased costs to retain customers. Rather than being rewarded for the strength of a business model that exhibited sober and conservative growth through the industry collapse, they are being edged out of their markets and forced to turn away from less profitable business channels traditionally underserved by the Big Banks. The Big Banks, on the other hand, are overwhelmed with demand but unconstrained by supply. They are definitely enjoying the opportunity to shore up their margins. This core imbalance in the infrastructure of the industry illustrates how well intended policy may have unintended consequences that must be addressed simultaneously.

MBA Urges Solutions

After analyzing the problem with the help of groups like The Warehouse Lending Project, the Mortgage Bankers Association (MBA) sent a recommendation brief to the Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corp. and the Office of Thrift Supervision.

This brief acknowledged that "... warehouse lending contributes to the financial capacity the industry provides for originating loans for first-time homebuyers; refinancing troubled borrowers into new mortgages; assisting other borrowers in securing credit for residential mortgage transactions; and originating loans for the purchase, refinance or repositioning of rental properties." The MBA further proposed that federal banking regulators cut the capital requirement on warehouse lines of credit by as much as 80 percent to alleviate a funding crisis facing non-depositories.

Unfortunately, for many independent mortgage bankers, the need for solutions is immediate. While motivating regulators and legislators to address the problem is a means to resolution, it will not be timely or address the situation currently at hand today.

Independent Mortgage Bankers: Carpe Diem

Calls for GSE intervention are constrained by charter limitations that require legislative

intervention. Lowering RBC (risk-based capital) requirements will not alleviate balance sheet allocation concerns. Clearly, we need to entice new warehouse lenders into the market. Motivated and inspired by its necessity, independent mortgage lenders must seize the day and become the driving force behind an inventive transformation of warehouse lending – expanding beyond its traditional embodiment as a peculiar type of lending for a single type of institution.

Warehouse lending is neither so complex nor so risky that regulated depository financial institutions cannot manage it. It also currently delivers a return on investment that makes it a desirable private equity tool in today's market. Independent mortgage bankers must individually, and as a group, work to persuade their community financial institutions on a grass roots level to create warehouse facilities that will allow them to facilitate mortgage financing in their communities.

As a note on risk in the current market, Denver-based Assurity Financial's CEO and Managing Member Calvin Hamler, an out of the box entrepreneur looking for additional capacity, told Titan he was "proud to tell the world that the average FICO for our loans funded in March was 723."

"The fact that we bank such pristine collateral is one of the reasons our warehouse lenders have always loved us so much – they have never taken a loss in doing business with our organization because of our very conservative approach to credit risk management," Hamler explained.

Assurity is a Denver, Colorado based mortgage banker with both retail and wholesale channels of production, specializing in FHA loans as a full eagle, Direct Endorsement lender, and a Fannie Mae approved seller, conducting business in 26 states.

"Never having focused on subprime or Alt-A loans and having been profitable for all seven years we have been in business, along with a very strong first quarter of 2009," Hamler said. "We are well positioned to continue to execute an aggressive growth plan in all channels of production to continue to gain market share."

Private Equity Funding

Some independent mortgage bankers have already discovered the option of establishing a warehouse line through private equity. GMI Home Loans (gmihomeloans.com), a New Jersey retail mortgage banker originating approximately \$500 million per annum in conventional, FHA and reverse mortgages, encountered liquidity challenges soon after its launch in 2007 when access to warehouse line facilities began shrinking industry wide. GMI turned to NVC Premier Fund LLC, an entity managed by New Vision Capital Partners, LLC, for its funds, and worked with Titan Lenders Corp to develop a warehouse line process management platform.

"As a matter of necessity, we went outside the box to secure reliable liquidity for our business,

and found a private equity source to fund our warehouse line," said GMI Home Loans founder and president Glen Lemeshev. "Making it work for our correspondent investors required that we secure a third-party administrator and custodian, and put into place processes and safeguards that ensure our loans are accepted for purchase by them."

Wall Street's volatility and a general degradation of quality in the bond market could be offset by the relative security of warehouse lending, which offers a solid return on an extremely low risk investment. Considering that residential real estate loans today are of the highest caliber in 15 years, with a product mix limited to agency and government backed loans, the stage is set for private equity investment into mortgage warehouse line lending.

Private equity funds can fill the gap between loan origination and ultimate investor with minimum start up and operating costs by outsourcing the technology infrastructure and process management. They can pilot programs on a smaller scale, taking their capital to market in a highly structured, process-driven environment. When these processes are refined and perfected, funds can scale up, down, regionally, nationally, conforming or niche.

Community Financial Institutions

Community-based lending for community-based businesses is a natural combination. Independent mortgage bankers should target, educate and entice their community Financial Institutions to fill the gap that threatens their localized mortgage economy. They should urge those financial institutions to advocate for the modification of some capital requirements for Community Banks and Credit Unions on Warehouse Line Lending and get the ball rolling!

Community financial institutions know the mortgage business well enough to be both originators and warehouse line lenders. Both are profitable models, both are sustainable for today's lower risk lending, and both promise consistent growth.

According to industry sources, credit union originations were up by 17 percent in 2008 at the same time that overall mortgage originations fell 39 percent. The result was that the credit union share of total mortgage lending jumped from 2.5 percent in 2007 to a record-high 4.7 percent in 2008. Nearly a quarter of credit unions 2008 originations came from five institutions – Navy Federal in Virginia, State Employees in North Carolina, Pentagon in Virginia, Boeing Employees in Washington, and Alaska USA in Alaska."

Clearly the current recession and declining consumer confidence in large banking institutions has created a great opportunity for credit unions and community banks to grow their customer base. As many reports have highlighted in recent weeks, despite the struggles of Big Bank institutions, smaller banks, community banks and credit unions have not experienced the same issues because they did not engage in risky investments.

Although they account for less than 10 percent of America's total banking assets, community banks' traditional, values-based approach is a model not only for their larger Wall Street

mortgage lending counterparts, but for traditional warehouse lenders. Most community bankers know their customers, both consumer and commercial.

Getting Started

Although more complex than other types of commercial lending, warehouse lending services can be effectively managed by a lean staff supported by an expert services provider. Independent mortgage bankers can be helpful in explaining to community institutions and private equity funds the advantages of aligning themselves with experts offering a solid understanding of mortgage warehouse line lending, origination, investment and regulation. Ideally, the provider will offer comprehensive fulfillment services and expertise to execute a warehouse line and include an operating platform limiting the required technology investment.

Warehouse lending outsource services providers should demonstrate a broad scope of operational expertise for both the primary and secondary mortgage markets, including a unique perspective on investor requirements to purchase loans; how to forestall salability issues; clarify process and procedures necessary to avoid repurchase, fraud and errors in production effecting salability; and take corrective measures quickly and efficiently in the event of worst-case scenarios.

Providers should be able to demonstrate that their warehouse lending service platform includes collateral management, line reconciliation, and technology infrastructure, providing community financial institutions and private equity fund managers the same operational support as any traditional warehouse line lender.

A Call to Action

"Progress is impossible without change, and those who cannot change their minds cannot change anything." George Bernard Shaw

In the vacuum created by the demise of traditional sources of capital liquidity, independent mortgage bankers have an opportunity to redefine the future and character of warehouse line lending. It is their opportunity to regain a greater sense of control and predictability allowing them to make more meaningful contributions to the health and economic self-determination of their communities.

Mortgage bankers should view their impact on the future of warehouse lending as one of their greatest leadership imperatives. By approaching community financial institutions or investors and adopting outsource alternatives for warehouse lending operations service, independent mortgage bankers can speed the entry of de novo warehouse facilities such as private equity funds and community financial institutions into a structured investments that help to secure their own future in the industry.

