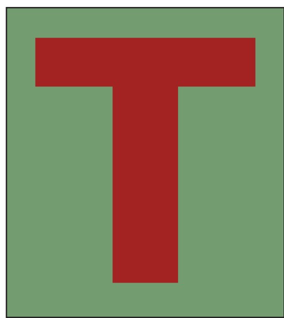
The FUTURE of Wholesale Lending



The mortgage industry is a financial intermediary that exists to connect individual borrowers to sources of capital. Though the way capital is intermediated on its way to borrowers has changed dramatically throughout the decades, this has continued to be the industry's ultimate goal. ■ Regardless of the complexity of the industry's structure, two touch points have always been critical: the relationship with the individual borrower and the access to capital. ■ In much of the last decade, access to capital has been a commodity. The so-called wall of liquidity enabled nearly universal access to cheap funding. Investors competed to own even thin-yielding assets. ■ The global abundance of funding liquidity and the indiscriminate hunt for yield reduced the strategic importance of having access to capital. Instead, value shifted to the other touch point of the mortgage industry—the relationship with the individual borrower. In a world of cheap capital, asset-generation is the primary source of value creation. ■ Brokers—who specialize in creating and managing relationships with individual borrowers but who do not have direct access to capital—were among the primary beneficiaries of this recent capital-flush environment. Brokers focus on marketing, pursuing leads, and customer interaction and service, and were able to capture much of the value from generating loans for a market more attuned to yield than to asset quality.

The wholesale lending channel is under stress from a variety of forces today. But broker lending is far from dead; instead, the business model is just evolving.

BY MATTHEW LIND, JEFF BABCOCK, MICHAEL ZELTKEVIC AND PIYUSH TANTIA

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Lenders, many of whom also had in-house mortgage origination units that competed against brokers, were generally happy to fund broker-originated loans. For lenders, brokers act as a valuable variable-cost source of loans.

Because borrowers in the United States usually have a no-penalty option to prepay their mortgages, overall origination volume is highly variable in response to interest-rate changes. During a refinance boom, such as happened in 2003, large mortgage seller/servicers with high fixed-cost servicing platforms must attract new loans to replace those that prepay. Mortgage brokers flourish during such times.

The highly favorable conditions for mortgage brokers that held for much of the current decade are now gone. In this article we survey the fallout and outline what the future may hold for broker-based wholesale lending.

Ultimately, the broker business plays a valuable role in the mortgage industry and is unlikely to disappear. However, it will need to change and is unlikely to return to the heights of the recent past any time soon.

Current trends in wholesale lending

Broker-originated mortgage lending experienced strong growth over the first half of the decade, driven first by the dramatic refinance opportunity and then by nonconforming originations—primarily in the subprime segment, but also in the alternative-A space and other exotic, risk-layered products. By capturing a large portion of originations of these newer products, mortgage brokers maintained a significant share of total mortgage originations during the housing boom (see Figure 1).

Because growth in the broker market was based on outsized broker participation in the origination of non-prime, non-traditional loan products, broker originations are now following these sectors into decline. Since 2007, brokers have been losing share to the retail channel (see Figure 2).

Annualizing data from *National Mortgage News'* production survey for the first half of 2008, wholesale originations on an annualized basis are down 45 percent over 2007. The broker channel is now undergoing a significant downsizing, with the number of wholesale lenders, brokers and broker-originated loans all decreasing.

Reduction in the numbers of wholesale lenders is being driven both by voluntary exits from third-party origination (TPO) channels as well as by institutional failures, as illustrated in Figure 3. Charlotte, North Carolina–based Bank of America's plan for the future role of Calabasas, California–based Countrywide Financial Corporation might reduce its wholesale market presence significantly.

A full one-third of the top-60 wholesale originators in 2007 have departed the broker channel, representing $214 billion or 32 percent of the total 2007 wholesale production volume.

While one could conclude that competition for broker business is decreasing, the more accurate observation is that fewer lenders are seeking their share of a much smaller pie. In other words, capital is no longer cheap and abundant.

Factors driving the evolution of the broker market

This dramatic realignment of the broker wholesale production business is being precipitated by a host of interrelated factors, including (in no particular order):

- A shift in origination mix from the broker-dominated segments to lower-risk, lower-margin products;
- Lenders' desire to exercise greater quality control over front-line origination processes;
- Financial and reputational pressure on bank lenders;
- Funding and operational pressures on independent wholesale lenders;
- Agency pricing and policy changes; and
- Retention and cross-sell for bank-affiliated customers

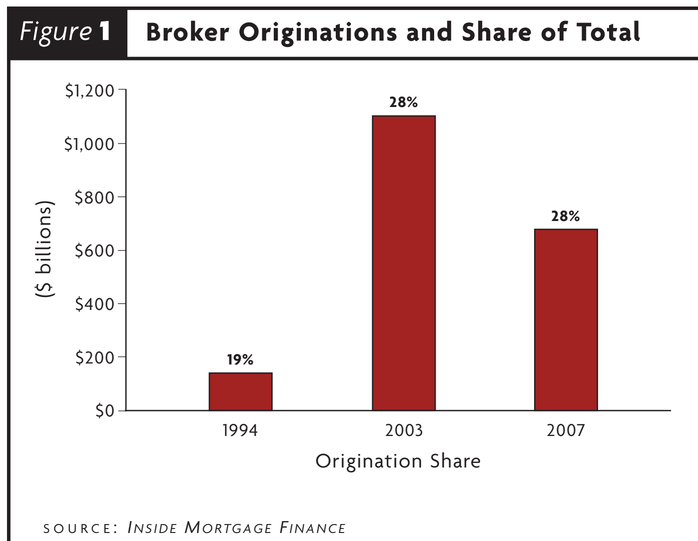
Now let's examine each of these factors in more detail.

SHIFT IN ORIGINATION MIX

The meltdown in subprime and alt-A lending virtually eliminated the higher-margin loan products upon which wholesale lenders were dependent to achieve profitability. According to the Mortgage Bankers Association (MBA)/STRATMOR Peer Group Survey and Roundtables, this is evidenced by the megalender wholesale peers' reported average profit of 18.44 basis points (bps) for the first half of 2007, compared with a loss of 21.85 bps for the full year.

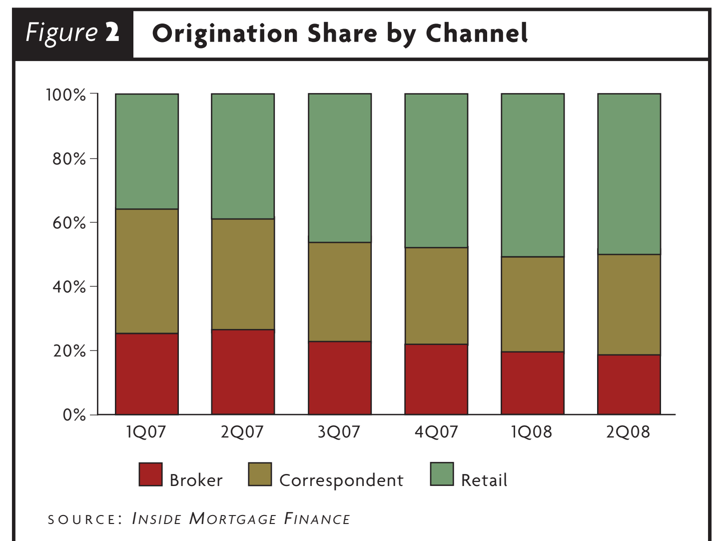
Many wholesale lenders found it difficult to retool their origination platform from subprime and alt-A production to

Figure 1 Broker Originations and Share of Total



SOURCE: *INSIDE MORTGAGE FINANCE*

Figure 2 Origination Share by Channel



SOURCE: *INSIDE MORTGAGE FINANCE*

agency and Federal Housing Administration (FHA)/Department of Veterans Affairs (VA) originations. In many cases, their broker customer base was so committed to nontraditional products they were forced to leave the business rather than convert to sourcing traditional loan products.

Lenders' desire to exercise greater quality control over front-line origination processes

MBA/STRATMOR Peer Group data confirm that mortgage brokers originated a significantly greater share of low-documentation, interest-only and option adjustable-rate mortgages (option ARMs) than their retail counterparts during 2006 and 2007. The relatively poorer asset quality of such loans compared with retail production led to massive exposure to investor repurchase demands. The investor repurchase risk alone caused several mid-market mortgage companies to close down their operations.

Many observers expect the financial industry to move toward business models in which lenders retain a greater degree of credit risk for mortgages they originate, such as funding mortgages on balance sheet through covered bonds. Regardless of the exact structure that emerges, increased exposure will compel lenders to maintain tighter control over credit quality. Such a desire for increased confidence in loan origination control inherently will favor in-house channels over third-party originations.

Financial and reputational pressure on bank lenders

As the commercial banking industry experienced significant hits to capital (but did not want to exit the mortgage business entirely), several bank-owned wholesalers exited the TPO channel to concentrate their limited capital resources on retail lending within the parent bank's geographic footprint. Ownership of the customer relationship was a strong motivator underlying this decision.

Regulatory pressure and local/regional legislative developments that are adverse to mortgage brokers have further diminished the strategic appeal of a business already suffering from severe quality, operational and profitability concerns. We believe that many regulated financial institutions are opting out of third-party originations to mitigate reputational damage.

Funding and operational pressures on independent wholesale lenders

The turmoil in the mortgage markets has engendered frequent program changes and sudden loan product discontinuations, as investor appetite has radically shifted away from many non-traditional loan products. In addition to the mounting operational inefficiencies these shifts caused, wholesale lenders had to manage a new risk—the accumulation of unsalable loans due to "program errors."

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Many independent wholesale lenders lack a stable source of funding, such as retail bank deposits. As wholesale funding in general, and warehouse lines of credit in particular, have been curtailed, independent wholesale lenders have been forced to reduce or abandon the broker business. Warehouse banks have reportedly imposed stricter controls and/or larger funding haircuts on TPO production.

Agency pricing and policy changes

Fannie Mae and Freddie Mac are implementing surcharges on loans that will negatively impact broker revenue. These surcharges include an additional delivery fee of 0.50 percent of the loan amount for all loans as of Nov. 1, 2008. In addition, both firms have introduced risk-based pricing adjustments,

Figure **3** **Status of Large Broker-Origination Lenders**

Lender	2006 Share of All Broker Originations	Status
Countrywide Financial Corp.	10.8%	Acquired by Bank of America
Washington Mutual	8.3%	Exited wholesale channel
Wachovia Corporation	5.8%	Exited wholesale channel
New Century Financial	5.2%	Filed for bankruptcy
Wells Fargo & Co.	5.0%	Exited subprime and home-equity wholesale
Chase	4.7%	Exited subprime and home-equity wholesale
Indymac Bancorp	4.7%	Taken over by FDIC
CitiMortgage	3.6%	Operations restructured
American Home Mortgage	3.3%	Filed for bankruptcy
GreenPoint/Capital One	3.2%	Exited wholesale channel
Option One Mortgage Corp.	3.1%	Originations ceased
GMAC ResCap	2.9%	Significant financing challenges; exited home-equity
Bank of America	2.8%	Exited wholesale

SOURCES: Company Releases, ml-implode.com

which are tied to individual credit scores and loan-to-value (LTV) percentages.

The loan-level pricing adjustments range from a credit of 0.25 percent (for borrowers with excellent credit) to surcharges of up to 3 percent. These risk-based fees will increase costs even for many "prime" borrowers, affecting some with credit scores as high as 740. It is anticipated that brokers dealing with clients who have lower credit scores will have difficulty qualifying them for mortgages. They will be handicapped by these fees as borrowers must now be qualified at full payments.

The government-sponsored enterprises (GSEs) also have tightened requirements for loan documentation and review, which tends to increase the compliance requirements and costs for brokers and lenders. For example, Fannie Mae and Freddie Mac entered into an agreement with the Office of Federal Housing Enterprise Oversight (OFHEO), facilitated by the state of New York, to reform the way appraisals are ordered.

Brokers and lenders will no longer have the authority to select an appraiser. An appraisal management company (AMC) or an independent lender appraisal department will be required. This will likely cause higher appraisal fees and could result in appraisers from AMCs outside the area where the home is located performing the appraisal—potentially negatively impacting home values.

Fannie Mae has also been listing pool-level third-party origination statistics in its mortgage-backed securities (MBS) disclosures since the third quarter of 2007. Fannie Mae recognizes that TPO loans tend to experience accelerated prepayment speeds, and as such, some investors have been paying a premium for pools that are non-TPO or retail-only. To avoid these risks, investors are willing to pay a premium for retail-originated loans.

Retention and cross-sell for bank-affiliated customers

The possibility that major bank-affiliated seller/servicers will finally solve the challenge of customer retention presents an ongoing threat to brokers.

Analysis by STRATMOR Group and New York–based Oliver Wyman Financial Services, a management consultancy, indicates that a reliably retained mortgage servicing right (MSR)—one that was always reacquired, so that the customer stayed on the servicer's books forever—would roughly triple the value for a typical MSR. While theoretical, this example underscores the tremendous financial pick-up inherent in customer retention. This added value is something that large seller-servicers understand but, as yet, have not been able to unlock to any great degree.

What is not theoretical, and has become apparent to the large seller-servicers, is that the cost of retaining an existing customer even via a refinance is a fraction of the cost of acquiring a new customer. In effect, net volume growth can come as effectively from better retention and refinance recapture as from new customer acquisition if you have a large customer base already.

We believe that bank-affiliated lenders are in the best position to harness the value of customer retention because of the many collateral and cross-sell banking and investment services they can offer. Put simply, because bank-affiliated lenders can target and value "share of wallet" for a new customer, they can price more aggressively than an unaffiliated lender both to acquire new customers and retain existing ones.

Further, as large seller/servicers improve their customer retention, they can afford to price very aggressively to capture first-time borrowers, who are likely to make up a larger share of the customer base in the current economic environment. The Housing and Economic Recovery Act of 2008 includes a first-time homebuyer tax credit. This credit will amount to 10 percent of the value of the home up to $7,500. This tax credit does eventually have to be repaid (over the course of 15 years), but married couples with adjusted gross income of up to $150,000 can qualify. This, combined with attractive FHA programs for first-time homebuyers, is anticipated to spur more first-time buyers into the market over the next year.

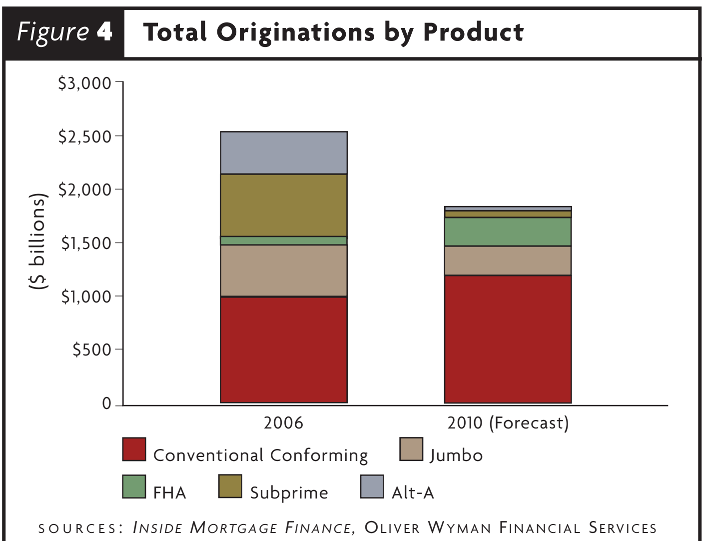
The possibility that major bank-affiliated seller/servicers will finally solve the challenge of customer retention presents an ongoing threat to brokers.

While most bank-affiliated lenders have thus far demonstrated limited marketing skills in customer retention, success would have the effect of limiting the market for both brokers and non-bank-affiliated lenders (and non-servicers) to serving first-time homebuyers, who typically represent just 20 percent to 30 percent of total annual originations. Indeed, real success in customer retention would radically alter the industry structure to one in which a handful of large bank-owned aggregators would accumulate first-time borrowers from a large network of brokers and correspondent lenders (and their own retail branches) and retain those customers for life.

Projections for the broker channel through 2010

Overall, mortgage production is set to decline during 2008–2009, and through 2010 it will remain lower than the record levels of recent years (see Figure 4).

Figure **4** **Total Originations by Product**



Sources: *Inside Mortgage Finance*, Oliver Wyman Financial Services

The origination mix will continue to shift away from the broker-dominated segments to lower-risk, lower-margin products.

Agency originations are expected to experience modest growth, partially driven by an increase in the conforming loan limit from $417,000 to $729,750. Upon extension of the higher GSE loan limits included in the new housing law signed in late July (the Housing and Economic Recovery Act of 2008), we estimate that 23 percent to 35 percent of jumbo volumes will be reclassified as conforming volumes (based on loan size only; there was no consideration of other loan features).

Alt-A originations will also decline as lenders have ceased offering risk-layered and exotic products such as non-amortizing and loans without documentation.

The virtual disappearance of subprime originations in 2008 will be followed by only limited recovery during 2009–2010. Many borrowers who previously relied on subprime loans will turn to FHA for financing. FHA originations (and to a lesser extent, VA volumes) have grown substantially in the last year, and will continue to grow rapidly in the short term as the government expands FHA eligibility criteria to help borrowers avoid foreclosure.

Going forward, we expect that subprime loans—a former mainstay of broker products—will largely be replaced by FHA-insured loans. But brokers are unlikely to be able to capture their proportion of FHA origination volumes due to stringent auditing and licensing requirements that historically have restricted the number of brokers that are FHA-approved.

Jumbo volumes are also shrinking due to the reclassification of former jumbo loans as "newly conforming." Additionally, as broker commissions on nonconforming loans (particularly subprime and alt-A) were significantly higher than on other products, the shift in mix implies a compression of average commissions earned, intensifying the impact of shrinking volumes.

Broker revenues are expected to fall dramatically in 2008 and then experience limited recovery over 2009 and 2010 (see Figure 5).

Oliver Wyman Financial Services' projections assume that unit commissions will remain at recent levels. In reaction to the industry contraction and lower broker share of originations, we expect that many brokers will exit the market over 2008–2010 (see Figure 6).

The mortgage brokerage segment remains highly fragmented, with many single-office players with low production volume. Many of these smaller shops are expected to exit the market due to the stricter regulatory and licensing standards being introduced.

Larger brokers will have the scale and cost advantage to comply with additional loan documentation and appraisal requirements. Significant consolidation of mortgage brokers is likely to occur as a result of the increased cost of doing business in the tighter go-forward business environment, creating an industry more closely resembling its Australian counterpart (see Figures 7 and 8).

The reduction in available broker business; shifting product mix; increased scrutiny and general pressure from regulators, rating agencies and investors on brokers and wholesale lenders to improve loan quality are driving the need for new business models in the wholesale space.

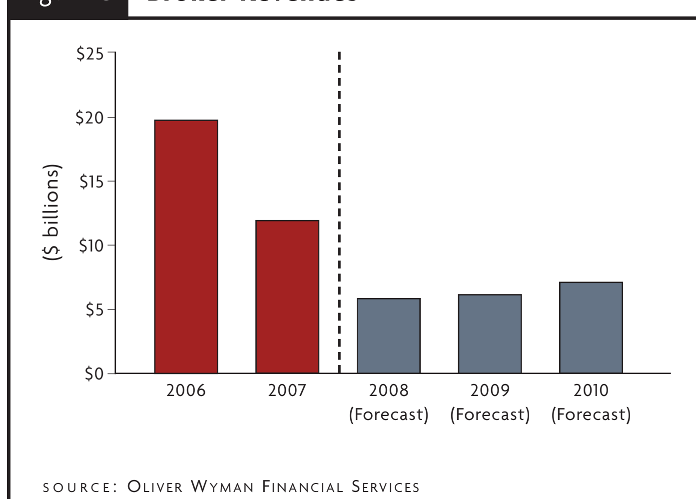
New approaches to the wholesale business

Business-as-usual is no longer a viable business model in wholesale production. Faced with shrinking revenues, thinner margins and greater regulatory scrutiny and oversight, we believe wholesale lenders will need to significantly modify existing business models and/or invent new ways of doing wholesale business. We see three key areas of change, which are described in the following sections.

DECLINE OF TRADITIONAL AE MODEL AND MIGRATION TOWARD IN-HOUSE VS. OUTSIDE AEs

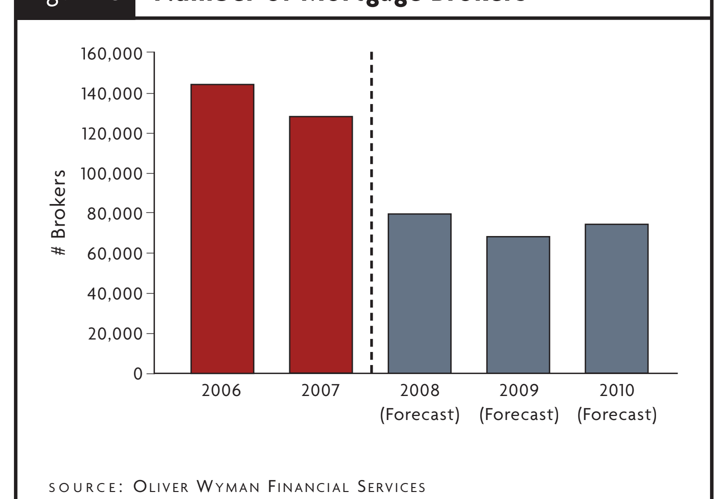
The disappearance of exotic mortgage products and the departure of many wholesale lenders and smaller brokers are bringing about significant changes in the traditional broker management model. Traditionally, almost all wholesale lenders maintained a sales force of account executives (AEs). Their role was largely to develop new broker accounts; increase the penetration of existing accounts; expedite loans through the underwriting process; assist client brokers with business management and development; and, in general,

Figure **5** **Broker Revenues**



SOURCE: OLIVER WYMAN FINANCIAL SERVICES

Figure **6** **Number of Mortgage Brokers**



SOURCE: OLIVER WYMAN FINANCIAL SERVICES

"schmooze" the broker and maintain strong personal relationships. Often, these AEs were external contractors who were paid on a commission basis.

The first significant change is a dramatic reduction in AE compensation. For the traditional functions they perform, AEs have been very well-compensated, as illustrated in Figure 9.

Based on MBA/STRATMOR Peer Group data, from 2003 to 2007, AE commissions among Group M wholesale lenders (megalenders) ranged from about 11 bps in 2003 to a peak of almost 15 bps in 2006. AE average compensation peaked at almost $250,000 per year during the 2003 refinance boom.

Despite significant declines in national origination volume from the $3.7 trillion peak in 2003, AEs were able to sustain average annual commission incomes of $130,000 to $140,000 as a result of the higher commission rates paid on non-agency loans.

While some of this reduction in compensation is a natural consequence of the precipitous decline in non-agency-eligible loans, which paid substantially higher AE commissions, several traditional wholesale lenders attending an April 2008 Oliver Wyman Financial Services/STRATMOR workshop held in Chicago spoke about reducing AE commissions on conforming production to as low as 4 bps.

Figure 7 Origination Volumes for Top U.S. Brokers (2006)

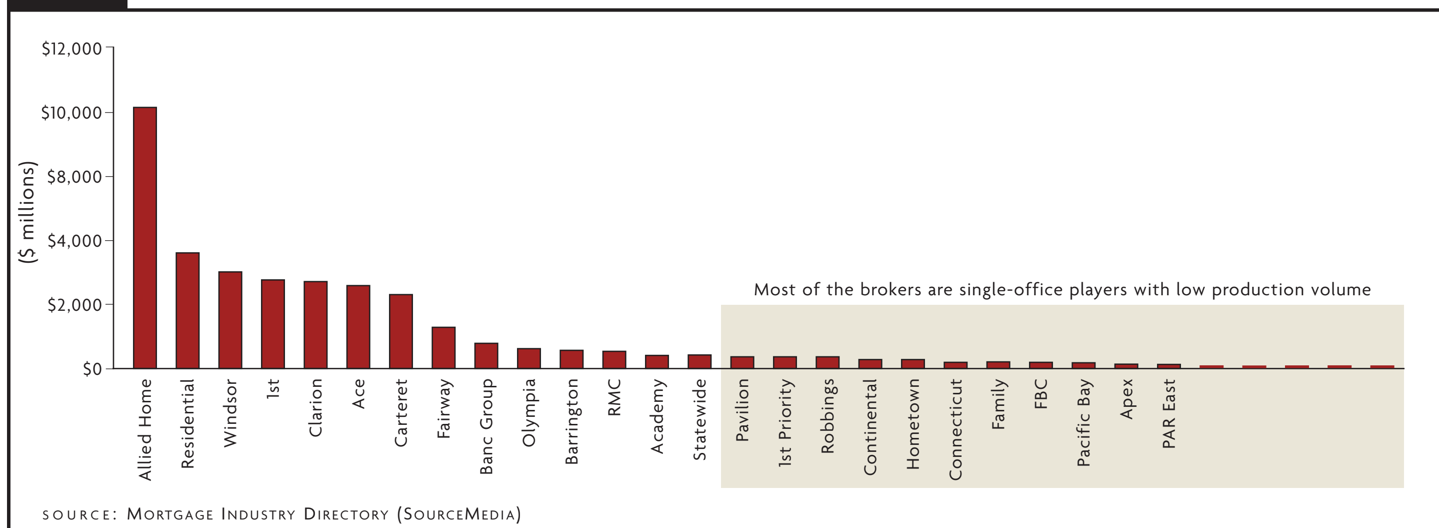


Figure 8 Mortgage Settlement Volumes for Top Australian Brokers (2005–2006)

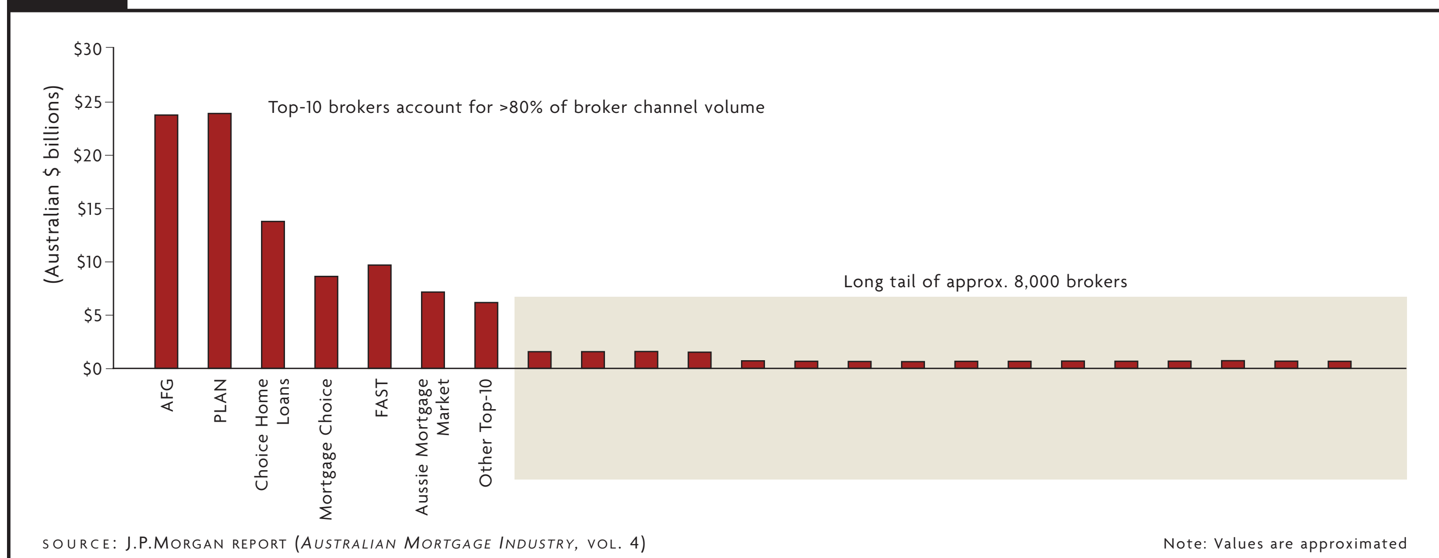


Figure 9 Account Executive (AE) Commissions, Non-Agency Loans and Compensation (2003–2007)

	2003	2004	2005	2006	2007
AE Commissions (bps)	11.07	11.31	11.95	14.91	12.50
% Non-Agency Loans	35.09%	35.38%	47.59%	46.97%	40.77%
Average Annual AE Compensation	$246,154	$130,732	$139,982	$134,197	$130,516

SOURCE: Mortgage Bankers Association (MBA)/STRATMOR Peer Group Survey and Roundtables

Second, and more significant, some existing wholesalers and new wholesale entrants are considering eliminating the external AE sales force entirely. An alternate approach being looked at would be to substitute a centralized in-house sales force supported by a help desk intended primarily to assist brokers with more complex loan situations.

These lenders believe that, in a wholesale world composed of larger, more professionally managed brokers and simpler loan products, there is little need for an expensive external sales force. Larger brokers, for example, typically need less business advice and assistance than smaller brokers, and require little assistance with relatively straightforward conforming loan products.

Further, anecdotal information suggests that larger brokers would willingly give up their AEs if doing so could result in higher back-end fees from their wholesaler. The total cost reduction gained from eliminating an AE sales force is roughly 8 bps to 10 bps of commission (assuming a largely agency-eligible loan mix and no reduction in commission rates) plus an additional 8 bps to 10 bps in support costs (based on MBA/STRATMOR Peer Group data) related to benefits, occupancy and other expenses.

Thus, eliminating an AE sales force could be expected to reduce lender costs by roughly 16 bps to 20 bps—an estimated 4 bps of which would be offset by the additional costs of internal AEs and a help desk.

Migration of processing/closing to agency-approved third-party platforms

The efficiency and quality of the traditional wholesale origination process leave much to be desired.

Figure 10 presents a portion of a value-chain analysis of wholesale origination expenses incurred for underwriting, processing and closing functions performed by both brokers and lenders based on Columbia, Maryland–based Wholesale Access broker data and 2002 MBA/STRATMOR Peer Group data.

Overall, the average cost of these functions was roughly $962 per closed loan. Included in this are pipeline fallout costs and redundant fulfillment costs that occur when lenders need to fully or partially reprocess loans that were poorly processed by their brokers.

Not included in the costs broken down in Figure 10 are incremental post-closing costs (e.g., quality control, loan review, etc.) incurred by lenders resulting from incomplete/inconsistent broker processing and shoddy closings performed by closing agents selected by the broker. Also not included are potential buyback and fraud costs for which lenders set up reserves.

> **Some existing wholesalers** and new wholesale entrants are considering eliminating the external AE sales force entirely.

One hidden cost is the time and attention many brokers devote to overseeing back-office operations that could be better spent on sales and marketing activities. Most brokers are salespeople both by training and instinct; selling loans and developing sales talent (no easy task) are where their strengths typically lie. Back-office operations and the associated day-to-day problems divert their attention from sales-management activities and detract, in our opinion, from top-line growth and overall profitability—which, because of the fixed costs of back-office operations, can quickly result in losses during market downturns.

What is needed, we believe, are independent third-party utilities that function between the lenders and brokers and provide fulfillment solutions that create reliably high-quality, saleable mortgage assets on an efficient basis. The creation of such utilities, however, requires industry leadership and is not easily accomplished either by wholesale lenders or

Figure **10** **Broker Underwriting and Processing/Closing Costs (per closed loan)**

	Underwriting	**Processing/Closing**
Broker		
Commissions	–	–
Processing	–	$599.50
Underwriting	$15.26	–
General and Administrative Expenses (G&A)/Other	$1.67	$64.15
Total Direct Broker Expenses	**$16.93**	**$663.65**
Lender		
Compensation (commission)	–	–
Compensation (salaries and other)	$20.53	$143.04
Occupancy/Equipment	$3.84	$18.09
Other	$68.19	$28.07
Total Direct Lender Expenses	**$96.56**	**$189.20**
Total Lender + Broker Direct Expenses	**$109.49**	**$852.85**

Sources: (MBA)/STRATMOR Peer Group Survey and Roundtables, Wholesale Access

third-party fulfillment vendors on their own. This leadership could, however, be provided by the GSEs, similar to the leadership they provided in creating automated underwriting solutions.

For lenders, this proposed solution—a multi-lender, multi-product platform with automated eligibility decisioning, risk-based pricing and best-practice fulfillment—allows for differentiation, proprietary products, customized decisioning, use of preferred service providers and, possibly, the mitigation of repurchase risk for agency products.

For brokers, key benefits of such a utility include increased operational efficiency, more opportunity to focus on sales activities and the transformation of the fixed costs of back-room operations to variable costs. In addition, the proposed platform could breathe life into the recently hammered small to mid-size broker segments of the market by reducing entry barriers and enabling more efficient sourcing of loans from these brokers by lenders. It is even possible that such agency-approved platforms could curtail or even reverse the trend toward broker consolidation by making it easier for smaller broker shops to meet regulatory and agency compliance requirements.

The notion that broker lending is dead as a business model is an erroneous one.

Broker-direct originations

The country's largest providers of broker origination software introduced in 2007 a new loan origination technology, dynamic loan origination (DLO), which enables wholesale lenders to directly access loans from their complete network of broker users—involving as many as 20,000 loans per day—without an AE sales force. Specifically, using DLO technology, lenders can make what amounts to pre-emptive offers screened in real-time on loan-level data as the data are entered into the origination system by the broker.

Using DLO, lenders can screen and price loan offers based on a combination of loan-level, borrower and broker attributes. Offers pop up in the broker's origination screens and can include price comparisons with other lenders. Because DLO potentially eliminates the need and costs of a traditional AE sales force (but not the need for a help desk and in-house recruitment of new brokers) and allows lenders to carefully tailor specific loan offers to workflow and processes of their back office, DLO offers the promise of substantially lower and scalable origination costs for participating lenders.

While use of DLO presents its own set of marketing challenges, we believe it offers a promising path for both new and existing wholesalers that want to operate without an outside AE sales force. While existing large-scale wholesalers such as Des Moines, Iowa–based Wells Fargo Home Mortgage can also use DLO, their investment in and dependence on a traditional AE sales force makes it difficult for them to switch to or even experiment with DLO, except perhaps in geographic markets in which they do not have an AE presence.

A smaller, smarter business

The landscape of wholesale lending is rapidly changing, but wholesalers that can adapt and make use of some of the business models we have discussed are those most likely to succeed in the current environment.

The notion that broker lending is dead as a business model is an erroneous one. Using the broker channel will always be an attractive proposition for lenders, as it allows them to add volume on a variable-cost basis. It also lets them penetrate geographic markets where they had little to no exposure and to diversify their production without incurring startup risks and bricks-and-mortar costs.

Experience has taught us that brokers are highly adaptable to dramatic changes in market conditions. However, it is unlikely that the broker share of originations—both nationally and in individual markets—will recover the ground it has lost in recent years.

In fact, further declines may occur, given that economics are unlikely to work for "business-as-usual" broker shops; and increased barriers to entry will deter new entrants and the return of "mom-and-pop" broker shops. These forces should work to concentrate wholesale lending in the hands of a smaller number of brokers that are larger, better-capitalized and better-managed.

Long-run winners will have to adapt, and are likely to employ new business models that:

- Lower customer acquisition costs (e.g., sales and marketing expense);
- Improve point-of-sale customer service while originating higher-quality loans that are better-suited to the borrower;
- Lower processing and other operational costs through improved use of both information technology (IT) and outsourcing; and
- Compete based on innovation and sales and marketing prowess.

Existing wholesale lenders and those wishing to re-enter the market will need to rethink their strategy and operating model in the face of new technology and process innovations that automate the funding of broker-originated loans. For example, agency-approved lending platforms, if built by non-lenders, could result in the disintermediation of lenders.

As ever, focusing on the touch point of the relationship with the individual borrower is what will ensure that broker business remains vital. However, all participants in the space have several challenges to consider in best positioning themselves for the future. **MB**

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