

The **CONTINUING** *Mystery* of **WHOLESALE**

"T'was a dark and stormy night. A flash of lightning punctuated the dying echoes of a blood-curdling scream, whose source was known only to the wind—and to the lurking figure who darted among the shadows outside the old, deserted, creaking mansion, its every corner as dark as the black heart of evil itself . . ."



By **JAMES HENNESSY**

Everyone loves a mystery, even one with a beginning as lurid as that one, but no one loves the rapidly developing mystery that is the current state of wholesale lending. This story has a film noir quality about it, and is literally a matter of life or death, with a vital national institution at stake—as well as the economic future of millions of Americans and others

around the globe.

What is the deal with wholesale? Why are veteran players running for the exits when there is no shortage in demand and the other problems in revenue and supply chain erosion are mostly fixable? Sam Spade had an easier time finding that black bird than observers are having trying to figure this one out. Why, for example, would an elite lender like Bank of America noisily bail out of mainstream wholesaling only to acquire the largest independent wholesaler on the planet a few months later? Is Countrywide in or out? If presumably smart people are questioning the viability of third-party originations, what are we lesser mortals supposed to think about a market segment that handles two-thirds of the nation's residential mortgages, the mortgage brokers?

The advent of wholesale to the mainstream in the mid 1970's meant an entirely new way of doing business. Savings and loans dominated residential conventional lending and mortgage banks pretty much owned FHA/VA. S&L's had a vehicle for dabbling in other businesses called "service corporations," which allowed them to diversify under tight controls designed to keep them out of trouble. A few of them set up non-originating lending companies to buy loans, primarily conventionals, from mortgage banks more comfortable with guvviés. The model was quickly replicated by other institutions, and when brokers arose *en masse* in the mid-80's, the modern wholesale business became fully fledged. Brokers took care of borrowers in ways the

large lenders could not match, and the roles became clearly defined.

Everything changed with the subprime meltdown, even for lenders who weren't heavily (or at all) into subprime and Alt-A products. They were tarred with the same brush by analysts who interpret the performance of public companies for the benefit of investors. They don't necessarily understand the ins and outs of the wholesale mortgage business, but they understand third-party originations were part and parcel of the subprime woes. Could this be why so many high-profile lenders have fled wholesale? Industry observer and consultant Greg Bowcott, CEO of Bowcott Associates, believes that is a distinct possibility. "There's nothing inherently wrong with the business model of wholesale," he says. "It is disturbing to think that leaving the sector is window dressing for the approval of stock analysts, but it might well be the case. They seem to be throwing out the baby with the bath water." A number of companies are redoubling their efforts in the wholesale segment and startups are being formed, he observes. "With the competitive landscape changing, there are significant opportunities for lenders that understand wholesale and they are investing in it right now."

Flagstar, for example, took the opportunity at the NAMB West Conference to ramp up their wholesale presence, even while B of A and Countrywide were minimizing theirs. Flagstar rolled out a technology initiative called "DocVelocity," a document management platform that makes brokers paperless quickly at a minimal cost, which demonstrates a firm belief in the future of wholesale. "The fact that Flagstar continues to invest significantly in new technologies such as DocVelocity, designed to support brokers and their businesses today and into the long-term future, is probably our best answer to the question of our commitment to wholesale," says Steve Brooks, EVP of Flagstar. So it appears that good amounts of smart money are indicating that wholesale is a fine place to be at the moment. "There is certainly market share on the table now due to those industry exits," Brooks says. "And so, wholesalers are going to fight for it. To do that, you have to differentiate yourself as a partner for the long term. For us, that means innovative offerings in technology, products and process, as well as turn times, service quality and dependability."

But what are we to make of the Bank of America exit from the business? NAMB president George Hanzimano-

lis has a take on it. "B of A invested \$2 billion in Countrywide stock after they announced they were exiting the wholesale market," he says. "Obviously, they believe the wholesale channel has some value or they wouldn't have invested then, and another \$4 billion now." As for the acquisition of Countrywide, he adds, "I've heard they are going to let Countrywide continue to operate as is for the next two years, and then see where it goes from there. I think it sends a strong message that even the big banks like B of A recognize a need to stay in the wholesale side of the market." Still, it seems odd to fire all your own people just to keep those of the acquired company. One hopes he's right, for moves like B of A's exit from wholesale sends a ripple effect throughout the industry, even if logic tells long-term participants that the business proposition of using brokers remains a sound one. Their parent companies start second-guessing their own experienced people and make a stock analyst-appeasement gesture that dumps thousands of people out of work unnecessarily.

Another concern about draconian moves by significant lenders is the possibility of changes to institutions of long-standing, like warehousing. "One story that will probably pick up steam is that some warehouse credit line providers are now requiring all lenders to sign personally," says Hanzimanolis. This can't be good news for small correspondents, especially since many won't have the personal net worth to cover a multimillion dollar line even if they wanted to, much less the liquid net worth that some warehouse lenders may be requiring. "I recently heard that National City is requiring this and will be shutting down their warehouse line operation this year," Hanzimanolis continues.

"Many small mortgage bankers will return to brokering so they don't have that liability." That also means, of course, that the additional income they realized as correspondents will go away, too.


Irrespective of the fact that the wholesale business model is sound, the powers that be aren't making things easier on companies remaining in that business. The cities of Baltimore and Cleveland, for example, are filing suits of high profile lenders and investment banks, alleging that their broker originators are responsible for the high foreclosure rates in their cities and the lenders must be held accountable for financial losses. In the NFL, it's called "piling on" and someone frequently gets hurt. The irony is, of course, that consumers are the ones ultimately hurt when credit becomes scarcer and more expensive, just as subprime borrowers are currently experiencing.

All the clues in this mystery seem to point toward a survival of wholesale after a period of fear, uncertainty and doubt—and we're presently experiencing all three at the same time. Still, as Bowcott points out, wholesale is a sound business model, especially with a few tweaks. "Lenders need to take back a lot of the functions they've delegated to the brokers over the last several decades," he says. "Brokers will become less like mini-lenders, and control-oriented lenders will take back functions like selection of closing agent, ordering title and appraisal, along with pre- and post-closing verifications and fraud checks on 100 percent of the loans they fund from third parties. Transactional transparency," he believes, "will be the order of the day." The transparency thing squares with Flagstar's DocVelocity play, as these platforms are inherently

transparent—all permitted parties to the transaction can indeed "see" the documents as the file is built.

The most obvious advice to originators selecting wholesale lenders is to take a close look at companies they are doing business with and try to determine who is in it for the long haul. Those that offer tangible demonstrations with new offerings and innovation are a good bet, and we have learned that size and name alone aren't necessarily the best indicators of long-term viability. You will be hearing a lot of noise in the coming months given that 15-25 percent of the wholesale market is up for grabs and many will want to fill that vacuum. Process the background noise carefully, don't believe everything you hear, and the truer signals will become clearer. Google the companies you're considering and you will find discussions that will help separate the wheat from the chaff.

In the final analysis of the mystery of wholesale, Hanzimanolis' observation is the most telling: "We are seeing many of the wholesale lenders that have left, now reorganizing and preparing to come back," he says. "As liquidity continues to flow into the market, these lenders will continue to commit to the brokers and will do well." As with nonprime lending, it's just too good and sensible a business to be kept down for long, and brokers, as the preferred originators in the marketplace, will continue to need funding sources.

As the *Pink Panther's* (famous movie) Inspector Clouseau might say, "*Le case, she is solve-ed.*" 

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