The Mortgage Brokers You've Never Heard Of
By Peter G. Miller

Whenever I need to finance or refinance a property I call up my friendly mortgage broker and about three weeks later the deal is done.

My mortgage broker is a good example of the best you can find in his profession, a profession which is now on the verge of extinction. I know when I deal with him that I'll walk away with the best available financing I can get and that I won't pay a dime to close.

Not everyone is so lucky.

For mortgage brokers, recent events have been especially grim, a hint of things to come. Increasingly, mortgage brokers are seen as a central cause of the mortgage meltdown, an excessive cost to lenders and as grossly unreliable by both borrowers and investors. Just recently a court threw out efforts by the mortgage brokerage industry to hide yield-spread premiums — a kind of back-door payment to lenders — on good faith estimate forms HUD will require after Jan. 1.

The Middlemen

The mortgage process today is essentially a distribution system which moves money from investors to borrowers. While it happens that local lenders provide loans for local borrowers, such quaint transactions are a small part of the lending system. For more than half of all borrowers the lending system is different: A mortgage broker takes the loan application, pulls together a loan file to prove that the loan meets the requirements of the lender and mortgage insurer and then submits the application to a lender.

So what is it, exactly, that the mortgage broker does for borrowers? According to the National Association of Mortgage Brokers (NAMB):

* "The consumer receives a knowledgeable professional throughout the complex mortgage lending process. The broker offers the consumer a variety of home loans."

* "By offering superior market knowledge and direct access to many different loan programs, a mortgage broker provides the consumer the most efficient and cost-effective method of obtaining a mortgage that fits the consumer's financial goals and circumstances."

So why would a lucid borrower pick mortgage broker Smith over mortgage broker Jones? Because one claims to offer the best rates and terms.

This seems logical except for one huge problem: While the borrower "receives a knowledgeable professional" and is introduced to many loan programs, the mortgage broker does not work for the borrower.

"Simply put," says Harry Dinham, a former NAMB president, "a mortgage broker should not, and cannot, owe a fiduciary duty to a borrower. The consumer is the decision maker, not the mortgage broker."

The conflict here is obvious: A borrower with limited mortgage knowledge relies on the advice and product offerings of a trained, experienced professional who can maximize his income by selling the most expensive loan possible to the borrower.

You think this doesn't happen?

In 2005 the Wall Street Journal found that 55 percent of all subprime borrowers actually qualified for conventional — and cheaper — mortgages. The rate rose to 61 percent in 2006. (See: Subprime Debacle Traps Even Very Credit-Worthy, The Wall Street Journal, Dec. 3, 2007.)

In other words, the majority of high-cost subprime loans were sold to people who could have enjoyed lower rates and better terms based on their credit profile — some of whom may now be facing foreclosure because of the costly toxic loans they received.

And who originates more than half of all loans? Mortgage brokers.

They Can Get It For You Wholesale
Mortgage brokers don't have cash to make loans, instead they rely on wholesale credit lines from those who do have cash such as banks, insurance companies and pensions.

This means that part of the mortgage broker's income is derived from the difference between the wholesale cost of a loan and the retail price paid by the borrower. The bigger the gap, the bigger the broker's profit.

Now you might think, aha, so the mortgage broker must be working for the wholesalers and seeking to maximize their profits. Nope, that's not right either.

"Mortgage brokers," says NAMB President, Marc Savitt, "do not create loan products, do not determine the automated underwriting systems used to qualify borrowers, do not underwrite the loans, and do not approve borrowers for those loans."

So what benefit do mortgage brokers provide for lenders?

"Essentially, mortgage brokers are independent contractors who supplement the lender's own sales force," says Jim Saccacio, Chairman and CEO at RealtyTrac.com, the leading online marketplace for foreclosure properties. "This holds down lender costs because banks, insurance companies and pension funds get an army of sales people who are only paid when they deliver loans.

"The looming question is whether lenders really want an outside sales force," continues Saccacio. "Some lenders are beginning to reconsider the issue, thinking that perhaps smaller wholesale operations or no wholesale operations would actually be a better option."

Jamie Dimon, Chairman and Chief Executive Officer of JPMorgan Chase, put it this way to a Chamber of Commerce meeting in March: "If I had to point out my biggest mistake, probably of my whole career, was not closing down our mortgage broker business sooner. Okay? It, a mortgage broker product, that was not our own salesperson from the client, has two or three times the loss rates of all our product."

Chase and a number of other lenders have now closed down or reduced their wholesale mortgage operations. The failure of Colonial Bank — a $25 billion bank with 346 branches and a major source of wholesale funding — substantially reduces the funding available to many mortgage brokers, meaning that many mortgage bankers have been left with less to sell and in some cases with no products to offer.

Not only are lenders closing down wholesale pipelines, the related issue is that investors — the folks who buy mortgage-backed securities and pump cash into the system — also want less risk, something they can get with better deals for borrowers.

Who Benefits?
So far it would seem that mortgage brokers as a group have pretty much gotten the recognition they deserve. But remember, there are good mortgage brokers out there. Just think about the guy I use.

Let's say for a moment that a very large number of wholesale credit lines are cut off or reduced and that the world suddenly has fewer mortgage brokers. Who comes out ahead?

If you're a bank you want to make loans because piles of cash in a vault don't produce any returns. One way to make more money is to dump high-cost outside marketers and instead use lower-cost, salaried staff.

This could be a good deal for both borrowers and banks if the result was mortgages with lower consumer costs. Then again, that's a fat "if" — consider how credit card customers have been treated, the costs of using ATMs and the fees for bouncing a check.

The Twist
Lenders and borrowers are not buddies. They're adversaries in the financial marketplace. Lenders want to maximize profits and borrowers want to minimize costs. Not since gladiators fought with lions has there been a more obvious clash.

All of which brings us back to mortgage brokers. Basically, this is a profession which needs to make a decision: Either keep representing no one and go the way of the ox cart or start providing a professional service in the sense of lawyers, real estate brokers or doctors.

Imagine this scenario: You need a mortgage. You hire a mortgage broker to represent you. The mortgage broker is paid a set fee negotiated in advance. There are no ups, extras or add-ons. You can rely on the mortgage broker because he's your agent.

You benefit because the mortgage broker is a professional, someone who knows which loan best meets your circumstances. As to which loan you chose, the fee-only mortgage broker has your best interests at heart. Why? Because he gets paid the same no matter which mortgage you choose — but if you get a really good loan you'll recommend him to other borrowers and other borrowers mean more fees.

NAMB says it has more than 25,000 members, but there's another association of mortgage brokers out there, one you need to know about.

UMBA

The Upfront Mortgage Brokers Association (UMBA) has just 80 individual members and 10 company members. Based on the ideas of Jack Guttentag, aka “The Mortgage Professor,” a nationally syndicated real estate columnist and a Professor of Finance Emeritus at Wharton, the group has a code of ethics that actually means something.

For instance, members pledge that “the broker will endeavor to act in the best interests of the customer.” Nothing fuzzy about this, it creates a fiduciary obligation to represent borrowers. Members also promise to “establish a price for services upfront, in writing, based on information provided by the customer.”

“The price,” says the UMBA code, “may be a fixed dollar amount, a percent of the loan, an hourly charge for the broker's time, or a combination of these. The price or prices will cover all the services provided by the broker. If the broker charges a loan processing fee, the amount will be disclosed to the customer, regardless of whether it is paid directly to the broker or to a third party.”

Lastly, with UMBA members hidden yield-spread premiums are out. Not only are such premiums disclosed, they're credited to borrowers.

“If the broker's fee is 1 point, for example,” says UMBA, “and the broker collects 1 point from the lender as a 'yield spread premium', the broker either charges the customer 1 point and credits the customer with the yield spread premium, or charges the customer nothing and retains the yield spread premium.”

You can see the benefit of the UMBA approach. If it makes sense to have a buyer broker representing you as a real estate purchaser, why would it not make sense to have a mortgage broker protect your interests when you get a loan?

UMBA is small and not well known, but the way things are going it's the future of mortgage brokerage. Members pledged to its standards are listed on its website, UpfrontMortgageBrokers.org

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