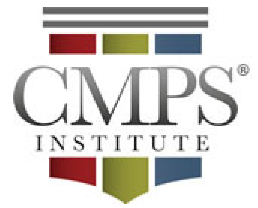
Saga of the US Mortgage Industry



The Old System of Mortgage Lending

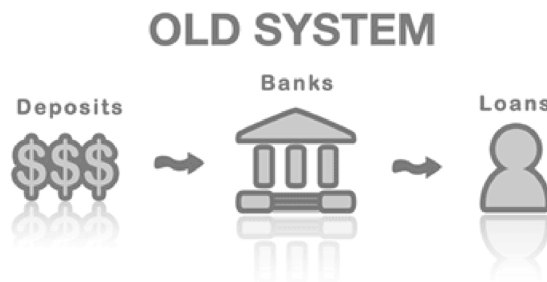
Once upon a time, during the good old days when life wasn't so complicated, banks lent money to borrowers and never sold these mortgages to unfeeling, multi-billion dollar institutions with call centers in distant lands.

Anyone could walk into his or her local bank and get a local home loan without signing truckloads of paperwork and being interrogated as though they were America's most wanted criminal. There was no fraud or borrower manipulation. There were no reckless bank failures or irresponsible lending practices. In those days, bankers were compassionate, foreclosures were minimal and consumers were respected. Right? RIGHT???

Wrong.

Selective memory is a wonderful thing…

As illustrated by the following chart, mortgage lending in America used to be a simple affair. However, this simple and rudimentary system of banking did have some HUGE drawbacks.



Remember the old Jimmy Stewart film, *It's a Wonderful Life* ? In that film, Jimmy Stewart plays a small town Savings and Loan banker named George Bailey. George was the good guy. His nemesis was Mr. Potter, the big bad monopolistic banker who would have controlled the town, renamed it Pottersville and kept the commoners dirt poor had George Bailey not been around to stop him.

During the film, which was set during the 1930s and 40s, George the good guy almost lost the family bank during the many "bank runs" that occurred. A bank run is when most, if not all, of the people who have deposited money in a bank decide to withdraw their money all at the same time. This panic-driven event is caused because bank customers get scared that the bank will fail and they will lose the deposits that they have at the bank. Well, needless to say, this often becomes a self-fulfilling prophecy because if everyone pulls their money from the bank all at the same time, the bank WILL fail!

You see, the way banks make money is by paying depositors a small interest rate on their deposits and then lending that same money to borrowers at a higher interest rate. In essence, the bank is borrowing money from you, the depositor, and lending those borrowed funds to your neighbor, the borrower who applies for a mortgage. Then, the bank borrows money from your neighbor when they deposit their money, and the bank loans those borrowed funds to you when you apply for a mortgage. That is how banks operated under the old banking system.

As you can imagine, this system, while simple and easy to understand, had many flaws:

- Numerous banks failed frequently during the many bank panics that occurred in this country throughout the 1800s as well as the 1900s. It was very easy for depositors to get anxious and withdraw all their money from the bank whenever a piece of bad news hit the town or local economy.
- It was very easy for the “Mr. Potters” of the world to take advantage of ordinary Americans because these “Mr. Potter” robber-barons had the deep pockets to snap up the failed banks at bargain basement prices. In this scenario, rampant fraud and unfair business practices were the norm due to easy manipulation of the banking system. The rich got richer while the poor got poorer.
- To protect themselves from failing in the scenario illustrated above, banks only issued mortgages that were “callable.” In other words, the banks had the right to call up any and every one of their borrowers and “call the loan due” immediately and for any reason. If you didn’t have the money to pay back the bank, you lost your home, mind you, not because you couldn’t make the monthly payments, but because the bank couldn’t meet the panic-driven withdrawal demands of their depositors.

Needless to say, this archaic system of mortgage lending allowed only very limited mortgage choices, and the lending guidelines were dreadfully restrictive.

The New System of Mortgage Lending

As time went on, and after the economic recovery that began during World War II, the US government and financial markets began exploring new ways for Americans to buy homes in ways where we wouldn’t be at the mercy of a small clique of wealthy bankers. Thus, the “secondary mortgage market” system was born.

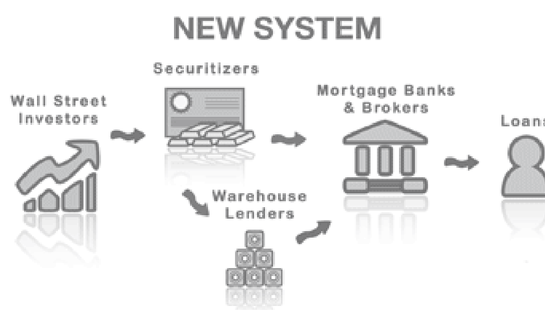
In this new system, bankers would be empowered to take all the mortgages that they issued to various borrowers and sell those mortgages to other investors in an “after-market.” In other words, if you owe the bank money, the bank has a valuable asset – your IOU! Two things happen when they take that asset and sell it to someone else:

- They can hopefully make a profit
- They can replace the funds that they loaned to you and loan more money to someone else

This process of loaning money and selling those mortgages to other investors is what we call mortgage banking.

In this sense, the banking process of taking a deposit from you as the bank depositor is separated from the banking process of loaning you money as the bank borrower. You are the same customer, but the bank sets up two different departments to service your needs. One department handles your checking and savings accounts, and the other department handles your loans.

In this sense, one hand no longer has to be involved with what the other hand is doing. See illustrations below:



The new system really has three steps with some action taking place on the sidelines.

- Step 1 - Consumers get loans from mortgage banks or brokers
- Step 2 – The mortgage banks or brokers sell that mortgage to secondary market investors like Fannie Mae, Freddie Mac and other financial institutions
- Step 3 – Secondary market investors package these mortgages as “securities” or bonds. This process is called “securitizing” the mortgages into a financial product that can be sold to Wall Street investors like mutual fund companies, individual investors and others

On the Sidelines – Warehouse lenders provide the interim financing for the mortgage banks. In other words, if a mortgage bank isn’t taking in deposits from banking customers, where do they get the money to loan out in the first place? Well, another group of lenders fill in the gap and loan money to mortgage banks during this interim period. These lenders "warehouse" these loans for short periods from 1 - 60 days while the mortgage banks sell them to Secondary market investors.

How Does This New System of Mortgage Banking Benefit the Consumer?

The money for your mortgage is coming directly from Wall Street sources. This basically means that you have literally hundreds of millions of investors across the planet who are itching to lend you mortgage money by investing in the mortgage bonds that trade in the US financial markets.

The result?

- You have an unlimited amount of cash flow and financing options because mortgage companies have financial incentives to innovate and create new mortgage products. The more products they create and sell, the more money they make and the more choices you have. As the saying goes, “when banks compete – you win.”

- Less room for manipulation and abuse due to competitive market pressures. If you can't get what you want now, just go down the street and chances are someone else is offering it better, cheaper and quicker.
- Consumer protections, flexible and fair lending guidelines that protect minorities and ensure that all Americans have access to mortgages and can buy their own homes.

The bottom line here is that in the US, we have a uniquely American, full-blown democratic process of getting a mortgage and buying a home. No other country in the world has this system. That is why we have literally thousands of mortgage choices that cater to just about any need you could possibly think of. Whether you are caring for elderly relatives, sending kids to college, trying to retire comfortably, investing in real estate, buying a second home, getting a divorce, starting a new family, or starting a business, there are mortgage choices for you.

Does this system have flaws? Yes, absolutely. In any highly democratic system, there is a need for discipline. Even in the US, innocent people end up going to jail, people die in car crashes due to drunk driving and many people don't have jobs or health insurance.

If you let people do anything they want without rules, chances are someone is going to get hurt sooner or later. That is exactly what has happened in recently in the mortgage industry.

You see, Wall Street investors were all looking for very high returns in the financial markets. So, they basically told the mortgage bankers, "Create new products and we will buy them." The mortgage bankers joyously replied, "Sounds great to me!" And so was born all these "no credit, no income, no problem!" loans. Consumers got greedy for loans they couldn't afford, mortgage banks got reckless in their guidelines and Wall Street investors in search of high returns financed the whole shebang.

When loans began going sour at the beginning of 2007, Wall Street investors decided to pull the plug and stop buying the risky mortgages from the mortgage banks. In fact, they even started requiring the mortgage banks to buy back all the loans they had sold them in the first place! In other words, the system started working in reverse – instead of providing new money to the mortgage banks, Wall Street started sucking money back from the banks. To compound the problem, the "Warehouse Lenders" who were providing interim financing from the sidelines created a "run on the mortgage banks" by closing down their lines of credit and calling all their loans due.

So there you have it! Instead of a consumer-driven run on the banks, we have a Wall Street and Warehouse Lender driven run on the banks! This liquidity crunch is currently affecting the entire mortgage industry. Mortgage banks who were very profitable up until this very moment are going out business. They aren't going out of business because they are no longer profitable. They are going out of business because of the "liquidity crunch" caused by this "run on the banks" phenomena that I just described.

What Is the Answer and What Can Be Done About the Situation?

That is the million dollar question! We know that we can't go back to having a small group of wealthy bankers in smoke-filled rooms limiting our financing options for us.

We also know that this fully democratic US mortgage process isn't 100% foolproof either. Here are two proposed solutions that should be implemented immediately:

- Industry Certification – no longer should bankers and brokers be allowed to recklessly sell mortgages without proper training, certification and ethical standards.
- Mortgage Planning vs. Mortgage Shopping - shopping for the elusive lowest mortgage rate with the wrong mortgage strategy should be replaced by a responsible, advice-driven relationship with a mortgage professional who understands and can articulate the best options for certain client circumstances. What's good for one client may be very dangerous for another client and vice versa. A strategy that helps your family save for your children's college expenses could cause another family to lose their home to foreclosure. A strategy that helps you become debt free could force another person to sell his or her home at a steep discount in a lousy real estate market for liquidity and cash flow reasons.

With these things in mind, the Certified Mortgage Planning Specialist (CMPS ®) certification is currently being embraced by consumer advocates and industry leaders alike as a plausible solution in the face of the mortgage industry's current problems. For more information on how you can benefit from consulting with a CMPS ® certified professional, please contact me using the contact info below.

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