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On Focus and In Depth

Mortgages' Big Two Are Too Big to Avoid

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Eleventh in a series

The crisis and consolidation in banking have given Wells Fargo & Co. and Bank of America Corp. an unprecedented share of the mortgage market and new clout in their business relationships.

Correspondent lenders and mortgage brokers now must work with one or both of the Big Two to be in the business, industry executives and observers say. Combined, the two companies originated 44% of all the home loans written during the second quarter, up from 28.6% a year earlier, according to *National Mortgage News*.

"The funding is all coming from B of A and Wells, either directly or indirectly," said Ken Jones, the president of Blue Oak Mortgage Corp. in Santa Rosa, Calif., and chairman of the California Association of Mortgage Brokers. "If you look at lending like a pyramid, with the big players at the top, slowly more and more production is being pushed up that pyramid."

The Big Two both attributed their market share gains to acquisitions they made of ailing institutions last year. B of A bought Countrywide Financial Corp., which had long been the top home lender.

Wells, the longtime No. 2 lender, took over Wachovia Corp. (which had purchased Golden West Financial Corp., a significant force in the mortgage market, two years earlier).

But market participants say the two megalenders have been using their new scale to fiercely compete for loans since the summer.

"They're pricing better than everyone else because they make money back on volume," said Matthew Pineda, the president of Castle & Cooke Mortgage LLC in Salt Lake City. His company, which has 25 offices producing a combined $100 million a month, sells most of its loans to B of A and Wells.

"I need them both," Pineda said.

However, he also sells to JPMorgan Chase & Co, GMAC Inc., U.S. Bancorp and directly to Fannie Mae.

"I need to maintain relationships with everybody because what happens if one of them shuts down?"

Tom Millon, the president and chief executive of Capital Markets Cooperative in Ponte Vedra Beach, Fla., a provider of secondary marketing services to banks, said that bank consolidation and a retreat from the correspondent business by some large players last year have resulted in too few outlets for loans.

"You're getting to the point where mortgage companies have very large … share [of their production] with one investor and they are essentially a de facto branch of Wells or B of A," Millon said. "It's a business risk of having just two big conduits."

Neither of the Big Two would make executives available. Terry Francisco, a B of A spokesman, said that correspondents can choose "between Bank of America and more than a dozen financial firms who are providing liquidity for the overall markets."

Teri Schrettenbrunner, a spokeswoman for Wells Fargo's home mortgage unit, said its "strategy has always been to go into this from the standpoint of controlled market share growth. We have been very focused on credit and underwriting practices and responsible lending."

LEVERAGE WITH GSEs

Millon said the larger banks can offer better pricing to correspondents because they are charged lower guarantee fees by Fannie Mae and Freddie Mac to insure the payments on securities they issue.

A July report from the Federal Housing Finance Agency, the regulator and conservator for Fannie and Freddie, cited several reasons why smaller lenders are charged higher fees.

Large sellers "have achieved a degree of leverage that can be used to negotiate better terms," the report said. From the government-sponsored enterprises' point of view, working with large lenders entails lower administrative costs and counterparty risk "tends to be higher for small-volume sellers."

"It's less of a free-market, 'size matters' argument now and more about pricing for the risk," Millon said. "In practice, apart from Wells and B of A — nobody else matters."

Adam Glassner, executive vice president and senior managing director at GMAC, which is trying to expand its correspondent business (see sidebar), said "it's hard to disagree" that Wells and B of A have significant control of the channel, "even though it's not true."

Though many third-party originators "talk about wanting to diversity their relationships," he said, "if 80% of their business is with one lender, it's because they're selling to the one with the best price."

He also dispelled concerns about market share gains.

"You can lead yourself to believe that [market share] is your driving factor and take credit risks that are not appropriate," Glassner said.

David Olson, a managing director at Access Mortgage Research and Consulting Inc., in Columbia, Md., said the overall costs of business have soared for small mortgage lenders, which are struggling to obtain warehouse lines of credit and meet higher net worth requirements set by federal agencies. (Last week, the Department of Housing and Urban Development proposed raising the minimum net worth requirement for Federal Housing Administration lenders to $1 million, from the current $250,000. Fannie and the Government National Mortgage Association have made similar moves in the past year.)

"The brokers are pretty much gone and now there will be a small coterie of correspondents left," he said. "All the states have raised fees, warehouse lines are now extremely expensive and if you have to do an annual audit by a [certified public accountant], then no one will make any money."

Moreover, the prospect of mortgage rates rising next year, after the Federal Reserve stops its planned buying of mortgage-backed securities in March, will further drive small players out of the market, he said.

"The industry is really shrinking," Olson said.

He said he expects total industry volume to fall by nearly half to between $1.1 trillion to $1.3 trillion next year.

Mortgage brokers accounted for more than 60% of the lending market at the height of the housing boom in 2006, but Olson estimates there are now just 15,000 brokers. Correspondent lenders also could see their ranks cut in half from 1,000 to 500 by yearend, he said.

"No one knows what's going to happen to the wholesale and correspondent channels," he said. "B of A and Wells do dominate and they don't want to play with the little guys."

National Mortgage News data shows that the top four originators — B of A, Wells, JPMorgan Chase and Citigroup Inc. — control 57.8% of the overall lending market.

Still, JPMorgan Chase with market share of 7.7% and Citi with market share of 5.7% are running a far distant third and fourth place; both lost market share in the 12 months ended June 30.

Overall, Wells was the largest mortgage originator in the second quarter. It funded $131.2 billion in loans, a 101% increase from a year earlier, while B of A came in second with $114.3 billion, up 223% from a year earlier.

REGULATION

Mortgage experts said a slew of new regulations will further tilt the balance of power in favor of the megabanks.

"The sheer pace and complexity of federal and state regulatory change promises to substantially increase the costs and risks of lending," said Louis Pizante, the chief executive of Mavent Inc. in Irvine, Calif., a provider of automated compliance software. "Ultimately, it will force small- and medium-sized lenders to exit the mortgage, and even consumer-loan, business."

Proposed changes by the Fed to Regulation Z, which implements the Truth in Lending Act, would require a recalculation of annual percentage rates for certain mortgage products and prohibit brokers from receiving certain types of payments.

Dave McDonald, a mortgage broker at American Dream Real Estate Group Inc. in San Diego, said the proposal, which the Fed released Aug. 26 for a 120-day public comment period, would radically change the business.

"As soon as this plan is implemented, the banks will stop taking third-party originations," he said. "The plan is supposed to appease the international banks by saying the risk has been taken out of their end and is 100% on the originator. But what will happen is because the originators have to accept all the risk, they won't do any perceived risky transactions."

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