

THE FUTURE OF Net Branches

THE CLIMATE IN THE MORTGAGE INDUSTRY IS constantly changing. One aspect of the business that has changed quite a bit in a positive way is net branches. There have been growing pains along the way with this unique approach to the origination business. And lessons have been learned. Yet all these developments have left the net branch production approach in the enviable position of gaining market share, and with new respect from peers.

BY DANIEL H. JACOBS

the new characteristics of this model.

The current production climate makes net branches look attractive to brokers. Here are some reasons why.

And because there is no one, universal definition for net branches, it should be understood that some operate as mortgage bankers that fund loans or a combination of banker/broker that originates and funds loans. However, the vast majority of net branches operate primarily as mortgage brokers that originate loans for lenders.

Because net branching is such a budding segment of the industry and because it is so entrepreneurial, there has been a tendency to allow anyone to migrate into our segment of the industry without a border patrol. If nothing else, the mortgage origination industry has no barriers to entry, and has allowed too many people in who were looking for a quick buck during a booming market.

These brokers who built first-generation net branches—just like the borrower with no vested interest in his no-doc loan with gift funds who will go into foreclosure without any heartache—walked away from our industry and allowed the first generation of net branching to be foreclosed upon.

However, it was in 2000, when the Department of Housing and Urban Development (HUD) released Mortgagee Letter 00-15, that a clear definition of what a net branch should be (and subsequent compensation) was provided to the industry. The letter endorsed the alternative compensation structure whereby the branch manager may be paid the net profit of the branch he or she manages.

“The HUD/FHA [Federal Housing Administration]—approved mortgagee collects the revenue from the branch, pays the branch expenses and then pays the branch manager the remaining revenues, if any, as a commission,” according to the letter. “Such an arrangement is, essentially, an alternative compensation program for the branch manager and is an acceptable branch arrangement if all other branch requirements are met.”

The bottom line is that the branching company has remote

ing, the originator did not lose the support and license of the home office, and the owner-operator did not have to pay the overhead associated with having an employee.

But since those early days, the model has evolved. Today, there are several net branch models. Even the name for the model is evolving as the term “net branch” became associated with older models no longer seen as fully compliant in today’s regulatory environment. Because there is no industrywide consensus on a term for the new breed of net branches, we will continue to use the term “net branch” while making the effort to educate people about

branches like any other mortgage company, and the “net branch” term refers to compensation to the manager, not the soundness of operation or responsibility of the licensed corporation. Many state regulators have since enacted rules that mirror HUD Mortgagee Letter 00-15.

By the time the HUD letter was published, a few unscrupulous operators had already given net branches a bad name. They were running classic “rent-a-license” shops, which allowed unethical players to run a branch, and shunned any corporate responsibility for the actions of the branches to which they rented licenses.

Good companies thrive

Despite the blemish created by these bad actors, several companies have made it a point to do business the way HUD mandated. Since 2000, these companies have built solid reputations. This promising start has come even though the model is still relatively new.

“The net branch model has unlimited upside potential,” says Joseph Falk, the 2001–2002 president of the National Association of Mortgage Brokers (NAMB), McLean, Virginia. “It’s a new origination channel that merges the independent entrepreneurial mortgage broker with the power of a large national company.”

Falk, who first got into the mortgage business in 1978 by working for his father’s mortgage company in Miami, says net branches give originators the opportunity to assert their sales skills while having someone else handle the back-office business.

Even with the affiliation with a larger company that handles compliance, marketing and other back-office issues, net branches still have to rely on the relationship that their home office has with lenders.

It is true that mortgage brokers are often ingenious entrepreneurs. They have filled a niche and have found ways to take market share away from overly rigid traditional lenders. But that could change quickly if mortgage brokers do not take a moment for some deep introspection and ensure they don’t allow greed to undermine the codependent relationship they have with lenders.

Relationship is everything

The codependency that exists between brokers and lenders is based on an understanding and mutual business need. Brokers—and subsequently their branches—need the products from lenders in order to do business. Lenders need net branches to reach the consumers they may not have access to by any other means. In order for these relationships to continue to grow, brokers have to take an honest look at their strengths and weaknesses.

One of those strengths is their ability to identify what the market needs and find creative ways to meet those needs.

Lenders sometimes develop new loan products based on the feedback their account executives get from their brokers. Other strengths include the personal touch that brokers offer borrowers and the access brokers offer to a wide variety of loan products.

But the relationship between brokers and lenders could be endangered because of this codependency. For example, it becomes dangerous when account executives from lenders are finishing loan applications, stacking loan packages, completing verification information and even speaking to borrowers. The over-involvement of account executives could very well undermine the role of the broker. And while technology has revolutionized the way brokers have conducted business, using technology to generate leads has created a climate that has made brokers lazy, in my mind.

“If brokers are ever viewed as a glorified lead-generation shop, their value is diminished greatly,” says Carly Fulmer, director of operations at 1st Metropolitan Mortgage, Charlotte, North Carolina. “Brokers have to work to make sure that does not happen, and they cannot rely on their customer relations to speak for themselves.”

Credit quality

Another perception that could hurt the relationship between lenders and brokers is that some brokers are not concerned about the quality of the loans they originate. There is a widespread assumption that, because brokers do not have a vested interest in the loans, they are not performing the same level of due diligence that a lender would.

“Brokers can stop this industry assumption that they do not care about loans they produce by becoming as interested in the long-term perfor-

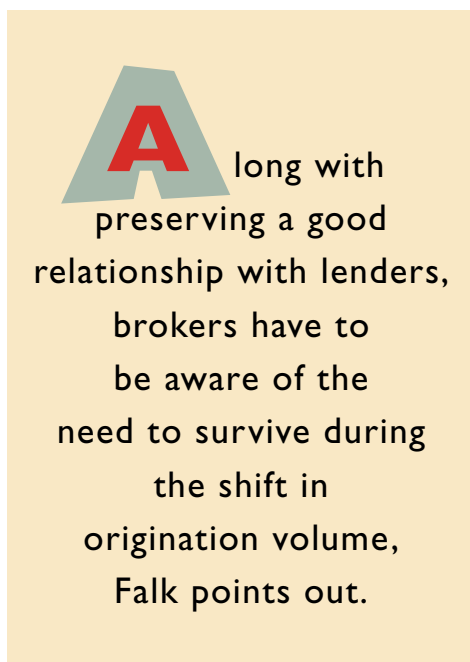
mance of the loans they originate as they are in the commissions generated by those loans,” Fulmer says.

Along with preserving a good relationship with lenders, brokers have to be aware of the need to survive during the shift in origination volume, Falk points out. “Because the net branch business model is relatively new, it has not stood the test of time in several different economic climates, such as those created by slow refinancings or rate changes,” he says.

Surviving a new day

“For mortgage brokers, the way to go is a net branch, because [net branches] bring [brokers] the preferred products, pricing and services that will keep them competitive as we move forward in a market that is under compression,” says Joe Trovato, national accounts manager of the partnership division for SouthStar Funding LLC, Atlanta. He says that by joining a net branch network, brokers are able to maintain their size while leveraging the economies of scale of a larger company.

Trovato, who says SouthStar has been offering loan products through net branches for seven years, says he’s seen net



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branching go in two directions: companies that have just allowed brokers to “park” their licenses and not developed any lines of communications, and the companies that provide direction for their branches and have a level of control that promotes business integrity throughout the branch network.

“The companies that develop alliances with lenders, credit companies and other industry partners will bring value to the branches,” Trovato says.

There are several other challenges mortgage brokers have to face in the coming months and years that will either make or break their net branches.

As origination volume shrinks, newer loan originators will not have the refinance boom to cut their teeth on. They will have to develop different ways to find good loans to originate. There is also the possibility that some sources of income such as yield spread premiums will come under scrutiny again. Mortgage brokers are faced with the possibility that there will be government regulations that will limit fees and change terms and conditions on certain types of loans, which can drastically cut a broker’s income. Therefore, brokers will have to make a special effort to train originators to pursue other sources of business, such as working with Realtors and builders, Falk says, in order to retain their branch membership.

The concern regarding predatory lending will also require net branch parent offices to provide a higher level of education to branches. Falk says it is too early to tell if state and federal regulations will restrict access to credit for borrowers by putting restrictions on loans where borrowers have limited incomes. By putting more training and quality-control standards in place, brokers will be able to navigate in this new environment, he says.

There are several other ways to help net branches survive the change in the mortgage climate.

Create barriers to entry. It should be hard to start a new mortgage company, and longevity should be measured in decades—not in months. New loan officers should have a commitment to the industry. There should be required education and testing, continuing education and a national licensing authority that has the ability to strip the licenses of bad actors and keep them out the industry.

In my view, brokers and lenders alike should band together to support a national mortgage loan officer licensing act—not a registration, but a licensing act with stringent requirements to pass and whose administrator has authority to suspend licenses for those who prove unfit to be part of the industry.

Form alliances. Brokers should be active in state and national industry associations such as the Mortgage Bankers Association (MBA) and the National Association of Mortgage Brokers, to create more solidarity and to forge a national voice.

Brokers should examine why they got into this business,

identify their strengths and focus on them. Most brokers are savvy marketers and salespeople. Somehow many end up focusing most of their time on running a small business rather than doing the work they went into business to do. By aligning themselves with a reputable branch network they gain national branding, back-office support and special lender pricing that puts the broker back in the business they love. This approach also lets them keep the lion’s share of the profits of the branch, which often is more than they would get going it alone since the infrastructure costs are shared by many in the network.

Regardless of which method is used, brokers must ally themselves with one another in order to grow and remain a healthy sector in the mortgage industry.

Work with unwavering ethics. Brokers must aggressively weed out the originators in their branches who cause people

to question the mortgage brokerage industry’s ethics. Some lenders are led to view brokers as essential to the current industry paradigm, yet at the same time they are seen as unloyal, unethical and uneducated about industry compliance and secondary market business models. This view needs to be improved. When the entire industry is working toward a common goal that is built on constructive and ethical motivations, everyone wins.

Education, education, education. The mortgage industry is one of the most highly regulated industries. And the bottom line is that a focus on education is essential for success. Lenders have stepped up internal education efforts and have even turned recently to educating brokers. For example, SouthStar Funding LLC, Atlanta, has a comprehensive broker training course; Countrywide Home Loans Inc., Calabasas, California, now has weekly

conference calls to train brokers; DecisionOne, Frazer, Pennsylvania, has some training available to brokers; and BayView Financial LLC, Miami, has created an entire training course on small commercial lending to train residential brokers. This external education effort is an example of lenders reaching out to make their relationships with brokers viable on a long-term basis. These efforts are not altruistic; lenders rely on having educated brokers in order to optimally distribute their products through the wholesale channel.

Brokers should aggressively educate themselves not only on marketing and sales techniques, but also on state and federal compliance, secondary market nuances and customer service. The real estate and insurance industries require extensive initial and continuing education. Mortgage brokers should aggressively educate themselves whether it is mandated or not.

Partner with lenders. As mentioned earlier, the relationship between lenders and brokers is a delicate one that has to be

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nurtured in order to be maintained and grow. But far too often brokers exploit several lenders for the here and now rather than partner with a few lenders for long-term business success.

Recognizing that lenders all have their specialties, core products and competencies is important, but business is still about relationships—and relationships have their ups and downs. Brokers must create true business partnerships with those lenders that will stand by them and allow their branches to be successful in the communities they serve. Let's face it: Wholesale lenders are not a constitutional right for brokers. Brokers depend on the distribution of product by lenders to brokers, to then sell to borrowers. That partnership should be a solid one that can weather good times (high origination volume) and bad times (not-so-high volume) alike.

This is an exciting time for mortgage brokers and their branches. Not only do they have the chance to help consumers by offering a variety of loan products, but brokers are a viable segment of a thriving industry.

Uncertainty about interest-rate cycles has always been an integral part of the mortgage industry. It is part of what

makes it an exciting business, Fulmer says. However, that uncertainty about business conditions makes it even more important to forge lasting relationships with business partners. The focus on maintaining long-term relationships will

be key to the success of net branches and go a long way to rebrand brokers as a viable source of quality loans.

As the regulatory climate becomes tougher, as brokers find technology a viable means to expand operations across state lines and as business becomes more complicated, brokers will need more sophisticated infrastructure to expand and continue to gain market share. Mom-and-pop owner-operators may find it difficult to compete in this environment. When properly deployed, net branch companies offer the support, infrastructure, compliance and legal support, education and branding needed to grow as a meaningful segment of the mortgage industry. With constant introspection

and a commitment to best practices, the future looks bright for mortgage brokers. **MB**

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