Funding Overview

In the context of the primary market, where business is transacted between the mortgage lender and the borrower, **funding** is the payment of loan money by a lender to a borrower so that he or she can purchase real estate. In the context of the secondary market, where business takes place between the mortgage lender and the investor, funding is the payment of money by investors to lender in return for mortgages sold to them. To avoid confusion between these two uses of the term "funding," we will use the term financing to discuss the overall process of how lenders obtain the money required to close loans.  
  
There are several different methods by which the lender finances loans, and which method is used by a particular lender depends on the lender's business model.

Warehousing

Since they are generally not highly capitalized, many mortgage bankers and some large mortgage brokerage companies borrow from a warehouse line of credit for the money they lend to the borrower at a mortgage closing. In this case, the money to finance the loans is borrowed using a short-term revolving line of credit established with a commercial bank called a warehouse bank. The money borrowed from this line of credit is used to make mortgage loans. Once the loans are sold to an investor, the mortgage banker repays the warehouse line and can use the line of credit to finance more loans.  
  
The interim period between the financing of loans at closing and transfer to the investor is called the warehousing period. During the warehousing period, closed loan packages are generally prepared for shipping and delivery to investors. Just before the loans are shipped, they are usually put through a final quality control check to ensure that everything is in order.

Sources of Funding

Mortgage lenders are considered financial intermediaries because they connect money they obtain from other sources with borrowers who need money. We will begin with a look at funding from the primary market perspective, where funding refers to the transfer of money from the mortgage banker to the borrower.

Sources of Funding

| **Type of Lender** | **Funds Source** |
| --- | --- |
| Depositories (banks, thrifts, credit unions) | Deposits from consumers and businesses, income from servicing operations, borrowing money from the Federal Home Loan Banks (FHLB) |
| Mortgage bankers | Borrow money from other financial intermediaries, such as warehouse lenders |
| Depositories or mortgage bankers | Federal, state, or local governments (USDA, state agency) |

Types of Funding

How a loan is funded depends on the business model of the lender and whether the loan is going to be kept in portfolio or sold to an investor. Mortgage lenders may fund secondary mortgage market loans in three ways, described in the table below. Often, a lender will use a combination of them.

| **Source** | **Lender** | **Description** |
| --- | --- | --- |
| Self Funding | Depository | A depository may fund a mortgage initially at closing with its deposits, then receive funding from the investor who buys the loan. (This can be days, weeks, or even years later.) This is often called a self-funded secondary mortgage market transaction. Large depository lenders (these would include "the big four" banks) often also have servicing operations and derive income from this source that can be used to fund loans as well.  Mortgage bankers or mortgage brokers do not self fund. They either use the investor's money at closing or borrow funds to close a mortgage loan until they receive payment from the investor. |
| Table Funding | Smaller Mortgage Bankers | Table funding is a mortgage transaction in which the investor lends its money directly to the borrower at closing. The third party originator (mortgage banker or correspondent lender) closes the mortgage in its own name for simultaneous assignment to the investor who advanced money for the funding.  This is a type of funding often used by mortgage lenders that are too small to qualify for a warehouse line of credit or other sources of funds. |
| Borrowing | Mortgage bankers | If the mortgage banker does not table fund, then it must borrow funds for the mortgage closing until the investor wires the money to the lender when the loan is actually sold.  The period of time between giving the borrower the money at closing and getting that money back from the investor can be a few days, weeks, or even months later. |

# Sources for Borrowing

The main sources for borrowing are:

* [Warehouse lending](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

**Warehouse Lending**  
  
A short-term lender for mortgage bankers. Using the note as collateral, the warehouse lender provides interim financing until the mortgage is sold to a permanent investor.  
  
The term "warehouse lending" harkens back to when the physical notes were held in a warehouse until the loan sale was finalized and they were delivered to the investor.

* [Repurchase agreement](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

**Repurchase Agreement**  
  
Through a repurchase line, the warehouse actually purchases the loan from the mortgage banker, who then agrees to repurchase the loan at a specified time and price for delivery to the investor.

* [Commercial paper](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

**Commercial Paper**  
  
Commercial paper is a short-term note, usually unsecured. A financially strong institution may obtain lending money by selling commercial paper to a securities investor. Repayment is normally made in 5 to 90 days after the lender has sold the loan on the secondary market.

* [Federal Home Loan Banks](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

These are wholesale banks that many community financial institutions turn to for funds. The Federal Home Loan Bank (FHLB) System was established in 1932.  
  
To borrow from the FHLB, a lender must be a member bank. Membership is open to thrifts (savings banks, co-operative banks, and savings and loans) and credit unions. Borrowing from the FHLB has the following advantages and disadvantages:

* ***Advantages***
  + Collateral requirements are low, making qualification easy for small member banks
  + The line of credit has no minimum or maximum level
* ***Disadvantages***
  + Interest rates can be slightly higher than those of a warehouse lender

# Warehousing Overview

The most common form of short-term borrowing for a mortgage banker acting as the lender is a warehouse line of credit. The mortgage banker has a line of credit with a warehouse bank. A warehouse bank is a lender's lender.  
  
The lender accesses its line of credit at closing. When the lender receives funding from the investor, it repays the line of credit. Once line of credit is replenished, the lender can borrow these funds again and start the process over.  
  
The use of borrowed funds to increase return on investment is called leverage.  
  
There are a number of features that determine how much the lender can borrow and how much the warehouse line will cost the lender. Let's look at some of these features.

Warehousing Features

There are a number of features that determine how much the lender can borrow and how much the warehouse line will cost the lender. Let's look at some of these features.

| **Feature** | **Description** | **Implications** |
| --- | --- | --- |
| Line of Credit | The lender obtains a credit line up to a specified maximum amount for a specified time. The dollar amount of the credit line is determined by the:   * Lender's financial strength * Lender's expected monthly volume * Average length of time the lender borrows money from the warehouse credit line | *How much can the mortgage lender borrow?* |
| Collateral and Wet Settlements | A warehouse line of credit is usually secured by collateral. The collateral for the line is made up of mortgage notes payable to the lender, which have been assigned and delivered to the warehouse, or the warehouse bank is otherwise in possession of the collateral package.  A warehouse may make a portion of the line available on an unsecured basis for [wet settlements](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)  **Wet Settlement**  An advance of new funds to a mortgage banker for funding or purchasing mortgage loans in which the collateral package is not in possession of the collateral agent, or is not free of lien or bailment.  . In this situation, an advance of new funds is not secured like it is in a collateral settlement. This is usually a more risky type of credit and may require a higher interest rate, shorter term, and greater financial strength on the part of the lender. | *Typically, the warehouse lender holds the note as collateral. A wet settlement has more risk for the warehouse lender.* |
| Outstandings | The funds currently on loan to the mortgage banker are referred to as *outstandings*. Lenders are charged interest on outstandings. The interest rate is normally floating and is based on the warehouse bank's prime rate. | *How much money is currently on loan to the mortgage banker?* |
| Compensating Balances | Lenders maintain a compensating balance to offset their interest rate on outstandings. Compensating balances are an agreed-upon level of non-interest paying deposits held in the lender's demand deposit account at the warehouse bank. The warehouse bank lowers the line of credit rate based on the amount of deposit. | *Does the mortgage lender have any money deposited with the warehouse lender to offset the interest rate?* |
| The Haircut | Generally, the amount advanced to the lender by the warehouse against each mortgage note is actually less than the face value of the note. The difference between the amount advanced and the face amount of the note is called the *"haircut.*" The warehouse does this to give itself a cushion in case the market price of the note decreases.  The percentage of haircut varies based on a number of factors, but is usually around 5%. Click for an [example](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)  **Example**  Here is an example of a haircut:   * A lender loans a borrower $100,000 for the purchase of a house. * The borrower signs a mortgage note with a face value of $100,000, payable to the lender. * The lender assigns the note to the warehouse lender as collateral and withdraws a $95,000 line of credit. * The warehouse lender retains the difference of $5,000, called the "haircut."   . | *How much is the warehouse lender willing to lend against an individual mortgage note?* |
| Fees | Also, most warehouses charge lenders an additional form of compensation. Although there are many miscellaneous fees that may be charged, one common type of fee is a commitment fee. A commitment fee is an annual charge for the use of the line of credit. | *What other costs must the lender pay?* |

Shipping and Delivery Overview

In the sale or securitization of mortgage loans, shipping is the preparation and delivery of documents for loans sold to investors. Delivery is the physical transfer of loan documents to an investor or agent in accordance with the [commitment](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

**Commitment**  
  
In secondary marketing, an agreement, in writing, between a lender and an investor to buy and sell mortgages under specific terms.

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A successful lender active in secondary marketing requires a good shipping and delivery operation. This area enables the lender to:

* Meet its documentation commitments on time.
* Receive prompt funding from its investors.
* Pay off borrowed funds.

Meeting these objectives improves the lender's profitability. Meeting investor commitments and requirements also allows the lender to maintain existing and develop new investor relationships, giving its customers more lending programs and options.

The Six-Step Process

The shipping and delivery staff are responsible for coordinating all the activities involved in packaging and delivering the sold loan to the investor or its agent. Specific operations differ from lender to lender and depend on investor requirements.

In general, the six steps of shipping and delivery are:

* [Match loans to investor commitments.](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

**Step 1. Match loans to investor commitments.**

The purpose of the shipping and delivery function is to see that investor commitments are fulfilled:

* + Within the specified deadlines
  + According to the investor's requirements

To meet the investor commitment requires that the lender submit a correct, complete file to the investor before the commitment expiration date. If the lender does not deliver the loans as required under the terms of the commitment, it is known as a "failed delivery," and the lender can be subject to penalties or to the re-pricing of the loans at a loss.  
  
A lender must complete a significant amount of work after loan closing in order to deliver it properly.

* [Review loan files and prepare required documentation.](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

**Step 2. Review loan files and prepare required documentation.**  
  
Once the proper loans are identified and in the shipping and delivery area, the shipping and delivery area will review the files for accuracy and completeness.  
  
Each investor requires different schedules and documents in order to make a "good delivery" under the terms of the commitment. Uniform documentation developed by Fannie Mae and Freddie Mac has made delivery a more manageable process.

* [Make a digital image or copy of critical documents for the lender's records.](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

**Step 3. Make a digital image or copy of critical documents for the lender's records.**  
  
The lender must maintain the complete application package in case the investor requests it for audit or quality control purposes.

* [Prepare transmittal documents.](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

**Step 4. Prepare transmittal documents.**  
  
Transmittal documents reconcile all of the principal, interest, and escrow funds that are changing hands or being "transmitted" between the lender and investor. The lender needs to establish a custodial account for borrower-paid funds so the investor can access them.

* [Perform a quality control check.](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

**Step 5. Perform a quality control check.**  
  
The lender will often perform a final, pre-funding quality control check just before delivery, since the loan file is almost complete at this stage.

* [Ship the loan documents.](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

**Step 6. Ship the loan documents.**  
  
The processes involved in shipping loans to an investor vary based on the delivery software, investor, and loan product. Consider:

* + **GSEs —**Use shipping software that checks for errors and prevents the entering of incorrect values into the system. Such systems are Fannie Mae's**Loan Delivery**application and Freddie Mac's**Service Loans**application. For example, if the shipper inputs an incorrect payment for a certain term, interest rate, and loan amount, the program will not accept it.
  + **Private Investors —**Generally want the shipping package to be in a precise order. The shipper must make copies of every form to retain in the company's loan file, as the private investors may want all the original forms shipped to them.  
      
    At a minimum, the investor requires the following documents:
    - Original Mortgage / Deed of Trust and riders
    - Note
    - Assignment of Mortgage
    - Loan Schedule itemizing certain characteristics of the loan

Click the links above for more information on these steps.  
  
Once the documents are shipped, the lender receives the wired funds from the investor.

Importance of Communication

It is critical that shipping and delivery, closing, and the [pipeline](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

**Pipeline**  
  
Loan applications that are in process that have not yet closed.

 managers communicate well, so the shipping and delivery area is aware of the immediate and upcoming investor commitments and has the time and resources to complete the final steps. Then the closing area must provide all the loans required in meeting these commitments.

Quality Control Overview

A lender will often perform a final, pre-funding quality control check just before delivery, since the loan file is almost complete at this stage. This helps to make sure the delivery goes smoothly.  
  
The area of quality control has grown in importance in the last ten years because of the discovery of high levels of mortgage fraud in many applications and because of poor repayment performance of loans included in various mortgage-backed securities.

Quality control programs have two main objectives:

* Detect and help minimize production and closing errors.
* Detect and help minimize mortgage fraud.

Investors require that lender engage in a quality control program and set minimum standards for such a program. Production errors and fraud can have serious consequences — not just for loan delivery to the investor, but also for repayment of the note or enforcement of the lien. At a minimum, a production error or discovery of fraud will delay the sale of the loan and often results in financial loss for the investor.

Common Elements of a Quality Control Program

Common elements of a quality control program include:

* Independence from the production area, even from the lender itself
* Required random sampling of a minimum percentage of loans produced
* Required targeted sampling of each different element of production:
  + Origination channels (online, retail, wholesale, correspondent, etc.)
  + Different loan programs
  + Different production areas, if applicable
  + Different originators, processors, underwriters, closers
  + Different high risk loan areas (i.e., self-employed borrower, condominium, etc.)
* Required re-verification of a minimum percentage of loans produced (reprocessing and re-underwriting of the entire loan file, including sending out verifications of deposit, income, and debt, and obtaining a new credit report, new appraisal, and any other documents used to make a credit decision)

Quality Control Process

Until 2000, most quality control activity occurred AFTER loan delivery to the investor. With the expansion of subprime mortgage lending, increases in third-party originations, and an increase in level of mortgage delinquency overall, the practice of quality control changed dramatically.

The industry moved to engage in quality control steps earlier and earlier in the lending process. Most QC reviews are performed before closing, even before an underwriting decision is rendered. This has helped to:

* Reduce underwriting, pricing, and documentation errors
* Correct compliance violations
* Reduce repurchase losses, defaults, and foreclosures

Discovery Activity

Ask your supervisor at what point or points in the lending process your company completes its quality control review.

**Repurchase Order**A growing concern in recent years is investor repurchase orders to the lender. If a loan is delivered but has some deficiency, then the investor may order the lender to repurchase the loan or replace it with another one.  
  
Repurchase orders can be a result of both production errors and/or of mortgage fraud. It often will take a lender a long time to correct the deficiency and re-sell the loan.  
  
Repurchases result in financial losses to the organization as well as an administrative burden. If a repurchase cannot be cured (fixed) it can result in the lender having to sell the loan at a loss in the market (scratch and dent sale) or hold the loan in their portfolio as an “unmarketable” loan. An unacceptable level of repurchases eventually leads to the investor refusing to do business with the lender.

# Mortgage Fraud

It is the responsibility of all participants in the mortgage industry to be informed on the various types of fraud that are perpetrated against mortgage lenders and to remain diligent in identifying potential acts of fraud by players from within and outside the industry.   
  
There are several organizations charged with investigating and prosecuting fraud in the mortgage industry, including the FBI, the Consumer Financial Protection Bureau, and the Department of Justice. The first line of defense against fraud, however, is for front line associates in every position within the industry to remain alert to red flags, follow protocols designed to prevent fraud, and report all cases of suspected fraud.   
  
The presence of mortgage fraud anywhere in a mortgage loan is a justification for an immediate [repurchase order](http://education.mbaeducation.org/courses/1/DL2_011012/content/_172509_1/index.html)

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