Flight To Quality

People, loans, and money are seeking out and moving toward quality. To survive in this market, you need to understand this fundamental shift.

Late one evening last week, I sat in the corporate offices of one of the nations largest mortgage lenders and watched the owners break down and cry at the thought that their company would go out of business within twenty-four hours. A multi-billion dollar mortgage lender was about to go...... poof! Days earlier a few of their concerned people asked me to fly in and help them determine what was going wrong within their lending system and if it could be turned around before it was too late. However, by the time I got there, they were already victims of the “Flight To Quality,” too bad they didn't see the shift months earlier.

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The problem lenders are feeling isn't a “Sub-Prime problem,” or a “Financial Crisis”.... it's a quality and educational problem. Before I explain this statement, let me provide a little background.

The thing called “Wall Street” or the “Secondary Market” is a vast pool of money supplied by many diverse sources (investors) including insurance companies, investment trusts, banks, companies in China, investors in Japan, FNMA, FHLMaC, and people off the street. All of these people and entities become involved with the Secondary Market by purchasing a variety of investments most commonly called mortgage backed securities (MBS).

Money flows through many hands. A home buyer fills out paperwork with a local mortgage broker who, sends the paperwork to a mortgage lender who “obtains” the money from the “Secondary Market.” The money is sent to an escrow agent who pays the seller and the buyer owns a home and a mortgage (phew).

For years people investing in the Secondary Market have been told that the quality of the mortgage backed securities was great. Making money was almost guaranteed and the chance of losing was almost impossible. As a result, investors poured trillions of dollars into the Secondary Market and were willing to accept a small return on their “safe” investment. The problem was, they were being lied to by the “Advisors” or bond rating agencies. As foreclosures in this country climb from 65,000 per month, to 165,000 per month, and likely go higher, the investors in the Secondary Market are finding that their investment analyst was .... well didn't know what he was talking about. “Advisor/Analyst” were throwing words around like “guaranteed,” “no way to lose,” “the safest investment in America.” The Secondary Market believed the hype and kept buying MBS even when things seemed odd.

Now we know the “Advisors” really did not understand the mortgage business at all. And the advice they gave to Wall Street wasn’t backed by good knowledge or research..... it was just some dweeb waiving his arms around making it look like they knew what they were talking about. After all, they had been hired by the brokerage houses and were paid big salaries.... so they have to know what they are talking about...... don’t they?

As I sat in the office of this large lender, I was trying to figure out what had gone so terribly wrong with their lending system. Then it became apparent. They hadn’t done anything terribly wrong..... only a little wrong.

Month’s prior, HUD found a number of loans going bad. Not unusual, but in this case the loans were mainly from a select few mortgage brokerages. Ends up that the lender had an ownership position in these various mortgage brokerages, scattered throughout the U.S. As a result of their ownership, the loans were not reviewed as thoroughly as they should have been and a few problems got thru the system. HUD discovered the problems, issued a cease and desist letter and said the lender should change its internal operations and divest itself of ownership in these mortgage brokerages. A letter was published, and a few changes made, and that was that. Minor pain.

After hearing about the little HUD issue, various investors from the secondary market started questioning the loans in their portfolio, including the ones with no payments problems. Upon closer review they discovered a few of the loan application forms contained misleading statements and the appraised values were not based upon the Federal definition of “market value” as required by law. The appraiser made a serious mistake by not following this definition when stating value. Oops there goes the quality.

Investors tend to become conservative especially when their safe secure “guaranteed” world has become shaky and at risk of losing money. Remember investors are often investing other people's money, and if they lose money, they’re out of a job. Investors have discovered that the Wall Street “analysts” didn’t know what they were talking about. Now investors don’t know who to trust or where to turn for help. Trust and the quality of information are big issues in the Secondary Market. So investors pull their money away from the one thing they felt comfortable with, MBS. Why?

The purchase and sale agreements, written up by agents, contain fraudulent terms..... like cash back to the buyer, or a new car in the garage of that new house.

Many loan originators, due to their lack of licensing, also lack good education. They think a “cash back deal” is acceptable, after all they saw late-night-TV-hype where they said getting $35,000 cash back at closing was a great investment tool. So it must be OK.

The appraiser was selected because he was the cheapest, could turn an appraisal in 24 hours.... and he “always hit the number.” The mortgage broker sends the appraisal request to the appraiser and states he’d better hit “the value”.... or the deal is dead. Unfortunately for the lender, the appraiser didn’t know there is a difference between sales price and “market value.” Oh well, no problem. We got the loan to close so what could possibly go wrong now?
Now we come to me sitting in the office of this major lender. Various investors from the secondary market have discovered the loans are not perfect..... the lender has a pimple. Not a big flaw... but enough that everyone could see. A small group of investors become nervous, due to the problematic HUD audit, and demanded that the lender “buyback” $50 million worth of mortgages. You know the performing ones that included the car or have a bad appraisal (the small pimple). $50 million is not an unusual sum.... but the investors want their cash back so they can invest elsewhere.... the “Flight to Quality” has begun.

Now the state banking department audits the lender and finds another small pimple or two and another group of investors demand “buybacks.” Others, being afraid and cautious, pull the lender’s lines of credit. And the “Flight to Quality” gets serious.

Why pull the lines? Because they are afraid and don’t know who to trust, so they default to anybody, any lender, any investment that looks perfect. Not just OK, as in the past, but blemishes free, and that lender with the minor HUD or State audit isn’t perfect, and perfect is in these days.

The investing community is crying out for quality and until they find it, they have pulled their money in close, to some safe place, regardless of the return. Safe is what they need and until the market can assure investors that they have a quality investment...... the money stays out of the market.

The United States.....and the World are not short of money to lend..... just short of quality loans to invest in. So anybody that has a quality product gets more money than they can handle. For example, the mid size bank Hudson’s or World Savings (prior to being purchased) have taken great pains to insure that the appraisals were rock solid. They didn’t want an appraisal that “hit the number” they wanted a real “market value” appraisal that they could trust. They even went so far as to review loan submissions and bar any that contained a car or cash back with the purchase of a new home.

Wow..... what a concept! A loan on the value of real estate.... not real estate and a personal loan or car loans..... an honest to goodness real estate loan backed by a great appraisal. It’s that quality thing I was talking about.

You know the result of all of this demand for quality? Hudson’s and every other nit picky lender like them are profitable, rolling in money and can make lots of loans..... even for Alt-A and Sub-prime mortgages. They are among the winners in the “Flight to Quality.” So now you should think back. What kind of loans did you do? Was the quality blemish free with no pressure on the appraiser or inclusion of cash back, or did you cause the “Flight to Quality” to flee from you, the mortgage broker and your lender?

So here’s what the market is going to do. Since it can’t trust the appraisals or prevent the inclusion of a cash back to the buyer it has to offset with something else:

- Require higher FICO scores for borrowers
- Require larger down payments.
- Higher interest rates.
- Pulling lines of credit and demanding “buybacks” from any lender with a blemish
- Requiring a higher net worth of all lenders
- More back ground checks on borrowers, appraisers, lenders and mortgage brokers
- Less money available in markets that have poor performing loans and high foreclosure rates

In other words, investors avoid anything that is less than perfect and are looking for anything that appears to be of high quality.

Solution

So what can you do to profit from the “Flight to Quality?” You must give the market what it wants. If you do, the money gates will burst open and you will have more money than you can swim in.

Here’s how to increase the quality:

1. Stop accepting deals with:
• Cash back to the buyer
• Inclusion of personal property
• Down payment assistance from anybody other than family
2. Hire great appraisers, not “form filling number hitters” but great appraisers.
3. Stop asking them to “hit the number.” Let them do their job and appraise at the federally required “market value.”
4. If values in your area are declining, appraisers must mark the box “declining values.” If they do not mark the correct box, then investors know the appraiser is lying and you’ve defeated the whole quality perception.
5. Require criminal background check for every loan originator.
6. Every loan officer and employee should get education..... lets correct that to.... great education including what is fraud and how to work with the appraiser.
7. Get every loan officer, working for a lender or mortgage broker, licensed... and do it immediately! Money is moving to states with loan originator licensing, so get in on the cash flow by licensing everybody.. and I mean everybody.

I’ve been through this “shortage of cash” several times before. I’ve watched lenders crash, while others soar. If you are unwilling to implement the suggestions, then get out of the business and let others do what’s right.

If you’re willing to change, contact me. I can help you earn incredible profits by riding the first class ticket on the “Flight to Quality.”