Warehouse Lending Fact Sheet

The liquidity for most home mortgage originations in the United States is provided by "warehouse lending" facilities — a little-known but vital source of liquidity that facilitates the American dream of homeownership. Warehouse lending operations efficiently and affordably finance the home mortgage lending of independent mortgage bankers (IMBs) that account for well more than half of all mortgage originations. The warehouse lending business is one of the most important, and perhaps least understood, ways in which insured depository institutions support our nation's housing finance system. Warehouse lending is a low-risk, efficient line of business that promotes competitive housing finance markets, lowers consumer costs, and supports safe and sound lending practices.

What is Warehouse Lending?

Warehouse lending is the well-established practice of depository institutions providing various structured financial solutions — either lines of credit or repurchase agreements — to non-depository independent mortgage banks (IMBs) to facilitate home-lending to individual borrowers.

IMBs are not traditional banks — they don't collect deposits and thus don't have a traditional bank's source of liquidity to fund loans. Instead, they rely on "warehouse lines of credit" — borrowing facilities usually provided by traditional insured depository institutions — to provide the necessary liquidity for IMBs to do what they're best at: originating loans to individual borrowers and selling them to investors. In short, warehouse lenders and their IMB customers move more than one trillion dollars of capital each year from Wall Street to Main Street.

Who are Warehouse Lenders?

Warehouse lending is usually a division or "vertical" of both large consumer or commercial banks as well as midsized community banks. Rather than engage in direct-to-consumer mortgage lending (though many also do this from a traditional mortgage division), warehouse divisions work directly with IMB clients to provide critical short-term funding for consumer mortgage originations. In these cases, warehouse divisions are simply another arm of a commercial bank's organization. In other cases, some banks, often called "capital banks," exist specifically to do this type of lending to IMB clients, relying on warehouse lending as their primary business. Regardless, virtually all of these lenders are depository institutions regulated by both federal and state banking regulators.

How does Warehouse Lending Work?

There are two principal warehouse lending facility arrangements, and while each is structured somewhat differently, they both perform the same basic functions: to provide short-term funding to IMBs to originate mortgages and repay the warehouse advances when the loans are sold. The structures are either a warehouse line of credit or a Master Repurchase Agreement (MRA).

- A Warehouse Line of Credit is a traditional revolving line of credit that uses the mortgage notes originated by the IMB as collateral for advances from the warehouse bank. The IMB retains ownership of the note, and all the benefits thereof, but the warehouse bank takes a lien interest and maintains control of the mortgage until the note is sold to an investor.
- An MRA is commonly called a "Repo." With this structured facility, the IMB originates and sells a closed loan to the warehouse bank with the requirement that the IMB repurchase the loan in the near future. The purchase of the loan by the warehouse bank is generally done simultaneously with the consummation of the note and security agreement, at the closing. Then, the repurchase by the IMB is generally done simultaneously with the sale of the loan to the end investor, with the proceeds of the sale making the warehouse lender whole.

How Does a Warehouse Program Work?

STEP 1

A warehouse lender enters a relationship with an IMB client. This relationship includes a "covenant," with safety and soundness standards the IMB must adhere to in order to maintain good standing with the warehouse bank. The IMB can then request funds from the warehouse bank to fund individual loans to borrowers, so long as they are eligible and meet the requirements spelled out in the covenant. These covenants are reviewed for compliance monthly or quarterly.

STEP 2

At the closing of a loan, the IMB requests funds and directs the warehouse bank to send funds to the specific settlement or closing agent. In most cases, if the collateral is acceptable to the warehouse bank, they will advance all but a small percentage of the loan amount, with the IMB providing a small "haircut" via their own funds. The warehouse "advance rate" typically runs between 97 to 100 percent of the loan amount.

STEP 3

The closing agent sends the mortgage note to the warehouse bank as collateral for the money the warehouse bank just extended. They expect the IMB that originated the loan to repay them in a few days to weeks. Each day the loan remains on the line (called "dwell time"), the bank accrues interest that the IMB will have to pay back to the warehouse lender.

STEP 4

To pay back the warehouse lender, the IMB needs to sell the loan to an investor. The IMB will sell loans that meet a given investor's underwriting requirements, either individually or in bulk, packaged together as a "mortgage-backed security" (MBS). Investors can be Government Sponsored Enterprises (GSEs) such as Fannie Mae or Freddie Mac, commercial banks, larger IMBs (known as "aggregators"), or investors in Ginnie Mae securities issued by the IMB.

STEP 5

When the investor's process for approving the purchase of a loan or MBS is complete, and they have received the collateral, the investor wires funds to the warehouse bank. The warehouse bank subtracts proceeds for principal, interest, and fees due from the IMB and then sweeps the remaining funds into a commercial checking account, generally held at the warehouse bank.

STEP 6

As soon as the warehouse lender is repaid, it releases the note to the end investor that purchased it from the IMB. The lending capacity is then replenished, allowing the IMB to fund another loan through the same process.

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Is Warehouse Lending an Expensive Source of Funds?

Warehouse banks typically charge a small funding fee to their IMB clients on each loan and also collect interest for the short dwell time between the origination and sale of the loan to an investor. As warehouse banks are competing for business among their IMB clients, they try to keep the costs of funds low. Warehouse credit is short-term, collateralized, and low-risk — thus, rates are relatively low. For warehouse lenders, sustaining loan volumes and managing operational risk are the keys to profitability, as margins are usually very thin.

Is Warehouse Lending a Safe Line of Business?

On a typical mortgage warehouse transaction, the warehouse bank has five sources of repayment. The primary source is the investor to whom the originator has committed to sell the loan. In the rare event that the transaction fails, the next source of repayment is the originator itself, who would repurchase the loan off the warehouse line. Alternatively, the warehouse lender could sell to a different investor, often one who specializes in buying "scratch and dent" loans. Should the originator be unable to repurchase the loan, the warehouse bank could take the loan into its mortgage portfolio and look to the consumer/borrower, as the source of repayment via regular monthly payments. And lastly, should the borrower not be able to repay, the warehouse bank could rely on the collateral secured by the mortgage and foreclose (and file claims under any insurance provided by FHA, VA, or private mortgage insurance).

Given the multiple repayment sources, warehouse lending is very safe and, when managed responsibly, presents a relatively low-risk business, both for the banks that conduct it as well as for the broader housing finance system:

1. **Warehouse Credit Is Short-Term:** The duration a loan is on the warehouse lender's "books" is usually about 15 days. Not only do warehouse lenders require their IMB clients to produce high-quality loans they can sell to an investor, but by being a part of the lending process for only a couple weeks, the risk of the warehouse lender being exposed to a default is small.
2. **Warehouse Credit Is Collateralized:** During the short time the mortgages are on the warehouse line, the warehouse bank possesses the notes collateralizing the line. Should the bank need to take possession of the mortgage as well, those whole loans are further collateralized by the underlying real estate. Importantly, in the rare case of selling a loan to recover monies owed, the warehouse lender is paid first, before the IMB originator.
3. **Warehouse Credit Is Diversified:** Warehouse lenders diversify their risk by working with many IMB clients. In instances of bankruptcy by an IMB client, warehouse lenders typically have dozens of other IMB clients, spreading the risk safely, as well as providing a ready list of potential buyers for the collateral in case of default. In addition, each warehouse credit facility is collateralized by a diverse population of individual mortgages.
4. **Warehouse Lending has Strong Risk Management Structures:** Warehouse lenders diligently and routinely monitor their clients' financial status and operational efficiency. In addition, the warehouse bank maintains control of the collateral supporting the lines of credit, releasing loans to investors only upon receipt of funds. Should an IMB fail, the warehouse lender can easily take possession of the collateral and liquidate it.
5. **The Warehouse Market Is Liquid:** The mortgage market is developed, mature, and liquid. The assets that collateralize warehouse credit facilities — particularly GSE- and Ginnie Mae-eligible loans — can be sold quickly and efficiently.

Warehouse lending is a critical component of the mortgage market because it allows each type of institution to maximize its special role in the housing finance system. IMBs are not full-service banks. Their specialty is offering residential mortgage loans to individual borrowers and selling those loans into the secondary market. IMBs are solely focused on the operational excellence necessary to deliver a complex product that helps make the dream of homeownership a reality.

Warehouse lenders facilitate this efficient delivery system by providing the necessary liquidity to IMBs, who in turn are the primary providers of government-backed and GSE loans designed to serve low- and moderate-income, minority, and first-time homebuyers. Consequently, federal banking agency policies — including risk-based capital requirements, Community Reinvestment Act rules, and other agency requirements — should recognize the vital role of warehouse lending in our housing finance system.