The Role of Nonbanks in Expanding Access to Credit

Prepared for Ginnie Mae

Prepared by: State Street Global Advisors and Urban Institute's Housing Finance Policy Center

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RESEARCH REPORT[1]

The last six years have witnessed a tremendous increase in the role of nonbanks in originating single-family residential mortgages. This is in part because the post-crisis retreat of large depository institutions from mortgage lending left a void, thus creating an opportunity for nonbanks. The pull back by depositories from government-backed lending was driven by a multitude of factors that include significantly higher bank capital requirements under Dodd-Frank thus making it expensive to own mortgages assets, as well as elevated levels of put back, enforcement, litigation and reputational risk.

The ramp up in nonbank lending is much needed because it offsets, at least partially, the corresponding decline in bank lending. But more importantly, this increase has come at a time when credit is extraordinarily tight, suggesting that nonbanks are playing a critical role in helping ease tight credit. This report describes the specific role of nonbanks in expanding credit access within the Ginnie Mae market by examining the borrower segments they are serving, and finds that nonbanks are more likely to lend to lower-FICO borrowers than banks are. This brief also discusses the need for better regulatory supervision of nonbanks and concludes that the growing role of nonbanks must go hand in hand with enhanced regulation to ensure a safe and sound industry that can serve borrowers in both good times and bad.

Post-crisis Growth in Nonbank Lending

Leading up to the financial crisis, banking institutions dominated almost all segments of the mortgage business, from origination to secondary market activities to servicing and loss mitigation. But this

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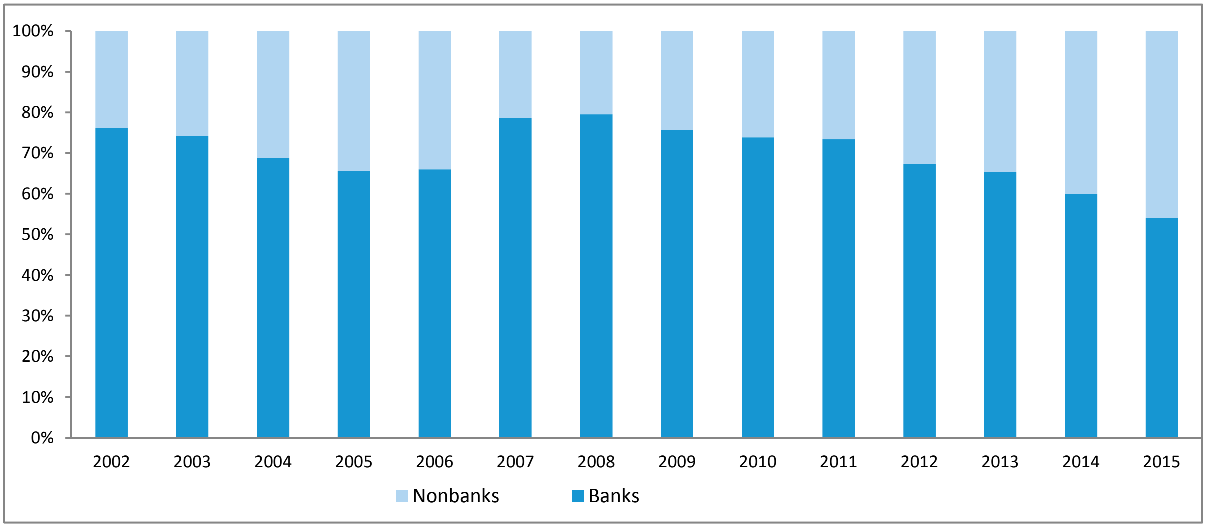
concentration of mortgage business in depository institutions has reversed significantly since the crisis, opening the door to smaller non depository institutions. Figure 1 shows the market share split between depositories and non-depositories based on annual origination volumes from 2002 to 2015 (all loans).

FIGURE 1

Origination Market Share Split Between Banks and Nonbanks, 2002–15, all Loans



Source: Urban Institute calculations based on HMDA and Inside Mortgage Finance data. 2002 to 2014 share calculated using HMDA data. 2015 share using IMF data

There are a few reasons for this shift. First, large depositories were heavily exposed to loans made during the housing bubble. As defaults increased after the bust, many of these loans were subjected to buybacks under the government-sponsored enterprises' (GSEs') rep and warrant and the FHA's indemnification policies. This forced banks to not only repurchase billions of dollars in troubled loans, but also pay tens of billions of dollars in hefty fines and legal settlements. Worried about future litigation and reputational damage, banks significantly curtailed their lending activities, especially at the lower end of the credit spectrum. At the same time, smaller nonbanks had limited legacy exposure and thus faced fewer such risks, putting them in a stronger position to pick up the slack.

Second, the capital cost of owning mortgage assets, especially mortgage servicing rights (MSRs) has become highly punitive under Basel III capital requirements, which treats MSRs highly unfavorably and doesn't apply to nonbanks. Under Basel III, which went into effect January 1, 2015, MSRs are subject to at least a 250 percent risk weight up to a certain threshold and a substantially higher risk weight thereafter. This, too, has forced banks to pull back from the mortgage lending, opening the door for nonbanks.

In addition to higher capital costs, depositories also witnessed a skyrocketing increase in the cost of servicing delinquent legacy loans. Having encountered very low delinquencies historically, banks didn't have much experience servicing large volumes of delinquent loans and were therefore ill-prepared for this task. In response, they sold the servicing of billions of dollars' of legacy loans to nonbanks. They also tightened their underwriting criteria substantially through credit overlays to reduce to likelihood of default on new business. Nonbanks—often smaller, nimble and less complex, with lower regulatory, capital and compliance costs, very limited legacy exposure, and pre-crisis experience in the origination and servicing of lower-quality loans—were better situated to respond to the changing landscape.

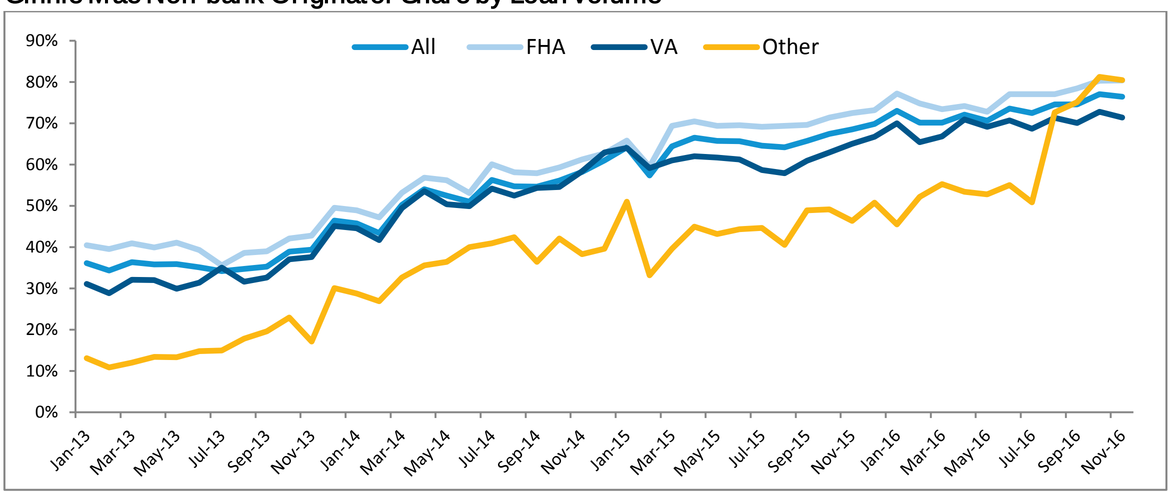
Growth of nonbanks in the Ginnie Mae market

The pull back of banks from mortgage lending has intensified even more in the last three years, especially within the FHA/Ginnie Mae market because of stringent enforcement by the Department of Justice under the False Claims Act. This has pushed several large lenders to either significantly curtail or completely abandon lending through the FHA[2]. Once again, this has created an opportunity for nonbanks to step in and significantly expand their role in FHA/VA lending.

Figure 2 shows the rapid growth of nonbanks within the Ginnie Mae space. This has caused the makeup of Ginnie Mae issuer base to also change dramatically – from being bank dominated to being predominantly nonbanks. Nonbanks' overall share of Ginnie Mae MBS issuances has more than doubled from 36 percent in early 2013 to over 77 percent as of November 2016. More noteworthy is the fact that this increase has taken place at a time when Ginnie Mae's MBS issuances have grown substantially – from $393 billion ($143 billion of which was nonbank originations) for full year 2013 to $461 billion ($339 billion of which was nonbank originations) for the first eleven months of 2016 (YTD November).

FIGURE 2

Ginnie Mae Non-bank Originator Share by Loan volume



Source: eMBS and Urban Institute; Other" refers to loans insured by HUD's Office of Public and Indian Housing and the Department of Agriculture's Rural Development. Data as of October 2016

[2] See http://www.wsj.com/articles/j-p-morgan-retreats-on-fha-lending-1406159133 and http://www.housingwire.com/articles/30708-nar-big-banks-exiting-fha-loans-is-a-bad-trend

Role of nonbanks in expanding access to government credit

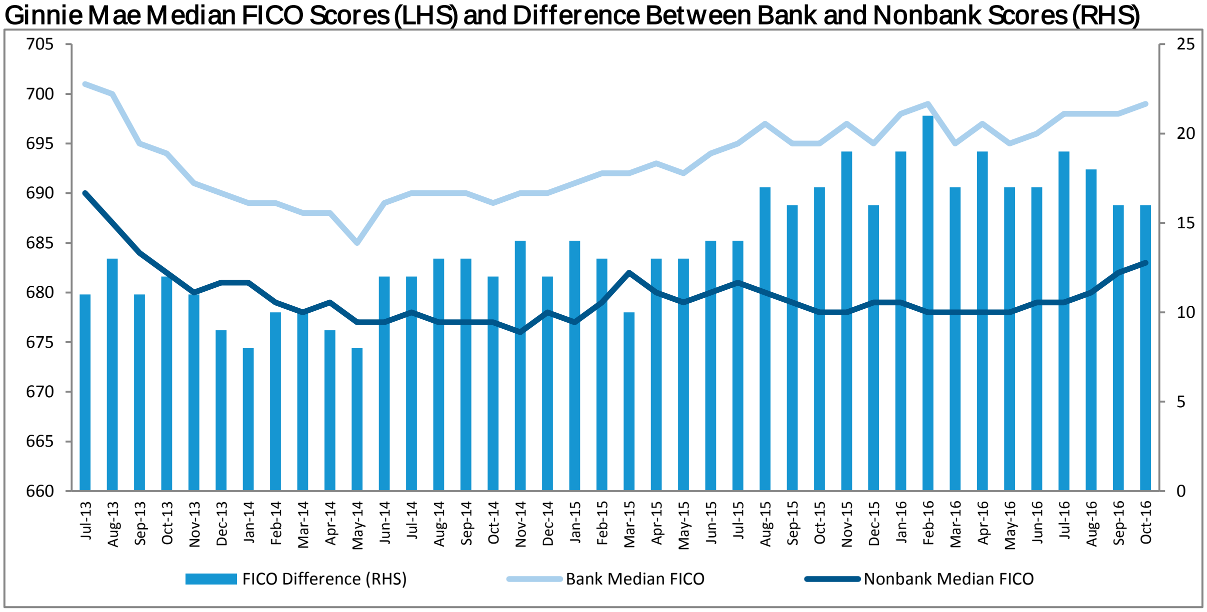
The growth of nonbanks, as measured by government channel market share discussed in Figure 2 is just one aspect of a much broader story. A deeper dive into origination data reveals that nonbanks have also led the way in improving access to credit for low- and moderate-income borrowers – a critically important function in an age of overly tight credit. A look at key indicators of credit availability such as credit scores and debt-to-income (DTI) ratios for Ginnie Mae securitizations shows that nonbank underwriting has been more relaxed than bank underwriting, while still being responsible. The loan-to-value ratio (LTV), which is also a key underwriting parameter, is not discussed below because median LTV ratios for bank and nonbank originations are virtually identical within the Ginnie Mae space.

Credit scores for Ginnie Mae issuances (banks vs. nonbanks)

Figure 3 shows the trend in median FICO scores for loans securitized into Ginnie Mae MBS for bank and nonbank originations from mid-2013 to mid-2016. The most obvious insight from this chart is that nonbanks have consistently required lower credit scores from their borrowers than banks have. Currently, the median FICO score for bank originations securitized into Ginnie Mae MBS is 698, compared to 680 for nonbanks. In other words, nonbanks have been more willing to lend down the credit spectrum. The second, more important takeaway from Figure 3 is that the difference between median FICO scores for banks and nonbanks (blue bars plotted on right scale) has *grown* between 2013 and 2016. While this widening was driven almost entirely by an increase in the bank median FICO (as large lenders pulled back from FHA lending), the fact that nonbanks have not followed suit shows their greater willingness to continue lending to lower FICO borrowers.

FIGURE 3

Ginnie Mae Median FICO Scores (LHS) and Difference Between Bank and Nonbank Scores (RHS)



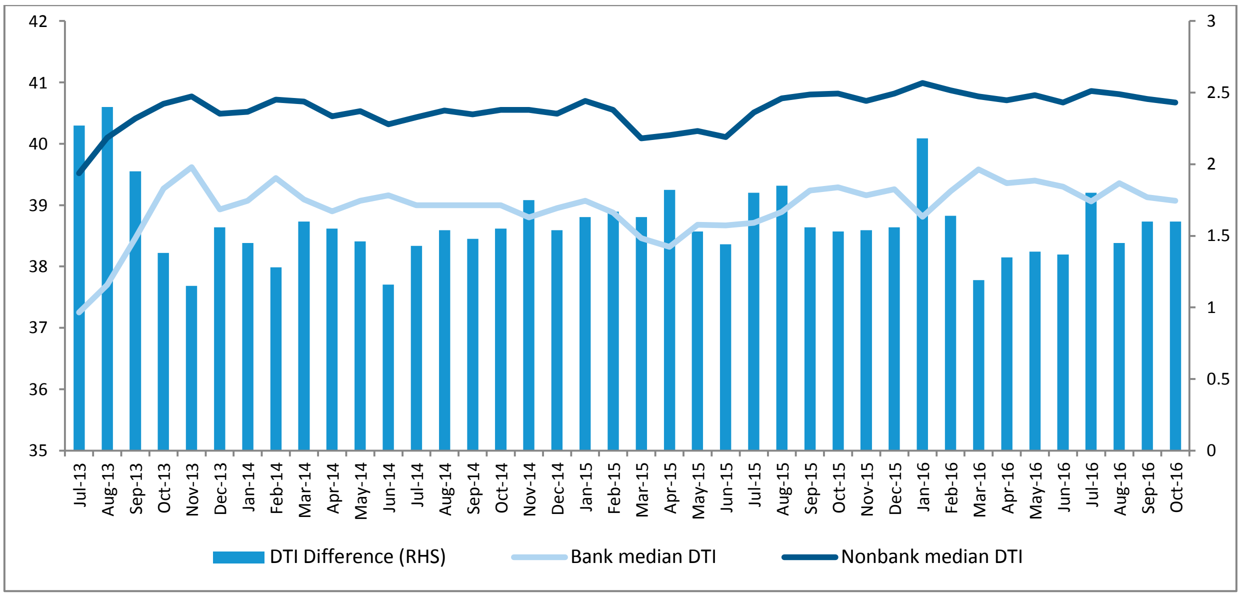
Source: eMBS and Urban Institute; Includes loans backed by the FHA, VA, USDA. Data as of October 2016

DTI ratios for Ginnie Mae issuances (banks vs. nonbanks)

A similar trend emerges when looking at median DTI ratios for bank and nonbank originations within the Ginnie Mae market. Figure 4 shows median DTI ratios for loans securitized into Ginnie Mae MBS from mid-2013 to mid-2016. As with FICO scores, nonbanks have been much more accommodative of higher DTI ratios than banks have been over this period. After increasing during the second half of 2013 for both banks and nonbanks, median DTI ratios have remained largely consistent –at 41 percent for nonbanks and 39 percent for banks. Once again, this shows that nonbanks have been more willing than banks to lend to borrowers with somewhat heavier debt burdens. Unlike FICO scores though, the difference between bank and nonbank median DTI ratios (blue bars plotted on right scale) has remained much more stable.

FIGURE 4

Ginnie Mae Median DTI Ratios for Bank and Nonbank Originations



Source: eMBS and Urban Institute; For loans backed by the FHA, VA, USDA. Data as of October 2016

The Need for Enhanced Nonbank Supervision

Clearly, nonbank financial institutions have proven to be a critical source of credit for low- and moderate-income borrowers. However, their growth has given rise to increasing concerns about nonbank safety and soundness. Unlike their bank counterparts, nonbanks are less stringently regulated and are subject to lower capital and liquidity requirements. This increases the risk of broad-based stress within the nonbank industry when market or economic conditions deteriorate.

Although both banks and nonbanks were under-regulated and under-capitalized before the housing crisis, the bank reforms put in place subsequently – such as ban on certain trading activities, capital and leverage ratio requirements, and stress tests – have substantially mitigated these issues on the bank front. While some progress has been made to improve nonbank safety – the GSEs and Ginnie Mae have issued new capital and liquidity requirements[3] for mortgages servicers doing business with them, – recent research from the Urban Institute shows that these measures don't offer adequate loss protection. This is in part because nonbanks are heavily exposed to mortgage servicing rights – a highly volatile level-3 asset that is difficult to value and difficult to hedge effectively.

The risk of rising mortgages delinquencies poses another challenge for nonbanks. When a borrower defaults, the servicer (either bank or nonbank) must continue to advance monthly principal and interest payment (P&I) to MBS investors using its own funds. Servicers eventually get reimbursed, but until such time must have the financial strength to keep advancing—an obligation that can cause liquidity crunch if defaults rise rapidly and unexpectedly. Because of their strong capital buffers, banks are currently in a much better position to withstand such stress. Nonbanks on the other hand, given their relatively thin capital buffers and a riskier balance sheet, are more exposed to this risk. The worst case scenario is a broad based rise in delinquencies that threatens multiple nonbank firms at the same time, causing industry-wide panic.

Conclusion

The growth of nonbank servicers over the past several years has filled a critical market need. If nonbanks had not filled the void left by depository institutions, credit availability would likely have been far tighter and mortgage servicing capacity much more limited than is presently the case. Especially noteworthy is the role of nonbanks in providing credit to lower- and moderate-income borrowers who lack high credit scores or have higher debt burdens. But the growing dependence on nonbanks also increases the potential for bigger disruptions when things go south. Although the new capital and liquidity standards promulgated by the GSEs and Ginnie Mae are a positive step, more work needs to be done to strike a healthier balance between nonbank growth and ensuring a well-functioning industry that can serve borrowers in all economic environments.

[3] See https://www.fhfa.gov/Media/PublicAffairs/Pages/New-Eligibility-Requirements-for-SellerServicers.aspx and http://www.ginniemae.gov/newsroom/Pages/PressReleaseDispPage.aspx?ParamID=94

About the Author

Karan Kaul is a research associate in the Housing Finance Policy Center at the Urban Institute. He researches topical housing finance issues to highlight the market impact of ongoing regulatory, industry, and related developments. He is also responsible for monitoring and reporting on mortgage market trends and current events weekly. Kaul came to Urban after five years at Freddie Mac, where he worked on various housing policy issues primarily related to the future of housing finance and the reform of the government-sponsored enterprises. Before Freddie Mac, Kaul worked as a research analyst covering financial institutions. He holds a bachelor's degree in electrical engineering and an MBA from the University of Maryland, College Park.

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