Artwork by Chuck Howard

More Than A MIRAGE

With diligent underwriting, the underserved market can be an oasis for originators

Too often, the common wisdom tells us the underserved market is a vast mortgage wasteland, a place filled with delinquencies and foreclosures, an arena to be avoided. The better idea, it's argued, is to stick with the "safe" borrowers — those with weekly paychecks and thick files who are most likely to fly through the application process.

Not to be a rebel — and not to suggest disruption — but experience and real-world numbers tell us otherwise. The underserved market can be a good place to be for mortgage originators.

By Ray Brousseau
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"We have all heard claims blaming the mortgage meltdown on borrowers with weak credit scores. The reality is different."

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Most borrowers can be good bets. They intuitively want to repay their mortgage and other debts. Could a little individual attention help them avoid financial hot water? Wouldn't everyone come out ahead if delinquencies and foreclosures could be avoided?

How can that be done? One part of the answer is faith in borrowers and the second part is the belief in scrupulous underwriting.

Reality of risk

A portion of the mortgage marketplace is underserved because of fears that returns will be minimal or nonexistent. The underserved market carries a lot of baggage. Surely, we have all heard claims blaming the mortgage meltdown on borrowers with weak credit scores.

The reality is different. A study released this past January by the Federal Housing Finance Agency found that "the stressed default rate for low-score loans moved essentially in tandem with that for higher-score loans over the entire period from 1990 to 2007. There was no systematic increase in the riskiness of low-score loans relative to other loans."

Instead, says the study, "risky loans became more plentiful and on more favorable terms to both low- and high-credit-score borrowers." The solution to underserved risk — and a good approach to borrowers in general — is not less lending. It's a continuation of a basic banking concept: know your borrower.

Trained and experienced

Automated underwriting systems (AUS) are great. Electrons moving to and fro with cosmic speed elate us. No doubt electronic systems are a timesaver and an economizer. But don't bet the company on them. Believe in manual underwriting. Believe that actual people, who are trained and experienced, sometimes see things that robots and software can miss.

Automated underwriting systems should be checked by a living person, regardless of whether the AUS approves or declines an application. When the AUS approves a borrower, that's great news, but did the AUS overlook something? If so, it may be necessary to decline the application. It's possible that the documents don't support loan-application numbers. Maybe the property's appraised value is insufficient to justify the requested loan amount.

People should also come into play when the AUS declines a borrower, because an uncomfortable conversation lies ahead. The dream of homeownership seems more distant. But, again, has the system missed something? For example, what if the borrower has a lot of cash left over each month? Strong residual income is a compensating factor that, in some cases, can lead to approval.

Misclassified loans

One of the worst problems associated with the mortgage meltdown involved borrowers who were shunted into the wrong programs. In great numbers, they were not approved for the best programs available to them.

In 2007, *The Wall Street Journal* reported on a study from First American LoanPerformance, a San Francisco research company. The analysis "of more than $2.5 trillion in subprime loans made since 2000 shows that as the number of subprime loans mushroomed, an increasing proportion of them went to people with credit scores high enough to often qualify for conventional loans with far better terms."

Furthermore, the report states that in 2005, the peak year of the subprime boom, borrowers with these types of credit scores received 55 percent of all subprime mortgages that were eventually packaged into securities and sold to investors. First American LoanPerformance noted that share rose even higher by the end of 2006, to 61 percent.

If an underwriter sees a borrower can qualify for a more traditional mortgage program, then that's the program they should be directed to. That means less risk for the lender and for the borrower. Misclassifying a loan simply makes lending riskier and that makes no sense for any company.

Better credit

Before the housing crash, borrowers could readily find mortgages with no-doc and low-doc requirements, such as NINA (no income, no assets) and NINJA (no income, no job, no assets). The results were easy to predict: without adequate underwriting, you're going to have a massive number of foreclosures.

Today's ability-to-repay standard requires lenders to verify borrower information. Many borrowers believe such information must include tax returns, but that's not what the rules say.

Under the Dodd-Frank Act, lenders are not required to review tax returns. The legislation states that lenders "making a residential mortgage loan shall verify amounts of income or assets that such creditor relies on to determine repayment ability, including expected income or assets, by reviewing the consumer's Internal Revenue Service Form W-2, tax returns, payroll receipts, financial institution records or other third-party documents."

Lenders increasingly have the ability to directly access bank statements, retirement accounts and mutual funds — but only with borrower approval. It's likely that most mortgage borrowers will approve. Here's why.

First, if borrowers don't have to gather, copy and send account records, the approval process can be shortened. This saves time for everyone, and eliminates the potential for incomplete or lost documents. Second, when provided directly, most bank-statement fraud can be prevented. Borrowers don't have the opportunity to "fix" paper records to show a better financial profile. Third, it's becoming increasingly attractive to share bank information, once a bastion of personal privacy.

A new attitude toward bank documents is emerging because, starting in 2019, borrowers may be able to get better credit scores by giving access to live financial records. Under the current system, credit-reporting agencies see what you owe, what you pay and when. What they don't see are the many other ways you use cash. By tracking account activity, it becomes possible to get a more complete picture of borrower cash flow.

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Lenders and the originators who do business with them need to pursue underserved markets. There are good borrowers out there — sometimes with short-term financial problems — who are very often good people with a strong desire to pay their debts.

In an automated age, manual underwriting is still an essential tool. The use of bank statements is destined to become more common. As a result, we'll likely see higher credit scores for many borrowers, as well as more approvals. That means more loans for borrowers who are ready for their share of the American dream of homeownership. ■

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