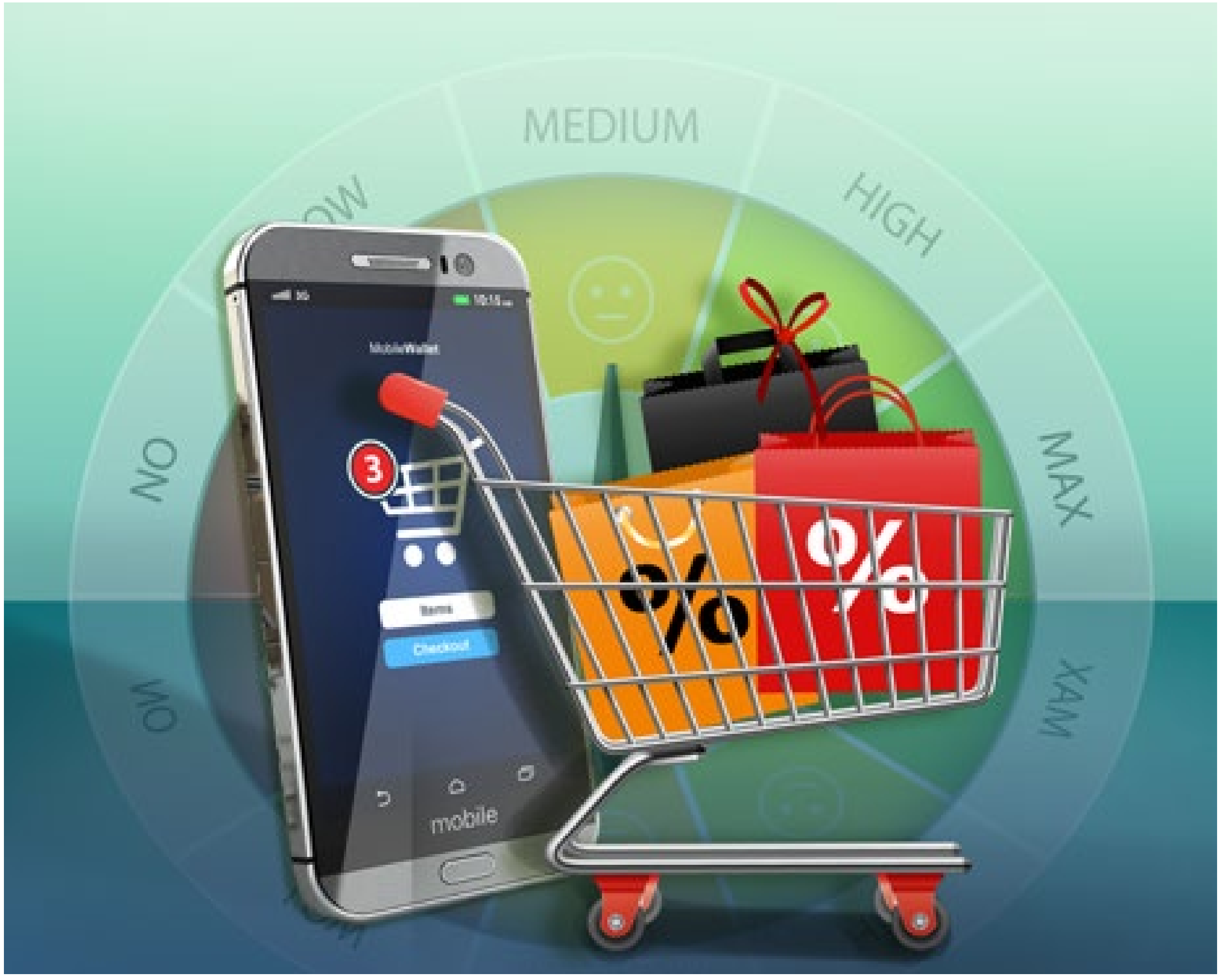
Nonbank Lenders Are Building Momentum

Originators should be aware of the reasons these companies are seizing market share

By Ray Brousseau



Where borrowers go mortgage shopping increasingly determines if they will get financing. The median FICO score for bank borrowers was 745 in February 2019, according to research from the Urban Institute, a nearly impossible mark for many who wish to finance or refinance real estate, and a major reason for the growth of nonbank lending.

On the other hand, the typical mortgage applicant for a nonbank lender passed muster with a median FICO score of 713, according to the Urban Institute. With a greater willingness to consider lower credit scores, nonbanks now originate more than half of all mortgages and their market share is growing.

This nonbank expansion raises a question: Why do nonbanks accept borrowers with lower credit scores, while traditional banks generally do not? The answer, it turns out, concerns risk appetite, underwriting and technology. These are reasons why mortgage originators should carefully consider working with nonbank lenders.

Marketplace acceptance

There's no doubt that the business model employed by traditional banks has been enormously successful. Institutions insured by the Federal Deposit Insurance Corp. (FDIC) earned $236.7 billion in 2018. If you're looking for proof of concept, there it is.

The success enjoyed by American banks is largely an outgrowth of risk appetite and the willingness to do business — but only within certain bounds. A good banking client is a depositor with solid credit and a good income who also might need a checking account, credit card, individual retirement account (IRA) and maybe a business loan. A mortgage is just part of the mix.

As successful as U.S. banks have been, there are other ways to cater to those who need financial services. For nonbanks, the opportunity is to provide mortgage financing for today's borrower — an individual who works in an economy that increasingly features self-employment, frequent job transitions, job sharing, gig employment and an environment where more than 10 percent of the population moves each year, according to the U.S. Census Bureau.

Like banks, nonbanks want relationships with borrowers. A nonbank wants to do a job that is so good that borrowers recommend the company to others, come back when new financing needs arise and, in the age of social media, give five-star reviews. For the most part, nonbanks are succeeding. Data from the Mortgage Bankers Association shows that nonbanks are gaining marketplace acceptance.

- **Nonbank market share** by number of housing units sold increased from 25 percent in 2008 to 54 percent in 2017.
- **In 2017, nonbanks** accounted for more than 80 percent of Federal Housing Administration loans, 70 percent of U.S. Department of Veterans Affairs loans and 64 percent of Rural Housing Service loans (each measured in units).
- **Most minority homebuyers** — 64 percent in 2017 — secured financing through a nonbank.
- **Most purchase loans** for low- and moderate-income borrowers — 59 percent — came from nonbanks.

Flexible underwriting

It's easy to understand that a mortgage well underwritten is a mortgage well originated. And it might seem that underwriting standards from one lender to another are fairly similar.

The reality is different. Risk appetite means each lender has an underwriting process that varies from the next. Lenders also have different standards. Bank A might be OK with a 640 credit score for one program while Bank B might require 680 or more.

Underwriting an applicant with a 745 credit score is simply different from underwriting someone with a score of 700 or lower. The applicant with the high score likely has a thick file and documented reserves, as well as the "right" debt-to-income and loan-to-value ratios.

Alternatively, in the great lottery of life, it may be that some borrowers have seemingly unfairly depressed credit scores. A medical emergency, a costly auto repair or the loss of a job due to a company closing can impact otherwise solid credit standings. These things

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can randomly happen to anyone. The bigger question is whether such applicants are more than the sum of their recent numbers and if they historically have made good on repayment promises.

Credit-score averages tell us that nonbanks are more open than traditional banks to lending to borrowers with less-than-perfect credit. To be successful, underwriting practices must delve more deeply into applications. Although technology helps, it's not the whole answer.

Nimble technology

Determining which loan applications should be approved or declined is a complex process. Although the mortgage industry has had an upsurge in the use of automated underwriting, the specific needs of individual borrowers remain unique, as they have always been. They don't all fit into the same box.

The conflict between the speed and efficiency of automated underwriting, and the very real need to individually consider applications, is contributing to the widespread inability of many borrowers to obtain financing. Some 6.3 million additional loans could have been originated between 2009 and 2015 had lenders followed the same standards they used in 2001, according to the Urban Institute.

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For some nonbanks, the solution is to employ automated systems and then manually review (not manually underwrite) every loan. This can make certain that electronic wizardry does not unfairly deny credit to some, or improperly offer credit to others. These nonbanks tend to employ large numbers of underwriters to ensure each borrower receives a thorough vetting.

The future will see more automation. There will be more automated valuation models and fewer appraisals. The federal government has proposed that the minimum threshold for appraisals should be increased from $250,000 to $400,000 for some loans (excluding conventional and government-backed mortgages). Today's borrowers can authorize lenders to skip physical appraisals. With a borrower's permission, electronic access to bank statements will speed up the underwriting process. Again, with borrower permission, the ability of credit-reporting agencies to track actual bank-account cash flow is expected to increase credit scores for millions of borrowers.

It is sometimes argued that nonbanks have made better use of technology than traditional lenders, but is that really true? Banks have enormous resources and surely have the ability to buy the best available technology. Banks have not become successful by ignoring change, especially when change is so obvious.

For many nonbanks, the idea is to be flexible. These companies welcome technology, and they believe it's increasingly efficient and effective. But nonbanks also are open to traditional ideas, such as knowing their borrowers and having experienced underwriters review all applications.

Think about it this way: Nonbanks are happy to find borrowers with 800 credit scores. At the same time, what do you call a loan applicant who refuses automated bank-account access, has a 620 credit score, is recovering from a financial calamity, has no interest in a business loan and wants a full-blown appraisal? Many nonbanks call them borrowers and are happy to work with them. ■