The mortgage industry's future: A legislative, industry and analytic view

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Executive summary

In just five years, the mortgage industry has changed substantially — and for everyone, including lenders, regulators and consumers. The Dodd-Frank Act is defining the risk retention rules for qualified residential mortgages, and many wary lenders are originating mortgages using these anticipated and proposed guidelines. There's little wiggle room; consequently, many consumers don't meet a qualified mortgage standard — even when some of them still might be less risky and, therefore, profitable in the long run. A lender's objective is to demonstrate objective, quantified policy that is defendable and allows it to grow its business while providing as many Americans with affordable mortgages as possible. This study provides a profile of consumers with the propensity to default on their mortgages.

The new mortgage landscape

Jeff and Betsy Ford have been saving for a house for as long as they can remember. Now the Fords (not their real name) have found their dream home, perfect for their growing family. However, a lot has changed in the mortgage industry in the past five years — and the young couple is painfully discovering just how much.

Since the housing bubble began to burst in 2006, mortgage lenders have been tightening up lending requirements. The government — taking its cues from the industry — has proposed and adopted several reforms — or some would say restrictions — of the mortgage industry. These restrictions include a new mortgage standard being defined by regulators as the qualified residential mortgage (QRM), with tougher lending requirements. For prospective homebuyers, its definition may be the most important definition of our time.

Many lenders wary of banking regulators during this time of rule refinement simply are shying away from granting home loans if applicants don't meet the requirements for a qualified residential mortgage. While final federal regulations aren't set yet, banking officials have signaled that buyers must put 20 percent down on a house if the lender wants to be able to package that loan for the secondary market.

Fuzzy rules require some assumptions

Recognizing how fuzzy the rules are at this time, Experian® has set an understanding that the mortgage applicant must have a debt-to-income ratio of less than 45 percent and a VantageScore®[1] — a credit score developed by Experian and other national credit-reporting companies whose scale approximates the familiar academic scale of A through F grades — above 635. The upshot: Many prospective homebuyers simply won't qualify. Although some may not qualify for good reason, the simplistic rules that knock applicants out of qualification are too broad. The Fords are among those who would be knocked out of qualification. Their VantageScore fell just below the qualifying figure. Their debt-to-income ratio also just missed the acceptable level. In traditional times, the Fords would have gotten their home loan — and their dream home.

[1]VantageScore® is owned by VantageScore Solutions, LLC

It's the new reality. Today, very little wiggle room exists for lenders to grant a home loan if an applicant doesn't qualify for one under the new regulations. This is true even when applicants still might be less risky and, therefore, profitable in the long run.

Mortgage lenders recognize that to prosper, they must continue to make loans. Yet economic conditions are such that mortgage lenders may have money to lend but not enough qualified applicants as defined by the new rules.

In addition, the lenders themselves are trying to determine how to demonstrate to regulators that they can develop objective, quantified lending policies using assumptions that are defendable and will allow them to grow their businesses while providing as many Americans as possible with affordable mortgages.

While regulators aren't looking more precisely at originations, lenders are. They're peeling back the onion, if you will, to identify what bands of home-loan applicants are low risks even though they don't meet the "qualified mortgage" requirements. Many lenders probably don't have enough data on a single portfolio to do this kind of analysis.

In addition, pilot tests aren't feasible for lenders right now. It takes at least a year to measure performance, and that's too long to wait for a lender eager to grow. Experian has employed a retrospective analysis to help determine how best to scrutinize a mortgage portfolio to find the criteria a lender might use to identify applicants who are unacceptable by official "qualified mortgage" standards but still could be quality loans.

Why are lenders so conservative?

What's specifically keeping lenders so conservative? Economic conditions, even though they're improving, aren't helping much in the housing area. Reflecting the recession's effect on consumers, the U.S. average mortgage is now 283 percent of the average income, which is above the traditional 250 percent.

In some states and cities, the percentage is way above that figure. In California, the average mortgage is 393 percent of the average income, and in Hawaii, it's 395 percent. In the District of Columbia, the percentage is a whopping 467 percent. Ten states and D.C. have average mortgages that are 300 percent of average income.

Interestingly, the highest and lowest average new mortgages are just 100 miles apart in the District of Columbia and West Virginia. In 2010, the average new mortgage in D.C. was for about $370,000; in West Virginia, it was about $125,000, which indicates how geographically specific "location, location, location" is.

Mortgage foreclosures remain a deep worry among regulators, lenders and consumers. While the rate of increase in foreclosures slowed in 2010, rising 16 percent from 2009, the number of foreclosures has surged 147 percent since 2006. Many economists worry that the peak won't come until later in 2011 as joblessness remains around 9 percent. Approximately two of five mortgage foreclosures (42 percent) have reflected joblessness in some way.

More on the Dodd-Frank Act

Lenders also have tightened their mortgage purse strings because of the government's drive to restore the private mortgage-backed securities industry. Reflecting the travails of Fannie Mae and Freddie Mac, Congress passed and President Obama signed in July 2010 the wide-ranging Dodd-Frank Wall Street Reform and Consumer Protection Act, which, among other things, includes stricter mortgage-lending regulations. The Act:

- Established a simple federal standard for all home loans under which institutions must ensure that borrowers can afford to repay the loans they are sold. Prohibits the financial incentives for subprime loans that encourage lenders to steer borrowers into more costly loans, and also bars prepayment penalties that trapped many borrowers into unaffordable loans.
- Set stiff penalties for lenders and mortgage brokers who don't comply with the new standards.
- Mandates that banks must retain 5 percent of the risk of a loan if it is packaged into securities and sold to investors. This provision anticipates that with a 5 percent "skin in the game," banks would be more cautious in their lending standards since they would still stand to lose if the borrower defaults. However, qualified residential mortgages would be exempt from the risk-retention provisions.

The concern is that lenders will not open new loans, will require higher down payments, or will charge higher fees and interest rates to borrowers who don't meet the requirements of a "safe" mortgage. These restrictions would keep many consumers like the Fords from being able to obtain a mortgage or make it so expensive that they won't be able to afford it.

Who's approved, who's rejected for loans

Mortgage data on who is getting loans and who isn't illuminates the problems ahead for mortgage lenders and consumers. In 2010, new mortgage trades fell 19 percent from 2009 and were 36 percent below 2006 levels of slightly more than 9 million trades.

Who got the mortgages, based on VantageScores, also underscores the tightening of home-loan underwriting (Figure 1). Far fewer nonprime candidates got mortgages in 2010. Consider that in 2006, 32 percent of loan applicants with VantageScores in the 701 to 800 range were approved; in 2010, that percentage fell to about 18 percent. In 2006, about 22 percent of loan applicants with VantageScores between 601 and 700 were approved; that percentage shrank to less than 5 percent in 2010. Also in 2006, about 3 percent of applicants with VantageScores of 600 or below got loans. That percentage was negligible in 2010.

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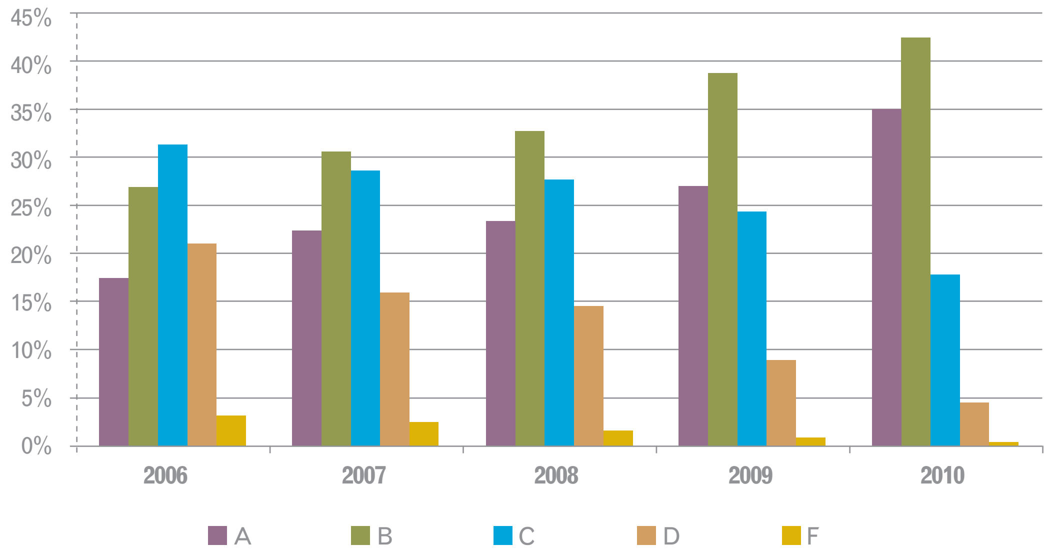
Figure 1: Distribution of first mortgage originations by VantageScore band

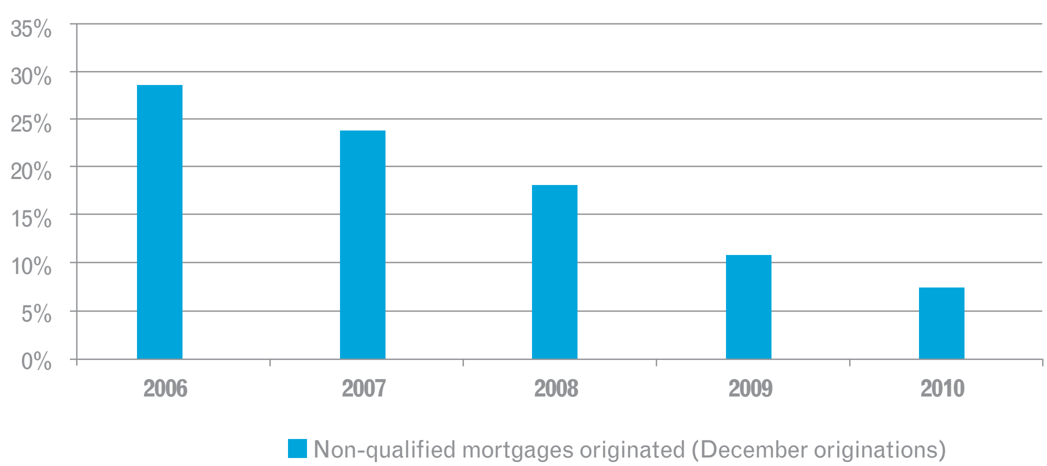


Notice that in 2006, the distribution of new mortgages was highest (over 30 percent) to C level VantageScore and that 3 percent of the new loans were granted to the lowest F band.

Since 2006, the lowest risk bands of A and B have made up more and more of the new mortgages. In 2010 the A and B bands made up 77 percent and F is almost gone.

Another Experian analysis also illuminates the tightening of credit. The study found that 29 percent of the new mortgages originated in 2006 wouldn't have met the standards to be qualified mortgages. By 2010, only 7 percent of the loans originated wouldn't have been qualified mortgages (Figure 2).

Figure 2: Tightening of credit: In retrospect — percentage of new mortgages that would not have been qualified mortgages (December originations)



What would not have passed the new rules, looking back? As for historical debt-to-income averages on new mortgages, the ratio was 35 percent in December 2006, and that figure has declined steadily since to 24 percent in December 2010.

How can lenders grow?

What's next? If mortgage lenders are going to prosper in this new regulatory environment, especially if the mandates of credit score and debt-to-income are considered too restrictive, they must consider ways to include more applicants who are eligible for loans.

Obviously, lenders today must proceed with caution. However, they also must employ more data about applicants in assessing their creditworthiness. This includes using retrospective quantitative analyses.

Using sophisticated data analysis, lenders can identify populations of applicants who are less risky than the expected matrix and who would fit as qualified applicants without raising eyebrows.

While lenders sometimes employ a pilot trial to determine how the applicants fare in these populations when approved for mortgages, a trial requires at least a year to determine performance. However, retrospective analysis can be completed quickly and doesn't put new test populations at risk.

Hopefully, by documenting their quantitative analysis and adhering closely to objective underwriting and policy standards prescribed by the analysis, lenders can convince regulators that they should continue to dig deeper into their mortgage population and identify control risks that would accept some of those applicants for mortgages that otherwise wouldn't qualify.

Results from Experian's analysis showed that while the Fords didn't meet the expected VantageScore or debt-to-income requirements of the Dodd-Frank Act, they still could be less likely to default on their mortgage than those who meet the requirements. By going less than 10 points below the VantageScore cutoff, using less than 40 percent of their bankcard credit limit and recognizing that they have a high revolving credit, the Fords have a profile that is actually less risky than the consumers passing the regulators' rules.

Conclusion

This we know: If banks and mortgage bankers have money to lend, they will be itching to spend it because if they don't, they're simply wasting those funds and keeping credit-responsible consumers from owning homes.

Experian has developed segmentation to determine which band of candidates might qualify using certain assumptions and otherwise would be rejected. Experian used advanced statistics to determine cutoffs and thresholds of attributes to determine the segmentation — and it is using this segmentation with clients to identify those bands of mortgage applicants who might not be rejected after all.

This truly is a win-win situation. Lenders can make more attractive loans than they could otherwise, and more consumers who are frustrated that they can't get home loans will get them.

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