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RMBS and Marketplace Lending – US

Mortgage Regulations and Industry Practices Will Limit Added Risk in Marketplace Lender RMBS

Executive Summary

The mortgage industry's current regulatory and securitization framework would reduce additional risks posed to potential residential mortgage-backed securities (RMBS) issued by marketplace lenders.

- As we have noted regarding consumer, student and small business loans originated by these lenders, new risks arise from their lack of historical performance and untested lending approaches.
- However, robust mortgage lending laws and regulations, as well as government and institutional supervision, provide strong checks on minimum mortgage loan credit quality for new entrants including marketplace lenders.
- In addition, strong RMBS industry practices, such as third-party due diligence checks, promote transparency and consistency and help to identify credit problems prior to securitization. The RMBS market also contains experienced securitization counterparties, such as mortgage servicers, trustees and custodians, which will support RMBS quality.

Although we do not currently rate any RMBS from marketplace lenders, we expect future issuance of such deals.

Marketplace lenders have newly developed operations with limited performance history

New to the mortgage industry, marketplace lenders' innovative methods and untested lending approaches increase the uncertainty in the quality and future performance of the mortgage loans they originate relative to traditional mortgage collateral from seasoned originators. While marketplace lenders may develop new, proprietary technologies to increase efficiency and transparency in loan origination, they may lack the operational robustness to ensure the production quality of the mortgage loans. Given their inexperience with an economic down cycle, marketplace lenders' business models have not been stress tested. As such, marketplace lenders face the challenge of building strong credit management operations that monitor and test their underwriting practices and product offerings.

Mortgage regulatory framework supports new entrants' loan credit quality

Recent mortgage lending laws and regulations, the equivalent of which are not currently present for non-mortgage consumer lending,[1] provide some checks on mortgage loan credit quality for new entrants in the mortgage space such as marketplace lenders. Federal consumer protection laws and government and institutional supervision guard against systemically poor lending practices. Complying with these rules and getting licensed in many states require new mortgage market entrants to make significant capital and knowledge investments.

The Consumer Financial Protection Bureau's (CFPB) Ability-to-Repay/Qualified Mortgage (ATR/QM) rule, effective January 2014, holds mortgage lenders liable for making loans to borrowers who don't have the reasonable ability to repay them. It requires lenders to consider the borrower's income or assets and employment status against the mortgage loan payment and other obligations of the borrower, and to verify income, assets and employment status using reliable third-party documentation. While increased technological savvy, such as allowing borrowers to upload W-2 forms and other documents or utilizing algorithms to pre-qualify borrowers based on a FICO score and stated income and/or assets may improve process efficiencies, they do not change the rule's fundamental requirements. Underwriters will still need to make a reasonable determination that the borrower has the ability to repay the loan, and the information on which the underwriter bases the decision must be verified via third-party documentation by the time the loan funds. Non-mortgage consumer loans are susceptible to looser underwriting criteria and unverified borrower information because an equivalent rule for that asset class does not exist.

The TILA-RESPA Integrated Disclosure (TRID) rule, effective October 2015, requires lenders to deliver comprehensive disclosures to the borrower reducing the likelihood that borrowers will take out loans that they can't afford due to increased transparency. TRID requires lenders to provide a loan estimate and closing disclosure to borrowers that make the terms of the mortgage loan clear, simple and consistent.

Besides ATR/QM and TRID, mortgage lenders must comply with a plethora of other consumer lending regulations designed to ensure safer mortgage loans, such as the Truth in Lending Act (TILA), the Real Estate Settlement Procedures Act of 1974 (RESPA), and the Home Ownership and Equity Protection Act (HOEPA).

Mortgage lenders are also subject to oversight from various government agencies, such as the US Department of Housing and Urban Development, the CFPB, and regulators in the states where they are licensed. They are also subject to supervision from government sponsored entities (GSEs) Fannie Mae and Freddie Mac if the lenders are approved sellers, as well as supervision from institutions, such as banks and insurance companies that invest in their loans. Such supervision typically consists of regular audits and feedback. In addition, if the lenders are GSE-approved sellers, the lenders must comply with each agency's respective eligibility standards and seller guides, which require standardized underwriting and origination practices.

Industry standards will help maintain marketplace lender RMBS credit quality

Strong RMBS industry practices and a mature market consisting of experienced securitization counterparties will support credit quality of RMBS issued by marketplace lenders. Some of these industry practices include comprehensive pre-securitization loan due diligence which provide checks on marketplace lenders' collateral quality, appraisal quality improvements, and representation and warranty (R&W) frameworks that give originators skin in the game.

Post-crisis RMBS transactions generally use independent third-party review firms to perform pre-securitization due diligence reviews of the mortgage loans selected for securitization, providing transparency and a check on the data quality of the mortgage loans. The scope of due diligence review consists of credit, property valuation, data integrity and regulatory compliance. In re-underwriting the mortgage loans, due diligence firms assess whether the mortgage loans conform to the lender's underwriting guidelines and evaluate evidence of the borrower's willingness and ability to repay the mortgage loan. The due diligence firms also review appraisals to assess whether the appraised values were reasonably supported. Lastly, the due diligence firms test the mortgage loans for regulatory compliance. To date, most post-crisis transactions have had this diligence check on either 100% of the mortgage loans or a significant statistical sample.

RMBS appraisal quality benefits from the Uniform Collateral Data Portal (UCDP) initiated by the GSEs in 2012. Under the UCDP, lenders must electronically submit all appraisals using the UCDP portal in a format that standardizes fields and definitions. This electronic collection of appraisal information gives the GSEs a large database from which they can compare characteristics of different appraisals to identify faulty information and poor appraisers, and detect appraisal fraud. Even though the UCDP applies mostly to GSE loans, it also benefits loans going into private-label RMBS because the tighter GSE quality control on appraisers, who value homes securing both conforming and non-conforming loans, have improved overall appraisal standards.

Recent RMBS transactions also benefit from R&W frameworks that have mechanisms to put defective loans back to their originators. Typically, these frameworks include a provision for an independent reviewer to check any loan that becomes seriously delinquent to see if it breached its R&Ws. Such R&W frameworks will discourage rogue origination practices because they will hold marketplace lenders responsible for buying back loans that don't meet the R&Ws.

We expect marketplace lenders to use many of the same transaction counterparties that traditional RMBS issuers use, such as servicers, custodians and trustees. These experienced counterparties have the knowledge and experience to service mortgage loans for new entrants through the business cycle. Their practices, data requirements and roles and responsibilities have evolved through the financial crisis with various regulatory and industry group guidance and regulations.

Moody's Related Research

» Understand the Risks of Marketplace Lending Securitizations, 4 May 2015.

» 2016 Outlook – Marketplace Lending Platforms Will Continue to Evolve, Expand Loan Types, 7 December 2015.

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

1 On 2 June 2016, the CFPB proposed regulations that target payday, vehicle title, and certain high-cost installment loans. These proposed regulations, among other rules, would require lenders to reasonably determine that the consumer has the ability to repay the loan.

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