

What Are the Factors for Success in Credit Union Mortgage Lending?

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Many credit unions focus on non-mortgage lending. Some only offer mortgages through CUSOs. Some don't offer mortgages at all. This article looks at three key factors that can help determine whether a credit union will have success offering mortgage loans.

Let's start by looking at the mortgage opportunity in 2017 (the last year data was available) and how much of it was due to Credit Union origination. According to statistics published by Lending Tree in December 2018¹:

- \$1.75 trillion in mortgages were originated in the United States in 2017.
- Credit unions' share of mortgages originated in 2017 was 9%.

Clearly, credit unions have an opportunity to grow their market share, especially since 76% of credit union members are homeowners, according to a survey published by CUNA in July 2014.²

PROFITABILITY

Independent mortgage banks and mortgage subsidiaries of chartered banks reported a net loss of \$118 per loan originated in the first quarter of 2018, according to an article published by HousingWire in December 2018³. This creates an opportunity for credit unions that have lower capital and marketing costs.

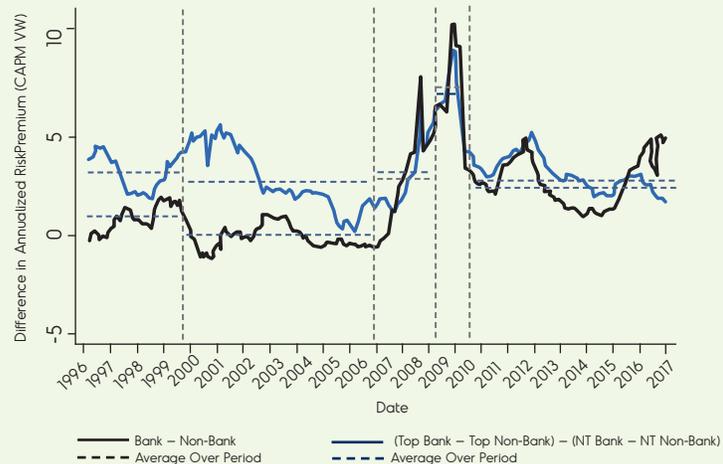
The cost of capital factors heavily into lending for banks vs non-banks,

according to a June 2018 staff report by the Federal Reserve Bank of New York.⁴ The cost of capital for banks over the last 20 years was consistently higher than the cost of capital for non-banks, the report states. It attributes the cost difference to regulatory requirements that only apply to banks.

The report states that the banking in-

dustry's value-weighted cost of equity capital soared to over 15% during the financial crisis, but then declined by 4.5% relative to non-banks after the passage of the DFA to 10.5%. "At the same time, banks' cost of capital has differentially increased by 1%-to-2% in the post-DFA period relative to the late 1990s," it notes. (See "Cost of Capital" chart.)

The cost of capital for banks compared to other industries



This figure plots the difference in the CAPM cost of capital estimate net of the risk-free rate for banks and top banks relative to other firms in the CRSP-Compustat universe value-weighted by market capitalization from March 1996 to December 2017. The dashed lines plot the average differences across subperiods.

A credit union's tax-exempt status results in a lower cost of capital. Given their ability to profit on mortgages in a low-rate environment, why then aren't credit unions capturing more market share? Let's look at the second decision credit unions must make before offering mortgages.

Like any other type of lender, credit unions need to manage loans after they close; they need to decide if they will warehouse and service the loans, sell them to a GSE or sell them to another entity. Each strategy has costs and benefits.

WAREHOUSE AND SERVICE

When credit unions keep loans on their books they reduce the amount they have available for other loans and they take on risk. Risks include default and concentration risks—collateral type, lien position, geographic area, non-traditional terms (such as interest-only, payment option or balloon payment), fixed or variable interest rate, low or reduced underwriting documentation and loan-to-value (LTV), according to a "Supervisory Letter on Concentration Risk" from NCUA.⁵

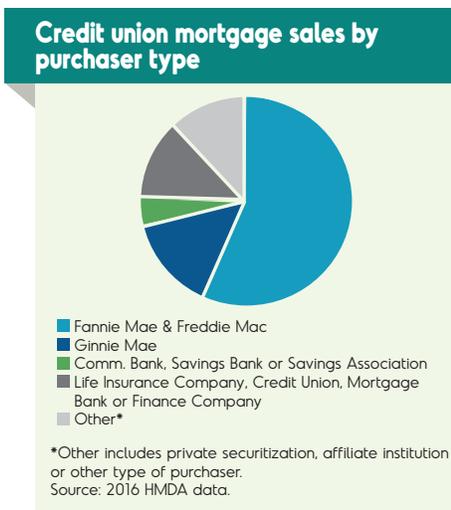
Risk can be mitigated with hedging strategies, but hedging reduces margin. On the other hand, servicing may generate fee income, and holding the loan provides a steady stream of payments, similar to a bond.

Some credit unions hold loans for up to a year, then sell them to GSEs; this is called selling before the loan "seasons," and it allows the credit union to collect the full spread on the loan for up to 12 months.

GSEs

Based on data released under the Home Mortgage Disclosure Act (HMDA), credit unions tend to utilize Fannie Mae and Freddie Mac more heavily than banks and thrifts. Among respondents to this year's survey, 24% sell mortgages to Fannie Mae, 12% sell to Freddie Mac and 11% sell to both, according to a survey in the "NAFCU Report on

Credit Unions" from November 2017.⁶ (See "Sale by Purchaser Type" chart.)



The GSEs will buy a qualified loan during the first 12 months of the loan term; after that, the loan is considered "seasoned," which adds conditions that cost the lender money. The GSEs also charge up to 50 basis points for the transaction, which can erode the total return on the loan significantly.

However, selling qualified loans to the GSEs is easy and supported by many Loan Origination Systems.

SECONDARY MARKETS

Through June 2017 credit unions sold 34% of first mortgage loans originated in the calendar year. Credit unions that participated the 2017 NAFCU survey indicated that, on average, 72% of their outstanding first mortgage loans qualify to be sold on the secondary market (up from 57% in the 2016 survey).⁷

Secondary markets may have lower selling costs and take non-qualified loans. Since non-qualified loans generally have richer fee income and higher interest rates, the ability to offer non-qualified loans helps the credit union's bottom line. Negatives associated with secondary markets include access to buyers, broker fees and longer time in the credit union's warehouse.

OTHERS

Among alternatives for plac-

ing mortgage loans, according to the "Supervisory Letter on Concentration Risk" from NCUA, the most popular were mortgage wholesalers (32%), FHLBs (26%), and credit union service organizations, or CUSOs (24%).⁵

CUSOs in particular are moving strongly into offering mortgages for their credit union clients. Many take on the burden of managing the borrower through the application process, regulatory requirements and disposing of closed loans. However, their fees may impact a credit union's margin on the loan.

Some credit unions contract with CUSOs as a way to get started with mortgage loans, then take mortgages back in-house once their loan volume is sufficient to cover the cost of internal Loan Officers and compliance management.

LOAN TYPES

Loan Types are the last major decision for a credit union. Loan Types may be imagined as a grid that has the Loan Purpose on one axis and Loan Buyers on the other axis. (See "Loan Type" chart.)

A Loan Purposes can include:

- Purchasing a home, vacation property or investment property.
- Refinancing a property to get a lower interest rate, shorten the term or get cash out.
- Home Equity Loans allow the borrower to take a lump-sum loan collateralized by real property. A borrower may have more than one lien on the home when this occurs. Home Equity loans work well when a borrower needs a well understood sum of money for college tuition, medical bills or debt consolidation.
- A Home Equity Line of Credit, or HELOC, is a revolving credit line the borrower can tap as needed. HELOCs are commonly used to finance renovations or in other situations when the borrower isn't sure how much money will be needed.
- Construction Loans finance home building or significant construction projects. These loans are installment-based, issued to the borrower in incremental payments as construction milestones are met. These

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loans are difficult to administer and require specialized knowledge

- Reverse Mortgages allow homeowners to receive a monthly payment against the value of their property. Commonly to pay monthly bills for elderly or older disabled persons, reverse mortgages are heavily regulated and they are rarely offered by credit unions.

Loan Buyers can include:

- Qualified Mortgages meet the guidelines set forth by the GSE. Generally, these are loans to people with standard employment relationships, good credit scores and loan values under a specified threshold.
- Non-Qualified Mortgages violate any of the conditions set forth by GSEs for qualification. The borrower might have a slightly lower credit score, be self-employed or need a loan that exceeds the GSE threshold.
- Smaller credit unions might participate in Loan Syndication to gain exposure to the asset class. A syndicated mortgage is a partnership involving two or more investors in a specific, targeted mortgage. A syndicated mortgage is an investment in a single real estate loan, rather than a pool.

out refinance loans they can sell to a GSE.

Construction loans are easy to resell to Fannie Mae. However, the credit union needs to hire or train a Loan Officer to properly communicate how it works. They may also need other specialized staff to administer the payments.

HELOCs and reverse mortgages add layers of regulatory burden and uncertainty about disposition. In many cases they are offered by very large credit unions or CUSOs that can afford more compliance people and oversight.

OPPORTUNITY

Of course, credit unions offering mortgages need to offer basic purchase and refinance options. Since competition for those loans drives down rate and fee income, consider adding lump-sum, home equity loans that generally have higher interest rates and fees.

Based on MortgageHippo research and our clients' 2019 experience, there's an increasing opportunity for credit unions to provide lump-sum, home equity loans.

Most of our clients start by offering cash-out refinancing options to members who need to pay tuition bills or consolidate debt, then the client can move into second liens as its team becomes more comfortable and builds up secondary market relationships.

fer mortgage loans. In the end, credit union size and risk appetite are the key factors for this decision.

We've also seen how CUSOs can help credit unions explore offering mortgages without taking on the compliance and cost risks of an in-house program.

Finally, we looked at the types of loans a credit union might offer to understand why purchase and refinance loan types are more common than home equity, construction, HELOC and reverse liens. ▲

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	GSE "Qualified"	Secondary Market	Syndicated
Purchase	Yes	Yes	Yes
Refinance	Yes	Yes	Yes
Home Equity	Yes (secondary liens)	Yes	
HELOC	No	Yes	
Construction	Yes with limits	Yes	
Reverse	No	Yes	

Examining the chart, we see purchase and refinance loans are the easiest to offer. They are well understood loans that the credit union may easily sell on to a GSE, so they provide predictable top and bottom line results.

Home equity loans are generally the next step for credit unions. Often they start along this path by providing cash-

Some credit unions keep home equity loans on their books, especially if they are smaller, shorter duration loans.

Larger credit unions may also benefit from offering construction loans.

SUMMARY

We've looked at the three factors that go into a credit union's decision to of-

Article Sources:

Here are the URLs to the online information sources used in this article.

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