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Weekly Post:Adjusting Loan Rates to Borrowers' Credit

Dear Clients-

Many banks and credit unions offer loan rates without taking the borrowers' credit score into account, as long as the borrower is qualified. This approach of one pricing fits all avoids possible regulatory concerns about discriminatory loan pricing, but with a cost. A loan pricing table allows you to segment the impact of credit risk and LTV and avoid the limitations of the one price fits all approach.

Offering a loan rate sheet to loan officers with an appropriate risk premium allows you to serve a broader customer base while enabling you to remain competitive. To avoid regulatory concerns, you can properly document the reasons behind the loan rates for each credit bucket of borrowers.

This post describes a sample loan rate sheet and its associated documentation.

Challenges

- How to charge for the credit risk for residential mortgage, auto and consumer loans?
- How should the loan rate be sensitive to the credit score of the borrowers?
- What factors should be considered in a loan rate table?

Solution

A loan rate table should Illustrate how the rates are dependent on the borrower's credit rating and the collateralization of the loan. For example, a loan rate table for a 30 year fixed rate mortgage can be presented as illustrated below. The rate may depend on the borrower's FICO score within a certain range. In addition, the rate may also depend on the loan to value (LTV) ratio.

The loan rate table based on the THC model suggests that the loan rate rises with acceleration as FICO score falls; increasing by three bpt for each 10% FICO score increment for borrowers scoring over 700 and 20 bpts for borrowers scoring below 650. High LTV should lead to higher rate; 3.3 bpt and 6.3 bpt rise per LTV 10% increment for high and low FICO score respectively.

Market Wisdom - Art Hilliard*

Adventures in Trading

Today, bids were submitted for a 17 loan scratch and dent pool. The pool traded to multiple bidders at a WaPrice of 90.04.

A good pool on the surface

- WaLTV 76.8, WaRate 4.06, WaFICO 752.Beautiful
- My Wavg price was 89.27 – Can't win'em all…

But there was trouble in paradise. The issue? Compliance

- My investors bidded on three loans and kicked the rest due to disclosure violations.
- In fact, the seller ended up kicking 5 loans of their loans on the trade date.
- As mentioned in previous posts, compliance is becoming more of an issue in portfolio transactions. Everyone, originators and investors, are nervous about compliance risk until they see where regulators and the CFPB is going draw the line.
- That doesn't mean that sellers shouldn't market their pools. Sellers should know their compliance issues going in and submit all loans regardless. Loans may be in an investor's sweet spot, and they may still like them – You won't know unless you ask.

Art Hilliard has been in the mortgage industry for 29 years. He has originated, managed secondary marketing, securitizations and settlements, provided mortgage financial advisory and performed multiple mortgage portfolio sales and acquisitions.He was past president of the Illinois Mortgage Bankers Association.

Pool details attached *THC* site *Conf Room*

Loan Rate Sheet for 30 year Fixed Rate Mortgages APR(%)

FICO	760-850	700-759	680-699	660-679	640-659	620-639
LTV 110	3.34	3.57	3.76	3.99	4.44	5.02
LTV 100	3.31	3.53	3.72	3.94	4.39	4.95
LTV 90	3.28	3.50	3.68	3.90	4.34	4.89
LTV 80	3.24	3.47	3.64	3.86	4.29	4.83

A loan rate sheet enables loan officers to serve their customers, meet their regulatory requirements and better manage their profitability given the level of risk.

Numerical Example

You may consider documenting the assumptions behind the loan pricing objectively and systematically. Below an example is provided. This report shows that the pricing, APR(%), for each bucket of borrower's credit score. I will discuss some of the factors that determine the pricing.

Fix 30 * LTV is 80%, amount is $300,000, servicing cost is 0BPS, recovery is 80%.

National Average

FICO	760-850	700-759	680-699	660-679	640-659	620-639
APR(%)	3.24	3.47	3.64	3.86	4.29	4.83
CPR(%)	5.33	5.67	5.95	6.19	7.69	10.62
WAL	8.46	8.17	7.89	7.56	6.51	5.17
Yield(%)	2.82	3.00	3.14	3.27	3.60	4.01
OAS(%)	0.97	1.17	1.32	1.46	1.81	2.35
Dur(year)	6.68	6.32	5.97	5.64	4.99	4.97

Source: THC Risk Officer, Market Indications

The factors are:

- *Recovery Rate*.You need to determine the appropriate recovery ratio.
- *Projected cashflow profiles*
    - an average annual prepayment as presented as conditional prepayment rate (CPR %)
    - Weighted Average Life (WAL) and Duration (DUR).
- *Risk premium* you should require a higher return to compensave for higher credit risk, and therefore the "clean option adjusted rate (OAS)" should increase as the credit score falls.

The table underscores the importance of documenting the factors affecting the base line loan pricing to ensure reasonableness in pricing across loan types.

Conclusions

Providing loan rate tables to your loan officers enables you to compete in the market more effectively. When you support the loan rate tables with documentation of the factors affecting the loan rate, then, you have a systematic asset-liability management process.

If you have further questions regarding the documentation of the loan pricing model, please do not hesitate to contact THC.

Regards,
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