Strengthening Loan Securitization:

Verifying Borrower Income and Employment to Improve Loan Portfolio Performance

Key Takeaways

Loan securitization is a proven strategy to replenish consumer loan funding, and a valuable tool for financial institutions looking to diversify their funding sources.

Automated income and employment verification can give financial institutions a competitive edge when looking to improve portfolio attractiveness for investors.

Lenders that verify income and employment at the loan level may be viewed more favorably as part of rating agencies' assessments.

Overview

This white paper discusses the benefits of automated income and employment verification as part of the non-mortgage consumer loan origination and securitization processes for both lenders and investors. This paper was informed by interviews with the following:

- Consumer loan securitization experts
- Lenders that leverage instant income and employment data to evaluate lending decisions
- Lenders that have seen benefits to portfolio health and attractiveness for loan securitization based on their use of automated income and employment verifications

Aite-Novarica Group interviewed six thought leaders who are knowledgeable about the trends, challenges, and opportunities in the consumer loan asset-backed securities (ABS) market.

Introduction

Financial institutions have several options to obtain the funds needed to originate consumer loans and ultimately grow their business. They can take on debt for this purpose, or—if the financial institution is a bank or credit union—they can attract deposits to serve as a source of loan financing. Alternatively, they can raise funds through the capital markets by packaging a set of loans to sell to investors, which will then receive future cash flows. When consumer credit, such as auto loans, credit cards, personal loans, and student loans, is securitized in this manner, the credit is referred to as ABS. In a highly competitive market, lenders can improve the attractiveness of their loan portfolio to ABS investors by leveraging automated income and employment data for decisioning at the individual loan level.

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ABS Process and Players

A financial institution that offers credit to consumers who meet their underwriting criteria can offer a security based on these loans (viewed by investors as assets). Thus, the financial institution (FI) can be referred to as both an originator and seller of loans that ultimately become part of the resulting ABS. To facilitate the construction and sale of an ABS, a special purpose entity (SPE) is formed, typically by the financial institution that originated the loans. While the FI may create the SPE, they are technically separate legal entities, with the SPE purchasing the assets from the FI. This firewall serves to protect the assets if the FI falls into bankruptcy. Once created, the SPE issues notes to investors backed by those assets.

The loans in an ABS generate cash flows for investors while they are in repayment. As with other loans, a servicer provides regular information to borrowers about their loans through statements or other means, collects their payments, and—if necessary—initiates collection activities. In the case of an ABS, the servicer remits these cash flows to the SPE which can then provide them to investors as agreed. The servicer, which is typically affiliated with the financial institution that originated the loans, is paid a fee for these services by the SPE.

The appeal of investing in a given ABS issuance is fundamentally tied to the strength of the underlying assets—a pool of consumer loans in this case. The type of loan that comprises the ABS, the profile of the borrowers, and the lender's underwriting criteria are key factors in its ultimate performance, along with external factors such as changes in the economy. Agencies such as Fitch Ratings, Moody's, and Standard & Poor's determine ratings for securities based on their credit risk and any "enhancements" included to reduce those risks. The type and extent of credit enhancement varies by the type of loan underlying the security and the lender's underwriting criteria for that loan product. For example, while income and employment verification is typically required on a mortgage loan, the same is not true for other consumer loans. Those lenders that include income and employment verification as part of their decisioning process may be viewed as having stronger underwriting relative to other lenders, which is one input in the overall rating of the subsequent security. Common enhancement strategies include overcollateralization, senior-subordinate structures, reserve accounts, and excess spread balances. In addition to credit enhancements, ABS issuers are also generally required to retain a small portion of the risk to help ensure its interest and those of investors are properly aligned.

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Common Types of Consumer Loan ABS

Auto loans were the first type of non-mortgage consumer credit to be securitized and continue to be the dominant form of consumer loan today, followed by credit card ABS. More recently, lenders have sought the same source of funds and liquidity for other forms of consumer credit including unsecured personal loans, student loans, home equity loans and lines of credit, as well as residential mortgages that do not meet the criteria to be included in an RMBS securitization.

Standard & Poor's estimates that approximately US$117 billion in ABS was issued between four common loan types—auto, credit card, personal, and private student loans—in 2021. This reflects a rebound to 2019 levels for auto loan ABS, while credit card and personal loan ABS remains significantly lower than the issuance in 2019.

Private student loan ABS increased in 2020 relative to 2019 and remained stable at around that level in 2021.

Auto Loan ABS

Auto loans typically carry a fixed interest rate and have uniform payments on an amortization schedule for up to seven years. While the asset by which these loans are secured is depreciating, losses are substantially less than for unsecured credit such as credit cards and personal loans since a lender can repossess the vehicle.

The main issuers of auto loan ABS are banks, credit unions, non-bank lenders, and captive finance companies which are owned by automakers.[1] Auto loans that are packaged into ABS and sold to an SPE are then put into an owner trust structure where they are consolidated into tranches that vary by term, credit quality, and cash flow to appeal to varied groups of investors, some of which are subordinate to others. Typically, several classes of notes are issued by the SPE which are distinguished by the underlying credit quality of the borrowers. Prepayment risk in the auto lending context is relatively low for several reasons. First, there is relatively little refinancing of auto loans, both because of the short loan term which limits the potential savings for the borrower and the zero and below market interest rate offers captive finance companies use to spur vehicle sales. Prepayment can occur if a vehicle is sold or traded in during the loan term, if an accident causes the vehicle to be declared a total loss, or if a default occurs (although significant recovery is possible).

To deal with credit and prepayment risks, a reserve account is established by lenders, using a small portion of the income generated by selling notes to investors. Accordingly, the amount of funds held in this account is tied to the magnitude of these risks perceived by rating agencies and investors, so more robust underwriting, which could include income and employment verification, may result in a reduced reserve requirement for the issuer. Strategies including over collateralization and subordination are also employed.

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Enhancing an ABS by Reducing Credit Risk

Financial institutions that securitize their loans are generally familiar with the fees and expenses incurred when using warehouse lines to fund their loans. A warehouse line of credit allows lenders to fund loans to a borrower without using the lenders' own capital. Lenders that use warehouse financing typically resell the loan to a secondary investor and use the proceeds to repay the warehouse loan. As a result of fees incurred during warehouse financing, the shorter a lender can make the time between loan origination and securitization, the better. One way to do this is by improving the attractiveness of their loan portfolio for investors that have an ABS issuance with strong underlying assets—a pool of consumer loans in this case.

The type of loan that comprises the ABS, the profile of the borrowers, and the lender's underwriting criteria are critical factors in a security's ultimate performance, along with external factors, such as changes in the economy. Agencies such as Fitch Ratings, Moody's, and Standard & Poor's determine ratings for securities based on their credit risk and any "enhancements" included to reduce those risks. These credit enhancements vary by the type of loan underlying the security and the lender's underwriting criteria for that loan product.
Common enhancement strategies include over-collateralization, senior-subordinate structures, reserve accounts, and excess spread balances. In addition to credit enhancements, ABS issuers are also generally required to retain a small portion of the risk to help ensure their interest and those of their investors are appropriately aligned.

Separate from these credit enhancements and specific to auto loan ABS, in the instances where an ABS is made up of loans with zero or below-market interest rates, they include a yield supplement overcollateralization amount (YSOA) to provide market-rate returns to investors.

Lenders that include income and employment verification as part of their decisioning process for non-mortgage consumer loans may be viewed as having more comprehensive underwriting relative to other lenders, which is one input in the overall rating of the subsequent security.

Multiple Data Points During Loan-Level Decisioning Can Positively Impact Portfolio Strength

Consumer lenders consider a variety of data points for loan underwriting. Data points such as credit score, debt-to-income ratio, and whether the loan is secured by an asset, such as a car or another type of personal property, can provide insight into a loan applicant's ability and willingness to repay a loan. Depending on the relative risk a borrower represents, a lender may adjust the interest rate or other terms.

The uneven and constantly evolving economic impacts of the pandemic—particularly on the employment status of borrowers in certain industries—have increased consumer loan lender interest in utilizing income and employment data for decisioning. Income and employment verification have been used for underwriting for years in the mortgage industry. However, its use has increased in recent years for auto and other consumer loans following the COVID-19 pandemic, which created economic volatility across most industries.

Automated Income and Employment Verification Methods

Information on a consumer's income and employment status can come in various levels of detail and delivery methods. For example, while income and employment are verified during the mortgage loan origination—often several times between application and closing—lenders have more flexibility on whether and how they verify income and employment for other credit products.

Some lenders even estimate a consumer's income through information that can serve as a close proxy or approximation, also commonly known as estimated income. Others conduct a more formal verification process, which is either manual or automated to some degree. For example, a manual process would involve the consumer providing a paystub or other documentation or the lender contacting the consumer's employer directly. But, lenders that want to include this information in their underwriting are increasingly turning to more automated approaches to bring in robust real-time data that can be refreshed both during the decisioning process and on an ongoing basis. There are generally two automated methods for a lender to access a borrower's income and employment data. The first method is for a lender to prompt a loan applicant to provide their banking credentials so that a connection can be made to provide payroll data to the lender. This process is somewhat similar to the process undertaken by consumers to provide their account transaction data to a third party through an API connection or screen scraping. Screen scraping is a process of automated data gathering. It occurs when a borrower discloses their online banking log-in credentials to a third party, which enables the third party to use scraping technology to log in to the borrower's online banking account and copy transactional information to support their service.
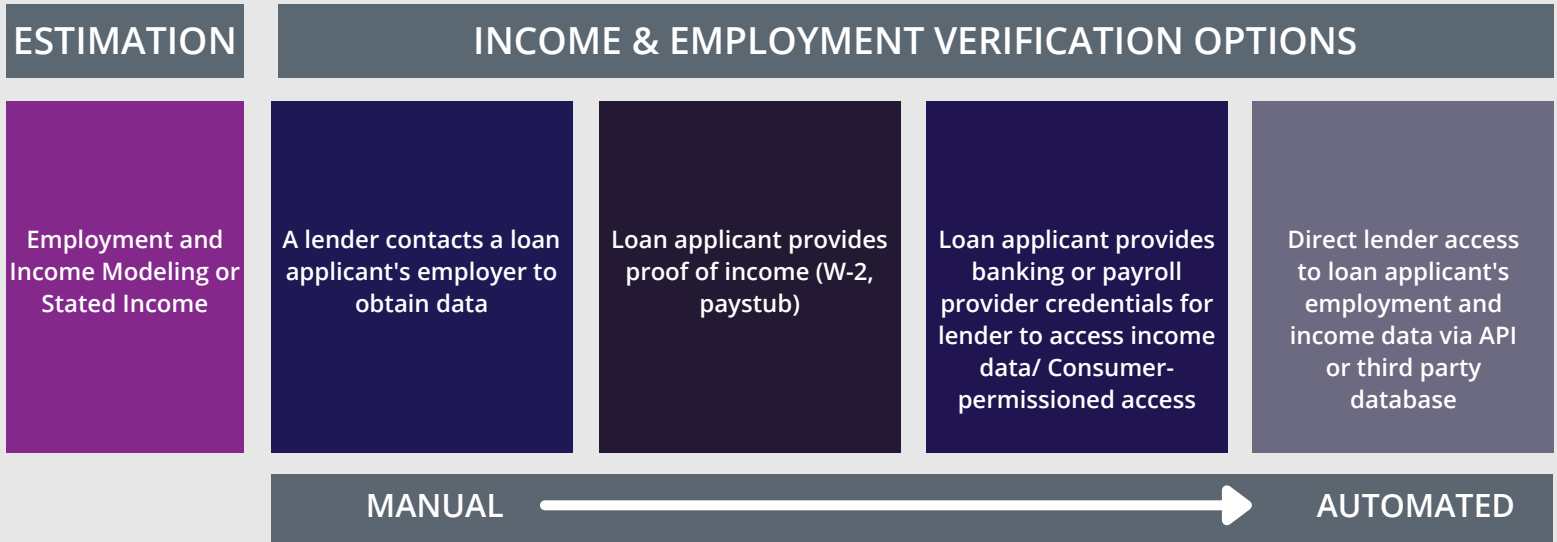
An alternative approach is for the lender to securely access such data directly through a third-party vendor that maintains extensive payroll data through partnerships that cover a significant share of consumers in the U.S. While the consumer may grant permission for this data sharing as part of the application process, the process is more streamlined since the burden is not on a borrower to provide payroll credentials or other sensitive banking information.

In both of these automated approaches, pertinent attributes can be readily transmitted to specific data fields that are used for decisioning and more detailed information, such as historical data and compensation structure, may also be available.

The uneven and constantly evolving economic impacts of the pandemic—particularly on the employment status of borrowers in certain industries—have increased lender interest in utilizing income and employment data for decisioning.

It is important for lenders and ABS investors to understand the dynamic relationship between a borrower's income and employment status and their likelihood to repay a loan.

ESTIMATION	INCOME & EMPLOYMENT VERIFICATION OPTIONS			
Employment and Income Modeling or Stated Income	A lender contacts a loan applicant's employer to obtain data	Loan applicant provides proof of income (W-2, paystub)	Loan applicant provides banking or payroll provider credentials for lender to access income data/ Consumer-permissioned access	Direct lender access to loan applicant's employment and income data via API or third party database

MANUAL ➡ AUTOMATED

Source: Aite-Novarica Group

Can Verification of Income and Employment During Decisioning Result in Higher Ratings From Rating Agencies?

How a loan is underwritten is a key component in rating agencies' evaluation of a lender's portfolio. Automated income and employment verification solutions can give lenders a competitive edge. ABS investors consider rating agencies' assessment and the lender's historical securitization performance when making an investment decision. How a loan is underwritten is a key component in rating agencies' evaluation of a lender's consumer ABS program. While it can take time for a lender to establish a solid track record, once that occurs, highly rated consumer ABS have enjoyed strong investor demand and serve as an attractive source for funding loans.

Verification of income and employment, along with other steps in the underwriting process, to clearly show that a loan applicant has the ability and willingness to repay can result in a higher rating for the subsequent securitization—especially if the lender can demonstrate that its decisioning criteria has routinely yielded strong results.

Over the last few years, as economic volatility has introduced external risk factors, rating agencies and investors are even more focused on the historical performance of a lender's portfolio as well as the rigor of their underwriting and how that can help mitigate changing macroeconomic conditions.

Automated income and employment verification can yield benefits for lenders and borrowers alike. However, if leveraged for decisioning, lenders should be prepared to demonstrate to rating agencies and investors that their verification method does not result in any credit quality deterioration relative to a manual approach. Fortunately, lenders report that moving from a manual to an automated verification process has had a positive impact on the quality of their loan portfolio. In addition, the efficiency gains and better customer experience have created opportunities for lenders to increase market share among consumers while lowering costs.

Benefits of Automated Income and Employment Verification

- Increased ability to discern an applicant's true credit risk

- Low-friction customer experience during application process (no submission of documents)

- Greater efficiency and ability to decision 24/7 (no calls to employers)

- Greater confidence in lending decisions when income and employment information is verified

Conclusion

- Verification of income and employment is increasingly common in non-mortgage consumer loan settings as lenders seek insights into a borrower's real-time financial condition.

- While it's routine for mortgage lenders to verify consumers' income and employment, lenders offering other consumer credit products are starting to see the value in doing so as well so as to ensure they manage credit risk more appropriately.

- Automated income and employment verification solutions not only allow lenders to provide a better application experience for borrowers, but they also help with credit risk management at the time of application and while the loan is in repayment or the credit line is open. In addition, lenders that securitize loan portfolios that utilized automated income and employment verifications may experience additional benefits as rating agencies and investors view their offerings more favorably.

- Consumer lenders increasingly recognize that confirming an applicant's income and employment status is an important input into the underwriting process for non-mortgage consumer loans. Certain automated verification approaches may carry enhanced benefits of validating an applicant's identity and ability to monitor for income and employment, as long as the lender has a permissible purpose. This can benefit lenders and investors alike.

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David Albertazzi is the Director of Aite-Novarica's Retail Banking & Payments practice, and he focuses on retail bank channels and core banking technologies. He specializes in technology solutions used by banks and credit unions to support their mobile banking, online banking, branch, ATM, and call center channels, and he assesses the strategies and technology implementations of financial institutions of all sizes. His recent research has addressed digital banking trends and technologies, including cloud computing, consumer mobile banking, digital onboarding, and the drivers of global core banking system replacement. David also covers electronic bill payment and presentment.

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