GSE Activity Report

Wednesday, April 20, 2022

Fintechs on the Firing Line

Summary

As we noted yesterday, the IMF's financial-stability report includes a searing assessment of fintech risk. In this report, we drill down into one of the study's case studies, which assesses mortgage fintech and concludes that this business model poses a raft of risks to financial stability. We note several methodological concerns with this conclusion, but it will nonetheless have significant bearing on what FSOC, FHFA, and Ginnie come to do about the nonbank business model.

Analysis

The IMF's assessment of mortgage-origination fintech recognizes its efficiency and speed benefits, but also argues that fintech mortgage banks pursue aggressive growth strategies that rely on ever-riskier borrowers. Many of these borrowers are younger and are said to prefer newer fintechs, but the paper notes that these younger borrowers have lower incomes and are more vulnerable to the higher-risk terms prevalent in fintech-originated loans (e.g., the higher LTVs evident between 2018 and 2020 according to data presented in the study).

Although the Fund acknowledges some credit-availability benefits from this fintech business model, it bemoans resulting risks to financial stability. The study finds that a one percentage point rise in fintech composite market share is associated with a 0.4 pp drop in bank mortgage interest revenue that can be offset by bank reduction in IT capability, which the Fund believes reduces systemic resilience. We note, though, that this reasoning suggests that any competitor that reduces borrower costs at the expense of legacy providers is a systemic threat – a dubious claim from a competition perspective – especially as the study found that growing fintech share doesn't adversely affect bank share, with the Fund positing that banks make up in portfolio loans what they lose to fintechs in secondary-market originations.

Indeed, the study's overall conclusions may be a bit fuzzy because the data come from 2007-20 HMDA data designed to identify credit discrimination, not market share or even borrower risk. These data do track matters such as LTV from which risk may in some cases be inferred, but it's at least debatable if systemic conclusions are possible without first demonstrating that fintechs are of a size or scope or lack of substitutability sufficient to cause systemic risk. The FSOC reaches this conclusion based on its overall review of nonbank originators and servicers, but that's not even close to the Fund's conclusion specific to fintechs.

The paper's approach to differentiating fintechs from incumbents is also challenging. It uses a standard industry definition which considers fintechs companies that offer online origination without need of human contact. However, large mortgage lenders the study considers fintechs (e.g., Quicken) have lots of points of contact, banks increasingly allow for online applications, and mortgage brokers – human points of contact no matter what some might once have said – often interact on behalf of companies that data might otherwise deem to be fintechs. The paper also infers a high-volatility business model

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for fintechs by concluding that they will grow faster than incumbent banks because they focus more on refis than banks and refis is a "naturally" larger market. Some years yes, some years no and, of course, some years the nonbank models do a lot better or worse due to these market gyrations without yet posing systemic risk.

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