NON-QM LOANS' COOL RECEPTION

— by MATTHEW OSTRANDER —

Consider the plight of a would-be borrower who, despite being a very good risk for a mortgage loan, is not eligible for a Qualified Mortgage (QM). The reason this particular borrower isn't eligible is because she doesn't fall neatly within all of the QM guidelines. Maybe her debt-to-income (DTI) ratio is higher than that magic number 43, despite her considerable disposable income. ¶ Or consider a mobile-home park owner who has plenty of income documented on his tax returns but does not want to go through the hassle of providing the complete lease copies for each space—making him ineligible for a Qualified Mortgage per Appendix Q of part 1026 of the Truth in Lending Act (Regulation Z). ¶ The fact is these people are good risks. And mortgage lenders exist to provide the ability to achieve homeownership to qualified borrowers.

Here's why lenders should be running at non-QM loans, not from them. It all comes down to this: Sometimes good risks are worth taking.

So, as long as borrowers' ability to repay is properly qualified according to the requirements of the ability-to-repay (ATR) rule, a lender should be comfortable giving them a non-QM loan.

Even though some people don't meet the QM guidelines, many of them can repay a mortgage and are good risks. After all, not all borrowers with DTI ratios of 44 and higher are created equal—and neither are all non-QM loans.

Simply put, the non–Qualified Mortgage space is tremendously misunderstood.

The industry to date has been hesitant to embrace this space for a variety of reasons. First, most lenders are plenty busy with a steady flow of QM loans these days, so they don't need to supplement their business with non-QM products per se. Not only that, borrowers who fall slightly outside the QM standards but who are otherwise excellent credit risks have difficulty accepting the higher rate that typically comes with non-QM loans. Then there is the lingering memory of the huge problems associated with subprime loans and the tendency for lenders to mistakenly lump them in the same category as non-QM loans; they don't understand the differences between subprime and non-QM underwriting.

And finally, there is not much of a secondary market interested in buying non-QM loans—at least not yet. Primarily higher-yield, fast-money buyers of credit risk are the predominant players—the slow money is sitting out and waiting for more data to calibrate the risk.

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The truth is, there is a much greater risk to lenders if they do not participate in the non-QM marketplace. The slower the industry is to adopt these products as viable alternatives for creditworthy borrowers, the slower the housing recovery will be—which will impact the nation's economic recovery as well. We should be running at these loans, not from them.

Biggest misconception: A non-QM loan is a poor credit risk

This sizable market is comprised of various niches that can be deemed safe enough to compensate for the perceived risk they carry—which for most lenders is the potential for future litigation. With all the data we now have from the Great Recession, it is not a stretch to say that risk can be thoroughly quantified and understood if carefully modeled using accurate assumptions.

In fact, the disconnect between the credit analysts and the portfolio managers/chief investment officers within certain key "slow money" institutional buyers is one of the key drivers in the rebuilding of the capital markets for non-QM bonds. Ask any conduit to Wall Street and they'll tell you time is a key factor and this "time" issue is going to leave a big hole in homeownership if not solved.

Borrowers who do not qualify under the QM guidelines but who have more residual income, non-traditional income or high-cash reserves can often be easily proven as good credit risks. The trick is for a lender to do its due diligence and properly qualify the borrower's ability to repay, making sure the ratings agencies and buyers of AAAs agree—which is no small feat.

For example, lenders that are wading into the non-QM space are working with people who have significant stock-option income but no other income sources, or they may be recently retired with considerable equity, assets and credit, but lack monthly income.

Self-employed borrowers are also good candidates for non-QM loans but often have complex financial profiles. There are also interest-only borrowers who have a high net worth and a low loan-to-value (LTV) ratio. These individuals are often financially sophisticated and use these loans as a cash-management tool for cash-flow and tax-deduction purposes. They are put into the non-QM box because they have chosen an interest-only option. Again, as long as all of these borrowers are qualified thoroughly and accurately, there should be no question as to their ability to repay.

Non-QM products also serve as alternative financing solutions for people with credit scores that fall just outside of the government-sponsored enterprise (GSE) guidelines, short credit histories or debt-to-income ratios that are higher than the QM threshold of 43 percent.

For example, consider the risk associated with two different borrowers, both with 50 percent DTI. One earns $50,000 annually and the other earns $1 million. The first borrower has only $25,000 left after spending $25,000 on his debts. The second borrower spends $500,000 on her debts with $500,000 remaining. She has significant cash reserves to indicate a strong ability to repay a loan.

This is an example of why a borrower who falls outside of the QM rules is sometimes not only a good risk, but an excellent one.

Next biggest misconception

The Consumer Financial Protection Bureau (CFPB) ability-to-repay rule established eight underwriting requirements that lenders must "consider" when making ability-to-repay determinations. Failure to do so can result in fines, enforcement

FIGURE 1

TOP RESIDENTIAL ORIGINATION MARKETS/PERCENT OF NON-QUALIFIED (NON-QM) MORTGAGE VOLUME

Los Angeles–Riverside–Orange County, CA CMSA	6%
San Francisco–Oakland–San Jose, CA CMSA	4%
Washington-Baltimore, DC-MD-VA-WV CMSA	3%
Dallas–Fort Worth, TX CMSA	2%
Denver-Boulder-Greeley, CO CMSA	3%

NOTE: April 2015 data based on top origination markets ranked by loan volume. CMSA = consolidated metropolitan statistical area; MSA = metropolitan statistical area.

SOURCE: Optimal Blue

actions and civil lawsuits. This added exposure has left many lenders hesitant to offer non-QM mortgages.

With that said, there is a lot of room for interpretation regarding said risks. For example, if you multiply your manufacturing quality by your default rate, you can quantify your probable risk—if you have a default rate of 5 percent (which is high, in my opinion) and your manufacturing defects are at 10 percent (also high, in my opinion), then 0.5 percent of your total loan population would be at "additional" non-QM litigation risk.

Your credit-manufacturing process and defect rates are key to your success when originating non-QM loans.

This also assumes the data given to you by the borrower was accurate—if the borrower presented false information, the lender could obtain a summary judgment, which would technically reduce the lender's non-QM default rate even further. The aforementioned data also assumes that there would be some sort of litigation instead of an agreement (arbitration/mediation). Most civil suits are settled outside of court because it is in everyone's best interest, and some states even require some form of mediation—which most sane legal minds would acknowledge is the best way to settle items.

In sum, your credit-manufacturing process and defect rates are key to your success when originating non-QM loans insomuch as you are trying to create mortgages and mortgage products that can actually be repaid at a price that is palatable for the borrowers' financial circumstances.

True, non-QM lenders will have fewer protections under the law—but if their borrowers are carefully and thoroughly qualified to repay, there should be little cause for concern.

The easing of QM standards over time

Though it is unlikely that QM standards will soften in the near term, lenders are already becoming more and more willing to interpret them less rigidly.

There is a growing consensus across the industry that the pendulum swung too far one way, hurting disenfranchised borrowers in the process. In fact, artificially limiting the supply of loans through regulatory constraints may, in the end, do more damage to the housing market than subprime lending did prior to 2008.

There are some potential borrowers in high-cost areas who need jumbo mortgages but are being denied entry into the world of homeownership. They are stuck paying more in rent than they would for a fully amortizing mortgage because they don't meet QM standards and the required DTI ratios. The fact that they have paid rent, on time and in full, for years, is dismissed as meaningless.

The perceived risks for lending to such borrowers under the current QM framework are limiting the opportunity for those borrowers to get out of the inflationary rent cycle, even though it would cost them less to buy a home. Think about it. When someone buys a house, his or her mortgage payment is fixed for 30 years. When someone rents a house or apartment, that monthly fee can go up every year.

Many renters clearly have the ability to repay, yet the current guidelines prevent them from owning a home or at least make it harder for them to move into homeownership.

Alternatively, imagine the plight of a recently graduated doctor or lawyer beginning his first residency or law firm job. Borrowers like these are likely to have higher-than-average incomes, substantial earning potential and solid credit. However, they are also likely to have significant debt because of their student loans. Despite their very real and promising financial futures, they would have difficulty qualifying under current QM rules.

San Francisco–based Social Finance Inc. (SoFi) has a term for these folks: Henrys (high earners not rich yet). Does anyone see an opportunity here?

Non-QMs and their impact on the economy

As more lenders participate in the non-QM space, more credit will become available and the lower rates will go. Demand will be supplemented with borrowers who would either have turned to hard-money lenders for loans at much higher costs or who would not qualify at all, which will also have a positive impact on the future of the U.S. housing market.

At the same time, more lending activity in the non-QM space will help balance housing supply with demand—which, in turn, helps sustain a healthy housing market.

There are many macroeconomic factors that can contribute to the growth of housing supply. However, little can be done to increase demand except to grow the universe of qualified borrowers. And that is exactly what non-QM lending does.

Lenders would benefit, too. By offering a broader universe of qualified borrowers a suite of responsible loan solutions, lenders gain market share. And for them, that is the real opportunity.

In the wake of the financial crisis, the government gradually has been expanding its credit box. Today, Freddie Mac and Fannie Mae are operating at 97 percent LTV. If the GSEs want to reduce their risk level exposure and relinquish some of their market share, non-QM lending is a good vehicle to accomplish that.

Further, once the non-QM market gains momentum, private capital can begin to re-enter the marketplace, thereby placing risk in the private market's hands instead of concentrating it in the government's.

Though there has been a fair amount of growth with some bank and non-bank entrants serving as investors on the origination side of things, warehouse lenders have been much slower to respond. Their primary concern has been insufficient liquidity due to the lack of non-QM investors.

To date, the nation's biggest banks and mortgage lenders have not agreed to take on the additional exposure. Rather, most have chosen only to broker non-QM loans. Unfortunately, these largest lenders have the cheapest funding and most reliable leverage for financing mortgage debt. That is precisely why they are the largest lenders and holders of mortgage debt in our financial system.

Until these large lenders begin to participate, non-QM lending will not be mainstream. (See Figure 1 to see how small the percentage of non-QM lending is in some of the nation's largest mortgage markets.)

On the flip side, as soon as there are more non-QM buyers, warehouse lines for these loans should become more readily available.

Non-QM loans, when underwritten properly, perform well.

What's the real risk?

It should be clear by now that non-QM loans, when underwritten properly, perform well. And they help the segment of the borrowing public that needs them the most.

Creating solutions for borrowers in the non-QM space is the most impactful thing a lender can do for borrowers today. Lenders also reap the benefits in the form of increased market share and opportunity.

So what's the risk of *not* having non-QM loans in our economy?

The risk is actually significant. It is entirely possible that if non-QM lending doesn't gain traction, the mortgage industry could end up with the same problems that arose from the multiple layers of risk that helped drive the meteoric rise in home prices and subsequent housing collapse in the previous decade.

In the near future, there may be periods of increased supply in housing as baby boomers retire. But without non-QM loans, housing demand could not only stall, but actually fall.

This imbalance is entirely plausible and could dramatically slow the pace of the housing market's recovery, negatively affecting the larger U.S. economy as well.

The cool reception non-QM loans have received up to this point is misguided. Every player in the industry should be running at them, not from them—not only because they are a good risk but because our job as lenders is to responsibly support the financing needs of qualified borrowers.

Qualified borrowers should be recognized for their ability to repay mortgage loans, not arbitrary lines in the proverbial sand of credit guides. Non-QM lending is a good risk worth taking. **MB**

Matthew Ostrander is chairman and chief executive officer of Parkside Lending, San Francisco, a national wholesale and correspondent lender. He also is a director for the California Mortgage Bankers Association (CMBA), where he serves as the president of residential real estate, and was recently appointed as a board member of the Freddie Mac Advisory Board. He can be reached at info@parksidelending.com.