"The non-QM market offers loan originators the opportunity to make profitable loans to low-risk homebuyers who don't qualify for qualified mortgages."

The Ayes Have It

Non-QM loans can be safe with a reliable third-party set of eyes

By Greg Holmes

After the Qualified Mortgage (QM) rule was implemented last January by the Consumer Financial Protection Bureau (CFPB), many lenders became understandably reluctant to originate loans that fell outside QM standards. These standards not only protect consumers from getting mortgage loans they can't afford, but also protect lenders from being sued by the borrower if s/he defaults on the loan.

The advent of these new rules, however, caused some lenders to reduce the size of their loan qualification "box" and choose to turn down loans that even came close to the non-QM line. Their fear was that higher-than-expected homeowners insurance or a requirement for flood insurance might kick them out of the safe harbor and into the unsecured, non-QM ocean. As a result, only about 0.5 percent of home mortgage loans originated this year have been non-QM[1], compared to 15 percent last year.[2]

But as the industry has grown used to the new regulations, and as the refinancing business has slowed due to rising mortgage rates, more lenders are beginning to take a cautious look at what non-QM lending might entail. Because the secondary market for non-QM loans is fledgling at best, these loans must be kept in the lender's portfolio, making them a riskier venture. Even so, a recent survey from the American Bankers Association showed that 29 percent of banks now plan to get involved in making non-QM loans in target markets.[3]

Many non-QM borrowers are good risks

There have always been borrowers who didn't fit the standard mold, but who were financially solid enough to be a good loan risk. In today's market, a large, non-QM segment includes many people who fall just outside QM standards.

Consider that the average credit score for a rejected prime mortgage loan in the U.S. is currently 724.[4] In the past, anything over 720 was considered "excellent" credit. What this means is that people who have a great credit score and credit history but don't fit the new "average" are being denied loans because they are falling into the non-QM category. People in this group might include:

- New medical professionals who have large student loans but a high income
- Self-employed business owners
- People with high assets but low income
- People with high or sporadic income, but low assets and little-to-no downpayment
- New graduates with high income
- New homeowners, and others

Create your own non-QM safe harbor with third-party verifications

Because most non-QM loans will be kept in the lender's portfolio, such loans should undergo a thorough verification process that mirrors the Ability-to-Repay (ATR) requirements for third-party verifications of income, assets, employment and more.

Due diligence in 2014 and beyond looks substantially different than it did in the sub-prime mortgage years. Advanced technology has fostered the development of a number of new, automated tools and services that can verify applicant information and monitor applicant behavior throughout the mortgage process. These verification tools streamline and simplify both the QM and the non-QM approval process for lenders, taking the stress out of validation and verification. New products include:

- **Undisclosed Debt Verifications:** More than 22 percent of all debt is taken on by applicants within 10 days of closing. Undisclosed Debt Verifications provide real-time monitoring into borrower credit activity initiated during the "quiet period"—from the initial credit file pull through loan closing. Reports provided by all three bureaus give lenders confidence that the borrower's income-to-debt ratio is remaining stable through closing. Undisclosed Debt Verifications monitor new tradelines; new inquiries; new secondary reissues; new bankruptcies, judgments, and liens; new collections; new late payments over 30, 60, 90, and120 days; and recent high utilization on existing bank card and revolving tradelines.
- **The Work Number:** This tool, offered through Equifax Workforce

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Solutions, provides fast, accurate employment and income verification to help lenders make informed decisions. The Work Number database contains the largest collection of payroll records contributed directly from employers, and houses more than 59 million current employment records contributed by more than 3,900 employers nationwide. This information is updated every payroll cycle, so lenders always receive the most up-to-date information possible.

- **Independent Appraisals**: Rules governing home appraisals underwent significant revision in response to the 2008 mortgage meltdown. Today, lenders are required to ensure the appraisers they use do not come under undue influence while doing their job. To avoid any appearance of impropriety, most lenders now use appraisal management companies (AMCs) which randomly assign appraisers as needed. AMCs offer valuation products that comply with the Uniform Standards of Professional Appraisal Practice (USPAP), Fannie Mae, Freddie Mac, Dodd-Frank Act, and Appraiser Independence requirements.
- **Affordable Quality Control (QC) Products:** Automated quality control (QC) products enable lenders to uncover inconsistencies in borrower loan data and ensure each loan remains in compliance. These QC products re-verify employment, run a credit refresh, check for undisclosed debt, review automated underwriting approval, review the appraisal, verify compliance with local, state and federal regulations, and more. They provide lenders with peace of mind that the non-QM loans they are originating are good loans to make.

Four tips for getting into non-QM lending

The non-QM market offers loan originators the opportunity to make profitable loans to low-risk homebuyers who don't qualify for qualified mortgages. Rely on the sound, tested underwriting guidelines you have used in the past to make loans that have generally performed well. As long as you make a reasonable, good-faith determination that the consumer is able to repay the loan based on common underwriting factors, as well as document the information you consider, you can originate any mortgage.

Lenders ready to take the leap should protect themselves in the following ways:

1. Require non-QM borrowers to meet the majority of the QM standards. In most cases, you may want to require that applicants conform to all but one QM factor. Setting your own strict level of compliance means that borrowers who receive non-QM loans are generally going to be those who already have high net worth and are on solid financial footing. This helps to protect you from the kinds of problems the market experienced just seven years ago.
2. Be rock-solid sure about the information provided by the borrower. Make sure the assets, income, debt and other information they report are accurate.
3. Consider only originating non-QM loans with a very low loan-to-value–such as a maximum 60 percent. This helps minimize the risk of default because the borrower has "skin in the game." And, should a default occur, the large down payment provides you with protection against loss even if property values drop a little.
4. Don't try to keep costs down by skimping on the use and expense of verification tools. There are so many more verification tools available today than there were in the sub-prime days. These tools can identify false information and flag data that is questionable. Non-QM loans can be a profitable path, but you're making those loans in an unsecured world. Protect yourself by using automated verification tools to your advantage.

Mortgage professionals moving into the realm of non-QM loans will find that there are some very good loans–and profits–to be made. The race will go not just to the swift, but also to the smart. As with every venture, it pays to do thorough due diligence and protect your company from unnecessary risk.

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Footnotes

1—www.nytimes.com (06/29/14).
2—www.mpamag.com (06/27/14).
3—www.americanbanker.com/issues/179_67.
4—www.fool.com/investing/general (06/22/14).