Angel Oak
MORTGAGE SOLUTIONS

Addressing Mortgage Credit Illiquidity with Alternative Products

The United States is six years into one of the greatest economic recoveries in history. The S&P 500 is up over 160 percent since the lows of 2009[1], unemployment is down to almost 5 percent after peaking at 10 percent[2], and consumer confidence has steadily risen since the lows of the recession[3]. Even recent existing home sales data shows a return to pre-recession numbers[4].

With such a robust economic rebound, it's no surprise that many forecasters are predicting that the Federal Reserve will raise interest rates before year-end. Such a rate hike could be a headwind for a U.S housing market that is just starting to get its legs back. Record low mortgage rates[5] are one of the chief drivers of the positive housing numbers. As those rates start to rise, consumers are more likely to shy away from taking on a mortgage.

A lack of credit liquidity in mortgage markets has created an uphill battle for U.S. housing in the post-crisis era. Strict credit guidelines put in place in the aftermath of the financial crisis have stymied many safe borrowers from returning to the market. Up until this point, low unemployment and low mortgage rates have won this battle and driven positive housing numbers.

Fortunately, there are signs that this credit freeze is beginning to thaw, and not a moment too soon. As more lenders adopt and issue alternative, non-government backed mortgage products, homebuyers that fall outside the typical credit box will return to the market and provide much needed stimulus in the face of rising rates.

An equal and opposite reaction

The years leading up to the housing bubble burst saw unsustainable growth in home ownership and home prices. In 2004, home ownership hit an all-time high of 69 percent[6]. That same year, many states saw average home prices appreciate in excess of 25 percent. The house of cards started to tumble in 2005, and by the end of that year, nearly 850,000 properties were in some stage of foreclosure[7].

In 2006, the U.S. housing market bubble finally burst, resulting in a credit crisis that would inevitably fuel the great financial crisis of 2007. The ensuing recession and market crash, however, triggered a kneejerk reaction from the federal government and its regulatory bodies. On July 21, 2010, President Obama signed into law the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in response to a lack of regulatory oversight that allowed the housing crisis to reach a boiling point.

Dodd-Frank has faced heated criticism from certain banks and financial institutions. Some think that such a wide-ranging financial regulatory overhaul overstepped its bounds and that efforts to prevent another catastrophic financial event were too severe. Indeed, Dodd-Frank has created an extremely tight credit market that has raised lending standards to an unprecedented level; however, significant steps needed to be taken to address some of the reckless and irresponsible practices that were going on throughout the mortgage and banking industries. Perhaps Newton's third law applies to economics, as well.

ATR

A result of Dodd-Frank was the requirement that residential mortgage creditors must make a reasonable and good faith determination based on verified and documented information that the consumer has the ability to repay the loan according to its terms.

Those in the mortgage industry are intimately familiar with ability-to-repay (ATR) regulations. The Consumer Financial Protection Bureau (CFPB) issued a final rule to implement laws requiring lenders to consider consumers' ability to repay home loans for owner-occupied and second homes before extending them credit. The regulation was passed specifically to address lax underwriting practices seen by many creditors in the industry.

There are eight pillars that make up ATR[8]:

- Current or reasonably expected income or assets (creditor must verify income for two full years of employment)
- Current employment status
- The monthly payment on the covered transaction
- The monthly payment on any simultaneous loan
- The monthly payment for mortgage-related obligations
- Current debt obligations, alimony, and child support
- The monthly debt-to-income ratio or residual income
- Credit history

For wholesale mortgage transactions, the lender is ultimately held responsible for adherence to ATR, not brokers or mini-correspondents. Violations of ATR are enforceable through the CFPB's administrative enforcement authority and are punishable by considerable monetary penalties and cease-and-desist orders. Borrowers can also take matters into their own hands and enforce violations through a private right of action or defense to foreclosure to exact monetary compensation.

Qualified Mortgages

Another result of Dodd-Frank was the development of a checklist that loans must meet in order to be considered "qualified." Government Sponsored Enterprises (GSEs) like Fannie Mae and Freddie Mac require that all loans they purchase have a "qualified mortgage" or "QM" designation.

Loans that meet these QM requirements also benefit from the "safe harbor" rule. If a court finds that a mortgage was originated as a QM, then that finding conclusively establishes that the lender complied with ATR requirements when they originated the mortgage, thereby making it nearly impossible for a borrower to claim they were unable to repay the loan.

In order for a mortgage to be considered "qualified," it must meet the following requirement[9]:

- Points and fees cannot exceed 3 percent of the loan amount
- No negative amortization, interest-only, or balloon loans
- Maximum loan term is less than or equal to 30 years
- Must meet the 8 pillars of ATR
- Cannot exceed a 43 percent debt-to-income ratio
- Prepayment penalties are prohibited (with limited exception)

This is where the credit squeeze occurs. Lenders are working with one hand tied behind their back. The QM designation creates such a narrow credit box for borrowers that it excludes many otherwise safe borrowers from obtaining a loan.

Stepping away from the agencies

In order for lenders to tap the vast market of borrowers that are excluded by QM restrictions, they need to look to products not backed by the government. Loans that cannot be sold to GSEs are frequently referred to as "non-agency" loans. The variety of non-agency mortgage solutions on the market today caters to the specific needs of individual borrowers who fall outside of the QM definition.

Non-agency lending is nothing new. It was a massive market prior to the housing crisis, reaching a peak of nearly $2.4 trillion in originations in 2007 and even outpacing agency lending[10]. Following the housing crisis, non-agency lending all but disappeared. For six years, it has remained mostly dormant; however, in early 2014, it started to make a comeback.

Non-prime: the new sub-prime

The sub-prime meltdown resulted from a combination of factors, including lenders extending credit to high-risk borrowers, lending without requiring a down payment or proof of income, and very little regulatory oversight. Some lenders failed to verify consumers' income or debts and qualified consumers for mortgages based on "teaser" interest rates that caused monthly payments to skyrocket after the first few years.

Sub-prime lending was just one ingredient in the turmoil of the financial crisis, but it's easy to see why it has become the dirty word associated with all that went wrong. It will likely take years to change the public's preconceived notions about sub-prime mortgages.

There is a stark difference between the sub-prime product that was rampant prior to the financial crisis and today's new issue, non-prime or nonqualified mortgages (non-QM). **The primary difference is that non-prime loans strictly follow the eight pillars of ATR.** That, in itself, removes much of the risk associated with writing loans outside of the QM safe harbor.

As a result of this strict adherence to ATR, average credit scores are higher. Non-prime credit scores today average over 680, which is not considered a typical "sub-prime" score. Furthermore, loan-to-value (LTV) ratios never exceed 90 percent, which means borrowers are required to put at least 10 percent into the transaction.

The new product resembles how sub-prime first began: borrowers have equity in the transactions and documented incomes. The kinds of non-QM loans many nonbank lenders are now offering look more like the sub-prime of the late 1990s than those of the mid-2000s.

The Sub-prime Market: Then and Now

2006

- Average credit score: 580
- Loans were made without requiring a down payment
- Income was undocumented
- Volume: Over $500 billion
- Limited oversight and regulation

2015

- Average credit score: 680
- Loans require no less than a 10 percent down payment
- Income must be documented
- Volume: $250 million and growing
- Tighter regulation and ATR requirements.

Such non-prime mortgage programs can be tailored to a borrower's specific needs. Here are some examples of the types of borrowers that can benefit from non-prime products:

- Borrowers who have experienced a recent credit event, such as a foreclosure or short sale
- Borrowers that don't have W2 income and instead rely off of income from investment properties
- Self-employed borrowers whose tax returns may not necessarily reflect their true income due to business write-offs
- Foreign nationals that don't have credit in the U.S. system
- Borrowers that have significant savings but limited income

Sub-prime lending was a huge market prior to the 2007 mortgage crisis. From 2004 to 2006, it accounted for over $500 billion per year in lending. Now, sub-prime is comparatively non-existent at less than $1 billion per year[11]. This indicates that a large market for these products exists and has not been served for most of the last seven years. Ultimately it's up to the private market to accommodate these borrowers' unique scenarios.

Common sense underwriting

Lenders that partake in non-agency and non-prime lending must assign top priority to safety in lending standards. It's crucial for lenders to ensure that income and assets are well-documented.

Non-prime loans are not the type of loans that can be underwritten by a computer; loans need to be analyzed individually by an underwriter qualified to make a lending decision. Though due diligence on non-QM loans is a manual process that takes time and resources, commitment to those practices – as well as stricter regulations on ATR requirements and LTV ratios – significantly reduces the likelihood of defaults.

Despite all the new regulations, the real key to mitigating non-QM risk is using well-documented, manual underwriting and avoiding the excessive layering of multiple risks that decimated loan performance during the mortgage crisis. With a disciplined approach to offering these programs, they can take their place back at the mortgage table.

Interest rates

Depending on the risk profile of the borrower, non-prime mortgages can carry interest rates anywhere from 5-to-9 percent. Many non-prime loans are High Priced Mortgage Loans (HPML) that have points and fees ranging from 3-to-5 percent of the loan amount and interest rates from 1.5-to-6.5 percent above the average prime offer rate (APOR). HPMLs are often confused with *High Cost* Mortgages, which have points and fees ranging from 5-to-8 percent of the loan amount and interest rates over 6.5 percent above APOR; however, the two types of loans are very different. HPML is much safer than High Cost and always meets the ATR requirements.

It makes sense that such loans have caught the attention of private investors in today's low-yield environment. Investors looking to diversify into high-yield mortgages have nowhere else to turn but toward sub-prime. This may change as interest rates rise across the board; however, that process is likely to be slow and could feasibly decrease traditional QM loan volume.

We are at the beginning of a new credit cycle in which investors are looking for new ways to create return and non-traditional borrowers are looking to return to the housing market. Unlocking the oncedormant sub-prime loan market not only provides investors with higher yields, but also provides brokers with a variety of new products that enable them to satisfy the needs of borrowers outside of agency lending guidelines.

Conclusion

Following the Great Recession, the housing market experienced a lock down on credit in which only the most qualified borrowers could obtain a mortgage. Fortunately, a healthy economic recovery was enough incentive to bring buyers back to market; however, as the current market matures and the Fed looks set to raise interest rates in the near future, housing is facing an uphill battle.

Fortunately, a much needed liquidity injection is around the corner. Public perception continues to soften on non-prime and other alternative lending products. Thus, we expect the market for non-agency mortgages to see significant growth as availability, awareness, and demand for these products continues to develop.

Tom Hutchens is Senior Vice President of sales and marketing at Angel Oak Mortgage Solutions. Angel Oak Mortgage Solutions is a team of mortgage professionals are at the forefront of the non-agency lending scene. They provide programs specifically geared towards consumers whose circumstances may not meet standard agency financing guidelines.

Sources:

1. S&P returns
2. Unemployment
3. Consumer confidence
4. Existing home sales; Pending home sales
5. Mortgage rates
6. Homeownership: Table 14
7. 2005 foreclosures
8. ATR
9. QM
10. Bloomberg Terminal
11. Subprime volume