

The Risks and Benefits of Non-QM Lending

Understanding How to Use These Loans Can Help Grow Your Mortgage Business

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Recent headlines like this one on *Bloomberg*, “Risky Mortgage Bonds Are Back and Delinquencies Are Piling Up,” or this one from *The Wall Street Journal*, “Mortgage Market Reopens to Risky Borrowers,” would have you believe that the subprime, liar loans of 2005 are back!

The truth is that “non-QM” loans make up a very small portion, but one of the fastest growing (and misunderstood), segments of the mortgage market today.

Non-QM lending encompasses an array of loan types such as bank statements, asset depletion, interest only, balloons, 43%+ DTI, foreign nationals and prior credit event, just to name a few. It generates clicks with statements like this one from *Bloomberg*: “Lenders have bundled more than \$18 billion worth of these loans into bonds this year that they then sold to investors, a 44% increase from 2018 and the most for any year since the securities became common post-crisis.” ([LINK:https://www.bloomberg.com/news/articles/2019-11-04/risky-mortgage-bonds-are-back-and-delinquencies-are-piling-up?srnd=premium](https://www.bloomberg.com/news/articles/2019-11-04/risky-mortgage-bonds-are-back-and-delinquencies-are-piling-up?srnd=premium))

It’s important to highlight the scale of just how small this compares to the past with a quote from *HousingWire*: “There were more than \$1 trillion in subprime and Alt-A mortgages originated in 2005 and 2006. That’s roughly equivalent to how many purchase mortgages originated in all of last year.” ([LINK: https://www.housingwire.com/articles/49224-non-qm-lending-is-on-the-rise-but-heres-why-its-not-the-subprime-of-the-past/?v=preview](https://www.housingwire.com/articles/49224-non-qm-lending-is-on-the-rise-but-heres-why-its-not-the-subprime-of-the-past/?v=preview))

That’s \$18 billion today vs. more than \$1 trillion in 2005, and the total mortgage market is roughly \$2 trillion for 2019.

HOW THE MARKET HAS EVOLVED

What’s more is understanding how the market has evolved since the crisis. Largely gone are the days of a borrower’s ability to “fog a mirror” or “have a pulse” to

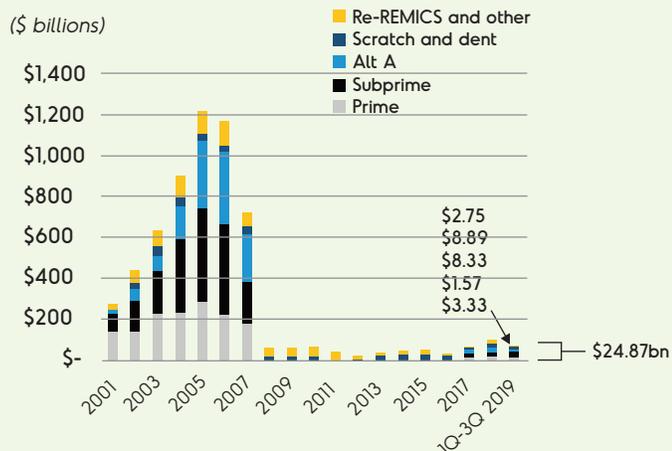
qualify for a loan. With the creation of the Consumer Financial Protection Bureau (CFPB), the “ability to repay” regulations and the non-qualified mortgage, the residential loan landscape has been dramatically altered.

The challenge now is to separate the fear of the past and the opportunity of the future.

As these new products evolve, you will develop new loan programs for your members, safely and soundly. The goal of this article is to help you understand the various facets of non-QM lending and highlight the risk (or lack thereof). This can be a growth area for your credit union and your members. (See accompanying “Non-Agency MBS Issuance” chart.)

First, let’s address a horribly titled and perhaps poorly designed regulation: the Non-Qualified Mortgage. A result of the housing crisis, it was created by

Non-Agency MBS Issuance



Sources: Inside Mortgage Finance and Urban Institute

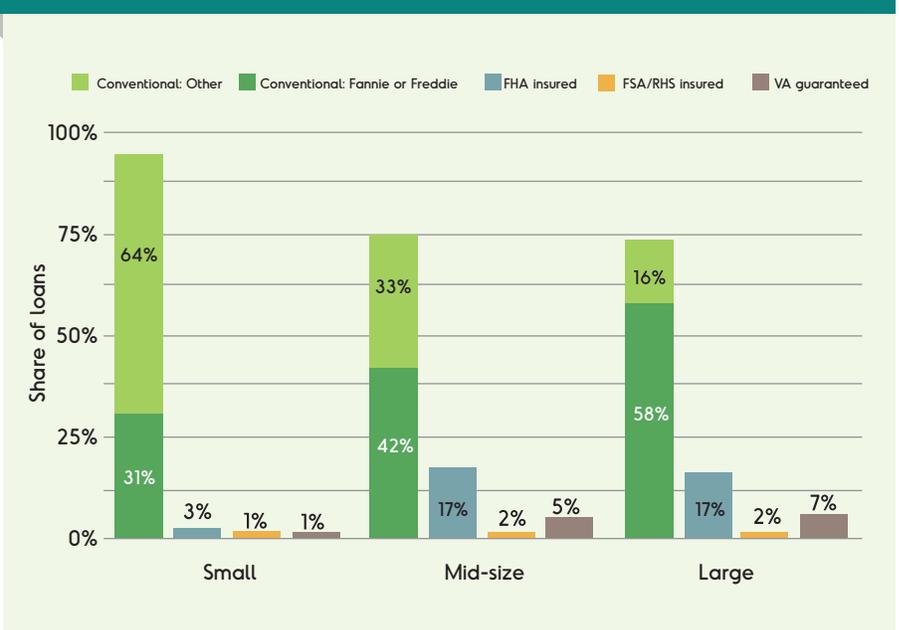
the CFPB to educate and protect borrowers and is defined in Appendix Q. ([LINK:https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1026/Q/](https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1026/Q/))

Some say it smells like subprime. How about expanded prime? Others call it non-prime. What exactly do any of these mean? I prefer to call this what it is: relationship or portfolio lending. These are loans that won't fit into the agency's credit box.

Per the CFPB, smaller servicers, typically community banks and credit unions, are generating a larger percentage of non-GSE loans currently. (See accompanying "Mortgage Type by Servicer Size" chart.) "At small servicers, most loans are neither government-insured nor serviced for Fannie Mae or Freddie Mac. Although small servicers may service some of these loans for other owners, if small servicers are not servicing conventional loans for Fannie Mae or Freddie Mac, it generally means they are holding the loans on their own books." ([LINK: https://files.consumerfinance.gov/f/documents/cfpb_2019-servicer-size-mortgage-market_report.pdf](https://files.consumerfinance.gov/f/documents/cfpb_2019-servicer-size-mortgage-market_report.pdf))

One of the biggest challenges involves the 43% DTI qualification and the ability to qualify income of the self-employed member. The CFPB has created this enormously broad, really scary sounding subset of the mortgage market where many struggle to understand the risk and the penalty if they miss something.

Mortgage Type by Servicer Size (Loans Outstanding in NMD8 September 2018)



Per the *American Banker*: "Roughly 70% of the working population are W-2 employees with little variable income, but 30% have income that is hard to document." ([LINK: https://www.americanbanker.com/news/new-villain-in-battle-over-cfpb-mortgage-rule-appendix-q](https://www.americanbanker.com/news/new-villain-in-battle-over-cfpb-mortgage-rule-appendix-q)) The *Wall Street Journal* estimates that loans with DTIs north of 43% were roughly \$260 billion in mortgages in 2018 alone. ([LINK:https://www.wsj.com/articles/cfpb-takes-aim-at-mortgage-patch-that-enables-riskier-borrowing-11564088615](https://www.wsj.com/articles/cfpb-takes-aim-at-mortgage-patch-that-enables-riskier-borrowing-11564088615)) That's an enormous segment of the market!

However, as shown in the accom-

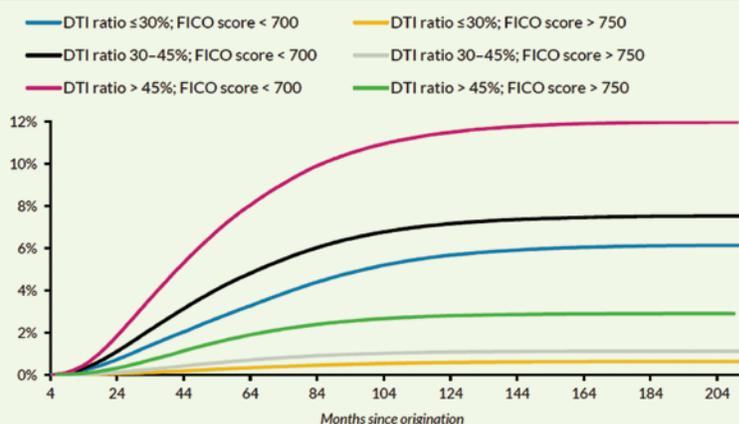
panying "Fannie Mae Loans Over 90 Days Delinquent" chart, the Urban Institute has shown that income is the worst qualifier of performance when comparing DTI, LTV and FICO over Fannie Mae's performance history dating to 1999. ([LINK: https://www.urban.org/sites/default/files/publication/101048/comment_letter_to_the_consumer_financial_protection_bureau_0.pdf](https://www.urban.org/sites/default/files/publication/101048/comment_letter_to_the_consumer_financial_protection_bureau_0.pdf)) In truth, as many credit unions and community lenders know, it's a layering of risk that helps estimate future performance.

You can see from the "Distribution of Fannie Mae Lending" table how the market has shifted as a result of the new regulation and mortgage crisis with Fannie Mae:

- Lower FICO score loans with high DTIs made up 40% of the market back from 1999-2004. From 2011-2018 they make up only 15%.
- Conversely, higher FICO score loans with high DTIs made up 28% of the market from 1999-2004. They have more than doubled to 59% from 2011-2018.
- You can really see the shift in credit starting in 2008. The shift up in FICO is apparent.

As a result of this shift, there is a tremendous opportunity for community lenders to capture business that would be classified as non-QM. (See accompanying "Chase's First Non-QM Issuance"

Share of Fannie Mae Loans Over 90 Days or More Delinquent (By FICO Score and DTI Ratio)



Source: Urban Institute analysis of Fannie Mae loan-level performance data.
Notes: DTI = debt-to-income. The Fannie Mae dataset includes 30-year fixed-rate, full-documentation, fully amortizing mortgage loans. These data include loans originated from the first quarter of 1999 through the second quarter of 2018. Loan performance is through the second quarter of 2019.

URBAN INSTITUTE

Distribution of Fannie Mae Lending, by FICO Score and DTI Ratio

Origination year	DTI ratio ≤ 30%			DTI ratio 30–45%			DTI ratio > 45%		
	FICO score ≤ 700	FICO score 700–750	FICO score > 750	FICO score ≤ 700	FICO score 700–750	FICO score > 750	FICO score ≤ 700	FICO score 700–750	FICO score > 750
1999–2004	28%	27%	45%	38%	30%	31%	40%	32%	28%
2005	28%	22%	50%	37%	27%	36%	39%	29%	32%
2006	29%	22%	50%	38%	26%	37%	40%	28%	32%
2007	29%	21%	50%	38%	25%	37%	41%	27%	33%
2008	16%	21%	63%	22%	27%	50%	28%	30%	42%
2009–2010	6%	17%	78%	10%	25%	66%	13%	28%	59%
2011–2018	9%	18%	73%	16%	27%	57%	15%	26%	59%
1999–2018	18%	22%	60%	24%	28%	48%	33%	30%	38%

Source: Urban Institute analysis of Fannie Mae loan-level performance data.

Notes: DTI = debt-to-income. The Fannie Mae dataset includes 30-year fixed-rate, full-documentation, fully amortizing mortgage loans. These data include loans originated from the first quarter of 1999 through the second quarter of 2018. Loan performance is through the second quarter of 2019.

Chase's First Non-QM Issuance

Chase's first non-QM issuance

- Unpaid principal balance of \$440.5 million
- Average credit score of 770
- Average loan-to-value ratio of 72%
- Average coupon of 4.6%

Source: Keefe, Bruyette & Woods

chart.) A great example of non-QM loans being confused with non-prime is JPM's recently issued private label security, discussed in an article in *National Mortgage News*. ([LINK: https://www.nationalmortgage.com/news/record-issuance-of-non-qm-securities-in-the-first-quarter](https://www.nationalmortgage.com/news/record-issuance-of-non-qm-securities-in-the-first-quarter)) The loans have a 770 FICO, with nearly 30% equity down, but what makes these loans non-QM? The answer: Most of the loans were classified as non-QM because they were underwritten using tax tran-

scripts rather than signed tax returns. Is this not a loan you would originate for your member?

A more current market example of true non-QM loan is the Citi deal in August 2019. In the accompanying "Collateral Characteristics by Program" table ([LINK: https://www.dbrs.com/research/349378/citigroup-mortgage-loan-trust-2019-imc1-presale-report](https://www.dbrs.com/research/349378/citigroup-mortgage-loan-trust-2019-imc1-presale-report)) you can see the nuanced differences to bank statement, investor loans or asset depletion. Note the FICO, LTV, DTI, reserves and income differences across the various programs: significant down payments; reserves twice the balance of the loan amount.

The "full doc" loans are the ones that carry the lowest FICO, highest DTI, lower reserves and probably the loans most would be comfortable with today simply because they are "full doc"!

LAYERS OF RISK IN NON-QM LOANS

Second, now that you've had a taste of

what's out in the market, let's dive into the varying layers of risk in these loans. How are they different and why is this space growing?

The accompanying "Loan Risks" chart highlights various non-QM lenders/securitizers. Note the FICO, DTI (or Debt Service Coverage Ratio (DSCR) if rental properties), doc type, and most importantly, coupon. In this chart, find the common strand other than that they are all heavy non-QM.

I think this chart and the "Collateral Characteristics" chart are great illustrations of the breadth of credit one might find in the underwriting, or layering of risk.

It's essential to point out that what you're seeing in the accompanying "Loan Risks" chart is only what is being securitized today. There are a number of Main Street lenders originating these products for portfolio and have been doing so for decades. The coupons needed to originate and sell profitably vs. originate and portfolio are vastly different. Many Main Street lenders pay no attention to the "non-QM" title. It's simply a portfolio loan, but they often don't adjust rates accordingly.

“With the creation of the CFPB, the 'ability to repay' regulations and the non-qualified mortgage, the residential loan landscape has been dramatically altered.”

Generically speaking, we see strong liquidity and acceptance of bank statement, asset depletion and DSCR lending in the secondary market. Some descriptions, rate sheets and details to those various products are explained below:

1. Bank statement. This segment is mostly focused on self-employed borrowers where you often have business cash flow commingled with personal cash flow. The gig/cash economy is becoming an increasing factor in this space. The market seems more receptive to those loans with longer periods of time for statements received from the borrower. As an example, we couldn't recommend doing 1-month bank statements today

Collateral Characteristics by Program (Simple Average)

Program	Loan Count	Total Current Balance (\$)	% of Current Balance	Average Balance (\$)	Credit Score	Original CLTV (%)	DTI (%)/DSCR	Documentation Type	Liquid Reserves (\$)	Annual Income (\$)
iQM Bank Statement	447	241,537,775	66.6	540,353	718	72.7	30.2	12 to 24 month Bank Statements	156,421	515,526
iQM Investor Premier	416	96,723,011	26.7	232,507	719	82.6	1.28	Reduced	126,998	N/A
iQM Agency Plus	56	19,216,468	5.3	343,151	682	84.8	38.4	Full	132,233	172,077
iQM Asset Qualification	13	5,103,382	1.4	392,588	723	64.9	N/A	Asset Verification Only	822,335	N/A

1 This figure represents the property cash flow ratio, which is used to qualify the borrowers in the investor cash flow/rental programs.

Loan Risks

Loan Count	Deal Balance	Am Loan Bal	Coupon	LTV	FICO	DTI	Interest Only	DSCR	% CA	Full Doc %	Purchase %	Foreign National %	
Verus 2019-3	1,158	\$589,106,870	\$491,457	8.70%	70.6%	702	38.3	23.8%	1.2%	61.0%	38.5%	47.5%	4.20%
Deephaven 2019-2	883	\$389,729,217	\$418,719	7.20%	73.2%	693	36.2	15.6%	18.2%	42.9%	34.5%	52.4%	3.10%
Arroyo 2019-3	2,215	\$945,896,114	\$427,041	5.39%	62.3%	740	37.7	3.6%	7.0%	58.2%	5.3%	88.4%	11.80%
Angel Oak 2019-2	1,807	\$623,957,201	\$345,300	6.97%	78.2%	703	34.9	3.0%	4.7%	20.7%	21.6%	88.0%	0.70%
Caliber 2018-4	621	\$354,493,121	\$570,842	6.00%	81.9%	724	40.3	0.6%	NA	38.2%	94.2%	79.9%	NA

as the market isn't quite there yet. 12- to 24-month bank statements are relatively common.

Taken from a recent presale report by *Standard and Poor's*: "Income on certain mortgage loans (47.5% of the deal, as a percentage of the balance) was verified using 'alternative methods' (personal or business bank statements with the majority using 24 months of bank statements). We view income verification using alternative documentation to be a weaker standard than 'full' documentation of income, and consequently we increased our loss coverages for these loans by applying an adjustment to the foreclosure frequencies. We applied an adjustment factor of 2.25x, 2.00x, and 1.75x to the foreclosure frequencies for loans using less than 12 months of bank statements, 12-23 months of bank statements, and for loans using at least 24 months of bank statements, respectively."

Example product descriptions/rate sheets are available here: (LINK: <https://angeloakhomeloans.com/product-offerings/bank-statement-program/>) (LINK: <https://www.newrezwholesale.com/loan-programs/smart-series/smartsself/>)

2. Asset depletion. Taken from a lender's guidelines: "Simply put, we add up all their eligible assets and subtract the entire loan amount and closing costs. Then we compare that to their total monthly obligations over 5 years plus reserve requirements. If qualifying assets are greater than their total obligations and reserves, they qualify."

We see two types of borrowers here. Imagine granny in a home and applying for a refinance. She's retired, drawing Social Security, with a 4mm retirement/investment account but not currently employed or drawing a paycheck. Social Security alone wouldn't get her below the 43% threshold, but if you take the 4mm and amortize it over a 5-year window she would be well qualified. The second, more dramatic example is a recent entrepreneur that has sold the business. He

picks up 30mm on the result of the sale and applies for 1mm loan. He's not employed, he just sold his business but if you amortize that 30mm over the next 30 years he easily qualifies for the loan on "income."

Example product descriptions/rate sheets are available here: (LINK: <https://redwoodconduit.com/wp-content/uploads/2018/12/Redwood-Program-Comparison-for-Website.pdf>)(LINK: <https://www.newrezwholesale.com/loan-programs/smart-series/smartsfunds/>)

“The CFPB has created this enormously broad, really scary sounding subset of the mortgage market [43% DTI qualification] where many struggle to understand the risk and the penalty if they miss something.”

3. Debt service coverage ratios "DSCR." Typically, these are investor loans (rentals) where that rental income is used to qualify. Does the income produced by the property support the debt, absent the underlying borrower? The loans are often more commercially underwritten vs. consumer/residential guidelines.

Lifted from a recent presale report by *Standard and Poor's*: "The mortgage pool contains property-focused investor loans that were underwritten to an investment property business purpose program (6.9% by balance) using debt service coverage ratios (DSCRs) ranging from 0.76 to 2.6. Depending on the DSCR, we applied an adjustment factor ranging from 3.15x to 5.26x to the foreclosure frequencies for these loans."

Example product descriptions/rate sheets are available here: (LINK: <https://caliberhomeloans.com/loans-programs/portfolio-lending-program/investment>) (LINK: <https://deephavenmortgage.com/wholesale/wholesale-products/#panel-4>) (LINK: <https://www.newrezwholesale.com/loan-programs/smart-series/smartvest/>)

We see some liquidity for foreign national loans but not quite as vibrantly as the previous products. This is more of a realm where either you're comfortable with this type borrower or you're not. It's often very geographically concentrated and sometimes carries a more Eastern demographic in the current market.

4. Foreign nationals. There are vari-

ous iterations here, but these borrowers likely do not have a social, nor a tax ID and often limited established U.S. credit. You might be dealing with various forms of Visas and sponsorship.

Taken from a DBRS Credit Rating Services presale: "Made to investment property borrowers who are citizens of foreign countries and who do not reside or work in the United States. Borrowers may use alternative income and credit documentation. Income is typically documented by the employer or accountant, and credit is verified by letters from overseas credit holders."

Example product descriptions/rate sheets are available here: (LINK: <https://www.citadelservicing.com/programs/outside-dodd-frank-odf>) (LINK: <https://angeloakhomeloans.com/product-offerings/foreign-national-program/>) (LINK: <https://deephavenmortgage.com/wholesale/wholesale-products/#panel-5>)

5. Interest-only loans. While often with impeccable credit, this is a loan that we've just not seen return to the secondary market since the crisis. Usually you find these loans with very high FICOs, very conservative LTVs but also very low coupons. They are often associated with wealth management clients where an ACH discount is given or a certain dollar amount of deposits discount is given. Coupled with interest-only being classified as non-QM as written by Appendix Q, this has been a double whammy in the space.

For most of the credit unions, we can't advocate that prior credit event (PCE) loans are something that should be in your stable of products. These are prior bankruptcies, short sales, foreclosures, missed mortgage payments, etc. Wall Street loves this product because it carries the most risk and the highest coupons. These are often loans that behave more like bridge lending. The FICOs are low, the down payments are high, and the borrower has a window to

“There is a tremendous opportunity for community lenders to capture business that would be classified as non-QM.”

help their FICO recover by making their payments on time. Once it gets back into that 680 range, the loan refinances. Or the borrower succumbs to the issues that previously caused the troubles on their ability to repay. This takes a nuanced and skilled underwriting set.

6. Prior credit event (PCE) products.

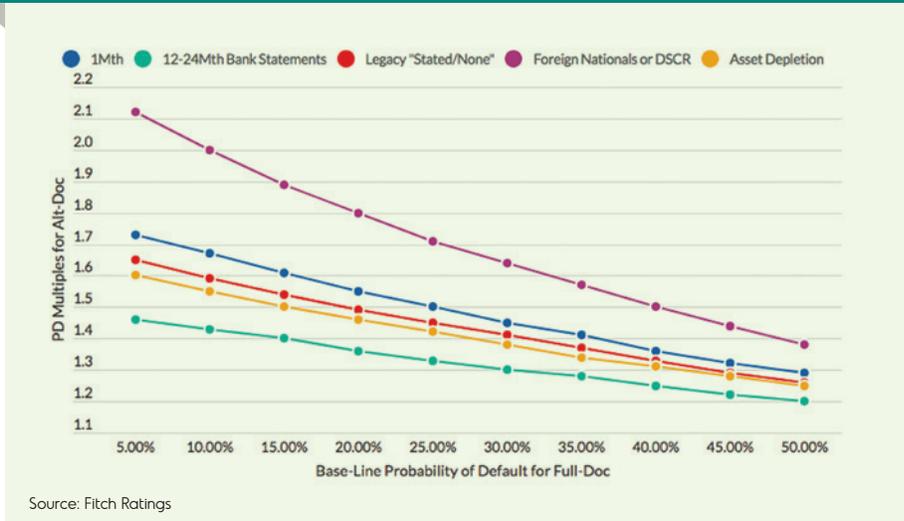
These are likely borrowers with a recent (shorter than GSE guides) short sale, prior delinquency/late payment, foreclosure or bankruptcy. When you read the headlines like the above referenced WSJ article, this is often the space that frightens readers most.

Credit to *Standard and Poor's* presale: "The borrowers on a portion of the mortgage loans have had one or more PCEs, such as bankruptcies or housing-related PCEs (foreclosures, short-sales, deed-in-lieu of foreclosure, etc.) that may have limited their access to loan products offered by the various agencies. Although these borrowers' updated FICO scores likely reflect their PCEs, we made an incremental adjustment to the foreclosure frequencies to account for this unique pool characteristic. We believe that a borrower's behavior surrounding a PCE could indicate what it would do when faced with a similar situation in the future, and suggests a greater likelihood that it would default, notwithstanding this and other adverse performance already incorporated in its FICO score.

"Therefore, these borrowers may behave similarly to borrowers who are 30 days delinquent. We focused primarily on prior bankruptcy, foreclosure, short-sale, and deed-in-lieu events (24 months from the cut-off date for bankruptcy discharges or dismissals and 36 months from the cut-off date for housing-related events). For loans to borrowers with more seasoned PCEs, we believe that the associated risks associated with those PCEs are reflected in the updated FICO. We applied a pool-level PCE-related loss coverage adjustment factor of 1.05x, which was derived from the 2.50x weighted average factor (30-day delinquent loan factor) for 46 loans (3.3% by balance), and a 1.00x factor for the remaining loans in the mortgage pool."

Example product descriptions/rate sheets are available here: [LINK: https://](https://)

Probability of Default Penalty by Alt-Doc Type



deephavenmortgage.com/correspondent/correspondent-products/#panel-3 (LINK: <https://caliberhomeloans.com/loans-programs/portfolio-lending-program/fresh-start-program>)(LINK: <https://www.citadelservicing.com/programs/non-prime-rate-sheet>)

PERFORMANCE ON PREPAYMENTS AND DEFAULTS

Third, we focus on performance both on prepayments and defaults. Fitch recently did a good piece highlighting the probability of default for these various non-QM products. (LINK: <https://www.fitchratings.com/site/pr/10080999>) The red line in the accompanying "Probability of Default Penalty" chart is the legacy, pre-crisis alt doc loans from a risk profile. Will these new products perform better or worse?

We have some early indications based on 2017-2019 vintage securitizations.

S&P recently wrote about 46 non-QM transactions that it has rated going back to 2017. (LINK: <https://www.spglobal.com/ratings/en/research/articles/190920-non-qm-s-meteoric-rise-is-leading-the-private-label-rmbs-comeback-11159125>) With regard to the various subproducts of non-QM, S&P says the accompanying "Delinquent Population" chart "shows that while there was some variance, there was no obvious pattern. The decreasing trend in delinquency rate with the more recent vintages is expected because the newer loans have had less time to underperform."

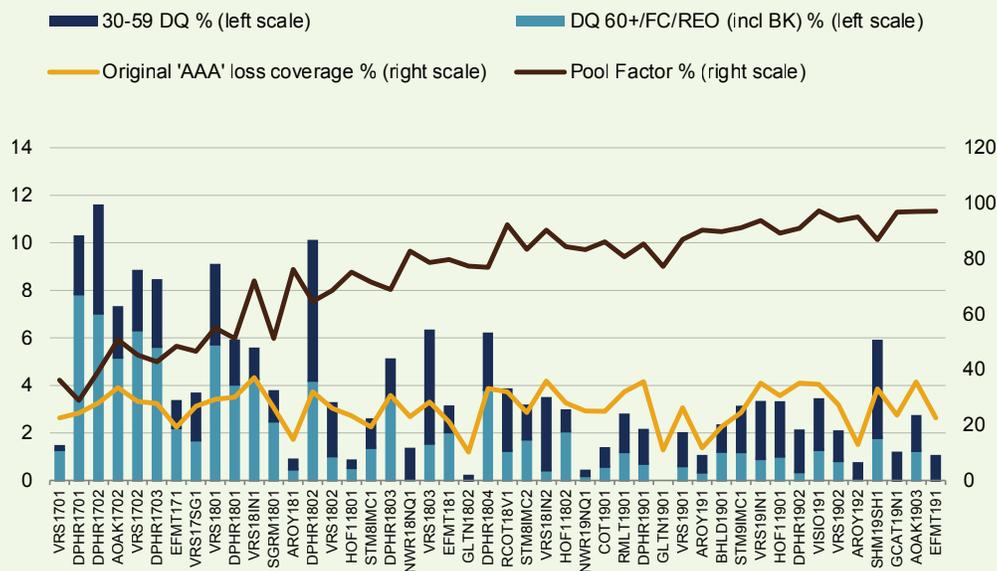
Looking at the 2017 vintage, oddly, full doc loans had the worst performance, followed by PCE loans and foreign nation-

Delinquent Population as Percent of Existing Population (i)

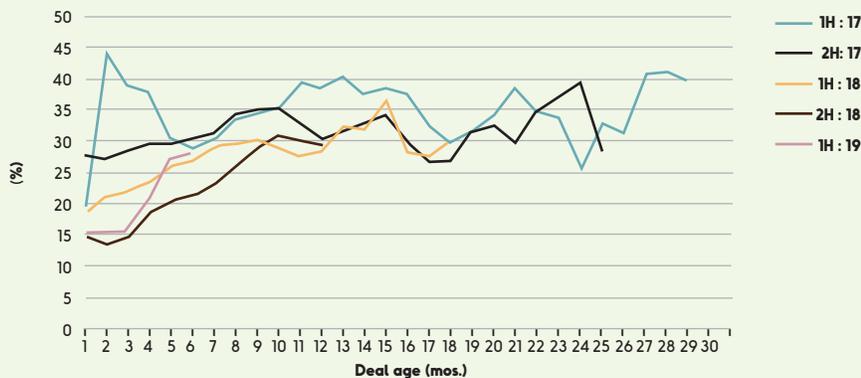
Characteristic	2017	2018	2019
Alternative documentation	7.82	3.06	2.47
Full documentation	10.32	3.72	2.30
Other documentation (ii)	3.88	2.81	3.30
DTI>43	6.22	3.90	2.69
Prior credit event	8.49	4.97	1.86
Foreign national	8.31	4.09	3.75

(i) Delinquent population includes 30+ days delinquent/foreclosure/real estate owned (including bankruptcy).
(ii) "Other" includes debt service coverage ratio, no ratio, and asset depletion loans. DTI – Debt to income.

Non-QM Collateral Performance (For 46 transactions rated by S&P Global Ratings)



Average Three Month Prepayment Rate



als. 2018 saw fully documented loan DQs drop substantially but PCE and foreign national remained high. (See accompanying “Delinquent Population as Percent of Existing Population” chart.) Though still too early to call for 2019 vintage, foreign national remains high.

As we get further and further from the recession, I suspect we will see fewer PCE loans due to a healthy long-term economy.

Prepayment speeds are also creating a challenge when looking at credit performance. Since speeds are considerably higher on non-QM loans, the remaining

balance of the pools from the accompanying “Non-QM Collateral Performance” chart also shows that pool factors have fallen relatively quickly for most issuances, which can, in turn, affect delinquency percentages, as they are based on outstanding balance.”

In general, non-QM loans, shown in the “Average Three-Month Prepayment” chart, typically hold coupons 50-200 bps higher than their full doc peers. Many expect higher prepayment rates despite more limited competition for the loan in the market. S&P states “The av-

erage non-QM prepayment speed was roughly at a 35% conditional prepayment rate (CPR)” in 2018. Prepayment speeds have picked up across the board in 2019 due to rapidly falling rates.

In conclusion, with the current administration signaling the coming end of the QM patch in 2021, many forecast this to be an area that continues to grow. Perhaps this is a growth area for your origination team once you determine the risk profile of your member segment and the underserved.

We strongly encourage a discussion with our underwriting team as you start to formulate your credit profile. Not all non-QM lending is created equal and each carries various layers of risk. ▲

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