NLC | NON-PRIME LENDING COUNCIL

The Lender

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Who's Caught in the Credit Blind Spot?

A deep dive into the demographics behind a $1.1 trillion loss in residential lending.

By: John Lynch

The credit blind spot is a real and ongoing phenomenon that affects high net worth and mass affluent individuals. What exactly is meant by the credit blind spot?

Take a look at the math. Between 2003 and 2007 the average residential loan volume per year was $2.7 trillion. Fast forward into the post-recession era of strenuous regulation and we see that from 2013 through 2017, the average residential loan volume per year dropped to $1.6 trillion.

The result is a loss of $1.1 trillion in residential loans.

The bulk of people who have missed out on that financing are likely high net worth and mass affluent individuals. This large swath of the population with significant buying power is shut out of the real estate markets. Asset rich with varying or flexible incomes, these potential borrowers are caught in the credit blind spot. Qualified-mortgage and ability-to-repay regulations end up forcing these individuals out of the credit markets, despite their high level of wealth.

This credit blind spot denies high net worth and mass affluent individuals not only credit, but the diversification and inflation hedging opportunities that real estate investing affords.

Clients in the mass affluent or high net worth category are among an estimated 32% of all U.S. households. And yet, only 3% of these households enjoy the benefits of managed money and private banking privileges; further denying asset rich individuals from making efficient real estate purchases and refinances.

This is not for lack of credit worthiness. The average age of most mass affluent and high net worth clientele is the late 50s to early 60s. They have been homeowners for three to four decades. They've owned homes and paid their mortgages consistently through countless recessions. And they've survived the "big one." Mass affluent and high net worth individuals came through the credit crisis after the 2008 recession—the most damaging credit and housing event since the great depression—standing tall and remaining prosperous.

It's clear that individuals with these levels of assets have experience

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managing credit and achieving financial success. Despite these facts though, overreaching regulation prohibits these individuals from accessing the credit markets. Instead of being rewarded for their achievements, people caught in the credit gap become pariahs of the credit markets, says PCMA CEO John Lynch.

The credit gap can be particularly evident in the refinancing markets. An unwilling to trade up or down to a new home because of their lack of access to viable financing cannot be ignored here.

PCMA's objective is to rebuild trust in the financial system among mass affluent and high net worth individuals caught in the credit blind spot. "We want to provide the liquidity to this market segment that not only matches individuals' achievements but also meets the needs of the modern economy," says Lynch.

Mass Affluent Asset Allocation

The mass affluent divide their wealth in the following ways. This diversification may be severely undercut by the growing credit blind spot.

Principal Residence	23%
Liquid Financial Assets	22%
Pension and Employee Retirement Plans	16%
Privately Held Business	16%
Investment Real Estate	14%
nsurance and Annuities	9%

Source: "Wealth in the U.S.," U.S. Federal Reserve, 2016

estimated $62 billion worth of housing debt was originated in California between 2001 and 2010 with recorded loan amounts between $550,000 and $2.5 million. These aged loans were originated pre-crisis, but due to safe harbor restrictions imposed on mass affluent and high net worth groups, these households have been unable to reposition this debt into new financing which has been available at the lowest interest rates of all time.

The credit blind spot is undeniably somewhat to blame for the current inventory shortages disrupting real estate markets throughout the country. The inventory crunch is often blamed on a lack of new homes being built., but the large number of high net worth and mass affluent individuals who are unable and

John R. Lynch *is the founder of PCMA. Prior to founding PCMA, Lynch Co-founded and grew Secured Funding Corporation into the country's No. 1 largest privately held independent loan originator of subordinate lien financing and a category leader. He is recognized as a serial entrepreneur and origination expert with a passion for building disruptive companies and a track record of growing some of the most respected companies in the financial services industry. He played a vital leadership role in several high-level M&A and strategic partnership negotiations with such major organizations as Capital One, HSBC, Merrill Lynch, New Century and other notable supporting firms.*

From the Chair

Welcome,

As Chair of the Non-Prime Lending Council (NLC), I am proud to work with so many industry leaders as we come together to drive innovation and continue to support the non-QM sector of the housing market.

The impacts of COVID-19 have extended beyond what any of us could have anticipated, and in this edition, we dive into the techniques being used to adapt and grow to meet the challenges of this pandemic.

In this edition of The Lender, we'll be focusing on how this industry continues to follow its own tradition of curating products to bring the American dream of homeownership to a greater audience. We'll explore the needs of borrowers in today's market, and discuss important changes within the CFPB and how those changes effect non-QM.

The NLC cannot exist without you, our members, and we want to share your ideas, programs, and initiatives with other NLC members. This newsletter is also an excellent opportunity to highlight new hires, promotions, and company news. Contribute to the progress made by NLC members: include your company news and data in future newsletters by contacting Rachel Williams at Rachel.Williams@TheFiveStar.com.

Thank you for your participation.

Sincerely,

Aaron Samples, CEO, First Guaranty Mortgage Corp.

Non-QM Now

The current forces behind the non-QM market.

By: Aaron Samples

In the wake of the recent liquidity crisis as a result of COVID-19, many were left questioning what the future of non-QM would look like—or if there was a future at all. Here's what the industry is seeing today.

Non-QM has been slowly re-emerging in the market with lenders reintroducing product lines and offerings. However, the non-QM market as we knew it at the beginning of 2020 has changed and has been replaced with retro guidelines. The adjustments are centered around more narrow property type requirements, higher credit scores, lower DTI and LTV requirements, and other guidelines to mitigate the risk of the unknowns for the future non-QM lending environment. In fact, you could say the reemergence of non-QM looks a lot like the introduction of non-QM several years back.

Even though the market has changed drastically over the first two quarters of the year, the borrower's need for non-QM has remained, if not grown.

While the unprecedented events of COVID-19 are the culprit of many changes in the mortgage industry this year, the non-QM market continues to evolve. Major forces that are shaping the current non-QM space include discussions within the Consumer Finance Protection Bureau (CFPB) around the QM patch, the shifting of investor appetite, as well as expected consumer need.

CFPB Changes

On June 22, the CFPB formally announced a proposal to redefine the qualified mortgage requirements described in Regulation Z. The language currently limits the DTI requirement for a qualified mortgage to not exceed 43%, but under the proposed legislation that may change. The proposal suggests not to rely as heavily on a strict DTI ratio; but instead, approach the borrower's profile holistically. This proposal could open additional doors to more borrowers with respect to qualified loans and create additional opportunities for non-QM lenders when the QM patch expires. The likelihood of these upcoming changes is pushing many lenders and investors to consider their entrance back into the non-QM market now in order to prepare for the transition.

Investor Appetite

After what could be described as a "blackout period" in the non-QM market just a few months ago, investors understandably have an overall attitude of reluctance and caution when evaluating non-QM. With so many unknowns surrounding liquidity, unemployment, forbearance, and the general unknown, the non-QM market had virtually dissolved by mid-April. Slowly investors have started to awaken in response to the current historically low rate environment and the opportunity for return of high margin, higher yielding non-QM assets. While there is still a "hangover" due to the events of the liquidity crisis, investors and financers are beginning to once again trust liquidity in non-QM as stability returns. This increased appetite by investors has created more opportunity and urgency with lenders to bring non-QM offerings back to the market.

On the Horizon

Even though the market has changed drastically over the first two quarters of the year, the borrower's need for non-QM has remained, if not grown. With the effects of COVID-19 likely impacting future borrowers with temporary job losses, career changes, forbearance, or financial strains; the loans in the future may require guidelines that account for bumps caused by events like a pandemic. Furthermore, growth in innovation and technology stemming from the pandemic could accelerate the number of self-employed borrowers and change the way jobs look, likely in a less traditional manner in the future. For now, the non-QM market seems to have reverted to where it was in its infancy, but it is expected to grow stronger as time goes on. As for the future, 2020 has shown that no one can ever really know; although the lenders and investors in the non-QM market remain passionate and hopeful about the market and its mission to expand homeownership opportunities.

Aaron Samples *is the CEO of First Guaranty Mortgage Corporation and has over 20 years' experience and expertise across all phases of mortgage lending and servicing. He has a proven track record of developing and implementing sales strategies, distribution initiatives, marketing, advertising, sales plans, establishing goals, and determining forecasts while motivating the team to achieve corporate goals, budgeting, and overall business planning at FGMC. Founded 30-plus years ago, FGMC is a retail, correspondent, wholesale, and non-delegated lender that has its own Non-QM Product Suite, Maverick Solutions.*

Market Adaptions

Non-QM financing adjusts to "new normal."

By: Denis Kelly

"Extraordinary times call for extraordinary measures."

—Benet Wilson

At mid-year 2020 in the face of widespread closures, isolation, historic unemployment, shifting job patterns, and high stress in every part of the U.S. economy and society, the non-QM mortgage industry is responding with confidence and innovation to help home buyers and the professionals who serve them with financing solutions that bring families and homes together.

Born of another economic crisis barely a decade old, the always competitive and evolving non-QM industry has adapted to today's "new normal" by introducing products, technology, and processes that are keeping the home ownership open for more and more buyers.

As the wave of COVID-19 coronavirus swept over the U.S. beginning in the winter of 2020, global credit markets stuttered, stumbled, and all but shut down. As a result, many types of financing became limited, inflexible, and expensive for residential home buyers.

Tapping the very core of an industry defined by thinking outside the box and in non-traditional ways, non-QM lenders re-assessed the changed market and responded to an economy increasingly characterized by vast shifts in the employment landscape, social isolation and distancing, record low interest rates, and a renewed embrace of home across all segments of society.

Responding to a Changing Employment Landscape

As COVID-19 decimated the health of Americans and widespread lockdowns became the norm, businesses, schools, governments, and others were forced or decided to shut-down or sharply cutback. These actions left millions unemployed, furloughed, or adapting to new roles and relationships with employers.

Millions have been added to the national unemployment statistics and the income-source landscape today is being further transformed by a trend that has been reshaping the US for many years—the rise of the "gig economy" or 1099 workforce.

Independent contractor 1099 compensation has been rising for years. According to a June 2020 U.S. Bureau of Labor Statistics report, nearly one-third of all jobs added between 2010 and 2014 were freelancers or independent contractors.

In fact, more than 50 million people—more than 1/3 of the U.S. workforce—earned an income as a freelancer in 2018, with many traditional W-2 salary workers supplementing their salaries with freelance income.

The non-QM industry has stepped up in service to this growth segment, and that's never been more important than it is right now.

As capital markets have started to reopen, originators using a combination of well-tested and proven underwriting standards with 1099-only income documents are today able to secure loans for credit-qualified independent contractors. These underwriting standards can include LTV ratio, reserves, length of employment in a current field, housing payment history, and FICO scores.

Driving Efficiency With Technology and Support Services

Business curtailments, social lockdowns, and health/safety considerations have changed how everyone interacts. Mortgage lenders, borrowers, and the professionals who serve them are no different.

Technology and automation are driving accessibility and efficiency in non-QM for every type of participant. At the center of this automation revolution is an Automated Underwriting System (AUS) that accounts for the intricacies of non-QM lending. An AUS empowers the modern-day originator to provide feedback and findings to their borrowers—and referral partners—24 hours a day, seven days a week, 52 weeks a year.

The accurate and timely results of a non-QM AUS allow originators to produce loans in a substantially similar process as if the loans were conforming. Minimizing the "leap" from QM to non-QM encourages adaptation and ultimately results in increased loan production.

While an AUS is a *must have* for non-QM investors, it is also necessary to provide support functions that are critical for success. For example, approximately 50% of non-QM production are loans with income is derived from bank statements for self-employed borrowers. Prior to inputting the income into the AUS, the lender's Bank Statement Desk must review and stabilize the income. To avoid fall out (and reputational risk), this analysis should occur prior to the borrower entering a purchase and sale agreement/ opening escrow.

Validating and clarifying the AUS findings with a subject matter expert from the non-QM investor is paramount to ensuring a pleasurable borrower experience. It is a best practice to leverage technology and support services prior to submitting loans to underwriting.

The Importance of The Human Element

It's clear that powerful, easy-to-use technology can help remove many of the reasons (excuses?) that producers might have for staying in their conforming

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comfort zone and avoiding non-QM loans. Technology augments—not replaces—an experienced account executive (AE), who can answer questions, run interference, and, most importantly, serve as the voice of the client within an organization. Travel restrictions and social distancing may have changed the way that AEs interact with their clients, but the need for those interactions remains as important as ever.

Credit Quality, Loan Performance Remain Strong

While the shifts in non-QM marketplace are substantial and impressive, one thing that is not changing is a focus on credit quality and loan performance.

Responsible non-QM lending is characterized by higher credit scores and lower LTVs that help mitigate the risks associated with higher DTI levels, limited documentation, or interest only non-QM products. Today's non-QMs are high quality loans with low delinquencies. As a result, serious delinquency rates for non-QMs are generally lower than that of QM and government-insured loans.

These are, indeed, extraordinary times for every aspect of U.S. society and business. As it has from its beginning in the previous economic turmoil, the non-QM industry is responding to today's environment by embracing the new normal and innovating extraordinary and essential changes in its quest to serve today's market.

Denis G. Kelly *is a SVP of Correspondent and National Wholesale for Sprout Mortgage, a leading non-agency/non-QM mortgage lender. Sprout specializes in broker- and correspondent-friendly platforms that focus on loans of up to $10 million in the following categories: jumbo and super-jumbo near miss loans; no-income verification investment loans; self-employed borrower 1099-only and bank statement loans; and loans to borrowers with recent credit events or challenging FICO scores.*

On the Other Side

Examining post-COVID-19 borrower needs.

By: Steven Winokur

Non-QM is different today due to the Coronavirus pandemic that caused turmoil in the worldwide economy. While it never went completely away, it was paused for a short time due to market shifts and the inability to evaluate credit risk. Without the safety net of government guarantees a non-QM pause was necessary. It is important to distinguish the difference between the housing crisis years ago due to faulty subprime lending. This pause had nothing to do with lending or non-QM lenders. It was an industry response to market conditions brought on by the pandemic.

Fortunately, the market has started to rebound with non-QM back to the market. "The industry has seen a solid track record with non-QM. Angel Oak just issued a second securitization since the pandemic which speaks towards the investor confidence in non-QM. There are always going to be non-QM borrowers that do not fit tight Agency guidelines. The demand for non-QM among brokers, borrowers and investors is high," said Tom Hutchens, EVP of Production at Angel Oak Mortgage Solutions.

Changes to non-QM and non-agency seem to be occurring almost daily as new guidelines are issued and products are released back into the market. It is important to understand the borrower demand, the products, and the future for non-QM to ensure a thriving mortgage industry.

The Demand

The bottom line is that it is crucial for non-QM to be back in the market. A few full doc products came back the last week in April and have been in origination for two months now. Not only is there a demand from borrowers who need it to purchase a home, but the investor demand for non-QM loans is there as well. As a result, some lenders are quickly adapting and bringing non-QM products, enhancements and new guidelines to the market weekly.

Self-employed borrowers, property investors, people with credit events and those needing jumbo loans aren't going to go away. There has been a huge void in the Jumbo market without a non-Prime alternative loan solution. These products and lenders who exclusively offer non-QM are unique and endured the crisis due to the validity of the products and the demand for them. Lenders are out there educating and meeting with people to help them understand and utilize non-QM as it is today. It's understood that the refinance boom we are enjoying won't last and pipelines don't stay full when reliant only on Freddie and Fannie.

The Products Available

Bank Statement—Bank Statement products are among the most popular and these borrowers are among the most people underserved. Hutchens says that they have seen the profile made up of "good borrowers with good to excellent credit and buying higher priced homes. The only obstacle is needing to qualify using personal or business bank statements." The self-employed population accounts for around 18 million people and 30% of all employees in the U.S., according to the Bureau of Labor Statistics. This accounts for a significant number of potential borrowers.

Some lenders have reported that they have seen income back close to pre-COVID levels based on recent bank statements they have analyzed. This is because many self-employed people who secured loans were web-based service

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providers who did not suffer a decrease in income. Their deposits remained consistent. Gig workers and those who owned brick and mortar businesses have reopened and their deposits look good and close to where they were. This is great news and looks promising for the economy and the mortgage industry.

Cash Flow Loans—Products such as Investor Cash Flow loans for property investors looks at and qualifies on rental cash flow and borrowers can be vested in an LLC. Many investors are looking at opportunities right now due to favorable market conditions for buying. This product is a great alternative and option for investors who need to qualify on cash flow to grow their portfolios. This was one of the first loan products to come back along with bank statement programs due to demand in the market.

Jumbo—There is a huge need for a full doc program in the market right now. A non-prime jumbo product helps people who just miss qualifying for prime who have been turned down by a big bank. Nonprime jumbo is the answer to fill a huge void in the jumbo market. As of late, only big banks were offering prime jumbo and nothing else. There is a significant population of people who cannot qualify for prime jumbo and this product is an excellent alternative to purchase a home outside of conforming limits.

Looking Ahead

It is always tough to forecast the future with a market that is constantly changing, even without a pandemic. Right now, non-QM products and non-QM lenders are evolving and quickly adapting. Non-QM experts are sought after right now for their guidance on how to utilize the products and responsibly lend right now and in the near future. There is a large amount of support from policy makers and the stability of capital markets and others are a lot safer and more secure now. No one knew how to respond in March, and it was responsible to pause non-QM lending. Now we know what to do and there shouldn't be a need to pull in demand non-QM products from the market should the pandemic come back later this year.

There is a lot of demand from investors and borrowers for non-QM. Confidence in this sector is coming back as it rebounds safely and responsibly. It's an exciting time to see how fast the non-QM market has come back and has already helped a large number of non-QM borrowers qualify for a mortgage loan. It is crucial to talk to a lender who is an expert on non-QM with a solid record in the space. Non-QM lenders are invaluable right now as we navigate how to help non-QM borrowers who need and want to purchase homes right now. We all want a thriving mortgage industry and non-QM is a large piece of the pie that adds to the strength of the market.

Steven Winokur *is the Chief Marketing Officer for Angel Oak Companies and oversees all marketing and branding initiatives for the firm and its affiliated companies. He has over 24 years' experience in marketing and branding in both corporate and agency environments. Prior to Angel Oak, Winokur was VP of Marketing for Buyers Protection Group, a national home warranty/home inspection firm. Prior to that, he was the AVP of Marketing and Brand Equity for United Guaranty.*

Mitigating Risk in Non-QM

Four strategies to implement in your business today.

By: Aren Anderton

The market for non-agency credits had been growing before COVID-19, leading the way to increased credit availability. However, the onset of the pandemic has reversed years of growth. As the non-agency market looks to reform yet again, lenders must adapt, changing processes and target markets to prosper.

Prior to COVID-19, large Non-QM and Ability-to-Repay (ATR)-exempt lenders were intensely focused on keeping pipelines full, and the securitization and whole-loan machine running. This segment of the market, despite representing just 1.5% of loans funded of the $2 trillion-plus originated in 2019, was building off a $25 billion securitization year. That represented an increase of more than 100% from 2018. As a result, expectations were high that securitization volume would grow materially during 2020, with S&P projecting non-QM volume to reach $35 billion.[1]

With the arrival of the coronavirus, the market came to a screeching halt. This led to a significant drop in credit availability, which is down 30 percent over the last three consecutive months, according to the Mortgage Bankers Association[2], depriving many Americans of housing credit. Tens of thousands of loans that were set to be funded were abandoned as lenders retreated, concerned about the pandemic lockdowns, the potential for job losses, borrowers' ability to pay, foreclosure moratoriums, and forbearance activity. Amid the volatility and uncertainty, lenders that had funded non-QM loans just before the capital markets froze worked quickly to remove them from their balance sheets. This depressed non-QM market prices and made further origination uneconomic.

Now, four months into the pandemic, some lenders have closed their doors and furloughed employees. Other lenders have moved away entirely from non-QM loans and are focusing on lower-risk government-backed loans. Some are tiptoeing back into non-QM origination, but with a much tighter credit box, reminiscent of the early days of non-QM production. As a result, many borrowers may fall into the abyss between the non-QM lending products of early 2020 and those seen today. To circumvent this, here are four strategies lenders can implement in their businesses:

1. Establish a Loss Mitigation Game Plan

Lenders will need a strategic game plan for the expected avalanche of forbearance requests. The full impact of COVID-19 on the U.S. economy is still unfolding and could take months to play out. While many lenders are offering forbearance programs, few are planning for what happens next. That requires clear protocols on how requests will be managed, qualified, and determined for longer-term loss mitigation measures.

2. Keep Geography and Local COVID-19 Trends in Mind

Lenders must carefully consider geography. Approximately 70% of non-QM borrowers reside in the hard-hit areas of California (50%), Florida (12%), or New York (8%). Lenders may need to realign their geographic target markets away from these states if they begin to experience an increase in default and forbearance requests. In the same way that some lenders have steered clear of certain geographies after natural disasters, they may want to retreat from specific markets until there is a flattening of coronavirus cases in those areas and the economic picture becomes more certain.

3. Focus on Employment

Lenders should keep employment at the forefront of lending guidelines. The non-QM world caters to the self-employed. Small mom-and-pop enterprises around the country have suffered tremendously as a result of pandemic lockdowns. While the offer of the Paycheck Protection Program (PPP) loans and other bailout programs have extended a lifeline for these businesses, time is running out. A study by Goldman Sachs released the week of July 13th found that 84% of small business owners who received PPP funds reported that they expected to run dry by the end of August.[3]

4. Utilize Technology

COVID-19 has accelerated consumers' use of technology and many states have embraced alternatives to traditional loan-closing processes and documentation requirements. Embrace these changes and look to establish programs that more fully utilize technology. This will drive down operational costs and reduce complexity. As a result, loan margins should increase, which will help offset the lower volumes that should be expected until the market fully revives.

Non-QM guidelines will need to continue to cater to the same borrower population as they did pre-COVID-19, while also protecting lenders from default. Lenders will need to target stronger borrowers and continue to tighten guidelines. This is a difficult tightrope to walk in these uncertain times, and small mistakes can mean the difference between keeping the doors open or closing them for good. As a result, we are likely to see a continued decline in non-QM lending in the near-term. Given the challenges in predicting the future course of the pandemic and its economic impact, caution is crucial.

> *Lenders will need a strategic game plan for the expected avalanche of forbearance requests.*

Aren Anderton *serves as Director of Training and Development at SitusAMC, where she is responsible for formulating strategies and deploying a world-class learning and development infrastructure that includes new hire and continued education, compliance, soft skills, and career enrichment programs across the organization. Prior to this role, Anderton served as Director of Credit Client Services at SitusAMC, where she excelled in managing post-secondary due diligence and securitizations for both newly originated and seasoned loans that included over 500 employees servicing over 200 clients.*

[1] https://www.spglobal.com/ratings/en/research/articles/200106-global-structured-finance-outlook-2020-another-1-trillion-plus-year-on-tap-11301282
[2] https://www.mba.org/news-research-and-resources/research-and-economics/single-family-research/mortgage-credit-availability-index?
[3] https://www.usnews.com/news/economy/articles/2020-07-14/majority-of-ppp-loan-recipients-will-run-out-of-coronavirus-relief-funds-in-august-survey-finds