# Non-Qualified Mortgages: Capitalizing on Today's Market Inefficiencies

Regulatory reforms, rigid underwriting guidelines, and a widespread misunderstanding of borrowers' risk profiles have created pricing inefficiencies and sound opportunities related to NQM loan origination and acquisition.

The U.S. housing and mortgage markets over the past 15 years have been defined by a series of corrections and overcorrections by lenders, investors, and regulators. While the housing market has largely returned to a level of normalization and stabilization, the mortgage market has not. As a result of attempts to eliminate the lending malpractices that led to the financial crisis, the underwriting pendulum has swung to the other extreme. This overcorrection has been driven by a confluence of regulatory, financial, and demographic factors.

A lack of understanding of today's non-Qualified Mortgage (NQM) market has resulted in a fundamental disconnect between the perceived and actual risk of these credits. This disconnect has created a significant lack of financing for the traditional buyers of starter homes and other borrowers whose credit profiles do not match the rigid guidelines now used by large financial institutions. The disconnect has also created a lack of liquidity and pricing inefficiencies for NQM securities.

Window Rock Capital Partners examines the causes of the inefficiencies affecting the NQM market. We also look at how the lack of financing for NQM borrowers and pricing dislocations related to these credits have created extensive opportunities for investors to generate attractive risk-adjusted returns in this segment of the U.S. housing and mortgage markets.

## HOW WE GOT HERE

September 15, 2008, the day Lehman Brothers filed for bankruptcy protection, will long be remembered as a landmark day in the history of the U.S. economy. January 10, 2014 – while certainly less dramatic – will be even more influential in shaping the trajectory of the housing and mortgage markets.

## Three Things Investors Need to Know About Today's Residential Mortgage Market

**1.**
**NQM ≠ Subprime:** Today's NQMs have little in common with the toxic paper that led to the financial crisis.

**2.**
**NQMs have delivered strong performance:** Despite borrowers' strong performance, NQMs are being priced at steep discounts.

**3.**
**Misunderstanding of NQMs has created attractive opportunities in a low-yield environment:** The disconnect between the actual and perceived riskiness of NQMs has created significant opportunities for astute investors.

That day the new underwriting standards for all residential mortgages required by the Dodd-Frank Act and the Consumer Financial Protection Bureau (CFPB) took effect. In an attempt to eliminate or minimize the types of exotic mortgage products and shoddy underwriting practices that created unprecedented levels of risk throughout the U.S. banking system in the years leading up to the housing crisis, Dodd-Frank and the CFPB imposed a series of wide-ranging reforms related to underwriting standards, documentation requirements, and risk retention. These regulations essentially divided all newly originated mortgages into two categories: Qualified Mortgages (QMs) and non-Qualified Mortgages (NQMs).

With all mortgages – QMs and NQMs alike – the originator is now required to make a good-faith effort to verify that the borrower has the ability to repay the loan. These "ability-to-repay" (ATR) standards effectively prohibit the no-documentation, no-verification underwriting practices that became rampant in the years leading up to the financial crisis. QMs, or mortgages underwritten according to criteria laid out by the CFPB, provide the originator safe-harbor protection against a claim that the ATR rules were not followed. QMs also are eligible for repurchase by Fannie Mae, Freddie Mac, and other government-sponsored enterprises (GSEs). In addition to setting limits on points and fees, terms, and debt-to-income ratios, the QM criteria also prohibit negative amortization, interest-only, and balloon loans.

***Dodd-Frank, the CFPB, and Basel III have drastically altered the U.S. mortgage landscape and eliminated many of the exotic loans and underwriting standards that precipitated the financial crisis.***

Originators can face a range of penalties and legal risks for failing to meet the complex ATR requirements. This legal and financial exposure includes fines from the CFPB and other enforcement agencies, criminal liability, and civil suits from borrowers. Because NQMs do not enjoy safe-harbor protection, originators of these loans have the burden of collecting and producing extensive documentation to prove that the underwriting process satisfied the ATR requirements. In addition to the onerous documentation requirements related to NQMs, Dodd-Frank, the CFPB, and Basel III imposed a series of risk-retention reforms that limited an originator's ability to transfer NQMs from the originator's balance sheet.

## ORIGINATIONS: FILLING THE NQM CREDIT HOLE

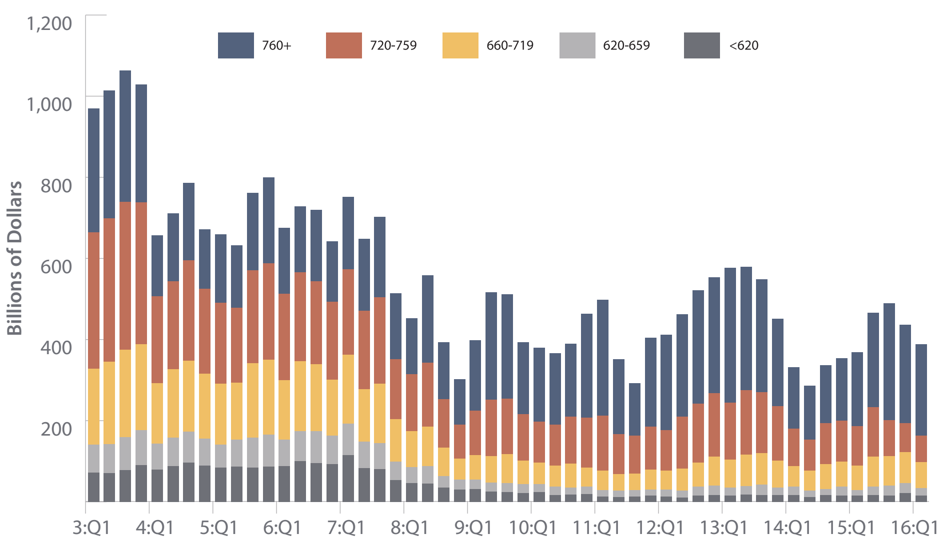
While these laws and regulations have been effective in returning the mortgage industry to the sensible underwriting standards that served the U.S. economy and homeowners well throughout the 20th Century, the new regulatory regime has also had important unintended consequences. The most important of these is the significant reduction in financing for would-be buyers of starter homes and other borrowers with less-than perfect credit profiles.

The combination of stringent documentation requirements, risk-retention provisions, and the federal government's aggressive enforcement of these rules, has led many large financial institutions to reduce their overall mortgage originations and exit the NQM market altogether. In a low interest-rate environment, many banks and other traditional lenders have concluded that the potential rewards of serving this market are not worth the risk of being sued by borrowers or fined by the government.

This pullback in financing availability is having a significant impact across the U.S. housing market, particularly for starter homes and other more affordable homes. "It's a great market if you have pristine credit and lots of money," said Sean Becketti, chief economist at Freddie Mac, in a May 2016 article in *The Wall Street Journal*.[i] "The people starting out who are looking for that first home – they're having a tougher time."

In the post-Dodd-Frank/CFPB world, large banks and other traditional lenders have adopted rigid underwriting guidelines and are relying more heavily on credit scores in the underwriting process. Despite an improving job market and strengthening personal balance sheets, mortgage originations have dropped precipitously over the past decade. The drop has been particularly steep for borrowers with less-than-stellar credit scores. In the first quarter of 2016, only 42% of originations involved borrowers with FICO scores lower than 760, down from 69% in the first quarter of 2003, according to data from the Federal Reserve Bank of New York.

## Mortgage Originations by Credit Score*




*Source: FRBNY Consumer Credit PanelEquifax*
* Credit Score is Equifax Riskscore 3.0

**Since the financial crisis, banks have employed rigid "credit boxes" that rely heavily on credit scores. As a result, borrowers with less than pristine credit are largely underbanked by traditional financial institutions. The percentage of originations that involved borrowers with credit scores less than 760 fell from 69% in 1Q-2003 to 42% in 1Q-2016.**

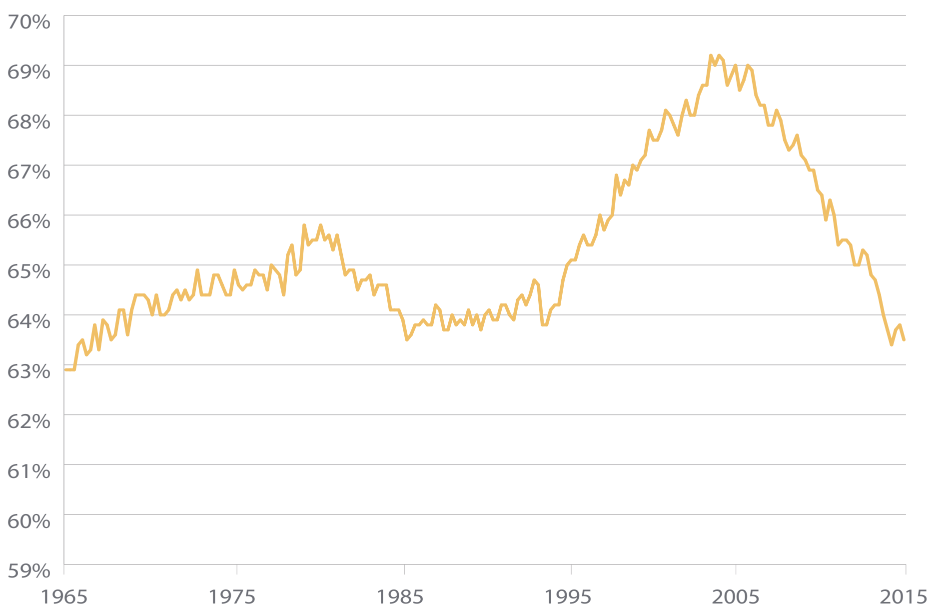
Meanwhile, overall mortgage origination volume fell by more than 50% from 2003 to 2013.[ii] Homeownership rates fell to 63.5% in the first quarter of 2016, a four-decade low, and the rate for individuals younger than 35 years-old fell to 34%, according to Commerce Department data as reported by *The Wall Street Journal*.[iii]

The Urban Institute, a research center focused on economic and social policy, has closely examined the impact that banks' rigid underwriting guidelines and increasing reliance on credit scores are having on various segments of the housing market. In an April 2015 report, "The Impact of Tight Credit Standards on 2009-13 Lending," the Urban Institute estimated that "if the cautious standards of 2001, rather than the severe standards of 2013 had been in place," an additional 4 million mortgages would have been underwritten between 2009 and 2013.[iv] The research found that the number of mortgages issued to borrowers with FICO scores greater than 720 declined by a modest 8.9%, compared with a decrease of 37% for borrowers with FICO scores between 660 and 720 and a staggering 76% for borrowers with FICO scores less than 660.

The use of rigid, FICO-reliant underwriting standards and the exit from the NQM market have resulted in several large cohorts of potential homebuyers being excluded from the market. Much has been written about the Millennial generation's career and household formation tendencies, but there is no denying that this group, which recently surpassed Baby Boomers as the largest living U.S. generation, represents an enormous block of potential homebuyers. Given their large student debts and short credit histories, however, many mortgage applicants younger than 35 are unable to get loans from traditional lenders. Similarly, older applicants who have a one-time credit blemish related to the housing crisis or applicants who are self-employed or have irregular income streams are often immediately declined.

At Window Rock, we believe that many cohorts of borrowers are being systematically underbanked because traditional underwriting standards do not properly understand the risk profiles of borrowers who fall outside of the "credit box." Within any of these cohorts there are large numbers of individuals who, despite having sub-720 FICO scores or other characteristics that disqualify them from QM underwriting, will perform just as well as a 760+ FICO borrower would. These high-performing, sub-720 borrowers may include Millennials with high levels of student debt and very stable, well-paying jobs; entrepreneurs with strong, yet irregular income and clean balance sheets; or experienced homeowners with a one-time credit blemish.

**U.S. Homeownership Rates**
(1965 - 2016)




*Source: The Federal Reserve Bank of St. Louis*

**The significant tightening of underwriting standards and pullback in mortgage origination volume have contributed to homeownership rates falling to 63.5% in 1Q-2016, just above the lowest rates in the past 50 years.**

***In a low interest-rate environment, many banks have concluded that the potential rewards of serving the NQM market are not worth the risk of being sued by borrowers or fined by the government.***

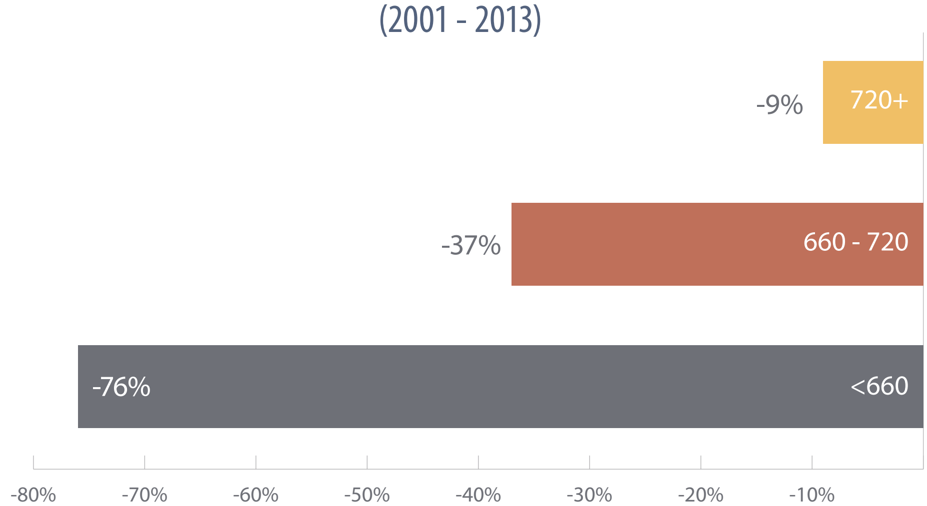
As banks have retreated from the NQM market, this has created a significant opportunity for hedge funds, private equity funds, and other non-traditional lenders to fill the void. Non-bank lenders that are able to properly assess the risk profiles of borrowers who don't fit the QM profile could generate attractive risk-adjusted returns and meaningful levels of origination volume.

While the Federal Housing Administration (FHA) and other GSEs have attempted to fill some of these voids, major gaps remain. The FHA's QM product that requires a 3.5% down payment and has a lower FICO threshold has been used widely, but it has significant limitations. First, the FHA loan is capped at $271,000, which means it gets priced out of many housing markets on the East Coast and West Coast and other more expensive housing markets across the country. Second, while the FHA product has lower down payment and credit score requirements, many of the other rigid guidelines related to income documentation remain.

## LOAN ACQUISITION: CAPITALIZING ON THE "NQM-SUBPRIME" CONFUSION

In addition to the significant opportunities related to NQM origination, acquiring these loans provides another attractive way for investors to capitalize on the inefficiencies related to the NQM market. Much of the current pricing dislocation stems from widespread confusion about today's NQMs and subprime loans circa 2005-2007. Investors currently are pricing NQMs as if they were sub-prime loans originated 10 years ago – despite the fact that today's loans bear little resemblance to the loans that caused the housing crisis.

**Decrease in Mortgage Originations by Credit Score**
(2001 - 2013)




*Source: The Urban Institute*

**Research by the Urban Institute found that the decrease in the number of mortgage originations from 2001 to 2013 was significantly greater, on a relative basis, for borrowers with sub-720 credit scores.**

> ***"It's a great market if you have pristine credit and lots of money. … The people starting out who are looking for that first home – they're having a tougher time."***
>
> ***Sean Becketti,***
> ***Freddie Mac chief economist***

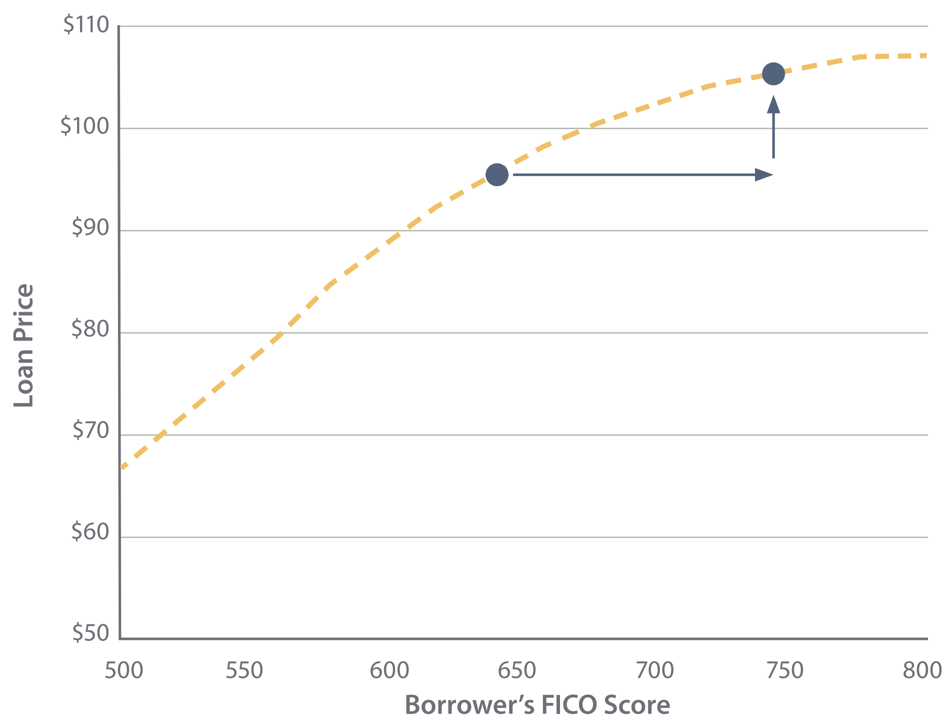
In the wake of the housing crisis, the term "subprime" was inappropriately used as a catchall for "all the bad stuff that caused the crisis." That stigma and definitional imprecision is alive today and continues to inappropriately influence the way people – the general public and investment professionals, alike – think about NQMs that have been originated since January 2014. Regulations implemented by Dodd-Frank and the CFPB have made it illegal to underwrite a residential mortgage using the no-documentation, no-verification processes that defined the subprime era.

We think that the mistaken belief that "NQM is the new subprime" has caused many investors to fail to understand the rigorous underwriting guidelines that all NQMs must meet. Because of Dodd-Frank and CFPB regulations, underwriting guidelines are more stringent than they have ever been, and all mortgages originated since January 2014 must meet the ability-to-repay and documentation requirements. As a result, NQM loans have been performing at levels very similar to QM loans. An April 18, 2016 press release from Fitch Ratings illustrates this point:

> *"Of the small fraction of loans not eligible for safe harbor, the combination of tight underwriting and a supportive economic environment has kept default rates low. In the newly originated Fitch-rated – mortgage pools issued since the start of 2014, only three loans are currently more than 60 days delinquent (none non-QM). Anecdotally, Fitch has been told default rates on non-QM loans that have not been securitized have been very low as well."* [v]

## Expected Loan Price Ranges as Credit (FICO) Improves Over Time

Loan-to-Value: 80% | Interest Rate: 7.0% | Term: 30 Years




*Source: Window Rock simulation using data from Andrew Davidson & Co.*

**In today's environment, loan prices increase significantly with incremental improvements to a borrower's credit score over time. For a mortgage with a loan-to-value ratio of 80%, the pricing increases from $95.10 to $104.40 (a 9.8% jump) as the borrower's credit score increases from 640 to 740. A credit-score improvement such as this could be achieved by the borrower simply making his or her mortgage payments on time for a year.**

The widespread misunderstanding of the risks associated with NQM loans has resulted in an inappropriately steep yield curve for these credits. The market is failing to appreciate that the NQM market is not monolithic. Within the NQM market, there are many borrowers who will perform very similarly to QM borrowers – and some who will fail to perform. Yet the entire market is being priced as if there were significant risk among NQM borrowers. Investors who are able to accurately assess the risk profiles of specific borrowers and mortgage pools have the opportunity to acquire and create solid assets at steeply discounted prices.

A big part of this assessment begins with the realization that FICO, which is inherently backward-looking, is a limited tool in predicting the future performance of a borrower. Many, though certainly not all, borrowers with less-than-pristine credit histories will perform very well on their mortgages. Investors who fail to realize this are at risk of making the same mistake that banks and other traditional lenders have made in establishing rigid underwriting guidelines that are overly-reliant on credit scores.

***Investors currently are pricing NQMs as if they were subprime loans originated 10 years ago – despite the fact that today's loans bear little resemblance to the loans that caused the housing crisis.***

One major factor that is contributing to the mispricing of the NQM market is the lack of historical data for these loans. Because the NQM market has a track record of only a few years, many investors use the historical performance data of subprime loans as a proxy, which leads to inappropriately steep risk premiums. While the history of the NQM market has yet to be written, the factors described above suggest that these borrowers will continue to perform well and that these loans will generate attractive returns for investors.

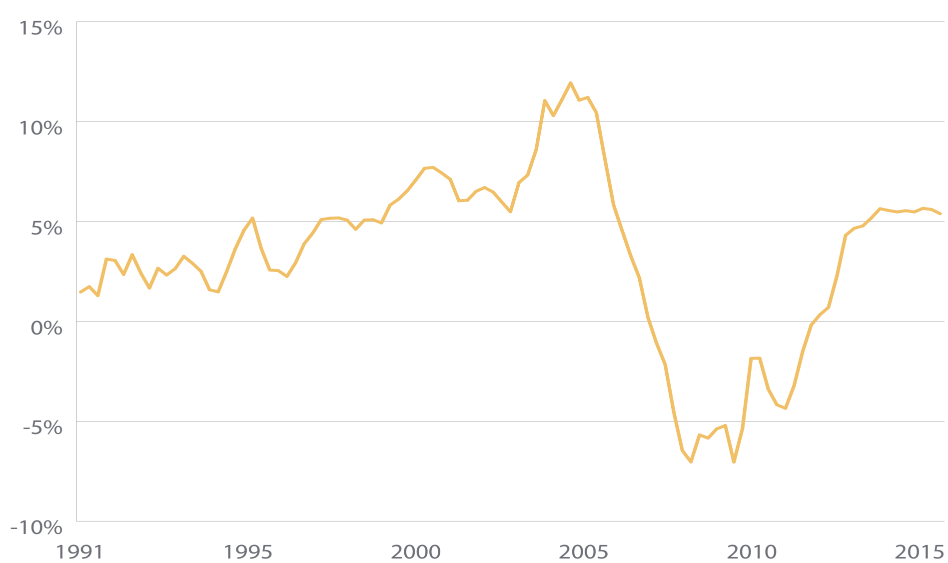
## COLLATERAL VALUES: STABILIZATION OF U.S. HOUSING MARKET

In addition to rigorous underwriting, another factor supporting the performance of NQMs is the fact that they have been underwritten in a housing market that has stabilized and has returned to normalized appreciation levels in most regions. At the lower-value end of the housing market, specifically, there are several factors that should be supportive of housing prices over the next decade:

***Millennial household formation:*** The Millennial generation's delay in forming households has resulted in pent-up growth of more than 2 million households, according to a presentation by Marquette University Professor Mark Eppli.[vi] Despite the fact that Millennials are waiting longer to start families, the percentage of Millennials who say that they expect to marry and have kids is actually higher than what previous generations reported at similar ages, according to a survey by The Council of Economic Advisors. This supports the idea that this large generation has not eschewed the idea of home ownership.

***Rising rents:*** The aforementioned lack of financing and demographic trends have resulted in surging rents in many parts

**U.S. Home Price Appreciation**



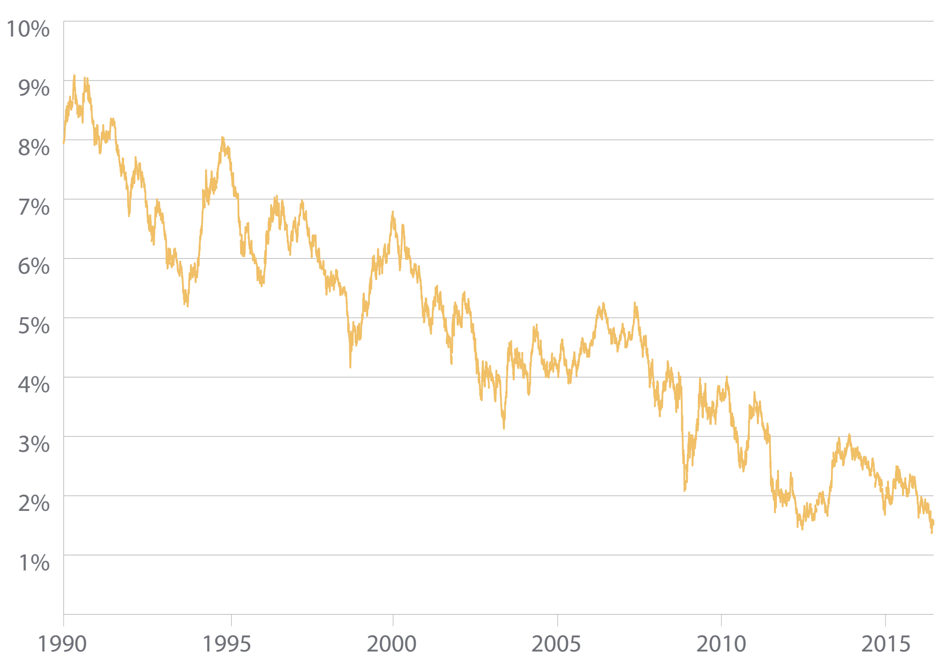

*Source: Federal Housing Finance Agency*

**U.S. home prices have returned to a level of normalized appreciation. This, in addition to the robust ability-to-repay underwriting guidelines that all U.S. mortgages must now meet, is a major factor pointing to the continued strong performance of NQM loans.**

of the country. In an April 2016 article, Zillow reported: "Americans making the nation's median annual income ($55,589) and looking to buy the typical American home (valued at $183,600 as of December) could expect to pay 15 percent of their income towards their monthly mortgage payment. The same American looking to rent a typical home should plan to set aside 30 percent of their income each month to pay their landlord."[vii] As rents continue to rise, the cost-benefit analysis of renting vs. owning will increasingly shift in favor of owning.

***Supply-demand imbalance:*** Overall housing stock in the first quarter of 2016 was 39% lower than four years earlier, according to data from Trulia; the decrease was even larger, 44%, for properties valued in the bottom third of all listings.[viii] Some major builders, such as D.R. Horton, have begun increasing building and marketing efforts to the entry-level segment, according to a May 2016 article from *The Wall Street Journal*.[ix] Despite these efforts, the supply-demand imbalance should continue to be supportive of housing prices in this corner of the market.

**10-Year U.S. Treasury rates**




**Quantitative easing and a host of other expansive monetary policies around the world have driven interest rates to historic lows. The opportunities presented by the NQM market are especially attractive in this low-yield environment.**

***The NQM market is not monolithic. Investors who can accurately assess the true risk profiles of NQM borrowers are well-positioned to acquire and create very stable assets at deeply discounted prices.***

## IMPLICATIONS FOR A LOW-YIELD ENVIRONMENT

The return opportunities presented by the NQM market are even more attractive when taken in context of today's low-yield environment. Expectations for low inflation and unprecedented expansive monetary policy by central banks over the past decade have driven interest rates to historic lows. This trend has accelerated over the past year with the introduction of negative interest rate policies in Japan and Europe. The decline in interest rates has come with a sharp increase in bond prices, particularly among government bonds.

In a May 2016 report, the McKinsey Global Institute (MGI) explained that many of the economic and business conditions that led to above-average returns for U.S. and Western European stocks and bonds over the past 30 years are weakening or reversing.[x] Echoing a belief held by many investors, MGI's analysis suggests that total returns for these asset classes will be significantly lower over the next 20 years than they were over the previous three decades.

Against this backdrop, investors will need to diligently search for opportunities to capitalize on pricing dislocations driven by market inefficiencies. At Window Rock, we believe that the NQM market currently provides such opportunities, both in terms of loan origination and acquisition. Driven by aggressive regulatory reforms, rigid underwriting practices, and widespread misunderstanding of the true risk profiles of NQM borrowers and loans, the post-crisis overcorrection in the mortgage market has created significant opportunities for investors and non-traditional lenders.

## ABOUT WINDOW ROCK CAPITAL PARTNERS

*Window Rock Capital Partners, LLC. focuses on identifying attractive investment opportunities in residential credit opportunities and in the residential real estate market. The firm has significant experience in underwriting and understanding borrower credit through proprietary data collections, internal systems, and processes. For more information, visit **www.windowrock.com** or email the company at **info@windowrock.com**.*

## ABOUT THE AUTHORS

### Patrick Cardon – Managing Member, CEO and CIO

*As Window Rock's chief executive officer/chief investment officer and a member of the management team, Mr. Cardon, who has worked in the finance industry since 2002, manages the firm's day-to-day operations and investment management. He incubated Window Rock within the Cardon Family Office and launched the firm in 2010.*

### Jeffrey Pettiford – Managing Member, Head of Business Development and Investor Relations

*Mr. Pettiford leads Window Rock's investor relations efforts and is responsible for client service, investor communications, product development, financial consultant relations, and fund raising. Mr. Pettiford, who began working in the investment management industry in 1999, is also a member of Window Rock's management team.*

## RESOURCES


i Kusisto, Laura and Kirkham, Chris. *The Wall Street Journal*. “U.S. Home Prices Jump as Supply Pinch Plays Out.” May 31, 2016.

ii *Federal Reserve Bank of New York*. “Quarterly Report on Household Debt and Credit.” May 2016.

iii Kusisto and Kirkham.

iv Goodman, Laurie; Zhu, Jun; George, Taz. *Urban Institute*. “The Impact of Tight Credit Standards on 2009-13 Lending.” April 2015.

v *Fitch Ratings*. “Fitch: Borrower Claims Nonexistent 2 Years after Ability-to-Repay Rule.” April 18, 2016.

vi Eppli, Mark J. *Marquette University*. “The Impact of Demographics and Millennials on Commercial Real Estate.” Presentation to YPO Chicago. September 28, 2015.

vii Gudell, Svenja. *Zillow*. “The U.S. Housing Affordability Crisis: How a Rent and Low-Income Problem is Becoming Everyone’s Problem.” April 11, 2016

viii Jamrisko, Michelle. *Bloomberg*. “One More Reason You Can’t Buy a Home.” March 21, 2016.

ix Kirkham, Chris. *The Wall Street Journal*. “Affordable Starter Homes Prove More Elusive.” May 6, 2016.

x *McKinsey Global Institute*. “Diminishing Returns: Why Investors May Need to Lower Their Expectations.” May 2016.