RMBS Research

Non-Qualified Mortgages are not the New Subprime

June 2017

Author:
Brian Sandler | Associate Vice President | brian.sandler@morningstar.com | +1 646 560-4557

Analytical Manager:
Brian Grow | Managing Director | brian.grow@morningstar.com | + 1 646 560-4513

Morningstar Perspective

There is often a misconception that loans that fail to meet the Qualified Mortgage designation are equivalent to the subprime mortgages of the precrisis era, but this comparison is over simplistic. Non-QM loans do not share the characteristics of the subprime mortgages that led to the financial crisis. The QM designation, which the Consumer Financial Protection Bureau developed more than three years ago, does not de facto equate to strong credit. Conversely, non-QM loans do not always indicate more problematic credit or excessive risks. Typically, underwriters thoroughly examine proof of income in applications for loans that, for one reason or another, fail to meet the QM requirements, unlike precrisis subprime loans that often required little or no income documentation. The performance of non-QM loans has been strong, as losses in non-QM securitizations have been rare, with most because of modifications rather than defaults.

QM Requirements

The CFPB implemented the QM rule to help ensure potential homeowners would be able to handle their mortgage payments. For a loan to receive the QM designation, it must meet certain requirements, including:

- Underwriters must follow the criteria outlined in Appendix Q of the Truth in Lending Act for determining monthly income and debt.
- The borrower must have a maximum debt-to-income ratio, or DTI, of 43%.
- Points and fees may not exceed 3% of the loan amount.
- The loan cannot have features such as interest-only periods, negative amortization, or balloon payments.
- The maximum loan term is 30 years.

Loans that meet the requirements of a QM loan but are higher priced (with rates exceeding the average prime offer rate by at least 1.5%) are designated as rebuttable presumption QM loans. In our credit analysis, Morningstar Credit Ratings, LLC treats rebuttable presumption QM loans as non-QM loans.

Borrowers may seek non-QM loans for many reasons. They may have inconsistent income that cannot be accurately verified according to the standards of Appendix Q. Their DTIs may be above 43%, or they may have experienced a recent credit event, such as bankruptcy, and not enough time has passed since that event occurred for a government-sponsored enterprise to purchase the mortgage.
Even when a mortgage is designated non-QM, the lender must document the borrower's ability to repay the loan. The ATR rule, implemented in 2014 under the Dodd-Frank Act, requires the lender to determine that the borrower can repay the loan by considering underwriting factors such as income, assets, monthly payments, debts, DTI or residual income, and credit history. This requirement essentially eliminates the possibility for stated income loans with little or no documentation, which were common before the crisis. Therefore, today's loans secured by primary residences and second homes (ATR rules do not apply to investment properties) have lower potential of fraud and improved underwriting quality than precrisis subprime loans.

Morningstar does not believe a QM designation automatically equates to stronger credit. For example, there is no maximum loan-to-value ratio or minimum FICO score for QM loans. A loan with a 90% LTV, 640 FICO score, and 43% DTI could be a QM loan if it meets all other requirements. Similarly, a loan with a 50% LTV, 800 FICO, and 43.5% DTI cannot be a QM loan because of the DTI. Based solely on these characteristics, the former is more likely to default than the latter. LTV and FICO are two of the largest drivers for projected loan performance in the Morningstar Credit Model. In addition, an interest-only loan with a 40% LTV, which would be non-QM, is less likely to default than a fully amortizing QM loan with a 90% LTV, all else equal. Interest-only loans can be appropriate products for some borrowers, such as self-employed individuals with irregular income streams.

Morningstar stresses the importance of using common sense when determining a borrower's ability to repay a loan. Investors must look beyond the classification of QM versus non-QM when analyzing credit strength. If a loan is non-QM for DTI more than 43% or lack of documentation, it is important to look for compensating factors, such as substantial reserves, low LTV, or high FICO. When running non-QM loans through the Morningstar Credit Model, we increase projected severities because of longer foreclosure timelines and higher foreclosure costs and do not adjust default projections.

Assessing Non-QM Credit Quality

Non-QM loans included in securitizations generally have credit attributes that do not indicate excessive risks. As seen in Table 1, while the weighted average metrics are weaker for non-QM loans than QM loans, the values for non-QM loans indicate generally strong loans. Based on FICO, LTV, and DTI alone, a borrower with the average attributes for non-QM loans would be able to qualify for most mortgage programs, including Fannie Mae and Freddie Mac programs.

Table 1: QM Versus Non-QM Attributes

Deal Type	WA Original FICO	WA Original LTV (%)	WA Original DTI (%)	Loan Count	Balance ($)
QM	767.9	69.3	32.3	25,214	18,533,870,961
Non-QM	688.2	75.2	36.6	2,346	736,922,400

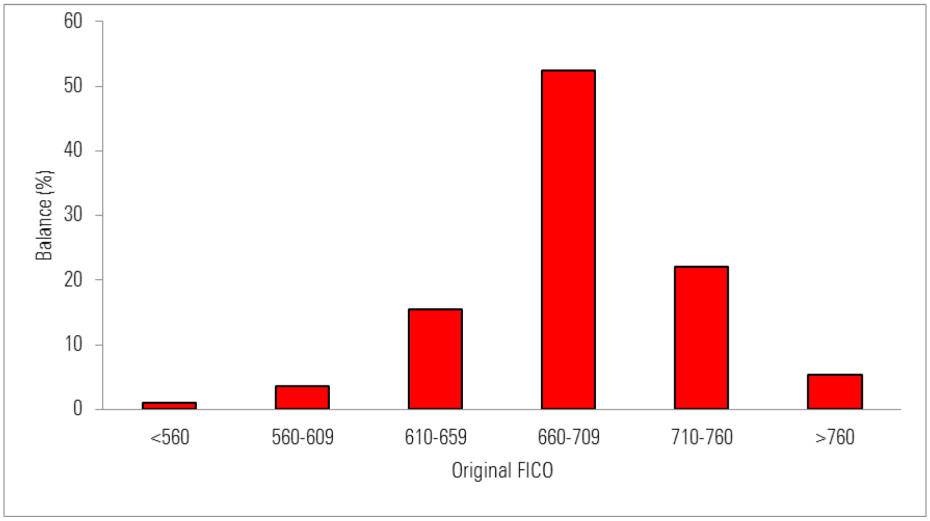
Sources: CoreLogic, 1010data

Note: FICO and DTI calculations exclude loans with a value of 0 or blank. Weighted based on closing balance.

For this analysis, Morningstar used a CoreLogic database in 1010data to find loans that are in securitizations of QM loans, have an origination date of Jan. 20, 2014, or later, are secured by primary residences or second homes, and have a DTI of 43% or lower. Only loans with an application date of Jan. 10, 2014, or later can be classified as QM, and since application date information is not available, we used a later date of Jan. 20, 2014, as a proxy origination date. To find non-QM loans, Morningstar found loans that are in securitizations of non-QM loans, have an origination date of Jan. 20, 2014, or later, and are secured by primary residences or second homes.

The following three charts show the distribution of FICO, LTV, and DTI for the non-QM loan population. Securitizations of non-QM loans do not contain high concentrations of low FICO, high LTV, or high DTI loans. Based on this data, non-QM loans are not the new subprime loans of yesteryear. As seen in Chart 1, the majority of loans (79.8%) have an original FICO of 660 or greater, and only 4.7% have a FICO below 610.

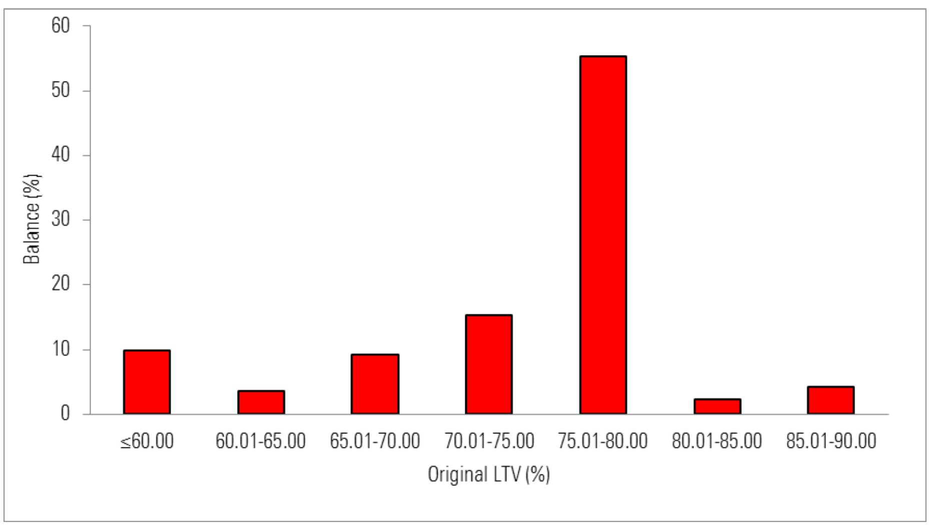
Chart 1: FICO Distribution of Non-QM Loans



Sources: CoreLogic, 1010data
Note: Excludes loans with a value of 0 or blank.

Chart 2 shows that 93.5% of non-QM loans have a LTV of 80.0% or lower. Only 6.5% of loans have an LTV of greater than 80.0%, and no loans have an LTV greater than 90.0%.

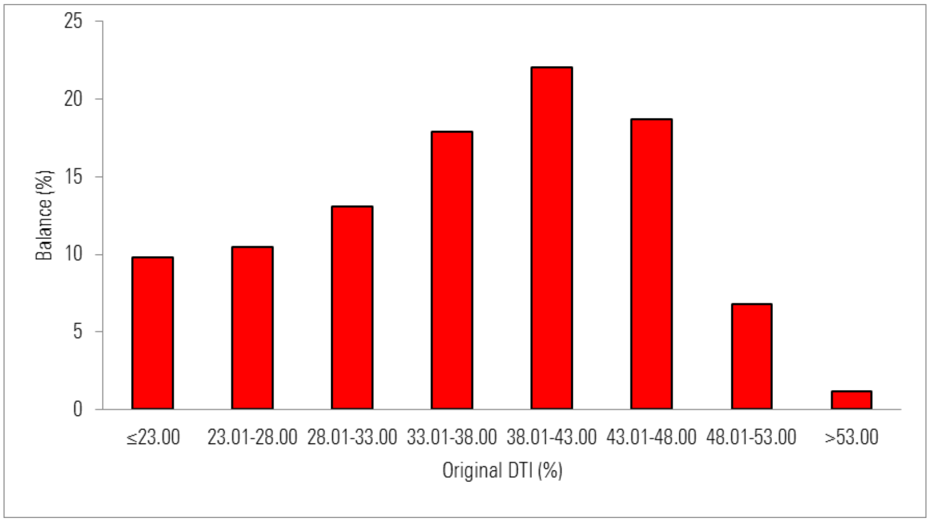
Chart 2: LTV Distribution of Non-QM Loans



Sources: CoreLogic, 1010data
Note: Excludes loans with a value of 0% or blank.

As shown below, only 26.7% of loans have a DTI greater than 43.0%. Only 7.9% of loans have a DTI greater than 48.0%. Also, 51.2% have a DTI of 38.0% or lower. Based on DTI, most of these borrowers have a high capacity to repay the mortgage.

Chart 3: DTI Distribution of Non-QM Loans



Sources: CoreLogic, 1010data
Note: Excludes loans with a value of 0% or blank.

Chart 4 shows the distribution of loan balances among non-QM loans by LTV and FICO. The numbers in green represent the three highest concentration buckets and the numbers in red represent the three lowest concentration buckets. This chart shows that 73.4% of loans have an LTV of 80.0% or lower and a FICO of 660 or higher. In addition, it shows that the borrower for all loans with an LTV greater than 80.0% had a FICO of at least 610 and that the borrower for all loans with an LTV greater than 85% had a FICO of at least 660.

Chart 4: LTV-FICO Distribution of Non-QM Loans

FICO / LTV (%)	<610	610-659	660-709	710-760	>760
≤60	1.12	2.09	4.15	1.90	0.67
60.01-65.00	0.36	0.55	1.92	0.71	0.13
65.01-70.00	0.81	2.51	4.03	1.32	0.58
70.01-75.00	0.74	2.64	**7.61**	3.37	0.89
75.01-80.00	1.67	7.55	**30.90**	**12.77**	2.48
80.01-85.00	**0.00**	0.16	1.08	0.73	0.35
85.01-90.00	**0.00**	**0.00**	2.73	1.20	0.30

Alternative Yet Thorough Underwriting Programs

Many non-QM loans use alternative means to document income if underwriters cannot accurately verify income using the methods in Appendix Q. Some borrowers, such as those who are self-employed, may struggle to qualify under Appendix Q, but we do not believe these borrowers are necessarily riskier. Morningstar generally holds a positive view of the non-QM programs (outlined below), as income is thoroughly documented.

Bank Statement Programs

Morningstar has seen more programs that use 12 to 24 months of bank statements to prove an ability to repay, especially for self-employed borrowers. We believe this can be a prudent way to underwrite self-employed borrowers, who may have difficulty documenting their income under Appendix Q because of the fluctuating nature of their earnings. In addition, using tax returns to verify self-employment income, as required under Appendix Q, may not accurately reflect the cash flow of businesses, as business owners aim to minimize their taxable income. Morningstar believes 24-month bank statement programs are stronger than 12-month programs. We also believe programs are stronger when lenders require a third-party prepared profit and loss statement and verify employment. These programs typically have strict limits on the number of overdraft protection transfers or nonsufficient funds on the borrower's bank statements, as these are signs of cash flow management issues.

Full Documentation but DTI Above 43% Programs

We have seen programs that meet all other QM requirements except that they allow DTIs above 43%. Higher DTIs do indicate a reduced capacity to pay obligations, but these programs typically offset the risk by requiring minimum credit scores in the mid to upper 600s or by reducing maximum LTVs. A loan with a 50% DTI can be a strong loan if the borrower has a high FICO score, low LTV, and substantial reserves, even though it would not be considered a QM loan. Morningstar treats these loans as full documentation loans, and the Morningstar Credit Model accounts for the higher DTI.

Asset Depletion and Asset Qualification Programs

Some programs use the borrower's liquid assets to determine a monthly income that can be used to repay the mortgage. The balance of liquid assets is amortized over the loan term to determine the qualifying income, which is then used to determine a DTI or residual income measure. Typically, borrowers provide two or three consecutive months of statements to fully document the assets, and there is typically a seasoning requirement, such as 120 days. We have a higher view of programs that do not assume a positive rate of return on the assets, as this is more conservative than programs that assume an annual return when amortizing the assets. Other types of asset qualification programs are similar in that assets, rather than income, help determine the borrower's ability to repay. However, with asset qualification, underwriters don't consider DTI or a residual income measure. Rather, the borrower must document enough liquid assets to cover the entire loan amount plus certain costs and additional reserves. Typically, the borrower must provide the most recent six or so months of bank statements and the balances must be stable. Both asset depletion and asset qualification programs should apply a discount to the value of stocks, bonds, mutual funds, and retirement accounts. Illiquid assets should not be included. We believe these programs are reliable because verifying the borrower's ability to repay is based on known assets in the borrower's possession. However, because there is a risk that the value of the assets can decline or that the borrower could use these assets for another purpose, Morningstar typically does not treat these as full documentation programs, but they are not as problematic as stated income programs with little or no documentation.

Foreign National Programs

Many foreign nationals have a difficult time providing income documentation required under Appendix Q. Because many foreign nationals may have little U.S. credit history and no U.S. credit score, it can be difficult to verify creditworthiness and determine recurring payment obligations. To compensate for the lack of U.S. credit history or traditional income documentation, reserve requirements are usually high, and LTVs for these programs are low, typically capped around 60.0%. If no U.S. credit score is available, the borrower typically provides alternative documentation, such as credit reference letters or a foreign credit report. We do not believe these sources are a comparable substitute for a U.S. credit report and increase the risk of such loans. Morningstar assumes a low credit score for foreign nationals who do not have a U.S. credit score.

To document income, two years of foreign tax returns are usually required. If there is no tax-return requirement in the borrower's home country, a wage earner can provide a letter from his or her employer indicating income for the prior two years and year-to-date income. If the borrower is self-employed, he or she may provide a letter from an independent accountant or auditor stating the approximate value of the company, personal income for the prior two years, and year-to-date income. We do not believe this documentation is as robust as the documentation provided by U.S. citizens and adds uncertainty surrounding future income stability. Because of doubts verifying credit history and income, Morningstar typically does not treat foreign national loans as full documentation loans, but they are certainly not as weak as stated income or no documentation loans.

Recent Credit Event Programs

Morningstar also sees programs for borrowers that have a recent credit event, such as bankruptcy, foreclosure, or deed in lieu of foreclosure. These borrowers typically have clean credit histories except for one event, which may have been because of an extenuating circumstance. Fannie Mae and Freddie Mac require a certain amount of seasoning for credit events, such as seven years for a foreclosure and four years for a bankruptcy, with lower seasoning requirements for events caused by an extenuating circumstance. Many non-QM programs offer lower, or even no, seasoning requirements. Such programs are stronger when there is a valid justification for the credit event (such as a life-changing event outside of the borrower's control) and when there are no other blemishes in the credit history. Additionally, there should be restrictions on LTV and FICO. For such programs, Morningstar may review the reason for the credit event, as it may not be an indication of poor credit history.

The Big Picture

While some non-QM programs use alternative underwriting procedures, the programs document income and the borrower's ability to repay, as opposed to the precrisis subprime loans. Morningstar stresses the importance of reviewing underwriting guidelines, originators, and aggregators to get a full picture of the origination process. When evaluating underwriting programs, Morningstar reviews guidelines and often visits the originator or aggregator. Morningstar then determines if programs are full, low, or no documentation programs, which affects our default projections. We may also adjust the default projections for full documentation loans based on the comprehensiveness of the income or asset verification process. We make these adjustments at the loan level. We do not dismiss the effectiveness of any mortgage program until we understand the originator's rationale for the underwriting strategy. For example, bank statement programs that require less than 12 months of statements may be strong if the originator has other methods to verify the borrower's ability to repay, such as a close long-term and comprehensive banking relationship. In addition, we review due-diligence results for a securitization to ensure underwriting guidelines are followed, especially when deviating from Appendix Q. If they are not, there should be sufficient compensating factors, which we have generally seen.

Future of Non-QM Loans

There is some uncertainty regarding how non-QM loans will perform in the future. One concern is the uncertainty surrounding non-QM loans in a foreclosure process. QM loans are protected from defense of foreclosure claims made by borrowers because of a failure to meet ATR requirements, but non-QM loans are not protected from such claims. However, we believe it is likely that lenders of non-QM loans will be able to defend how they determined the borrower's ability to repay. As mentioned, lenders of non-QM loans must document how each borrower meets ATR requirements. The industry may gain more comfort with non-QM loans after some go through the foreclosure process, as this will clarify how courts will treat such loans. Another concern has been the lack of liquidity for non-QM loans, but with the increasing number of non-QM securitizations, this should be less of an issue. We expect that with the strong demand for non-QM loans from borrowers, the increase in lenders introducing non-QM programs, and more non-QM securitizations, non-QM originations will continue to expand despite rising interest rates.

DISCLAIMER

The content and analysis contained herein are solely statements of opinion and not statements of fact, legal advice or recommendations to purchase, hold, or sell any securities or make any other investment decisions. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MORNINGSTAR IN ANY FORM OR MANNER WHATSOEVER.

To reprint, translate, or use the data or information other than as provided herein, contact Vanessa Sussman (+1 646 560-4541) or by email to: vanessa.sussman@morningstar.com.