Don't Drown in the Sea of Lending Sameness

Specialty lending can help to bulletproof your business by making you stand out from the competition

By Denis G. Kelly

The definition of "good enough" is a moving target. Specific to the mortgage loan originator, what was considered "good enough" 12 months ago is likely not good enough today.

Considering the compressed profit margins, the significant decrease in overall loan originations, rising production costs and other negative industry pressures now afoot, a successful mortgage originator must be proactive in order to successfully navigate these dynamic market conditions.

The first step begins with a comprehensive audit — an audit of everything. Ask yourself deep, probing questions about your business practices. What can — and must — you do better? Consult your peers to determine if there are nuggets that are easy to implement and also move the production needle.

Although there are myriad considerations, one focus should be on the loan solutions that must be part of a modern mortgage originator's arsenal to properly support business-development initiatives. With the scarcity of leads and the increased competition, modern originators must leave no stone left unturned. If there is a reasonably accessible loan solution, then originators need to be empowered to close and fund with this solution.

There are many innovative lending products and terms for these products (such as non-QM, non-agency, nonprime, to name a few). Instead of dissecting the differences between the terminology (which provides no value to business-development initiatives), let's consider all of them under the umbrella of specialty residential-lending solutions.

Which solutions are "must-haves" for the modern loan originator? As the varying names for specialty residential-lending products indicate, there are a variety of solutions.

Near-miss jumbo

All else being equal, why not close larger loans? If margins compress, then it may be possible to mitigate some of this overall negative effect by increasing your revenue — and consequently profit — per funded loan. In general, near-miss jumbo loans are designed for borrowers who don't quite qualify for mainstream jumbo loans.

The following are among the typical reasons for disqualification from the commonplace, restrictive jumbo-underwriting box: a slightly higher debt-to-income (DTI) ratio, limited reserves, late consumer and/or housing payments, a significant credit event without adequate seasoning, substantial reserves but minimal qualifying income, FICO credit-score issues and/or a loan-to-value (LTV) ratio that exceeds threshold limits.

The following are near-miss jumbo features that originators need in place in order to serve this market: maximum loan size of $20 million; maximum DTI of 59 percent; no maximum cash-in-hand requirement; cash-out funds that can be utilized for reserves; reserves allowed from various accounts, including retirement and business accounts (without haircuts); late consumer and housing payments acceptable; utilization of the primary wage-earner's FICO score; and an asset-depletion program for borrowers with significant liquid assets.

Self-employed borrowers

Business owners typically — and legally — take advantage of Uncle Sam's tangled tax-policy web. As such, true income for self-employed individuals frequently is considerably more than what is reported to the IRS. Traditional lenders do not account for this discrepancy between true income and reported income, which leads to many truly qualified borrowers not qualifying for traditional loans.

This flaw in the system is unfair to self-employed borrowers, but it creates opportunities for forward-thinking originators. If a self-employed borrower does not qualify utilizing the full documentation calculation methodology, rather than saying "no," it is best to provide a potential solution — which is typically a bank-statement loan program.

The essence of a bank-statement program for self-employed borrowers is to forensically extrapolate income based on deposits (revenues) and deduct expenses (typically via an expense ratio) to derive true income. There are many different types of businesses and lenders have various methods through which to stabilize income via bank statements.

Following are some key factors for originators to consider when working with bank-statement loans. Profit-and-loss statements from accountants should be the exception, not the rule. Lenders must have a bank-statement desk to help stabilize borrower income at the beginning of the process — for purchase scenarios, this is prior to opening escrow or executing a purchase-and-sale contract. Why enter into an agreement and submit a loan to underwriting if the income does not qualify? And finally, there must be an ability to utilize personal or business bank statements, or both.

Moderate credit

There are life events — such as divorce, illness, death and/or job loss — that may result in financial duress and also negatively impact credit. The "timeout period" for traditional financing is typically fairly lengthy — but it is dependent on the specific program. This results in an underbanked market of qualified borrowers.

From a risk perspective, borrowers who have experienced significant credit issues should not be in the same loan programs as borrowers who have demonstrated timely payments — until they have re-established a history of on-time payments. This doesn't need to be a go or no-go equation, however. There is a middle ground in which lenders offer intermediate financing solutions, whereby the risk is measured and mitigated.

Such loans frequently feature lower maximum LTVs, higher reserve requirements and/or higher interest rates (as compared to conventional financing). Many borrowers elect to proceed with these terms because the alternative is to wait a considerable period to re-establish a timely payment history. Borrowers may choose to accept these more burdensome terms initially — understanding that with continued timely payments for 12 to 48 months, they likely will again qualify for the market's most favorable terms.

No-income verification

Owner-occupied (or consumer) loans are required to pass the ability-to-repay (ATR) test per both responsible lending and the Dodd-Frank Wall Street Reform and Consumer Protection Act. Business-purpose loans, however, are not subject to the same test, and this paves the way for no-income verification, business-purpose financing.

Some 30 percent of real estate transactions are non-owner-occupied transactions, according to the National Association of Realtors' 2018 Home Buyer and Seller Generational Trends Report. So, it stands to reason that a well-equipped mortgage originator should provide solutions that address this large market. Borrowers purchasing investment properties tend to be rather sophisticated, and this product uniquely provides such borrowers financing tailored to their needs.

The main no-income verification products are

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debt-service-coverage ratio (DSCR) and no-ratio loans. DSCR is calculated by dividing net operating income by total debt-service costs. Lenders have different requirements for DSCR loans, but generally it is best to work with one that doesn't discount the rent for either expenses or vacancy. It also is important that the DSCR calculation consider the interest-only payment (if elected).

No-ratio loans do not consider DSCR (and hence "no ratio"). The loans are easier to qualify for relative to DSCR; however, because of the increased risk, the rates tend to be higher and the LTVs lower. Both the DSCR and no-ratio loans should allow for gift funds.

Fix-and-flip and foreign nationals

Fix-and-flip financing targets investors who purchase homes, rehabilitate them and sell them for a profit. Some 5 percent of single-family and condominium purchase transactions involve fix and flips. So, there is significant opportunity for originators who understand and market this product. The key factors when evaluating fix-and-flip financing (other than pricing) are loan-to-cost (LTC) and as-repaired loan-to-value (AR LTV) ratios.

There are many factors that determine the maximum LTC and AR LTV. Those include, but are not limited to, the experience of the borrower with remodeling projects; the significance of the rehab job (e.g., light, medium or substantial renovation); and FICO scores. For well-qualified, experienced fix-and-flip remodelers, originators should seek lenders that offer an LTV of 90 percent and AR LTV of 75 percent.

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The world is flat, and it is becoming flatter as technology progresses and the ranks of the middle and upper classes explode in many countries. Foreign buyers account for 8 percent of the existing-home purchases in the United States, according to the National Association of Realtors.

With this understanding, multiple loan solutions for foreign borrowers are necessary. This includes full-documentation, asset-depletion, debt-service-coverage ratio and no-ratio mortgages. It also is important that foreign buyers do not have exhaustive country-of-origin restrictions.

Yet another category is a mixed-use product — typically involving a combination of residential, retail and/or office properties. There are considerable business-development opportunities for mortgage originators who have a comprehensive loan-product offering represented by the other solutions detailed in this article.

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In addition to business-development returns being enhanced through specialty lending, these offerings also protect existing referral-partner relationships. If an originator does not have access to these products, another competitor likely will, and that's who your existing referral partners will turn to when the need arises. Such a scenario will likely lead you to lose business — and possibly even referral relationships.

That would result in an already challenging business environment becoming a virtually impossible environment in which to achieve success. Developing a solid specialty residential lending strategy will prevent originators from being thrust into this undesirable situation and, consequently, from drowning in a sea of lending sameness. ■