

QRM Will Help Restart 'Non-Tradition' Lending

Analysis and Opinion by Whole Loan Capital

Summary

As the banking industry accepts the limitations that QRM and a regulator-heavy environment dictate, the line in the sand about what can and cannot be done from a residential bank lending perspective will brighten. This line will define in and out-of-bounds for FDIC insured institutions. While this could result in borrowers that reside inside the 'box' being over-banked, the opportunity created by borrowers outside the lines needing credit will be enough to restart some form of non-traditional lending.

Analysis

Inappropriate forms of 'non-traditional' lending (stated income with high LTVs) created havoc in the US and world economy. The Fed along with Dodd Frank address those issues.

It can be argued that requiring skin in the game for future securitizations along with a new stricter QRM loan menu is addressing the issue twice and has gone too far. Time will tell. QRM will create a meaningful population of borrowers that don't fit in the QRM box for illogical reasons, are fully capable of repaying and supporting mortgage debt, have significant equity either in properties or for down payment, and still need credit. Non-depository lender/operators that are not boxed in by the FDIC and have no problem with 'skin in the game' will find opportunities in the new lending landscape. This will be slow to develop but early signs of life are emerging.

The opportunity that will develop is for an experienced lender/operator to step into this non-QRM space and make credit available at 'higher costs' but well within regulatory guidelines. That lender will need 100% control over all lending and servicing processes, as well as tight QC. Regulation and prudence require very careful underwriting to properly assess a borrower's ability to repay a loan, in combination with full and proper disclosure to the borrower relative to loan terms.

Due to issues with Rating Agencies, and a dearth of clean structured products in the face of good investor demand, modest leverage is available to increase equity returns in this lending business. That leverage will take the form of unrated securitization transactions. Those transactions will be based on the characteristics of the pooled loans and thus create a very well matched liability structure. In these securitizations there will be meaningful skin in the game - skin in the form of the lender's equity.

The result of these efforts will be a vehicle (REIT) that will generate a steady and very acceptable income stream (dividend) for investors with minimal (no) losses due to the careful lending approach and lack of competition.

After some time there will be renewed interest by large lenders and banks to reenter this lending space. Having a significant head start in building this lending franchise will serve to enhance the enterprise value and could result in a healthy premium for the business at sale or IPO.