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House Rules

FINANCE: Lenders can still make loans outside the new guidelines, but at greater risk

By Mike Allen

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Like many borrowers seeking a mortgage or refinancing an existing one, Shae Geary knew the process would involve a lot more time and paperwork. Yet the reality was worse than she expected.

“It was a bit of overkill,” said Geary, who closed a refinance of her North County home earlier this month. The new mortgage is a jumbo loan of more than $417,000 with a 4.5 percent fixed rate for 30 years.

To get the loan, Geary and her husband provided proof of their income and tax returns for the past three years, along with several other documents showing every aspect of their financial standing. Still, the lender asked for more. Her husband had worked some overtime and had different salaries on his tax returns, which apparently set off red flags, she said.

“They wanted his company’s [human resources] department to verify all those differences, things that were already spelled out in on his paystubs. … It got a bit ridiculous,” Geary said.

Ridiculous as the mortgage approval process may seem to some, the new normal on mortgage lending got even tougher last month when new regulations took effect.

Housing Bubble to Blame

In general, the new rules follow provisions outlined in the Dodd-Frank banking reform law of 2010 aimed at eliminating the kinds of lending abuses that were rampant during the run up to the housing bubble.

The new rules require lenders to prove that borrowers absolutely have “the ability to repay” the loan, and explicitly define what constitutes a “qualified mortgage,” or one that can be bought by Fannie Mae, Freddie Mac or Ginnie Mae, the government entities that hold trillions of dollars of mortgages.

Meeting that qualified mortgage, or QM, designation also means borrowers must prove their outstanding debt — including their prospective mortgage payment — doesn’t exceed 43 percent of their monthly income.

Lenders can still make nonqualified mortgages, such as jumbo loans above $417,000, or those charging adjustable interest rates, but those loans won't carry the same legal protections if a borrower files a lawsuit against the lender should a foreclosure occur.

The new rules also limit the total fees on a mortgage to 3 percent of the total, and eliminate prepayment penalties.

Mark Goldman, a lecturer on real estate at San Diego State University and a mortgage broker, said for the most part, lenders have been implementing the new rules over the past several years, so the overall impact from the QM regs won't be that great.

Indeed, most lenders have instituted much tougher underwriting criteria in the wake of the mortgage meltdown years ago, and they are closely verifying borrowers' income capabilities so that loans can be sold on the secondary market, Goldman said.

'No Major Changes'

"For most lenders, there's going to be no major changes, but for those people with credit issues, they may end up paying more for those products" that aren't qualified mortgages, he said.

Among mortgage products outside QM are jumbo mortgages that charge adjustable interest rates, 40-year loans, loans with balloon payments, option payment loans and negative-amortization loans that allow borrowers to pay lower monthly payments resulting in the loan's principal growing.

Non-QM loans aren't prohibited, but because they don't carry the same legal protection as qualified mortgages, "therefore they will have higher risks, and therefore they will likely carry a higher interest rate," Goldman said.

While the 43 percent debt-to-income provision may be a stumbling block for some, especially in the San Diego market, the government mortgage agencies have already said they will accept such loans if borrowers can show other data to offset that deficiency, several industry sources said.

Among the strategies used to get a loan qualified are making larger down payments and paying off excess consumer debt, said Craig Brown, president of Rancho Financial, a Rancho Bernardo mortgage bank.

"Today, we're doing 52 and 53 percent debt-to-income loans," Brown said. The mortgages are usually sold to larger investment banks such as Wells Fargo Bank, Credit Suisse and New Penn Financial, he said.

Brown, along with other mortgage sources, said the new federal regulations have caused some anxiety among real estate agents and borrowers. Yet, like virtually every lender interviewed, the new regulations won't have any significant impact on his firm, Brown said.

Katie Miller, vice president of mortgage products at Navy Federal Credit Union, said her credit union has always underwritten mortgages showing borrowers have the ability to repay them. “Fundamentally, we haven’t changed how we underwrite because of the new regulations,” Miller said.

Like many mortgage lenders, business has been good at Navy Federal in recent years as the housing market continued recovering from the housing bubble bursting and the Great Recession.

Navy Federal reported mortgage originations last year were $11.1 billion, up from $10.2 billion in 2012. About half of the originations were Veterans Affairs-guaranteed loans, Miller said.

She said nonqualified mortgages the credit union makes can be held on its books. For example, Navy Federal does a 100 percent financing mortgage called Homebuyers Choice, and all of those loans will be held, even though some may meet the QM criteria, Miller said.

Although Navy Federal had to ramp up considerably to ensure it is complying with the new regs, it hasn’t slowed down business at all, and the credit union anticipates another strong year in originations, Miller said.

Legal Liability Limits Lending

Yet Tom Meuser, chairman of El Dorado Savings Bank in Placerville, has a much different story. Meuser, who has been in banking 56 years, said his thrift will likely do much fewer nonqualified mortgages because of the legal liability that goes with them.

“We’ve always made loans to people who we knew well and were loyal customers. We called them character loans. … Now, those loans are out,” Meuser said.

If a borrower defaults and the thrift initiates foreclosure, the thrift would be legally liable, he said.

“These are loans that we would have made in the past, but under the new rules, we won’t do them because of the legal risks,” Meuser said. Because of the QM regulation, El Dorado will reject about 30 percent of the loan applications it gets this year, he estimated.

El Dorado, with about $1.9 billion in assets, is like many other community banks that have said they intend to stop making any consumer loans because of the increased liability and increased compliance costs.

“It’s cost prohibitive to do [consumer lending] now, so most community banks aren’t offering any,” said Rick Sanborn, CEO of San Diego-based Seacoast Commerce Bank, which makes mostly business loans guaranteed by the federal Small Business Administration.

Smaller Banks Hit Hardest

What riles many community bankers is how the new regulations seem to have a disproportionate effect on smaller banks when many of the causes for the housing bubble came from the biggest banks and Wall Street credit rating agencies.

Borrowers seeking adjustable rate mortgages and jumbo mortgages won't be entirely shut out, industry sources said. At Union Bank, based in San Francisco and with 58 branches in the county, the bulk of its mortgages use adjustable interest rates that are set for a specific term and adjust based on a select index. Jumbo loans, most of which are non-QM, account for a huge part of Union's mortgage business.

James Francis, Union executive vice president and head of its consumer lending department based in San Diego, said the bank is comfortable making non-QM loans to the right customers and has a good track record in these loans.

"Even during the toughest time, around 2009-2010, we only had a handful of foreclosures," Francis said.

Last year, total consumer originations for Union Bank were $10.3 billion, up from $8.9 billion in 2012.

Francis doesn't expect much impact on Union's business because of the new regs. "The real issue will be around those people who have changing incomes, or who may have worked full time one year, and part time the next, or got higher salaries one year and less the next," he said.

"The new rules leave less leeway and less flexibility than there used to be," he said. "Generally speaking, some borrowers on the margin will have a harder time getting a loan."