What you need to know about 'alternative' mortgage lenders

A Consumer Action Publication

Close to half of all home loans are made by mortgage lenders that are not banks. These "alternative" lenders include well-known online direct lenders such as Quicken Loans, private and publicly held mortgage lending firms and credit unions. Online mortgage brokers such as LendingTree connect borrowers with a variety of lenders, including many non-bank lenders that are not household names. All mortgage lenders are subject to state and federal rules and regulations.

Alternative lenders are gaining ground over traditional banks because, in some markets, these companies can close loans in a much shorter time period—in some cases, in as little as 15 days. Some alternative lenders also feature lower fees and lower downpayment requirements, particularly on higher dollar (jumbo) mortgages.

These non-bank lending companies, many of which operate only online, closed 42 percent of all home refinancing loans in 2015, according to the Federal Reserve. Quicken Loans, the largest non-bank mortgage lender in today's market, is the number two housing lender in the U.S., trailing only Wells Fargo, a national bank.

Mortgages from alternative lenders played a big role in the foreclosure crisis of 2008. Subprime mortgage lenders like the infamous Countrywide Mortgage became known for making high-risk home loans to people who could not afford them. Many of these "exotic" loans had risky features that are harmful to borrowers, such as:

- Interest-only payments, which never reduce the amount borrowed (principal);
- Balloon payments (a large, lump sum due after a few years); and
- No income documentation requirements ("no doc" loans).

These consumer-unfriendly loan terms led to millions of home loan defaults and foreclosures. While the non-bank lending market has evolved, mortgages with risky terms, common in loans that defaulted, are still being offered. This fact sheet will help you steer clear of mortgage offers with unfriendly terms.

Non-bank lenders

Today, alternative lenders have returned to the market, handling nearly five in 10 home loans. They target a variety of borrowers, including moderate-income consumers, first-time homebuyers and those seeking jumbo loans. (Jumbo loans are a category of mortgages that exceed conforming loan limits established by government regulation. This is defined as loans of more than $417,000 in most areas, or more than $625,000 in high-priced markets.)

Since the foreclosure crisis, well-established banks have been tougher about approving mortgage applications, particularly for borrowers with poor credit and little or no downpayment. Non-bank lenders now issue the majority of loans insured by the Federal Housing Administration (FHA). First-time homebuyers and those with damaged credit histories often rely on FHA-insured loans, as they tend to require lower downpayments (as low as 3.5 percent) and will qualify borrowers with lower credit scores. FHA loans require homebuyers to buy private mortgage insurance (PMI) to cover the lender's risk of lending to people with poor credit and smaller downpayments. PMI adds to the borrower's monthly mortgage costs.

While it's possible to get good mortgages from alternative, non-bank lenders, there are a few things to be aware of:

Cons

- Non-bank FHA loans to borrowers with less-than-perfect credit and small downpayments have shown a greater potential to lead to borrower default.

- Consumers with lower credit scores will pay higher interest rates for a home loan.
- Non-bank lenders still offer mortgages with risky terms, such as interest-only payments, complicated adjustable rates and large balloon payments.

Pros

- All mortgage lenders—banks, non-banks and credit unions—are subject to new federal rules developed to make mortgage loans safer for borrowers.
- Non-banks are subject to the same federal mortgage lending laws as banks, including the Truth in Lending Act (TILA), the Real Estate Settlement Procedures Act (RESPA) and the Equal Credit Opportunity Act (ECOA).
- Non-bank mortgage lenders may offer more flexible access to credit, allowing borrowers who are shut out of the traditional bank mortgage market to qualify for homeownership.
- Non-bank lenders compete with banks, which can keep mortgage costs down due to competition among lenders.
- Non-bank lenders are the primary source of FHA loans today, making these mortgages more widely available to those with imperfect credit records.

Standards protect consumers

All mortgage lenders, by law, must make a reasonable effort to evaluate a borrower's income, assets, credit history and monthly expenses to ensure the borrower can afford to repay the loan. The "ability to repay" rule is part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in response to the foreclosure crisis.

Non-bank mortgage lenders must comply with state licensing laws and pass the SAFE Act competency test, background checks and take SAFE Act education classes annually. (The SAFE Act is shorthand for the Secure and Fair Enforcement for Mortgage Licensing Act of 2008.)

The Consumer Financial Protection Bureau (CFPB) oversees all non-bank mortgage lenders and the "ability to repay" rule for non-bank mortgage lenders, servicers and brokers. Mortgage lenders (originators) lend money for home loans, while mortgage servicers manage monthly loan payments, loan modifications and foreclosures. (Lenders and servicers often are different companies.)

The CFPB relies on consumer complaints filed with the agency to help it identify emerging problems in mortgage lending. Consumers can submit mortgage complaints to the CFPB at www.consumerfinance.gov/complaint or 855-411-2372. Complaints can be made by phone in 180 languages.

Qualified Mortgages

Mortgage loans with safer characteristics, called "Qualified Mortgages," or QM, protect consumers from riskier loan features and protect mortgage brokers and lenders from lawsuits and regulatory liability in connection with those loans. Lenders that offer Qualified Mortgages must adhere to stringent underwriting and documentation requirements.

Important: While mortgage lenders must reasonably determine that a borrower can afford the required monthly payments, lenders are ***not*** required to offer QM loans with safer features. It may not be obvious if a loan is "QM," so make sure to ask lenders if loans you are considering contain risky features such as interest-only payments, complicated adjustable rates and large balloon payments. If any of these features exist, the loan cannot qualify as a QM loan.

A QM loan must:

- Be affordable for the specific borrower's financial situation (all credit obligations, including the mortgage, must amount to no more than 43 percent of a borrower's income);
- Have clearly understandable terms and can't exceed 30 years in length (unless refinanced);
- Not feature risky interest-only payments, balloon payments and "negative amortization" (where the loan balance goes up because the minimum required monthly payment does not cover the interest you owe for that period); and
- Limit upfront fees and "points" (money paid upfront to the lender in exchange for a reduced interest rate) to three percent of the total loan amount.

QM alternative loans

Lenders offer alternatives to Qualified Mortgages, sometimes called Alt-QM loans, which may contain high-risk features that could lead to borrower delinquencies and even foreclosure. People with subprime credit histories, spotty incomes, who are self-employed, have income that's hard to document or who seek more flexible qualification requirements may be offered these loans.

Alt-QM loans should be approached with extreme caution because they may include features such as an interest-only option. Interest-only loans

are banned under QM rules because borrowers' payments include only interest and do not reduce the amount originally borrowed (principal) for many years (payments typically increase in five to seven years to include some principal repayment). Some lenders will approve borrowers with high debt levels, which could mean a greater chance of default for those borrowers. Alt-QM loans feature higher interest rates to compensate for added borrower risk.

CFPB mortgage servicing rules

Since 2014, under Regulation X of the Real Estate Settlement Procedures Act, mortgage servicers are obligated to:

- Provide borrowers with information about their mortgages;
- Correct errors; and
- Establish reasonable policies to assist delinquent borrowers and those at risk of foreclosure. (However, mortgage servicers are not obligated to offer borrowers a modified loan to help them stay in their homes, although many companies allow homeowners to apply for loan modifications.)

If a borrower is having trouble paying the mortgage, CFPB rules prohibit the mortgage servicer from foreclosing on a home unless the borrower is more than 120 days late, allowing time for the homeowner to apply for a loan modification.

For more information on the CFPB's mortgage servicing rules, visit http://1.usa.gov/21tHUmU.

Warnings, tips and resources

Compare costs. Get a "loan estimate" from several different mortgage lenders to see how much you qualify for, including a breakdown of rates, fees and points. Normally, when you seek new credit, it can have a negative effect on your credit score. However, you have 30 to 45 days to shop around for a mortgage without it having an impact on your credit score. (See the CFPB article "What do I have to do to apply for a mortgage loan?": http://1.usa.gov/1PanOan.)

Check your credit report. Before you start shopping around, request free copies of your credit reports at www.AnnualCreditReport.com or 877-322-8228. Check the reports for errors and follow the directions to dispute inaccurate information.

Know your score. When you apply for a mortgage, ask lenders to provide you with your "mortgage credit score," a specialized number used by lenders in the loan application process.

Seek help from a HUD-approved housing counselor. Learn the size of the mortgage you qualify for and how to obtain a home loan without risky features that might result in delinquency or foreclosure. To find a local counselor, visit www.consumerfinance.gov/find-a-housing-counselor/.

Be aware that mortgages with conditions that expose borrowers to risk of default are still legal. Avoid mortgages with high-risk features, such as interest-only payments, high debt-to-income allowances and balloon payments.

Beware of scams. Don't put money down to apply for a mortgage without receiving actual loan documents. You should receive a loan estimate, closing cost disclosure form and all other documents required by law. (See the CFPB's "What documents should I receive before closing on a mortgage loan?": http://1.usa.gov/22hQfQl.)

Report problems with mortgage lenders or servicers to the CFPB. The Bureau accepts complaints at www.consumerfinance.gov/complaint or at 855-411-2372.

Notify state authorities about your mortgage complaints. Find your state's attorney general at www.naag.org. Find your state's financial regulator at www.nasaa.org.

Get tips for the entire home buying process. Visit the CFPB at www.consumerfinance.gov/owning-a-home/ for access to tools and resources to help you make the best choices throughout the mortgage application process.

About Consumer Action

www.consumer-action.org

Through multilingual consumer education materials, community outreach and issue-focused advocacy, Consumer Action empowers underrepresented consumers nationwide to assert their rights and financially prosper.

Submit consumer complaints to our advice and referral hotline: www.consumer-action.org/hotline/complaint_form/ or 415-777-9635. Chinese, English and Spanish are spoken.

Consumer Action created this guide with funding from Housing Information (www.housing-information.org), a Consumer Action project that gives consumers and community-based agencies serving consumers access to multilingual educational resources promoting intelligent and cost-effective home-buying decisions.

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