Money

Why the Return of Subprime Lending Isn't All Bad

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For shoppers and homeowners alike, today's mortgage market offers plenty to cheer about. After edging up last year, interest rates are again ultralow. With the financial crisis long over, lenders are loosening up, approving borrowers with a few credit blemishes in their past. First-time buyers can again put down as little as 3%. You can apply for a mortgage right from your smartphone. More affordable "interest-only" loans are showing up on the menu at major banks. And not having a steady paycheck is no longer a barrier to financing a home.

Didn't this kind of easy lending, spurred by steadily rising home prices, spark the financial crisis in the first place? As home values recover across the country, is history repeating itself? Like real estate, "lending is cyclical," says Mark Calabria, director of financial regulation studies at the Cato Institute. "The longer prices increase, the looser lending standards get. We're not back at 2006, but we are a lot closer than we were in 2010."

It's one of the most absurd scenes in *The Big Short*. An exotic dancer tells an investor played by Steve Carell that she has qualified for not one but six mortgages by telling lenders she's a "therapist." After the housing crisis, loans for borrowers who couldn't (or wouldn't) document their incomes all but disappeared.

Good riddance, right? Not so fast. Plenty of Americans—from small-business owners to plumbers and contractors—can well afford a home yet never see a corporate paycheck. Without a W-2 tax form proving how much you make, you often don't pass muster in the world of highly automated bank underwriting systems. "There was a time when, if you were self-employed, it was almost impossible to get a mortgage," says Calabria.

That's starting to change. With yields on traditional fixed-income investments near rock bottom, some investors—such as private equity and hedge funds—are willing to make these types of loans again. “They are designed to allow a person to buy or refi when they have strong cash flow but also write off a lot of business expenses,” says Brian Hickey, a senior loan officer at Unity West Lending, who estimates he arranges two or three such mortgages a month.

As long as lenders stick to top-shelf borrowers, these loans aren’t necessarily “a flashing red light,” Calabria says. Of course, that’s a big if, especially if housing and the economy sour. Still, this time around, the rules are tougher for this bubble-era favorite that’s staging a minor comeback. Here’s how to borrow smart.

Amass your evidence

After getting burned in the financial crisis when borrowers who had never provided backup for their income could no longer pay, lenders that offer these loans—now called alternative income verification loans—are more rigorous, says Hickey.

To qualify, you’ll need a credit score of 680 and a down payment of 20% to 30%. You’ll have to produce statements showing two years of regular bank deposits to prove your earning power and enough easy-to-liquidate assets to cover a year of mortgage payments. You’ll pay a rate of 6% to 7%, plus one or two “points,” compared with less than 4% interest with no points for a conventional 30-year mortgage. And allow two months for the loan to close, since investors review the deals individually.

Curb your enthusiasm

While your portfolio may help you qualify, don’t be lulled into thinking you will be able to easily tap it to pay your mortgage. After all, if the economy turns south, your stocks might be down at the same time your business is flagging. “You need to make sure you can afford the house in a bad year, not just in a good year,” says Greg McBride, chief financial analyst at Bankrate.com.