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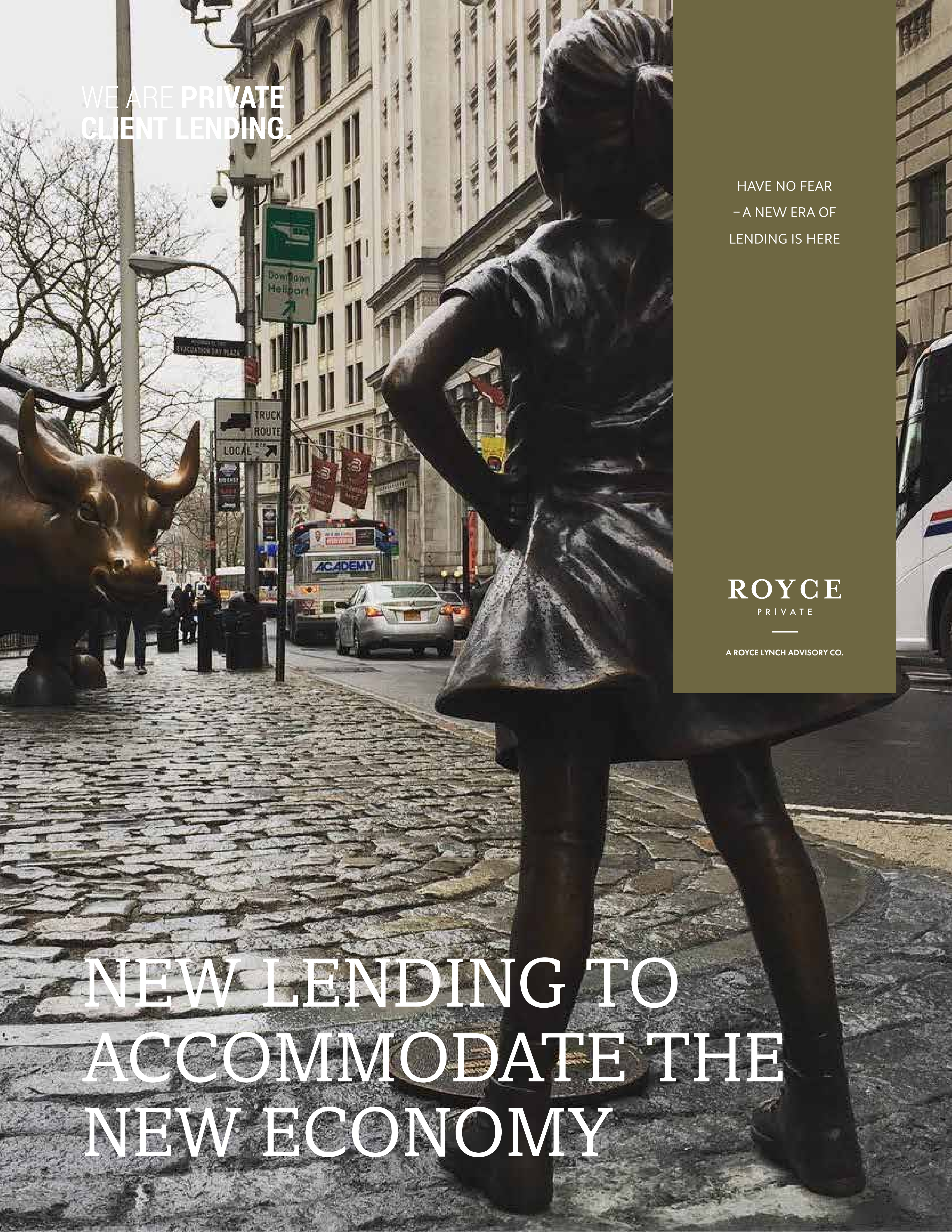

HAVE NO FEAR
– A NEW ERA OF
LENDING IS HERE

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NEW LENDING TO ACCOMMODATE THE NEW ECONOMY

Over the last decade a significant shift has taken place, one where workers have slowly moved away from the confines of corporate life and into a new era of digitalization that fosters far more diverse career options. In this new landscape people all over the world are connected instantly, facilitating networking and commerce in just a few clicks. Thanks to digitalization, workers from all walks of life, entrepreneurs, cubicle drones, contractors, and C-levels alike are now united by a common value: freedom and flexibility over stability and structure.

With digitalization, self-employment is on the rise. Today, more than 15 million Americans are self-employed, with 27 million more reporting they plan to be (or hope to be) leaving traditional jobs by the year 2020, which would bring the number to over 42 million.[1] In lieu of the 9-to-5, working for oneself has become a more universal sign of success, rather than the upward corporate career trajectory of the past. Today's workers want jobs that will allow them freedom to live on their own terms, with the flexibility to follow their dreams, whatever those may be.

The American Dream and the Rise of Digitalization

The American Dream has changed. It’s no longer the picket-fence and two-car garage in the ‘burbs. Walk into your local coffee shop and you’ll see it in front of you, typing on a laptop, sipping on a golden latte. The Digital Revolution is happening from coast to coast: in coffee shops, in libraries, in homes, and in co-working spaces; in small towns and major cities, millions of people working remotely, many self-employed either full-time, part-time, or as side hustles.

New technology has paved new avenues to being self-employed by providing countless ways to generate income, turning someone without an entrepreneurial bone in their body into a one-stop-shop by using their assets (AirBnB), time (Instacart), talent (Etsy) or skills (Upwork) — for example — to earn steady income. Self-employment goes beyond the “gig economy” and hipster Millennials. Although many do use apps to find temp work, young people working part-time only account for a fraction of the growing self-employed workforce.

The self-employed spans demographics — age, gender, ethnicity, education level, income. It’s comprised of business owners, independent contractors, consultants, free agents, virtual assistants, artists, tradespeople, writers, producers, realtors, IT directors, and many, many more. To be sure “self-employed” also encompasses those workers who don’t rely on self-employment to pay the bills, such as traditional 9-to-5ers who might moonlight for supplemental income. It’s the country’s most diverse workforce to date, and one largely defined by the high premium placed on flexibility and freedom.

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Co-Working and Virtual 'Office Space'

The collective move away from the office will only continue in coming years. Need proof? WeWork, a company that provides co-working spaces in major U.S. cities was recently valued at 45 billion dollars.[2] If investors didn't foresee the future of work moving toward virtual work, rather than cubicle farms or office complexes, why would WeWork be valued so heavily? Savvy forecasters understand modern professionals are motivated by a desire for agility, rather than a steady climb up the corporate ladder.

If investors didn't foresee the future of work moving toward virtual work, rather than cubicle farms or office complexes, why is remote work so popular?

And it's not just young people taking advantage of new technology to break free. Consider professional 30-somethings who want flex schedules so they can raise their children. Seasoned executives ready to test out their skills in the wild. Mid-career workers slowly being replaced by automation. Or what about Baby Boomers and even Gen X-ers who have been, or will be, edged out ("aged" out) of the workforce years before they're ready? Nearly 60% of all self-employed professionals aged 50-65 report wanting to continue working rather than retire.[3] In some cases, one could argue, it's the older workers who benefit most from remote work; with their experience they can often charge higher rates. Digitalization, while commonly relegated to Gens Y and Z, affects all generations, when expanding opportunities for work.

It's difficult to say whether the rise in technology has created more remote jobs, or the desire to work remotely has inspired innovation. But one thing is clear: the ones reaping the benefits are today's workers, especially the self-employed.

Virtual staff costs much less — as much as 20-30% less annually.

New Opportunities for Large Companies

Workers aren't the only ones who benefit from digitalization, however. Companies benefit too, and the larger the company, the bigger the advantages. With more employees preferring to work remotely, many businesses are also giving up the office (and office rent), and operating virtually.

It makes sense. Virtual staff costs much less — as much as 20-30% less annually — than hiring full-time employees who also require PTO and other compensation benefits.[4] With the Affordable Care Act, too, many companies have been forced to keep headcount low in order to stay afloat while complying with EEOC regulations.

Savings in revenue could also be attributed to the overall satisfaction many remote workers report, which minimizes turnover. Since hiring can be an enormous expense, with small business owners spending time and effort on hiring — as much as $7645 per recruit — the longevity remote workers demonstrate (due to perks like work-life balance), reduces turnover by as much as 50%, which boosts overall bottom lines.[5]

With so many contractors available for hire, large companies can now choose from a wide range of candidates no longer bound by geographic location, broadening the quality of talent. Thus, the flexibility remote workers enjoy also serves the companies that hire them.

Small Businesses Still Power the Economy

A healthy economy that supports self-employment is nothing new. For years, Americans of all backgrounds have owned and operated their own businesses. This is the backbone of any thriving capitalist society. Small businesses built this country, and today it remains true with 28.8 million accounting for 99.7% of all U.S. businesses, and employing almost half of the U.S. workforce. Small businesses are also proliferating, thanks to the internet. Only instead of on Main Street, money is being made on the web, and with unlimited "cyberspace," the possibilities are endless. You no longer need capital to open a storefront and set up shop. Now anyone with an idea and an IP address can start earning income.

Technology is also changing the way people do business, with apps like Docusign that make virtual contracts possible, Square for online payments, and Shopify for e-commerce, to name just a few. While small businesses have always been important, their impact has widened. Now they include everything from the mom & pop bagel shop that lets you order online, to the woman hawking leggings on Facebook, to the virtual agency contracting out to multiple corporations, to your next-door neighbors renting out their second home.

What do these new small businesses have in common with self-employed individuals? The shared value of freedom: the freedom to "do what you love" (and be fairly compensated for it); the freedom to set your own hours (whether part-time or over-time); the freedom to work wherever you want in the world (or the freedom to work from home).

Freedom also means the opportunity to own your own home. Home ownership has always been a defining step in the American Dream, then and now, available to people of diverse socio-economic statuses in a wide number of industries. These days, unfortunately, due to factors such as fluctuating U.S. Administrative policies and archaic lending practices that ignore present-day needs, obtaining a home loan, for many, has become less attainable than ever before, and especially for the self-employed.

The 2008 Housing & Credit Crisis “Reform”

The U.S. housing market was transformed when the government took control over the mortgage lending industry. The Dodd–Frank Wall Street Reform and Consumer Protection Act sought to oversee all aspects of home financing in order to prevent another market collapse. The story sold to consumers was the government needed to step in and tighten regulations so that vulnerable buyers would be protected from falling prey to evil and careless lenders. While reform measures seemed fair in theory, and indeed necessary in some aspects, in practice there were a few fundamental flaws.

NEGATIVE EFFECTS ON LENDERS

What the story didn’t include were the long-term consequences to home buyers and residential lenders. For one, the new, stricter regulations left lenders in a bind. Many if not most had been in good faith following best practices surrounding home loans during the time leading up to the crisis — a high-pressure climate to sell more-more-more, coupled with incentives and extremely low interest rates.

Two key clauses in Dodd-Frank also affected lenders. New regulations dictated all mortgages be divided into Qualified (QM) or Non-Qualified (Non-QM) mortgages. Now potential home buyers would have to meet even stricter standards to qualify for a loan. Essentially, QM = traditional W2 wage earners, while Non-QM meant . . . everybody else.

Prior to the housing collapse, proving buying power had been more flexible, with other factors also contributing to income, apart from or in addition to, a regular paycheck. In a situation with a borrower who was not a traditional wage earner, like a small business owner or self-employed worker, other criteria could be used for underwriting, such as FICO score, investment portfolio, trust fund, or cash in the bank. Not so under the new law. Lenders found it difficult to find prospects with adequate buying power under the new strict standards. As a result, they were forced to sell the loans their borrowers could afford: Fannie Mae and Freddie Mac — programs sponsored by the U.S. government.

The other clause outlined in Dodd-Frank, Ability to Repay (ATR), states the lender must: “make a reasonable and good faith determination based on verified and documented information that the consumer has a reasonable ability to repay the loan according to its terms.” Otherwise, if somewhere down the line the borrower stops paying, either unable or unwilling, the lender may be found in violation of ATR. How or under what terms this would be measured wasn’t clear, which is is precisely what got lenders worried. In fact, the clause was written in such ambiguous terms that any lenders who tried to originate loans other than QM could (potentially) be found in violation.

While potential for litigation might not seem a big deal to some, the threat of class-action lawsuits certainly scared off many lenders, new and inexperienced especially, who didn’t understand the ins and outs of Dodd-Frank or ATR well enough to risk it. The law was left open to interpretation, so to avoid any traps, many lenders decided to only service QM loans.

The crisis legislation was designed to keep a check on the market, but it instead created a climate that pushed many lenders out. Rather than cater to what was left of the market, a plethora of Non-QMs (thanks now in part to the slow, steady rise in self-employment), lenders were now faced with few choices: sell loans to an insurance company or Wall Street, and leave themselves vulnerable to untold litigation liability. Or do what the government wanted them to do and sell VA or FHA loans. Many lenders bowed down. But many more left the industry, and stayed gone.

Until now.

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NEGATIVE EFFECTS ON BORROWERS AND REFINANCERS

What should be noted is Dodd-Frank didn't only affect lenders. It affected borrowers too … lots of them. One negative consequence of ATR that has become more significant in the past few years is the huge segment of the population now completely shut out of lending. These potential home buyers aren't subprime loans, either. They are largely the self-employed and small business owners who can prove they are reliable earners. Now many of them find they're suddenly unable to be considered for a QM loan, to buy or even refinance a home they have made regular, timely payments on for years. And why not? Because they're not traditional wage-earners.

Without a W2, they can't comply with underwriting requirements, no matter how much money they may have in the bank. This could be one reason why more homes have been paid for in cash in the past few years, in spite of some of the lowest interest rates in history. In 2017 alone houses paid in cash accounted for almost 30% of all homes sold.[7]

Who buys homes for cash? It's not just investors. It's also the freelancers and independent contractors, the small business owners, and those who work side-gigs to supplement their income (but can't count the extra income as buying power) who also can't qualify for a QM loan. In short, the millions of self-employed: much of the new and growing workforce.

New Lending Caters to the New Economy

It's not all doom and gloom. In fact, the future of lending is looking brighter each day. We are excited to report that today, a number of market forces have converged to create a climate ripe for change: the rise of new technology and the digital economy; more workers now becoming self-employed; the proliferation of small businesses; and under the current Administration, a less hostile regulatory environment amid relaxing loan restrictions. A new era of credit is upon us indeed with the potential to be more versatile than ever.

This should be music to the ears of lenders who have been struggling in the QM space for years, relying on leads from realtors, or clocking hours of fruitless prospecting. The question now is how do we begin to serve this high-earning, highly credible, highly populated market — and in turn, serve the entire residential loan industry?

The good news is the new lending products are flexible, innovative, and accommodating, designed to not only serve high-income professionals, but many other types of borrowers as well, borrowers who might not fit inside a neat, little box: asset-rich retirees, foreign investors, trust fund kids, entrepreneurs, small business owners — and all 42 million of the self-employed, increasing and diversifying by the minute.

And where is this available market? Take another look and you'll see. It's all around you — sitting in your local coffee shop and beyond. Here at Royce Private we've created some exciting new strategies and lending products that will show you exactly how to reach them, and where to start.

The new era of lending is upon us, and we've only just begun.

Footnotes

[1] https://www.freshbooks.com/_themes/freshbooks/brand-assets/2018selfemploymentreport.pdf

[2] https://www.wsj.com/articles/softbank-boosts-wework-valuation-to-45-billion-1542121203

[3] https://www.freshbooks.com/_themes/freshbooks/brand-assets/2018selfemploymentreport.pdf

[4] https://recruiterbox.com/blog/freelance-vs-fulltime-pros-cons-hiring-independent-contractor

[5] https://smallbiztrends.com/2018/09/cost-of-hiring-a-new-employee-in-2018.html

[6] https://www.sba.gov/sites/default/files/advocacy/United_States.pdf

[7] https://www.pymnts.com/loans/2017/cash-payments-home-buying-mortgage-lending/

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We are pledged to the letter and spirit of U.S. policy for the achievement of equal housing opportunity throughout the nation. We encourage and support an affirmative advertising and marketing program in which there are no barriers to obtaining housing because of race, color, religion, sex, handicap, familial status, or national origin.