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RMBS – US

Cash Flow-Based Underwriting of Investment Property Mortgages Presents Unique Risks and Strengths

Summary

Investment property mortgages underwritten to property cash flows[1] pose unique risks, but also have strengths relative to similar loans underwritten to borrower personal income. Although focusing on income from an individual single-family rental (SFR) property relative to its mortgage payments could potentially prove a better gauge of default probability than focusing on a borrower's financials, such underwriting introduces new risks, for which there is limited historical information to assess. The extent to which lenders effectively address the risks will drive the overall credit quality and performance of such loans.

» Underwriting investor property loans based on mortgage payments relative to property-level rental income – property debt-to-income ratios (property DTIs) – rather than the personal DTIs of borrowers (borrower DTIs) will limit a lenders ability to assess borrower creditworthiness. However, some lenders appear to be contemplating several options that could partially address the lack of borrower financial information, such as incorporating in their guidelines (1) additional equity, higher credit scores or reserves requirements, (2) well-defined in-place lease/tenant eligibility criteria and/or (3) reviews of property owners/third-party managers for proficiency in overseeing rentals.

» Meanwhile, underwriting loans to property DTIs may allow a lender to better assess a borrower's propensity to default based on debt relative to the property cash flows, with a low property DTI indicating a low borrower incentive to default.

» Lenders already use debt service coverage ratios (DSCRs), a form of property DTI, to assess loans backed by pools of SFR properties, securitizations of which (including deals known as multi-borrower SFR transactions) we have rated in recent years. Although these loans could provide insight into the potential effectiveness of property DTI underwriting on single-property loans, and thus the performance of future securitizations of such loans, the performance of loans backed by SFR pools is still relatively untested.

New investment property mortgage underwriting creates new risks

Some SFR lenders are looking to originate investor property mortgages using a property DTI approach, viewing it as a better way to gauge borrowers' incentive to avoid default than borrower DTI.[2] Lenders are introducing the loans amid a surge in the use of single-family

homes for rentals as a result of the continued decline in homeownership since the financial crisis.[3]

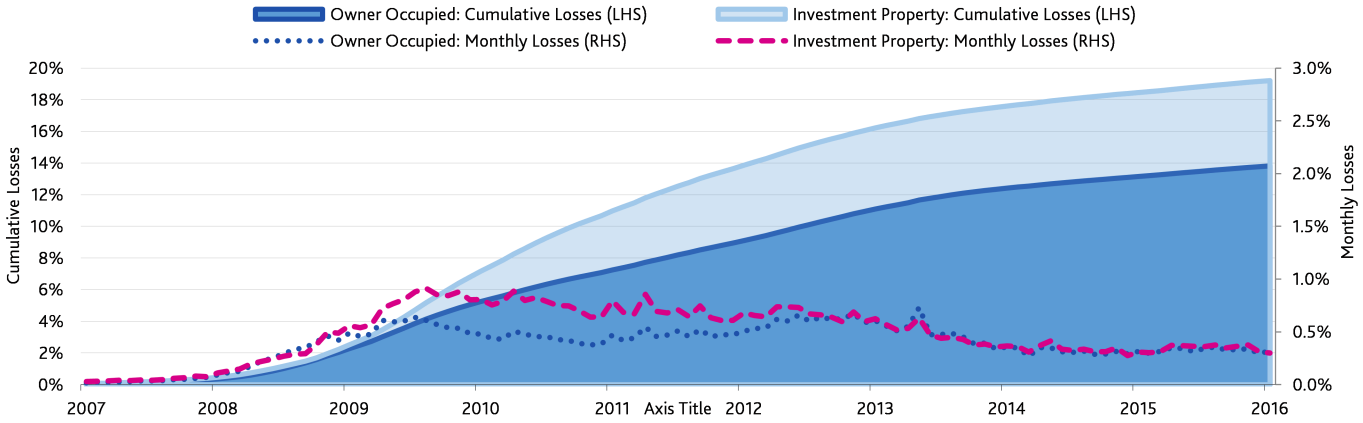
Originators of these loans will need to address several risks created by forgoing reviews of the overall financials of borrowers. Using property DTI underwriting on loans secured by single investment properties introduces risks stemming from the lack of visibility on a borrower's other debt obligations relative to a steady source of income that lenders can verify through documentation. For example, not examining borrowers' fuller financial profile could mean an inability to assess the availability of sufficient personal free cash flow to make the mortgage payments during tenant vacancies, or to cover unexpected costs tied to property maintenance or repairs. Borrowers who lack sufficient non-rental income are also more likely to divert rental income toward paying other liabilities, such as a separate mortgage on a primary residence or onerous credit card bills.

Property DTI-based loans also may have other risks. If originators treat these loans as commercial rather than residential loans, as allowed under regulation, they will not need to adhere to post-crisis rules that strengthen credit quality for residential loans, including appraiser independence and loan officer licensing/registration requirements. Furthermore, lenders will also face the potential for compliance violations if homeowners do occupy the properties; the Ability-to-Repay (ATR) rule requires specific underwriting steps to ensure owner-occupants can afford to repay their loans.[4]

In addition, there is limited historical data on mortgages underwritten using property DTIs. In contrast, investment property mortgages underwritten via borrower DTIs have significant historical performance information available, covering both loans guaranteed by Fannie Mae and Freddie Mac and loans included in private-label residential mortgage-backed securities (RMBS).[5] Moreover, as Exhibit 1 shows, such mortgages securitized in private-label RMBS suffered greater losses than securitized owner-occupied loans during the US housing crash. (For more information on recent performance of remaining loans, see Lower Default Rates Offset Higher Liquidation Losses in Pre-Crisis Investor-Property Loans, 12 April 2016).

Exhibit 1

Investment Property Mortgages Suffered Greater Losses During Housing Crash



Note: RMBS transactions issued between 2003-07. Cum losses represent % of original balances, monthly losses represent % of current balances.
Source: Moody's Investors Service; ABSNet Loan® (registered trademark of Lewtan)

Lenders appear to be addressing the various risks posed by a property DTI approach in a number of ways, including by requiring adequate credit scores, strong homeowner equity and liquid reserves. Higher credit scores will indicate a borrower's general creditworthiness. Higher equity will discourage borrowers from diverting cash flows from rentals to cover other expenses, allow borrowers to sell negatively cash flowing properties before defaulting, and reduce losses upon foreclosure. Requiring borrowers to have significant reserves at closing helps ensure they can handle unexpected property expenses or vacancies.

Some lenders appear to be further mitigating risks associated with property DTI-based underwriting by deploying criteria not generally required for traditional investment property loans, such as requiring in-place leases, and reviews of property owners and/or third-party property managers to assess their proficiency in overseeing rentals.

A property DTI underwriting approach could further be strengthened by leveraging certain aspects of the more rigorous residential mortgage criteria. For instance, some lenders are considering using full appraisals rather than broker price opinions or automated valuation models and diligent appraiser selection processes. Lenders may also use certain origination procedures (such as reasonability checks or borrower attestations) to address legal risks tied to "reverse occupancy fraud," in which a borrower lives in a home they were supposed to rent out. Although a loan to such a borrower likely would not meet the ATR requirements, the lender could avoid penalties if the borrower attested that they plan to rent out the property.

Checks and balances in underwriting process will be especially important because these loans could draw a weaker set of borrowers who are unable to qualify for traditional investment property loans, which typically carry lower costs. Borrowers that qualify for traditional investment property mortgages might choose property DTI-based loans instead in order to finance more properties overall than allowed under traditional programs[6] or to avoid potentially impairing their personal credit profiles.[7]

Property DTI underwriting and other product features offer some strengths

Although a property DTI-based approach introduces some risks, the approach allows a lender to assess the level of debt expenses relative to the cash flows that a rental property will generate (with haircuts for various items), and thus how large of an incentive the owner will have to avoid defaulting on the mortgage. Similar to commercial mortgage underwriting, property DTI-based underwriting takes into account a range of items that can affect the profitability of a rental for a landlord. Exhibit 2 shows how the metric can be calculated.

Exhibit 2

	Amounts
Income	
Annual Lease	$13,615
Adjustment Based on Market Rents (If below lease)	-1,000
6% Haircut (Reflecting potential vacancies, etc)	-757
Gross Income:	11,858
Expenses	
Principal and Interest ($100,000 mortgage at 5%)	6,442
Taxes	1,080
Insurance	1,020
Homeowner Association Fees	300
Total Debt Expenses	8,842
Property DTI (Total Debt Expenses/Gross Income)	75%

Note: Representative calculation. Lenders may use different terms and different calculations
Source: Moody's Investors Service

Using a property DTI analysis can help prevent situations where borrowers can qualify for loans on rentals that are not producing positive cash flows. For example, a borrower that qualifies for a loan based on borrower DTI might appear to have sufficient total income to cover the mortgage obligation, but instead may have higher debt relative to the specific property cash flows.

In addition, under a borrower DTI analysis, a borrower can potentially get loans when they do not have in-place leases for a rental property. The lack of a lease could lead the borrower to overestimate the property's income potential, making them more likely to walk away from the mortgage during a downturn in home prices. Requiring in-place leases and positive property cash flows also helps guard against short-term property speculation, which would leave a loan more exposed to home price declines and idiosyncratic challenges.

Loans in multi-borrower SFR securitizations use a measure similar to property DTI

DSCR, a form of property DTI, is already a standard metric lenders use to underwrite loans secured by multiple SFR properties. Although those loans have some positive and negative attributes relative to single-property loans, the performance of these multi-property SFR loans and securitizations could provide some insights into the performance of similar single-property loans and the effectiveness of property DTI underwriting. However, the performance on such loans is relatively untested given the short history of such deals being securitized.

Moreover, the diversity of the collateral securing loans included in multi-borrower SFR deals and larger sizes of portfolios owned by their borrowers present several benefits that single-property SFR loans lack. For instance, a borrower with multiple homes can use excess rents from one to service their debt during vacancies on another. In addition, borrowers financing multiple properties are likely to be more sophisticated managers that utilize economies of scale to reduce expenses. Also, loans in multi-borrower SFR deals require property managers to provide regular reports on items such as rent rolls and, in certain cases, detailed overviews of incomes and expenses. In some cases, such managers also must employ cash management mechanisms such as lockboxes and cash-trapping triggers. Smaller landlords will likely have less ability and experience with these operational aspects, and may not need to deploy some of them as a condition of the loans.

Exhibit 3 shows some general features of different categories of loans secured by single-family rentals.

Exhibit 3

	GSE investor loans	Non-agency investor loans	Single asset SFR	Multiborrower SFR	Traditional SFR
Typical Number of Properties as Collateral	1	1	1	10-500	2,800-5,500
Loan size	Up to $625,500	$100,000-$1.5m+	$75,000-$1m+	$400,000-$50m+	$300m-$1.2b+
Maximum LTV	85%	65-95%	75%-80%	75%	80-85%
Maximum DTI	36-50%+	36-50%	85% (Property DTI)	N/A	N/A
Typical Underwritten DSCR	N/A	N/A	N/A	1.05x - 2.70x	1.29x - 3.25x
Minimum FICO	620-720	660-720	620-680	N/A	N/A
Underwriting Approach	Residential	Residential	Business	Business	Business
Valuation	Appraisals	Appraisals	Appraisals	Appraisals/BPOs	BPOs
Fixed/Floating	Mostly fixed, some floating	Mostly fixed, some floating	Fixed	Fixed	Mostly floating, some fixed
Loan term	30 years	30 years	30 years	5-10 years	5-10 years
Amoritization	Amortizing	Mostly amortizing/Some interest only	Amortizing	Mostly amortizing	Mostly interest only

Note: Information reflects typical range of guidelines and attributes and will not capture all versions of programs.
Source: Moody's Investors Service

Moody's Related Research

Sector In-Depth

Declining First-Time Home Ownership in the US is Credit Positive for SFR Securitizations, 7 June 2016

Lower Default Rates Offset Higher Liquidation Losses in Pre-Crisis Investor-Property Loans, 12 April 2016

Higher-Than-Expected Net Operating Expenses Are Credit Negative for SFR Transactions, 16 February 2016

SFR Securitizations Benefit from Alignment of SFR Operators' Economic Interests 16 February 2016

First Defaulted Loan in Colony 2015-1 Multi-Borrower SFR will Have Negligible Credit Impact, 9 February 2016

Underperforming Loan in FirstKey Lending SFR Deal Will Have Slight Impact on Performance, 16 December 2015

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

1 These mortgages are sometimes called "single-borrower single-property," "single-asset" or "single-loan program" single-family rental mortgages or "investor cash flow mortgages" and mainly differ from traditional investment property mortgages because of the different underwriting approach. They differ from loans included in so-called multiple borrower SFR transactions partly because they are backed by single properties, rather than multiple homes.

2 The borrowers for these loans can be either individuals or special-purpose vehicles, whose owner(s) would serve as a guarantor. In this report, we use the term "borrower" to mean either the individual borrower or the guarantor of the SPE.

3 See Census Bureau's 28 July 2016 press release.

4 See final rule on Consumer Financial Protection Bureau website.

5 The share of 1-to-4 family mortgage originations used to finance investment properties totaled about 8.5% by loan count in 2006, and almost 7% last year and early this year, according to CoreLogic data. About 7% of outstanding 1-to-4 family mortgages are secured by investment properties.

6 Fannie Mae allows borrowers to own up to 10 financed properties, while Freddie Mac allows up to six. However, some originators set lower limits.

7 If a landlord is borrowing through an SPE, the obligation may not show up on their personal credit reports.

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