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RMBS - US

# Lower Default Rates Offset Higher Liquidation Losses in Pre-Crisis Investor-Property Loans

## Executive Summary

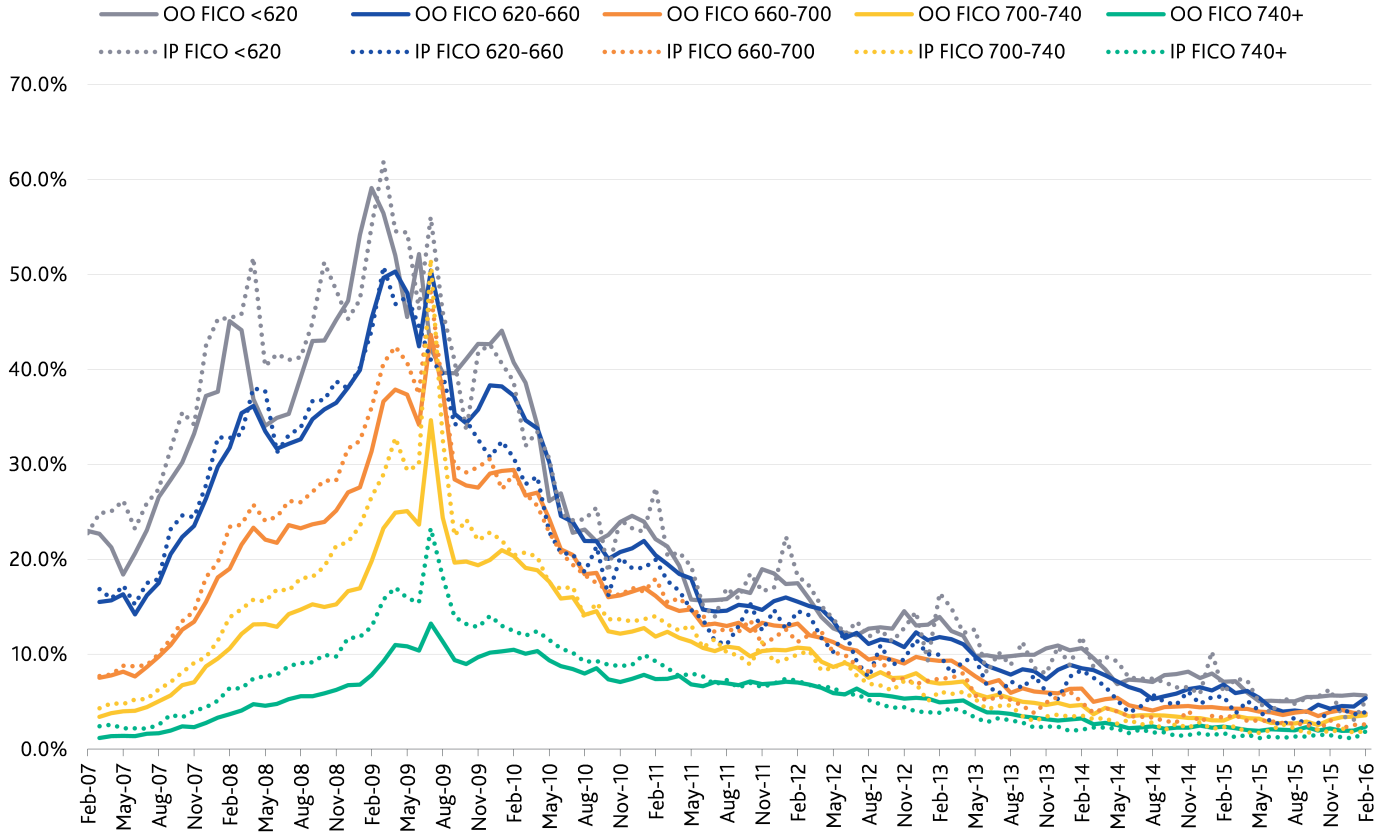
Loans for investor properties[1] in pre-crisis RMBS are defaulting at lower rates than are loans for owner-occupied properties. Because investor property loans are less likely to receive modifications and have higher loss severities in comparison with owner-occupied loans, the losses for the two types of loans are about the same. This trend will likely continue as long as the economy is growing and rental demand remains strong, but if the economy slows, investor loans will default at higher rates than owner-occupied loans with similar borrower characteristics, as they did during the 2007-09 economic downturn. That said, investor-property loans with loan-to-value ratios (LTV) below 70 to borrowers with FICOs over 740 will likely perform as well as or better than most of the owner-occupied loans will in any economic scenario.

## Investor-property loan defaults have fallen below owner-occupied loan defaults as the economy has improved

Pre-crisis investor-property loan defaults have fallen below defaults on loans for owner-occupied properties as the economy has grown in the wake of the financial crisis. Exhibit 1 shows that since early 2011 investor loans in RMBS transactions issued between 2003-07 have been defaulting[2] less frequently than have owner-occupied loans with comparable borrower FICO scores[3]. During the financial crisis, however, investor loans did default much more frequently than comparable owner-occupied loans.

Exhibit 1

**Default Rates for Private-Label RMBS Investor-Property Loans and Owner-Occupied Loans Vary by FICO scores**




*Source: Moody's Investors Service; ABSNet Loan® (registered trademark of Lewtan)*

The recent lower default rates on investor loans are the result of strong rental demand. Strong rental demand helps investor loan borrowers that run into financial difficulty retain their properties because if the properties are generating sufficient rental income, the borrowers will be able to make their mortgage payments. Default rates on investor loans will remain low because rental demand will likely remain strong and unemployment low, at least through 2017. Single-family rental (SFR) property operators have been able to raise rents by 3%-5% on average, an indication that rental demand is strong[4]. Several factors contribute to the continuing strong rental demand, such as:

» A historically low homeownership rate of just above 60%[5], a result of tight lending standards

» A steadily growing rate of household formation

» Adverse credit events (foreclosure, short sale, or bankruptcy) during crisis years that are still affecting the credit of many would-be buyers

If the US economy enters another severe downturn, investor loans will likely resume defaulting at higher rates than comparable owner-occupied loans. Owner-occupied loans experienced lower default rates during the 2007-09 downturn because owner-occupied borrowers had stronger incentives to keep current on their mortgages so that they could remain in their homes. By contrast, investors were more willing to walk away from their mortgages, especially if their rental income became insufficient to cover their mortgage payments.

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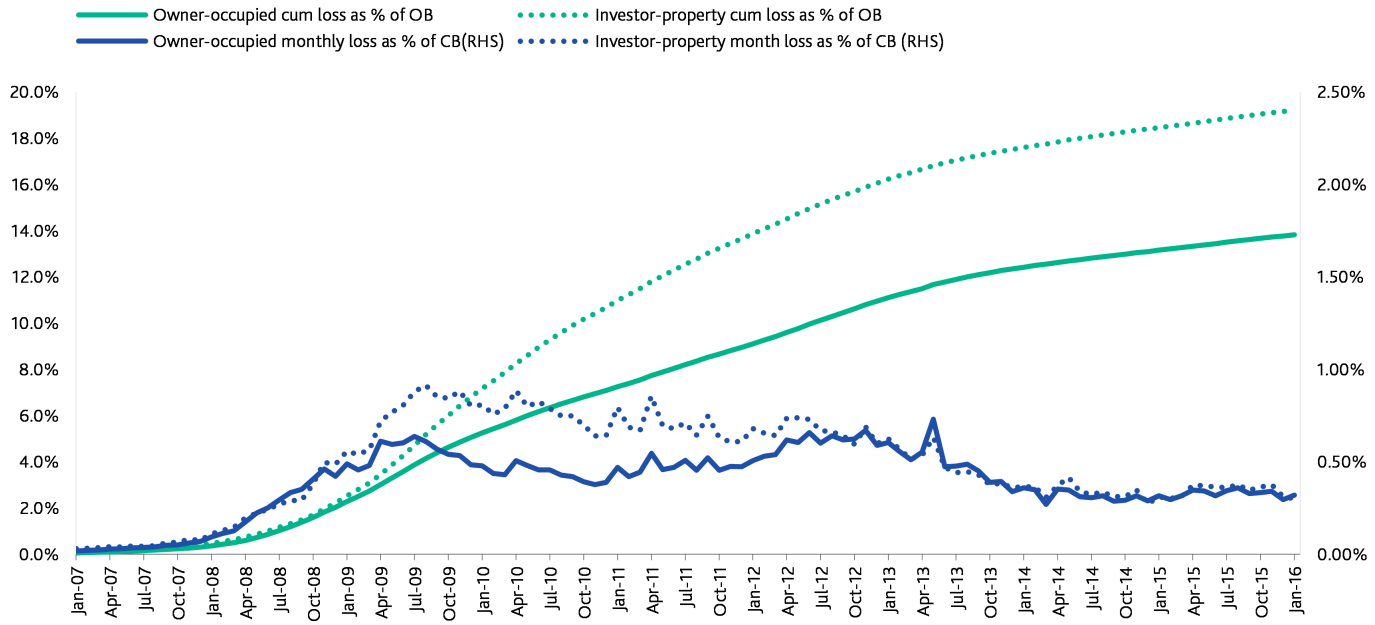
## Despite fewer defaults, losses on investor-property loans are in line with those on owner-occupied loans

Even as investor loan defaults have fallen below owner-occupied defaults, losses on investor loans are in line with losses on owner-occupied loans. Exhibit 2 shows that since late 2012 monthly losses on investor-property loans have been at the same level as losses on owner-occupied loans. However, cumulative losses on investor loans over the same time frame remain higher than those on owner-occupied loans owing to losses incurred during the crisis.

Exhibit 2

**Cumulative Losses on Investor-Owned Property Loans Are Higher Than Those on Owner-Occupied Property Loans , but Monthly Losses Are Similar**

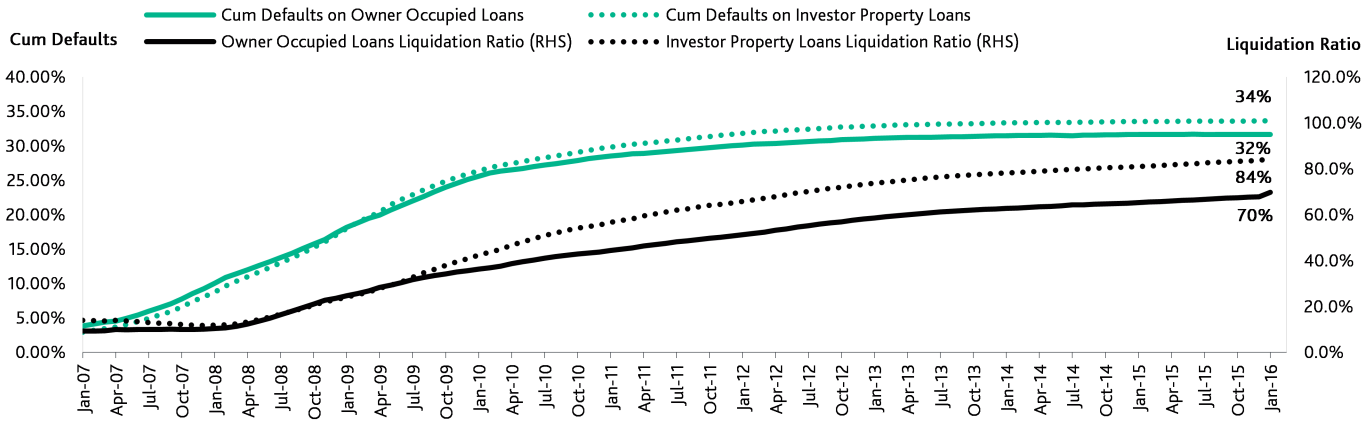



*Source: Moody's Investors Service; ABSNet Loan® (registered trademark of Lewtan)*

One reason that defaulted investor loans still incur the same level of losses as owner-occupied loans do despite fewer defaults is because investor properties backing seriously delinquent loans are more likely to be liquidated than owner-occupied properties. Exhibit 3 shows that since 2007 servicers liquidated properties on about 84% of the seriously delinquent investor-property loans, as compared with about 70% of the owner-occupied property loans. The higher share of liquidations on investor-property loans makes sense because once the borrower of an investor property loan becomes seriously delinquent, the borrower is less likely to get a loan modification than an owner-occupied borrower is and more likely to go through a foreclosure or a short sale. The servicer is more likely to offer a modification to an owner-occupied borrower to help this kind of borrower remain in the home; a modification is less likely to incentivize an investor to keep a property if the property's rental income makes for a poor investment.

Exhibit 3

**Servicers Liquidated a Larger Share of Seriously Delinquent Investor Properties Than Owner-Occupied Properties**



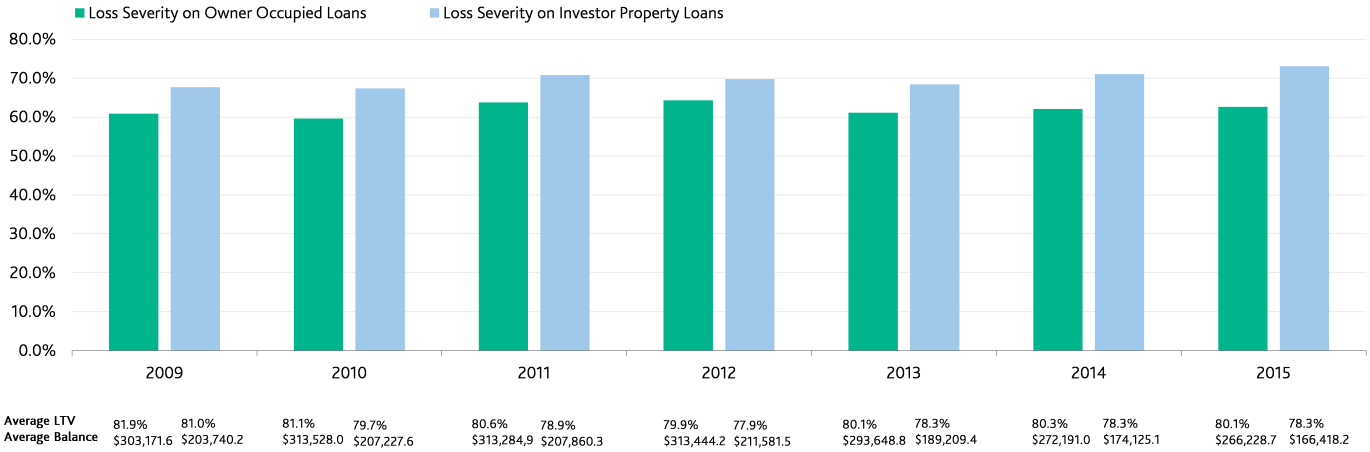

*Source: Moody's Investors Service; ABSNet Loan® (registered trademark of Lewtan)*

Another reason that investor-loan losses are about the same as owner-occupied loan losses is that defaulted investor loans incur higher loss severities than do owner-occupied loans. Exhibit 5 shows that liquidated properties that backed seriously delinquent investor property loans on average had higher loss severity rates in each year since 2009. Higher loss severity on investor loans is the result of their smaller balances and the likely lower quality of the underlying properties. Losses on lower-balance loans are typically higher because the fixed liquidation-related costs, such as foreclosure-related legal fees, are larger as a proportion of the loan balances.

Exhibit 4 shows that investor loans on average have consistently had significantly smaller balances than owner-occupied loans, although their LTVs are comparable. Lower average loan balances and similar LTVs on investor-property loans suggest that on average the values on investor properties are somewhat below the values on owner-occupied properties. Lower values indicate that investor properties might be of a lower quality or located in a less desirable area. Going forward, loss severities should remain higher on investor loans because the average balance of currently-delinquent investor loans is lower than that of delinquent owner-occupied loans. As of February 2016, average loan balance of the seriously delinquent investor loans was $190,804, or about 33% below the average loan balance of $285,349 for the seriously delinquent owner-occupied loans, but LTVs were about the same, at 77.5% and 79.5%, respectively.

Exhibit 4

**Properties Backing Investor Loans Were Consistently Liquidated with Higher Loss Severities than Those Backing Owner-Occupied Loans**



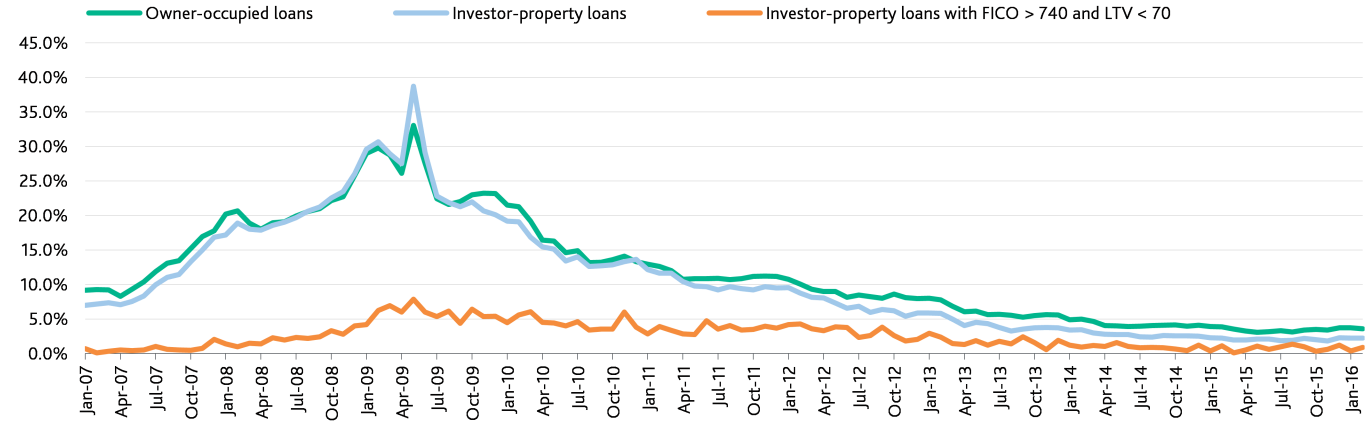

*Source: Moody's Investors Service; ABSNet Loan® (registered trademark of Lewtan)*

## Higher-quality investor-property loans will perform as well as or better than average-quality owner-occupied loans

Investor-property loans with LTV ratios below 70 to borrowers with FICOs over 740[6] will likely perform as well as or better than most of the owner-occupied loans in any economic scenario. Exhibit 5 shows that investor-property loans with FICO over 740 and LTV below 70 have defaulted less frequently than average owner-occupied loans during the 2007-09 recession and in a growing economy. One reason for this lower default rate is that investor loan borrowers with high credit scores will likely have the financial resources and willingness to continue making mortgage payments for some time, even when a property cannot be rented. In addition, having 30% or more equity in the property bolsters a borrower's incentive to maintain the ownership.

Exhibit 5

**Default Rates on Investor Loans With High FICO And Low LTVs Have Always Stayed Below Average Default Rates on Owner-Occupied Loans**




*Source: Moody's Investors Service; ABSNet Loan® (registered trademark of Lewtan)*

## Endnotes

1 Investor-property loans are loans given to borrowers who use the properties as investments rather than as their own residences. These loans are underwritten based on borrowers' personal financial information. For this research, we have examined private-label RMBS loans originated between 2003-07. As of February 2016, the outstanding balance of the investor-property loans covered in this research is $32 billion and that of the owner-occupied loans is $351 billion, which are 7.1% and 78% of the total outstanding balance of private-label RMBS loans, respectively.

2 The default rate is defined as an always-current-to-default roll rate calculated as an annualized transition rate at which always current loans become 60 or more days delinquent and transition to foreclosure or to REO.

3 Weighted average LTV ratios for the investor-property loans and owner-occupied loans in different FICO buckets are similar. We have also reviewed the default rates on investor-property loans and owner-occupied loans in different LTV buckets and have not found their performances to be materially different from each other.

4 Investor-property borrowers' ability to increase rents may differ from that of large institutional single-family rental (SFR) operators. However, a steady increase in rents by SFR operators indicates strong rental demand for single family homes, which benefits all single family rental units, including those backed by investor-property loans.

5 According to data from Moody's Analytics, US homeownership rate was 63% for year 2015

6 The outstanding balance of investor-property loans with LTV ratios below 70 and FICOs over 740 is $9.0 billion as of February 2016, which represents 28% of the total outstanding balance of all investor-property loans.

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