Enhanced Underwriting for New Breed of Single-Family, Single-Property Investor Loans

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Morningstar Credit Ratings, LLC has found that investor loans where the property income exceeds 1.2 times the debt service have generally experienced a better-than-average default rate. A new type of investor property loans has emerged from single-family rental originators such as B2R Finance L.P., FirstKey Lending LLC, and Colony American Finance LLC. Underwriting guidelines reviewed by Morningstar vary among originators, but they all focus on qualifying borrowers based on property income rather than personal income. This approach makes sense: borrowers should be less likely to default if a property generates enough rent to cover debt obligations and are more likely to default if the debt service exceeds the rent. It is common practice for commercial lenders to look at debt service coverage ratios as a key driver of default, and it seems logical to apply this approach to single-property investor loans.

Single-family, single-property investor loans have traditionally been underwritten as residential rather than commercial loans. Borrowers of these residential investor loans provide the lender with the expected rental income with a portion of this rent added to the borrower's personal income. However, lenders typically focused on the borrower's personal credit and income data and were less concerned with the ability of the property cash flow to cover the debt service.

To quantify the impact of debt service coverage on default, Morningstar analyzed more than 900,000 nonagency investor property loans originated from 2002-07. A challenge in performing this analysis is that rent is not typically provided for traditional investor property loans that are underwritten to a borrower's personal income and personal credit. The rent can be included in the denominator of the borrower's debt-to-income ratio, but there is no way to segregate the property income from the borrower's personal income. Therefore, Morningstar attempted to match regional rent estimates from RentRange LLC to individual investor properties in the CoreLogic Inc. nonagency loan-level data. Details of this analysis and related assumptions can be found under the research section at https://ratingagency.morningstar.com.

The results showed significantly lower defaults for investor loans with rents exceeding debt service payments and higher defaults for similar loans with rents that do not cover debt obligations.

For example, examining loans with a borrower FICO score greater than 699 and a combined LTV less than or equal to 70, Morningstar found that, at 12%, the default rate for loans where rental income covers only half of the debt service amount was more than double the 5.6% default rate of loans where rental income covers twice the debt service amount.

Table 1 - FICO > 699, CLTV <= 70

Rent/PITI* Ratio	Default Rate (%)
<0.4	11.6
0.4-0.6	12.0
0.6-0.8	13.4
0.8-1.0	11.9
1.0-1.2	9.8
1.2-1.4	7.4
1.4-1.6	7.1
1.6-1.8	6.6
1.8-2.0	5.6
>2.0	5.4
Average	9.4

*Principal, interest, tax and insurance.

Therefore, when underwriting an investor property loan where rent is available and verified, default projections can be adjusted based on the amount of (or lack of) excess rent.

Morningstar expects these single-family, single-property investor loans to be a driver of single-family rental market growth. According to market participants, borrower demand for these loans is strong and the current residential mortgage underwriting process is arduous for borrowers and limits financing options for small investors.

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