

# The Myth of the Irresponsible Investor: Analysis of Southern New England's Small Multifamily Properties

By Jeffrey Greenberg, Ren Essene, and Kai-yan Lee

Representing 21.6 percent of southern New England's housing stock, small multifamily (SMF) properties (defined here as two- to four-unit properties) are vital to the supply of affordable rental housing in Rhode Island, Massachusetts, and Connecticut.<sup>1</sup> From Q1-2005 through Q1-2009, 74.1 percent of SMF properties in southern New England were purchased by owners intending to occupy one of the units ("owner-occupants"); another 25.3 percent were purchased by investors living outside the property. Analyzing and comparing the borrowing trends of these owner-occupants and investors in the SMF property market reveals that investors may not engage in as much risky behavior as public sentiment leads one to expect. In fact, our analysis shows that owner-occupants have riskier borrower characteristics and take out riskier mortgage products than their investor counterparts.

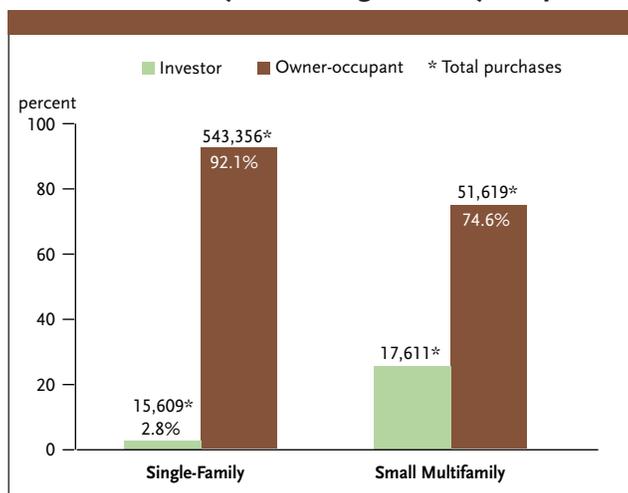
Not surprisingly, investors prefer purchasing SMF properties over single-family properties. Having multiple units in a property allows investors to collect rent from several different occupants, reducing the risk of vacancy losses and providing better cash flow. Figure 1 illustrates the more significant role of the investor in small multifamily properties than in the single-family market.<sup>2</sup>

SMF properties provide housing for many people in low- and moderate-income (LMI) communities throughout southern New England, as Figure 2 illustrates. This concentration of SMF properties in LMI ZIP codes likely reflects the makeup of the neighborhoods' housing stock, including a large share of

historic "triple-deckers." Starting in the late 1800s, SMF properties helped recently immigrated, working-class families to buy property for themselves and rent out additional units, frequently to relatives.<sup>3</sup> The differences across neighborhoods' housing stock may also reflect the active policy decisions in non-LMI communities, where zoning laws explicitly and implicitly restrict the construction of affordable, multifamily housing and the conversion of single-family properties for multifamily uses.<sup>4</sup>

Recent public opinion and public policy favor rescuing struggling owner-occupants while excluding investors facing similar difficulties. When President Obama announced the \$75 billion foreclosure prevention package, he responded to public sentiment by highlighting that the program would help only owner-occupied homes and not speculative investors.<sup>5</sup> Likewise, regional programs, such as the "90-Day Right to Cure" in Massachusetts, deliberately exclude investors from receiving government assistance.<sup>6</sup> No one wants to reward the speculative behavior that was common among investors in California,

**Figure 1: Investors Purchase More Small Multifamily than Single-Family Properties**



Source: LPS Applied Analytics.

Note: For southern New England first-lien purchase loans originated between Q1-2005 and Q1-2009, excluding second homes. Calculated by the Federal Reserve Bank of Boston.

The main source of data for this article is Lender Processing Services Inc.'s Applied Analytics (LPS), formerly known as McDash. The LPS database covers around 70 percent of the entire mortgage market of southern New England, especially loans administered by large servicers, and approximately 75 percent of the prime securitized mortgage market. However, LPS has limited coverage of the subprime market. First American LoanPerformance (LP) data from nonagency securitized pools are also used. The LP database captures about 70 percent of the subprime securitized mortgage market with limited coverage of the prime market.

This article uses the dataset with the best coverage ratio and, when necessary, consolidates the two datasets to ensure sufficient coverage. The data are first-lien purchase loans and therefore do not include second-lien and refinance loans. The mortgage origination data do not represent the total property stock for a given year. For chart 1, a low- and moderate-income (LMI) ZIP code is defined as a ZIP code where the median income is at or below 80 percent of the state median income. For the purposes of this article, we focus on Q1-2005 through Q1-2009 data. For our foreclosure petition analysis, we focus only on borrowers who received petitions between Q1-2005 and Q1-2009 for first-lien purchase loans originated in 2005.

Florida, Arizona, and Nevada and fueled the real estate bubble. However, according to mortgage data provided by major servicers, that cowboy approach to real estate was not as common in southern New England.

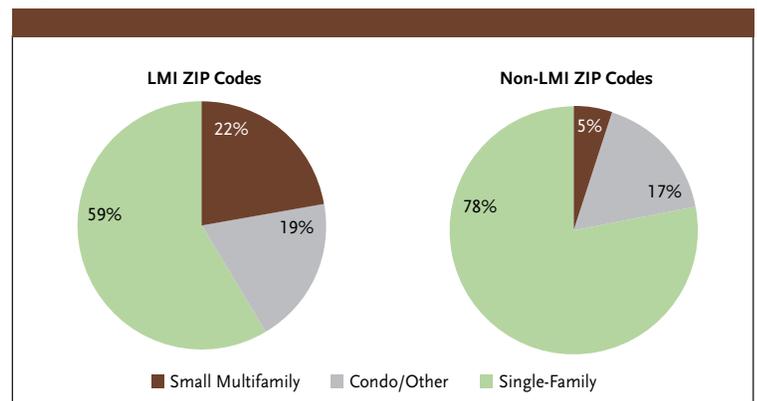
A common misperception of investors is that, compared with owner-occupants, they have “less skin in the game,” worse borrower characteristics, and are more likely to foreclose on a property when the market drops.<sup>7</sup> Figure 3 compares investors' and owner-occupants' characteristics at loan origination and identifies investors as having better credit quality and taking on less risk than owner-occupants.<sup>8</sup> The prima facie explanation for this phenomenon is that, on the whole, SMF property investors are simply better qualified than owner-occupants.

Another explanation for investors' stronger characteristics could be that investors face stricter loan underwriting criteria in the secondary market than their owner-occupant counterparts. Servicers explain that these differences stem from the perception that investors have less emotional attachment to their properties and, as a result, have a greater potential for negative consequences. Conclusions drawn from Figure 3 must also take into account that the data have better coverage of servicer loans than portfolio loans. Also, these data exclude loans that investors may turn to if they are denied conventional mortgages, such as private loans and those from “hard money lenders.”

In addition to owner-occupants having riskier borrower characteristics, they also use riskier mortgage products more commonly than investors to purchase SMF properties. Figure 4 illustrates that subprime loans were used in comparable proportions among investor and owner-occupant purchasers of single-family properties. However, subprime mortgage products are used far more commonly among owner-occupant purchasers of SMF properties than investors.

Anecdotes from owner-occupant purchasers of SMF properties reveal that some buyers are being “upsold” by realtors who downplay the risk of SMF ownership.<sup>9</sup> In recent interviews, first-time buyers explained they began their home searches looking for single-family homes, but were then convinced by mortgage brokers

**Figure 2: Small Multifamily Homes Make Up a Significant Portion of Purchases in LMI Communities**



Source: LPS Applied Analytics.

Note: For first-lien purchases originated between Q1-2005 and Q1-2009. LMI ZIP codes = ZIP codes where the median income is less than or equal to 80% of the state's median income. Data represent ZIP codes in RI, MA, and CT. Calculated by the Federal Reserve Bank of Boston.

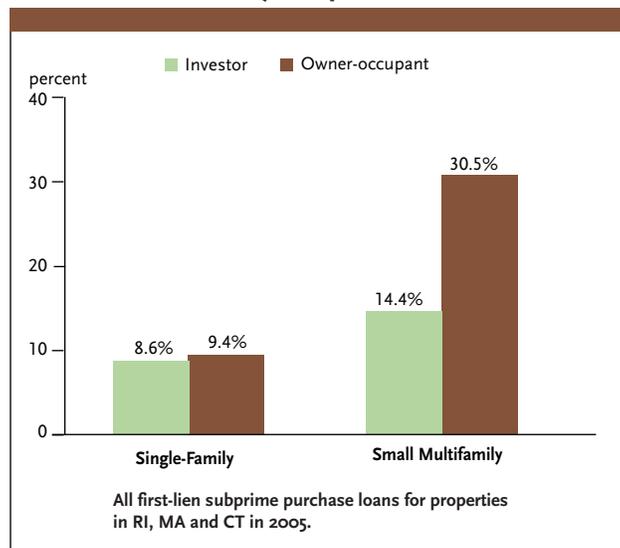
**Figure 3: Investors in Small Multifamily Properties Have Less Risky Borrower Characteristics and are Less Leveraged than Owner-Occupants**

Underwriting Indicators	Investor	Owner-occupants
Loan Amount	\$217,600	\$244,800
LTV Ratio	70	78.26
DTI Ratio	39	41
FICO Score	720	688

Source: LPS Applied Analytics

Note: Underwriting indicators are median values at time of first-lien purchase loan origination from Q1-2005 through Q1-2009 in RI, MA, and CT. Calculated by the Federal Reserve Bank of Boston.

**Figure 4: Subprime Loans are Most Common Among Owner-Occupants of Small Multifamily Properties**



Source: LPS Applied Analytics (LPS) and First American Loan Performance (LP).

Note: We consolidated the prime loans from LPS with the subprime and alt-a loans from LP. Each bar in the above chart displays the percentage of subprime loans. Calculated by the Federal Reserve Bank of Boston.

or realtors—on the basis of rental income and the perception that home values would continually increase—to purchase more expensive SMF properties. As owner-occupants buy beyond their budget, they become riskier borrowers and rely more heavily on riskier subprime mortgage products.

An unambiguous indicator of increased risk and overstretched budgets is the percentage of owner-occupants receiving foreclosure petitions. Figure 5 shows, by loan type, the percentage of investors and owner-occupants who received foreclosure petitions. Other than single-family prime loans, across other product and property dimensions, owner-occupants who purchased properties in 2005 received a higher percentage of foreclosure petitions than investors. The significant share of petitions received by subprime mortgagees also stands out for owner-occupants. In fact, for loans originated in 2005, over one-third of owner-occupants (35.4 percent) with subprime mortgages on SMF properties received at least one foreclosure petition by March 2009. For prime loans, more than twice the percentage of owner-occupants who bought SMF properties received foreclosure petitions (8.7 percent) compared with single-family properties (4.0 percent).

Another indication of owner-occupants being more vulnerable and overstretched financially than investors is the speed with which they receive their first foreclosure petitions. Figure 6 shows, by state, the length of time between origination and the first foreclosure petition for owner-occupants and investors. Rhode Island has the biggest disparity, as the median time it takes for an owner-occupant to receive a first foreclosure petition is 229 days earlier than for an investor.

Contrary to public opinion, mortgage data from Q1-2005 through Q1-2009 illustrate that owner-occupants have riskier borrower characteristics, take out riskier loans, have greater numbers of foreclosure petitions, and move more quickly into foreclosures than investors. However, limitations of the datasets may make it difficult to draw conclusions for the market overall. Further research could explore alternative lending channels and evaluate the differences between owner-occupants and investors as landlords of SMF properties. While the data may capture some

differences in loan underwriting, the comparison of owner-occupants and investors is compelling. The results underscore the importance of informing lenders and the public on the actual risks associated with small multifamily properties. Overall, the emotional attachment of being an owner-occupant does not negate the increased risks of less stringent underwriting criteria nor the risks associated with the use of subprime lending products.

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## Endnotes

<sup>1</sup>Small multifamily housing represents just one-tenth of housing units nationwide. Rhode Island, Massachusetts, and Connecticut are the three states with the highest shares of housing units in SMF properties, with 25.2 percent, 23.0 percent, and 17.8 percent, respectively, 2000 Census. While these first statistics focus on the housing stock, the remainder of the article is concerned with the flow (purchases) of properties..

<sup>2</sup>The investors' market share may even be underrepresented in this chart as a result of some banks keeping investor loans in their portfolios rather than selling them on the secondary market.

<sup>3</sup>Abby Goodnough, June 20, 2009.

<sup>4</sup>Jenny Schuetz, July, 2006.

<sup>5</sup>Michael A. Fletcher and Renae Merle, February 19, 2009. President Obama said further, "[This foreclosure prevention plan] "...will not rescue the unscrupulous or irresponsible by throwing good taxpayer money after bad loans."

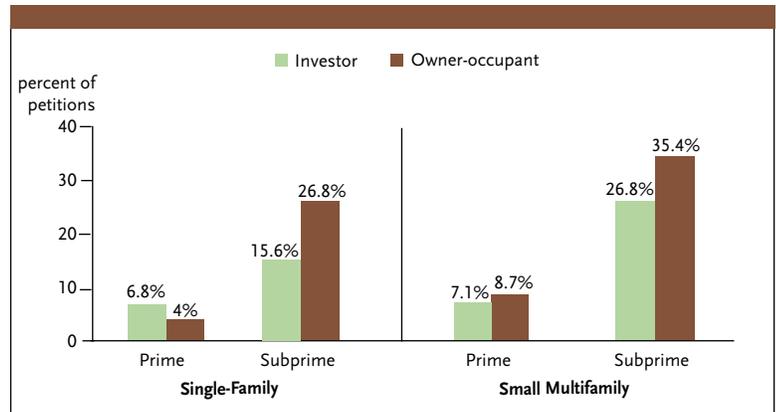
<sup>6</sup>The 90-day right to cure in Massachusetts is found in Chapter 206 of the Acts of 2007.

<sup>7</sup>Alan Zibel, October 26, 2008.

<sup>8</sup>While this dataset is mainly prime loans, these findings are consistent with prior Federal Reserve Bank of Boston research on subprime loans by Kai-yan Lee, May 20, 2008. Further investigation of the LP data confirms that owner-occupants are also much more highly leveraged than investors for subprime mortgages. The mean combined loan-to-value (LTV) ratio for owner-occupant purchasers of SMF properties is 97.2 compared with 91.2 for investors. These figures demonstrate the extent to which subprime owner-occupants must stretch themselves financially to purchase small multifamily properties.

<sup>9</sup>Hannah Thomas, July 23, 2009.

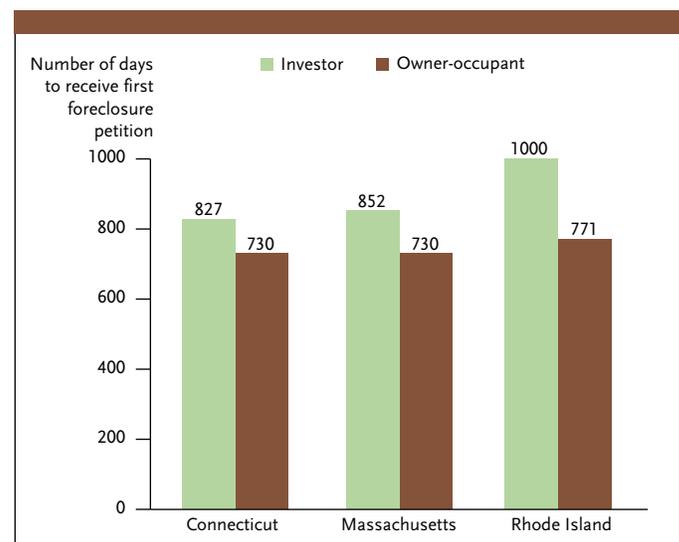
**Figure 5: Foreclosure Petitions are Most Common Among Owner-Occupants of Small Multifamily Properties**



**Source:** LPS Applied Analytics for prime loans and First American LoanPerformance (LP) for subprime loans in RI, MA, and CT, see data box.

**Note:** Calculated by the Federal Reserve Bank of Boston.

**Figure 6: Owner-Occupants Receive Foreclosure Petitions on Multifamily Properties Earlier Than Investors**



**Source:** LPS Applied Analytics

**Note:** Median days between date of mortgage origination in 2005 and date of first foreclosure petition for borrowers who received petitions. Calculated by the Federal Reserve Bank of Boston.