



BY AUSTIN KILGORE

## strategic default

is a national epidemic and as an increasing number of borrowers face owing more on their mortgage than what their home is worth, more and more are considering the option of walking away from their homes.

The servicing world is trying to find a solution to the problem. But traditional loss mitigation efforts are so far, unsuccessful, and the industry is looking outside the box. An emerging trend on that front is the concept of equity sharing. Proponents of the solution claim it can stop strategic default without the moral hazard of unearned principal write downs, while critics call it a gimmick.

According to a recent Fannie Mae housing survey of more than 3,400 Americans, underwater borrowers show a greater tendency toward loan delinquency. In addition, a second poll by market research firm Harris Interactive found that nearly one-quarter of borrowers surveyed believe they are underwater.

According to the Fannie poll, two-thirds of respondents prefer owning to renting, even while the nation is recovering from a recession and fac-

es declining home values. But that doesn't mean that borrowers aren't finding ways to justify strategic default. A contagion effect within communities is leading borrowers to consider default as an acceptable option in the face of financial hardship, Fannie found. Delinquent and current mortgage borrowers are more than twice as likely to consider not paying their mortgage if they know someone who defaulted.

But thinking about walking away and actually doing it are two different issues, according to Kathleen Day, a representative at the Center for Responsible Lending.

"From everything we know, no one defaults if they could possibly stay in their homes," she told *HousingWire*. "We just don't see people responsibly walking away. It's people who are at the end of their economic rope."

A Harris Interactive online poll of 2,320 people found 69 percent of respondents have an outstanding mortgage. Of those with mortgages, 11 percent report having "a great deal of difficulty" paying off their mortgages. Another 18 percent are having "some difficulty." The survey also found 24 percent believe they are underwater. Of the respondents that believe they are underwater,

26 percent reported having "a great deal of difficulty" and 23 percent are having "some difficulty" paying their mortgages. In addition, in the pool of respondents that believe they are underwater, 42 percent are "very concerned" and another 38 percent are "somewhat concerned" about not having enough income to cover their costs.

"These findings underline the very large number of people whose homes are worth less than their outstanding mortgages and even larger numbers who are worried about covering their costs and expenses generally," Harris Interactive said in the poll results. "If the percentages are converted into numbers, approximately 27 million adults believe they are 'under water' — that their houses are worth less than their mortgage debts."

And it doesn't look like the problem is going away anytime soon. First American CoreLogic estimates that the typical U.S. homeowner who is in negative equity will not experience positive equity until late 2015 to early 2016. In severely depressed markets, the typical borrower in negative equity may not experience positive equity until 2020 or later.

CoreLogic projects more than 11.3 million — or 24 percent — of all residential properties with



# A piece OF THE pie

## Is equity sharing a solution to the nation's strategic defaulters?

mortgages had negative equity at the end of the Q409. While the largest decreases in home prices appear to have already happened, it remains to be seen when borrowers will return to positive equity.

To predict how much long borrowers will remain in negative equity, CoreLogic projected future home values and unpaid principal balances for a selected set of Core Based Statistical Areas (CBSAs) to gauge how long it will take for the average underwater borrower to return to positive equity.

According to the projections, it will take the typical borrower until late 2015 or early 2016 for negative equity to disappear. But in severely depressed markets, like Detroit, negative equity won't dissipate even by 2020, because of its depressed economy. Negative equity is widely considered a trigger to strategic default, and a Treasury Department program attempts to address the problem by pushing lenders and servicers to offer borrowers principal reductions on their mortgages.

And although house price appreciation will, over time, offset negative equity, amortization — the paying down of loan balances — will in most cases be a more significant remedy to nega-

tive equity, a research note from CoreLogic economists states. Over the next 10 years, the average loan balance will decrease by an annual rate of 3.3 percent; meanwhile home prices are expected to increase at a 3 percent annual rate over the next decade, they claim.

Of the ten markets CoreLogic studied, the Washington-Arlington-Alexandria CBSA is expected to reach positive equity by 2015; Atlanta-Sandy Springs-Marietta, Dallas-Plano-Irving and Riverside-San Bernardino-Ontario are projected for 2016; Boston-Quincy by 2017; and Cape Coral-Fort Myers, Pittsburgh, Las Vegas-Paradise and Lancaster, Pa. by 2020. It is estimated that Detroit will not reach positive equity until after 2020.

The projections are based on a 3 percent annual home price appreciation. An alternative scenario of 5 percent annual price appreciation would put the first markets recovering by 2013, but CoreLogic said 5 percent appreciation would be much higher than historical appreciation, especially given today's low inflation environment. Conversely, a 1.5 percent annual appreciation, which would be fairly low relative to history, would push back the point of positive equity to at least 2017.

### A POSSIBLE SOLUTION

Many ideas have been proposed to tackle the issue of strategic default. One of the latest initiatives, equity sharing, would encourage lenders to voluntarily reduce a borrower's mortgage principal in exchange for a slice of ownership in the home. In an ideal situation, the lender will make a profit off the future appreciation of the home, assuming values increase.

Equity sharing programs aren't new; in fact, most are based off programs initially introduced to give homeowners a way to take equity out of their home without using a traditional home equity line of credit (HELOC) or second mortgage.

"The original thought was high net worth homeowners would go out, and instead of going into debt to extract equity from their home, a third party investor could provide that liquidity in exchange for a share of current equity and future appreciation," explained Kevin Hardin, managing director of Phoenix-based EquiDebt Solutions, a company that calls its equity sharing program Home Equity Fractional Interest, or HEFI.

Another equity sharing program is a partnership between mortgage technology and services provider Bensalem, Pa.-based ISGN and its part-

ner, San Francisco-based EquityRock, formerly known as REX&Co. The equity sharing program is called a Real Estate Shared Equity Transaction, or RESET. ISGN hopes RESET will help mitigate the risk of negative equity homeowners from strategically defaulting.

"We've worked through downturns before and the strategy has been to throw people at it and wait it out and eventually the market will return," ISGN's Bill Garland, the senior vice president in charge of the firm's home retention unit, told *HousingWire*. But in today's market, the name of the game is do anything to stabilize the one-to-four unit housing market. "Until then, we'll have more defaults, no liquidity, and high loss severity."

By working with banks to facilitate equity sharing deals, homeowners can pay a mortgage with a reduced principal without the moral hazard of a write-down.

"The moment that the bank starts talking about principal reduction to head off redefaults, that's when we are in front of that servicer talking about how to do principal reduction and what the results of that are going to be," Hardin said.

"Here's a security instrument that's going to put you in a much better position than you would be by just freely gifting the equity to the homeowner," he tells servicers.

In an equity sharing agreement, the bank agrees to modify the borrower's mortgage to reduce the loan-to-value (LTV) from a negative equity position to a state of positive equity. The interest rate doesn't have to be modified, but because the principal is now lower, so is the borrower's monthly payment. In exchange for the write down, the borrower signs an agreement that en-

titles the note holder to a share of the equity that's created in the transaction, as well as future appreciation of the property. When the house is sold, the mortgage is paid off and whatever profits are left are split between the borrower and the bank. The percentage of the split varies, depending on the terms of the agreement the bank picks.

Many proponents of strategic default argue that walking away is a business decision, justifying it by comparing it to a company filing for bankruptcy to restructure or eliminate debt. EquiDebt Solutions said its HEFI program is rooted in similar business reasoning. Residential real estate equity sharing is similar to when a company that has distressed revenue but can remain viable with lower debt undergoes financial restructuring. In such an arrangement, lenders reduce debt in exchange for a fraction of equity and the resulting deleveraged firm can continue in business. In the HEFI transaction, homeowners can avoid foreclosure by granting a fraction of homeowner equity in exchange for a reduction in their mortgage balance. The borrower remains in the home, retaining the benefits and obligations of ownership while the value of equity fraction received mitigates lender's write-down.

Of course, both plans hinge on the future appreciation of the property for the lender or mortgage holder to benefit from offering a borrower an equity sharing transaction. But even if it doesn't, EquityRock co-CEO James Riccitelli said the losses associated with a distressed sale are greater. In addition, before the home is sold, the borrower returns to making timely loan payments, bringing the mortgage back into performance and out of default. "It's a better deal for the lender," he said.

EquityRock spent approximately \$30 million vetting the legal process for these equity share transactions, and so far, it's been cleared in 14 states, covering more than half of the U.S. population, Riccitelli said. For ISGN and EquityRock to profit from facilitating these transactions, the firms intend to collect a fee for each completed agreement. But the potential for profit goes way beyond fee collection. Equity sharing proponents envision a world where the agreements become assets traded by investors, where additional profits lie in facilitating those transactions.

"Ultimately, the money is going to be made when we create a secondary market," Hardin said. "There will eventually be the ability to truly originate a HEFI."

So far, ISGN and EquityRock are shopping the initiative to lenders, but no one has yet to sign on. As it continues to market the service, ISGN and EquityRock are asking lenders to provide information on recent loans that have fallen out of the Making Home Affordable Modification Program (HAMP). With the data, a report is prepared to analyze which of those loans may benefit from an equity sharing arrangement.

As for EquiDebt Solutions, the company said it is working with a major loan servicer on a pilot project. In the pilot project, EquiDebt isn't making any money off of the transactions in an attempt to at least get some business moving in the equity sharing space.

No officials at the lenders and government-sponsored enterprises (GSEs) *HousingWire* interviewed were willing to speak on the record about equity sharing, and just as many were highly skeptical of the proposal.



## A sample equity sharing transaction

**JAMES RICCITELLI**, co-CEO of EquityRock, provided *HousingWire* a simplified version how one of its Real Estate Shared Equity Transaction, or RESET, agreements could be arranged.

A borrower has an outstanding mortgage principal of \$120,000 but his home is currently only worth \$100,000, making the borrower \$20,000 underwater with a loan-to-value of 120 percent. The note holder modifies the mortgage and forgives \$30,000 of the debt, bringing the principal owed to \$90,000 and the LTV to 90 percent. That principal write-down creates 10 percent equity for the borrower.

In addition, the loan modification puts the borrower in a 30-year, fixed-rate mortgage with a standard interest rate. The borrower's payments are reduced because of the 25 percent decline in principal, making the home more affordable. The lender is free to sell that mortgage into the secondary market or hold onto it.

In exchange for the modification, the borrower signs an equity sharing agreement, the note holder holds 5 percent of the equity, the ho-

meowner gets 5 percent. In addition, any future appreciation is shared 50-50 by the borrower and his mortgagee. In the future, if the home appreciates 5 percent, there is an additional \$5,000 in equity. That \$15,000 is shared equally between the borrower and the lender.

As the home continues to appreciate, the borrower and the note holder continue to share that increased equity. The equity sharing agreement obligates the borrower to remain in the home for a set amount of time, "The homeowner's not building positive equity as quickly as they would if they had all the equity to themselves, but under the original loan, they wouldn't have any positive equity until the house went up at least to \$120,000," Riccitelli said.

Riccitelli warns equity sharing won't work in all scenarios for every borrower. "The RESET agreement is not designed for people that don't want to stay in their homes. It's designed for people that can make their payments and want to stay in their home for a certain number of years. If they do that, then they'll have the principal forgiveness," he said.

## A PIECE OF THE PIE

"What's the difference between that and forbearing the principal?" a GSE official asked *HousingWire*. "We can do that by forbearing the principal for 40 years and the borrower doesn't have to pay it back until 2050."

The official said while the program may eliminate the moral hazard of principal forgiveness, it's not better than forbearing part of a borrower's principal to a balloon payment at the end of the mortgage term, especially if that term is 40 years from now, as is the case in many HAMP modifications.

By that time, if the borrower is still in the house, they have the opportunity to save up for the payment, refinance into a new mortgage or even sell the property in an improved housing market.

Hardin argued that an equity sharing agreement is not a debt instrument that has to be calculated in determining a bank's capital reserves, making it a better alternative for lenders.

"Institutions are looking for a way to diversify their investments. Buying up debt causes problems for banks, they have to reserve for it," Hardin said, but he did concede that equity sharing is not a cure all. "It's for one sliver of the pie," he said.

The GSE official said an equity sharing agreement doesn't change the fact that the borrower's equity is already gone.

"We already have an ownership stake. We own the mortgage on this thing and its secured by the house," the official said. "What do we get out of this? Why is the borrower going to be less likely to walk by doing this?"

An official at one of the nation's largest banks expressed concern about the increased cost of working with a third party, especially when HAMP modifications can be done in-house.

"With the equity sharing agreement, you've added to your costs," the official said. "The real question for the investor is: Do you want to cash out of this asset and figure this is as good as its going to get, or do you want to stick with it? If you want to stick with it and the formula calls for principal forbearance, then that's what you do."

Working with a third party also opens the door for damaging the servicer's reputation, the official added. "It would be the reputation of the large servicers that's on the line and if the company can't perform for whatever reason, then it's our reputation at risk. We're paying them more for what we could do ourselves," he said.

Furthermore, it's not a forgone conclusion that the note holder will foreclose on the borrower. "Unless we immediately sell that risk, we're still holding it. If we decide to avoid a foreclosure by deferring principal, I'm not sure we'd need them to do it."

But Riccitelli said simply forbearing principal isn't enough to deter strategic defaulters. "If you just forbear the principal and cross your fingers and hope the homeowner makes their payments, some of them will. You gave them some relief, their payment is lower and some of them will stay there and do that," he said. "Some of them will choose to default even with a lower payment because they see themselves as so far underwater, they don't see the economic rationale of making the payments."

By offering borrowers principal forgiveness with an equity sharing agreement, the bank takes the risk that the home won't appreciate and the bank won't recover what it wrote down. But, Hardin argues, the risk is less.

"People say there's no guarantee the home will appreciate. There is one guarantee — homes will go up and will go down in value, they have forever," he said. ☛

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