Credit Risk Retention

Qualified Residential Mortgages, Down Payment Comment

Responding to Request for Comment, number 121, page 24124:

"The Agencies request comment on the proposed amount and acceptable sources of funds for the borrower's down payment."

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I. Summary

To increase the success and availability of the QRM program, we propose that the Agencies allow shared equity as an additional source of funds for the home buyer's down payment. Under a shared equity arrangement, a 3rd-party investor would provide part of the home buyer's down payment in return for a Shared Equity Fractional Interest (SEFI) in the house at the time it is sold.

The SEFI is created under an agreement between the home buyer and a 3rd party investor. The SEFI provides a source of financing for the homeowner. It is not a loan; rather it is an equity interest in the home. The homeowner agrees to share *pari passu* with the SEFI investor a fraction of the home equity when the house is sold, when the mortgage becomes due and payable, or when the homeowner does a cash-out refinance (home equity is defined as the house sale amount less the mortgage amount at its origination).

The SEFI receives payment only after the QRM is repaid in full. Unlike a second mortgage, it requires no payments prior to full QRM repayment. The SEFI would be created pursuant to a standardized contract, filed with the county as a lien that is subordinated to the mortgage. (See Appendix A: *SEFI Agreement Summary*)

To ensure that the homeowner has a substantial stake in the home ("skin in the game"), we propose that the amount of the down payment provided by the SEFI investor be capped at 50%. We also propose that the share of equity accruing to the SEFI investor be capped at 50%. Further, the SEFI agreement prohibits a homeowner from taking out a 2nd mortgage or other encumbrances. (See Section II: *Example: SEFI as part of down payment*)

The SEFI can be repurchased at the option of the homeowner at any time more than a specified number of years after origination, at a price equal to the greater of fair value of the SEFI or the funds provided by the SEFI investor at origination plus interest compounded at the original mortgage rate. Fair value is defined as the SEFI equity-sharing fraction times the difference between the appraised value of the house at the time of SEFI repurchase and the mortgage amount at origination. (See Section III: *Example: SEFI repurchase by homeowner.*)

Because the SEFI investor is paid only after the mortgage is paid in full, QRMs originated with a SEFI will meet the standard of "very high credit quality" required under the proposed rule. In fact, the SEFI could boost QRM credit quality due to the additional independent scrutiny by 3rd party SEFI investors. (See Section IV: *Effect of SEFI on credit quality*.)

In addition to preserving credit quality, *the SEFI brings an additional and important social benefit*: it expands the number of income/credit qualified home buyers who would qualify for QRMs, by allowing them to supplement their down payments with funds from SEFI investors, *while limiting loan-to-value (LTV) at origination to no greater than 80%.* (Of course, SEFIs could also be used with higher LTVs at origination).

SEFI investors are motivated to provide part of the original down payment by the prospect of sharing in potential future gains in house prices. We envisage that the ultimate SEFI investor is an institutional pension, endowment, foundation or sovereign fund, *providing a deep funding source for home finance that does not impose additional homeowner debt*. In its early stages, lenders or other financial intermediaries may originate and securitize SEFIs.

Homeowners who use SEFIs enjoy the full benefits of residing in their houses, and solely decide when to sell their houses (and at what price). Homeowners share only the sale proceeds above the mortgage amount at origination and thus retain all of the equity attributable to loan amortization, helping to preserve incentives to stay current and pay down the mortgage balance.

SEFI investors act as silent partners: after appropriate scrutiny of the transaction, they provide some part of the down payment and benefit if and only if their partners (the homeowners) benefit.

We believe the SEFI, in conjunction with the QRM proposed maximum 80% LTV ratio, creatively addresses the dilemma of how to assure high quality mortgages while aiding the ability of homeowners to afford substantial down payments. Outside equity participation is an essential part of financing businesses; it can become an equally essential part of financing home ownership.

For other details, see the following sections of this Comment and the Appendices.

II. Example: Shared Equity Fractional Interest (SEFI) as a partial source of the Home Buyer Down Payment

In a basic scenario, described below, the homeowner purchases a house with an 80% LTV mortgage. The home buyer provides 60% of the down payment, and an outside (SEFI) investor provides the remaining 40%.

In return, the SEFI investor receives 40% of any equity at the time of sale, when the mortgage becomes due and payable, or when the homeowner does a cash-out refinance.[1] In effect, the SEFI is a "silent partner" with the homeowner.

EXAMPLE:

Home Purchase price –	$200,000
Mortgage at origination –	$160,000
Home Buyer funds –	$24,000
SEFI Investor funds –	$16,000

In the example above, if the house later is sold for $160,000 or less, the lender receives all of the proceeds. If the house sells for more than $160,000, the amount above $160,000 is shared 60/40 between the home buyer and the SEFI investor.

For example, if the house sells for $240,000, the lender gets $160,000. The resulting equity of $80,000 is shared 60/40: the homeowner receives $48,000 (60%) and the SEFI investor receives $32,000 (40%).[2]

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[1] Home equity is defined as the gross house sale amount less the mortgage amount *at its origination*, when that amount is positive. Thus homeowners retain all of the equity attributable to loan amortization, helping to preserve incentives to stay current and pay down the mortgage balance. (See Section IV for further discussion of incentives). Our valuation model, available upon request, suggests that a 40% share of equity (or slightly less) going to an investor is appropriate compensation for providing 40% of the down payment.

[2] Other variations on this basic idea could also serve the same purpose. For example, a borrower may want to have an investor contribute a lower or higher (up to 50%) share of the down payment, but home buyer would not be allowed to use SEFI funds for more than 50% of the down payment.

III. Example: SEFI Repurchase by Homeowner

The SEFI can be repurchased at the option of the homeowner at any time more than a specified number of years after origination, at a price equal to the greater of fair value of the SEFI or the funds provided by the SEFI investor at origination plus interest compounded at the original mortgage rate. Fair value is defined as the SEFI equity-sharing fraction times the difference between the appraised value of the house at the time of SEFI repurchase and the mortgage amount at origination.

EXAMPLE: Homeowner Repurchase of SEFI Six Years after the initial SEFI Transaction:

House Purchase price –	\$200,000
Mortgage at origination –	\$160,000
Mortgage Interest Rate –	5%
Appraised Value of the House at SEFI Repurchase date	\$240,000
SEFI Equity-sharing Fraction --	40%
Initial SEFI Contribution to the Downpayment = 0.40 x \$40,000 or	\$16,000
SEFI Minimum Repurchase Price = \$16,000 x (1.05)^6 or	\$22,696
SEFI Fair Value = 0.4 x (\$240,000 – \$160,000) or	\$32,000

Since the SEFI fair value exceeds the SEFI minimum repurchase price, the homeowner cost to repurchase the SEFI is its fair value, \$32,000.

IV. Effect of SEFI on QRM Credit Quality

The SEFI is an arm's length transaction between the home buyer and a 3rd party investor. The SEFI is not a loan; rather it is an equity interest in the home. Unlike a second mortgage, the SEFI imposes no cash payment obligations on the homeowner prior to full repayment of the QRM. Upon sale or cash-out refinancing, the homeowner agrees to share a fraction of the home equity with the SEFI investor (home equity is defined as the gross house sale amount less the mortgage amount at its origination). Payments to the SEFI investor will be required only in circumstances where (i) the QRM has been fully repaid and (ii) the homeowner has sufficient funds from sale to satisfy the SEFI obligation after QRM repayment. The SEFI would be created pursuant to a standardized contract, filed with the county as a lien that is subordinated to the mortgage.

Prior to offering a home buyer a SEFI, the 3rd party investor would conduct an independent evaluation of the transaction. That means a QRM including a SEFI as part of the down payment receives an evaluation by two independent parties: the mortgage lender (from a senior debt perspective) and the SEFI investor (from an equity perspective). Two independent evaluations should result in a higher quality QRM than a QRM without a SEFI investor.

Since no cash payments are owed on the SEFI prior to full repayment of the QRM, defaults caused by cash insufficiency will never exceed those of a QRM without a SEFI. But it could be argued that the homeowner with a 60% interest in the home's appreciation (the SEFI investor has the remaining 40%) might "strategically" default at a lower LTV than the homeowner with a 100% interest in the home's appreciation.

We have examined this question with a rigorous model (available upon request). If the homeowner retaining 100% of the home's appreciation would strategically default at a 150 LTV, s(he) would strategically default at a 141 LTV when retaining a 60% interest in the home's appreciation. We estimate this would add 0.05% (5 basis points) to the probability of default over 7 years, the average term of home ownership. But recall that a homeowner with a SEFI is likely to have a lower default probability than the average QRM homeowner because of the SEFI investor's additional screening of the transaction.[3]

We have not contrasted the independent 3rd party SEFI investor with a family or charitable contribution as part of the down payment, since this provision may not survive in the final QRM rules. But if it did, we believe that the case for an independent SEFI investor is even stronger because of the greater degree of scrutiny that a SEFI investor likely would provide.

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[3] A 75% LTV loan plus a 40% SEFI will have slightly *lower* strategic default risk (and lower required cash payments) than an 80% LTV loan with no SEFI. Yet the initial financing required of the homeowner would be 15% (60% of 25%) versus 20% (100% of 20%) for the 80% LTV loan.

Appendix A: The SEFI Agreement Summary

The SEFI Agreement is a contract between a homeowner and an investor that implements a new Standardized Method for equity investing in Single Family, Owner Occupied Residential Real Estate. The SEFI Agreement defines the Rights and Obligations of each party.

The Agreement allows the homeowner to finance their ownership without increasing their debt load. The investor will, in consideration for his/her contribution to the home purchase transaction, share in the equity of the home at the time of sale (home equity is defined as the gross house sale amount less the mortgage amount at its origination). The example in Section III assumes a 40% contribution to the down payment by the investor in return for 40% of sale price less original mortgage value.

The homeowner fully benefits from the use value and tax advantages of owning the house, and is fully responsible for paying the mortgage. The homeowner makes all decisions as to when to sell the house and may elect to repurchase the SEFI investor's percentage.

The investor is seeking a secure investment in Single Family, Owner Occupied Real Estate, without any involvement in the day-to-day use of the property. The homeowner is required to keep the house in good standing at the homeowner's expense, and wholly retains the available tax advantages for any such payments and expenses.

Under the Agreement, the investor is not required to pay any portion of these expenses, but is an "Informed Party" by way of the Servicer of any delinquencies that the homeowner failed to address. The Agreement may provide for certain homeowner credits for substantial improvements to the home.

The investor has the Right but <u>not the Obligation</u> to "Cure" any defect as set forth above to protect the value of the house. Should circumstances obligate the investor's involvement to protect the house value, there are a number of safeguards and provisions within the Agreement to allow such intervention, and to compensate the investor for curing the defect.

Proceeds

Assuming that the homeowner continues to perform his/her obligations for the life of the SEFI Agreement there should be no involvement required on the part of the investor.

Once the homeowner decides it is in his/her best interest to sell the property, redeem the SEFI or refinance the property, the homeowner must notify the Servicer. The investor may prevent the sale or refinance of the house should a supplemental appraisal show that the value is artificially low.

Once an accepted offer is in place, the sale progresses as any residential real estate transaction would. Document management, fees and payments all would be handled by the Escrow Company, settlement agent or closing attorney. At the closing, the Title Company or settlement agent would verify the disbursements of proceeds in accordance with the SEFI Agreement. The remaining mortgage claim would first be paid. The SEFI investor would then receive the specified percentage of the Net Sale in compensation for redemption of the SEFI at the closing. The homeowner would receive the remaining amount, which includes amortized principal during the life of the mortgage.

The investor may at his/her option offer to let the SEFI percentage roll over, thereby making the entry costs for the new buyer more attractive. The investor may offer this opportunity to a buyer at the investor's option. The investor's SEFI is not "Assignable" by the homeowner.

Architecture of the Agreement

The SEFI includes safeguards for the rights of both parties and provides rules for the protections of both parties.

The obligations of the investor are to contribute a portion of the investment into the house at the origination of the Agreement, i.e. a portion of the downpayment. Typically, no further involvement is required until the eventual sale or refinancing of the property occurs. The investor is kept informed by the Servicer of the status of the property.

The homeowner's role is to maintain the condition of the property and ensure that the mortgage, taxes, and insurances remain current at all times.

Curing, if Required

Should any issues occur in the performance of the homeowner, there are safeguards in the Agreement to discover and correct in order to protect the proper standing of the underlying property.

The Servicer will immediately give notice to the homeowner and investor should a default under the SEFI Agreement occur. Under the SEFI Agreement Cure provisions, the investor is due consideration from the homeowner for "Curing" any delinquency.

Conversion to Tenant In Common (TIC)

In an Event of Default by the homeowner under the SEFI Agreement, the investor would have the option to exercise their Tenant In Common Option. If the investor chooses to exercise their option in the Tenant In Common interest in the property, the Agreement then allows for the investor to sell the property at fair market value.

Standardization of the SEFI Agreement

The SEFI is designed to be a uniform Security Instrument. The Agreement would be standardized for recording. A Memorandum of SEFI is recorded in each County Recorder's office representing Notice of the lien position of the SEFI. SEFIs are assignable and transferable within all 50 states to enable the formation of a Secondary Market and new class of investments in a Single Family, Owner Occupied Real Estate market.

SEFI Servicers would provide estimated quarterly valuations for the property using recognized Automated Valuation Model (AVM) Data.

In Conclusion

Adding a SEFI opportunity to the current world of primarily debt based financing would provide a broad range of benefits to homeowners to facilitate the purchase of a home or for the restructuring of an existing mortgage

The SEFI also provides investors with the opportunity to invest in the Single-Family, Owner Occupied Residential Housing Market, thereby providing a much needed, new level of equity-based financing to the distressed US housing market.

Appendix B: SEFI Frequently Asked Questions

1. What is a SEFI?

- The SEFI (Shared Equity Fractional Interest) is an agreement between a home buyer and the SEFI investor that grants a specified fraction of the equity in the house when the house is sold, or when the mortgage becomes due and payable, or when the homeowner does a cash-out refinance (home equity is defined as the gross house sale amount less the mortgage amount at its origination).
- The SEFI is secured by a lien on the house and is subordinate to a QRM. The homeowner retains all the rights and responsibilities of home ownership.

2. Does the SEFI share of equity have to be 50%?

- No. Other sharing proportions are equally feasible. For example, the SEFI share of equity value at mortgage termination could be 30% or 40%.
- We propose that the SEFI share be no greater than 50%, implying that the homeowner's equity share be at least 50%.

3. Does the SEFI affect who owns the home?

- No. The homeowner retains full rights and responsibilities of home ownership, including payment of the mortgages, taxes and insurance. And the homeowner benefits from tax deductions for monthly mortgage interest and property tax. The homeowner solely decides when to sell the house, and for how much.
- The SEFI investor has a lien on the property, but does not own any part of the house.

4. How is the SEFI different from a Shared Appreciation Mortgage (SAM)?

- SEFIs are completely separate from the mortgage. Indeed, they are subordinate to the mortgage. SAMs make the appreciation rights an integral part of the mortgage.
- The SEFI is a completely stand-alone instrument. It can be transferred, say, by selling it to other investors in the capital markets.
- SEFIs are analogous to shares of common stock in corporations. They both convey rights to some fraction of the net proceeds of an enterprise. But, unlike common stock, SEFIs do not convey ownership.

5. Has anything like the SEFI been approved by the government?

- Yes. The H4H program had a shared appreciation feature and HAMP approves equity sharing arrangements in its modification programs as noted in Supplemental Directive 10-14.

6. Is a 20% down payment that is half-financed by a SEFI the same as a 10% down payment?

- No. The resulting mortgage has an 80% LTV, not 90% LTV. The total down payment is 20%, providing twice the cushion against default as a 10% down payment.
- The homeowner and the SEFI investor are *pari passu* equity participants. Both have positive equity value when the price of a house has fallen less than 20%. With a 10% down payment, a 20% price fall would leave the mortgage substantially underwater.

7. Would a transaction including a SEFI be of a lower credit quality than one without a SEFI?

- No, for two reasons:
  - The SEFI investor is in a first-loss position and would provide an additional, independent scrutiny of the transaction. Only the most qualified home buyer and houses with potential price appreciation would be offered a SEFI.
  - The homeowner initially has at least 10% of their own funds invested in the home, and continues to have positive equity until the home value declines by more than 20%. See Section IV for further comment.

8. Will the homeowner with a SEFI have greater incentive to default than with no SEFI?

- With or without the SEFI, the LTV will be the same.
  - The presence of the SEFI does not affect whether equity is positive or negative.
  - The SEFI imposes no additional cash flow requirements on the homeowner prior to full repayment of the QRM.
  - The homeowner's lesser equity amount will add a negligible amount to the strategic default probability. See Section IV for our analysis.
  - Equity increases due to amortization or pre-payments are not shared, but rather accrue entirely to the homeowner.

9. Will the 80% LTV mortgage with a 40% SEFI have less default risk than a 90% LTV mortgage without a SEFI?

- Yes.
  - Our financial model (see Section IV) estimates that an 80% LTV mortgage with 40% SEFI will have a probability of default of 0.16% over 7 years (the average term of home ownership).
  - A 90% LTV mortgage with no SEFI has default probability more than three times as great (0.51% over 7 years). Similar results hold when parameters are changed within reasonable ranges.

10. Are there incentives for the homeowner to stop paying on the mortgage and leave it to the SEFI investor to cure?

- No. There are no incentives for the homeowner to stop paying on the mortgage that are unique to the situation where SEFI funds are part of the down payment.
- If the mortgage is terminated and the proceeds are insufficient to repay the QRM in full, then no payment is made to the SEFI investor.
- There are significant negative repercussions to personal credit scores to homeowners who stop paying their mortgages, regardless of the sources of their original down payments.

11. Can banks hold SEFIs on their balance sheets?

- It is not clear, but we believe bank holding companies will be allowed to hold the SEFI as an investment, in much the same way that they sometimes hold equity participations connected with commercial real estate lending.
- The SEFI investor does not hold any "title" to the house. The SEFI is recorded as a lien against the house, just as a mechanics lien, a tax lien, or a legal judgment lien is recorded.

12. When can the homeowner repurchase the SEFI?

- The SEFI can be repurchased at the option of the homeowner at any time more than a specified number of years after origination, at a price equal to the greater of fair value of the SEFI or the funds provided by the SEFI investor at origination plus interest compounded at the original mortgage rate.
- Fair value is defined as the SEFI equity-sharing fraction times the difference between the appraised value of the house at the time of SEFI repurchase and the mortgage amount at origination. (The equity-sharing fraction may differ from the percentage of the down payment that the SEFI investor contributed.) See Section III for further comment.

13. What obligations does the homeowner have to the SEFI investor?

- The SEFI does not obligate the homeowner to make any payment to the SEFI investor before a mortgage is terminated. See Appendix A for further comment.
- At mortgage termination, the homeowner agrees to share *pari passu* with the SEFI investor a fraction of the home equity (home equity is defined as the gross house sale amount less the mortgage amount at its origination).

14. Does the SEFI investor share in pay-downs of the mortgage principal by the homeowner?

- No.
  - Payments by the homeowner that reduce (amortize) the loan balance are entirely paid by and accrue to the homeowner's equity.
  - The SEFI investor has no further cash flow obligations beyond providing the initial fraction of down payment.

15. Are improvement costs partially absorbed by the SEFI investor?

- The SEFI equity sharing agreement could be specified so that the homeowner gets appropriate credit for the change in market value of the house that are attributable to home improvements. See Appendix A for further comment.
- A list of "qualified improvement projects" with pre-specified depreciation and valuation rates could determine the value of improvements. Examples of data for such list are provided by various realty organizations.

16. What about taxes?

- The SEFI does not affect the income tax deductibility of mortgage interest or of property taxes. The homeowner pays these and can deduct the full amounts (consistent with IRS guidelines).
- Nor does SEFI affect capital gains exemptions associated with sale of the house. Capital gains to the homeowner would be calculated net of any payments to SEFI investors.
- Capital gains or losses on SEFIs would be treated like those on other equity investments.