



Foreclosure Derivatives

Swap Rent plan matches struggling borrowers with investors

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By **JERRY DeMUTH**

A Corona, Calif.-based company has come up with a solution to rising foreclosures. Under its concept, delinquent and struggling borrowers would get financial help from investors who receive, in return, all or a portion of any property appreciation.

Under Advanced e-Financial Technologies Inc.'s patented SwapRent program, investors also would receive monthly rental payments from the homeowners, who then would receive from the investors monthly payments larger than those rental payments, Chairman and CEO Ralph Y. Liu explained to *MortgageDaily.com*. The balance would then go toward homeowners' mortgage and any escrow payments and also property taxes.

The SwapRent program is not a mortgage but is a separate document or agreement that is imbedded into an existing or new mortgage and runs for two or more years, he pointed out.

When the SwapRent period ends, borrowers must then pay to the investor all or a previously agreed on percentage of any increase in appreciation. The higher the percentage of any increase in value that is given up to investors, according to Liu, the higher the amount of the monthly payments homeowners receive from investors.

Homeowners, to pay investors the amount of the appreciation that is required, can then do a cash-out refinance of the new, higher value of their homes. Although this would mean a larger mortgage amount, and probably higher monthly payments, troubled homeowners should have recovered by then, Liu said. If not, they can extend their SwapRent agreements.

But all the while, borrowers participating in the program retain legal title in their homes, which they would be unable to do if forced into a costly sale/lease back program by their inability to make their mortgage payments, he points out.

If the value of a home does not increase, investors receive only the monthly rent payments, which, since borrowers are able to continue their legal ownership of their homes, is termed "synthetic rents" by Liu. If homeowners want to protect themselves from any decline in the value of their homes, they can combine the "appreciation give-up" SwapRent, or SwapRent AG, with another SwapRent program, called SwapRent DP,

for depreciation protected, under which investors pay them the amount of any decline in value. But this shifting of more risk to investors increases homeowner costs, including higher monthly "synthetic rents," according to Liu.

"At the present time," he noted, "there is no efficient means for individuals homeowners to protect the value of their investments in their homes when residential real estate values are declining."

This protection, he said, would most interest, not low income persons for whom a home is only a place of shelter, but high income or wealthy persons -- "risk-averse conservative property owners who treat their property not just as shelter but also as financial assets and therefore may be more willing to buy protection against potential financial loss."

Either SwapRent program, and their variations, would be open to virtually everyone, according to Liu.

"As long as a property owner has the mental capability to sign a contract to purchase a house or to sign a lease to rent an apartment," he said, "he or she will have the ability to sign a SwapRent contract."

The SwapRent program is being sold to banks, other lenders, and to investors, and, Liu said, some banks already have expressed interest in the programs.

The government sponsored enterprises also have been kept informed of the SwapRent program, according to Liu.

"Freddie, Fannie and Ginnie and HUD are aware of this [program]. We've been in touch a long time," he said. "We could even license it to Fannie for all their conforming loans. If Fannie doesn't take it, Ginnie or Freddie can take it."

Banks and such other financial institutions as mortgage lenders could either be involved as middlemen or simply as guarantors of the credit exposures associated with such transactions, he explained.

"They could in turn manage the credit exposure for themselves by using such existing banking products as collaterals, mortgages or HELOCs to support these new types of transactions," Liu said.

To help shift risks away from participating banks, which would make their participation more likely, he said the SwapRent program will be involving "the new real estate risk management industry" through the use of specially designed options, swaps, derivatives and arbitrage and hedging opportunities.

"To make the whole thing work," pointed out Liu, who once headed the derivatives business for Chase Manhattan Bank, now J. P. Morgan Chase & Co., and for UBS AG in Asia, "you need to create an industry. If there's only one rank, then the provider would

have to assume unnecessary risk. And internal risk guidelines and regulators would not allow it. So underwriters need a way to lay off the risk. Then it will become a realistic business and the market will create liquidity."

As such, the SwapRent program has two major roles, Liu said. "One is to act as a superior OTC property derivatives instrument in the inter-bank and institutional dealing community and the other is to act as a bridge between the esoteric institutional derivatives market and the vast consumer finance market."

The SwapRent program, which can also be used for commercial properties, also enables investors to synthetically invest in real estate, he noted.

To determine property values and rent levels, Liu is creating new property value indices for various zip codes that, he says, can be used for "all kinds of research, analysis, derivatives contract trading and index-linked structured products settlements."

Discussing how SwapRent might work, Liu gave as an example a home purchased at \$500,000 and now worth \$800,000. The annualized "synthetic rent" would be 2 percent of \$800,000, or \$16,000 per year, and the investor's payments would be 5 percent of \$800,000 or \$40,000 per year, providing the homeowner with \$24,000, or \$2,000 every month, to be used toward the mortgage and other expenses.

But the "synthetic rent," which can be traded, will, according to Liu, "reflect more than just a conventional rent concept. The 'synthetic rent' will incorporate the aggregation of yield derived from the actual rents, if any; risk premium of holding property equity; transaction costs; tax considerations and overall supply and demand sentiments at a particular point in time." Thus, he explains, the "synthetic rent" will have no "direct, straightforward relationship" to the actual rent the home owner may have been able to collect if he or she rented out the home.

While, under SwapRent AG, homeowners give up some or all of any appreciation in the value of their homes, Liu stresses that it does enable them to retain their equity, which otherwise could be lost in a foreclosure.

Jerry DeMuth is an award winning journalist who has been reporting for four decades.