2014

Principal Reduction as Foreclosure Prevention

AN EVALUATION OF EXISTING PROGRAMS & RECOMMENDATIONS FOR IMPLEMENTATION

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INTRODUCTION

Two programs are using innovative, self–supporting approaches to help homeowners avoid foreclosure through a form of principal reduction: The State of Oregon's Loan Refinancing Assistance Pilot Project (LRAPP) model, and Boston Community Capital's SUN Initiative. The programs have proven successful and sustainable, and appear replicable.

Both programs identify and underwrite participants on the brink of or already in foreclosure, purchase the homes from willing lenders, and then re–sell them back to the original homeowners at an affordable, market value. This model can be replicated and would seemingly serve a clear need in either the City of Seattle, a broader region including Seattle, or the entire state of Washington.

PRINCIPAL REDUCTION AS FORECLOSURE PREVENTION

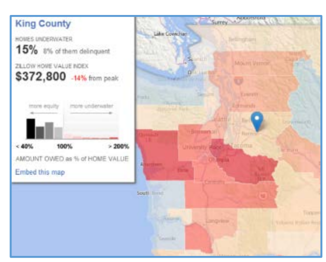
Historically, principal reduction has been rarely used for foreclosure prevention, due largely to moral hazard concerns. The LRAPP and SUN Initiative models effectively achieve principal reduction, while utilizing market mechanisms in a way that benefits all parties:

1. Lending institutions can unload distressed loans before or after foreclosure, based on the market value of that home – with losses mitigated by the potential for greater loss, if there was no sale.
2. The homeowner avoids foreclosure, and having recovered from a hardship, is able to afford the new mortgage and regains lost equity.
3. The owner of the new loan gains a property in its portfolio that has been rigorously underwritten to assure affordability and consistent future payment.
4. Blighted neighborhoods and economy at large are boosted by the creation of conditions for increased consumer spending

This model makes the LRAPP and SUN Initiative programs unique, as they do not rely on one–time subsidies, and are built on the same market mechanisms that sustain the broader mortgage system. Loans are underwritten on an individual basis and then held or sold as performing assets. Program costs are primarily paid through earned fees and the recycling of program dollars.

RELEVANCE TO SEATTLE & SURROUNDING AREA

According to Zillow, 15% of the home mortgages in King County are currently underwater. Of those, 8% are delinquent. According to the 2010 US Census, there were 365,701 owner–occupied houses or condos with a mortgage in King County, which means there are nearly 30,000 homeowners delinquent and underwater, in danger of foreclosure.



Presumably, there are a significant number of homeowners among these delinquent, underwater mortgages that could in fact afford their mortgages and avoid foreclosure, if they were able to effectively "reset" their loan to the market value and an affordable monthly payment. Doing so would save the family, the lender, and the community from the considerable costs associated with foreclosure.

CHARACTERISTICS OF PROGRAM PARTICIPANTS

Policies have been established for both programs that allow funds to be strategically targeted. Both programs require that applicants demonstrate an ability to afford a new, reduced mortgage through rigorous underwriting. While the underwriting process is similar to traditional lending, it differs in that applicants may have poor credit, and may be behind on their loan. In terms of the conditions that led to the homeowner becoming behind on their loan, both programs also require a hardship letter or affidavit.

A practical difference between the SUN Initiative and the LRAPP model is that LRAPP will accept program participants that are **not** behind on their loans, provided they can demonstrate that the loan – due to excessive interest rate, amount underwater, or payment amount – presents a significant financial challenge and threatens foreclosure.

Policies that determine qualified candidates are a critical aspect of both programs, as continued access to funds requires consistent, timely payments from homeowners. ***In the case of LRAPP, maintaining a loan portfolio comprised of healthy loans, with on−time, affordable payments from the homeowners is a critical aspect to the most appealing aspect of the program, its ability to revolve funds and be self−sustaining.***

PROGRAM PROCESS / MODELS

Aside from differences in how frequently participants make mortgage payments (monthly for LRAPP, bi−weekly for SUN), there are few distinguishable differences to the actual program participants, as both programs:

- Rely on program partners for referrals; non−profit housing agencies, real estate agents, etc.
- Are voluntary in that the original mortgage holder must approve a short sale offer (however, the SUN program also purchases homes **after** foreclosure).
- Once purchased, both programs re−sell the home back to the original homeowner, with interest rates and closing costs that support program administrative costs.

Thus, both programs benefit from staff/contractors with experience negotiating short−sale offers and/or relationships w/in the lending industry. **Additionally, Oregon's LRAPP program benefits from a formal agreement with FHA, and an evolving project with Fannie Mae and Freddie Mac.**

Significantly, both programs are self−supporting and do not require subsidy after an initial investment of capital. Program income is earned through two methods.

1. A margin is added to the purchase price of the home. Oregon adds **12%**, while the SUN Initiative adds **25%** to the acquisition price as part of a loan−loss reserve.
2. The mortgage interest rate is set at a rate that is higher than the underlying cost of funds, but still lower than a homeowner with bruised credit could expect independently.

Neither of these methods impact overall affordability for the homeowner, given that the underwriting is done based on their ability to afford a new mortgage, inclusive of these terms.

ORGANIZATIONAL STRUCTURE

Boston Community Capital (BCC) is an independent non–profit that manages the SUN Initiative. It is a permanent, established program with a robust operator in BCC. The State of Oregon contracted its program management to a local company headed by former government housing executives. Further Development is a for–profit that acts as an agent for the State's nonprofit.

	LRAPP	SUN Initiative
Program Administration/Oversight	Oregon Department of Housing and Community Services	Boston Community Capital
Capital/Financing	Oregon Affordable Housing Assistance Corporation (State of Oregon)	SUN Initiative Financing LLC
Property Acquisition	Further Development	NSP Residential, LLC
Loan Origination	Further Development	Aura Mortgage Advisors, LLC

PROGRAM FINANCING /FUNDING

The State of Oregon allocated $12 million of its Hardest Hit Funds into a revolving fund for the LRAPP program. When funds are near depletion (due to the origination of new mortgages), Oregon sells the pool mortgages and revolves the money. The SUN initiative has been supported by Boston Community Capital with funding from a variety of sources:

	LRAPP	SUN Initiative*
Funding Source(s)	Hardest Hit Funds ($12M)	R&D grants from foundations
		Seed capital ($5M) from BCC's own assets
		Private investment ($3.5M)
		Debt capital sufficient to support $50M in lending
		Grant capital from State, Federal & Attorney General's Office
		Loan & grant capital from lending institutions (BOA, Wells Fargo, Citi) and foundations (Open Society, John D. and Catherine T. MacArthur)

Source: "Boston Community Capital SUN INITIATIVE "From our community to yours: A blueprint for delivering foreclosure relief to your community"

The LRAPP program collects loans in its portfolio until a threshold has been reached, allowing for the loans to be packaged and re–sold to an investor. That sale returns the program seed money, and allows for new homes to be purchased. The LRAPP program has sold two portfolios of loans thus far, both of which were to a Seattle institution.

PRINCIPAL REDUCTION PROGRAMMING IN SEATTLE/WASHINGTON

NEW PROGRAM FINANCING

Both financing approaches appear to be equally effective. Given that there is no practical difference to program participants, it would seem to be more a matter of what financial resources are available in Seattle. If Seattle has access to an institutional investor interested in making a long–term investment in mortgages, then the SUN initiative model appears worth replicating.

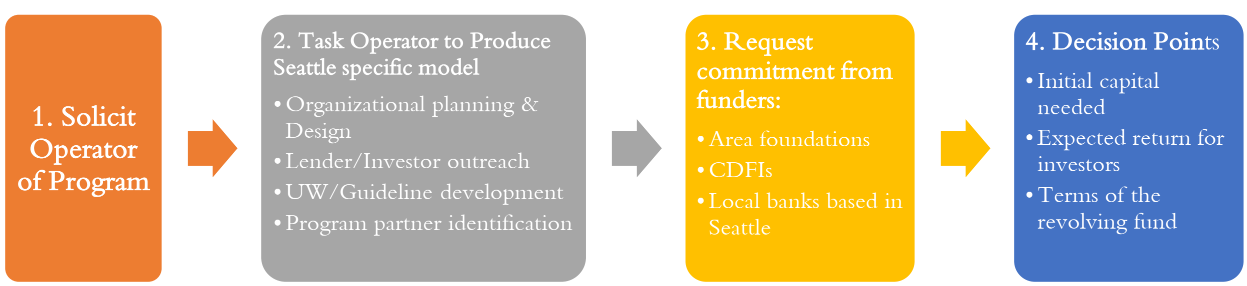
For a new program, the Oregon model requires a smaller revolving fund, and therefore a smaller infusion of start–up capital. As a market, Seattle appears to be an ideal location for seeking investment capital to begin a revolving fund, given the proximity of large foundations. Foundations may be receptive to a model that allows them to invest funds with a likely full return of the principal after an agreed upon investment period. The revolving fund needs investment but not subsidy and would be a good fit for a Program Related Investment (PRI) from a local foundation's endowment. The investment is secured by collateral and will earn interest that can offset potential losses. The Oregon and Boston projects suggest that the overwhelming majority of these loans perform, once "right–sized" on an individual basis.

A new fund should be able to prevent 50 foreclosures a year for every $10 million invested. At scale, a revolving fund of $50 million could serve 250 families a year. While a mature fund of $50 million would appear to be a reasonable goal, the program will likely need to be proven locally before growing to that size. An initial investment ranging from $2–10 million would seem an achievable start.

NEW PROGRAM PROCESS STEPS

As previously discussed, both program models appear replicable and scalable. With that said, each has adapted to the political, legal, and funding landscape of their areas.

A program in Seattle can utilize many of the lessons learned from the SUN Initiative and the LRAPP program, but will require an operator to investigate environmental factors. The following steps represent a possible path for the City of Seattle to develop and implement a principal reduction program similar to those described in this report.



1) SOLICIT INTEREST IN PARTNERING WITH CITY TO DEVELOP PROGRAM

Given the unique nature of these programs, the first step appears to be to solicit an experienced program partner. The two programs currently operating represent likely partners, but there may be other potential partners in the region with mortgage lending, financing, and short–sale negotiation expertise.

2) TASK OPERATOR TO PRODUCE SEATTLE/WA MODEL

Upon finding a program partner, there are several key steps before funding can be committed, including:

ORGANIZATIONAL PLANNING/DESIGN

- Identify nonprofit to manage capital and hold the loans (required by lenders/investors)
- Identify experienced financial entity to manage funds
- Identify licensed mortgage originator
- Identify program administrator (strategy/marketing/lender relations/program oversight/etc.)

While this might appear to be separate organizations, in fact, one or two groups can likely manage multiple roles, as is currently the case for the SUN Initiative and LRAPP.

In terms of identifying a nonprofit, ideally there would be the opportunity to work with a Community Development Financial Institution or other experienced non–profit mortgage originator.

SOLICIT INTEREST FROM FHA, FANNIE & FREDDIE MAC

For the program to work, there needs to be willing sellers. The LRAAP program has existing agreements in place that should be replicable/transferrable to the City of Seattle or State of Washington. This aspect of the program underscores the political nature of program operations and the need for political expertise, either from local government or from program partners/operators.

DEVELOP BASIC PARAMETERS/UNDERWRITING GUIDELINES

The availability of comprehensive guidelines from pre–existing programs should make this step of the process fairly straight–forward. There will be several policy decisions to make regarding program criteria, based on how much or little the program chooses to deviate from traditional lending standards.

In addition to underwriting guidelines, the City will need to make overarching policy decisions about the focus of the program. Given the number of loans in the area, and the relatively small scale of the program, the program could focus on homeowners of a particular demographic or economic condition, if desired.

IDENTIFY KEY PROGRAM PARTNERS

Program partners will be a valuable source of referrals and expertise related to the type of issues most often faced by Seattle homeowners. Important partners for the program may include housing counselors, realtors, legal assistance providers and other housing advocates.

3) REQUEST COMMITMENT FROM FUNDERS

The challenging aspect of implementing this program in Seattle is securing capital. While the programs are able to revolve funding and likely able to re–pay investors, it is still an unknown model, and likely requires investment from a socially motivated investor. This is an area that the City of Seattle may be well–suited to add value, through an initial contribution of funds to demonstrate a commitment to the program, and through political leverage and relationships with lenders.

4) DECISION POINTS

The actual mechanics of the fund should be decided based on the insight and experience of participating funders. The amount of initial capital needed, the expected return for additional investors, and the terms/thresholds for a potential revolve/cycle of program funds can all be identified once the financing partner has been secured. Additionally, once the scope and nature of the fund has been decided, other program decision points can be made, related to the number of loans made per month, target demographics, marketing, etc.

CONCLUSION

Seattle appears to be an ideal candidate to implement a sustainable principal reduction program due to:

- **Need** – Initial data indicates a clear need in the Seattle area, with thousands of underwater and delinquent mortgages *(further research is needed to better understand the characteristics of this population and to identify those that are delinquent due to an economic hardship).*
- **Access to Investors** – Seattle has access to multiple forms of potential investment capital (foundations, CDFIs, local banks headquartered in Seattle) that could fund the initial program and/or purchase the loan pool for a revolving fund.
- **Borrower Representation** – The Attorney General has funded a substantial amount of legal aid and homeowner counseling; a principal reduction program could supply those advocates with a meaningful tool for homeowners.
- **Developed Model** – The State of Oregon and Boston Community Capital have developed and implemented models, leaving the program(s) transferrable for the next entity to it
- **Lender Participation** – Major lenders have agreed to participate in the Oregon LRAPP program (Fannie Mae, Freddie Mac, FHA)

The benefit provided to families that have overcome a hardship through these programs is hard to overstate – they are able to remain in their homes long-term, and pay a mortgage that is based on a real value. Perhaps more importantly – there is no ongoing subsidy.

It's quite imaginable that Seattle could learn from the existing programs quickly and be the first jurisdiction to get these proven approaches to scale. The impact on an individual and neighborhood level would be significant and the risk quite low.

SOURCES

Boston Community Capital, "SUN INITIATIVE: From our community to yours: A blueprint for delivering foreclosure relief to your community

"Interview with Further Development President Erik Sten." Telephone Interview. 13 Aug. 2014

"Oregon Homeownership Stabilization Initiative." *Oregon Homeownership Stabilization Initiative*. N.p., n.d. Web. 14 Aug. 2014. <http://www.oregonhomeownerhelp.org/>.

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PROGRAM COMPARISON

	LRAPP	SUN Initiative
Program Origin	2012	2009
Homeowners Assisted	140+	500+
Participant Benefit	Average of $533 in monthly mortgage payment reduction, $100,000+ principal reduction	Average mortgage payment reduction of 38%
Start–Up funds	Initial costs paid for out of Oregon's HHF administrative budget – subsequent costs were paid for out of individual loan sales. Start–up funds recouped.	$3.7 million for planning, one–time start–up costs, and initial home purchases/mortgages
Real Estate Brokers	Market driven	SUN acts as Broker
Loan Mark–Up	12%	25%
Participant Mortgage Payment	Monthly	Bi–Weekly
Terms of Re–Sale	No restrictions	Sun is due 50% of any realized profit above the value of the new loan
Capital Reserve Account	No	Yes
Revolving Fund	Yes	No
Loan–Loss Reserves	Loans are not held	25% mark–up on distressed market value
Property Appraisals	Broker Price Opinion	Full appraisal before underwriting
Loan Servicing	3rd party	3rd party
Program Administration/Oversight	Oregon Department of Housing and Community Services	Boston Community Capital
Capital/Financing	Oregon Affordable Housing Assistance Corporation (State of Oregon)	Sun Initiative Financing LLC
Property Acquisition	Further Development	NSP Residential, LLC
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