THE LEVER:

To Fix the Economy – Fix Housing

By

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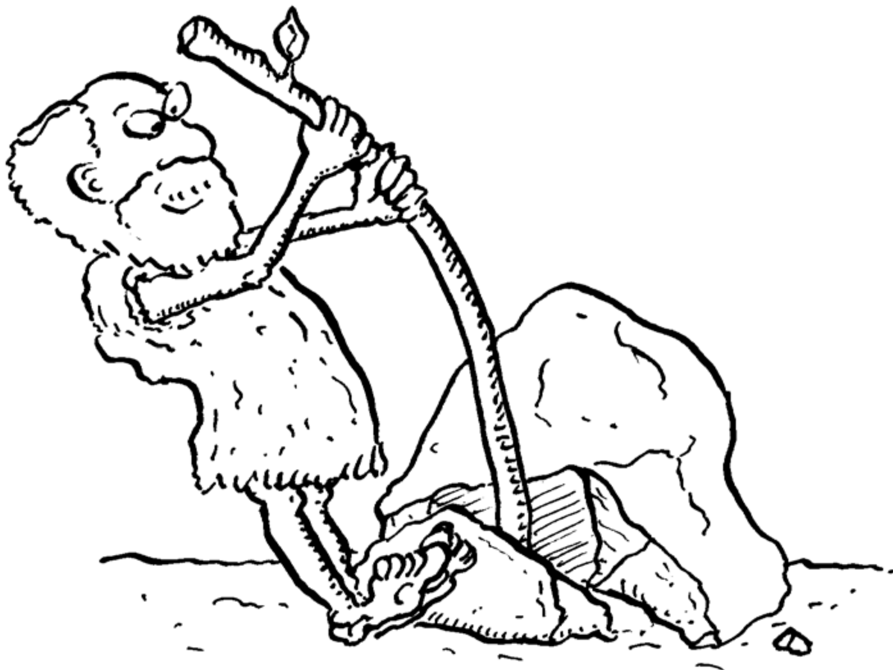

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The American economy is in a mess. We all know it. Worse … we are mired in that mess. Our politicians seem more interested in fighting each other than in helping the average family. We need jobs, we need liquidity, and, most important, we must restore confidence and our hope for a brighter future.

Our economy is trapped in unremitting doldrums. The government proposes stimulus packages that provide little relief. We spend trillions on wars that fail to provide little sense of security at home. Our children face a bleak future.

We are stuck.

We are stuck with unimaginative, traditional fixes that aren't working. As Churchill once said, "You can depend on America to do the right thing, after it has tried everything else!" Having tried everything else, it's time to do the right thing.

Fingers of blame point in all directions but seldom discussed is the root cause of the problem - the housing market. Why is it the root cause? Because the government and the banks have allowed nearly a trillion dollars' worth of losses in residential real estate to go unrecognized. Both government and banks pretend that homeowners will be able to find a means of repaying this lost value. The Japanese did this in the 1990s and their economy never recovered. Pretending that losses did not happen does not work. It makes demands on homeowners which they cannot meet. It increases the financial risks to all. "Unhealthy" assets remain on banks' books and amplify due to the massive multiplier effect of the derivatives, MBSs, MBOs, CDOs, and swaps built upon this folly of "junk".

On September 12th, 2011 Brett Arends, a prominent Wall Street Journal columnist, suggested that the only appropriate solution was massive bankruptcies.

> *The real cause of our economic slump isn't too much government or too little government. It isn't red tape, high taxes, low taxes, the growing divide between the rich and the poor, too much government debt, too little government debt, corporations, poor people, "greed," "socialism," China, Greece, or the legalization of gay marriage. It isn't, in short, any of the things all the various nitwits say it is. It's the debt, stupid. The key thing to understand is that most of that money has gone to what a fund manager friend of mine calls "money heaven." Most of these debts will never, ever be repaid in real money. Not gonna happen. We have tens of millions who cannot repay their debts. But they are all trying to. That sucks huge amounts of money out of the economy. And that means these people cannot function properly as consumers or workers. That's the reason people aren't coming into your restaurant. It's the reason people aren't taking your yoga class. It's the reason they haven't hired you to redo the kitchen. And so tens or hundreds of millions of perfectly responsible business owners and employees are also suffering from this slump. That's the reason we have a shortage of demand. That's the reason no one is hiring. Even worse: People who are underwater on their mortgage, but who do not want to default, cannot move to where the jobs are either. They are stuck with their home. You want to break this logjam? Try Chapter 11 for the nation. Massive defaults. Clear the decks, clean the books. (Brett Arends, WSJ, 9/12/2011)*

A surfeit of bankruptcies is a drastic step. Eliminating mortgages and forcing people from their homes would address the housing market. But at what cost? Surely the answer to our economic woes cannot be the deliberate creation of a new generation of homeless citizens. There is no need for such pain to millions of homeowners and their families and to the millions more who will incur massive investment losses. Rather than create pain, let's do what has not been done. Let's fix housing.
When the President proposed a stimulus during the first week of September, he barely mentioned housing. The numbers illustrate just how large a problem is being ignored. Today the value of U.S. residential mortgage market is underwater (the principal amount of debt exceeds the underlying value of the collateral) by more than $700 billion. The banks and the government are pretending that this $700 billion is going to magically reappear sometime during the next few years, supposedly from rising real estate values. It is not going to happen. This "magical accounting" (or perhaps "lie") affects more than $2.5 trillion of mortgages. It affects 15% of the TOTAL debt carried by U.S. households. As the Wall Street Journal noted, the illogical insistence that homeowners somehow find a means to repay the banks this $700 billion is the root cause of our listless economy. Until we rid ourselves of this delusion, we will continue to face financial ruin.

To solve our economic crisis, we need to deal with these underwater mortgages head on.

The U.S. single family, owner-occupied market is a $20 trillion market split about equally between debt and equity. We cannot allow 25% of that marketplace to continue to be uncertain, chaotic, and unable to be repaid. We must restore the mortgage marketplace to health. If we were starting from scratch, all loans would be in amounts equal to 80% or less of current market value and with interest rates at current low rates (around 5%). The solution to the crisis is to engage in a process that replicates starting from scratch. We must get the loan to value ratios back in line with marketplace norms (roughly 80%), and interest rates on those loans must reflect current rates (5% or less). By making mortgages more affordable and better aligned with lower property values, homeowners can afford to continue paying their mortgages - and will find it worthwhile to do so. Homeowners will have more money in their pockets to spend. Net result: a stimulated economy, increased consumer spending, and more jobs. The financial markets will have healthier assets – enabling lenders to lend. Fixing housing can and will fix the economy.

How?

There Is An Answer.

We call it "THE LEVER". The name derives from the simple fact: a relatively inexpensive solution (in cash terms) can create huge benefits for the economy. Almost instantly. In finance they call this leverage. Thus our plan is "THE LEVER."

THE LEVER is a three part program designed to fix America's housing market. Fix housing and we fix the economy. Without THE LEVER, any recovery in home values remains years away as foreclosures dump more properties onto the market while the jobless rate hovers around 9 percent and strict lending rules hurt sales. THE LEVER can be implemented in months (not years). It is optional not mandatory. It creates spending money. It stabilizes markets. It stems the tide of "underwater mortgages." It will cost the taxpayers next to nothing. Now that's leverage.

THE LEVER works because it is already built into our financial system. It requires nothing new – except courage and confidence. Its three steps are simple:

1) Get prepared. Homeowners desiring to refinance via the LEVER will be required to get new home appraisals (the cost of which may be covered by their lender or deducted from their taxes, more on this below). These new appraisals will be used to determine current market values. Homeowners will also need to ensure that their 2010 taxes have been filed. Their tax returns will provide the basis for the calculations of "affordability" which sound lending requires.

2) Wipe the interest rate slate as clean as possible and take advantage of today's low interest rates. Every homeowner who is current on the mortgage on a primary residence will be given the option to refinance 100% of that mortgage at current interest rates. These are the folks who are paying their bills. They did not cause the real estate market collapse, but are suffering the consequences. They should get the same opportunity as others to free up some cash – especially if we are going to help those who have not been paying their bills.

3) Restore as many loans as possible to "performing" status. Performing loans are loans which are both current (money is paid when due) and which have an acceptable risk profile. Performing loans are "liquid" -- lenders can sell them to one another, can securitize them and, yes, even sell derivatives on them. But 25% of all residential mortgages in the United States are underwater. These homeowners have negative equity – the outstanding principal due on their loans exceeds the current value of the homes. We cannot fix housing until and unless we restore as many of these loans as possible to performing status.

   All homeowners who are occupying their homes will be given a second choice – refinance the existing mortgage in a principal amount equal to 80% of the current market value of the home and, in return, give the bank a significant equity interest in the future value of the home. (This concept is known as shared appreciation and will be described in much detail as this white paper progresses.) Notice we said "all". Homeowners who have been doing the right thing should get the same opportunity as those who are underwater. The financial choice will be theirs.

Details matter and we will explain further, but these three steps will instantly:

- generate spending money for homeowners (via lower monthly payments),
- improve balance sheets for banks (via a revived portfolio of performing loans),
- stabilize the housing market (by getting rid of most of the overhang of foreclosures and short sales), and
- boost consumer confidence that the markets finally have this issue under control.

Notice what is NOT involved. The banks are NOT being asked to "forgive" anything (swap or exchange for value, yes – forgive without return, no). No one is getting a below market interest rate. No one is being rewarded for speculating. No bank is being rewarded for bad behavior. No one is being forced from home. No one is forced to participate.

"Determine current market value – refinance to current rates – restore loans to performing status."

These three steps are "***THE LEVER***".

Now What Does This Mean?

It means we have a tool which quickly can help to restore health to the economy at a minimal cost. It means that the economic outlook does not need to be listless.

It means we can give millions of Americans the ability to hold their heads high once again instead of floundering in sludge of never ending, never to be paid back debt.

If we implement THE LEVER, we can expect the following:

1) *Consumer Confidence Will Increase Dramatically Due To The Actual Existence Of A Real Plan*

In September, confidence among U.S. consumers plunged to the lowest level in more than two years as Americans' outlooks for employment and incomes soured. The U.S. Consumer Confidence Index (CCI) is an indicator designed to measure consumer confidence, defined as the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending.
A month-on-month decreasing trend suggests consumers have a negative outlook on their ability to secure and retain good jobs. Thus, manufacturers may expect consumers to avoid retail purchases, particularly large-ticket items that require financing. Manufacturers may pare down inventories to reduce overhead and/or delay investing in new projects and facilities. Likewise, banks can anticipate a decrease in lending activity, mortgage applications and credit card use. The Conference Board's index slumped to 44.5, the weakest since April 2009, from a revised 59.2 reading in July.

The index averaged 98 during the economic expansion that ended in December 2007. THE LEVER is anticipated to raise that index value above 70 (back to levels from when the crisis first started – before the public believed it was spinning totally out of control). Increased confidence has a huge multiplier effect. Confident consumers spend money. And, spending money is the key to fixing the economy.

2) *Stable Mortgage Rates At Or Below 5% For Two Or More Years*

The program involves the refinancing of $1 to $2 trillion of mortgage loans at a fixed 5% rate. While the refinancing rate is not a firm predictor of the borrowing cost for new loans it is likely to be a determinative boundary on the marketplace. Stable interest rates help homeowners plan, and low interest rates help them consider both new construction and home improvements. There is nothing sacrosanct about the 5% rate – the idea is that everyone who lives in their home and who can afford that home (based on current values and ignoring the history of prior loans) should get to take advantage of the historically low rates now available.

3) *Cash In Consumers' Pockets Which They Can Spend*

Lower mortgage payments means increased cash in consumers' pockets. Lower mortgage balances means that consumers are no longer going to be worried about that negative equity somehow coming due – instead they can focus on the present and future needs of their families. That's right, their families and not some bank. The economy only works when consumers are spending. Consumers can only spend from cash (which is in short supply) and debt (which they have already massively overdone and the supply of which is basically over). Thus to get the economy moving we need cash in consumers' pockets. THE LEVER provides significant cash

4) Increased Confidence In Government And Wall Street

Who are we kidding? The economic mess has done nothing but erode confidence in both government and Wall Street. Endless speeches, innumerable plans, and nearly useless forecasts of the economy turning the corner have produced nothing. No simple plan has emerged that is understandable, can be implemented, and will produce solid near-term results. THE LEVER is such a plan.

5) An End To The Robo-Signing Mess

Robo-signing refers to a variety of practices. Banks and their partner firms file mortgage documents with county deeds offices to prove that there are no liens on a property, that the bank owns a mortgage or that a bank filing for foreclosure has the authority to do so. The signature of a qualified bank or mortgage official on these legal documents is supposed to guarantee that this information is accurate. The paper trail ensures a legal chain of title on a property and has been the backbone of U.S. property ownership for more than 300 years.

Robo-signing can mean a qualified executive in the mortgage industry signs a mortgage affidavit document without verifying the information. It can mean someone forges an executive's signature, or a lower-level employee signs his or her own name with a fake title. It can mean failing to comply with notary procedures. In all of these cases, robo-signing involves people signing documents and swearing to their accuracy without verifying any of the information.

The nation's foreclosure machine almost came to a standstill when the nation's largest banks suspended foreclosures last fall. Part of the problem, banks contended, was that foreclosures became so rampant in 2009 and 2010 that they were overwhelmed with paperwork. The banks reviewed thousands of foreclosure filings. Where they found problems, they submitted new paperwork, with signatures they said were valid, to courts handling the cases. The banks slowly started to resume foreclosures this winter and spring. The 14 biggest U.S. banks reached a settlement with federal regulators in April in whom they promised to clean up their mistakes and pay restitution to homeowners who had been wrongly foreclosed upon. The full amount of the settlement has not been determined.

Because THE LEVER involves refinancing most of these "problem" loans, the "faulty" documentation will be replaced with new signatures from all concerned.

6) An End To The Foreclosure Overhang (the forecast 3.5 million more homes expected to be foreclosed upon during the next two years)

Implementing THE LEVER will enable perhaps 80% or more of the underwater mortgages to be restored to health. The housing market will cease to be depressed by the specter of an ever increasing supply of foreclosed homes threatening to come to market at reduced prices. On September 14, 2011 Moody's Analytics head Mark Zandi estimated these "likely to be foreclosed upon" homes to number between 2 and 5 million over the next two years. Yes, the current supply of already foreclosed homes needs still to be sold off. But, if the marketplace no longer has reason to believe that another 2-5 million foreclosures are yet to come, the threat of further price reductions is greatly reduced.

Homeowners stay in their homes. This has many advantages: we do not get neighborhoods hollowed out and blighted by rows of boarded up, unoccupied homes; family members stay in school and continue to have access to community facilities and to their neighbors; and municipalities continue to get property taxes in an unbroken stream.

Again confidence is increased.

7) *An Increase In Capital At Banks Due To Non-Performing Loan Recoveries Increasing To 75% To 80% Of The Loaned Dollar From The Current 35% To 40%*

When banks do foreclose they seldom receive even 50 cents back on each dollar of old loan principal. Bank of America's recently released statistics show an average recovery of around 36%. Why is this? Start by realizing that the foreclosed home can only be sold for perhaps 80% to 85% of current market value. The very idea of a "repossessed house" carries a stigma which depresses values. Also, many of these homes are not in good shape. Banks are notoriously poor property managers and evicted owners may express their anger by leaving homes in poor or damaged condition. Finally, the specter of the foreclosure overhang described above haunts the selling bank (as it looks at the future marketplace for repossessed homes) and can be used as a bargaining chip by a clever buyer. The depressed value is confirmed when newly cautious appraisers deliver moderated estimates of worth when establishing the value of the repossessed house for a new lender. A vicious downward spiral on prices is the outcome.

Let's use a typical foreclosure as an example of the current situation. If the current market value of a foreclosed home is $100,000, the bank may manage to sell it for $80,000. From that $80,000, it is likely that the bank will payout $4,000 for commissions, $3,000 for closing costs, and $15,000 to cover expenses incurred by bank in the foreclosure process. Theoretically, the balance of $58,000 is recouped by the bank. This is not the whole picture, however. The bank also probably paid two years property taxes, another $3,000. The balance is now down to $55,000. Also, the bank's initial investment probably was far more than $100,000. Let's say that the bank had loaned the prior owner $140,000 on the home, which had been valued at $175,000 at its peak price. The bank probably failed to collect at least two years of payments on the loan or nearly $17,000. The bank's actual exposure was about $160,000. Its total return in cash slips $55,000. Clearly not a good investment.

THE LEVER is different. On that same loan, using THE LEVER, the bank can now receive nearly $100,000 cash (or almost the full current market value of the home) or if the bank retains its portion of the Shared Upside it might receive back as much as $120,000 (under THE LEVER, remember, future increases in value above the current market value are shared with the bank).

8) A New Financing Vehicle For Homeowner Equity

THE LEVER's arrangements for sharing the future appreciation of a home can easily be applied to new home construction as well as to the refinancing of existing homes. HES LLC, a firm comprised of several Berkeley financial economists which holds a patent on one form of such a sharing arrangement, estimates the present value of the future upside to be worth as much as 11% of the current value of the home. This means that the purchaser of a new home need only come up with 10% cash down and can allow the purchaser of the Shared Upside to supply the other 10%. Lower cash out of pocket requirements will help to spur new home building – since the cost of entry will be lower. New home construction has been a critical component of economic growth for decades. Providing a means for new buyers to enter the market with lower cash requirements (and NO increase in risk to the lenders) can only help spur new growth.

In addition, an existing homeowner – who is current on a mortgage – can receive a cash infusion by entering a sharing arrangement. No longer will speculation on the future value of a home (which in any other market would clearly be labeled as an equity arrangement) be disguised as debt.

9) *A Vehicle To Short Homeowner Equity Without Using Toxic Credit Default Swaps*

Since the shared future appreciation agreements will be documented, they can be bundled and sold as "securities." Investors will be able to buy and sell such securities and will be able to sell them short. The marketplace has longed for a way to sell residential real estate short and THE LEVER will introduce such a vehicle. This will allow hedging by large investors. Markets which have hedging possibilities are almost always more stable than markets which do not. Here THE LEVER is opening up new possibilities.

10) *The End Of A System Based On Lies*

Finally but perhaps most important the use of THE LEVER will end the big lie being perpetuated by the government and the banks. The $700 billion which is underwater is not coming back and THE LEVER is based on everyone admitting this. The current system instead is attempting to rearrange the deck chairs of a sinking ship. If we just ignore the $700 billion, perhaps it will go away. Japan tried this and is paying the price today more than 30 years later. As your mother always told you – tell the truth, you will feel better. Only the truth will free this economy. It is time for the housing market to tell the truth. If it does so, then THE LEVER can set it free.

History

Sounds too good to be true, doesn't it? The details are coming, but first it is important to realize that this plan in one form or another has been around for several years. Graciela Chichilnisky (one of the authors) proposed a variant of this plan which was considered by the Obama team during 2008-2009. The Berkeley financial economists who patented the home equity sharing arrangement in 2009 have been publicly suggesting variants of the plan for years. Even the White House acknowledges that it has considered various forms of "principal reduction" for the past several years.

In September 2008, a group of prominent New York based professors published a Brookings Institution report entitled, "Facilitating Shared Appreciation Mortgages to Prevent Housing Crashes and Affordability Crises." They argued "that development of shared appreciation mortgage (SAM) markets in the United States would moderate the impending decline in homeownership and lower the risk of future housing crashes. SAMs can increase the affordability of homeownership by reducing the amount of monthly payments and spreading risk more broadly between borrower and lender. We present SAMs

as both the obvious workout vehicles in the current default crisis and a vital part of the housing finance system that should be available at any time to interested homebuyers." Beyond getting an Op-Ed published in the Wall Street Journal, the proposal went nowhere.

Even Obama's first Chairman of the National Economic Council agreed in concept:

> *"[M]ethods need to be found to enable creditors who accept a writedown in the value of their claims to retain an interest in the future appreciation of the homes on which they have mortgages. This is standard practice in situations of corporate distress, where debt claims are partially replaced by equity claims." (Larry Summers, "America Needs a Way to Stem Foreclosures," Financial Times, Economists' Forum)*

SAMs have been around in various forms for many years. Along with adjustable rate mortgages, they drew thousands of customers during the early- and mid-1980s because double-digit mortgage rates left people scrambling to lower their mortgage bills any way they could. British banks implemented the idea in the late 1990's as home prices began their dramatic rise. More recently, the city of Burbank had a small program in place as did a number of other cities in California and Oregon. Even the Federal Government had a small shared appreciation plan called the HOPE for Homeowners program as established by Title IV of the Housing and Economic Recovery Act of 2008 (the "HOPE Program"). Even the IRS has a say: Revenue Ruling 83-51 (1983) specifies conditions under which the contingent interest in a shared appreciation mortgage may be considered tax-deductible mortgage interest. (In particular, a shared appreciation mortgage must stipulate an unconditional obligation of payment of principal to avoid being characterized as an equity-sharing agreement, which may lead to different tax consequences.) But, when it came time to coupling the concept of shared future appreciation with a write-down in the level of principal currently owed this history did not matter. The very idea of a write-down came to be seen as a "gift" which rewarded irresponsibility and the coupling of the write-down with a true upside for the lender was ignored.

The prior proposals got nowhere primarily because they implicitly asked both government and the banks to recognize that real estate values had crashed, that havoc has been wreaked on loan to value ratios, and that "clean-up" required write-down to realistic valuations. When Chichilnisky recorded her You Tube video in 2008 urging a 50% reduction in all mortgage payments, 50% seemed an unsupportable loss. Unimaginable. Yet today, banks are recovering less than 35% on foreclosed homes. By comparison, 50% would constitute a windfall.

When the Obama economics team faced the prospect of principal reduction, it appears that they only seriously considered the concept of "forgiveness." To forgive the debt excess of the past struck many as morally wrong. And forgive is a loaded word.

Think of the many articles which urged:

> *Millions of Americans are now deeply underwater on their mortgage. If you're among them, you need to stop living in a dream world and give serious thought to walking away from the debt. No, you shouldn't feel bad about it, and you shouldn't feel guilty. The lenders would do the same to you—in a heartbeat. You need to put yourself and your family's finances first. If you are reluctant to give up on "your" home, realize that it isn't "yours." If you are in negative equity, it's the bank's home. You're just renting it. And right now you may be paying way above market rates. You need to be ruthless about*

> *your cash flow. Whether we like it or not, walking away from debts is as American as apple pie. Companies file for bankruptcy all the time, and their lenders eat the losses. Executives and investors pocketed millions from the likes of Washington Mutual, Lehman Brothers and Bear Stearns when the going was good. They didn't have to give back one cent of that money when the companies went into bankruptcy. Limited liability, after all, is one of the main reasons every business from your local dry-cleaner to a major multinational gets incorporated in the first place. They're not shy about protecting themselves if things go wrong. You shouldn't be either. (Brett Arends in the WSJ, 2/26/10)*

Bankers and politicians took to the mass media to denounce the very idea that homeowners should act like business people. Instead they urged that there was a moral obligation for homeowners to repay banks -even if it required money that the homeowners did not have. “There is nothing moral about a strategic default” was the bankers’ battle cry. The same bankers who were on the receiving end of most of a $700 billion bailout.

The work of Chichilnisky and others did not stop though. In time even the mass media would recognize that loan modifications (fancy talk for lowering interest rates) would not suffice, and that true loan principal reductions would be needed. The specter of Japan began to haunt the banking industry. What to do with the $700 billion plus of negative equity?

Martin Evans, a retired professor living in Cambridge, Mass offered this in 2010:

> *Last year when foreclosures on sub-prime mortgages began, one reaction of the general public was, "Well, they got what they deserved. They made a risky investment that they couldn't afford. Serves them right." People were unsympathetic to a plan like shared appreciation mortgages that would reward those who took undue risk or engaged in outright fraud. A year later, the situation is quite different. The latest round of foreclosures is falling on ordinary people: people who, through no fault of their own, have lost their jobs or had their hours reduced so that they no longer earn enough to continue paying their mortgages. The government should step in and join with them in a shared appreciation mortgage. As with any government endeavor, there is risk for the government. Only if the housing market steadies and prices improve will the government stand to get back its investment in these mortgages. However investing in these mortgages is just what is needed to steady the housing market, get construction moving again, and start a recovery in prices.*

When Japan ignored its version of this problem, economic stagnation set in and growth as we know it has never returned. The “bad loans” and “negative equity” which remained hidden acted like a soggy blanket smothering efforts to spur their economy. The US cannot afford a similar scenario.

On September 14, 2011, while a Senate committee began to discuss the pains of principal reduction, the press reported, “The consensus among economists for the probability of another U.S. recession in the next 12 months rose to 31 percent …"The economy is dangerously close to stall-speed. There is no buffer, and even a moderate shock could derail the cycle."

THE LEVER is designed to propel us away from that stall, without forgiveness, but with a debt for equity swap instead. THE LEVER is not "something for nothing". It offers an open recognition that a home with negative equity really does belong to the bank and that the bank does not want the home. The bank wants to maximize its recovery. The homeowner wants to keep the home. THE LEVER allows both to get their desires. It is based on current market values and current ability to pay -not on the imagined values of a historic yesterday. It's a swap of worthless debt for meaningful equity - a win-win LEVER for the economy.

Details Matter – So Here They Are:

Eligibility: THE LEVER is only available on properties which are occupied by their owners. It is not a bailout for rental property, or investment property, or second homes. Part of the confidence that the new loans will be repaid comes from the simple fact that people care about the homes they live in. Make those homes affordable and people will take good care of them. They will put pride into their homes. That care and pride underlie what THE LEVER is all about.

In addition it is critical that all new loans originated under this program are NOT predatory in nature which means that the lenders need to be able to verify that the borrower can actually afford to make the requisite mortgage payments. This is where the 2010 tax returns come into play. THE LEVER makes use of a simple "affordability" test: the payments due on the new mortgage obtained via THE LEVER cannot exceed 31% of the adjusted gross income shown on the borrowers'/taxpayers' 2010 return. Yes, in theory there are circumstances where such a test will exclude potentially good borrowers, but the interests of expediency and simplicity dictate that THE LEVER needs an easily understood and easily complied with test.

Thus two eligibility requirements are: 1) home ownership and occupancy and 2) affordability.

Affordability factors into each of the two financing options under THE LEVER. THE LEVER has two financing options both of which will refinance 100% of the current mortgage:

a) Option A – Homeowner Upside

   If the homeowner is current on his/her existing mortgage, desires to keep control of all of the equity in the home and, if a 100% refinancing at a 5% rate results in payments which do not exceed 31% of the income shown on the 2010 tax return, then the mortgage can be refinanced at a 5% rate for a new 30 year term. This option does NOT demand a particular loan to value ratio. If the homeowner is current on their existing debt, then, BY DEFINITION, they can afford the new debt at a lower payment.

b) Option B – Shared Upside

   If the homeowner cannot afford the Homeowner Upside option or desires a lower monthly payment, then the second option calls for a new loan at 80% of current market value and a swap of the remaining balance on the existing loan for two new instruments: a zero interest ten year loan on the remaining 20% of current market value and a shared equity agreement with respect to the future increases in value of the home above the current market value. This option is available to all homeowners who can demonstrate that an 80% of current market value

financing at a 5% rate results in payments which do not exceed 31% of the income shown on the 2010 tax return.

Homeowners who cannot demonstrate that they can afford even an 80% of current market value financing are simply in a home that they cannot afford and are ineligible for this program. Quite bluntly such homeowners need to move. Based on statistics provided by CoreLogic and Moody's Analytics, we estimate that such homeowners are fewer than 10% of those who currently occupy their own owned home.

Valuation: Current market value will be determined pursuant to an appraisal. (If the original lenders dispute this appraisal they have the right to order two more appraisals at their expense and the middle number will be the accepted value.)

Financing Options:

a) Option A – Homeowner Upside: 100% refinancing at a 5% rate regardless of loan to value ratio.

This option is only for those homeowners who are current on their mortgage (or who make sufficient makeup payments so as to be once again current). It recognizes that being current is a measure of both affordability and willingness to pay. Lenders may object that the "normal" standards for loan to value ratios (usually 80% loan to value) are being ignored. These are not normal times. If a homeowner was going to default as a matter of calculation (what some call a strategic default) it is highly likely that by this point in the economic crisis they would have already done so. Homeowners who are current need to be rewarded by the system. The Homeowner Upside Option can provide such a reward.

b) Option B - Shared Upside: 80% of current value refinancing at a 5% rate plus shared future appreciation with the lender.

Those homeowners making use of the second option (the 80% of current market value loan) are agreeing to repay the current market value of the home in full (remember they are borrowing the other 20% at a zero interest rate for 10 years) AND to give the lenders a significant share of the upside should the house be sold.

The shared equity arrangement rewards the banks for agreeing to reduce the principal amount of debt owed on the home while preserving the homeowner's interest in building equity. The shared equity arrangement would give the lenders 100% of the appreciation of the home during the first twenty-five (25) months and then the share would decline to 50% on the fifth anniversary date. The rationale for this is simple: the longer the homeowner remains living in the home, the more equity they have the potential to earn on the home. Beginning after the second year, each month of continued ownership will add a 1% share to the homeowner's stake – until the 50% mark is reached.

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Example #1: Home with current market value of $200,000 (as established via the appraisal)

New LEVER mortgage at 80% of that current market value or $160,000. Monthly payment at 5% is $1,174. New LEVER zero percent mortgage for $40,000. Monthly payment is zero. ($160,000 plus $40,000 total to the $200,000 current market value.)

The Home is sold in five years for $250,000. The $160,000 mortgage is paid off (the principal balance at the end of five years will be $146,926). The $40,000 zero interest mortgage is paid off. The lender (or the owner of the Shared Upside arrangement if the lender has sold it) receives 50% of the $50,000 increase in value between the $250,000 sales price and the $200,000 value established when the home entered THE LEVER program which equals $25,000. The homeowner receives the remaining cash ($250,000 less $146,926 less $40,000 less $25,000) equal to $38,074 less closing costs on the transaction. Assuming closing costs at 7%, these would be equal to $17,500: leaving a net to the homeowner of $20,574.

The lender has received $225,000. The homeowner has received $20,574.

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Example #2: Home with current market value of $200,000 (as established via the appraisal)

New LEVER mortgage at 80% of that current market value or $160,000. Monthly payment at 5% is $1,174. New LEVER zero percent mortgage for $40,000. Monthly payment is zero. ($160,000 plus $40,000 total to the $200,000 current market value.)

The Home is sold in five years for $220,000. The $160,000 mortgage is paid off (the principal balance at the end of five years will be $146,926). The $40,000 zero interest mortgage is paid off. The lender (or the owner of the Shared Upside arrangement if the lender has sold it) receives 50% of the $20,000 increase in value between the $220,000 sales price and the $200,000 value established when the home entered THE LEVER program which equals $10,000. The homeowner receives the remaining cash ($220,000 less $146,926 less $40,000 less $10,000) equal to $23,074 less closing costs on the transaction. Assuming closing costs at 7%, these would be equal to $15,400: leaving a net to the homeowner of $7,874.

The lender has received $210,000. The homeowner has received $7,874.

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Example #3: Home with current market value of $200,000 (as established via the appraisal)

New LEVER mortgage at 80% of that current market value or $160,000. Monthly payment at 5% is $1,174. New LEVER zero percent mortgage for $40,000. Monthly payment is zero. ($160,000 plus $40,000 total to the $200,000 current market value.)

The Home is sold in five years for $200,000. The $160,000 mortgage is paid off (the principal balance at the end of five years will be $146,926). The $40,000 zero interest mortgage is paid off. The lender (or the owner of the Shared Upside arrangement if the lender has sold it) receives 50% of the zero increase in value between the $200,000 sales price and the $200,000 value established when the home entered THE LEVER program. The homeowner receives the remaining cash ($200,000 less $146,926 less $40,000) equal to $13,074 less closing costs on the transaction. Assuming closing costs at 7%, these would be equal to $14,000: leaving a net loss to the homeowner of roughly $1000.

The lender has received $200,000. The homeowner has lost $1000.

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Example #4: Home with current market value of $200,000 (as established via the appraisal)

New LEVER mortgage at 80% of that current market value or $160,000. Monthly payment at 5% is $1,174. New LEVER zero percent mortgage for $40,000. Monthly payment is zero. ($160,000 plus $40,000 total to the $200,000 current market value.)

The Home is sold in five years for $300,000. The $160,000 mortgage is paid off (the principal balance at the end of five years will be $146,926). The $40,000 zero interest mortgage is paid off. The lender (or the owner of the Shared Upside arrangement if the lender has sold it) receives 50% of the $100,000 increase in value between the $300,000 sales price and the $200,000 value established when the home entered THE LEVER program which equals $50,000. The homeowner receives the remaining cash ($300,000 less $146,926 less $40,000 less $50,000) equal to $63,074 less closing costs on the transaction. Assuming closing costs at 7%, these would be equal to $21,000: leaving a net to the homeowner of $42,074.

The lender has received $250,000. The homeowner has received $42,074.

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Shared Appreciation: If the home is sold during the first 25 months, 100% of any upside will belong to the lender (or the owner of the Shared Upside arrangement). Thereafter, the home owner will "earn" one percent of the Upside each month, until both the lender and the homeowner each "own" 50% (fifty percent) of the appreciation over the initially declared "current market value".

Note: If the house has not been resold by the tenth anniversary (the same date that the 20% zero interest loan becomes due) the shared equity will be valued through a new appraisal (same process as above) and will convert to a new ten year zero interest loan.

The documentation for the shared equity arrangement already exists. In fact the ability for these arrangements to be bundled into securities and traded already exists (one such system was patented by HES LLC in 2009). What this means is that the program can hit the ground running. There is no need for new documents. There is no need to create new financial arrangements. These already exist.

Additional Protections for the Lenders: All financing and refinancing done per THE LEVER program will carry four additional provisions:

1) The homeowners must agree to a stipulation which states that missing four consecutive mortgage payments or eight payments out of the previous twelve will trigger a "stipulated foreclosure" fully agreed to in advance. This is NOT a look back provision. It begins simultaneously with the new loan.

   By having a "stipulated foreclosure" provision in the original documents, both the lender and the borrower will have agreed to a speedy resolution for the "cannot afford" to pay scenario which despite all best intentions may still yet occur. Further, stipulated foreclosure provisions remove much of the risk of the "unwilling to pay" scenarios. The terms which constitute default will be clearly spelled out and agreed to in writing. The provisions for moving out of the home and further liabilities will also be spelled out clearly.

This will remove much of the need for protracted litigation over future foreclosures (with regard to loans made under THE LEVER program). Litigation is needed when provisions are not clear, when rules have not been followed, or when lending was perhaps predatory in nature. THE LEVER will involve none of that notorious list.

2) The homeowners will agree to take out insurance which will cover their mortgage payments for a minimum of a year in the event of a job loss during the first two years of the new financing.

   Job losses happen. It is critical that the stability of home ownership and occupancy offered under THE LEVER program not be undermined by the continuing negative economic outlook. Many credit card providers offer this kind of job loss insurance to their clients.

   If paying for the job loss insurance renders the payments due under the Homeowner Upside Option unaffordable, then that homeowner shall be redirected to the Shared Upside Option. If paying for the job loss insurance renders the payments due under the Shared Upside Option unaffordable then the homeowner is clearly at a precipice regarding the general affordability of that home.

   Ideally either the lender or a government agency will create an insurance program to assist those who fall into this grey area. These homeowners would best be served by a mutual insurance policy operated as a cooperative amongst its insureds – this is where the premiums paid serve as a self-insurance pool and that amount which is not drawn down as coverage payouts is then refunded pro-rata to all those who paid premiums and did not collect on the coverage. This type of insurance is common amongst self-help groups around the globe and its use in conjunction with THE LEVER program would aid the economy in general (but that is a subject for another report).

3) The documents will provide that the lender is prohibited from granting a deficiency waiver in the event of foreclosure or its equivalent which would bring the recovery amount to less than the 100% of current market value established as the basis for the new loan.

   The 100% of current market value standard is the very basis of THE LEVER program. Both the borrowers and the lenders are explicitly recognizing that the home is only worth its current market value and that in return for the homeowner keeping control and occupancy of the property, the lender is entitled to receive 100% of the current market value of the home upon a future sale.

4) With respect to the Shared Upside Option, future sales of the property through the first ten years must be at arm's length to parties unrelated to the borrower. If a less than arm's length sale occurs or there is a sale to a related entity, then the previously agreed to Shared Upside arrangements will continue in force and be applied to the subsequent purchaser. That subsequent purchaser and the lender can reach an agreement which releases that purchaser from the Shared Upside arrangements in return for a cash payment, but that payment amount is subject to separate negotiation between the lender (or whomever owns the Shared Upside at the time) and the purchaser of the home.

> This provision is designed to prevent mortgage fraud. It removes the incentive for a borrower to "game" the system by attempting to sell the home at a below market price to a relative, friend, or "co-conspirator." To the extent that such transfers are necessary for family reasons (such as job loss, divorce, or health issues), the legitimate "inside/related" purchaser will have no reason to object to the continuation of the Shared Upside arrangements. By contrast, those who may be inclined to "game" the system will discover that this provision removes nearly all their economic incentives for doing so.

These provisions are designed to ensure that there will not be a repeat of the present foreclosure crisis. The rules and outcomes will be defined in advance. The lenders will be reassured that the payments are not only affordable but well protected against default. The court system will not face protracted foreclosure suits since the matters will have been fully agreed to in advance. And borrowers will have little incentive to attempt to "game" the system since they cannot be "let off of the hook" – they remain responsible to see to it that the lender recovers at least current market value of the home.

Tax Implications: To the borrower, the Option A Homeowner Upside loans have no tax effects (except that the transaction costs perhaps be deducted as interest). Any write-down in loan principal amount under the Option B Shared Upside is presently excluded from taxation through 2012. It would be desirable for Congress to both extend this tax treatment and to clarify that the transaction costs incurred are deductible as interest. To the lender, the tax treatment will depend on how they presently value the loans outstanding to a given homeowner. Even exchanges have no tax consequences. Write-downs are recognized as losses while increases in asset value and decreases in reserves are recognized as income.

Bank Capital: Financial institutions which have already properly accounted for the "underwater" and non-performing loans in their portfolios are likely to see a marked increase in capital stemming from their ability to value LEVER loans at a much higher ratio than the existing debt to a given homeowner. Conversely, financial institutions which have put off their day of reckoning on underwater but still sort-of performing loans will incur a hit to capital. Such a hit was inevitable, and if Japan is any guide, the sooner recognized, the healthier the financial institution will be.

Programmatic Eligibility: The massive securitization of residential home mortgages poses problems for THE LEVER program just as it does for almost any attempt to restore sanity to the mess. THE LEVER can most easily be applied to the portfolio loans of any institution be that a government entity such as Fannie Mae, Freddie Mac, FHA etc. or the portfolio of a financial institution. Applying THE LEVER to loans which were sold and bundled into securities is harder. There needs to be a "defensible finding" (be it by a regulator, Congress or the Courts) that doing refinancing pursuant to THE LEVER is better than the alternatives of either doing nothing or allowing the current recipe of robo-signings, foreclosures, liars loans and the like to demand that stagnation be our only option. We say "defensible finding" because the trustees who hold fiduciary responsibility to the holders of these securities are not going to risk their very existence on a policy position which can help the economy. Regulators and perhaps Congress will need to step in to provide the legal cover which would allow these trustees to act.

But there are perhaps a trillion dollars or more of portfolio held mortgages to which THE LEVER can be applied now. We need not wait to solve the securitized loan issue, before starting on portfolio loans. Further, to the extent that applying THE LEVER to portfolio loans has the positive win-win outcomes we suggest above, those results can provide powerful evidence in support of the "defensible finding." As in much of life, we need to take one step at a time.

Balance Sheet Effects: Banks and other lenders who have already written down the mark to market value of underwater residential loans will derive a positive outcome from THE LEVER program. If expected recovery from compromised assets can be shown to improve to the 75% range from the 36% range, there can be a lowering of reserves, an increase in asset value, or both. Unfortunately not all banks have taken the necessary painful steps. We would respectfully suggest that the application of THE LEVER program will help to ease these banks pain. Write-downs from the reductions in real estate values are necessary and cannot continue to be postponed.

Psychologists suggest that happiness may depend less on perfect performance than on learning how to recover from setbacks and improve regardless of the obstacles. We have had our share of setbacks and obstacles in the housing market and in the economy in general. It is time we acted to recover from what has occurred rather than continuing to bemoan the loss of what never was quite real.

What Needs To Be Done

The banks need to face reality. The housing market in general is not going to recover until the burden of this $700 billion of "missing equity" is removed. Homeowners cannot afford to pay the money. The tax payers both cannot afford it and have no reason to take on any more of that burden than they presently have. The banks need to recognize that a program which pays them more than 95% of the current market value of the home is a much better alternative than postponing the inevitable and perhaps collecting only half as much.

The program described above is voluntary for the banks. It can be accomplished without government assistance. But the government can make this all work much faster. And FASTER is what the economy needs right now.

The key to speedy implementation is the creation of a new FHFA approved FHA/Fannie Mae/ Freddie Mac program to buy the new LEVER loans from the lenders. This program would stipulate that, if the lender fully documented the provisions above, the loans would be purchased (would as in mandatorily not could as in optional). Option A (Homeowner Upside) loans would be purchased at 99.5% of principal amount. Option B (Shared Upside) loan packages (the 80% of current market value loan, the 20% of current market value zero interest rate loan, and the shared equity agreement) would be purchased at 95% of current market value of the home.

It is imperative however not to merely create incentives for the Option A loans alone. Thus, participation in the government program should be tied to the financial institution offering both Homeowner Upside and Shared Upside loans. The requirement for purchase of an Option B loan is that the lender has swapped the existing loans on the home for the Option B package. No deficiency payments. No remaining balances. The requirement for the purchase of an Option A loan is that the lender sells to the FHA/Fannie Mae/Freddie Mac loan program at least an equal amount of Option B loans. These requirements create the incentive for the lenders to participate in both programs and thus to voluntarily reduce the collective mortgage burden on the country.

The banks are presently negotiating with the 50 State Attorneys General about the creation of a $20-40 billion fund as a settlement of the robo-signing and related messes which affected consumers (investors are a different matter). That Fund should be used to provide the economic support for the FHA/Fannie/Freddie purchase program. The amount involved is less than 10% of the stimulus package

called for by the President on September 8. It can be funded by Congress first and then repaid by the bank settlement. With such a fund in place, much of the mortgage mess could be eliminated in less than twelve months. Without a government fund the LEVER process is likely to involve far fewer loans and could take as long as five years. Five years we simply do not have.

The experts who called for shared appreciation mortgages in 2008 had the right idea:

> *Almost 75 years ago, in the depths of the Great Depression, the nation faced a housing market collapse even more brutal than today. The federal government responded with a strategy that allowed homeowners to keep their homes and kept the bottom from falling out of the real-estate market. Unprecedented at the time, the 30-year fixed rate mortgage has since become the gold standard in markets around the world. Today, facing a similar collapse, the federal government needs to be equally bold. SAMs are the new deal in housing that our children need.*

It is not just our children who need THE LEVER: it is all of us. How do we make this happen?

To begin, the large banks currently negotiating with the State Attorneys General can offer to create the funding to allow THE LEVER program to get underway. Those same banks can immediately begin to offer LEVER loans to the many underwater mortgage borrowers represented in their owned portfolios.

Regulators and Congress can meet to determine how to legislate the “defensible finding” which would allow the trustees and fiduciaries who control the securitized mortgage portfolios to participate in the program.

The FHFA needs to write the rules which will allow FHA/Fannie Mae/Freddie Mac to offer LEVER loans to the borrowers of mortgages which they own. Congress needs to amend the FHFA statute so that the goal is not the maximization of returns to the Treasury from the Freddie and Fannie assets but rather the promotion of the overall health of the housing market.

We all need to embark on a program which recognizes that swapping underwater, illiquid, unlikely to be paid back debt in exchange for a significant share of future equity appreciation is a sound business transaction and not a gift to the underwater borrowers. We need to understand that as much as we may abhor the potential moral hazard from seeing borrowers repay less than the nominal amount of their original borrowing, the greater moral hazard lies in allowing the entire economy to stagnate because we refuse to recognize that some debts will NEVER be able to be repaid.

Martin Evans closed his proposal by noting:

> *The SAM of 2010 program could be to the housing market what the WPA was to employment in the previous Depression.*

THE LEVER is what we need to rescue the economy. Its implementation is simple (at least in the beginning). Its impacts are profound.

The time to start is now.