Frequently Asked Questions about Equity Assurance

Introductory questions

What's the program called that you are running in Syracuse?
The Home Equity Protection (HEP) program. The product that customers will buy is called a "Home Equity Protection plan." ("Equity assurance" is just a label for the concept).

Who's running the program?
Equity Headquarters, Inc. is running the program. Equity Headquarters is a non-profit subsidiary of Home Headquarters, Inc, a NeighborWorks® organization in Syracuse, NY.

How does the program work?
Home Equity Protection (HEP) provides financial protection to homeowners in the event that home prices decline in the area where they live between the time they enroll and the time they sell their home, in exchange for a one-time fee.

Here's the simple description: when you sign up for Home Equity Protection, you tell the program how much protection you would like to purchase (typically how much your home is worth). That becomes the Protected Value of your home. When you resell your home, the program pays you (or pays down your mortgage for you) if home prices have dropped in your ZIP code. For instance, if you buy Home Equity Protection for $50,000 and prices have dropped 10% by the time you resell your home, HEP will pay you 10% times $50,000 = $5,000 – no matter what price your home actually sells for.

How does the program measure whether home prices have dropped in a ZIP code?
The program uses a repeat sales house price index to measure the change in home prices in a ZIP code. Several corporations have developed repeat sales house price indices, including the Mortgage Risk Assessment Corporation (MRAC), Freddie Mac, and Case Shiller-Weiss (CSW). To build these indices, researchers look at a particular home, and see what it sold for at the different times that there was a sale (hence the term "repeat sales" index). By conducting this comparison for many homes within an area, the researchers can track how house prices are changing over time, while holding the quality of the homes fairly constant.

Who can sign up for this program?
Currently, anyone who is a homeowner (or who is buying a home they will live in) in the City of Syracuse can purchase a Home Equity Protection plan from Equity Headquarters.

How much does it cost?
As of July 1, Equity Headquarters will charge a fee of 1.5 percent of the Protected Value of the home. For a home worth $60,000 (roughly the average-priced home in Syracuse), the fee would be $900. Based on our analysis for Syracuse, this fee fully covers the expected losses for the program plus administrative expenses. (The pricing would be different in other cities and could also change over time in Syracuse).

Customers can finance the fee they pay to enroll through a second mortgage loan from Home Headquarters. Financed at 6% interest over 10 years, a $900 fee would require a monthly payment of $10.

When does the program start?
The program starts July 1, 2002.

Detailed questions about program design

When is protection available to the borrower?
Only upon sale of the home, after a three-year waiting period from the time of enrollment. Protection is available for a 30 year term – at the end of 30 years, if the homeowner has not sold their home, a payment is made automatically if the price index has declined from the time of enrollment.

What if the homeowner loses more money upon reselling the home than they get from the Home Equity Protection Payment? What if they make money upon reselling the home, but the index has gone down?
The Home Equity Protection program will make a payment only when there has been a decline in the index and only for the percent change in the index times the protected value. Because the index represents the average performance of home prices, some people will experience losses greater than the decline in the index while some people will experience losses less than the decline in the index. Indeed, it is possible that a homeowner could sell their house at a profit but still receive a Home Equity Protection payment if the index has declined in their neighborhood.

How is payment made in the event of a claim?
Payment is made via a check to the mortgage servicer to pay down the outstanding mortgage principal balance by the amount of the protection. If the outstanding balance is less than the amount of the Home Equity Protection payment, the program will pay off the mortgage completely and write a check directly to the homeowner for the remainder of the payment.

Are there different prices for different zip codes?
No, although a future national product could do so.

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What happens if the homeowner defaults on their mortgage?
If the homeowner wants to sell their home in order to avoid a foreclosure then they will be eligible for a HEP payment so long as the other conditions are met. However, if the bank has completed a foreclosure on the home, Equity Headquarters will not make a HEP payment.

What happens if the homeowner refinances their mortgage?
The homeowner would still be enrolled in the Home Equity Protection plan. However, the homeowner will not receive a Home Equity Protection payment upon refinance – they must sell their home.

Is there a waiting period?
Homeowners must live in their home for a 3-year waiting period after enrolling in the Home Equity Protection plan, unless a hardship such as job loss or illness can be demonstrated that requires the sale of the home. Determination of hardship is at the discretion of the program administrator.

Why is there a waiting period?
There are several reasons why we chose to impose a waiting period. First, the program is intended to encourage homeowners that are committed to remaining in Syracuse in the long term. Second, house prices movements can be somewhat predictable over the short term, but over longer periods such as three years the predictability is much reduced. The presence of a waiting period prevents a situation of adverse selection whereby homeowners increase their protection at times when the market is weak, impacting the sustainability of the program. Finally, the presence of the waiting period enables us to keep the premiums affordable.

Is there a cap or are there any exclusions on the amount of coverage to be provided?
There is currently no cap on the coverage. However, there are exclusions that limit the payments the program would make if a large-scale disaster (such as a hurricane, an environmental disaster, or an act of war or terrorism) were to affect many properties in a given ZIP code, causing the price index to decline. The consumer contract contains details on these exclusions.

What's the procedure for filing and processing a claim?
The homeowner must provide a copy of a purchase offer on their home and the letter accepting that offer to start the claims processing process. Equity Headquarters will make the Home Equity Protection payment to the lender and/or the homeowner, as appropriate, at the closing or within 21 days of receiving these documents from the homeowner, whichever comes later.

Is it a problem if the Protected Value is more or less than the actual market value? Is there a maximum or minimum Protected Value that a homeowner can have?
There are good reasons that a consumer might choose to have a Protected Value somewhat different from the home's actual market value. For instance, she might be planning renovations that would boost the value of her home, and want to include some of that additional value in the Protected Value. Or, she might want to pay less and have the program assume less of the downside risk – similar to a "copay" arrangement with insurance products– by setting a lower Protected Value than the market value. In most cases, we would recommend that the consumer choose a Protected Value close to their best estimate of the home's current market value. Equity Headquarters will set maximum and minimum protected values – maximum values so that it can serve more customers with the resources available and minimum values to help it recover the administrative costs of enrolling and tracking customers. (Reasonable protected values in Syracuse at the current time might range between $30,000 and $150,000).

Questions about the financial viability of the program

Is there a moral hazard problem here? Would homeowners stop maintaining their home or try to sell it at an artificially low price if they had this protection?
No. Remember that the Home Equity Protection payment is based only on what

happens to the price index, not what the home sells for. Homeowners have every incentive to maximize the resale value of their home – they can make money on the resale of their home and still get a Home Equity Protection payment, if the index has dropped.

How will the program be able to make payments?
Equity Headquarters will maintain capital reserves to make payments in the event that prices fall. These reserves are funded by the enrollment fees that customers pay, by a $5 million subsidy from the Federal Government, and by investment returns on invested reserves. Additionally, we are seeking investments and grants from foundations and financial industry partners to further bolster reserves.

Capital reserves will initially be maintained equal to 10 percent of the total Protected Value of homes enrolled in the program. Maintaining reserves at this level would keep the program solvent for a 30-year period through 99 percent of the thousands of forward-looking scenarios that were generated by our research team. The reserve levels needed to maintain this solvency level will fluctuate over time depending on the number of policies written by the Program, their timing and the actual evolution of prices within Syracuse. We are committed to maintaining the reserves of the Program so that it meets a 99% solvency test. If reserves should dip below this level we will seek additional reserves or reduce the volume of new enrollment until the situation stabilizes.

Will this program turn a profit?
The pro formas that we have developed for this program indicate that it may generate a modest, positive return. We are refining these pro formas currently.

What happens if the absolute worst-case scenario occurs?
The program will go out of business. This is also the case with insurance firms today. Our researchers inform us that using the best models available, the program appears to have the equivalent risk to an A or AA rated entity. Nevertheless, with innovative programming there does come a certain amount of risk. We are doing everything we can to manage that risk.

If this program works so well, then how comes the private sector hasn't already tried it? Why should we be supporting it with a subsidy?
The private sector is interested in learning about this program. Down the road, it is possible that private sector companies will experiment with offering this product (in fact, that is one of the long-term goals of the research pilot, rather than seeking to operate this as a government program). While the models indicate that this program may be successful, private investors would prefer to see the concept field-tested before embarking upon such a significant business venture.

We are seeking private sector investments to support the pilot program. These investments would help to bolster the capital reserves of the program so that it can serve more people. Without the initial $5 million in federal funds that the pilot program has received, however, it would be impossible to attract these investments. The federal funding helps to leverage the return to potential investors to make it more attractive, and will be used to partially shelter the investor from losses. The federal funds also help to make up for the disadvantage that the program is not diversified geographically or over time (see below).

Would such a program have better financial performance if it operated in more than just one city or region?
Yes, it would. The capital reserves required for a Home Equity Protection program would be lower (as a percentage of the total Protected Value of homes) if that program served more than one city, since the probability that all of the ZIP codes in all of the cities would decline at the same time becomes much smaller the more regions and cities you add. Essentially, one of the reasons why the pilot program requires some subsidy is that it is not diversified geographically (for that matter, it is also not well diversified over time since it is a start-up). However, geographic diversification could only be achieved with substantial private sector investments, which would not be likely until the program has some operating history.

From a loss perspective as well, a national program looks considerably more attractive than the pilot in Syracuse, which has experienced a "down" market relative to the nation. Our research team has looked into price trends in every ZIP code in the country for the past 15+ years. They estimate that the average loss across all ZIP codes nationally, over time, is about 88 basis points (0.88 percent or .0088 of Protected Value). In other words, a national program that charged a fee of 88 basis points and was protecting the same proportion of the total market value of homes in each ZIP code would have broken even, assuming it had no administrative costs and no cost of capital for the necessary reserves.

Don't we need an appraisal or information from a home sale to set the Protected Value? What's to keep people from taking out a policy on a million dollars of value for a $50,000 home?
No, we don't need an appraisal. The fee is a set percentage of whatever the customer chooses to be the Protected Value. In most cases, customers will probably choose to protect their home for its purchase price, although they could choose a higher or lower value. The program will, however, set maximum protected values (to be sure that the limited resources can be used to serve a wide range of customers) and minimum protected values (to be sure that we can meet administrative costs).

Isn't there a risk of adverse selection with this program? Wouldn't people who knew that prices were going to decline in their area be more likely to sign up?
Adverse selection is an important issue in the design and implementation of an equity assurance program. Adverse selection could happen in several different ways. First, if people can correctly "time the market" for a particular metropolitan area, more people may sign up when the market is at a peak and fewer people may sign up when the market is at a trough. Second, if the same price is charged across different ZIP codes within the same metropolitan area, and people can correctly predict whether certain ZIP codes are at a higher risk of price declines, we might expect more customers to sign up from the higher-risk ZIP codes. Some degree of adverse selection may, in fact, occur with this program. However, it's important to keep the following points in mind:

- The presence of adverse selection in and of itself does not mean that an insurance product or financial option is doomed to fail. Dental insurance is a good example of insurance that suffers from significant adverse selection, but insurers are able to price for it so that the product is viable.
- Home price trends do have some momentum – that is, if home prices went up in an MSA last year it is somewhat more likely that they will continue to go up this year. However, home price trends also have an unpredictable component.

It is not easy to predict home price movements and it is impossible to predict them perfectly – even for experts such as the ones on our research team, not to mention the consumer. It becomes even harder to predict what home price movements will be 5 or 7 years out, when many people sell their homes.

- The program would charge different prices at different times in any given metropolitan area, reflecting the momentum of home prices in the area at that time. In an "up" or stable market, Home Equity Protection will be relatively less expensive to purchase, while in a "down" market, it will be relatively more expensive to purchase. This differential pricing will greatly reduce if not eliminate outright any problem of adverse selection over time within a city or across cities.
- We believe that it is best to charge the same price across different ZIP codes within a city. This handles issues of perceived fairness, and just as importantly, avoids creating the potential for equity assurance pricing itself to become a "market signal" (people incorrectly assuming that if the price is higher in a certain ZIP code, it must be a bad place to live). This does mean that there may be some degree of adverse selection across ZIP codes. However, it is difficult to say whether this is really a serious problem. We are not sure that consumers can really distinguish when a given ZIP code is at a greater risk of decline than another. To the extent there is a problem, there are several ways that this problem can be handled:
    - The program could charge a price for the entire city that covers expected losses for the ZIP code where these losses are expected to be the highest. Fewer people may sign up from other ZIP codes within the city, but many people may still find the protection to be a good deal for them.
    - The program could charge a more "middle of the road" price and cities could choose to make a financial contribution to the program for customers signing up from the ZIP codes where that price does not fully cover expected losses. Effectively, the city is helping to subsidize the cost of the program as a revitalization tool.

This just seems like a very risky enterprise. Why would someone want to take on all of this risk?
Actually, both individuals and institutions are already taking on this risk, every day. Investors in the lending industry, including the FHA, private mortgage insurers, and the GSEs, bear a significant risk from substantial home price declines, since borrowers may default on their mortgages if the market value of their home dips below the outstanding principal balance on their mortgage loan. Consumers, of course, bear the brunt of house price risk – and they are in a highly leveraged, poorly diversified position, which makes them the worst parties of all to be facing this risk. Home Equity Protection would provide valuable protection for both consumers and the lending industry.

Now that you mention it, this product does seem kind of like mortgage insurance from an MI company or from the FHA. What's the overlap between Home Equity Protection and MI?
There is an overlap between mortgage insurance and Home Equity Protection. Some mortgage defaults that MI companies pay for are "rational" defaults where the borrower decides to default because their home is worth less than what they owe on their mortgage. In these cases, Home Equity Protection could help to prevent the default from happening, or would provide an additional tool to help the borrower work-out his or her mortgage.

Freddie Mac and the FHA have agreed to work with us to analyze the extent to which Home Equity Protection could help to reduce these credit losses; this analysis has begun.

Questions about how the program will help homeowners and communities

This doesn't seem like a very attractive deal for consumers. It's so expensive! (A frequently implied related question: Don't house prices usually go up? They've always gone up where I live). (Related question: Hey, homeownership is one of the best investments you can make. There might be a small probability you can lose money, but so what? All in all the gains outweigh the risks).

Home Equity Protection might seem expensive, but that's a reflection of just how risky investing in a home really is. While on an aggregate level, the US housing market has performed well (especially recently), house price declines are fairly common and can have disastrous consequences for homeowners. Many MSAs have experienced steep declines at one point or another in their history. Examples of regional declines include the "oil patch" states in the mid 1980's, Detroit in the early 1980's, and the Northeast in the early 1990's.

Price declines at the ZIP code level are more common than at the MSA level – in fact, the volatility of aggregate home prices at the ZIP code level in some areas is almost as great as the volatility of the stock market. For example more than 50% of homeowners who purchased a home in the early 1990's saw their ZIP code indices decline in the subsequent five years, by an average of 13%. In Syracuse in 1997, more than half of homeowners selling their home that year sold at a loss. Yet while we don't allow people to buy stocks on 50% margin, we encourage people to buy homes on over 90% margin. The result is that even a small decline in home prices can completely wipe out a homeowner's equity, prevent them from moving or refinancing their home, and even force them into bankruptcy.

Recall, as well, that when a city is truly enjoying a stable or rising market, the price of Home Equity Protection would be lower. The price of Home Equity Protection in, say, Boston today might be substantially lower than the current price in Syracuse. And a low-cost Home Equity Protection plan might be very sensible for buyers in Boston who worry that they may have purchased a home at the peak of the market.

Additionally, there are several improvements that can be made to improve the product's value to consumers over time, with the cooperation of the lending industry:

- As discussed earlier, the cost of private mortgage insurance or FHA insurance could be reduced for customers who also purchase Home Equity Protection, given the overlap in the risks that these programs address.
- If lenders agree to consider the Home Equity Protection payment that would be due if the house were to be sold as an implicit part of the homeowner's equity, Home Equity Protection will also help buyers to refinance their mortgage even when their home is "underwater."
- The product pricing for the pilot program does not include a capital charge to provide a market-rate return on capital reserves to investors. This charge needs to be included for the program to become self-sustaining. However, by

diversifying the program to serve multiple cities, reserve requirements could be significantly reduced, improving the return to investors.

Finally, over time it is possible that we will be able to substantiate that the presence of Home Equity Protection actually has a positive effect on the housing market, by stimulating demand in areas that might otherwise be considered a risky bet for investment. If this effect is strong enough it might influence the pricing of the product.

Do people really care about this? Don't people look mostly at things like how affordable the house is and whether the schools are good when they choose a place to live?
Our research indicates that home price trends are an important consideration for most homebuyers when they decide where to live. We surveyed approximately 1,300 recent homebuyers nationwide about the most important factors these homebuyers considered in choosing a neighborhood. The perception that "houses in the neighborhood hold their value" was an important factor to over 70 percent of respondents – an important factor for more respondents than was school quality.

Our focus group research in Syracuse also showed strong interest in and support for the idea. Eighty-seven percent of our focus group participants liked the idea very much or at least somewhat (an unusually strong result for such a novel product). Focus group participants also found the concept easy to understand. In our national survey, where respondents had nothing to go on but a brief written description, 22 percent of respondents reported liking the idea (most were "neutral") and 9 percent would probably or definitely consider purchasing Home Equity Protection.

Would this program really encourage people to consider moving to a city neighborhood?
Thirteen percent of the national survey respondents indicated that the presence of a Home Equity Protection plan would encourage them to purchase a home in a neighborhood that they liked but where they perceived property values as "shaky." Were neighborhoods that are perceived as "bad bets" for investment to succeed in attracting this kind of additional investment, Home Equity Protection could become a significant neighborhood revitalization tool.

Would the program charge different prices across different ZIP codes or "redline" certain areas where it knew home prices were going to decline?
No. We are charging the same price for all ZIP codes in Syracuse for the pilot. [see discussion of adverse selection under the financial questions section]

If people were going to live in the same house forever, why would they want this protection?
Home Equity Protection is generally not an appropriate product for people who intend to stay in their home for more than 30 years. That's because the protection is based on nominal (not adjusted for inflation) price trends, so over time inflation tends to move the price index upwards. We will educate consumers about this aspect of the product and will discourage people who do intend to live in their house forever from purchasing the product.

How good is the protection that is provided by a ZIP code index? Couldn't somebody's actual loss experience on their home differ substantially from the Home

Equity Protection payment they would get?
In many cases, the homeowner's actual loss experience will indeed differ from their Home Equity Protection Payment. This is because the payment is based on aggregate price movements at the ZIP code level, while the change in price of the home depends not only on those movements but also on the owner's home maintenance and improvement decisions and on events in the area immediately surrounding their home. Of course, it would not be appropriate for the program to compensate owners for price declines relating to a lack of maintenance of their home.

Our research team used historical price data from Syracuse to evaluate the extent to which Home Equity Protection payments would have covered homeowners' actual losses. On average, the program would have covered fully half of actual losses. It is important to note that this measure significantly underestimates the actual effectiveness of the coverage, since actual losses include losses due to deferred maintenance. Additional research we performed in Syracuse also strongly suggests that most of the variation of individual home prices around the ZIP code price index path is not due to trends at the neighborhood level, but rather to home maintenance and events immediately around the home.

Wouldn't Home Equity Protection encourage people to move away from their home in a down market, thereby exacerbating the very price decline we are trying to prevent here?

Consumers do not have an incentive to sell their homes merely to take advantage of a Home Equity Protection payment. While it is true that if the Index were to rise, the amount of the Home Equity Protection payment the homeowner could claim might decline, under the same set of circumstances the resale value of their house would also be likely to increase. Moreover, regardless of where the index is, the transactions costs, emotional costs, and other considerations involved in a move are likely to rule the day. In fact, in many circumstances Home Equity Protection may be likely to encourage people to stay in their homes. Currently, when prices are perceived to be on a verge of a decline, people may decide to sell their home before they are hit with the economic loss. With Home Equity Protection, since people are protected against the decline, they can afford to stay. They would simply move when it is most convenient for them to do so based on the changes in their personal lives.

It is true that there are certain circumstances under which people might be likely to move away if they had Home Equity Protection, whereas today they would be likely to stay put. This situation could arise if the market is down when a homeowner has lost his or her job and/or has better job opportunities elsewhere. Because their home is "under water" in these situations, many people today may choose to stay rather than move and either default on their mortgage or write a big check to the bank at the closing. With Home Equity Protection, they might be able to sell their home and move. We would argue that this benefit is good both for the consumer and from a public policy perspective, in that it allows workers to go where their skills are most needed. We do not see why it is a good thing that homeowners who currently find themselves in such a situation are trapped in their neighborhood, even if we are trying to revitalize that neighborhood.

Legal/regulatory questions

Is this product insurance?
That probably depends on the regulator to whom you are talking. The New York State Insurance Department has decided that Home Equity Protection does not constitute an insurance product. That's because they decided that the amount of the Home Equity Protection payment is not directly related to the loss experienced by the consumer – the consumer could gain money on the resale of his or her home and still receive a payment. Furthermore, the "trigger" for the payment – sale of the home at a loss – is not a "fortuitous event" as defined by the Insurance laws, since the decision to sell the home is under the control of the homeowner.

Are Home Equity Protection payments taxable?
We will work with the IRS to answer that question. It is possible that Home Equity Protection payments would not be taxable if they were considered part of the sale proceeds of the home.

Who would regulate this product in New York State?
We are working closely with regulators at both the NYS Insurance Department and the Banking Department, to ensure that the product does not violate any of the regulations of these departments and to provide appropriate disclosures and education to consumers. However, at the current time it does not appear that the product falls under the direct regulatory authority of either agency.

Partnerships and partner roles

What has Neighborhood Reinvestment's role been in making this happen?
Neighborhood Reinvestment has responded to requests from stakeholders in the Syracuse Neighborhood Initiative to research and construct an equity protection tool to encourage families to buy homes and stay in Syracuse neighborhoods. Neighborhood Reinvestment has been a lead partner in the development of Home Equity Protection. NR has invested over $325,000 in cash and in kind resources to support financial, market, and legal research for the product, and has led the development of the partnerships with the Yale University School of Management and Freddie Mac that are enabling the pilot product to become a reality.

What has been the role of the Yale University School of Management?
Yale SOM, along with affiliated researchers from NYU and from Potomac Ventures (a venture capital firm in Washington DC), has led the financial research effort to determine the viability of the product, and to evaluate product pricing and capital reserves requirements. Yale and the affiliated researchers will continue to play an important role in evaluating the project and refining the concepts behind it.

What is Freddie Mac doing to support this effort?
Freddie Mac is a partner in this effort and they are lending their name to it. They are providing in-kind technical assistance to refine pricing estimates and product design, develop strategies to raise capital reserve funds, and provide legal and marketing assistance. They are helping us to build partnerships with lenders to market this product and have committed to buy mortgages where the consumer has also purchased Equity Assurance and help us track the performance of those loans.

Who is Home Headquarters, Inc.?
Home Headquarters is the parent corporation of Equity Headquarters, which will be operating the Home Equity Protection program. Home Headquarters is a 501(c)(3) organization and a NeighborWorks® network member providing homebuyer education and counseling, residential lending, real estate development, and other community services to revitalize communities and help families build assets. Home Headquarters has 22 staff, an operating budget of approximately $5 million, and last year helped over 400 families to buy or repair their homes. It is a member of the Campaign for Homeownership.

What is the role of participating lenders?
Participating lenders (such as HSBC, most likely) will help us to market the product, and will provide us with information to help us run and evaluate the program. In return, the lenders get a valuable tool for default prevention and foreclosure workouts.

Overall

It seems that there are a lot of questions about this program. Should we do more research before implementing it?

The pilot program in Syracuse is a research effort – many questions about equity assurance simply can't be answered without trying it!