

# Negative Equity Loans

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## WHAT ARE NEGATIVE EQUITY LOANS

A Negative Equity Loan is given out to a person who is completing or planning to complete a 'short sale' so that they have the funds required to clear the mortgage secured on the property. A loan is issued to the individual and is used to pay the financial institution; the ability to service the loan is secured on the individuals tax credits via the Revenue Commissioners.

## WHY WOULD THEY BENEFIT IRISH BORROWERS

Having paid dearly to save our banking system, and given the issues inherent in the Irish residential property market, it would be pointless to see any measures which exacerbate the banks financial position further, given that they are ultimately underwritten by the Irish taxpayer. Negative Equity Loans are a method that allows a person in financial difficulty to gain forbearance without giving up responsibility, as well as allowing the market to set prices accordingly between willing sellers and willing buyers<sup>3</sup>.

Negative Equity Loans (NEL) can facilitate people who want to move, who are over-indebted and who are unable to pay and/or need to retrain. They also address the key demographic who 'won't pay'.

It is important to have at least some measure of loss or loss sharing by the bank, this is so that a NEL doesn't become the first prescription for people in financial difficulty. It is also in acknowledgement of the cost savings versus a repossession – this would need to be a standardised figure determined by certain bands/brackets and or independent consideration. There could also be an incentive scheme which writes off chunks of the debt at a later day (in the same manner as the Loan Value Group in the USA).

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<sup>3</sup> Currently a person in negative equity may want to sell due to labour mobility needs or for the sake of removing the majority of their debt/risk, but they cannot do so as they are unable to clear the mortgage during the transaction.

## WHERE DOES THE MONEY COME FROM AND HOW IS IT DONE

The money could come from the Housing Finance Authority which currently operates a lending scheme called 'Home Choice Loan'. This scheme has not been successful to date, but they do have a lending mandate and funding lines.

The NEL could be done as a promissory note to the bank which they could use as collateral or hold as an asset, paying a negligible coupon, or as a cash payment. In the mean time the bank would accept a short sale proposal from a buyer, and the difference would be made up via the NEL. It would then be up to the HFA to collect interest on the NEL.

This allows a person in negative equity to get out from under a large debt and service a smaller one while giving them freedom of mobility. Alternatively they may sell their home and continue to live in it via a sale and lease back option. Lastly, the bank will not suffer immediate write-downs which push additional costs onto taxpayers and other performing loans (via increased costs in financial services).

## PROPERTY MARKET OVERVIEW

An analysis of the current state of the Irish property market, and in particular coverage of the problem of negative equity, is given by Duffy (2009)<sup>4</sup> whose key descriptive statistics are;

- 2007 – 19,525 homeowners in negative equity
- 2008 – approx 50,000 homeowners in negative equity
- 2009 – est. 116,000 homeowners in negative equity
- 2010 – est. 196,000 homeowners in negative equity

We note, however, that in isolation the onset of negative equity for a homeowner is not necessarily an immediate problem. Providing that their current income is sufficient to cover both living expenses and debt repayment then the homeowner can simply continue living in their house. Should their income fall to around the level of their total outgoings, anecdotal market evidence combined with reports from media sources as well as general bank statements suggest that mortgage forbearance measures are readily available and thus will allow householders to reduce the monthly cost of servicing their debt. In summary, negative equity will not necessarily trigger an immediate default on mortgage payments for the average homeowner.

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<sup>4</sup> David Duffy, Negative Equity in the Irish Housing Market, ESRI Working Paper 319, 2009

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Our focus, however, is on one particular segment of homeowners who are currently in a state of negative equity; first time buyers and those who are employed in 'vulnerable' sectors. Duffy (2009) defines 'vulnerable' sectors as construction, other production industries and the hotels and restaurants sector. Unemployment in these sectors fell -31%, -11.4% and -11.1% respectively from Q1 2007 to Q1 2009 and we note that these sectors account for around 25-30% of total mortgage holders. For such people, forbearance measures may be insufficient to prevent defaulting on their obligations. Using figures from Duffy (2009), the Central Bank and the Financial Regulator, we provide a crude estimate of the number of householders who may require external assistance in servicing their mortgage as 50,000<sup>5</sup>.

This figure requires further in-depth analysis in order for it to be considered rigorous. However we use this as an initial base and we conduct and present the results from a range of sensitivity analyses of the models used in this paper. It is currently our opinion that such a figure lies near the upper bound of those who require external financial assistance.

### NEGATIVE EQUITY LOAN OVERVIEW

We propose the introduction of an agency which will provide funds to homeowners who are in negative equity and are unable to service their mortgage. This agency will provide a loan to cover the shortfall resulting from the difference between the funds raised from the sale of the underlying property and cost of the mortgage, which by the definition of negative equity will exceed the sale price. The combination of the proceeds from the sale and the negative equity loan (NEL) will allow the homeowner to clear his debt with the originator of the mortgage and reengage with property market, either by renting or by purchasing a property. Apart from allowing the homeowner to escape from negative equity, the effects of this transaction are threefold:

- The personal credit situation of the homeowner is improved
- The balance sheet of the mortgage originator is improved
- Labour mobility is increased

The loan would be issued in a manner similar to that of the UK based 'Student Loan Company' which is a quasi governmental organisation who provide student finance packages to people who are engaged in full time third level education. The attraction of this model is that principal repayments and associated

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<sup>5</sup>There are 661,453 households with outstanding mortgage debt in Ireland, taking 25% of these to be 'vulnerable' and assuming that 30% of these vulnerable workers are in negative equity yields approximately 50,000.

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service charges are captured as an additional tax imposed on a recipient and hence we see how the security for the NEL is the future earnings of the recipient, although it could also be collected via a removal of tax credits.

A wide range of binding policy options are open for recipients of NELs who are engaged in full time employment, part time employment, higher level education, retraining courses and unemployment. For those engaged in employment, a tax based system will ensure repayment is on a flexible, equitable manner while set reductions can be made for those who are unemployed following the receipt of the loan but who are engaging in either retraining or higher level education. Homeowners who find themselves unemployed but who refuse to engage in skill transformational programmes may find that their benefits are being used to part service their outstanding debt.

### NEGATIVE EQUITY LOAN MODELS

Based upon the figures below, we present an overview of the financial aspects involved in running an agency which will issues negative equity loans while presenting a variety of loan application cases. We initially present the loan from the consumer's point of view giving two examples of a homeowner caught in negative equity.

	Case 1	Case 2	Case 3
House Purchase Price	€500,000	€500,000	€500,000
Price Drop (%)	15	25	40
Current House Price	€425,000	€375,000	€300,000
Mortgage Value	€460,000	€460,000	€460,000
Mortgage Rate (%)	3	3	3
Mortgage Duration (Years)	25	25	25
Monthly Repayments	€2,181	€2,181	€2,181
Shortfall	€35,000	€85,000	€160,000
NEL Rate (%)	2	2	2
NEL Duration (Years)	20	20	20
Monthly Repayments	€177	€430	€809
Est. Monthly Rent <sup>6</sup>	€1,000	€1,000	€1,000
Total	€1,177	€1,430	€1,809
Total Saving per month	<b>€1,004</b>	<b>€751</b>	<b>€372</b>

We believe that these cases are good point estimates between the upper and lower bound of the requirements. Duffy (2009) offers an overview of the extent of negative equity where he notes that for

<sup>6</sup> Estimated Monthly Rent based on figures supplied by Ronan Lyons from daft.ie.

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23% of householders, negative equity accounts for less than 5% of the estimated house prices while approximately another 17% will face negative equity of between 5-10%. 30% of householders have negative equity between 10-20% while finally around 29% have negative equity of at least 20%. We have shown in the tables above how people who have lost up to 40% of the value of their home will still be able to reduce their monthly debt related outgoings while simultaneously clearing their credit record.

Tables 1 and 2 demonstrate the estimated annual cash flows for the NEL agency. Apart from assuming that 5% of the total repayments are not recovered each year, we have not explicitly addressed the risk of either debtor default or delayed payment. Instead we have modelled the spread which creates a fund which can be used to smooth repayments which are delayed or reduced due to consumers engaging in retraining activities.

### NEGATIVE EQUITY LOAN RISK

Prime risk in this project comes from the lack of an underlying tangible asset to secure the loan against. Instead, the loan is secured against future earnings, which means in that in the event of a default, there is no recoverable asset. We don't, however, foresee this as an insurmountable obstacle. We focus on three types of credit risks;

- Default
- Suspension of payments
- Reduction of payments

**Default** on payments will be triggered by a recipient either entering long term unemployment or emigrating from Ireland. In the first case, the options facing the NEL agency are limited to either recovering partial recompense through a reduction of social welfare benefits or else a total write down of the loan. Should the homeowner re-enter reemployment in the future, then repayment of NEL will recommence. In the case of emigration, there is little option for recourse until the émigré returns to Ireland. However, it must not be forgotten that a person willing to emigrate in order to avoid debt repayments can do so at any time, an NEL is not prerequisite.

**Suspension** of payments is foreseen in circumstances where the NEL recipient engages in either a retraining scheme or returns to full time education. The choice between either full suspension or a reduction in payments is a matter of policy, but it is clear that normal servicing of debt will not be possible under these circumstances. Under this scenario, the funds raised by the spread between the loan cost and offer rates can be used to cover inter-temporal shortfalls in the repayment schedule of the

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NEL agency. We note how the arrears which occur due to forbearance while training will result in a much smaller accrual than that which occurs on a larger loan at a commercial rate.

**Reduction** of payments as a measure of forbearance may occur for similar reasons as the suspension of payments discussed above along with scenarios such as a change in employment status where the NEL recipient is unable to meet the full cost of repaying the NEL but has sufficient income to continue a structured repayment schedule. Once more we note how the funds created from the spread between the loan cost and offer rate can be used to cover any cash flow interruptions.

There is likely scope for a carrot and stick incentive approach, the first being that early repayments will result in a discount multiplier on the debt (with recourse to the bank for the difference), the stick being that in latter years the rate goes up.

In all of the above cases we note how judicious employment of existing recommended lending practice, adapted for application with a NEL, will lead to a reduction in the overall risk of the project.

**Table 1 – NEL Cost @ 1.5%, NEL loan @ 2%, Amount finance; €40,000, Duration; 20 yrs, Bad Debts @ 5% pa, Business Costs at €500,000**

	Participants	Total Loans	Income Received	Accumulative Income Rec'd	Accumulative Loans	Loan Cost	Spread	Income less Bad Debt and Business Cost	Accumulative Net Position
Year 1	20000	€800,000,000	€48,564,800.16	€48,564,800.16	€800,000,000	€46,324,359.25	€2,240,440.91	€1,628,418.87	€1,628,418.87
Year 2	5000	€200,000,000	€60,706,000.21	€109,270,800.37	€1,000,000,000	€57,905,449.07	€2,800,551.14	€2,160,523.58	€3,788,942.45
Year 3	5000	€200,000,000	€72,847,200.25	€182,118,000.62	€1,200,000,000	€69,486,538.88	€3,360,661.37	€2,692,628.30	€6,481,570.75
Year 4	4000	€160,000,000	€82,560,160.28	€264,678,160.90	€1,360,000,000	€78,751,410.73	€3,808,749.55	€3,118,312.07	€9,599,882.82
Year 5	3000	€120,000,000	€89,844,880.30	€354,523,041.20	€1,480,000,000	€85,700,064.62	€4,144,815.69	€3,437,574.90	€13,037,457.72
Year 6	1000	€40,000,000	€92,273,120.31	€446,796,161.51	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€16,581,453.57
Year 7			€92,273,120.31	€539,069,281.82	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€20,125,449.41
Year 8			€92,273,120.31	€631,342,402.14	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€23,669,445.26
Year 9			€92,273,120.31	€723,615,522.45	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€27,213,441.10
Year 10			€92,273,120.31	€815,888,642.76	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€30,757,436.95
Year 11			€92,273,120.31	€908,161,763.07	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€34,301,432.80
Year 12			€92,273,120.31	€1,000,434,883.39	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€37,845,428.64
Year 13			€92,273,120.31	€1,092,708,003.70	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€41,389,424.49
Year 14			€92,273,120.31	€1,184,981,124.01	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€44,933,420.33
Year 15			€92,273,120.31	€1,277,254,244.32	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€48,477,416.18
Year 16			€92,273,120.31	€1,369,527,364.63	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€52,021,412.02
Year 17			€92,273,120.31	€1,461,800,484.95	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€55,565,407.87
Year 18			€92,273,120.31	€1,554,073,605.26	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€59,109,403.71
Year 19			€92,273,120.31	€1,646,346,725.57	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€62,653,399.56
Year 20			€92,273,120.31	€1,738,619,845.88	€1,520,000,000	€88,016,282.58	€4,256,837.73	€3,543,995.85	€66,197,395.41
Year 21			€43,708,320.15	€1,782,328,166.03	€1,520,000,000	€41,691,923.33	€2,016,396.82	€1,415,576.98	€67,612,972.39
Year 22			€31,567,120.11	€1,813,895,286.14	€1,520,000,000	€30,110,833.51	€1,456,286.59	€883,472.26	€68,496,444.65
Year 23			€19,425,920.07	€1,833,321,206.20	€1,520,000,000	€18,529,743.70	€896,176.36	€351,367.55	€68,847,812.19
Year 24			€9,712,960.03	€1,843,034,166.24	€1,520,000,000	€9,264,871.85	€448,088.18	€-74,316.23	€68,773,495.97
Year 25			€2,428,240.01	€1,845,462,406.24	€1,520,000,000	€2,316,217.96	€112,022.05	€-393,579.06	€68,379,916.91

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**Table 2 – NEL Cost @ 1.5%, NEL Loan @ 2.5%, Amount Financed; €40,000, Duration; 20 yrs, Bad debts @ 5% pa, Business Costs at €500,000**

	Participants	Total Loans	Income Received	Accumulative Income Rec'd	Accumulative Loans	Loan Cost	Spread	Income less Bad Debt and Business Cost	Accumulative Net Position
Year 1	10000	€400,000,000	€25,435,338.87	€25,435,338.87	€400,000,000	€23,162,179.63	€2,273,159.24	€1,659,501.28	€1,659,501.28
Year 2	2000	€80,000,000	€30,522,406.64	€55,957,745.50	€480,000,000	€27,794,615.55	€2,727,791.09	€2,091,401.53	€3,750,902.81
Year 3	1500	€60,000,000	€34,337,707.47	€90,295,452.97	€540,000,000	€31,268,942.50	€3,068,764.97	€2,415,326.72	€6,166,229.53
Year 4	750	€30,000,000	€36,245,357.88	€126,540,810.86	€570,000,000	€33,006,105.97	€3,239,251.92	€2,577,289.32	€8,743,518.85
Year 5	250	€10,000,000	€36,881,241.36	€163,422,052.21	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€11,374,795.71
Year 6			€36,881,241.36	€200,303,293.57	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€14,006,072.56
Year 7			€36,881,241.36	€237,184,534.92	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€16,637,349.41
Year 8			€36,881,241.36	€274,065,776.28	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€19,268,626.26
Year 9			€36,881,241.36	€310,947,017.63	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€21,899,903.11
Year 10			€36,881,241.36	€347,828,258.99	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€24,531,179.97
Year 11			€36,881,241.36	€384,709,500.34	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€27,162,456.82
Year 12			€36,881,241.36	€421,590,741.70	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€29,793,733.67
Year 13			€36,881,241.36	€458,471,983.05	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€32,425,010.52
Year 14			€36,881,241.36	€495,353,224.41	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€35,056,287.37
Year 15			€36,881,241.36	€532,234,465.76	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€37,687,564.23
Year 16			€36,881,241.36	€569,115,707.12	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€40,318,841.08
Year 17			€36,881,241.36	€605,996,948.47	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€42,950,117.93
Year 18			€36,881,241.36	€642,878,189.83	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€45,581,394.78
Year 19			€36,881,241.36	€679,759,431.18	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€48,212,671.63
Year 20			€36,881,241.36	€716,640,672.54	€580,000,000	€33,585,160.46	€3,296,080.90	€2,631,276.85	€50,843,948.49
Year 21			€11,445,902.49	€728,086,575.03	€580,000,000	€10,422,980.83	€1,022,921.66	€471,775.57	€51,315,724.06
Year 22			€6,358,834.72	€734,445,409.74	€580,000,000	€5,790,544.91	€568,289.81	€39,875.32	€51,355,599.38
Year 23			€2,543,533.89	€736,988,943.63	€580,000,000	€2,316,217.96	€227,315.92	<b>-€284,049.87</b>	€51,071,549.51
Year 24			€635,883.47	€737,624,827.10	€580,000,000	€579,054.49	€56,828.98	<b>-€446,012.47</b>	€50,625,537.04
Year 25			€0.00	€737,624,827.10	€580,000,000	€0.00	€0.00	<b>-€500,000.00</b>	€50,125,537.04

## **NEGATIVE EQUITY LOAN SUMMARY**

In summary, we can see how the application of an NEL will not result in a bailout for a homeowner who is presently in negative equity but rather offers them a manner in which to fulfil their immediate mortgage obligations and restructure their immediate financial commitments to a level which appropriate for their current income. Since the NEL does not release the recipient from all forms of debt, we believe there is little opportunity for the introduction of moral hazard apart from the recipient engaging in triggering a default on NEL repayments. We believe that this is a more attractive proposal than write downs on properties purchased with currently impaired mortgages as NEL recipient will not be able to engage in a strategic default as they lose ownership of their underlying property as a result of the loan. We propose a revenue neutral model where retained earnings are used to smooth the institutions debt repayment schedule.

The key constituencies that need to be considered are covered within this document; from borrower to bank, to taxpayer, and while this plan is not a cure to every ill in the Irish property market, it is fair to say that no one solution will remedy the issues arising in the residential mortgage market.