Weekly Financial Review
Vol. 21, No. 38 (6 Oct 2012)
www.kif.re.kr

Sale-and-Leaseback Programs for the House Poor and their Policy Implications*

Christopher Byungho Suh

SUMMARY

□ The FRB proposed the idea of a sale-and-leaseback program to help cash-strapped homeowners, and Bank of America (BOA) launched the program in March 2012.

□ In Korea, Woori Financial Group announced a plan to launch a similar scheme, a trust-and-leaseback program, in September. Meanwhile, politicians and the media are discussing the idea of using taxpayer's money to fund the program.

□ However, using public funds to support the house poor might cause moral hazard, hurt efficiency and equality; also, a sale-and-leaseback program operated by a third party could raise concerns over the fair price of houses.

□ Considering that the house poor issue is essentially a debt problem, the intervention by a third party and use of public funds should be avoided if possible. Instead, debt restructuring between a lender and a borrower would be a better approach as is the case of Woori Financial's trust-and-leaseback program.

□ Considering the peculiarity of lease contract in Korea, it is important to notice that tenants of the distressed homes can be most vulnerable as potential victims in a crashing property market, and adopt measures to protect them.

* *Opinions expressed are those of the author and do not necessarily reflect the official positions of the Korea Institute of Finance.*

Background of Introducing a Sale–and–Leaseback Program

A “sale–and–leaseback” is a financial arrangement in which companies sell buildings, land or facilities to a financial company and immediately lease them back, while using the proceeds from the sales for business operation and investment. This arrangement has been widely used in business restructuring, and recently, it has been tapped for the potential to help distressed homeowners; according to the plan, people whose houses are facing foreclosure may sell their homes to a (bad) bank or a public fund, rent it on a monthly basis, and use the money to make the mortgage payment.

The FRB proposed a sale-and-leaseback for the house poor in January 2012, and the BOA launched the program in March.

This idea was first proposed by the Federal Reserve Board of the US. In a white paper[1] issued last January, FRB said that banks and housing–related institutions should positively consider purchasing homes that face foreclosure and lease them back to former owners. It is expected to relieve many related problems: a growing number of houses in auction market, plummeting housing prices, social issues arising from declining home ownership, sluggish domestic consumption, and an increase in loan loss provisions to cover non–performing loans and auction costs.

Following this move, Bank of America (BOA), the largest bank in the US, launched a Mortgage–to–Lease program last March, which has essentially the same mechanism with a sale–and–leaseback. When the bank took over the largest mortgage company in the US, Countrywide Financial, in 2008, it piled a substantial amount of bad debts, and as foreclosure rose sharply thereafter, auction market came under a great pressure. In the US, banks are allowed to

1) According to the paper, as of end–October 2011, the housing prices in the US fell 33% on average compared to end–June 2006. In June 2011, more than 25% of 2 million houses for sales on the property market were foreclosed homes. And, by the end of 2011, some 120 million households occupied homes whose prices are below the amount of mortgage loan.

involve in property rental business to some degree, and FRB issued a policy statement last April saying that it is legitimate for banks to lease houses that are about to be foreclosed.

Meanwhile, in Korea, Woori Financial Group announced a plan to introduce a similar scheme, a trust–and–leaseback program, to handle houses under the risk of foreclosure. Unlike the BOA's program, it was introduced as a precaution against mounting household debts in Korea. Since banks' property rental is not allowed under the Korean banking law, a straight sale–and–leaseback scheme may not be adopted at this point. Instead, Woori Financial designed a trust–based program, and there have been broad discussions on introducing fund–based sale–and–leaseback programs by KAMCO and National Housing Fund. The media proposed an alternative idea to establish a house bank, similar to a bad bank in concept.

In Korea, Woori Financial Group launched a trust-and-leaseback program in September, and politicians are discussing the idea of adopting fund-based sale-and-leaseback programs through KAMCO and National Housing Fund.

Mechanism and Features of Sale–and–Leaseback

According to the BOA's mortgage–to–lease program, the bank acquires property documents of a distressed home, and let the tenants continue to occupy the place on a yearly contract up to three years. That is, an exchange is made between property documents and claims on mortgage payment, and thus the amount of mortgage loan is regarded a sales price. It can be said that the homeowner's debt is partially written off for the discrepancy between the house's market price and the amount of mortgage loan. In return, the bank claims ownership of the house, and can choose to sell it after maximum three years. If the property market recovers during the period, the bank will be able to recover its investment and even earn capital gains.

According to the BOA program, the bank exchanges home ownership with claims on mortgage loan. The bank may earn capital gains while the homeowner can partially relieve debts.

In order to qualify for the BOA program, the homeowner should have mortgage payment that is 60 days or longer in arrears, occupy the home, and should not have other loans so as to prevent free-riding by financial companies. Also, the homeowner should produce a proof of income to pay the rent, and have exhausted all other foreclosure alternatives such as debt restructuring and short sales. The BOA examined the applicants and selected 1,000 homeowners in March from three states of Arizona, New York and Nevada. The bank went on to select additional 1,500 homeowners in California in May.

By comparison, Woori Financial's trust-and-leaseback program is closer to debt restructuring; it does not involve debt write-off and the bank cannot benefit from capital gains as it merely puts off repayment during the trust period.

According to Woori Financial's trust-and-leaseback program, the bank acquires proprietary right of the house for the contract period of three to five years, and the homeowner may choose to sell the house at the end of the contract. Since banks in Korea are prohibited from property rental business, the homeowner retains the ownership and can earn capital gains if the housing market recovers during the contract period. If not, the homeowner will give up the house, dumping the bad loans on the bank. However, by transferring the risky assets to the trust accounts, Woori Financial's business soundness might temporarily improve as the loan is converted to beneficiary certificate. Moreover, the bank can avoid a bad reputation that comes from forcing a foreclosure. From the homeowners' perspective, they can avoid credit bankruptcy while they pay a modest monthly rent equivalent to the loan interest rate, instead of paying punitive interest that can be higher than 10%.

To qualify for Woori Financial's program, the homeowner should have mortgage payment that is in arrear for up to three months, occupy the home, produce a proof of income, and should not have multiple loans. Those who own high-priced home or more than one homes are precluded from the program. Currently, some 700 homeowners are estimated to qualify.

By comparison, politicians and the media have been voicing different plans, for example, utilizing a public fund or a bad bank to collectively take over or

purchase distressed homes and lease them to the former homeowners. One political party proposed the sales of property share, funded by joint investment of KAMCO (KRW 1 trillion), government (KRW 0.5 trillion) and the financial industry (KRW 0.95 trillion). According to the scheme, whole or partial shares of a distressed home will be sold off and the homes will be converted to rental units. To qualify, the house price should be KRW600 million or less in Seoul metropolitan region, KRW300 million or less in other regions. Also, the owner should own no more than one house, with the DTI ratio over 20%. In case of partial purchase of property shares, the going market price is paid, and if a whole house is bought, 80% of the market price will be paid. The former homeowners continue to occupy the house, while paying monthly rent equivalent to 8% of the sales price, or depositing key money equivalent to 52% of the market price. Like Woori Financial program, the former owners can buy back part or whole of their homes at the sales price at the end of the contract.

Issues of Sale–and–Leaseback Program

If implemented, a sale–and–leaseback program is likely to raise several issues. Undoubtedly, people will question whether it is “fair” to use public funds to rescue distressed homeowners. No matter who gets the benefit, the issue of equality would surely arise as the program will be spending taxpayers' money; the resistance would be especially hard if the benefit goes to well–off people. This is unavoidable since the so–called “house poor” is mostly from the middle class, people who took out loans beyond their means to buy a house. Thus, the program will be criticized for helping homeowners with taxpayers' money, many of whom are yet to be homeowners. They will also oppose to the idea of stabilizing the house prices since they need the property market to slump so that the prices would fall into an affordable range.

Using public funds for a sale-and-leaseback raises several issues: equality for favoring the middle class, poor efficiency with a low loan recovery rate, as well as moral hazard.

Next, the currently proposed method might not be so efficient, which could be a serious issue considering the limited resources of public funds. At this point, measures proposed by politicians and the media allow repurchase rights to former homeowners, unlike the BOA program. Accordingly, the public funds or bad banks cannot earn capital gains. Had they rights to sell the homes, the funds and bad banks would be able to offset the loss in one region with profits from others, at least hypothetically; however, as long as original homeowners retain repurchase rights, this cannot be done. Further, according to the scheme, a large number of homes will be bought and sold around the same time, and the market will be swamped with homes for sale, possibly depressing the house prices in the end. This will lead to a low recovery rate of the funds. Lastly, using public funds makes it hard to evict tenants who fall behind payment schedule, and some tenants would refuse to pay the rent in time, if at all.

Third, the 'house poor' issue is essentially a debt problem, and turning to the public funds might create moral hazard. Generally, a lender takes the loss for neglecting to check a borrower's credit and post-loan management, and a borrower is pressed to pay punitive interest or claim a bankruptcy when failing to repay the debt. However, if public money intervenes, the lender has incentives to dump the loss on the government, and the borrower is less likely to make best efforts to repay the loan. In other words, taxpayers' money will be spent to plug financial institutions' loss from mortgage loans, and the former homeowners might try to free-ride on the program. More important, if the government steps in to rescue the distressed homeowners, it might be read as a sign that the government would not let the property market collapse, and this could lead to a property market overheating in the future. For these reasons, BOA introduced mortgage-to-lease program only after exhausting all other

A sale-and- leaseback run by a third party such as a public fund or a bad bank raises concerns over the fair price of homes.

means including debt restructuring, short sales and workout program.

Fourth, operating a sales-and-leaseback program with public funds or bad banks raises confusion over the fair price of homes. This is not a concern for BOA or Woori Financial since the former exchanges claim on mortgage loan with home ownership, and the latter establishes trust funds. However, if a third-party purchases distressed homes, the sales price could be arbitrary. For example, the proposed sales of property share is based on the going market price, which could be overestimated when the sales are far and apart amid the sluggish market. Some suggest using the average amount of auction price and appraised price; in theory, this could be approximate to fair price, but in practice, it can be quite onerous. It would take substantial time and money for the Korea Appraisal Board to appraise value of all houses, and conflict might arise on the fairness of the prices. When the auction market is small and slow, it is virtually impossible to find auction prices of tens of thousands of houses that match in location and size.

Policy Implications

Supporting the house poor with public funds might not be the best approach as it raises issues of equality, efficiency and fairness. It is a debt problem by nature, and as such, it should be left to a lender (financial institution) and a borrower (homeowner) to find a workable solution through debt restructuring and loss sharing. If systemic risks rise as financial institutions' business condition deteriorates, public funds might be drawn to provide recourses. In this case, it is important to ensure that the money is returned, and the non-performing borrowers go through a workout program or a credit recovery program.

> Since the house poor issue is essentially a debt problem, it is desirable to avoid intervention of a third party or use of public funds.

The trust-and-leaseback program of Woori Financial is similar to debt

restructuring, and might be free from equality or fairness issues that arise in a sale–and–leaseback scheme. For a broader application, more banks should be encouraged to develop similar programs, and it might be positively considered to partially allow banks' rental business and let them design leaseback programs that do not give repurchase rights to former owners.

Woori Financial's trust-and-leaseback is a type of debt restructuring effort without a third-party intervention. In implementing the program, it is important to take measures to protect tenants.

A collapse of the housing market would hit tenants of the distressed homes most severely, and thus, measures should be taken to guarantee return of the key money. For example, it is conceivable to include houses that are owned by people with multiple home ownership in a trust–and–leaseback program, and let the tenants occupy the place while the owner pays monthly rent in lieu of interest payment during the contract period.

Focus & Brief

Oct 15–19

■ Policy Issue in Brief:
  Promoting Private–Sector Funding to Support Youth's Start–Up in Knowledge–based Businesses

■ News Briefs:
- A Sharp Appreciation of Korean Currency against USD
- Financial Companies Expand Issuance of Subordinated Bonds
- ELW Market Adopts Market Warning System

■ Market Indicators: Oct 15–19

□ Policy Issue in Brief:

Promoting Private–Sector Funding to Support Youth's Start–Up in Knowledge–based Businesses

JiEun Lee, *Senior Research Fellow*

■ Summary: Currently, revitalizing the job market is among the most important tasks, and youth's entrepreneurship should be encouraged, especially for innovative businesses based on specialized knowledge and intellectual property. However, private–sector funding for start–up businesses is quite limited, and to address this, some of the conceivable solutions can be establishing a specialized asset management company, offering related fund products, and promoting lending against intellectual property.

■ Establishing a virtuous cycle of steady economic growth through job creation has become an urgent economic issue, and to this end, youth's entrepreneurship should be promoted.

· Korean economy is mired in a vicious cycle of 'jobless growth.' Especially the youth unemployment rate has risen to 8%, nearly twice the total unemployment rate.

· During the 2004-2009 period, some 600,000 new businesses sprouted each year, creating 2,170,000 jobs. However, 580,000 businesses closed down over the same period, shedding 1,880,000 jobs. That is, only 290,000 jobs were newly added.

· While many middle-aged people run businesses after retirement that do not require special skills or knowledge, start-ups by young people are often based on new technologies, intellectual property or other advanced knowledge.*

 * This includes computer engineering, software design & consulting, data processing, IT facility management, online information & database, legal & accounting services, construction & engineering, science & technical services, advertising, design and so forth.

· Youth's entrepreneurship should be encouraged to promote information-based industry as a new growth engine for the economy and enhance competitive edge of the country.

· Recently, start-ups among young people have been modestly increasing in IT industry, but the trend remains weak both in terms of the number of jobs and their quality.

 * During 2008-2011, the number of new enterprises has increased by 8.6% on average each year, however, the rate among people aged under 39 stood lower at 5.8%.

■ The government is pushing policies to revitalize start-ups by young people, but the measures are often short-lived, and other problems arise from limited funding, a lack of follow-up and effective training on starting a business.

· Between 2011 and 2012, budget to support youth's business start-up grew 2.5 times to KRW1.6 trillion. Also, new programs were introduced that provide a package of training, consulting and funding and that pairs young entrepreneurs with "angel" investors for matching investment.

■ Private-sector funding for start-up business through angel investment, venture capitals and bank loans is harder to secure than public funding by organizations such as the Small & Medium Business Administration, Korean Intellectual Property Office, Korea Technology Credit Guarantee Fund, and Korea Credit Guarantee.

- Angel funding has been declining since the venture capital bubble bursted. It is mainly because there is no pre-IPO exit while it takes a long time to recover the investment. Also, angel funding has not been efficiently managed in terms of seeking investors and providing business support.
- Such lack of support may be attributed to concerns over an adverse selection due to information asymmetry.
- Under this circumstance, venture capital is concentrated in companies that are soon expecting an IPO. As a result, funding availability varies widely among start-ups depending on their growth stages, and for this unevenness, it is hard to create a good flow and a favorable environment to promote start-ups.

■ Considering this, private-sector funding in the areas of IT, intellectual property and knowledge-based business should be promoted to provide financial support more efficiently to start-up businesses in various stages of growth.

- To strengthen intellectual ground of the Korean economy, meet the needs of an aging society, and weather the global economic recession, it is essential to expand private-sector funding for innovative, knowledge-based businesses.
- Though these businesses can be high-value added and be a new growth engine, they currently receive very limited support. This could take a heavy toll later, for example, if a foreign competitor accuses the fast-growing businesses for infringement of intellectual property rights.

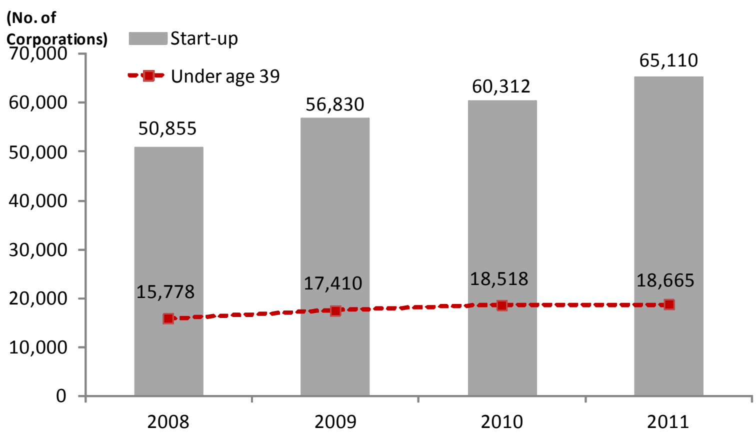
■ To promote private-sector funding, it is necessary to establish asset management companies that specialize in intellectual property and knowledge-based businesses, offer related fund products and expand lending against intellectual property.

- For example, various financial instruments can be designed based on patents, patent licenses, or contracts between patentee and its users.

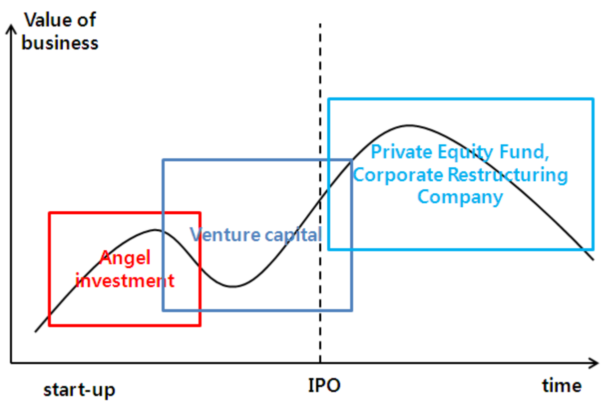
· Korea Technology Credit Guarantee Fund conducts technical evaluation and issues certificates for intellectual property, which can be used as securities against bank loans. However, this has practice has not been broadly adopted as people are unfamiliar with the idea, and normally use real estate as securities.

· Meanwhile, similar examples can be found in China and Japan. In 2011, there were 1,953 loans made against patents in China, in the amount of CNY9 billion, and in Japan, Howa Bank launched a growth–based fund in September 2012 to provide loans against intellectual property.

<Graph 1> Start–up Business by People under Age 39



<Graph 2> Funding Sources by Growth Stage of Business



☐ Policy & Industry News Briefs: Oct 15-19

■ A Sharp Appreciation of Korean Currency against USD

According to the FSS, the average USD/KRW exchange rate in Q3 2012 fell by KRW19.1 from the previous quarter. As of end-September, the USD/KRW exchange rate stood at KRW1,111.4, down KRW34 or 3.5%, from end-June. This is largely due to a massive inflow of foreign capital, following the ECB's commitment to purchase more sovereign bonds, as well as additional rounds of quantitative easing in the US and Japan. During Q3 2012, the daily average volume of FX transaction was USD21.67 billion, sliding 4.6% in a quarter. Also, the day-on-day volatilities of the USD/KRW exchange rate reduced significantly from KRW4.2 in Q2 to KRW3.2 in Q3. Meanwhile, the NDF transactions by non-residents recorded net sales of USD4.7 billion, rising sharply from USD620 million in the second quarter.

■ Financial Companies Expand Issuance of Subordinated Bonds

The FSS said in a statement that the outstanding amount of subordinated bonds issued by Korean financial companies stood at KRW40.53 trillion at the end of June, up KRW1.66 trillion from end-2011. The issuance of subordinated bonds had declined since 2008, but began to rebound in 2010. Specifically, banks held the largest amount of subordinated bonds at KRW35.59 trillion. It was the highest level since 2008, and this is mainly because banks issued more subordinated bonds to increase capital buffer and meet stricter regulations under the Basel III. The FSS plans to tighten supervision in this regard by requiring notification of bond issuance in advance and deterring bond issuance by poorly qualified companies to strengthen consumer protection.

■ ELW Market Adopts Market Warning System

The Korea Exchange announced a plan to operate the Market Warning System in ELW market starting from this month to improve investor protection. The system discloses stock items that are heavily traded by a few securities companies or through a small number of accounts. ELW products that show certain signs are posted on the warning list for a day during the trading hours, and displayed on the KRX website and HTS of securities companies. The specific criteria include stock items for which over 70% of transactions are handled by a particular branch office, or over 90% of transactions by five or less branch offices, or over 90% of transactions are made through ten or less accounts. These criteria are based on three−day transaction records and do not include liquidity providers.

□ Market Indicators: Oct 15−19

		2011 Avg.	Sept Avg.	Oct 15	Oct 16	Oct 17	Oct 18	Oct 19
Interest Rates (%)	Call Rate (1d)	3.10	3.01	2.75	2.75	2.75	2.75	−
	CD Rate (100 mil. won)	3.44	3.14	2.87	2.87	2.87	2.87	2.87
	Industrial Finance Bond	3.66	2.91	2.88	2.90	2.92	2.94	2.92
	Corporate Bonds (3yr, unsecured·AA−)	4.41	3.03	3.27	3.29	3.32	3.35	3.33
	Korean Treasurys (3yr)	3.62	2.81	2.76	2.78	2.81	2.84	2.81
	Nat'l. Housing Bonds (5yr)	4.10	3.31	2.99	3.01	3.04	3.07	3.05
KOSPI & Trade Value (KRW 100 mil.)	KOSPI (1 Jan 1980 = 100)	1,983.41	1,961.29	1,925.59	1,941.54	1,955.15	1,959.12	1,943.84
	Trading Value	68,308	52,169	45,915	38,501	42,599	42,904	40,562
	Investment Balance	174,122	183,723	180,986	175,512	181,468	177,350	−
	Foreigner Net Purchases	−371	1,638	−1,711	−344	248	535	−2,215
FX Rates	Won/Dollar	1,107.96	1,123.62	1,110.50	1,107.20	1,105.50	1,104.30	1,103.30
	Won/Yen	1,391.92	1,438.11	1,407.66	1,405.43	1,397.07	1,391.51	1,390.25
	Won/Euro	1,541.48	1,446.42	1,449.76	1,449.32	1,449.53	1,443.21	1,441.90