

SwapRentSM-empowered FARM – An 8-minute Introduction

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Mr. Leo Kolivakis, the publisher of Pension Pulse and a guest blogger at Nakedcapitalism blog asked me to write up a short and concise introductory text on FARM and SwapRentSM so that I may put my 8 years of research work into 8 minutes of introductory reading for people new to the ideas to have a quick big picture overview for the first time. Leo published the following quoted text contribution from me at his two blog sites on August 18th, 2009.

There have been many proposals on how to fix the current mortgage default crisis. It does not seem that the politicians have not been presented what the better ways may be to fix the foreclosure problems but rather the politicians' lack of political will to adopt any of those good ideas. Looking back in history, most of the time people do not get what they deserve that makes most economic sense. They get what the politicians tell them to get, in most instances, based on the politicians' own non-economic considerations. This time around it seems no different from before.

So irrespective of what route we may take to get out of this current credit default crisis. Even no more measure is taken there will still be an end to it when the last house gets foreclosed. At that time what alternative housing finance system should we adopt for the future? Are we going to tread on the same old path or should we learn the lesson well and look for something that will give us a paradigm shift in the way people own homes going forward so that the same mistake of lending and borrowing abuse of an even more massive scale could be avoided?

FARM (Flexible And Reversible Musharakah or Mortgage) is one of such paradigm shifting new methodologies that many governments could consider an implementation for their nations. At Advanced e-Financial Technologies, Inc. (AeFT) we have been working on developing consumer financial products for the past 8 years that could offer the same economic benefits of the conventional complicated financial derivatives without its opaqueness and potential shortcomings. It has been a long way to get to these innovative ideas fine-tuned and come up with the mature design of a few new consumer housing financial products for a new housing finance system.

First we developed a quantitative methodology based on the cost differentials between owning and renting a real estate property in order to put a value of the two major benefits of owning a real estate property. The first benefit is the right to occupy and use a property similar to a conventional renting. The second one is the right to future financial gains from appreciation and the obligation of bearing the downside risk of financial losses due to depreciation. We created a new financial instrument called a (Generic) SwapRentSM contract to represent this financial profile of a property ownership. We then took one more step and split the Generic SwapRentSM contract into two more sub-contracts to

separately represent each of the future upside appreciation potential (an AG SwapRentSM) and the downside depreciation risk (a DP SwapRentSM).

The secondary marketplace for people to trade these new SwapRentSM contracts is called REIDeX and currently hosted at <http://www.REIDeX.com> . For those interested in more details please visit our research and development web site at <http://www.SwapRent.com> .

Developing those quantitative methodologies was the hard part. Once a new way to quantify and trade these future appreciation units of owning a property is done then things could get a lot more interesting when you start applying these new methods into a few real fool-proof consumer financial products. For example, FARM is a new consumer property finance product where would-be homeowners could start out as a renter and buying these appreciation units represented by SwapRentSM along the way based on their own economic monthly income capability at the time. The homeowner's down payment will entitle him as being a co-owner with the bank or a local government agency in a bankruptcy remote trust account that he rents from. This co-ownership legal trust structure is already a common practice in many conventional Islamic mortgages that FARM was also based on.

Here are two original product design white papers, FARM - A new type of housing finance products without foreclosure possibility (<http://www.scribd.com/doc/18306698/FARM-A-new-type-of-housing-finance-products-without-foreclosure-possibility>) and FARM vs. HELM - The Two Opposite Entry Points to Adjust Economic Ownership in Real Estate Property (<http://www.scribd.com/doc/18596828/FARM-vs-HELM>).

The homeowner could purchase the entire property from the bank (or the local government agency provider) any time if he has the money. If he doesn't, then the monthly payments will first go to cover the regular rental payments so that he will have the right to occupy and use the property for whatever length of time he desires. Whatever additional monthly income capability will then go to purchase these appreciation units represented by SwapRentSM contracts to mimic a conventional property ownership.

Two immediate benefits are first, he could purchase the appreciation potential of the property for only part of the entire house value if he does not have enough monthly income to own entirely. This opens up opportunity for a lot more people to own homes who normally may not become homeowners without such a new product like FARM, hence the increased portable housing affordability and homeownership in a country. In the past, the way for these low-income families to own homes was to be offered a subprime mortgage. That was the root cause of our current financial crisis. SwapRentSM and FARM allow the low-income families to occupy and use the property at their own preference and still get to own a part of the future financial gains derived from the appreciation potential without the risk of being foreclosed.

That leads to the second major advantage that is when the homeowner loses his monthly income capability due to unforeseeable loss of job or disability in the future, he will probably only lose a part of these future appreciation units. As long as he still has the

monthly income to pay the rent to the trust he could continue to own, occupy and use the property for whatever length of time he wishes. Nobody will ever be able to foreclose and evict him, as in addition to being a renter of the house he himself is still a part owner of the house in the co-ownership trust he set up with the bank or local government agency before. That is why we call this new invention of SwapRentSM-empowered FARM a new housing finance product without foreclosure possibility.

From the institutional investors' perspective, pension funds for the first time could have a liquid way with very low transaction cost to establish a position in pure residential real estate market exposures through these SwapRentSM contracts that either the homeowners or the co-owning banks and local government agencies would like to pass on to other free market-based investors. The institutional investors could therefore easily further diversify their investment portfolios with many residential property exposures located in different parts of the country or even different parts of the world. The residential real estate could finally be treated as a separate investable asset class in the institutional investment world.

Although SwapRentSM would actually operate much better in a totally free market environment without any of the government's involvements but the government's awareness and regulatory support as a gamekeeper may offer certain degree of comfort for these potential economic landlord investors to be more willing to work with homeowners with or without any financial intermediaries in a fair and equitable way under a pure free market mechanism.

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