

Equity Sharing: Yesterday's Solution to Today's Problem

Is equity sharing, paired with debt financing, a foregone conclusion for the future of the residential housing market? It sure seems that way, in view of the Treasury's recent announcement advocating the use of equity sharing when paired with principal reduction activities (HAMP Update: Supplemental Directive 10-14). But the question remains; what form and function of equity sharing will be the most suitable and amenable to implement across all applications and on a mass scale?

Does a Need Exist?

Businesses have embraced the concept of debt and equity for hundreds of years. It is not only seen as practical but as an intelligent way to diversify risk. Yet, for households who wish to expand, debt finance has been their one and only option. Despite the ever-growing sophistication of corporate capital markets, homeowners are forced to utilize only the most archaic of options....debt. The lack of options creates many of the economic complications that manifest throughout a homeowner's life-cycle can be directly ascribed to the 'all-or-nothing' constraint on home ownership financing options.

There was little interest in equity sharing in the early 2000's since debt financing alternatives were easy and cheap. That began to change in 2006, but home equity began to evaporate as well. The potential market for equity participations shifted to foreclosure mitigation. Regardless, the equity sharing idea gained little traction as both lenders and the government chose to focus on the more familiar route of lowering mortgage interest rates and extending maturities. Now that the familiar refinancing/modification alternatives are proving ineffective, attention is being given to mortgage principal reduction.

The longer term benefit of creating equity participations is to provide more robust home financing alternatives for homeowners, distressed or

not, and to create a residential home equity market that would allow investors to diversify beyond the traditional stock and bond markets.

Most Americans take for granted that mortgage financing has always been readily accessible. Nothing could be further from the truth. Just as the derivatives market really came into play during the late 1970s, the widespread use of debt only dates back to the New Deal Era.

"Due to financing mechanisms currently available, homeowners tend to have too much of their portfolios invested in their homes and institutional investors have too little invested in owner-occupied housing," according to Robert Schaefer, in a 1998 paper titled *Equity Participation in Homeownership by Institutional Investors*.

Caplin and Joye in their 2003 report, *Innovative Approaches to Reducing the Costs of Home Ownership*, recognize that "This begs the question as to the absence of equity finance in the first instance. One answer instantly offers itself: securitization. In the past, it was not practicable for a single unsponsored entity to go around gobbling up interests in individual properties in the vain hope that they could bundle these contracts into something that would look like a regulated holding."

Fortunately, we are in a market place today that has an immense knowledge and appetite for securitization and is ready (although they might not know it yet) to add equity participations in the residential housing arena into their financial repertoire.

What Is Equity Sharing

In its traditional use, equity sharing is a way for a home buyer and an investor to jointly buy property and share ownership. Typically the home buyer has exclusive occupancy rights and takes care of the ongoing financial obligations (mortgage, taxes, insurance, etc.). The investor normally is a passive participant. There are both public and private applications of equity sharing. In the public applications a local government body may act as the "investor" with a primary goal of

making the property perpetually affordable for the current and subsequent owner. In such cases, the sale price of the property is purposely limited so that the next owner is aided also. In private applications, the investor is motivated (like the home buyer) by the appreciation of the property value. In that case, there is no price limit for the sale of the home.

Equity sharing is not, however, limited to home purchases. Equity participations can and are being used during loss mitigation activities that include principal reduction. They can also be used for other opportunities such as: cash-out refinancing, reverse mortgage alternatives and builder down-payment-assistance programs.

Equity Sharing Today

Equity sharing has been utilized for hundreds of years across a multitude of applications. In fact, odds are that you are personally involved in a multiple of equity sharing arrangements right now.

Businesses/Corporations. Businesses regularly accept equity partners to avoid increasing their debt load or to structure an increase of their cash position. As a share holder of a company, you are, in fact, participating in a form of an equity sharing agreement.

Commercial Real Estate. Debt and equity have coexisted in the commercial real estate realm for over a hundred years. These transactions, also referred to as “dequity”, are extremely common and are the only way to obtain high loan-to-value funding.

Residential Real Estate. Equity sharing arrangements are utilized every day but are typically found in agreements amongst family members or other groups such as universities and their professors.

Many first time homebuyers find themselves turning to their parents or another relative for help with a down payment. Sometimes this help comes in the form of a gift, while other times a more formal agreement is put into place governing the repayment and equity/appreciation sharing due upon sale.

There are universities that are located in high-cost areas and have a need to help subsidize the cost of housing for their professors. Some, such as Stanford University, utilize an equity sharing arrangement and down payment monies from their endowment fund to aid their staff in being able to afford to live nearby.

Equity sharing has been in use in non-profit housing for years. According to the Center for American Progress, “Hundreds of local communities

and several states have developed shared equity homeownership programs that have already created hundreds of thousands of permanently affordable homeownership units. There are currently 425,000 families living in limited equity housing cooperatives. There are more than 200 community land trusts in 42 states that have built or acquired more than 5,000 shared equity homes. And more recently hundreds of inclusionary zoning and similar programs have created tens of thousands of price-restricted homes for low- or moderate-income households.”

Models & Approaches

Betsy Zeidman, in her 2010 report *Financial Innovations for Housing: After the Meltdown*, stated that “Shared equity is a concept that implies reduced assets in exchange for reduced liability. It is often referred to in two contexts. One approach attempts to balance wealth generation for individual owners by preserving affordable housing. An alternate approach is the private-sector, shared-equity model in which investors provide a share of the housing cost in exchange for a portion of appreciation. Both approaches foster access to homeownership at reduced levels of debt, and lenders reduce their risk by maintaining a share of ownership.”

Public Sector. Public Sector equity participations usually involve a non-profit organization or government entity which subsidizes the purchase price of the property. This results in a lower overall cost of the home which means the lower income borrower can now qualify for the mortgage payment. When the house is sold, depending on the model used, the sales price is either restricted or reduced. The homeowner receives any equity between the mortgage balance and the sales price.

The form of equity participation that is used in the public sector generally includes one of three models: limited equity cooperatives, community land trusts and deed-restricted housing. These models guarantee occupancy, ensure maintenance is kept up, help to avoid foreclosure and are time tested to be effective and sustainable. Community land trusts (CLTs) have been a very popular and successful model in the public sector version of shared equity. They almost always involve the establishment of a nonprofit organization to hold the land so that any property built on it is perpetually affordable. CLTs keep the appreciated value of the land out of the marketplace which maintains affordability for homeowners who are only required to afford the value of the “sticks.”

Private Sector. Private Sector equity participations usually involve a financial institution, as equity partner, which contributes a proportion of the purchase price of the property and where the homeowner contributes their small portion. This results in a reduced deposit and mortgage required by the homeowner. When the house is sold the equity partner receives a share of the equity in the house which represents a deferred return on capital; and the homeowner receives any remaining equity.

The form of equity participation that is used in the private sector takes the form of either debt, as a Shared Appreciation Mortgage (SAM), or true equity, as a Tenant-in-Common (TIC) interest.

SAM's have been used for over 40 years but they have never garnered the broad interest that they were designed to capture. Banks, in general, are not allowed to participate in a contingent interest on debt in this fashion.

TIC ownership refers to an arrangement under which two, or more, people co-own a home. TIC ownership allows the investor to be essentially a passive partner where the homeowner gets all the usage rights. Direct TIC ownership has been used for hundreds of years and is most popular among universities, parent/child partnerships and fractional ownership vacation homes.

Dr. Andy Sirkin, a recognized expert in fractional ownership, tells us that, "The [TIC] structure has become a popular style of ownership in many different real estate contexts. For example, income property investors and real estate syndicators are increasingly using [TIC] as a vehicle to facilitate income tax-deferred exchanges. At the same time, vacation home buyers and resort developers are increasingly using [TIC] (often called "fractional ownership" in this application) to share ownership and usage [rights]."

There is another variation on TIC ownership that does not take a direct ownership in the property. This form of TIC is structured as an option, or Tenant-In-Common Option (TICO). It is most similar to a "call option" on a share of common stock. This type of structure provides a "wall" that the investor can sit behind without having to expose themselves to all the inherent risks that come along with being an owner on the title.

What is Today's Solution?

Despite the various models of equity participations tried to date, no model has been accepted as a permanent solution for the residential housing arena. Clearly, however, the concept of equity sharing works.

The problem has always been how to take a one-off solution and develop a model that can be adopted by large institutional investors and be attractive to the capital markets once securitized.

The only type of equity sharing that fits both of those stipulations is the TICO model. This model protects the investor and the homeowner alike. The investor does not take on the unnecessary risk of directly owning a portion of the property and the homeowner does not have to share their ownership, and the rights that come along with it, with the investor.

The TICO model represents a pure equity relationship and does not stray into debt territory. This is important for several reasons: ⁽ⁱ⁾ The homeowner does not have a monthly payment on equity participations secured through a TICO; ⁽ⁱⁱ⁾ the loan-to-value, during underwriting, is based solely on the debt portion and not the equity participation; ⁽ⁱⁱⁱ⁾ the TICO acts as a hedge against inflation; and ^(iv) it opens up a new asset class for the capital markets to invest in.

Currently there are two companies that have developed an equity participation concept around the TICO model. To date, only one of those companies has a patented product/process and it is referred to as a Home Equity Fractional Interest or HEFI. (www.equidebtsolutions.com)

Final Thoughts

The development of an equity sharing vehicle that would permit institutional investors to participate in this segment of the economy will vastly improve the condition of the real estate and capital markets. A program could immediately be implemented to curb foreclosures and provide the needed structure to allow for principal reductions to take place. Builders and developers could also design a sales program where they reduce the cost of homeownership by providing a debt and equity purchase option.

The most intriguing aspect to this solution is that there is not a need to re-invent the wheel. It doesn't need to be market tested or vetted out in court. The mechanisms contained within this solution are time tested and have been proven to work and be desired. This old solution is ready to become the now solution.

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