



# TIME FOR A NEW PARADIGM

COMMENTARY ON H.R. 6256

By Steven A. Cinelli  
PRIMARQ Incorporated

October 2010



Housing continues to be a much-maligned part of the US economy, with most discussions about how to stem the challenge being thoughtful but without substance. That is why I am pleased to see Congressman Gary Miller (R:CA) taking a substantive step in introducing legislation that can and will improve the future of housing finance. His bill, HR 6256, entitled “Strengthening FHA through Shared Equity Ownership Act of 2010”, will establish a series of “equity sharing” finance programs under the aegis of the FHA, complementing the agency’s existing loan guarantee programs. Having reviewed the bill as well as observing the initial media coverage, I hope that a more full understanding of what “equity share finance” can do to address our housing crisis will become a broader discussion. Limiting the application of this bill to loan modifications alone is like peeling back only the first layer of an onion. The applications are far reaching and, when successful, this will be a much needed paradigm shift in US home finance.

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## HISTORICAL PERSPECTIVE

For perspective, since the days of the New Deal, the US housing finance system has been exclusively built upon the usage of high levels of mortgage debt, encouraged by creative mortgage products (ARMs, subprime loans, teasers), the capital markets structural approach, i.e., securitization, and government intervention, with the roles of the FHA and the GSEs. Collectively, buyers and owners could purchase and sustain ownership with limited amounts of their own funds, as mortgage products were rampant with decreasing

levels of accountability on the part of loan providers. Lenient underwriting requirements and imprudent advance rates spawned excessive debt in the system, negatively affecting buyers, owners, lenders, and the feds (read taxpayers), even in recognizing that the asset being financed (the home) is volatile in value. In other asset classes, there seems to be logic of prudence in leveraged financing, understanding that if an asset value can erode, don't lend as much against it. But this was not the case in housing.

#### A CHANGE IN CAPITAL STRUCTURE IS NEEDED

As Congressman Miller's bill implies, there is a desperate need to redress the capital structure of home financing, limiting the amount of debt used, which accordingly suggests more equity is required. As it is true, the biggest obstacle already to home buyers successfully purchasing a home is providing sufficient down payment, i.e., equity, funds, but with a now desired lower level of mortgage financing, where may incremental funds be sourced? Consistent with Congressman Miller's bill, such funds should be equity funds and sourced from the private sector investors. As the bill's directive is to establish a series of "equity sharing" pilot programs, our particular approach is establishing a comprehensive capital market system for equity sharing investments between

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owners/buyers and investors, but there are other approaches we are familiar with too. I believe the market will welcome many of these approaches. But first, let's look at the fundamental methodology.

#### EQUITY SHARING FINANCE

"Equity sharing finance" is simply the inclusion of a third party equity investor contributing equity capital into a transaction for which the investor is purchasing an ownership position in the owner-occupied property. Analogous to having a shareholder in a company, the investor is seeking to participate in the potential appreciation of the property. The investor also recognizes that if the property declines in price, the value of his investment may also decline. This differs from mortgage lending, wherein a mortgage lender does not intend to take price risk, and will not take less than full value of its mortgage loan unless all the equity value of the homeowner is eroded. While low down payment levels with high levels of mortgage debt can provide for considerable "wealth creation" due to the leverage, such leverage can also backfire and completely erase down

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payment wealth with a nominal price drop. With a 90% loan, a ten percent drop in value eliminates an owners' housing wealth. Over the last four years, the US has witnessed almost a \$10 trillion drop in housing values, which has decimated the housing equity of American households. Imagine if the buyer shared his equity, and reduced his debt level. With an incremental ten percent equity, which is willing to take the downside risk, the homeowner is sharing the downside risk, limiting his wealth destruction. Shared return, true, but also shared risk.

Equity sharing finance can be utilized in all areas of housing finance, from home purchases to equity access/release, as well as loan modifications and recapitalizations. Home buyers can purchase homes with less levels of debt by including an equity sharing partner. This will translate into lower levels of debt, possibly at better rates, and the concomitant lower mortgage payments. Further, having a larger equity component in the financing, thereby lowering the loan-to-value level, can reduce the level of mortgage insurance, another monthly cost. Of course, one "concern" voiced is that an investor is gaining at the disadvantage of the homeowner, taking away some of his potential wealth. Do understand that the investor is investing on the hope of appreciation, without any guarantee of gain, and is taking price risk of the property. The homeowner, still participating in the appreciation, is immediately gaining value in that the now lower level of absolute indebtedness begets lower payments, thus improving the personal cash flow of the homeowner. One may then compare the (present) value of the improved cash flow over the life of the investor's investment, and, even with "giving up" some of the upside, the homeowner has enjoyed value with better affordability and the incremental cash that can be invested in other asset classes or address current funding needs, such as education or healthcare.

#### "ALL YOUR EGGS IN ONE BASKET"

In a similar vein, the average household in the US has the bulk of its wealth tied into the equity value of its home. This equity served as the US "piggybank" for much of the 1990's and early 2000's, but as most portfolio managers might comment, does it make sense to have virtually "all your eggs in one basket", i.e., total value in not only a single asset class but a single asset? With the correction of the last four years, this "housing-biased" wealth got hammered to the extent of the \$10 trillion, tremendously impacting the viability of the US economy. But there were those that "accessed" their equity, true, but the

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mechanism used were HELOCs and HECMs (home equity loans and home equity

conversion mortgages or reverse mortgages), i.e., loan products, that are not intended to take price risk. As the value of the homes eroded, the debt levels did remain constant, and again, homeowners saw the troubled side of leverage. Equity sharing can be applied in these circumstances also. Rather than borrowing from the equity value, and obligating oneself to the full amount of the debt regardless of the potential value changes in the home (plus incurring monthly payments), an owner could “sell” a portion of his equity to an investor, thereby monetizing or releasing equity value, yet not incurring incremental payments AND shifting part of the future price risk to the investor. If the homeowner still wanted to be “exposed” to residential real estate, he could reinvest in other properties via equity sharing, and build a more diversified position. Our view is that a homeowner should take a bifurcated view of his home as to (i) its “utility value”, i.e., a place to reside, and (ii) its “financial value”, in terms of treating it as any other financial asset.

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#### RECAPITALIZING TROUBLED MORTGAGES

Equity sharing finance can also be of benefit to homeowners with troubled mortgages. With eroded values, and the resulting increases in the loan to value levels, many homeowners have not been successful in modifying their existing loans, including tapping into historical low interest rates. Lenders with 90% to 100%+ LTV levels are exceeding slow to improve the structure of the home ownership finance structure. Insert equity sharing into the discussion. By “recapitalizing” a portion of the existing mortgage debt with an equity participation, i.e., using equity funds to pay down the existing loan to conforming levels (~80% of current value), the homeowner can sustain his ownership on a more “cash flow” prudent basis (lower debt at lower rates with lower payments. The immediacy of cash flow improvement is of great economic value, even though some of the “potential” appreciation may be shared with an investor. And now the lender has an asset (the loan) that should perform satisfactorily.

#### BENEFITS FOR ALL CONSTITUENTS

And while we speak of the benefits to the homeowner in “sharing the risk”, we do see a compelling investor proposition. The housing stock, while significantly valued lower today than in 2006, is still a \$16 trillion asset class, second only to the equities market. Real estate has been a staple of the investment community, and yet current offerings largely consist only of commercial or multi-family properties, structured in REIT-like portfolios. In our research, having access to home price movements represents an exciting new subclass, and add to that the inherent (and prudent) levels of leverage finance in homeownership, investor returns can be compelling.

We at PRIMARQ embrace a new paradigm of housing finance, namely the inclusion of third party equity funds into the mix. Maybe simplistically, but we view that all constituents in housing benefit as such:

- Homebuyers benefit with better affordability due to less debt, and can share the risk of price movement, while enjoying exclusive occupancy;
- Homeowners benefit by having the opportunity to access/diversify their largest equity/investment position, without incremental debt, while sharing the risk of price movement;
- Lenders benefit with better performing mortgages, due to lower LTVs and lower debt to income ratios. And enabling lenders to approach financing more conservatively, lending activities can resume.
- Investors would have access to a tremendous asset class in the US, which in its present form, not available on a passive investment basis.
- The Federal Government and its agencies benefit with lesser reliance on direct or contingent exposure due to lower loan levels and improved mortgage performance, and
- Society in general benefits with a new model of sustainable homeownership, which has positive impacts on neighborhood stability, children and family outcomes, and provides a more prudent means of wealth creation.

#### FINAL THOUGHTS

Again, we applaud Congressman Miller in laying down an initiative, which not only can alleviate the current malaise, but sets forth a direction for more affordable and sustainable homeownership, more prudent lending practices, and reduction in the role of government in supporting a most critical element of the US economy.