

# The Case for Shared-Equity Mortgages

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# What Are Shared-Equity Mortgages?

- Consider a \$40K SEM for 20% of a house initially valued at \$200K and sold 10 years later for \$300K. Two alternatives:
  - Sharing of appreciation: Pay back \$40K plus 50% of gain, for total of \$90K.
  - Shared equity rate: Pay back 30% of house value, for total of \$90K.

# What's Wrong with Current Mortgage Contracts?

- Current mortgages expose borrowers to the full risk of house-price movements.
- This is unusual in our financial system, which generally uses a combination of debt and equity in order to spread investment risk.

# Why Have Shared-Equity Mortgages?

- Shared-equity mortgages reduce chance of borrowers being “under water” when home prices fall. This reduces the risk of default-driven financial crises such as that we are now facing.
- Shared-equity mortgages allow for lower downpayments without raising the risk of borrowers being “under water” when home prices fall. This raises affordability without raising risk.

# Shared-Equity Mortgages are Timely but not New

- Relevant to current sub-prime crisis:
  - Expands work-out options for lenders.
  - Congressional “equity strip” proposals require beneficiary of write down to share gains
  - Prevent ensuing lock-out crisis
- Lessons of U.S. history unclear:
  - Introduced in early 1980s to cut mortgage payments when inflation and rates were high.
  - Bear Stearns failed at 1990s re-introduction.

# Do Homebuyers Want Them?

- Survey results show that renters are interested.
- Funding could be achieved via “shared-equity-mortgage-backed securities”:
  - Avoid agency problems in appraisals
  - Investor properties for the mass market so investors accept risks related to house prices. No bail outs are needed.

# Two Tax Obstacles

- 1. No Advance Ruling List
  - 2. Burdensome taxation if ruling made
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- 1. Is SEM “debt” or “equity”?
    - 1983 ruling for a very limited case, then and to this day placed on “no advance ruling” list
    - Uncertainties need to be disclosed up front, making it hard even to file taxes
    - Tax uncertainties doomed Bear Stearns’ launch.

# Two Tax Obstacles

- 2. Likely covered under contingent interest rules (communication with Treasury)
  - Lender taxed on imputed interest
  - Only certainty for lender/investor is payment of taxes, no certainty as to date or amount of payback
  - No corresponding offset for borrower
  - Other contingent interest instruments are symmetric as between borrower and lender

# How Can Tax Treatment Be Fixed?

- Negative treatment afforded SEMs seemingly unintentional
  - Treasury has regulatory authority to change
  - Prevented by fear of collateral damage
- Alternative strategies:
  - Public and political awareness campaign
  - Legislation to pre-empt absence of ruling and unfavorable treatment
  - Setting up a specific and favorable regime based on an equity characterization