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The Promise and Perils of Shared Equity Financing

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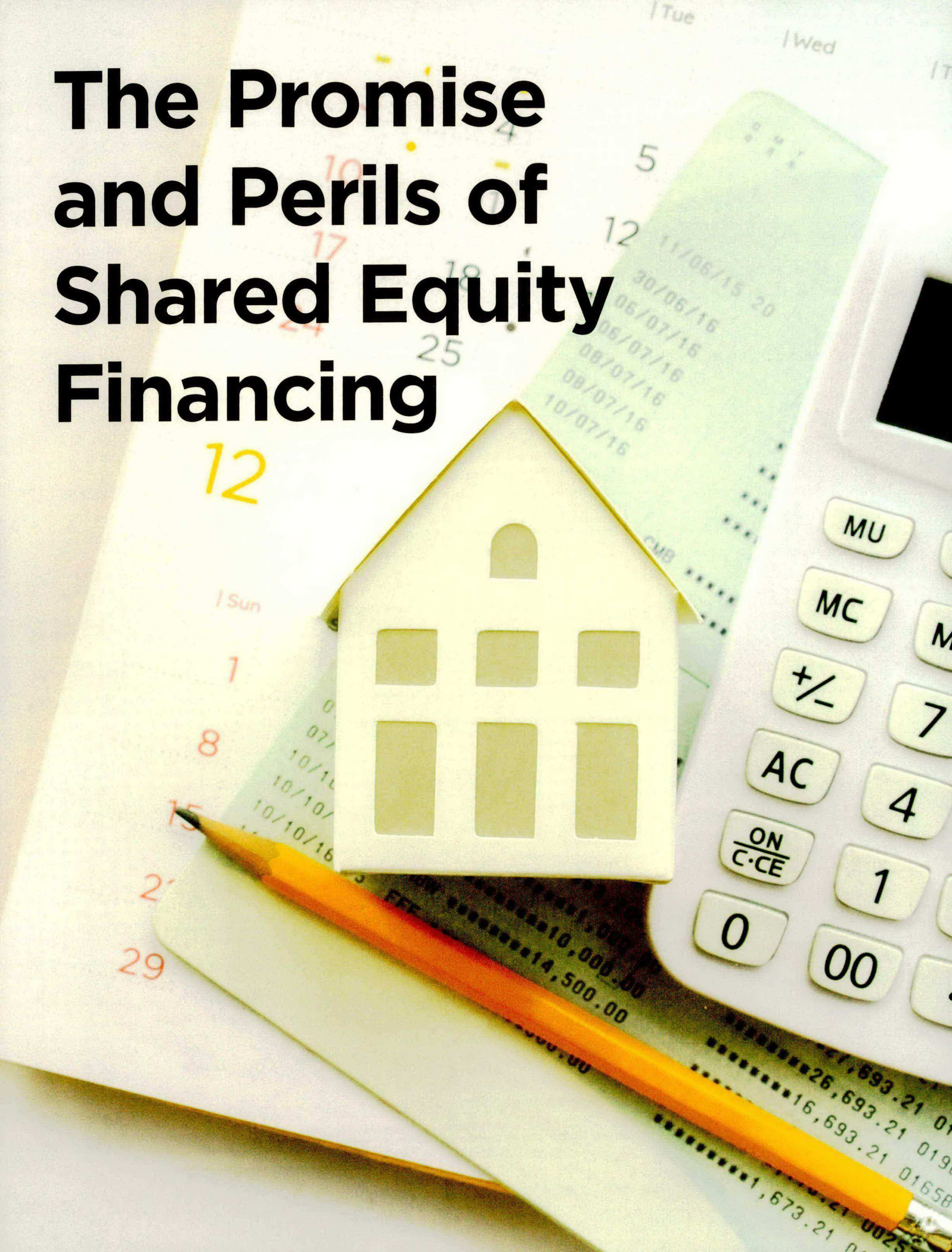

By Ernira Mehmetaj and David Reiss

It is the rare homeowner, or even lawyer, who thinks twice about why mortgages are part of so many real estate transactions. Real estate is expensive, and few have the money to pay cash for a home. As a result, people enter into transactions with mortgage lenders and are exposed to all of the risks that come along with mortgage financing: default, late fees, and foreclosure.

If you stripped away all of our history and our current practices in financing homeownership with mortgages, you might ask how could people with limited assets acquire something as expensive as a home? It turns out that there are all sorts of ways to divide the rights and responsibilities of homeownership to offer households just the aspects they want and no more.

A new development, shared equity financing, will make us all think twice about mortgages. Sharing the risks and rewards of a home purchase will be attractive to many, but shared equity financing also has its share of perils that are unique to it.

Slicing and Dicing Mortgages

Mortgages themselves can be sliced and diced in many ways. One can shrink the size of down payments to expand homeownership opportunities. Both the government and the private sector have done this. This strategy has reduced the amount of standard down payments significantly over time (although history has shown that zero down payment loans seemed to have been a bridge too far).

One could shrink monthly payments and even get rid of them. This has been attempted more frequently with existing homeowners than with prospective homeowners. Reverse mortgages, for instance, allow people to borrow and not make monthly payments. But even new homeowners sometimes can get in on the action, with interest-only loans or pick-and-pay mortgages that allowed homeowners in the early 2000s to have negative amortizing loans in which the amount owed *increases* over time.

One could allow a homeowner to give up some of the upsides of owning a home with a shared appreciation mortgage, where the lender charges a lower interest rate in exchange for some of the upside on the sale of the home. Or one could limit the downside of owning a home with nonrecourse debt, either through the mortgage terms or because of an applicable statute.

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Slicing and Dicing: Beyond the Mortgage

One can divide the rights to a house in other ways. The way with which we are most familiar is by allocating the right of possession to one party (the tenant) and all of the other rights of ownership to another (the landlord).

Fintech companies are continuing to develop new ways to ease the burdens of acquiring a home. The authors evaluate one of these ways below, shared equity financing. The authors focus on whether shared equity financing is a good deal for homeowners, compared to the other available options.

Although financial firms have recently stepped onto the playing field, the concept of shared equity financing has been around for quite some time. A shared equity financing agreement typically involves two parties: a potential homeowner and an investor. The investor invests alongside the potential homeowner and, in return, owns a percentage of the equity in the new home. If the investor does not provide all of the additional equity that the prospective homeowner needs, the homeowner can apply for a mortgage to make up the difference.

The homeowner would then typically occupy the home, pay all expenses in connection with owning it (taxes, insurance, etc.), and maintain it according to the investor's requirements, without any monthly payments to the investor. Upon the maturity of a set investment term (or an earlier termination because of an agreed-upon condition like a sale), the investor would receive the initial amount of its investment, plus its equity share in the home's value. To pay off the investor, the homeowner could refinance, sell the property, or pay off the investor from savings.

Precursors to Private Shared Equity Financing

Taking note of the hurdles individuals face in purchasing a new home, various government agencies and not-for-profits have stepped in to alleviate some of the burdens of homeownership over the last few decades. They have created long-term, affordable homeownership opportunities through alternative shared equity methods such as community land trusts, deed-restriction programs, and limited equity housing cooperatives.

Community land trusts increase affordability with a dual ownership model, where one party holds title to the land and the other holds title to the building located on the land. Because the cost of the land itself is eliminated from the purchase price of a home, the homeowner has a greater likelihood of being able to afford the house, thereby encouraging homeownership. The homeowner's interest is subject to a ground lease that contains certain sale price restrictions to maintain affordability for future buyers.

SHARED EQUITY OF FINANCING COMPANIES

	Hometap	Noah	Point	Unison
Established	2017	2016	2015	2004
Availability	12 states	5 states	17 states + DC	31 states + DC
Min. Investment	Not available	–	$35,000	20%
Max. Investment	$300,000	$350,000	$350,000	$500,000
Max. Share of Value	Not available*	40%	20%	70%
Investment Term	10 years	10 years	30 years	30 years
Fees	3% of the financing amount, appraisal, and third-party fees	Servicing fee of $2,000 or 3% of the financing amount, whichever is higher; underwriting, appraisal, and third-party fees	3%–5% of the financing amount, appraisal, and third-party fees	3.9% of the financing amount, which includes appraisal and third-party fees

*Not confirmed by Hometap.

Sources: Hometap, *The Smart Way to Tap into Your Home's Equity*, https://www.hometap.com (last visited Dec. 20, 2020); Noah, *Access Your Home Equity Without the Burden of Debt or Monthly Payments*, https://www.noah.co/ (last visited Dec. 20, 2020); Point, *Get Up to $350k with No Monthly Payments, Ever*, https://point.com/ (last visited Dec. 20, 2020); Unison, *Welcome Home*, https://www.unison.com/ (last visited Dec. 20, 2020).

Deed restrictions limit to whom homeowners can sell their home and at what price. The restrictions, which are contained in the deed, limit sales to income-eligible individuals at an affordable price, while typically allowing the homeowner to benefit from some portion of the price appreciation.

Limited equity housing cooperatives are similar to traditional co-ops but are made available to income-eligible individuals at affordable prices. Like the other models discussed, the current homeowner's ability to profit from price appreciation is capped at the time of resale.

Various government agencies and not-for-profit entities saw another opportunity to create long-term affordable homeownership programs through shared equity financing. In return for providing a potential homeowner a subsidy, these agencies and entities would retain a percentage of a home's appreciation at the time of resale. The funds these agencies and entities would receive from the appreciation in value would be reinvested in subsidies provided to new homeowners, thereby recirculating funds available for affordable housing to more income-eligible households. This model essentially bridged the gap between the financing homeowners were able to obtain and the actual market cost of purchasing a home.

Private Shared Equity Financing Options

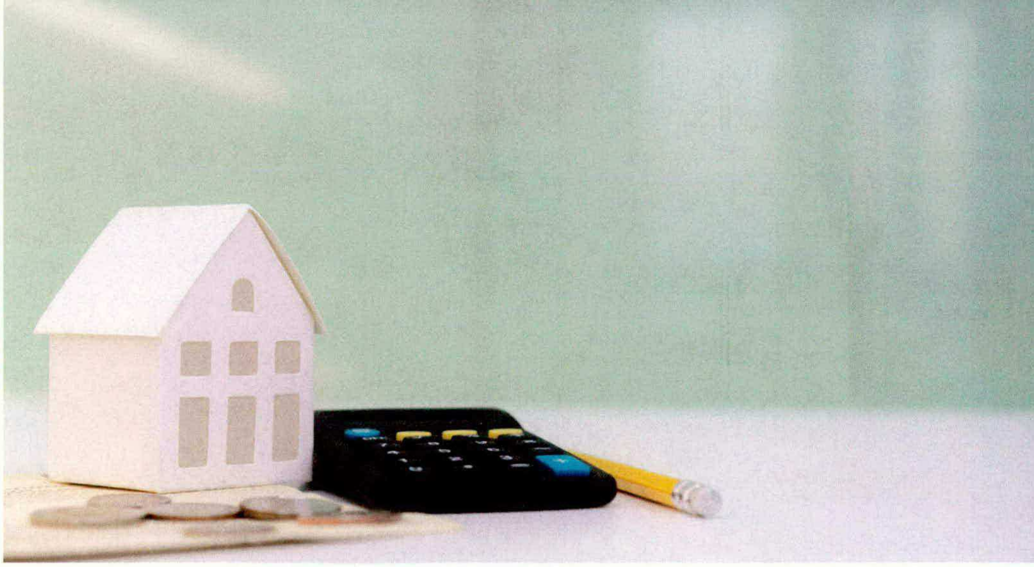
The private sector jumped on board the shared equity financing bandwagon more recently. Players such as Unison, established in 2004, and others such as Hometap, established in 2017, have been extending their reach to more and more states. *See generally* Unison, *Your Homeowner Questions, Answered*, https://www.unison.com/faq_homeowner (last visited Dec. 21, 2020); *see also* Hometap, *How It Works*, https://www.hometap.com/how-it-works/ (last visited Dec. 21, 2020). Unison, for example, offers maximum investments of up to $500,000. *Your Homeowner Questions, Answered*, *supra*. The chart above outlines the terms that different players in the private sector offer.

To understand how these private players function, it is important to discuss how they structure a deal. Let's take Noah, for example. First, it determines a property's adjusted home value. *How It Works*, Noah, https://www.noah.co/how-it-works. It does this by subtracting the product of the current home value (as determined by an appraiser) and the valuation adjustment (a percentage that typically ranges from 10 percent to 20 percent) from the

current home value. *Id.* For illustrative purposes, if an appraisal determined that a home's value is $1 million and Noah's valuation adjustment is 10 percent, the adjusted home value would be $900,000 (i.e., $1,000,000 – ($1,000,000 × 10%)). Noah offsets its risk through the valuation adjustment, thereby reducing its exposure to downturns and amplifying its returns in a rising market.

In an appreciation scenario, the total payout to Noah would be determined by calculating the difference between the increased home value and the adjusted home value, then multiplying that number by the percentage of the equity share, then adding the original funding amount. *Id.* Once again, for illustrative purposes, and with numbers taken from the Noah website, if the increased home value is $1,343,916, then the total payout to Noah would be $233,175 (i.e., ($1,343,916 – $900,000) × 30% + $100,000 (original funding amount)). Accordingly, Noah's investment gain is $133,175 and its annualized ROI is 8.83 percent over 10 years.

In contrast, in a depreciation scenario, when a property's value is decreased to $737,424 (again, with this scenario taken from Noah's website), based on the same calculation method stated above, its payout would be $51,227, representing an investment gain of –$48,773 and an annualized ROI of –6.47 percent over 10 years. Something to keep in mind when reviewing depreciation scenarios is that many borrowers under traditional mortgages escape deficiency judgments when their home loses significant value. But with the depreciation scenario described above, the homeowner would still owe Noah a payout even if the homeowner had no equity left in the property. A home would have to have depreciated significantly for Noah to be wiped out completely.



Risks for Consumers

The private market's innovative shared equity financing products can seem extremely attractive for homeowners, especially because they would not have to worry about monthly payments due to an investor for their equity investment. There are, however, numerous disadvantages and risks associated with it. Homeowners are likely to suffer significant reduction in their capital gains because they must share a significant portion of it with their investor. If a home were to substantially appreciate in value, for example, homeowners could end up paying the shared equity investor a lot more than they would have paid a traditional mortgage lender if they had just obtained a conventional mortgage.

Shared equity financing provides opaque profit centers for investors, which have designed a system in which it is extremely hard for them to lose. From the start, private shared equity investors shield themselves from loss, as we saw with the Noah example above. Shared equity financing firms transfer a lot of the risk of a downturn to homeowners. At the same time, they amplify their own returns in a rising market.

Although shared equity financing entities claim not to have a prepayment penalty as lenders sometimes do, many of them do not share in any depreciation if a homeowner were to sell or refinance her home within a set period after funding. For instance, if a homeowner sells or refinances her home within the first five years, that homeowner would need to pay Unison the full amount of the investment, plus the investor's share in the equity, without taking into consideration any decrease in market value. *FAQ Homeowner: Scenarios*, Unison, https://www.unison.com/faq_homeowner/scenarios. So while the term "prepayment penalty" is not used by these investors, an early payout can mimic the effects of a prepayment penalty.

Finally, homeowners limit their options when seeking mortgage financing because only a few of them are comfortable working with a borrower who is a party to a shared equity agreement. As a result, some of the shared equity financing firms, like Unison, require homeowners to work with certain designated lenders, which limits their ability to shop around for the best mortgage terms. *FAQ Homeowner: Advanced Topics*, Unison, https://www.unison.com/faq_homeowner/advanced.

More Regulation Ahead?

In the early 2000s, homeowners were offered "easy" money on opaque terms. That scenario did not end well once the financial crisis hit. A lot of the easy money was anything but easy once homeowners began to default. Homeowners who are attracted to shared equity financing agreements may find themselves regretting the "easy" money offered by shared equity financing companies once they see how the numbers can work against them.

Because of the lack of familiarity with this alternative financing method and all the risks that come along with it, state and federal regulators should take a close look at this innovative financial product before its market share grows much more. ■