

Is there a Role for Shared Equity Products in Twenty-First Century Housing? Experience in Australia and the UK

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1. Introduction: the question

An important aspect of traditional housing markets has been that the equity in the home tends to be held by a single individual. Owner-occupiers, in particular, while they stake the full value of the asset as collateral to mortgage institutions for funding purposes, remain as owners of the dwelling. This housing asset is usually the largest single asset in the households' portfolio. Moreover ownership, especially in the early years, tends to mean that the household portfolio is heavily geared and is subject to significant risk from house price volatility. This is in sharp contrast to most other larger, more lumpy, assets where values and risks are spread among a large number of owners who are at the same time enabled to access more balanced portfolios. The more the household's wealth is concentrated in their housing and the higher their borrowing requirement the greater the risks they face.

In this scenario it might have been expected that the market would develop a range of products to enable households better to manage their risks. However in most financial environments the only options available are to remain as a tenant with no investment in housing or to invest in housing as a small scale landlord, with exactly similar implications, for given wealth, with respect to the risks faced by the owner-occupier. Equally, given household aspirations to owner-occupation and the extent to which governments favour the sector, it might be expected that they would develop policies to help those most exposed to risk (Whitehead et al, 2005; Berry et al, 2004; MacLennan et al, 2002). In practice across the world there have been a range of innovative products introduced by both governments and the market but none have become mainstream.

This paper examines innovations in two of the countries that have made the most progress in developing a range of shared equity and shared ownership products – Australia and the UK. The next section clarifies the definition of shared equity and the attributes of the available products. The paper then goes on to examine the rationale for shared equity in more detail and to link that rationale to product attributes. Section three looks at government sponsored schemes, while section four examines market based developments. Finally we compare the experience between the two countries and assess the potential for mainstream provision of shared equity products.

2. What is Shared Equity?

The terms shared equity and shared ownership cover a range of products that make it possible to divide the value of the dwelling between more than one legal entity¹.

¹ While these terms are often used to refer to very specific products and have not been used consistently over time or across countries, in this paper they will be used interchangeably as an

These products enable the main purchaser (often called the primary owner) to reduce their outgoings at the expense of giving up rights to part of the equity in their home. At the same time they share the risks associated with home ownership between the owners (legal entities).

Three main attributes of a shared equity product can be identified. These relate to (i) how it is funded; (ii) how the value is allocated (which can be affected by whether or not they are subsidised) and (iii) the nature of any transfer rights between the primary and secondary owner. The different ways in which these attributes are packaged together is what distinguishes one product from another.

The majority of shared equity products that exist at present are in the form of mortgages, with the primary owner (the purchaser) giving up the right to a proportion of equity in the dwelling to the mortgage company for the period for which the mortgage is outstanding. The terms for this arrangement, and therefore the allocation of value, vary considerably between products - from a simple shared equity arrangement where both parties benefit or lose in proportion to their share of the equity as dwelling prices change; through shared appreciation mortgages where the primary owner carries all the downside risk; to mortgages where the primary owner also pays an interest rate (or rental element) to the secondary owner, which may be paid in the form of an increase in the equity forgone.

More traditional shared equity products involve an element of direct ownership by the secondary owner who may or may not charge a rent to the primary owner. In this form there is little or no finance market innovation involved. The primary owner takes out a traditional mortgage on the share of the dwelling they are buying, usually backed by 100 per cent of the value of the property. The secondary owner's property rights are then subordinated to the mortgagee. The secondary owner may fund the arrangement from their own equity; by a traditional unsecured loan; or by securitising a package of loans. Not surprisingly, these types of shared equity products tend to be government sponsored and to be targeted at lower income employed households entering owner-occupation for the first time. Thus they involve some element of partnership with the public sector and often some additional subsidy in order to make such products affordable to target groups.

Finally, the rights the primary owner has in relation to changing their share also vary enormously. At one extreme, unless the secondary owner decides to sell, the primary owner may have no right to become a full owner of their property. The most usual example here, especially in the USA but also important across much of Europe, is the Community Land Trust where the Trust keeps a proportion of the equity (often, but not always, directly related to the land value) either for a period or in perpetuity (Davis, 2006). At the other, the shared equity element is part of the mortgage – so that when the mortgage is paid off, the full rights lie with the primary owner. If the property is sold before term end, the mortgagee takes their share of the realised value. In between there is a whole range of products where the secondary owner has direct ownership of their proportion of the property but gives the primary purchaser rights to

umbrella term to cover the broad range of government and market led products that have emerged in a number of countries. Hereafter 'or shared ownership' is dropped when generic products are being described.

purchase under certain conditions. The most usual example here (known as staircasing) is where the primary owner may, whenever they wish, buy additional equity up to 100 per cent at the then going market price. In some instances they may also reduce their share if they so wish.

These shared equity products may be taken out by first time buyers to reduce the costs of entering the housing market; by more mature owners who wish to diversify their housing equity risks; by older households who are looking to release equity; or by other specific groups where there are other reasons, such as ensuring effective management, which may make shared ownership efficient. They may be provided by traditional mortgage lenders; by special purpose vehicles that access the wholesale market for equity funding; by developers; or by the public sector.

2. The rationale for shared equity products

The main reason why shared equity products are in the forefront of discussion at the present time is that housing affordability has been declining, primarily because house prices have been rising faster than incomes in many industrialised countries (Demographia, 2007; OECD, 2005). As a result new entrants to the owner-occupied market are finding it increasingly difficult to purchase. Moreover problems of access and affordability are putting pressure on governments who both wish to meet aspirations for homeownership and have an incentive to limit public sector commitments. Shared equity can help to reduce initial outgoings and so enable lower income households to enter the market. In so doing, it makes it possible to use shallow subsidies to help additional households into owner-occupation and to meet government objectives. Thus affordability, rather than market efficiency, has been the primary reason for the development of shared equity products. For government a related objective has been to provide a cost-effective way of leveraging a given amount of government funding to meet housing policy goals.

A very different rationale and more general rationale for shared equity products, is that owner-occupation carries with it the risks of price variation, which cannot normally be efficiently borne by individual households. Given the extent of such volatility, if such a market could be seen to be efficient it might be expected to develop as a mainstream market product (Caplin et al, 1997; Caplin et al., 2007).

Owner-occupation involves households investing in a single asset which is large in relation to their overall assets; has a history of significant variation in value; has the additional complications of being in a particular location (so that the capital value is affected by local conditions); has large transactions costs; as well as timing difficulties associated with realising the asset. These problems are exacerbated when a significant proportion of the purchase price is funded by debt finance, as the impact of price variation on the individual's capital and security increases with leverage.

Theoretically, the owner should transfer some of the risks of owning this specific housing asset to others better able to bear this risk, such as financial institutions or large scale investors. This would both give the household greater financial flexibility and free up funds from the housing asset to allow them to invest in other investments

with different risk profiles. This rationale suggests that shared equity products should be suited to a much wider market than simply first time buyers.

A further rationale is that shared equity provides the capacity to release equity for consumption purposes. For most households the largest asset over which they have control (unlike their pension fund) is their home. Older people in particular may want to supplement their pensions by running down their investments. However many do not want to move to release funds. The alternative is to realise part of the asset either by borrowing against that asset or by transferring part of the value to another entity that wishes to invest in owner-occupied housing. Shared equity products enable this transfer while the primary owner remains in the family home.

A very different reason for the existence of shared equity products arises when owners/developers want to keep some control over the land they own and/or the estate they are developing by keeping an equity stake in the properties they sell. This particularly applies in the context of public/private partnerships for the provision of affordable homes. In particular, the public sector may want to keep control over who gains access to affordable housing to ensure that some of the benefits are passed on to future purchasers. A shared equity arrangement for a specified time period or into perpetuity can be a way of doing this. The same rationale may apply to private providers, especially in large scale mixed developments where suppliers want a direct equity involvement in the value of the overall asset for both investment and management reasons. A shorter term reason is when markets are depressed but developers think prices will rise. In this case they can sell some of their stock but maintain some rights to future gains by selling only a share of the dwelling.

The development of shared ownership products thus has potential benefits for all relevant stakeholders – purchasers; equity investors; the mortgage and investment industries; and government. For purchasers it provides a new mortgage class with lower repayments. This gives them access to higher valued, larger or better-located property and, in some cases, provides the only opportunity they have of becoming an owner-occupier. Later on it enables the possibility of equity release. Throughout the contract period, it can reduce the household's exposure to risks both with respect to interest rates and capital value variations. For the equity investor it enables greater diversification through access to a residential asset that is not fully correlated with other investments and which can be made tradable and divisible. For both the mortgage and investment industries it provides an opportunity to expand into new markets and access to a different asset class. For the government it helps to lever in private finance and to provide shallow or even no subsidy products to households who would benefit from becoming owner-occupiers but face cash flow constraints or are particularly concerned about housing risk. By expanding owner occupation it also reduces the numbers of households needing assistance in the rented sectors and potentially limits the government's long-term commitments to older households because these households will have an asset that they can realise to support consumption in old age.

These benefits depend significantly on access to financial markets where risks can be better managed and thus interest costs can be reduced. This in turn is likely to depend on the development of a secondary market with appropriate derivative products so that the equity from a wide range of dwellings with different risks can be packaged

and sold. Eventually, the successful launch of such markets at scale could have the capacity significantly to reduce the costs of financing owner-occupied housing.

However, partly because shared ownership products are relatively new and partly because they have complex attributes, they also involve major costs and potential market failures. These are reflected in higher transactions costs; asymmetric information between the purchaser and provider of the shared equity product; the potential for post contractual opportunism (notably moral hazard with respect to the upkeep of the property and its resale value); the need for a price index against which to benchmark payments (especially where a secondary market is developed); the likely thinness of resale markets for products which continue to be partially owned; and many unavoidable contractual complexities.

The potential for the development of different types of shared equity products depends on the extent to which benefits can be realised to offset the costs involved in these more complex products. It also depends on what alternatives are available. For example, interest only mortgages can reduce outgoings while enabling the purchaser to maintain 100 per cent of the residual value. Equity release mortgages have very different risk characteristics for both primary owner and their partner from those where interest is foregone in return for a disproportionate share of capital gain after a specified period of time. What works best depends on the legal and administrative system that applies to both the housing and finance markets. In some countries for instance it would require legislation to enable partial ownership and in most countries an appropriate regulatory framework for the financial instruments employed would have to be developed. Successful expansion of the market also depends on the way shared equity products are treated by the tax and benefit system. This is likely to depend on the specific characteristics of each shared equity product and may not be clear on a priori grounds, thus adding to uncertainty and to the costs associated with developing new products. These points imply that there must be government commitment to facilitate the growth of a shared equity markets and to provide an environment in which potential participants can obtain the necessary risk-return balance. Most fundamentally, development depends upon there being demand among both new entrants and more established households to be prepared to share the equity in their home.

3. Government sponsored developments in Australia and the UK

Shared equity products exist in a number of countries, particularly those with 'Anglo-Saxon' legal frameworks. Pinnegar et al (2008) provide an overview of some of these schemes. Davis (2006) and Jacobus and Lubell (2007) give an indication of the current status of shared equity products in the US which, in their terminology, are all subsidised. Equally the concept of shared equity or shared ownership as a means of managing portfolio risk has been developed in the US literature, notably by Caplin and his colleagues (Caplin et al, 1997; Caplin et al, 2003, Caplin et al, 2007). In other countries, such as France and Germany there are legal constraints on the development of shared equity products. In many others, in countries as widely separate as Sweden, South Korea and China there is growing government interest in developing appropriate instruments often based on the use of the planning system to provide affordable housing (Whitehead and Scanlon, 2007). However the two countries that lead the world in the use of shared equity products are Australia and the UK.

The vast majority of initiatives in both Australia and the UK have been aimed at improving access to owner-occupation rather than at risk management. They have also mainly been sponsored by government. In both countries early steps tended to be local, as increasing inflation in the 1970s generated ‘front loading’ cash flow problems for lower income households taking out traditional mortgages. The Birmingham ‘half and half’ project was an early example – funded by guaranteed local government borrowing (Harloe and Martens, 1990). In Australia, their introduction was delayed because more widespread use of indexed lending arrangements partly addressed the constraints imposed by inflation.² Such schemes existed in both the private and public domains but those that provided the greatest access to home ownership for marginal borrowers were the publicly provided schemes (see, for example, Pinnegar et al., 2008).

The idea of shared equity became embedded in national and state policy in both countries in the early 1980s. An overview of these early schemes can be found in Allen (1982) and Booth and Crook (1986) for the UK and in Yates (1992) for Australia. Details of similar early schemes in other countries can be found in Harloe and Martens (1990). In an environment of high and variable inflation with the standard variable rate mortgage dominant, households faced both strong financial constraints and significant interest rate risk. Shared equity products were one way of improving access and affordability as well as reducing risks to the purchaser.

In both countries the shared equity product of the 1980s and 1990s, more often than not called *shared ownership*, involved provision of dwellings by the public sector, partial purchase and subsidised rents on the equity share owned by government. In the UK, purchasers obtained a standard variable rate mortgage and the product was only available for newly built or renovated properties (Bramley and Morgan, 1998; Whitehead et al, 2005). In Australia the purchaser funded their equity share through a government provided index linked mortgage which put a greater constraint on their effectiveness. In both countries the purchaser had the right to staircase up in tranches to 100 per cent whenever they wished to do so at a price based on the then current value (Yates, 1992).

This type of product put little pressure on financial institutions to do anything other than provide existing mortgages instruments based on security of 100 per cent of the capital value of the dwelling. From the point of view of financial institutions, there was a trade-off between accepting people with somewhat lower incomes but with less exposure because of smaller mortgages and lower outgoings. There were however significant transactions costs, particularly because of the lack of standardisation of contracts, the fact that institutions dealt with relatively few cases each year. The risks

² When as in Australia, but not in the UK, shared ownership schemes are financed with indexed or low start mortgages much of the increase in servicing capacity brought about by increases in nominal income over time has already been taken into account. Under such circumstances, the schemes introduced are not a surrogate for financial innovation; they are an extension of it. In these cases, the scope for shared ownership to lower the constraints on access to home ownership arises only when rental (or interest) costs on the partner share are lower than what would have been the low start mortgage costs on a 100 per cent mortgage. Likewise, the potential for a household to purchase increased shares and ultimately to fully own its dwelling is limited by the extent to which it experiences increases in income over and above the escalation rate imposed on mortgage repayments. See Yates (1992).

of house price volatility lay asymmetrically with the government as purchasers could use their right to staircase up at will.

The model worked well in periods when incomes were growing steadily. However there were significant problems, especially in Australia, during the recession of the late 1980s and early 1990s, primarily as a result of design weaknesses in the state-based lending schemes that were used to fund purchaser equity (Breen, 1992)³. These problems impacted on both purchasers and suppliers so that only since the turn of the century has interest taken off again but in a very different economic environment of low inflation and rapidly rising house prices.

The current position in the UK

The principles of shared ownership and shared equity have been embedded in the UK system for over two decades. The terms however define very specific and different products – the first involves a social landlord directly owning of part of the dwelling while the second is a shared equity mortgage.

Shared ownership

Shared ownership products were introduced in 1980 and have been an element in subsidised housing provision ever since. They are now an increasingly important aspect of policy in part because of the policy to provide affordable housing through the land use planning system (S106). Government data show shared ownership has increased from around 12 per cent of S106 affordable housing completions in England as a whole in 2001-2002 to one third by 2005-06 (DCLG, 2007). Under this policy the local authority has a right to negotiate a proportion of affordable housing on larger sites which can be in the form of social rented housing or shared ownership. Shared ownership involves shallower subsidy than social rented housing and therefore can provide more affordable housing. Equally, shared ownership accommodates lower income employed households, notably key workers, rather than those in priority need, which makes it more comfortable for developers. Government is looking to expand provision significantly as part of their policy to increase overall output by more than a third by 2016 (ODPM, 2005; DCLG, 2007a).

Shared equity mortgage products

In the late 1990s, the UK government turned to the development of mortgage instruments that could allow the purchaser to pay for their home through a mix of interest and shared equity payments. *Homebuy* involved a government provided shared equity mortgage - funded from public funds - where the eligible purchaser could choose their own dwelling on the market and obtain an interest free equity mortgage on 25 per cent of the value of the dwelling Jackson, 2001; Housing Corporation, 2003). Again the purchaser had a right to pay back that mortgage at any time, based on the then current valuation and so become a 100 per cent owner. The product helped overcome purchasers' deposit and initial cash flow problems as well as enabling them to share the house price risk with the government. Eligibility is

³ In the NSW scheme, for example, loans were securitised and investors who purchased the mortgage backed securities were guaranteed a fixed interest return at the peak of the interest rate cycle. Repayments for borrowers also had escalation rates that were fixed at the high point of the inflation cycle and which exceeded subsequent income growth.

restricted to existing social tenants, key workers and a small number of other priority households.

This product avoids many of the difficulties associated with a broader based market scheme because government provides the money and the first charge on the dwelling goes to the financial institution providing the traditional mortgage. The valuation of the property for sale or mortgage repayment is administratively determined by the district valuer and tends to favour the purchaser.

More generally, both schemes are funded by public expenditure, so the private market incurs few additional default risks offset by lower repayment risks. However schemes are necessarily small scale and only available to a narrow range of potential purchasers who meet the governments' criteria – with access increasingly limited to key workers. As such, while they effectively assist a small number of households into owner-occupation, they do little to improve the efficiency and offering of the housing finance market (Shared Ownership Taskforce, 2006).

Figure 1: Current market oriented HomeBuy products in England

Open Market HomeBuy - 25% loan

Involves two equity loans – each worth around 12.5% of the value of the home, the first provided by the same participating lender as the conventional mortgage loan; the second is provided by the government through HomeBuy Agent – a housing association in England that has been appointed to operate the product.

Open Market HomeBuy - 17.5% loan

One equity loan - worth up to a maximum of 17.5% of the value of the home or £50,000 - whichever is lower.

Open Market HomeBuy - 32.5% loan

In December 2007, Yorkshire Building Society introduced a 15% equity loan, to be used in conjunction with the 17.5% product, offering a combined loan value of 32.5% of the value of the property. The loan is used alongside a conventional mortgage from Yorkshire Building Society.

Source: The Housing Corporation, 2007

In 2006 the government introduced a new form of HomeBuy involving a 12.5 per cent loan, interest free for the first five years, from private lenders who also provide the traditional mortgage, called *Open Market HomeBuy*. The objective was to stretch the public funding available but also directly to involve the financial institutions in taking up equity products. The process has proved extremely difficult, in part because the Financial Services Authority, that regulates financial institutions, has required a complex form of 'hybrid' mortgage. Only five main lenders signed up as providers for the original product and the terms and conditions – eg in one case shared appreciation rather than shared equity - did not provide good value for money.

In response to these problems there are now three Open Market HomeBuy products (Figure 1). One offers the ‘original’ 25 per cent equity loan in partnership with lenders; a second offers a 17.5 per cent government provided equity loan; and the third is a 32.5 per cent equity loan offered by one lender in conjunction with the government loan. For all three products there is no charge, interest or monthly payments levied on the government equity loan. For the 25 per cent and 32.5 per cent products there is no charge or interest levied on the equity loan by the participating lender for the first five years.

These products are budget constrained. Equally, they are as yet by no means as popular as the original HomeBuy product which assisted many households to achieve the homes they wanted (Cho and Whitehead, 2006). In part this lack of success lies in the hybrid nature of the market provided mortgage; in part the product is more complicated; in part it may provide lower subsidy (as in the 17.5 per cent loan) than the earlier product; and significantly because house price increases mean that the target group has found it harder to afford these products.

The current position in Australia

Publicly initiated shared equity products in Australia are only just beginning to re-emerge after the collapse of the state supported share equity schemes linked to low-start loans that were the primary solution to the increasing problems of access to home ownership that emerged in the 1970 and 1980s.

Currently all of the various state and territory governments in Australia are showing a renewed interest in the potential of shared equity schemes as a means of assisting lower to moderate income households into home ownership and all but Queensland and NSW have some form of state subsidised shared equity scheme. The states and territories with the most established schemes are those that maintained their previous lending programmes (Pinnegar et al, 2008).

Many of the schemes are targeted to current public housing tenants or to those on public housing waiting lists. One of the earliest and more established of these is the Western Australian Department of Housing and Works Goodstart Shared Equity Scheme which has been taken up by over 1,000 households (Figure 2).⁴

Figure 2: Good Start Shared Equity: an Example of State Provided Shared Equity Schemes

- Purchase 70% - 100% of equity. Homewest retains other proportion but charges no rent. May staircase to 100% at any time
- Own tenanted property of WA property made available by Homewest identified on the web
- Deposit of A\$2,000 or 2% must cover all transactions costs
- May be combined with A\$7000 First Home Owners Grant
- Homewest Keystart loan available – market rate but no ongoing fees/insurance payment

⁴ This is now one of many schemes available from the Western Australia government. Details can be found at <http://www.keystart.com.au>.

Since 2006, embryonic state and territory government assisted schemes targeted at low to moderate income working households have also been put in place. These vary according to the maximum equity the government is prepared to take (generally 30 to 40 per cent), the maximum property value permitted (reflecting significant differences in regional house prices in Australia), the level of subsidy provided and on whether the government takes a proportionate or disproportionate share of any capital gain. Current take up is still low (less than 2,000 households across all schemes by the end of 2007) and budget allocations limit projected take-up over the next 3 or so years. (Pinnegar et al, 2008).

Overall, there is increasing government and state interest in expanding the availability of new build shared ownership products and in finding ways of using public sector land to support the provision of affordable housing. Charitable providers are also involved in schemes aimed at enabling them to use their own equity to expand supply through a range of shared ownership products. All of these schemes aim to lever in private finance in order to stretch available public funding and to sweat public and charitably owned assets.

4. Market based developments

Limited progress in the UK

In the UK the extent of market interest in developing shared equity products has been very limited. Banks and building societies have been prepared to fund the mortgage element of shared ownership using traditional mortgages. Even so they have raised concerns about the lack of standardisation and the small scale of the product – both of which increase transactions costs and make it difficult to move the mortgages off balance sheet.

The conditions necessary for the emergence of a specialist secondary market do not exist. First, there is simply inadequate business in the sub sector within tiny numbers of true equity shares. Banks and building societies can fund their existing levels of exposure through their normal processes. Second there is little known about the incidence and timing of staircasing, so that knowledge of prepayment risks is very limited, making securitisation more difficult. In the context of the credit crunch there seems little prospect of looking to special purpose vehicles for what will remain a tiny element in the overall mortgage market.

What examples there are of market based shared equity products are basically self funded. There were a number of developer initiatives during the recession of the early 1990s, where the purchaser was enabled initially to purchase less than 100% and to staircase up as their circumstances improved. These were basically provided to improve developer cash flow while at the same time maintaining values on the developer's balance sheet and providing a discount to the part purchaser. Since then these types of product have been out of favour because market conditions have made it easy for developers to sell at full price. In the last few months new examples (eg from Barrett) have begun to re-emerge as demand becomes less buoyant.

The government has issued a challenge to both the finance and development industries to develop more structured and longer term products (DCLG, 2007a; Housing Corporation, 2007a). This challenge is said to have been taken up by a

number of major developers and funders including not only Barrett but also Lovell, Bellway and Redrow and the Yorkshire Building Society (the results of the challenge will be known over the next 3 months – can update then).

There are a large number of shared equity products offered by mortgage institutions as part of their overall portfolios (various mortgage institutions websites). Most of these are re-mortgaging arrangements, aimed either at older households looking to realise some of their equity or, to a more limited extent at those with equity who are having cash flow difficulties. These are not standardised products; in particular the basis on which capital values are determined where the mortgage is repaid without sale are specific to each product and the funding comes from the general pool. Moreover, there has been considerable adverse publicity relating to problems for older people in downsizing after taking out shared equity and shared appreciation mortgages.

The market product which has the most capacity to enable consumers to diversify their investment in housing is the property bond. This enables people to invest in a managed portfolio of properties where the value is based on a defined and relevant price index. In principle the assets behind these bonds could include owner-occupied housing equity, although at present this is not generally the case (IPD, 2007; Tsolacos, 2007). These bonds allow people to invest in a range of properties rather than a specific dwelling. As such they enable tenants to buy a share in potential residential capital appreciation. The market for such products has been growing – but it has been badly affected by the recession in commercial property, to the extent that a number of asset managers are freezing withdrawals from small savers in the face of liquidity problems. These difficulties will not be rapidly overcome and will further reduce the likelihood of developing a residential property based market in the short to medium term.

For all these problems the Treasury taskforce which is looking at ways to improve the operation of the mortgage market is intending to include an assessment of the potential for developing shared equity markets (HM Treasury, 2007). The outcome of this assessment may be included in the budget statement in March.

The evidence in the UK is that it is only government sponsored shared equity and shared ownership products that are viable. At the levels provided these do not require specially identified streams of private finance – they are simply part of institutions' general mortgage portfolios. The situation may change if and when either developers or institutions find themselves with large scale equity on their books. But as yet there has been very limited appetite for market innovation and no sign of an unsubsidised instrument emerging which is directly based on shared equity.

More innovation in Australia?

The situation in Australia appears far more dynamic with both governmental and private initiatives. The starting point for market interest was the recommendations of a Taskforce set up by the Prime Minister, which reported in 2003 (Caplin et al, 2003). The recommendations were based on the Housing Partnership model first put forward by Caplin in the USA, using the economic principle that individuals should want to use the finance market to transfer some of the risk associated with the owner-occupied

home to others. The model put forward by the Taskforce suggested that the purchaser should fund their part of the property with a conventional loan together with any subsidy (such as the first-time buyer grant available to some households in Australia). The investor (ie the secondary owner) would receive a return made up of any increases in capital value together with a rent/dividend on the equity owned which would be deferred until sale. This element would be paid for by increasing the share of the equity owned by the investor – so for instance an investor might own 30% at the time the agreement but 50% twenty years later when the property is sold.

The benefits of such a model are seen to arise from the reduction in portfolio risk as housing as an asset class is relatively uncorrelated with most other assets. Such a model provides flexibility for both lender and borrower and reduces the borrowers' outgoings at periods when they are cash constrained. However it also increases the house price risk faced by the borrower because reductions in prices are not transferred (Berry et al, 2004).

The report provided a stimulant for a range of innovative potential products. The three products that have made the most progress are those from Macquarie/Rismark, Greenway and Firstfolio/Residex. The first is most closely related to the Taskforce proposals and is the only one that had been launched by the end of 2007.

Rismark announced their intention to develop an shared equity product in late 2005 and, after tentative partnerships with a number of different financial institutions, finally launched their 'equity finance mortgage' (EFM) in 2007 through the Adelaide Bank. The product, developed by the key contributors to the Prime Minister's Taskforce is true to the principles articulated in that report (see Figure 3). In order to fund these EFMs, Rismark plans to launch a new unit trust, the Rismark Active Property Trust (RAPT), with returns linked to the future capital values of [residential] properties. House price indices specific to the scheme have been put in place. Towards the end of 2007, Rismark International took out patents over the shared equity home loan it invented to stop its larger rivals breaking into the market. In principle, the product is targeted at first time buyers as well as other aspirational purchasers facing cash constraints. In practice, press reports suggest that the wealthier end of the market, focused on houses in the \$1 million to \$2 million bracket (2-4 times median values), is turning out to be one of the biggest users of the product.

Figure 3: Rismark - an Example of a Market Based Product

- Shared equity loan of up to 20% of the value in return for up to 40% of the capital value over a 25-year period
- Zero interest payments
- Lender takes up to 20% of realised losses associated with negative equity
- Primary owner pays all transactions and repair/improvement costs
- Use of specialist price index developed by Rismark to determine capital gains and returns on Unit Trust
- Traditional home load from specific bank

The Greenway Equity Mortgage (GEM) has also been aggressively marketed. It is a shared equity product targeted both at asset-rich retired people (as an alternative to a

reverse mortgage), intending retirees (who could use their housing equity to boost their superannuation contributions), to those wishing to upgrade to a bigger home and to those wanting to extract equity for other purposes, including providing support for family. Assistance to first home buyers was not included in the intended target group. The product is to be an interest-free loan for up to half of the value of the property. Borrowers must agree to repay the original amount of the loan and a set percentage of any increase in the value of the property, where a percentage increases as the size of the initial loan increases. The examples given in one media report were a 20 per cent loan would be available for a Greenway share of capital gain of 30 per cent. For a 50 per cent loan, Greenway's share would be as much as 75 or 80 per cent. Media reports suggest there is a no negative equity guarantee built into the mortgage so that the most that can be owed is the full market value of the home. Greenway aims to raise \$1 billion to begin funding equity mortgages. In the first instance, this will be collected in an 'originating trust'. When sufficient equity mortgages have been written, the plan is to securitise them and on-sell to a 'term trust' (at which point the original investors will earn a return on their investment).

The Firstfolio/Residex product, a shared appreciation mortgage (iSAM), was originally proposed in early 2005. It was based on the idea of reducing the rent/dividend element of the return on the equity share by increasing the proportion of capital value transferred – with that capital value determined by a local house price index. The issuer's intention was to raise significant finance from the market to fund the offer and to target first time buyers. Towards the end of 2006 an executive involved in the financing side of the initiative was reported as saying that the group's strategy was to establish a niche position in the high value end of the residential market. However there is still no information available about progress on the initiative and a search on both the Firstfolio and Residex websites provided no information on iSAM.

Based on a series of interviews with potential lenders and institutional investors in Australia towards the end of 2007, Pinnegar et al (2008) report that shared equity is being regarded by these lenders 'with cautious interest' and is seen as a response (albeit a complex one) to well-understood market failure. Lenders saw the risks with such products as arising from the costs involved in bringing products to the market; from the uncertainty about how loans would perform in the absence of any experience with such products; and to lender reputation if they were unsuccessful. They also expressed the view that, for the market to be developed, there was a need for financial regulatory structures to take account of the specific issues raised by shared equity products; for taxation issues (on how and when capital gains are to be taxed) and accounting issues (on how potential uplift is to be treated) to be addressed; for information on the regulatory capital treatment in terms of Basel 2 guidance; and for guidance for the advice that lenders and brokers should provide for products when the cost of these will not be known for some years. Government assistance with the creation of a house price derivative that could be used to offset the risk of a downturn in house prices was also seen as something that would assist in the development of the market.⁵

A recent research report released by Genworth Financial, based on a survey of 2000 individuals in June 2006, indicated that 30 per cent of respondents would be willing to

⁵ A list of those interviewed and their affiliations is provided in Pinnegar et al (2008).

use shared equity products if these were available (Genworth Financial, 2006). The willingness to do so increased with household income. The results are interpreted as indicating the aspirational nature of those in middle income brackets and providing support for shared equity products targeted to those wanting to upgrade their homes. A supplementary survey of 1300 recent graduates undertaken at around the same time suggested 43 per cent of this higher and potentially higher income group would be interested in a shared equity product. However, the majority (57 per cent) said they would not be interested. Of these, equal proportions (39 per cent) said they would rather save the deposit or that the lender is more likely to benefit while 20 per cent felt it was too risky.

5. Is there a potential mainstream market for shared equity

The evidence on shared equity products in Australia and the UK shows that they are seen as important as government sponsored instruments to assist households into owner-occupation through mixing shared equity with traditional loans; sharing house price risks, and providing shallow subsidy.

The UK leads here in part because there has been consistent central government interest since the 1980s and because the approach has been integrated with other policy developments, notably affordable housing through the planning system. Australian experience sponsored by state governments varied more with the economic cycle and have been on a much smaller scale. In both countries, increasing problems of access to owner-occupation over the last few years has led to greater interest and innovation on the part of government, but the institutions' role remains one of lending traditional mortgages protected by government subsidy.

Australia has led the way on market developments but following on from a government initiative in identifying a potential gap in mainstream product provision. Even so, after five years, there has been very little practical progress. What has become clear is that the most likely markets for the products are either those with high incomes and high debts or with large scale assets that the householder wishes to realise. Thus the market products are in no way filling the same gaps as the government sponsored instruments.

The evidence from Australia is relatively positive: interest is highest not among younger and cash limited households but rather among those in the highest income quartile who are looking to balance their portfolios more effectively, while provider interest is for reverse mortgages or particular niche markets.

In general there are a number of obstacles still to be overcome notably with respect to increasing concerns about regulatory risk. The products are complex and consumers need to be well informed. The potential for mis-selling and the possibility of poor valuation processes is considerable and more general experience in the mortgage market tends to make institutions risk averse.

Linked to the issue is the potential for moral hazard behaviour where the occupier runs down the value of the property and limited incentives for improvement investment. This already appears to be an issue for older households who are

releasing equity for other purposes and who do not want to use cash flow to maintain and increase prices.

Third, long term investors are proving difficult to find, in part because of scepticism about the possibility of continuing capital appreciation; in part because of the uncertainties about tax treatment for particular instruments; and in part just because scale is necessary to generate significant cost reductions and risk transfer – and it is simply unclear that there is enough demand to make this possible. Generating significant benefits of lower cost funding involves the use of both secondary markets and the transfer instruments based on capital values that are not dependent on the sale of the specific property. There must therefore be robust price indices in place before investors will come forward. Such price indices present major problems, especially in countries where properties have very individual attributes. In this context even repeat sales price indices cannot solve quality adjustment problems.

Where there are innovations using special funds – in the commercial property market – there are already emerging problems with respect to cash flows which are likely to undermine the already limited confidence in such instruments. More fundamental market failure issues with respect to pricing and post contractual opportunism have yet to be addressed.

Most fundamental to the long term development of a mainstream product is that consumers do not seem to regard shared equity products as comparable to traditional mortgage indebtedness. People are happy to see themselves as owners, even when they have mortgages of 90% or even 100% of the value of the property. However this mindset does not transfer easily to a part ownership product where the secondary owner is a financial institution.

Finally, the current credit crunch and its fallout is likely to have a major negative impact on the development of more innovative products. House price falls will make many of the instruments which are based on shared appreciation highly undesirable for both sides. Problems associated with pricing and contractual conditions are likely to emerge more strongly. Many of the products have sub-prime attributes while securitisation, even of prime loans (as in the case of Northern Rock), is very much out of favour and likely to remain so for some time.

Overall therefore shared equity still appears to be an idea whose time has not yet come, although there is some evidence of progress both in terms of better government- sponsored products for first time buyers and the possibility of growth in niche products in the market sector.

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