THE LAST WORD

A house divided stands OK

Capitalism's efforts to develop a more human face needs to expand beyond traditional mortgage options, writes Christopher Joye

ON June 6 this year, I delivered a 378-page report to Prime Minister John Howard that advocated a variety of demand and supply-side approaches to radically reducing the costs of home ownership in Australia.

At the heart of that effort lay the belief that it is time capitalism developed a more human face. For centuries now, businesses in need of funds have had access to both debt and equity. Yet for households wanting to expand, mortgage finance has been their only alternative.

In an attempt to rectify the asymmetry between corporate and consumer capital markets, we recommended offering Australian families the option of using both debt and equity finance when purchasing their properties. In this way, aspirants could fund their housing needs with both a mortgage and a passive institutional partner which contributes equity (via a synthetic debt contract) to the dwelling in exchange for a claim on the prospective price movements, with no other monetary payments made between them.

Importantly, occupiers would retain virtually all of the decision-making rights free and unencumbered, just as in traditional markets.

While this sounds fine in theory, how would it work in practice? Think of a young, cash-constrained couple that wishes to start a family and move into a $200,000 home. Prior to purchase, they will have to scramble to scrape together funds for the deposit and the myriad other costs such as stamp duty and mortgage insurance.

This long period of intense saving often induces a considerable consumption squeeze and may severely restrict lifestyle choices.

In fact, the bulk of young Australian dwellers end up investing around 80 per cent of all their wealth in one highly illiquid and very volatile asset: the owner-occupied residence.

There are then the costs associated with servicing the mortgage and maintaining the home.

The weight of such commitments frequently forces families to endure spartan-like conditions in the early to middle years — these are the so-called "house poor".

Now let us imagine an alternative scenario, in which this couple draws on both debt and equity finance.

In particular, suppose that a financial institution lends them 30 per cent ($60,000) of the appraised value of the property upfront in return for rights to 30 per cent of the price declines and 60 per cent of the potential price rises.

As a consequence, our family needs to fund only $140,000 ($200,000 less $60,000).

If we once again assume a 90 per cent loan-to-value ratio, the size of the home loan plummets by 30 per cent to $126,000; the interest and principal payments fall by a similar margin; the required deposit drops from $20,000 to $14,000; and the cost of stamp duty on the loan itself and mortgage insurance are also cut.

In addition, there is a striking rise in the couple's disposable income once they move into their property (as a result of the diminished debt servicing obligations), a dramatic reduction in their risk of default, and a huge increase in their "liquid" wealth at retirement, since they no longer have to dedicate most of their savings to the otherwise inaccessible dwelling asset.

And so, whereas this family might once have been priced out of the market, home ownership has now become a much more realistic ambition.

One critical aspect of these arrangements that has been overlooked to date is the valuable insurance service the institution supplies by sharing 30 per cent of the downside risk.

> **We recommend using both debt and equity finance when purchasing properties**

In our submission to the Prime Minister, we found that one in four Australian home owners lose money in real terms (ie, after removing the influence of inflation) when they sell their properties.

Clearly, this does not rest comfortably with the notion that residential real estate is an exceedingly safe investment.

Most Australians own one house, situated on one street, pointing one direction, with all its manifest peculiarities.

Indeed, economists in the US estimate that the "idiosyncratic" risk attributable to a single-family home is more than six times that which one would impute to a well-diversified portfolio of property (of course, the use of large amounts of leverage only serves to magnify these hazards).

Yet if a financial planner advised you to commit more than two-thirds of all your wealth to one security for the next 10 years of your life, you'd think he was crazy.

Perhaps most significantly, though, these contracts have been designed such that when the housing market declines, the cost of equity finance is low, while when it booms, it is comparatively high (which is obviously ideal from the consumer's perspective).

More precisely, if there is no price appreciation, households are not obliged to make any economic transfers to the institution over and above the original loan amount — certainly a superior outcome to paying interest on a massive mortgage.

In the event that there is price depreciation (as was the case in the early 1990s), households benefit from being able to redistribute some of these risks to the investor.

Of course, debt finance affords no such advantages.

Even if we make ridiculously optimistic assumptions about future price growth, it is almost impossible to envision a situation in which the consumer's equity holding declines to low levels.

For example, suppose the value of the house rises by 15 per cent per annum in nominal terms over the next 64 years, and that the lender offers finance along the lines outlined above.

At the end of this 64-year period, the total amount owed to the institution represents only 60 per cent of the dwelling's appraised value.

Hence, in spite of unimaginable price growth over a half-century horizon, the occupier still retains roughly 40 per cent of the equity in their home.

It therefore came as no surprise when we surveyed non-owning households that over half responded that they'd be more likely to buy a property if such opportunities were made available to them.

Among renters alone, that represents a $150 billion market in the making.

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