

Overlooked solution to credit crunch

Christopher Joye | *December 15, 2008*

Article from: [The Australian](#)

THE most fundamental lesson of the global credit crisis has been that the financial system had too much leverage, particularly the household sector, which in many advanced economies had assumed unsustainably high levels of mortgage debt. But surprisingly, that there has been little comment about the most salient solution: equity.

For hundreds of years listed companies have been able to seamlessly issue both debt and equity to finance their spending. Yet apart from recent innovations pioneered here in Australia, households have never been able to source both external debt and equity finance when buying their homes. This extreme reliance on debt has propagated huge problems, particularly in the US and Britain where the conjunction of flawed institutional frameworks and poor lending standards exacerbated the debt binge.

According to Fujitsu Consulting, the average home owner's mortgage debt represents 57 per cent of the value of their property. The typical first time buyer's mortgage accounts for over 70 per cent. Some gear up to an incredible 95 per cent or more. In today's fickle markets, companies with that much leverage would be crucified. Yet this debt is secured against what is, in fact, a very risky asset. Our empirical research indicates that an individual home with all of its economic idiosyncrasies is about six times riskier than a diversified national property index. Indeed, the risk of an individual property is more akin to that of shares. The experience of the past 12 months has reinforced the fact that single family homes can suffer serious price falls even though most have avoided this fate.

Make no mistake: residential property is very safe if you get access to a diversified portfolio. An Australian house price index proxies for more than \$3.3 trillion worth of assets but the index's incredibly low volatility is a mirage for the individual home owner who assumes a far higher probability of loss (and has about 60 per cent of their wealth invested in this asset).

In 2003 I was the principal author of a report commissioned by the Prime Minister's Home Ownership Task Force that presented a solution to the high levels of household debt that triggered the global credit crisis: the development of private markets in equity finance. Under our proposal, households would get access to zero-interest rate, shared equity home loans in exchange for trading away a small portion of the risks and returns of home ownership to outside investors. By doing so, they could cut their monthly mortgage interest repayments by 30 per cent or more while reducing their vulnerability to adverse economic shocks (think 2008-09). Importantly, they also retain complete control of their homes; they choose when to sell, what renovations to make, and at what point in the contract's maximum 25-year term they wish to repay it.

Investors, such as super funds, get extremely low-cost, highly enhanced and very long-dated exposures to what has during the past three decades (including the recent calamity) been the largest and best performing of all investment classes: residential real estate. Historically, investors have only been able to access highly concentrated, risky development-style holdings comprising small parcels of properties that incur heinous transaction costs of about 12.5 per cent. By investing in a portfolio of thousands of shared equity interests, super funds could avoid all of these costs and secure the low risk diversification that they have never had before. Independent actuarial analysis suggests that about 15 to 30 per cent of all super fund capital should, in theory, be allocated to housing, in part because its returns are so unrelated to the performance of other investments. Compare the 50 per cent plus losses in shares and listed property trusts in the past year with the fact that the RP Data-Rismark Australian House Price Index has tapered by only -0.8 per cent.

The former secretary of the Treasury and now head of super fund adviser Mercer, Tony Cole, has commented: "We find the case for institutional investment in [shared equity] compelling. Historically, residential real estate displayed a negative correlation with commercial property markets and a low correlation with the share market, providing diversification benefits in a multi-asset class portfolio." Actual returns to Australian-shared equity portfolios during the past one-to-two years have validated this investment case.

While some commentators have made hyperbolic predictions of precipitous house price falls they have been proven relentlessly wrong. The tremendous improvements in affordability delivered by the Reserve Bank's reversal of its monetary policy settings, combined with the shortage of homes in this country, will likely ensure that this continues to be the case.

Following the 2003 task force's recommendations, Bendigo & Adelaide Bank in conjunction with Rismark International launched the world's first private-sector, mass-market shared equity finance program in which the lender participates in both the capital gains and wears the losses associated with home ownership without charging any interest. Hundreds of Australian families have bought their first home or cut their monthly mortgage costs by 30 per cent or more as a consequence. Since then the initiative has won industry awards and public praise. Kevin Rudd even canvassed it as one solution in the housing strategy paper that he launched before last year's election.

The task force recommendations and the Australian experience have been explicitly used as a guide for billions of dollars of government investment in shared equity initiatives in Britain and New Zealand. More recently, I have been invited by the Rockefeller and MacArthur foundations to show the new Obama administration how they could apply the Australian model to ease their housing woes.

Leading academics including Edward Glaeser at Harvard, Barry Nalebuff at Yale, Luigi Zingales at the University of Chicago and Joshua Gans at Melbourne University are

calling on governments to help borrowers swap a portion of their mortgage debt for shared equity-style instruments along the lines of the Australian model.

While the Rudd Government has guaranteed trillions of dollars of bank debt and injected \$8 billion into the securitisation market, it should turn its mind to addressing the more fundamental problem of the mix of debt and equity on household balance sheets. They face few political risks since the Opposition has declared their support for the solution. The South Australian, West Australian and Tasmanian governments have committed more than \$500 million to underwriting public shared equity initiatives. But there remains a critical role for the commonwealth to play in fostering the mass market. Asymmetrical policy that only benefits the banks and conventional mortgage providers does not achieve this aim.

Christopher Joye was the principal author of the 2003 Prime Minister's Home Ownership Task Force report and is the chief executive of Rismark.