Federal Policy Proposal — Home Equity Share program
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Summary

The Home Equity Share program would allow anyone buying or refinancing their primary residence to convert a portion of their mortgage principle to equity that would be owned by the government. This would make it easier for people to buy homes, free up disposable income, and reduce downside risk for new and existing homeowners. Further, it would help give home-buyers an advantage over investor-buyers, and allow home affordability to become less dependent on home prices.

Situational Assessment

There's no doubt that housing affordability has become an issue in Canada. While most real estate markets across the country have seen substantial growth, a handful of markets have seen home prices skyrocket. The median-multiple affordability ratings in these markets put them among the least affordable markets in the world, and vastly exceed even the most generous definitions of affordability. The causes of these massive increases are up for discussion to some degree, but the consequences are fairly clear, namely that society can't function if people can't obtain adequate, suitable shelter. Further, the economy in these markets has become increasingly dependent on real estate and related industries, a situation that makes them extremely vulnerable to market volatility.

It's not controversial at this point to suggest that some form of government intervention is necessary to ensure that people can secure adequate housing, but policy makers must now contend with a difficult problem that I'll call the price-affordability dilemma.

The Dilemma

In Canada's most overheated markets, home prices have become so detached from the fundamental economics of their respective regions that it has become clear that this is not a problem that will correct itself easily or painlessly. In Vancouver, at the time of this writing, the median home price is currently ~$1.15M while the median household income is ~$72k. This level of disparity between local market fundamentals and the actual market conditions is largely unprecedented and increasingly worrisome.

This is where the first part of the dilemma comes in. Regardless of the ultimate cause of the rising prices, there are only a couple of ways this can shake out:

1. **Prices stay high** - It's possible that prices will level off at a new equilibrium set by the addition of the investor-class buyers, and stay more or less constant, give or take some baseline volatility. We could be there now, or we could see more increases. Either way, prices stay high.
2. **Prices deflate** - It's also possible that we see a crash in prices like in 2007-2008 during the financial crisis as investors pull money out of markets that are no longer reflective of market fundamentals. This could happen soon, or it could be years away. It could happen all at once, or it could happen over time. Either way, prices fall.

Neither of these outcomes is good. High prices will mean more and more people are kept out of the housing market, and more and more housing stock will be concentrated into fewer hands. Even if local home buyers do manage to enter the market, they will likely be spending a significant portion of their incomes on housing, which lowers quality of life for the homeowner, and reduces the amount of discretionary income they have to spend, slowing the local economy as the velocity of money decreases.

Price deflation comes with its own issues. Many people have significant amounts of debt secured by their homes, either in the form of their mortgage, or as a HELOC, and lowered prices will have a huge effect on them. Even if someone doesn't have any debt leveraged against their home, they might be counting on their home being worth a certain amount for their retirement. Further, the real economic impact of a housing market slowdown would be significant and not limited to real estate owners. The question is very much not whether or not we're in for a hard time, but when will it happen, how bad will it be, and over what period of time.

The second part of the dilemma relates to the cause of the high prices. It is more or less necessarily true that these prices cannot be driven by demand from average Canadians. We are left to conclude that there is a class of buyer looking for real estate as an asset, and that these buyers are able and willing to outbid the average household looking to buy a home. Whether these buyers are domestic or foreign, resident or non-resident, individuals or groups, is largely irrelevant to the problem at hand. Further, real estate investors have always been a part of the market.

What seems to have changed as of late is that where prices for residential real estate used to be driven mostly by demand from the local market of home buyers, with investors being largely an afterthought, prices now seem to be driven primarily by demand from investors, who are not as limited by the same constraints as typical home buyers (such as mortgage lending rules, household income, or interest rates).

This part of the dilemma is important because it gets to the heart of the relationship between price and affordability. Many of the policy solutions that have been suggested or implemented are around what to do about home prices, and how to engineer a return to affordably priced housing, usually through some combination of increased supply of housing stock, and tax and fiscal policy to reduce demand. The problem with this approach is that what is affordable to local home buyers will also be attractive to investors. Some policies, like mortgage regulations and interest rate hikes, have an effect where prices go down, but affordability remains constant. These measures, while often good for the overall health and stability of the market, actually serve as a barrier to affordability for home buyers, but not for investors.

Bottom line: price and affordability of housing have become largely decoupled as a result of overall market forces, and the end result will likely leave many average Canadians with the consequences.

Policy Directions to Address the Dilemma

If we assume that the price-affordability dilemma is a sound proposition, that prices have truly become decoupled from affordability, and we take as a given that we want everyone to have a home, then policy direction needs to reflect the difference between investor-buyers and home-buyers. Further, we need to recognize that the economies in key markets have become dangerously dependent on real estate, and any degree of significant volatility will have an outsized effect.

This is the point where existing policy discussions have fallen short. Some people believe that the market should be left alone and the problem allowed to run its course. Given the massive disruption caused by the financial crisis, from which many people are still recovering to this day, this seems like a risky option.

Mortgage lending regulation and monetary policy can help keep things stable, but it won’t make things more affordable.

Increasing housing supply alone will have a questionable effect on affordability. First, data about migration and new home construction suggest that supply has been adequate to meet the increase in population in overheated markets, which points to the role of the investor-buyers in accumulating the excess supply. Further, the building industry in places like Vancouver and Toronto is very nearly at capacity, and is limited by the amount of skilled labour available, and affected by increasing materials costs. More importantly, no one is going to build housing if they can’t make a significant profit. There is no way the market, left to its own devices, will create a housing glut so long as the demand from investors is steady. If demand wanes, there should be adequate supply. At the core, building housing to satisfy speculative demand is insanity. It is effectively trickle-down housing.

Tax policy addressing “toxic” demand from investors, such as the Foreign Buyers Tax, the Speculation Tax, the Empty Homes Tax, and so forth, is a step in the right direction, but has some very serious risks. Addressing toxic demand is a very difficult problem, or rather addressing it without collapsing the market is a difficult problem. Investor behavior is driven by whether or not they believe that there is a return to be made in a given market. If the government institutes policy specifically designed to push investors out and lower prices, they won't wait around while their assets depreciate in value. They'll try to get out of the market unless there's reason to believe that the deflation is temporary. The risk of causing a market crash makes tax policy tricky. A crash would be both an economic disaster and political suicide.

More to the point, none of the above solutions will solve the core dilemma. Prices still only have two options, high or low, and neither are good absent a strategy to increase affordability and decrease the risk to homeowners.

Policy Solutions

What is needed, then, is:

1. A way to give home buyers an advantage over investor buyers so that affordability can improve independently from pricing.
2. A way of de-risking the market for existing homeowners so that price deflation is less devastating.

This is a challenging problem, but the recent federal budget has paved the way for a possible solution. The First Time Homebuyers Incentive (FTHBI) is a program designed to help new home buyers to enter the market by having the federal government provide a portion of the financing for a home in exchange for an equivalent equity stake in the property. It is geared to help first-time buyers establish homeownership, as well as to encourage increased supply, but it appears to be designed to largely avoid putting demand pressure on the already-overheated markets.

This policy is intriguing because it fulfills both outlined solution criteria. People looking to buy a home have an advantage over investors because they can pay more for a home while having a smaller mortgage. They are also insulated somewhat from the downside risk of owning a home because they are sharing their exposure with the government. This policy, while not massive in scope, has indicated a willingness on the part of the federal government to take an active position in the housing market, and opened the possibility for a promising policy lever that could be the missing ingredient in the pathway to a more balanced and sustainable housing system. In addition, it could lead to a variety of other, more active, and more narrowly-focused policies that could help to reach what I would hope is the overall goal, namely that every Canadian, present and future, has a suitable and stable home.

The Home Equity Share Program

While the FTHBI program is promising, it's a fairly narrowly-targeted policy. Given the novelty of it, at least in a Canadian context, it's prudent to keep the scope relatively focused at first. However, assuming it has no insurmountable flaws, there is an opportunity to expand the program, or start a new program, that would see the benefits of the government sharing equity with homeowners more universally. The FTHBI could be considered a pilot to a more comprehensive policy.

Enter the Home Equity Share program (HES). This policy would allow any homeowner to convert a portion (say 10%, up to some TBD absolute cap) of the debt secured against their home into equity that would be owned by the government (either directly or through an investment vehicle or crown corp). Similar to the FTHBI, the HES would apply at the start of a new mortgage, but could also be applied at the renewal of an existing mortgage, and would be available to anyone buying or refinancing a primary residence.

Here's how it would work:

Someone buys a home for $600,000. They put 10% down on the home and take out a mortgage in the amount of $540,000. Within or in parallel with their mortgage agreement, they agree to allow the HES program to take an equity share in their property in exchange for paying a portion of their mortgage. The HES program pays the lender 10% of the total mortgage amount, $54,000, and takes an equivalent equity share at the purchase price of the home. In this case it would be 9% of the equity ($54,000 worth of equity at a $600,000 value).

The homeowner now lives in a $600,000 home with a $486,000 mortgage, rather than a $540,000 mortgage. At a 4% interest rate with a 25-year amortization, their monthly mortgage payment goes from around $2,850 to $2,565, freeing up $285/month, or $3,420/year. Given that neither principle nor interest on mortgage payments are tax deductible, this savings would be roughly the equivalent of a $5,000-$6,000 increase in gross annual income.

Let's assume the homeowner decides to renew their mortgage, again using the HES. After 5 years of regular mortgage payments, their new principal balance is around $425,000, and the value of their home is assessed at around $660,000 (a ~2% annual increase year-over-year). The HES would allow them to take $42,500 off of their mortgage in exchange for an equivalent equity position in the home (around 6.44% at the new $660,000 assessment). Their new mortgage balance is $382,500. If they keep the same amortization schedule, their mortgage payment goes down to around $2,300 from $2,565, saving them another ~$250/month, or ~$3,000/year. The homeowner could also choose to keep the payments at the original amount and shorten the amortization period to pay off the balance sooner.

The HES would have accrued a 15.44% equity stake in the home, the homeowner retains the balance. Upon sale or transfer of the property, 15.44% of the sale price would go back to the

HES program. Should the owner wish to transfer or donate the property, the 15.44% share must be repaid at current assessment value. The owner may buy back the HES equity at current assessed value at any time.

Benefits of the HES

1. As with the FTHBI, new homeowners can enter the market more easily by having the HES help reduce the cost of owning their home.
2. Similarly, existing homeowners can more easily move to more suitable housing if their needs change.
3. Homeowners reduce the immediate carrying cost of their home, freeing up their discretionary income.
4. Homeowners are insulated somewhat from the downside risk of home ownership, as the HES takes on some of the risk of owning real estate.
5. The government gets equity in a tangible, appreciating asset.
6. The net worth of the homeowner is neither increased nor decreased. This is not a subsidy or transfer.
7. Since the program only applies to a percentage of a remaining mortgage balance, there is no incentive to abuse the program as a refinancing tool.
8. Investors can still participate in the market as before.

The biggest benefit, in my opinion, and the one that makes this program very elegant in its approach, is that it naturally targets homeowners and new home buyers who are/will be exposed to the most risk.

By making the equity portion a function of a new or existing mortgage balance, rather than a function of the total value of the home, and by capping the total amount that can apply to any given home, it is slanted towards average buyers and owners in overheated markets, as well as existing owners who have bought more recently at inflated prices. Meanwhile, owners who own their homes outright, or who have already paid down most of their mortgage, or who never had a large mortgage to begin with, while not excluded from the program, won't see much benefit unless they decide to refinance their home to a significant degree. In this way, the program provides the most relief in places where it is needed the most.

Drawbacks of the HES

1. This is a novel approach in Canada, and therefore carries inherent risk.

We don't know how exactly this sort of thing would work in Canada. Many other nations have various forms of public ownership of housing. Singapore is an excellent example of a publicly-owned housing system that sits alongside a smaller private residential and commercial market. The good news is that the initial test run of the FTHBI program will give a great deal of data and feedback as to the strengths and weaknesses of such a policy.

2. It has the potential to inflate prices further in overheated markets.

This sort of policy would have an inflationary effect, or at least might artificially buoy prices. This may or may not be a problem depending on the overall market conditions. Indeed, the government may consider this a positive if it means that home ownership can also increase. The FTHBI program has a modest inflationary effect, but the effect is projected to be smaller than other policies they considered.

The inflationary effect can also be offset by taxation strategies, and if used in tandem could allow both policy directions to be more effective. For example, if the HES program came with significant inflationary effect, that just leaves room for more aggressive anti-speculation tax policy or fiscal policy to rebalance the market with a bias toward owner-occupied homes, rather than investment or vacation properties.

3. The government is directly exposed to investment risk.

On the one hand, this is a big issue that should not be underestimated. On the other hand, it’s actually a feature of the program. The government is already at risk from volatility in the housing market in many ways. Increased housing costs have negative externalities that end up with significant public costs (homelessness, increased need for social welfare supports, decreased economic competitiveness, etc.), and a housing market crash would similarly have significant real costs, especially given that the public, through the CMHC, is the insurer of much of the mortgage debt in the country. No matter how things shake out, there are untold opportunity costs to either scenario in addition to real costs. As is, most of the costs are downloaded to the individual homeowners. If the government can ballast those uncertainties, it can more easily and directly manage these costs and risks proactively, as well as insulate homeowners from significant market downturns.

It’s worth noting that the FTHBI program has the same issue, for better or worse, if at a smaller scale.

4. It doesn’t address the housing needs of non-homeowners.

This isn’t a problem of the policy so much as this policy isn’t designed with renters or other non-homeowners in mind. There is a need to consider the whole picture, but it is in addition to, rather than inclusive of, this policy. It is worth noting that this program should have an indirect benefit to renters by taking pressure off of the rental market.

5. It requires a great deal of up-front capital.

This is another big issue. The price tag of something like this could be significant. It represents a big shift in priorities, and there is the potential for sticker shock. Ultimately, though, it's a matter of political will, rather than fiscal considerations. The cost would go towards buying equity in residential property, a very secure asset with a long history of steady growth. Liquidity becomes an issue, but even this is an opportunity. If the government is willing to issue bonds backed by their equity stake in the Canadian housing market, they could create a true Canadian housing index that the market could purchase, which might even take pressure off of the regional markets by providing a way for the global capital markets to buy into the Canadian real estate market without the hassle and consequences of buying actual housing units.

To give an order of magnitude, let's consider what this program might cost: The total outstanding mortgage debt for owner-occupied primary residences in Canada is sitting at around $1.1T. If we assume that mortgages get renewed every 5 years (the large majority of mortgages are 5-year terms), there is probably around $220B worth of new and renewed mortgage agreements happening annually. If the government adopted the HES program, and it was applied to 30% of every new or renewed mortgage at 10% of the mortgage value, the program would require around $6.6B/year until the program reached saturation, at which point the program would likely end up being more or less self-sustaining as owners sell their homes and repay the equity portion, which could then go back into the program. $6.6B/year is a significant budget item, but not infeasible, and very defensible given that the money goes to purchasing tangible, appreciating assets with few carrying costs.

Requirements for Participation

Although the program is intended to be very inclusive, there would need to be a few conditions to participation:

1. The homeowner must have a new or existing mortgage, and the program can only be used to convert debt to shared equity (the purpose of the program is to relieve homeowners of debt and risk exposure, not to be used as a refinancing mechanism, per se).
2. The homeowner must agree to repay the program's equity portion upon sale or transfer of the property.
3. The homeowner would only be able to use the program for their primary residence.
4. As above, no household would be able to use the program with more than one property, so should their primary residence change, they would need to buy out the equity in the first property, either with cash, or with equity transferred from the new primary residence property.
5. The homeowner must be a resident of Canada.
6. The homeowner must hold the property personally (cannot be held by an entity or trust).

There are probably other criteria that should apply, but this is a suggested baseline.

Additional Considerations

There are some open considerations that would need to be addressed, up-front or over time. It is worth noting that most of these will need to be factored into the FTHBI program anyway, if they aren't already specifically addressed.

1. What portion of a given home would the government be willing to own?

    The FTHBI program takes a 5%-10% equity stake, but there is no practical reason that it couldn't be more. The amount would be dependent on the budget for the program, and the degree to which the government wanted to take a stake in the housing market. I would argue that, on principle, the HES should not own more than 50% of the equity stake in a given property, else they might as well own the property outright. Given that the program takes equity as a function of a remaining mortgage balance, there is already a natural limit to the HES equity position.

2. Would the transaction be up-front or in increments?

    The FTHBI program calls for 5%-10% equity (existing home vs new) in a home's total value for first time buyers, which is a lump sum at the time of purchase. The HES program could adopt a similar approach. Tying the program to new and renewed mortgages would make the most sense. If tied to mortgage terms, it might make sense to tie the amount to the term length, say 2% of the total mortgage balance times the number of years in the term. Thus for a 5-year term mortgage, the HES would pay 10% of the mortgage balance in exchange for an equivalent equity stake in the property.

3. Would there be a cap in absolute dollars?

    It might make sense to cap the dollar amount of any given application of the HES so that the government doesn't end up artificially buoying or inflating luxury property prices, or de-risking extravagant purchases. However, it does make sense to take a position in these properties from the perspective of creating a truly diversified index of housing equity. I'm unsure what would be an appropriate upper limit, perhaps a function of the average home price (say absolute dollar limit of no more than 20-30% of average home price, which would be $150k-$200k at current prices), or the average household income (no more than 2-3x average national household income, again around $150-$200 at ~$70k/year).

For reference, there are around 6 million mortgages in Canada, with an average value of around $200k each. Targeting a maximum of $200k in cash outlay per home, indexed to either inflation or Home Price Index (HPI), would give ample room for the average homeowner to de-risk their home purchase while doing relatively much less for owners of expensive luxury homes.

4. Shouldn't the program be means-tested?

A cap on the absolute amount would make more sense than means-testing the program, while more or less serving the same purpose. Means-testing distorts the indexing feature of the program by effectively excluding certain markets and types of housing, plus, as stated before, since the program isn't a transfer, it does not increase anyone's net worth. Making the program available to any homeowner makes it easier to understand and implement, and the cap ensures that it is only modestly beneficial to people with expensive homes. It is analogous to the TFSA, which, to people for whom being able to invest $5,500/year with no tax on gains, represents a significant opportunity, but for wealthy or even high-income households is a somewhat negligible benefit.

5. What about owner-occupied multi-unit properties?

Some primary residences have multiple units. A very common feature is a "mortgage helper" suite, a small, rentable dwelling unit attached to a larger unit, often a converted basement, garage, or carriage house. Given that a home with a rentable suite already has the potential income from the suite priced-in, it makes sense to simply allow the HES to take its equity portion and not worry about things like rent sharing for sake of simplicity. Further, it might make sense to limit the program to homes with no more than one additional dwelling unit, so as not to subsidize or de-risk a multi-unit investment property that happens to have an owner-occupied resident in one of the units.

6. What happens in the event of a foreclosure?

In the event of a foreclosure, the HES shares the downside risk with the homeowner in proportion to their respective equity positions.

7. Does the HES pay its share of the property taxes? What about homeowner grants and such?

I would defer to whatever precedent is set by the FTHBI for the moment.

8. What about improvements or repairs?

Minor repairs or improvements should be of negligible consideration and not factored in one way or the other. Major improvements, such as a significant renovation or addition, should be reported at the time of completion and the gain in assessed value factored into the equity calculation.

Potential Expansion and Evolution of the HES Program

The HES program opens up a lot of interesting opportunities in terms of policy. The infrastructure and processes required to manage the program can be evolved in a number of ways.

For one, equity ownership opens the possibility for, as an example, giving the HES first right of refusal on properties that go up for sale, which would make acquiring land for social housing or other public works much easier. Additionally, it could offer a different way to sell homes. Instead of hoping that someone will buy the home, the owner could simply sell to the HES at an assessed or agreed-upon price, and they could then decide what to do with it.

The other major opportunity is the creation of a housing-backed financial security: The Canadian Housing Index Fund. If the HES owns a small piece of a significant number of the homes across Canada, they could theoretically create an index fund backed by their equity and sell it to investors. The program could potentially finance itself in this way, if there is a demand for a financial product based on the value of Canadian housing. This would create liquidity, as well as allow the program to charge a small management fee to investors, which would likely be more than enough to cover the administration costs of the program.

On the other end, the program could be used as a way to incrementally nationalize the entire housing market in Canada. The amount of equity could be ratcheted up by, as an example, allowing people to buy only the homeowner portion of a home that is already partly owned by the HES. In that way, homes would get incrementally more affordable as the government held more and more of the equity in certain properties, until eventually a given property could be wholly owned by the HES. At that point, the HES could decide to rent, or redevelop, or provide long-term leases, in a similar way to which Singapore's public housing system functions.

Conclusion

The housing market in Canada is in a very vulnerable place. If left to its own devices, the market will continue to be exposed to the risk of significant volatility. Worse, it could end up concentrating in the hands of a smaller and smaller number of landlords. If nothing is done to address the current situation, average Canadians will be shut out of their own housing market in another generation, if not sooner. The Home Equity Share program is a way to create affordability while addressing both of the untenable possibilities discussed earlier, namely that home prices stay high, or they crash. Given the options, I would argue that it is a proposal worth considering.