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High Time To Share

By Terry Loebs

ORIGINATED IN SMALL VOLUMES BY NICHE LENDERS AND AROUND FOR decades, the shared appreciation mortgage (SAM) may be about to emerge from obscurity. Converging forces in the mortgage market and the economy could be the catalyst that liberates the SAM from remaining the well-kept secret it's been in the U.S. market.

The prospect of a robust U.S. market for this mortgage product is significant. Its built-in appeal derives from the additional choices and opportunities the loan product offers homeowning borrowers, lenders and investors. Although SAMs are not for everyone, in light of their potentially significant populist appeal and societal benefits (e.g., they afford more financing and lifestyle choices, can stimulate savings and enable asset-class diversification), one can only wonder why our country's most formidable mortgage finance institutions have not already cultivated a market for them.

Is there a market in the United States for a mortgage where borrowers get lower rates by giving lenders a piece of their future house appreciation? Maybe—if some Wall Street firms see it right.

A shared appreciation mortgage gives borrowers low interest rates in exchange for giving the lender a share of future house price appreciation. For example, with SAM financing on an 80 percent loan-to-value (LTV) transaction, a borrower might be entitled to a discounted, fixed-interest rate of 6.50 percent for a 30-year term, compared with an 8.00 percent rate for a conventional mortgage.

The reduced rate results from the borrower's pledge to the lender of up to 70 percent of any future home appreciation over the life of the loan. In the event that the home price declines over the SAM term, the borrower does not owe the lender any payments related to depreciation. Thus, with SAMs, borrowers still retain a significant financial interest in their homes. The interest rate is a function of the borrower's chosen amount of shared appreciation and the LTV ratio. Generally, the greater the level of appreciation shared by the borrower and the lower the LTV, the lower the mortgage rate. A comparison of SAM terms and payments with those of conventional loans appears in Figure 1.

Fannie Mae and Freddie Mac are aware of SAMs, but have chosen not to assume a leadership role in developing a market for the product. This certainly seems inconsistent with GSEs' mission statement (making homeownership possible for more Americans via fostering the development and health of secondary mortgage markets), to say nothing of the added homeowner benefits (affording borrowers greater financing choices and wealth-diversification opportunities). However, the GSEs (and additional private conduits) will be hard-pressed to ignore SAMs should they gain momentum. As part of their effort to stimulate the U.S. SAMs market, Bear Stearns & Co., New York, in conjunction with National Commerce Bank Services, Inc., Memphis, Tennessee (NCBS), is playing the role of private conduit (e.g., the outlet for mortgage banker SAM originations), as is explained later in this article.

SAMs: New choices and opportunities

Homeowners

SAMs are a compelling financing option for both prospective and existing borrowers who wish to trade off a portion of their returns from the appreciation of their homes for returns from other asset classes. (Typically, households use a lot of leverage to finance the home, and generally commit significant funds to both its purchase and the ongoing debt-service requirements the asset brings. In a portfolio context, the equity interest that many homeowners have in their house is a highly leveraged bet on an investment that possesses significant geographic

Figure 1 SAMs Comparison with Conventional Mortgage Financing

	Mortgage Type					
	SAM			Conventional		
Borrower's Interest Rate	6.50%			8.00%		
Initial Loan Amount	$250,000			$250,000		
Initial Home Value	$312,500			$312,500		
Monthly P&I Payments (30-year term)	$1,580			$1,834		
Monthly Savings	$254			N/A		
Annual Savings	$3,048			N/A		
Borrower Holding Period	10 Years			10 Years		
Holding Period Savings	$30,480			N/A		
Borrower's Appreciation Share[1]	50%			100%		
Total Holding Period Amortization	$38,060			$30,688		
Total Holding Period Interest	$151,561			$189,441		
Total P&I over Holding Period	$189,620			$220,129		
Unpaid Principal Balance	$211,940			$219,312		
	Scenario			Scenario		
	1	2	3	1	2	3
Holding Period Appreciation (%)	-15	+10	+30	-15	+10	+30
Home Appreciation Amount	-$46,875	$31,250	$93,750	-$46,875	$31,250	$93,750
Share of Appreciation Due Lender[2]	$0	$15,625	$46,875	$0	$0	$0
Lender Payoff Amount	$211,940	$227,565	$258,815	-$219,312	$219,312	$219,312
Capital Appreciation: Home	-$46,875	$15,625	$46,875	$46,875	$31,250	$93,750
SAM vs. Conventional Mortgage	$0	-$15,625	-$46,875	$0	+$15,625	+$46,875
Capital Appreciation: Other Assets[3]	$69,905	$69,905	$69,905	$0	$0	$0
Pretax Capital Gains	+$23,030	+$85,530	+$116,780	-$46,875	+$31,250	+$93,750

[1] SAM program options currently available enable the borrower to share 30%, 40%, 50% or 60% of Future home appreciation

[2] During the term of a SAM, the lender may use a "comparable market rate" to determine the amount of interest deemed paid for federal income tax purposes. Thus, the IRS may treat appreciation payments due to lenders as a form of deductible interest.

[3] Assumes monthly SAM savings of $264 is invested in the equity market over the holding period, and that the average annual return is 15%.

SOURCE: CASE SHILLER WEISS, INC.

and asset-class concentrations.

Joseph Tracy, a vice president at the Federal Reserve Bank of New York, asserts, "The latest information we have suggests that the typical household continues to have about 65 percent of its total wealth concentrated in the home, while stock holdings account for 5 percent or so." Thus, SAMs should command consideration from any borrower who appreciates the merits of portfolio diversification.

With disciplined investments of mortgage payment savings (resulting from financing a home transaction with a SAM in lieu of a conventional mortgage), borrowers could use the savings to invest in asset classes that, historically, have had higher and/or negatively correlated investment returns relative to residential real estate (see Figures 2 and 3).

Homeowners who have significant home equity—particularly the so-called "pre-senior" demographic of people aged 50 to 65 years—may obtain SAM financing as a means to unlock some of the equity in their homes for consumption or investment purposes. Many homeowners who are recently retired or approaching retirement (often, these individuals are house-rich and cash-poor) could use a low-LTV, high appreciation–share SAM offered at approximately 300 basis points below prevailing conventional rates as a means to help fund their retirement savings and diversify their wealth sources. (To be eligible for a reverse mortgage, homeowners must be at least 65 years of age; the average age of today's reverse mortgagor is 72 years.)

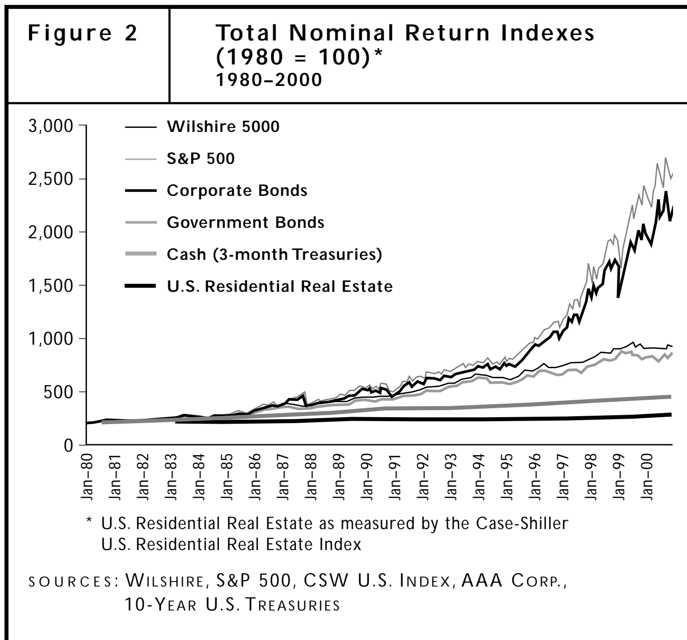

Figure 2 **Total Nominal Return Indexes (1980 = 100)*** 1980–2000

* U.S. Residential Real Estate as measured by the Case-Shiller U.S. Residential Real Estate Index

SOURCES: WILSHIRE, S&P 500, CSW U.S. INDEX, AAA CORP., 10-YEAR U.S. TREASURIES

SAMs should be considered by prospective homeowners who wish to realize—and existing homeowners who wish to maximize—the dividend returns associated with homeownership. The dividends of homeownership are derived from the ongoing use of the home as shelter, federal tax benefits associated with any mortgage interest payments and the less tangible but significant pride factor.

Growing families that really need a larger home, but can't afford one, may find SAMs a godsend.

In making the case for why major lenders should revisit this underused mortgage product, it is helpful to review the specific benefits SAMs offer. They include:

- With a SAM, prospective first-time homeowners with cash constraints or modest income may be able to afford a home purchase that they otherwise couldn't at prevailing conventional mortgage rates.
- Families that highly value living in an area with outstanding public schools could find making a move to such a neighborhood (where homes sell for premium prices) financially feasible with SAM financing.
- Growing families that really need a larger home, but can't afford one, may find SAMs a godsend. Consider a single-earner family of four expecting twins six months from now. If this family is currently living in a two-bedroom home, a SAM could be a way for them to maintain comfortable living space through the purchase of a larger home, or by building an addition to their current one.
- Homeowners who may not truly need, but really want to trade up to a newer home (to avoid home-maintenance labor and expense) or to a more luxurious home may be able to do so with a SAM.

Although SAM borrowers may have to make a substantial payment to their lender when the loan terminates (reflecting the degree to which the home value has appreciated since

Figure 3 **Annual Returns and Volatilities**
(12-month holding periods; last holding period: June 2000)

	Mean Annual Return			Standard Deviation		
	3-Years	5-Years	10-Years	3-Years	5-Years	10-Years
Wilshire 5000	23.8%	24.6%	17.8%	11.3%	10.7%	10.6%
S&P 500	25.3%	26.2%	18.5%	11.4%	10.5%	10.3%
Corporate Bonds	7.2%	8.6%	9.4%	6.3%	6.4%	6.4%
Government Bonds	7.2%	8.2%	8.8%	8.0%	8.0%	8.1%
Cash (3-month Treasuries)	5.1%	5.1%	5.1%	0.2%	0.2%	0.2%
U.S. Residential Real Estate*	6.6%	5.1%	3.1%	1.5%	1.4%	1.3%

* U.S. Residential Real Estate as measured by the Case-Shiller U.S. Residential Real Estate Index

SOURCES: WILSHIRE, S&P 500, CSW U.S. INDEX, AAA CORP., 10-YEAR U.S. TREASURIES

origination), unlike adjustable-rate mortgage payments (which also offer lower rates at origination than comparable-term, fixed-rate mortgages) SAM payments do not change. This eliminates the prospect of borrower "payment shock" in a rising rate environment. Further, if the home appreciates over the period in which it's owned, the borrower's "appreciation share payment" to the lender may be treated as deductible interest as per established IRS guidelines for contingent interest debt.

Lenders

The below-market rates, added borrower financing options and relative novelty of SAMs might grab the attention of those looking over lenders' rate-sheets in an increasingly competitive and commodity-like primary mortgage market. Provided the lender has reliable SAM funding sources (or balance-sheet capacity) and servicing resources, offering the consumer another choice—in this case, a below-market-rate mortgage product—seems like an appealing proposition.

Bear Stearns & Co. is among those that agree. Pioneering executives at this Wall Street firm were at the forefront of shaping the SAMs market from scratch in the United Kingdom, and they now have their sites set on the far larger U.S. mortgage market. Indeed, Bear seems to be on a mission to make "SAM" a household name in the U.S. mortgage marketplace and is putting its money where its mouth is. In recent months, the company has made strides toward establishing a uniform SAM product and assembling the requisite infrastructure to foster a successful SAM product launch in the United States.

Through an arrangement with NCBS, Bear has committed to purchase large numbers of SAMs via a wholesale lending network of more than 1,000 originators. This plan to originate SAMs marks the first time in recent U.S. mortgage history that an institution has attempted to make the loans widely available throughout the country.

In December, with its network of 2,000 originators, Allied Mortgage Capital Corporation, Houston, launched its SAM product drive. Triad Guaranty Insurance Corporation, Winston-Salem, North Carolina, has agreed to provide mortgage insurance on SAMs when required. Alliance Mortgage Co., Jacksonville, Florida, will service the product, and Bear will underwrite SAM-backed securities to trade with investors.

SAMs also afford mortgage lending organizations an opportunity to broaden their traditional roles to include more of a financial planning and wealth-management flair. Appropriately, considerable concern and increasingly sophisticated technologies have been focused on customer retention in recent months. If there's a product that's conducive to the notion of creating longer-lived customers, it's the SAM. Particularly in the earlier stages of development of the U.S. SAM markets, borrowers will stay with their mortgage longer because they already enjoy a below-market rate and are subject to a penalty if they refinance or terminate the SAM within the initial three years.

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More opportunities to cultivate broader and deeper relationships with customers might occur if the lender has a means to serve the customers' broader financial needs throughout the life of the mortgage. Successful retail-oriented financial institutions of the future will capitalize on the synergies of fusing mortgage lending strategies with financial planning products and services.

Today's mortgage lenders should consider strategies and products that maximize their future position to provide customers integrated, flexible and efficient wealth-management solutions. Nicolas Retsinas, director of Harvard's Joint Center for Housing Studies, Cambridge, Massachusetts, says, "Although the likely timing of such developments are unclear, as successful mortgage lending institutions evolve, I believe they will embrace wealth-management and financial-planning solutions to serve the broader financial needs of their customers. If SAMs attain critical mass, they could fit nicely with the universal account concept many banking institutions have been developing in recent years."

It will be interesting to see how mortgage market leaders play their wealth-management services option, and if SAMs will be offered as part of their menu.

Scott Stafford, president of NCBS's correspondent lending group, Memphis, Tennessee, says, "As the broader refinance market has dried up, SAMs have proven to be timely. We have several origination channels, including a network of financial planners. We're working on a CPA [certified public accountant] network, too. In addition to increasing a borrower's purchasing power by 15 to 20 percent in the housing market, SAMs have already proven popular as a conduit for wealth diversification. For example, the majority of SAM borrowers who choose to take cash out are relatively low-LTV [loan to value] borrowers reinvesting in other asset classes."

SAMs and Other Potential Savings Stimuli in 2001

In the coming year, it's possible that consumers will have unprecedented opportunities to substantially increase annual tax-deferred contributions via new forms of retirement and college savings plans. Two developments to look for in 2001 that have the potential to quickly stimulate savings activity include enactment of The Retirement Savings and Security Act and more widespread availability of Section 529 College Savings Plans. (The Retirement Savings and Security Act has strong bipartisan support; 529 College Savings Plans are already being marketed heavily by investment company giants.)

For financial institutions, these new savings plans will provide opportunities to revisit with customers their prior retirement plan choices, and/or offer new advice concerning their personal-wealth plans. The question for many consumers will be: How will they be able to take advantage of plan incentives and fund the plans? For the savings- and diversification-minded homeowners and their financial advisers, SAMs may be the answer.

Figure 4 **12-Month Return Correlations**
(12-month holding periods; last holding period: June 2000)

	Wilshire 5000	S&P 500	Corporate Bonds	Government Bonds	Cash
3-Years					
Wilshire 5000					
S&P 500	0.95				
Corporate Bonds	0.35	0.53			
Government Bonds	0.15	0.33	0.93		
Cash (3-month Treasuries)	0.03	0.03	0.51	0.65	
U.S. Residential Real Estate*	-0.55	-0.65	-0.73	-0.65	-0.52
5-Years					
Wilshire 5000					
S&P 500	0.95				
Corporate Bonds	0.45	0.55			
Government Bonds	0.32	0.43	0.95		
Cash (3-month Treasuries)	0.22	0.19	0.68	0.71	
U.S. Residential Real Estate*	-0.34	-0.40	-0.53	-0.41	-0.65
10-Years					
Wilshire 5000					
S&P 500	0.97				
Corporate Bonds	0.38	0.37			
Government Bonds	0.36	0.36	0.96		
Cash (3-month Treasuries)	0.02	0.08	0.08	0.12	
U.S. Residential Real Estate*	0.30	0.32	-0.39	-0.32	-0.25

* U.S. Residential Real Estate as measured by the Case-Shiller U.S. Residential Real Estate Index

SOURCES: WILSHIRE, S&P 500, CSW U.S. INDEX, AAA CORP., 10-YEAR U.S. TREASURIES

In early October, Countrywide Investment Services (CIS), Calabasas, California, was launched to sell mutual funds, annuities, securities and individual retirement accounts (IRAs). Consumers will be able to buy these products and get related advice from financial planners at retail branches, over the phone or on the Web.

In an October 2000 interview with *American Banker,* Keith Pipes, CIS president and chief executive officer, said, "We see this as an opportunity to provide more services to the Countrywide Home Loan customer base. We've already helped our customers meet one financial objective—buying a home—so now we can help them meet others by giving them access to financial planning and to investment products."

It will be interesting to see if SAMs will be on the Countrywide menu in 2001.

INVESTORS

Triple A-rated, SAMs-backed pass-through securities will afford institutional investors a safe and efficient means of investing in a portfolio of residential real estate (without having to take title to individual houses), as the return on these bonds will be a function of coupon rate, capital appreciation *and* shared house-price appreciation.

Why would SAM securities be attractive to institutional investors? "By opening up this $10-trillion asset class [residential housing] with SAM securities, investors have a means to diversify their portfolio," says Sam Masucci, managing director, Bear Stearns & Co. "As huge as the residential housing market is, without SAMs there currently is no way for investors to own the equity side of owner-occupied residential real estate without being some kind of transaction-cost-laden, real estate–operating company."

Institutional investors are attracted to large asset classes that have little or negative correlation of returns with respect to their other holdings (e.g., stocks and bonds). (See Figure 4.)

Consider how mortgage originators typically use a front-end (housing expense to gross income) qualifying ratio of 28 percent. This creates a meaningful link between wages and houses. Defined benefit pension plans need to hedge wage inflation (benefits paid are based on the average of the retiring employees' last three years' wages). Since home prices are more strongly correlated with wages than stocks or bonds are, SAMs could afford such institutions a more effective hedge for their long-term liabilities.

SAM securities will also draw institutional investor interest due to their superior convexity properties relative to comparable-vintage mortgage-backed securities (MBS) collateralized by higher coupon mortgages (e.g., bond duration will be more stable with SAM bonds as prevailing interest rates fall). The prepayment risk of SAM pass-throughs is low because the bond collateral is comprised of below-market-rate mortgages that have a three-year prepayment penalty.

Societal benefits

For buyers who would otherwise be shut out of the market because they can't afford payments on a traditional mortgage, a SAM can make the dream of homeownership an affordable reality. SAM rates can be 150-plus basis points less than rates on ordinary fixed-rate, fixed-term mortgages.

Once a deep cash market for a home price–related security is established, the prospects for successful development of innovative risk management products and institutions become viable. For example, derivative home price–linked securities could be developed for hedging or investment purposes, and a futures market for residential home prices could be cultivated.

SAMs can be a useful tool to help disciplined homeowners diversify their personal portfolio and augment savings rates. Why is this important now? Consider the following.

■ By at least one measure, consumer savings are at historical lows. Figure 5 depicts personal savings from the beginning of 1959 through September 2000. Although this Bureau of Economic Analysis (BEA) measure excludes capital gains (gains that many consumers probably think of as savings), the trend depicted is clear.

■ Some consumers' inability to effectively manage their financial affairs (see Figure 6) in this era of unprecedented economic prosperity is also troubling. This suggests that society should embrace financial innovations that can elevate the awareness of overspending pitfalls, while offering savings-stimulating products (see sidebar, "SAMs and Other Potential Savings Stimuli in 2001").

Acceptance barriers and the need for SAM education

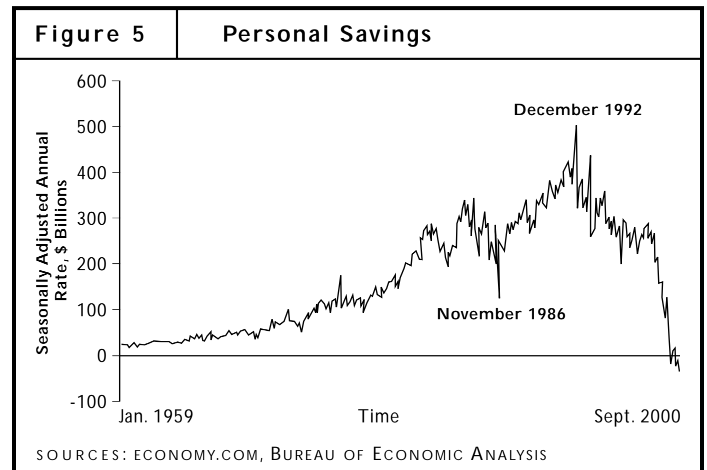
Notwithstanding the potential allure and known benefits of SAMs, the mortgage clearly is not for everybody. For example, in the primary market, skeptical borrowers will find SAM terms too unusual, or construe the product as gimmicky.

Emotional borrowers will struggle with the notion of parting with even a portion of return related to their largest, pride-bound, tangible asset—whether or not they feel strongly about where home prices will be in the future. As a result, SAM lenders should be prepared to thoroughly educate prospective borrowers about unique program benefits and terms, as well as tradeoffs.

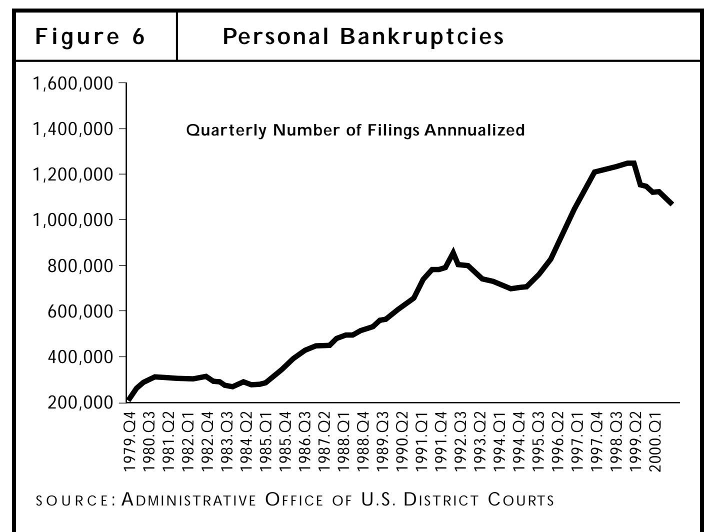
Also, at first glance, SAMs may elicit more skepticism than praise from consumers because so much attention has been focused on how hot certain real estate markets have been in the recent past. Although many markets have recently exhibited record appreciation rates, it's probably safe to assume that many of these rates are not sustainable beyond the short term.

Indeed, for a significant majority of the major cities tracked in the quarterly *The Wall Street Journal*/Case Shiller Weiss, Inc., "Home Price Forecast Report," the outlook is for slowing appreciation rates in 2001. These projected trends may prove to be the onset of a turn toward depreciation in several markets. With respect to certain areas, Karl Case, professor of economics at Wellesley College, Wellesley, Massachusetts, and co-founder of Case Shiller Weiss, Inc., says, "A correction is overdue."

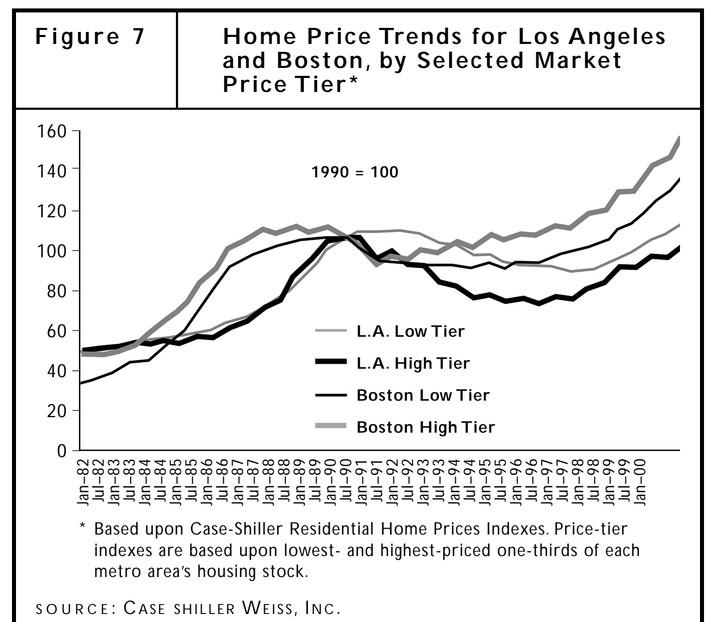
An examination of past behavior can provide insights into the cyclic, seasonal and sometimes unpredictable nature of home prices that Case's message suggests. Consider Figure 7, and Boston's high-priced housing market segment. Since early 1997, appreciation has matched rates not witnessed since the mid-1980s in Boston. Following the latter period's four-and-a-half-year price run-up (which ran out of steam in third-quarter



SOURCES: ECONOMY.COM, BUREAU OF ECONOMIC ANALYSIS



SOURCE: ADMINISTRATIVE OFFICE OF U.S. DISTRICT COURTS



* Based upon Case-Shiller Residential Home Prices Indexes. Price-tier indexes are based upon lowest- and highest-priced one-thirds of each metro area's housing stock.

SOURCE: CASE SHILLER WEISS, INC.

1987), the market subsequently fell 19 percent, and failed to reach precorrection levels for eight years.

Figure 7 also shows that high-priced homes in Los Angeles have yet to fully recover from their peak level more than a decade ago. In retrospect, it's clear that had SAMs been taken out by certain Boston homeowners with a 10-year holding period starting in 1987, or by most Los Angeles homeowners who purchased or refinanced in the late 1980s through the early 1990s, they would have made a wise choice. This would have been especially true if they used the SAM payment savings to fund investments in mutual funds, stocks or bonds.

(Metropolitan area home-price indexes are used here for illustration purposes and simplicity. Other accurate indexes of submarkets that comprise metro areas—e.g., county indexes, ZIP code indexes and those of their respective price-tier segments—can be better proxies of a particular home's historical price path.)

Robert Shiller, Stanley B. Resor professor of economics at Yale University and another Case Shiller Weiss, Inc., co-founder, says, "In 1989, San Francisco housing prices went up 21 percent in one year—a boom almost as spectacular as the current one. But seven years later, prices in that city were 6 percent lower than they were at the end of '89. SAMs can be a compelling risk-management vehicle for homeowners."

"History has shown that housing can be a good investment over the long term for consumers," says Harvard's Retsinas. "From a return-on-investment perspective, homeowners could do better—but they also could do a lot worse. Steadfast optimism of American families regarding home-price appreciation may prove to be a SAM originator's greatest hurdle in the near term. Of course, it's this optimism that creates a tendency to underestimate or dismiss the real risks they face from house-price volatility, particularly when households use the recent past as their value compass."

Although some of the foregoing comments may seem ominous, house-specific and geography-specific price declines are inevitable. The good news for SAM investors is that their bonds will be backed by diversified pools of mortgages (and home-appreciation shares) throughout the country. Thus, the returns associated with cool real estate markets will be offset by those in hot markets.

The U.S. Residential Real Estate Index (depicted in Figures 1 and 2) suggests that if a long history is any guide, geographically diverse residential real estate investments will reward long-term residential real estate investors with steady, positive returns. Returns to borrowers who finance their homes with a SAM can also be positive, since the mortgage can be used as a tool for the consumer to mitigate exposure to the housing asset class, augment wealth via investment in asset classes with (historically) higher returns or increase purchasing power. Lenders, who will benefit from slower run-off (and thus, greater retention), will have longer-lasting servicing income streams and ongoing opportunities to meet homeowner demand not only for loans, but for a broad variety of financial products and related wealth-planning services. **MB**

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Recent SAM History

A RECENT TESTAMENT TO THE SHARED APPRECIATION MORTGAGE'S (SAM'S) broader appeal was a 1996 program launch in the United Kingdom by The Bank of Scotland. In early 1997, SAMs accounted for approximately one-third of the bank's average daily origination volume. SAM-backed securities issues and new entrants to the origination market soon followed.

Although dwarfed by most every U.S. mortgage-backed security (MBS) issuance benchmark in 1997 and 1998, it is significant to note that the success of SAM securitizations in those years required intensive education of European investors regarding the benefits of owning fixed-rate MBS. (A U.K./European MBS market did not exist previous to the mid-1990s.) Further, since these issues were denominated in British Pounds Sterling, investors in countries outside of the United Kingdom had to concern themselves with currency hedges.

SAMs lost momentum in the United Kingdom by 1999, as Swiss Bank's investment banking unit—the primary SAMs securitization principal for Bank of Scotland's U.K. issues—was bought by Union Bank of Switzerland, which exited residential mortgage product business lines (including SAMs underwriting). Without an intermediary to continue the cultivation of a still-nascent market, both primary and secondary SAMs markets wilted.

Today, the U.K. SAMs market is poised to reemerge. The introduction of the euro will foster the product's continued development and acceptance. Ten years of significant U.K. home-price appreciation have increased demand for equity-release products. Large U.K. lenders, such as Abbey National PLC and Halifax Group PLC, have begun securitizing mortgage pools with the help of several investment banks that are eager to reenter the U.K. SAMs market.

According to Sam Masucci, managing director, New York–based Bear Stearns & Co., "Every major U.S. investment bank [and] some commercial banks and lenders—including Chase, Citibank and Countrywide—are over there trying to transport U.S. mortgage technology as a means to get a foothold in what will become one of the largest bond markets in the world."

Besides regulatory and cultural differences, the U.K. and U.S. products are very similar. In the United Kingdom, there were two basic types of SAMs—one geared toward first-time and move-up borrowers (similar to the U.S. product currently offered), and another targeted to retirees featuring low loan-to-value (LTV) ratios and high appreciation shares (e.g., 25 percent LTVs with 75 percent appreciation share). Although the U.S. SAM program may appeal to some retirees, the current product design is probably a better fit for a younger market segment.