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Managing Home Equity to Build Wealth - Part II

As I explained in Part I (the June 2007 newsletter), home equity should not be ignored when managing your capital to reach your retirement goals. In that first part of this series, I explained that withdrawing equity using a bigger mortgage can increase wealth and liquidity while reducing risks. Similarly, this month's newsletter will explain another way to further accomplish these same goals and reduce losses from declining home prices without actually selling your home. I will explain a new financial product called a REX agreement.

REX Agreement Description: What and How

A REX agreement is a contract to share appreciation or depreciation in a home's value with an investor (REX and Company). It is not a loan and thus there are no payments. The agreement is recorded along with a security agreement but this does not interfere with mortgaging the property – up to an agreed limit ranging from 70-80% of property value. The agreement lasts 50 years[1] or until you sell your house. You can terminate early, but will pay a penalty to terminate in the first five years. You choose the percentage of future appreciation/depreciation to share up to 50%. You receive an immediate payment equal to 28.57% of the house value, times the percentage sharing chosen. (I call this the cash ratio). Therefore, if you choose the maximum of 50%, you will receive cash equal to 14.285% of the house value up front. When the house is sold, the amount due to or from REX is calculated and netted with the upfront payment to determine what portion of proceeds go to REX. For example, if the house depreciated 28.57% over the life of the agreement, REX gets nothing at the end and you keep all the cash they paid up front.

At inception of the contract, the homeowner and REX and Company must agree on the value. This would typically be set by a third party appraiser. If the agreement is terminated prior to an actual sale, the ending value would also be

[1] Limited to 40 years in Illinois and 30 years in North Carolina.

determined by an appraisal. If terminated in the first five years, the house value cannot be less than the initial value and there is a penalty payment specified as a declining percentage of the up-front payment:

Year	Penalty as % of Cash
1	25%
2	20%
3	15%
4	10%
5	5%

There are some limitations on eligibility. The home must be single family detached, owner occupied in one of the following states: California, Colorado, Illinois, Florida, New Jersey, Virginia, and Washington. New construction is not eligible.

Termination of a REX Agreement

The agreement terminates when you sell your house. Or, you can choose to terminate earlier if you believe your house will soon appreciate rapidly. At termination there is a settlement payment which depends on the change in the house value since inception of the agreement. Assuming the house has not declined in value by more than 28.57%, the payment to REX and Co. at termination is calculated as follows:

Settlement = Up-Front Payment + Change in House Value x *REX % share*

Note that if the house depreciates, the change in value will be negative and therefore the final settlement payment to REX and Co. will be less than the amount received up front. If the house declines by more than the cash ratio of 28.57%, then the above Settlement is negative and REX and Co. must pay the homeowner at termination.

The above applies after 5 years have elapsed. Prior to that, the Change in Value cannot be less than zero and, in addition, the homeowner would pay the penalty amount as noted previously.

Why Do It?

This is technically a derivative contract in which you sell exposure to the change in the underlying house (asset) value. Thus it allows you to hedge against a value decline without having to actually sell the house. There are no consequences with regard to living in the house and thus no emotional issues to deal with in evaluating this as a financial decision. Let's look at the benefits.

Most importantly the REX contract allows you to hedge the risk of a decline in the value of your house and thus provides partial protection for your current equity in the home. In most markets, house prices will likely to be lower 5 years from now and therefore a prudent investor will want to reduce exposure to this asset. This is no small risk. A recent analysis prepared for Forbes magazine provides an economically based forecast for various metropolitan markets. (see http://money.cnn.com/2007/11/06/real_estate/home_prices.fortune/index.htm) It predicts home prices in the East Bay Area will be 31% lower by June 2012. Even if you don't believe prices are going down in your neighborhood, you will recognize that there is risk that should be properly managed. The REX agreement is a tool for managing this risk.

Another aspect of risk that can be addressed is diversification. Many people simply have too much of their wealth invested in their home. Redeploying some of this equity into other types of assets can reduce the chances of large drops in wealth if the new investments have low correlation with home equity. If the money were invested in foreign stocks for example, such assets would likely be relatively unaffected by drops in U.S. house values - thus, insulating retirement savings from the risk of an overly concentrated portfolio of assets.

Besides minimizing risks, we also want to maximize returns on capital. Even if house prices come back to current levels by the end of 5 years, that still implies no return on equity. Meanwhile any equity you can pull out could produce cumulative after-tax returns over 5 years of 22% to 62% depending upon the investment. After-tax returns could be even higher if funds were moved into a tax deferred retirement account.

Tax Effects

The REX contract is like a forward sale contract (without a stated maturity) and is therefore an unexecuted contract until final settlement. For tax purposes it should be treated as an option on real property. Therefore, the up-front payment received is not taxed and there are no tax implications until contract termination. The homeowner covers all expenses and mortgage payments and gets the corresponding tax deductions.

If the contract ends with the sale of the property, the up-front payment should be treated as if it were part of the sales proceeds and the final settlement payment to REX and Co. will effectively reduce the sales proceeds received. Therefore, assuming the total gain is within the excludable amount on the principal residence, the gain on the hedge would not be taxable.

If the contract is terminated without a sale there is no definitive treatment under the current tax code. Any net payment from REX and Co. (i.e. after the five year penalty period) would surely be taxable as ordinary income. A payment to REX and Co. would probably be treated as closing of the option contract and therefore a capital loss. This should be deductible but only to the extent of $3,000 in excess of offsetting capital gains.

Breakeven Analysis

Because REX and Co. does not pay for depreciation if the agreement terminates in the first 5 years, it is only useful for long term hedging. Still, even an agreement lasting as short as 2 or 3 years will be worthwhile if the up-front cash is invested wisely. So long as the cumulative after-tax returns on the cash exceed the penalty, you come out ahead. The following table shows calculation of the maximum appreciation rate where the homeowner breaks even during each of the first 6 years assuming a 50% sharing agreement and 6% after tax returns on cash.[2]

REX Agreement		All Table amounts expressed as pecent of house value				
Penalty by Year	Early Termination Penalty as % of Cash	Penalty for share: 50%	After Tax Return on cash at 6.00%	After Tax Returns on Cash net of Penalty	Cumulative Breakeven Appreciation	Annualized Breakeven Appreciation
1	25%	3.57%	0.86%	-2.71%	Not Applicable	
2	20%	2.86%	1.77%	-1.09%	N/A	NA
3	15%	2.14%	2.73%	0.59%	1.2%	0.39%
4	10%	1.43%	3.75%	2.32%	4.6%	1.14%
5	5%	0.71%	4.83%	4.12%	8.2%	1.60%
6	0%	0.00%	5.98%	5.98%	12.0%	1.90%

Thus, at this rate of return you would not enter the REX agreement unless you would keep the house more than 2 years. So long as appreciation is below the levels shown here you come out ahead even after paying the penalty for early termination. Given the high likelihood of price declines over the next 5 years, homeowners not intending to sell should benefit from entering a REX agreement.

Numerical Example

There is a strong case that the REX agreement is worthwhile as a risk management tool, but to fully understand the range of financial outcomes we need to look consider the various combinations of potential changes in house values and returns on cash. Assuming you keep the REX agreement outstanding for 5 years and 1 day, you avoid the penalty payment and can be paid for depreciation. Therefore the table on the next page shows the range of outcomes for a 5 year period assuming you choose the maximum 50% sharing agreement. For smaller percentages you would scale down the result accordingly (i.e. a 10% share is 1/5 of the result in the table). Note that all percentages apply to the original house value at signing of the REX agreement.

[2] These calculations assume that the payments to REX and Co. are not tax deductible.

5 year After Tax payoff of 50% share REX agreement expressed as a % of house value at start						
Pretax Return on Cash		6%	8%	10%	12%	15%
After Tax Return		4.08%	5.44%	6.80%	8.16%	10.20%
Cumulative	-30%	18.2%	19.3%	20.6%	21.9%	23.9%
5 yr Change	-25%	15.7%	16.8%	18.1%	19.4%	21.4%
In House	-20%	13.2%	14.3%	15.6%	16.9%	18.9%
Value:	-15%	10.7%	11.8%	13.1%	14.4%	16.4%
	-10%	8.2%	9.3%	10.6%	11.9%	13.9%
	-5%	5.7%	6.8%	8.1%	9.4%	11.4%
	0%	3.2%	4.3%	5.6%	6.9%	8.9%
	5%	0.7%	1.8%	3.1%	4.4%	6.4%
	10%	-1.8%	-0.7%	0.6%	1.9%	3.9%
	15%	-4.3%	-3.2%	-1.9%	-0.6%	1.4%

Each column of the payoff table corresponds to how much you would come out ahead in 5 years with a REX agreement if your returns on the up-front cash payment match the amount at the top of the column. The rows correspond to the cumulative 5 year house price changes shown in the left column. For example, assuming you entered a 50% sharing agreement on a house worth $1 million and you reinvested the cash to earn 6.80% after tax and the house was worth $900,000 (down 10%) at the end of 5 years, then you would gain $106,000 (10.6% of $1 million) from the REX agreement.

Given the high probability of a protracted decline in home prices in many markets, the gains shown in the upper half of the table seem most likely to be realized. This means very significant amounts of capital preserved for retirement and a very good contract in the current market environment.

REX's Point of View

So why are they offering this deal. First of all, I believe this product was conceived, designed, and the promoters obtained their funding commitments before it became clear that prices were headed down. They may well withdraw this if they become as pessimistic as I am about housing prices.

Fundamentally the concept is very appealing to institutional investors such as pension funds because it provides better diversification which modern portfolio theory says is very important for minimizing risk for a given level of return. They have very long investment horizons and this provides a new opportunity to diversify their investments into an asset class which they previously could not access. They expect very low correlation with their other investments. Hence it should lower their risk. The poor market timing cannot be known to them until after the fact and they give such issues much lower priority than perfecting their application of portfolio theory.

Another interesting point is that this product effectively gives them a leveraged investment in residential housing because they are getting the rights to a larger percentage of the property (its change in value) than they must pay cash for up front. The mechanics of the agreement are equivalent to the owner loaning the balance[3] to REX and Co. in return for the right to free rent on their portion of the property. This is relatively inexpensive leverage and would provide very good returns if real estate were actually appreciating at the long run rates.

Conclusion

Fortuitous timing has led REX and Co. to introduce their agreement at the perfect moment for homeowners wishing to hedge against the coming declines in house prices. For those wishing to preserve capital and reduce risks, now is the time to take advantage of this new tool. If you decide to go this route you will need to stay in your home at least 2 years and invest the up-front cash wisely. Please call us and we would be glad to advise you in implementing this strategy.

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[3] The mirror of the cash ratio is the 71.43% leverage portion of the REX contract.