The Evolution of Real Estate Leverage

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Introduction

The concepts of property rights and ownership have generated a great deal of thought through the ages. One can find references to property ownership in the Old Testament (Genesis 13), ethical contemplations by Plato and Aristotle, and early establishment of property rights by the Romans as the first lawmakers to formulate the concept of absolute private ownership (Pipes 1999). With property ownership being central to an ordered society, and with the notion of leverage becoming a dominant strategy of our time, we should be able to identify impacts in the real estate realm. It is within that context that we turn to the evolution of real estate leverage and its effects on modern American society. In the other chapters of this book, we see how leverage has become ubiquitous in personal, business, and political spheres. Here, we examine how the growth of leverage in general has led to an evolution of the use of leverage in the real estate arena. What was historically an application of simple economic leverage is evolving into a combination of resource leverage and investment leverage that engages the local and regional community as a whole.

Background

In terms of property ownership and real estate financing, it is instructive to start with the recent financial crisis, examine how it has impacted the availability of mortgages, and evaluate how the use of leverage has evolved in the periods before and after this episode in American history.

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The financial crisis of 2008–2010 provides an example of an over-leveraged economy. Leading up to the downturn in the economy, we witnessed destructive leverage—overuse of financial leverage, which contributed to the severity of the crisis. In the aftermath of the crisis and the burst of the housing bubble, it has become harder for consumers to obtain mortgages in general. Working families that desire homeownership face new challenges and a growing need for financial assistance in realizing this goal. As a result, we have seen growth in the use of constructive leverage with a community-based approach to the purchase of real estate.

It is important to first introduce the term "community-based mortgage" as it is used in this chapter. The term refers to community-based home purchase programs that can take several forms. In all cases, there is a combination of public–private partnerships that provide financial assistance with a property purchase in designated geographic areas or for a target audience. In most cases, these programs offer a means to assist employees in purchasing property close to their work location. The programs may provide below-market mortgages, assistance with closing costs, and/or other assistance to prospective or existing employees. In other cases, assistance is aimed at bringing homeowners into core areas of a city or into particular targeted growth areas that fit in with long-range urban planning objectives.

The notion of leveraging financial resources in order to buy a house is nothing new. Individuals and families have been doing so to buy property for generations, and this concept is commonly practiced in most westernized countries. What has changed regarding the purchase of real estate is that the concept of leverage has expanded from individuals to institutions, permeating work life, community, social, and urban planning facets of our lives.

Community-Based Mortgages: An Example

A number of municipalities, companies, and higher-education institutions have established programs to help employees purchase real estate. But these programs do more than simply assist employees. For example, Johns Hopkins University's "Live Where You Work" program has broader goals. This program is a three-way partnership between the university, its employees, and Baltimore City. The objectives of the "Live Where You Work" program include the following:

- Helping employees to become homeowners in Baltimore City—in many cases for the first time—and to build home equity.
- Cutting commuting costs and travel time for employees.
- Helping Johns Hopkins to recruit and retain employees.

As stated in the Johns Hopkins program material: "Employees enjoy the economic and social rewards of urban living while strengthening their new neighborhoods and contributing to the vibrancy of the city." The program is in sync with the Baltimore region's "smart growth" strategy in that it encourages development where infrastructure already exists as a way to reduce sprawl, cut traffic congestion, and promote environmental sustainability. If successful, programs such as these can lead to an improved quality of life—both short term and long term—benefiting individuals and the future well-being of American cities.

Origins of the Community-Based Approach

We have seen programs established throughout the country to support low income and/or urban homeownership. Most of these programs have been in place since the early 2000s—pre-dating the recent financial crisis. So the initial impetus for these types of programs did not come out of the financial crisis, but was indicative of the growing use of leverage in our society. At the same time, we have seen a ramp-up in employer-assisted programs of this nature in the aftermath of the Great Recession. With increased scarcity of financial resources since the crisis, individuals and organizations have been forced to identify ways to leverage these resources—i.e., to maximize efficiency of the limited resources available. We anticipate further expansion of joint employer–employee–government programs to support urban homeownership as we go forward.

The need for community-based financial leverage programs has grown over the last 50 years. The reasons become apparent if we contrast the workforce of a prior era to the current day. Let us look back on that 1950s worker who maintained the same job for a decade or more—sometimes for a lifetime. His employer was typically more integrated with the local and regional community than employers of today. It was to the benefit of the employer, employees, and the community as a whole to have companies that were part of the fabric of the community. Today, workers are more transient, companies are more transient, and neither establishes the roots that were common in prior eras. With workers becoming more autonomous from their employers in the late twentieth century, there became a growing need for community-based leverage from those organizations that recognized the benefits of a more fully integrated workforce. It is not surprising that many of these organizations are colleges/universities that have longevity within the community and want to nurture that aspect of their character—their organizational DNA, if you will.

The Johns Hopkins program is one example of a myriad of similar initiatives that have been established throughout the USA. The state of Maryland was at the forefront of this movement by adopting a program in 1997 as part of the smart growth initiative to encourage workers to move closer to their workplaces in targeted residential development zones. This program creates a three-way partnership because an eligibility condition is that the homebuyer, the homebuyer's employer, and the state/local government must all participate in the program. Within Maryland, there are similar programs in place at Loyola University and the University of Maryland. The impetus for moving in this direction was provided by Parris Glendening, who served as Governor of the State of Maryland from 1995 to 2003. While in office, he created the nation's first state-level smart growth policy package.

Breadth and Growth of Programs

Since then, the community-based approach has grown significantly, and its reach has gone far beyond Maryland. To provide a sense of the broad scope of these programs, the following examples illustrate other community-based mortgage programs that have been implemented in the USA:

- Live Where You Work (LWYW)/Live Near Your Work Programs (LNYW)—These LWYW/LNYW programs are similar to the State of Maryland/Johns Hopkins program. An employer/employee/government partnership is created to assist homebuyers. Incentives are offered in targeted areas, may be aimed at certain demographics, and often are an element of a smart growth initiative for a municipality. Examples from various parts of the country include the following:
  - Washington, DC—The DC Office of Planning initiated a pilot LNYW program in 2011, partnering with particular employers to offer closing cost and down payment assistance on homes purchased in DC near subway stations and bus lines. Participants in the program include American University and Gallaudet University.
  - New Jersey—The New Jersey Housing and Mortgage Finance agency initiated a LWYW program in 2008. It provides low-interest mortgages to homebuyers purchasing homes in towns where they are employed. Additional closing cost assistance for home purchases within designated smart growth areas of the state is also available. This program started by offering benefits only in participating, approved municipalities, but as of August 2012, it is available throughout the state.
  - Delaware—The Delaware State Housing Authority established an employee-sponsored LNYW program in cooperation with state and local jurisdictions. Employers and local jurisdictions have the ability to customize the benefits and eligibility requirements. This program was established in 2003.
  - Other Public–Private Partnership programs—Several cities have created programs through public–private partnerships in the recent past, geared toward providing affordable housing in the city for employees of the sponsoring institutions. Examples of these employer-assisted housing (EAH) programs include Cleveland's Greater Circle Living program (2012), the University District Partnership Alliance in Minneapolis (2007), the Mayo Clinic (2006), Chicago's "Find Your Place" program (2008), and the "Select Milwaukee" program (2000). Most of these programs are oriented toward university and hospital employees; some include public schools. A complementary strategy involves the state providing tax credits to employers as an added incentive for the employer to invest in affordable homes for their employees. This approach has been implemented successfully in Illinois through the Illinois Housing Development Authority (Lubell 2006).

- Silent Second Mortgage—A different approach comes from Tucson, AZ, where the city created a program in 1994 offering down payment assistance using a "silent second mortgage." (Lubell 2006) The second mortgage offers a below-market interest rate, but more importantly, the interest is forgiven if a family stays in the home for 20 years. So there is incentive for the homeowner to repay the mortgage. The added benefit is that it allows the city to "recycle" the investments made to use for future home buyers, as the mortgages are repaid.

- Shared Equity Mechanisms—The concept of shared equity is being used in some communities to help make these programs self-sustaining. These types of programs are in response to a concern, by some policy-makers, that up-front assistance may provide only temporary relief as home prices rise. In order to combat rising prices, which can effectively price out many prospective working families upon resale of targeted properties, the shared equity approach has been adopted by a number of states and localities (Lubell 2006). Under this approach, when a subsidy is used to purchase a home, the homeowner agrees to share any home price appreciation with the entity that provided the subsidy. The homeowner can generate a reasonable return on investment, while the public investment keeps pace with the market, thereby ensuring that there is no reduction in the number of families that can be assisted over time. So these types of programs benefit all parties—current home purchasers, the municipality, and prospective future home purchasers by maintaining long-term affordability of targeted housing.
- Homeownership Education and Counseling—Some programs package education regarding the home-buying process and financial counseling into their community-based programs (Lubell 2006). When these elements are part of the mix, what we are seeing is resource leverage used in conjunction with economic leverage to benefit the community.
- Federal Government—While programs must often be deployed through legislation implemented at the local level, the federal government may provide the structure and/or impetus to initiate these efforts. Some examples at the federal level are provided below:

  – A partnership between the National Oceanic and Atmospheric Administration (NOAA) and the Environmental Protection Agency (EPA) established in 2005 supports the coastal and waterfront smart growth initiative. The stated objectives of the joint partnership are "to protect the safety, health, and property of people living in or visiting coastal communities and to help these communities become more environmentally, economically, and socially sustainable." A number of the LNYW programs have grown out of this initiative, which establishes a connection between community-based mortgages and smart growth efforts.
  – Of a different nature was a program initiated in California in 2005 and promoted by the U.S. Department of Housing and Urban Development (HUD) and the Department of Energy (DOE) called PACE, or Property Assessed Clean Energy. The PACE program allowed communities to encourage energy efficiency enhancements to homes and businesses. Under the program, the up-front cost of the enhancements would be provided to the participant and treated as a lien, to be paid-off over time—enabling homeowners to effectively "mortgage" these improvements. The energy savings would often offset the incremental payments on the improvements, making it a net positive for the homeowner.

While they may take different forms, let us look at the common drivers behind these programs. These include expanding homeownership, supporting financial well-being and stability, fostering re-urbanization of cities, increasing efficiency of existing resources and infrastructure, and promoting environmental responsibility. According to David H. Stevens, President and CEO of the Mortgage Bankers Association, and previously Assistant Secretary of Housing with the Federal Housing Administration (FHA), the key to the public–private partnerships is that you need to align what are often disparate interests into a common outcome from which they all see benefits (Stevens 2013). These types of programs do just that. Stevens goes on to characterize the motivating factors into one of two areas: altruism and economics. For some parties, the motivation comes altruistically—people or organizations that want to enhance the protection of the waterfront, for example, or help ensure access to affordable housing. The other mechanism is businesses that think about ways to expand their business model. “It became really easy for environmentalists and private corporations to combine together under like outcomes, even though they had different reasons for being a part of it,” noted Stevens in reference to the PACE program (Stevens 2013). Businesses providing energy enhancements were motivated by increasing sales and profits through participation in the program; proponents of the program in the public sector were motivated by benefiting the environment. To help ensure the success of these programs, Stevens concluded you have to create public policies that promote private investors to take advantage of the benefits and you have to anticipate where the objections are going to come from. With respect to the last point, it was “objections” within the financial community that led to the phasing-out of the PACE program. While the program was successful for several years, its undoing was ultimately caused by issues regarding lien priority that made it impracticable.

Leverage in Public Discourse

In addition to the wide variety of community-based mortgage programs that have come into existence, we have also seen a change in public discourse on housing—the way politicians and public entities talk about affordable housing programs. For example, the San Diego Housing Commission, in an approach encouraged by HUD, implemented an affordable housing program using an innovative strategy to create low-interest mortgages by leveraging the equity of existing housing units granted to the agency under a prior agreement with HUD (Business Wire 2010). This program created a public–private partnership that both preserved and produced affordable housing. The headline in a December 2010 article from Business Wire states that the Commission “…Raises Close to $100 million by Leveraging Equity in Real Estate to Create Hundreds of Affordable Housing Units for Families in San Diego.” (Business Wire 2010) Another example comes from the Center for Housing Policy’s publication on proposed solutions to promote affordable housing from 2006. One of their proposed strategies is to “Leverage employers' commitment to affordable homes for workers." We have already looked at some programs along these lines, but the relevant point is the use of the term "leverage" in describing the concept. It has become commonplace to see the term "leverage" used in public discourse, which is one indication of how the strategy has permeated current-day society. Furthermore, the increased use of leverage language, if you will, is indicative of an "unconscious response" to address housing concerns using new leveraging strategies. Many research and clinical psychologists address unconscious processes in the cognitive, behavioral, and psychoanalytical traditions. Applying this to the current context, these models can be extended to institutions. Some of these programs represent a conscious effort by organizations to achieve the benefits described above—a direct response to the current needs of our communities as a result of the financial crisis and other factors. But largely, this is an unconscious response by municipalities that is driven by self-preservation, as we will see later in this chapter.

Safeguards Against Financial Risk

As we look at the evolving real estate landscape, a critical factor will be the extent to which these community-based mortgage programs steer clear of the causes that led us to the recent leverage crisis. We need to assess whether these types of homeownership programs could lead us back toward a financial crisis—i.e., whether these programs increase or decrease the risk of heading toward another financial crisis. Let us start by looking at whether these programs are exclusively constructive or whether there could be risks of destructive leverage. And since these programs increase the accessibility of mortgages to lower-income individuals, we need to evaluate whether this will necessarily be constructive or whether there could be detrimental impacts on the financial health and stability of American cities.

To answer these questions, we should start by reiterating two principal factors that contributed to the onset and severity of the financial crisis, namely:

1. *The pursuit of short-term versus long-term benefits*—The objective of short-term profits, or even the appearance of short-term financial success, was driving the major players in the financial community. These practices were taking place without regard to the long-term view.

and

2. *The practice of financial leverage and investment in the absence of sound underlying fundamentals*—Traditional fundamental analysis of financial products and evaluation of return on investment were abandoned throughout the entire financial ecosystem. Financial risks and exposures were ignored or masked by some of the largest participants, which led to a worldwide over-leveraged condition. In a speech entitled "Some Observations and Lessons from the Crisis" given in June 2010 by Simon M. Potter, Executive Vice President

of the Federal Reserve Bank of New York at the time, Mr. Potter notes in his conclusion the critical impact of "…allowing perverse incentives to build within the financial system and allowing significant gaps in the regulatory framework to persist." (Potter 2010, p. 7) This is a manifestation of destructive leverage that was allowed to flourish due to the regulatory environment in place at the time.

The community-based approach steers clear of these risks because its goals include an emphasis on long-term benefits and sound fundamental practices. More specifically:

1. *Emphasis on long-term benefits*—Objectives of the public–private partnerships include building equity for the employee; cutting commuting costs and travel time for the employee; and helping the employer to recruit and retain employees. These objectives provide short-term and long-term benefits for the employee *and* promote the long-term health of American cities. The fact that long-term value is emphasized for all parties involved—including the community at large—helps to ensure the constructive nature of these programs.

and

2. *Sound fundamentals*—The programs provide return on investment to all parties involved: the individual, the employer, and the community. Additionally, many of these programs involve shared risk factors such that all parties have "skin in the game" and a vested interest in the success of the program. Benefits that are accrued to each party can be described as follows:

- For the individual homeowner: They obtain a below-rate mortgage or other financial assistance in their home purchase; they experience reduced commuting time; and there are generally minimum cash contributions required of the participants. These factors contribute to an improved quality of life.
- For the employer: They attract a higher-quality workforce and experience reduced staff turnover. This enhances workplace productivity.
- For the community: The results should include reduced traffic congestion; a larger tax base (both short-term and long-term); and a positive effect on long-term operating costs by supporting smart growth principles.

We see that the core underlying principles of community-based mortgages are financially sound. They balance the risks and incentives among all parties, with the ultimate beneficiary being the community itself. These types of programs not only reduce the threat of a financial crisis, but could help communities discover their leverage mean by balancing individual and public participation in real estate ownership.

In addition to a sound foundation, the community-based approach often includes safeguards to protect against destructive leverage. We have seen examples such as shared equity mechanisms and silent second mortgages that balance individual and public investment incentives and that contain self-sustaining aspects, thereby supporting long-term objectives of the specific programs. These efforts often support smart growth initiatives as well. Another example is the

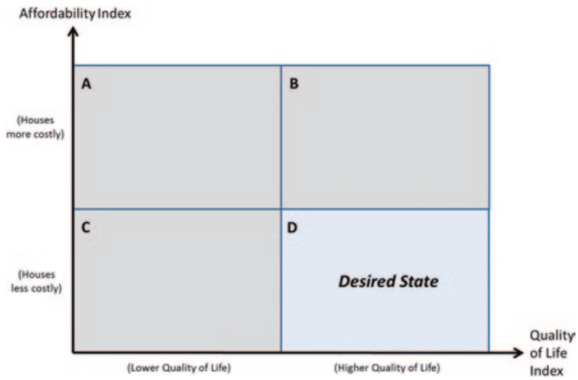


Fig. 1 Affordability versus quality of life matrix

homeownership education and counseling aspects that are sometimes a part of these programs. The community offers education to its members, coupled with community mortgage assistance, which helps strengthen the financial foundation of its citizens and reduces the risk of families failing financially. Additionally, many community-based programs contain qualifying criteria and/or limits on the percentage financed that provide inherent safeguards as part of the program's structure.

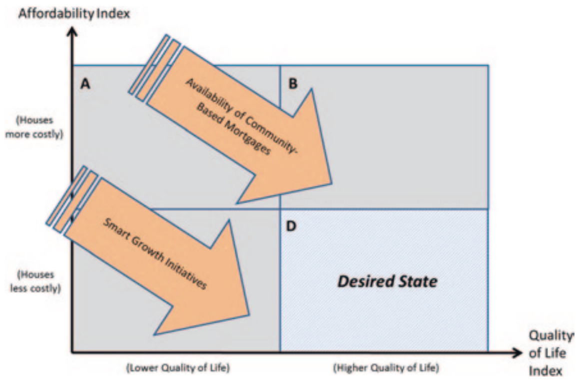
Implications for the Future

So we have observed how the use of community-based mortgages has increased over the past 10–15 years in tandem with the increased use of leverage as a dominant theme in society in general. But what does this tell us about the future? What are the implications of the community-based approach as we look to the future?

In order to frame the argument where we believe the notion of leverage will guide municipalities in the future, consider two key factors that drive the "health" of a city: affordability of housing and "livability" or quality of life. To help illustrate the relationship of these factors, we will reference Fig. 1.

On one axis, the Housing Affordability Index provides a measure of the cost of a home relative to the typical family's income. More specifically, the index is a gauge that represents the ability of a family earning the median income to qualify for a mortgage on a median-priced home. As this number increases, housing becomes less affordable to the average family. On the other axis is the Quality of Life Index. Quality of life is a measure that was developed by The Economist Intelligence Unit in 2005, using a methodology that links the results of subjective life satisfaction surveys to the objective determinants of quality of life across countries (The Economist Intelligence Unit 2005). A higher value for the Quality of Life Index represents a better quality of life, according to the methodology. Note that up to this point, the quality of life has been calculated for countries, not at the city level, so this index is theoretical in terms of American cities.

Fig. 2 Influence of community-based mortgages and smart growth initiatives



The absolute numbers of the indices are not important for our purposes; what is relevant is the relative measure of where a city or community sits on the continuum for the corresponding index. Clearly, municipalities would or should strive to be in quadrant D in the lower right of Fig. 1, which is labeled the "Desired State." Quadrant B offers a similar quality of life but is less affordable—out of reach of many families; quadrant C provides affordability but at the expense of a reduced quality of life; and quadrant A offers neither attractive affordability nor a high quality of life.

While there are many other factors that affect these measures, two key drivers to help move a city toward the desired state are the availability of community-based mortgages and the implementation of smart growth initiatives. The influence of these two factors is illustrated in Fig. 2. As the arrows depict, the presence of these types of programs will tend to move a city downward and to the right in the diagram. But it is not enough to simply move the needle in this direction; sustainability is critical or the benefits will be short-lived. We have seen above that the community-based programs provide sustainability by employing constructive leverage—offering long-term benefits and, in some cases, recyclable features. As such, the community-based approach does not only move cities in the right direction, but can help to keep them there.

As a building block used in conjunction with smart growth initiatives, we would argue that the community-based approach is not only desirable for cities, but will become essential in their growth, health, and viability. These programs should be a necessary part of any smart growth initiative to help promote affordability and to buoy quality of life. On an anecdotal basis, presenting at a recent DC Affordable Housing and Community Development Summit, Jeff Lesk of the Nixon Peabody law firm noted that one trend to watch in the affordable sector is public–private partnerships—developers doing more with fewer resources (Real Estate Bisnow 2013). Mr. Lesk's observation underscores the importance of resource leverage in the growth of urban communities.

Looking back at the diagram, if the Housing Affordability Index were to increase, we would need to see an increased use of community mortgages, otherwise the quality of life would suffer—moving the city in the upper-left direction toward quadrant A. We would argue that a city in this state was under-leveraged in terms of both financial and resource leverage.

So, where is the leverage mean? Communities must find the leverage mean by investing in a combination of smart growth and community mortgages, or they risk sacrificing the quality of life. If this happens, it would likely lead to negative population growth and reduced prosperity due to a smaller tax base. In other words, cities that do not employ constructive leverage could see a decline, while cities that do will be positioned for long-term growth. And each path is self-sustaining—both in a positive and negative direction. As Davidson describes in "The Overleveraged" Crisis of 2008 from the Standpoint of Keynes's Monetary Theory of Capitalism", government intervention uses leveraging to help create a leverage mean. Davidson goes on to note the fundamental role of leveraging, in establishing public policy, to promote full employment and economic growth. In this manner, individuals and businesses are better positioned to achieve a leverage mean with government intervention into the private sector. The case of community-based mortgages illustrates this point in that it is through these public–private–employer partnerships that communities can reach their leverage mean.

To further discussion, it will be helpful to define the "health" of a city or municipality as follows:

$$\text{Health of City} = \text{Quality of Life} + \text{Sustainability}$$

While *Health of City* is not a numerical measure, we can nonetheless look at it as a relative measure based on these other factors. It is intended to not only represent the present state of a city, but also embody implications for the city's future viability. Further analysis could be undertaken to quantify *Sustainability* based on factors such as infrastructure, financial condition, population growth, job growth, environmental programs, smart growth implementation, and utilization of community-based mortgages. One of the transformations we anticipate is an evolution by municipalities from using the community-based approach as purely an unconscious response toward sustainability, to a conscious, planned deployment of these strategies. Community-based mortgages will become an important tool for public policy-makers to safeguard the health of our cities and to guide them toward the leverage mean.

The community-based mortgage approach allows individuals to purchase homes without over-leveraging. It helps to promote affordability, livability, sustainability and should be a key component of smart growth initiatives. Our hypothesis is that the number of community-based programs and the participation level of the community will increase over time to promote healthy, vibrant cities by employing resource and economic leverage. In fact, we believe that American cities and metropolitan areas will need to act out of necessity—self-preservation—to work toward their leverage mean. Otherwise, they will be left behind and risk declining growth and reduced "health." If successful, these types of community-based programs can lead to an improved quality of life—both short term and long term—benefiting individuals and the future vitality of American cities.

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