A Shared Equity Mortgage

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Suppose you wish to buy a house for yourself and your family to live in. The usual procedure in contemporary western society is to go to a bank and apply for a mortgage to finance the purchase. Suppose the purchase price is $100,000. The bank may require that you make a down payment equal to 10 percent of the appraised value, which may or may not be the same as the purchase price. Let's suppose that the appraised value and the purchase price are the same, in which case the bank will require $10,000 down and will lend you the remaining $90,000. You will sign a mortgage contract, which will require you to make monthly payments over a period of years. Typically, home mortgages run for a period of twenty, thirty, or sometimes as many as forty years. The bank, of course, charges interest based on the amount of the unpaid principal. The rate of interest you are required to pay, and the time period of the loan will depend on the then prevailing market conditions.

Let's assume the bank agrees to give you a thirty-year mortgage for $90,000, at an interest rate of 8 percent per year. People usually prefer to make equal payments each month to amortize (repay) such a loan. In this case, the monthly payments would be $660.39. Each payment will consist partly of interest due and partly the repayment of principal. Since the interest is figured on the basis of the remaining unpaid principal balance, most of your early payments will consist of interest but as time goes on the interest portion of the payment will decline while the principal portion will increase.

A loan amortization table shows that, over the thirty-year term of the mortgage, you will pay the bank $237,740.40, or more than two and a half times the $90,000 you borrowed. The bank will have collected interest totaling $147,740.40. Now what happens if you miss a few payments? If you fail to make the payments as scheduled, the bank might add penalty payments or even take the house in foreclose and sell it house to recover the amount of principal and the interest you still owe. You may or may not recover any of your own investment depending on how much the house brings in the foreclosure sale. Since the bank's claim has priority over yours, it will probably not try very hard to get the best price. The bank is mainly concerned about recovering its own investment, not yours, so it may set the selling price low in order to liquidate the property quickly—leaving little or nothing for you to recover.

Now let's consider the possibility of an equity sharing arrangement. This is nothing new. During the thirteenth century, a time when laws against usury were strictly enforced, it was common practice among the Dutch banks to provide this sort of financing for business ventures. Some present day Islamic banks have been using a similar approach to provide a so-called "halal mortgage," one that is in accordance with Islamic law, rather akin to kosher in Jewish custom. This avoids usury by avoiding debt. Let's imagine a different kind of bank—a cooperative bank perhaps. Instead of making a loan and asking you to sign a mortgage contract, the cooperative bank takes a temporary equity share in your house. How does this work? How do you achieve full ownership, and how does the bank earn a return on its investment? Just as in the conventional debt arrangement, the co-op bank will require some down payment. That will be your initial equity share. Let's assume you make the same down payment as before, 10 percent, or $10,000. The co-op bank puts up the remaining $90,000. Now you and the bank are partners or co-owners. You own 10 percent of the house, and the coop bank owns 90 percent of the house. There is no interest to be paid on the co-op bank's capital—but if you occupy the house, you will be required to pay rent to the owners. Of course, since you are a part owner, part of that rent comes back to you. At the outset, the bank will get 90 percent of the rental payments, and you will get 10 percent. But you are also allowed to increase your ownership share at any time by making additional payments to the co-op bank—in effect, buying out the bank's interest in the house. As you do so, your proportionate share increases while the coop bank's share decreases and the distribution of the subsequent rental payments will change accordingly.

Let's compare this arrangement with the conventional mortgage in the example given above. The big question, of course, is what is a fair amount for the monthly rent? It might be reasonable to assume that it is equal to the monthly payments you would have made under the conventional mortgage arrangement—in this case, $660.39. At the outset, you will receive 10 percent of that rent as your ownership share and the co-op bank will receive 90 percent. Let us also assume that you apply your share of the rental payments to increasing your share of the ownership. My calculations show that, under this arrangement, you will own 100 percent of the house after making the 350th payment, or in twenty-nine years and two months. You will have paid total rent of $231,018.30. The bank's total share will have been $141,018.30. This is a saving of more than six thousand dollars over the amount of interest paid on the conventional mortgage. In percentage terms, this is a saving of a little over 4.5 percent. This may not seem like much, but as we shall see when we compare this approach with conventional mortgages carrying higher interest rates, the savings can be quite substantial. Additionally, if the "fair rent" had been set at a lower level, but you had made the same monthly payments of $660.39, you would achieve full ownership of the house more quickly and would have saved yet more relative to the total interest payments on the conventional mortgage. However, the more important advantage derives from the risk sharing inherent in the shared equity approach. Under this arrangement, if you are unable to make the additional principal payments, you will not be foreclosed—you simply do not add to your ownership share. If you are unable to pay the rent, however, your equity share will diminish accordingly; and at some point, perhaps when your equity share falls below a certain percentage, you could be required to vacate the house, just as if you were renting from anybody else— but you would not lose your ownership equity. When the house is rented to someone else, you would still receive your share of the rent, or if the house were to be sold, you would get your share of the proceeds based on the percentage of the equity that you own at the time of sale. Of course, since the co-op bank's claim does not take priority over yours, it is in the best interests of both you and the bank to try to get the highest price possible from the sale.

Compared to the conventional mortgage debt, the relationship between you and the co-op bank is amicable rather than antagonistic and your interests are congruent rather than opposed. The conventional mortgage tends to be exploitative. It creates conflict, stress, and insecurity while contributing to greater disparities of income and wealth—the rich get richer and the poor get poorer. The shared equity financing (or halal mortgage), however, reduces conflict, stress, and insecurity, and makes for a more harmonious and equitable society.

To fully appreciate the advantages of the shared equity approach, we need to examine the numbers pertaining to higher conventional mortgage interest rates. Table 20.3 below shows the figures for conventional mortgages at various interest rates (6 percent, 8 percent, 10 percent, and 12 percent) along with the figures for comparable halal mortgages. It can be seen how seemingly small changes in the interest rate cause huge increases in the amount of money you must pay back. At 12 percent interest, for example, you will repay $333,270.00 on your $90,000 loan over thirty years, giving the bank interest income of $243,270.00. However, a shared equity or halal mortgage with the same monthly payment of $925.75 would give you full ownership in twenty years and ten months. The total rent shares to the co-op bank would be only $141,323.14, saving you over $100,000.

Conventional Mortgage						
Comparative figures for different interest rates						
30 year conventional mortgage: $90,000 principal; $10,000 down						
Interest rate	Monthly payment	Total payback	Total interest paid	Number of payments	Time to complete payback	
6%	$539.60	$194,256.00	$104,256.00	360	30 yr	
8%	$660.39	$237,740.40	$147,740.40	360	30 yr	
10%	$789.81	$284,331.60	$194,331.60	360	30 yr	
12%	$925.75	$333,270.00	$243,270.00	360	30 yr	
Shared Equity ("halal mortgage" or "equity mortgage")						
$90,000 initial bank equity (90%); $10,000 initial buyer's equity (10%)						
Buyer's share of monthly rent applied to repurchase of bank's share						
	Monthly rent	Total payout	Bank's share of rents	Number of payments	Time to complete buyout	Savings relative to conventional mortgage
	$539.60	$230,879.35	$140,879.35	428	35 yr 8 mo	($36,623.35)
	$660.39	$231,018.30	$141,018.30	350	29 yr 2 mo	$6,722.10
	$789.81	$231,167.29	$141,167.29	293	24 yr 5 mo	$53,164.31
	$925.75	$231,323.14	$141,323.14	250	20 yr 10 mo	$101,946.86

Table 20.3 Comparison Between Conventional Mortgage and "Equity Mortgage"

The reader may note from the chart that at an assumed mortgage rate of only 6 percent you would end up paying more for equity mortgage financing than for the conventional mortgage. This is partly the result of the assumptions we are making about the amount of a fair market rent. Setting it to be the same as the monthly payment on the conventional mortgage may not be realistic in all of these cases. However, the greater total payment to the co-op bank is mainly due to the fact that with the lower monthly payment assumed in this case you would have taken considerably longer to repay the co-op bank's share—thirty- five years and eight months, as opposed to an even thirty years for the conventional mortgage. For those who might care to pursue this possibility further, it would be instructive to run the numbers for a conventional mortgage of that same duration (instead of 30 years), and further, to make some similar comparisons based on actual rental market data.