Contracts That Offer Homeowners Cash for Home Equity Can Be Riskier Than They Look

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Homeowners in the United States collectively have billions of dollars of equity in their homes. But the recent COVID-19 crisis has left many desperate to use that equity to pay bills or resolve a mortgage delinquency. Older homeowners who have paid down their mortgages and have a lot of equity are also at risk. The traditional way to turn home equity into cash, without selling the family home, is to get a home equity loan. There are many different kinds, including home equity lines of credit, second mortgages, and cash-out refinancing.

Some companies claim a new product can help people tap their equity without a loan. There is no standard name for this new product. It can be called shared equity, shared appreciation, or even a home equity investment. Here, we call it an "equity product." Whatever it's called, policymakers should protect homeowners from those who may abuse it.

Equity products go by many names and vary widely. But it's the details that matter. If the contract requires the homeowner to turn over too much of the equity, it's not a wealth-building product. While some products may expand cash-out or home retention opportunities, they may also prevent homeowners from refinancing when interest rates go down or result in unaffordable balloon payments.

Equity products are different from traditional home equity loans.

In a traditional home equity loan, a lender provides the homeowner cash up front, and the homeowner promises to repay it in installments, no matter what happens to the value of the home. If the homeowner defaults, the lender can foreclose and recover the amount owed by selling the house. In some states, the lender can also sue the borrower for any remaining balance. Laws regulating consumer mortgages protect homeowners from certain unfair lending practices, and many states regulate foreclosures carefully.

Now, companies are offering homeowners money up front in return for a share of the home equity they expect the homeowner to have in the future—instead of a fixed amount of principal plus interest. These equity products are offered to homeowners who might otherwise seek a traditional home equity loan or reverse mortgage. The homeowner is not required to make any payments until a deadline set by the contract and then must pay the company a percentage of the equity that accumulated during the term of the contract.

For example, if the home is worth $200,000 at the beginning of the contract and $500,000 at the end of the contract, the homeowner would be required to pay a percentage of that $300,000 of new equity. Companies often advertise that the transaction is not a loan and that the homeowner will not owe anything if the home loses value, but the contract terms may conceal important surprises. **In practice, these contracts are closer to old-fashioned bullet loans.**[1]

In contrast, some lenders—including non-profit affordable housing programs—offer equity products to help finance a home purchase. For example, the lender may cap the future sales price of a home to make it affordable for the next buyers. Or the lender may take a share of the equity to fund its operations and loans for other families. While some of the same issues may apply to home purchase products, this issue brief focuses on products used by existing homeowners.

What happens if the homeowner can't pay when it's time?

When the time comes (at the end of the term or sooner), the homeowner must pay the company a share of any accumulated equity. Most people will do so in one of three ways: by selling the home, by using money from savings, or by getting a traditional mortgage. If the homeowner does not or cannot do any of these, the contract may authorize the company to sell the home out from under the borrower.

Because these contracts do not treat the transaction as a loan, the company will not follow state foreclosure laws. But for the homeowner, the end result is the same as a foreclosure—the homeowner gets evicted.[2]

How much equity can the company take?

The equity owed depends on how much the homeowner is willing to sell. Homeowners may be attracted by a large payment now in return for a percentage of equity to be paid later. But when the time comes, that may leave the homeowner owing far more than they originally received. One court refused to void a 50-year contract transferring 100% of the future increase in value.[3] And another court enforced a contract that gave the funder a 2,000% return on the amount initially paid to the homeowner.[4] This is a problem if the homeowner is counting on using the equity to do something else—such as buy a new house, pay for assisted living, or fund retirement.

Do existing consumer protections or disclosures apply?

Whether protections apply depends on whether these transactions are considered mortgage loans. Because mortgage loans are complicated, state and federal laws require lenders to provide disclosures that summarize and emphasize the most important terms to help the consumer understand how much the loan will cost, how long it will last, and whether they can get a better deal somewhere else. There are also extensive federal and state laws restricting certain abusive loan terms and lending practices.

But some purveyors of equity products claim they are not making loans and that mortgage laws do not apply. Without the application of mortgage laws, consumer protections are far more limited, despite the extreme complexity and risk in these transactions.

Are they loans or not?

Some companies say the transactions are not loans because the contract does not require the consumer to pay them anything if the property value goes down. But companies may limit these products to homes that are highly likely to increase in value. As a result, it's almost certain that the consumer *will* have an obligation to pay. From the consumer's perspective, they are very much like loans—the consumer gets money upfront and must expect to repay it later. Whether applicable laws currently define these products as loans or not should not determine whether consumers are adequately protected from complex and potentially abusive transactions with risks that are hard to spot.

RECOMMENDATIONS

Because these contracts are so complex, it's hard for consumers to spot the risks or unfair terms. These transactions also exploit aspects of consumer psychology that can trap even financially sophisticated people.[5] Caveat emptor will not work here. State and federal policymakers should take the following steps to protect homeowners:

- Subject these contracts to the same protections as traditional mortgages, an especially important measure if they are marketed to particularly vulnerable homeowners, such as the elderly or those desperate to avoid a foreclosure.
- Place a dollar cap on how much the homeowner will owe. Doing so will make the cost clearer and facilitate accurate disclosures.
- Mandate a clear and prominent explanation of whether the homeowner can be forced out of their home for non-payment.
- Require the funder/lender to give the homeowner a new, market-rate mortgage at the end of the contract term if the homeowner cannot otherwise repay the debt.
- Ban forced arbitration in these contracts.
- Prohibit excessively long contracts, especially if there is no dollar cap on the repayment obligation.
- Mandate disclosure of the important terms of the contract, including an APR or other cost measurement.

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Endnotes

[1] "A type of loan whose principal . . . must be paid in one single payment when the period of the loan ends." Cambridge Business English Dictionary (online).

[2] See discussion below about whether these products are loans. Also note that if mortgage laws wouldn't apply, eviction laws would probably still apply.

[3] Foster v. EquityKey Real Estate Investments, 2017 WL 1862527, at *2 (N.D. Cal. May 9, 2017).

[4] Comstock v. Steinbergh, 2004 WL 3120554 (Mass. Super. Dec. 16, 2004).

[5] Specifically, these contracts exploit hyperbolic discounting, "the tendency to overweight the immediate consequences of a decision and to underweight those that will occur in the future, mak[ing] it difficult for consumers to make rational disclosure decisions." Ari Ezra Waldman, Cognitive biases, dark patterns, and the 'privacy paradox', 31 Current Opinion in Psychology 105 (2020).