EQUITY ASSURANCE

Leonard S. Rubinowitz

September, 1977

410 North Michigan Avenue
Chicago, Illinois
(312) 644-4469

Woodstock Institute Chicago, Illinois

About the Author

Leonard S. Rubinowitz is an Associate of the Woodstock Institute. The Woodstock Institute is a non-profit organization which conducts research, training and education for the public, private, and voluntary sectors about ways to ameliorate disparities in the availability of capital and credit.

Leonard is also an Associate Professor of Law and Urban Affairs at Northwestern University. He received his B.A. Degree from the University of Wisconsin at Madison in 1965 where he majored in history, and his L.L.B. from Yale Law School three years later. Prior to his coming to Northwestern he served as Special Assistant to the Regional Administrator of HUD Region V. In his capacity as a Field Associate of the Brookings Institution since 1975, he has analyzed Housing Assistance Plans from the Chicago metropolitan area for a study that is being conducted by that institution. He is the author of Low Income Housing: Suburban Strategies (Ballinger Publishing Company, 1974), and numerous law review articles having to do with housing and urban affairs. He was part of a team that conducted research and strategy identification for the Illinois Governor's Commission on Mortgage Practices in 1974, and is the co-editor of a set of working papers used by the Commission entitled "Mortgage Lending Practices in Older Urban Neighborhoods" (Center for Urban Affairs, Northwestern University, 1975).

EQUITY ASSURANCE PROGRAM

Summary

This is the fifth of a series of papers analyzing publicly initiated reinvestment strategies.

A family's home usually represents its single largest investment. For this reason, people buy insurance whenever possible to protect them against perils -- fire, flood, vandalism, etc. -- that may threaten the value of their home.

In recent years, businesses and some government agencies have recognized that in addition to physical hazards there are economic perils which may affect the resale value of a home. For this reason, many businesses have programs to assist employees who are being transferred in selling their homes. In some cases, an employee's company will even buy the home at its fair market price, and then resell it in a timely fashion after the employee has departed for a new assignment. The employee is then able to purchase a new dwelling with the equity from his old residence while the company waits for a reasonable offer on the old home. The Department of Defense has a program to guarantee up to 95 percent of an employee's equity in the event of military base closings. Both of these programs remove some of the anxiety that homeowners have about the potentially negative consequences of economic perils.

With the advent of open housing laws, and the gradual but nonetheless steady erosion of the discriminatory dual housing market, white homeowners in neighborhoods that have been undergoing integration or racial transition have often quickly

sold or disinvested in their properties based on their fears of racial change.

Communities which want to obey open housing laws, but avoid the economically and socially negative consequences of total resegregation, have long sought ways to assure white homeowners that their property values will not be adversely affected by integration unless whites panic and move in numbers great enough to depress the market. Since the basic element in the resegregation process is <u>fear</u> of economic loss, some communities have proposed programs to insure -- or "assure" -- homeowners and potential homeowners that if they remain or purchase property in racially integrated areas, they will suffer no catastrophic economic loss upon resale.

The community of Oak Park, Illinois -- an older suburb which shares an eastern border with the city of Chicago -- described its reasons for proposing an equity assurance program in the following manner:

> The Equity Assurance Program is an attempt to deal with fear -- specifically economic fear -- that when non-whites integrate a community, property values will decrease. This fear is not necessarily based on fact, but on a pre-conceived notion that this is true... To put it simply, if one can insure his home against various physical perils, and do so quite routinely, one ought to be able to insure it against economic perils as well. This concept is especially significant because, although loss through physical perils may cause difficulties to the person who experiences it, it is generally an isolated loss with relatively little effect on the rest of the community. Economic perils, on the other hand, whether real or illusory, have a "ripple" effect through a community, causing extreme instability.*

*Village of Oak Park, Illinois, Application for Federal Assistance, Department of Housing and Urban Development, Innovative Projects Proposal - FY 76 (June 1, 1976), pp. 1,2.

In this paper, the author discusses the mechanics of equity assurance, its potential benefits as well as abuses, and describes the kinds of neighborhoods in which it might contribute to stabilization.

EQUITY ASSURANCE PROGRAM

An Equity Assurance Program is a way of insuring homeowners against economic loss of the value of their homes. One community which is considering adopting such a program defines the purposes of equity assurance as follows:

> (1) To deal with fears of economic loss of present and potential home owners;
>
> (2) To provide for greater community stability by establishing a guarantee system on the sale of single family homes;
>
> (3) To strengthen the tax base of the community by use of the guarantee system to preserve and improve single family home values; and
>
> (4) To recognize the special character of the single family residence in the total social and economic health of a community.[1]

The purpose is to insure that people buying homes in older neighborhoods or racially changing neighborhoods do not suffer a loss of property values when they eventually sell those homes. Even if there is evidence that property values are not decreasing in the areas involved, the fear of such a loss may reduce the market for housing in a particular neighborhood or community. This fear in itself can become a self-fulfilling prophecy and result in a negative effect on the property values of homes in the area.

The Equity Assurance Program attempts to maintain the confidence of buyers and owners of homes by guaranteeing the resale value of homes in the area. If people have confidence that their property values will be protected through an insurance policy, then the property values in the neighborhood or community should be stabilized since there will be a continuing market for the housing.

The financing of an Equity Assurance Program involves basically two parts. The first portion involves the administrative functions. These include the development of the program and marketing survey, research and development, legal activity (including a judicial determination of the legality of the program), and general administration. The second cost of the program involves the insurance function itself, establishing a substantial claims fund and perhaps purchasing re-insurance.

With regard to the administrative cost of the program, funding might be secured through a variety of sources. Local tax money or state and federal grants might be sought. Private foundation grants might also be available for the research and development of such a program.[2]

The participants in an Equity Insurance Program could include individual homeowners, state or local governments and private insurance companies. The individual homeowners would purchase equity insurance (or assurance) just as they would purchase insurance against other kinds of losses to their homes. The state or local government could provide the insurance itself through property tax, state or local bonding authority and/or federal or state grants. In other words, the insurer could be a state or local government. Alternatively, the insurance could be provided by a private insurance company which would underwrite this new form of policy.[3] Other sources of funds for the payouts could be private foundations and other charitable sources which are concerned about preserving neighborhoods and communities and see this program as a way of helping to maintain confidence in these areas.

If the insurance was to be provided by private insurance companies, the state or local government might participate through a master policy, with part of the cost paid with state or local tax funds.[4] In order to secure the cooperation of the insurance industry, it might be necessary to provide re-insurance by a governmental entity, at the federal, state or local level. Providing this re-insurance would help to make the insurance available at reasonable rates.[5] It would also enable the governmental entity to influence the insurance rates and conditions and to guarantee that there would be equal access to this equity assurance without discrimination based on race or location of the home. State or local goverments might thus play a significant role in developing and implementing such a program even if the insurance is provided by private insurance carriers. The public role would both provide continuity and also indicate to the community that the state or local government is responsive to the the needs of the neighborhoods or communities involved in the program.

In order to determine the probable cost of such a program, it would be necessary to conduct market surveys. It seems likely that the cost could be covered by modest premiums that would be within the means of even the lower income homeowner, especially if the cost of the premium is based on the insured value of the home. This seems likely because the risks which are insured against are not likely to be substantial if the housing is physically sound. Even though these risks may seem very significant to the homeonwers involved, the existence of the insurance program itself would remove most of the risk by removing the fear of buying in an area that could become a self-fulfilling prophecy leading to the lowering of property values.

Under an equity assurance program, any homeowner who wished to secure equity assurance would have an appraisal made of the home at the time of securing the insurance. That appraisal would establish the value of the home for insurance purposes.[6] The insurance would provide protection when there was a loss in selling the house. The loss would be measured against the appraised value of the house. Generally, a percentage of the loss, such as 80 percent, would be insured. For example, if the appraised value of a home was $ 30,000 and it was sold for $ 27,000, the insurance might provide the seller with a payment of $ 2,400, or 80 percent of the difference between the $ 30,000 and the $ 27,000. Once the appraisal was made and the appraisal fee was paid (either by the homeowner or the state or local government), the insurance would go into effect.

The program could also provide an opportunity for a reappraisal of the home either because of inflation in home values or because of improvements made by the owner.[7] In either case, the new appraised value probably would be subject to the same kinds of conditions as were imposed initially, although it might not go into effect for several years after the reappraisal. The program could use the appraisal fee as a way of providing an incentive for property owners to make substantial improvements on their homes. Homeowners might be charged a reduced application fee for the reappraisal if the request for the new appraisal is due to substantial property improvements.

The state or local government might stipulate that it be given the right of first refusal, i.e., the right to buy the home from the applicant at the price he received his equity assurance.[8] This would provide a safety factor for the government in cases where it is in its best interest to acquire the home directly, presumably for purposes of resale.

The equity assurance approach presents opportunities for abuse if additional protections are not built in. For example, there could be a quick move-in and move-out situation or a quick move-in, quick loss situation if protections are not built into the program. Since the purpose of such a program is to contribute to stabilization of neighborhoods, there might be a specified period after the insurance was obtained before the guarantee could be activated.[9]

Once the homeowner obtained an insurance policy there could be a five year period before the insurance would become available in event of sale. In addition, the program might include a waiting period from the time the home is placed on the market to the time the guarantee, if it is necessary, is paid. This waiting period could be in the three to four month range. This would insure that the homeowner would take full advantage of the normal market mechanisms to sell the house at the maximum price available.

An additional condition could be that the insurance benefits would not compensate the homeowner for losses due to the homeowner's own negligence or lack of maintenance.[10] This limitation could be implemented by an appraiser inspecting the home at the time of settlement. If there was significant loss of value due to negligence or lack of upkeep by the homeowner during the period while the policy was in force, this diminution in value would be subtracted from the value of the home for insurance purposes before determining whether there was a loss on the sale that was covered by the equity assurance.

The equity assurance approach has been used or considered in a variety of situations. The department of Defense Home Owners Assistance Program guarantees up to 95 percent of the home ownership equity for Department of Defense civilian employees whose equities are adversely affected by the closing of military bases.[11] Second, some urban universities have provided this kind of insurance for faculty members purchasing homes in the area surrounding the university. Third, some corporations have adopted this kind of program for executives who are being transferred. The company guarantees that the executives will not lose money on the sale of their homes even if it becomes necessary for the company to purchase and resell the home.

Among state and local governments, the Village of Oak Park, Illinois, has given perhaps the most serious consideration to establishing an equity assurance program. Oak Park is a suburb immediately adjacent to the west side of the City of Chicago. Much of the impetus for an Equity Assurance Program there came from concern about possible declines in property values on the eastern edge of Oak Park, which is next to a predominantly black community in Chicago.

The Oak Park Program was proposed by "First Tuesday," a women's discussion and action group with a membership of around 60 women. "First Tuesday" presented the Equity Assurance Program to the Village's Community Relations Commission in 1973.[12]

If the Oak Park program is ultimately enacted, it will make use of an appropriation already made by the Village Board. In 1976, the Board appropriated $100,000 of municipal funds for the development of an equity assurance program. This was seen as an initial appropriation with the possibility that additional appropriations might be necessary depending on the volume of the applicants once the program was started. The Oak Park proposal also contemplates raising funds through a direct tax levy of approximately 1% of a property owner's real estate tax.[13]

As of the middle of 1977, the Village was drafting a policy for an Equity Assurance Program. Support for the Equity Assurance approach in Oak Park has come from insurance carriers, bankers and real estate sales people. On the other hand, citizens have shown relatively little interest in the program. This is largely because the housing market has substantially improved since 1973, when the program was first conceived. At that time there was less confidence in the stability of certain neighborhoods on the East end, and an equity assurance program was viewed as being necessary to instill confidence in residents and prospective purchasers in those neighborhoods.

In general, equity assurance has been used to date only for specialized purposes by the federal government and the private sector. However, state and local governments are beginning to consider it as a tool for neighborhood stabilization. As one housing official in the Northeast recently noted, "The incentive for the federal and state governments to provide such insurance in addition to existing mortgage insurance is substantial: it would curb both the incentives of existing owners to sell quickly, as well as prevent newer owners from abandoning property because they feared their amortization payments were not building up their equity."[14]

The program seems to have the greatest potential in neighborhoods where the housing is structurally sound, but where there is concern about the potential economic impacts due to racial change. In these situations, equity assurance may alleviate some of the fears about the "inevitable" decline of property values, and thereby prevent the self-fulfilling prophecy that can result from such fears.

Footnotes

1 Oak Park Village Views, Village of Oak Park, July, 1975, p. 1.

2 Yarmolinsky, Adam, "Reassuring the Small Homeowner," The Public Interest, p. 110.

3 Ibid.

4 Ellis, Lee A., Oak Park, Illinois Village Manager, as quoted in Jedlicka, Albert, "As Oak Park Integrates, Real Estate Stays Stable," Chicago Daily News (March 5, 1976).

5 Yarmolinsky, p. 110.

6 A more conservative way of establishing the value of the home would be to take the lower of two values: the market value or the sum of the balance due on the mortgage plus the amount the owner has actually invested in the home. See Yarmolinsky, p. 107.

7 Village of Oak Park, Illinois, Application for Federal Assistance, Department of Housing and Urban Development, Innovative Projects Proposal - FY 76 (June 1, 1976), p. 4.

8 Ibid.

9 Ibid., p.3.

10 Yarmolinsky, p. 110.

11 Department of Defense Home Owners Assistance Program, Public Law 89-754, Section 1013, passed November, 1966.

12 "Proposal for An Equity Assurance Plan," First Tuesday, (May 24, 1973).

13
Ibid., p. 1.

14
Goetze, Rolfe, *Building Neighborhood Confidence*, Cambridge, Massachusetts: Ballinger Press, 1976, pp. 62-63.