DEBT-FREE RESIDENTIAL REAL ESTATE FINANCE

Introduction to active and passive equity

In finance, there are users and providers of finance. With debt transactions, these roles are clear, the debtor is the user of finance and the creditor is the provider of finance.

With traditional equity, this distinction between the users and providers of finance is less clear and this leaves out interesting potential for equity as an asset class.

Active and passive equity are complementary in nature and are introduced to capture synergies between users and providers of equity finance.

The active equity holder typically is a user of finance, with interests to control or operate assets or activities.

The passive equity holder is a provider of finance, seeking investment returns (in whatever form) and an exit from the investment proposition over time, without interests to control and operate assets or activities. Whereas debtors *must* pay off their debt to creditors, active equity holders *have abilities* to buy out passive equity holders.

Active and passive equity can substitute debt and facilitate debt-free finance.

Context

One of the main challenges of residential real estate finance is that a relatively large amount of debt is taken on by people (in an early stage of life), typically with amounts that equal multiple annual incomes. Such indebtedness, in the context of adverse changes in housing prices, employment or income conditions, partner relationships, mobility requirements, interest rates and the economic situation in general can seriously affect the quality of life, plans of family expansion or even make life financially unbearable.

As a result, many (potential) home buyers, especially from poorer economic backgrounds, avoid at least part of debt associated risks and abandon part of their socioeconomic potential.

Debt-free real estate finance example with active and passive equity

It is very well possible to buy (residential) real estate with debt-free finance if we would use active and passive equity. The following example clarifies.

Suppose you have 20% of means to buy a house and need an additional 80% in funding. Instead of taking a bank mortgage, you take a 20% active equity stake in this house and become an active equity holder with exclusive rights to use 100% of the house.

Say, a pension insurer, through a liquid fund structure, can become an 80% passive equity investor in this house, given that the active and passive equity stake have to add up to 100%. As passive party, the pension insurer receives rental income (determined by a mutually agreed third party) for the part of the passive equity stake in the house.

The active equity and passive equity holders can agree that the active equity holder is allowed to buy out the passive equity holder, every quarter, with 1% of the value of the house. This means that the active equity holder can become 100% owner of the house in 20 years (80 quarters), without the need of ever being indebted. This provides a lot more socioeconomic flexibility and takes away 'debt worries'.

Price volatility becomes less relevant in building up wealth, as wealth is built-up relative to price levels, making wealth accumulation more secure, both for the active and passive equity investor, also in shorter periods of time with adverse price movements.

As a liquid fund structure can hold a certain number of real estate objects, risks can be diversified. Flexibility can be built in to provide liquidity in times of need. It could be established that in times of (personal) economic prosperity, more could be paid off than the 1% per quarter. In more challenging times or after retirement, it could become possible to sell active equity and convert it into passive equity, releasing cash from the value of the house.

The liquid fund structure also makes the investment exposure liquid to the passive equity investor. The passive provider of finance is exposed to the real economy and as such obtains natural inflation protection by remaining invested in the house during exposure.

Moreover, the portion of rental income ensures positive purchasing power returns.
The pension insurer, which is to provide coverage for future long term housing expenses can achieve more aligned income streams with its investment objectives, avoiding credit risks from debt investments and volatility from traditional (leveraged) equity investments.

A bank or other financial institution could be a mediator, structurer, contract manager, third party valuator or market maker for (debt-free) active and passive equity investment solutions.

While the bank or financial institution loses interest income, there is no more balance sheet to hold and with it, costs and risks to maintain a balance sheet with capital and liquidity disappear, just like traditional credit and counterparty risks. Instead, the bank will earn more on mediation and structuring activities, contract management and other services, which have more value added features without the speculative features that interest based income streams typically bring along. It will change society's perspectives of banks and with it, banks' social license to operate.