

## An Affordable Homeownership Strategy That Promotes Savings Rather Than Risk

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With contemporary political discourse extremely polarized, policies that would expand homeownership opportunities are appealing because they are attractive to liberals and conservatives alike. They stimulate the economy, promote racial and ethnic unity, and enable more Americans to share in the risks and rewards of our unmatched system of market capitalism. Both the Clinton and Bush administrations embraced the goal of expanding home-ownership. Evidence of this proposition is that there is little practical difference in the Clinton administration's 1995 goal of achieving an all-time-high national homeownership rate by 2000 and President Bush's goal of increasing the number of minority homeowners by 5.5 million by 2010.<sup>1</sup> Because the white rate of homeownership is very high relative to minority homeownership rates, it is virtually impossible to raise the national homeownership rate without disproportionately increasing the number of minority homeowners.

Notwithstanding broad bipartisan agreement on the value of homeownership, significant debate remains on the most appropriate means of achieving this goal. One possibility is to reduce wealth constraints by eliminating down payments. Another way to increase affordability is with nontraditional mortgage products, such as interest-only loans or adjustable-rate mortgages that start with lower payments than a traditional mortgage and count either on a borrower's income rising over time to keep up with rising payment requirements or continued market appreciation of the home in order for the homeowner to accrue equity. For example, interest-only loans, on which no principal payments are made to pay down the mortgage debt, made up nearly one-third of mortgage originations during 2004 and 2005.<sup>2</sup> While these products address the right problems, they do so in the wrong ways for low- and moderate-income families.

While no-down-payment and other risky loans<sup>3</sup> make it easier to buy a home, they also drive up default rates, increase foreclosures, and possibly trigger neighborhood decline.<sup>4</sup> According to one estimate, of the 7.7 million households that took out adjustable-rate mortgages in 2004 and 2005 to buy or refinance, "up to 1 million could lose their homes through foreclosure over the next five years because they won't be able to afford their mortgage payments, and their homes will be worth less than they owe."<sup>5</sup>

A better way to deal with the wealth constraint is to help individual households save for a modest down payment by promoting savings incentives as a part of homeownership policies. With research confirming that low- and moderate-income households positively respond to savings incentives the same way that higher-income households do, this policy reform should enable buyers to move into their homes with an equity stake from day one. Down-payment savings initiatives, financial literacy programs, and homeownership counseling target individual homebuyers, comprising the first part of a two-part homeownership strategy for the twenty-first century. The second part, which focuses on the market, builds

upon recent advances to help lenders sell more affordable housing loans into the secondary market, which would generate billions of dollars for new mortgage lending to underserved populations.

To better appreciate my strategy, it is important to understand recent changes in the demographics of homeownership, the resultant developments in affordable housing finance, and homeownership's role in democratizing capitalism and building household wealth, all of which I discuss here. I then examine past and current homeownership policies, including the two reform suggestions just mentioned.

## RECENT HOMEOWNERSHIP GAINS

During the 1990s a perfect storm of favorable demographics, unparalleled economic growth, and low interest rates combined with an aggressively supportive public policy environment to propel national homeownership rates to record levels. Historically low interest rates sustained housing's bull market through the recession that ended in the fourth quarter of 2001, while rising home prices boosted consumer spending through the so-called wealth effect. But what is most notable about this housing boom is that it was led by gains in the affordable housing sector and among minorities, thanks in part to the widespread adoption of "affordable" mortgage products. These mortgages follow flexible underwriting guidelines that feature lower down payments, higher debt-burden limits, lower cash reserves, and nontraditional means of verifying creditworthiness. Flexible underwriting is important because it helps address barriers to homeownership among nontraditional borrowers.

From 1993 to 2003 home purchase loans grew almost six times faster to Hispanics than to whites, four times faster to Asians, and twice as fast to African Americans. At the same time, loans to low- and moderate-income (LMI) buyers doubled, while loans to higher-income borrowers rose by 88 percent. Importantly, conventional loans to LMI borrowers grew by 150 per-cent, compared with a 25 percent increase in government-guaranteed originations.<sup>6</sup> This means that these gains were driven much more by effective market demand than by federal subsidies.

Mortgage lending to underserved populations is on the rise because the changing demographics of the country and best business practices demand it. Minority homebuyers, once a submarket forged out of the fires of federal antiredlining mandates, are a critical component of the mortgage industry's core business. Redlining refers to a time "when it was not uncommon to walk into a bank that had maps with red lines on them indicating areas in which the bank would not lend, due either to the racial or economic make-up of the indicated community." This practice of redlining is what the Community Reinvestment Act (CRA) was intended to stop.<sup>7</sup> The minority share of the U.S. population, 26 percent in 2000, is estimated to reach 34 percent by 2020,<sup>8</sup> and 90 percent of the country's projected population growth through 2050 will consist of minorities. In short, the combination of public policies and business realities has fundamentally altered home lending practices for the better.

For the decade 1995–2005 minorities accounted for just under half of the 12.5 million new homeowners.<sup>9</sup> Despite impressive gains over the last decade—the percentage of black homeowners went from about 43 percent to more than 48 percent, and Hispanic homeowners from 42 percent to almost 50 percent—at the end of 2005 these groups still lagged behind white homeowners by nearly 25 percentage points.<sup>10</sup> Nevertheless, the 12 million African American and Hispanic households expected to enter the home purchasing market over the next five years will account for as much as 80 percent of all first-time homebuyers. Homeownership policies must recognize and build upon this new market-based reality.

## THE IMPORTANCE OF HOME EQUITY IN HOUSEHOLD WEALTH

Homeownership is not just about building wealth. Surveys also find that families who own their homes tend to be more stable and satisfied with life.<sup>11</sup> Nevertheless, because of its significant potential to generate large returns on small amounts of invested capital, homeownership plays a powerful role in helping families secure their financial futures. Historically, Americans have always held an enormous amount of their collective wealth in their homes; in 2002 this was a staggering \$7.6 trillion, which translates to an average equity per homeowner of \$104,000.<sup>12</sup> However, since the high-tech meltdown in 2001, when stock portfolios lost \$1.4 trillion in value, housing's relative importance in household portfolios has grown considerably. With housing out-performing the rest of the economy, home equity grew by more than \$405 billion from 2001 to 2002. Among homeowners who also hold stock, 66 percent had more home equity than stock wealth in 2002, an increase of 5 percent from the previous year.<sup>13</sup> Moreover, the recent run-up in housing prices has pushed home equity levels even higher, to more than \$11 trillion at the end of 2005.<sup>14</sup> While rising interest rates and excess inventories in the first three-quarters of 2006 have dampened price increases and in some of the hottest markets led to falling prices and reductions in home equity for some more recent buyers, at the end of this down part of the cycle, homeownership will likely retain its prominent role in household wealth portfolios.

Home equity has been especially important to those households at the bottom quintile by income. For homeowners in this group, the median net wealth in 2001 was \$68,000, while that of similarly situated renters was only \$500.<sup>15</sup> "Among these owners, home equity accounted for 80 percent of their net worth, compared with 48 percent for owners in the middle quintile and 26 percent for those in the highest quintile."<sup>16</sup> Home equity represented more than one-half of net wealth for moderate-income, African American, and Hispanic households.<sup>17</sup>

While the recent narrowing of the black-white wealth gap cannot be tied with statistical certainty exclusively to the recent rise in African American homeownership, the latter is without doubt a powerful factor. From 1989 to 2001 the ratio of median household wealth among African Americans compared with that of all U.S. households rose from about 9 percent to 22 percent, while the rate of homeownership among African Americans climbed from 42 percent to 48 percent over a roughly comparable period. In constant dollar terms, the median net wealth of the typical African American household rose from \$2,500 in 1989 to \$11,800 in 2004, an inflation-adjusted increase of 372 percent. By comparison, the median net wealth of the typical U.S. household rose by just 23 percent.<sup>18</sup>

Low-income homeownership policies are especially important in that research also suggests that, over time, nonhousing wealth accumulation is at best scant and, for minority families, often negative.<sup>19</sup> This proposition is confirmed in an early assessment of the wealth effects on lower-income participants in the Self-Help/Fannie Mae program described later in this chapter. Overall, Self-Help initiative homes bought between 1999 and 2003 enjoyed an average annual paper capital gain of 7.43 percent through the end of March 2006. This is slightly below the national house price appreciation index, which rose an average of 8.86 percent per year, but more than three times greater than the average annual rise in the Dow Jones Index (2.51 percent) and more than twice the average rate on a six-month CD (3.49 percent) over the same time period. As robust as these returns are, they pale in comparison with the returns that homeowners enjoyed on their original equity investments. For all owners, the average annual rate of return on initial equity was a whopping 65 percent,<sup>20</sup> with black owners gaining 47 percent per year, Hispanics 73 percent, and whites 69 percent.

## INFUSING SAVINGS INCENTIVES INTO HOMEOWNERSHIP POLICIES

National policies should encourage greater household savings for macroeconomic and social purposes. Not only are our entrepreneurial economy and continued growth in productivity dependent upon a growing pool of national savings, but household savings are also a key to greater retirement security. Nevertheless, only about half of all private-sector wage and salary workers are covered by a pension plan, including just a fifth of workers in households with incomes below \$20,000.<sup>21</sup> The reasons for savings incentives that target those near or at the bottom of the wealth and income scales are persuasive: one-third of all American households have zero or negative financial assets; nearly half of all children live in such households.<sup>22</sup>

Motivated by the adage that “income feeds the stomach while assets change the head,” a growing number of social welfare academics and consumer advocates argue that finding ways to narrow the large and growing wealth disparity in the country is at least as important as, and perhaps even more important than, further narrowing the income gap. Where economists once argued that such inequality was the price of national economic progress, there is now evidence that social policies to lessen inequality are not necessarily inconsistent with economic policies to maximize growth.<sup>23</sup>

Because housing policies that increase homeownership also have the potential to both create and democratize wealth, it makes sense for the federal government to help low-wealth families save for a down-payment on a home. This is a much sounder idea than promoting no-down-payment loan programs, a favorite strategy of conservative administrations.<sup>24</sup> Such programs will lead to higher levels of failed homeowners because research confirms that borrowers who have none of their own money invested in their homes are more likely to default on their loans during challenging times.

A variety of tax credit measures have been introduced in Congress to stimulate the supply of affordable homes. Some would reward developers who agree to build affordable homes in underserved neighborhoods; others would reduce effective down-payment requirements to qualified buyers through a refundable tax credit; and still others would be used to capitalize deferred-payment second-mortgage loan pools.<sup>25</sup> While there are too many of these proposals to evaluate here, it should be noted that the full value of tax credits to developers is not always passed on to buyers, and such measures may also limit consumers’ neighborhood choices. Policymakers should be mindful of the research that finds that the positive effects of homeownership on children are weakened in distressed neighborhoods, especially those that are residentially unstable and poor.<sup>26</sup>

In my opinion, a first-time homebuyer tax credit that would only be available to lower-income families in lower-income neighborhoods is neither sound public policy nor good community development policy. The forgone tax revenues that result from a tax credit program could be more productively invested in a down-payment savings initiative.

While I am not sure that tax credits are the best vehicle for capitalizing second-mortgage pools, in some very high-cost markets household savings, even with a government match, may not be sufficient to enable a working family to buy a home. In these cases a deferred-payment second mortgage in an amount equal to 10 to 20 percent of the home price may be necessary to make a starter home affordable. Sometimes referred to as a “silent second,” a deferred-payment mortgage does not require monthly payments to be made, but is paid off in its entirety at the time that the home is either refinanced or sold. Many state and local agencies operate deferred-payment loan programs targeted to high-cost markets.

## SPECIAL-PURPOSE SAVINGS INCENTIVES

Although none is at a scale to really matter, in the last 30 years the federal government has made at least four attempts to create special-purpose savings accounts to help low- and moderate-income households achieve homeowner-ship. The first of these efforts came in the late 1960s. Under the Turnkey III public housing program, aspiring tenant-buyers could earn credit toward a down payment on a unit. This credit was based on the value of the labor, or “sweat equity,” tenant-buyers contributed toward maintaining the units.<sup>27</sup>

The second effort, called the Family Self-Sufficiency (FSS) program, was developed in 1990 by the Department of Housing and Urban Development and has enabled more than 30,000 households to save for a down payment or other major expense.<sup>28</sup> In 1996 the Federal Housing Finance Board<sup>29</sup> began a program to encourage working families to save for a down payment and closing costs on a home. By amending the regulations for its Affordable Housing Program, the board permitted member banks to match each dollar of a first-time homebuyer’s savings with up to \$3 of Affordable Housing funds. The match generally was capped at \$5,000 or \$10,000 for a homebuyer living in public housing.<sup>30</sup> Several regional home loan banks have established pilot programs for their member thrifts, the most prominent being in the Seattle region. I mention these initiatives here to underscore the point that helping working families save for a home has significant precedent in federal policy. None of these initiatives, however, has achieved the visibility of Individual Development Accounts.

Since the concept was first developed by Michael Sherraden in 1991, Individual Development Account (IDA) programs have sprung up across the country with broad bipartisan support.<sup>31</sup> IDAs are matched, dedicated savings accounts that can be used by eligible participants for purchasing a first home, paying for postsecondary education, or capitalizing a business. Two national pilots together have supported nearly five hundred IDA programs across the country and about 15,000 matched savings accounts.<sup>32</sup> Empirical assessments of these pilots have shown that contrary to conventional wisdom, poor people can and do save in response to positive incentives such as the opportunity to have their deposits matched from outside sources.<sup>33</sup>

The proposed Savings for Working Families Act (SWFA) has the potential to institutionalize and dramatically expand public funding for IDA matches and operating funds by authorizing a national program of 900,000 Individual Development Accounts over a seven-year period (2007–14), with up to \$500 in matching funds and up to \$50 in administrative and financial literacy expenses per account per year.<sup>34</sup> As of September 2006, SWFA had yet to become law, due in large part to the philosophical opposition of House Republicans to using tax credits to help the poor build assets.<sup>35</sup>

All these proposals would work well in conjunction with local programs aimed at increasing the take-up rate among working poor families of the Earned Income Tax Credit. In 2005 alone, more than 21 million low-income working families received EITC refunds totaling \$39 billion.<sup>36</sup> If just one-third of these tax refunds were channeled into homeownership savings accounts, even a low one-to-one match rate would generate \$26 billion in down payments.

## PUBLIC POLICY TO FOSTER GREATER SECURITIZATION OF AFFORDABLE MORTGAGE LOANS

In addition to proposals that encourage savings strategies for potential home-buyers, public policy should also look for ways to make loans for affordable housing more attractive to traditional lenders. Working families who manage to save a few thousand dollars of their hard-earned wages to put down on a house still need flexibly underwritten first-mortgage loans to buy a home, and they need a market that will support these flexible loans. This is why the second part of my two-part national homeownership strategy aims to expand the affordable lending capacity of

thousands of conventional mortgage lenders.

As indicated earlier, the interaction of demographic and market forces with political and technological developments has put a premium on serving the homeownership needs of underserved populations. Over the last five years, 40 percent or more of all homes sold have been to low- and moderate-income persons, and the strength of this market is not likely to diminish in the coming years.<sup>37</sup> Notwithstanding strong demand, lenders would be reluctant to serve this market if it were not profitable to do so. The key is in this tension between a first-time homebuyer's need for a flexibly underwritten loan and the difficulty a lender faces in selling these flexible loans on the securitized secondary market.

The Community Reinvestment Act (CRA) presents an example of this tension. This act, enacted in 1977 in response to evidence that banks were refusing to lend in many inner-city urban areas, established that banks have "a continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered to do business."<sup>38</sup> Since CRA's passage, it is estimated that covered lenders have made more than \$1.7 trillion in CRA loan commitments to minority and lower-income neighborhoods.<sup>39</sup> Most CRA mortgage products feature the flexible underwriting necessary for low-income buyers, which makes these loans hard to pool into securities for sale in the secondary market without higher guarantee fees or credit enhancements such as private mortgage insurance, the cost of which frequently makes these transactions uneconomical for originating lenders and home seekers alike. Flexible underwriting also reduces liquidity and raises the overall risk profile of a lender's portfolios. Accordingly, when the volume of CRA mortgages lenders hold grows beyond a self-defined comfort level, they slow down their affordable mortgage lending.<sup>40</sup>

#### THE COMMUNITY ADVANTAGE SECONDARY MARKET DEMONSTRATION PROGRAM (CAP)

The federal government can play a role in resolving the conflict just described. The government can leverage the expertise of CRA-covered institutions and other proven affordable housing lenders and can share in the increased risk assumed by lenders who are involved in affordable housing loans. By sharing the incrementally higher guarantee and credit enhancement fees, such a program would enable participating lenders to sell their affordable loan portfolios in the secondary market. This not only takes advantage of the market and reduces a lender's risk, it also frees up additional capital for new LMI lending.

One successful pilot that could be used to tailor such a national initiative is the Community Advantage Secondary Market Demonstration Program (CAP). Fannie Mae partnered with the Center for Community Self-Help, an innovative community development financial institution, on this effort to demonstrate that affordable housing loans made to low-income homebuyers can be profitable for lenders, as well as advantageous for the homebuyers themselves (see inset). Through CAP, Self-Help has pooled nearly 45,000 CRA loans to LMI families worth nearly \$5 billion originated by more than 20 lenders across the country for sale to Fannie Mae.<sup>41</sup> These transactions freed up an equivalent amount of capital to enable participating lenders to originate new affordable housing loans. Though these loans could not readily be sold on the traditional secondary mortgage market, CAP set out to prove that lenders such as Fannie Mae could confidently serve this market, despite the higher risk involved in loans to low-income persons. The demonstration was implemented in 47 states and in the District of Columbia.

Assuming Self-Help's annual loss rate of less than 1 percent, a program that helps underwrite a portion of the transaction costs and perceived increased risk of CRA-backed mortgage securities would be more cost-effective than HUD's existing down-payment assistance program. It may be even more important during periods of rising interest rates, when originating lenders are less likely to be able to absorb the higher guarantee fees and still sell their portfolios without booking a loss. This is why pilots such as the CAP are important: they benchmark the risk profiles and market performance of loans to a low-income population in the expectation that over the long term many of these mortgage products will prove to perform sufficiently well to qualify for sale in the secondary market without any special credit

enhancements. These pilot programs provide the evidence that traditional lenders need to participate in this non-traditional market. On a dollar-for-dollar basis, using scarce federal resources to expand and replicate the Self-Help/Fannie Mae partnership is a far more cost-effective way of expanding homeownership opportunities to lower-income households than either a similar-sized down-payment grant program or paying the insured losses that would result from a large-scale, government-insured zero-down-payment loan program.

## MAKING HOMEOWNERSHIP A REALITY BY BELIEVING IN WORKING-CLASS FAMILIES

*Martin Eakes*

Self-Help, a North Carolina community development lender started in 1980, views homeownership as the single best way for working-class families to build wealth. The strong repayment history of our borrowers confirms our belief that low-wealth families are dependable borrowers who deserve a chance to own a home.

Self-Help's mission is to create wealth and ownership opportunities for minority, rural, and female-headed families. We started as a small-business lender but soon realized that home equity is often a business owner's primary source of capital. Further, 60 percent of African American and Latino family wealth is in home equity. The minority homeownership rate of 48 percent lags far behind the 73 percent homeownership rate for white families, and the corresponding equity gap has left a 10-to-1 wealth disparity between white families and families of color.

Clearly, in order to help families build wealth, we had to engage in home lending. In 1984 we started with loans mainly to African American single mothers then considered unbankable and now have made \$200 million in home loans to 3,000 North Carolina families.

Realizing that our direct reach is limited, Self-Help started a secondary-market program in North Carolina to partner with large banks to provide more home loans to low-wealth borrowers. Assisted by the Ford Foundation, Fannie Mae, and conventional lenders, we took the secondary-market program national in 1998. To date we have provided financing of \$4.5 billion to 45,000 low-income and minority families. Approximately 42 percent of the loans are to families of color, 39 percent to woman-headed households, and 18 percent to rural families. These families have an average income of 64 percent of area median income.

Our lending experience proves that low-income families are dependable borrowers who deserve a fair opportunity. These families have been able to pay back their loans. Our annual loan loss rate is well under 1 percent. And families also have created wealth through the program: a recent University of North Carolina study estimated a 30 percent appreciation by the end of 2005, which translates to \$1.2 billion in home equity created to date.

Our lending also provides an alternative to high-cost subprime loans. Our loans have a standard 30-year amortizing fixed rate, the rates and fees are comparable with those of conventional loans, and foreclosure rates are 10 times lower than for subprime loans. We also work proactively to help families protect family wealth from predatory lenders and started the affiliated Center for Responsible Lending in 2001 (see [www.responsiblelending.org](http://www.responsiblelending.org)).

Every hardworking American family should have an opportunity to own a modest home. In particular, America's low minority homeownership rate provides a window of opportunity for public policymakers. Self-Help believes that there should be a national goal of raising African American and Latino homeownership rates to the national average by 2020. Given the opportunity, we know that these borrowers

will pay their mortgages. We believe that it is our collective responsibility to bring the American Dream of homeown-ship into reach for these families, and that our nation would be all the stronger for it.

## CONCLUSION

Although owning a home is not a ticket to wealth, 59 percent of renters rank buying a home among their top priorities in life.<sup>42</sup> And while history documents that not all homes increase in value, American adults believe by a four-to-one margin that buying a home is a safe investment compared with stocks.<sup>43</sup> I support current policy goals to increase homeownership, but I strongly oppose government initiatives such as zero-down-payment programs that by design will force one out of every six buyers into foreclosure or a forced sale to prevent one. Rather than continuing down the path toward the complete elimination of down payments or relying on the kinds of nontraditional mortgage products that are leading to a new wave of foreclosures, I urge the federal government to help families save for a modest down payment, and I have identified several ways this could be done. As illustrated earlier, there is no shortage of ideas of how savings and homeownership policies might be better coordinated. Given strong and enduring market fundamentals and secondary market innovations that have the potential to channel significantly more capital to affordable lending, the mortgage industry will respond to the upsurge in effective demand from households who come to the table with savings in hand, financially ready and able to become successful homeowners.

## NOTES

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12. Ibid.

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29. This board is the safety and soundness regulator for the nation's savings associations.

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