VIEWPOINTS

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Creating Pathways to Sustainable Homeownership That Builds and Retains Wealth

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The challenges of achieving homeownership, particularly for lower- and moderate-income families, remain a perennial issue in housing policy. Yet our public policy discussions of these matters seem old and tired, especially in light of the devastation caused by the millions of foreclosures during the Great Recession. Policy debates seldom dwell on why we promote homeownership in the first place and whether our public policies are aligned with those objectives. Also, part of the staleness of our debate is that such discussions often become arguments about how to bend underwriting standards to encourage homeownership. We ought to be thinking instead about the process of moving from renting to owning, how we help families prepare to be successful homeowners.

To stimulate debate and hopefully offer fresh thinking, this essay addresses the following five questions:

- Why does public policy promote homeownership?
- What paths would assist families migrating from renting to owning?
- How can improved risk assessments reduce mortgage defaults?
- Why should we shift policy attention from debt to equity?
- How does public policy encourage the *depletion* of home equity?

Why Ownership?

In public policy discussions, the most frequent argument for why policy should promote homeownership is the opportunity it creates for wealth building by low- and moderate-income families. Renters pay as they go, but years of rent paying do not create an asset. For a homeowner, years of paying the mortgage slowly reduces the loan balance, thereby building equity in the property. Using debt to finance the home is one of the few times families use leverage, which can increase returns if house prices rise (but creates added risk if they do not). Most homeownership advocates also see this as a form of “forced savings” that allows families to gradually build wealth. Indeed, past generations used to hold mortgage-burning parties to celebrate the payoff of the mortgage. Wikipedia describes such parties as a "twentieth-century American custom" but notes that such events "are nearly unheard of in the present-day United States . . ."[1]

Given that the average first-time homebuyer owns the house for less than ten years—and for many, a lot less than ten years, during which time hardly any principal is paid down at all—is wealth building a good reason for public policy to put a finger on the scale to encourage ownership over renting? More generally, few people buy a house, get a mortgage, and then hold both the house and the mortgage for thirty years.

A house is a very expensive asset to maintain over time, and its value can fluctuate substantially, as we have all been recently reminded. The flip side of leveraged investments is that principal can be lost quite easily as well. Homeownership also carries substantial fixed costs of entry and exit; that is, buying and selling a house has a lot of transaction costs. It also gives a household less freedom of movement in response to changing family or job circumstances. And housing is a nondiversified asset.

Beyond all that, there is a general misconception about house-price appreciation, perhaps created by the inflationary growth in house prices during the high-inflation 1970s and 1980s. Robert Shiller, a Nobel economist, has measured the real growth in house prices over a century-plus time period and concluded that real (inflation-adjusted) house prices have largely been flat:

> Historically, however, investing in homes just hasn't rewarded most homeowners that much. As I have calculated, home prices corrected for Consumer Price Index inflation nationally were nearly flat for the century ending in 1990. And when nominal home prices are deflated by per capita disposable personal income, it turns out that real prices of existing homes fell 12 percent while real prices of newly built homes fell 30 percent from 1975 to 2015.[2]

Now this is not to say there is no public policy purpose to expanding homeownership opportunities. Owning your own house has become a quintessential American ideal, and I am not arguing it should be otherwise. Where you are owner of your own home, you exercise a degree of control and personal expression that is less attainable in a rental. You are committed to that property, and hence its community, in a deeper and more permanent way. These are likely profound and meaningful, albeit intangible, goals of many homebuyers.

With those cautionary notes, let us accept that homeownership is valued and there is a general public policy interest in ensuring households that want to own will find a competitive mortgage-finance system ready to provide credit. Further, let us also accept the potential wealth-building aspects of homeownership. But then we should ask how housing finance policy might more effectively and constructively support homeownership opportunities and do so in a way that may better encourage long-term wealth building rather than exacerbating financial risk for vulnerable families.

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1. "Mortgage burning," *Wikipedia*, last modified November 30, 2016, https://en.wikipedia.org/wiki/Mortgage_burning.
2. Robert Shiller, "The Overinflated Fear of Being Priced Out of Housing," *New York Times*, June 10, 2016, https://www.nytimes.com/2016/06/12/upshot/the-overinflated-fear-of-being-priced-out-of-housing.html.

Transitioning from Rental to Ownership

An oddity of public policy toward homeownership is the peculiar lack of attention to the transition process from being a renter to being a homeowner. One frequently hears complaints about the challenge of saving for a down payment and criticism of lenders for not making loans to "credit-worthy" borrowers with low credit scores and small down payments. Rather than viewing these as insurmountable obstacles for households for which lenders must make the adjustments, why not ask how our housing finance system in general, and federal programs and policies in particular, might help families help themselves in meeting these challenges?

Meeting Today's Challenges: Savings, Borrower Education, and Credit Repair

Meeting the challenges of many of today's renters desiring to become homeowners involves three steps: (1) savings, (2) borrower education, and (3) credit repair. These steps require time but lack any process in today's system. In too many situations, addressing these issues may not even begin until the borrower has an eye on a particular house, or even a contract in hand.

Saving for a down payment to buy a house was an expectation for generations. Yet it may be true that saving for a meaningful down payment *is* harder today than in the past. Real wages have been stagnant for years yet house prices have not. We have put young families on a debt treadmill early with the enormous growth in student-loan debt. The demographics of our country are changing rapidly, and many younger Americans do not have parental assistance for down payments. Years of past credit subsidies have driven up house prices in many parts of the country. And the high cost of rent in many areas makes saving while renting very difficult.

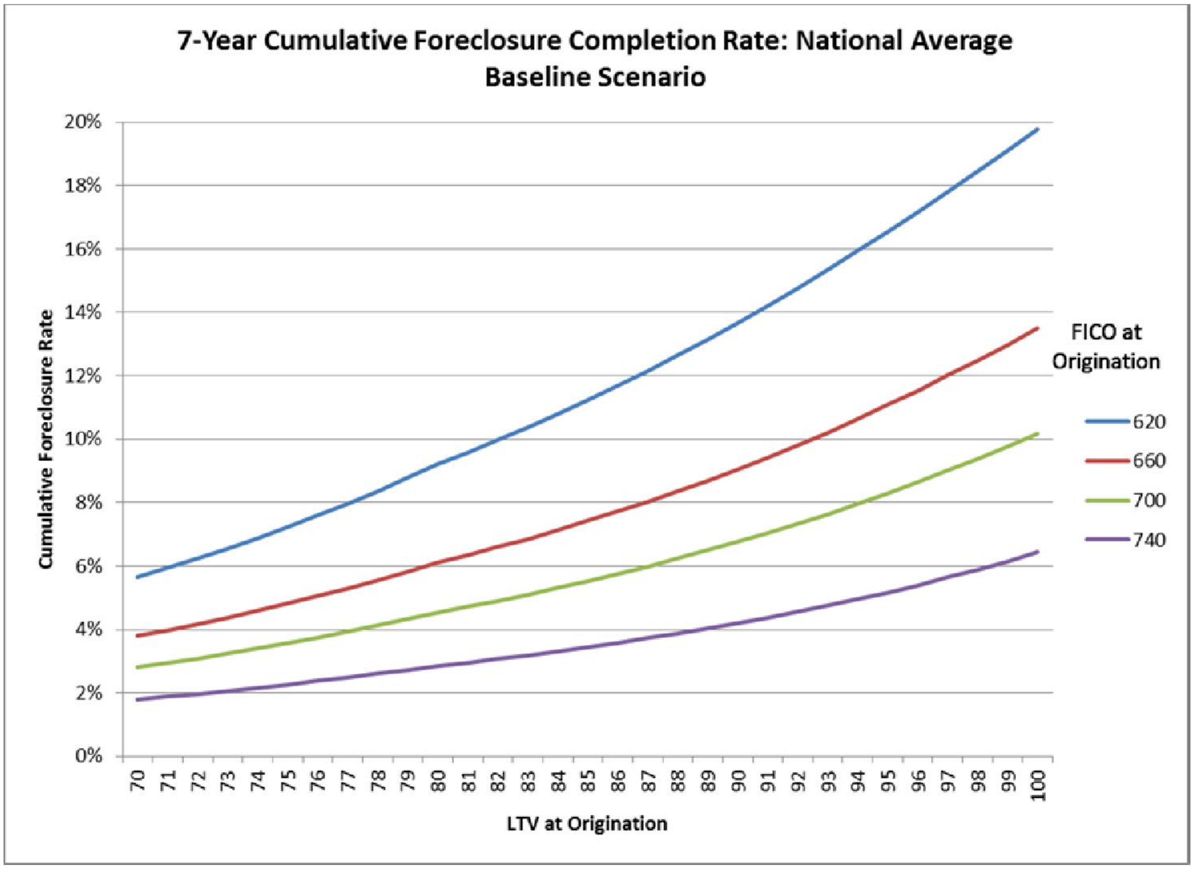
That does not mean saving is impossible and should not be expected. While 20 percent down can be a considerable challenge, it is not the norm, especially for first-time homebuyers. On the other hand, 3 percent down without a plan to help a household build equity quickly and establish a rainy-day fund at the same time is risky. After all, when you get up from the settlement table, if you haven't put 8 to 10 percent down, you start off underwater.

While little publicized, there are programs out there to help families build savings for a down payment and closing costs. Some of these options are described below. But the basic economics must be understood. A down payment gives the borrower "skin in the game" that protects the borrower and lender alike. Among other things, a down payment serves as a shock absorber in the event of an income disruption or other adverse event affecting the borrower's ability to repay. If the borrower needs to sell the house for whatever reason, a down payment at least equal to closing costs can save the family from a damaging foreclosure or short sale.

Any rational housing policy should be more interested in incentivizing and assisting with building a down payment than in incentivizing and facilitating a degree of leverage on household balance sheets that would result in a bank being classified as undercapitalized.

A 2013 working paper describes the significant increase in default and foreclosure probability as loan-to-value ratio increases (that is, the lower the down payment). These effects are even more pronounced as borrower credit scores decline, as shown below in exhibits 1 and 26 taken from the paper.[3] Readers should note the inflection points across the board at 90 percent loan to value; above that ratio, foreclosure rates rise at an increasing rate.

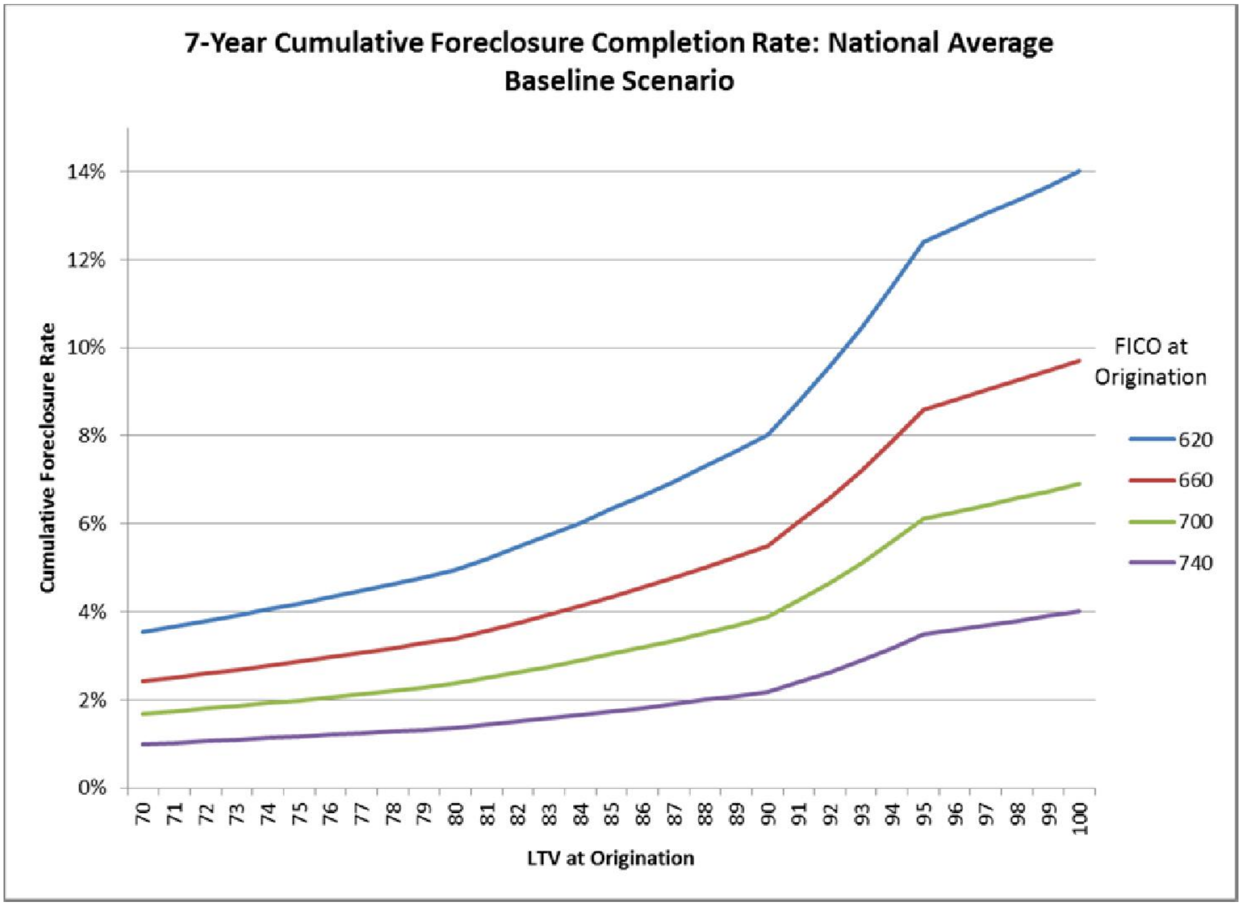
Exhibit 1. GSE market segment



Source: FHFA Working Paper 13-3.

3. Ken Lam, Robert Dunsky, and Austin Kelly, "Impact of Down Payment Underwriting Standards on Loan Performance: Evidence from the GSEs and FHA portfolios," Federal Housing Finance Agency Working Paper 13-3, December 2013, https://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/2013-12_WorkingPaper_13-3-508.pdf.

Exhibit 2. FHA market segment



Source: FHFA Working Paper 13-3.

Borrower education also needs greater attention. There are countless programs out there. Often private lenders encourage borrowers to take the training but it is not required typically as a matter of policy in federal lending programs targeting low- and moderate-income homebuyers.

There is widespread concern at the lack of financial literacy in the country. The time when a family starts thinking about buying a house presents a unique opportunity to focus the attention of a household on its family balance sheet, its cash flow, its long-term financial plan (including education, health care, and retirement), and its financial risk management. If we are interested in helping families become homeowners, especially to provide them a path to financial security, then we should think harder about how to develop a transition process before home buying commences. Qualified housing counseling services are widely available, both from private sources and from nonprofit groups. The U.S. Department of Housing and Urban Development (HUD) has a network of more than 2,300 certified housing counselors nationwide.

Related to housing counseling is credit repair. As the FHFA exhibits show, the likelihood of default also increases sharply as a buyer's credit score declines. Still, a low credit score is not a birthmark; it is not indelible, beyond the control of the household. It reflects past circumstances and financial practices. Credit scores can be repaired and progress in repairing a weak score can be made fairly quickly. By educating households on what led to a weak score and how it can be remedied, counselors or lenders can give families valuable insights on prudent financial practices that can have other long-lasting benefits. And, importantly, if we open the secondary market to more competition and break from the domination of the government-sponsored enterprises' (GSEs) underwriting rules, perhaps new and enterprising institutions can develop even more successful and predictive measurements of a homeowner's willingness and capacity to repay a loan.

Surely encouraging, or even requiring or subsidizing, such borrower education and credit repair is a better approach than pushing lenders to make loans to those with weak credit scores and limited understanding of the risks and consequences of failing to stay current on a mortgage. Such an approach is about dealing with root causes of past financial challenges and creating opportunities for greater financial security going forward.

In short, worrying about whether housing finance reform will continue to deliver a flow of subsidized mortgages to households with little savings and weak credit is the wrong concern. Instead, we should be asking whether and how the housing finance system, through government programs and agencies, but also through nonprofit organizations and private lenders, can do the harder work of helping families prepare to become *sustainable* homeowners. Such an approach may delay the time at which a household can buy a house by some months, or maybe even a year or two. Or it might lead to buying a slightly lower-cost house initially. But if it can materially improve the odds of the household avoiding default and its consequent long-term damage, while it becomes better informed about managing family finances, we can improve the odds of achieving long-term financial stability for that family and, yes, wealth building.

Systems and programs exist today, and others are under development or could be developed, to help achieve this outcome.

Down Payment Assistance

Numerous down payment assistance programs exist, although they do not seem to garner much publicity. Most are targeted to low- and moderate-income homebuyers, and often to first-time homebuyers. Perhaps because they may slow down the home-buying process or require additional research or paperwork or meetings, they are not sought out by all who may benefit from them. Rather than attempting to catalogue such programs, I identify a handful here to illustrate their prevalence and to encourage greater attention to, and funding of, such programs. Not all down payment assistance programs are the same, nor do they all work well. Successful programs are likely to incentivize the borrower's own savings and involve borrower counseling; questionable programs often involve seller financing of the assistance.

State housing finance agencies are a common source of down payment assistance programs. These vary in structure. For example, some are grants and others are no-interest second liens that may be forgiven over time. They have eligibility rules set by the state. Local housing agencies and nonprofit organizations are also an important source of home-buying assistance and many operate their own down payment assistance programs. A noteworthy aspect of most of these programs is the concurrent counseling that goes on as part of the education and borrower-preparation process. Almost all these entities invest a meaningful amount of direct time with the potential homeowner discussing his or her goals and readiness for homeownership. This sort of counseling may sometimes lead to conversations that the household is not ready for homeownership, which helps the household avoid the consequences of a future foreclosure.

Many private lenders offer down payment assistance, either directly or through nonprofit partners or local governmental agencies. The Federal Home Loan Bank System, through its Affordable Housing Program, offers down payment matching funds to first time homebuyers through their member banks, thrifts, and credit unions. These matching grants may provide two dollars, three dollars, or even four dollars for every dollar saved by the homebuyer. The Federal Home Loan Bank of New York takes a noteworthy approach to this process. It requires potential first-time homeowners to sign up for a monthly savings program at their local bank. The family commits to save a certain amount each month for a period of time, typically 10 to 24 months. During this time, the family undergoes home-buying and financial-education training. When they are ready to buy, the Home Loan Bank provides up to four dollars for every dollar the family has saved, up to a limit of $7,500. For example, a family that saves $150 a month for a year could have $9,000 at settlement.[4]

An online site, DownPaymentResource.com, maintains an inventory of nearly 2,400 down payment assistance programs across the country. The most typical benefit amount is $10,000.[5] In 82 percent of the 513 counties it studied in conjunction with RealtyTrac (a private firm that provides information on the foreclosure market), the average down payment assistance available exceeded 3 percent of the price of the median-valued house in that area. That study also found that the average assistance amount was more than $12,000.[6]

Finally, a federal program, Individual Development Accounts (IDAs), offer eligible households a source of matching funds to their own savings that can be used for a down payment. A study by CFED and the Urban Institute found that low-income homebuyers using IDAs to purchase a home had relatively lower foreclosure rates during the financial crisis. The researchers attributed the apparent success of this program for low-income buyers to the screening, credit counseling, and down payment assistance of the IDA program.[7]

Taken as a group, down payment assistance programs have several important advantages that argue for their expansion relative to credit subsidy programs. The programs typically match or supplement the borrower’s own savings, thereby incentivizing not substituting for the borrower’s own savings. Often the programs include a financial education component and counseling, which help inform the borrower and

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4. For more information on the Federal Home Loan Bank of New York’s First Home Club,SM see http://www.fhlbny.com/community/housing-programs/fhc/index.aspx.
5. Down Payment Resource, accessed February 19, 2017, http://downpaymentresource.com.
6. “Down Payment Assistance Programs Save Qualifying Homebuyers More Than $17,000 on Average Over Life of Loan,” RealtyTrac, June 8, 2016, https://www.realtytrac.com/news/home-prices-and-sales/2016-down-payment-assistance-affordability-analysis/.
7. Ida Rademacher et al., “Weathering the Storm: Have IDAs Helped Low-Income Homebuyers Avoid Foreclosure?” CFED/Urban Institute, April 2010, http://cfed.org/assets/pdfs/WeatheringTheStorm_Final.pdf.

may keep households not ready for homeownership from putting themselves in a high-risk situation. These programs also may be targeted to a defined set of eligibility criteria, which focuses the support on those deemed eligible rather than creating a general subsidy for all borrowers that simply drives up house prices.

Rent-to-Own and Other Alternative Paths to Ownership

Becoming a homeowner does not always need to follow the path of "buy a house and get a mortgage." If we want to be serious in thinking about real-life affordability and access problems and the struggles some families face, we ought to consider other paths to homeownership.

Rent-to-own programs have been around for many years with mixed success. Arguably they have worked better in theory than in practice. Still, since the financial crisis, renewed attention has been paid to this transitional approach from renting to homeownership. Renting a house with an option to purchase the house at a later date, usually at a specified price, if done properly allows a potential homebuyer the opportunity to begin living in a house in a desired community even if the prospective owner is not ready to actually buy. The rental period allows households the chance to continue saving for a down payment, improve a damaged credit history, or otherwise improve their financial situation before locking in to the responsibilities of ownership.

Because there is no standard contract or approach with rent-to-own programs, consumer-protection issues can arise. Some private lenders have attempted to respond to these concerns by establishing clear disclosures and qualification standards.[8] Time will tell whether and how these new approaches to an old problem work out.[9] The larger point here is that private-market participants are developing new approaches to reach households with difficult access to homeownership and provide options tailored to their circumstances while showing a greater concern for consumer protections than in the past. Such approaches should be encouraged, studied, and evaluated as opportunities to create access to homeownership.

In light of past problems with some rent-to-own transactions, I believe that private firms promoting this path would be well advised to develop and publish clear consumer-protection standards to which they will hold themselves. In particular, the standards should be clearly stated, simple, and fair. Among other things, this includes a clear understanding of what happens should a family decide they are unable or do not want to exercise the option to purchase the house and what the financial implications would be.

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8. Home Partners of America and Trio are two examples of this modernized approach to creating a transition path from renting to owning. Their approaches are not identical, and just as in buying a home outright, consumers should educate themselves before signing a contract. For more information, see https://homepartners.com/ and https://www.thinktrio.com/default.php. Land-lease contracts are a distant cousin to rent-to-own contracts. Efforts to make this form of home purchase more consumer friendly may also open another constructive path to home ownership for those unable to purchase a home directly due to their financial circumstances.
9. A recent issue brief from the Center for American Progress notes the "checkered past" of rent-to-own arrangements but also identifies promising public-sector and private-sector approaches for rent to own leading to home ownership. See Sarah Edelman, Michela Zonta, and Julia Gordon, "Lease Purchase Failed Before: Can it Work Now?," Center for American Progress, April 29, 2015, https://www.americanprogress.org/issues/economy/reports/2015/04/29/112014/lease-purchase-failed-before-can-it-work-now/.

Such an approach would add credibility and transparency that would give consumers and housing advocates alike greater confidence in the integrity of the process.

There is also increased interest today in shared appreciation mortgages. A shared appreciation contract adds to a borrower's down payment with a private capital investment in exchange for the investor sharing in the upside (or downside) that the homebuyer realizes over time.

Finally, marketplace lenders (also referred to as peer-to-peer lenders or fintech firms) in the small-business and student-loan markets are beginning to emerge in the housing finance sector. The unique data-driven approaches to lending are also a promising opportunity for new market-driven alternatives to create pathways to homeownership.

The challenge these examples provide future homebuyers, policymakers, government agencies, nonprofits, and for-profit lenders and capital sources alike is this: How can we foster alternative paths to homeownership that use the innovation and resources of private capital combined with clear information to consumers and protections from disreputable practices? A common theme found today across numerous nonhousing markets is the disruption of new approaches and technology creating new opportunities for consumers. Far from being immune to such change, housing finance should embrace the possibilities and potential.

Improving Risk Assessments

One of the less productive arguments in affordable housing today is whether access to credit is too tight. A more thoughtful approach would consider two questions. First, do underwriting standards, both those applied by private and government lending programs and those imposed by consumer-protection rules, produce a prudent framework for analyzing a borrower's probability of default and hence creditworthiness? Second, are collateral risk assessments sufficient to protect both the homebuyer and the lender?

Ability to Repay and Residual Underwriting: Recognizing the Risks from Income and Expense Volatility

One of the more consequential regulations resulting from the Dodd-Frank Act is the Consumer Financial Protection Bureau's (CFPB) Ability to Repay Rule.[10] Hailed by some as a much-needed consumer protection, the rule requires lenders to "make a reasonable, good faith determination of a consumer's ability to repay" a mortgage.[11] Others take a less enthusiastic view, claiming the rule stifles lenders' ability to make credit judgments and, in so doing, limits credit access.[12] Clearly, a borrower's ability to repay was not a hallmark of much of the precrisis lending, which more often concerned itself with the value of the underlying collateral. Still, as is so often the case with Washington policymaking, housing finance reform must grapple with an enormous—and ironic—loophole in this rule.

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10. See https://www.consumerfinance.gov/policy-compliance/rulemaking/final-rules/ability-repay-and-qualified-mortgage-standards-under-truth-lending-act-regulation-z/.
11. Ibid.
12. As just one example, see "Brief: Repealing Dodd-Frank," Heritage Action for America, March 17, 2016, http://heritageaction.com/sentinel-brief/repealing-dodd-frank/.

The CFPB drafted the rule to limit mortgage credit when the combined monthly debts of the borrower exceed 43 percent of monthly income. However, it made an exception for any mortgage that qualified through the automated underwriting systems of Fannie Mae or Freddie Mac. On the one hand, the CFPB was recognizing that these proprietary systems (black boxes, some might say) have built in to their decision process a method for weighing other relevant repayment factors beyond income. But the loophole created a clear competitive advantage for the GSEs relative to other market participants. Rather than helping to gradually shrink the government's enormous footprint in the mortgage market postcrisis, this rule enhanced it.

The Ability to Repay rule needs to have a consistent standard for all lenders without reference to the GSEs. Absent a better solution than we have today, the rule will continue to make obtaining mortgage credit harder for retirees, the self-employed, single earners who live in urban areas and choose to spend a large share of monthly income on housing, those in new jobs, and other borrowers who rely on assets or other sources of repayment beyond just wage income.

Another underwriting standard that could benefit from reexamination is known as "residual-income" underwriting, often employed by the Veterans Administration (VA). Simply put, rather than just measuring debt-to-income ratios, the VA also requires lenders to prepare a monthly budget with the borrower to see the "residual income" left after making the proposed mortgage payment and meeting other debts and expenses. The borrower must have sufficient residual income according to the VA's guidelines in order to qualify for the loan. A study by the Urban Institute found "strong evidence that the residual income test may be a critical differentiating factor" in explaining the better loan performance of VA loans compared to comparable Federal Housing Administration (FHA) loans, which lack this test.[13] This suggests that the FHA, and borrowers, may benefit from the FHA adding a residual-income underwriting test to its underwriting.

Finally, two factors affecting borrower outcomes that are especially important in the market for low- and moderate-income households do not get enough attention in policy circles. The first is the stability of a borrower's source of income, not just the amount. Income sources relatively immune from curtailment due to a recession or bad weather or such make for a less risky borrower than income sources prone to such disruptions. Yet CFPB rules and FHA lending guidelines are limited in how they consider this risk factor. An emerging literature points to the growth in income volatility, particularly among lower- and middle-income households.[14] The increasing importance of income volatility is a risk factor that mortgage underwriters and policymakers alike should be factoring into their work.

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13. Laurie Goodman, Ellen Seidman, and Jun Zhu, "VA Loans Outperform FHA Loans. Why? And What Can We Learn?," Urban Institute, July 16, 2014: 11, http://www.urban.org/sites/default/files/publication/22776/413182-VA-Loans-Outperform-FHA-Loans-Why-And-What-Can-We-Learn-.PDF.
14. Jonathan Morduch and Rachel Schneider, *The Financial Diaries: How American Families Cope in a World of Uncertainty* (Princeton, NJ: Princeton University Press, 2017). See also Michael Barr, *No Slack: The Financial Lives of Low-Income Americans* (Washington, DC: Brookings Institution Press, 2012) and J. M. Collins, ed., *A Fragile Balance: Emergency Savings and Liquid Resources for Low-Income Consumers* (London: Palgrave Macmillan, 2015). Scorelogix has applied this concept of income volatility in producing an alternative consumer credit score. See www.scorelogix.com.

Second, whatever the stability of an income source, borrowers are vulnerable to life events. Stuff happens, and it often costs money. Whether it is a leaky roof, a failed heating system, a health issue, a car repair, or a family concern, all borrowers face the risk of large, unexpected expenses. The availability of "rainy-day funds" to assist with such events can make a difference in the borrower remaining current on a mortgage. Lending programs should encourage borrowers to be mindful of the importance of liquid savings in addition to savings for the down payment and the need for residual income.[15]

In our enthusiasm to help families become homeowners, we sometimes forget just how close to the financial edge many people live. A greater sensitivity to this fact, combined with giving more thought to ensuring families have sufficient shock absorbers, may not make credit more available but it would surely help lead to more successful mortgage-lending outcomes.

Collateral Risk Considerations: House Price Volatility and Home Inspections

The postcrisis focus on a borrower's ability to repay the loan should not cause lenders or policymakers to neglect collateral risk and its implications for the affordability and sustainability of homeownership for low- and moderate-income families. While the borrower's ability to repay is, and should be, the primary lending consideration, the collateral itself also matters to the overall risk assessment in the lending process. I focus here on two aspects of collateral risk: house-price volatility and home inspections.

It is a mistake to treat house-price volatility as a constant across houses and an even greater mistake to assume that lower-cost houses have less house-price volatility than higher-cost houses. In fact, the opposite is true. Lower-value houses in a given community tend to have greater house-price volatility. This is exacerbated when land value is a substantial component of overall house value and when the construction quality is lower. Disturbingly, house-price volatility is also greater in minority communities than nonminority communities.[16] The implication for policymakers is that encouraging homeownership, especially highly leveraged homeownership, in lower-income and minority communities places those homebuyers at greater risk than borrowers in communities with more middle-valued homes. Of course, lower-income families also tend to have greater income volatility than do other families, layering another risk factor onto the homeownership proposition for these families.

The conclusion from a paper by Yu Zhou and Donald R. Haurin is worth considering:

> Knowledge about house price volatility also should be an important input to housing policy. Whether low-income households should be encouraged to become homeowners depends on

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15. In a book describing the lessons learned from a partnership among Self-Help, the Ford Foundation, and Fannie Mae to promote home ownership for lower-income households, the authors describe approvingly a hypothetical low-income borrower whose lender requires a month's mortgage payment in reserve as well as careful screening and borrower education as part of the underwriting process. All these themes are consistent with what I am describing here. See Roberto G. Quercias, Allison Freeman, and Janneke Ratcliffe, *Regaining the Dream: How to Renew the Promise of Homeownership for America's Working Families* (Washington, DC: Bookings Institution Press, 2011).

16. Yu Zhou and Donald R. Haurin, "On the Determinants of House Value Volatility," *Journal of Real Estate Research* 32, no. 4 (2010). See also Stephen Oliner, "The Housing Boom and Bust in Los Angeles Under the Microscope: Land Prices Hold the Key," UCLA Economic Letter, November 2015, and Diego Escobari and Damian S. Damianov, "A time series test to identify housing bubbles," *Journal of Economics and Finance* 39 (January 2015): 136–52.

many factors, one of which is the house price risk that they would bear. Our finding that low-quality houses (and low-valued homes) have relatively high price volatility is directly relevant.

Other housing market participants, such as mortgage lenders, also should be interested in the correlates of house price volatility. For example, both default risk and the rate of recovery of collateral values are related to house price volatility. One would expect lenders to price this risk in the cost of a mortgage. Thus, risk-based pricing of mortgages would account for the characteristics of both the borrower and the dwelling.[17]

These conclusions reinforce the importance of encouraging prospective homeowners to save for a down payment and build equity quickly in order to reduce leverage. They also point to the importance of considering residual income and the availability of other assets in underwriting mortgages in lower-income communities. The stability, not just the amount, of income is also relevant; the less stable the income source, the more these other factors like down payment and cash reserves matter. The point here is not to discourage homeownership; it is to be more realistic about the risks involved so that risk mitigators can be found.

One of my greatest concerns with the unrestrained advocacy of "access to credit" for riskier borrowers is the limited consideration of the costs of failure on those borrowers and their communities. When a homeowner defaults on a mortgage, the financial catastrophe, including the loss of the home and the long-term credit score damage (which may impede future job opportunities) are substantial but generally understood. Less understood are the broader health consequences for the homeowners, their children, and even their neighbors. Jones, Squires, and Ronzio document these impacts during the Great Recession, which include physical effects such as hypertension as well as mental health impacts, by mapping them against measures of inequality.[18] Our housing policies do not consider these costs. If they did, we might be less tolerant of the foreclosure rates our current policies generate, particularly through the FHA program.

A separate but also important aspect of underwriting the property is the likelihood of costly repairs. Most lower-cost single-family homes tend to be older construction. This highlights another important risk factor for low- and moderate-income homebuyers—the risk that the house may require significant repairs or upgrades after the family moves in. So, the home-buying process needs to consider not just the affordability of the monthly mortgage payment but also the probability of needing to finance major repairs, whether a new roof, electrical upgrades, foundation reinforcement, or any other of a countless array of possible issues.

A rigorous home inspection before purchase by a trained professional is one risk mitigator. But such inspections, while recommended, are seldom required. Moreover, home inspections add to closing costs, a reason they may often be skipped. FHA loans require a home appraisal that includes an assessment of whether the home meets HUD's standards for health and safety. VA loans require a home

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17. Zhou and Haurin, 390–91.
18. Antwan Jones, Gregory D. Squires, and Cynthia Ronzio, "Foreclosure Is Not an Equal Opportunity Stressor: How Inequality Fuels the Adverse Health Implications of the Nation's Financial Crisis," *Journal of Urban Affairs* 37, no. 5 (2015).

appraisal of whether the home meets VA's minimum property requirements. While each of these is helpful, greater consideration should be given to a professional home inspection, not just appraisal, that can inform the homebuyer of defects with key systems.

When someone buys a house with little money down because he or she cannot afford to save for a down payment, the risk of facing a payment shock because of an unexpected expense, such as a the repair or replacement of critical systems, is exacerbated. A housing-policy approach that is more focused on the sustainability of the home purchase than simple scoring the sale itself would place more emphasis on these types of risks to the homebuyer.

If we can acknowledge these risk factors rather than ignore them, our housing policy might steer toward ways of reducing these risks. Such an approach would not only advance access to credit by reducing risk but also increase the likelihood that extending credit would lead to a sustainable mortgage and ultimately financial security and long-term wealth building.

Equity Building: Good for Consumers, Taxpayers, and Financial Markets

A family's housing wealth, in financial terms, is their equity in the house: the value of the house minus the mortgage balance outstanding. As I described in a recent *Milken Institute Review* article, much of federal housing policy promoting homeownership is actually a debt policy; it subsidizes and incentivizes taking on debt to own a home rather than building equity in the home.[19] The mortgage interest deduction, the credit subsidy in the FHA program, and the once implicit, and now explicit, federal support of Fannie Mae and Freddie Mac all subsidize leverage, that is borrowing, rather than incentivizing or subsidizing equity. Since equity building is the public policy objective, this seems a curious approach.

If policymakers really want to promote *sustainable* homeownership (reducing default rates while increasing the probability that homeownership truly creates a path to long-term wealth building), and if they want to encourage private lenders to make mortgage credit widely available to low- and moderate-income families, reduce systemic risk and protect taxpayers, they should embrace housing policy that pays greater attention to equity building.

There are many ways this could be done, some of which are detailed in the *Milken Institute Review* article. Higher down payment requirements and/or greater funding for down payment assistance are straightforward options. Shorter loan amortization periods or splitting a loan into two payment streams so equity is built faster in the initial years of ownership would help. Providing more lending options might help reach this goal. For example, interesting work at the Federal Reserve on an alternative thirty-year mortgage, or the "Wealth Building Home Loan" championed at the American Enterprise Institute, attempt to tackle these issues.[20]

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19. Edward DeMarco, "Homeownership, Wealth Creation, and Financial Stability," *Milken Institute Review*, Fourth Quarter 2016.
20. Diana Hancock and Wayne Passmore, "Cost of funds indexed mortgage contracts with government-backed catastrophic insurance (COFI-Cats): A realistic alternative to the 30-year fixed-rate mortgage?," *Journal of Economics and Business* 84

These proposals are important to highlight because each demonstrates that there are analysts with fresh ideas out there wrestling with these problems. The more that policy officials, academics, researchers, lenders, and others focus on the challenges described in the preceding pages, the quicker we can get to better ideas. Policymakers cannot legislate the creation of better ideas, but they can write rules that foster them. These better ideas may be the breakthroughs we need to create a private market where mortgage credit is widely available and the homeownership it creates is truly accessible, affordable, and sustainable.

Equity Retention

To this point, I have argued for a more considered process for preparing low- and moderate-income families to become sustainable homeowners. The challenge does not end once the saving, borrower education, and credit repair are complete and the furniture moved in. For the borrower to remain successful in making mortgage payments while building wealth over time, the borrower needs to retain equity as it is built.

Earlier in this paper I noted that the primary public policy purpose for promoting homeownership is long-term wealth building for families. But the challenge is not just to promote equity building but to also consider the government's current incentives for borrowers to *deplete* equity. There are two housing finance subsidies that actually encourage people to withdraw equity from their homes.

The first incentive is the mortgage interest deduction, which applies not just to purchase-money mortgages but to refinancing. Cash-out refinancing allows this tax benefit to subsidize nonhousing consumption. By doing so, it adds risk to the housing finance system and encourages continued leverage by homeowners.

The second incentive is the availability of government-backed securitization for refinanced mortgages that involve cash-out and/or term extensions. As with the tax benefit, cash-out refinancing using government-backed securitization subsidizes nonhousing consumption. Allowing term extensions, a refinance that results in pushing off the date the mortgage is finally paid off, increases household leverage and thus risk to the household and to financial markets. The serial refinancing of mortgages in order to extract equity or extend the loan term runs counter to the policy objective of wealth building and misappropriates the subsidy. This is not to say that people should not be able to refinance, or that they should not be able to remove home equity when they refinance. But it does raise the question as to why the government guarantee should be used to subsidize such activity. There are logical limits that could be considered. I offer two simples ones here.

First, the government could limit the deductibility of interest in the case of refinancing that withdraws equity or extends the loan term (only weak limits exist today).

(March–April 2016): 109–130; "The Wealth Building Home Loan: Providing homebuyers a straight, broad highway to building wealth," American Enterprise Institute, media release, September 8, 2014.

Second, the government guarantee of mortgage securitization could be limited to purchase-money mortgages only. Once the guarantee has helped the borrower achieve ownership, any refinancing of the original obligation could be done in purely private markets, absent the government guarantee. That would both limit the guarantee to assisting with home purchases and remove the subsidy for extracting equity for nonhousing purposes.

To repeat, I am not objecting to refinancing per se, or to the extraction of home equity. What I am saying is that we could more appropriately focus government subsidization of mortgages on facilitating homeownership and equity building. Beyond that, the private market would operate absent taxpayer supports.

Conclusion

Housing policy needs to pay great attention to building pathways to sustainable homeownership. Waiving common sense underwriting rules to enlarge the pool of homeowners is easy. And so long as the economy remains healthy and house prices rise, the risk often pays off. But when that is not the case, the damage to the very households policy intended to help is enormous. It would make much more sense to focus policy efforts on creating pathways to homeownership that lead to more sustainable outcomes and to engage private lenders in this effort.

While we all welcome the wealth-building results from years of successful mortgage payments, we cannot lose sight that homeownership is primarily consumption, not investment. Its returns tend to be low and volatile. Policy efforts to promote homeownership should do more than they do today to protect vulnerable families and to produce more sustainable mortgages, even in difficult economic environments.

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About the Author

Ed DeMarco is a senior fellow in residence at the Milken Institute. He has been named president of the Financial Services Roundtable's Housing Policy Council, effective June 1, 2017. Before joining the Milken Institute, DeMarco was a 28-year civil servant, culminating with his role as acting director of the Federal Housing Finance Agency from September 2009 to January 2014. There he dealt with the challenges of managing the mega-institutions Fannie Mae and Freddie Mac. DeMarco crafted the 2012 FHFA Strategic Plan for Enterprise Conservatorships and the associated scorecards and set into motion the credit risk transfer and common securitization initiatives that underpin administrative efforts today.

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