

Do You Own Your Home – or Does Your Mortgage Own You?



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Since the financial crisis, lenders and borrowers have shown greater appreciation for the risks in highly leveraged mortgage lending. The federal government has not.

What does it mean to own a home?

A partial answer to this question was provided 15 years ago in the title to a paper by Josh Rosner, “Housing in the New Millennium: A Home Without Equity Is Just a Rental with Debt.”

This prescient paper described the risky path the country was on long before the collapse of the housing finance system, a collapse energized by equity-light home buying across the country.

With little or no money down, people bought houses using mortgages with 30-year repayment periods. Homebuyers and lenders alike operated with an implicit assumption that prices would continue to rise. Yet because of the repayment structure of a 30-year mortgage,

most of the monthly payment in the early years is being allocated to interest. This leaves the homebuyer with little equity and vulnerable to foreclosure if confronted with an economic shock.

Furthermore, many existing homeowners, seeing house prices rise, chose to extract equity through cash-out refinances, second liens or home equity lines of credit. Homes were no longer simply places to live, consumption goods with potential long-term wealth-building benefits. Rather, they were used as piggy banks, a revolving source of funds for other consumption.

The result? Catastrophic financial losses for families and lenders alike when prices collapsed and the country fell into a deep recession.

The damage was dramatic: over 7 million foreclosures and short sales, and an even greater number of loan modifications.

It seems fair to ask, eight years after the financial crisis, what have we learned and how has it altered our approach to financing homeownership?

Federal housing policy provides numerous subsidies to promote ownership, almost all of which are focused on borrowing. This encourages home buyers to take on more debt rather than build equity. While subsidizing debt lowers borrowing costs, it also drives up prices.

Perhaps most obvious, the mortgage interest deduction reduces the personal income tax liability of homeowners by allowing them to deduct the interest they pay from their taxable income. Thus, it provides a tax benefit not for building equity in a home, but for carrying debt on it. The larger the debt and the longer the loan term, the greater the tax benefit.

The other key source of government assistance comes through direct and indirect subsidies in mortgage finance. The Federal Housing Administration (FHA) loan guarantee program protects investors in the event the borrower defaults. Yet, this

program encourages very low down payment lending, often to borrowers with weak credit histories. Similarly, Fannie Mae and Freddie Mac, directly backed by taxpayers since their conservatorships in 2008, also encourage low down payment loans.

These programs result in a slightly wider availability of mortgage credit at a slightly lower price than a fully private market might produce. But why is the government continuing to promote households taking on long-term debt rather than building equity? Doesn't this risk a repeat of what happened less than a decade ago?

Ironically, leverage — that is, debt relative to equity — is what bank regulators have been working to reduce on banks' balance sheets to improve their safety and soundness. Why not the same approach for household balance sheets?

There are only two ways to reduce leverage. Either homebuyers make larger down payments or they repay principal faster than in a standard 30-year loan.

Since the financial crisis, lenders and borrowers have shown renewed appreciation for the risks inherent in highly leveraged mortgage lending. Yet, the federal government has not had such a course correction. Indeed, the past year has seen changes in the FHA program and in

underwriting by Fannie and Freddie that further encourage low down payment, long-term mortgages.

What if the subsidies embedded in existing federal programs were redeployed to help homebuyers build equity rather than subsidize the cost of debt? For instance, eligible homebuyers could receive funds to supplement their down payments instead of a subsidized interest rate.

What if we encouraged accelerated principal repayment? Shorter-term mortgages would accomplish this, as would incentives for making added monthly principal payments on a 30-year mortgage.

The issue has greater urgency today. Millennials burdened with student-loan debt face difficulty saving for down payments. At the other end of the working-age spectrum, aging baby boomers face retirement while carrying more debt than previous generations.

Homeownership means having home equity. Directing subsidies toward building equity rather than debt, combined with incentives and opportunities to build and retain equity, would strengthen family balance sheets while making our credit markets safer and sounder. That would be real — and sustainable — homeownership.

DID YOU KNOW?

\$200,000

30-year mortgage at 5% interest has a monthly payment of \$1,073.64

After five years, only \$16,343 in principal has been repaid. If the loan was zero-down, the loan-to-value ratio is 92 percent absent house price changes. Since selling costs are typically 6 percent to 7 percent, the homeowner has little equity remaining to go toward a new next house. And after 10 years, the homeowner has paid \$129,000, yet has added less than \$38,000 in equity.