Center for American Progress

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Homeownership Done Right

What Experience and Research Teaches Us

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Introduction and summary

In the wake of the U.S. housing crisis that began in 2007 and still reverberates across the country today, as many as 12 million families may lose their homes to foreclosure. Our national homeownership rate could well drop from a high of over 69 percent in 2004 to below 64 percent by the time we are done, which would be the lowest rate since 1968. All this is happening while nearly 100 million Americans live in households spending more than 30 percent—and many more than 50 percent—of their incomes on shelter.[1] This is hardly a path to encourage what for many is part and parcel of the American Dream.

Nor need it be. Evidence abounds that lower-income homeowners benefit from well-designed affordable homeownership programs, many of which are weathering the foreclosure crisis reasonably well. For example, a 2009 examination of the foreclosure experiences of five city-based affordable homeownership programs in Boston, Chicago, Los Angeles, New York, and San Francisco found that out of nearly 9,000 low-income families who turned to these programs to purchase their homes, the overall default rate was below 1 percent. All of these lending programs boasted default rates below the average for their cities.[2] Similarly, a recent report on New York City's affordable homeownership program showed only 13 foreclosures out of more than 20,000 homes sold to low-income buyers since 2004.[3]

Research confirms these are not isolated successes. The University of North Carolina Center for Community Capital compared the performance of home loans in a large, national portfolio of 36 lenders' prime-rate mortgages offered to lower-income and minority borrowers, to that of subprime home loans in a mortgage industry database that covers about two-thirds of the market. Their analysis of borrowers with similar profiles (such as comparable lending risk factors, the size of down payments, and local property market conditions) shows that the borrowers who obtained subprime loans were three to five times as likely to default as their counterparts who had received the prime, affordable mortgages. Of particular note: The study found that adjustable rate mortgages, prepayment penalties, and broker origination were features associated with increased risk of default, with the layering of these features generally magnifying default risk[4] (see Figure 1). These risky features are more commonly found among the subprime and toxic mortgages that precipitated the housing crisis, and avoided in homeownership programs that work.

Unfortunately, many business leaders and policymakers may be leaping to a flawed conclusion based on the massive numbers of foreclosures. Some seem to believe that we should give up on efforts to help working families become homeowners. Not only is that view a misreading of what went wrong, it is also blind to many things that have gone right in the homeownership area—even amid the worst housing crisis since the Great Depression.

In short, the salient lessons from the research and programs we have reviewed are these:

- The irresponsible surge in subprime lending from 2001 to 2007 cannot be blamed on lower-income borrowers or on federal, state, and local affordable homeownership programs that worked to help increase homeownership among historically underserved borrowers during the prior decade.
- The subsequent foreclosure epidemic also cannot lead us to the specious notion that lower- and moderate-income families should have never been owners to begin with.
- Examples abound of consumer-oriented homeownership programs that, by contrast with predatory loans, work well for low- and moderate-income homebuyers.

This is not to say that there were not borrowers who consciously took out loans that were high risk for their particular income or assets, or that there was no fraud or misrepresentation by borrowers. But the evidence is overwhelming that subprime risky lending was driven by mortgage brokers and investment banks eager to originate high-priced loans, package them up as Triple A-rated mortgage-backed securities for sale to institutional investors worldwide, and take away lucrative fees in the process.

High-risk mortgage features were much more common among the subprime mortgages they peddled—predatory mortgages that were frequently targeted at lower-income and minority borrowers. Federal Reserve Board Governor Ned Gramlich said it best when he asked:

> *Why are the most risky loan products sold to the least sophisticated borrowers? The question answers itself. The least sophisticated borrowers are probably duped into taking these products.*[6]

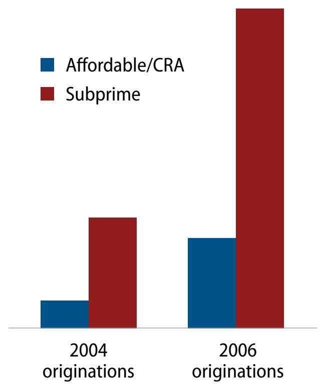
But that does not explain how lenders, policymakers, regulators, and investors lost sight of the difference between making mortgages possible and making *as* many mortgages *as* possible.[7]

Sensible policymaking requires a clear understanding of the real facts of a situation. This paper will provide a short, direct summary of the studies, data, and other available evidence regarding home mortgage products and programs designed to build homeownership among first-time homebuyers in our minority and lower-income communities and then evaluate what works. As will be demonstrated in the pages that follow, many affordable housing programs, including Community Reinvestment Act lending by regulated financial institutions worked as intended (see box below on CRA). These successes can help point the right way forward out of the U.S. housing crisis.

FIGURE 1

Affordable mortgages work

A comparison of delinquency rates among homeowners who borrowed through affordable housing and Community Reinvestment Act programs against similar borrowers who tapped subprime loans



Note: Predicted serious delinquency 24 months after origination.

Community lending and subprime loans to similar borrowers.[5]

Estimation is based on a borrower with a FICO score between 580 and 620 with the mean value of other regressors. Controlling variables include borrower DTI, FICO_score, home equity, loan age, loan size, area credit risk, area unemployment rate, and interest-rate environment. Values indexed to 2004 affordable/CRA 24-month default risk.

Mortgages that work

Despite the excesses of the subprime lending era, America today still boasts hundreds of thousands of working families who became successful homeowners during this period—homeowners at the lower end of the pay scale. Many achieved ownership through policies that reduce wealth barriers to homeownership among first-time, low-income, and minority homebuyers. Studies of such efforts in the1990s had shown that lowering down payment and cash required to close were found to have the most potential impact on closing homeownership gaps.[12]

Easing wealth constraints to homeownership in a way that protects against the risk of default is particularly critical to addressing the racial homeownership gap. Median household income for minority households is close to that of white households (reaching 72 percent in 2007 from 61 percent in 1998), but the wealth gap remains startling. The median minority household holds only 16 cents in wealth for every $1 held by a white household. Homeownership continues to represent an important wealth-building ladder to financial stability for both minority and low-income households, whose home equity represents a greater share of wealth than it does among white and higher-income homeowners, respectively.[13]

In practice, we have decades of experience from around the country demonstrating the benefits of a range of policies and programs that effectively create sustainable, affordable homeownership, even for borrowers with little equity to invest in a home. These approaches have been proven on the ground and analyzed by various experts. They point the way to a better homeownership policy for the future. Below are several examples of how to expand moderate-income ownership that is stable, affordable, and sustainable for the long term.

The Self-Help secondary market program

Since the early 1990s, Self-Help has made nearly 4,300 direct home loans totaling more than $318 million. It also created a secondary mortgage market program that helped finance the purchase of more than 50,000 home loans from low-income and minority borrowers in 48 states totaling more than $4.5 billion. These loans were purchased from nearly 40 lenders, mostly between 1999 and 2005, and then sold in the secondary market. Roughly 40 percent of these loans were to minority families, more than 40 percent were to female-headed households, and average borrower income was only around $33,000, or 62 percent of their area median income. The average loan was around $70,000.[14]

These loans featured minimal cash-to-close requirements, with more than half the mortgages having loan-to-value ratios of 97 percent or higher. A higher LTV is necessary in many areas in order to address the lack of wealth among many lower-income borrowers, particularly minority families.[15] In addition, participating lenders commonly offered flexible guidelines and alternative ways to document credit history and income (though all loans are fully underwritten by the originating lenders).

In fact, as of December 2009, on net, Self-Help secondary market borrowers were holding on to positive equity gains roughly equivalent to 80 percent of the median borrower's annual income. Self-Help-financed families realized a return on assets better than the Dow Jones Industrial Average, for example, and a double-digit annual return on their modest equity investment. More importantly, most are still holding on to homeownership, with a delinquency rate well below those who tapped subprime adjustable rate mortgages, subprime fixed-rate mortgages and even prime ARMs.[16]

Neighborhood Housing Services

Neighborhood Housing Services reported in 2007 that of nearly 3,000 home loans it funded to borrowers averaging only two-thirds of the national median income and fitting the profile of subprime borrowers, the delinquency rate was only 3.34 percent. This was just a bit above the national *prime* delinquency rate of 2.63 percent for the same period, and vastly below the nearly 15 percent subprime default rate prevailing at that time.[17]

These results were achieved even when Neighborhood Housing Services' borrowers chose high loan-to-value and lower down payment mortgages, with the loan-to-value ratio of up to 97 percent at purchase. The upshot: these fixed-rate mortgages with monthly payments in amounts affordable to the borrowers offset initially low personal equity investment in achieving stable ownership.

The Massachusetts Affordable Housing Alliance

The Massachusetts Affordable Housing Alliance offers lower-income homebuyers a so-called "soft second" mortgage as a path to ownership. Through this program, first-time homebuyers with incomes generally below 80 percent of area median (although open to purchasers at up to 100 percent of median) take out a 30-year fixed-rate first mortgage covering 77 percent of the purchase price from a participating bank. The buyer makes a personal down payment of 3 percent. The balance of 20 percent is a second mortgage loan that is interest free, "soft," for the first 10 years. In addition, the first and second mortgage loans are at interest rates slightly below-market.

This program enabled more than 13,000 families with below median incomes to become first-time homeowners over the past 18 years. According to one recent review, the program's "delinquency rate in the first nine months of 2008 was 2.2 percent, compared to a 4.4 percent rate for all prime mortgage loans statewide," and far below the subprime default rate.[18]

Why these affordable home loan programs work

These impressive mortgage payment records by working-class families at the lower end of the income spectrum illustrates why it is wrong to blame hardworking Americans for the U.S. housing crisis. In fact, these mostly first-time homebuyers consistently made their mortgage payments month after month, year after year because they adhered to established home lending fundamentals:

- Fixed-rate, fully amortizing loan terms over 30 years
- Full documentation of income and demonstrated ability to pay the mortgage
- Escrows of taxes and insurance to ensure regular payment

In addition, there is an important element in effective affordable ownership lending programs—checks against refinancing with high-cost and exotic mortgages, such as most of the underregulated subprime products that caused the U.S. housing crisis. Some affordable loan programs also prohibit refinancing or home equity loans without consent, which has proven an effective barrier to predatory loan sales efforts.[19]

But perhaps equally important is third-party counseling, arranged or even required by many programs for aspiring first-time homeowners. Studies show a range of potential benefits from homebuyer education and counseling, depending on quality and delivery method. These potential benefits include:

- Reduced delinquency and default[20]
- Lower-cost mortgages[21]
- Higher satisfaction with housing payments[22]
- Improved financial standing[23]
- Increased likelihood to seek foreclosure prevention assistance[24]
- Improved likelihood of subsequent refinancing to a lower-cost mortgage[25]

Moreover, counseling services disproportionately assist lower-income and minority borrowers. More than half of the clients of counseling agencies approved by the Department of Housing and Urban Development had incomes below 50 percent of the area median, and another 30 percent had incomes between 50 percent and 80 percent of the area median. While the majority of clients where white, 35 percent were African American, despite accounting for only 13 percent of the overall U.S. population. Similarly, 49 percent of surveyed agencies served clients who were predominantly nonwhite.[26]

Despite these and other success stories, some will no doubt argue that it is time to pull back public efforts to assist homeownership for low- and moderate-income families. A quick review of history, however, shows that the American housing market is more stable and affordable when the federal government takes an active role in the regulation and oversight of the market.

Rebutting directly the myth that mortgages offered to lower-income and minority borrowers encouraged by the CRA and similar polices somehow caused the foreclosure crisis, San Francisco Federal Reserve Bank President Janet Yellen puts it most succinctly:

> *There has been a tendency to conflate the current problems in the subprime market with CRA-motivated lending, or with lending to low-income families in general. I believe it is very important to make a distinction between the two. Most of the loans made by depository institutions examined under the CRA have not been higher-priced loans, and studies have shown that the CRA has increased the volume of responsible lending to low- and moderate-income households.*[27]

Indeed, government home mortgage programs covered a shrinking share of the housing market during the recent subprime boom, and CRA even less. The reason: CRA only applies to commercial banks' and thrifts' loans to low- and moderate-income borrowers and those made in low- and moderate-income communities near the branch offices of these financial institutions. But the majority of subprime loans were originated by non-bank independent mortgage companies, not subject to CRA, that were mostly financed by Wall Street investment banks looking to package and sell these loans in the form of mortgage-backed securities to institutional investors worldwide.

Consequently, only a fraction of a fraction of home mortgage loans could be reasonably attributed to the CRA. Indeed, the share of mortgages subject to CRA examination dwindled during the recent years when many of the loans that subsequently went into default were originated.[28] In fact, only a small share (9 percent) of the high-cost mortgages made to borrowers targeted by the CRA were made by banks for CRA credit.[29]

On the contrary, low- and moderate-income and CRA home lending mandates helped, rather than hurt, ownership stability. During the 1990s, banks and investors in home mortgages, particularly Fannie Mae and Freddie Mac, introduced incremental innovations in lending policies that bit by bit opened the doors to their mortgage products, especially to previously underserved borrowers. In particular, new flexibility in underwriting guidelines and efforts to address wealth barriers were important steps toward broader access to homeownership.

These flexible underwriting guidelines (such as reduced down payments, higher debt-to-income ratios, and alternative approaches to verifying credit and income) combined with risk mitigation strategies (such as credit enhancement, prepurchase counseling, and proactive loan servicing procedures) are a distinguishing characteristic of sustainable affordable lending efforts. Specifically, these features enabled affordable mortgages to be made because of:

- Reduced down payments and cash required to buy a home
- Higher debt-to-income ratios to enable lower-income families to qualify for mortgage payments that are often similar to their previous rental outlays
- Pertinent histories of stable income as opposed to stable employment with the same employer to take into account the fact that some lower-wage workers are more likely to switch employers while remaining stably employed in the same type of work
- Use of rent or utility records to document creditworthiness
- Reduced cash reserves offset by education and counseling, enhanced mortgage servicing to prevent defaults[30]

Together with the other tools of affordable home lending, it is clear that responsible lending to lower-income and minority homeowners can be done effectively and efficiently. Going forward, if utilized more broadly, such programs could safely boost homeownership rates for underserved communities in our country.

Debunking the conservative myth that the Community Reinvestment Act "caused" the U.S. housing crisis

The Community Reinvestment Act of 1977 was enacted to address practices of redlining (the practice of overtly excluding segments of society from access to affordable credit) and discrimination in lending.[8] CRA requires regulated depository institutions—basically, banks, thrifts, and any institution that enjoys the benefit of a federal deposit insurance—to "help meet the credit needs of the local communities in which they are chartered" in a way that is "consistent with the safe and sound operation of such institutions." The CRA has been shown to increase the flow of funds into minority and low- and moderate-income neighborhoods, but critics complain that it is unnecessary interference in private business.

In the wake of the U.S. housing crisis, numerous respected and knowledgeable parties have rejected claims that CRA "caused" the subprime lending explosion and subsequent wave of defaults. Here's what Federal Deposit Insurance Chairman Sheila Bair, one of the first regulators to warn about the true causes of the U.S. housing crisis, had to say about Community Reinvestment Act lending and the U.S. housing crisis:

> *I think we can agree that a complex interplay of risky behaviors by lenders, borrowers, and investors led to the current financial storm. To be sure, there's plenty of blame to go around. However, I want to give you my verdict on CRA: NOT guilty.*
>
> *Point of fact: Only about one-in-four higher-priced first mortgage loans were made by CRA-covered banks during the hey-day years of subprime mortgage lending (2004-2006). The rest were made by private independent mortgage companies and large bank affiliates not covered by CRA rules.*
>
> *You've heard the line of attack: The government told banks they had to make loans to people who were bad credit risks, and who could not afford to repay, just to prove that they were making loans to low- and moderate-income people.*
>
> *Let me ask you: where in the CRA does it say: make loans to people who can't afford to repay? No-where! And the fact is, the lending practices that are causing problems today were driven by a desire for market share and revenue growth ... pure and simple.*
>
> *CRA isn't perfect. But it has stayed around more than 30 years because it works. It encourages FDIC-insured banks to lend in low and moderate income areas, and I quote, "consistent with the safe and sound operation of such institutions.*
>
> *Another question: Is lending to borrowers under terms they cannot afford to repay "consistent with the safe and sound operations"? No, of course not.*
>
> *CRA always recognized there are limitations on the potential volume of lending in lower-income areas due to safety and soundness considerations. And, that a bank's capacity and opportunity for safe and sound lending in the LMI community may be limited.*
>
> *That is why the CRA never set out lending "target" or "goal" amounts. That is why CRA supporters, many of you here today, have labored for three decades to figure out how to do it safely. It makes no sense to give a loan to someone under terms you know they can't pay back. That's a set up for failure.*
>
> *Despite our current problems, the homeowner is still one of the best credit risks in the world. Today, the delinquency rate on all home mortgages is only 3.6 percent. For subprime loans, there is a stark difference in the type of loan. The rate of seriously delinquent subprime fixed rate loans is a little more than one-third the rate for subprime adjustable rate mortgages.*
>
> *Any family willing to work, save money, pay the mortgage on their house is a sound basis of credit and a sound basis for America.*
>
> *So let the record show: CRA is not guilty of causing the financial crisis.*[9]

Or read what Federal Reserve Board Chairman Ben Bernanke had to say about home lending through the Community Reinvestment Act in a recent letter he sent to Sen. Robert Menendez (D-NJ):

> *Our own experience with CRA over more than 30 years and recent analysis of available data, including data on subprime loan performance, runs counter to the charge that CRA was at the root of, or otherwise contributed in any substantive way to, the current mortgage difficulties.*[10]

And Gene Ludwig, former comptroller of currency, in a detailed study assessing the claim that CRA drove subprime lending, similarly reached this conclusion:

> *[I]t is apparent that the increase in subprime defaults did not result from the CRA inducing banks to reduce underwriting standards or undervalue risk. Rather, investors' desire for higher investment yields and Wall Street's response pulled the non-CRA, unregulated mortgage market in that direction.*[11]

The shared equity approach to homeownership works

Another approach that addresses the wealth barrier facing lower-income and minority families is so-called shared equity down payment assistance. The shared equity approach bridges the gap between an affordably sized first mortgage not exceeding 80 percent of the purchase price and the borrower's limited savings. Shared equity programs do this by providing down payment assistance from either governmental agencies or nonprofit groups. This down payment assistance, however, is treated as an investment. It creates in effect a partnership between the individual homebuyer and the public or nonprofit institution providing the additional support.

Shared equity fairly returns to the public (either taxpayers or nonprofit donors) a share of the investment through the creation of a long-term affordable asset—a home affordable to future families in need—while returning to the homeowner a reasonable increase in personal wealth. Shared equity approaches are often done by community land trusts, which aid affordability by owning the land under the home, reducing the upfront cost to the initial homeowner. Land trusts also ensure that future sales of the assisted home are to other low- and moderate-income buyers, and very often land trusts come to the aid of borrowers who get into financial trouble. Other shared equity programs use deed-restricted resales, which are another legal mechanism for ensuring that the terms of the original deal are followed.[31]

The results are impressive. One recent study found that the foreclosure rate among community land trust homeowners was less than 0.2 percent, or one-sixth of the national average and an even smaller fraction of the average among the lower-income homeowners that these groups serve.[32]

Savings programs such as Individual Development Accounts also appear to create more stable homeownership. IDAs are special savings accounts that permit a low-income family to add to its savings and receive a matching amount of savings from private donors or government programs. IDAs may be used for postsecondary education or job training, homeownership, or to start a small business.

A soon-to-be released study sponsored by the Corporation for Enterprise Development examined the incidence of foreclosure among a sample of 831 IDA participants who purchased homes between 2001 and early 2008. Roughly 68 percent of IDA buyers were minority households, and roughly 75 percent were headed by women. But only 3 percent of the IDA borrowers entered foreclosure between 2001 and April 2009. This is in contrast to an overall foreclosure rate in the same communities for all loans originated over the same time period of 6.3 percent, and a nearly 9 percent foreclosure rate for low-income individuals who purchased similarly priced homes over the same time period.[33]

Conclusion

Structuring the equity and debt components of homeownership to fit the needs of first-time lower-income and minority borrowers is essential to sustainable homeownership. This paper demonstrates why affordable mortgage financing that incorporates underwriting guidelines based on borrowers' ability to repay, as well as measures to help first-time borrowers bridge the wealth gap with down payment assistance or IDA savings, can work well.

Indeed, successful homeownership efforts from around the country demonstrate that affordable and first-time homebuyer programs are likely to do well when the ability of the borrower is aligned with the interests of mortgage originators and investors through policies that encourage the financing of sustainable homeownership and that deter the proliferation of defective and high-risk loans.

In contrast, the U.S. housing foreclosure crisis laid bare the dangers of mortgage lending driven by mortgage brokers and investment bankers who only want to earn fat fees for lending, packaging, and reselling high-priced, high-risk mortgages. These predatory lending practices are the root cause of the foreclosure crisis still haunting communities across our country. Affordable housing programs are an important part of the answer for low- and moderate-income borrowers in search of a piece of the American Dream.

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7 While beyond the full scope of this paper, a quick review of federal housing policy holds some answers. Prior to the 1930s, the federal government had limited involvement in housing Americans. Buying a home required down payments of up to 50 percent. Those that could afford the down payment had access to only short-term, interest-only mortgage loans. The Great Depression exposed the risks of these mortgage terms as foreclosures rose to the point where 10 percent of all homes were bank owned.

The federal government responded by creating the Reconstruction Finance Corporation, the Federal Home Loan Bank System, and the Federal Housing Administration during the 1930s. The FHA provided government insurance for mortgages, eventually leading to the 30-year fixed-rate self-amortizing mortgage that became the staple of American real estate markets. The Federal National Mortgage Association (Fannie Mae) was chartered in 1938 to securitize FHA loans, creating the secondary mortgage market. These reforms brought stability and affordability to the housing market, opening the possibility of homeownership to more Americans. From 1940 to 1960, the homeownership rate increased from 44 percent to 62 percent.

Yet the benefits of homeownership were not accessible to everyone. The Civil Rights era brought new reforms, such as the Fair Housing Act in 1968 and the Home Mortgage Disclosure Act and the Community Reinvestment Act in the 1970s. These efforts were meant to counter redlining, the practice of overtly excluding segments of society from access to affordable credit. In 1992, Congress imposed affordability goals on Fannie Mae and its companion enterprise Federal Home Loan Mortgage Corporation, or Freddie Mac, both of which had been privatized in the 1970s, to encourage them to extend credit to lower-income and minority borrowers. Enforcement of the CRA was improved in 1995. Along with strong economic growth, these changes helped increase the homeownership rate from 64 percent in 1990 to 66 percent in 2000. More significantly, homeownership gains were particularly strong for lower-income and minority households. This period was marked by stability, low-credit losses, and steadily rising house prices.

In this fertile field, sowed by an aggressive deregulatory trend promoted by numerous Bush administration agencies, a new and invasive species began to flourish. A new "originate-to-distribute" lending channel emerged, one that used mortgage brokers and nonbank lenders to originate loans, and financed this lending through the sale of mortgage-backed securities. Because it relied on nondepository funding and utilized nonbank actors to do its lending, this lending channel fell outside the regulations that kept commercial banking in check. This private, largely unregulated mortgage-backed securities market fed the dramatic expansion of subprime and Alt-A mortgages, financial products that were not eligible for funding through the traditional, governmentally regulated channels. Wall Street-based private financial sector capital funneled into private label mortgage pools increasingly displaced Fannie Mae, Freddie Mac, and the Federal Housing Administration. At the height of the housing bubble in 2006, private-label MBS accounted for more than 50 percent of MBS issued.

This model had some obvious weaknesses. A lack of skin in the game and financial incentives to sell more and costlier products meant that largely unregulated mortgage brokers and lenders had perverse incentives to originate unsustainable loans. Mortgage originators extended mortgages with exotic and risky features, such as hybrid ARMs, interest-only and negative-amortization schedules, and prepayment penalties. Underlying fundamentals, like borrower income, mattered less and less as demonstrated by the popularity of stated income loans, where borrowers only had to state their incomes to qualify. In fact, the period between 2002 and 2005 was the only time in the last two decades analyzed when the growth of mortgage credit was negatively correlated with the growth in income.

Any boost in homeownership that these "innovations" created proved illusory. The homeownership rate peaked nationally in 2004 at 69.2 percent. By 2007, house prices had begun to fall. The early wave of spiking foreclosures concentrated among borrowers in risky subprime loans initiated, or exacerbated, neighborhood price declines. More and more homeowners fell "underwater," including millions who had stuck with safer conventional and conforming Fannie Mae and Freddie Mac loans with large down payments.

We now have 2.6 million fewer homeowners than at the peak, and as the foreclosure crisis continues to unfold that number is sure to grow. Among African Americans, however, the homeownership rate has fallen further—from more than 49 percent in 2004 to 46 percent at the end of 2009, a level not seen since 1999. Nevertheless, that trend is not irreversible if we both properly police the mortgage market for unsafe products, and expand financing and other programs that actually work well for lower-income and minority households.

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