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Homeownership: America's Dream?

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Homeownership is central to the notion of the "American Dream." It is thought to confer benefits not only to individuals in the form of asset building and life satisfaction, but to society as a whole through increased property values, reductions in crime, and general neighborhood prosperity. As a result, homeownership has been a legislative priority since the passage of the National Housing Act in 1949. In the past two decades political and social efforts to promote homeownership among lower-income households has intensified, resulting in what some have labeled a boom [Belsky and Duda, 2002]. Unfortunately, delinquency and foreclosure rates have also dramatically increased in recent years, reaching unprecedented levels by 2007. Among the most susceptible are lower-income households, which leads to the question: do the benefits of homeownership outweigh the potential costs for lower-income Americans?

Findings

- Homeownership among lower-income households increased dramatically between 1994 and 2006. This is largely the result of social and political action, particularly legislation enabling financial institutions to make loans to applicants they previously would have denied.
- While it is almost taken for granted that homeownership results in financial and social benefits, there are inherent risks associated with homeownership. Given that these risks may be particularly acute for lower-income homeowners, it is not obvious that for them owning is necessarily better than renting.
- Simulations measuring costs and benefits of lower-income homeownership indicate mixed results. When potential homeowners buy in lower-income neighborhoods, are able to put down at least 5%, and experience at least moderate appreciation, there is potential for increased wealth. Under less ideal circumstances this is less sure, and buying a home in a middle-income neighborhood rarely makes financial sense for lower-income homebuyers.
- The risk of foreclosure is very real for lower-income homebuyers, and analysis of zip-code level data confirms that foreclosure rates are indeed higher in areas with higher rates of poverty and lower average incomes.

Explaining the Increase in Lower-Income Homeownership

In 2006, 38% of households in the bottom income quintile, and 57% of those in the second quintile owned their homes, as compared to 91% in the top quintile and 69% overall. While this represents a significant gap, homeownership among lower-income households has dramatically increased during the past two decades. Between 1994 and 2006, homeownership among the lowest income quintiles grew more quickly than the national average, increasing at roughly double the national rate during the first half of the period.

While there is evidence to suggest that the financial situation of lower-income households improved over the 1990s, homeownership increases for this group are largely a result of the evolution of the financing system that supports homeownership. Starting with the Community Reinvestment Act of 1977, which created incentives for federally insured depository institutions to help meet the credit needs of the communities they serve, a number of legislative and regulatory changes have improved access to credit in underserved populations. A key piece of legislation was the Depository Institution Deregulation and Monetary Control Act of 1980. Prior to deregulation, financial institutions faced caps on the interest rates they could charge on loans, and as a result, high risk applicants were routinely denied. Applicants with impaired credit or low income or wealth were simply shut out of the market. Once banks were free to charge higher interest rates to compensate for the higher risk they were assuming, there was an explosion of new high cost, or "sub-prime" loans. Indeed, during the 1990s, the number of sub-prime loans increased 900% [Hurd and Kest, 2003], and by 2006 they represented 13% of all outstanding home mortgage loans [Duncan, 2006].

Emerging Issues Related to Lower-Income Homeownership

In addition to the potential for asset building, homeownership also poses significant risk, particularly for lower-income individuals. Because they tend to buy homes in lower-income neighborhoods, lower-income homeowners may face greater than average uncertainty with regard to the condition and potential appreciation of their houses and neighborhoods. In addition, the lack of affordable housing in many parts of the country results in a serious cost burden for many lower-income homeowners. Over 20% of first time lower-income homebuyers spend more than 50% of household disposable income on housing, as compared to the overall rate of 12% [Gramlich, 2007]. This puts them in a serious cash bind if and when unexpected expenses or income disruptions occur, which could eventually lead to foreclosure.

Perhaps most importantly, the rapid evolution of the mortgage finance market has resulted in a number of new loan products which differ dramatically from the traditional fully amortizing 30-year fixed rate loan, in which monthly payments are constant. New products, such as the 2/28 ARM loan (a low "teaser" rate for the first two years, then rates that are annually adjusted over the next 28 years) or the 5/1 ARM (a relatively low fixed rate for the first five years, which then switches over to an adjustable rate), have variable payment patterns. They represent a new type of risk for borrowers, since if interest rates rise they now face an elevated risk of default, even if their own personal circumstances haven't changed. A certain degree of financial sophistication is necessary to fully understand the intricacies of these loans, and many lower-income applicants are less adept in this regard. A lack of financial sophistication can also lead to predatory lenders taking advantage of potential borrowers through high prepayment penalties, excessive points and fees, inflated appraisals, etc. [Hurd and Kest, 2003; Carr and Kolluri, 2001]. Falling victim to such practices certainly increases the potential for significant equity loss and even foreclosure.

Does Homeownership Pay for Lower-Income Households?

In order to address this question a model is created to simulate how the wealth of low-income households might evolve over time if they had purchased homes under various scenarios*. In each simulation, households are assumed to be identical with respect to income, living expenses and inflationary environment, so that differences in wealth accumulation derive from growth in equity and savings. The results indicate that homeownership can be, but is not always, beneficial to lower-income households. In the short run (1 year), families buying homes in lower-income neighborhoods experiencing moderate appreciation, might expect wealth gains under all but the most extreme financing situation ($0 down, 2/28 loan). In contrast, buying in a middle-income neighborhood would almost always be a losing proposition, with only those families able to put 10% down and that experience a relatively high (12.3%) appreciation rate likely to experience gains in wealth. Over a 10 year period, for homes purchased in a lower-income neighborhood, wealth gains appear possible under a number of financial arrangements. The extent of the gain appears to be largely a function of the size of the initial down payment. Wealth gains from homeownership in middle-income neighborhoods are, again, a much less sure thing. When appreciation is low, only those able to put down a relatively large down payment would expect to see an increase in wealth, and such increases are modest. During periods of higher rates of appreciation, larger wealth gains are possible, but only for those able to put down at least 5%. Whether homeownership is preferred to renting is a separate question. It turns out that during periods of relatively high home appreciation, homeownership often produces more wealth than would renting. In periods of lower appreciation, however, renting often produces greater increases in wealth than does owning because more saving is possible.

Simulation results also suggest that especially in periods of low home appreciation, lower-income homeowners will be unlikely to amass adequate wealth to be able to

* The simulation involves 27 prototype households defined by age, household size and relative income, two different scenarios regarding neighborhood affluence, 12 combinations of down payment (0, 5% or 10%) and mortgage type (30 year fixed, 2/28 ARM, and 5/1 ARM), and two home appreciation rates (4.1% or 12.3%), over a 10 year time horizon.

weather unexpected expenses or shocks to income. This, of course, can lead to an inability to make monthly payments, and ultimately, foreclosure. Zip code-based data show that the period June 2006 to May 2007 saw a marked increase in foreclosures; the by-product of a dramatic slowing of the nation's housing market beginning in 2006. An analysis of zip code based data indicates foreclosure rates were indeed higher in areas with higher poverty rates and lower average incomes, as well as in areas with higher housing costs. Consistent with the simulation we see higher vulnerability to foreclosure for lower-income homeowners in weak markets. And for families facing this situation, foreclosure can have more devastating consequences than rental eviction, since they may lose not only their housing, but also assets and credit [Gramlich, 2007].

Conclusions and Policy Directions

Lower-income homeownership has grown dramatically over the past 20 years, allowing households previously shut out of this market an opportunity to enjoy its potential benefits. Homeownership is not without risk, however, and lower-income households are not only particularly susceptible to such risk, but due to high cost burdens and the types of loans they qualify for, may face more risk than their better-off counterparts. The current housing environment, featuring low rates of appreciation and the heavy use of subprime mortgage instruments, leaves lower-income families extremely vulnerable to homeownership failure.

Moving forward, it is important to take steps to help shield lower-income homeowners from these heavy costs. Several ideas come to mind. Perhaps most important involves increasing the financial sophistication of lower-income households so that they can make better judgments as to whether a certain mortgage instruments makes sense for them. Homeownership counseling programs, and including financial literacy as part of the high school curriculum, are two possibilities. Other tacks include increasing savings among lower-income families so that when they purchase a home they can make a larger down payment, as the risk of default appears to be significantly reduced when homeowners acquire equity early on. Regulatory reform may also be warranted. In particular, anti-predatory lending laws, requiring brokers to be bonded with the bond drawn upon if a mortgage defaults, and the establishment of a reporting system that rates brokers according to the number of bad loans they have made, might all be considered. Finally, subsidizing the construction of affordable housing, particularly on the two coasts where there are acute shortages, certainly makes sense.

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