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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, Stephen Oliner, resident scholar at the American Enterprise Institute and a senior fellow at the UCLA Ziman Center for Real Estate, details the innovative Wealth Building Home Loan that boosts homeownership with minimal risk.

A BETTER MORTGAGE LOAN

By Stephen Oliner, senior fellow, UCLA Ziman Center for Real Estate

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For more than 50 years, U.S. housing policy has relied on loosening mortgage lending standards to promote homeownership and wealth accumulation, particularly for low- and middle-income households. This approach, however well intentioned, suffers from two basic flaws. First, it piles heavy debt burdens onto households with limited financial resources. And second, by relying on 30-year loans with small down payments, homeowners build equity very slowly unless their house happens to appreciate a lot. The combination of onerous debt payments and little home equity creates a wobbly foundation for the housing finance system.

"The Wealth Building Home Loan offers a much safer path to homeownership and financial security than a 30-year mortgage that pays off very slowly.''

Given these flaws, it is no surprise this approach has failed. The homeownership rate in the U.S. is no higher today than it was in the 1960s. Nor has the goal of building wealth for low- and middle-income households been achieved. For households in the 20th to 40th percentile of the income distribution – likely those at the margin of homeownership – Federal Reserve data show that median net worth fell in inflation-adjusted terms over the past two decades.[1]

Housing finance needs to be refocused on strengthening household balance sheets through sustainable homeownership. The new Wealth Building Home Loan that Edward Pinto and I developed at the American Enterprise Institute does exactly that. It offers a much safer path to homeownership and financial security than a 30-year mortgage that pays off very slowly for years to come.

The WBHL can have either a 15-year or a 20-year term. In either case, borrowers accumulate home equity quickly, in effect making sizable contributions to a "home savings account" every month. The interest rate on the WBHL can be fixed for the life of the loan or can adjust after a minimum of five years provided that the payment increase at the time of adjustment is modest. This option gives lenders the flexibility to design loan products that limit their interest-rate risk and simultaneously lower the initial monthly payments for borrowers.

The WBHL requires little or no down payment. Even with no money down, the 15-year WBHL generates more equity within two years than a 30-year mortgage with five percent down, and the equity advantage of the 15-year loan widens from there.[2] The 20-year version of the WBHL builds more equity than the comparison 30-year loan in less than three years.

Borrower funds that would normally go for a down payment are instead used to buy down the interest rate on the WBHL. The rate buydown serves several purposes. First, it lowers the monthly payments somewhat. Second, it reduces the likelihood that the loan would be refinanced, which is attractive to lenders and investors looking for a stable payment stream. Finally, it should contribute to neighborhood stability, as borrowers reap the benefit of the lower interest rate only by staying in the home.

The final element of the WBHL is its use of sound underwriting procedures that adhere closely to those employed by the Department of Veterans Affairs. The VA's so-called "residual income underwriting" looks beyond the standard debt-to-income ratios, focusing instead on the entire household budget to ensure that the borrower can comfortably meet other living expenses while paying down the mortgage. This careful underwriting reduces the risk of default. In a competitive market, the lower risk ultimately benefits borrowers via reduced mortgage rates or reduced costs for mortgage insurance.

For many low- and middle-income borrowers, the alternative to the WHBL would be a 30-year loan guaranteed by the Federal Housing Administration. A key question is how much house one could buy with the WBHL compared to the FHA loan and how large the monthly payments would be. We estimate that the 15-year WBHL allows the borrower to buy almost 90 percent as much house as the FHA loan, with a slightly higher monthly payment; the 20-year WBHL nearly replicates the buying power of the FHA loan, with essentially the same monthly payment. Thus, the WBHL provides a way for home buyers to build substantial wealth with, at most, a modest downsizing of their house purchase and a small increase in monthly payments.

Widespread adoption of the WBHL would sharply lower the odds of another financial crisis. Because the loan amortizes quickly, instances of negative equity would be unusual, even in areas with volatile house prices. Should borrowers encounter payment difficulties, lenders have an incentive to offer remediation options because borrowers with equity are more likely to remain current after a loan modification. Even in a worst-case scenario, there is a good chance that the homeowner could sell the house and pay off the loan.

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[1] See the Survey of Consumer Finances (http://www.federalreserve.gov/econresdata/scf/scfindex.htm).

[2] Five percent is the median down payment today on mortgage loans to purchase primary residences.

Last September, the Neighborhood Assistance Corporation of America, a national nonprofit that supports homeownership in lower- and moderate-income neighborhoods, offered the first WHBL. With subsidized funding from Bank of America and Citigroup, NACA's loan has no down payment, no closing costs, and no mortgage insurance, and borrowers can buy down the interest rate practically to zero by paying six points, which most borrowers have opted to do. NACA reports strong demand for the loan, which is available through all of its offices, including the two in California (Los Angeles and Oakland).

The first lender to offer the WBHL as an unsubsidized, market-rate product was Androscoggin Bank in Lewiston, ME. Androscoggin launched its program in February with a 15-year loan that has a two-step rate structure: a bought-down rate of 1.75 percent for the first seven years, which adjusts to 5 percent in year eight for the remainder of the loan term. Borrowers pay three points for the buydown. The rate adjustment entails minimal payment shock, as the stepped-up rate is applied to a loan balance that has shrunk more than 40 percent from the original amount. Like NACA, Androscoggin has seen robust demand for the loan. Based on its early success, Androscoggin is now introducing a 20-year WBHL.

Other community lenders are preparing to offer the WBHL or are already in the market. One such lender, Atlantic Coast Bank in Jacksonville, FL, has rolled out the loan under a pilot program developed by MGIC, a national mortgage insurer. MGIC is offering mortgage insurance tailored to the loan and has already signed up 14 lenders across nine states for the pilot. Separately from the MGIC program, we are talking with several other lenders about offering the loan.

The best way to avoid a repeat of the financial crisis is to encourage the extension of safer mortgages that build home equity. The WBHL is an important step in that direction.

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