The Wealth Building Home Loan

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Workshop on the Appropriate Government Role in U.S. Mortgage Markets
Federal Reserve Bank of New York
April 27, 2017

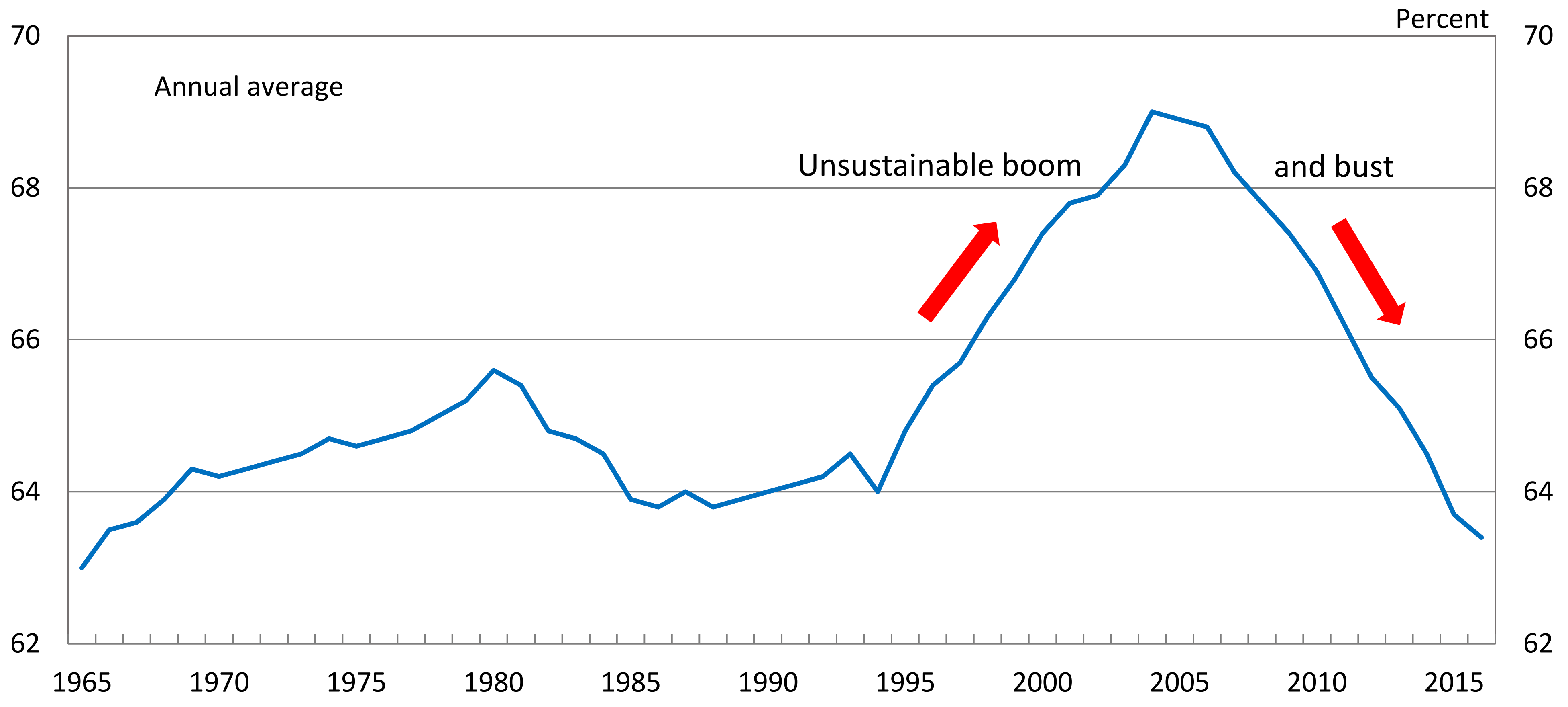
The views expressed are the authors' alone and do not represent those of the institutions with which we are affiliated.

Background and Basic Principles

- Homeownership can be an effective way to build wealth, but current policy undercuts this goal with mortgages that
  - Place heavy debt burdens on many buyers
  - Pay off very slowly
- To build wealth, homeowners must:
  - Buy a house they can comfortably afford to minimize risk of default
  - Pay off the mortgage well before retirement. Can't count on home price gains to build equity.
- We developed the Wealth Building Home Loan (WBHL) to meet these goals
  - It's a throwback to a safer era of mortgage lending
  - Has received very favorable press and is being offered in the marketplace

Homeownership Rate – No Higher Today Than 50 Years Ago

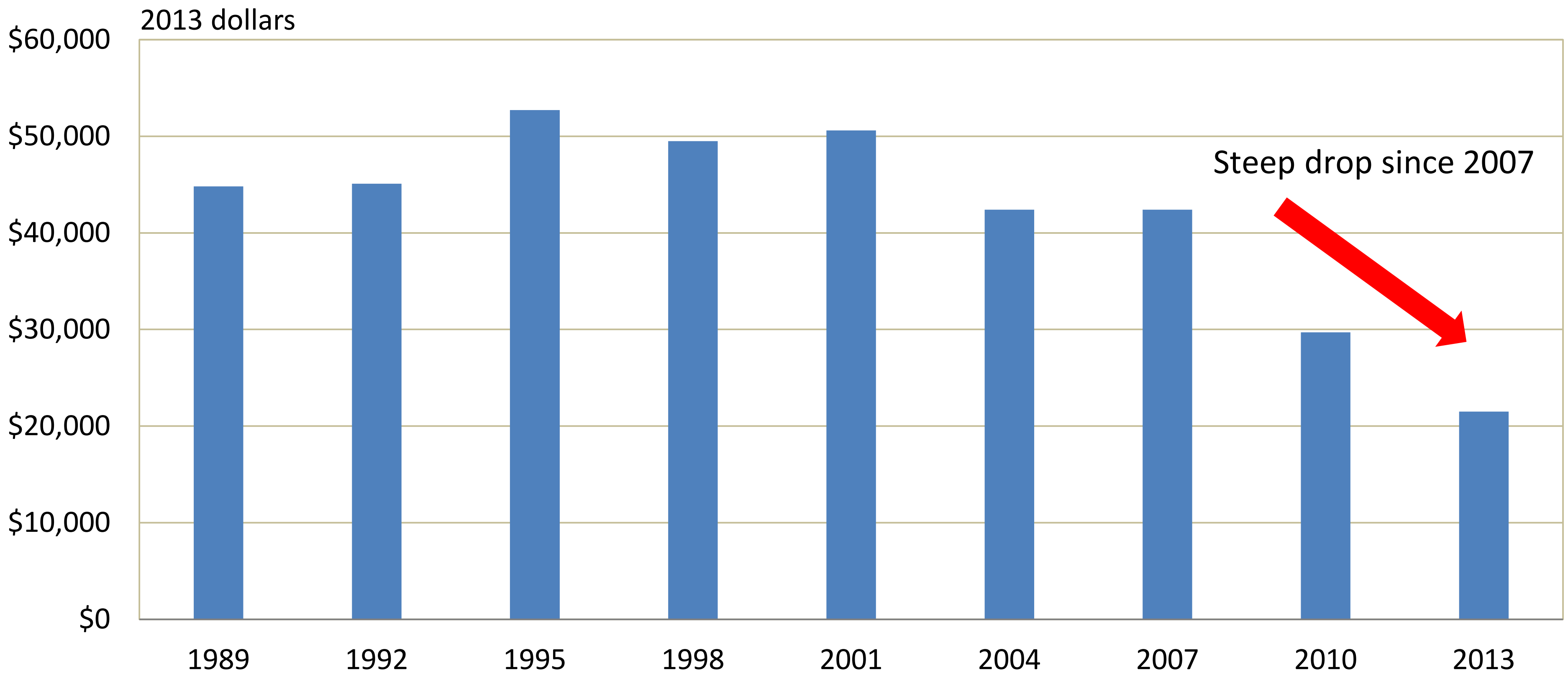
Unsustainable increase from 1994 to 2004, following by a bust in which millions of households lost their homes.



Source. U.S. Census Bureau

Net Worth Has Fallen for Lower and Moderate Income Households

No gain in real terms from 1989 to 2007, followed by a steep drop. Efforts to build wealth haven't worked.



Note: Each bar shows median net worth for households in 20^{th} to 39.9^{th} percentile of the income distribution. Figures are adjusted for inflation and are expressed in 2013 dollars.
Source: Federal Reserve Board, Survey of Consumer Finances, https://www.federalreserve.gov/econres/scfindex.htm, table 4, public data file.

Homeowners Can't Count on House Price Gains to Build Wealth

- We show this with FHFA zip-level house price indices for top 100 CBSAs covering 1990-2015
  - More than 5000 zip codes
  - Group the zips into price tiers (lower, middle, upper) within CBSA using Zillow data
  - Lower tier especially relevant because that's where new homebuyers tend to locate
- Find that prices rose almost everywhere from 1995 to 2005
- But many zips saw declines in other periods, especially in lower price tier:

	Share of zips with decline in HPI		
	1990-1995	2005-2010	2010-2015
Upper price tier	28%	72%	15%
Lower price tier	42%	84%	42%

- Risk for individual homes greater than shown in the table. WBHL mitigates the risk.

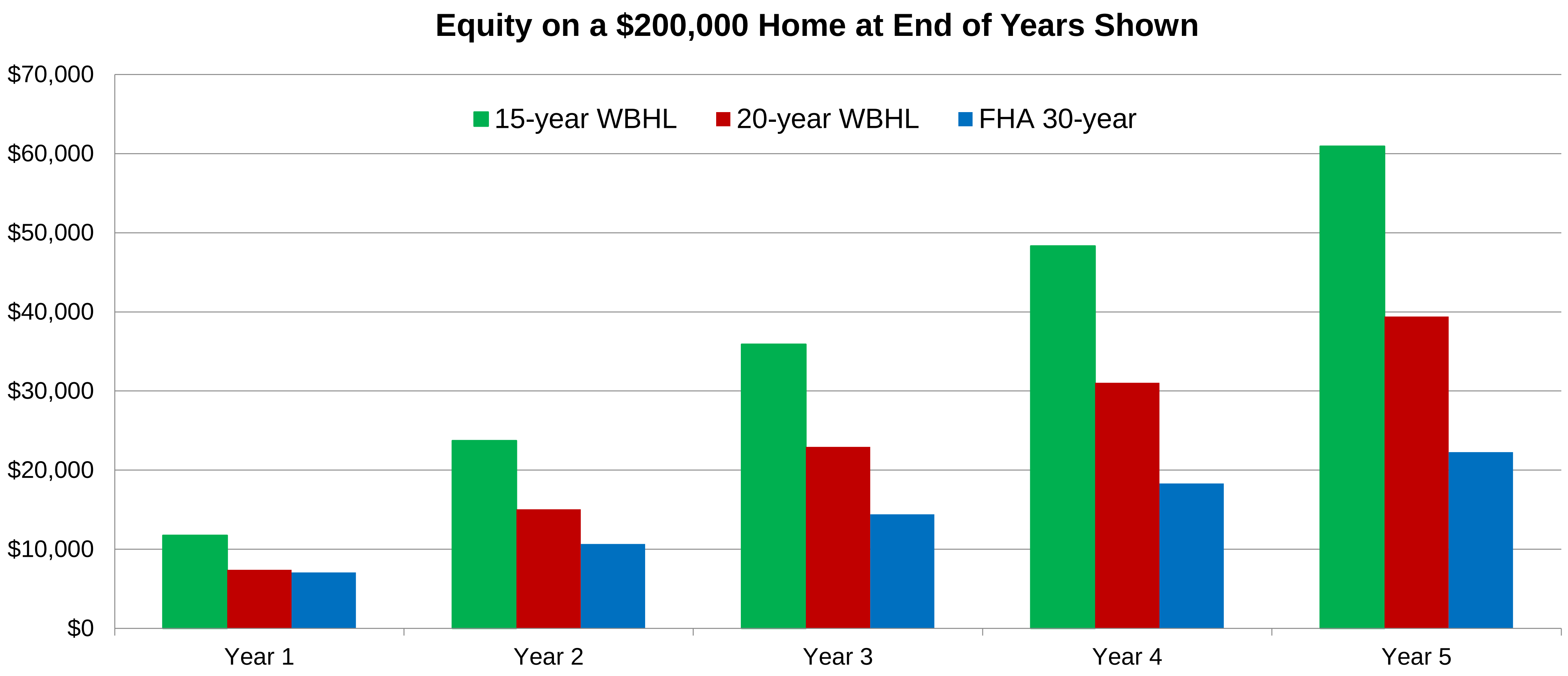
Key Features of the WBHL

- 15-year or 20-year fully amortizing loan. Two main versions:
  - Fixed interest rate for life of loan
  - Initial rate fixed, usually for 7 years, with requirement of minimal payment shock at time of adjustment
- Prudent underwriting that right-sizes the house to borrower's budget
  - VA's residual-income underwriting is the recommended approach
  - Reduced default risk lowers cost of credit enhancement to the borrower
- Low down payment or none at all
- Funds typically used instead to buy down interest rate
  - Can lower monthly payments
  - Reduces prepayment risk, making the loan attractive to many mortgage investors
  - Promotes neighborhood stability, as homeowner realizes benefit of the buydown only by staying in the house

WBHLs in the Market Today

- More than $100 million of WBHLs have been originated
- Neighborhood Assistance Corporation of America (NACA) offers a 15-year fixed rate WBHL with subsidized funding from Bank of America and Citibank
- Androscoggin Bank in Maine developed first market-rate WBHL and uses a two-step rate structure for 15- and 20-year loans
  - Rate fixed for first 7 years (1.75% for 15-year loan; 2.99% for 20-year loan)
  - Rate adjusts at beginning of year 8 to higher fixed rate for remainder of loan
- About 25 other lenders are offering WBHLs through a program developed by MGIC, which provides mortgage insurance for the loans

Rapid Buildup of Home Equity with the WBHL



Note. 15-year WBHL has an interest rate of 1.75% for first 7 years and 5% for remaining 8 years, no down payment, and 3 buydown points. 20-year WBHL has an interest rate of 2.99% for first 7 years and 5.25% for remaining 13 years, no down payment, and no buydown points. FHA 30-year loan has a 4% interest rate, 3.5% down payment, and a 1.75% upfront mortgage insurance premium rolled into the loan amount, for an effective initial LTV of 98.19%. Nominal house price is assumed to be unchanged.

Three Other Benefits of the WBHL

- Lower monthly payments than other 15- and 20-year loans
  - In fact, 20-year WBHL has about the same monthly payment as 30-year FHA loan!
  - Main reasons for reduced monthly payments: (1) lower cost of credit enhancement due to prudent underwriting and (2) two-step rate structure
- Protection against negative equity
  - Simulation exercise shows that 15-year and 20-year loans would have substantially reduced incidence of negative equity during financial crisis
  - Greatest benefit in areas with volatile house prices
- Lower risk for the financial system
  - During the financial crisis, 15-year loans defaulted only a third as often as otherwise identical 30-year loans. 20-year loans defaulted only half as often.
  - Lower defaults reflect a combination of self-selection and greater equity

Final Thoughts

- We think the WBHL is the model for how mortgage lending should be done, especially for first-time buyers
- Mortgage lending used to be safe, and it can be again
- Any questions – please contact me!