

Low Income Home Ownership: Now More Than Ever

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In late 1989, members of the American Society of Real Estate Counselors participated in a survey about the major forces that will influence real estate over the next two decades.¹ The respondents agreed overwhelmingly that the economic environment of the United States would determine the vitality of the real estate market. Despite a soft economy, there was substantial optimism. Nearly half felt that interest rates would stabilize at about 9 percent over the next 10-20 years. Of the remainder, however, almost twice as many expected interest rates to increase as expected them to fall. The more optimistic expectations were based on a belief, shared by nearly two-thirds of the experts, that the United States would become more competitive in world markets during the next twenty years, resulting in an improvement in the U.S. balance of trade.

According to many observers, however, the globalization of the American economy, and its transformation away from goods production toward services and information processing will lead to greater income inequality during the 1990s. Job losses will continue in higher paying, traditional goods-producing industries with low educational requirements. Job growth will be concentrated in newer, more technologically-oriented sectors with high wages and educational requirements, as well as in the service and retail trade sectors, which have lower pay and educational requirements.

Despite the fact that our increasingly globalized economy is creating large numbers of high-wage, highly skilled jobs, "the dominant trend in American job creation during the 1970s was for low-paying jobs to replace those which formerly provided a middle-class standard

of living."² This trend will continue into the 1990s. One recent national study shows that 64 percent of American jobs paid middle-level wages in 1979, while the share of middle-wage jobs created during the 1980s was only 38 percent. Over half of the net increase in employment was in poverty-level jobs.

During roughly this same period, inflation-adjusted rents for poor households living in unsubsidized housing increased by nearly a third.³ Since 1981 all rents have risen 16 percent faster than inflation.⁴ As a result, real residential rents in the United States are higher now than at any time during the past 20 years. This rent inflation has exacted a heavy toll on the supply of affordable housing, suggesting that homelessness will not abate and that housing affordability problems will become even more widespread and persistent.

According to the Joint Center for Housing Studies, the number of units renting at or below \$300 a month in real terms fell by one million between 1974 and 1985.⁵ Looking ahead, another 30 percent of this stock is estimated to be physically inadequate or at risk of loss through upward market pressures.⁶ Even without the dramatic cutbacks in federally assisted housing during the Reagan years, the affordable housing crisis would have worsened.

Apart from the convincing argument for substantially more federal housing assistance of all kinds, there is an equally compelling case for more low-income home ownership assistance. For many years, the poor have not received an equitable share of federal housing subsidies. In just 1989 and 1990, the amount of federal tax expenditures for all home owners totaled \$107 billion, two-thirds of which went to households with incomes of \$50,000 or more. This was approximately equal to the amount of money spent directly on all low-income subsidized housing programs during the 1980s. These same tax breaks for home owners exceeded \$80 billion in fiscal 1991 alone, which is more than five times greater than all budget outlays for assisted housing by the Department

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Home ownership assistance would also enable families to gain financial equity in an asset. This could be especially important to low-income minorities because equity in a house represents a very large portion of the net wealth of minority households.⁷ In 1988, 54 percent of the average home owner's net wealth was equity in a house. Although both net wealth and home equity were lower among black owners, equity accounted for fully 80 percent of their net wealth. Among Hispanics, home equity represents virtually all (98 percent) of a household's net wealth.

For a variety of reasons, including racial discrimination, minority home ownership rates are substantially lower than those for whites. This also means that "the lack of home ownership opportunities for...[minorities] has undermined their ability to accumulate wealth."⁸ It further implies that properly structured low-income sales programs could help remedy this injustice.

Significantly, the majority of public housing residents are minorities, as were more than 90 percent of all home buyers in HUD's recently completed national Public Housing Homeownership Demonstration. The amount of equity that public housing buyers ultimately accrue in their units will depend upon the extent to which the initial pricing and financing of the transaction accurately reflects underlying market value, the nature and length of resale restrictions, and the prospects for price appreciation.

As long as there is real value present to begin with, a low-income family can realize a relatively large increase in net wealth even in a flat market, because home ownership is such a highly leveraged investment. Each one percent increase in price boosts a home owner's return to equity by ten times that amount if she has a 90 percent mortgage, and by 33 times with a 97 percent loan. The combination of mortgage amortization and a five-year price-appreciation rate of just 3 percent a year for a house that was financed with a 30-year, 97 percent Federal Housing Administration (FHA) loan will generate a 40 percent annual return on initial equity. In just five years, this modest rate of market appreciation will produce more than a four-fold increase in the home owner's initial equity.

There is a third, and often underemphasized, argument in favor of low-income home ownership programs. Targeting the program to higher-income occupants of public- and other federally-subsidized rental housing will make these units available for poorer families on the waiting list. According to HUD, it costs around \$69,000 to build a typical new public housing unit. The operating subsidy needed to keep the rent affordable to the very poor over the economic life of the public housing unit would add another \$10,000-\$15,000 (in present value terms) to the federal cost. A program that would open up an existing public housing unit by helping a family

move into home ownership at a long-term federal cost of less than \$80,000 a unit is more cost-effective than building more public housing.

The FHA Reform Bill

Although the Bush Administration's one program, the HOPE initiative, is consistent with a home ownership-oriented, low-income housing policy, recent actions to tighten FHA mortgage lending regulations are not. Stimulated by a Price Waterhouse audit of the FHA insurance fund which found that losses exceeded premium income by a wide margin on FHA transactions that took place between 1975 and 1985, the FHA reform measure enacted into law as part of the 1990 National Affordable Housing Act increased up-front cash requirements on a \$70,000 house by more than \$1,300 (a 44 percent increase). This is the result of an additional insurance surcharge on low down payment loans, and a two-thirds reduction in the amount of closing costs that can be financed.

The Administration's emphasis on restoring the FHA Insurance Fund to fiscal solvency is not necessarily misplaced. However, requiring unsubsidized, lower-end FHA insured loans to cover their own losses while at the same throwing millions of dollars at a public housing home ownership program that is cost-driven and without market-based discipline does not make a whole lot of policy sense.

Ironically, those in the Administration who successfully raised the cost of FHA financing to moderate-income families in the name of fiscal integrity are the same officials who have already approved spending more than \$30 million (more than \$65,000 a unit) on the rehabilitation of the 464-unit Kenilworth-Parkside public housing complex in Washington, DC. The Federal government has since sold the complex to a resident management council for one dollar. While preaching actuarial soundness for FHA, HUD gave its blessing to a preliminary plan to convert Kenilworth-Parkside into a limited equity co-op. To maintain its long-term viability, this plan would have required resident incomes to increase each year at a rate substantially greater than the national average. When the General Accounting Office (GAO) questioned the unrealistic underwriting assumptions of the Kenilworth-Parkside conversion, the project's financial consultant defended the financing plan with the comment that "in order to prove themselves financially capable of purchasing their apartments, a significant number of [Kenilworth-Parkside] families will declare the additional [unreported] income they are already making."⁹

The Administration's move to tighten up FHA's first-time home buyer programs in accordance with the Price Waterhouse recommendations, while not doing the same to its various public housing home ownership initiatives, is myopic at best. At worst, it suggests an implicit

policy to get the federal government out of the public housing business at any cost.

The Lessons of the Price Waterhouse Study

The Price Waterhouse study contains five findings that are particularly relevant to low-income home ownership. First, there is an inverse relationship between the rate of inflation for house prices in the country and rates of mortgage default. During the late 1970s, when house prices appreciated at about 12 percent a year, FHA default rates were very low. Since 1980, house prices have increased less than 3 percent per year and default rates have surged.

Default is most likely to occur when a borrower has negative equity in a property. This usually happens because the value of the property has fallen below the loan balance. While a borrower's equity is a function of several factors, the two most important factors are the initial loan-to-value ratio and the subsequent price appreciation of the property. Holding appreciation rates constant, lower down payments result in higher default rates. In fact, borrowers with an initial down payment of 3 percent or less defaulted on their mortgages five times more frequently than those whose down payments exceeded 25 percent. To attach numbers to these rates, nearly 9 percent of all recent FHA loans with an initial down payment of 3 percent or less have already failed. This compares with a failure rate of less than 2 percent for loans with an initial down payment of 25 percent or more. Additionally, within the FHA portfolio, lower valued loans also tended to have a higher rate of default. This was especially true for houses valued under \$48,000, where the failure rate was more than 8 percent.

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The economic model that Price Waterhouse used to predict mortgage claims demonstrated that a home buyer's decision to default on a mortgage will be determined largely by their perceptions of home equity and their desire or obligation to move. When real estate markets experience significant and sustained declines, the best financial option is often to walk away from the property. This choice will be made when the resale value of the home falls far enough below the market value of the remaining mortgage balance to outweigh the economic and non-economic costs of default.

Finally, it is frequently argued that, especially among lower income borrowers, default is caused by factors beyond the home owner's control, such as illness, divorce, or unemployment. According to the Price Waterhouse analysts, as long as borrowers have positive eq-

uity, they are more likely to sell their homes to recover that equity rather than default on their loans.

The Results of HUD's Public Housing Home Ownership Demonstration

Over a 51-month period (June 1985 through August 1989), the seventeen public housing authorities participating in the demonstration sold 320 public housing units, only a quarter of the more than 1300 units they had planned to sell.¹⁰ Despite HUD's demonstration rule that units had to be sold to existing tenants, lack of effective demand among public housing tenants resulted in nearly one out of every four sales to non-resident households on public housing waiting lists.

Housing authorities encountered a variety of problems that affected their ability to carry out their home ownership programs at the scale and pace originally intended (or, in some cases, to carry them out at all). These overlapping problems, which had a particular impact on multi-family conversions, can be roughly divided into the following categories:

- Lack of effective leadership, including internal conflict within the local public housing authority (PHA) and/or the community over the goals of the public housing home ownership program;
- Poor program design and/or legal constraints concerning title to public housing and involuntary relocation;
- Adverse local market conditions, where public housing sales had to compete with the bargain sales of FHA foreclosed houses;
- Lack of replacement housing; and
- Inadequate tenant incomes.

Too little time has passed to determine how well the former public housing tenants have coped with the costs of home ownership. There is, however, some data on short-term affordability problems. To place these numbers in perspective, we should keep in mind that Price Waterhouse has found that about 9 percent of all FHA-insured, low down payment loans originated between 1975 and 1985 have already failed. The early evidence from the public housing home ownership demonstration indicates that failure rates will probably be in the same range. As of the end of August, 1989, five of the demonstration's twelve active sales programs had already reported a problem with late payments or more serious borrower delinquencies. Within the first 18 months of closing, between 10 and 15 percent of the buyers indicated that they were having problems meeting their housing costs. About 31 percent of all buyers indicated that their mortgage payments were causing a strain on their budgets, and 10 percent said they were already at least one month behind on their payments.

In one demonstration site with two public housing co-ops, one of the co-ops had a 20 percent delinquency rate. In the other, a third of all buyers had fallen behind in their housing payments within the first eighteen months of closing and had little hope of catching up.

Annual turnover in one of these co-ops was about 27 percent, while in the second it was a lower 7 percent. Virtually all of this turnover occurred without one market sale of a single co-op share taking place. Despite Jack Kemp's sentiment that "owning something changes behavior in ways that no amount of preaching middle-class values ever could," in at least one home ownership site, one in five low-income buyers have already walked away from their public housing co-op as if they were renters. This brings us back to the Price Waterhouse finding that even where the decision to move is caused by personal factors, default is most likely to occur when a borrower has no home equity.

In general, the typical single-family public housing buyer has a positive equity position in the property from day one. The buyer's equity, which equals the difference between the market price of the unit and the discounted sales price, cannot be immediately realized under the terms of the deferred payment, second mortgage that the housing authority holds. If buyers remain in their homes beyond the expiration of the HUD- and PHA-imposed resale restrictions, however, they can realize the full amount of their initial equity by selling or refinancing their property. If property values appreciate during their tenure, so much the better. For example, in buying their single-family public housing units at highly discounted prices, buyers in Baltimore received an average of \$5,300 in initial locked-in equity. In Chicago they received about \$17,000.

This is not the case in multi-family home ownership projects. In two out of the three multi-family conversions that actually closed in this program, sales prices were based largely on total rehab costs with the financing arrangements designed to enable the housing authority to eventually recover its capital costs. Rather than reflecting real equity that the buyer can eventually realize through maintenance of the unit and responsible participation in the governance of the co-op, the forgivable silent second mortgage held by the housing authority represents excess debt. It secures that portion of the rehab cost that the tenant buyers could not afford to amortize on a current basis. Since buyers have negative equity in the co-op from the outset, it is not surprising that buyers walk away from their investments because of unforeseen changes in their personal circumstances, the responsibility of self-governance, or mismanagement of the co-op.

Conclusions

In light of the findings of these two studies, low-income housing policies must pay more attention to

expanding low-income housing opportunities. It is more cost effective to provide opportunities for higher-income public housing residents to move out of public housing into a home of their own than it is to sell off the public housing inventory. Rather than simply fighting the administration's privatization policies, more housing authorities should be actively pursuing their own home ownership initiatives that reward successful residents. In cases of public housing home ownership programs, families should be given a positive equity stake in their property from the beginning. Resale restrictions and prohibitions against "windfall" profits should be more lenient than those proposed by many housing advocates.

A public housing home ownership program should have its own source of rehabilitation capital that does not have to be fully repaid by residents when costs exceed market value. This source should be separate from existing rehabilitation programs so that the urgent need to revitalize the public housing stock will not be compromised by a sales program.

Providing buyers with post-sales financial assistance is necessary to any public housing sales program. Early experience with families who have bought units under the public housing home ownership demonstration suggests that even with deeply discounted prices, many families need continuing subsidies to keep their housing affordable. The Administration is therefore correct in proposing to make available housing vouchers to tenants who buy their public housing units.

Home ownership must be a large component of a broad-based, revitalized national low-income housing policy. It should not be the entire policy, however. Given the level of housing need in the country, successful rental programs for the very poor should not be cannibalized by any level of government in order to fund new home ownership initiatives.

Notes

- ¹ Charles J. Delaney and Maury Seldin, "Real Estate Issues in the 21st Century: A Delphi Perspective", *Real Estate Issues*, V. 14, No. 2, Fall/Winter 1989.
- ² The New York Times, March 12, 1989, pg. 1
- ³ Joint Center for Housing Studies, *The State of the Nation's Housing 1989*, Cambridge, Harvard University, 1989. Pg. 17.
- ⁴ Joint Center for Housing Studies, *The State of the Nation's Housing 1990*, Cambridge, Harvard University, 1990. Pg. 4.
- ⁵ Joint Center for Housing Studies, *The State of the Nation's Housing 1989*, Cambridge, Harvard University, 1989. Pg. 5.
- ⁶ *Ibid.*, pg. 6.
- ⁷ Joint Center for Housing Studies, *The State of the Nation's Housing 1990*, Cambridge, Harvard University, 1990. Pg. 15.
- ⁸ Joint Center for Housing Studies, *The State of the Nation's Housing 1989*, Cambridge, Harvard University, 1989. Pg. 10.
- ⁹ General Accounting Office, *Public Housing: Planned Kenilworth Parkside Sale Raises Issues for Future Transactions*, Washington, DC, December, 1989. Pg. 80.
- ¹⁰ William M. Rohe and Michael A. Stegman, *An Evaluation of the Public Housing Homeownership Demonstration*, U.S. Department of Housing and Urban Development, April, 1990.