

America's Second Housing Boom

Edward M. Gramlich

The American landscape changed dramatically after World War II, as homeownership rates rose from 45 percent to 65 percent in little more than a decade. This burst was fueled by the opening of mortgage credit and ownership to the middle class, symbolized by the now-classic 30-year fixed-rate mortgage. Millions of American households were able to purchase their split-level homes in the suburbs and send their children to the public schools there.

Low- and moderate-income households were generally excluded from this earlier movement. Either they could not get mortgage credit at all, or could not afford the down payment or monthly payments. Minority families often faced discrimination on top of these other factors. As a consequence, the national homeownership rate stabilized at about 65 percent for 35 years (figure 1).

But recently, homeownership again expanded. The share of Americans who owned homes rose from 64 percent in 1994 to 69 percent by 2005 (figure 2). This time the new homeowners were largely low- and moderate-income groups, and minorities. Over the decade, the homeownership rate in the lowest tenth of the income scale rose 4 percentage points to 43 percent, the second lowest rose 4 percentage points to 49 percent, and the rates for blacks and Hispanics rose 7 and 8 percentage points, respectively, to 49 percent. About 12 million new homeowners have emerged, roughly half of them blacks, Hispanics, and others of mixed race. The overall rate of 69 percent moves the United States into the top rung in world homeownership rates.

The Subprime Mortgage Market

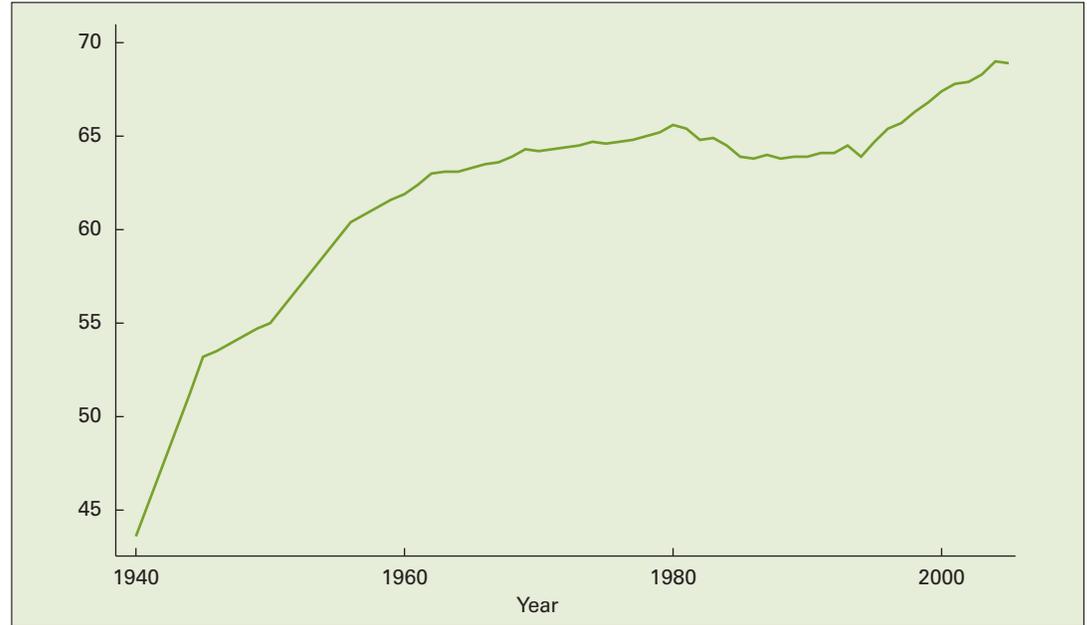
While the first surge in ownership involved the prime mortgage market, the second surge has been largely fueled by the development of the subprime mortgage market. This subprime market can render down payments as low as zero. Subprime borrowers have lower incomes and inconsistent credit histories, forcing them to pay high interest rates, sometimes double-digit interest rates, to get their loans. Points and fees are higher for subprime mortgages and prepayment penalties are almost universal, making it much more costly for borrowers to get out of subprime mortgage loans.

This subprime mortgage market is a reasonably new financing option. Subprime mortgage originations were a mere \$35 billion in 1994, less than 5 percent of total mortgage originations. By 2005, subprime originations had risen to \$625 billion (figure 3), now up to 20 percent of total originations and 7 percent of the total outstanding mortgage stock. Over the decade, subprime originations increased 17-fold, a whopping 26 percent annual rate of increase.

Just as the middle classes did at the close of World War II, these new low- and moderate-income homeowners now have a chance to build wealth, invest in their neighborhoods, have their children attend better schools, and reap other advantages of homeownership. Both presidents Bill Clinton and George W. Bush have engaged in significant cheerleading for the growth in homeownership. At this point most of the cheerleading has been from the bully pulpit, since there has been very little new federal money behind the growth in homeownership.

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FIGURE 1. Homeownership Rates, 1940–2005 (percent)

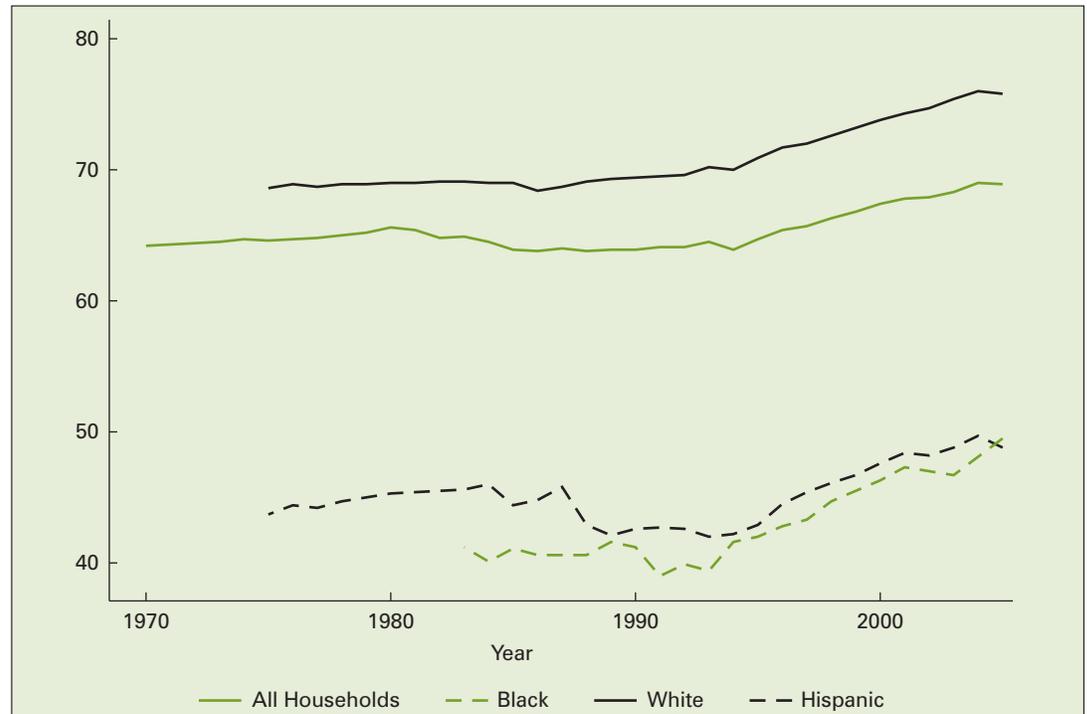


Source: U.S. Census Bureau.

But any social change this large is likely to have some mixed blessings. Overall delinquency rates for subprime mortgages are on the order of 7 percent, 10 times as high as the normal rate in the

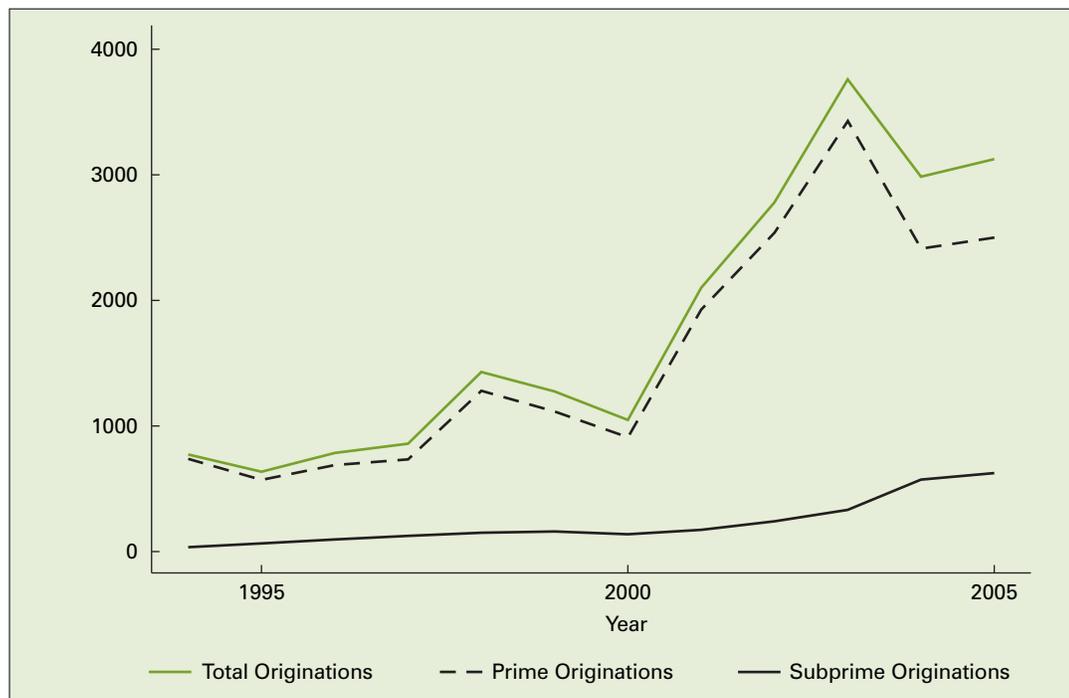
prime market (Joint Center 2006). Various indicators suggest that another 10 percent of subprime borrowers could be flirting with credit problems, even if not in actual delinquency or foreclosure status

FIGURE 2. Homeownership Rates, 1970–2005 (percent)



Source: U.S. Census Bureau.

FIGURE 3. Mortgage Originations, 1994–2005



Source: Mortgage Statistical Annual.

(Schloemer et al. 2006). And foreclosures have likely been held down by the recent period of very low short-term interest rates and the proliferation of financing instruments that take advantage of these rates. Now that short-term rates establish more normal levels, interest payment burdens for many subprime borrowers are rising sharply, and further increases in delinquencies and foreclosures are almost sure to follow.

Indeed, early reports show exactly that happening in late 2006. Three subprime lenders have recently declared bankruptcy, and an intensive study of six million recently made subprime mortgages forecasts sharply higher foreclosure rates (Schloemer et al. 2006). The numbers are not large enough to threaten the macroeconomy, but even a small rise in foreclosures could damage the prospects of millions of low- and moderate-income households.

The Role of House Prices

House prices play an ambiguous role in this story. When house prices rise at

healthy rates, as they have until just recently, borrowers make capital gains on their homes and build wealth. If they get in trouble with their mortgages, they can just sell their houses, pay their prepayment penalties, and walk away from the whole problem. Or they can refinance their mortgages on favorable terms.

Yet, the rise in house prices, combined with slow growth in low-income wages, has led to significant gaps in the stock of affordable housing. Nearly half of all households in the bottom quarter of the income scale now spend more than 50 percent of their income on housing, and another quarter spend between 30 and 50 percent of their income (Joint Center 2006, table A.6, 36). With housing expenditures at this rate, households have little left to spend on other things, and whether they buy or rent, they are likely to experience financial difficulties.

Consequently, the latest slackening in house price appreciation rates could have ambiguous impacts. Foreclosure problems might worsen or, perhaps, shortages of affordable housing might become less serious.

What Caused the Changes?

Several factors opened up housing markets. One clear factor is the disappearance of usury laws against unreasonable or excessively high interest rates. The Depository Institutions Deregulatory and Monetary Control Act of 1980 abolished usury laws on first mortgages, and states followed the federal lead and eliminated many of their own usury laws throughout the 1980s. Borrowers with inferior credit histories previously denied credit have become much more likely to qualify for subprime mortgage loans, perhaps even for prime mortgage loans. Reflecting this fact, mortgage denial rates, reported under the Home Mortgage Disclosure Act, have dropped noticeably (figure 4).

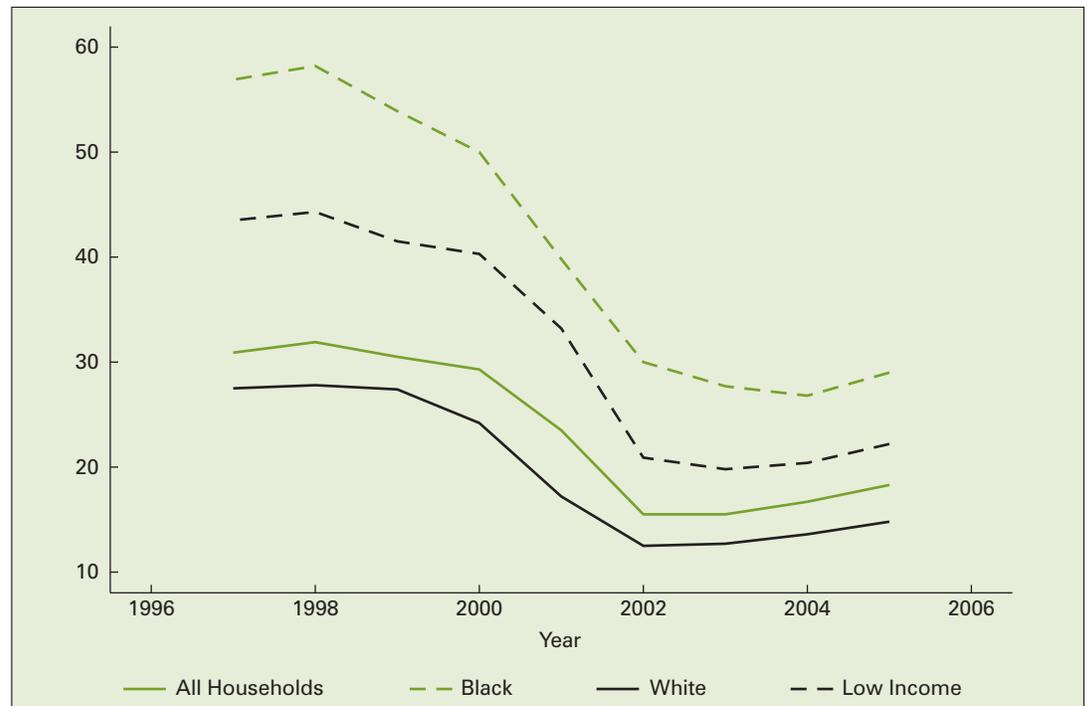
The reduction in usury laws has joined larger changes in credit markets. Lenders now rely much more on credit scoring and other such technologies to assess the risk of particular borrowers, and they have set up entities to compete for the new subprime business. Parallel developments have taken place in markets for auto finance and credit cards. Many new mortgage brokers and subprime lenders have emerged, as

have many old-line lenders with subprime mortgage subsidiaries. Financial regulation of these new entities is a good deal less stringent than for the traditional banking sector.

Another regulatory change that facilitated these developments was the 1977 Community Reinvestment Act (CRA). Through the 1980s and 1990s, the CRA encouraged banks to make low- and moderate-income mortgage loans in redeveloping areas. To their surprise, banks often found these loans to be profitable. In effect, the CRA opened up new areas of business to lenders unaware of the profit possibilities in these low-income markets. Thus, lending has expanded significantly to low- and moderate-income households. A large share of the new loans has financed the new set of low- and moderate-income homeowners.

There are other changes as well. The scope and breadth of community-based organizations have expanded significantly, whether they operate on their own or are tied to national networks such as Neighborworks America or the Opportunity Finance Network. The Federal Housing Administration, which guarantees the

FIGURE 4. Denial Rates for Conventional Mortgages, 1997–2005 (percent)



Source: Home Mortgage Disclosure Act.

mortgages of many first-time homebuyers, has liberalized its rules. Giant secondary-market purchasers like Fannie Mae and Freddie Mac have expanded into lower-income mortgage markets to meet their new and more stringent housing goals.

Benefits and Costs for the New Homeowners

The parallel growth of homeownership rates and the subprime market suggests that the new homeowners are drawn largely from groups formerly excluded from credit markets. A voluminous literature has tried to measure the basic benefits of homeownership. Essentially, these homeowners save more, build wealth, and act to improve their neighborhoods. The biggest problem with this literature is correcting for selection bias—are the new homeowners benefiting from owning a home, or would they have benefited anyway because of innate differences between them and renters? Did homeownership or the innate differences cause the gains? Earlier studies did not correct for this bias and generally found significant impacts of homeownership. Some of the newer studies in this area, beginning about 1990, have used panel data and other sources to correct for these biases (Dietz and Haurin 2003). While these new studies still find positive effects from homeownership, the impacts are not as large and are sometimes quite tenuous.

These post-1990 studies can be summarized briefly (Dietz and Haurin 2003). Homeowners might be expected to save more—and they seem to—since they have

the self-control mechanism of having to make their monthly mortgage payments. Homeowners might also be expected to build more wealth, both because of any added saving and the relative rise in house prices. Here the empirical confirmation is stronger, especially in areas where house prices are rising rapidly. Homeowners might be expected to be less mobile, due to the higher transaction costs of owning a home. Here there is strong empirical confirmation. They might be expected to work harder, particularly if they have to stretch to make their mortgage payments. Here there seems to be strong evidence that at least women increase their labor supply. Homeowners might be expected to invest more in their home, neighborhood, community, and children, and to guard more against crime. There is confirmation of some of these relationships, though not all. There is also some empirical evidence of greater self-reported satisfaction (table 1).

The American Housing Survey permits a more careful look at those buying a home for the first time in the 1990s (Herbert and Belsky 2006). These new homebuyers seem to be satisfied with their homes and to have made reasonable purchases from a physical standpoint. Again, it is hard to verify significant neighborhood improvements. The new homebuyers have generally put very little money down on their mortgages, though their interest rates are only slightly higher than on conventional mortgages. The most troubling aspect is that many new buyers now face significant cost burdens, and while they are not actually going into foreclosure, a high

TABLE 1. Theoretical and Empirical Impact of Homeownership (Post-1990 articles)

Impact on	Theoretical Impact	Empirical Confirmation
Household saving	Weak positive	Weak
Wealth accumulation	Strong positive	Depends on house prices
Mobility	Strong negative	Strong
Labor supply	Weak positive	Reasonable, for women
Property improvements	Strong positive	Weak
Urban environment	Strong positive	Weak
Political activity	Strong positive	Reasonable, on voting
Crime	Strong negative	Weak
Child outcomes	Strong positive	Reasonable
Satisfaction	Weak positive	Reasonable

share sells their houses after only a few years.

On the cost side, delinquency and foreclosure are the dramatic risks. Studies of the foreclosure problem in the city of Chicago suggest significant costs all around (Home Ownership Preservation Initiative 2006). Homeowners can lose their property, their equity, and their chance to build wealth. Even the lenders do not often fare well, with a series of servicing costs. The city loses, particularly when the property remains vacant and entails continuing costs. And neighborhood values go to pot when surrounding homeowners lose significant value.

There are more subtle costs as well. Even though refinancing a subprime mortgage is costly, some homeowners refinance often, up to several times a year. A series of terms—loan flipping, equity stripping—have come into use to characterize conditions in these markets. Some of these problems can be attributed to predatory lending and some to the fact that borrowers may have lost jobs (and their ability to make their mortgage payments).

Policy Changes

The country has, in effect, performed a huge experiment in opening up housing and mortgage markets to new groups of homeowners with marginal credit records, presumably lower incomes, and a higher representation from racial or ethnic minority groups. The changes are so huge they are likely to be irreversible—the country will not likely go back to homeownership rates of a decade ago and the subprime mortgage market will not likely shrink.

From an overall standpoint, this change would appear to represent a net social improvement. There seem to be more gainers than losers, and unless the losers lose a lot more per household, the net gains would seem to outpace the losses. Hence the over-

all net social benefit tally should be positive. But this is not the best way to view the change. Rather than evaluate the overall change, it makes more sense to see if there are measures that could reduce the costs or enhance the benefits.

An obvious potential policy measure is improved lending counseling, now already used by various community groups such as Neighborworks America. Targeted programs such as these can require that clients enter lending counseling programs, making these clients more selective in taking on credit and more disciplined in making mortgage payments. The programs can give valuable advice when consumers want to refinance, provide legal help in disputes, and refinance loans on terms preferable to those privately available. But lending counseling might inherently have limited effectiveness. Mortgage contracts can be unfathomable even to those with advanced degrees in finance, and the notion of universal housing counseling may be hard to shove down prospective buyers' throats. Also, attempts to establish universal counseling may create an industry of phony consultants.

Product restrictions might play some role. Very often subprime, and even prime, borrowers exhibit what economists call myopia, where they are more aware of short-term than long-term costs. If consumer myopia is a general problem, it may make sense to ban balloon payments in this market, as the Home Ownership Equity Protection Act of 1994 (HOEPA) already does for very high cost mortgages. HOEPA also contains strictures against long-term prepayment penalties, another restriction that may be appropriate to lessen the costs of mistakes. Many states have adopted their own policies, often patterned after the 1994 law, and these can be extended as well.

Measures could also be taken to reduce market inefficiencies. The U.S. Department of Housing and Urban Development (HUD) has promoted

the idea of folding all closing costs into one amount and of informing the consumer of this total amount in advance. Such a plan would provide better market information to consumers, and also give consumers a chance to shop around, as they do in other areas of the economy. Secondary-market purchasers such as Fannie Mae and Freddie Mac could also use their considerable leverage to lessen market distortions and standardize and clarify loan terms.

Financial lenders in this market could also be more closely regulated. Prime mortgage lenders are subject to arduous bank examinations every three years, examinations that monitor lending practices, verify borrowers' incomes, and assess repayment probabilities. Similar regulations could be extended to the affiliates of these prime lenders, and perhaps even to independent lending companies, the source of most allegations about predatory lending. There may also be ways to regulate mortgage brokers, who are placing ever-growing shares of subprime mortgages.

There are also ways to encourage homeownership on better terms. HUD has been doing some experimental programs under which tenants' rent payments are partially devoted to escrow accounts, to permit the tenants to become owners. These tenants have to satisfy difficult conditions to become owners, but the early experience is that once they do that, foreclosure rates are much lower (Lubell 2006). The lesson again seems to be that some coaching on homeownership may pay big dividends.

Conclusion

Wittingly or unwittingly, the United States has passed through an era of enormous social change in housing markets. The mortgage market has been opened up to millions of potential new homeowners, and the implications are huge, for both owners

and renters. There has been much research on particular aspects of these changes but very little in the way of overall assessment. There has also been little evaluation of potential policy changes. It is now time to begin that process.

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1997 to 2005. Dr. Gramlich spent his academic career at the University of Michigan, serving as provost and dean of the Public Policy school. From 1994 to 1996, Dr. Gramlich was chair of the Quadrennial Advisory Council on Social Security. In 1986–1987, he was first deputy and then acting director of the Congressional Budget Office. He also served as director of the Policy Research Division at the Office of Economic Opportunity (1971–1973), as senior fellow at the Brookings Institution (1973–1976), and in the Research Division at the Federal Reserve Board (1965–1970). Dr. Gramlich also was the staff director for the Economic Study Commission of Major League Baseball. He is author of a popular text on benefit-cost analysis, and has authored several other books and many articles on topics such as macroeconomics, social security, budget policy, income redistribution, and fiscal federalism.

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Given the chance, many low-income families can acquire assets and become more financially secure. Conservatives and liberals increasingly agree that government's role in this transition requires going beyond traditional antipoverty programs to encourage savings, homeownership, private pensions, and microenterprise. The Urban Institute's *Opportunity and Ownership Project* policy brief series presents some of our findings, analyses, and recommendations. The authors are grateful to the Ford Foundation and the Annie E. Casey Foundation for funding the policy briefs.

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