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The Case for Homeownership

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Outline

- Homeownership is an important source of wealth, and is a primary tool for wealth-building
- Sustainable homeownership is key; when borrowers are over-extended, in bad loans, over-leveraged, or not aware of the challenges of homeownership problems can develop
- Rental housing can be unstable, with rising rents and little control over maintenance
- There is no investment alternative that is as beneficial for wealth-building for middle-class Americans

Homeownership is a tool for building wealth.

Homeownership is an effective vehicle for wealth accumulation

Laurie S. Goodman and Christopher Mayer, “Homeownership and the American Dream”, *Journal of Economic Perspectives* 32, no. 1 (Winter 2018): 31−58.

- Homes have generally appreciated in price over time
- With today’s mortgages, owners typically pay down mortgage principal each month with nominally fixed payments that decline in real terms
- Homeowners can earn “sweat equity” by making improvements in their home
- Herbert, McCue, and Sanchez-Moyano (2014, 2016) find that homeownership was still associated with significant gains in household wealth after the crisis- although the magnitude of the gain was much smaller after the recession than before.
- For most of the post-war period, the opportunities for wealth-building through homeownership were enhanced by the ability of ordinary people to use leverage.

Homeownership is financially better than renting

Homeownership was advantageous most of the time, as demonstrated by the high annualized rates of return.

Internal Rate of Return on Homeownership versus Stocks and Bonds, 2002–16

	2002	2004	2006	2011	2016
Imputed rental "income" (Zillow)	$11,611	$12,452	$13,293	$15,015	$16,833
less annual maintenance (AHS)		$445	$470	$513	$506
less property taxes (AHS)		$1,591	$1,773	$2,034	$2,018
less homeowners insurance (AHS)		$478	$532	$569	$583
Net operating income		$9,938	$10,516	$11,899	$13,726
less capital improvements (AHS)		$2,815	$3,472	$3,311	$2,728
less mortgage payments		$7,658	$7,658	$7,658	$5,171
Imputed cash flow (net benefit)		-$536	-$613	$930	$5,827
plus value of tax deducation (if itemize)		$2,175	$2,177	$2,097	$1,444
Imputed cash flow with tax benefit		$1,639	$1,563	$3,028	$7,271
Financial cash flows					
Value of home	$134,200	$153,200	$188,200	$157,900	$181,600
Cash to purchase	-$28,987				
Net sale proceeds (each year)		$37,996	$73,771	$55,452	$85,127
Annualized financial return on equity		39.9%			
IRR on equity		12.6%	24.9%	6.9%	10.0%
IRR on equity with tax benefit		20.0%	30.6%	12.7%	14.3%
S&P 500 Index after-tax returns		14.1%	10.5%	3.3%	5.9%
Bond Index after-tax returns		5.2%	3.6%	3.8%	2.8%
S&P 500 Index returns		17.4%	12.7%	4.0%	6.9%
Bond Index returns		6.9%	5.0%	5.7%	4.4%

Source: Laurie S. Goodman and Christopher Mayer, "Homeownership and the American Dream," *Journal of Economic Perspectives* 32, no. 1 (Winter 2018): 31–58.
Notes: AHS = American Housing Survey; IRR = internal rate of return. The annualized return is computed using the cash at purchase in 2002, the annual imputed cash flow for each year of ownership, and the cash at sale in the year the property is sold.

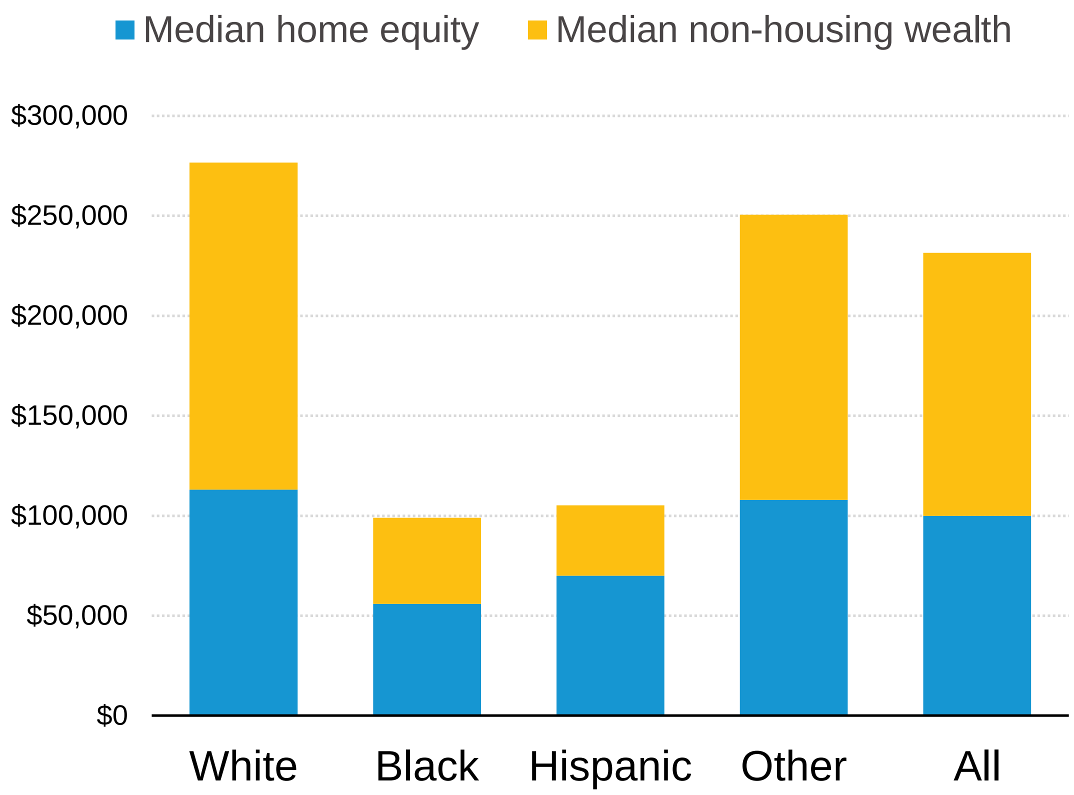
Internal Rate of Return on Homeownership

	2002	2004	2006	2011	2016	Annual change in home value, 2003–16
Dallas						
Value of home	$122,800	$129,600	$142,500	$137,400	$180,700	2.8%
IRR on equity with tax benefit		-3.3%	11.1%	8.2%	12.5%	
Los Angeles						
Value of home	$271,900	$393,500	$587,400	$417,600	$557,600	5.3%
IRR on equity with tax benefit		60.7%	54.3%	15.2%	15.1%	
Phoenix						
Value of home	$139,900	$157,300	$269,300	$139,800	$215,600	3.1%
IRR on equity with tax benefit		12.5%	48.7%	4.1%	12.1%	
Cleveland						
Value of home	$128,100	$137,700	$144,800	$119,400	$124,800	-0.2%
IRR on equity with tax benefit		-4.6%	4.0%	-4.1%	2.1%	
Denver						
Value of home	$214,200	$223,500	$234,900	$218,600	$324,200	3.0%
IRR on equity with tax benefit		-11.8%	0.1%	-1.6%	9.0%	
New York City						
Value of home	$261,800	$338,700	$432,500	$357,300	$379,300	2.7%
IRR on equity with tax benefit		41.3%	39.2%	14.5%	13.1%	
Chicago						
Value of home	$181,500	$213,900	$238,500	$186,500	$194,300	0.5%
IRR on equity with tax benefit		17.2%	18.6%	2.9%	7.3%	
United States						
Value of home	$134,200	$153,200	$188,200	$157,900	$181,600	1.9%
IRR on equity with tax benefit		20.0%	30.6%	12.7%	14.3%	

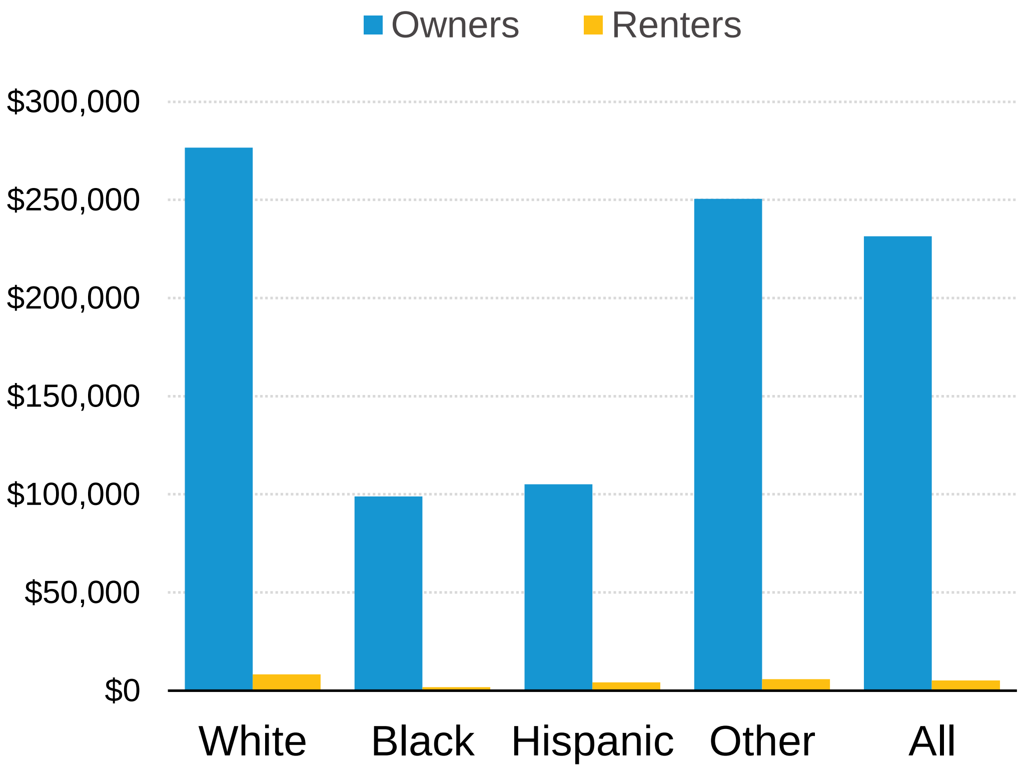
Source: Laurie S. Goodman and Christopher Mayer, "Homeownership and the American Dream," *Journal of Economic Perspectives* 32, no. 1 (Winter 2018): 31–58.
Notes: IRR = internal rate of return. The annualized return is computed using the cash at purchase in 2002, the annual imputed cash flow for each year of ownership and the cash at sale in the year the property is sold.

Renters have significantly less wealth than homeowners

Home equity as a portion of total wealth for homeowners



Total wealth: owners vs. renters



Source: JCHS tabulations of Federal Reserve Board, 2016 Survey of Consumer Finances.

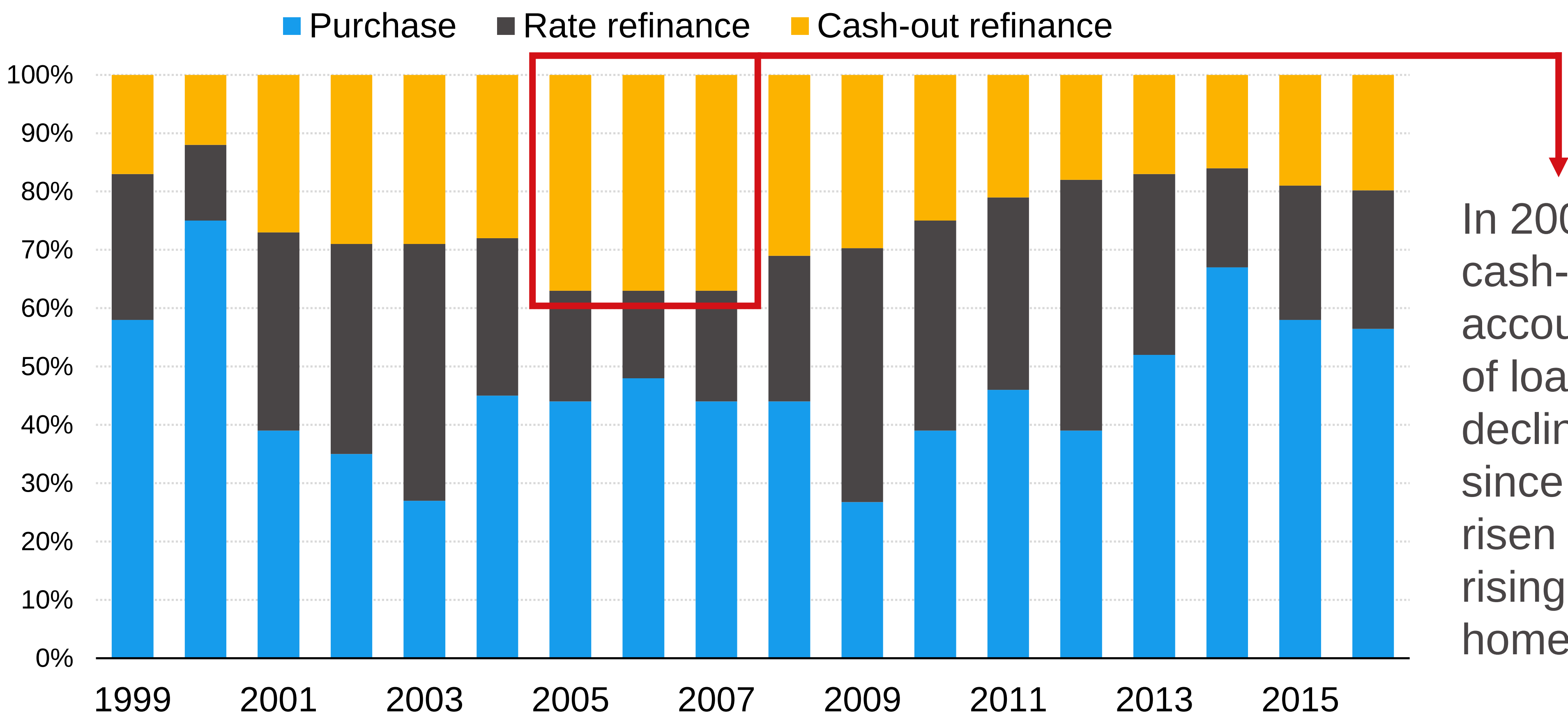
Sustainable homeownership

The Role of Cash-Out Refinances in the Financial Crisis

Laurie Goodman and Jun Zhu. 2018. *What Fueled the Financial Crisis*. Washington, DC: Urban Institute. https://www.urban.org/research/publication/what-fueled-financial-crisis

- Cash-out refinances surged in the pre-crisis years, resulting in many borrowers over-leveraging themselves.
- Data used for the analysis: information released to support CAS and STACR deals. This includes **only** 30-year, fixed rate, fully documented, fully amortizing mortgages, back to 1999. These are high-quality loans.
- **Excluded**: mortgages with special features such as interest only, negative amortization, terms longer then 30-years, adjustable rate mortgages, mortgages purchased under certain special programs.
- **Conclusion: purchase loans performed much better in the crisis, and continue to do so.**

Cash-out refinances surged in the years preceding the crisis

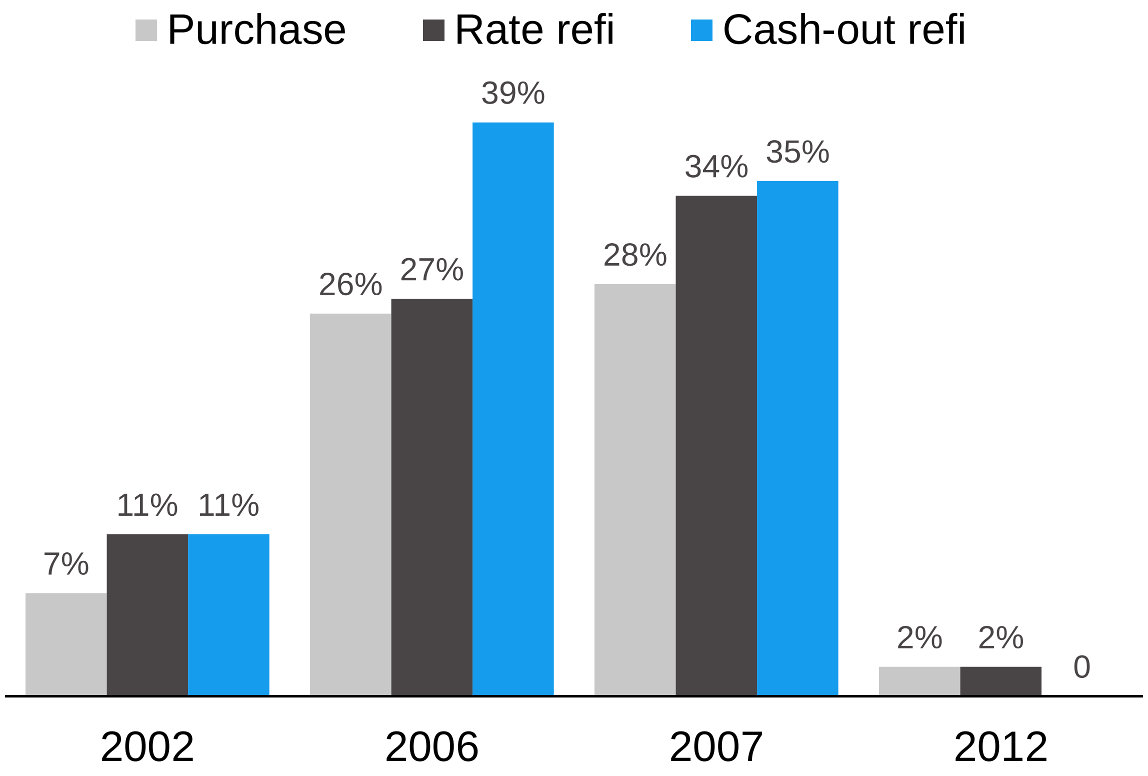


In 2005, 2006, and 2007, cash-out refinances accounted for 37 percent of loans. This has declined significantly since the crisis, but has risen recently due to rising interest rates and home price appreciation.

Source: Urban Institute calculations from Fannie Mae and Freddie Mac Single Family Loan Level Dataset.

Regardless of loan characteristics, cash-out refis had higher default rates, severities, and losses.

Default rate (D180) for low-FICO, high-LTV loans



Losses by loan type

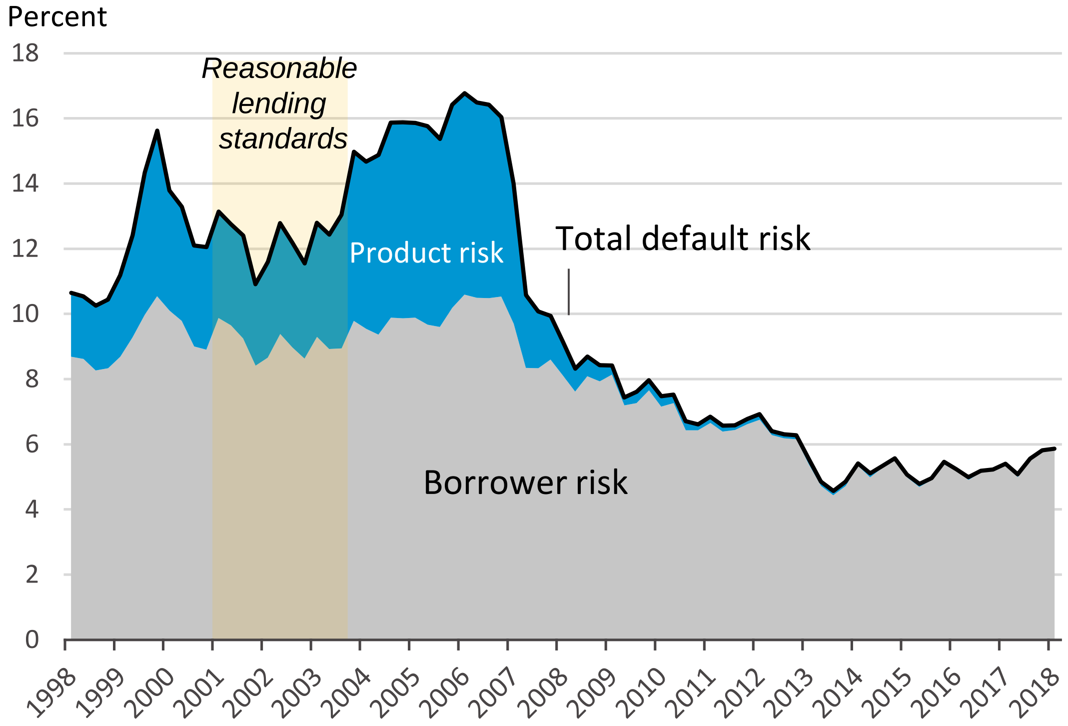
Origination year	Purchase	Rate refi	Cash-out refi	All
2002	0.42%	0.61%	0.76%	0.59%
2006	3.18%	4.60%	5.99%	4.43%
2007	2.78%	5.58%	6.02%	4.50%
2012	0.02%	0.02%	0.05%	0.02%

Source: Urban Institute calculations from Fannie Mae and Freddie Mac Single Family Loan Level Dataset.
Note: Includes loans with FICO less than or equal to 700, and LTV greater than 90. In 2012, there was an insufficient volume of cash-out refis with these characteristics to calculate a default rate.

This study focuses on high-quality loans- there are more issues surrounding sustainable homeownership

- The study does not include no-documentation, negative amortizing, adjustable-rate, or other kinds of risky loans, which played a large role in the crisis.
- Dodd-Frank put guardrails around the kinds of mortgages that are available- there has been a significant decline in product risk.
- HERA resulted in important reforms in the mortgage brokering industry.
- There are more ways to support sustainable homeownership- encouraging savings before and after closing, effective homeownership preparation, buying the right amount of home with a good quality mortgage

Default Risk Taken by the Mortgage Market, 1998Q1–2018Q1

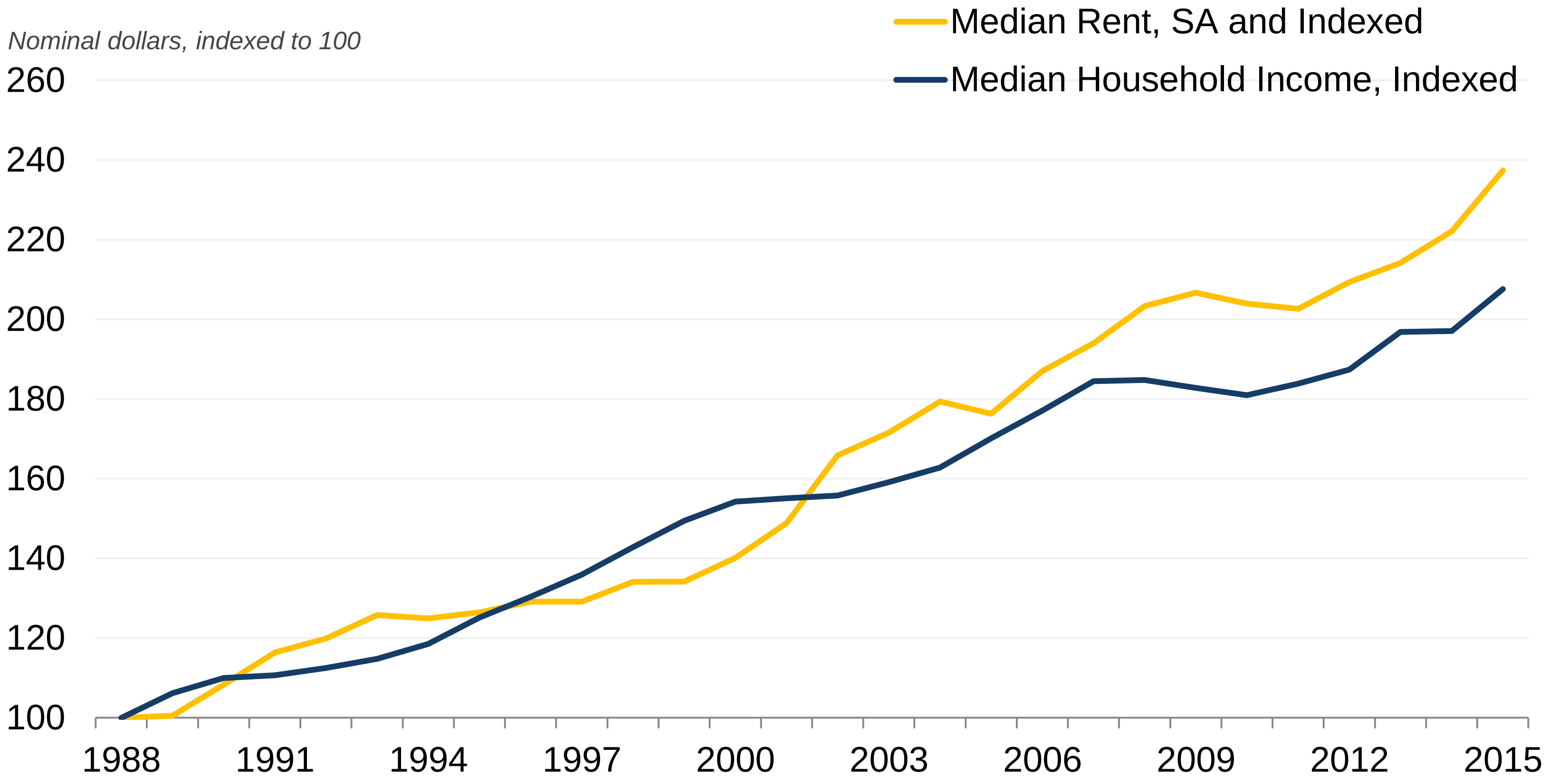


Sources: eMBS, CoreLogic, HMDA, IMF, and Urban Institute.

As demand for rental housing increases, questions of stability loom.

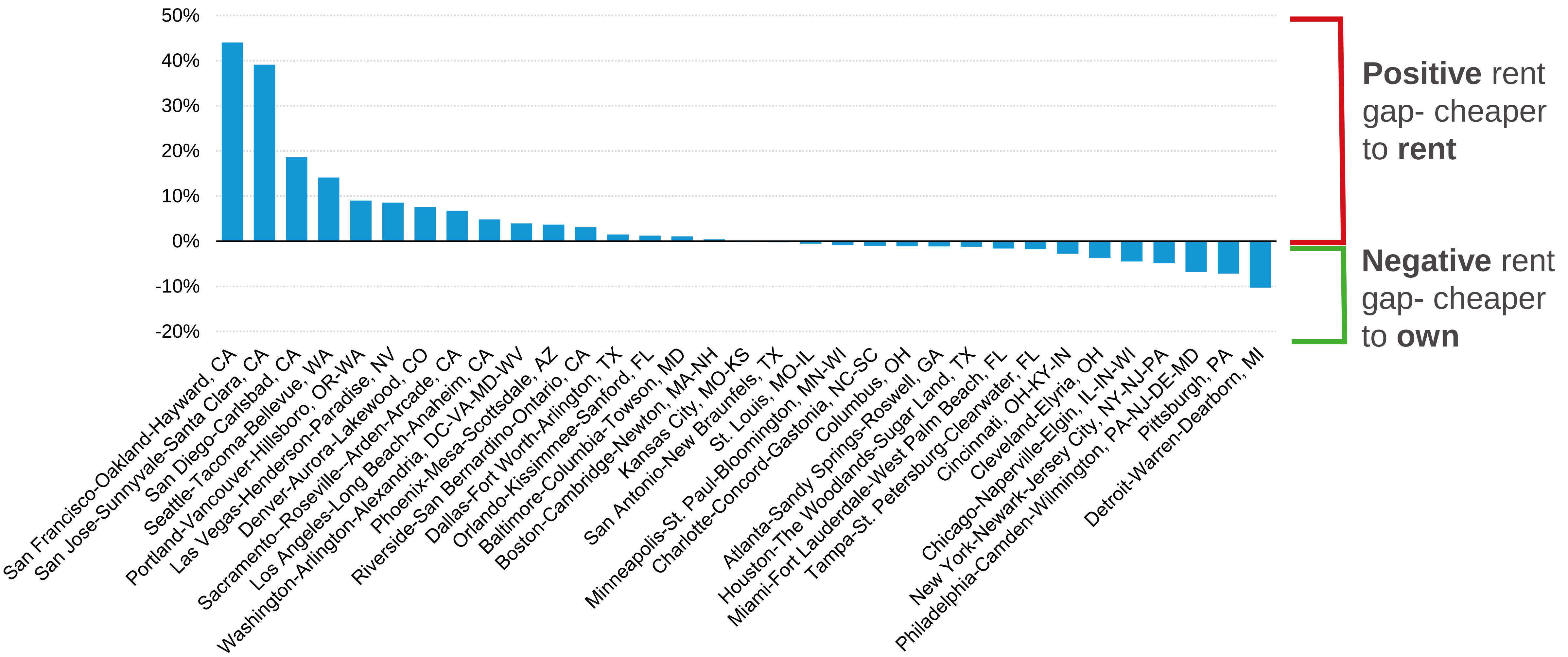
Rents are growing faster than incomes

Median Rent vs. Household Income, 1988-2015



Sources: U.S. Census Bureau Housing Vacancy Survey, U.S. Census Bureau Current Population Survey (CPS), and Urban Institute calculations .

In half of the largest US cities, it's cheaper to own a home than to rent



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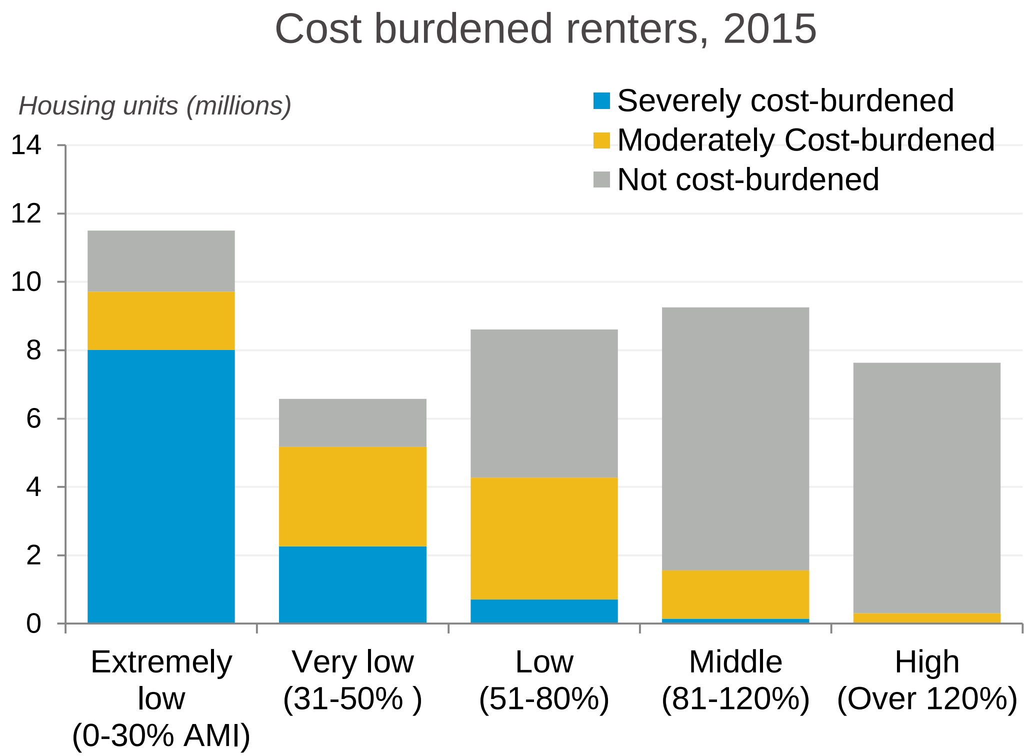
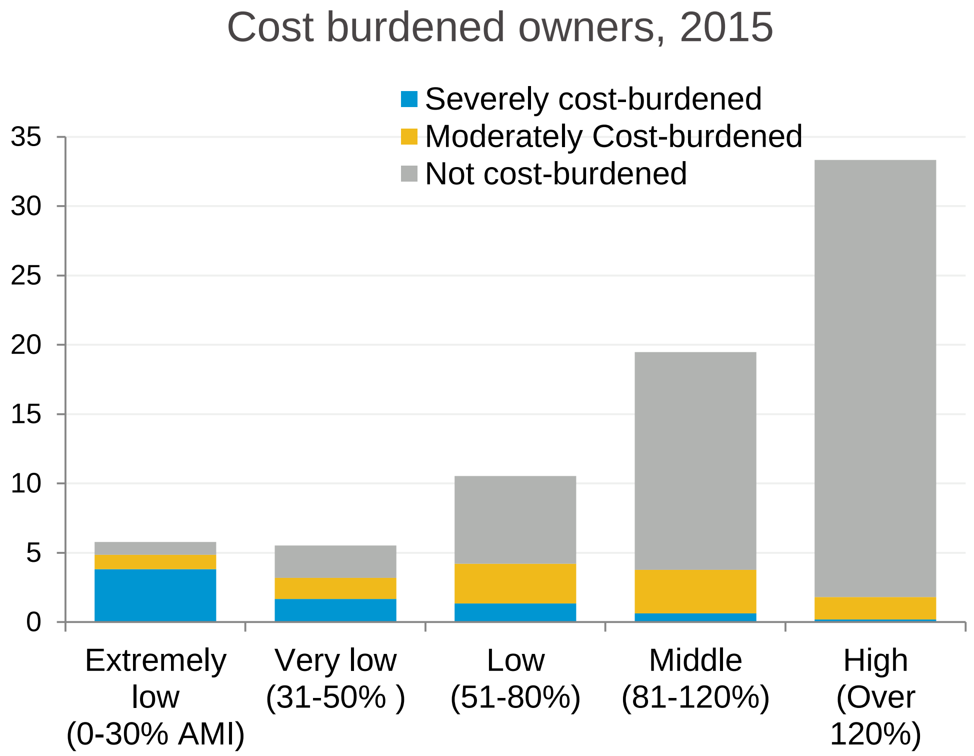
A quarter of renters compared to 10% of owners spend over half their incomes on housing

Most of the burden falls on those earning less than 30% of area median income (“extremely low income”)





Source: Urban Institute tabulations of American Community Survey data. Severely cost-burdened is defined as spending at least half of income on housing. Moderately cost-burdened is defined as spending more than 30 percent of income on housing.

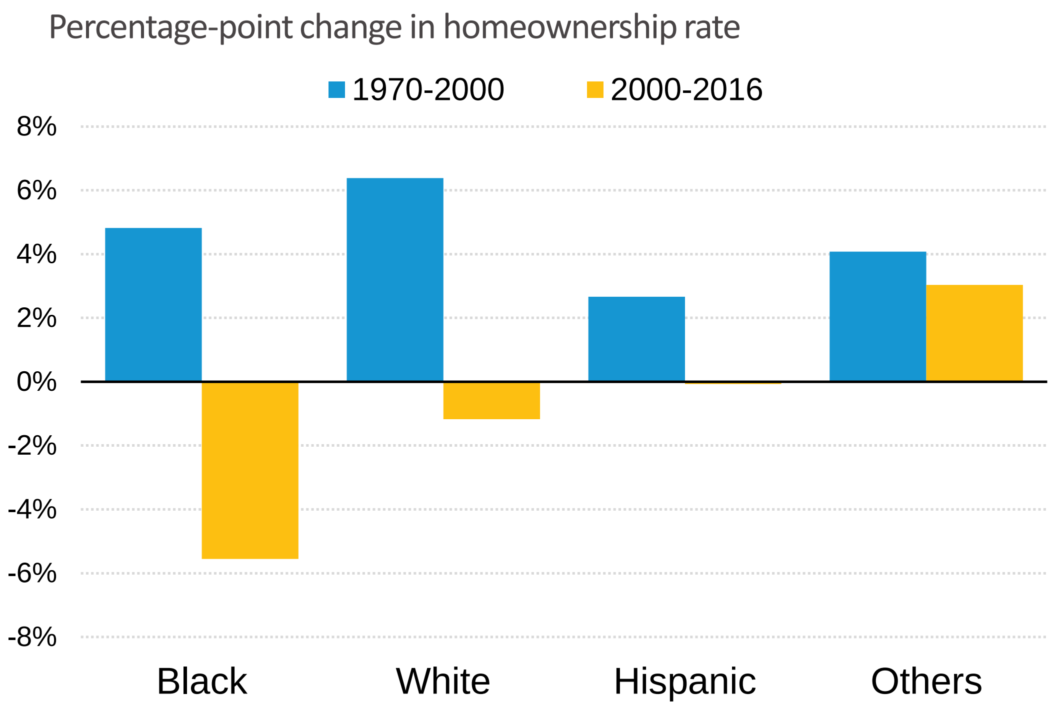
Homeownership is still the best vehicle for savings.

The lack of alternatives makes homeownership the best option for wealth-building

- There is only one leveraged investment that ordinary people have access to: a home.
- Low-income people don’t have ready access to the one unleveraged investment that has proven to be successful- stocks.
- Defined benefit pension plans largely don’t exist any more, especially for new hires, and defined contribution plans are not broadly available to seasonal, part-time, low-wage, or many small business workers.
- In an era of low interest rates, lack of good information on lower-risk stock market investments, and limited access to pension plans- homeownership **done right** is by far the best alternative.

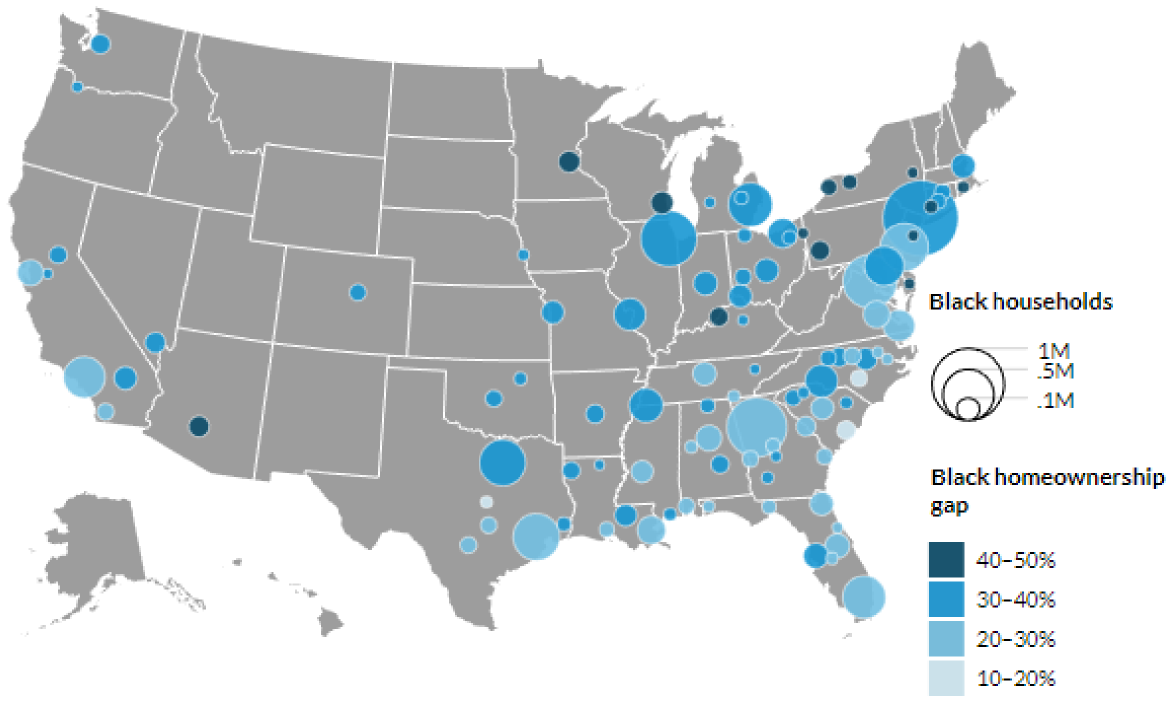
Minorities have missed out from the gains to homeownership

All gains in black homeownership since the Fair Housing Act have been erased since 2000



Source: US Census Bureau, American Community Survey, and Urban Institute.

No major US city has come even close to closing the gap between black and white homeownership.

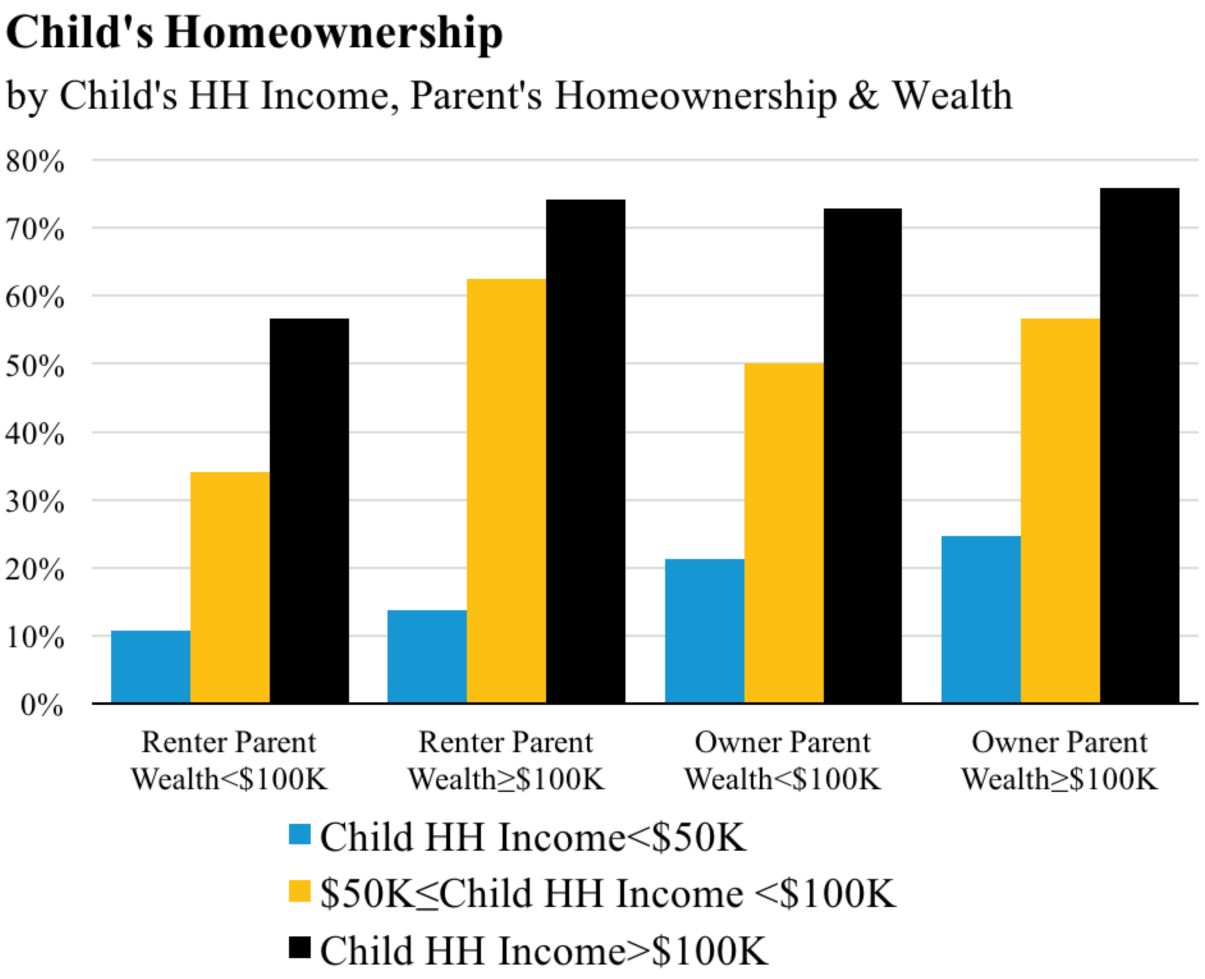


Source: American Community Survey and Urban Institute.
Note: Data as of 2016.

Intergenerational wealth transfer will cause disparities to grow

Highlights from a new study on intergenerational wealth and homeownership:

- Children of homeowners parents are 4-5 percentage points more likely to be homeowners, all else equal.
- Children are more likely to be homeowners if their parent's are stable homeowners, and their parent's wealth exceeds $200,000.
- Since African American wealth and homeownership are lower, the homeownership gap will be even bigger



Source: Panel Study of Income Dynamics

Conclusion

- It has become more difficult to be a homeowner; this is driven by several factors, including the tightening credit box and rising home prices.
- Homeownership is still the most beneficial way to build wealth but there are risks, especially for lower income and minority households.
- We need to help borrowers engage in safe, sustainable homeownership. This means:
    - Buying the right amount of home
    - Buying when ready
    - Getting the right kind of mortgage that helps build equity
    - Not overleveraging
    - Having and building back-up savings

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