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Gimme Shelter

Three Ideas to Protect the American Dream of Homeownership

by Paul Weinstein Jr.

America is in the midst of the worst housing slump in 16 years. Across the country, home sales are in decline, and prices are falling. In some states, the housing slump has been particularly severe. In Florida, sales in the second quarter of this year were down 41.3 percent compared to the same period a year ago, while in Nevada they dropped by 37.5 percent. Many other states have had declines of 20 percent or more, including Arizona, Tennessee, and Maryland.[1] Nationwide, the overall decline was nearly 11 percent from last year. As a result, many families are holding onto properties that are now worth less than their original purchase value.

While home sales are slumping, of equal concern is the rising number of Americans who are losing their homes because they are no longer able to make their monthly mortgage payments. In the second quarter of 2007, the percentage of U.S. mortgages entering the foreclosure process set a new record, according to a September report by the Mortgage Bankers Association.[2] That record is sure to be broken many times in the next year as more than $1 trillion dollars worth of adjustable-rate mortgages (ARMs) are due to reset between now and November 2008.

Over the last decade, subprime lending has grown at an explosive pace, reaching nearly $1.2 trillion in mortgages outstanding.[3] The practice has helped increase the share of families that own their homes to a record 69 percent, from about 65 percent a few years ago, with much of that increase among minorities. It has become clear, however, that some lending practices in the subprime market were questionable and that disclosure of the requirements of these loans—such as prepayment penalties and the real possibility of higher interest-rate payments at a later time—were not explained or even downplayed by some lenders.

Furthermore, toward the end of the housing boom, when interest rates reached some of their lowest levels, lenders became more aggressive about marketing their services to borderline applicants. In many cases, these applicants lacked the financial wherewithal to meet their mortgage payments if market conditions changed (such as a drop in home prices coinciding with the expiration of low, "teaser" interest rates). As a result, millions of

Paul Weinstein Jr. is the chief operating officer and a senior fellow at PPI. He lectures at Johns Hopkins University.

homeowners are now trapped in a financial stranglehold: They can't sell, because they paid more for their house than it is now worth; nor can they afford the new, higher mortgage rates.

As a result, the delinquency rate on subprime loans has soared recently to approximately 13 percent, and most analysts predict that it will climb much higher, especially as the teaser rates on some 2 million subprime mortgages must be reset by the end of 2008. (A reset is the point in time when the teaser rate on certain types of mortgages-like subprime products-expires and a new rate—usually much higher—becomes effective.[4]) That means even more Americans will lose their homes, including a significant share of minority families who have only recently been able to claim their piece of the American Dream. Furthermore, the loss of individual homes could spiral into a broader problem for many communities, as neighborhoods beset by foreclosure signs become vulnerable to blight and a loss of economic vitality.

In Congress, many leaders on both sides of the aisle have offered proposals to prevent some of the most abusive and predatory lending practices. These ideas include legislation to prohibit mortgage brokers from steering people into subprime loans if they qualify for cheaper conventional mortgages; a ban on hidden brokerage fees that are rolled into higher interest rates; and a halt on prepayment penalties that make it difficult for people to refinance.

While these may be worthy prescriptions, there remains a more basic problem. Too little attention has been paid to helping the millions of families who have lost or will lose their homes. In this policy brief, the Progressive Policy Institute offers three proposals to help those families who have already lost their homes—and reduce the number of those who are at risk of future foreclosure:

- Expand the First-Time Homebuyers Tax Credit (HBTC) beyond the District of Columbia and allow those who have been victims of foreclosure to use the credit to purchase new homes;
- Establish a temporary emergency housing voucher program to help those who are struggling to make payments on their subprime mortgages stay in their homes; and
- Utilize Fannie Mae and Freddie Mac to provide temporary liquidity and stability to the housing market.

Expand the HBTC

One the most successful community development initiatives of the 1990s was the HBTC for Washington, D.C. Put into place by the Clinton administration and Congress in 1997, the HBTC has been, according to a study published by the Fannie Mae Foundation in March 2005, "an effective policy instrument for increasing the first-time homeownership rate."[5]

Like many cities, Washington D.C., has struggled to create an environment that would attract and retain middle-income families. In 1997, more than 10,000 people moved out of the nation's capital, bringing the net loss of population during the first seven years of the 1990s to 78,000. One way to entice people to return to the inner city was to provide more affordable housing opportunities. It was this rationale that led to the enactment of the HBTC in the nation's capital.

According to the Fannie Mae Foundation study, among program participants, first-time homebuyers represented 67 percent of all District homeowners between 1997 and 2005, significantly outpacing the national first-time homebuyer average (40 percent) and the central-city average (51 percent) for the same period. Furthermore, while the majority

of credit claimants were already living in the District, some 14 percent were from the nearby suburbs, a number that was rising over time. Finally, and maybe most importantly, lower-income buyers (which, in the relatively expensive D.C. market, meant those with incomes between $30,000 and $50,000), formed the largest group of those taking advantage of the HBTC.

The HBTC is fairly straightforward. The credit is available to first-time District homebuyers. The legislation defines a first-time buyer as someone who has had "no present ownership interest in a principal residence in the District during the one-year period ending on the date of purchase."

The one-year test differs from some other first-time buyer benefits available nationally. The credit is not limited to current city residents. Someone who owns a home in the suburbs is eligible so long as they meet the other criteria. A buyer who previously owned a D.C. home but has been renting a principal residence for more than a year also would be eligible. An otherwise ineligible homeowner cannot marry his or her way into the credit—both spouses must be individually eligible in order for a couple to take advantage of this benefit. The HBTC is for one-time use only. Unlike some other tax incentives, it applies to buyers in any D.C. neighborhood—not just economically distressed areas.

The amount of the HBTC varies according to the buyer's income. A single taxpayer with modified adjusted gross income of less than $70,000 is eligible for the entire $5,000 tax credit. The credit phases out between $70,000 and $90,000 in modified adjusted gross income.

Joint filers are eligible for the entire credit as long as their modified adjusted gross income is less than $110,000; the benefit phases out between $110,000 and $130,000. Unmarried taxpayers who purchase a residence jointly will be allowed to split the credit. Unused portions of the credit can be carried over to future tax years.

As the experience in Washington, D.C., has proven, the HBTC could be an effective tool in helping families and neighborhoods recover from the damage created by the subprime market collapse. Expanding the HBTC to other cities could potentially increase the first-time homebuyer average by up to 16 percent, potentially reducing the foreclosure rate in hard-hit communities.[6]

Under this proposal, the HBTC would be expanded to 10 high-risk communities—places where the subprime market collapse has been particularly severe. Communities that have high foreclosure rates could apply for HBTC designation for up to five years. Communities would be judged on their plans to match the HBTC with tax incentives or other housing programs of their own. To provide them a second chance, those families who lost homes due to the subprime market collapse and who held one of the dominant subprime mortgages (228 or 327 ARM products)[7] would, along with first-time homebuyers, also be allowed to take the HBTC. (The program would apply to primary residences only.)

Expanding the HBTC to 10 cities would cost an estimated $450 million over the next five years. If policymakers wanted to expand the program further, they could reduce the HBTC to $2,500 and double the number of communities to 20.

Establish a Temporary Emergency Housing Voucher Program

Created in the 1970s, the Section 8 housing voucher program has become the dominant form of federal housing assistance. Low-income families use vouchers to help pay

for housing that they find in the private market. The program is federally funded, but vouchers are distributed by a network of 2,400 local, state, and regional housing agencies. A family with a voucher is generally required to contribute 30 percent of its income for rent and utilities. The voucher then pays the rest of those costs, up to a limit (called a "payment standard") set by the housing agency.[8]

Income-eligibility limits for the voucher program are set as percentages of the median income in the local area. Each year, the U.S. Department of Housing and Urban Development (HUD) estimates the median income for households of different sizes in every metropolitan area and rural county in the nation. State and local housing agencies have substantial flexibility to determine which families they will serve and are permitted to establish admission preferences based on household characteristics (such as preferences for working families, families that live in particular areas, or the currently homeless).

While vouchers are primarily used by families to help meet their rental payments, they can also be deployed to help with mortgage payments, enabling low-income families to purchase homes. In addition, up to 20 percent of voucher funds can be used for subsidies—called "project-based" vouchers—that are tied to a building rather than to a particular family, and which can help pay for the construction or rehabilitation of housing for low-income families. The cost of the current Section 8 voucher program is $15.9 billion annually, funding just over 2 million vouchers nationwide.[9]

Unfortunately, the demand for housing vouchers is roughly three times greater than the supply. Therefore, policymakers should create a temporary category of 100,000 new vouchers under a special program that would sunset after three years. These vouchers would target families who have purchased 228 and 327 subprime loans and are at risk of losing their home (primary residences only) or have already suffered foreclosure (primary residences only).

Recipients could use the vouchers to help make their mortgage payments while they work with their lenders on identifying new mortgage products that might have a higher payment than their teaser rate, but a lower one than their reset rate. In addition, if they lose their homes, families could use the vouchers to help defray rent payments. As these families get back on their feet, the dollar amount of the voucher could be reduced. In total, families would only be qualified to receive these vouchers for up to 12 months, after which the vouchers would be made available to other eligible families. The total cost for this program would be $768 million each year.

Tap the Resources of Fannie Mae and Freddie Mac

There has been much debate in recent years over the regulation of Fannie Mae and Freddie Mac in the wake of accounting irregularities at both of these government-sponsored enterprises (GSEs). As result, both GSEs have agreed to place caps on their portfolios. Despite past problems, it makes little sense to ignore the tremendous potential of these organizations to provide much-needed liquidity and stability to the housing marketplace.

Sen. Charles Schumer (D-N.Y.) has introduced legislation entitled the "Protecting Access to Safe Mortgages Act." This law would temporarily lift the limits on GSEs' mortgage portfolios by 10 percent, which would free up approximately $145 billion for the purchase of new mortgages. An approach like this—with a "flexible goal" of 25 percent to 50 percent of the total going

specifically toward refinanced mortgages for borrowers whose existing adjustable—rate loans were scheduled for an interest rate reset between June 2005 and December 2009—is a sensible compromise that will allow the GSEs to help restore confidence.[10]

While this policy would give current and aspiring homebuyers greater confidence in the security and stability of the mortgage market, it would also help fund foreclosure-relief efforts across the country before the "October surprise" of subprime resets further shocks the mortgage markets. One trillion dollars worth of ARMs are due to reset between now and November of 2008. Fannie Mae has estimated that 1.5 million subprime homeowners who face resetting ARMs and potential payment shocks this year and next would qualify for a safe, fixed-rate loan backed by the GSEs.[11] The Bush administration, instead of playing politics with the economic security of millions of Americans, should let the GSEs help restore stability and confidence to the housing marketplace.

Conclusion

The housing sector has been a powerful catalyst of the national economy, as millions of Americans have bought homes for the first time—and millions more have watched their largest investment appreciate in value.

Even these vast contributions to American prosperity do not capture the full economic and social importance of a healthy housing market—as people became more willing to invest in the purchase and upkeep of their houses, once-neglected neighborhoods revived; the construction and home-improvement industries prospered; and, most importantly, home-owning individuals and families made vital investments in their own future and the future of their communities.

Underlying all of these beneficial developments was a sense of security-namely, the security of one's own status as a homeowner and the security of the housing market as a whole. It is precisely this sense of security that has been undermined in the subprime housing crisis.

This is a solvable problem, however, and the solution lies in recognizing the need for stronger institutional protections for homeowners, particularly the more vulnerable buyers who have purchased homes on the subprime market. Some of the potential solutions are temporary, such as the emergency-voucher program outlined above. Other useful fixes would be of a more lasting nature, including the expansion of the highly promising HBTC.

What these solutions have in common is a recognition that home ownership represents both an individual good and a community interest. Indeed, this is the understanding that lies at the root of the mortgage-interest deduction in our tax code. It is in our national interest to encourage home ownership, and to offer carefully targeted assistance to ensure that this hallmark of the American Dream remains attainable, and sustainable, for as many Americans as possible.

Endnotes

[1] National Association of Realtors, August 2007.
[2] Coy, Peter, "Light at the End of the Subprime Tunnel," *Business Week*, September 7, 2007.
[3] "Subprime" refers to the risk associated with a borrower, not to the interest rate being charged on the mortgage. Typically subprime mortgages are offered at interest rates above prime, to customers with below-average credit ratings.
[4] Andrews, Edmund, "Democrats Prepare Bills to Tighten Loan Rules," *The New York Times*, September 6, 2007.
[5] Tong, Zhong Yi, *Washington D.C.'s First Time Homebuyer Tax Credit,* Fannie Mae Foundation, March 2005.
[6] Over several years, based on the D.C. program increase over the central city average.
[7] 228 or 327 loans are Adjustable Rate Mortgages (ARMs) that are fixed for the first two or three years, after which the borrower faces a payment increase or a payment shock of well over 30 percent.
[8] "Introduction to Housing Voucher Program," Center on Budget and Policy Priorities, July 6, 2007.
[9] "President's 2007 Budget Renews Same Number of Housing Vouchers Funded in 2006," Center on Budget and Policy Priorities, April 25, 2006.
[10] Press release, Office of Senator Charles Schumer, September 10, 2007.
[11] *Ibid*.

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