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Rebuilding the American Dream: Strategies to Sustainably Increase Homeownership

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Rebuilding the American Dream: Strategies to Sustainably Increase Homeownership

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Prepared by Rosen Consulting Group for the National Association of REALTORS®

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About the Study

Rebuilding the American Dream: Strategies to Sustainably Increase Homeownership was prepared by Rosen Consulting Group for the National Association of REALTORS® and jointly released by Rosen Consulting Group and the Fisher Center for Real Estate and Urban Economics at the University of California, Berkeley Haas School of Business. This report, the third and last in RCG's series on homeownership, highlights potential policy responses that could help combat the numerous hurdles limiting homeownership. In particular, we focus on opportunities to mitigate the challenges of supply constraints, affordability, student debt, post-foreclosure stress disorder and mortgage availability. While we include a wide range of proposals, the goal is to combine innovative approaches with pragmatic strategy, in order to focus on revitalizing homeownership in America in a safe and responsible manner.

About Rosen Consulting Group

Rosen Consulting Group (RCG) is a leading independent real estate economics consulting firm. Founded in 1990 and with offices in Berkeley and New York, RCG provides strategic consulting and unbiased investment guidance through all market cycles. RCG is a trusted advisor to leading banks, insurance companies, institutional investors, and public and private real estate operators. For more information go to www.rosenconsulting.com.

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The Fisher Center for Real Estate & Urban Economics (FCREUE) mission is to educate students and real estate professionals, and to support and conduct research on real estate, urban economics, and the California State economy. FCREUE strives to be the leading center for research on the California economy and excels nationally as a center for urban economic and public policy research. It also regularly provides a practical forum for academics, government officials, and business leaders. For more information, go to <http://groups.haas.berkeley.edu/realestate/>.

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Rebuilding the American Dream: Strategies to Sustainably Increase Homeownership

Introduction

In the wake of the Great Recession, widespread foreclosures and a sustained shift to renting created a homeownership crisis in America. As highlighted in our previous papers, *Homeownership in Crisis: Where are we now?* and *Hurdles to Homeownership: Understanding the Barriers*, households continue to struggle to become homebuyers amid rising affordability challenges and limited mortgage availability, while new homebuilding remains limited. Homeownership rates continue to hover near fifty-year lows, with the national homeownership rate up only slightly during the past year to 63.9%, as of the third quarter 2017. With millions of households unable to reach the American Dream of owning a home, the many advantages of homeownership are lost for individuals, communities and the national economy. Indeed, if the homebuilding industry returned to a more normalized level, Rosen Consulting Group (RCG) estimates that more than \$300 billion would have been added to the national economy in 2016, representing a 1.8% boost to GDP.¹ Despite significant hurdles to owning a home, there is still much that can be done at the federal, state and local level. Indeed, the crisis in homeownership warrants a vibrant national campaign to promote greater access to homeownership. Through the reform of existing regulations, expansion of current programs and creative thinking about innovative, yet pragmatic new products and programs, policymakers, advocacy groups, Realtors®, lenders, homebuilders and many other players in the housing industry could do much to further support homeownership in a safe, sustainable and affordable way.

This report, the third and last in RCG's series on homeownership, is intended to follow-up on our first two papers, by highlighting potential policy responses that could help combat the numerous hurdles limiting homeownership. In particular, we focus on opportunities to mitigate the challenges of mortgage availability, affordability, student debt, a phenomenon we call post-foreclosure stress disorder, and supply constraints. While we include a wide range of proposals, the goal is to combine innovative approaches with pragmatic strategy in order to focus on revitalizing homeownership in America in a safe and responsible manner.

Overcoming Supply Constraints

New single family housing supply, is an integral factor in maintaining a balanced for-sale housing market, supporting homeownership rates, and promoting greater housing affordability. As stated in our previous papers, significant barriers restricted homebuilders in the United States from building at a normal pace consistent with the long-term average for new supply additions, vastly under-delivering new housing units in recent years. As such, RCG estimated a cumulative deficit of nearly 3.7 million new home starts in the last eight years.² Even as homebuyer demand returned in the for-sale housing market after the recession, several major hurdles continued to hamper development of new supply. With rapidly rising costs of land and construction curtailing affordability, and the overall effect of local land-use and zoning regulations significantly restricting new construction, supply additions remained limited nationwide.

In particular, onerous regulatory environments played a key role in reducing new for-sale housing supply. As such, local, state and national elected officials, need to encourage new policies to spur the delivery of greater levels of supply, especially in highly regulated markets. If the current trends endure and supply additions continue to stagnate, homeownership rates are unlikely to recover substantially in the coming years.

Reducing Regulatory Hurdles to Development

Across the United States, zoning ordinances enacted by local governments greatly affect the costs, size and quantity of new single family homes built. In States and municipalities with stricter or more comprehensive regulations, building costs typically increase and fewer homes are built, especially when compared with areas with fewer regulations. The negative consequences of regulatory hurdles are discussed in detail in our previous papers, but in summary, more land use regulations lead to less housing production and exacerbate the shortage of available for-sale housing. As stricter and numerous regulations stifle new supply, land prices and construction costs rise, greatly reducing affordability and limiting homeownership. In the medium and long term, strict regulatory environments benefit existing homeowners, by inflating housing prices, at the expense of shutting out new or future homeowners. Therefore, in order to help bolster the overall homeownership rate, a major policy aim should be reducing and reforming onerous regulatory hurdles, especially in high cost markets. RCG believes that a more streamlined and less arduous regulatory environment will promote more development, and boost homeownership in the medium and long term, as the cost of constructing new housing decreases and more supply is delivered.

Typically, a single regulatory hurdle is not solely to blame for restricting new supply and rising land and construction costs, but instead an entire regulatory regime contributes to this trend. In many places around the country, land use regulations such as development fees, minimum lot sizes, the environmental review process, and the steps required to obtain a permit work in tandem to create a regulatory environment that severely reduces the ability for developers to deliver new supply. Further restricting new supply, regional level policies such as smart growth policies, urban growth boundaries and growth management programs, which are all policies that limit development to specific areas and boundaries, in an attempt to preserve open space, can further limit the amount of developable land available in a specific market. Indeed, many of these regulations are designed with the legitimate goals of protecting farms, forests and wetlands, as well as the character of existing communities. Unfortunately, the collective impact of these requirements are associated with increased housing costs within their established boundaries, further increasing the costs of construction, restricting new supply availability and ultimately fueling affordability challenges that hurt homeownership rates.

Prior research by Ken Rosen, found that cities in the San Francisco Bay area that implemented growth management programs had home prices 17% to 38% higher than in communities without such regulations.³ These regimes concentrate on preserving open space, but many times fail to increase density in the remaining areas that could still accommodate new development, thereby limiting the availability of new land for construction. For instance, the coupling of a smart growth policy with a larger minimum lot size requirement is found to significantly amplify housing cost increases over time. To be clear, preserving the environment and access to open space are important and necessary goals that are key to ensuring sustainable development. However, in order to avoid unnecessary barriers to development, such preservation needs to be balanced with a combination of designated spaces where new development is encouraged and greater density zoning to provide more opportunities for infill development in other areas of the community.

The wide variety of land use regulations currently in place and the full effects these regulatory regimes can impose on the ability to construct new housing supply is a vast topic and outside the scope of this paper. However, land use restrictions do significantly impact home prices and new construction deliveries and as such, need to be reformed in order to reduce housing costs and boost available supply. In fact, metropolitan areas with more extensive land use regulations can have up to 45% fewer new housing starts than less-regulated markets, both restricting new supply and driving costs up during the long term.⁴ Moreover, the benefits of reducing or abolishing various land use regulations are significant. Reducing or eliminating zoning restrictions will allow developers to construct new homes at a cheaper cost and will promote a greater mix of new construction, making it possible to build lower-cost homes that could be affordable for

first-time buyers. It is only through this kind of paradigm shift that it will be possible to significantly limit the growth in housing costs for aspiring new homeowners and increase homeownership in the coming years.

Reduce Fees and Streamline Approvals

Development impact fees, or one-time levies on developers, represent a tax on residential real estate development, which raises the cost of construction for new homes. These fees are generally intended to cover city costs that arise as a result of the new development. Examples include costs related to the processing of the application for the development in the municipal planning department, costs related to providing sewer and water system access for new homes and other burdens placed on city services. Impact fees are widespread throughout the United States and are levied by approximately 60% of cities with more than 25,000 residents.⁵ Local fees can vary widely in amount and can add an average of nearly \$20,000 in costs per unit for developers, and as much as \$47,000. These fees often vary greatly from project to project, typically adding more in high-cost housing markets compared with low-cost markets.

There are a variety of challenges that impact fees can create in the housing market. Impact fees can disproportionately influence the construction of smaller homes, as fees are only slightly lower for smaller homes than for larger homes. While it is relatively easy for homebuilders to pass along the development fees as part of the price of the home for high-end buyers, the increased cost is more prohibitive for moderate income buyers seeking small and mid-sized homes. This presents a hurdle that limits the construction of smaller homes, which could appeal to first-time or less-affluent homebuyers. In addition to the direct costs of impact fees, homebuilders also face numerous additional development hurdles, including the challenge of inconsistent and unpredictable approval times for projects. In high-cost markets, this could delay the development of housing units for months, as developers incur greater carrying costs which eventually pass on to the consumer. In fact, regulations that lengthen the development process could potentially have an even more significant effect on housing costs than the simple existence of impact fees.⁶ Moreover, unexpected delays impact a development more profoundly than expected costs, which can be incorporated into a development budget. Regulatory delay is far from a new issue, but costs incurred because of delays are compounded by the current shortage of new housing construction and the increased complexity of the permitting process in many markets. As such, while impact fees alone may not greatly affect the production of housing, the combination of fees, approvals delays, and unexpected costs can significantly influence developers' bottom line.

What is critical for developers, is for municipalities and States to streamline the process of development permitting and paying impact fees, such that unexpected delays and effects are negated. By reducing impact fees and regulatory hurdles that delay the planning and permitting process, homebuilders will be able to create more housing supply at reduced costs, thereby boosting the availability of new homes, helping to facilitate a stronger trade-up market and making it possible for more households to transition to homeownership.

In order to achieve these goals, existing regulations will need to be revised or repealed, or new laws that supersede existing regulations will need to be passed at the state or local level. Impact fees should be reduced, and local planning, building, fire and other administrative departments will need to work together to help accelerate timelines and decrease development costs.

One such example of a program that was successful in the promotion of more supply deliveries, is the Safe, Mixed-Income, Accessible, Reasonably-priced, Transit-Oriented (S.M.A.R.T.) program in Austin, Texas. The S.M.A.R.T. program started in 2000, and expedites the processing of new developments while granting fee reductions to developers that include affordable housing. The program shifted the city of Austin from a regulatory development model to an incentive-based development model, by encouraging developers to build more affordable housing stock and more units with a cheaper price point, in exchange for reduced impact fees and expedited approvals. For example, a project that included 10% of affordable units would receive a 25% reduction in the impact fee and would qualify for an expedited approval process, which takes 30 days under S.M.A.R.T, compared with 60 days under the normal process.⁷ This encouraged developers to opt into the program, in order to receive the benefits, both streamlining the permitting process and lowering the costs incurred by new construction. As such, the program has been very successful. Within the first five years of the program, more than 26,000 units were certified to participate in S.M.A.R.T., of which 14,500 were single-family homes. This incentive-based development model or other similar programs, could be archetypes for other municipalities across the country to duplicate, in order to further encourage more housing supply deliveries.

Minimum Lot Sizes

Minimum lot sizes are another zoning ordinance enacted by local governments across the United States, which influences the costs of new development by regulating the lot size that each housing unit must be allotted. Large minimum lot sizes require developers to acquire more land, inflating the costs of development, which is passed on to new homeowners. Minimum lot sizes force developers to use more land for less housing. In many markets geographical limitation such as

oceans, lakes, rivers, and mountains limit the availability of developable land, and as such, minimum lot sizes further compound land supply concerns and can dramatically inflate land and housing costs. These ordinances reflect policy choices made by localities that benefit existing homeowners at the cost of welcoming new ones. By setting minimum lot sizes, municipalities preclude or zone out the possibility of providing smaller, more affordable homes, while increasing the value of existing homes. By prohibiting developers from building smaller, lower-cost housing units, on smaller lots of land within that community, minimum lot sizes lead to less housing production in municipalities, promote greater sprawl and lower housing density. Minimum lot sizes therefore have profound effects on housing availability and costs, especially in markets where a significant portion of cities, towns and municipalities have particularly restrictive minimum lot sizes. In the long term, these regulations increase the cost of housing, prevent new households from entering the for-sale housing market and decrease overall homeownership.

As such, minimum lot sizes can significantly alter home prices. A 2009 MIT and Tufts University study, found that minimum lot sizes had a substantial price effect on housing costs in the Greater Boston area.⁸ Similarly, a 2006 study by the Home Builders & Remodelers Association found that as lot sizes increased by one acre, the share of homes in a city that qualify as affordable dropped by 8% to 20%, controlling for all other factors.⁹ Indeed, research by the Mercatus Center at George Mason University found that minimum lot size regulations have a stronger effect on limiting supply and increasing costs than any other form of land-use restrictions.¹⁰ For this reason, reducing or eliminating minimum lot regulations currently found in communities around the country has the potential to substantially influence housing costs by promoting more single family supply deliveries, which would facilitate a higher level of homeownership during the long term.

The benefits of reducing or abolishing minimum lot sizes are substantial. Relaxing zoning regulations or eliminating minimum lot-size requirements will give developers the flexibility to build smaller, more affordable homes on smaller and more affordable lots, decreasing housing costs and creating a larger supply of more affordable homes in the process. This will particularly be helpful for young families and single-parent households looking for starter homes, bolstering homeownership in these large and growing demographics. These smaller homes may also provide viable options for older baby boomer generations seeking to downsize while maintaining the ability to own their own home.

To abolish or reform minimum lot sizes, regulations will need to be revised or repealed, or new laws that supersede existing regulations will need to be passed at the state or local levels. Loosening these regulations is contextual to each locality, but examples of reforms could include the passage of new rules that: end minimum size requirements

for new lots, allow for narrow or smaller lots, create an easier process to subdivide existing lots, allow for the creation of courtyard housing or multiple units sharing the same backyard space, modify front and side yard requirements, and alter or abolishing parking and landscaping requirements. All of these types of regulations represent potential ways to reform, reduce or eliminate the regulatory hurdles that restrict new supply. RCG believes that a nationwide push to override and loosen minimum lot sizes requirements, and more broadly to reduce these kinds of regulatory supply hurdles, would promote new housing construction and increase new supply deliveries, particularly in high-cost and supply-constrained housing markets.

Meaningful change could come through a variety of reforms, but the Los Angeles Small Lot Subdivision Ordinance is one example of a city trying to utilize undeveloped land in order to promote more housing development. In 2005, Los Angeles implemented a new reform that allowed for the subdivision of underutilized land in multifamily and commercial areas to be used as a small lot for new for-sale housing. These small lot subdivisions have reduced yard setbacks and street frontages, as they were typically located in passageways between buildings or in other open spaces on an existing lot. The ordinance provided a more space-efficient and economically attractive alternative for sites zoned for apartment or condominium uses, simplifying the land subdivision process and creating an easier environment for developers to construct new homes in urbanized areas. As such, the reforms were successful, and as of November 2013 the ordinance created more than 1,500 individual lots which housed thousands of new households.¹¹ Similar reforms, while small in an individual context, could create a large collective impact in bringing more housing supply to the market.

Expedite and Simplify Environmental Review

In addition to minimum lot sizes, many other zoning ordinances affect the amount of new supply delivered, and the size and cost of new homes constructed. In fact, one of the most critical parts of the approval process is often the environmental review. These reviews are designed to accomplish the goals of measuring and mitigating unnecessary environmental impacts. However, the review process in many States and municipalities can be onerous and unnecessarily time consuming, and is ripe for reform. While some environmental guidelines are undoubtedly necessary, overbearing environmental regulations lead to less housing production in local communities, both by increasing the cost of homebuilding to comply with guidelines and by requiring developers to go through an onerous review process which can delay or deny developments. Unfortunately, the environmental review process is often utilized as a mechanism to restrict any new development from taking place, instead of as a tool to better existing proposals or curtail plans that

would be most harmful to the local natural environment. The lack of new supply and the increased costs of construction related to environmental review reduce affordability, hurt the trade-up market and limit homeownership in the process.

Not all environmental review regulations carry similar impacts. Several States, particularly New York and California, have stricter regimes that curtail new development in more profound ways. In both California and New York, approval of private development projects is based on the preparation of environmental impact statements, adding substantially to the cost and time needed for projects to be approved. In particular, the current application of the California Environmental Quality Act (CEQA) is a large hurdle that adds time and cost to all new construction within California, and specifically raises the cost of housing developments. CEQA also gives development opponents significant opportunities to challenge housing projects on environmental grounds, and can, in fact, stop housing from being built or require it to be built at lower densities even after local government approves a development. Under the status quo, special interests and local groups of opposition are able to use the environmental review process to prevent many housing developments from being built at all.

Of course, protections for the local environment are critical, and local and state regulations should provide the framework to do so. However, many of the local and statewide anti-development advocates take unfair advantage of environmental protections and use these regulations and laws as a justification to block any new development.¹² Some of the motivations behind these groups blocking development reflect legitimate environmental concerns regarding the impact of over-development; however, according to a 2003 study from Princeton, homeowners and local anti-development groups are more motivated to lobby for exclusionary zoning because of private economic gain in order to protect the value of their homes, rather than by altruism for the environment.¹³

In order to be the most effective and to limit the potential for abuse, environmental review requirements need to be straightforward, with a focused and streamlined review process – allowing for sensible and much-needed housing development. Unfortunately, the current form of CEQA, among many other regulatory regimes around the country, fails in this respect. Outside of state level environmental review, many localities also have their own environment regulations and review processes that can stymie development, and are in need of serious reform. Reforming municipal environmental review regulations and methods would, in many places, be an incredibly difficult proposal at the local level. As such, meaningful reform would likely require a state-level law that could give developers a work-around to ensure as-of-right development. Because state officials are less sensitive to local opposition to new development and are motivated to

pursue policies that will increase statewide economic growth, this policy option could be a valuable tool in bringing reform to high cost markets, particularly in places with significant supply constraints and an organized and politically strong collection of anti-development organizations.

Override Local Regulatory Hurdles with Statewide Reforms

A major factor contributing to the shortage in new housing supply is the collective impact of local resistance to development in communities throughout the United States, known as Not in My Back Yard or NIMBY groups. The current municipal planning system in the United States enables and empowers local opposition to new housing, as well as encourages a different set of rules in each city and town, magnifying a collective action problem. Specifically, many households do not want the hyper localized impact of new housing in their own backyard, even though they may welcome the overall positive externalities, such as lower overall housing costs or a stronger economy, if that development took place in a neighboring area. As such, many localities dis-incentivize or restrict development through a variety of means to the detriment of the local, regional and national economies.

However, the incentives at the state level are to increase economic development, and a statewide approach could provide a potential pathway to offsetting the biases against new development that are common at the local level. For this reason, statewide planning legislation that effectively acts as an override for restrictive local zoning, may be the most prudent path forward to help overcome local objections and to enable new development in communities in desperate need of additional housing. For example, the complexity and length of the development entitlement process in California is a key factor constraining supply and increasing housing costs throughout the state. Depending on the nature of the project, the development process can involve amendments to a general plan, zoning adjustments, subdivision approvals, site-specific permits, conditional use permits, variances, design review and environmental review under CEQA.¹⁴ As a result, it takes about two and a half months longer, on average, to issue a building permit in coastal communities in California than the typical U.S. metro (seven months compared with four and a half months), according to the Turner Center at UC Berkeley.¹⁵ To combat these impediments and those regulations like CEQA, there are a variety of policies that would reduce regulations and dis-incentivize the continued resistance to development. These potential reforms will have a greater effect on homeownership in high-cost States or for localities that have an onerous regulatory system.

One prominent example of a state legislature promoting new development through a statewide override of local development restrictions, is the Massachusetts Comprehensive Permit Law (Chapter 40B). Chapter 40B was intended to

provide relief from exclusionary zoning practices that prevented the construction of low and moderate income housing, particularly in suburban municipalities. Specifically, Chapter 40B, which was adopted in 1969, entitles developers to pursue an expedited approval process for development projects that contain affordable housing units. Chapter 40B includes important provisions that guide the approval process, including a set timeline for approvals, pre-certified developers (which reduces regulatory costs for developers), a local Zoning Board of Appeals (ZBA) that can act on behalf of more than half a dozen local departments (such as the planning, health, fire and police departments) streamlining the decision making process, and, most importantly, provides developers with an appeal process for local zoning board decisions. After the implementation of the law, Chapter 40B had a significant impact on the production of affordable and market-rate housing statewide, boosting overall housing production, reducing the costs of development and improving the local planning processes. As of the most recent data, Chapter 40B facilitated the production of approximately 58,000 housing units, including 31,000 affordable housing units and 27,000 market-rate units.¹⁶ Additionally, the program encourages an increased share of affordable housing in each local community, as the law incentivizes communities to approve affordable housing outright, such that development proposals are not subject to 40B appeals.

Chapter 40B was successful in increasing the number of both affordable housing and market rate housing units built across Massachusetts, including in affluent suburbs that have traditionally resisted affordable housing developments. For other States, Chapter 40B offers a compelling framework that could help streamline the development process and significantly expand housing supply. In California, there were several reforms passed and enacted in 2017 that could mark important first-steps in helping reduce the burden to developers in this historically undersupplied state. Senate Bill 35 (SB-35) streamlines the approval for affordable housing proposed in locations within cities where zoning is already authorized for residential development. The bill creates an updated approval process for housing in cities that are not meeting their housing goals, which is established by the Regional Housing Needs Assessment (RHNA). The RHNA is a state-mandated process that sets targets for the number of housing units based on expected needs, at all affordability levels, for each local jurisdiction. Under SB-35, if cities are not on track to meet those goals, then the approval of housing projects will be streamlined as long as the projects meet a set of objective criteria for affordability, density, zoning, historic preservation, environmental impact and construction labor standards. This bill should help facilitate the creation of significantly more housing units statewide, overriding local opposition and encouraging all localities to contribute their fair share to building new housing.

However, neither the Chapter 40B in Massachusetts nor SB-35 in California are magic silver bullets. For example, even with the implementation of Chapter 40B in Massachusetts, the state still faces many challenges towards development, including supply constraints and high construction costs. Each step helps a little, but it will take many steps, including more comprehensive planning and zoning reform, as well as a paradigm shift toward a pro-development, Yes in My Back Yard (YIMBY) mentality among existing residents and homeowners to dramatically change the cost of construction and reduce housing affordability challenges in communities around the nation. However, statewide override proposals and policies are an important tool to reduce the negative effects of local regulatory regimes, in order to encourage more housing supply and in the process boost homeownership.

Localized Reforms

A major factor contributing to the shortage in new housing supply is the collective impact of local resistance to development in communities throughout the United States. Although statewide reform is one method to promote a reduction in regulations, there is also a great deal of reform that could and should happen at the local level as well. The local planning system in the United States enables and empowers local opposition to new housing, as well as encourages a different set of rules in each city and town, creating a patchwork of regulations that can confuse developers and obfuscate new development requirements. Specifically, the fact that many households do not want the hyper localized impact of new housing in their own backyard, is a driving force behind the continued political support of these standards and regulations.

Unfortunately, the collective local resistance to development in communities throughout the United States creates an environment where homebuilders are unable to satiate housing demand. The result is rising construction costs and land prices, and reduced supply deliveries. All of these factors prevent new households from entering the for-sale market and limit homeownership nationwide. Therefore, it is important for localities across the nation to do their fair share, and aggressively streamline and reform onerous land use and zoning regulations, to encourage more development and sustain the long term health of their local economies. There are a variety of policies and examples of municipalities creating such reforms.

One such policy or local reform, is home equity insurance. Home equity insurance guarantees a specific home sale price to homeowners upon the sale of their home. This price could be set on a certain percentage of the original purchase price, ensuring that if that minimum set price could not be achieved at the time of a future sale, the insurance policy would pay out the difference. This approach would provide homeowners with confidence in the value of their home,

giving less incentives to vote and advocate for more onerous land use regulations that would combat a potential decline in the homeowner's property value. While such insurance may not directly discourage homeowners from pursuing new land-use regulations, a local guarantee on housing prices from a government-sponsored or private program could help local policies break away from the motivations fueled by NIMBY groups. Unfortunately, there is no good example of such an insurance scheme being implemented with renowned success in the United States, and as such this policy is an untested reform.

Another tool that could be used to reduce restrictive zoning at the local level is to pass a zoning budget. A zoning budget would set a ceiling on how much local elected officials can restrict growth (instead of setting a limit on how much growth is allowed) through new land-use regulations, forcing localities to make zoning density tradeoffs. For instance, with a zoning budget, if a locality wants to restrict housing density and potential residential growth in one neighborhood, the local government would need to increase housing density and potential residential growth in another area to balance the budget. Each year the budget of the minimum residential square footage could be raised by a small percentage, requiring municipalities to slowly up-zone existing neighborhoods at a moderate pace, thereby encouraging consistent and sustainable increases to potential new supply. As an enforcement mechanism, these development budgets could be tied to local or state funding, with localities that are unwilling to comply forced to relinquish some local funding. Similar to home equity insurance, this reform is also mainly theoretical. Planning reforms similar to a zoning budget are in place in several high cost markets, such as the RHNA law in California, which requires each municipality to plan for their fair share of new housing. However, these acts or ordinances are non-binding, and lack any true enforcement mechanism that punishes municipalities that do not follow through. In California, SB-35 attempts to address this concern by creating a process for developers to move around regulatory barriers if municipalities are not in compliance with RHNA guidelines. Yet, this is different than a direct requirement for municipalities to comply with the law, and does not penalize localities that do not fulfil their obligations in any meaningful way. As such, a zoning budget is another policy option that would force localities to take more direct action in facilitating greater housing supply.

Another potential mechanism that could be implemented to promote more housing development is a Tax Increment Local Transfer (TILT), which is a tax-recapture vehicle that would benefit existing property owners in exchange for promoting more local development. TILTs would transfer a portion of an increase in the tax base from any new land development directly to nearby property owners, allowing households to personally benefit from new development and help offset the risk associated with decreasing property values amid new supply deliveries. TILTs incentivize neighborhoods to support new development, creating a profit motive for individual households, encouraging more development and reduc-

ing local opposition to new housing. Currently, local homeowners have little reason not to oppose new developments that might be perceived to lower their property values, increase congestion or incur other hyper-localized costs of new development. As such, this policy would help promote new development, without degrading local control of land use regulations. Unfortunately, TILTs represent another theoretical idea, with no municipality implementing this reform within the United States to great effect.

A key problem with the process of reducing local environmental regulations, is that local reform can easily elicit push back from local residents who fear higher density, overcrowding, the overextension of the capacity of city services, reduced property values, or an altered neighborhood character. As such, buy-in from the local community is incredibly important to reducing the regulatory regime in various localities. Dialogue between different actors is therefore a vital aspect of such work, which is reflected in an existing model for policy change called a Community Benefits Agreement (CBA). A CBA results from the negotiations between a developer proposing a particular land use change or reform, and a coalition of community organizations that represent the individuals and groups affected by the proposed development. In a typical CBA, community members agree to support the proposed development project, or at least promise not to oppose the project, and in return, the developer agrees to provide the community with benefits such as assurances of local jobs, affordable housing, infrastructure improvements and environmental protections. CBAs are an interesting local way to ensure approvals for large new developments and provide a rubric for streamlining the environmental review process for future projects, particularly in markets with high costs.

One of the earliest examples of a CBA is the creation of the Lowry neighborhood in Denver, CO. Lowry is a mixed-use, master-planned community which opened in 1998. The neighborhood was built on a 1,866-acre site that was a former Air Force base, decommissioned in 1994. During the 1990s, as the project was being planned and developed, the Lowry Redevelopment Authority encountered multiple regulatory challenges. As the underlying zoning for the base property was for open space, the entire acreage needed to be rezoned. Hundreds of public meetings were held in order to facilitate direct feedback from the local community and various government agencies that would need to provide services to the new neighborhood. Considerable public outreach was needed because the lack of regulatory clarity for the developers created uncertainty among residents about how the site could and would be developed. Despite the many hurdles, the Lowry Redevelopment Authority created one of the first CBAs in the county, and paved the way for future mixed-use projects in Denver. In Lowry, the final development created more than 4,500 homes, 1.8 million square feet of office space, 130,000 square feet of retail space, and more than 800 acres of parks and open space.¹⁷ However, the lasting impacts of the Lowry CBA led to at least ten more large mixed-use planned communities built in the Denver area since

the project, all of which benefitted from the regulatory reforms spurred by the project that proceeded. Indeed, CBAs may not work in all markets or localities, but they profoundly impacted the development regime in Denver to the advantage of the local economy and housing market.

CBAs are a relatively recent phenomenon but grow out of a long history of negotiations among developers, land use authorities and elected officials, the affected community and various other stakeholder groups, such as environmental groups or organized labor, for development proposals that require governmental approval. As most CBAs are relatively new, there is scant evidence to evaluate whether CBAs are a net benefit to all the parties who enter into these agreements. Nor is it yet clear what effect CBAs generally have on the land use process or on the economic development policies of local governments, more generally. Additionally, CBAs may be too local of a solution, since the ad-hoc nature of these agreements fails to address the underlying and systemic problems of onerous regulatory regimes. However, in many high cost, anti-development and restrictive communities, CBAs represent a good first step policy change that could help foster the political will to create a larger regulatory reform that recognizes the value of generating more housing development.

Increasing New Home Construction

Onerous regulations are not the sole factor to blame for constraints on housing supply. In recent years, rising construction costs and changing consumer preferences limited deliveries of new housing supply and contributed to a decrease in affordability nationwide. Rising housing costs and limited available supply further stalled homeownership rates even as the economy recovered, as potential homeowners were unable to afford for-sale housing. As highlighted in our previous papers, construction costs, for both materials and labor, increased dramatically from the end of the recession, and in many cases are now above pre-recession peak levels. Rising construction costs significantly contributed to the rise in for-sale housing costs, with new construction home prices currently on par or above pre-recession levels in many markets.

As such, local elected officials and developers alike need to encourage new policies and construction methods to help control costs in the building process and spur the delivery of greater levels of supply at more affordable costs. If current trends endure and construction prices continue to rise, homeownership rates are unlikely to recover substantially, as affordability issues persist in the long term. However, there are a variety of ways to reduce the construction costs of new units and encourage the delivery of more supply.

Pre-Fabrication and Modular Housing

As rising construction costs are limiting the delivery of new housing supply, inhibiting for-sale housing affordability and curtailing homeownership rates, pre-fabrication and modular construction are building techniques that could help to reduce the overall cost of constructing new housing. Each method produces housing units, or parts thereof, at an off-site production area, with the components subsequently transported and assembled onsite. Pre-fabricated homes represent a general category of housing construction, which includes pre-cut kit homes and panelized home construction techniques that are sometimes used in the homebuilding industry today to reduce costs. Modular housing, however, is another less common pre-fabrication method where housing units are built in box-like modules or sections that are subsequently installed or assembled onsite. Although built in a factory, modular housing still enables builders to customize homes and to design them to meet specific local and state regulations. While modular housing in particular can reduce the costs of new homes in both large new developments and in single family home construction projects, the greater utilization of a wide range of pre-fabrication methods in housing construction could dramatically reduce the costs of building new construction.

Critically, pre-fabrication and modular housing also reduce the time needed to build a home and is a more efficient form of housing production. Parts or units are produced off site, and therefore can be built in a factory production line that operates 24 hours a day, 365 days a year, without concerns over noise, theft or inclement weather. Increasing the speed of housing construction would reduce overhead for the developer and allow for a faster delivery of new units to the market. In fact, modular construction can reduce construction time for a housing project by up to 40%, according to the Turner Center for Housing Innovation at U.C. Berkeley.¹⁸

Off-site construction is also significantly more efficient and cost effective than on-site construction, as the engineered design and precision of factory building allows for quality and cost gains. As production occurs in a controlled factory environment, modular and pre-fabricated housing takes advantage of the most sophisticated industrial manufacturing technology. This streamlined manufacturing process significantly reduces the risk of deficient work product or budget overruns, which are much harder to control on traditional construction projects. In addition, because of the large volume of homes factories can produce, there is significant potential to realize economies of scale in the procurement of building materials – which are largely the same materials used in the construction of site-built homes. There are also economies of scale in the production process because manufacturers can utilize the most cost-efficient assembly-line techniques to further reduce costs for prospective buyers.

Significantly, the assembly-line process requires fewer employees than site-built construction, further reducing total construction costs. Additionally, since many pre-fabrication and modular factories locate in low-wage areas, these costs savings can further reduce overhead for building housing for adjacent high cost and coastal markets, where construction wages increased rapidly in recent years. Since construction in pre-fabricated and modular housing factories is year-round, seasonal worker shortages and delays caused by worker availability issues are also less common in pre-fabrication and modular housing factories.

Compared with traditional methods of construction, the total costs for builders to deliver new housing units using these methods is significantly lower. In fact, a recent study found that modular construction reduces the total construction costs on a project by up to 20%.¹⁹ Both pre-fabrication and modular housing construction techniques provide the potential to meaningfully reduce construction costs and could help alleviate the housing supply shortage in many markets around the country.

Pre-fabrication is not an uncommon method and is used today by many builders across the United States to expedite the construction process. However, modular housing is used much less frequently and there are several key barriers restricting the widespread adoption of modular housing techniques that need to be addressed.

First, local governments may need to change local zoning ordinances to permit the construction and existence of modular homes either on new sites or within existing communities. Today, many localities restrict the placement of manufactured housing, full housing units produced completely off-site, because of the common association that such units are both undesirable and not up to local fire, building and zoning regulations. Yet, modular housing is different than manufactured housing, although there may be certain limitations. As modular housing is still custom-built for each housing unit, this type of housing can be more readily adapted to the select regulations within each market. However, some localities or States will therefore need to override or reform existing regulations that ban or restrict modular construction (or specifically designate modular construction as a separate category outside of manufactured housing), so that this cost-saving construction method can proliferate.

There are also pipeline and capacity challenges for modular housing builders, as each production facility has fixed costs and less flexibility to adapt to market fluctuations. Economic downturns can exacerbate these issues, and could potentially cause factories to shut down. In order to combat this, modular construction companies need to effectively ensure a consistent production schedule and a steady pipeline of new orders. This can be challenging, especially for new

businesses. However, as technology and business systems improve, concerns over building practices and delivery time tables should decrease. Additionally, vertically integrated companies that combine the expertise of an on-site builder with the cost savings of a factory manufacturing process may generate substantial efficiencies by working together to ensure a steady pipeline of new home sales as well as a consistent production process.

As modular construction methods continue to improve, it will be increasingly important to educate developers, contractors and, perhaps most importantly, current and potential future homeowners about the advantages of modular and pre-fabricated construction techniques and the ways these methods can create high-quality, attractive and cost-effective new homes across a broad array of neighborhoods and communities. Educating consumers, Realtors® and local elected officials will also be critical in advocating for more efficient and cheaper housing construction techniques throughout the United States. Overcoming the stigma attached to pre-fabricated homes and modular construction will be a large factor in promoting the development of new housing supply using these techniques.

Lenders and equity investors will also need to adjust in order to provide the large up-front financing required for modular housing production. The costs associated with the construction of a factory, buying all of the necessary raw materials and equipment for that factory, the production of new housing units and parts and the assembly of those parts on the final housing location, will all require new investment. Moreover, as the cash flow requirements for such an operation differ greatly from traditional construction methods, lenders and equity investors will also need more education on how and when they will see a return on their investment. Building a new modular housing factory represents a significant upfront expense and, unfortunately, there are few examples of existing modular housing companies that have sustained profitability long term. Still, if modular construction techniques were to take hold successfully, the potential increase in for-sale housing supply around the country is significant, especially in municipalities with the highest construction costs.

Modular construction is still a relatively small and nascent industry with significant barriers to entry. As such, large-scale builders are unwilling to rely on modular building for major new developments because of a fear of delayed delivery timelines or deficient product. Yet, there are some notable successes. Champion Manufactured Housing has 28 facilities located throughout North America, and has produced manufactured and modular homes since the founding of the company in 1953.²⁰ Another example is a modular housing factory in Boise, ID, Guerdon Modular Buildings, which won numerous awards on designs, while also creating a substantial pipeline of projects ensuring continued viability. With an optimal service-area radius of 800 to 1,000 miles, factories located in more affordable markets, like Guerdon in Boise, can deliver product to adjacent markets that have elevated construction costs, such as Seattle or Portland.²¹ This

comparative advantage is crucial to the business model. As such, other companies, such as Ripon, Entreka, Prescient, BMC's Ready Fram, Blu Homes, Modular Lifestyles and half a dozen others are all trying to expand their facilities and distribution points across the country in order to meet anticipated strong demand for affordable new construction, according to Builder Magazine.²² However, public and private actors will still need to address the challenges remaining for modular and pre-fabricated construction to become more widespread across the United States in a manner that will truly boost the supply of new homes nationwide.

Accessory Dwelling Units

The promotion of accessory dwelling units is another method aimed at increasing new housing supply, particularly in high cost, supply-constrained markets. Accessory dwelling units (ADUs) are additional living quarters constructed on single-family lots that are independent of the primary dwelling unit. ADUs are a simple policy change that can help increase the housing supply in a community. These separate living spaces are equipped with kitchen and bathroom facilities, and can be either attached or detached from the main residence. These units make it possible for existing single-family lots to deliver more supply of housing, typically one- or two-bedroom units, which cost less to construct than entirely new housing units on a separate lot. The construction of ADUs is particularly useful for existing homeowners as additional space for family members, hence the colloquial term, in-law unit, which is used to describe this practice. However, ADUs are increasingly leased to other households, creating more rental housing supply and a more affordable housing option for low- and moderate-income residents, easing rental demand in desirable, but high cost housing areas.

In particular, ADUs provide a way to add additional housing stock in built-up communities that are resistant to up-zoning or further development on existing open space. As such these units are commonly located in coastal markets where the construction of new housing is particularly expensive, such as Berkeley, CA, Cambridge, MA, Santa Cruz, CA, Portland, OR, or Honolulu, HI. This policy reduces supply limitations, particularly easing tenant demand for rentals and starter homes, and provides more affordable housing stock. In many markets, ADUs frequently rent at higher costs per square foot but at lower total monthly rent levels than larger apartments, according to 2014 Furman Center report.²³ Therefore, ADUs remain a source of affordable housing, especially in supply-constrained housing markets, where any production of additional dwelling space will ease housing market pressure.

The production of ADUs also provides several other benefits. The first is that ADUs can be used by the owners to supplement mortgage expenses with rental income from these units. Indeed, a recent survey of the ADUs in Portland,

OR, found that 80% of these units were rented out for long-term use, indicating a significant source of income for many households.²⁴ This could increase the value of a particular property or help current homeowners with mortgage payments or other costs, sustaining existing homeownership. Lastly, depending on local regulations, ADUs could also function like condominiums, and be built and sold to buyers separate from those owning the primary house and land. Today, most jurisdictions that currently allow ADUs do not permit these units to be purchased separately. However, relaxing these restrictions in a safe and sustainable way would make it possible for ADUs to provide a source of new, low cost for-sale housing supply in markets where the available supply is limited. This would increase the number of potential homeowners by providing a new supply of smaller one- and two-bedroom housing units further promoting homeownership.

The ultimate barrier to the proliferation of accessory dwelling units throughout the United States are various local zoning regulations. If ADUs are to become more widespread, zoning ordinances would need to be removed or substantially reformed. For example, a common hindrance to the creation of ADU units is parking requirements for new housing units, which require the creation of a new off-street parking space for the production of an ADU. Moreover, building heights, minimum lot sizes, Floor Area Ratio (FAR) regulations and other ordinances can impact the legality of constructing new ADUs – potentially requiring wholesale reform to allow for the construction of such units on existing properties. Such requirements would need to be relaxed or reformed, either at the local or statewide level. There is no set rubric for ADU guidelines, but they are typically zoned to be smaller than the existing home. ADUs typically do not exceed 25%-50% of the total existing habitable space, and are restricted to certain lots sizes. In Portland, OR, 85% of the ADUs were 800 square feet or less, according to a recent State of Oregon survey.²⁵ In some municipalities, such as Santa Cruz, ADUs are not allowed to be more than 750 square feet. However, these specifications could be altered depending on the needs of each community. Regardless of the details, there is great potential to leverage a national or regional set of “pre-approved ADU plans” or guides that would help municipalities to follow best practices when implementing new ADU regulations.

Local level NIMBYism may be a significant deterrent in particular municipalities and an option to create a statewide law which overrides the prohibition of such units may be the best way forward. A New Hampshire state law promoting ADUs (Senate Bill 146) was signed in March 2016 and took effect in June 2017, but has yet to yield results.²⁶ Similarly, California passed Senate Bill 1069 in September 2017, easing statewide regulatory burdens related to creating ADUs, such as providing exemptions from parking restrictions for certain locations.²⁷ This has yet to be fully implemented, but may help proliferate the construction of ADUs statewide. Additionally, a similar law is under consideration in Massachusetts, but has not yet passed.

Still, there are barriers and factors that limit the appeal of ADUs nationwide. First, ADUs will typically be more desirable to build in areas with high housing costs. Indeed, for many mid-priced markets, there may be little motivation for the creation of these units. As of mid-2013, the average costs of construction for an ADU was nearly \$78,000 in Portland, OR.²⁸ Even if ADUs become allowable in a municipality, implementation factors can plague homeowners trying to build these units. In particular, financing and permitting issues were the largest challenges for homeowners in delivering new ADUs in a recent survey.²⁹ Also, a proliferation of ADUs may create local concerns over parking or the provision of local services, such as schools, water or electricity. As the promotion of ADUs is a bottom-up approach to development, with each town and city needing to address their own unique zoning ordinances, efforts to promote ADU construction nationwide will also be difficult. Despite these challenges, less restrictive zoning that promotes ADUs has great potential as part of the solution to increase new housing supply and bolster homeownership, with multiple successful programs across the United States that can serve as models moving forward.

Trade Schools & Apprentices Programs

Widespread labor shortages in the construction industry represent a major barrier to new homebuilding, with rising wages representing a significant source of the increase in construction costs in recent years. As mentioned in our previous report, the number of single family general contractor employees decreased by 58.5% between 2011 and 2016, as workers fled to other types of construction or industries.³⁰ In stark contrast to before the recession, finding skilled labor in the trades and construction industry is very challenging, particularly in high-cost markets, where builders compete for a limited supply of workers. With such a severe shortage of construction labor, local, state and national policymakers need to find solutions that encourage more individuals to enter the building trades. There are multiple ways to encourage this transition, which could help reduce labor shortages in the near and medium term. At the local level, municipalities and states, could offer new trade school programs or expand existing programs, ensuring adequate funding and actively promoting these programs throughout their communities. Local construction employers should also be encouraged to create stronger support for apprenticeship programs that could provide additional training for young adults in high school, community college or local trade schools, in order to gain the needed on-the-job experience, and to help funnel these workers into construction based careers. Other potential avenues to increase construction labor include: 1) targeted student debt relief for education in these critical, high need industries; and 2) funding for job retraining, specifically targeting workers who lose positions as employment in the U.S. manufacturing industry continues the long term secular decline in recent decades. Indeed, there are a variety of methods policymakers could use to increase the

number of people working in the construction industry, thereby relieving labor supply shortages and helping to provide the necessary workforce to build new homes.

Tax Credits for New Construction Homebuyers

After almost a decade into the recovery from the foreclosure crisis, homebuilding across the United States remains limited. The sluggish pace of housing construction has failed to accommodate growing for-sale housing demand. As such, home prices rose significantly in recent years reducing affordability for many American households trying to purchase a home. Crucially, the country is in need of national policies to encourage the construction of additional supply. One tool that federal or state policymakers should consider to encourage additional homebuilding is a tax credit for the purchase of a newly constructed home. This new home tax credit would be most effective at the national level, lowering the price of new homes, which are typically significantly higher than existing homes. The tax credit would make it possible for a greater number of existing and potential homeowners to afford these new construction properties, fueling increased demand. Increased demand for new construction should help to spur a significant increase in homebuilding activity, make it easier for homeowners to trade-up to newer homes, free up cheaper existing starter homes for new and young buyers and help increase the inventory of existing homes available for sale. This net effect of more housing supply would promote greater homeownership rates, as greater supply makes it possible for more households to affordably purchase a home.

For builders, a new home tax credit should also make it somewhat easier to finance new homebuilding. As mentioned in our previous paper, single family homebuilders, particularly private builders, continue to face significant challenges in securing financing for new projects. In the wake of the foreclosure crisis, many banks withdrew from lending to single family homebuilders, with construction lending remaining below the long term average in recent years. However, a new home tax credit and the potential for an increase in demand for new home purchases, could mitigate lender and investor concerns and bring a renewed confidence to the homebuilding industry.

There is precedent for such an intervention by the federal government into the for-sale housing market. During the Great Recession, the federal government used tax credits to promote housing demand and mitigate the foreclosure crisis. In 2008, the U.S. created the first-time homebuyer tax credit, which was a temporary provision intended to bolster home purchases and stabilize the housing market. Applying to any first-time homebuyer, homes purchased from 2008 through 2010 could receive a one-time tax credit of \$6,500 to \$8,000.³¹ The tax credit was eligible to single head of households making less than \$75,000 to \$125,000 and joint filers making less than \$150,000 to \$225,000, depending on the year of

the program. Many homebuyers received an advance on the tax credit to use toward their down payment, in the form of an interest-free short term loan from the mortgage lender, who then received the tax credit amount when the household filed for their taxes. An estimated 3.3 million claims were made for this tax credit throughout the tenure of the program, demonstrating that such a program provides an incentive and motivation to buyers. Indeed, if a similar incentive was created that specifically targeted home sales for newly constructed homes, the program could have the potential to substantially increase new home sales, fueling housing construction and increasing the supply of homes nationwide.

While the amount of the new home tax credit would still need to be determined and will likely require further research, the goal would be that eligible households could receive and use the tax credit in a similar manner to the first-time homebuyer tax credit. The new home would need to be a primary residence of the homebuyer, and the tax credit could only apply up to a certain price cap for new purchases. Additionally, the length and permanence of the tax credit would also need to be considered, as a temporary program could potentially only move forward planned home purchases instead of actually sustaining supply growth, whereas a permanent tax credit could be an expensive proposition and dissipate in effect through the long term. Although there are a number of factors to be considered, a new home tax credit could have great potential to boost new supply of housing on either the state or federal level, creating a healthier housing market and bolstering homeownership.

Improving Access to Affordable, Safe and Sustainable Homeownership

Affordability

Housing affordability continues to be an important factor impacting homeownership rates across the United States. Despite elevated single family affordability relative to income compared with the period prior to the Great Recession, many households are delaying homeownership simply because they cannot save enough for a down payment. As rent growth accelerated rapidly in recent years in major markets across the United States, rental affordability for low- and middle-income households diminished. Rising apartment rents combined with other elevated household costs, such as transportation, healthcare and child care, are straining household budgets. As the cost of living accelerated in recent years, many households were unable to save enough for a down payment, even if they could otherwise afford the monthly mortgage payments to buy a home. Stagnate wage growth, particularly through the early stages of the recovery, forced millions of people to remain as renters. In particular, young, single-parent and minority households struggled to make the transition to homeownership in such an environment.

Looking ahead, as both household costs and apartment rents are expected to continue to rise in the coming years, the combined effect will continue to limit homeownership opportunities without creative solutions to help households save and to make financing a home purchase more affordable. In particular, policymakers at all levels of government should focus on policies to promote greater affordability, especially programs to help households who can afford monthly mortgage payments but need assistance in making the initial purchase, as well as households early in their careers, who are currently forced to delay purchasing a home. If affordability issues continue to prevent millions of eligible households from obtaining a home, homeownership rates are unlikely to recover substantially in the long term. Fortunately, there are a variety of approaches that could help ease affordability issues and aid households who are on the precipice of owning their own home to achieve their goal.

Down Payment Savings Program

As affordability limits households from purchasing a home, it is important to focus on policy interventions to encourage increased household savings. One such policy is a down payment savings program that allows households to save their income in a tax-deferred account, much like a 401k or Individual Retirement Account (IRA), which could then be used towards the purchase of a home without a tax penalty. Currently, the U.S. Government incentivizes saving for retirement

through tax-qualified defined-contribution pension accounts, where payments are either made directly or deducted from an employee's paycheck before taxes are withheld, and placed into a separate tax-deferred account that can, generally, only be withdrawn at retirement, without incurring a tax penalty. The current law is a cornerstone of the American retirement savings program, and is very successful in helping households accumulate savings to be used later in life. A similar principal could be used to encourage homeownership opportunities. A down payment savings program would function in a similar way, but with the goal of the program specifically geared toward helping households save for a down payment on a home. Using such a model to encourage homeownership could be an important step in helping to ease the current housing affordability crisis.

Under current tax rules, households are already allowed to withdraw limited funds with restrictions, from an IRA account to purchase a home. As such, a full pre-tax down payment savings program could essentially operate as an expanded and refocused version of the existing rules within the IRA tax structure. Specifically, the 1997 Taxpayer Relief Act allows an individual to withdraw up to \$10,000 penalty free - once in a lifetime -- from both a traditional IRA and a Roth IRA for home-related costs, as long as the individual is a first-time homebuyer or has not purchased a home in at least two years.³² For married households, each person can withdraw \$10,000 without penalty from individual IRAs toward a home. Within the current terms, acceptable uses include the costs of buying, building or rebuilding a home, along with any settlement, financing or closing costs. Such withdrawals can be a helping factor in assisting households to afford a down payment, as there is no additional tax penalty for such activity, although a withdrawal from a traditional IRA will still need to pay ordinary income tax.³³ However, the relatively small size of the maximum withdrawal amount severely limits the ability for many households to use this approach to significantly contribute to a down payment.

Indeed, for a down payment savings program to be successful in promoting homeownership more broadly, such withdrawal limitations would need to be significantly reformed. As a relatively straightforward solution, Congress could simply expand the limit on the amount available for withdrawal towards a home purchase. However, such a policy change would only apply to IRAs, leaving households enrolled in a 401k without such a withdrawal option.

There is currently an option available to most 401k account holders. Similar to the penalty-free allowance to withdraw retirement savings from an IRA account, most 401k plans offer short-term loan options, which allow an individual to borrow up to 50% of their account balance, up to a maximum of \$50,000.³⁴ Unlike the withdrawal from an IRA account, the loan amount must be repaid during a period of no more than five years, although extensions are permitted for home purchases. However, such a loan comes with risks, if the loan is not fully repaid according to the stipulated rules and

time period, the withdrawal is taxed as income with an additional 10% penalty. Additionally, many households may be hesitant to take advantage of either the IRA withdrawal or the 401k short-term loan, as these options are permanently or temporarily taking away savings from their future retirement. Indeed, a more focused approach of creating a parallel program that establishes pre-tax savings accounts with the intended purpose of saving for a down payment would be a far more effective tool in encouraging homeownership. Research from the 2017 Nobel laureate Richard Thaler on mental accounting concludes that individuals do not treat their money as one large fungible pool. As such, separating out savings into different accounts can encourage households to save for an explicit purpose; which in this case would be to purchase a home.³⁵

An account for the intended purpose of helping households to save for homeownership could be implemented using similar mechanisms to a typical 401k or IRA account. The program would serve as an opt-in account, designed to aid in the accumulation of a down payment and could be limited to usage only for first-time homebuyers or households who have not owned a home for a period of more than two years. The program would make it possible for employees to have wages withdrawn directly via payroll, before taxes, as with standard pre-tax retirement savings. These automatic payroll deductions would be placed into a separate savings or brokerage account. Such a program would encourage a change in household spending behavior, promoting savings and incentivizing home purchases. As people commit to the program and start saving without ever seeing the money as income available for current spending, they will likely be more motivated to continue to save. Upon withdrawal, these funds would be taxed as income, but interest earnings would be untaxed, giving a distinct tax advantage to such accounts, further encouraging greater savings activity. Additionally, by keeping the down payment savings in a separate account, rather than integrated with retirement savings, households are likely to be less resistant to using these funds for a home purchase, since it would not involve withdrawing the funds directly from their future retirement savings.

In addition to the creation of a separate account to allow for down payment savings, other programs could be coordinated with this effort to encourage greater buy-in from households. For instance, employers could be encouraged to match employee contributions, similarly to retirement savings programs. A down payment savings program could also be coordinated with any government or local down payment assistance or grant program. The HOME Investment Partnerships, Federal Home Loan Banks program, and the Affordable Housing Program are all funding sources used by local governments or nonprofits to make direct grants to first-time homebuyers for down payments. Programs such as these could be combined with the savings program to better focus available resources. Additionally, homebuyers could

leverage low down payment FHA mortgages to maximize the effectiveness of their down payment savings in making a home purchase possible.

The down payment savings program could certainly help many households, such a program would also have limitations. One of the major benefits of retirement accounts that makes them such compelling savings vehicles is the compounding growth generated during a long period of time. With a down payment savings account, this benefit will be substantially reduced, as households would likely use this account for a much shorter period of time compared with a retirement fund. Second, as an opt-in program, there is the potential that many of the households most in need for this account, may not use it. Without proper awareness and promotion, this program will not be effective, especially if households most in need do not sign up for it. Indeed, such a case happened with a similar statewide program in Montana. In 1998, Montana created a homebuyer savings account program, which is open to any first-time buyer regardless of income. The program allows individuals to deduct up to \$3,000 per year for up to ten years, from their state taxable income.³⁶ When savings are withdrawn, both the income saved and the interest earnings are untaxed by the state. Despite the potential to save as much as \$30,000 (plus interest) tax-free for a first-time home purchase, the program is rarely used. According to the state revenue department, no more than 225 people, and as few as 125, have participated annually since the inception, with total annual deposits averaging around \$400,000.³⁷ Policy advocates believe that awareness is a key factor in the limited success of this program. Moreover, for-sale housing affordability is also much less of an issue in Montana compared with many other markets, and therefore a program along these lines could have a more significant impact if implemented in other areas of the country. Indeed, a state model such as this may work very well in high cost and relatively high tax coastal markets, such as California or New York.

Despite these challenges, a down payment savings program has great potential to bolster household savings for the specific purpose of purchasing a home, at either the state or federal level. In particular, creating a tool that would be available nationwide would help mitigate one of the greatest barriers preventing households from purchasing a new home, and would boost homeownership in a sustainable way. If such a program was crafted with the right parameters, it could significantly aid households who live in costly markets that require significant down payments in order to buy a home, as well as young households in early stages of their careers. Given that these are two key groups are the most effected by the drop in homeownership following the Great Recession, a down payment savings program could significantly bolster homeownership.

Given the many advantages of homeownership at the national, community and household level discussed at length in our prior papers, it is important for U.S. tax policy to support safe and sustainable homeownership. Currently, existing and potential new homeowners can take advantage of tax savings that assist in making homeownership somewhat more affordable. In particular, the home mortgage interest deduction (MID), allows households who own a home to reduce taxable income by the amount of interest paid on their mortgage loan. In addition to the MID, homeowners can currently deduct property taxes from household income, further reducing their federal tax liability. Effectively, the MID and property tax deductions help reduce the annual cost of owning a home. Particularly in the early years of the loan, MID can account for thousands of dollars in tax savings, thereby providing assistance to homeowners who recently purchased a home and helping to ease the transition to homeownership for first-time buyers.

As such, it is important to consider that substantial tax reform that changes the benefits for owners could influence the trajectory of U.S. homeownership in the coming years. While tax reforms may generate macroeconomic effects that influence growth and affordability, on the margin, reform proposals such as capping the mortgage interest deduction, increasing the standard deduction without changing the mortgage interest deduction, and eliminating the property tax deductions would limit the relative tax advantage for homeownership as compared with renting. Moreover, increasing the annual cost of owning a home could also influence the price of the underlying asset. While the specific details of any reforms would be critical to determining the net effect, tax reform that materially alters the incentives, could significantly influence home buying and the homeownership rate.

Another significant tax benefit to homeowners is the capital gains tax exclusion. Under the current law, homeowners that occupied their principal residence for at least two of the past five years do not need to pay taxes on the first \$250,000 in profits from the sale of their home. For married joint filers, the exemption is increased to \$500,000. In addition, tax rules allow homeowners to add capital improvement expenses to the cost basis of a home, which lowers the total capital gain. Despite the benefits associated with the capital gains tax exclusion for many homeowners, in high-cost markets, particularly areas with significant long-term home price appreciation, the current policy incentivizes some households to hold onto their home instead of selling, in order to avoid large capital gains and the related taxes. As a result, some homeowners are either staying in their home or moving and renting out their home. This dynamic is currently inhibiting mobility and perpetuating low inventory in several major high-cost coastal markets and making it more challenging for first-time buyers to find affordable homes. While this represents an increasingly significant concern, particularly as

more Baby Boomers reach retirement age, further research will be necessary to determine how to develop policies to counteract the impact of capital gains taxes on housing mobility. Indeed, this could prove very important in high-cost markets in order to support the goal of safe and sustainable homeownership.

Graduated Payment Mortgages

Many potential first-time homebuyers are in the early stages of their career and professional life and have not yet reached peak earning potential. These individuals aspire to own a home and reasonably anticipate higher future earnings that would support their aspiration, but given the increase in home prices and the challenges of affordability, must delay ownership until they can move further in their career and bring in higher income. The graduated payment mortgage (GPM) makes it possible for households in these situations to purchase a home earlier than would otherwise be possible using more conventional financing options, helping to tackle affordability hurdles and make homeownership an option for younger households.

In its simplest form, the GPM is a fixed-rate mortgage with slightly lower monthly payments early in the life of the loan and slightly higher payments later in the life of the loan. Unlike the constant monthly payments of a standard fixed-rate mortgage, the “graduated payment” schedule more closely tracks expected household income, so that lower initial payments make homeownership affordable today and future income growth offsets the increased payment burden later in the life of the loan. GPMs are potentially more efficient financial instruments than standard fixed-rate mortgages because they help stabilize the real cost burden of housing payments relative to income, rather than the nominal dollar amount of payments.

GPMs are not new to the mortgage industry, and in fact have been a part of policymakers’ toolkit to address housing affordability since the 1970s. The FHA first began insuring GPMs through its Experimental Finance Program, which was authorized by Congress in 1974 under an amendment to Section 245 of the National Housing Act. The passage of the Housing Community Development Act of 1977 made the program permanent.³⁸

GPMs are not the only mortgage product designed to increase initial affordability by lowering early payments, but have a number of desirable properties as compared to the alternatives. Adjustable-rate mortgages (ARMs), particularly those with teaser rates, can also have lower initial payments but pass interest rate risk from the lender to the borrower, who is likely not as well suited to fully understand or manage that risk. The payments on an ARM depend on future interest rate movements and cannot be known in advance, creating a great deal of uncertainty and risk for borrowers. The GPM,

however, is still a fixed rate mortgage product, and even though the monthly payment obligations vary across the life of the loan, the payment schedule is established in advance. Therefore, the borrower knows with certainty at the time of origination exactly what future payments will be required. Consequently, the GPM is much easier to explain to borrowers, and there are no surprises, which is a key distinction as compared with adjustable rate mortgages.

Many lenders also allow borrowers to “buy down” the interest rate on a mortgage by paying a lump sum amount at loan close. Obviously, this option requires a significant upfront cost and so is not particularly well suited to address affordability. The federal government, however, has explored programs to subsidize mortgage rates for low- or middle-income borrowers by buying down their rates. Even beyond the political challenges of subsidies, however, such programs are an inefficient way to increase affordability as compared with GPMs. The government would incur a large upfront cost to buy down individuals rates. In contrast, GPMs have no such costs, because the lower initial payments are effectively subsidized by the borrower’s own future income, rather than an initial lump sum payment from the borrower or government. By offering insurance for GPMs, the government could achieve the goal of lowering initial payments without incurring any financial cost or liability, as long as the insurance pools are run on an actuarially sound basis.

Borrowers who choose the GPM should be aware of a few key aspects that differ from a standard fixed-rate mortgage. First, because borrowers make lower initial payments in return for higher future payments, they ultimately pay more interest during the life of the loan. Second, if the initial payment does not cover the initial interest due, the difference is added to the principal balance. So, depending on how the loan is structured, the loan balance on the GPM could increase early in the loan life, also known as negative amortization. In this situation, the homeowner would not only fail to build equity in the initial years of the loan, but would also owe more than they did when they bought their home. Lenders consider the peak loan balance, rather than the initial loan balance, when considering loan-to-value requirements on negative amortizing loans.

Fortunately, the negative aspects of the GPM can be significantly mitigated depending on how each specific loan is structured. For example, the initial payment can be determined to ensure that it is at least equal to the initial interest due, to avoid negative amortization.³⁹ Additionally, the total interest paid on the loan can be minimized by selecting a graduated payment schedule with smaller increases over a shorter period of time.

The FHA originally offered mortgage insurance for five graduated payment schedules.⁴⁰ Eligible mortgages specified a five or ten year period during which payments increase at the end of each year, after which the monthly payment

remains constant through the remainder of the loan. The FHA offered insurance for three 5-year increase plans (with annual payment increases of 2.5%, 5.0% or 7.5%) and two 10-year increase plans (with annual payment increases of 2.0% or 3.0%). While in no way exhaustive as compared with the infinite range of possible payment schedules, these plans provided a fairly wide range of options, from the more conservative 2.0% or 3.0% increase per year over ten years, which should remain affordable even with normal levels of inflation and limited real wage growth, to the more aggressive 7.5% increase over five years, for those that expect a significant increase in household income in the near term. Of course, many more schedules are possible for this loan concept, which could even span the full thirty year length of the loan. By creating a wide range of options, GPMs increase borrower choice and borrowers and lenders can jointly determine the schedule that is most reasonable for all parties, based on expected income growth, years until the payments stabilize, and the amortization schedule.

The availability of mortgage insurance will be key to supporting the wider availability of GPMs, and to making sure that the product reaches lower and middle-income households. GPMs are very similar in nature and structure to standard fixed rate mortgages, but may carry slightly higher default risk if the borrower's income does not increase as expected. Negative amortization, if present, could also contribute to increased default risk because the loan balance is increasing and the homeowner is not growing equity early in the life of the loan. Without mortgage insurance, lenders will likely concentrate GPMs among those borrowers perceived to be the safest bets, and the most upwardly mobile. However, such households are more likely to already be able to afford a home with a conventional mortgage, and may use the GPMs to simply increase the amount of home that they can afford to purchase. Mortgage insurance pools can significantly alleviate biases in the approval process and ensure that all households with strong income growth prospects that can afford reasonable monthly housing payments can have an opportunity to achieve homeownership.

Despite the creation of a federal program to support GPMs more than forty years ago, many borrowers were not aware that such a product ever existed and utilization decreased sharply over the decades, particularly as low inflation lessened the potential benefits from the GPM program. The Section 245 program formally ended as part of the Housing Economic and Recovery Act of 2008. However, with interest rates expected to normalize in the coming years, public policy can promote the increased usage of GPMs by (1) reviving the FHA Section 245 program; and (2) promoting a larger private mortgage insurance market for these products so that the GPM option is more widely available. In this way, policy makers can significantly contribute to the health of the housing market by improving affordable access to the housing market for young families in a fiscally and actuarially responsible manner.

Shared Equity Products

Barriers to home buying, such as large down payments and high monthly mortgage payments, combined with limited financial resources have made it difficult for many households to become homeowners. As affordability issues continue to hamper homeownership in high-cost markets, standardizing new forms of ownership agreements may help households obtain equity in their own home. Shared equity is a homeownership model that allows a household to purchase a house by dividing the equity stake of the home among multiple parties. Shared equity expands the opportunity to purchase a home to a broader demographic group, allowing young and middle income households who could not otherwise afford for-sale housing in high-cost areas, an alternative way to pursue homeownership. The goal of this practice is to lower the cost of a down payment, mortgage payments, and other housing costs, by dividing the ownership share. This promotes greater affordability and increased access to at least partial ownership.

In particular, these agreements could reduce the costs of ownership significantly for households who would like to become homeowners, particularly in high-cost areas. Making the transition from renter to owner is especially hard today, as the price of starter homes, the most affordable homes on the market, have continued to rise in recent years. As such, shared equity agreements could be used as a stepping stone for young and low or moderate income families, as a tool to accumulate wealth, and could be a first step, before ultimately purchasing a single family home with more conventional out-right ownership. Additionally, shared equity homebuyers typically have low delinquency and foreclosure rates, according to a 2010 Urban Institute Study.⁴¹ This study found that shared equity purchases are used as a gateway to more traditional homeownership models. After entering into shared equity arrangements, homeowners tended to transition into another home, or trade-up, at rates near the national average, using the sales proceeds from their shared equity homes, to purchase a different home without assistance.

There are several different nonprofit, municipal and for-profit investor models that exist today, that provide options for households to purchase a home by partnering with an organization or investor. In return for dividing the initial cost of the home, the homeowner typically shares a portion of the future capital gains when the property is sold with their partner organization or investor. A prominent example of a nonprofit working with shared equity products is Home Base Texas (HBT), based in Austin. HBT promotes affordable homeownership by selling homes at below-market prices to income-eligible buyers and limiting the resale price that these homeowners can charge when they later decide to sell.⁴² The amount HBT contributes is established at the time of the initial purchase of the home, by subtracting the market value at the time of the initial sale from the actual purchase price. When the home is resold, the contribution paid by

HBT is recaptured from any financial gain, and any additional increase in equity is allocated between the homeowner and HBT. As such, the gains HBT receives ensures that more households will enter into such agreements, as these gains are reinvested into new homes, securing even more affordable housing for additional households.

This program is similar to the market-driven shared equity models that are beginning to emerge. A small number of start-ups are attempting this shared-equity ownership model, providing funds up-front for the down payment. In these market-driven approaches, investors use private money to pay a share of the purchase price, essentially buying a portion of the home, and in exchange, the homeowner gives the investor a share of the future price appreciation. One example of this kind of company is Unison. Founded in 2004, Unison contributes up to 12.5% of the value of a property through a match on the down payment, for any home valued at \$500,000 or less.⁴³ As such, Unison is an investment partner with each homeowner, with returns or losses depending on the future appreciation on the price of a home. Once the home is sold, Unison collects 35% of the value of appreciation, or will take a 35% of the loss if the value of the home depreciates. This is a relatively new and untested model, but could be a private-sector solution to helping expand homeownership to households who could otherwise not afford the initial purchase, especially in costly markets.

Other potential program methodologies include shared equity partnerships with related buyers purchasing together, either by cohabitating in one single family home or through an investor-like relationship. An example would be co-buying a home with parents or two siblings purchasing a home together. Shared equity purchase agreements could also be created to allow two unrelated households (such as two individuals in a multiple bedroom home) to purchase a property together. These products could be structured in various ways, but would generally be designed to make it easier for households to access homeownership, through sharing both the upfront cost and the potential gains resulting from the appreciation of a home. Instead of sharing the down payment costs with private investor or a nonprofit organization, these partnerships would share the initial purchase price and potentially also the monthly mortgage, with their equity partner. However, in this model of shared equity between two different buyers, there are considerable complications and risks involved. If one buyer can maintain their mortgage payments, but the other buyer cannot, there will need to be a mechanism that will allow the original lender to “buy-out” the partner, or otherwise sell the share in the home. Indeed there are significant potential risks involved in this homeownership model. As such, only a limited number of lenders are currently willing to work with shared equity buyers.

However, well designed financial products could address many of these issues and further encourage such partnerships. It is also important that financial institutions understand their own risks in a shared equity property, and the consequences

of a default or foreclosure on such a home. Despite the challenges, this unconventional model has a great deal of potential. The opportunity to own a partial share of a home could still provide many of the benefits of homeownership. Especially in high cost markets, owning half a home could be much better than never having the opportunity to own at all. As such, an overall shift to standardizing shared equity products both for smaller partnerships and in collaboration with larger investors could provide real advantages for many households and could help to spur homeownership opportunities, especially for young, single-parent, minority and other households who are currently struggling with the challenges of affording homeownership.

Lease-Purchase Agreements

Outside of conventional, graduated payment and shared equity mortgages, other options can promote affordability and provide households with additional avenues to purchase a home. A lease-purchase mortgage option, also known as rent-to-own, allows a household to rent for a period of time before purchasing a home and taking on the ownership of a property. Before taking on the responsibility of a mortgage, this rental period allows households to increase their savings and build a positive credit history.⁴⁴ Depending on the specifics of the contract and the pace of home price growth, a lease-purchase agreement may also make it possible for the household to lock in a below market home price, ensuring greater affordability. As barriers to home buying, such as accumulating a down payment and rising mortgage payments as home prices increase, have made it difficult for families with limited financial resources to become homeowners, lease-purchase programs offer an additional option that could help some households purchase a home, thereby boosting homeownership.

Historically, lease-purchase agreements were offered by both for-profit and nonprofit entities, but widespread abuse of participants in certain programs tarnished the reputation of this arrangement, and as such, lease-purchase agreements became less desirable. Moreover, lease-purchase agreements have traditionally been used as a financing mechanism of last resort both for buyers and sellers; attracting both sellers of hard-to-move properties and borrowers who do not have access to prime mortgages. However, it is important not to let the history of older lease-purchase programs limit the perspective on the significant potential opportunities for lease-purchase agreements moving forward. A well-structured new model for lease-purchase mortgages, particularly programs with built-in consumer protections, could provide a viable mechanism for low and middle-income and young households to make the transition to homeownership. This could be especially effective in high-cost markets and could help to safely increase homeownership across many different areas and demographic groups.

The basic framework for a lease-purchase program is as follows; the owner (mortgagee) cannot sell the property for the duration of the lease, unless they sell it to the renter. The renter makes market rate rent payments to the mortgagee for the duration of the lease. The renter maintains the house as if it were their own, including taking care of minor repairs up to a certain maximum annual expense, for example \$2,000, beyond which the owner pays for any major repairs or maintenance. At the expiration of the lease term, which is typically three to five years, the renter has the option to buy the home. Depending on the specific agreement, the lease holder may also have the option to purchase the home at designated periods prior to the expiration of the lease. If the renter wishes to purchase the home, they must have access to reasonable mortgage finance, as in the case of a typical home purchase. In a lease-purchase agreement, renters can lock in a lower house price with a lease-purchase deal. As such, a lease-purchase contract stipulates an assumed rent rate for the duration of the lease, and a pre-determined purchase price when the option to buy the home is executed. Depending on market conditions, the agreed upon purchase price could be lower than the market price of a comparable home at the time of the sale, giving the existing residents a more affordable home to buy. As such, well-crafted lease-purchase agreements give rent and purchase price guarantees to renters, and stability and good-faith efforts towards an ultimate sale for the property owner.

In this mutually beneficial arrangement, a lease-purchase agreement could prove helpful to homeowners who cannot afford existing mortgages and prospective buyers who find it difficult to come up with a down payment or who need to establish a longer or stronger credit history in order to obtain a mortgage. Lease-purchase programs can also have other benefits for homeownership, outside of helping households who may not otherwise be able to afford a home. In particular, widespread use of these agreements can contribute to neighborhood stabilization and improvement, bringing the stability and investment associated with homeownership to communities still suffering the lingering impacts of the foreclosure crisis. Additionally, a troubled homeowner could stay in his or her home, and convert the loan obligation to a lease with a term of three to five years under a lease-purchase agreement.

Importantly, however, there are no set guidelines for lease-purchase agreements. A lease-purchase agreement can be facilitated by a variety of third parties, such as a municipal government or nonprofit, through a private company or within the lease structure itself between the owner and the tenant. Therefore, encouraging lease-purchase programs would not necessarily involve government reform, but could also be accomplished by promoting programs already available and encouraging more private operators to enter the business.

Of the programs currently administered by nonprofits, lease-purchase agreements are typically used to bolster homeownership in low income and minority households. As such, many lease-purchase agreements that are facilitated through a nonprofit, screen potential applicants for income eligibility, typically 60% to 140% of the area median income, as well as other factors such as employment history, an analysis of total debt and history of rent payments, in order to determine eligibility.⁴⁵ If the potential buyer meets the guidelines set by the nonprofit lender, the tenant will sign a lease-purchase agreement that requires them to make monthly payments to the lender for a limited period of time. The lender may place a portion of the lease payments in an escrow account to cover costs related to the down payment, closing, home maintenance or other housing costs; however, not all programs do provide this benefit. At the end of the agreement, the renter can either purchase the home at the agreed upon price or renegotiate a new lease.

The Cleveland Housing Network Partners (CHN) operates a successful lease-purchase program, converting multifamily units developed through affordable housing programs into lease-purchase homes. Per the structure of the affordable housing program, these units remain rentals for 15 years, and are rented out to low-income tenants earning less than 60% of the area median income.⁴⁶ After the rental provision is fulfilled, CHN facilitates sales of the properties to existing tenants, with an 85% to 90% renter-to-owner conversion rate.⁴⁷ For the remaining households who are unable to transition to homeownership, CHN sells these homes to local landlords that are able to keep them as affordable housing. Homes are generally sold well below market rates, and with such a long lease period, CHN is able to sell properties with mortgage payments similar to the monthly rental payments for a household. CHN also provides other down payment and savings assistance, which adds to their success.

Additionally, there are a plethora of private sector operators that have stepped into the lease-purchase business in recent years. These investors recognize the gap between available supply in the for-sale housing market and the financial realities for many households, and are attempting to better match supply with demand. There is a lot of potential in such a model, with opportunities for many more operators or larger platforms within this space. Typically agreements are structured in a similar manner to nonprofits, but under much shorter spans of lease times and with less financial assistance to households. However, these homes are rented at market rate, and therefore the population of tenants typically has a higher income compared with the targeted group for nonprofits.

One prominent example of a private sector organization is Home Partners of America (HPA), which operates in 20 States in more than 50 markets.⁴⁸ The HPA business model first involves finding eligible households who are financial capable of purchasing their own home in the near term. Next, HPA helps those households identify a single-family home in a

qualified community and buys that property on behalf of the household. HPA then becomes the landlord, and rents that property to the household with the intention to sell it to them after the lease expires. Tenants are also given the option to purchase the home prior to the expiration date. Unlike other private sector operators, this model allows households to select their own future homes, ensuring more determination from tenants on the final intent to purchase. In the first two years of the lease, HPA estimates that 10% of their tenants purchase their home.⁴⁹ As a relatively new operation, HPA expects that 30% to 60% of their tenants will ultimately buy their homes within the next five years.

However, several significant challenges that are particular to private investors, restrict widespread adoption of lease-purchase agreements. The primary challenge for investors is calculating the expected rate of return on these investments. Private operators need to sufficiently calculate what the expected level of appreciation will be on each property, and what a reasonable price will be after an extended lease term. This is less of a problem with nonprofits that typically have a much longer hold on properties and may have additional help from government sources. Companies also run the risk that renters may not be able to obtain financing at the end of their lease term, failing to convert these households to homeowners, leaving operators without a sale. Adding to these risk factors within the private sector, most lease-purchase timelines give a tenant a maximum of three to five years to purchase a property. This timeline may be too short for many households, especially those who have limited savings, moderate income, a short credit history, or recently experienced a foreclosure. Lastly, acquiring and holding these lease-purchase properties on a large scale may be too risky for many private sector operators or investors, especially in neighborhoods of potential home price decline, limiting the number of players willing to consider this type of business.

Depending on the partner and structure of the deal, there are additional challenges for tenants in such agreements that could hurt renter households, more than help. A typical lease-purchase agreement stipulates market rate rents, an expected home price increase and a share in maintenance costs, all of which is settled before entering the agreement. Yet, the average market rate rent could fall at some point in the lease term, the projected home price increase could prove to exceed market conditions, and maintenance costs could prove to require significant funds. In this way, some households may not in fact end up better off financially under such a long-term arrangement. In particular, for tenants entering a lease-purchase agreement with a private operator, that does not provide down payment or savings assistance, a household may not benefit financially unless the home value and/or the market rate rent rise faster than the agreed upon price. Yet, under these conditions, private operators may not make enough from the model to be profitable. Finding a middle ground is possible, and efficiencies created by a greater economy of scale, new management practices and, potentially, the addition of government assistance or standardized lease agreements, could all help to create a

more sustainable and less risky operation. Moreover, given the large number of households who would like to own a home someday and the challenges of affording to purchase, there is great potential for lease-purchase programs to aid households who are close to homeownership but just need a little assistance making the transition. For this reason, lease-purchase programs are another potential tool that could combat affordability issues, stabilize household finances and bolster homeownership in the medium and longer term.

Student Debt

It is critical to pay close attention to the continued increase in student debt loads because in combination with rising costs of living and other debts, student loan debt is detrimental to homeownership, particularly for young millennial households. As was discussed in our previous paper, taking on additional debt exacerbates the challenges of adequately saving for a down payment and reduces the amount of income available each month for mortgage payments, making it more difficult for households to afford homeownership. Student debt also hinders homeownership because it impacts beliefs and perceptions regarding the ability to purchase a home in the future. Although RCG believes that efforts to reduce the growth in tuition costs, minimize student borrowing costs, and reduce the rate of delinquency among student borrowers could all be beneficial in the long term, below we highlight three key proposals that we believe will help to lower the barriers to homeownership through making repayment of student debt less burdensome and by expanding credit to borrowers.

Standardized Mortgage Underwriting

Although student debt is only one of the many issues limiting affordability for young households, as more students take on debt and average debt loads rise, efforts to reduce the burden of student debt and ensure access to mortgages for these young households are increasingly important. A standardized method for underwriting mortgages for borrowers with student loans and criteria that accommodates student loan debt is essential. If borrowers with student debt apply for a mortgage and meet all other underwriting requirements they should not be unduly penalized for having outstanding student loans in their credit profiles.

Clear and standard underwriting guidelines related to student loan debt that also do not penalize prospective borrowers for holding student debt would encourage additional lending and the expansion of credit, thereby boosting homeownership. Policies like this would also likely improve the perception of accessibility to affordable mortgage credit, as was

discussed in our previous paper. This is particularly true for young households and potential first-time homebuyers with many believing that their student debt is hindering their ability to become homeowners. If households with student debt knew that their existing loans would not unduly inhibit their ability to qualify for a mortgage, many more would be likely to try to make the transition into homeownership.

Existing income-based repayment (IBR) plans, which are available on federally guaranteed student debt are beneficial for some households because monthly payments are based on a share of income rather than the total amount that is owed. However, such plans can make it difficult to apply for a mortgage because the monthly payment amount is only good for one year before student debt payments increase or decrease based on income. Mortgage lenders generally perceive this as an unstable future debt payment, which makes it difficult to assess the borrower's DTI ratio. Because the payments are expected to change, typically rising over time, the lender evaluating the mortgage application cannot directly use the current lower payment when calculating the DTI ratio. In most cases, mortgage lenders were instructed to use 1% of the principal balance to estimate the monthly student loan payment, which tends to overstate the actual monthly cost of the student debt, thereby inflating the DTI ratio.

Fannie Mae recently announced policies specifically to assist borrowers with student loan debt, by helping borrowers pay down their student debt and to overcome student debt related barriers to purchasing a home. The new policies aimed to offer flexible payment solutions for current and future homeowners, and also to increase lending.⁵⁰ Under the new Fannie Mae guidelines, lenders can use the existing payment that shows up on the borrower credit report unless the number is zero. However, if the credit report does not identify a monthly student loan payment, then the lender is required to use the 1% value of the loan or a calculated payment that will fully amortize the loan based on the loan repayment terms. By providing simplified options to lenders in these cases, it should be easier to underwrite loans for student borrowers on an IBR plan, which could potentially result in more households with student debt qualifying for mortgages. It is essential that these guidelines are applied broadly across all mortgage lenders so that mortgage availability will expand for young households.

In addition, there are many student debt borrowers who repay their loans with outside help, such as assistance from parents or employers. In fact, a growing number of employers are offering student loan repayment as a benefit to their employees. Historically, situations such as these were not considered in calculating the DTI ratio required in underwriting for mortgages. However, Fannie Mae recently adjusted requirements for excluding non-mortgage debts from the DTI ratio, including installment loans, student loans and other monthly debts. Under the new rules, if a lender can document

that a non-mortgage debt was paid by a third party for at least the last 12 months, then the debt can be excluded from payments that are used to calculate the DTI. This change was intended to assist lenders by simplifying the underwriting process and hopefully will extend mortgage credit to more borrowers with student debt.

While these recent policy changes are crucial steps toward facilitating homeownership for borrowers with student debt, much more still needs to be done in order to standardize lending and avoid penalizing otherwise qualified borrowers with student debt.

Student Loan Interest Deductions

Current U.S. tax policy regarding the maximum student loan deduction, qualifying income limits and rules surrounding married joint-filers significantly restrict tax benefits associated with student loan interest deductions, and thus inhibit the ability of student loan borrowers to pay off their debt and save for a down payment on a home. Changes to existing tax rules, however, could help to reduce the student debt burden. Several proposals that would assist student debt holders include raising the maximum student interest deduction, allowing multiple borrower deductions per tax filing, eliminating income limits or increasing income limits for deductions such that married, dual-earner or dual-student borrower households are not penalized.

Currently, the maximum student loan tax deduction is set at \$2,500. The full deduction is available for a single filer with a modified adjusted gross income of \$65,000 or less. This deduction can be helpful for borrowers that meet the income limit, such as recent graduates. However, the deduction is reduced for filers with a modified adjusted gross income between \$65,000 and \$80,000, and student loan interest can no longer be deducted for single filers with an adjusted gross income of \$80,000 or more. For married couples the income limits mentioned above that are in place for single filers simply double. However, the maximum deduction of \$2,500 remains unchanged regardless of the number of student borrowers. Married couples when filing jointly generally are more likely to exceed the income threshold because of dual incomes or higher individual incomes since married couples tend to be older, and thus may be further along in their careers. These rules in regards to income limits and the maximum allowable deduction when filing jointly essentially penalizes married, dual-earner, and especially dual-student borrower households thereby further reduce the benefits associated with such deductions.

In addition, while many student loan borrowers use an income-based repayment plan, monthly student loan payments for these plans are set each year based on income from the borrower's federal tax return. Therefore, borrowers with

IBR plans can benefit from lower monthly payments if filing separately because the loan servicer will only consider one borrower's income instead of the cumulative income of the household when filing jointly. However, married couples that file separately are not eligible for student loan interest deductions. For many borrowers this results in a complicated choice because filing separately for reduced monthly payments can be beneficial, but as a result they may lose other benefits such as the student loan interest deduction.

The concept of a student loan interest deduction is a beneficial tax policy because it allows taxpayers to subtract interest paid on their debt from taxable income, thus reducing the cost of borrowing. This potentially frees up more money to be used for things, such as saving for a down payment or affording mortgage payments. However, the current student loan interest deduction itself may not be all that beneficial even if a household qualifies for the full deduction. This is because student loan balances increased by 106% in real terms between 2007 and 2016, yet the maximum federal deduction of \$2,500 has not changed since 2001.⁵¹ Effectively, this deduction can save eligible households up to \$625 in taxes annually, assuming that the modified adjusted gross income is \$65,000 or less and the borrower falls within the 25% federal income tax bracket.⁵² Although this deduction provides some relief to borrowers it does not reflect the increase in student debt load over time and is currently unlikely to be sufficient to substantially impact the ability for households to save for a down payment on a home.

For this reason, it is important to reform the rules surrounding the student loan interest deduction to more adequately reflect the increase in student debt loads over time, and so that dual borrower student debt households, which are increasingly common, are not unduly penalized. Increasing the maximum income limit for joint filers and allowing for a student loan interest deduction per borrower would eliminate the marriage penalty and help to reduce the burden of student debt. In addition, increasing the maximum deduction to more adequately reflect the rise in student debt loads over time would also lower debt burdens and help improve household finances, especially for younger households.

One example of a proposal to help facilitate these improvements was the Student Loan Interest Deduction (SLID) Act of 2015, which was introduced to help ease student debt burdens through tax breaks for borrowers. Key provisions of this act included: (1) doubling the tax deduction for interest paid on student loan debt from \$2,500 to \$5,000 for single filers and increasing the limit to \$10,000 for married couples; and (2) eliminating upper income limits on deductions so that regardless of how much a household makes they would still be eligible to receive the maximum deduction.⁵³ The bill was introduced on January 22, 2015, yet was not enacted.

While this particular reform effort proved unsuccessful, similar tax policy changes either through similar legislation or through broader tax reform could help to make the student loan interest deductions a more effective tool to reduce debt burdens for households, improve household finances for student loan borrowers, and ultimately make it at least a little easier for young households to save for a future home purchase.

Student Debt Mortgages

The costs of higher education continue to increase and the number of graduates entering the job market with significant debt burdens is expected to remain elevated through the foreseeable future. A policy proposal for an alternative mortgage product that provides an avenue for new homebuyers to consolidate debt and lower monthly payments is aimed directly at easing the barriers to homeownership created by high student debt burdens. Households delaying home purchases until they can pay off their student loans or eliminating the option of buying a home altogether because of the inability to afford or qualify for monthly mortgage payments would be encouraged to enter the for-sale housing market. With student debt delinquencies comparatively higher than other debt types, a Student Debt Mortgage would also likely reduce late payments and improve credit profiles, thereby enhancing the ability of potential homebuyers to qualify for larger mortgages and trade up over the longer term. The policy would be especially effective in supporting younger, first-time homebuyers most burdened by student loans. With the composition of high-debt borrowers shifting to those with less earning potential during the past several years, the policy would also help bring more lower-income buyers into the market.

The goal of a Student Debt Mortgage would be to consolidate outstanding student debt with the mortgage on the purchase of a new home. The borrower would have one payment, lower than the two individual payments, which reduces monthly student loan outlays and frees up income to allocate to mortgage payments. An insurance mechanism similar to private mortgage insurance would be needed to protect the lender from the uncollateralized student debt portion of the new mortgage.

The new loan product would increase available income to spend on housing by refinancing student debt at a lower interest rate and extending over a 30-year time period, and rolling the student debt balance into a home mortgage, creating a single payment. The blended interest rate would likely be slightly higher than that for a typical home mortgage because of the higher risk associated with the uncollateralized student debt. However, in many cases the overall monthly payments could be lower than would be required for separate student loan and mortgage payments, increasing

the ability of households to take out a Student Debt Mortgage. There could also be tax benefits to rolling student loans into mortgages, especially for individuals in higher tax brackets.

Mortgage lenders are the most likely candidates to originate Student Debt Mortgages. In addition, a growing number of fintech companies have entered the student loan refinancing and consolidation arena during the past few years, and represent another potential source of new mortgage originations. Several fintech companies also serve as platforms for student loan borrowers and lenders to share information and could play an important role in educating borrowers about qualifying for available loans and linking them with lenders. Given the risk associated with uncollateralized student debt, government incentives and guarantees along with mechanisms to securitize these loans may be necessary to promote lending. A public agency willing to purchase Student Debt Mortgages and guarantee them via the secondary market would go a long way to help ensure the availability of capital in the targeted segment, encouraging lenders to increase loan volume while keeping risks associated with individual loans under control. Either existing GSEs, namely Fannie Mae and Freddie Mac, or a new agency in a similar role could serve as financial intermediaries that support a new market for these consolidated loans, either independently or working in partnership with major student loan companies such as Sallie Mae and Navient. With the focus largely on lower down payment loans, there is also a potential role for the Federal Housing Administration.

While this new loan type could make homeownership accessible to a larger number of student debt holders, there are also important factors to consider that could deter borrowing and compromise successful implementation. First, federal student loans carry several protections and benefits that would be lost with consolidation. These include flexible payment plans based on income and the ability to defer payments if a debt holder is out of work or decides to go back to school. While interest accrues for certain types of student loans that are put on hold, for example, for others it does not and holders of the latter would face greater risk of rising loan costs with a Student Debt Mortgage. Additionally, unlike most student loans that default to a 10-year standard plan, standard home mortgages have a 30-year life span. While the longer loan term decreases the monthly payment, it increases the total amount of interest paid over the life of the loan. On the implementation side, the coordination among various government agencies and the private banking community is a complex process with numerous potential hurdles. Moreover, careful attention would need to be paid to creating underwriting standards that balance the provision of a benefit to potential homebuyers, while limiting default risk.

The student loan debt crisis and its link to homeownership has steadily gained attention among policymakers, generating various new proposals to address the issue. Fannie recently announced new provisions that allow borrowers with suf-

efficient home equity to fold their student loan balances into their home mortgages in order to reduce student loan debt. Fannie, in conjunction with SoFi, introduced a pilot loan product last year called the *Student Loan Payoff Refi* before the full roll-out earlier this year.⁵⁴ Under the new program, mortgages can be refinanced to include funds to repay student loans with borrowers receiving the same rates for the amount used to pay off student loans as for the new mortgage. Although a cash-out option was already available for homeowners with equity in their properties, the cash amount over the value of the mortgage typically had fees and higher interest rates attached. As part of the new underwriting rules: (1) total mortgage debt is restricted to conventional loan limits; (2) the new loan cannot exceed 80% of the current home value; (3) the borrower has to qualify for the higher mortgage based on normal underwriting standards; and (4) at least one student loan must be paid back in full with the funds. However, because these provisions focus on current homeowners with significant equity in their homes, including parents who co-signed on loans for their children, the program is not specifically targeted at bringing new homeowners into the market.

A few proposed legislative bills and programs at the federal and more local levels are attempting to address the issue more directly and provide examples of possible ways to convert student loans into mortgages, thereby creating a path to homeownership for thousands of young households. Congresswoman Marcy Kaptur of Ohio introduced the *Transform Student Debt to Home Equity Act of 2017* in June to implement a program for creditworthy student debt holders to purchase eligible homes.⁵⁵ The bill does not lay out a specific plan, but authorizes the U.S. Department of Housing and Urban Development and the Federal Housing Finance Agency to establish a pilot program for first-time homebuyers to refinance student loans and transition them into mortgages through specialized financing and the introduction of new mortgage products. At the local level, the State of Maryland started a program last year called SmartBuy in which Maryland will refund up to 15% of the price of a home purchased off the government registry, a sum which must be applied towards the buyer's student debt.⁵⁶ SmartBuy participants must then occupy the house for at least five years. In Pittsburgh, there is a city council proposal to follow the Maryland model that would also tie a home purchase to student loan relief.⁵⁷ A similar GSE-led pilot program to provide student loan relief incentives through the home buying process could serve as a test model for a broader-based loan product.

With thousands of potential homebuyers stymied by student loans, a new mortgage product that eases debt burdens could help to significantly increase the rate of homeownership nationally, allowing thousands of young households to start building home equity and improving their standard of living. Success will be contingent on effectively coordinating the wants and needs of the variety of players involved, including potential homebuyers, lenders and public entities, to create a self-sustaining program.

Post-Foreclosure Stress Disorder

Despite the persistent belief in the benefits of homeownership and the continued desire to own a home, many households still suffer from the lingering effects of the foreclosure crisis, and the U.S. homeownership rate has recovered only slightly in recent quarters from a 50-year low. RCG believes that the economic, social, and emotional effects of the foreclosure crisis fundamentally altered many individuals' perceptions of financial risks and generated long-lasting psychological changes in financial decision-making, particularly the housing tenure decision of whether to buy or rent. To explain this contradictory trend, we highlighted a phenomenon called *post-foreclosure stress disorder* in our previous paper. Given the shift in the perception of risks, particularly the risks associated with mortgage loans, RCG believes that housing education and housing counseling programs could be extremely beneficial tools to help address the challenges of post-foreclosure stress disorder. Indeed, the potential to use a variety of programs to help consumers overcome the psychological hurdle of buying a new home is a vitally important piece of the puzzle and could prove to be a key step to sustainably increase homeownership nationwide.

RCG proposes a three-tiered approach to simultaneously address several dimensions of the phenomenon of post-foreclosure stress disorder. At the broadest level, we advocate for a wide-ranging public relations campaign to emphasize the benefits of homeownership to the general public. While aimed for everyone, the particular intention would be to reach those individuals or households who have developed the belief that they will never be in a secure enough financial position to actually own a home. However, through a comprehensive approach to educating the public about the many real benefits of homeownership for individuals, communities, and the nation, as well as the true risks, this group may gradually begin to reconsider the possibility of buying a home. Moreover, this kind of broad campaign would reinforce public sentiment about the beneficial values of homeownership, helping to revitalize the American Dream.

Simultaneous to a broad public relations campaign, RCG recommends developing a standardized suite of publically available education programs for prospective homebuyers. This second-tier of interventions would clarify the intricacies, allay fears, and reduce stress during the complex home buying process. In particular, the target audience for these programs would be households who are considering buying a home, but may not know where or how to start. Many existing assistance programs are offered by various stakeholders including Realtors®, lending institutions and many other organizations. However, the impact of such assistance programs would be strengthened if the curriculum could be standardized and classes were made widely available. Prospective buyers could then easily enroll in a basic education program to learn about the process and steps involved in buying a home, ideally at little or no cost. Providing a

pressure-free environment in which potential homeowners can learn and ask questions could give consumers greater confidence in the decision to buy a home.

Perhaps most importantly, RCG believes that a targeted counseling program for those homeowners who previously experienced foreclosure could go a long way in allowing this group of millions of households to consider once again buying a home in a safe and sound way. The existing counseling programs surrounding foreclosure are generally oriented to mitigation or assistance during the foreclosure process. However, this proposal targets those who have already been through that process. The seven-year waiting period is beginning to expire on many of these borrowers' credit reports. This program would aim to be a timely intervention, fortifying this group with the knowledge, assistance, and fiscal judgment to re-enter the housing market in a sustainable way.

Creating a simultaneous, multi-pronged public outreach effort would help unpack and address various aspects of post-foreclosure stress disorder, ultimately working to gradually undo much of the lasting psychological damage of the Great Recession.

Public Relations Campaign Promoting Sustainable Homeownership

Even as the American Dream remains strong, the ideal seems out of reach for many households. This is primarily because their perception of the risks involved in taking out a mortgage loan has changed as a result of the housing-induced Great Recession. Studies have shown that in addition to those who actually experienced foreclosure, their friends and family were also affected vicariously. For younger generations, their substantive experience with homeownership was formed, either directly or vicariously, at a very unusual time in history when owning a home contributed to financial problems for many households. This experience of the Great Recession created a broad societal wariness of mortgage debt. Moreover, as America is increasingly a renter nation, future generations are growing up in renter households and are likely to become renters themselves, resulting in a general lack of personal exposure to the experience of owning a home. Therefore, in addition to affordability, supply constraints, and the challenges of mortgage availability and student loans, it is also crucial to consider the wide-ranging psychological impacts of the housing bubble and bust on future homeownership.

To counteract these effects, the first tier of proposed interventions is a broad-based, nationwide advertising campaign extolling the benefits and importance of homeownership. Fostering a nationwide culture of homeownership would re-emphasize the relationship between homeownership and the national economy, the importance of being invested in

your community, fiscal responsibility, personal pride, and the building of multi-generational wealth for your family and future generations. Targeted to the general public, the public relations campaign would underscore homeownership as an American lifestyle and cultural value.

Various existing programs already provide assistance to households looking to become new homeowners. However, these programs are largely crafted for those who have already decided to buy a home or are on the path to homeownership. Given the nature of post-foreclosure stress disorder, a portion of the population may be precluding themselves from the possibility of actually owning a home. Fostering a nationwide campaign to encourage homeownership and commend its benefits for individuals and communities could help to reinforce the idea to this self-selecting group, thereby increasing the number of people willing to consider homeownership. The goal would be to bring homeownership back to the forefront of American society, especially for young and minority households, in order to help revive the American Dream through an extensive public relations and advertising campaign.

It is important to recognize that some consumer advocacy or political groups may be wary that an intense push for homeownership will translate into a rise in predatory lending or enable the same irresponsible practices that led to the housing crisis in the first place. However, the goal would be for this public relations campaign to be executed in conjunction with education programs to help households make better financial decisions and properly understand the risks and benefits associated with homeownership. The goal will not be to make everyone a homeowner, but rather the campaign will be one part of a larger effort focused on fiscally responsible homeownership.

As highlighted in our previous paper, the cultural atmosphere of the postwar period in the aftermath of the Great Depression and World War II, is a particularly useful precedent. The federal government in conjunction with private lenders and real estate developers helped make homeownership affordable and normalized the lifestyle of homeownership in America through various innovations and public campaigns. The mission of today's new public relations campaign would be an updated vision, drawing on the wide-ranging strategies of programs and messaging from that earlier era of socioeconomic progress, but targeted to modern 21st Century American households.

Counseling Programs for Potential Homeowners

In addition to a broad-based public relations campaign promoting homeownership, a standardized homeowner education program is necessary to counsel prospective homebuyers on the intricacies of the home buying process. To a large extent, many such programs already exist. However, there is a wide variety of programs and the availability of classes can be

based somewhat arbitrarily on the offerings of local Realtors®, brokers, banks, credit counseling firms, regional housing advocacy groups, community development organizations and other private entities. One of the largest programs is the NeighborWorks America network of national organizations that provide both homeownership education and counseling to aspiring homeowners. In addition to these private resources, the federal government runs extensive homeownership counseling operations that sometimes partner with private institutions. HUD's Office of Housing Counseling, offers homeownership education and counseling programs (known as HECs) as well as certifies third-party HUD-approved Housing Counseling Agencies (known as HCAs) around the country. Still, there is a significant opportunity to further standardize these programs, coordinating the plethora of homebuyer assistance and education programs that are already run by a wide range of existing organizations.

Counseling helps households navigate a variety of barriers to attain or maintain homeownership. Many prospective homebuyers do not shop around for home financing, even though having access to more options might lower their costs. In fact, a Consumer Financial Protection Bureau 2015 survey of mortgage borrowers found that approximately half of borrowers seriously considered only one lender or broker before deciding where to apply and 77% of borrowers submitted an application to only one lender or broker.⁵⁸ Homeownership counseling services play an important role by helping potential homebuyers develop a budget, strengthen their credit to maximize their chance of getting the lowest possible mortgage rate, set a realistic timeline for the purchase, and connect with other needed experts, including Realtors® and home inspectors. The fact that most applicants do not approach more than one lender or broker highlights that a more standardized education program on the homeownership process could teach potential homebuyers how to find the right broker and lender to suit their needs.

Prospective homebuyers often do not know or understand their financing options, and homeowners can encounter unexpected costs, struggle to maintain their initial payment plans, or encounter financing scams. In fact, nearly half of all first-time, low-income homeowners experience significant unexpected home repairs.⁵⁹ Research demonstrates that homeownership education and counseling can provide powerful support as households assess their options and make decisions. This curriculum could be engaged by those households that have already made the decision to buy a home, prior to developing a relationship with a Realtor® or lender. The program could also be extremely beneficial for individuals that have not yet decided to buy a home. The idea is for the program to act as a no-pressure, no-strings-attached, in-depth guidance program designed to demystify the entire home buying process as well as explain the responsibilities of home insurance, taxes, and maintenance. This suite of homeownership courses would help people better understand

the realities of owning a home, as well as provide a space for them to ask questions in a pressure free environment. Households benefit most from homeownership education and counseling when the support is appropriate for their needs, easily accessible and offered early in the home purchase process.⁶⁰

The focus on a standard curriculum would be especially helpful to young households or households with limited experience with the homebuyer process. Counseling offers information and guidance through the home buying process, helping provide households with the necessary tools to achieve the goal of purchasing a home that they can safely afford. Ultimately, the goal of homeownership education and counseling is to create a better informed consumer. This program would allow participants to develop the familiarity and confidence to consult several experts and institutions and take greater ownership throughout the home buying process. This shift towards a more educated buyer should translate into a lower rate of foreclosures and help make homeownership more sustainable by ensuring that new homeowners fully understand the process and can remain in their homes through the long term.

Post-Foreclosure Targeted Assistance

The third tier of counseling and public outreach calls for addressing the needs of a particular segment of the overall population – the millions of households who lost their homes during the foreclosure crisis, especially low-income, minority, and immigrant households. It is natural that the financial and emotional hardship of having gone through the foreclosure process would turn many households off from ever wanting to own a home again. As the seven-year waiting period on the credit reports of these households begins to expire over the course of the next few years, many in this group will become eligible to own a home again. However, of the households who have already become eligible for a mortgage loan in the past couple years, only a small share have actually re-entered the market and bought another home. This presents a timely opportunity for a trusted program to provide counseling and assistance to this large segment of the population. Given the prior experience with foreclosure, it could prove very helpful for these households to go through counseling before borrowing again, in order to foster a better understanding of the appropriate risks involved.

This targeted program would include a specific curriculum centered on encouraging responsible homeownership. Group sessions could allow participants to learn about particular topics from an expert in the field as well as from one another's experiences during discussion sessions. The counseling program could also be used as a mechanism to improve credit worthiness. In addition, one-on-one counseling sessions, individual assessments and financial plans could prove very beneficial for this population to regain the confidence and skills to re-enter the for-sale housing market.

As noted in our prior report, nearly nine million people lost their homes during the housing crisis and many of these households will start becoming eligible for mortgage credit again very soon.⁶¹ This represents a large pool of potential homeowners that could re-enter the housing market. If armed with better financial knowledge and risk assessment skills, this population could buy a home again while avoiding the pitfalls of their previous experience. Therefore, the goal of the program would be to capitalize on this moment, as they become eligible for mortgages again after seven years from the date of foreclosure, to enhance homeownership by capturing the potential for this group to become stable owners in the future.

Many programs already conduct foreclosure counseling, mitigation, and negotiation, prompting some to question the need for an additional program focused on foreclosure. But this proposal could build on the expertise of these pre-existing programs while advocating for a pivot towards addressing the needs of the group of households with previous foreclosures. This shift in the nature of the programs could also be branded as responding to a timely need as the seven-year period expires. However, resource allocation could be a major issue. Local and tailored counseling is the most helpful to households, but it is hard to provide or target the households most in need. Therefore, it would likely require a large, national effort to raise funding and advocate for such a targeted program. Moreover, this advocacy could prevent future predatory lending schemes that may intend to prey on this population. This proposal for a targeted program would enable households to identify bad loans and attain the fiscal management skills to understand what constitutes an acceptable level of risk.

Many community development organizations and low-income housing programs that assisted with foreclosure mitigation and counseling could potentially be recruited to aid in doing this targeted type of counseling for those households that have already gone through foreclosure. In addition, the FHA “Back to Work – Extenuating Circumstances” program, which ended in October 2016, could be revived to assist those that have gone through foreclosure to re-enter the for-sale housing market. And finally, the National Foreclosure Mitigation Counseling (NFMC) Program, created by NeighborWorks America, has served more than 1.9 million homeowners at risk of foreclosure and helped build the nation’s largest foreclosure counseling capacity. Given the NFMC program’s experience in aiding foreclosure clients, encouraging a shift in this program to further assist those that were previously foreclosed upon with future home purchases could be a fruitful enterprise. Their resources and demonstrated expertise in this arena are useful starting points for a more targeted effort to encourage sustainable homeownership for those newly eligible for mortgages.

This third tier of intervention advocates for new or existing foreclosure counseling and mitigation programs to address the needs of those households who were previously foreclosed upon and are becoming eligible for a mortgage loan. Such a targeted counseling program could enable these households to own a home once again, with the knowledge and understanding to appropriately manage the risks associated with a mortgage loan, supporting increases homeownership in a sustainable way nationwide.

Mortgage Availability

Improving Access to Credit for Consumers

In the wake of the foreclosure crisis and the tightening of mortgage credit in the past decade, there are currently many otherwise qualified borrowers who are unable to receive access to affordable mortgage credit. Many consumers have limited traditional credit histories, less than outstanding credit scores, or hold existing debt, such as student loans, that inhibit them from gaining access to credit. However, if a borrower is able to make mortgage payments consistently and can satisfy other sound underwriting requirements, then none of these factors should necessarily indicate that they are unqualified borrowers. Indeed, RCG believes that it is essential that government policymakers and lending institutions establish methods to extend credit to a broader array of borrowers, in order to increase homeownership in a sustainable way. In the following sections, we outline two key ways to expand credit to consumers that can be achieved without adding significant additional risk for lenders.

Debt-to-Income Ratio

Increasing the standard debt-to-income (DTI) ratio required to meet the criteria of a qualified mortgage (QM) is one key step that could help to expand the availability of mortgage credit. DTI is typically calculated using monthly debt and income sources before tax, and the ratio is used to demonstrate the ability of the borrower to make monthly payments. While the DTI ratio is an important underwriting metric and could be a predictor of mortgage default risk, there are a significant number of potentially high quality borrowers who fail to qualify for mortgage loans because their DTI ratios exceed the current restrictive DTI requirements.

The current DTI limit was established by the Consumer Financial Protection Board (CFPB) under the Dodd-Frank Wall Street Reform and Consumer Protect Act as a requirement under a new class of mortgages that were formed called

qualified mortgages. The QM standard was created to provide safer and easier-to-understand mortgages for borrowers. For example, a QM precludes fees of more than 3% of the loan and restricts negative amortization, interest-only periods, loan terms longer than 30 years and ballooning principals.⁶² To be considered a QM loan, lenders must also determine through a complicated underwriting process that a borrower will be able to repay the loan, also known as the ability-to-repay rule. Although lenders should benefit from these rules because they help to reduce mortgage defaults, lenders are primarily interested in satisfying the QM requirements because this standard provides the potential for legal protection known as safe harbor. Indeed, if the lender is able to determine that a borrower meets the ability-to-repay rule and the loan meets other QM requirements, then those loans are protected from borrower lawsuits and loan buybacks, thereby reducing major legal and financial risk for lenders.

While many of these guidelines are important for prudent lending practices, one of the underwriting requirements set by the CFPB for a loan to be considered a QM is that the borrower must possess a DTI that is no more than 43%. However, temporary rules also extend QM status to loans that are eligible for purchase or guarantee by Fannie Mae and Freddie Mac, the Federal Housing Administration (FHA), and other smaller federal programs through agencies including the U.S. Department of Veteran Affairs, the Rural Housing Service, and the U.S. Department of Agriculture. Loans that are purchased or guaranteed by the Government Sponsored Enterprises (GSEs) and federal agencies must meet the same requirements of general QM loans in regards to the basic loan structure, with a maximum loan term of 30 years and points-and-fees restrictions, yet these loans are not directly subject to the DTI limit.⁶³ This temporary provision expires when the GSEs exit federal conservatorship or receivership, or in 2021, whichever occurs first.

Importantly, however, in order to qualify for a mortgage the borrower must also meet a broader set of underwriting standards, including an examination of income, credit scores, loan-to-value ratio, and other measures, such that raising the DTI ratio alone does not necessarily pose much additional risk for the lender. In fact, the GSEs can and do buy and secure loans with DTI ratios more than 43%. In particular, on May 30, 2017, Fannie announced plans to consider mortgages with DTI ratios of up to 50%. This represented an increase from a prior 45% DTI limit after researchers at Fannie analyzed borrowers with DTIs between 45% and 50% and found that a significant number of them possessed good credit and were not prone to default.⁶⁴ Freddie allows flexibility in terms of loans in the 45% to 50% DTI bucket, yet historically purchases mortgages based on the Fannie automated underwriting system.

After the recent increase in the Fannie DTI ratio to 50%, the Federal Housing and Finance Agency (FHFA) is expected to closely monitor the performance of loans in the 45% to 50% DTI bucket. To the extent that these loans do, in fact,

provide little additional risk, Freddie, the FHA and other federal agencies should consider opportunities to expand the credit box through similar modest easing in underwriting criteria to help expand credit availability. In fact, a standardized increase to the DTI limit could significantly impact the number of households qualifying for new mortgages since these loans represent a large share of total mortgages. The Urban Institute estimated that the recent increase in the DTI limit would generate 85,000 new loans annually through Fannie and 15,000 new loans from Freddie, resulting in the combined addition of 100,000 additional GSE mortgages per year.⁶⁵ Moreover, the expansion of credit by raising the DTI limit comes at a low cost because loans also need to be evaluated using other stringent underwriting standards set by the GSEs. In fact, the Urban Institute found that raising the DTI ratios from 45% to 50% posed significantly less incremental risk in comparison with an increase in the loan-to-value ratio or a decrease in FICO score.⁶⁶

Formally incorporating this change into the general QM definition as set by the CFPB could even further reduce mortgage availability challenges. This kind of broad-based increase in the DTI ratio would expand the credit box allowing more households to gain access to mortgage credit, and thereby support increased homeownership. In particular, well-qualified borrowers in higher-priced markets would benefit from a higher DTI. Raising the limit would also help younger households who may have larger debt loads resulting from student debt, and therefore higher DTI ratios. Moreover, a rule change to the ratio would likely assist in facilitating the transition to homeownership for minority groups, particularly African American and Hispanic households, who are disproportionately affected by the DTI ratio rules because these households typically spend a larger percentage of income on housing.⁶⁷

While there is some potential risk that raising the DTI limit too much would mean that borrowers do not have a sufficient buffer to ensure monthly mortgage payments, stringent underwriting systems that closely examine incomes and other measures should be adequate to limit these risks. Consistent with this view, several leading industry stakeholders support raising or eliminating the 43% debt-to-income standard because the DTI limit results in inflexible underwriting conditions that prohibit further examination of an applicant's wider credit picture and results in lenders rejecting creditworthy applicants.

Ultimately, RCG believes that other federal institutions should take notice of Fannie's recent change to their DTI requirements and follow suit. Raising the DTI ratio required by QM lenders would increase availability and accessibility of mortgage credit across the board. It is both relatively easy and inexpensive to implement, and adds little additional underwriting risk. Such a move would especially help young and minority households that tend to possess lower DTI ratios because of spending more income on housing and larger debt loads, particularly related to student debt.

Alternative Measures of Credit Scores

Utilizing alternative measures of credit to generate credit scores could help to improve access to lending for millions of people, particularly those with a limited or non-traditional credit history. Compared with traditional credit measures, utilizing a wider range of data points and big data technology to create a more comprehensive credit score could potentially help underserved consumers establish creditworthiness and gain access to mortgage credit. In fact, approximately 26 million Americans currently have no credit history and an additional 19 million have credit histories that are either outdated or lack enough information to produce a score, according to the CFPB.⁶⁸ Many consumers cannot even consider a mortgage because they have thin or non-traditional credit histories, meaning that a credit profile does not have enough recent activity or history of loan repayment to meet the requirements of traditional scoring models. However, the burgeoning big data industry is utilizing a broad range of data to create powerful tools to analyze data in new ways and to improve efficiency within many different industries, and the mortgage industry should be no different.

Traditional credit scores are based on information reported by banks and credit card companies to major credit bureaus. In many cases, alternative credit reporting and scoring products rely on aggregating large public and proprietary sources of data that traditional scoring methodologies do not use. Alternative methods assign scores utilizing data from sources such as cellphone and cable accounts, frequency of changing home addresses, rent payments, payday loans, and checking account histories. These kinds of nontraditional information can round out the profile of an applicant, adding significantly more information and allowing lenders to target offers more precisely.

Using alternative scoring methods for consumers with thin or no credit history could help to expand the number of households eligible to apply for a mortgage. Depending on the validity of the method used, alternative measures could create more mortgage consumers without creating additional risk for lenders. This would potentially open up mortgage lending to a large group of consumers currently locked out of the traditional credit environment, allowing more people the opportunity to become homeowners. Additionally, alternative data used to create these scores would likely more accurately reflect each individual's true risk profile, allowing lenders the ability to extend credit with greater confidence and with terms that are better targeted to each borrower's underwriting risk. This could improve homeownership affordability for many households that otherwise may not qualify for a mortgage, or would only qualify for a higher mortgage rate using traditional credit scoring measures. Alternative measures could be particularly helpful enabling young, minority and low-income consumers with limited credit history to gain access to mortgage credit. Moreover, alternative measures of credit scores would increase competition, thereby encouraging greater transparency. Competition would also encourage

faster incorporation of new information, making it possible to more accurately score borrowers.⁶⁹ If lenders were able to feel more confident in the risk that each borrower poses, mortgage credit could be more readily expanded, allowing for many potential homeowners to make the transition to buying a first home.

Although alternative credit scores could increase homeownership, there are some challenges associated with using new methods of measurement. Since alternative datasets may not be reported or collected as robustly as other credit data, researchers may be forced to rely on sample data. This creates concerns regarding the predictive behavior of sample data to draw conclusions about the entire population. In addition, with nontraditional data there is greater variety of data captured and an inconsistent level of coverage from person to person, potentially making it challenging to ensure that alternative credit measures are robust, predictive, and consistently meet compliance standards for all potential borrowers. Additionally, there is currently significant legal and regulatory uncertainty limiting widespread adoption of alternative credit measures. Specifically, lenders looking to use alternative credit scores would need to comply with a wide range of compliance standards, including the Equal Credit Opportunity Act, Fair Credit Reporting Act, and Fair Housing Act. Federal law also demands that consumers can review and dispute their payment records.⁷⁰ When it comes to nontraditional data sources, the systems needed to ensure that consumers can reconcile the disputes and correct reports are not yet established. Additionally, there are potential technological challenges associated with mining datasets stored across complex legacy systems and finding a way to deliver the data in a format that meets lender specifications, while demonstrating compliance with safeguards.⁷¹ Lastly, it is important to point out that using alternative measures of credit may either increase or decrease the measure of creditworthiness. For example, subprime loans like payday loans may harm a consumer's credit report. However, this may also make it possible for alternative credit scores to be used to more accurately predict borrower reliability, which should support safe and sound lending and help to prevent another crisis related to risky lending practices.

Despite these challenges, there are many potential advantages to improving the ways that credit scores are measured and the upside for expanded credit and improved underwriting create a significant opportunity to support homeownership in a sustainable way. Currently there are a number of programs as well as proposed legislation at the state and national level that should help to investigate the effectiveness and potential ways to integrate alternative credit score measures into underwriting standards. In 2015, the FHFA required Fannie Mae and Freddie Mac to "assess the feasibility of alternate credit score models and credit history in loan-decision models."⁷² The 2016 Scorecard Progress Report released in March 2017, stated that the FHFA continued to work with the enterprises to study the costs and benefits of migrating to or implementing additional or alternative credit score models, with plans to conclude the assessment in

2017. However, the FHFA offered an update to the alternative credit score project in August 2017, noting the complexity of the analysis and indicating that no changes would occur prior to mid-2019. The New York City comptroller, Scott Stringer, announced a plan in October to encourage landlords and property management companies to give tenants the ability to report their rent payments in an effort to boost credit scores. The goal of the plan is to assist households, particularly low-income households with limited credit to build a stronger credit history.⁷³

Legislation in the House (H.R. 898) and Senate (S. 1685) could also compel the FHFA to develop procedures for the GSEs to accept alternative scoring models. H.R. 898 and companion bill S. 1685 were introduced as the “Credit Score Competition Act of 2017” to require Fannie and Freddie to establish procedures for considering alternative credit scores in making a determination whether to purchase a mortgage.⁷⁴ The intent of these bills would be to increase the chances of an applicant being approved for a mortgage. The representatives that introduced these bills argued that using the single credit scoring method (FICO) to make decisions, combined with the dominance of GSEs in the secondary mortgage market, results in a monopoly in credit scoring.

In addition, there are many private companies already working to develop algorithms and tools to form alternative sources of scores including: VantageScore, Cignifi, FactorTrust, First Access, eCredable, HappyMango, Juvo, Neener Analytics, SharedLending, Trooly, TrustingSocial and ZestFinance among others.⁷⁵ While the question of which types of credit scores will prove most reliable and how exactly to implement them remains to be determined, it is essential to create programs and tools to utilize and integrate alternative measures of credit into the mortgage underwriting process in an effort to improve access to mortgages for otherwise qualified potential borrowers. In particular, RCG believes that alternative credit measures will be most helpful to increase access to homeownership for those with limited or non-traditional credit history including young and minority households who were hit hardest by the Great Recession and the pull-back in mortgage credit availability.

Reducing Post-Foreclosure Lending Aversion

Although credit availability continues to improve gradually, some lending institutions remain wary of extending loans to consumers with anything less than stellar credit because of the recent experience with large fines and put-backs in the aftermath of the foreclosure crisis, unknowns regarding compliance and enforcement procedures, and restrictive regulations. As a consequence, many lenders reconsidered whether mortgage lending, in particular FHA lending, is a viable and profitable business line, given the many real and perceived risks. In our last paper, we referred to this phenomenon as

post-foreclosure lending aversion. This dynamic is limiting lending and significantly exacerbating the current challenges of mortgage availability for consumers. Additionally, the rise of the gig economy created a growing number of workers with less stable income. As a result, these households find it more difficult to qualify for a mortgage, especially given current tight and inflexible underwriting standards, even if they are able to satisfy most qualifications and are able to afford the purchase of a home. However, there are a number of practical steps that regulators can take to help mitigate these problems and improve access to homeownership. In particular, RCG believes that providing clear regulations and strong legal protection, combined with efforts to limit compliance costs, are essential to help reduce the persistent effect of post-foreclosure lending aversion that is hindering the flow of mortgage capital to credit-worthy households.

Regulations, Rulemaking and Legal Protections

As discussed earlier, lenders generally seek to satisfy the requirements of a qualified mortgage in order to ensure that loans will gain safe harbor status, protecting lenders from the legal and financial risks of borrower lawsuits and loan buybacks. In addition to specific loan criteria, qualified mortgages must comply with the ability-to-repay rule. The rule requires lenders to make a good faith determination of a consumer's ability to repay the loan before extending them credit and to subsequently retain evidence of compliance. In particular, creditors are required to consider income or assets, employment status, the monthly payment on the mortgage, other debt, alimony or child support, the debt-to-income ratio and credit history.⁷⁶ However, there are no specific underwriting models required, and while intended to ensure safe underwriting, the end result is that lenders are left with a great deal of uncertainty. In particular, it is not clear what criteria would be sufficient to support a good faith determination, or what constitutes sufficient evidence that the borrower will indeed be able to pay back the loan.

As a result, ensuring that loans meet the ability-to-repay obligation in order to qualify for safe harbor can prove challenging, time consuming and costly for lenders. The extensive and largely unclear requirements make it more difficult for loans to qualify for qualified mortgage status and safe harbor. Moreover, lenders are effectively forced to document a wide range of potential issues for borrowers, some of which may not even reflect underlying lending risk, in an attempt to prove good faith and remain in compliance.

Further complicating factors, even with these hurdles designed to demonstrate safe lending practices, the risk, scale and cost of potential future litigation for lenders in the case of borrower defaults remains largely unknown and untested under the current rules. Enforcement for these regulations is also unclear and leaves open a potential risk for lenders

to face harsh punishments for failure to comply, the threat of which effectively discourages overall lending. The cost of compliance under Dodd-Frank particularly hurts community banks, which have to choose between meeting regulatory requirements and extending credit to borrowers. Smaller loans also tend to be negatively impacted by lenders unwillingness to extend credit for mortgages that are not guaranteed safe harbor, since many borrowers seeking these loans are first-time homebuyers, with lower incomes, or households that tend to possess less than pristine credit.

Given the complexity involved in the ability-to-repay rule, lenders need a more straightforward mechanism to readily demonstrate full compliance, and upon doing so, should automatically be given full protection. Lenders need iron-clad safe harbor provisions that shield against the risk of lawsuits, put-backs and the associated negative public attention. If lenders were certain of how to comply with the ability-to-repay rule and were convinced that compliance and safe harbor standards would effectively eliminate legal and regulatory risks, then the credit box would likely widen and mortgage availability could expand significantly in a safe and sustainable way.

In order to reduce future uncertainty, the CFPB should use formal rulemaking and published guidelines to establish a clear mechanism for lenders to demonstrate full compliance with the ability-to-repay rule. Consistent with this need, the CFPB should adopt clear rules to create additional regulatory certainty and consistent protections for consumers. This kind of increased regulatory clarity with regards to compliance procedures, as well as the financial and legal implications for infractions or errors in lending, could significantly increase lender confidence in making loans. Ultimately, this would help to expand credit availability, ensure competition among lenders, and benefit consumers looking to purchase a home.

Several industry experts have proposed to expand safe harbor to all loans that satisfy QM requirements because the current standards are too narrowly defined. Recent proposals also include considering all mortgages originated and retained in bank portfolios as QMs with guaranteed safe harbor. This is currently also a provision in the Financial Choice Act that was passed by the House in June 2017 that will be discussed in further detail below. This is generally considered a safe lending practice because the bank is responsible for 100% of the risk of these loans, and therefore the good faith ability-to-repay protections are implicit in the underwriting process, as the bank will only extend in-house loans if they believe the borrower will be able to fully repay the loan.

In June 2017, the House passed the Financial Choice Act, which would erase some of the Dodd-Frank Banking rules that were put into place in 2010. The proposed act would exempt some financial institutions that meet capital and liquidity requirements from many of the Dodd-Frank restrictions. In addition, the act would weaken CFPB authority. There is

still a significant need for practical, common sense reforms to the existing Dodd-Frank rules. Such reforms could go a long way toward substantially reducing the current regulatory burden and would help to increase lending and improve mortgage availability for new homeowners.

FHA Lending

The FHA plays a significant role in providing credit for a wide range of borrowers, particularly first-time, low- to moderate-income and minority homebuyers. However, considerable uncertainty currently exists surrounding what is considered an approvable loan and the potential treatment of origination errors under the False Claims Act that is used to extricate settlements from lenders that misrepresent the quality of FHA loans. In particular, aggressive use of the False Claims Act and complex regulations caused many lenders to shy away from FHA lending under a perception that it is too risky. In order for FHA to continue to make affordable, low down payment loans broadly available for borrowers, it is essential to create and enforce clear rules for lenders so that the legal risk associated with FHA lending is reduced.

As a result of uncertainties surrounding what constitutes an approvable loan and strict enforcement of the False Claims Act, many lenders tightened credit standards beyond the FHA minimum standards, while others shifted away from FHA lending entirely. Establishing clearer regulations surrounding what constitutes an approvable FHA loan and the consequences of origination errors would improve lender confidence and increase credit access for otherwise qualified borrowers.

In January 2017, the FHA announced implementation of the Loan Review System (LRS), which provides an electronic platform for FHA loan-level file reviews.⁷⁷ In particular, lenders use the LRS to interact with the FHA regarding single family mortgage quality control processes. The LRS was designed to assist in streamlining and enhancing quality control processes for mortgages and the FHA. In particular, the Loan Quality Assessment Methodology, also known as the Defect Taxonomy, was implemented to increase efficacy in FHA quality assurance efforts, and to identify and capture information about defects revealed through an individual loan-level review.⁷⁸ The Defect Taxonomy describes which loan errors or defects will be placed into one of four levels of severity.

Although the FHA launched the LRS to streamline the process for mortgages, many critics argue that it was not enough to prompt lenders to do more FHA lending. Some experts believe that the Defect Taxonomy fails to clarify many of the consequences associated with particular types of loan defects. As a result of these large uncertainties regarding what is considered an approvable loan, many potential lenders may continue to stay away from FHA lending even after the

launch of LRS because of risks associated with the False Claims Act. Moving forward, in order to help reduce post-foreclosure lending aversion, it will be important for the FHA to work to further improve the clarification of the Defect Taxonomy and to work with the U.S. Department of Justice to find ways to limit aggressive indemnification requests through the False Claims Act.

Making Small Loans Profitable

Reducing and streamlining processes and eliminating unnecessary compliance requirements could significantly cut compliance costs for lenders. Requiring lenders to document issues that may or may not impact lending risk increases costs for borrowers and incentivizes them to lend only to borrowers with pristine credit. As such, streamlining the regulatory environment so that compliance is more efficient and reducing unnecessary documentation is essential to reducing costs. In particular, a reduction in costs would make smaller home loans more profitable for lenders, thereby increasing the likelihood that lenders would extend credit to lower income or first-time homebuyers. Reducing the administrative costs of compliance would also make it possible for a greater number of smaller lending institutions to remain in the mortgage lending business, increasing competition and reducing borrowing costs for individual borrowers.

The current variations in regulatory requirements among federal agencies can also add complexity to the lending system and establish inefficiencies. As previously discussed, regulators need to work more closely with lenders rather than relying on enforcement actions and fines. Moreover, federal agencies and government guarantors should be required to coordinate with one another, as this would benefit the mortgage servicing market by minimizing regulatory conflicts and providing consistency in mortgage servicing. Shifting the lending environment to a more collaborative system would increase productivity, limit costs, and further increase the willingness of lenders to lend to borrowers beyond only those with pristine credit.

Fundamentally, emboldening lenders to better understand the steps needed to ensure compliance, limiting the regulatory risks associated with mortgage financing, ensuring legal protection, and reforming requirements that restrict lending and drive up costs are essential steps for increasing the homeownership rate. Prospective homeowners, particularly those who are on the margin with the ability to afford a home, but with limited access to credit, would likely benefit significantly from these common sense changes, which could support homeownership in a safe and sustainable way.

Safe and Sustainable Future for GSEs

The future for the GSEs is uncertain. Although the FHFA is in the process of making improvements to streamline Fannie Mae and Freddie Mac, the long term viability of the GSEs has not been addressed. In order to ensure the financial stability and liquidity of the housing finance system and to provide opportunities for homebuyers to get access to affordable loans, the U.S. housing market will require a specific plan to establish a sustainable system for the future. In particular, any viable plan will require: (1) a clearly defined government role; (2) methods to ensure liquidity for retail lenders; (3) programs to sustain a well-functioning secondary market that improves mortgage affordability and accessibility; (4) safeguards against catastrophic system-wide failure and stability for the housing finance system; and (5) protections for taxpayers to limit liability and reduce the need for future bailouts.

Current Conservatorship Model

The current conservatorship model is unsustainable because, although the FHFA closely scrutinizes the GSEs and has initiated many reforms to increase operational efficiency, Fannie and Freddie remain under capitalized and vulnerable in the event of a crisis. As discussed in our previous paper, the conservatorship requires any GSE profits to go directly to the U.S. Treasury in the form of dividends and the enterprises are unable to build capital reserves or pay off outstanding debt from the Treasury. As a result, the GSEs do not currently have enough capital reserves to remain solvent in the event of an adverse economic event and would likely require a new bailout if home prices were to fall substantially once again. Although it is unclear what will happen to the GSEs at the end of their conservatorship, it is most essential to ensure sufficient capital reserves to guarantee stability in the housing finance system and liquidity for lenders. This will reduce risk in the event of an economic downturn, ensure capital availability for potential homeowners, and safely increase mortgage lending in the future.

The FHFA released their 2018 through 2022 Strategic Plan in September 2017. This plan stresses ensuring safety and soundness of the GSEs, promoting stability, liquidity and access in the housing market, and lastly managing the conservatorship of Fannie and Freddie.⁷⁹ In managing the conservatorship, the FHFA aims to reduce taxpayer risk by conducting more risk-sharing transactions with private capital, developing the GSEs Common Securitization Platform (CSP) and implementing the Single Security. In an effort to achieve these goals, the GSEs, under FHFA's direction and guidance, formed a joint venture called Common Securitization Solutions to develop and operate a CSP. Currently, there is substantial overlap in the function and operation of Fannie and Freddie, leading to inefficiency as a result of duplicated

work. The enterprises need to continue to work together towards a more uniform platform that reduces inefficiencies and costs, thereby increasing credit availability and affordability to low- and moderate-income households.

To fully leverage the advantages of CSP, the FHFA created the Single Security Initiative in an effort to improve the overall liquidity of the GSE's securities. The Single Security Initiative involves the development of a common security called the Uniform Mortgage-Backed Security. The purpose of this common product is to increase overall liquidity in the secondary mortgage market and support security prices, lower yields, and create a deeper market for the securities. In addition, this should reduce or eliminate the trading value disparities between Fannie and Freddie securities. The Single Security Initiative is scheduled to be implemented in the first half of 2019 once both Fannie and Freddie are on the CSP.⁸⁰

Although this is a significant step in the right direction, the CSP plan does not address key issues that are currently limiting the stability of the housing finance system. The CSP plan fails to acknowledge the lack of capital held by the GSEs and does not modify the agreement that prohibits the GSEs from using profits to build reserves. Even though strides are being made to reduce taxpayer exposure, systemic risk will not be eliminated through the current FHFA Strategic Plan because of the continued lack of capital, which leaves taxpayers potentially liable for bailout. CSP is also not designed to help with that issue and instead is really an approach designed to increase efficiency of the GSEs.

Although higher guarantee fees and risk-sharing deals may help mitigate credit risk and a common platform may streamline and increase efficiency, the potential taxpayer liability remains, with elevated risk because of the dominance of the GSEs in the secondary market, as well as the lack of sufficient capital reserves. The combination of depressed mortgage credit availability and taxpayer liability are driving most GSE reform efforts, with both issues making it politically unsustainable to maintain the GSEs under the current structure long term. Instead, it is essential to find a solution to mitigate taxpayer exposure, while ensuring stability in the housing finance system and the availability of credit, in order to make it possible for more households to have the opportunity to become homeowners across all stages of the business cycle.

Failed Legislative Bills

There were a number of proposed legislative reforms that surfaced in recent years, each dealing with the future of GSEs, taxpayer exposure to credit risk, and private insurance options, among other challenges. Some of the most notable legislative bills included: the Protecting American Taxpayers and Homeowners Act (2013), the Corker-Warner bill (2013), and the Johnson-Crapo bill (2014).

Under the proposed Protecting American Taxpayers and Homeowners Act, the FHFA would remain in existence and oversee risk sharing programs, establish a National Mortgage Market Utility and regulate the Federal Housing Administration and Rural Housing Service.⁸¹ The role of the government would be clearly defined and limited. In an effort to attract investment and encourage positive change, barriers to private capital would be removed. Market participants would also be given clear and transparent rules to increase competition. Lastly, consumers would be given more choices of mortgage products to find the best fit for them. The proposed utility would be constructed and operated as a not-for-profit entity that creates standards for servicing, pooling, and securitizing residential mortgage loans. This bill was introduced in 2013, but was not enacted.

Beyond unwinding the involvement of the two GSEs in the secondary market, the Corker-Warner Bill was intended to expand the role of private mortgage insurance, and create a single government backstop to provide a CSP and catastrophic mortgage insurance for qualified mortgage-backed securities.⁸² The key element to this bill was to create a single government-owned independent corporation that would provide this backstop, called the Federal Mortgage Insurance Corporation (FMIC). The purpose of the FMIC would be to: (1) support a robust secondary market and the production of residential mortgage-backed securities, and thus provide increased access, liquidity and transparency in the market; and (2) reduce taxpayer liability in the event of economic stress. This bill failed in the Senate in 2015.

The Johnson-Crapo bill, also known as the Housing Finance Reform and Taxpayer Protection Act of 2014, was based on the Corker-Warner legislation, yet with slight differences.⁸³ Similar to the prior bill, it would create the FMIC, wind down the role of the GSEs, and provide a smooth transition to a new housing finance system. The main goals of this bill were to increase accessibility of mortgage credit to a wide-range of borrowers, monitor consumer and market access to credit, and to maintain broad liquidity. Although the bill never advanced to the Senate floor, it was the only comprehensive housing finance reform measure to receive bipartisan support.⁸⁴

Although these bills failed to move through congress, the proposals were certainly taking a step in the right direction. In particular, these bills each represented a concerted effort to address current uncertainty and to consider the long term importance of ensuring stability and liquidity in the housing finance system and reducing potential taxpayer risk.

Outstanding Proposals

There are a number of proposals written in recent years laying out ideas for the future of GSEs, including how to deal with taxpayer liability, private insurance options that would replace government credit guarantees, insurance for catastrophic

losses that extend beyond typical cyclical credit losses, and the specific nature of the future securitization platform. One of the most prominent non-legislative proposals from respected researchers and organizations in the industry is a series of policy papers by Jim Parrott, Lewis Ranieri, Gene Sperling, Mark Zandi and Barry Zigas released in 2016 and 2017, entitled *A More Promising Road to GSE Reform*.

The More Promising Road proposal merges Fannie and Freddie into a single entity called the National Mortgage Reinsurance Corporation (NMRC).⁸⁵ The NMRC would be a government corporation and not an agency. The NMRC would essentially perform the same core functions as the GSEs. Duties of the NMRC would include: purchasing conforming loans, pooling them, issuing securities through a CSP, providing master servicing on loans, ensuring compliance with goals regarding affordable housing, and providing equal access to liquidity for lenders of all sizes.⁸⁶ The NMRC would be required to transfer all non-catastrophic risk on the securities to a wide range of private entities. The mortgage-backed securities would be fully backed by the U.S. government for which an explicit guarantee fee would be charged. The NMRC would also not be able to use its portfolio for investment purposes. Lastly, the FHFA would continue as the regulator. The FHFA would establish the guarantee fee for catastrophic risk and manage a mortgage insurance fund financed by those fees acting as a backstop for the housing finance system, similar to the role played by the Federal Deposit Insurance Corporation (FDIC) within the banking system. This plan allows for additional flexibility in the system because employees of the NMRC would not be part of the government and the NMRC would not need to rely on Congress for funding. In addition, the NMRC would not face restrictions on rule-marking that may otherwise limit government agencies, and borrowers would benefit from increased competition among private institutions in both the primary and secondary markets.

Other proposals suggest that the GSEs be re-chartered, or re-privatized, with a specific focus on making it possible for new firms to apply for a guarantor charter in order to allow for more competition in the market, thereby lowering the cost of credit. Whether through a dramatic change or more gradual reform, it is crucial that future plans ensure the flow of mortgage credit through economic cycles, increase capital and availability of loans, and reduce taxpayer risk. Ultimately, the status quo cannot continue and no matter what may happen after the GSE conservatorship ends, it is essential for the government to play a well-defined role, with the capability to act as a backstop in times of crisis and the resources to support the critical functions of promoting accessible, affordable, and safe mortgages to a broad-range of households, while ensuring stability and liquidity in the housing finance system.

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