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When Home Buying By The Poor Backfires
For many families, a house can be a bad investment

By: Peter Coy

Mildred Wilkins calls it "falling out the back door." It's what happens when low-income families who have bought their first houses are forced out because they can't keep up the mortgage payments. Says Wilkins, an Indianapolis consumer advocate who once worked for Fannie Mae (FNM) selling foreclosed properties: "I don't care if you put five families in the front door if three families fall out the back door. It breaks my heart to see it. It absolutely breaks my heart

In Washington, making it easier for the poor to buy homes is as uncontroversial as Mom's apple pie. Measures to increase the rate of low-income homeownership have historically been strongly supported by both Democrats and Republicans, as well as homebuilders and banks. Fannie Mae and Freddie Mac (FRE), the giant mortgage-finance institutions, have justified their existence by their promotion of homeownership among the poor. More recently, boosting low-income home buying has been an important part of what President George W. Bush calls the "ownership society."

Unlike many government initiatives, the homeownership campaign is succeeding: The nation's homeownership rate reached a record 69.2% in the second quarter, up from 67.2% four years earlier. Among families in the bottom half of incomes, the rate rose to 53.1% from 50.8% over the same stretch. Advocates say ownership builds wealth while promoting responsibility.

Misguided Policy

But the steady push of homeownership to lower and lower income groups, while positive in many ways, is not an unadulterated good. Despite conventional wisdom, extensive research has shown that homeownership is not the most reliable means of building wealth for low-income families, especially those with unreliable incomes and few other investments. Over the long run, home prices tend to rise more slowly than other assets, such as stocks. Moreover, poor families are now so easily able to tap their home equity to pay pressing bills that many don't accumulate wealth. Finally, as more poor families buy homes with low-downpayment mortgages, the odds of seeing their investments wiped out goes way up. Such loans make it easier to get in the door but raise monthly payments

That's a message few people want to hear these days, with ownership the main plank of national housing policy. Last year, Congress passed the Bush-backed American Dream Downpayment Act, which gives money to low- and moderate-income families to help cover their downpayments for Federal Housing Authority-insured properties. In his reelection campaign, Bush has advocated allowing the FHA to insure loans that involve no downpayment at all, compared with the current minimum of 3%. Meanwhile, Fannie Mae is aggressively promoting lending to low-income families. Where it once bought only loans with 20% downpayments, now it supports offers such as "Special 100," which requires no downpayment.

The most important argument of those who advocate increasing homeownership among the poor is that instead of throwing away money on rent, they can automatically save money and build wealth by paying off their mortgages. As owners, they are in a position to benefit from rising home prices. Says a 2002 study by the Housing & Urban Development Dept.: "Over time, purchasing a home has proven to be an effective wealth-building strategy for millions of Americans.... When housing prices rise, the benefits flow to all income levels." That has certainly been true lately: Single-family house prices rose 44% over the past five years, according to the Office of Federal Housing Enterprise Oversight, the agency that oversees Fannie Mae and Freddie Mac.

But it's essential to remember that the recent runup in housing prices is highly unusual. From 1975 to 1995, the inflation-adjusted rise in house prices nationally was just 0.4% a year.

Moreover, home prices can stagnate for long periods or even fall -- especially if they're as high as they've gotten recently. A Harvard University study of house sales in Philadelphia, Boston, Denver, and Chicago from 1982 to 1999 found that sellers of low-priced homes lost money 20% to 40% of the time, once transaction costs were taken into account. Not surprisingly, the odds of taking a loss were higher if the seller bought after prices had already risen. "Whether homeownership is a good or bad investment clearly depends on the time of purchase," concludes another study led by Karl E. Case, a Wellesley College economist.

On top of that, returns on housing tend to be lower than returns on stocks -- and the risk is high when the vast majority of a family's wealth is tied up in a single, undiversifiable asset. Economists William N. Goetzmann and Matthew Spiegel of Yale School of Management argue that low-income homeowners would do better investing in lower-risk, more-liquid assets such as stocks and bonds. In a 2001 paper, they wrote that "it seems likely that sometime in the next 20 years a substantial number of the 'beneficiaries' of this policy [of promoting low-income homeownership] may find their meager savings severely diminished, if not totally depleted."

The argument that owning a house forces low-income families to save is also flawed. It used to be that homeowners would in effect be forced to save as they paid back the principal on their mortgage loan. Today, however, it's easy to get home-equity loans, which allow people to extract whatever wealth they've accumulated. That may be good in the short run, but it undercuts the goal of building wealth. These days owning a house is no more a means of forced savings than putting money into stock mutual funds is.

Several other factors make homeownership a worse deal for low-income families than for the middle class and the wealthy. For one, they usually pay higher rates for mortgages. For another, many don't fully benefit from property-tax and mortgage-interest-payment deductions, which are worth less for families in low tax brackets. And for an inexpensive house, deductible housing expenses can be less than the standard deduction: $7,150 for head-of-household filers this year.

Advocates of wider homeownership correctly observe that a house is the only asset a family of limited means can buy with a big loan, which juices returns. "Because home buying is a highly leveraged investment, potential increases in the values of homes can bring rich returns," the HUD study notes.

Leverage, however, is a two-edged sword. With very small downpayments, it's easy for the price of a house to fall below the amount remaining on the mortgage. When that happens, it's impossible to extinguish the debt by selling. Making matters worse, house prices tend to fall when the economy weakens -- and because of the nature of their work, low-income families are more exposed to layoffs in downturns. So they can't sell, and they can't make payments because they're jobless. That's a recipe for foreclosure. According to the Mortgage Bankers Association of America, 4.6% of subprime loans -- most of which go to low-income families -- were in foreclosure at the end of the second quarter. That compares to just half a percent of prime loans. Nearly 10% of subprime loans were in foreclosure in Indiana, where Mildred Wilkins is president of Home Ownership Matters, an advocate for responsible lending.

Losses Beyond the Financial

When congress passed the Community Reinvestment Act in 1977, it was because banks wouldn't make loans in poor areas. But the tide has turned. Now many banks and finance companies specialize in high-rate loans to low-income families -- generating so many loans that federal regulators are proposing to exempt small banks from the rules. Subprime lenders earn enough money on the loans that don't go bad to swallow some foreclosures. That would be fine if investors bore the full cost of those losses, but they don't. The most important losses are felt by the families who lose their homes and the neighborhoods they live in, says Paul Bellamy, executive director of the Lorain County Reinvestment Coalition in Ohio.

Homeownership does have some important social advantages. Economists such as Harvard's Edward L. Glaeser have found that homeowners are more likely to vote for measures that have short-term costs and long-term benefits, such as new roads. People also take better care of properties they own. Studies by Donald R. Haurin of Ohio State University and others have found that children of homeowners do better in school than children of renters, holding other factors constant.

Up to a point, there's no doubt that raising homeownership rates for the poor is a plus. But after years of trying to insure that poor and minority families have access to mortgage credit, the pendulum may have swung too far. As economics teaches us, everything comes to a point of diminishing returns -- including homeownership.