Variations on an America Dream: Alternative Homeownership Models

By Erin Graves

Homeownership has been a hallmark of US housing policy since the Great Depression (Shlay, 2006). However, following the most recent collapse of the housing market, the rate of traditional home ownership has declined. In the third quarter of 2010 the rate fell to 66.9%, its lowest level since the first quarter of 1999 (Joint Center for Housing Studies, 2011). The decrease reflects both a reduced appetite for homeownership and the reality in the current economic environment that low-income individuals and households with lower credit scores have limited access to traditional mortgages.

The decline in homeownership poses a broad problem. The many constituencies benefiting from homeownership include the homeowner, neighborhoods, government at all levels, and a variety of industries, including construction, financial services, and real estate. Communities benefit from homeowners' presence because homeownership is associated with higher property values, better property maintenance, and greater civic participation. For families, the potential benefits of homeownership include asset building, having a fixed housing cost, and increased community attachment and involvement. However, it may not be homeownership per se that causes some of these positive social outcomes, but rather is a factor often associated with length of tenure and attachment to a place. Moreover, some households may be able to participate in alternative forms of homeownership that potentially offer some of the social and economic benefits of traditional homeownership without great financial risk.

A growing body of research argues that alternative homeownership products can offer participants many positive benefits, including competitive returns, while keeping homes affordable to lower-income buyers in the long term. Additionally, research shows that homeownership under these programs had high levels of fiscal sustainability, including very low delinquency and foreclosure rates (Lauria and Comstock, 2007, Jacobus and Abromowitz, 2010, Tempkin, Theodos and Price, 2010)

Unlike the established traditional homeownership model, which operates similarly across the country, these alternative homeownership structures vary by program. Yet most fall within a framework with four broad categories: limited equity cooperatives, community land trusts, owner-occupied houses with affordability covenants, and lease-to-own programs.

- Limited equity housing cooperatives (LEHCs) are corporations in which residents buy a low-cost share of the ownership of a building but are limited on the return from resale of the housing.
- Community land trusts (CLTs) are nonprofits that enable participants to own the physical structure of their home but not the underlying land, which they lease from the CLT. The CLT either repurchases the homes at below-market prices whenever the owners decide to resell or requires them to resell their homes to another income-eligible household for a below-market price.
- Shared-equity deed-restricted homes provide lower-income families with owner-occupied housing, with deeds that restrict resale to another income-eligible homebuyer for a formula-determined, "affordable" price. Covenants restricting the resale usually last at least 30 years.
- Lease-purchase programs typically allow participants, called lease purchasers, to select a home and a local housing finance agency or nonprofit buys the home on their behalf. The agency serves as the initial owner, mortgagor, and property manager for the lease period of approximately

three years. After demonstrating the ability to make timely lease payments to the agency, the lease purchaser purchases the home by assuming the unpaid principal balance of the mortgage.

Despite their long history and the recent research showing positive outcomes for participants in alternative homeownership, very few homeowners use these models. We engage experts from a variety of sectors on the topic of the potential of more widespread adoption of alternative homeownership products. We asked Esther Schlorholtz (ES), Senior Vice President & Director of Community Investment at Boston Private Bank and Trust; Joe Kriesberg (JK), President and CEO of The Massachusetts Association of Community Development Corporations; David Abromowitz (DA), Director and Co-Chair of the Real Estate group at Goulston & Storrs, and Paul Willen (PW), Senior Economist and Policy Advisor at the Federal Reserve Bank of Boston about the current state of homeownership in low- and moderate-income communities and the feasibility of implementing these models more broadly.

NECD: In the current economic environment, what are some of the obstacles to traditional homeownership for lower-income people?

Esther Schlorholtz

ES: The obstacles are many. First, there are supply-side issues. Despite a general market decline, home prices remain high, and therefore there are few opportunities to buy for most low- and moderate-income first-time home buyers, especially in Greater Boston. Many current owners are staying put and not selling, contributing to fewer homes on the market. Partial causes of this may be desire to wait for property values to increase over time rather than selling at the bottom of the market, and many loans may not be able to be sold for enough to cover existing mortgages. The available homes may not be of high quality, require substantial renovations, or they may have other issues, such as clouded titles, unattractive locations, small size, etc. Moreover, there are few affordable homes being newly built in Greater Boston with public sector support, as in the past would have been built, so new production is extremely limited. The state and cities/towns have fewer public subsidy sources to build and are directing their limited resources to housing options other than new, affordable homeownership.

Second, on the banking side, we see more conservative underwriting standards, including higher minimum credit scores and credit history scrutiny, which can result in a decline in homeownership. Lenders place more emphasis on a good credit history, strong savings, larger down payments and employment stability, and lower loan-to-value based on credit score.

Finally, I see more structural issues. Many communities, especially in the suburbs of Greater Boston, have restrictive zoning that prevent the production of more dense and lower-cost housing opportunities, therefore decreasing supply further. There is continued opposition to building any new housing in communities regardless of incomes of purchasers. The not-in-my-backyard syndrome is strong. This contributes to the high cost of building, which affects the ability to produce homes affordable to low-/moderate-income buyers.

Paul Willen

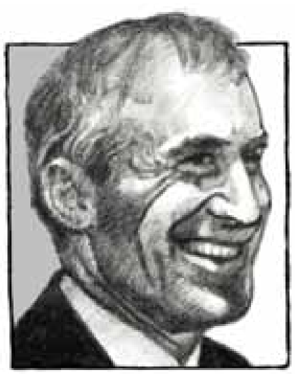
PW: Let me make three points. First, I think many investors fear further declines in house prices, which limits their willingness to lend to borrowers without substantial liquid assets or an unblemished credit report or well-documented income. Because lower-income people typically suffer from at least one of the above limits, they are limited to loan programs where the government explicitly insures all credit risk. Fortunately, although there has been talk of reducing FHA's [Federal Housing Administration's] economic footprint, there are no concrete plans to do so and the administration's plans for reforming the GSEs [government-sponsored enterprises] point to a continued role for FHA going forward.

Second, the extent of contraction of borrowing opportunities for lower-income people is not as obvious as one might think. The share of borrowers putting zero or less down in Massachusetts fell from 24 percent in 2006 to 7 percent in 2010, reflecting the disappearance of the non-agency mortgage market and suggesting that major obstacles have emerged for borrowers without substantial liquid assets. However, if we focus instead on borrowers who put less than 5 percent down, the story is considerably more nuanced, as that share has fallen only 3 percentage points from 28 to 25%. In fact, that 25%

share of borrowers putting less than 5% down, which exceeds the pre-2004 peak by nearly 10 percentage points, is near the all-time high.

Third, I view a return to the situation in 2004–2007 as possible despite the regulatory changes we've seen. If investors and lenders assess very small probabilities of a decline in house prices, they will lend freely to anyone, and if borrowers hold similar beliefs about prices, they will want to borrow and nothing about the new regime, neither risk retention nor the qualified residential mortgage nor the consumer financial protection bureau nor macro-prudential supervision, will stop them.

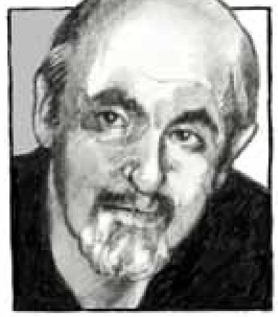
NECD: If the economy recovers as generally forecasted, do you believe that some of these obstacles will recede?



Joe Kriesberg

JK: Homeownership has always been challenging for lower-income families, and today's economic and policy environment will make it much more difficult in the years to come—despite the fact that we have demonstrated consistently over the years that low-income families can be successful homeowners with the right products and supports. Some of the challenges are obvious and inherent to being low income: Homes are expensive to buy and maintain; utilities are high and increasing; incomes are stagnant at best; and many people are unemployed or underemployed. Even those who are currently employed are likely to feel great uncertainty about the future and may therefore be reluctant to buy.

These challenges are made more difficult by the changing mortgage lending environment. The pendulum is now in full swing from a period of credit that was too easy to a period where even worthy borrowers are denied credit. Lenders now require or will soon require larger down payments, higher debt to income ratios, better credit scores, and higher interest rates. Stagnant home values are also making lenders and borrowers more cautious. Homebuyer education and counseling programs—essential to long-term success—are also being threatened with budget cuts.



David Abromowitz

DA: For some time, the larger barrier to home ownership has been wealth, even more than income. There are millions of lower-income households who have the income to support a reasonably sized mortgage and the other expenses of ownership, but lack the savings for a down payment of the necessary size. This is particular acute for families of color, who far more often lack the intergenerational wealth transfers that assist typically one-third of white families into first-time home ownership. Shared equity home ownership (including community land trusts and inclusionary zoning housing units) addresses this wealth barrier, has a proven track record of success, including very low foreclosure rates, and is being used in a wide variety of settings around the country.

Without policy change, these problems will not recede with time. While some out of work heads of households will regain employment, it is unlikely that household savings will grow very much for lower-income households. On the contrary, we are already seeing rising rents in many areas of the country, due to constrained supply and growing household formation. As rents and health costs continue to rise, and employers shift more benefits costs on to employees, how will lower-income households save up to buy a home?

NECD: Recently, several organizations have released research examining the costs and benefits of alternative homeownership models. Is there also increased interest from potential homeowners or community development organizations in using alternatives?

ES: Our culture is geared to homeownership and that generally will continue substantially to be by far the preferable model for consumers. However, the biggest demographic that likely will be interested in alternative models are those under age 35. This population is much more open to other housing alternatives that respond to environmental concerns, lower costs, more shared living arrangements, and they are interested in living in more urban and dense housing environments. CDCs [community development corporations] and other developers will be interested in alternatives if there is sufficient demand for that type of housing (which is hard to establish), costs can be managed (without substantial brain damage for all parties putting together the deals), and the end result is more affordable housing that can be managed effectively. Zoning restrictions and community opposition to any housing being built continue to be substantial obstacles and increase costs of development substantially.

JK: Alternative homeownership models like community land trusts and limited equity co-ops continue to gather interest among community developers and housing professionals. In some markets, especially relatively strong markets, these products have significant potential. However, in weaker real estate markets, including some of our Gateway Cities [Gateway Cities are cities in Massachusetts with a population between 35,000 and 250,000, that also have an average household income below the state average and an average educational attainment rate below the Massachusetts state average.], these products are challenging. To be successful, such products need to be priced competitively—buyers expect a significant price discount in exchange for limiting their potential upside appreciation. This is especially true since these products limit upside appreciation but do not always protect against downside depreciation. Given the experience of recent years this is a significant factor. We also have to make sure that these products are structured in a way that reflects the added risks and burdens that homeowners face compared to tenants (in particular, home repairs and maintenance) and allow such homeowners to eventually transition to traditional homeownership. Indeed, in some Gateway Cities we may need to relax deed restrictions in order to entice homebuyers to those markets.

I think one of the major challenges of attracting participation in alternatives to ownership is a romantic conception of homeownership, which makes many Americans view anything short of ownership as inferior.
—Paul Willen

Finally, such products have to be relatively simple to understand—confusing deed restrictions can deter homebuyers and some lenders. One reason that I have always liked the community land trust model is that it is inherently simple and logical—and also recognizes housing as both a community asset and a family asset.

NECD: What are some of the potential costs and benefits of participating in alternatives to homeownership, and how do these compare to traditional homeownership?

DA: This very much depends on the specifics of what kind of alternative we are talking about. In a shared equity approach, because there is a longer term relationship being established between the homeowner and the public source of the downpayment, it is a more complex arrangement. This requires pre-purchase counseling, and ideally post-purchase support. But most studies show that counseling and support are critical parts of any meaningful effort to make homeownership work well for lower income households, even "traditional" homeownership.

PW: I think one of the major challenges of attracting participation in alternatives to ownership is a romantic conception of homeownership, which makes many Americans view anything short of ownership as inferior.

Let me go out on a limb here and argue that the link between homeownership and the American dream has its origins in the fact that the landlord-tenant relationship is still somehow considered feudal and inconsistent with our republican ideals. For many Americans there is still a sense that the landlord has all the power in the rental relationship and the tenant bears all the risks: If demand for the property goes up, the landlord can raise the rent; if the renter gets ill or loses a job, the landlord can evict them. In contrast, in the face of a life event like job loss or illness, a home is a source of comfort for a homeowner.

The reality of homeownership is, of course, quite different. For most, homeownership involves converting a promise to pay rent to a rapacious, venal landlord into a promise to pay interest and principal to a rapacious, venal lender. A mortgage contract is, in many ways, far more demanding than a rental agreement in the sense that the borrower commits to 30 years of monthly payments whereas a renter typically only commits to one. The fallacy of the folk wisdom that owning beats renting because, "When you rent, you are just throwing your money away," illustrates the problematic logic of homeownership. In fact, an owner using the admired 30-year fixed rate mortgage devotes most of his or her monthly payment to interest, it's money "thrown away," and after five years, has only paid off 5% of the balance of the mortgage.

NECD: Alternative homeownership models have been around a long time: Limited equity housing cooperatives, in particular, have operated since the 1930s. Yet experts estimate that only about 500,000 homeowners own their homes through these models. Why are these models used so infrequently? Are there potential policies or changes in industry practices that could encourage wider adoption?

JK: The United States would have to actively support alternative homeownership through a number of changes to policy and practice in order to see such models go to scale. First, we would need to create a number of incentives for homebuyers to participate in such programs, in particular, more favorable lending terms. For example, if the 20% down payment is to become the new norm, perhaps the lending industry and its regulators could agree that a 10% down payment is sufficient for a limited equity home because it is less risky. Second, we would need to provide substantial education about these models to homebuyers, real estate attorneys, lenders, appraisers, and other industry professionals. Third, we need to standardize a few specific models so that each transaction is not a "first of its kind" transaction. Fourth, we need to provide public subsidies to allow nonprofit developers to build these homes and sell them at competitive prices. Right now there is very little public funding for such projects.

DA: I hear this question frequently, and sometimes ask: "If electric cars are clearly environmentally superior, why aren't we all driving them?" While homeownership structures that benefit lower-income households may be well understood and superior to other approaches, that does not mean that there is an economic incentive to duplicate the success widely or bring it to scale. Indeed, since by definition this is a product that is likely to be low profit to developers, there is a need to approach scaling it up differently. Also, effective alternative strategies as noted above generally require more effort and counseling than simply using low down payment loans as a primary ownership support.

I believe scaling up requires: (1) standardization of documentation; (2) preapproval by the sources of mortgage securitization (currently, the FHFA [Federal Housing Finance Agency], VA [Veterans Affairs], and FHA), some of which is in process for community land trusts; and (3) economic support for those engaging in shared equity approaches to help with the up-front costs of counseling and getting this model more widely known.

NECD: Do you see any specific models for alternative homeownership that seem to show more promise than others?

ES: The condominium form of ownership continues to be a more viable alternative than co-housing or limited equity co-ops. However, they are increasingly tough to finance due to secondary market restrictions as well as condo fee delinquencies.

...the complexity of the ownership structures and therefore the costs involved with creating them must be simplified or they will continue to be rare alternatives.
—Esther Schlorhotz

There are substantial obstacles to producing any alternative homeownership model. The biggest obstacle to production is the uncertainty of demand. Whether co-housing, cooperative, or other models, the demand for alternative housing is considerably smaller than for simple housing. When the homeownership model seeks to limit equity, requires some form of congregate governance (requiring substantial time commitments), is built more densely to reduce costs, and comes with other income or deed restrictions, the market is more limited and the interest in buying much curtailed. Because these are less familiar models of homeownership and marketability is more limited and uncertain, they are much harder to finance by both private and public sources. Limited equity co-ops, which are usually syndicated (Low Income Housing Tax Credit) are generally simply rental housing until the 15-year compliance period for LIHTC completes, and are not true ownership models until after that (right at the point they need to be renovated). They are very expensive to build and maintain due to their complexity. Most require additional and increasingly scarce public funding, and each source comes with restrictions that may affect marketability.

Unless these forms of housing become more attractive to larger numbers of potential homebuyers, they are unlikely to be successful in greater numbers. The more they are built and the clearer the evidence of demand for these housing forms, the more likely it will be that financing is obtainable. Additionally, the complexity of the ownership structures and therefore the costs involved with creating them must be simplified or they will continue to be rare alternatives.

PW: I think the main problem with traditional homeownership, by which I mean a mortgage property, is that it does not provide a completely robust exit strategy for a resident dealing with one of the many shocks that beset the typical American family: job loss, illness, divorce, etc. There is an exit strategy, to be sure: So long as house prices are rising, and, as a result of inflation, they usually are, a traditional homeowner can sell the property and pay off the mortgage. The reason I say that it is not completely robust is that it fails to work when house prices are falling.

Alternative models of ownership, like lease purchase, solve the exit strategy problem by allowing residents to walk away from the contract without any penalty while still preserving what I think are key benefits of ownership.

What lease purchase does, in my mind, is to turn the repurchase obligation into a repurchase option. In a lease purchase the borrower rents the property for a fixed period of time and the lender agrees in advance that it will sell the house to the borrower for a pre-set price. If we set the "rent" equal to principal and interest on an equivalent mortgage and reduce the repurchase price by the amount of the principal, then a lease purchase replicates the payment and outcomes of a mortgage exactly with the exception that the borrower can elect not to exercise the repurchase right without any penalty.

What is crucial here is to understand that, in my view and arguably in the view of Massachusetts law, the resident is just as much of an owner during the lease phase of the agreement as they would be in a traditional homeownership.

Because a lease purchase makes it easier for borrowers to default, borrowers will pay more but how much more will depend. If investors think house prices falls unlikely, they will not charge much more for a lease purchase but, in the unlikely event of a collapse in prices, borrowers will have an exit strategy that they don't have right now.

As I mentioned above, the idea that ownership is superior to anything involving the word rent is deeply ingrained in our culture, and I think most people would find my argument that a lessor with the option to buy has just as strong a claim to ownership as a homeowner with a mortgage excessively abstract. But in the millions of foreclosures we see around, we are witnessing the costs of our stubborn attachment to traditional ownership.

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Question:

What is the most important challenge facing low- and moderate-income communities in your area?

Response:

60.3% of respondents suggested that the lack of employment opportunities is the most important challenge facing their communities.

3.4% of respondents cited poor educational systems as the most important challenge facing their communities.

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