

The Key to Housing Affordability Is Not Mortgage Finance

The difficult problem with affordable housing is how to provide it without making it unaffordable. Finance is not the answer. We all want affordable housing. There are numerous government programs designed to provide low-cost rental and ownership properties to people in all walks of life. Lenders, builders, realtors and buyers all benefit from affordable housing because affordability means an increase in transaction volumes and more money into the pockets of those dependant on the real estate market.

Most of those who worked in the mortgage business really believed the "financial innovation" meme. At its core, the belief among financiers is that affordability products reach more customers and permit home ownership for a larger number of people. The statistics during the Great Housing Bubble seem to warrant this enthusiasm.

Unfortunately, increasing the home ownership rate also dramatically increased prices and created an unsustainable bubble in both. Why is that? As with all macroeconomic concepts, it emerges from the microeconomic circumstances of individual borrowers and buyers. If you look back to the lending practices which endured the crash of the last housing bubble in the late 80s, you see that the financing arena was dominated by 30-year conventionally amortizing loans with 20% downpayments and conservative debt-to-income ratios. This is the only loan program that has relatively low default rates even if prices decline. So what happens when a new "affordability" product is introduced into this stable system?

Look at an example. Assume our would-be buyer makes \$100,000 a year and could qualify for a \$300,000 loan using conventional financing. He has save \$100,000 for a downpayment and costs. He is looking to buy a \$375,000 home. In our stable system, he would find a home relative to his income. If he is making the median income, then he would be able to afford a median priced home. Now let's say that lenders "innovate" and start offering interest-only loans with a 10-year fixed term followed by an interest rate reset and a recast to a fully amortized loan on the remaining 20-year schedule (sound familiar?) Our buyer is conservative and does not want to purchase on these risky terms and take the risk on future interest rates or the need to refinance later because he may not be able to afford the higher payment in 10 years. However, other potential buyers will ignore these risks and embrace the new financial innovation because it allows them to buy a house they previously could not afford. The same payment on an interest-only schedule now finances 15% more money, so other potential buyers in the marketplace who are making \$100,000 can now finance around \$345,000 instead of \$300,000. When our conservative buyer goes out in the open market to bid on properties, he now finds himself being consistently outbid on properties. At this point, he has a choice to make: embrace the new financial innovation and bid 15% higher for the same property, accept a lower quality property, or not buy a home.

The affordability product did not make houses more affordable, it made them less so.

About the Author

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