Statement before the House Committee on Financial Services

Devalued, Denied, and Disrespected: How Home Appraisal Bias and Discrimination Are Hurting Homeowners and Communities of Color

Faulty Evidence and Misdiagnosed Solutions

Why centralizing appraisal standards and criteria under a new federal agency as proposed under the Fair Appraisal and Inequity Reform Act is not justified

Tobias J. Peter
Assistant Director, AEI Housing Center
Research Fellow, American Enterprise Institute (AEI)

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Chairwoman Waters and Ranking Member McHenry, and distinguished Members of the Committee, thank you for the opportunity to testify today.

Executive Summary:

The case for centralizing appraisal standards and criteria under a new federal agency as proposed under the Fair Appraisal and Inequity Reform Act is not justified. It is based on unsubstantiated claims of systemic bias and racism in the housing finance sector and represents an unwarranted power grab by the federal government and one giant step towards the federal government setting fiat home values. Upending the appraisal process risks mis-valuing millions of properties, which could have serious repercussions for minority neighborhoods and rural areas, where home sales are sparser.

Last week's report by the Interagency Task Force on Property Appraisal and Valuation Equity (PAVE) alleged "inequities within current home lending and appraisal processes" for communities of color.

The work cited by PAVE contained serious red flags that were obvious from a cursory look. The work of the AEI Housing Center has also debunked the Brookings study and Freddie Mac exploratory note, which both heavily relied on in the PAVE report and this hearing's memo. Most importantly, these studies conflate race with socio-economic status (SES), i.e. income, buying power, marriage rates, credit scores, etc. Once adjusted for differences in SES, race-based gaps found in these studies either entirely or substantially disappear, which raises serious questions regarding a race-based explanation.[1]

While individual appraiser bias certainly exists, the PAVE report admits that "the exact number of instances of valuation bias is difficult to assess." We have undertaken a study with over 240,000 loans for which we knew the race of the borrowers. Our statistical analysis found that racial bias by appraisers on refinance loans is uncommon and not systemic. These results and our methodology have been confirmed by other academic research.[2] All of this work was ignored by PAVE. Further, research by Fannie Mae, which directly contradicted Freddie Mac's preliminary findings, was so selectively cited this point was lost.

It is questionable how PAVE could arrive at its conclusions when its own report admits a lack of data.[3] Furthermore, this lack of data is the fault of the government. Two years ago, we outlined a statistical approach using existing data that would have allowed FHFA, Fannie Mae, and Freddie Mac to identify bad actors using existing data. This offer was ignored.

Now, two years later we are debating a task force report and draft bill based on cherry-picked data, discredited research, and flawed conclusions, suggesting a lack of interest in getting to the truth and an alternative motive to provide an excuse for centralizing appraisal valuation standards and appraiser criteria in the federal government.[4]

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[1] The same critique of the Brookings paper also applies to research by Howell and Korver-Glenn (2021) or a recent Redfin on the same topic.
[2] See Ambrose, Brent W., James Conklin, N. Edward Coulson, Moussa Diop, and Luis A. Lopez. "Does Appraiser and Borrower Race Affect Valuation?." Available at SSRN 3951587 (2021).
[3] In particular, the PAVE report states "lack of access to complete data has been a hindrance to research on appraisal disparities and on the impact of racial and ethnic bias in appraisals."
[4] For our detailed critique of the PAVE report, please see Appendix A1 on page 22.

Instead of this bill, agencies should get to work using existing data. These data should be anonymized and made available to independent researchers to verify as a bipartisan group of Senators agreed to at last week's Senate Banking hearing.[5] This would allow bad actors, whether racially biased or incompetent, to be removed immediately from the profession, as they should.

Additionally, since PAVE has misdiagnosed the problem, its proposed agency actions will not address racial and ethnic differences in homeownership rates, the financial returns of owning a home, or median wealth levels. Instead it will likely make these differences worse or divert attention from finding effective solutions.

Rather than discredited claims of systemic appraiser bias, homeowners and communities of color are being hurt by the combination of low SES, which certainly reflects a legacy of past racism and lingering racial bias, which leaves Blacks at a large income and wealth disadvantage relative to most Whites, and foreclosure-prone federal lending practices.

A recent paper out of UC Berkley finds that Black and Hispanic homeowners experience lower returns than White homeowners, which it attributes almost entirely to the higher prevalence of distressed home sales – and not appraiser bias. The study finds that "[t]he disparity [in distressed home sales] explains about 40% of the Black-white gap in housing wealth at retirement." The paper also notes that "[i]mportantly, absent financial distress, houses owned by minorities do not appreciate at slower rates than houses owned by non-minorities," which again directly contradict the PAVE report.

Foreclosure-prone affordable housing policies have been targeted at low-income and minority borrowers. These policies subsidize debt by providing excessive leverage and lower rates. Coupled with a supply shortage, the increased demand from additional leverage has fueled unforgiving boom-bust home price cycles. During the Financial Crisis, these policies contributed to over 10 million foreclosures and other forced dispositions, which were proportionally higher in low-income and minority neighborhoods. While higher SES individuals have the wherewithal to withstand economic or personal shocks, low SES individuals do not. Notwithstanding massive subsidies and lending, federal housing policies have not built generational wealth.

The PAVE report even acknowledged the importance of SES, stating that "[m] uch of the gap in rates of homeownership can be traced to socio-economic factors that differ on average between Black and white homeowners." It then proceeded to ignore it in its 21 proposed agency actions, all of which related to appraiser bias. This could have unintended consequences similar to prior housing task forces such as the 1967 Presidential Task Force on Housing and Urban Development, which ended up destroying many American cities, especially Black neighborhoods, or the 1995 National Homeownership Strategy, which ended in millions of foreclosures. Mis-valuing millions of property could have similar consequences, with minorities once again being the victims.

Closing the racial wealth gap requires addressing differences in SES head-on. Housing solutions include a focus on generational wealth building through better mortgage products with more prudent underwriting, increasing supply, and opening up more areas of opportunity for lower-income

[5] Senators Toomey, Tester, Smith, and Brown stressed data transparency for independent researchers in the hearing of the Senate Banking Committee "Strengthening Oversight and Equity in the Appraisal Process" on March 24, 2022.

households. But policy also needs to focus on closing gaps in educational attainment, stable families, and public investment relating to minority neighborhoods, among other things.

1) **Evidence on devaluation: A critique of the Brookings study and the Freddie Mac note**

Both the Brookings study and Freddie Mac exploratory note were heavily relied on by PAVE. However, they are fundamentally flawed in that they conflate race with socio-economic status (SES), i.e. income, buying power, marriage rates, credit scores, etc. Furthermore, our analyses show that Black, White or Hispanic households with similar SES all had similar results, raising serious questions regarding a race-based explanation.

In the **Brookings study "The Devaluation of Assets in Black Neighborhoods,"** Perry et al. claimed that:

- *"Homes of similar quality in neighborhoods with similar amenities are worth 23 percent less in majority Black neighborhoods, compared to those with very few or no Black residents."*
- *"Across all majority Black neighborhoods, owner-occupied homes are undervalued by $48,000 per home on average, amounting to $156 billion in cumulative losses." (p. 3)*

This conclusion rests on their claim to have completely controlled for structural characteristics and neighborhood amenities using 23 control variables, therefore, the remainder of the gap has to be due to racial bias.

AEI Housing Center Critique:

After having replicated Perry et al., we add just one additional SES control variable, the Equifax Risk Score for the neighborhood without removing any of their original 23 control variables.[6] We find that ERS alone is able to explain the entirety of the devaluation.[7]

Specification	**% Devaluation**	**# of Tracts**
23 control variables for all tracts	-22.0%	33,066
23 control variables (limited – new baseline)	-21.8%	32,998
23 control variables & ERS control variable	0.3%	32,998

By adding just one additional SES-related explanatory variable, the devaluation found by Perry et al. disappears. Thus, their approach did not fully adjust for structural characteristics and neighborhood

[6] We show that the Equifax Risk Score (ERS) is race neutral and suitable for use as a control variable. The Equifax Risk Score (ERS) is a compilation of Vantage credit scores from 2013, representing a summary metric of the stock of all individuals of any type in a neighborhood with a score. It includes over 220 million scored individuals. In its 2007 "Report to Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit," the Board of Governors of the Federal Reserve System stated that "credit characteristics included in credit history scoring models do not serve as substitutes, or proxies, for race, ethnicity, or sex" (S-1f). Vantage credit scores are one of two industry standard scores and they are race blind as confirmed by the Fed report.
Based on the above, we don't think Perry and Rothwell's (2021) critique of ERS holds. As we have shown in our initial critique and will also show below, ERS is highly predictive. The fact that the data are propriety credit scores is not disqualifying. Indeed, credit scores are used routinely in empirical work involving mortgage and housing markets. The ERS data are aggregated up from ZIP-7 to census tract and are from November 2021.

[7] Other SES variables such as the share one one-adult borrowers also significantly reduce the gap.

amenities as they claimed and their estimate of devaluation due to racial bias is, at a minimum, seriously overstated.[8]

Further evidence that refutes the Brookings study:

1) We demonstrate clear omitted variable bias in the Brookings study.
2) We show that similar devaluation gaps are present in majority White or White-only tracts across different SES levels.
3) We find that relatively few Black borrowers choose to buy in majority Black tracts. This is especially true for Black borrowers with higher incomes. If constant-quality prices in majority Black tracts were really 23% lower, then why are Black buyers not taking advantage of the price discount in majority Black tracts?
4) There has been progress in racial integration. If home values in majority Black neighborhoods were undervalued all else equal, Black homeowners would not have shifted to predominantly non-Black areas.

For details on these case studies, see pages 37-41 in appendix A2.

We also found that Perry and Rothwell's (2021) rebuttal to our critique supported our claim of omitted variable bias, failed to rebuke our methodology, and never addressed our case studies. We also presented solutions based on our findings.

For the full study, see appendix A2 (starting on page 26) and for our rebuttal to Perry and Rothwell, see appendix A3 (starting on page 53).

In **Freddie Mac's note on "Racial and Ethnic Valuation Gaps in Home Purchase Appraisals"**, Freddie Mac noted "substantial appraisal valuations gaps" for minority versus White tracts. While the note described the research as "exploratory" and "preliminary," the language in the press release that went along with the report was, however, stronger: it spoke of a "persistent problem" and implied causality, which Freddie Mac's note never claimed.

AEI Housing Center Critique:

Using a dataset that substantially replicated Freddie Mac's, we demonstrated that rather than being due to racial discrimination by appraisers, Freddie's claim of an "appraisal gap" is much more likely the result of would-be first-time buyer inexperience, socio-economic status (SES), or government actions (in particular a concentration of FHA lending in certain census tracts) with a disparate impact on protected classes.

Our analysis, which goes well beyond Freddie Mac's "exploratory research" which used no control variables, concludes that:

[8] The same critique of the Brookings paper also applies to research by Howell and Korver-Glenn (2021) and a recent Redfin post on the same topic.

- We can explain around 85% for Black tracts and 29% for Latino tracts of the gap through differences in SES, leverage, and borrower characteristics. With the full set of control variables, the Black gap disappears entirely, while the Latino gap falls by half.
- The literature provides strong evidence that an appraiser is likely providing some would-be buyers a consumer benefit by providing an appraised value below the contract price, by alerting the buyer that he or she is overpaying on the home, which then usually triggers a renegotiation. This benefit is greater for borrowers with higher LTVs.[9]
- As noted earlier, high leverage federal programs (especially FHA) and suppressed interest rates tend to drive up prices during a seller's market, as they are quickly capitalized into higher prices. Minority FHA-insured borrowers have the most to gain from the consumer-protection benefits of a low appraisal that leads to a renegotiation. All of this was ignored by PAVE.

For the full study, see appendix A4 (starting on page 67).

Research by **Fannie Mae entitled "Appraising the Appraisal: A closer look at divergent appraisal values for Black and white borrowers refinancing their home"** provides a likely, non-race based explanation for the valuation discrepancy found by Freddie Mac.[10] It is worth noting that Fannie Mae's explanation casts a favorable light on the appraisal industry.

Fannie Mae concluded that for refinance applications "Black borrowers refinancing their home on average received a slightly lower appraisal value relative to automated valuation models" and that "the frequency of 'undervaluation' did not have a notable racial pattern."

Interestingly, Fannie Mae (2022) also rebuked the methodological approach in Freddie Mac's research note that was cited by PAVE as one of the three main studies.[11] Fannie Mae also offered an alternative explanation for differences in appraisals such as gentrification, which they are still in the process of studying.

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[9] Further, "when a low appraisal occurs, … the probability of downward renegotiation rises to 55.8% and continues steadily to rise as appraised value falls further short of contract, reaching 79.9% when appraised value is short of contract by seven to 8 %" or that "higher LTV borrowers renegotiate more often, in more than 93% of cases for applications with an LTV of 97 when the appraised value's shortfall from contract is greater than 2%. Renegotiation likelihood drops much lower for LTVs of 70 or less, where the low appraisal is less likely to jeopardize the loan". Finally, a low appraisal "sharply raises the probability of downward price renegotiation" and "shows that high LTV borrowers usually recapture the entire difference between contract and appraised value. Borrowers with lower LTV, including unconstrained borrowers, split this difference, giving up more to the seller as constraints loosen."

[10] Williamson, Jake and Mark Palim. "Appraising the Appraisal: A closer look at divergent appraisal values for Black and white borrowers refinancing their home." (2022).

[11] In particular, Fannie Mae wrote that "We chose to study refinance applications, as opposed to home purchase applications, because the appraiser in a refinance transaction typically interacts directly with the homeowner (i.e., the borrower), establishing a pathway for potential bias to influence the appraisal results. The race or ethnicity of the borrower is often disclosed in the loan data, making it possible to directly observe any correlation with value. On the other hand, in a purchase transaction, the appraiser typically does not interact with the buyer (i.e., the borrower) of the property but rather with the seller or the seller's agent. The availability of racial or ethnic data of sellers and real estate agents is limited, thereby making an analysis of valuation differences by different demographics for purchase transactions limited or incomplete relative to the analysis detailed below using refinance transactions." (p.3)

Research by FHA's Kevin Park (2022) found that "minority applicants are more likely to experience underappraisal, but also … that underappraisal has a small effect on the likelihood of endorsement..."[12]

Research by Kermani and Wong (2021) find that "[i]mportantly, absent financial distress, houses owned by minorities do not appreciate at slower rates than houses owned by non-minorities," which again counters the unsubstantiated assertion that underappraisals or appraiser bias are holding Black wealth back.[13] Rather it is the federal government's involvement in the housing market and housing finance that has created problem time and time again (more on this below).

Based on this evidence, it is premature and not justified to proceed with this draft bill which would centralize appraisal standards and criteria under a new federal agency.

2) **PAVE has provided no evidence from sources using rigorous analysis to support its assertion that there is a recurring pattern of appraiser discrimination**

Recent media stories have highlighted individual instances where a second appraisal came in an average of about $126,000 or 25% higher than the initial appraisal after the Black applicants disguised their race. The implication is that intentional and perhaps unintentional appraisal bias is commonplace and the valuation gaps are large. While the facts alleged may well be true, any policy response must be based on whether the cases are the result of "bad apple" appraisers or systemic racial bias. A literature search found no credible statistical analysis to support a claim of systemic racial bias.

AEI Housing Center Critique:

To evaluate the claim of systemic racial bias, we assembled a unique dataset with over 240,000 loans for which we knew the race of the borrowers. We used two different approaches and many different robustness checks to see if on average there is a value difference (or a gap) between refinance loan appraisals for Blacks and Whites. Our approach and methodology have recently been validated by Ambrose et al. (2021). They concluded that "contrary to media allegations, our statistical analysis found that racial bias by appraisers on refinance loans is uncommon and not systemic."[14]

Contrary to the stories in the media, our statistical analysis found that racial bias by appraisers on refinance loans is uncommon and not systemic.

While there is no denying that there are individual cases of racial bias, a count of media reports is not a valid sample upon which to base a conclusion. There is likely selection bias and no ability to conclude the cases are representative of all instances.[15] Appraiser bias cases, such as those cited by the media,

[12] Park, Kevin A. "A Comparison of Mortgage Denial and Default Rates by Race, Ethnicity, and Gender." Ethnicity, and Gender (February 7, 2022) (2022).
[13] Kermani, Amir, and Francis Wong. Racial Disparities in Housing Returns. No. w29306. National Bureau of Economic Research, 2021.
[14] Ambrose, Brent W., James Conklin, N. Edward Coulson, Moussa Diop, and Luis A. Lopez. "Does Appraiser and Borrower Race Affect Valuation?" Available at SSRN 3951587 (2021).
[15] In particular, claims of bias should be set in relationship to the purchase price and an appropriate level of home price appreciation (HPA) for the area. In a story on CNN, a Black homeowner purchased "her home for about $100,000 three years ago and, given home price appreciation in her area, she expected her home's value to be about $185,000 when she applied to refinance." Absent any improvements, this implies an expected average

may well result from "bad apple" appraisers or incompetence on both minority and non-minority appraisals.[16]

Our recommendation to regulators and agencies continues to be the same as we suggested 2 years ago:

- Given that a number of regulators and agencies have access to appraiser names, we have suggested that they use our or similar statistical methods to identify, investigate, and root out both appraisers with racial animus and those that are just plain incompetent.

Our recommendation to stakeholders:

- Propose and implement robust apprenticeship and training programs.
- Work with historically Black colleges.
- Adopt much of the VA appraiser and appraisal process, including the VA appraisal management approach, appraiser vetting, the Tidewater initiative (PAVE did mention this initiative favorably), and appraisal preparation guidance.

For the full study, see appendix A5 (starting on page 88).

Other evidence

Fannie Mae (2022) also concluded that for refinance applications "Black borrowers refinancing their home on average received a slightly lower appraisal value relative to automated valuation models" and that "the frequency of 'undervaluation' did not have a notable racial pattern."[17]Interestingly, Fannie Mae (2022) also rebuked the methodological approach in Freddie Mac's research note that was cited by PAVE as one of the three main studies.[18]

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annual HPA of 23% per year, which is about twice the level of 11% HPA for homes in the low price tier in Indianapolis over the same time period. The first appraisal came in at $125,000 and the second at $115,000, which implies an average annual HPA of 8% and 5%, respectively. Eventually after removing all traces of her race from her home and having a White friend stand in, the third appraisal came in at $259,000, which implies an average annual HPA of 37%, an extraordinary level of appreciation absent substantial improvements or purchase at a bargain price.

[16] This shortcoming may be demonstrated by this simple thought experiment. Take 1000 appraisals and assume 100 (10%) are performed by incompetent appraisers. Further assume for simplicity that there are 800 White borrowers and 200 Black borrowers. Also assume that 80 (10%) of the White and 20 (10%) of the Black borrower appraisals were done by an incompetent appraiser. Now assume that 20 of the White and 5 of the Black borrowers with appraisals done incompetently complain to the media. The media find the stories of 5 Black borrowers to be newsworthy and the stories of the 20 White borrowers not to be of interest. A search of the resulting media reports would come up with 5 stories, all from Black borrowers and all done by incompetent appraisers. And the erroneous conclusion would be that this proves systemic racism by appraisers.

[17] Williamson, Jake and Mark Palim. "Appraising the Appraisal: A closer look at divergent appraisal values for Black and white borrowers refinancing their home." (2022).

[18] In particular, Fannie Mae wrote that "We chose to study refinance applications, as opposed to home purchase applications, because the appraiser in a refinance transaction typically interacts directly with the homeowner (i.e., the borrower), establishing a pathway for potential bias to influence the appraisal results. The race or ethnicity of the borrower is often disclosed in the loan data, making it possible to directly observe any correlation with value. On the other hand, in a purchase transaction, the appraiser typically does not interact with the buyer (i.e., the borrower) of the property but rather with the seller or the seller's agent. The availability of racial or ethnic data of sellers and real estate agents is limited, thereby making an analysis of valuation differences by different

A FHFA blog post, which was prominently cited by PAVE as evidence of pervasive bias, stated that in their "review of appraisals, we have observed references to race and ethnicity in the 'Neighborhood Description' and other free-form text fields in the appraisal form." FHFA concluded that the use of such references is evidence of bias as the "racial and ethnic composition of the neighborhood should never be a factor that influences the value of a family's home" and released 16 specific examples.

While we all can agree with FHFA's statement that "racial and ethnic composition of the neighborhood should never be a factor that influences the value of a family's home," the blog post failed to provide any specifics as to the frequency of such occurrences. It only stated:

> From millions of appraisals submitted annually, a keyword search resulted in thousands of potential race-related flags. Individual review finds many instances of keywords to be false positives, but the following are [16] examples of references when the appraiser has clearly included race or other protected class references in the appraisal.

The blog post was conspicuous in failing to provide any information that would allow the reader (or PAVE) to determine the frequency of such occurrences. Did it occur 5 times per million (0.0005%) or 50,000 times per million (5%)? The policy solutions would be quite different for the first level of incidence versus the second.

We have outlined a statistical approach that would allow FHFA, Fannie Mae, and Freddie Mac to identify bad actors today, be they biased or incompetent. These data should be anonymized and made available to independent researchers to verify. Bad actors should be removed immediately from the profession by the appropriate regulator. A failure to proceed in this common sense fashion would confirm a lack of interest in getting to the truth and that the real goal is to provide an excuse to centralize appraisal valuation standards and appraiser criteria in the federal government.

For the outline of this approach, please refer to page 104 in appendix A5.

3) Many housing task forces and congressional actions have contributed to the racial wealth gap we find ourselves in today. This might serve as a warning for many of today's proposed policies.

HUD, and its predecessors, have played a major role in perpetuating segregation and racial wealth disparities. As noted by PAVE throughout the 20th century, the "federal…government systematically implemented discriminatory policies that led to housing segregation." Not mentioned by PAVE were:

- the U.S. Commerce Department's role in implementing a zoning regime designed to keep Black and ethnic minorities out of single-family detached neighborhoods (see Chapter 1, AEI Light Touch Density E-Book),
- the 1949 Housing Act which resulted in the high-rise public housing and urban renewal programs, both of which worked to the great detriment of Black households and neighborhoods,

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demographics for purchase transactions limited or incomplete relative to the analysis detailed below using refinance transactions." (p.3)

- the 1967 Presidential Task Force on Housing and Urban Development (headed by HUD Secretary Weaver), which proposed a 10-year housing program to eliminate all substandard housing in the U.S., which program was enacted in the 1968 Housing and Urban Development Act, the consequences of which led to HUD and FHA destroying many American cities, especially Black neighborhoods (Cities Destroyed Cash: The FHA Scandal at HUD),
- the Tax Reform Act of 1986, which created the Low Income Housing Tax Credit, which has perpetuated racial segregation (Chicago tax credit program mostly produces affordable housing in poor black areas, March 15, 2021),
- the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, which granted HUD the authority to set affordable housing mandates for Fannie Mae and Freddie Mac, and
- HUD's 1995 National Homeownership Strategy: Partners in the American Dream, which led to over 10 million foreclosures and did much to create the wealth disparities Blacks now face. All of these failures may be traced to HUD, or its predecessor agencies responsible for federal housing policy.

Despite PAVE's claims of "extensive consultation with subject matter experts and leaders across industry, academia, trade and civil rights groups, and government," PAVE ignored a large body of research as outlined above.

And while the PAVE report openly admits that "the exact number of instances of valuation bias is difficult to assess," it arrives at the conclusion that "homeownership is often hindered by inequities within current home lending and appraisal processes, which research shows disproportionately impact people in communities of color." It is questionable at best how PAVE could arrive at its conclusions when its own report states that "lack of access to complete data has been a hindrance to research on appraisal disparities and on the impact of racial and ethnic bias in appraisals."

It seems to suggest that the Biden administration and the media had concluded even before the work of the task force began that there is systemic racial discrimination in the housing market, including systemic racism and bias in housing valuations and property appraisals.

This is clear when, on June 1, 2021, President Biden established the Property Appraisal and Valuation Equity (PAVE) Task Force to be directed by HUD Secretary Marcia Fudge:

> "The Administration will take action to address racial discrimination in the housing market, including by launching a first-of-its-kind interagency effort to address inequity in home appraisals, and conducting rulemaking to aggressively combat housing discrimination…."[19]

Again from the readout from PAVE's first meeting held on August 5, 2021, stated:

> "Task Force members discussed how current appraisal practices are a significant contributor to the disparity in housing values. The practice of comparing properties within similar

[19] https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/01/fact-sheet-biden-harris-administration-announces-new-actions-to-build-black-wealth-and-narrow-the-racial-wealth-gap/

> neighborhoods can be a proxy for racial demographics, which leads to the perpetuation and exacerbation of the legacy of segregation and redlining."[20]

The above statements are not supported by credible data and research and making housing and valuation policy based upon such statements would likely do lasting harm to minority borrowers (and low-income borrowers generally).

Based on the debunked Brookings and Freddie Mac research and the data available, the federal government has not proven the need for a new centralized behemoth. It is highly questionable that PAVE's proposals will address racial and ethnic differences in homeownership rates, the financial returns of owning a home, and median wealth levels. In some cases, they may make these differences worse or take the pressure off of finding effective solutions, which could ultimately end in disaster for minorities, just like many task forces and housing bills before.

4) The importance of socio-economic status (SES)

Rather than PAVE's finding of "inequities within current home lending and appraisal processes, which research shows disproportionately impact people in communities of color" the real culprit is inequities in SES, which PAVE acknowledges when it states that "[m]uch of the gap in rates of homeownership can be traced to socio-economic factors that differ on average between Black and white homeowners." While lower SES certainly reflects a legacy of past racism and lingering racial bias, which leaves Blacks at a large income and wealth disadvantage relative to most Whites, PAVE should have addressed this in its policy recommendations. Thus, the PAVE Action Plan, by misdiagnosing the causes of the racial gap, will likely lead to unintended consequences as the Action Plan does not address the root problem.

We agree with PAVE that we ought to support opportunities for income and wealth growth among lower-income households. PAVE proposed 21 agency actions. However, none of them address the root cause of lower SES, and instead addressed unsubstantiated claims of systemic bias and racism in the housing finance sector.

<u>**Based on an objective diagnosis of symptoms and causes using rigorous data analysis, we propose the following solutions:**</u>

The housing policy solutions are:

- Building generational wealth through sustainable homeownership for low SES households by reducing leverage for aspiring low-income home buyers.
- Increasing supply and reducing income stratification through Light Touch Density.
- Promoting Walkable Oriented Development in existing neighborhoods with a mix of residential and commercial properties.

Other policy solutions, which might be explored, are:[21]

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[20] https://www.whitehouse.gov/briefing-room/statements-releases/2021/08/05/readout-of-the-first-interagency-task-force-meeting-on-property-appraisal-and-valuation-equity-pave/

[21] Many thanks to our AEI colleagues Naomi Schaefer Riley and Angela Rachidi for many of these ideas. Please see their thoughtful analysis: https://reason.com/2021/02/24/fix-family-poverty-with-free-markets-for-once/

- Encouraging two parents in households with children (single-parent households have been found to be a significant SES factor by a wide ranch of academic researchers).
- Enacting occupational licensing reforms and allowing small businesses to be run out of one's home (this has been found to be a significant barrier to low SES households).
- More economical childcare by rolling back burdensome government regulations (childcare costs are a significant barrier to gainful employment by low SES households).
- Real school choice for access to quality elementary and secondary education (racial and ethnic minorities would benefit greatly from real school choice).
- Improving access to technical and apprenticeship training (this would open up access by low SES households to these well-paying jobs).
- Encouraging state and local governments to address public investment disparities relating to minority and lower income neighborhoods.

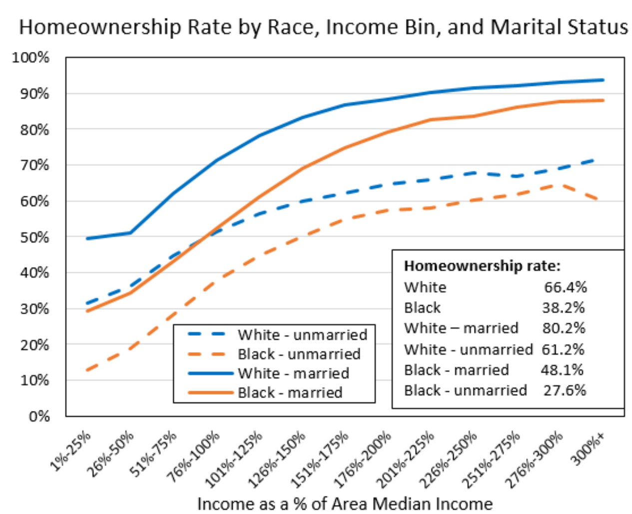
Recognizing the importance of SES factors is key to fashioning appropriate public and private responses. A misdiagnosis that focuses on other factors will not address the root problem and could potentially lead to unintended consequences. We must be mindful that many public policies aimed at addressing racial discrimination have had unintended consequences that have done substantial harm to low-income households generally, and minority households in particular.

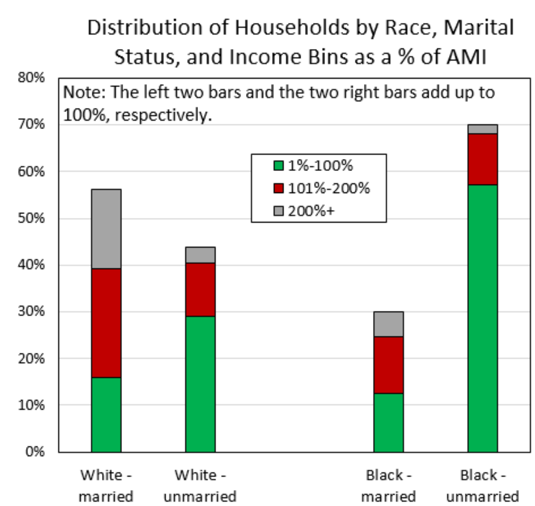
Marital Status and Income Are Key Drivers of the Homeownership Rate by Race

The Black homeownership (HO) rate is much lower than the White HO rate, but the difference gets smaller as income grows. The HO rate for White or Black married households (HH) is much higher than for unmarried White or Black HH (left panel).

There is a big disparity by marital status between Blacks and Whites. Unmarried Black HH comprise 70% of Black HH, and the vast majority are below area median income (right panel).

Policy challenge: Reduce income and marital status disparities between Black and White HH.





Note: Data are for urban household heads aged 25-65 and exclude widowed households.
Source: Census Bureau and AEI Housing Center, www.AEI.org/housing.

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For a lengthier discussion of the policy solutions, see appendix A2 (starting on page 26).

5) **Foreclosure-prone affordable housing policies have contributed to the racial wealth gap we find ourselves in today.**

Foreclosure-prone affordable housing policies for single-family lending have subsidized debt by providing excessive leverage. These policies have been primarily targeted at low-income and minority homebuyers and began in 1954, when Congress authorized the 30-year loan for use on existing FHA home loans. Congress also raised loan-to–value (LTV) limits around the same time. The average FHA loan term and LTV in 1954 was 21.4 years and 79.9%. These rose to 27 years and 90% by 1959.

Congress doubled down on this policy with the passage of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, which would have a devastating effect. During the Financial Crisis, these policies contributed to at least 10 million or more foreclosures, which were proportionally higher in low-income and minority neighborhoods. For example, the 27% foreclosure rate in low-income census tracts (defined as <80% of area median income) was 1.5 times as high as the 18% foreclosure rate in high-income census tracts (defined as ≥120% of area median income). Similarly, the foreclosure rate of 30% in census tracts with a Black and/or Hispanic share of households of at least 50% was twice as high as the 16% foreclosure rate in census tracts with a Black and/or Hispanic share of households of less than 10%.

Table: Foreclosure Rate by Neighborhood Type

Census Tract to Area Median Income Ratio	Foreclosure Rate
<80%	27%
80% - <120%	22%
≥120%	18%
All	22%

Census Tract Black and/or Hispanic share	Foreclosure Rate
≥50%	30%
20% - <50%	24%
10% - <20%	18%
<10%	16%

Note: Foreclosure rate is for loans originated between 2004 and 2008.
Source: LLMA and AEI Housing Center.

Yet, the homeownership rate in 2020:Q4 was 65.8%, only marginally higher than the rate of 63.0% in 1964:Q4.[22] Today, the federal government's twin legacy of racially-motivated zoning and poorly designed affordable housing policies continue to make the housing market separate and unequal.

This is the paradox of accessible lending: When supply is constrained, credit easing will make entry-level homes less, not more, affordable. Credit easing merely permits one borrower to bid up the price against another would-be buyer for a scarce good.[23] Thus, much of the credit easing that these federal policies provided are quickly capitalized into higher home prices. This is especially pertinent for entry-level homes, which are perennially in short supply. This puts upward pressure on home prices, does not expand access, and is dangerous; concepts we have had to learn and relearn.

[22] Pinto, "Housing finance fact or fiction? FHA pioneered the 30-year fixed rate mortgage during the Great Depression?" June 2015, https://www.aei.org/economics/housing-finance/housing-finance-fact-or-fiction-fha-pioneered-the-30-year-fixed-rate-mortgage-during-the-great-depression/

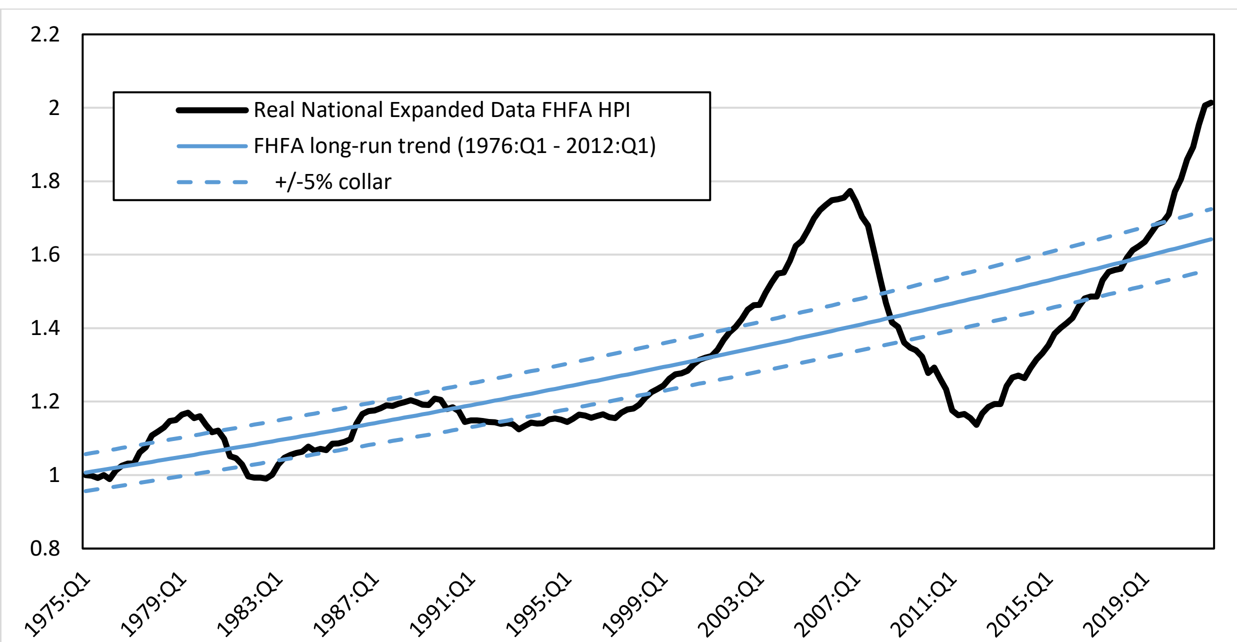
[23] Fed Chairman Marriner Eccles, Federal Reserve Bulletin, The Current Inflation Problem, 1947.

An NBER paper by Kermani and Wong (2021) has looked at the evidence in detail. It is worth quoting their abstract in full:[24]

> We document the existence of a racial gap in realized housing returns that is an order of magnitude larger than disparities arising from housing costs alone and is driven almost entirely by differences in distressed home sales (i.e. foreclosures and short sales). Black and Hispanic homeowners are both more likely to experience a distressed sale and to live in neighborhoods where distressed sales erase more house value. Importantly, absent financial distress, houses owned by minorities do not appreciate at slower rates than houses owned by non-minorities. Racial differences in income stability and liquid wealth explain a large share of the differences in distress. We use quasi-experimental variation in loan modifications to show that policies that restructure mortgages for distressed minorities can increase housing returns and reduce the racial wealth gap.

Yet, merely a decade after the last housing crash, the country is in the midst of yet another housing boom already nine years in the making and which according to Nobel Laureate Robert Shiller was "already gigantic" by 2018.[25] The Federal Housing Finance Agency has developed a measure of the current state of the housing market in terms of the long-term inflation-adjusted home price trend. We are well above the long term trend and home prices are expected to continue to significantly increase in 2021 and likely 2022. An extended price boom not only makes homes unaffordable, but also promotes price volatility and unforgiving mean reversion.

Chart: Inflation-adjusted National Home Price Index with FHFA's Long-run Trend and Collar



Source: FHFA and AEI Housing Center.

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[24] Kermani, Amir, and Francis Wong. Racial Disparities in Housing Returns. No. w29306. National Bureau of Economic Research, 2021.

[25] Robert Shiller, "The Housing Boom Is Already Gigantic. How Long Can It Last?" NYT Dec. 7, 2018.

Based on an objective diagnosis of symptoms and causes using rigorous data analysis, we propose the following solutions:

- Eliminate demand boosters as they create unaffordability until the balance between supply and demand has been restored:
    - Congress should task FHA, not the GSEs, with guaranteeing loans for high-risk, low-income borrowers.
        - FHA should limit mortgage default risk at loan origination through the use of shorter loan terms.
        - HUD should study how to increase borrower resiliency by examining the effectiveness of the residual income test, month's reserves at closing, the Massachusetts Housing Finance Agency unemployment program, and a loan with a reserve accumulation component. In all cases, the data should be made available to private researchers for independent study and evaluation.
    - FHFA should set a limit on mortgage default risk at loan origination.
        - The MDR is a comprehensive stressed default rate, which represents the worst-case scenario stress test similar to a car crash test or a hurricane safety rating. The NMDR has shown to be incredible predictive of loan defaults during the COVID- 19 pandemic.[26]
        - The MDR would also help end policies, especially risk layering, that have had a disparate impact on low-income households, especially ones of color, and would therefore affirmatively further fair housing under the Fair Housing Act.
- Shrink the government's footprint in the housing market.
- Do not relax underwriting standards in an overheated housing market
    - It has been tried many times since 1954 and has not worked.
    - There is a growing consensus that the way to make housing more affordable is to increase supply, not to ease credit, increase government subsidies, or suppress interest rates.
    - Yet, rather than shrinking the government's footprint or reducing risk, Fannie has already increased risk layering and FHFA has recently made policy changes that increase GSE competition with the private sector and will lead to greater risk-layering. Many other changes are being discussed such as:
        - June 2021: CFPB delayed the mandatory compliance date of the QM rule until Oct 1, 2022. The CFPB's 2020 replacement of the QM rule with a new standard based on the Average Prime Offer Rate) would similarly relax underwriting requirements and thus promote higher risk loans and unsustainable home price appreciation. The same applies to an expansive stand-alone DTI limit.
        - August 2021: FHA updated its student loan monthly payment calculations.
        - August 2021: FHFA proposed a new benchmark level for minority & low-income tracts home purchase in 2022-24.
        - September 2021: Fannie and Freddie suspended limits on second homes and investment properties, and risk layering limits on loans due to higher risk characteristics

[26] https://www.aei.org/housing/mortgage-risk-index/

- September 2021: Fannie started to include rental payment history in its risk assessment processes.
- Possible for 2022:
  - Pressures on FHA are building to lower FHA's current level of mortgage insurance premiums (MIP). Secretary Fudge has for the moment ruled out a cut to the MIP, but if a cut were to be implemented during an overheated housing market, it would have similar consequences as the 2015 MIP cut, which drove up prices and did not materially expand homeownership.[27] A move such as this would restart a dangerous bidding war between FHA and the GSEs, who would be facing higher affordable housing goals for low-income and minority borrowers, which leads a race to the bottom in terms of lending standards.
  - Acting FHFA Director Thompson announced in September 2021 that "the agency is weighing changes to the loan-level price adjustments enacted in 2008 to help the government-sponsored enterprises manage risk."[28]

Each one of these proposals on its own seems innocuous. However, the accumulation and combination of them should raise alarms.

With new leadership at federal agencies and regulators, a concerted effort to lower underwriting standards again – as happened during the 1990s and 2000s – seems to be underway.

Raising the Affordable Housing Goals requires lessening criteria on risk layering, otherwise the goals could not achieve much. At the same time, the effort to bring in higher-risk borrowers requires larger cross-subsidies, which requires lower changes to the LLPAs.

While lower-income Americans are being crowded out of the housing market (more below), bringing them back by lowering underwriting standards through concerted efforts by federal agencies and regulators is a recipe for disaster and risks creating more housing risk. This will put the exact people the policies are intended to help into harm's way.

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[27] At the time, the FHA claimed that the premium drop would result in 250,000 new first-time buyers over the next three years, and save each FHA buyer $900 annually. Our research found that home prices went up by about 2.5% for FHA borrowers. These borrowers had to use part of their new found "wealth" — obtained by paying lower FHA insurance premiums —to pay for the higher house price. Prices also went up for non-FHA buyers in neighborhoods with FHA insured sales. After all, it is one housing market, where borrowers, no matter the financing, compete for houses. This caused the non-FHA buyers, who did not receive the benefit of lower premiums, to largely offset the price increase by buying a home of lesser quality (perhaps a smaller home, a smaller lot, or in a different location) – they were the clear losers. We estimate that about 500,000 of these non-FHA borrowers were first-time homebuyers. Each of these non-FHA homebuyers paid approximately $6,200 extra per house, a total extra payment of about $3.1 billion. From a cost-benefit perspective, this averages to an incredible $180,000 for each of the roughly 17,000 new FHA first-time buyers! The big winners were the realtors who received hundreds of millions of dollars in higher commissions from higher prices. For more, see Davis, Oliner, Peter, and Pinto, The impact of federal housing policy on housing demand and homeownership: Evidence from a quasi-experiment, http://www.aei.org/wp-content/uploads/2018/01/Oliner-homeownership-WP-Update.pdf?x91208

[28] https://www.americanbanker.com/news/fhfa-weighs-cutting-price-adjustment-fees-on-fannie-and-freddie-loans

Equally worrisome are increases to the GSEs appraisal waiver practices, particularly purchase loans. In the past, human appraisals have successfully alerted lower-income and minority borrowers when they were overpaying. An appraisal waiver may simply confirm the negotiated sale price, while the competition between Fannie and Freddie for market share may create a race to the bottom on standards – not to mention that these processes can be gamed, which was commonplace with respect to the GSEs automated underwriting systems in the lead up to the Financial Crisis.

6) The crowding out of low- and moderate-income and minority borrowers

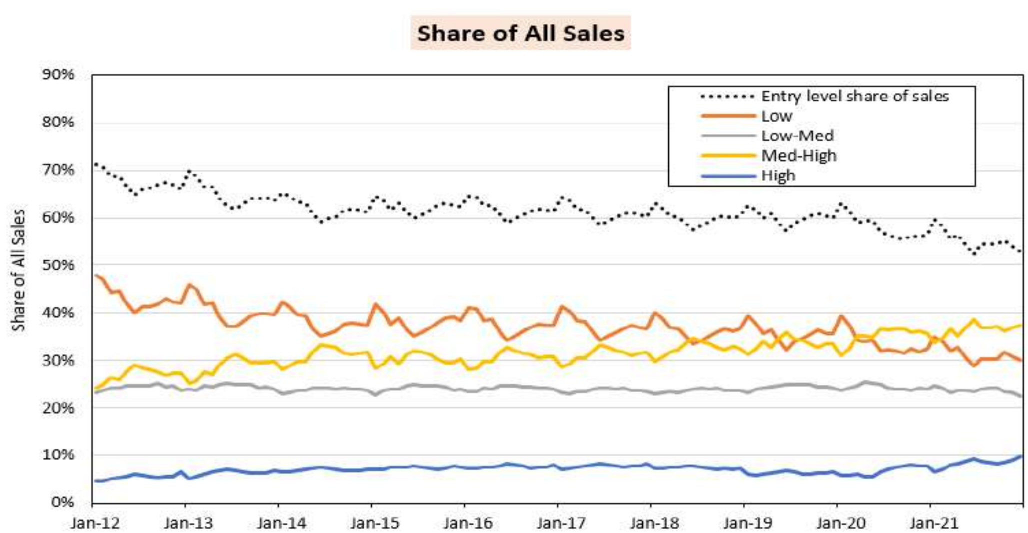
These federal housing policies, including the Fed's role in artificially lowering interest rates through its easy monetary policy during a seller's market, have contributed to rapidly rising home prices. These high prices are having the effect of increasingly crowding out lower-income and minority would-be homebuyers out of the housing market. It begs the question of how these individuals should ever be able to accumulate wealth if they cannot get on the first rung of the housing ladder.

Here is a list of data on the recent single-family housing boom, which started in 2012:

- Uninterrupted seller's market since 2012, which is now the longest ever recorded.
- Housing supply is currently at its lowest level ever. In December 2022 the months' supply of low- and low-median price tiers was 0.9 and 1.0 months respectively. Traditionally about 75% of homes at these price points are first-time buyers.
- Since 2012, home price appreciation has far outpaced the growth in market fundamentals (wages, construction cost, rents).
- Since 2012, home prices have appreciated 102%. Entry-level prices are up even more (118%).
- Home price appreciation (HPA) has further accelerated in the aftermath of the pandemic.
    - Since Jan. 2020 prices are up 27%.

<u>Example 1:</u>

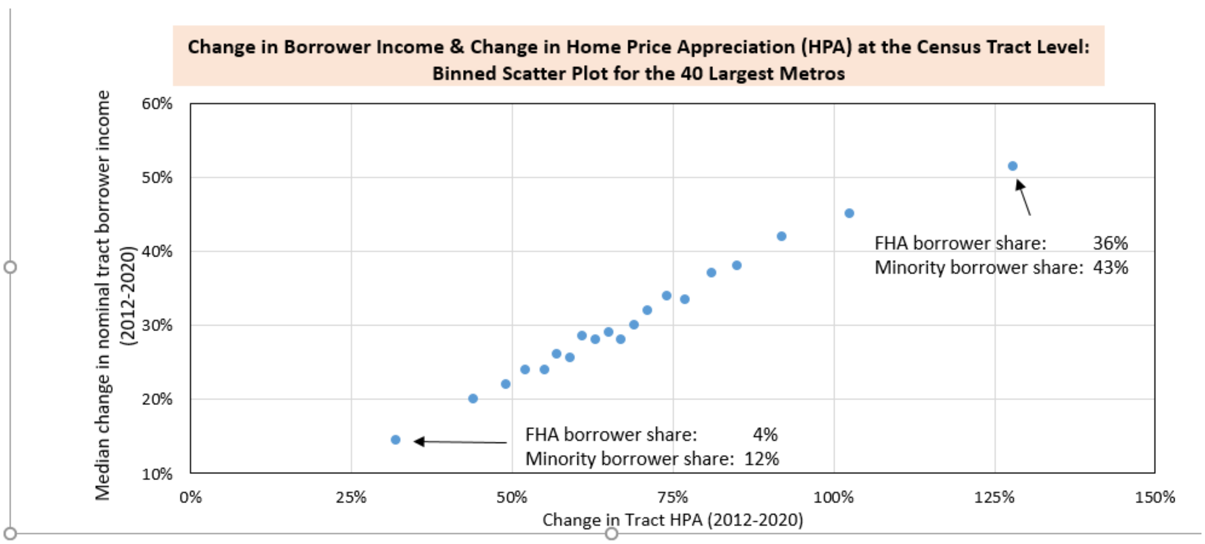
The entry-level share of home sales has been declining from 71% in Jan. 2012 to 53% in Dec. 2021.



Source: AEI Housing Center.

Example 2:

- For census tracts with the fastest HPA (+125% since 2012), we observe borrower income growth (+50%) twice the rate of the national income growth (~27%).
    - Unfortunately, it is highly implausible that the incomes for this group of borrowers have gone up that fast.
    - What is more likely happening is that due to the rapid price spiral, a different mix of buyers is buying in these neighborhoods.
    - For example:
        - In 2012, the borrowers purchasing in census tract A had a median income of $40,000.
        - By 2020, these borrowers should be making $51,000 according to wage statistics from the Atlanta Fed.
        - However in 2020, we observe that the borrowers now purchasing in census tract A have a median income of $61,000.
        - Had the borrowers from 2012 not purchased in 2012, but rather tried to purchase in 2020, their income would not have sufficed to compete with the higher income borrowers that actually purchased in 2020.
- The census tracts with the fastest HPA also had the highest share of FHA purchase loans (an indicator for lower-income) and minority borrowers.



Note: Tracts are weighted by their respective loan counts. Binned scatter plot accounts for differences in metros. FHA and minority borrower shares are for 2020. HPA stands for constant-quality home price appreciation
Source: HMDA and AEI Housing Center, www.AEI.org/housing.

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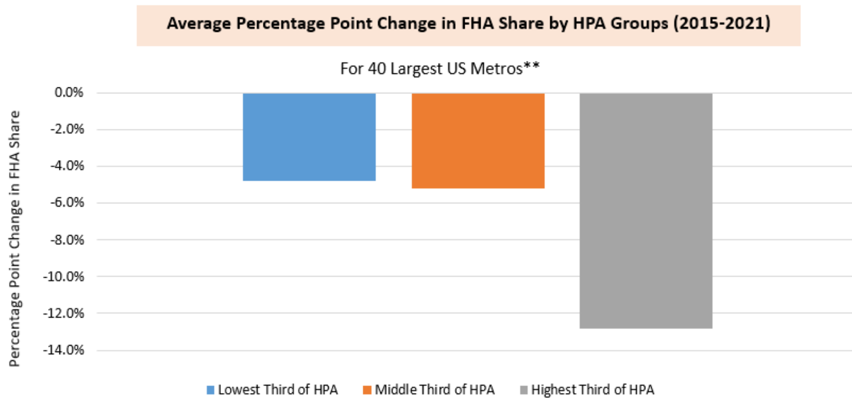
Example 3:

- The top one-third of large metros with the highest growth in HPA have seen a 13 percentage point reduction in FHA purchase loan share compared to a 6 percentage point reduction for the two-thirds of metros with lower levels of HPA.
- Since FHA is a proxy for lower-income and minority borrowers, this trend is indicative of substantial crowding out of low-income and minority potential home buyers.



* FHA purchase share is used as a proxy for lower income, minority, first-time, and first-generation borrowers
****Metro Cities in Lowest Third HPA Category**: Baltimore, MD; Chicago, IL; Cincinnati, OH; Cleveland, OH; Houston, TX; Kansas City, MO; New York, NY; Philadelphia, PA; Pittsburgh, PA; Raleigh, NC; San Antonio, TX; St. Louis, MO; Virginia Beach, VA; Washington, DC.
Metro Cities in the Middle Third HPA Category: Austin, TX; Boston, MA; Cape Coral, FL; Charlotte, NC; Columbus, OH; Dallas, TX; Detroit, MI; Indianapolis, IN; Jacksonville, FL; Los Angeles, CA; Miami, FL; Minneapolis, MN; North Port, FL.
Metro Cities in Highest Third HPA Category: Atlanta, GA; Denver, CO; Las Vegas, NV; Nashville, TN; Orlando, FL; Phoenix, AZ; Portland, OR; Riverside, CA; Sacramento, CA; San Diego, CA; San Francisco, CA; Seattle, WA; Tampa, FL.

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Source: American Community Survey, Public Records, and AEI Housing Center, www.AEI.org/housing.

The conclusion is that because of an out of control price spiral there is increased competition for fewer and fewer affordable homes. Potential entry-level buyers are increasingly pushed to the sidelines as they cannot compete with more deep pocketed individuals, who experience the same competition only higher up the price spectrum, and so on. As home prices rise faster than incomes, it will permanently price low-income and minority households out of areas of opportunity. These trends are indicative of the crowding out of low-income and minority potential home buyers, which results from the house price boom due to federal monetary and housing policies. It is a violation of the Fair Housing Act.

Appendices: