Addressing Appraisal Gaps and Expanding Access to Small-Dollar Mortgages

Overview

Lower-cost homes (below about $100,000) are an important source of unsubsidized affordable housing, especially in legacy cities and rural areas with soft housing markets.[1] However, mortgages for these homes can be difficult to obtain for at least two reasons. First, few lenders are willing to offer small-dollar mortgages below $100,000. Second, the appraised value of these homes sometimes falls below the cost to purchase and renovate them to ensure they are fully habitable, which leads to an "appraisal gap." Conventional lenders may require buyers to pay the difference in cash, which puts the homes out of reach for many. In addition to acting as a barrier to homeownership for individuals and families, this lack of financing can have implications for entire neighborhoods, in some cases contributing to a cycle of disinvestment and deterioration.

The issue particularly affects Black and Hispanic households, who have historically had less access to homeownership and mortgage financing than other households.[2] These households are more likely to be renters than White households and less likely than White households to be able to afford higher-cost homes. With better access to financing, lower-cost homes could represent an opportunity for more Black and Hispanic households to become homeowners, helping to close the racial gap in homeownership and expanding opportunities to build wealth.[3] Actions to resolve these financing challenges could also facilitate investment in economically distressed neighborhoods, improving the quality of the housing stock and the health of the community.

Policy makers, practitioners, researchers, financial institutions, and others are experimenting with a variety of approaches to help resolve financing challenges related to lower-cost homes.

Challenge: Lack of access to financing for lower-cost homes

Lower-cost homes are often inexpensive both because of their location in a soft housing market and because they are aging and in poor condition.[4] The problem is particularly acute in neighborhoods or cities with long-standing disinvestment, where large numbers of distressed sales leave few comparable sales of renovated homes at market rates upon which to base appraisals, leading to low appraised values. For example, an analysis of the Detroit housing market completed in 2017 found that there were only 490 home purchase loan originations in the city of Detroit in 2014, the last year of data included in the analysis.[5] This can mean that the combined costs of purchasing and rehabilitating an older property may be greater than the appraised value of the renovated home, limiting the amount that a lender is typically willing to lend and complicating efforts to obtain financing. Small numbers of market sales also enhance the adverse effects of any low appraised values that result from appraiser bias, creating further obstacles to property financing.

Support for this research was provided by the Robert Wood Johnson Foundation. The views expressed here do not necessarily reflect the views of the Foundation.

There are other challenges to financing small-dollar mortgages as well. Many costs of mortgage origination and servicing are fixed, and these costs are hard to recoup on small-balance loans.[6] In addition, mortgage origination commissions are typically based on the size of the mortgage, so there may also be little economic incentive for mortgage brokers and others to make small loans. There is evidence that racial bias in the appraisal process can also affect appraised values, potentially creating further obstacles to securing financing (see *Related Issues* below).

The lack of access to financing for lower-cost homes is a severe challenge for this subset of the homeownership stock. Nationwide, only about one in four lower-cost homes were purchased using a traditional mortgage compared with about four in five higher-cost homes.[7] The lack of conventional financing options for lower-cost homes imposes a significant barrier to homeownership for low- and moderate-income households who would otherwise be able to afford these homes. Alternatives to conventional financing are more expensive and often offer fewer protections for borrowers. Many transactions in low-cost housing markets are made using cash, typically to investors who will rent out the property rather than owner-occupants.[8] For example, a 2017 analysis of the Detroit housing market found that 97 percent of home sales were cash sales in 2014.[9]

Challenges arising from lower-cost homes in poor condition, including a gap between appraised values and the costs of purchasing and rehabilitating them, are inextricably linked with neighborhood stability. In strong housing markets, older homes in poor condition are often snapped up by developers, who either renovate them for upscale resale or demolish them and replace them with higher-cost housing. The financing challenges discussed above result primarily impact soft housing markets with a concentration of lower-cost homes. The appraisal gap and lack of access to small-balance mortgages can further inhibit reinvestment in these communities, contributing to a cycle of neighborhood disinvestment that can be difficult to reverse.

Related Issue:

As with any effort that seeks to encourage private investment in lower-cost neighborhoods, it is important to monitor neighborhood conditions to ensure that these efforts do not lead to the displacement of long-time residents.

Solutions: A combination of approaches to increase access to small-dollar mortgages and finance appraisal gaps

No single solution is likely to be sufficient to fully resolve barriers to financing lower-cost homes, and particularly those with an appraisal gap. Instead, a full slate of policy, technological, and market approaches, working in concert, are likely needed to address these challenges. Some approaches are still experimental, and it remains to be seen how effective they will be in overcoming the financing challenges.

In developing and implementing solutions to the appraisal gap problem, it is important to keep in mind the need to protect both the borrower and the community from the negative effects of high rates of foreclosure. Effectively closing appraisal gaps for lower-cost homes in soft markets means lending an amount greater than the appraised value of the home. Some stakeholders and industry observers are concerned that this could put both the borrower and the lender at risk, since the loan will be "under water" from the very start. Closing the appraisal gap responsibly, to minimize risk to all parties, may require a partnership in which a first mortgage is offered by a traditional financial institution and a second mortgage for the amount in excess of the value of the property is held by a CDFI or other nonprofit.

CDFIs and other mission-driven lenders are important partners in this effort, as they may be more willing to experiment with financial products that are designed for lower-cost homes. For example, some CDFIs in Chicago have loan products that allow homebuyers to borrow based on ability to repay the loan rather than property value. The rationale behind these loans, which may reach loan-to-values of up to 140 percent, is that investment in the neighborhood will contribute to re-establishing neighborhood property values and a well-functioning market with sufficient market-rate purchases to be used as comparable sales to establish more accurate appraisals. For more information, see the Local Housing Solutions brief on small balance mortgages.

Actions: Opportunities to support efforts to increase access to financing for lower-cost homes and fill appraisal gaps

Successfully addressing appraisal gaps and expanding access to small-balance mortgages will require a concerted, coordinated effort by a variety of stakeholders working to resolve the diversity of factors contributing to the problem. The following are several actions stakeholders could take to support these efforts.

1. ***Close the appraisal gap through a combination of creative financing options and subsidies.***
   Key actors: CDFIs, philanthropic partners, financial institutions, policymakers, advocacy organizations

As noted above, closing the appraisal gap may require both a first and second mortgage. Many homebuyers will need subsidies for the second mortgage, such as a zero-interest rate. For relatively small appraisal gaps, grants or loans that are forgiven over time may be an efficient solution. Coordinated efforts by policymakers, philanthropic partners, financial institutions, CDFIs, and other nonprofits to assemble the subsidies and mortgage products will be needed to meet the needs of these homebuyers.

Advocates have proposed a national Neighborhood Homes Tax Credit that would substantially expand resources for addressing the appraisal gap. The credit, which was included in a version of the Build Back Better bill proposed in 2021, would encourage investments to close the appraisal gap in distressed areas, bridging the financing gap between the cost of construction or rehabilitation and the sales price of homes. Strong stakeholder advocacy and support for legislation that includes the Neighborhood Homes Tax Credit will be needed for passage.[10]

Example

The Detroit Home Mortgage Program was launched in 2016 to help stimulate investment in Detroit's large stock of low-cost homes. The program – a collaboration between a number of financial institutions and foundations at the local and state level - allows buyers to borrow based on the "true" value of the home rather than the current appraised value. The primary mortgage covers the current appraised value; a second mortgage covers the appraisal gap.

2. ***Support development of new mortgage products and markets for small-balance mortgages.***
   Key actors: CDFIs, philanthropic partners, financial institutions, policymakers, researchers

A small handful of local programs and pilots have been launched to offer small-dollar mortgage products and markets. Efforts are needed to evaluate the current pilots and small programs to determine which are working well and how they can be improved. Once successful models have been developed, investments may be needed to take them to scale.

Example

The Opportunity Home Loan Fund provides mortgages under $50,000 for borrowers in Memphis, TN. The product is available to first-time borrowers and can be paired with down payment assistance and credit counselling. The Opportunity Home Loan Fund is a partnership between Pinnacle Bank and The Works Inc., a nonprofit CDC.

3. ***Support process and technological improvements to reduce costs of originating and servicing small-balance mortgages.***
   Key actors: government-sponsored enterprises, financial institutions, policymakers

Process and technological improvements could help reduce the costs of originating small-dollar mortgages. For example, automated underwriting models and automated valuation models could reduce the need for costly manual/in-person reviews.

Example

The MicroMortgage Marketplace, a demonstration project developed by Fahe and the Homeownership Council of America, combines streamlined loan processes with underwriting changes that increase households' ability to finance small-balance mortgages and bridge appraisal gaps. The product allows the use of automated valuation models to reduce costs to the borrower and shorten the timeline for origination. The goal is to help homeowners build wealth through homeownership and strengthen the housing market in the community.

4. ***Make changes to federal laws, regulation, and practices to facilitate small-balance mortgages.***
   Key actors: advocacy organizations, regulators, federal policymakers

A number of changes to current practice could expand access to small-balance mortgages. For example, although the FHA has a small-dollar mortgage product, it is not widely used. FHA's program could be expanded and improved by simplifying underwriting and increasing its flexibility, and reducing costs (e.g., dropping the requirement that the borrower pay for mortgage insurance for the life of the mortgage).[11] FHA's program is also limited by the fact that it cannot be layered with public subsidy that requires liens, eliminating the possibility of its use with a second mortgage that covers the appraisal gap.[12]

Other public policy changes could encourage lenders to originate and purchase small-balance mortgages, despite the lower profit margins. For example, the Mortgage Bankers' Association advocates for changes to the Community Reinvestment Act to provide full and separate CRA credit for small balance mortgage loans.[13]

Appraisal industry reforms could also significantly reduce the likelihood of an appraisal gap. For example, in markets where there are few comparable market sales available, appraisers could be allowed to use an alternative to the sales comparison approach that is the current industry standard for setting appraisals. Alternative approaches include basing appraisals on the costs of replacing the home or the amount of income a property would generate in rent. These approaches might reduce or even eliminate the appraisal gap in many situations.

Conclusions

Lower-cost homes have the potential to provide both affordable housing and an entry into homeownership and its potential for wealth building for low- and moderate-income families, especially families of color. This potential remains unrealized because of barriers to obtaining a home mortgage, including reluctance on the part of lenders to offer small-balance mortgages and, frequently, a gap between the appraised value of the home and the cost of purchase and renovation. A concerted effort by stakeholders to address the range of challenges to removing these barriers – including changes in policy and practice, providing subsidies, introducing new products and markets, and implementing technological changes – could go a long way toward improving access to financing, providing both homeownership opportunities and new investment in underserved communities.

Related Issues

- Several studies have found evidence of appraisal bias in minority neighborhoods, creating racial disparities in home value and related obstacles to property financing and wealth building. A 2018 study by Howell and Korver-Glenn found that neighborhood racial composition has an influence on home values even after home characteristics and quality; neighborhood characteristics including housing stock, socioeconomic status, and amenities; and consumer housing demand are accounted for. A 2021 Federal Housing Finance Agency review of millions of appraisals found thousands of potential violations of Fair Housing law in appraisals, in which the appraiser included references to race or other protected class references in the appraisal. This suggests that the appraiser believed this information was important to establishing value.

Other Resources

- Urban Institute has conducted several studies related to small-dollar lending and partnered with Fahe and the Homeownership Council of America in developing the MicroMortgage Marketplace pilot. Publications on Urban Institute's website include a paper describing the pilot and an analysis of the loan performance of small-dollar mortgages, among many others.

- Several local programs provide examples of financing approaches to close the appraisal gap. These include the Opportunity Home Loan Fund in Memphis, the Detroit Home Mortgage, and Restore, Repair, Renew in Philadelphia.

- The Local Housing Solutions website includes overviews of approaches to financing small balance mortgages and the appraisal gap.

For More Information

- This brief is part of a research series that explores how homeownership can be used to advance health and racial equity. To review the other resources in this series, visit https://www.abtassociates.com/HomeownershipEquity.

Endnotes

1 Lower-cost homes are not an insignificant share of the housing stock. In 2015, 14 percent of all single-family homes sold for $70,000 or less. See McCargo et al. 2018.

2 McCargo, A., Choi, J. H., & Golding, E. (2019). *Building Black homeownership bridges: A five-point framework for reducing the racial homeownership gap.* Urban Institute.

3 Trapasso, Clare (2020). "Lots of Homes Under $100K Are for Sale, but Most Buyers Can't Get One for This Reason." Realtor.com.

4 Poethig, E. C., Schilling, J., Goodman, L., Bai, B., Gastner, J., Pendall, R., & Fazili, S. (2017). *The Detroit housing market: Challenges and innovations for a path forward.* Urban Institute.

5 Poethig et al. (2017).

6 The Mortgage Bankers Association reported that average production costs per loan for independent mortgage banks and mortgage subsidiaries of chartered banks were about $8,500 in 2017, and that almost three-quarters of those expenses were unrelated to loan size. See MBA press release, "MBA News: Independent Mortgage Bank Production Profits Down in Fourth Quarter 2017," May 23, 2018.

7 McCargo et al. (2018).

8 McCargo et al. (2018).

9 Poethig et al. (2017).

10 Novara, M., & Khare, A. (2017). *Two Extremes of Residential Segregation: Chicago's Separate Worlds & Policy Strategies for Integration*. Proceedings of A Shared Future: Fostering Communities of Inclusion in an Era of Inequality, 202-215.

11 McCargo, A., Zhu, L., Strochak, S., & Ballesteros, R. (2020). *The MicroMortgage Marketplace Demonstration Project.* Urban Institute.

12 Neighborhood Housing Services of Chicago (October 17 2016). *Notes from policy meeting with Senator Richard Durbin.*

13 Mortgage Bankers Association (February 16, 2021). Comment Letter on Advance Notice of Proposed Rulemaking Modernizing the Regulatory and Supervisory Framework for the Community Reinvestment Act, Docket No. R-1723.