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VIEWPOINTS

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The case for innovation in housing

For the last 30 years, transaction costs have grown at a faster pace than inflation

Every day we are bombarded with news and information about the newest gadgets, developments in sophisticated technology, who said what on which television show and the latest political upheaval. Yet seemingly overlooked in the daily hustle and bustle is a piece of our lives that is both necessary for our livelihoods and nevertheless too often underappreciated for its substantial size, importance and presence in the overall U.S. economy.

I'm talking, of course, about the U.S. housing market.

Consider these statistics: Housing accounts for more than one-third, about 35%, of all U.S. consumer spending, according to the 2013 Bureau of Labor Statistics Consumer Expenditure Survey, and BLS estimated that the average U.S. consumer spent $17,798 on housing expenses during 2014.

American consumers spend more on housing each year than on any other single class of expenses.

Given this reality and the dramatic changes that technology has stirred across the economy, the lack of innovation in U.S. housing is quite shocking.

Consider for a moment that in the last 30 years, transaction costs, including brokerage and loan origination, have not declined on a percentage basis but have actually grown at a faster rate than inflation.

At the same time, borrowers are sold the same home and loan offered to their grandparents via a chain of intermediaries that operate with significant frictions in scale and cost of capital.

Further consider that the taxpayers are seemingly required to backstop approximately 70% of the mortgage market. The largest most sophisticated economy on the planet can't seem to figure out how to connect buyers and sellers for less than $14,000 in expenses or savers with borrowers without $8,000 in fees and taxpayer support. This is not a sustainable system.

To complicate matters, the U.S. residential market is experiencing significant cross-currents that will require a more responsive housing ecosystem.

SUPPLY/DEMAND IMBALANCE

This problem begins with the physical housing stock available in the market. The average age of a U.S. home is 42 years, and 40% of all homes are more than 50 years old.

In many markets, housing built before 1978 is loaded with environmental issues, code violations, and sub-standard ameni-

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ties. In many cases these homes are truly crumbling and this aged stock has not been properly supplemented post-crisis. We estimate that between 2 and 5 million new homes are missing from the market, due to a lack of development capital and mortgage credit.

To make matters worse, the demand for housing has grown. Americans are living longer, retiring later and living independently until later in life than previous generations – creating a longer use cycle for their homes.

Millennials, born between 1981-2000, the largest generation ever, are accelerating their pace of household formation and will soon be looking for housing with family-friendly amenities. The number of net new housing units is not keeping up with household formation. This has created a significant gap between supply and demand for a broad swath of U.S. housing markets.

Perhaps the most noteworthy change in the housing market over the last two decades is the secular shift away from homeownership toward rentals.

The U.S. homeownership rate fell to 63.1% in 2015, from 66.2% in 2000, according to the U.S. Census and the 2015 American Community Survey, as every age group under 64 years experienced declines in homeownership rates during that time.

This was the first time in decades we saw declining numbers of total homeowners, despite a growing number of households. Nearly 8 million new renter households entered the market even as homes occupied by owners went down. In addition to the undesirable supply, consumer credit constraints, changing demographics and flat wage growth for Millennials have all played a role in this shift.

Demographic shifts will also push many more of future households to be renters. According to the Urban Institute, about 88% of net new households formed by 2030 will likely be minority households. These groups have historically owned homes at a lower rate than other demographics and, while an unfortunate reality, typically have lower average household incomes. This has and will continue to drive rental rates and demand higher in parts of Southwestern U.S., including Arizona and Texas, and Southeastern U.S., notably Georgia and North Carolina, Amherst data shows.

Even with this change well underway, there exists a shocking lack of infrastructure for managing, maintaining and financing single family rental real estate. The vast majority of these rental units are owner-operated, which is not required to be managed in compliance with the Fair Housing Act and in many cases does not contribute to borrowers' credit histories that might ultimately broaden and lower the cost of its capital base.

This lack of transparency can lead to unfair practices for consumers.

INNOVATION FOR A SUSTAINABLE HOUSING FUTURE

Innovation in housing has stalled on all fronts and the existing ecosystem is no longer effective in serving U.S. consumers or investors. Various layers of local, state and federal regulations, as well as powerful incumbent industry players, have created significant barriers to entry for new disruptors.

Policy makers should focus on these barriers in order to build a more modern and efficient U.S. housing market.

For instance, if consumer financial information was mandated to be more readily accessible, and in a form that met regulatory requirements, lenders could become more efficient in credit decisioning and monitoring.

Today, this information is spread across banks, brokerage firms and the IRS in electronic form, and yet, consumers find themselves copying statements and returns only to have mortgage banks manually re-enter the information back into their own loan origination system.

This error-prone process creates unnecessary costs.

Fundamentally changing the flow of information during the loan origination process would be a substantial improvement. Today, a growing share of all loans are originated by independent mortgage bankers, who serve borrowers during the origination process by gathering financial information and completing the required steps to create a compliant, fungible loan. During this process, these organizations become a permanent part of the loan by guaranteeing the borrowers' qualifications, in effect turning an auxiliary function into a critical aspect of the loan's credit quality.

This is the weak link in the credit transfer process. A better system would consist of independent verification of loan details, thus removing risk that a seller might make errors or intentionally misrepresent a loan being sold.

Finally, a vital area for innovation is in improved coordination between local, state and federal governments regarding housing construction and finance. The NIMBY ("Not in My Back Yard") mentality and local zoning laws have driven up the cost of land and construction, limiting the ability to build affordable housing. Due to these restrictions, the nation's aging housing stock is in many cases toxic, energy inefficient and often obsolete.

Local governments should embrace policies that encourage renovation, demolition and construction so that homeowners can efficiently improve the quality of their housing. In discussions of housing finance reform, the federal government should thoughtfully amend the Dodd-Frank Act to create a better environment for more varied forms of lending that better serve a broader selection of consumers.

Safe, quality and affordable housing is essential. Yet, the current housing ecosystem is ill-suited to adequately address consumers' growing preferences for rentals and the financial realities of those most likely to purchase housing over the next 15 years.

Our mission should be to devote our collective energy, brainpower, technology and resources to develop innovative solutions that allow the U.S. housing ecosystem to evolve and meet the needs of consumers once again. ■

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