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Policy Brief

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DEFAULT RISK AND DOWN PAYMENT ASSISTANCE:

ADVERSE SELECTION VS. PROGRAM CHARACTERISTICS

There are plenty of potential reasons for someone to not be a homeowner, but lack of savings is one of the most common. Without substantial accumulated savings, it can be very difficult to afford a down payment on a home. In an attempt to alleviate this problem, many nonprofit and government-run programs have been established across the country to provide down payment assistance (DPA) to low- to moderate-income borrowers. The goal of these DPA programs is to help households become homeowners, and many of the programs have been very successful in achieving this goal. However, observation has shown that people who receive DPA have higher default rates than those who do not receive DPA, meaning that they are more likely to fall behind on their mortgage payments.

The research behind this report, performed by Yuanjie Zhang, PhD student in Economics at The Ohio State University was designed to determine the causes of this increased rate of default among DPA borrowers. How much of this might be due to the structure of the DPA program itself, and how much might be due to characteristics of the homebuyer? The answer to this question will help inform the future design of DPA programs, and may reduce the likelihood that a borrower receiving DPA will default.

DOWN PAYMENT ASSISTANCE

DPA programs are designed to increase homeownership by providing money to be used as a down payment on a home. This money decreases up-front expenses for low- to moderate-income borrowers, making homeownership more affordable. Like many other state housing agencies, The Ohio Housing Finance Agency (OHFA) administers a First Time Homebuyer program that offers DPA, in addition to an affordable mortgage product, to qualifying homebuyers. From 2005 to 2009, this program provided mortgages to over 25,000 borrowers, almost 10,000 of which received DPA.

Each DPA program is structured differently, but most are offered in one of two ways: (1) a grant, with no repayment expected (but may include higher costs for the primary mortgage); or (2) a loan, with repayment either monthly or upon the sale of the home.

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In OHFA's program, DPA was previously offered as both a grant and a 15-year second loan; it was up to the homebuyers to choose which form they preferred. If a borrower chose a DPA grant, they paid a slightly higher interest rate on their first mortgage, increasing their monthly payment, but not increasing the total amount of "principal" that they owed on their loan. If a borrower chose the DPA loan, they would pay two mortgage bills every month, one for their first mortgage and the other for the DPA loan. However, with the DPA loan, the combined monthly payments were typically lower than what they would pay with the DPA grant. Thus, there is a tradeoff between more equity with the DPA grant, and lower monthly payments with the DPA loan. An important question for this research is to determine if one form of DPA is better than the other, in terms of reducing default.

Causes of Higher Default Rates For DPA Borrowers

During the period of this study, 9.7% of DPA grant borrowers and 12.5% of DPA loan borrowers defaulted on their mortgages within the first four years, while only 6.9% of borrowers that did not receive DPA defaulted in that same time. This research addressed two causes of the increased rate of default for DPA borrowers when compared to non-DPA borrowers. The first of these causes is that borrowers who choose to apply for DPA are riskier than those borrowers who choose not to apply for DPA. The second option is that characteristics of the DPA program itself (i.e., higher monthly payments and/or less equity) create increased default risks for its borrowers. Both of these factors were found to contribute to the increased rate of default.

The study found that borrowers who receive DPA are riskier because they generally have higher non-housing debt (such as credit cards, personal loans, and student loans) than do borrowers not receiving DPA. They also tend to have lower credit scores, perhaps demonstrating their difficulty meeting monthly payment obligations. Interestingly, lower incomes do not appear to account for higher default among DPA borrowers. DPA programs themselves may also contribute to higher default risk by increasing monthly payments for borrowers receiving DPA. Further, if structured as a loan, DPA borrowers have less home equity than non-DPA borrowers (the difference in their home value and how much they still owe on the home is smaller), further increasing their default risk.

48 Month Default Rates for MRB Borrowers

Non-DPA	DPA Grant	DPA Loan
6.9%	9.7%	12.5%

Improving DPA Programs

Causes of Increased Default Risk for DPA Borrowers

People who choose to apply for DPA are riskier borrowers due to having more non-housing debt

Increased monthly payments and decreased home equity resulting from enrollment in DPA program

There are two potential ways to reduce the probability of default for DPA borrowers. One way would be to tighten credit requirements in order to be eligible for DPA, i.e., increase the minimum credit score for eligible borrowers. This prevents the riskiest borrowers from receiving DPA, lowering the default rate for DPA borrowers. However, this option may also make the DPA program less effective. Since DPA programs are designed to help households become homeowners who may not be able to do so otherwise, the implementation of stricter credit score requirements for DPA borrowers may reduce access to those who need it the most. The second option would be to enforce debt-to-income requirements for DPA borrowers, or require that borrowers receiving DPA have lower monthly debt, relative to their income This may encourage borrowers who apply for DPA to pay off debt prior to buying a home and/or purchase smaller more affordable homes, thereby lowering their monthly debt payments. To make their monthly debt affordable, most borrowers would only have to downsize the amount of home they purchase by about 10%. By doing these things, this policy would lower the default risk by making it easier for borrowers to afford their mortgage payments.

In summary, rather than one or the other, it is higher debt caused by both borrower and program characteristics that increases default among DPA borrowers. Nonprofit and government agencies offering DPA programs should carefully consider strategies to limit the housing and non-housing debt of homebuyers seeking assistance. This may not only reduce the likelihood of default, but may also enable the homeowner to build wealth through ownership.

Why Does This Matter?

It is important to know what causes higher default rates in order to inform policy decisions and more successfully design and operate DPA programs. If policymakers are aware of the causes of increased default among homebuyers receiving DPA, then they can make better decisions about the future design of DPA programs. Governmental agencies like OHFA can also use this information to make changes and improvements to DPA programs in order to make them as effective and efficient as possible.

The complete paper by Yuanjie Zhang (2010). High Default Risk on Down Payment Assistance Program: Adverse Selection Vs. Program Characteristics? is available at: http://www.ohiohome.org/oahr/DPAresearch.pdf