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The Shadow Mortgage Market: An Informal Pathway for Hispanic Homeownership

By **David Ruedas,** *CHCI-Wells Fargo Housing Graduate Fellow*

Executive Summary

In the United States, homeownership is the bedrock of the American Dream. There are two different pathways to homeownership.[1] Americans finance their home purchase through a traditional mortgage or alternative financing agreements.[2] A Pew Charitable Trust survey conducted in 2019 found that one in five home borrowers pursued alternative financing options at least once as a pathway to homeownership.[3] Higher mortgage rates, declining housing affordability, creditworthiness, and lack of small dollar mortgages has contributed to the increasing use of alternative financing agreements.[4] These alternatives

provide Americans – who would otherwise be excluded from homeownership – a path to obtaining ownership. However, these alternatives come at a cost. Some of these borrowers go on to experience higher costs, evictions, loss of equity, and other unforeseen costs.[5] New research suggest Hispanics are more likely than any other ethnic group to use risky alternative financing agreements.[6] Considering that Hispanics will make up 70% of new homeowners over the next two decades, their inability to access the traditional mortgage market could inhibit their ability to become homeowners and build wealth.[7] Alternative financing agreements, such as contracts for deeds, land installment contracts, and seller-financed, are not federally regulated, poorly regulated across states, and offer limited legal safeguards.[8] Without proper regulations, access to small dollar mortgages, and affordable housing, more Hispanics across the country could be forced into risky alternative financing agreements – preventing Hispanics from owning their home . To combat this increasing concern, federal and state governments must take action to provide the housing market with fair and viable alternative home financing agreements, affordable housing units, and small dollar mortgages.

Background

Owning a home is predominantly a symbol of prosperity and success. The fundamental principle of homeownership in the U.S. has been the legal framework that ensures buyers have the ability to hold and transfer secure, marketable title.[9] This principle allows for homeownership to exist and for families to build generational wealth. In the U.S. there are two different pathways to homeownership, with two unequal tiers of legal protections.[10] Most American homeowners purchase a home through participation in the traditional home mortgage market.[11] Homeowners financing their homes using traditional amortized[12] mortgages benefit from a series of oversight and legal safeguards that ensure buyers retain clear title and equity in their homes.[13] While the majority finance their home purchases through the traditional mortgage market, millions of Americans have not had the same access.[14]

The second pathway to homeownership involves the use of non-mortgage alternative financing arrangements. This informal pathway to homeownership provides would-be buyers with limited |access to legal protections and third-party oversight – placing many consumers in a position with limited legal protections and uncertainty in the transfer of title.[15] A recent study showed that 36 million Americans have used alternative financing at some point in their lives while seven million are currently using these agreements.[16] Furthermore, the study showed low-income communities of color tend to use alternative financing arrangements at higher rates than moderate and middle-income families.[17]

Hispanic home borrowers are more likely than other racial and

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ethnic groups to use these risky arrangements.[18] According to Pew, roughly 34% of Hispanic home borrowers have used alternative financing at some point, compared to 23% of Black home borrowers and 19% of White borrowers.[19] While the housing supply shortage and high cost are significant barriers to Hispanic homeownership, alternative financing arrangements can be detrimental to Hispanic families attempting to buy a home and build generational wealth.

Traditional Mortgage Market

A traditional mortgage is a credit agreement used to purchase real estate that involves a third-party lender. The lender's involvement in the transaction is performing the underwriting of the original loan, which requires compliance with federal and state mortgage lending laws.[20] A mortgage is a necessary financial product, if the consumer is unable to finance the purchase with cash on hand.[21] A mortgage product is a secured loan, meaning the lender has legal rights to repossess real property – which is normally used as collateral – if the consumer fails to meet the terms of the agreement.[22] Buyers using mortgages are afforded vast legal protections including: habitability standards, foreclosure laws, rights to cure, notice of rights, limits of acceleration for minor defaults, rights of reinstatements, limits on deficiency judgments, rights of redemption, and right to a public sale upon foreclosure.[23] While using a mortgage is the logical way to finance a home, millions of Americans are unable to participate in the mortgage market economy.

Informal Mortgage Market

Elevated prices, lack of housing supply, and barriers to mortgage credit limit options for many aspiring homebuyers. Barriers to homeownership are particularly high for low-income minority households.[24] These barriers have resulted in the growing trend in the use of non-mortgage instruments to finance a home. These agreements are commonly referred to as contracts for deed.

Contracts for deed are also known as land contracts, installment contracts, lease purchase agreements, rent to own, and, a "poor man's mortgage."[25] Essentially, these alternative instruments are a private real estate contracts between the buyer and seller.[26] They promise a pathway into homeownership without the involvement of a bank or other financial institutions.[27] These alternative agreements are generally structured as a rental agreement wherein the tenant has the option to purchase the home after a predetermined amount of time.[28]

The most common types of alternative financing are:

- Seller Financing. The seller is the lender, extending credit to the buyer and the loan is repaid over the term of the agreement. Title is transferred to the buyer once the agreement is finalized.
- Contract-for-Deed. The title is transferred once the final payment is made. These contracts have inflated costs and lack clear foreclosure protections, ownership protections, and recording requirements.
- Lease-Purchase or Rent to Own. The buyer occupies the property as a tenant while having an agreement in place where after the fixed term of the contract, the buyer is entitled to purchase or own the property.[29]

In theory, these arrangements could be favorable to a buyer without a credit score sufficient to secure a mortgage loan, for buyers lacking access to formal financial services, or for buyers lacking access to small balance mortgages.[30] Reports suggest that the buyers in these transactions are almost exclusively African Americans or Hispanic homebuyers.[31] Further, Pew's survey found that 34% of Hispanic households have financed a home purchase with alternative financing.[32] High mortgage rates, declining housing affordability, and insufficient housing supply has made contracts for deed – and the like – the only option for many Hispanic would-be buyers. Their market demand could provide many Hispanics the dream of owning a home, if the product is viable.

However, they are unduly risky for Hispanic buyers. Buyers are unable to accrue housing equity, suffer from limited consumer protections, and encounter unforeseen liabilities. These agreements are mired with legal issues and fail to transfer title at the inception. In essence, they are predatory agreements that combine all the responsibilities of homeownership with all the disadvantage of renting – while offering the benefits of neither.[33] Therefore, government action is needed if prospective Hispanic buyers are to fully attain homeownership via alternative financing agreements.

Barriers to Homeownership

Homeownership has for decades been an important way for families to build wealth and achieve the American Dream.[34] Homeownership is a wealth builder by acting as a forced savings mechanism and through home value appreciation.[35] It further promotes intergenerational homeownership and wealth building.[36] While the current system has generated wealth for millions of Americans, it has disproportionately benefitted White Americans. White Americans have had a nearly 70% homeownership rate since 2017.[37] According to a report from the National Association of Hispanic Real Estate Professionals (NAHREP), in 2021 the homeownership rate for Hispanic Americans was slightly above 47% and then rose to 48.4%.[38]

Priced Out

The barriers that Hispanic Americans face while trying to become homeowners are evident. Access to credit, financial stability, exclusion from lending, lack of affordable housing, and access to traditional mortgages have made homeownership among Hispanics a significant struggle.[39] Hispanics are disproportionately more likely to hold low-paying jobs, residing in low-income communities.[40] As of 2021, the median Hispanic household income was $55,000 as compared to the non-Hispanic White household median income of $74,900.[41] The median salary necessary to afford the median priced-home nationally is $68,008.[42]

From 2021 to 2022, median prices for existing homes averaged around $366,900[43] and the median new home price reaching $442,100.[44] Prices were up between 2021 and 2022 in 98 of the 100 markets, while 10 markets – all in the Southeast – experienced a price increase of over 20%.[45] As a result of rising interest rates, reduced inventory, and rising home prices, monthly mortgage costs have increased for buyers. For example, in April 2021, payments on a home priced at the national median sales price with the 30-year fixed rate mortgage rate would have resulted in monthly housing costs of $2,060 per month.[46] In April 2022, monthly costs for the national median priced home at the going 30-year fixed rate were $2,780.47

Lack of housing supply also limits options for many aspiring Hispanic homebuyers. The supply of existing affordable single-family homes for sale remains low.[48] The inventory of existing homes fell below one million units in December 2022, leaving just 2.9 months of supply at existing sales rates.[49] The housing industry generally considers six months of supply a healthy level. New homes for sale reached 461,000 the same month, about nine months of supply.[50] Single-family housing construction has also slowed, reducing the rate at which new homes will be added to the housing stock. Single-family home starts declined throughout 2022, with the number of new starts falling below 2020 levels.[51] Essentially, the lack of housing supply, increased costs, and the decline in construction of new affordable homes, has priced many Hispanic families out of the current market.

Creditworthiness

Credit in the United States has been traditionally extended based on an impartial measure of a person's creditworthiness, i.e. their credit score.[52] Credit scores reflect the wealth and credit history of those that are banked.[53] Furthermore, lenders use credit scores to understand how likely a borrower is to fulfill their obligations – the higher the score the more likely the debt will be repaid.[54] Having poor credit history results in a number of financial consequences, including being denied for a mortgage.[55] According to a survey, roughly 41% of Hispanic Americans report having no credit or a poor to fair credit score – which is any score below 640.[56]

Consequently, this attributes to the poor homeownership rate amongst Hispanic communities. Hispanic buyers experienced a 19.1% home-purchase denial rate for conventional loans in 2021 and were 81% more likely to be denied than non-Hispanic home buyers.[57] Also, being unbanked limits access to mortgage loans within the Hispanic community. According to the FDIC, in 2019, 12.2 percent of Hispanic households were unbanked compared to 2.5 percent of white ones.[58] Unbanked Hispanics tend to have little to no credit history thereby making it harder for them to qualify for home loans.[59] The lack of Hispanic participation in the financial system[60] further prevents them from financing a home with a mortgage loan, consequently, encouraging Hispanics to use risky alternative home financing agreements

Same Balance Mortgages

Since 2020 there were more than 50,000 listings nationwide for single-family homes priced at or below $100,000.[61] The problem many face is access to lenders willing to finance a small dollar mortgage.[62] Alternative financing provides an informal pathway to homeownership in low-income communities, especially in areas

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with lower-cost homes.[63] The data shows that small mortgages – those less than $150,000 – are largely unavailable.[64] According to U.S. Census Bureau data, in 2020 only 43% of homes sold below $80,000 were financed with a mortgage.[65] Lenders fail to originate and service small balance loans due to their high fixed costs and minimal return on investment.[66]

The lack of small mortgages encourages the participation of low-income Hispanic families in the informal homeownership market. Pew found that the lack of small mortgages disproportionally harms first-time buyers, Hispanic families, and low-income households.[67] Pew's research indicates the lack of small balance mortgages forces Hispanics to use alternative financing agreements more often than any other racial group.[68] These disparities in the use of alternative financing reflect racial and ethnic inequalities in mortgage access, approval rates, loan costs, income volatility, and little or no credit history.[68]

Despite the obstacles, Hispanics will make up a large share of the housing market as its population grows. In the next 20 years, there will be an estimated 6.9 million net new homeowner households.[69] These persistent issues will continue to drive more Hispanics into using risky home financing options, consequently harming their prospects of realizing the opportunity to become homeowners.

Rise of the Informal Mortgage Market

While proponents argue that alternative financing arrangements provide homeownership opportunities to low-income families – specifically Hispanic families – the lack of ownership clarity and legal protections pose a significant risk for Hispanic families. Alternative financing arrangements contain risky and predatory terms that lead buyers to pay higher costs, which result in default and loss of home equity.[70] These arrangements often place the responsibility for expensive repairs and upkeep on the buyer.[71] Oftentimes homes are in disrepair, which is not disclosed to the buyer.[72] These issues are prevalent due to the lack of consumer rights and protections that homebuyers with traditional mortgages enjoy.[73]

The lack of regulations and protections also creates a profit-driven [churning] market for sellers.[74] Pew found that millions of Americans have used more than one type of alternative financing arrangement across multiple home purchases, yet little is known as to whether or not those individuals actually obtained title. [75] Furthermore, little research has been conducted on the number of Hispanic families that have achieved homeownership through the use of alternative financing agreements. Instead, the research indicates the possibility that many using alternative financing agreements do not obtain homeownership, but instead remain renters.[76] Since title does not transfer until the terms of the agreements are satisfied, alternative financing agreements have become a money trap where owners initiate the sale of the same house repeatedly, receiving deposits – or unsecured payments – followed by a quick eviction.[77] While these arrangements can provide an informal pathway to homeownership, evidence shows that alternative financing arrangements are inherently predatory and exploit Hispanic buyers.

Conclusion and Recommendations

Research

Alternative financing agreements are not well regulated which leads to predatory and abusive practices. However, these agreements can provide many Hispanic families an alternative path to homeownership. While there is ample evidence that shows their increasing use, little research has been conducted to prove the viability of alternative financing agreements. Federal, state, and non-profit organizations should collaborate and conduct a nationwide research project that details the extent to which the number of Americans are currently using alternative financing agreements, their success rate in achieving homeownership, its market potential, and best practices.

Further, there is less information on whether undocumented Hispanics use alternative financing agreements. It is estimated that there are 11 million undocumented immigrants residing in the United States.[78] According to the Center for Migration Studies of New York (CMS) there are 7,410,000 million undocumented immigrants of Hispanic origin in the U.S..[79] In essence, there are millions of undocumented immigrants that are unable to open a bank account, obtain a mortgage, nor secure a property loan due to their immigration status. Federal, state, and non-profit organizations should collaborate and conducting a nation-wide research project that details the extent to which the undocumented immigrants are using alternative financing agreements, its market size and its success rate in providing undocumented immigrants a path to homeownership. Furthermore, research should include the availability, accessibility, and success of ITIN mortgages.

Federal Action

Legislation and Regulation

A comprehensive set of rules are needed to govern alternative financing agreements. Currently, there is enough data for lawmakers to craft comprehensive legislation that affords buyers with the same legal and consumer protections – mortgage holders enjoy – for those using alternative financing agreements.[80] However, there is not enough data at the moment for lawmakers to craft sophisticated policy proposals that would provide the market with a viable alternative non-mortgage product. Evidence derived from a nationwide research project would be used to introduce legislation or regulation to supply the market with a viable alternative non-mortgage product.

Housing Supply and Small Balance Mortgages.

Access to affordable housing and financing is a key step to achieving homeownership goals. There is ample data that indicates the lack of affordable housing and small balance mortgage directly contributes Hispanic households' inability to become homeowners. The federal government must work in conjunction with the private sector to build more affordable housing units. Further, it must foster a lending environment that is conducive to first-generation, first-time homebuyers who do not rely on generational wealth to fairly compete in today's market.[81] That environment should make loans of $100,000 or less more accessible and include a plan for removing barriers to small-dollar loans.[82]

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