In the aftermath of the Great Recession, new forces have emerged that are reinforcing longer term trends toward an unequal geography of housing outcomes contributing to inequalities in life opportunity based on location. Although historical factors that concentrate on poverty and race in urban neighborhoods are well-studied, the degree to which new forces will, in the future, limit housing affordability across metropolitan areas is uncertain. What is known points to the need for research in two emergent areas: (a) the changing structure of housing finance and (b) the new regional economics of housing affordability.

In the aftermath of the housing crisis, the critical policy question going forward is how to rebuild a housing finance system that avoids the emergence of a dual housing finance system, in which access to housing finance varies geographically. Since 2006 (the peak of the housing boom), we have seen to date essentially zero net new homeowner households, a rise of 6 million new-renter households, and a dramatic decline in household formation rates. This has occurred at the same time as new lending standards have been implemented that are more restrictive than those that prevailed during decades of sustainable homeownership prior to the period of irresponsible lending that led to the crisis.¹

There is a lack of consensus on what to do about tight lending standards just as there is little consensus on how to rebuild the housing finance system. The institutional and financial market imperfections that triggered the collapse of the housing market need to be taken into account in reforming the housing finance system, along with the overarching purposes that the system is to serve. Most recent research in this area has documented the failures of the past housing finance system, but it has not shed much light on the issue of what to do about the tightening up of mortgage standards for first-time homeowners, who as a share of homebuyers are now at a 30-year low, despite historically low interest rates.

Had financial stability prevailed, it is unlikely that lenders would have felt the need to tighten up credit qualifications. But in an effort to reduce the risk of being forced to repurchase loans and to service loans in default, mortgage originators have added substantial overlays above the underwriting standards set by the government-sponsored enterprises (GSEs) and Federal Housing Administration (FHA). Meanwhile, Fannie Mae and Freddie Mac have instituted sizable individual loan-level price adjustments to insurance fees that they charge based on individual loan and borrower characteristics. Both of these regime shifts in lending have been undertaken a posteriori to compensate for risks associated with the crisis.

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Although more evidence is needed to show the extent to which the tightening of lending standards has caused the decline in homeownership and the increase in rentership,\(^2\) it is clear that increasing rental demand is causing rising rents, making saving for down payments more difficult, and increasing the value of homeownership as a hedge. Current proposals for housing finance reform focus on critiquing the historical federal response to the mortgage meltdown; this is useful, but going forward we need to deepen our understanding of the likely outcome of shifts in lending practices that are occurring now.

The shift in lending practices set up in the aftermath of the crisis to reduce risk to mortgage lending entities may undermine mutual insurance opportunities and lead to a segmented market in mortgage lending. Although loan level pricing for risk may seem both inevitable and efficient, the outcomes of this possible new regime should be analyzed. Among other impacts, if there is another entity which is not risk-based pricing, that entity will likely find itself with a pool of higher risk borrowers. In addition, to the extent that lenders adjust pricing for risk in response to geographically distributed income shocks, the role of diversification in supporting default insurance is undone (Pavlov, Wachter, & Zevelev, 2015).\(^3\) If insurers offer lower priced insurance to a less risky pool, the pool of borrowers with greater risk will be adversely selected against, with less risky borrowers leaving that pool and joining the less risky pool. If these pools are geographically separated, borrowing into the higher risk market comes with a higher risk of price volatility even for the less risky borrowers who would otherwise choose to own in these markets, thus reinforcing segmentation of markets based on borrower characteristics and making house prices in these areas more volatile. In a crisis, of course, the government-insured market would expand to rescue the whole market just as it did in this past crisis; nonetheless, this rescue role has in the past and could in the future further undermine financial solvency, requiring higher pricing of risk furthering the outcome of a dual market.

The relative lack of research that considers the impact of the structure of the housing finance system for these issues is striking.\(^4\) Research is also needed on the likely dimensions of another emergent cause of geographical divergence: housing affordability. Together with the housing market crisis recovery, long run factors in place prior to the crisis are causing a decline in affordable homeownership and renting options in regional markets, which have experienced productivity gains and where housing supply is inelastic.\(^5\) After decades of losing population, American cities, since 2000 and in some cases since 1990, are growing with an influx of youth and immigrants. Although this reversal has many positive implications, it has also exacerbated the rise in rents—and by extension, the inequality between residents who can afford to live in the most productive cities and regions and those who cannot. This new regional inequality adds to neighborhood segregation by race and income.\(^6\)

Inequality of opportunity from regional segmentation based on income and race is the subject of the Equality of Opportunity Project, under the direction of Raj Chetty, Nathaniel Hendren, Patrick Kline, and Emmanuel Saez, which focuses on regional components to the lack of socioeconomic mobility. Their findings indicate that the variation in economic mobility across the country is large and persistent and related to region-wide market segmentation based on race and income (Chetty, 2015).\(^7\) Recent work by Rebecca Diamond (2015) and Enrico Moretti (2012) shows how this geographic sorting is increasingly playing out in regional labor markets, with highly skilled workers gravitating toward high-wage cities and low-skilled workers to low-wage cities, reinforcing the disadvantage in productivity, investment, and amenities and exacerbating the divergence

\(^1\) S. Wachter
between the cities in a self-reinforcing dynamic. The result, according to Diamond’s work, is growing inequality in well-being that is even larger than the increasing inequality in income or wealth.

We need to think more deeply about affordability outcomes in the potentially more polarized world of tomorrow as emerging economic trends and housing finance practices reinforce longstanding neighborhood segregation based on race and income and lead to increasingly divergent socioeconomic opportunities across metropolitan areas.

**Disclosure statement**

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**Notes**

1. Research on the causes of the crisis including the role of affordable housing finance in causing the crisis is substantial and growing. See, for example, Levitin and Wachter (2010). Also, see Avery and Brevoort (2015).
2. For a measure of the tightening of credit standards following the crisis, see Li et al., (2014).
3. As Pavlov et al., (2015) show, insurance that spans geographical markets operates efficiently because random shocks are not known, and therefore insurable. If one market is known to be riskier than another, the two markets will not join in insurance against shocks at the same price.
4. But for related research, see: Hancock and Passmore (forthcoming); Mosser, Tracy, and Wright (in press); and Wachter (2014, October).
6. See Voith and Wachter (2009) for a discussion of the rebound of cities and how this impacts housing affordability.
7. Also see Jargowski (2015) for a discussion of the continuing segregation of communities by race and income.

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