Borrowing Against Home Equity

In recent quarters households have been liquifying their home equity at a pace not seen since 1979. Debt outstanding on existing homes expanded by an estimated $40 billion in the second half of 1983 alone (chart). Households can use the proceeds from these borrowings for various purposes: to repay other outstanding debt, to accumulate assets, or to finance consumption expenditures.

Households can usually borrow against home equity at rates that are slightly above prevailing mortgage rates. The cost of all forms of unsecured personal borrowing is substantially higher than the cost of mortgage borrowing. (The spread between the average two-year personal loan rate and the average contract mortgage rate has been as much as 5 percentage points.) Also, mortgage loans allow longer repayment periods than personal loans. Thus, home equity is a preferred source of personal finance to direct consumer credit for those who can utilize it. The method used for liquifying accrued home values, however, has varied over time with credit and housing market conditions.

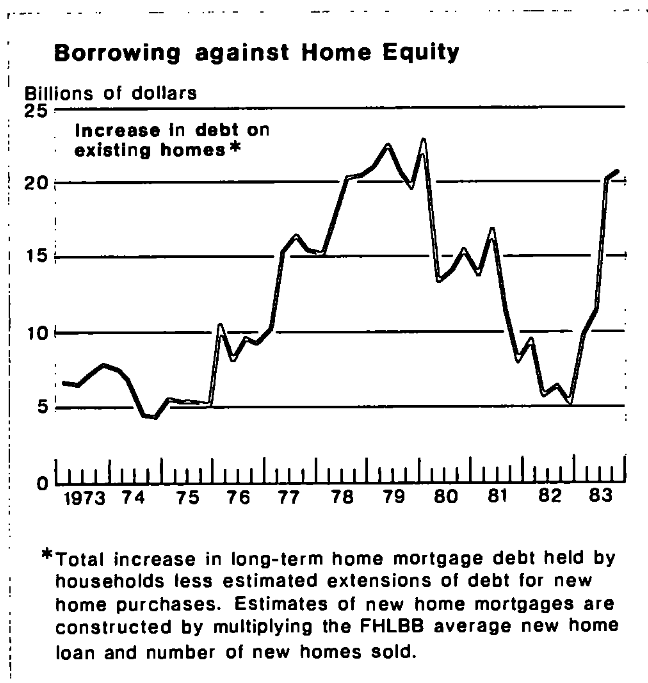
When home prices are accelerating, households can sell their homes, extinguish their outstanding mortgages, and realize capital gains. These profits need not be fully invested as downpayments on the next homes. Since the mortgage rate for a home purchased with 50 percent down is on average less than 50 basis points lower than the rate for the same home purchased with a much smaller downpayment, investing the funds in the downpayment offers little advantage. The cost of the funds gained in the existing home transaction, then, is essentially the rate on the new mortgage. This method of liquifying home equity was widely used during the booming housing market of the late 1970s.

A second way of getting access to tangible wealth

through the mortgage market is to refinance in excess of an existing mortgage. This is an especially attractive alternative when interest rates drop since the household can take on a larger debt than the outstanding mortgage and still have the same monthly payment. Again, the cost of the additional funds borrowed is the mortgage rate.

A third mechanism for obtaining funds backed by homeownership is taking on a second mortgage. Second mortgages were not particularly popular with lenders or borrowers in earlier years; low interest rate ceilings made them unprofitable for lenders while borrowers found the terms inflexible. But with the removal of "usury" rate restrictions, lenders have made second mortgages more appealing to borrowers by offering lines of credit as well as the conventional lump sum contracts.

Which of these home equity financing techniques have been prominent recently? Refinancings are estimated to have accounted for more than half the current surge in debt on existing homes. They became particularly appealing during 1983 when mortgage rates dropped more than 150 basis points. In the second half of the year, the increase in debt from refinancings at savings and loan institutions totaled $13 billion. Data on refinancing activity at other types of lenders are not available. But, if those lenders experienced the same volume of refinancings per dollar of originations during the six-month period, total refinancings would have accounted



*Total increase in long-term home mortgage debt held by households less estimated extensions of debt for new home purchases. Estimates of new home mortgages are constructed by multiplying the FHLBB average new home loan and number of new homes sold.

for about $30 billion in net mortgage flows. By comparison, for all of 1979, when market values of houses rose rapidly, refinancing contributed an estimated $21 billion in additional mortgage debt and accounted for only 25 percent of the increase in debt outstanding on existing homes.

Also, the new line-of-credit type of second mortgage financing is being actively marketed. These contracts, frequently called equity access accounts, are accessible by writing checks. The maximum line of credit is usually 70 to 80 percent of the difference between the home's current sale value and the balance remaining on the first mortgage. The interest rate charged is typically one to two percentage points above the prime or some market rate. So, equity access funds are cheaper than ordinary revolving credit and personal loans, as well as more flexible than the conventional second mortgages of the past. If their availability continues to spread, future increases in home equity values could become more readily and quickly liquified to support consumption or for other purposes. However, the future popularity of equity access accounts tied to market rates will depend, in part, on how willing households are to absorb the risk of variable rate liabilities.

Robin C. DeMagistris