January 19, 2001

Equity Shrivels as Homeowners Borrow and Buy

By LOUIS UCHITELLE

When Erica Hutchinson and her fiancé, Lynn Corbett, bought their brownstone in the Clinton Hill section of Brooklyn for $175,000 three years ago, they persuaded a bank to lend them $230,000. Their argument was that the value of their new home would jump once they used the extra mortgage money to gut the three-story building and fill it with new bathrooms, a new kitchen, new flooring, new windows — new everything.

They were right, of course. The Corbetts, now married, say that after several years of a flush New York economy their brownstone would easily sell today for at least $370,000. Their bankers seem to agree. The couple recently added a $30,000 home equity loan, using the new money to pay off credit card bills. "The construction costs were more than we had anticipated so we charged them," said Ms. Corbett, who is 30, like her husband, "and we paid for our wedding with credit cards, too."

For most American families, their home is their biggest investment, and...
after years of prosperity in which home prices rose substantially, family wealth has increased as well. But like the Corbetts, millions of households borrowed heavily against their homes, often to help support greater spending.

The borrowing has been so extensive, in fact, that homeowners, after building up equity through much of the 1960's and 1970's, have let their ownership shares deteriorate over the last two decades to the lowest level on record, the Federal Reserve reports. The borrowing even accelerated in the 1990's, helping to explain how Americans managed to easily outspend their incomes through two long economic expansions.

Now a slowing economy catches the average household owning less of a stake in its home than in any economic slowdown since the advent of the modern mortgage in the 1930's. If a recession develops and people start worrying that they have too little equity left to continue borrowing safely against their homes, the blow to spending could turn a mild recession into a prolonged one. That would certainly happen, economists say, if a downturn causes home prices to fall, shrinking even more the equity stake that households still have in their homes.

"When you make borrowing dependent on your home, then you erode the fire wall that protects your standard of living and we are going into this slowdown with the fire wall clearly eroded," said Nicolas Retsinas, director of the Joint Center on Housing Studies at Harvard. "The home is not just a financial transaction, it defines who you are and what kind of community you live in. When all of a sudden you get into trouble, you can't just rip it up like a credit card."

The average homeowning household owed lenders 46 percent of the market value of its residence during last year's third quarter, up sharply from about 30 percent in 1982 and 40 percent in 1991, at the start of the current economic expansion, the Fed reports show. For a typical family with a home worth the median market value of $144,000 late last year, that meant their equity was $77,760 while their debt was $66,240.

That still sounds like a relatively safe cushion. But American society once exalted a different norm — a 20 percent down payment and the balance paid off through a 30-year fixed-rate mortgage. The Champagne toasts and mortgage burnings that celebrated the final payment are gone today. Instead, a growing number of Americans are approaching or entering retirement still making hefty home payments.

In many ways, the shift makes sense. Home equity loans and the refinancing of mortgages have become vehicles for converting standard consumer debt into loans that usually enjoy tax breaks,
lower interest rates and smaller monthly payments. Millions of people have managed to borrow against their homes at rates under 10 percent, while channeling other funds into retirement plans and into a stock market that until recently achieved average returns of 15 percent or more a year.

Whatever the justifications, the family home is now more at risk as collateral for the spending that underpins economic growth.

The vulnerability cuts two ways. For people like the Corbetts, convinced that their brownstone on St. James Place can only rise in value as their neighborhood improves, there is still room to borrow more and spend it avidly, softening any downturn. "We are definitely ahead of the game," said Ms. Corbett, who works in the fashion industry. Her husband runs a Boy's Town center in Brooklyn and their income is $120,000 a year, not counting the $1,300 a month they receive as rent for an apartment in their brownstone.

But for homeowners like Thomas Murray, an executive for a Cincinnati company that cleans food processing plants, even a leveling off of home prices would be chilling. He is painfully aware that if he sold his four-bedroom brick suburban home for the $220,000 that he thinks he can get for it and then paid off his mortgage and his home equity loan, he would walk away with — as he puts it — "$8, maybe $9."

"If I had to take a pay cut or had to accept another job for a lower level of pay, then I would have the credit card problem again, and no equity left in my home to solve it," said Mr. Murray, 36, who landed his present job last spring at a sharp increase in salary, to above $100,000. Over the last five years, he had made less than $80,000 a year. As a result, the family accumulated $20,000 in credit card debt, which he and his wife recently converted to a $25,000 home equity loan.

"Car repair, dental bills, mandatory home repairs, clothing for the kids, birthday parties, you cannot afford all this and stay out of debt," Mr. Murray said. "Unless you have a big enough income, which I have — now."

The big concern among economists is not a relatively short recession, but a longer one, lasting a year or so. "In a brief recession, the extra borrowing and spending would even soften the downturn," Mark Zandi, chief economist at Economy.com in West Chester, Pa., said. Indeed, a new surge in mortgage refinancing as interest rates fall — the fourth surge since 1993 — is likely to give a lift to spending as some people go further into debt, pocketing the extra mortgage money without increasing their monthly payments.

"But in a longer recession," Mr. Zandi said, "housing prices would
weaken and many homeowners could easily find themselves owing more on their homes than the homes were worth."

If that happened, the abrupt pullback in spending as these families tried to work down their debts and preserve their homes would exacerbate a recession. Many Japanese behaved in just this way after the collapse in real estate prices in that country a decade ago.

Or, with monthly mortgage and home equity payments in the United States at a record level as a percentage of disposable income, trouble on the job — layoffs, for example, or cutbacks in overtime pay — could quickly restrict spending, also deepening a recession.

Alexander Wright, a 40-year-old aircraft mechanic for Northrop Grumman in Jacksonville, Fla., is currently going through just this experience. He is among the millions of relatively new homeowners who could not meet the old requirements for a down payment to purchase a home, but achieved his goal as lenders relaxed their standards, offering mortgages that cover nearly the entire cost of a home.

Mortgage insurance has encouraged this expansion of homeownership. So has the increasingly popular practice of packaging mortgages into bonds that are then sold to many investors, thus spreading the risk of default. Government-sponsored programs aimed at allowing lower-income families to buy a home with little money down have helped as well. Together with the robust economy, these forces have propelled homeownership to a record 67.7 percent of all households, although many of the new homeowners own only a modest stake in their homes.

Mr. Wright and his wife, Carvetta, an assembly line worker in a microchip plant, are in this situation, having purchased their three-bedroom ranch house several years ago for $64,500, obtaining a mortgage for the entire amount.

"I've done a lot of renovation, doing the work myself, and I would price the house now at $82,000," Mr. Wright said. He has worked the mortgage down to under $55,000.

But the family also owes $30,000 on a home equity loan the Wrights took out to pay off credit card bills and to help buy a car. With two teenagers, they were paying off the debt without undue sacrifice, Mr. Wright said, until his overtime suddenly stopped last June. Repair work at Northrop Grumman had slowed. The Wrights' combined annual income is about $54,000, and the overtime once added $10,000 a year. Without it, the payments on the debt continue, but family spending is curtailed.

"I am going to try not to draw down the $4,000 that remains on my
home equity credit line," Mr. Wright said. "We are trying to tough it out. We don't go out anymore, and we try not to buy the name-brand clothes that the kids want, none of that Tommy Hilfiger stuff. We had two dogs, and we got rid of one."

If Mr. Wright is worried, David Murphy, who owns a home in Madeira, an upscale Cincinnati suburb, certainly is not. The Murphys — he sells computer systems to hospitals, she is an electrical engineer — completed a lavish $130,000 kitchen renovation last year, borrowing the full sum to expand the space to make room for a stone fireplace and archway. They installed new custom cabinets, granite counter tops and a Sub-Zero refrigerator.

That was only the latest renovation to a three-bedroom home that the Murphys bought nine years ago for $225,000, putting $50,000 down and borrowing $175,000. The upgrades include an entertainment room and an outdoor cooking center, and the debt against the home has risen to $400,000. But Mr. Murphy is confident that he could sell his home for $550,000 today. A bank appraiser told him that the $130,000 kitchen remodeling raised the selling price of the home by the full amount spent on the renovation.

Is that accurate? Or are people overly optimistic about the values of their homes?

"We are stunned by the optimism that shows up in our surveys," said David F. Seiders, chief economist at the National Association of Home Builders in Washington. "The attitude used to be that remodeling is great, but don't expect to get it back in resale value."

Mr. Murphy could well be right about his home. But what if he is wrong? "There is not yet a problem with house prices," Mr. Seiders said, "but if this slow down continues, you could see problems."