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# Fed's Dudley Wants You to Refi (Safely, of Course)

Debt finances additional consumption.

That could be the summary of a speech given on Tuesday to the National Retail Federation's annual convention by William C. Dudley, President and CEO of the Federal Reserve Bank of New York. Dudley's remarks focused on the **connections between housing and retail sales** and why changes in the housing and mortgage markets "Have had important consequences for the dynamics of consumption over the last decade." These connections, he said, are among the reasons the recovery and economic expansion have been weaker than desired. The good news however, is that, while the current expansion is quite old in chronological terms, it is still quite young in terms of households' financial health.

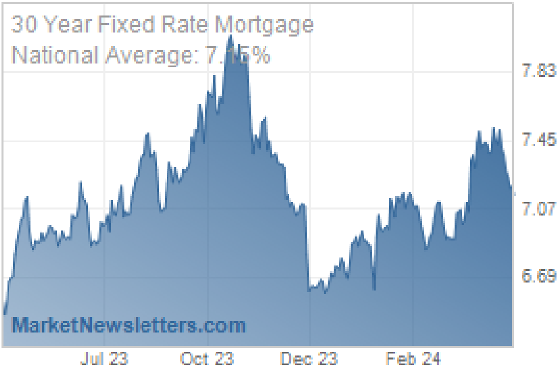
Household incomes tend to increase as individuals age, but ideally households would like to even out consumption based on their lifetime incomes, raising consumption in their earlier years. This would mean that young people would consume a relatively high share of their incomes while older people would save more. Young people might even wish to borrow against their future income to enjoy the benefits of consumption at a younger age.

But there are **constraints** on such a shift in consumption through borrowing. Lenders don't have a reliable way to compel repayment without a pledge of assets that can be claimed by the lender in the event of default. For most households the main form of wealth is human capital, but that is difficult to collateralize. The second most important household asset for many is their housing equity and it, for those that possess it, becomes the most important form of collateral.

This makes the performance of the **housing and mortgage markets** important to retail business, Dudley said. During the housing boom that started in around 1995 and ended in 2006, the aggregate value of real estate owned by households and nonprofits rose from $8.6 trillion to nearly $25 trillion.

What isn't as well known is that borrowing was growing almost exactly as fast. Households were **not** saving that extra housing-driven wealth, they were diverting a large share of it to other purposes. "The fraction of every additional dollar of households' housing wealth that was consumed seems to have been higher than that for financial wealth-such as investments in equities and bonds-suggesting that [homeowners] viewed the increase in

## National Average Mortgage Rates




| | Rate | Change | Points |
|---|---|---|---|
| **Mortgage News Daily** | | | |
| 30 Yr. Fixed | 7.15% | -0.05 | 0.00 |
| 15 Yr. Fixed | 6.63% | -0.03 | 0.00 |
| 30 Yr. FHA | 6.61% | -0.03 | 0.00 |
| 30 Yr. Jumbo | 7.39% | -0.02 | 0.00 |
| 5/1 ARM | 7.34% | +0.01 | 0.00 |
| **Freddie Mac** | | | |
| 30 Yr. Fixed | 7.09% | -0.35 | 0.00 |
| 15 Yr. Fixed | 6.38% | -0.38 | 0.00 |
| **Mortgage Bankers Assoc.** | | | |
| 30 Yr. Fixed | 7.24% | +0.11 | 0.66 |
| 15 Yr. Fixed | 6.75% | +0.11 | 0.64 |
| 30 Yr. FHA | 7.01% | +0.11 | 0.94 |
| 30 Yr. Jumbo | 7.45% | +0.05 | 0.56 |
| 5/1 ARM | 6.64% | +0.12 | 0.87 |

Rates as of: 5/9

## Recent Housing Data

| | | Value | Change |
|---|---|---|---|
| Mortgage Apps | Apr 24 | 196.7 | -2.67% |
| Building Permits | Mar | 1.46M | -3.95% |
| Housing Starts | Mar | 1.32M | -13.15% |
| New Home Sales | Mar | 693K | +4.68% |
| Pending Home Sales | Feb | 75.6 | +1.75% |
| Existing Home Sales | Feb | 3.97M | -0.75% |

home prices as permanent."

| | | Value | Change |
|---|---|---|---|
| Builder Confidence | Mar | 51 | +6.25% |

Dudley said a database the Federal Reserve developed with Equifax found that, between **2004 and 2006** households were increasing their cash flow by over $200 billion a year by **borrowing** against their housing equity. They supplemented this with another $185 billion in non-mortgage borrowing.

They were of course **mistaken** in viewing home price increases as permanent. Home values began to fall in mid-2006 and by 2008 there was a massive reversal in behavior toward equity and consumption. "People went from borrowing hundreds of billions of dollars per year and increasing their mortgage debt, to paying back hundreds of billions of dollars and reducing their mortgage debt." The $400 billion in net cash flow from increased borrowing sharply reversed to negative $150 billion by 2010. An increased pay-down in residential mortgage debt was the main source. This rapid reduction of more than $500 billion annually in resources for household consumption resulted in a sharp and prolonged slump in such expenditures during the Great Recession. "Typically, consumption growth slows but remains positive during a recession. In contrast, consumption actually contracted by over $300 billion during the Great Recession," he said.

Households continued to pay down all kinds of debt (other than student loans). Housing prices finally stabilized and began to increase again in 2012, but while values have risen over 40 percent since and are nearly back to pre-crisis levels, and while other kinds of debt, auto and credit cards have risen, housing debt has stayed relatively flat. "The previous behavior of using housing debt to finance other kinds of consumption seems to have completely disappeared. Instead, people are apparently leaving the wealth generated by rising home prices "locked up" in their homes."

This has been quite significant for the retail sector, Dudley said. If housing debt had risen apace with home prices since 2012-rather than staying flat as it has-then we would once again be seeing housing debt making about $200 billion in cash flow available for consumption. Instead, households are **diverting** about that same amount to paying down their housing debt - a difference of roughly $400 billion per year, or about 3 percent of total consumption.

Household behavior has apparently changed because of an **interaction between the supply and demand** sides of the credit markets. On the demand side, Dudley said:

- Consumers may have become **more cautious** about housing's value as a financial instrument, accepting that housing wealth, like other investments, can be transitory rather than permanent. Therefore, it is not prudent to spend too much from this source of wealth.
- The deep job losses of the Great Recession may have brought home the need for **precautionary savings**.
- Some potential homeowners may have, after experiencing the housing crisis, soured on homeownership altogether, and homeownership rates have declined, especially among younger workers. But there are also indications that consumers still view housing as a sound investment and reduced homeownership doesn't explain why people who still own homes have become less likely to tap their available equity to finance consumption.
- The housing crisis left a lot of **scars** - some lost their homes and saw their credit badly damaged while others watched it happen to their neighbors. Experiencing or witnessing these consequences may have led to a precautionary demand for preserving higher housing equity to guard against the risk of negative equity. Positive equity can provide a cushion in the event of job loss or another housing downturn.
- The demand to tap equity for consumption might also be constrained by a wish to **retain mobility** in case of a change in labor markets or merely a desire to upgrade a home or neighborhood.
- The Federal Reserve's accommodative monetary policy which has allowed millions to refinance into very low fixed-rate mortgages may also have **lessened** demand. As rates rise there is a higher cost to extracting equity through a cash out refinancing which has indeed been very low. Even other ways of taping equity such as second mortgage or home equity lines (HELOCs) are not being utilized and in fact these loans have been paid down more aggressively than first mortgages.
- There has been a **change in the distribution** of increasing housing equity which, while in the aggregate is back to pre-crisis levels, has gone disproportionately to older, wealthier households. Presumably, these households have less demand for credit to fund consumption while those who would like to convert housing wealth into retail purchases

have less of it, reflecting, in part, slower rates of mortgage balance paydown. In addition, younger and less credit-worthy households also experienced higher relative declines in homeownership rates.

Dudley said that demand-side factors are reducing equity extraction but there is a strong supply-side effect operating as well.

- Consumer credit data indicate that minimum credit scores for mortgage lending and **more rigorous underwriting standards** for HELOCs have playing an important role in limiting consumers' ability to convert equity into new consumption. He calls the drivers of this change in lender behavior complex but probably include a combination of more regulation and stress testing of bank portfolios and more conservative practices by Fannie Mae and Freddie Mac.
- Bank experiences from the crisis period have caused lender to reassess the degree to which they lean on collateral and to shift underwriting more toward the creditworthiness of the borrower. This is consistent with the fact that mortgage credit is now much harder to get for lower credit-rated borrowers than during the housing boom.

When and to what extent will households again start tapping into home equity, making it again a fundamental driver of consumption? Dudley said we do not want to repeat the experiences of the housing boom, "but there are prudent ways for households to access their housing equity." Still, several milestones have already passed that could have reignited lenders' and borrowers' appetite for home lending yet have not done so. Home prices stopped falling in 2010 which could have signaled that the worse was behind us, yet homeowners continued to divert cash into debt reduction. Home prices and equity resumed growing in 2012 and homeowners continued to deleverage, reinforcing the role of rising prices in rebuilding equity. Now both prices and aggregate equity are **nearly back to their peaks**.

Perhaps, we will soon see a recovery in equity extraction expanding consumption, he said, in which case the household saving rate will begin to decline. Alternatively, we may have a longer wait until both homeowners and lenders decide it is safe to go back in the water. "Whatever the timing," Dudley says, "a return to a reasonable pattern of home equity extraction would be a positive development for retailers, and would provide a boost to aggregate growth." In the meantime, consumption growth will largely be determined by income growth, the trajectory of wages and the strength of the labor market.