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Get Cash to More Families That Need It Now: Give Banks More Discretion to Make Home Equity Loans and Refinance Mortgages

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The economic dislocations caused by the coronavirus pandemic will almost certainly result in economic contraction. There have been calls for bold actions to attenuate the effects of this contraction and also to provide cash for struggling Americans whose incomes may be temporarily disrupted. But these actions, including direct cash payments to American households, will add to the federal deficit, and recent large fiscal deficits have tempered enthusiasm for immediate large federal outlays.

The pandemic will lead to a deep contraction that hopefully will be short. The more that national consumption can be smoothed during this time, especially for households that experience the largest temporary hits to their incomes, the quicker the recovery will be. There may be a way to allow American households to help themselves through this period and to lessen the need for more federal spending—by easing some of the restrictions on mortage lending, to allow Americans to access their single largest asset: their homes. The nation is in the midst of an emergency, desperate for liquidity and for current sources of secured spending. It is worth considering the value of tapping this source of liquidity.

Many limits were put in place to restrict mortgage lending after the housing boom of the first decade of the 21st century. One area that has been limited is cash-out refinancing. Since the crisis, Fannie Mae, Freddie Mac, and the Federal Housing Administration have all added rules that prevent borrowers from using a mortgage refinance to take out extra cash if that would leave them with less than 20 percent equity in their homes.[1]

There are also a variety of fees, underwriting requirements, and mandates that have made it much more difficult for borrowers with lower incomes and lower credit scores to qualify for new or refinanced mortgages. Even borrowers with above-average credit scores and high incomes sometimes cannot get approved for mortgages. It has also been more difficult for borrowers with nonstandard incomes, such as income from gig economy work, to qualify for new or refinanced mortgages. These are the borrowers who may be the most vulnerable to short-term disruptions to their incomes. But they are also the borrowers who have flexible and self-directed incomes. They can likely make up that lost income when the economy recovers.

The effect of new mortgage restrictions has been extreme. For instance, according to the Federal Reserve Bank of New York, home equity lines of credit peaked in 2009 at about $710 billion.[2] The outstanding amount of home equity loans has fallen nearly every quarter since then and is down to $390 billion today.

Furthermore, the Federal Reserve estimates that home equity has recovered so that, in the aggregate, American homeowners are less leveraged than they have been for most of the past 30 years.[3] Thus American homes can be a source of liquidity.

Approximately 81 million families in the United States are homeowners. They have home equity of nearly $19 trillion on properties valued at nearly $30 trillion. Hundreds of billions of dollars can be injected into the economy quickly to boost current spending without changing aggregate homeowner leverage more than a few percentage points. According to CoreLogic, more than 95 percent of mortgaged homes now have positive equity, and about 85 percent have more than 20 percent equity.[4]

When interest rates declined in 2003, there was a wave of tactical refinancing. In the fourth quarter of that year, mortgages worth $290 billion were originated for borrowers with credit scores above 760. In the fourth quarter of 2019, when borrowers again were taking advantage of low rates, $479 billion in new mortgages was issued to those borrowers with pristine credit—about 65 percent more than in 2003. Yet for all borrowers with credit scores below 760, originations in the fourth quarter of 2019 were only $273 billion, compared with $737 billion in 2003—a decline of 63 percent. The evidence suggests that there is demand for hundreds of billions of dollars' worth of tactical refinancing among homeowners with less-than-pristine credit. Temporary forebearance on postcrisis regulations that prevent some owners from tapping those assets could be a lifeline to struggling households and practically a free lunch for a federal government dealing with the fiscal constraints that prevent bolder actions.

One way to relax these regulations would be to create a carve-out. Currently, loans that are sold to Fannie Mae and Freddie Mac are considered qualified mortgages, which means that lenders are exempted from some regulatory liabilities on those loans. Similarly, Congress could create a temporary category—call it a coronavirus HELOC (home equity line of credit). These loans could be limited to lines of credit held on banks' portfolios, so there would be no federal risk exposure.

Coronavirus HELOCs could be defined as lines of credit originated during the second quarter of 2020 and held on the books of the originating bank. The bank would still be liable for all the normal dangers of lending: if borrowers default in the future, banks will need to seek recovery through foreclosure and suffer losses where foreclosure sales don't cover the amounts outstanding. But banks could be given temporary power to make loans based on their own discretion, without worrying whether federal regulators will second-guess their underwriting in the future if some loans default.

The cost to borrowers who would use a HELOC to get through this temporary crisis would be very low. A homeowner taking out a $10,000 HELOC at 4 percent would incur a mere $33 in monthly interest expenses as a result. Better yet, a relaxation of rules regarding refinancing might mean that millions of homeowners who have been denied refinancing because of newly tight underwriting could lower their monthly payments even after taking cash out, just like millions of homeowners have already done. Furthermore, the risks associated with lending before the 2008 financial crisis aren't relevant here. There has been no multiyear buildup of speculative debts. There is little chance that a wave of refinancing in the face of a pandemic is going to fuel a housing bubble.

Lending to borrowers with less stable incomes or with less equity in their homes is associated with more frequent defaults. The regulations implemented since 2007 have been motivated by the goal of reducing foreclosures, and that is commendable. However, those regulations are creating an unnecessary and destabilizing side effect if they end up forcing some families to default on their mortgages or sell their homes in the midst of a pandemic, even though they have equity in their homes that could be used to smooth over the disruptions of the pandemic.

One of the concerns about direct cash payments to Americans is that implementing such cash payments is very expensive and that it will be impossible to quickly administer that relief in a way that targets the households who need it. Creating a temporary avenue for secured bank lending will provide a way for American families to decide for themselves who needs short-term cash and to accept responsibility for paying for it later when the economy stabilizes. It will give banks the chance to inject cash into the economy and to help the Americans who need it without increasing federal debt.

ABOUT THE AUTHOR

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NOTES

1. Fannie Mae, Selling Guide *Announcement SEL-2014-13*, November 10, 2014; Freddie Mac, "Maximum LTV/TLTV/HTLTV Ratio Requirements for Conforming and Super Conforming Mortgages," accessed March 18, 2020, http://www.freddiemac.com/singlefamily/factsheets/sell/ltv_tltv.htm; US Department of Housing and Urban Development, "HUD Announces Agency Efforts to Reduce Risk from Cash-Out Refinance Lending," news release no. 19-114, August 1, 2019.

2. Federal Reserve Bank of New York, Center for Microeconomic Data, *Quarterly Report on Household Debt and Credit 2019:Q4*, February 2020.

3. Federal Reserve Bank of St. Louis, Federal Reserve Economic Data, "Households; Owners' Equity in Real Estate as a Percentage of Household Real Estate, Level (HOEREPHRE)" (dataset), March 12, 2020, https://fred.stlouisfed.org/series/HOEREPHRE.

4. CoreLogic, "CoreLogic Reports the Negative Equity Share Fell to 3.8% in the Second Quarter of 2019," news release, September 20, 2019.