Tessa: A new economic tool: A Temporary Equity Spend and Save Again system

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Introduction

The corona virus pandemic has caused and will cause severe hardship for nearly all countries in the world. Government expenditures have gone up dramatically in many countries and tax revenues will drop substantially. Unemployment levels will reach historical highs according to the International Labour Office. Worldwide some 1.6 billion workers will be severely affected[1]. Governments have helped companies to furlough staff and pay such staff from government budgets. Central banks have expanded Quantitative Easing activities and lowered interest rates to practically zero or in case of the ECB to below zero. On April 29th this year, the Fed left its target range for its federal funds rate unchanged at 0-0.25 percent and reiterated it is committed to using its full range of tools to support the economy hit by the coronavirus crisis. U.S. policymakers said that the on-going public health crisis will weigh heavily on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term.

Savings incorporated as equity in homes constitute a very substantial source of wealth in many countries. To give a few examples: in the U.S. the net worth embedded in homes was approximately U.S. $23 trillion as per February of 2020. The U.S. GDP for 2019 was $21.2 trillion. In 2018 in the U.K. the total household sector had a net worth in non-financial assets of £4.74 trillion. U.K.'s GDP was £2.11 trillion in the same year. In another example: in 2018, Italy had a home equity level of approximately €3.28 trillion with a GDP level of €1.757 trillion. Spain has a home ownership level of 76.2% far above Germany with 51.5% of households.

In many countries, the collective levels of home equity wealth -or in other words the savings locked into homes- are often a multiple of annual GDP levels. Why is it that these savings are not used at all to stimulate economies?

There are two reasons for it: The first one is linked to the banking sector. The latter can only turn an asset into a liability. The second reason is that part sales of a home are an untested territory in economic terms.

This paper will explain the economic option of a Temporary Equity Spend and Save Again (Tessa) system.

[1] https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/briefingnote/wcms_743146.pdf

1. The Why Question

As a consequence of the corona virus pandemic, governments are trying to do all they can in funding companies, large and small, and also in temporarily helping households to maintain some sort of income. Central Banks have opened the sluice gates to buy up mortgage and government debts as well as some corporate debt. Central Banks have lowered interest rates to a minute level, or even to negative levels as in the case of the ECB.

Will it do?

The hurricane that went and is still going through economies is one that cannot be judged by rational arguments. The cause is the corona virus pandemic that threatens the behavior of mankind in a manner not seen since the early 20th century. Since that time, the world has become a much smaller place, where trade and people's mobility have risen to levels unheard of a century ago. What happened in China was -in a matter of weeks-, spread around the world. No medicine was and is yet available to cure the disease.

The lock down that followed in nearly all countries hit their economies very hard. The IMF 's latest World Economic Outlook report expects Italy's GDP this year to drop by -9.1% and Spain's by -8.0%.[2] The U.K. Daily Telegraph of the 4th May this year had, in its business section, three headlines that sums up the mood of the corporate sector: "Corporate confidence slumps to an all-time low"; "Bank loan losses to pass £50 billion as households and firms struggle in debt,"; and "Warren Buffet ditches U.S. airlines as turbulence spreads to lessors".

One may draw the conclusion, as quite a few economists have done already, that this crisis will last longer and will have a more devastating effect on governments; on businesses and on households than any other financial crisis over the last 100 years.

All the more reason to consider whether there is a glimmer of hope in considering to temporarily unlocking some of the wealth built up over years of saving. Such wealth is embedded in home values.

In the introduction, it was already pointed out that many countries have a very high level of savings locked up in homes.

[2] https://blogs.imf.org/2020/04/14/covid-19-crisis-poses-threat-to-financial-stability

2. The how and how not question.

Starting with the "how not" question. Banks and the wider financial services companies are well suited to lend money in case a borrower wants a mortgage. A mortgage is meant to bridge the gap between the funds available to the purchaser and the price asked for the property to be purchased.

A totally different situation occurs when the owner of a home has, over time, made equity savings in the home and wants to cash in some of his/her savings. Banks, with shareholders and depositors to satisfy, cannot turn such type of savings into cash for free as their costs of funds is based on borrowing costs and on the need to remunerate shareholders. Assets owned by the homeowner are turned into a liability for the benefit of a bank. Furthermore banks do not usually want a house price risk, so their lending is based on the "borrower's" future income and cash flow levels to pay back the so-called loan. In the U.K. there are Equity Release lenders. However, they prefer a contract based on life expectancy of the owner. Such equity release is usually for elderly homeowners. The costs are high at between 4 and 6 percent interest per annum. At say 4.5%, the interest due can quickly built up due to the compounding effect of paying interest over interest and because the contract runs for the rest of the client's life.

Currently, the only other way to release cash out of one's property is to downsize. This is a rather drastic measure and one that brings a lot of other costs with it.

2.1 The macro picture

Central banks: the U.S. Federal Reserve, the Bank of England, the European Central Bank and the Bank of Japan have all practiced Quantitative Easing (QE). The Bank of Japan's QE activities started in the late 1980's. The Fed and the Bank of England followed in 2009 in reaction to the financial crisis of 2008 and the ECB was the latecomer in 2011 under Mario Draghi as President of the ECB.

In QE exercises, it is often claimed that the purchases made by central banks were assets, rather than liabilities. In a way, this is a correct picture. Central banks buy such assets from individuals and institutions that own the debt titles of governments and mortgagees. Sometimes corporate bonds are also acquired. However, the assets that were bought, like government bonds, mortgage-backed securities or corporate bonds, all do represent liabilities. Liabilities constitute debts, rather than savings.

Of course, the QE exercises did and still do pump money into circulation, but the main conclusion can be that such exercises first of all replaced ownership of debt titles rather than fund additional consumption. For instance, pension funds are big investors in government bonds. If they see a chance to turn such holdings into a profit, they will do so. However, the result will not be a large-scale increase in pension payouts in the current period.

What is an interesting item to study is the Federal Reserve Bank's balance sheet over the period 2008-2020[3]. The balance sheet of the Fed on the 15th of September 2008 showed an outstanding balance of $1 trillion. From then on the balance sheet total increased to $2.24 trillion by the end of 2008. By January 5 2015 it had grown to $4.5 trillion. Then a period of trying to lower the outstanding balance followed. By August 2019, the balance sheet had been reduced to $3.76 trillion. From then on, the balance sheet showed another period of rapid expansion. On the 20th of April 2020, the balance sheet total reached an nearly all time high of $6.573 trillion. The latest data are for the 29th of April 2020[4], where the balance sheet showed a total of $6.7 trillion. Government securities were held to the extent of $3.7 trillion and mortgage backed securities (Fannie Mae, Freddie Mac and Ginny Mae) to the extent of $1.6 trillion.

What does this imply for QE? Expansion is relatively easy, but QT (Quantitative Tightening) or the way back is very hard. A possible reason can be that the underlying assets of the Fed are based on borrowings by either the U.S. government or mortgagees. The U.S. government, in line with many other governments, does not create a positive medium term cash flow in order to reduce the volume of the outstanding debts.

To put this in perspective: In 2019, U.S. Federal government revenues were $3.46 trillion[5] and Federal government expenditure in the same year was $4.45 trillion, leaving a budget deficit of nearly $1 trillion. Total U.S. government debt stood at $22.67 trillion per end of fiscal 2019.

The $3.7 trillion government securities level held by the Fed is already more than the annual Federal Government revenue in 2019. This, in my view, shows the dilemma for the Fed, but also for all other central banks. What is going to be the source of their repayment? The current fiscal climate affected by the corona virus epidemic will show much lower U.S. government revenues over fiscal 2020 and a much increased government spending level; a worse case scenario compared to the 2008 financial crisis.

To help reduce the $3.7 trillion level of government securities held by the Fed, it could, in theory, suggest that taxes might need to be raised. In the current situation this would be catastrophic in economic terms, as the economy needs more expenditure rather than less.

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[3] https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm
[4] https://www.federalreserve.gov/releases/h41/current/h41.htm#h41tab9
[5]https://www.usgovernmentrevenue.com/

Most of the $1.6 trillion of the mortgage-backed securities portfolio held by the Fed, has a remainder maturity of over 10 years. This leaves little leeway for a quick recovery of the funds.

The conclusion out of the above is that QE, as it has been practiced by the main world central banks, has paid a somewhat scant attention to the sources of repayment for either the government securities or for the mortgage backed ones. This became clearer for the ECB with the ruling of the German Constitutional Court on May 4th 2020. Germany's Constitutional Court ruled that the ECB overstepped its powers in purchasing €2 trillion of government debt in the past five years. The court gave the central bank three months to prove that the purchase scheme was necessary and "proportional". If the ECB fails, the Bundesbank must quit the scheme and sell its €533.9 billion worth of German government debt, the court said, setting the stage for potential mayhem in bond markets.

Is there a choice? The simple answer is yes: link both QE and QT to household savings embedded in homes and a QE regime can stimulate consumer demand when needed and the QT regime can help lower the QE outstanding amounts over time.

2.2 The micro picture

In the introduction, the huge level of savings incorporated in homes has already been mentioned.

How can such savings be mobilized on a temporary basis?

One has to start with the needs of individuals for cash. With unemployment levels reaching new highs, with demand for consumer goods at an all time low for most products and with governments running up huge deficits as tax payments will drop substantially and expenditure levels have and will go up, the wealth of home owners occupiers can be used to stimulate an economy on a temporary basis.

A homeowner has the option to go to a bank and ask for a loan, but why should he/she. The homeowner has already accumulated savings in the home, savings made in previous periods. For instance in 2018, in Italy 72.4% of the country's total number of households owned their homes outright. On average such savings amount to about €200,000 per household. Why not give households the option to temporarily turn some of their wealth into cash, especially when the only demand from the fund provider would be that over time, this amount will be replenished out of future earnings.

2.3 The Tessa tool

The Tessa tool is a bank account specially designed to bring micro and macro economic objectives together. As the letters in the word Tessa indicate, it is a temporary facility. It is a home equity withdrawal facility, funded by QE from central banks. It is a household spending facility to stimulate economic growth after the worst financial crisis to occur as a consequence of the corona crisis pandemic. It is also a savings again facility, when after a grace period of say a year, the economy has picked up again and households can start saving again. It is also a QT (Quantitative Tightening) facility, as households start to save again and thereby reduce the outstanding QE amounts. It is furthermore a facility linked to the ability to save. In a side document, households need to agree to save 28% of their income annually and add these amounts to their home equity values again. In doing so households are less exposed to fixed amounts (like in a mortgage contract) as the savings are related to actual income levels. In good times a higher amount will be saved and in recessions a smaller amount will be saved. It is also a facility especially aimed at homeowners, who own homes below or just at the median house prices in their area. If couples, that own a home together, want to use the facility; both partners should be able to do so. Finally, as with most QE facilities, the interest rate applied is 0%. For banks offering the Tessa accounts, there are no bank solvency requirements; banks act as pay out and pay in administrators. For this service they could be paid 25 basis points in the first year and 15 basis points in subsequent years per facility. Such payments could come from a country's Treasury.

The request to make use of the facility should come from the home owner(s). The facility is meant only for owner-occupiers and not for landlords as the latter operate as a business. Such risks from businesses cannot be covered in a Tessa account.

The legal status of the Tessa Accounts will need to be defined by the Central Bank in each country that adopts the accounts. The valuation procedure to value a home should be made on basis of February 2020 data, rather than relying on scant data obtained during the corona virus period.

Some unscrupulous households might sometimes abuse such Tessa accounts. They might accept the funds, but refuse to resave when the option is open. In such cases a transfer to a loan facility with penalty interest rates might be considered. Such facility should come with a government guarantee to the banking sector and with the government's option to ultimately claim the property when, over a lengthy period, no savings were made.

A practical country example: Italy.

For Italy, a very rough calculation might be made to indicate the potential size of the wealth incorporated in homes and the size of QE that may be needed.

In 2018, Italy had a population of 59.3 million inhabitants. With an average household size of 2.6 persons per household, this translates into 22.8 million households. Of those households, 72% were outright homeowners or 16.4 million households. If the average dwelling is 100 square meters with an average price of €2,000 per square meter, then the average house price is €200,000. Of course there are great differences between cities and rural areas and between north and south Italy. A very rough estimate leads to an Italian home equity level of €3.28 trillion. If 50% of the households take up the offer for QE for 20% of their home equity, then the QE needed would be €660 billion. In comparison: Italy's GDP was €1.757 trillion in 2018. Probably a somewhat lower level than 20% might be wise as € 660 billion represents an injection of 37.5% of Italy's GDP. 10% might a better ballpark figure, depending on the take-up.

In the European case: the ECB would supply the QE funds at 0% to the Bank of Italy (central bank). This bank could transfer the funds to the local bank where homeowners keep their salary or pension accounts and into the Tessa account. After a, say a year, grace period the money flow could start to go in the opposite direction; from the Tessa account user back to the Bank of Italy and back to the ECB.

Countries with a substantial level of home mortgages.

In the U.S. and in most of the Northern European countries, home mortgages are quite common. For the U.S. it is striking that the total outstanding volume of home mortgages has not changed between 2008 and 2019, while the net worth embedded in homes has gone up quite dramatically. This is demonstrated in an article written for the National Association of House Builders in the U.S.[6] The conclusion is that since the last financial crisis in 2008, U.S. home owners have increased their home equity to an all time high in. The latest data from February 2020 show that home mortgage debts are currently at the same level as in 2008.[7]

For Northern European countries that wish to apply the home equity release method in the form of Tessa accounts, it is best that such accounts are opened with the same bank that has granted the original mortgage.

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[6] https://eyeonhousing.org/2019/03/strong-equity-cushion-formed-for-u-s-homeowners-by-2019/
[7] https://fred.stlouisfed.org/series/MDOTP1T4FR

3. Some conclusions

Economies around the world are in need of an economic stimulus. Such stimulus can come from Central Banks, but in a changed pattern. The high home equity levels built up after the last financial crisis can help to create Tessa accounts that combine the funding of such consumer expenditure out of home equity with the savings element that, after some time, replenishes such savings out of future income levels.

Economic growth levels will benefit, employment levels will benefit, companies' turnover will benefit, government tax receipts will benefit and life after the corona virus pandemic is over, will look less grim that most forecasters are hinting at.

In an interdependent world, what will help the world economies most is that the more countries apply the Tessa system, the quicker the world economic turnaround will occur.

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