Rebuilding the U.S. economy after the corona virus pandemic: a new Home Equity Release Method (HERM)

De Koning, Kees

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By

Drs Kees De Koning

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Introduction

At the time of writing, in many countries the corona virus has not reached its peak yet. The virus has led to unimaginable consequences for all types of businesses and for individuals.

Governments have shut down many economic activities, due to the possibility of ever increasing levels of infection. In some countries a total lockdown has been promulgated.

The measures taken, so far, in the U.S. and in many European countries all point to an unprecedented level of financial assistance for companies, for workers who have lost most or all of their income and of course for the health services.

During the 2007-2009 financial crisis about 8 million Americans lost their jobs. It has been reported that the White House estimates that the unemployment rate will go up to 20%, which would imply that by June/July 2020 over 30 million Americans would be unemployed. This statement was later denied.

Job losses mean income losses and defaults on home mortgages and other loans. The U.S.$ 2.2 trillion economic rescue package will cushion some of the losses, but companies need time to recreate employment. One cannot put a precise date on it, but experiences from previous crises has shown that it will be a matter of years rather than months, before the level of unemployment will have returned to the 5.8 million reported by the Fed as for February 2020.

In the past, the writer has analyzed the four sources of wealth in the U.S.:
Stock market values, U.S. government treasuries, pension savings (overlapping with stocks and bonds) and the net worth built up in homes.

The Dow Jones Industrial Average reached its peak on 12th February 2020 with a value of 29551; by 23 March 2020 it had dropped to 18592 or a drop of 37%!

U.S. government bonds and quantitative easing activities will increase by at least U.S.$2.2 trillion. Pension funds invested in U.S. stocks and in government bonds, will have shared in the fall of the Dow Jones and in the lowering of interest rates.

The only source of U.S. wealth, mostly untapped, is the housing stock net worth of just over U.S.$ 23 trillion. A new Home Equity Release Method (HERM) will be set out in this paper.

1. Current status in the U.S.

U.S. unemployment claims surged by over three million for the week ending March 21 2020 to 3.283 million, a record, according the Department of Labor (DOL). It is the first official reckoning of the devastating toll the coronavirus pandemic is having on the labour market.[1] "This marks the highest level of seasonally adjusted initial claims in the history of the seasonally adjusted series," the DOL said in its weekly report of claims by state. The previous high was 695,000 in October of 1982. However, the latest data for the week ending March 28 2020 show that unemployment claims exceeded the previous week by a large margin. Another 6.6 million workers made a claim.[2]

One cannot predict with any certainty whether U.S. unemployment levels will reach 30 million individuals. By October 2009, the total number of unemployed reached 15,352 million[3]; the highest level during the last financial crisis. The current unemployment level has already exceeded the highest point of 2009, and that has happened in just two weeks.

The impact on the U.S. economy will be felt in a number of ways. The first element is linked to the household disposable income levels, not only for those made redundant but also for those, for instance self-employed, who see their income levels drop. The lower disposable incomes will lead to less consumer spending levels.

The second element is linked to financial obligations. An individual who has been infected by the corona virus has other things on the mind rather than thinking of how to repay outstanding financial obligations. How to survive for the next days and weeks becomes more essential. This will have great repercussions on interest and principal payments on outstanding financial obligations. The latter may be student loans, car loans, mortgages and/or overdrafts. The obligations will weigh heavily on many households' incomes. Notwithstanding temporary help from the U.S.$ 2.2 trillion rescue package, many households will find it increasingly hard to service their debt levels. If they still continue to service their debts, it will be at the costs of consumption levels. Banks will become more cautious and as a consequence will lend less to individual households.

These factors combined will show up in a substantially lower level of economic activities over the coming months, if not years.

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[1] https://www.msn.com/en-us/money/markets/us-unemployment-claims-surged-a-record-3-million-for-week-ending-march-21-from-week-before-entertainment-hit/ar-BB11KgFQ

[2] https://www.bostonherald.com/2020/04/02/staggering-6-6-million-new-u-s-unemployment-applications-last-week-seek-as-layoffs-mount/

[3] https://fred.stlouisfed.org/series/UNEMPLOY

2. The loans that should not be loans

There is one element of households' wealth that can be used, but is currently not being used effectively. To analyse this phenomenon, one has to understand how the banking world works. If an individual or a household wants to buy a first home –in contrast to some practices preceding the 2007-2009 financial crisis- at least a 10% down payment needs to be made in order to obtain a 90% mortgage. The mortgage amount acceptable to a bank is linked to the income level of the (family) household. The bank will furthermore require that the loan be linked to the property acquired. In case the customer defaults on the loan, the banks do give themselves priority over all other lenders to claim all outstanding monies back from the property and banks will evict the occupants from the premises.

So far this is the current practice.

A household's intention is generally to repay the outstanding mortgage loan over a fixed period, usually over 30 years for the lower and median income families. What these monthly payments do is to pay for the borrowing costs of the mortgage loan. Such costs have an interest and a savings element. The savings element is the equity base owned by the household. This equity element gradually grows from the 10% down payment to 100% after 30 years if all payments were made on time.

In the run up to the 2007-2009 financial crisis, especially after 2004, some mortgage loans were granted on basis of 100% of the purchase price of a home; sometimes mortgage loans were offered at below market interest rates. Also speculators bought several homes in the expectation that the rents could pay for their mortgage obligations. Add on top that such mortgages were sliced and split into mortgage backed securities and sold on to the general public and the cocktail mix was complete for the financial crisis to occur. It is important to mention one further element: repossessions or in another term foreclosures.

Completed foreclosures are an indication of the total number of homes actually lost to foreclosure. Since the financial meltdown began in September 2008, there have been approximately 5.6 million completed foreclosures across the U.S., and since homeownership rates peaked in the second quarter of 2004, there have been approximately 7.7 million homes lost to foreclosure.[4] Using the Fed data on home ownership[5], in 2007 the level of home ownership was 67.4% out of the total number of households of 116 million. This translates in approximately 78

[4] https://www.consumeraffairs.com/foreclosure-rates-and-mortgage-delinquencies

[5] https://fred.stlouisfed.org/series/USHOWN

million homes. Repossessions over the years 2004-2014 counted for approximately just over 10% of the housing stock. It is highly likely, but it is difficult to prove that lower and median income families were most affected by the repossessions. What complicated and exacerbated the crisis was that home equity was turned into mortgage loans.

In Q1 2007 the median house price sold was U.S.$ 257,400 [6]. It took five years before the nominal median house price sold exceeded the 2007 level. In Q1 2013 the median house price sold did finally overtake the Q1 2007 price by a small margin. The figure was U.S.$ 258,400.

One potential conclusion is that the forced sales of some 10% of the housing stock over this period substantially extended the length of the financial crisis. The benefits to the banks or other holders of mortgage backed securities did not square well with the losses made by the owner-occupiers. In the next chapter an analysis will be made of what debt and equity in a home means for owners-occupiers.

2.1 The build up of equity in a home

A homeowner builds up equity in a home through the monthly mortgage payments. Equity is not a loan; it represents an asset for the owner, just like cash in a bank.

When clients ask banks for a release of equity out of a home, banks do not act as investors or as risk partners in the home. They will only accept a client if the client is willing to borrow the funds from the bank. An asset is converted into a liability and the households' own equity is reduced by the current and future liability. There is no sale of a share in the home or a bank cash payment for such share; only a conversion from an asset into a liability. A liability reduces future income flows by the principal and interest to be repaid. For households who experience a serious drop in incomes a fixed liability can easily turn into hardship or worse if the home is repossessed. In the latter case the equity built up in the home will be lost.

The release of home equity can only occur once the mortgage contract has existed for some time and the mortgagee has started building up the equity base from 10% to a higher percentage of ownership.

[6] https://fred.stlouisfed.org/series/MSPUS

U.S. households have collectively built up a fantastic equity base of U.S.$23 trillion in their homes.[7] The value of the U.S housing stock was U.S.$ 33.6 trillion in February this year according to the World Property Journal. With a collective outstanding mortgage debt level of U.S.$ 10.6 trillion[8], the net asset value was U.S.$23 trillion.

Of course, with the current corona virus pandemic, this amount may have been reduced somewhat.

What is indisputable is that the net worth locked up in U.S. homes is very impressive and that it has grown since 2008 not by borrowing more, but by saving more. The Federal Reserve statistic as quoted in footnote 7 assessed that in Q3 2008 the total outstanding level of home mortgages was U.S. 10.667 trillion (the highest level ever) and per Q4 2019 the level was U.S.$10.610 trillion. In the period between Q3 2008 and Q4 2019, the level of outstanding mortgages never exceeded the Q4 2019 level. Over this period individual households collectively saved in terms of home equity rather than consume more of their wealth.

2.2 Home equity should not be turned into a loan

The main lesson that can be learned from the 2007-2009 financial crisis is that equity release from a home with the method of additional mortgage lending is economically inefficient. Equity represents a saving made. A higher percentage of a home than the original 10% down payment has been saved up.

Home equity represents past savings. Whether one saves in a bank, in stocks, shares or bonds, none of these savings, if used, lead to more debt. Why is it that banks feel that home equity release needs borrowings? Is it, just because their main funding sources are customer deposits and that the latter require some form of compensation over the amounts placed with a bank?

For many lower and middle-income families, home equity is their main or only form of savings. Some will also have pension savings. The latter type of savings has a specific aim: to provide an income during the retirement years. Pension savings are therefore not suitable to be turned into cash early; even if such option would exists.

[7] https://www.worldpropertyjournal.com/real-estate-news/united-states/los-angeles-real-estate-news/real-estate-news-zillow-housing-data-for-2020-combined-housing-market-value-in-2020-us-gdp-china-gdp-rising-home-value-data-11
[8] https://fred.stlouisfed.org/series/HHMSDODNS

2.3 The Home Equity Release Method (HERM)

In a previous paper by this author[9]: "How home equity can be used to fight a recession. A U.S. case study", it was explained that the first priority can be to change the cash withdrawal mechanism from turning part home equity into cash.

The second priority can be that income levels could determine the level of savings to be converted into home equity. In the HERM method, lower incomes would lead to lower home-related payments. However one would still apply a fixed percentage of home-related payments out of the variable income levels. Savings in home equity could go up when incomes go up in high economic growth periods and savings could come down in recession periods. Dissaving – home equity withdrawal into cash- could be stimulated in recession periods.

The first priority is to change the cash withdrawal mechanism. If an individual household decides that there is more than 10% of equity in the property -owned and occupied by the household- and the household requires some cash, for instance in the current environment of a temporary loss of income, then in the current circumstances the only option is to take out a financial sector loan. In no other financial transaction, like selling shares or bonds or cars or other valuables, would the buyer not pay cash for the item that is handed over. The suggestion is that a part share of a home is treated equally to all other purchases and be paid for in cash.

The second suggestion is to simultaneously sign up the homeowner to agree to a payment ratio for the home of 28% of the monthly and/or annual gross income. This a recommended percentage, used by many U.S. financial sector companies, including Sapling[10]. However, banks fix the amounts to be paid on day one of the mortgage contract, irrespective of future income developments of the client. The HERM can change this and allow a fixed 28% payment of a variable income level, to be verified by U.S. tax returns.

Can banks operate within these priorities? Highly unlikely! The experience with banks is that self-preservation has the priority. They will do what is good for their shareholders but this may be unsuitable for the macro economic developments. For instance banks cannot cope with monthly payments based on declining income levels. However such a payments structure provides households with a relatively higher level of spending power on consumer goods, when economic growth levels are in decline. Secondly banks do not buy part shares in a home; as such exposure will mean that the banks are exposed to housing

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[9] RePEc:pra:***mpra***:99037

[10] https://www.sapling.com/7502861/much-house-can-buy-salary

market price risks. They prefer to relate a home loan payment just to income levels and therefore, for better or for worse, the payment risks are fully transferred to the banks' customers. This is fine for a starter mortgage, but not for a loan for a home equity conversion.

In conclusion system changes are needed to bring bank customer interests in line with macro-economic interests. A new Home Equity Release Method is needed.

2.4 How could HERM be implemented?

The U.S. government could consider setting up a separate vehicle to accommodate the changes that could facilitate funding the purchase of parts of a home, once households own equity levels exceed 10% of the market price. Such a vehicle could be called: A Mortgage Debt Stability Fund (MDSF).

Why should the U.S. government consider the set up of such MDSF vehicle?

There are basically three reasons for it:

The first one is macro-economic. An MDSF, once established, is capable of buying up part shares in homes at a speed of its own choosing. In other words, when economic circumstances deteriorate, like in the current climate, it can open the window for households to transfer such home ownership elements to the MDSF and get paid for it. The MDSF can decide on behalf of the government, how much of a total money injection into the economy it wants to see. When such level has been reached it can slow down or even close the window again. Rather than expanding government expenditure levels, the request to obtain the HERM facility is made by private households. The latter are only likely to do so if they are in need of immediate cash for current expenditure. Private households will facilitate the boost to an economy, rather than the government doing so. As of December 2019 private consumption in the U.S. contributed for 69% to GDP.[11] HERM represents a move away from Keynesian economics, whereby the government takes the initiative to stimulate an economy. In the HERM concept individual households will stimulate the economy through using some of their savings incorporated in their homes.

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[11] https://www.ceicdata.com/en/indicator/united-states/private-consumption--of-nominal-gdp

The second element related to the MDSF is linked to the assets that are provided. Quantitative Easing as it has been applied, was directed at purchasing existing securities. This method changed the ownership of such securities from private hands into public ownership. What matters is what the individuals or institutions who owned such securities before would do with the cash received. Most of these holders were or are already cash rich, so their incentive to spend the money received on consumption will be less than the one by a group of homeowners, who often have no other savings than their home equity. This is especially the case for lower and median income families. They should get priority from the MDSF. They are most likely to spend their savings element on consumption of goods and services.

The third reason is that Quantitative Easing of this type does not incur costs to a government The Federal Reserve creates the money. The benefit to the government is indirect. HERM will cause sales and income taxes to go up as part and parcel of the additional consumer spending levels. Lower unemployment levels will also help individual households as well as the wider economy.

Under the HERM scheme, a sale and buy-back arrangement for part units of homes can be done at 0% interest rates. This helps the U.S. economy to grow and pay more taxes. The latter will help the U.S. government to reduce faster its recently approved U.S.$ 2.2 trillion debt burden. The latter amount has been pledged for fighting the effects of the corona virus epidemic. HERM is a win for households, a win for economic activities, including employment levels and a win for the U.S. government in its tax receipts.

There is one operational element to be considered. Just funding the share of a home to be purchased by the MDSF will leave the rest of the mortgage loan in limbo. It would therefore be necessary to bring the whole remainder of the outstanding mortgage loan over from the existing lender concerned to the MDSF. In the U.S. a number of State Sponsored financial institutions, like Freddie Mac and Fanny Mae already help homeowners in getting the best market rates for their mortgages. These institutions can be very helpful when a loan transfer from a bank to the MDSF needs to be made.

The borrowers should make such a transfer request. Standard terms should be worked out for such transactions, but such terms should be neutral or generous to the borrowers, as banks have made mistakes in judging future income flows. In the past years of 2007-2014, such mistakes were for some 10% of their mortgage loans; this percentage may well be much higher in the current corona crisis.

3. The need to get as many households as possible in a home ownership position

In previous paper: “Inequality as a Source of Recessions and Poverty”[12] attention was drawn to the fact that households that did not or could not participate in the ownership of their home, did miss out on a substantial amount of money savings over their lifetime as compared to their fellow citizens, who did.

Providing equal chances to all could be a U.S. government’s aim, especially when all who wish to own their home, could be helped with a start up facility of 10% own equity and 10% government grant. Such help could be considered in the light of fighting future recessions, when part ownership transfers of homes could help save the U.S. economy from a severe downturn. This help should particularly apply to lower and middle-income families.

In the quoted paper, the long drawn out cycles were described between high levels of home ownership and high levels of tenants. The latest data suggest that there are still over 45 million households renting a home. These households represent about 112 million Americans who do not share in the savings built into their homes. Home ownership is not just an option; it is a remedy to fight recessions!

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Drs Kees De Koning
Chorleywood,
U.K.

The writer is an economics graduate from Erasmus University Rotterdam.
Worked for the International Labour Office (ILO), Bangkok and Geneva;
Worked for AMRO Bank, later ABN AMRO in Holland (Economics Bureau), London Branch, Country Manager Indonesia, CM China (Hong Kong), CM Japan, CM Denmark and finally CEO Asset Management, London with responsibility for Central and Eastern Europe for DC pension funds. Now retired.

[12] https://mpra.ub.uni-muenchen.de/98684/1/MPRA_paper_98684.pdf

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