

Bianco Research L.L.C.

An Arbor Research & Trading Affiliated Company

Independent · Objective · Original

Volume 18, No. 24

1731 North Marcey, Chicago IL 60614

www.biancoresearch.com

Commentary

Market Opinions and Topics of Interest

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March 19, 2007

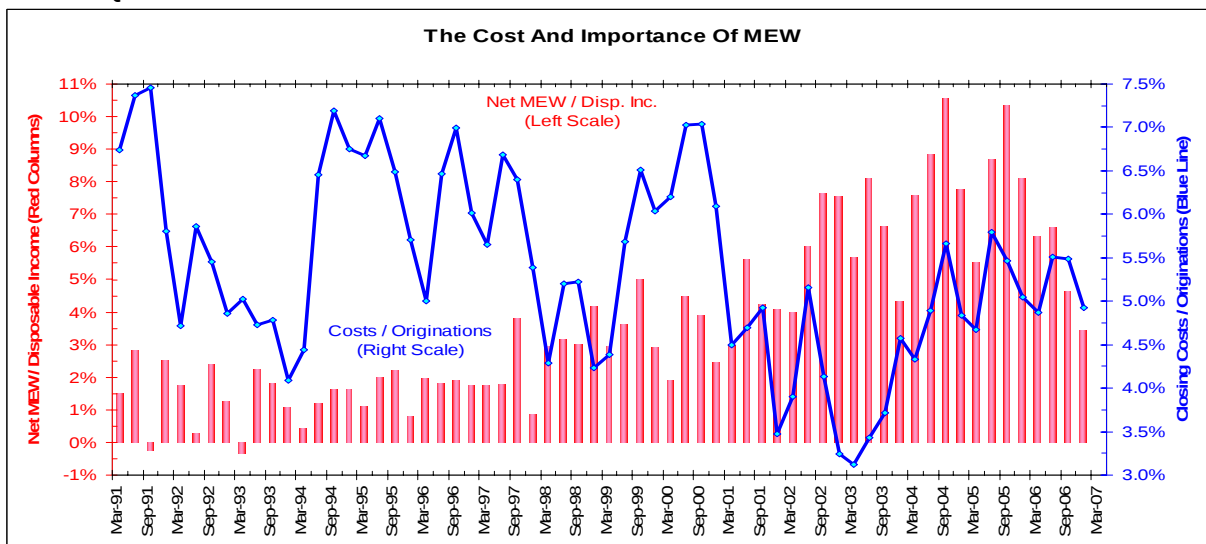
Impact Of Mortgage Equity Withdrawal

Alan Greenspan and James Kennedy of the Federal Reserve authored a [2005 study](#) of mortgage equity withdrawal (MEW). The analysis was motivated in large part by concerns homeowners were financing their current operating budgets out of household capital accounts. The ease with which second mortgages, cash-out refinancings and home equity lines-of-credit were obtained was part of the environment from which the present sub-prime lending morass emerged.

Net MEW as a percentage of personal disposable income (red columns) increased from 2.5% in 2000:Q4 to 10.5% in 2004:Q3. Competition amongst mortgagors to provide these services led to a drop in costs as a percentage of total mortgage originations (blue line) from 7.0% in 2000:Q3 to 3.1% in 2003:Q1.

That situation was correcting itself before the present sub-prime story became major news. Net MEW as a percentage of disposable income fell from 10.4% in 2005:Q3 to 3.4% in 2006:Q4, the last datum available, and as this number is not low by historic standards, a further decrease is likely. And the mortgage service industry has been able to push its fee capture of originations back to the 4.75-5.75% zone.

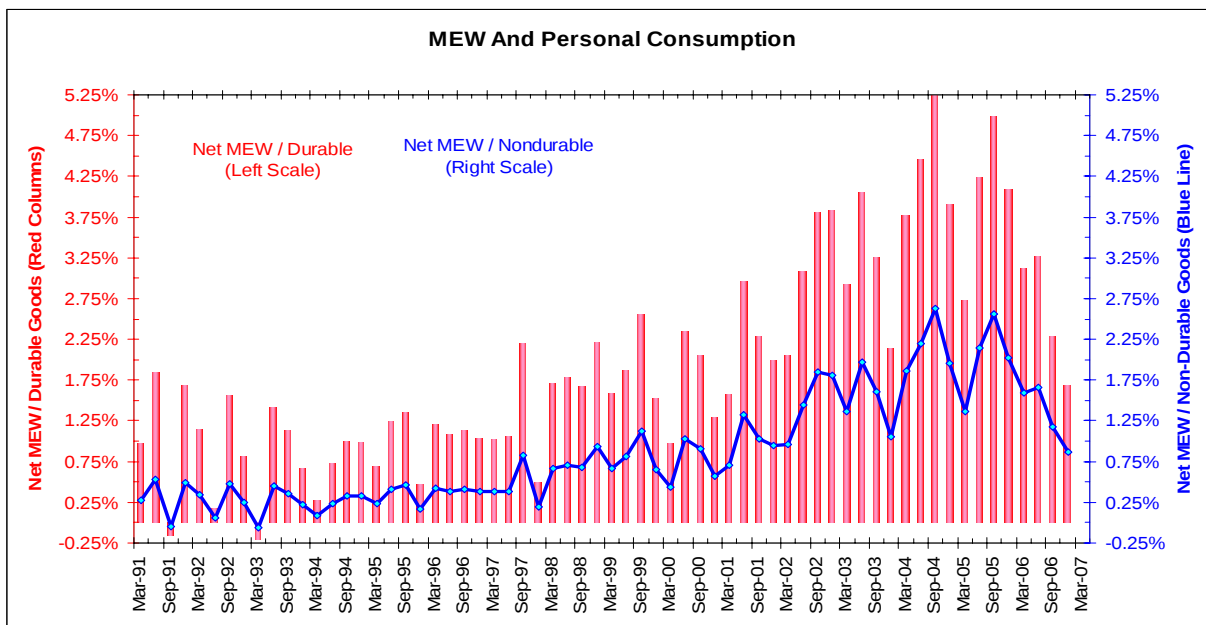
Will a further correction in MEW back to historic levels be a disaster for consumer spending? The answer appears to be, "No," when taken by itself. If taken in combination with downturns in other sources of personal income or other rising claims against that income, the answer could be different.



Uses of MEW

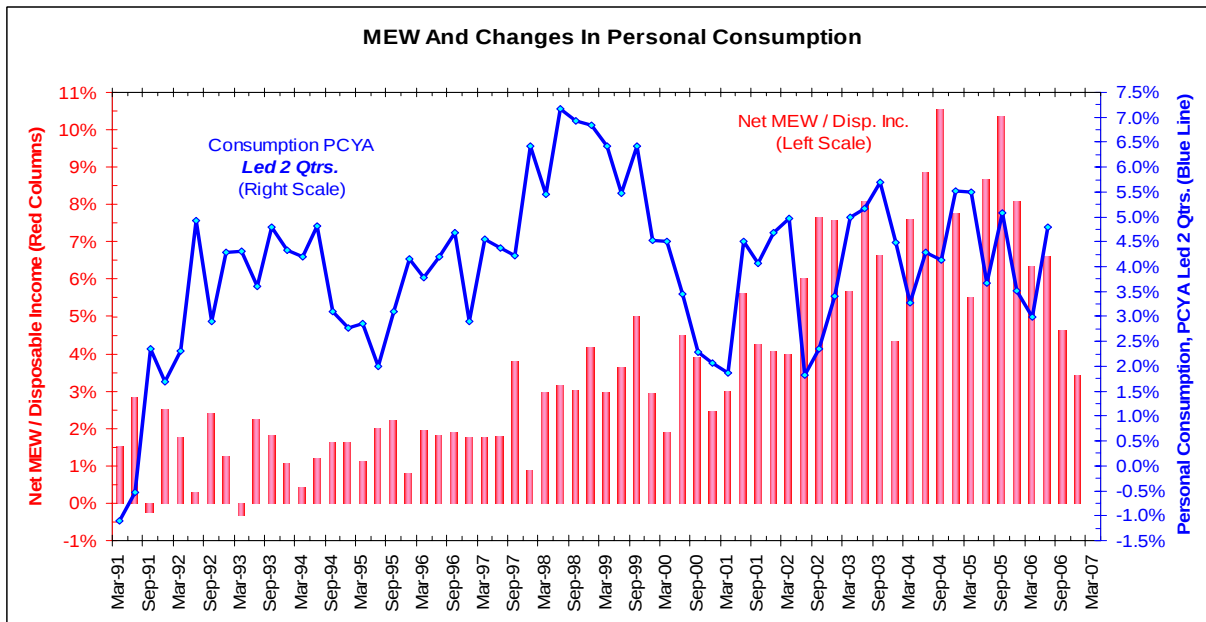
The American consumer has earned his or her place next to the proverbial drunken sailor in the annals of profligacy. Yet if we compare net MEW to consumption for durable and nondurable goods (red columns and blue line, respectively, following page), we see how much of the money borrowed against

housing went back into durable items, including home improvements and other assets with a capital-like quality. Spending on nondurable goods rose along with MEW, to be sure, but the image that capital assets were traded for current operating expenditures by households does not appear to be accurate.



Even more surprising is how little the percentage of disposable income represented by net MEW (red columns) affects year-over-year changes in total personal consumption led two quarters (blue line). The large surge in personal consumption in the mid- and late-1990s occurred with much lower MEW

levels than seen today, and even the large MEW levels of 2003-2005 did not lead to major increases in year-over-year personal consumption. **Restated, the American consumer did not mortgage him or herself to the hilt to finance a spending binge.**



Conclusion

It would be overly simplistic to say the downturn in housing prices and the reduction of mortgage credit at the margin will have no effect on disposable income or spending patterns. The 1991-2006 data available in the Greenspan-Kennedy study do not

subsume a period of declining home prices and/or decreasing credit availability.

But we can reject the notion American consumers were financing their spending by borrowing ever-greater amounts against what for many is their principal capital asset, their homes.

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