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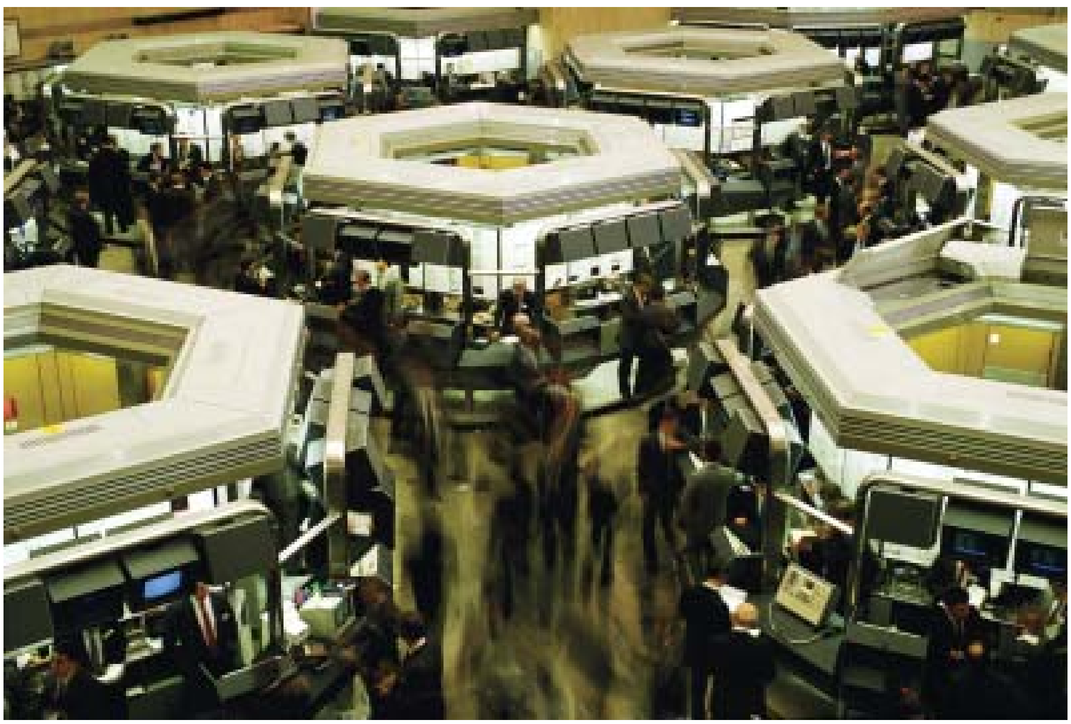
Refinancing and the U.S. Economy

The recent surge in refinancing activity has raised issues regarding the costs and benefits of refinancing for homeowners as well as for the economy.

By M.A. Anari and Mark G. Dotzour

Yields on 30-year, fixed-rate mortgages (FRM) peaked at 8.51 percent in May 2000. Since then, the rate has been falling in response to the cooling U.S. economy. From May to December 2000, the rate fell from 8.51 to 7.38 percent, well before the Federal Reserve Board's (Fed's) interest rate reductions.

Since January 2001, the Fed has cut the federal funds rate 11 times in an effort to keep the U.S. economy from slipping into recession. The drop in the Fed funds rate from 6.5 percent in January 2001 to 1.75 percent has mostly influenced short-term interest rates. The 30-year FRM rate decreased to 6.82 percent in September 2001, the lowest rate since January 1999.



The 1.7 percentage point drop in mortgage rates since May 2000 has sparked a refinancing boom (Table 1 and Figure 1). The volume of refinancing originations increased 230 percent from fourth quarter 2000 to first quarter 2001. Refinancing volume climbed to $251 billion in second quarter 2001, the highest level since fourth quarter 1998 when it reached $263 billion. Refinancing originations increased from 25 percent of total originations in fourth quarter 2000 to 55 percent in first quarter 2001, dropping slightly to 50 percent in second quarter 2001.

Microeconomics of Refinancing

Homeowners can benefit from lower mortgage rates in one of two ways. They can get lower monthly payments on their existing mortgage balance, or they can increase the amount owed on their mortgages, thus increasing their monthly mortgage payments in return for a lump sum to be spent as they wish (the cash-out option). Refinancing allows homeowners to either spend or save more.

Table 1. Mortgage Originations on One-to-Four-Family Residences First Quarter 2000 through Second Quarter 2001

	Originations (in billion dollars)			Share of Originations (in percent)	
Period	Total	Refinance	Purchase	Refinance	Purchase
2000 Quarter 1	200	42	158	21	79
2000 Quarter 2	276	41	235	15	85
2000 Quarter 3	286	49	237	17	83
2000 Quarter 4	262	66	197	25	75
2001 Quarter 1	396	218	178	55	45
2001 Quarter 2	502	251	251	50	50

Source: Mortgage Bankers Association and Real Estate Center at Texas A&M University

Mortgage refinancing is costly. Processing a new mortgage requires an origination fee, credit report, appraisal, hazard insurance, title insurance policy, closing fees and an escrow account. These costs may be paid in cash or added to the new loan balance. The number of months required to recoup these costs is an important component of a refinancing cost-benefit analysis.

In the past, refinancing was economically viable when the difference between old and new mortgage rates was about 2 percent (200 basis points). However, transaction costs of refinancing have been decreasing steadily since 1985. Monthly interest rate surveys by the Federal Housing Finance Board show that fees and initial charges on conventional fixed-rate mortgages have fallen from 2.56 percent (of the loan) in 1985 to 0.75 percent in 2000. The median balance of a single-family mortgage purchased by Freddie Mac in 2000 was $107,250. A 150-basis-point reduction in the mortgage rate thus results in an annual savings of $1,608.70 ($107,250 x .015) for a typical homeowner.

Mortgage interest rates are the key determinant of refinancing activity. As Figure 2 shows, higher levels of refinancing originations have been closely associated with lower mortgage interest rates, and lower refinancing volume with higher interest rates. For cash-out refinancing, house price appreciation is also an important factor because the maximum amount of the new mortgage is determined by the value of the home.

Figure 1. Mortgage Originations, First Quarter 1990–Second Quarter 2001

Source: Mortgage Bankers Association and Real Estate Center

In the 1990s, refinancing accounted for an average of 31.9 percent of all loans originated and ranged on an annual basis from 11 percent to 60 percent of loans originated. Over the same period, the mean value of 30-year conventional mortgage rates was 8.11 percent, ranging from a high of 10.3 percent to a low of 6.7 percent. Since 1990, the median sales price of new privately owned single-family houses sold in the United States has increased from $122,900 to $168,000 (in 2000), an increase of 36.6 percent (U.S. Bureau of Census, Surveys of Construction). The median sales price of U.S. existing single-family homes increased from $92,000 in 1990 to $139,000 in 2000, an increase of 51 percent (National Association of Realtors, Home Sales Surveys).

Figure 2. Refinancing First Quarter 1990–Second Quarter 2001

Source: Mortgage Bankers Association and Real Estate Center

Macroeconomics of Refinancing

Total refinancing originations in the first six months of 2001 stood at $442 billion. It is reasonable to assume that mortgagors who refinanced realized savings equal to at least 1 percent of refinancing originations; otherwise they would not have undertaken the refinancing process. Thus, in the first half of 2001, refinancing mortgages provided consumers with about $4.4 billion to spend.

If a cash-out refinancing is assumed to be equivalent to ten times the annual savings from refinancing, consumers may have gained $44 billion to spend. This represents about 0.6 percent of annual personal consumption expenditures and helps the U.S. economy at a time when businesses have cut investment expenditures, leaving consumers to become the saviors of the economy.

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