Discussion of

Housing Wealth and Household Indebtedness: Is There a Household 'Financial Accelerator'

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Introduction

- This paper considers the implications of the existence of unsecured debt for the response of household indebtedness to changes in house prices

- Taking the so-called *financial accelerator model* as the standard model of reference, the authors argue that

  Explicit consideration of the potential *substitutability* between secured and unsecured debt can help understand the empirically low impact of house prices on total household debt

- The evidence is based on data of the 1995 and 2000 waves of the British Household Panel Survey and is directed to find evidence of the *substitutability hypothesis*

Financial accelerator model

- Simple intertemporal consumption problem with housing in which the *perfect capital markets assumption* is modified:
  - Secured debt is households' only means of borrowing
  - Secured debt financing is subject to borrowing constraints

  [Bank practices also involve income-based or affordability constraints but authors focus on collateral constraints]

- The predicted effect of (positive) house price shocks:
  - Unconstrained households$\longrightarrow$ standard substitution & wealth effects $\longrightarrow$ ambiguous response in current consumption & borrowing
  - Constrained households$\longrightarrow$ collateral constraint is relaxed$\longrightarrow$increase in current consumption & borrowing

Puzzle & conjecture

- The microeconometric evidence in favor of the accelerator model is rather weak:

  Opposite to the importance of the above-mentioned responses in calibration exercises, the micro-evidence unveils a small response of current consumption & borrowing to the shocks

- The authors argue that the explicit consideration of unsecured debt may help us understand why

Alternative model

- *Alternative* model is actually an *augmented financial accelerator* model in which households can also access unsecured debt, which:
  - Charges higher interest rates than secured debt
  - Is not subject to collateral constraints
  - Involves lower adjustment costs [not formally considered]

- The central hypothesis is that collateral-constrained borrowers can use unsecured debt to satisfy their marginal borrowing needs:

  Households are likely to readjust their debt portfolio in response to house price shocks (without increasing total indebtedness so much)

The empirical contribution

- Evidence is based on a number of empirical correlations & reduced-form equations:
  - Documents importance of secured & unsecured debt in UK household financing
  - Explores the evidence in favor of the substitutability hypothesis by looking at debt restructuring (remortgaging, total indebtedness) between 1995 & 2000

    [exploiting cross-sectional variation in house price increases]

- The main results appear in Tables 2-5

Findings (i)

Table 2

Probit/Tobit evidence that

- Home-ownership is important for the access to unsecured debt
- Value of housing equity is negatively correlated with the intensity in the use of unsecured debt

Table 3

Tobit evidence that

- Unsecured debt is more intensively used by households whose LTV (in mortgage financing) is high,...
- Even after controlling for income, age, and other socioeconomic variables

Findings (ii)

Table 4

Probit evidence that

- Falls in LTVs (following an increase in house prices or a decline in the outstanding balance) increase the probability of *remortgaging*
- Effect is much more important for households with sizable amount of unsecured debt in 1995

Table 5

OLS and Heckman-type evidence that total indebtedness

- Does not significantly respond to changes in (self-reported) house value; not even among set of potentially constrained households...
- Only responds significantly, *positively* (and sizably) among "constrained households with high use of unsecured debt in 1995"

In sum

- Housing equity $\uparrow \Rightarrow$ Unsecured debt $\downarrow$
- LTV $\downarrow \Rightarrow$ Unsecured debt $\downarrow$ (the same?)
- $\triangle$LTV$*$Sizable unsecured debt $\downarrow \Rightarrow$ Pr(remortgaging) $\uparrow$
- $\triangle$House value$*$Constrained$*$Sizable unsecured debt$\uparrow \Rightarrow$Total debt$\uparrow$

What I am convinced about:

- Unsecured debt is more important than typically regarded
- Collateral constraints do not seem so important

What I am not convinced about:

- Nature of interaction unsecured debt $*$ borrowing constraints
- Unsecured debt is important for explaining why the micro-evidence on the operation of the household 'financial accelerator' is so small

Main criticism

- The paper provides indirect / reduced-form evidence that suggests unsecured debt is an imperfect substitute for secured debt when collateral constraints bind
- But fails to clarify whether its central hypothesis is accepted or rejected by the data
- Possible reasons for this failure
  - Theoretical underpinnings of the hypothesis are not fully stated (microfoundations of credit constraints & transaction costs)
  - Empirical part jumps probably too quickly into a number of indirect tests

Alternatives (i)

- The paper emphasizes opposition between standard accelerator model & augmented accelerator model... [but isn't the existence & use of unsecured debt somehow enough to reject the former?]

- Perhaps one should oppose a model of unsecured debt in which financial constraints play no role to another where they are central

- For instance, a model in which, because of the structure of transaction costs:
  - Secured debt financing dominates for the coverage of predictable, sizable, long-term needs
  - Unsecured debt dominates for unpredictable, small, transitory needs

Alternatives (ii)

- If this is a reasonable alternative story, I am not sure the current estimates properly *control* for it

  For example:

  – Unsecured debt never appears in isolation, but interacted with variation in LTVs & house value of constrained households

  – The alternative story would predict that after accumulating sufficient unsecured debt households might opt for remortgaging, if at all feasible

  – Couldn't some of the current coefficients reflect the bias due to having omitted this type of debt restructuring pattern?

Final remark

There is some literature on the microfoundations of the coexistence of secure & unsecured debt financing

For example,

- In a corporate finance context:

  Besanko & Kanatas (1993, RFS), Repullo & Suarez (1998, RFS)

- In a household financing context:

  Bar-Isaac & Cuñat (2006, "Long-term debt & hidden borrowing")