Does the Option to Extract Home Equity Affect House Prices?

Albert Alex Zevelev

Real Estate can be pledged as collateral for a loan at the time of purchase and after purchase via a home equity loan. My recent paper “Does Collateral Value Affect Asset Prices?” asks whether the ability to pledge an asset as collateral after purchase affects its price. Economic theory predicts the answer is yes: if households are credit constrained, they should prefer to own assets which facilitate their future ability to borrow.

The challenge to answering the question is to disentangle collateral value from other factors that affect house prices. The paper exploits law changes in Texas where home equity loans were illegal before 1998. The empirical strategy is to compare house prices in Texas zip codes to border zip codes before and after the law using a difference-in-differences estimator. The identifying assumption is parallel trends: that the law change was uncorrelated with other variables that affect Texas house prices. Research has linked this law change to the Tax Reform Act of 1986, a circuit court ruling in 1994 and growing Republican control in Texas. This assumption can be defended as these factors are not clearly linked to Texas house prices.

The impact of the law change on house prices was PHD: Positive, Heterogeneous and Direct. The law increased Texas house prices 3.5-5%. Pre-trends are parallel and the rise in prices was gradual. House prices rose more in inelastic locations, consistent with theory. Prices rose more in zip-codes with higher pre-law house prices, income and employment. This indicates that wealthier households value the option to extract home equity more strongly. Finally, variables related to house prices such as rent and income were unaffected by the laws. This indicates the rise in prices was due to demand for the option to extract equity.

References: