

Living On The Edge: Characteristics and Practices of Overextended Homeowners¹

This study describes characteristics and practices of homeowners who were experiencing financial difficulty during the early 1990s. Demographic information, financial characteristics, including financial ratios, and debt management characteristics and practices are reported. The findings illustrate the extent of financial difficulty experienced by overextended homeowners. Implications for educators and financial professionals are discussed.

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Introduction

The statistics are startling. Household indebtedness in the United States grew at an average rate of 10% per year during the 1980s. Between 1981 and 1990, the percentage of disposable household income consumed by debt service increased from 14.5% to 18.5% (Courtless, 1993). In addition, consumer debt ratios are believed to underestimate actual debt levels due to the growing use of home equity lines of credit and auto leasing. Both practices create "implicit debt" not reflected in government estimates (Consumer Debt, 1994).

In many cases, debt incurred in the 1980s was leveraged against an assumed increase in home equity which "evaporated" in many areas of the country. Increases in household income often did not materialize either. Between 1989 and 1993, all regions of the country saw significant declines in inflation-adjusted median income (Georges, 1994).

Hughes (1991, p. 44) notes that the 1980s were "a decade of economic confidence and robust consumer spending." The 1990s are quite different, described as an "age of anxiety" (Swoboda, 1993), due to many Americans' deep, underlying fear of joblessness. In 1993 alone, more than 2 million Americans were predicted to lose their jobs (Swoboda, 1993). Many have gone from earning over \$15 an hour to half that amount, often without benefits such as health insurance.

Housing expenses are generally the largest component of

most household budgets, consuming up to 40% of disposable income (Garman & Fogue, 1994). In many areas of the country, housing prices outpaced income growth during the 1980s (Powers, 1993). Of particular concern are the debt problems experienced by recent homeowners, especially those who bought at the height of the 1980s price growth. Many have since seen the value of their homes decline, some to the point of negative equity.

Refinancing may help some financially-strapped homeowners. Unfortunately, many others have been unable to refinance their mortgages because of substantially-diminished home values or high debt-to-income ratios. Many homeowners with negative equity and high monthly payments have had little choice but to stay put and continue making payments, sell at a loss, or rent their homes and try to cover the mortgage (Ravo, 1993).

This study was conducted to examine characteristics and practices of homeowners who have recently experienced financial difficulty. Demographic information, financial characteristics, including financial ratios, and debt management characteristics and practices are reported. Currently, little industry data exist on this topic. Monitoring of changes in homeowners' financial status is done infrequently or never, despite the availability of credit tracking systems through the three major credit bureaus (Harney, 1994). Traditionally, lenders check homeowners' credit, income, and debt ratio levels once, at the time of loan application. Homeowners experiencing financial difficulty often "juggle" other bills to pay their mortgage as long as

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possible. But, by the time they miss mortgage payments, their financial difficulties are usually substantial.

Related Literature

Household indebtedness has been a frequent topic of research by family economists. Ryan and Maynes (1969) studied data from the 1960 Survey of Consumer Finances and found that the greatest proportion of debtors in trouble were unmarried, poor, and under 25 or 65 and older. Households headed by women were more likely to experience debt trouble, as were those with a change in income. Caplovitz (1974) interviewed debtors who had been sued by their creditors and found that they were primarily working class, ethnic minorities, less educated, relatively young, and had marginal incomes. The single most important reason for default was some reversal in their flow of income.

Summarizing a number of studies, Heck (1980) profiled the typical insolvent household as low income, with a high debt level and a debt-to-income ratio over one (i.e., debts greater than earnings). The household was often in the early stages of family formation. Marital difficulties or divorce were also likely, as were heavy medical expenses. Educational and occupational levels were often lower than the general population and low aspirations, emotional immaturity, and fatalism were common.

A study of households with late or missed payments (Sullivan & Fisher, 1988) found that the percentage of borrowers who were slow payers declined as income, age, and educational level of the household head increased. Homeowners had lower slow payment rates than renters. The probability of slow payment also increased as the debt burden and ratio of consumer credit payments-to-income increased. Canner and Luckett (1991) found that households with rental housing, a divorced or separated household head, a household head under 35, and a high debt-to-income ratio had the highest proportion of payment difficulty. Most became overextended by taking on too much debt or experiencing an unforeseen change in their employment or health status.

Factors that distinguish households who repay their debts from those who do not was the subject of a study by Marlowe (1981). She found that debt-to-income ratio was a strong discriminator of ability to repay. Another was the existence of high medical debt, perhaps because the debt was due to an event beyond a household's control, rather than to poor management. Olson (1994) compared overextended households with controllable (e.g., overspending) and uncontrollable (e.g. medical) debt and found that those with debt unrelated to their spending habits were more likely to implement behavior adjustments to improve cash flow.

Researchers have also examined the usefulness of financial ratios as guidelines or predictors. Griffith (1985) proposed financial ratios representing four areas of personal finance: liquidity, debt, inflation protection, and net worth. Prather

and Hanna (1987) applied these ratios to household net worth data from the 1983 Survey of Consumer Finances and found ratios comparing liquid assets to another value to be useful indicators of a household's financial status. Iwuagwu (1989) found several financial ratios were statistically significant predictors of a household's financial security. DeVaney (1993) concluded that some financial ratios function reasonably well as indicators of changes in household financial status. In a subsequent study, DeVaney (1994) also found financial ratios, particularly those related to liquidity and the proportion of debts to assets, to be useful predictors of insolvency.

To summarize, the literature suggests that a myriad of factors appear to be related to household indebtedness, including income, educational level, marital status, age, ethnicity, stage in family life cycle, debt-to-income ratio, and housing tenure. Unanticipated life events, especially unemployment or the reduction of income, also are related to financial difficulty, as is the type and amount of debt that households incur. Financial ratios appear to be useful indicators of household economic status. The purpose of this study was to specifically explore characteristics and practices of overextended homeowners.

Conceptual Model

This paper is drawn from a larger demonstration and research project based on a conceptual model of housing stability developed by Parrott and Lytton (1993). A continuum of housing situations ranging from "stable housing" to "no housing" indicates that the risk of homelessness may increase as a household experiences one or more precipitating, or life, events. Situational factors, or household characteristics, may mediate or exacerbate the effect of these events. However, the result is a changed economic status. Depending on the extent of change in the financial situation and the availability of mediating factors, a threat of housing loss may result. Alternatives range from seeking cheaper housing to "doubling up" with others. Without intervention, the household may exhaust all resources and eventually become homeless. This study was designed to identify attributes of overextended households, in the early stages of an economic crisis, as well as factors related to their financial difficulty.

Data and Sample

Data for this study resulted from a U.S. Department of Health and Human Services homeless intervention project conducted by a county Cooperative Extension office located in the Washington DC SMSA. Purposes of the project were to identify risk factors which may threaten a low-to middle-income family's housing, to provide a computerized referral network for matching of available services, and to identify intervention strategies, particularly financial management education, which may avert a further decline in economic status.

The development of a database for scientific research was not

a primary project objective. However, the information needs for pre-screening clients for service eligibility and testing the intake and referral system made the development of a database for research a natural extension of the project. Nevertheless, limitations of the data should be considered when interpreting this research.

Generalizability of findings is limited because of the truncated self-selected sample representing households experiencing financial distress. Preliminary analysis, however, suggests a level of socioeconomic diversity not common to most convenience samples (i.e., a full range of age, income, and educational levels). Data accuracy is limited to respondents' knowledge of their financial situation and willingness to divulge information.

Two data bases resulted with the option of linking them for analysis. The first data base, with comprehensive expenditure and net worth statements, was a primary component of the intake and referral system. Using a computerized intake form, a trained volunteer queried participants about all sources of income, all expenditure categories, and a complete listing of assets and liabilities.

The second data base was derived from a 169-item questionnaire developed to identify risk factors characteristic of households experiencing a threat to their housing stability. One representative from each household was asked to complete the questionnaire as part of the pre-screening interview. Based on a comprehensive, cross-disciplinary review of literature on homelessness and financial distress, the instrument assessed financial attitudes and practices, levels of social support, family functioning, and several personality measures. Original items and scales were developed; however, previously-used items and scales were incorporated where possible.

Instrument revisions were made on the basis of pretests with representative respondents and service providers, and a pilot test with participants in the financial counseling program. Data were collected between January, 1992 and June, 1993. Of 765 clients providing information, 757 cases were usable. The other 8 files were omitted because of errors, omissions, or inconsistencies. For this study, the sample was limited to the 245 homeowners who completed both a financial profile and a questionnaire.

Findings and Discussion

Three types of sample characteristics are described below: demographic information, financial characteristics, including selected financial ratios, and debt management characteristics and practices.

Demographic Characteristics As shown in Table 1, young and middle-age households comprised the majority of the sample. The average age of households was 38. Eighty percent of the sample were not college graduates but 41.9%

had some education beyond high school. Almost 60% of the sample were white and another 30% were African-American. Gender was split almost evenly.

Over a third of sample households were headed by a single individual or single parent, although the majority were married. Gross monthly household income averaged \$2,497, or less than \$30,000 a year. The employment status of adults was known in all but 17 households. Over 60% of those reporting were one-earner households. The average number of children per household was two, with dependent children present in 82% of the households.

The loss or reduction of income was identified by project staff as the primary problem experienced by 55% of households. Medical bills or illness were the primary problem for 12% and divorce or separation for another 11%. Financial mismanagement was identified as a problem in about 5% of the cases.

Financial Characteristics Although the average net worth of sample households was \$35,543, fully a quarter of respondents had a negative net worth, i.e., liabilities greater than assets. Over a quarter of households had a net worth between \$15,000 and \$50,000 while 29.3% reported a net worth between \$50,000 and \$150,000. Only seven households (2.9%) had a net worth above \$150,000. The average value of household liquid assets (e.g., checking account, savings account, CDs, credit union) was \$708, with half the sample holding less than \$125 in reserve and 75% with less than \$585. Invested assets (e.g., stocks, bonds, retirement plans) averaged \$2,087 but 75% of the sample reported no assets of this type. Tangible assets, primarily the home, averaged \$112,452 and were, by far, the largest component of most households' net worth.

Table 1. Demographic Characteristics of Sample (N =245)

Demographic Characteristic	Frequency ⁵	Percentage
Age		
Less than 25	11	4.5
26 to 35	88	35.9
36 to 45	92	37.6
46 to 55	40	16.3
56 to 65	13	5.3
66 to 75	1	.4
Educational Level		
Less Than High School	12	5.0
High School Diploma	81	33.6
Some Post-High School	101	41.9
4-Year College Degree	31	12.9
Some Graduate School or Degree	16	6.6
Ethnicity		
White (Caucasian)	143	58.4
Black (African-American)	75	30.6
Other	27	11.0
Gender		
Male	117	47.8
Female	128	52.2
Gross Monthly Household Income (Earned & Unearned)		
Under \$1,000	23	9.7
\$1,000 to \$1,500	31	13.0
\$1,501 to \$2,000	46	19.3
\$2,001 to \$2,500	35	14.7
\$2,501 to \$3,000	32	13.4
\$3,001 to \$4,000	40	16.8
\$4,001 to \$5,000	17	7.1
Over \$5,000	14	5.9
Marital Status		
Single	13	5.3
Married	158	64.5
Single Parent	2	.8
Separated, Divorced, Widowed	70	28.6
Other (e.g., Shared Living)	2	.8
Number of Adult Household Earners		
None	19	8.3
One	138	60.6
Two	71	31.1
Number of Children in Household⁶		
One	90	36.7
Two	95	38.8
Three	45	18.4
Four	10	4.1
Five to Seven	4	1.6
Eight to Ten	1	.4

A debt-to-asset ratio was calculated by dividing each household's total debts by total assets. This ratio is a measure of a household's solvency and ability to repay debts (Garman & Fogue, 1994). The average debt-to-asset ratio was 1.8 (i.e., debt of \$1.80 for every \$1 in assets). A full 25% of the

sample had a debt-to-asset ratio greater than one and were technically insolvent.

Three additional ratios (see Table 2) provide more evidence of the extent of financial difficulty experienced by the sample. When monthly household expenses were compared to monthly net income, three-quarters of the sample needed to spend more than 100% of their income to cover these expenses. The average expense-to-income ratio was 1.78 (i.e., expenses 178% of net pay). The housing expense-to-income ratio was 50% or more for two-thirds of the sample. Thus, 50% or more of their income was consumed by housing-related expenses. Lytton, Garman, and Porter (1991) advise devoting no more than 40% of disposable income to housing. Almost 18% of the sample, however, spent more than 100% of their income on housing alone.

A third ratio, the back-end ratio used for mortgage qualification, compares monthly principal, interest, taxes and insurance (PITI) and consumer credit payments to gross monthly income. The higher the ratio, the higher the percentage of monthly debt repayment as a percentage of household income. Generally, total monthly debt payments cannot exceed 36% of gross monthly income to qualify for a conventional loan. This is a guideline established by federal housing agencies for mortgages sold in secondary markets (Dorfman, 1992). If sample households were applying for a mortgage at the time of the study, only 10% would probably qualify. The other 90% had back-end ratios over the 36% industry standard. Over two-thirds spent more than half of their gross income on debt repayment, including a mortgage.

Most respondents' financial situation worsened during the previous year. In response to the statement "Overall, I am more in debt than this time last year," over 80% of the sample agreed or strongly agreed. The average number of creditors owed by sample households was 6.8, although 43.3% owed only one creditor. About a quarter of the sample owed more than five creditors.

Most respondents had a relatively short housing tenure. The average number of years remaining on mortgages was 24. Over a third (36.6%) also had a second mortgage or home equity loan and almost half (49.6%) had made expenditures for home improvements during the previous three years. The average monthly mortgage payment (PITI plus any second trust or home equity line payment) was \$1,120. Over half reported a monthly payment in excess of \$1,000.

⁵Number of respondents may not total 245 due to non-response.

⁶Includes adult children living at home.

Table 2. Selected Financial Ratios of Survey Respondents (N= 245)

Expense/Income Ratio	Frequency ⁷	Percentage ⁸
.20 to .35 (35%)	1	.4
.3500001 to .50 (50%)	2	.9
.5000001 to .75 (75%)	9	3.8
.7500001 to 1.00 (100%)	48	20.3
1.0000001 to 2.00 (200%)	135	57.2
Over 2.00 (more than 200%)	41	17.4
Housing Expense/Income Ratio	Frequency ⁷	Percentage ⁸
0 to .20 (20%)	2	.8
.2000001 to .35 (35%)	21	8.9
.3500001 to .50 (50%)	58	24.6
.5000001 to .75 (75%)	84	35.6
.7500001 to 1.00 (100%)	29	12.3
1.0000001 to 2.00 (200%)	30	12.7
Over 2.00 (more than 200%)	12	5.1
Back-end Mortgage Ratio	Frequency ⁷	Percentage ⁸
0 to .36 (36%)	24	10.1
.3600001 to .50 (50%)	48	20.3
.5000001 to .75 (75%)	85	35.9
.7500001 to 1.00 (100%)	34	14.3
1.0000001 to 2.00 (200%)	29	12.2
Over 2.00 (more than 200%)	17	7.2

Debt Management Characteristics and Practices The debt management characteristics and practices of sample households raise a number of "red flags" that are indicative of overextension. Over three-quarters of the sample agreed that they: have little or no money available for a downpayment on purchases, worry about monthly credit payments, have received overdue notices from creditors, and have received calls or letters from creditors' legal departments. Over 80% indicated that a temporary decrease in household income would likely cause a major financial emergency and that it costs more to live than the amount of money they have coming in. About two-thirds said they were reluctant to open mail for fear of finding more bills.

Most of the sample did not, however, believe in borrowing their way out of debt. Over half disagreed that they regularly borrow money from people they know and almost 75% disagreed with the statement "Purchases which were previously paid for with cash are now purchased on credit." Over 90% of the sample indicated that they had not recently obtained new credit cards.

Conclusions and Implications

In the largest empirical study of consumer bankruptcy in the United States (Sullivan, Warren & Westbrook, 1989), more than half of over 1,500 sample debtors filing bankruptcy were homeowners. Yet, these same households once survived a credit check and met mortgage qualification ratios at or below

prescribed levels. The researchers, noting this irony, wrote "this high proportion [of homeowners] suggests a certain fragility in factors that make people economically safe" (p. 141).

Results of this study provide insights into characteristics and practices of overextended homeowners. Many experienced a significant life event, especially unemployment, and some were just an event or paycheck away from financial disaster. Young or middle-aged, the majority with high school or some post-secondary education, the average household earned almost \$20,000 less than the \$49,370 median income for the county where data were collected (Virginia Center, 1993). Monthly mortgage payments for more than half the sample, however, exceeded \$1,000.

Other sample characteristics were inadequate emergency savings, a lack of invested assets, and, for 25%, a negative net worth. Many households owed more for monthly expenses—even just housing expenses—than they earned. Contact from creditors was frequent and financial ratios appeared to have declined significantly from what they must have been at the time the homeowners had obtained their mortgages. The respondents did not, however, appear to rely on credit to "solve" their problems.

A need for homebuyer education is evident from the results of this study. Over half the sample owned their homes for five years or less. Seminars need to stress integrating housing costs into existing monthly expenses and setting money aside for financial emergencies, maintenance, and home improvements. Qualified financial counselors are needed to educate and counsel homebuyers both before and after their purchase.

Consideration should also be given by mortgagees to periodic reviews of homeowners' credit files. The technology already exists to do this. Lenders could then flag rising credit card or loan balances and, perhaps, changes in employment status. Specific "triggers," such as two or more late payments, could alert lenders to possible problems (Harney, 1994). Homeowners could then be contacted in the early stages of financial difficulty to develop proactive remedies to prevent default. Privacy issues are a concern, however. Safeguards need to be instituted to insure that information is used for credit-tracking purposes only, with the intent to provide remedial, not punitive, interventions.

A third implication of this study is the need for homeowners to increase their liquid assets. Seven hundred dollars is not much of an emergency fund! The often-quoted guideline of three to six months' expenses is a pipedream for many families. Strategies to make saving relatively "painless" need to be taught by Cooperative Extension faculty and others providing financial planning information to youth and adults.

Unemployment was a problem for many in this sample.

⁷Number of respondents may not total 245 due to non-response.

⁸Percentages may not total 100% due to rounding.

Homeowners also need to be convinced to sharpen their employment skills to stay "marketable" in the current economic environment. Blind loyalty to one employer or career can threaten financial security. The majority of the sample earned less than median income and were not college-educated. Levy and Michel (1991) note that it is harder now for high school graduates to earn their way into the middle class than it was 10 years ago. Additional training or upgrading of skills may be necessary.

Another implication of this study is that maintaining a home today, especially in an expensive metropolitan area, may not be possible without two paychecks. In almost two-thirds of the sample, there was only one wage earner. Interestingly, in the bankruptcy study by Sullivan et al. (1989), only about a third of the wives in that sample were employed also. Levy and Michel (1991) note that young families without two earners appear to be falling further behind in their efforts to achieve upward mobility.

Finally, mortgage underwriting standards need to be stringent enough to allow only truly qualified borrowers to obtain mortgages. Back-end ratios of up to 41%, and sometimes higher if other qualification standards are exceeded, are allowed for some loans. The advisability of committing such a high percentage of income for housing may be questionable.

This study explored characteristics and practices of overextended homeowners. Future research, using multivariate statistics, might determine to what extent these traits explain homeowners' financial difficulty. Results of this research increase understanding of borrowers who have recently become overextended.

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