Journal of Student Financial Aid

Volume 20 | Issue 3 Article 3

12-1-1990

A Question of Equity: The Effect of Home Value On Need Analysis

Sean McHugh

A Question of Equity: The Effect of Home Value On Need Analysis

by Sean McHugh

Sean M. McHugh is a Corporate Research Analyst at the New England Education Loan Corporation.

Mandatory need analysis for federal financial aid programs determines what a family can reasonably contribute toward higher education costs. In most cases, the need analysis system accurately reflects a family's ability to contribute toward funding a college or university education. But in the last several years the system used to determine need has shown inequities to families in certain regions where home values have increased at much faster rates than in other parts of the country.

Need analysis uses the Congressional Methodology (CM) to determine a family's financial situation. CM uses a family's adjusted gross income and discretionary assets, such as a home, to determine all sources of liquidity available to pay for postsecondary education. Home value, defined by CM as assessed value less outstanding debt, is an important factor used to calculate an estimated family contribution (EFC). However, high home values in certain regions of the U.S. prevent families with limited incomes from borrowing against available equity to cover their education expenses; their monthly income simply cannot meet the additional debt service requirement that a home equity or consumer loan would demand. In other words, home equity is a source of liquidity only when there is an existing ability to repay the credit. For many families with $30,000 incomes or less, this ability to borrow based on their high home value does not, in some cases, exist.

The disparity between the national standards employed by CM and the actual effect of regional home values on EFC has resulted in the filing of legislation in Congress which would alter CM's asset calculation procedures. Most bills call for eliminating the use of a family's home equity in all EFC calculations for families with gross incomes of $30,000 or less. Sponsors of this legislation, including Rhode Island's Democratic Senator Claiborne Pell, Chairman of the Senate's Subcommittee on Education, argue that in some sections of the country home values are so inflated that equity loans or secured consumer loans for higher education are impossible to repay. Counting assessed home value (less outstanding debt) as a source of liquidity, which is exactly what CM does, in many instances records a nonexistent cash-flow, and incorrectly assesses a family's true financial need.

The Issue of Home Equity and Cash Accessibility

CM assumes that discretionary assets are a form of immediate liquidity. However, the theory behind discretionary assets can be misleading in many circumstances. Assets being "available" to pay for education expenses depend on their ability to generate cash. This holds true when considering such assets as cash reserves, or the capital

raised by the sale of securities or investment property. However, a family's home cannot in many instances generate liquidity in the same manner as these assets, because cash generated from a family's home, such as a home equity loan, must be repaid. Repayment responsibilities can often restrict a home owner's ability to obtain funds.

Short of selling the home for cash (an occurrence which almost never happens in non-emergency situations), home equity loans, personal loans, or private supplemental loans are the only methods available to home owners to obtain liquidity to meet college expenses. However, a family's home can increase in value at a much faster rate than a family's yearly income, creating a situation in which total equity is too high to support repayment. In other words, a family's income may not be sufficient either to borrow against their home or to repay a consumer loan. This situation is occurring in a number of regions, including the Northeast, California, the farm regions and some sections of the South.

After conducting a series of need analyses, the results showed that EFC differs greatly according to geographic regions when income is held constant at $30,000. These variances in EFC are directly related to the inclusion of home value as a source of liquidity. For example, EFC for a family of four living in San Francisco on a $30,000 annual income is $7,278 while for a family in Kansas City with the same income and family size, it is $2,945.

Using hypothetical examples shows that CM's current assessment of home value in EFC calculations is inequitable to students in certain regions of the U.S. because it prohibits them from receiving the same financial assistance that equal families receive in areas with lower assessed home value.

Home Value's Effect On EFC

To illustrate this inequity, a series of need analyses was conducted using a hypothetical, but average, family situation. Each test used constant data elements combined with changing data to yield an EFC.

The family income used in the analyses was $30,000, primarily because an adjusted gross income of $30,000 was the determining income for a need analysis prior to enactment of CM. The student in the need analyses was a dependent freshman. No student assets were used, as it was assumed that not many freshmen can realistically contribute enough funds to affect college costs. The student was not considered a displaced homemaker, a dislocated worker, a veteran, or a ward of the court.

Throughout the test the parents were married, the older one was 45 years old (because this is the median age in CM's Asset Allowance Protection Allowance table), and the family size was four. Also, the number of U.S. income tax exemptions was four, with two children in college. The family size was derived by the fact that CM uses a standard family of four when calculating cost of living adjustments. An amount of $3,000 in savings was used and was a randomly chosen amount.

The elements which changed for each test were home value, remaining mortgage debt, and state of residence. Four metropolitan areas were chosen specifically for their varying cost of living indexes according to the American Chamber of Commerce's Cost of Living report: Boston, Fort Lauderdale, Kansas City, and San Francisco. The median home values used in each test were obtained from the National Association of Realtor's (NAR) Monthly Home Sales, December, 1988. The equity applied to each needs test was actual (estimated) equity, and 50 percent equity.

Each need analysis was implemented through the use of ABLE, a need analysis software issued by the New York State Higher Education Services Corporation. The software, updated for use in the 1989-90 academic year, calculates student, parent, and total estimated family contribution, as well as the Pell Grant Index. All data elements approximate the tables and formulae of the Congressional Methodology, and are certified for use by the U.S. Department of Education. The equity figure was calculated by using the national average mortgage rate in 1969 of approximately 7.75 percent for new homes, with a term of 25 years (also the average in 1969). The original purchase price is according to the NAR's Monthly Home Sales, 1969. CM defines home value as assessed value less outstanding debt. Therefore, outstanding debt was calculated using a Mortgage Amortization Table, and subtracted from the December 1988 average home value obtained from the NAR. Taxes were not included in the calculations.

Need Analysis A

The following figures show EFC by selected cities, assuming actual home equity, a $30,000 adjusted gross yearly income, a family of four, with two children in college. The student budget is derived from the average cost of tuition, room and board for a public, four-year institution in 1989-90 (estimated), as published by the *Digest of Education Statistics,* U.S. Department of Education.

City	Home Value (median)	Family Contribution	Estimated Student Budget	Estimated Need
Boston	$183,000	$5,871	$5,431	NA
Fort Lauderdale	82,400	3,466	5,431	$1,965
Kansas City	67,100	2,945	5,431	2,486
San Francisco	228,000	7,278	5,431	NA

The estimated need for the families from Fort Lauderdale and Kansas City will be met by federal loans, grants, and other forms of aid. However, the FC will be an out of pocket expense for the family regardless of the type or amount of aid received. As seen by the figures, the families from Boston and San Francisco do not qualify for any federal financial aid, and will have to contribute more to funding higher education costs than the families from Fort Lauderdale and Kansas City, *even though all of the families have an income of $30,000.* CM's policy of considering home equity as a form of liquid-

ity has, in effect, assumed a non-existent cash flow for the families from Boston and San Francisco based on assessed home values, when in fact accessibility to cash from this source is often financially burdensome, and in most cases impossible to acquire for families in this income range.

The ability to secure a home equity or other consumer loan is based upon a family's debt to income ratio. A $30,000 annual gross income for a family of four, after taxes, mortgage payment, car payment, monthly utility payments, and basic expenses such as food and clothing, would in many cases create a situation in which the existing ratio would not be able to support additional debt.

Need Analysis B

The following figures are the results of a need analysis assuming 50 percent home equity, at a constant income of $30,000 a year, for a family of four. CM automatically adds a $700 student contribution for all freshmen. In the actual tests, no student assets were used. The median home value is derived from the National Association of Realtors.

City	Home Value (median)	Estimated Family Contribution
Boston	$183,000	$3,594
Fort Lauderdale	$82,400	$1,940
Kansas City	$67,100	$2,358
San Francisco	$228,000	$4,722

Again, the results show that the EFC is very different for each city, even though income, family size, number of college students, and equity amount is held constant. Although some calculations in CM adjust for regional cost of living, the actual affect is still biased against families in certain regions, such as Boston or San Francisco, when home value is used in the contribution calculation.

Conclusion

The figures shown in this study are quite clear. A family from Boston, with an annual income of $30,000, is in effect penalized by CM because of the area's inflated home values. The same can be said for families in San Francisco, Atlanta, New York, Los Angeles, and some areas in the farm belt. The value of a home increases in most instances as a result of market forces, not from conscious decisions of home owners. If home value increases to a point where the amount of available credit outweighs a family's ability to repay, the "cash source" disappears. CM does not consider this circumstance.

CM should be adjusted to include an element within its standard calculations to estimate a family's ability to borrow against home equity, and must also recognize that some assets cannot necessarily be converted to cash. Home equity is, in effect, non-liquid if obtaining the available funds places a financial hardship on a homeowner.

Those families with equal abilities to pay should contribute equal amounts toward their children's higher education, but equal

assets on paper do not necessarily show an actual ability to contribute. Such is the case between the family from the Boston area and the family from the Kansas City area: when every important element is held constant except home value, the EFC's differ by over $2,900. Moreover, a $30,000 income in Kansas City goes much further in real buying power than it does in Boston. So why is the family's EFC in Kansas City lower than the family's from Boston? The answer lies in the fact that the average home value in the Boston area ($183,000) is nearly three times higher than the average home value in Kansas City ($67,100). In terms of real dollars, the family in Kansas City making $30,000 a year is better off than the family making $30,000 in Boston, yet it is the family from Kansas City that qualifies for more financial aid, according to CM's calculations.

"Equal assets on paper do not necessarily show an actual ability to contribute."

There are a number of proposals calling for a restructuring of CM currently pending in Congress, including Senator Pell's proposal to reinstate the $30,000 income cap when considering home value. Specifically, Senator Pell's bill calls for eliminating from CM a family's home equity from all asset calculations for families with annual gross incomes of $30,000 or less. The House version calls for eliminating home value from CM for families with annual gross incomes of $40,000 or less.

However, it should not be suggested that the consideration of assets in CM's calculations be eliminated. Undoubtedly, assets are a fundamental component of a family's overall financial status. On the other hand, it should be strongly suggested to build into CM an alternative calculation - an adjustment table of sorts - which would weigh heavily a family's ability to repay any borrowed funds secured against home equity. Real, verifiable financial need does in fact exist in situations where home equity outpaces an ability to repay credit. ✦