A House of Cards

Refinancing the American Dream

BY JAVIER SILVA

Borrowing to Make Ends Meet Briefing Paper #3, January 2005

In response to ever-increasing financial pressures, families have come to depend on high-cost credit as a way to bridge the gap between stagnant or decreasing incomes and rising costs. How are families coping with their new burden? To hang on to the American Dream, to be part of the ownership society, homeowners are depleting their homes' equity to pay off a growing mountain of unsecured debt —a financial strategy fraught with serious consequences.

As mortgage interest rates fell to record levels during the refinance boom, it became more appealing to cash out home equity during the refinancing process to pay down credit card debt and finance current living expenses—a short-term solution that fails to address the long-term economic realities faced by the average family. The added burden of missing a mortgage payment results in putting at risk your home—your family's most important asset. All of these factors lead to a crisis in personal finance: a blurred line between good debt—debt that results in appreciable asset—and bad debt, which does not.

Key Findings

- Households cashed out $333 billion worth of equity from homes between 2001 and 2003, the beginning of the refinancing boom—levels three times higher than any other three-year period since Freddie Mac started tracking the data in 1993.
- A majority of households that refinanced between 2001 and 2003 used cash equity from their homes to cover living expenses and pay down credit card debt, further eroding their homes' cash value, which many families rely on for economic security.
- Between 1973 and 2004, homeowner's equity actually fell—from 68.3 percent to 55 percent. In other words, Americans own less of their homes today than they did in the 1970s and early 1980s.
- In 2002, the financial obligations ratio— the percentage of monthly income to the amount needed to manage monthly debt payments —reached 18.56 percent, a single year record since data started being collected in 1980.
- The rise of appraisal fraud has fueled inflated home prices over the last several years. Even though it is underreported, appraisal fraud was the fastest type of mortgage fraud reported by major lenders in 2000, and could leave many homeowners owing much more than the true market value of their home.
- Homeowners who reduced their homes' equity during the refinance boom could suffer devastating effects if home prices begin to fall. As a result, a homeowner could owe more on their mortgage than the house is worth—known in the industry as being "upside down" in a house.
- As the Federal Reserve continues to raise interest rates, a mortgaged family with an adjustable rate mortgage will experience a significant increase in their monthly mortgage payments. The combination of higher mortgage payments coupled with rising costs of basic living expenses represents a growing financial threat.

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Introduction

As middle-class families maneuver through an economy that has undergone dramatic changes in just a generation, the family budget is facing new and increasingly profound pressures. The financial obligations ratio—the percentage of monthly income to the amount needed to manage monthly debt payments—reached a single year high of 18.56 percent in 2002. Home equity, a measure of family financial health, has fallen to its lowest level in 30 years. Steady deregulation of the banking and financial industry since the 1970s has resulted in higher credit card interest rates and fees. Healthcare costs have risen by double digits over the last several years, and housing costs account for an increasing share of family income. Despite a slow recovery from the recession in 2001, incomes for the middle class have actually *decreased*.

In response to financial pressures, families have come to depend on high cost credit as a way to bridge the gap between stagnant or decreasing incomes and rising costs.[1] How are families coping? To hang on to the American Dream, to be part of the ownership society, homeowners are relying on their homes' equity, a financial strategy fraught with serious consequences. As mortgage interest rates fell to record levels during the refinance boom, it became more appealing to cash out home equity during the refinancing process to pay down credit card debt and finance current living expenses—a short-term solution that fails to address the long-term economic realities faced by the average family. What's worse, recent Federal Reserve interest rate increases translate into higher mortgage payments for families who refinanced with an adjustable rate mortgage. The added burden of missing a mortgage payment results in putting at risk your home—your family's most important asset. All of these factors lead to a crisis in personal finance: a blurred line between good debt—debt that results in appreciable asset—and bad debt, which does not.

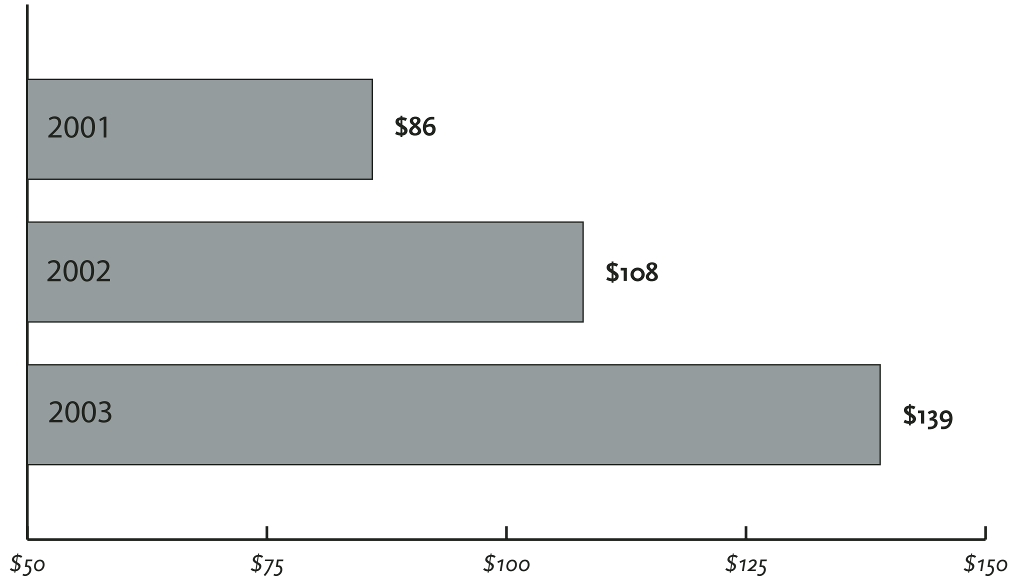
Home equity, a measure of family financial health, has fallen to its lowest level in thirty years.

This briefing paper begins with an examination of the refinance boom. The focus then shifts to an analysis of rising debt and debt burdens. Finally, the consequences of leveraging equity, including policy recommendations and conclusions are discussed.

The Refinance Boom: 2001–2003

Pulling together key data points from various sources to understand the scope of the refinance boom, a few trends become clear. Millions of households replaced more expensive credit card debt and financed current living expenses with mortgage debt by withdrawing equity from their homes.[2] According to Federal Reserve data, a majority of households who refinanced by 2001 or early 2002 did so with a fixed rate mortgage. Of these, 44 percent pulled out equity during refinancing. While the share of those who refinanced with an adjustable rate mortgage was small in 2001 and 2002, 57 percent of these borrowers withdrew equity.[3] As the boom picked up steam between 2002 and 2003, nearly half of all mortgage debt was refinanced. According to the Mortgage Banker's Association, adjustable rate mortgage refinancing also picked up steam with 17 and 18 percent of refinancing in 2002 and 2003, respectively.[4] A recent Harvard study on the housing market revealed households cashed out an astonishing $333 billion from their homes between 2001 and 2003[5] (Figure 1).

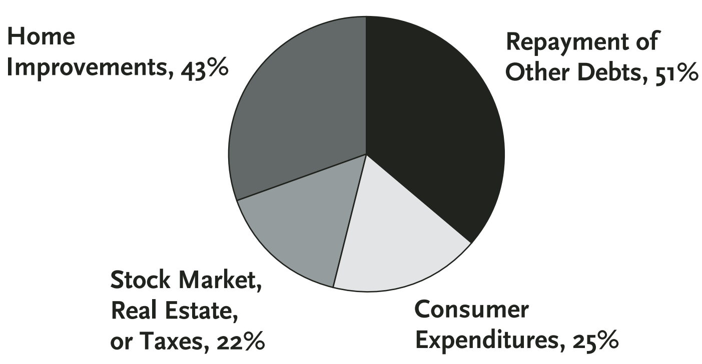
Figure 1. Amount of Equity Cashed Out Between 2001 and 2003 (in Billions of Dollars)



Source: Joint Center for Housing Studies of Harvard University.

According to Federal Reserve data, the average amount of home equity extracted in 2001 and early 2002—the early stages of the refinancing wave—was $27,000. Refinancing reached an all-time high between mid-2002 and mid-2003. What did homeowners do with this newfound cash? A majority of them, 51 percent, used funds to cover living expenses and to repay other non-mortgage debt such as credit cards, which are used increasingly to cover living expenses. And 25 percent used funds for consumer expenditures such as vehicle purchases, education, and medical expenses (Figure 2). In other words, a majority of households who refinanced converted credit card debt and current living expenses into long-term mortgage debt.

Figure 2. Use of Funds From Refinancings, 2001 and 2002



Percentages add up to more than 100 because each refinancing loan could have been used for multiple purposes. Source: Federal Reserve System, Flow of Funds Accounts of the United States.

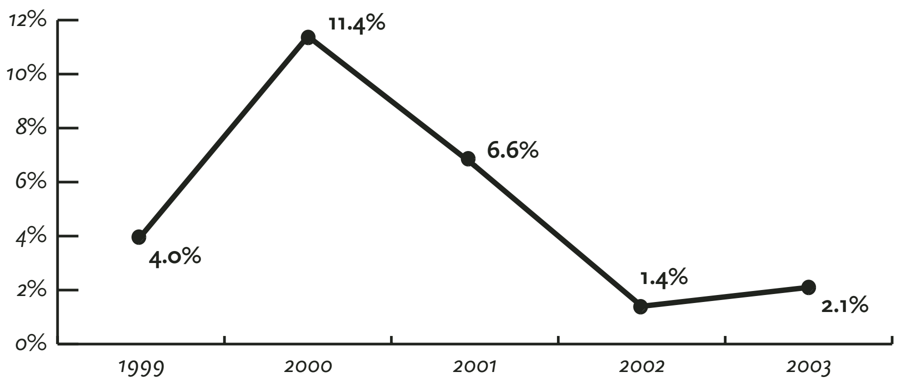
Plundering Assets: The Role of Rising Debt

Average credit card debt among all families increased by 53 percent, from $2,697 to $4,126, between 1989 and 2001.

Prior to the refinance boom households were experiencing high levels of debt accumulation. According to a recent Demos analysis of the Federal Reserve's Survey of Consumer Finances, average credit card debt among all families increased by 53 percent, from $2,697 to $4,126, between 1989 and 2001 (2001 dollars). During the same period, middle-income families—those earning between $50,000 and $99,999—had an average increase of 75 percent, to $5,031, by 2001. Among those over 65, the average credit card balance increased by 149 percent to $4,041.[6]

The onset of the refinance boom helped slow the growth of aggregate levels of credit card debt in the short-term as increasing numbers of families used a portion of their homes' equity to pay down unsecured revolving debt (Figure 3). At the peak of the refinancing boom, aggregate credit card debt grew by only 1.4 percent. In comparison, aggregate credit card debt grew by 11.4 percent in 2000.

Figure 3. Year-to-Year Growth of Aggregate Revolving Debt, 2003



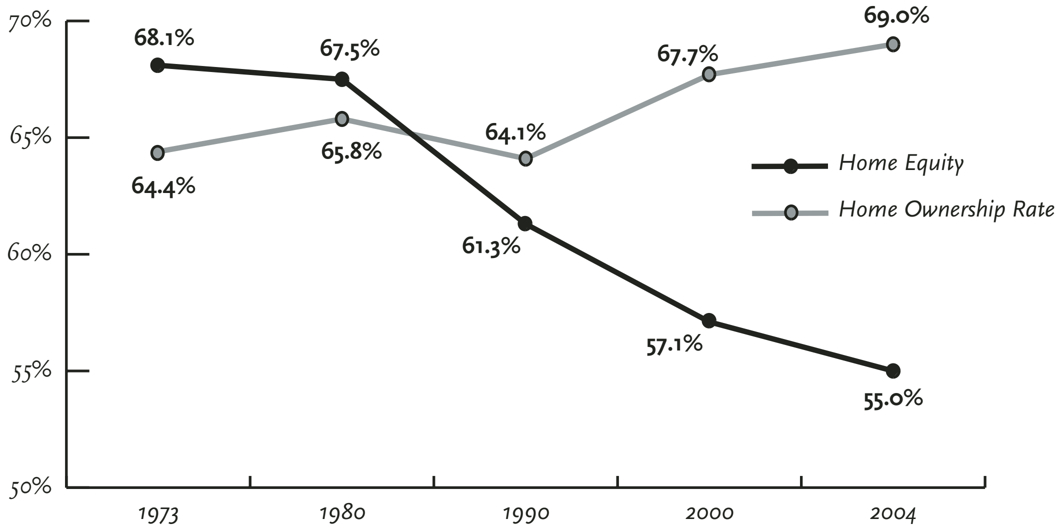
Source: Federal Reserve Board, G-19.

Americans own less of their homes today than they did in the 1970s and early 1980s.

As home equity declines and debt burdens rise, there is cause for alarm about the ability of families to continue along this path. Declining interest rates made "cash out refinancing" an attractive alternative to maintaining non-mortgage debt and using credit card debt to bridge the gap between wages and expenses. Nearly a quarter of all families who cashed out equity during the refinancing process to pay off credit card debt and finance current living expenses were left with higher monthly payments and longer loan periods.

Even though homeownership has reached record levels, home equity has fallen since the early 1970s. Despite a booming real estate market that has increased home prices over the last five years by 45 percent across the U.S., between 1973 and 2004, homeowner's equity actually *fell*—from 68.3 percent to 55 percent through the second quarter in 2004 (Figure 4). *In other words, Americans own less of their homes today than they did in the 1970s and early 1980s.*

Figure 4. Homeowner Equity as a Percentage of Household Estate and Homeownership Rates, 1973–2004



Source: Federal Reserve System, Flow of Funds Accounts of the United States and US Census Bureau.

Record Debt Burdens

As home equity has fallen, household debt service burdens have risen to record levels. Between 2001 and 2003, the "financial obligations ratio"—the amount of disposable income needed to pay down debt—averaged 18.44 percent.[7] Since 1980, the first year data was collected, the single year record occurred in 2002 with a financial obligations ratio of 18.56 percent.

At great risk, families are using their home equity to manage increased financial obligations. High debt service ratios are occurring in an economic climate of stagnant or declining wages. The typical American family experienced negative wage growth of -1.2 percent between 2000 and 2002. Add in rising healthcare premiums and housing costs, and the pinch on the family budget becomes more acute. Since 2000, healthcare premiums have risen nearly 60 percent and housing costs have increased by double digits in nearly every part of the country.[8]

At great risk, families are using their home equity to manage increased financial obligations.

Being "Upside Down" in a House

All homeowners stand to lose if we are indeed nearing the end of the housing bubble, as some analysts predict.[9] If it does burst, some homeowners will be at greater risk than others. Those who reduced their homes' equity during the refinance boom could suffer devastating effects if home prices begin to fall, especially those who live in regions where housing property appreciated the most. According to Freddie Mac, home prices have risen across the country by 44.8 percent over the last five years. A closer look at regional increases in home values during the same period reveals that certain areas of the country experienced greater appreciation than others. The Pacific coast region led with a 74.2 percent increase followed by 71.8 percent increase in the Northeast and 60.6 percent in the Mid-

All homeowners stand to lose if we are indeed nearing the end of the housing bubble, as some analysts predict.

Atlantic region. If reductions in home prices are substantial, they can lead to a situation where a homeowner could owe more on their mortgage than the house is worth, also known as being "upside down" in a house.

Families who moved into homeownership with low or no down payments may also be particularly vulnerable to financial crisis if homes decline in value. Because they have little or no equity in their homes, their loan-to-value ratios are high. Even a small decrease in home values would put these homeowners upside down in their home. Borrowers with adjustable rate mortgages are also at greater risk, because these types of mortgages are subject to fluctuating interest rates. As a result of recent increases in the interest rates by the Federal Reserve, homeowners with adjustable rate mortgages will soon face increasing mortgage payments and find themselves grappling with the unenviable paradox of having to make higher payments on a devalued asset.

Mortgage Fraud

Appraisal fraud was one of the major contributing factors to the Savings and Loan scandal of the 1980s—a legacy that continues in today's inflated housing market. The appraisal process is one of the most important steps during a refinancing, or home purchase. It is also the step most susceptible to fraud or manipulation. Even though appraisal fraud is underreported, it was the fastest-growing type of mortgage fraud reported by major lenders in 2000.[10]

Specifically, appraisal fraud is the practice of inflating home values during a mortgage transaction or refinancing. The end result of appraisal fraud, in some cases, is loans that exceed the real market value of the house. In most cases, the practice is the result of direct pressure on the appraiser from the loan originator, broker, or realty agent to inflate home values. If appraisers under pressure to inflate home values during the appraisal process do not do so, they risk losing repeat business from the broker or others involved in the transaction.

The appraisal process is the step most susceptible to fraud or manipulation.

Even though appraisal fraud is underreported, the Mortgage Asset Research Institute reported that between 2000 and 2002 nearly 20 percent of reported mortgage fraud involved appraisal fraud. This figure underestimates the level of appraisal fraud because a lender rarely verifies that appraisal fraud occurred when more than one type of fraud is discovered, even when the appraisal appears to be false. The Appraisal Institute recently reported that more than 7,000 appraisers had been subjected to pressure to inflate property values. More recently, results from the National Appraisal Survey reveal that 55 percent of appraisers report feeling pressured to overstate property values, and a quarter of appraisers report they feel pressured nearly half the time.[11]

Who wins? Third party mortgage brokers, primarily, reap significant rewards in this process with increased commissions or closing fees. The banks providing the loans also benefit, although they may be left in the dark on illegalities. These mortgages are purchased from banks at the inflated appraisal price and bundled into risk pools by governmental, quasi-governmental, or private firms. Government agencies that participate in the securitization of mortgages include Ginnie Mae, Fannie Mae, and Freddie Mac. Because the loans are held for such a short period by mortgage issuers, due diligence is an often-ignored concept.

Who loses? Everyone else: home buyers who cash out phantom equity in an overvalued home could find themselves "upside down" after the prices settle or the bubble bursts; anyone with a retirement account, like a 401(k), that invests in portfolios padded with risky bundled mortgage backed securities; and US taxpayers, who could be faced with a massive industry bailout.

Combined with a decline in home values and rising costs, individuals and families could be faced with a perfect storm for financial disaster.

From Good Debt to Bad

The notion of good debt was created with the development of the thirty-year mortgage, which enabled Americans to borrow for the purposes of a long-term investment. Borrowing for consumption purposes—in many cases, to make ends meet—does not result in an appreciable asset, and therefore has long been considered "bad debt." In light of current refinancing trends, however, the difference between good debt and bad debt is increasingly becoming blurred.[12] Homeowners have used billions in home equity to payoff credit cards or to cover increasing costs of living. If consumers continued spending equity through 2003 at the same pace as they did between 2001 and early 2002, nearly $253 billion of mortgage debt would represent bad debt.

In light of current refinancing trends, the difference between good debt and bad debt is increasingly becoming blurred.

Despite some benefits, combining bad debt with good debt—thereby stretching out repayment of bad debt over twenty or thirty years—may prove to be the worst financial decision a household can make. Consider that combining $15,000 of bad debt into a 30-year mortgage will result in $16,341 in additional interest payments alone, slightly less than keeping the balance on the credit card and paying the minimum (Figure 5).[13] While this seems counter intuitive, the credit card payment will hover just under $400 the first month and decrease each month afterward while the added cost to the monthly mortgage payment remains constant at $87. While benefits may seem negligible versus a 30-year mortgage, the consequences of missing a mortgage payment are dire. Missing your mortgage payment not only jeopardizes your credit score but also jeopardizes your most valuable asset—your home.

Figure 5. Comparison of Mortgage and Credit Card Interest Payments

	Amount Borrowed	*Annual Interest Rate*	*Monthly Payment Amount*	*Number of Years*	*Total Interest Paid*
Credit Card Debt	$15,000	15.99%	minimum payment = 2.5% or $10, whichever is higher	30	$16,597
Mortgage Debt	$15,000	5.7%	$87	30	$16,341

Source: Demos's calculations.

While the advantages of adjustable rate mortgages are apparent—such as lower interest rates and tax deductibility of interest paid—the pitfalls of such loans can be devastating when rates begin to rise, and underscore the dangerous effects of borrowing against a home's value to pay off bad debt.[14] As the Federal Reserve continues to raise interest rates, mortgage payments for adjustable rate loans will begin to rise accordingly. As a result, a mortgaged family with an adjustable rate mortgage will experience an increase in their monthly mortgage payments. The combination of higher mortgage payments coupled with rising costs of basic expenses such as healthcare, childcare, and groceries represent a growing threat to middle-class security.

Policy Recommendations

Current credit card industry practices ensure families fall deeper into debt.

Major change in the way the credit card industry operates is needed so families are not faced with risking their nest egg to payoff high cost credit card debt and penalty fees. Today, an increasing number of working families are squeezed by rising costs of housing, healthcare, and stagnant or declining wages. There is an urgent need to begin to address these broad economic challenges. However, the role of the credit card industry can no longer be ignored. As families have become increasingly reliant on credit card debt to bridge the difference between rising costs and stagnant wages, current industry practices ensure these families fall deeper into debt. In addition, homeowners who refinanced in the mist of the refinance boom may have been at risk of appraisal fraud—the deceptive practice of inflating home values. The full impact of appraisal fraud will become apparent as the housing boom slows. The following policy recommendations are aimed at ensuring that families have a fair chance at keeping their nest egg in the midst of economic challenges, unfair credit card industry practices, and a housing boom fueled in part by appraisal fraud.

ADDRESSING CREDIT CARD INDUSTRY PRACTICES

While the long-term goals of increased economic security and opportunity will help families protect their nest egg for future generations by avoiding the pitfalls of debt, certain policy changes at the federal level could help today's homeowners pay down their debt at reasonable rates, over reasonable amounts of time.

The following policy changes would help ensure Americans the opportunity to protect their most important asset while also helping families get ahead and build strong, financially secure futures. Enacting just one of these reforms would help reduce the need for Americans to borrow from tomorrow's nest egg to offset high cost healthcare, education, and declining or stagnant wages.

Today there are no legal bounds to the amount of fees and interest credit card companies can charge borrowers.

Enact a Borrower's Security Act. Today there are no legal bounds to the amount of fees and interest credit card companies can charge borrowers. In addition, credit card companies, unlike other lenders, are allowed to change the terms on cards at anytime, for any reason. As a result, cardholders often borrow money under one set of conditions and end up paying it back under a different set of conditions. Legal limits on interest rates and fees have traditionally been established by the states. But because card companies can export interest rates from the state in which they are based, consumers are left unprotected from excessive rates, fees and capricious changes in account terms.

A Borrower's Security Act would restore responsible credit practices to the lending industry by extending fair terms to borrowers. Specifically, legislation is needed to:

- Require card companies to provide a reasonable late-payment grace period to protect responsible debtors from being unduly penalized by a run-of-the-mill tardy payment; limit rate increases to 10 percent above the cardmember's original rate.
- Ensure card companies are accountable to the original contract with the cardmember for all purchases up to any initiated change in terms. Any change to the annual percentage rate should be limited to future activity on the card.
- Establish a floating interest rate ceiling that is indexed to a federal interest rate. A floating limit would ensure the continued profitability of the credit industry during periods of high inflation when interest rates climb. Likewise, it would ensure savings are passed on to customers when national interest rates decline.

- Require disclosure of the full costs of only paying the minimum payments, including the number of years and total dollars it will take to pay off the debt. Raise the minimum payment requirement to 5 percent of the total balance for new cardholders to curtail excessive debt loads and interest payments.
- Require credit cards issued to individuals under 21 to have a co-signer, unless they can prove they have independent means of support.

Maintain Existing Bankruptcy Laws For Individuals In Severe Economic Distress. In 2003 nearly 1.6 million people filed for bankruptcy.[15] Congress will soon reconsider legislation that would make it more difficult for individuals to recover from financial collapse. The growing presence of families in the bankruptcy courts should warn policymakers of the importance of safeguarding this difficult last resort for consumers.

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ADDRESSING REAL ESTATE PRACTICES

One of the major contributing factors to the Savings and Loan scandal of the 1980s was found to be appraisal fraud. This legacy from the S & L scandal continues in today's inflated housing market. The appraisal process is one of the most important steps during a refinancing, or home purchase—it is also the step most susceptible to fraud or manipulation. Even though appraisal fraud is underreported, it was the fastest type of mortgage fraud reported by major lenders in 2000.

Protect Americans from Appraisal Fraud. Appraisal fraud is the practice of using false home appraisals to complete a mortgage transaction or refinancing. In most cases, appraisal fraud is the result of direct pressure on the appraiser from the loan originator, broker, or realty agent to inflate home values. If appraisers do not inflate home values during the appraisal process they risk losing repeat business from the broker or others involved in the transaction. This practice results in households borrowing amounts that, in some cases, exceed the true value of the property.

Far worse, appraisal fraud is a key component of "flipping" schemes, a practice where the appraiser, seller, and lender work in concert to inflate property values. In turn, these homes are sold to unsuspecting first-time home buyers who are unable to maintain the monthly mortgage payment at inflated prices. Inevitably, victims of "flipping" schemes end up filing for bankruptcy or end up in foreclosure. Because mortgage loans for most first-time homebuyers are guaranteed through the government's Federal Housing Authority (FHA) program, lenders participating in this scheme are repaid at the inflated appraisal price when these loans enter default status.

Appraisal fraud is a key component of "flipping" schemes.

While Congress passed comprehensive reforms after the Savings and Loans financial crisis, further reform is needed to protect consumers from the ruinous effects of appraisal fraud. The Appraisal Institute reported that more than 7,000 appraisers have been pressured to inflate appraisals.[16] Congress should ensure that brokers are prohibited from coercing or intimidating appraisers in order to receive a desired property appraisal value. A simple and easy to implement solution which guarantees the integrity of the appraisal process is a fee panel system. A fee panel system would organize appraisers into a queue; appraisers would then be assigned from the list on a rotational basis. Thus, a fee panel system would remove the lender from the process of selecting an appraiser. Should the lender opt-out of the fee panel system and choose their own appraiser, the appraiser would become an agent of the lender. In case of a fraudulent appraisal the lender would also be held legally responsible if they did not participate in the fee panel system.

[PERSONAL STORY]

Silvia and Gary Brown

Gary and Silvia Brown have been married for 30 years, and have three adult children—two still in college. They own a home, and have always paid their credit card balances in full. That is, until just a few years ago. Now their financial security is at risk, with their home's equity depleted and credit card balances at an all-time high.

In 1999, after having paid off their first mortgage loan, the Browns took out a second home mortgage equal to $100,000 to pay for their children's college education. "It [home ownership] felt great, but it was nice to have the equity to send my kids to college," explains Silvia. As each of their children enrolled in four-year universities—three in as many years—the Browns quickly felt the impact of rising college education costs. Tuition increased successively with each child—$25,000 a year for their first, $27,000 for their second and $31,000 for their third child. Silvia and Gary stretched themselves thin and depleted much of their home's equity to make tuition payments, even though their children also took large student loans.

THE BROWNS BEGAN USING CREDIT CARDS TO BRIDGE GAPS IN THEIR MEDICAL EXPENSES.

As their eldest child entered his third year in college in 2002, the Brown's financial health plummeted. Gary had suffered a work-related injury earlier in the year and was forced to take early retirement. As a union member at his trucking firm he received a lifetime monthly pension of $1,500, plus $800 a month in Social Security benefits. But his health insurance only covered work-related medical expenses. At 50, Gary could no longer see his doctor for preventive care or health maintenance.

Gary's reduced earnings increased the strain on an already tight household and healthcare budget: he was the only Brown family member with employer-sponsored health insurance, while Silvia and the children were always covered under expensive family, not group, medical plans. The Browns began using credit cards to bridge gaps in their medical expenses.

Meanwhile, Mrs. Brown's faltering restaurant with three straight years of net losses finally closed in November 2004. Realizing that she would be unable to recover the $120,000 invested in start up costs she was forced to sell her restaurant for $40,000. To make up the difference the Browns once again turned to home refinancing. They paid a $5,500 fee to readjust their home mortgage for $150,000. And again they turned to credit cards to make ends meet.

To date, the Browns have accumulated a total of fifteen credit cards. One with a balance of $10,000 and 0 percent APR is used for medical expenses. Mrs. Brown and two of her children buy into a health care plan at $650 per month that covers emergency visits but not prescription drugs and dental/eye exams. The second credit card with a balance of $10,000 and a 7 percent APR is used for residual business expenses that were not covered by the loan or from the sale of the restaurant. The remaining credit cards have a total approximate balance of $5,000 with an average of 12 percent APR. They are used for everyday expenses such as groceries or gas. With credit card balances quickly increasing, and only being able to make minimum payments on balances, the Browns have had to cut corners. "I'm doing without new eye glasses," Mrs. Brown reveals.

The Browns' monthly budget is $2,300, not enough to begin maneuvering out of debt. Sixty-five percent goes to monthly loan repayment and twenty-eight percent goes to healthcare for Mrs. Brown and her two daughters. This leaves very little to cover costs from prescription drugs and doctor visits not covered by the Browns' limited health insurance and day-to-day expenses such as food or utilities. Very little to none is left to pay down credit card debt.

The Browns' immediate future seems brighter with Silvia's new job as a legal aid in a law firm, which will bring in about $2,000 a month. But even with this new injection of much-needed cash it will take the Browns years to pay off their mortgage and credit card debt. And of course, there is no equity left in their home for an emergency or retirement.

In eight years, Mr. Brown will qualify for Medicaid, reducing some of the dependence on credit cards to cover medical expenses. Silvia's new job does not provide health benefits, so the Browns will continue to pay out of pocket for Silvia's health insurance. They must also continue to purchase catastrophic care insurance for each of their children, until they find employer-sponsored healthcare.

The Brown's financial future may be bleak. Today, after refinancing their home for a third time in 2002, they owe $150,000 in home mortgage loans. In the past 5 years, the Browns acquired over $25,000 worth of credit card debt to make ends meet. They are both around 50 years old, lack comprehensive health care, and have zero equity in their home.

Silvia is distressed.

"Both times we refinanced, I felt trapped knowing we had no choice but to refinance," she says. "At my age it is not fun to have a $150,000 mortgage. It's what life dealt us and we're doing the best we can to make it work. I'm not going to whine about it. But I'm worried about my retirement—no money for an IRA, and there won't be much left from social security."

Conclusion

In response to financial pressures, families have come to depend on high cost credit as a way to bridge the gap between stagnant or decreasing incomes and rising costs. To ease the burden of high cost credit card debt, families have resorted to their homes' equity to pay down consumer debt and finance current consumption needs. While using a home's equity may create a short term financial breathing space, this financial arrangement has blurred the line between good debt and bad debt. In other words, there is a component of consumer debt now hidden in mortgage debt across the country. This has led to the permanence of bad debt imbedded in mortgages. The results of this trend can be disastrous—missing a credit card payment has serious implications for a family's financial health, while missing a mortgage payment could end up costing a family their home.

Missing a mortgage payment could end up costing a family their home.

Notes

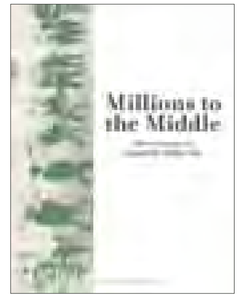
1. See Tamara Draut and Javier Silva. (2003). *Borrowing to Make Ends Meet: The Growth of Credit Card Debt in the '90s*, Demos: A Network for Ideas and Action. New York, NY. Also, see Tamara Draut and Heather McGhee. (2004). *Retiring in the Red*, Demos: A Network for Ideas and Action. New York, NY.
2. In 1986, with the passage of the Tax Reform Act (TRA), the government significantly limited the deductibility of interest by prohibiting individuals from deducting consumer interest but continued to allow interest to be deductible on mortgages for first and second homes. As a result, interest paid to service credit card debt is not deductible whereas mortgage interest is deductible.
3. *Federal Reserve Bulletin*. (2003). Mortgage Refinancing in 2001 and Early 2002, P. 472. Washington, DC.
4. See the Mortgage Bankers Association Long-Term Mortgage Finance Forecast at: http://www.mortgagebankers.org/marketdata/forecasts/mffore_lt_1003.pdf
5. Joint Center for Housing Studies of Harvard University. (2004) *The State of the Nation's Housing*, P 7, Cambridge, MA
6. See Tamara Draut and Javier Silva. (2003). *Borrowing to Make Ends Meet: The Growth of Credit Card Debt in the '90s*, Demos: A Network for Ideas and Action. New York, NY. Also, see Tamara Draut and Heather McGhee. (2004). *Retiring in the Red*, Demos: A Network for Ideas and Action. New York, NY.
7. The financial obligations ratio (FOR) adds automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance, and property tax payments to the debt service ratio in addition to estimated required payments on outstanding mortgage and consumer debt..
8. The Kaiser Family Foundation and Health Research and Educational Trust (2004). "*Employer Health Benefits*", Washington, DC
9. See Center for Economic and Policy Research section on the Housing Bubble at http://www.cepr.net/pages/housing_bubble.htm. Also, Ian Morris, U.S. economist at HSBC Securities Inc. estimates that housing prices nationally will slide 5 percent to 10 percent over the next five years in a report called *The U.S. Housing Bubble*. Lastly, Michael Buchanan and Themistoklis Fiotakis of Goldman Sachs report that on average home prices are overvalued by 10 percent with California and New York more susceptible to being overvalued.
10. Matthews, W., et al (2004) *Sixth Annual Case Report to Mortgage Bankers Association*, Mortgage Asset Research Institute, Inc., Reston, VA.
11. *October Research*. (2003). National Appraisal Survey: Unveiling the Secrets of the Appraisal Business, Richfield, OH.
12. Of course, student loans are an obvious exception.
13. This assumes a 30-year mortgage at a fixed rate of 5.7 percent. Now compare $16,341 to $16,598 in total interest paid if the balance remained on a credit card and the minimum payment was made until the balance was retired. Over time, the savings become negligible.
14. Some of the advantages of mortgage refinancing are offset by closing costs such as points and fees. Also, depending on whether a household itemizes on their tax returns or uses the standard deduction, the full tax advantages of the mortgage interest deduction may not be realized.
15. American Bankruptcy Institute, (2004). *Non-Business Bankruptcy Filings by Chapter, 1990-2004*, Alexandria, VA
16. *The Wall Street Journal*, "Shaky Foundation: Rising Home Prices Cast Appraisers In a Harsh Light" by John Hechinger, December 13, 2002.

Related Resources from Dēmos

Borrowing to Make Ends Meet: The Growth of Credit Card Debt in the '90s
by Tamara Draut and Javier Silva

Using new data, this report illustrates how families are increasingly using credit cards to meet their basic needs. Also examines the factors driving this record-setting debt and the impact of financial services industry deregulation on the cost, availability and marketing of credit cards.

Millions to the Middle: Three Strategies to Expand the Middle Class
by David Callahan, Tamara Draut, and Javier Silva

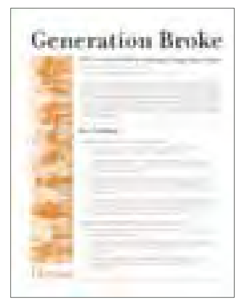


This report on the future of economic security in the New Economy offers long-range ideas in the areas of higher education, income, debt, and assets for creating tomorrow's vibrant middle class.

Retiring in the Red: The Growth of Debt Among Older Americans
by Tamara Draut and Heather McGhee

This briefing paper documents the rise of credit card and mortgage debt of older Americans since 1992 and also delves into what is driving this disturbing trend.

Generation Broke: The Growth of Debt Among Younger Americans
by Tamara Draut and Javier Silva



This briefing paper documents the rise in credit card and student loan debt between 1992 and 2001 and examines the factors contributing to young adults' increased reliance on credit cards.

For more information about Dēmos' work on debt and assets, please contact:
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