Risking Homes to Pay Off Credit Cards

Debt-consolidation mortgage refinancing is not a winning financial formula for many families

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For most Americans, homeownership is the primary tool for building wealth and preserving financial security. Nearly 60 percent of the total wealth held by middle-class families resides in their home equity – the share of their home they own without debt.[1] For these families, long-term economic security and prosperity depends largely on increasing their home equity. For example, many homeowners draw on equity to send children to college, pay for medical emergencies, or afford retirement.

Unfortunately, the fear of overwhelming credit card debt is driving many Americans to hand their equity back to mortgage lenders in the form of "cash-out" refinances. Rather than generating cash to invest in the family's future or cover short-term emergencies, "cash-out" refinances frequently serve as equity-draining transactions that only repay ("consolidate") short-term debts, such as credit card balances. Worse, the benefits of refinancing are often temporary, as homeowners build up additional new credit card debt and start the refinance process again.

Between 2002 and 2004, Americans withdrew $2 trillion of the equity in their homes.[2] Cash-out refinances represented 47 percent of all prime mortgage refinances and 83% of subprime mortgage refinances in 2004.[3] Outstanding credit card debt, accounting for $800 billion in the U.S. in 2004,[4] serves as a convenient hook for lenders to promote cash-out refinances to debt-loaded homeowners.

Cash-out Mortgage Refinances

In cash-out mortgage refinances, homeowners replace their current mortgage with a loan amount larger than the amount they owe on their home. While they take all or part of the difference as cash, the funds are often used to pay off other debts.

For example, say a borrower owes $150,000 on a home that appraises for $200,000 – giving the borrower about $50,000 in equity. In a cash-out refinance that consolidates credit card debt the borrower receives a new mortgage for $175,000, pays off her previous mortgage ($150,000) and uses the remaining $25,000 to pay off credit card debt (minus closing costs).

Although the borrower might get a lower interest rate, she also is left with a higher loan balance and has lost half of the equity from her home.

Families Under Pressure: Credit Card Debt and Aggressive Marketing

The Federal Reserve Board's most recent Survey of Consumer Finances (2001) revealed that 44 percent of families at all income levels were holding credit card balances. Recently Demos and CRL released findings from a new consumer survey of low- to middle-income families that showed the average credit card debt of low- and middle-income households is $8,650.[5]

A majority of surveyed families are using credit cards to pay for basic living expenses or to deal with unexpected financial emergencies.[6] However, at a time when many families depend on credit cards as a "safety net" to meet essential expenses, such credit is getting more expensive. Common business practices of credit card companies — e.g., universal default, penalty pricing, high fees, and low minimum payments — have significantly increased the cost of credit card debt.[7]

The financial pressure of mounting credit card debt makes cash-out mortgage refinancings attractive to families of all income levels, especially when their lender or mortgage broker suggests it as a sound financial move. An industry representative summed up the marketing tactic for mortgage refinancings that has been in use for at least 10 years: "Nobody applies for a loan. It's all push."[8] <u>Much of this "push marketing" that encourages debt consolidation mortgage refinances occurs in the subprime market</u> – over 80 percent[9] of refinances in the subprime market are cash-out refinances.

However, cash-out refinances used to pay off credit card debt may actually make a homeowner worse off. Pressured by the burden of credit card debt and aggressive marketing tactics, many families don't realize how much equity they will lose, the total costs of that loss, or that they are putting their home in jeopardy in order to temporarily repay unsecured credit card debt.[10]

For many homeowners, cash-out refinancing does not live up to its promise to lower monthly payments by any significant amount. Particularly in the subprime market, financing excessive points and fees can strip out more equity on top of the "cashed-out" equity, leading to compounded costs and higher monthly payments.[11]

> ***"Nobody applies for a [refinance] loan. It's all push."***
>
> – Robert Elliott, Household Finance Group Executive "HFC Profits Nicely by Charging Top Rates on Some Risky Loans", *Wall Street Journal* (December 11, 1996).
>
> *Homes are not ATM machines infused with cash for homeowners to draw down. Homeowners should be cautious about stripping equity from their home because the equity may never replenish.*

Beyond draining potential savings for the future and failing to put the borrower in a better financial position, securing previously unsecured credit card debt with the home only further increases the risk of losing the home to foreclosure.[12]

After Debt Consolidation: Even More Debt

A 1998 study by Brittain Associates found that nearly two-thirds of homeowners who used home equity to pay off credit card debt reloaded additional credit card debt within two years.[13] More recently, the Demos-CRL study revealed that low- to middle-income credit card refinancers carry 18 percent more debt (credit card and mortgage combined) than homeowners of comparable income who refinanced without paying down credit card debt. At the time of the survey, those debt consolidators who had refinanced within the previous three years already carried an average of over $14,000 of credit card debt in addition to a larger mortgage.

The chart below, based on data from the Demos-CRL study, illustrates the spiraling cycle of credit consolidation — demonstrating higher combined monthly payments for debt consolidators.

Refinancing may briefly eliminate credit card debt in the short-term, but it doesn't address the core economic and social issues that drive and encourage families to continue using their credit cards to accumulate more debt.

Table 1. Refinanced Credit Card (CC) Consolidation.
Lost Equity – More Debt

Source: The Plastic Safety Net, Demos and CRL, 2005.

	Refinanced, No CC Consolidation	Refinanced, CC Consolidation, New CC Debt
Avg. Income	$47,371	$47,668
Avg. CC Debt Consolidated	$0	$12,067
Current Avg. CC Debt	$8,810	$14,149
Avg. Mortgage Debt[14]	$99,338	$111,460
Mortgage Payment @7.5%	$699	$783
CC Payment @13%[15]	$148	$238
CC Payment @ 25%	$213	$342
Combined Monthly Pmts	**$847 – $912**	**$1,021 - $1,125**

Lost Wealth Hurts Long-Term Financial Viability

The boom in home values experienced in some regions of the country has helped feed the high volume of cash-out mortgage refinances. However, housing appreciation is not as evenly distributed across the country as cash-out refinances. Even in the boom markets, if home values stabilize or weaken, cash-out refinancing may prove to be a financial disaster for homeowners because they may never recover equity taken out as cash. While home equity climbed 10 percent in 2004, homeowners extracted 13 percent of their refinanced debt, according to Freddie Mac.[16] Perhaps even more disturbing, Americans own less of their homes today than 25 years ago, as home equity dropped from 68 percent in the 1980s to 55 percent in 2004.[17]

Another negative trend is the inflation of appraisals: many cash-out refinances may not be supported by the true value of the property. Fidelity Hansen Quality, Inc., which reviews appraisals for loan buyers in the secondary market, found that 15 to 30 percent of appraisals are significantly inflated (over 15 percent of what the property is worth).[18] Stripped equity from over-valued homes is a dangerous combination, all too often leading to foreclosures, and ultimately community-wide devaluation.[19]

Refinancing Credit Card Debt Not Always a Sound Decision

Responsible credit practices must be restored to protect homeowners from the cycle of expensive credit card debt that often drives homeowners to push-marketed cash-out refinances. Reforms to credit card practices should include prohibitions on universal default provisions, excessive penalty pricing, inadequate minimum payment requirements, binding mandatory arbitration clauses, and substandard underwriting guidelines.[20]

Additionally, abusive lending practices in the subprime market and among cash-out refinances need to be eliminated, including the following: deceptive push-marketing; lending without regard to the borrower's ability to repay the loan; excessive fees and insurance; incomplete loan disclosure and fraud; broker yield-spread premiums; high interest rates and "balloon" payments; loan "flipping;" prepayment penalties; and binding mandatory arbitration clauses.[21]

The short-term *and* long-term impact of using mortgage refinancings to reduce the stress of credit card debt should be carefully weighed before stripping a home of valuable equity. Homeowners may be better off accessing alternatives to refinancing their mortgage, such as savings and reworking non-mortgage debt.

FAST FACTS

- In 2004, over $150 billion of cash generated from refinances was used to pay off credit card and other consumer debt.[22]
- Whether interest rates are increasing or decreasing, subprime borrowers consistently use refinancing as a source of cash.[23]
- Prime mortgage borrowers refinance most often during periods of low interest rates, and primarily in order to lower monthly payments, with only 32 percent seeking cash. In contrast, when interest rates are higher, fewer prime borrowers refinance and among those who refinance, a larger portion opt for cash-out refinances (79 percent).[24]
- Surveys indicate that for a significant portion of debt-consolidating refinancers, credit card debt builds up again in just a few years.
- Americans' homes increased in value 34.7 percent between January 2003 and June 2005. Those gains were almost exactly matched by outstanding mortgage debt that increased by 34.5 percent during the same time period.[25]
- Equity extracted from homes grew from $297 billion in 2000 to $800 billion in 2004, a 270% increase.[26]

About the Center for Responsible Lending

The Center for Responsible Lending (CRL) is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, the nation's largest community development financial institution.

For additional information, please visit our website at **www.responsiblelending.org**.

Notes

[1] Edward N. Wolff, *Changes in Household Wealth in the 1980s and 1990s in the U.S.*, Levy Economics Institute, Working Paper No. 407, 34, at http://www.levy.org (May 2004).
[2] Alan Greenspan and James Kennedy, *Estimates of Home Mortgage Originations, Repayments, and Debt on One-to-Four-Family Residences*, Table 1 Line 21 Federal Reserve Board, at http://www.federalreserve.gov/pubs/feds/2005/200541/200541pap.pdf (September 2005).
[3] *Cash-Out Refi Report 3Q 2005*, Office of the Chief Economist, Freddie Mac (2005). Loan Performance, Inc., Loan Performance Asset Backed Securities Database (April 2004).
[4] *Consumer Credit Outstanding, (revolving credit, not seasonally adjusted)*, Federal Reserve Statistical Release (September 8, 2005), at http://www.federalreserve.gov/releases/g19/current/default.htm.
[5] *The Plastic Safety Net: The Reality Behind Debt in America*, Demos, and the Center for Responsible Lending, at http://www.responsiblelending.org/pdfs/DEMOS-101205.pdf (October 2005).
[6] *See The Plastic Safety Net*, note *5.*
[7] *See The Plastic Safety Net*, note *5.*
[8] *"Nobody applies for a loan. It's all push,"* quote from Robert Elliott, *Household Finance Group Executive HFC Profits Nicely by Charging Top Rates on Some Risky Loans*, Wall Street Journal (December 11, 1996).
[9] Loan Performance Asset Backed Securities Database, note 3.
[10] Margaret Webb Pressler, *It's on the House; Now Everybody is Paying for Everything With Home Equity*, The Washington Post (May 8, 2005).
[11] Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, 57 Fla. L. Rev. 295, 326 (April 2005); Eric Stein, *Quantifying the Economic Costs of Predatory Lending*, Center for Responsible Lending (October 2001).
[12] Dan Immergluck and Geoff Smith, *There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values*, Woodstock Institute, 1 at http://www.woodstockinst.org/publications/task,cat_view/gid,86/ (June 2005). *See* The State of the Nation's Housing 2005, 19, endnote 11. Studies indicate that a higher loan-to-value places homes at higher risk of foreclosure, and "hidden high LTV loans" result from inflated appraisals. *See, e.g*. Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, 25-26 University of North Carolina (January 25, 2005) at http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf; *Mortgage Foreclosure Filings in Pennsylvania: A Study by the Reinvestment Fund for the Pennsylvania Dept. of Banking*, 18 (2005), at http://www.trfund.com/policy/PA_Foreclosures.htm.
[13] Liz Pulliam Weston, *The 3 Worst Money Moves You Make*, MSN Money, at http://moneycentral.msn.com/content/Savinganddebt/Managedebt/P42811.asp;
National Regional Outlook, First Quarter 1999, FDIC, at http://www.fdic.gov/bank/analytical/regional/ro19991q/na/infocus1.html.
[14] Mortgage: Basic data derived from DEMOS/CRL survey results. Calculations assumed the principal loan amount for the refinance without credit card consolidation was $100,000, and $112,000 for the credit card debt consolidation. Assumes a 30-year fixed rate of 7.5%, which is approximately 1.5% above the 6% rate currently reported. This is slightly below the spread, which would trigger HMDA reporting as a "higher-cost" loan, and thus may be below the rate charged in the subprime market. (Robert B. Avery and Glenn B. Canner, *New Information Reported under HMDA and its Application in Fair Lending Enforcement*, Federal Reserve Bulletin, 344, 370 (Summer 2005); Current weekly rate, Bankrate.com)
[15] Credit Card: Assumes both a 13% standard rate (Bankrate.com), and the average 25% penalty rate, which is affecting an increasing number of cardholders. (*See* Tim Westrich and Malcolm Bush, *Blindfolded Into Debt: A Comparison of Credit Card Costs and Conditions at Banks and Credit Unions*, Table 6, Woodstock Institute (July, 2005). The minimum monthly payment was determined by assuming an eight-year amortization of the debt (96 months), within the seven to ten year payoff window recommended by regulatory guidelines. (*See* Steve Bucci, *Credit card double trouble: Minimums up, law changes*, at http://www.bankrate.com/brm/news/debt/20050511a1.asp.)
[16] *The State of the Nation's Housing 2005*, Joint Center for Housing Studies of Harvard University, 6, (2005) at http://www.jchs.harvard.edu/publications/markets/son2005/index.html.

[17] *Household Financial Conditions: Q2 2005*, Financial Markets Center, 2 at http://www.fmcenter.org/atf/cf/{DFBB2772-F5C5-4DFE-B310-D82A61944339}/HFC_sept05.PDF (September 24, 2005).
[18] Erick Bergquist, *A View of Refi Boom Pressures from the Appraisal Trenches*, American Banker (February 5, 2004).
[19] *See* Immergluck *and Smith,* The State of the Nation's Housing 2005, Quercia et. al,, and *Mortgage Foreclosure Filings in Pennsylvania*, note 12.
[20] *The Plastic Safety Net*, note 5, 18-26 (additional recommendations for financial safety net for borrowers and responsible credit practices for lenders outlined in further detail).
[21] For further discussion on abusive or predatory lending practices, *see The Case for Predatory Lending Reform, Center for Responsible Lending*, at http://www.responsiblelending.org/abuses/thecase2.cfm.
[22] $600 billion times 25% = $150 billion. *Fed Chief Keeps Eye on Housing,* The Kansas City Star (October 4, 2005). Federal Reserve Chief Alan Greenspan said roughly one-fourth of home equity loans and cash-out refinancings is used to refinance existing credit card and other consumer debt. *See* Greenspan and Kennedy, *endnote 2*, Table 1 Line 23, $599.5 billion net equity extraction.
[23] Loan Performance, Inc, note 3. Rates for cash-out refinances leveled around 80 percent from 2000 to 2004 – with rates of 83, 82, 78, 77 and 83 percent for each respective year.
[24] *Subprime Mortgage Loans, 2004*, SMR Research Corporation, 16 (2004). As interest rates increased in 2000, prime borrowers obtained a record number of cash-out refinances at 79%. When rates returned to the lowest interest rates in years in 2003, cash-out refinances dropped to 32%.
[25] *Household Financial Condition: Q2 2005*, Financial Markets Center, 4 at http://www.fmcenter.org/atf/cf/{DFBB2772-F5C5-4DFE-B310-D82A61944339}/HFC_sept05.PDF (September 4, 2005)
[26] *See* Greenspan and Kennedy, note 2.