boston.com

THIS STORY HAS BEEN FORMATTED FOR EASY PRINTING

The homeowner's day of reckoning

The Boston Globe

As property values soared, we got hooked on the idea of using our house as a bank, pulling out blocks of equity to pay for renovations, vacations, and more. Now, will the softer real estate market cost some of us our homes, our shirts, even our retirement?

By Lisa Prevost | October 15, 2006

Gregory Truman and Wayne Pruitt didn't need a real estate agent to sell their Brighton condo two years ago - but they could have used a crystal ball.

The market was so hot that Truman, then an assistant professor of information systems at Babson College, and Pruitt, minister of the Union Church in Waban, were able to sell the unit in a matter of days for more than $468,000. They promptly upgraded, paying $644,000 for a 1930 Colonial across the border in Brookline. They got a first mortgage for $333,700 and secured a home equity line for $140,000 (they used $70,000 of that money for the initial purchase of the home and $52,000 to spruce up the place). Over the next two years, in addition to sanding and painting both inside and out, the couple landscaped the front yard, added stone walls, and put pavers on the driveway. Yet in May of last year, the house they had refashioned as their own became suddenly unaffordable when Truman learned that, much to his dismay, he hadn't made tenure. He would be out of a job by August of this year.

Downsizing was in order. Once again acting as their own agents, Truman, 46, and his 56-year-old husband put their house on the market in May of this year for $748,000, hoping to net a decent return on top of the cost of their improvements. Yet even after three busy open houses, the only offer they received came in the form of a casual inquiry through a neighbor as to whether they'd go as low as $699,000.

Unwilling to take a loss, the couple decided to refinance instead. They lowered their monthly payment by using a somewhat risky mortgage with an adjustable rate negative amortization, which allows them to pay less interest than the amount actually being charged. The difference, however, is added to their loan balance, essentially chipping away at their equity month by month.

Truman views the loan as a stopgap but is nevertheless chagrined to find himself in such a predicament. He doesn't foresee a housing market recovery until long after next year's round of faculty hires. "If I find another academic position in another part of the country, I really don't think we'll be able to sell and get any sort of return," Truman says. "I regret buying the house. It was really a blunder."

Perhaps, but then, perspective is easily regained now that we're on the other side of the pop, the bust, the not-so-gentle thud (assign it whatever resonance you like). When we were living through what was unquestionably the biggest borrowing frenzy in history, homeownership shook off its staid status as the American dream and reemerged as the American joy ride. If our grandparents stashed money under the mattress to get ahead, our houses did the saving for us. Every sale down the block, every bidding war, every visit to zillow.com confirmed that we were rich and getting richer.

Practicality was almost illogical. Though we skimmed off layer after layer of equity to upgrade our kitchens or pay down our credit cards, our home values magically rose as if to compensate within the same year, sometimes within months. More than just places to live, our houses morphed into pots of cash, vessels so deep they could seemingly supply our material wants now and our retirement needs later.

But with buyers back in control and perspective restored, most of us homeowners aren't feeling quite so wealthy anymore. As our equity levels recede, some of us, like Truman, are feeling foolish that we stretched our finances so thin. And clearly, with the midyear foreclosure rate up more than 60 percent over last year, some of us are downright devastated. Our equity spending spree isn't exactly over: Higher interest rates have homeowners rushing to refinance out of adjustable rate loans, and most borrowers are upping their debt burden and walking away with cash, according Freddie Mac, the federal mortgage agency. Yet the implications of all this borrowing are coming into sharper relief. Some economists and, surprisingly, many real estate agents would welcome a halt to the drawdown, saying homeowners' eagerness to upgrade, expand, buy bigger may come back to haunt them come retirement - if not sooner.

"People have gotten used to relatively large gains in values," not only in real estate but in the stock market, says Mark Zandi, chief economist at Moody's economy.com. But, he warns, "this period of growth is unlikely to be repeated again in our lifetimes. It's important that people adjust their expectations."

It's easy to understand why homeowners adopted such high expectations. Average selling prices for single-family homes in Massachusetts appreciated 55 percent between 2000 and 2005, while condominium prices in the state surged an astonishing 81 percent. Those soaring values helped push the level of first mortgage debt in Massachusetts over $207 billion by the second quarter of this year, a 114 percent increase over the first quarter of 2000, according to research conducted by Equifax and economy.com.

Mortgage lenders sought to make homeownership more affordable by expanding the availability of exotic products like interest-only loans, loans with an initial period of low fixed rates followed by periodic adjustments (called adjustable rate mortgages, or ARMs), and so-called 80-20s, which provide 100 percent financing through a first mortgage covering 80 percent of the loan amount and a higher-cost second mortgage covering the balance.

And the surge in home values unleashed the bonanza of equity borrowing, a nearly nonexistent market just two decades ago. Aided by low interest rates and a 1986 tax law that eliminated the deductibility of interest on credit cards, the lending industry encouraged homeowners to spend their newfound wealth by borrowing against it. In Massachusetts, the outstanding debt on home equity lines of credit alone has swelled nearly six-fold since early 2000 to $17.88 billion.

Nationally between 2003 and 2005, homeowners cashed out $150 billion more in equity through refinancing than they had in the previous eight years, according to Harvard's Joint Center for Housing Studies. Equity borrowing was a cheap way for wealthier homeowners to free up money for other investments. At the same time, borrowers of middle-class means unlocked their gains so that they could live more like the wealthy. As for struggling homeowners, tapping equity was a way to pay the bills more easily. "This is unprecedented in terms of the scale and the size of the borrowing," Zandi says, "and for the use of the home as a piggy bank."

With so many more pathways for getting into the rising market and a host of lower-cost options for pulling the cash value out, the psychology of borrowing became more focused on short-term gains than long-term debt - and not just among investors. "It became less important to pay down the mortgage, because you were building equity without doing it," says John Battaglia, president of Cambridge Mortgage Group and chairman of the Massachusetts Mortgage Bankers Association. "People are looking at it more as they're always going to have a payment to live in the house."

Our new way of thinking defines the house not as a place to settle down so much as a temporary profit venture. Though precise data are hard to come by, surveys by the Federal Reserve and Los Angeles Times/Bloomberg suggest that the bulk of the cash borrowed during the housing boom paid for home improvements. "A lot of people were caught up in this whirlwind of houses going up and up. People thought they could buy a house, open a line of credit, fix it up, and put it back on the market and make a lot of money," says Katherine McNally, a loan officer for Carlson GMAC Real Estate in Gloucester. We've all adopted the mind-set of property flippers to varying degrees, borrowing against our houses to make those improvements that will boost our bottom line come resale.

The shift is particularly apparent among 20- and 30-somethings. When Tim deRosa, an assistant vice president at the Boston office of the Chubb Corp., bought his Brookline condo for $357,000 less than two years ago, he, like many other buyers in pricey locales, saw it as a steppingstone to a bigger place. A $30,000 home equity loan enabled him to put in the top-notch kitchen he hoped would result in a higher sales price three or four years down the road. The 30-year-old didn't count on meeting his future wife in the meantime, however. Now engaged, deRosa is trying to sell the condo for $399,999 so he and his fiancee can move to the North Shore. He hasn't had any offers, and he's unwilling to drop his price. Far from worried, deRosa is businesslike about the turn of events. "I'm not desperate to sell - I don't have to move," he says. So he'll wait it out. He's refinanced the condo to lower his payment and plans to rent the unit if he and his fiancee find the right house. His $40,000 in equity will cover the down payment, deRosa says.

Giti Saeidian, a 47-year-old real estate agent with Chobee Hoy Associates, already rolled her equity gains into a bigger house. Saeidian and her husband sold their Brookline condo in 2004 and used the seven years' worth of equity growth - about $260,000 - to put a down payment on a $1.3 million multifamily home elsewhere in town. The couple now live in one unit and rent out the other three. Originally built in the 1880s, the house represented a major undertaking - the 1950s-era interior cried out for updating, and the purchase price required the Saeidians to take on first and second mortgages. Now, having put another $200,000 into the property and refinanced into a single, slightly higher-priced mortgage, Saeidian says she's confident the $8,780 check she writes every month to cover mortgage and taxes will eventually pay off. Like many other Iranian immigrants she knows who have invested heavily in Boston-area real estate, she says, "I happen to be a risk taker."

Saeidian's approach is a far cry from the old play-it-safe model of homeownership. The notion that a mortgage is something to be paid off still has loyal adherents like Bob Romeo, president of Century 21 Franklin Street Associates in Lenox. Romeo's story used to be the norm: In 1967, he and his wife built the three-bedroom ranch where they raised their kids. In 1987, they made their last mortgage payment. Yes, he acknowledges, he did borrow a little extra to add a family room and a pool but repaid that debt in the same term. The debt-free ethic was so widely shared that it became the theme for neighborhood parties. "When someone paid off their mortgage, we'd all get together and eat and drink," Romeo says. "It was a real milestone."

Now 63, Romeo and his wife live mortgage-free in the same house, where his grandkids splash in the pool. He does not borrow against his equity, which has grown to somewhere between $350,000 and $400,000 - roughly 13 times his investment. To his way of thinking, the creator of home equity lines ought to be "tarred and feathered, among other things."

"We're really thinking only about today," Romeo says. "We're not looking 10, 20 years down the road."

To the contrary, says well-known economist Michael Hudson, the head of the Institute for the Study of Long-Term Economic Trends in New York: Americans still take a long-term view when it comes to their homes - houses remain the major asset for most families. What's changed, he says, is that homeowners are willing to leverage themselves to an extent not seen before because we've come to equate bigger debt with a bigger return. We borrow to buy as much house as possible and sell with the intent of moving into something even larger. "The perception," Hudson says, "is running into debt is the way to wealth." Grounded in the assumption that housing prices will continue to outpace the return on stocks and bonds, he says, heavy borrowing will saddle more-recent home buyers with mortgage debt well into their retirement.

Not all economists take such a dark view of the borrowing blitz. After all, even with so much cash flowing out of houses, nearly 90 percent of American homeowners still had equity equaling at least 20 percent of their home's value as of 2004, according to Harvard's housing center. Some economists are worried, however, that Americans are relying so heavily on their houses as cash-generating vehicles that they aren't putting other money aside. Economists call this "the wealth effect" - buoyed by rising home values, carefree consumers spend more and save less. Meanwhile, the personal savings rate, a respectable 7.8 percent of disposable personal income in 1990, has fallen into the negative zone. The net national savings rate, a more inclusive measure that considers both public and private sector savings and expenditures, is at its lowest point since the Great Depression.

All this feel-good spending in both the public and private sectors ignores two big bills coming our way - Social Security and healthcare for the massive wave of baby boomers soon to retire, says David Laibson, a professor of economics at Harvard University. "It's all the way we're 'dis-saving' simultaneously," Laibson says. "If there were some offsetting wealth, I wouldn't care about the borrowing on home equity."

Homeowners forced to sell in this market may indeed wish they'd stashed the cash they invested in granite countertops and bluestone patios in an IRA instead.

Lynne Nadorff has never touched her home equity but is second-guessing some of the improvements she made on the two-family Colonial she bought in downtown Lenox in 2002. Some of the roughly $200,000 worth of repairs and renovations made over the last four years were necessary, like the new roof and chimneys, while others, like her new bathroom and sun porch, were enhancements. A divorced mother of two teenagers who works as a special education teacher, Nadorff is trying to sell so she can move to South Carolina, where her son attends the state university. But the housing market isn't cooperating. After initially listing her house in July for $595,000, Nadorff has since reluctantly dropped the price to $495,000. "Maybe it would have worked better if I hadn't put so much into it," she says of her investment. Knowing she won't get out what she put in is hard to take. "It's my retirement; it's my nest egg; it's everything."

IF THE HOUSE IS MORE PROFIT VENTURE THAN shelter these days, so, too, is it an instant source of cash for the financially challenged. Surveys show that about one-fourth or one-third of the cash pulled out of houses is used to consolidate debt, often from credit cards. The lending industry has persuaded middle-class and lower-income families that borrowing against their homes is sensible way to plug holes in household budgets, says Elizabeth Warren, a Harvard University law professor who has studied consumer bankruptcies. The strategy makes sense on its face, because the interest rates on credit card debt are often two or three times that of equity loans. But adding to, rather than paying down, mortgage debt virtually guarantees a bumpier retirement for families without other major assets. "Home equity lines have robbed Americans of the number one retirement plan," Warren says. "They will not have fully paid off their homes, and their monthly mortgage costs will likely exceed their Social Security benefits. For millions, because of home equity loans, retirement won't be a soft landing."

Yet the marketing message is so widely accepted that some overzealous borrowers don't question the impact of repeated refinancing until they find themselves in foreclosure or bankruptcy. "People, whether it's naivete or denial, don't seem to see where it's leading," says Janet Werkman, a bankruptcy lawyer based in Cambridge. Easy access to home equity, along with risky mortgages, contributed to the startling 66 percent rise in Massachusetts foreclosure filings from the first half of last year to the first half of this year. Credit counselors and bankruptcy lawyers also link the climbing default rate to the proliferation of subprime lenders, who provide high-cost mortgages to people with bad credit. While subprime lenders have helped boost the homeownership rate among minority and low-income populations, they have turned the basis for homeownership on its head by promoting equity borrowing as a low-cost way to consolidate debt. Too many of these loans, credit counselors say, put people at risk of financial ruin rather than giving them greater security. "I tell people all the time they're not going to take away the TV that you charged, but they will come and take the house if you can't make the payments," says Donna Cabana, a foreclosure prevention counselor for HAP Inc., a nonprofit housing organization in Springfield.

Brokers have also targeted the elderly, the population with the fastest growing rate of refinancing in the country, says Len Raymond, founder and executive director of Homeowner Options for Massachusetts Elders (HOME), a Braintree-based nonprofit that helps seniors who are in danger of losing their homes find low-cost financial products. Nationally, the percentage of homeowners aged 75 or older with home-secured debt nearly doubled between 2001 and 2004, from 9.5 percent to 18.7 percent. "It's not that they're succumbing to enhancing their lifestyles - though there are those who do - but the largest single category is their costs," Raymond says. In Massachusetts, HOME's average client is 80 years old and has $10,000 in consumer debt, largely a result of unmanageable healthcare costs and property tax hikes. Though many have refinanced their homes, very few have taken advantage of property tax deferrals, elder tax exemptions, and other forms of relief. They are prime targets for aggressive brokers. "We had a client who had refinanced 12 times in four years," Raymond says. "Each time, that much more house got gobbled up," not just by the amount borrowed, but by steep transaction costs.

The state's recent shutdowns of six mortgage brokerages for allegedly inflating borrowers' incomes on loan applications did not come as a surprise to local credit counselors, who say they've noticed such a pattern among their clients facing foreclosure. Padding income figures may help a borrower obtain a larger loan, but once the payments start, the borrower frequently falls behind. "Sometimes people have only had their mortgage for three months and they can't afford it," says Mary Ellen Rochette, executive director of Pro-Home Inc., nonprofit affordable-housing agency in Taunton. "I have a client now who is a cook and makes about $38,000 a year. The mortgage company listed him as a head chef with an income of $68,000." Regardless of whether clients in these cases were aware of the puffed-up figures, once they sign and the loan goes through, it's difficult to make a case for fraud.

Liana Williams-Etheridge says she feels "kind of stupid" for refinancing her way into a corner. But the 40-year-old hairdresser and mother of three believes she was deliberately misled by unscrupulous brokers who persuaded her she could afford the loans, then left her with monthly payments much higher than promised.

Williams-Etheridge has refinanced her five-bedroom Victorian in Roxbury several times since she and her husband bought it in 2000. Each time, she borrowed against the house's rising value, using the cash to pay for repairs on the property and, at one point, get her through the financial strain of marital separation. By last year, however, Williams-Etheridge had fallen behind on her payments, and her stress was exacerbated by the death of her estranged husband. So when a mortgage broker called promising low-cost financial relief, Williams-Etheridge jumped at the offer.

At first, her loan application was rejected. Williams-Etheridge says the broker persuaded her to sign over the deed to her house to a close friend who had better credit. The loan was indeed approved, but the rest of the broker's promises proved too good to be true. Williams-Etheridge wound up with a monthly payment $600 higher than she expected, and although she paid a fee to have the lender settle the back taxes she owed the city, the taxes were never paid. The loan's high closing costs ate further into her equity - the list of fees totaled more than $14,000, excluding taxes and insurance, according to Virginia Pratt, a foreclosure prevention counselor for the Jamaica Plain group Ensuring Stability Through Action in Our Community. Now working with Williams-Etheridge, Pratt has notified the state banking commission about what she believes are numerous problems with the loan.

Williams-Etheridge, determined not to lose her house, has complained about the last broker's practices to the mortgage company's corporate headquarters and is consulting with the state attorney general's office. Meanwhile, her phone keeps ringing with refinancing offers. "They call all day long," she says.

Whether we've poured money into our houses or routinely pulled money out, our expectations (and perhaps those of lenders) have reached unsustainable levels. These days, the reality check comes at sale time. "When somebody goes to sell, and they've taken out equity to make improvements or pay tuition or whatever, a lot of people are surprised to find that they don't have the equity they thought they had," says Gary Rogers, a sales associate with RE/MAX First Realty in Waltham. "I tell them you can't spend the money twice."

Lisa Prevost is a freelance journalist who regularly writes about real estate for The New York Times. *E-mail her at lprevost@prodigy.net*. ■

© Copyright 2006 The New York Times Company