More use homes as main asset

By George Avalos
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Instead of building a nest egg for retirement, a growing number of homeowners are putting themselves in a debt trap.

Economists and investment advisers say that more Americans are relying on their homes as their primary asset for retirement. These retirees-to-be reckon they can always tap the expanding wealth in their residence to cover their leisure years.

The reasoning goes something like this: Need some cash? No problem, just get a home-equity line of credit. And because home values have skyrocketed in recent years in places such as the East Bay, homeowners figure they can replace the equity lost from taking out the loan within a year or two. Plus, down the road, they assume they can always just sell the house or get another loan to raise some quick cash for retirement.

"People are making the mistake of thinking they live inside a big piggy bank," said Libby Mihalka, president of Altamont Capital. "They don't realize it can all snowball out of control very quickly. Their house is not an ATM."

Two new studies confirm the trend. One, by the Securities Industry Association, found that the declining savings rate in America in recent years has coincided with an increase in mortgage debt. Another study, by a San Francisco-based economist with the Federal Reserve Bank, found that the level of property-debt burden, compared with income, has risen in recent years.

"This is a form of financial insanity," said Frank Fernandez, chief economist with the Securities Industry Association. "You are digging yourselves deeper into debt using an asset that could decline in value."

This phenomenon extends to the East Bay. Several portfolio managers tell stories of people in Alameda County or Contra Costa County who have taken on steadily rising levels of debt in their house.

One individual, who is in his late 40s, has refinanced his primary residence seven times in six years, each time at a higher level of debt.

"He has all the latest goodies and toys," said John Valentine, president of San Ramon-based Valentine Capital Management. "He uses it for other investments. He just keeps increasing the mortgage. The debt-to-equity ratio on his house is at the maximum level."

In 1989, about 14 percent of a household's income was devoted to paying off monthly mortgage debt, according to the study by Federal Reserve Bank of San Francisco economist Mark Doms. In 2004, that had increased to about 17 percent. Doms believes that most people can handle these levels of debt.

Still, "you have a number of people who have adjustable-rate mortgages whose payments will go up and will not be able to make those payments," Doms said.

The SIA study also found that nearly half of all Americans are not saving for retirement at all. And two-thirds are not saving enough to retire adequately.

And from 2004 to 2005, a year when the American savings rate turned negative, the mortgage debt on homes increased 15 percent to reach $1.14 trillion, the SIA found.

"People started saving less in the late 1990s during the stock-market bubble," Fernandez said. "I suspected the same thing was occurring with regard to the housing bubble, and that is what appears to be happening. As the value of your financial assets increases, people save less money."

Financial companies have certainly made it easier for homeowners to siphon off housing wealth. Relaxed credit and income requirements for home-equity loans, no-interest loans, hybrid fixed and adjustable mortgages, and 40- and 50-year loans are more common.

"Innovative financing instruments have really increased," Fernandez said.

"Your house is like insurance now," Doms said. "If you lost your job or you had another temporary hit to your income, it is very easy to borrow equity to help smooth out short-term rough times."

The trend to tap equity seems especially prevalent in the East Bay, primarily because of the white-hot housing boom in the region. Valentine, who has hundreds of clients, sees differences in the portfolio mix of his East Bay and Peninsula customers.

"Among my East Bay clients, I often see a person's retirement plan and equity in their home comprise well over 90 percent of their net worth," Valentine said. "Among Peninsula clients, it's only about 50 percent."

Valentine believes South Bay clients tend to have more individual stocks and bonds, or wealth accumulated from venture-capital investment than is the case with East Bay clients, who have gained wealth from rising home values over the past 15 years.

Data specific to the East Bay seem to confirm that. In May 2004, the value of the average refinance mortgage was about $333,000. In May 2005, that climbed 17 percent to $390,000. In May 2006, it went up an additional 7 percent, to $417,000.

But tapping the equity in your house constantly, or cutting back on saving for retirement because of rising home values, can backfire, warned George Feiger, an executive with Berkeley-based Contango Capital Advisors.

"You are mortgaging your future," Feiger said. "If you borrow money on the house, you have to pay the interest. That's cash out of your pocket. So, you are betting not only on the house value appreciating in the future, you also need enough cash flow to service that debt."

Mihalka, of Altamont Capital, says the financial pressures will catch up to more people. She recounts the stories of two clients:

• One couple in their 30s, each with a good income, decided to buy their dream home in Pleasanton. They mortgaged themselves to the hilt with an interest-only loan. But they also became saddled with dramatically higher property taxes, which forced them to begin paying the dreaded alternative minimum tax. "They are cash-poor," Mihalka said.

• Another couple in their 50s had begun to spend beyond their means. They took out a line of credit on their home and used it to buy a car and take a vacation. Now it looks as if they could be stuck with big mortgage payments in retirement.

Consumption underpinned by mortgage payments that increase and equity that shrinks could end in severe financial setbacks for people if the housing market cools. Mihalka points out that just a few years ago, people were similarly certain the stock market would not retreat amid the Internet bubble.

"People assume home values in the East Bay will only go up," Mihalka said. "I'm not saying we will have a huge downturn in housing, but when you see the mentality that you can never lose money, that worries me. There is no sure thing."

Some investment advisers said people who are seven to 10 years away from retirement should avoid tapping into the equity in their house.

"You can't sell the house and be sure you can get what you want," Feiger said. "A house is not a controllable tool for retirement. It is not like a bond or a stock you can sell. Look at what happened with the decline in real estate in Southern California between 1991 and 2000. Suppose you had wanted to retire in the 1990s?"

With the 10-year retirement horizon, people should use only the home equity for necessary house-related repairs and maintenance.

So, why have people drifted away from gaining wealth the old-fashioned way -- by earning it? Exotic financing instruments may tell only part of the story.

"It's keeping up with the Joneses, and in this country, you can only keep up through spending," Feiger said. "The psychological pressures to conduct conspicuous consumption interacts with easily available financial tools."

"Everything is now. There is no such thing as waiting to buy something," Mihalka said. But, she added, "You have to plan your finances in a way that on the worst day, you can say it will be OK."

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The best way to deal with a mortgage debt trap is: Don't get in one. So how do you avoid one, and if you do get in the trap, how do you get out? Here are some tips from George Feiger, president of Berkeley-based Contango Capital Advisors.

Avoid the trap

• Be sure to check your income and subtract all of your expenses, paying special attention to the interest you would pay if you were planning to take on a new and larger mortgage.

• Ask yourself if you could still handle the expense part of the equation if you were unable to sell your house right away and had to wait two or three years before selling.

• Ask yourself if you could meet the expenses from the larger mortgage if you suffered the misfortune of losing a job and could not find work for three to six months.

Escape the trap

Let's say you're already stretched too thin because the payments on the mortgage are too burdensome and you can barely keep up with your expenses -- or worse.

• Above all, don't lose the house. Sell your car, sell your boat, but do all you can to hang on to the primary residence that has your hard-earned equity in it.

• Go to a debt counselor. Don't go to the credit companies right away. Get advice on creating a financial cushion and stretching out your payments.