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Cashing Out Equity May Be Tempting, But the Risk is High

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Americans are lining up to tap their real estate equity.

New research by mortgage market giant Freddie Mac has found that 60 percent of all refinanced mortgages the corporation purchased during the third quarter of 2004 involved "cash-outs," where homeowners increased the size of their loans and pocketed the difference tax-free. That 60 percent figure was up from 42 percent during the second quarter and represents the highest rate since mid-2002.

In hard-dollar terms, American homeowners converted \$41 billion in real estate equity into spendable cash in the third quarter alone, up from \$28.5 billion during the second quarter. For the year as a whole, Freddie Mac estimates that homeowners will cash out \$118 billion of their home equity.

A typical cash-out works like this: Say you have a mortgage balance of \$200,000. But the market value of your house has risen over the past few years and the property is now worth \$400,000. If you need cash, you could easily refinance your \$200,000 loan and replace it with a \$250,000 or \$300,000 mortgage. The proceeds of the refinancing -- \$50,000 or \$100,000, less the transaction costs -- would be yours to keep, tax-free.

The key to this trend, of course, is an unusual confluence of high home value appreciation with near-record low borrowing costs. The average house in the United States has gained 44 percent in value in the last 60 months alone, according to the Office of Federal Housing Enterprise Oversight. In some high-roller markets on the West and East coasts, gains of 60 percent to 80 percent or more have been common. Meanwhile, 30-year mortgage rates have hovered at or below 6 percent, making borrowing money from your home piggy bank cheaper than in four decades.

In Freddie Mac's study, the houses securing cash-out refinancings had experienced a median appreciation of 17 percent in value during the brief, 2.6-year median life of the preceding mortgage. Even with the high cash-out ratio, however, many refinancers were able to lower the interest rate on their notes. More than half of all refinancings in the study produced net decreases in the rate from the preceding mortgage to the new loan.

Another booming technique for tapping rapidly accumulating home real estate wealth: equity lines of credit. In a recent survey of a sample of its members, the Mortgage Bankers Association recorded a major surge in new applications for home equity lines of credit -- up an astounding 77 percent in the first half of 2004.

Not only were new applications on the rise, but the size of the credit lines appears to be ballooning as well. The average credit line was \$71,932 in January and swelled to an \$83,630 average for new lines in

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July, a 16 percent jump. The initial average drawdown on the lines also was up -- from \$42,523 in January to nearly \$46,000 in July.

Home equity credit lines are hot in part because lenders have cut rates, reduced settlement fees and streamlined the closing process dramatically. Equity lenders, primarily big banks, now routinely offer credit lines priced at or below their prime commercial rates for eligible homeowners with high credit scores. After taxes, the effective cost of these lines is in the mid- to upper 3 percent range for many consumers.

As just one example of the trend, Bank of America's popular "equity maximizer" program offers lines up to \$500,000 for eligible homeowners and guarantees no appraisal fees, no title charges, no origination or underwriting fees, no local transfer or recordation taxes, no annual maintenance fees and no early termination penalties.

With most of the traditional application and settlement fee hassles removed, should equity-flush owners join the crowd and hock their homes to the hilt? Hardly. Remember: Equity lines and cash-out refinancings add to your outstanding household debt, and can raise your total monthly debt payments significantly. Equity lines typically have floating rates that can be adjusted monthly or quarterly, putting you in a potential payment squeeze should short-term rates suddenly spike upward.

More sobering still: Because both types of mortgages are secured by your house, they open you to the possible loss of your residence and your equity in the event of a foreclosure, unlike other consumer loans.

On the other hand, you shouldn't ignore financial reality: If you truly need to borrow money for a major project, take a hard look at the equity sitting frozen in your home. It may well be your cheapest and quickest source of cash.

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