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Refinancing Is Sustaining Spending, But Do Dangers Lurk in the Details?

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PHOENIX, Ariz. -- It's one of the great puzzles of the current economic slowdown: Consumer spending has remained relatively strong, despite rising layoffs and weakening business conditions. To understand one reason why, meet Paul Campbell.

The 44-year-old account executive at a computer company here turned \$32,000 of home equity into cash this summer, using an increasingly popular technique known as cash-out mortgage refinancing. Mr. Campbell and his wife, Beth, are allocating some of the money to pay off credit card and other debts. But they are also splurging on "some goodies," says Mr. Campbell, including a \$3,600 air-conditioning system and a \$1,700 home theater with a 36-inch television and "surround-sound" speakers. They also are considering buying a condo for their college-bound son.

The refinancing caused the monthly mortgage payments on the Campbells' \$230,000 house to rise \$200, to about \$1,400. But the Campbells, who had total family income of \$99,000 last year, "won't even feel" the increase, Mr. Campbell predicts. In fact, he says, the extra cash from the refinancing "is making everyone around our house breathe a little easier."

All over America, borrowers such as the Campbells are rushing to take advantage of the rising value of their homes. And the cash squeezed out of these refinancings has helped keep consumer spending increasing -- by an annualized rate of 3.1% in the first five months of the year. Economists figure all the refinancing activity contributed nearly half of the 1.2% annualized growth in first-quarter gross domestic product -- and may yet help the U.S. skirt a recession.

"The truly important stabilizer of the economy right now is wealth coming from homes," says Sung Won Sohn, chief economist at San Francisco-based **Wells Fargo & Co.**, one of the country's largest mortgage lenders.

\$33 Billion Windfall

Using a variety of government and mortgage-industry data, Economy.com², a West Chester, Pa., consulting firm, estimates that mortgage loans with a value of \$495 billion were refinanced during the first six months of this year. Consumers have extracted about \$33 billion in cash from those transactions. Both amounts are nearly three times as high as those for the same period last year.

Economists estimate that rather than paying down nonmortgage debt, borrowers lately have been spending more of their cash-out bounty than has been the case in past periods of heavy refinancing. Lenders and others in the business say people are typically cashing out \$20,000 to \$40,000 per refinancing, substantially more than the norm during the last big wave of the transactions, in 1998.

Federal Reserve Chairman Alan Greenspan told Congress in testimony last week that consumers' spending stamina this year has been "assisted in part by a continued rapid growth in the market value of homes, from which a significant amount of equity is being extracted."

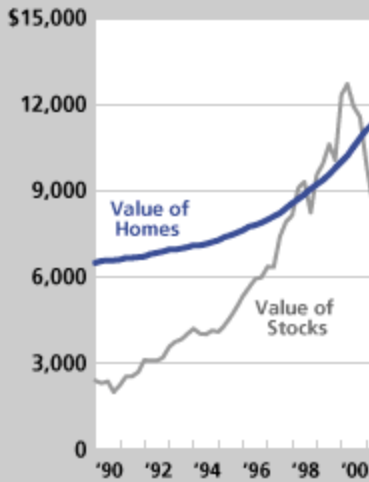
Defying Gravity

During past slowdowns, consumers have sharply reined in their spending, as unemployment rose and the value of assets -- including homes in many areas --

▶ ¹ How do you expect your home's value to change in the next year? Participate in the **Question of the Day**.

BACK HOME

With stock prices weakening and housing prices on the rise, homes are once again Americans' most-valuable asset. Figures are in billions.



Source: Barclays Capital

decreased. This time, though, home prices have continued rising. Nationwide, home prices climbed 8.9% last year, according to the government's Office of Federal Housing Enterprise Oversight. By their index, this was the strongest annual gain in housing since 1979.

Meanwhile, mortgage rates are low. According to Freddie Mac, the average rate for a 30-year fixed-rate mortgage has hovered around 6.9% to 7.2% so far this year, compared with an 18-month high of 8.6% in May 2000.

There are lots of theories about why home prices are defying gravity these days. Possibilities include those attractive mortgage

rates, which embolden buyers, and the flight of individual-investor money into real estate from the volatile stock market.

Another factor is marketing: Lenders are egging on potential buyers by aggressively hawking mortgage loans, whose fees are helping offset shrinking profits from commercial lending.

Richard Fawley, Jr., a Scottsdale real-estate broker, says he has been getting three or four solicitations from mortgage companies a day, mostly by fax. Mr. Fawley, 52, was a receptive audience. His house, which cost \$425,000 when he and his wife, Norma, bought it a year-and-a-half ago, was recently appraised at \$535,000, a 26% jump. In the spring, they refinanced and snagged \$55,000 in cash, which they sank into vacation-and-investment property in Ruidoso, New Mexico.

With their new loan of \$380,000, their monthly mortgage payments will go up \$200, to about \$3,000. The Fawleys had combined annual income last year of about \$110,000 -- plenty to cover the higher amount, Mr. Fawley says.

He remembers the Sun Belt real-estate bust of the late 1980s and early 1990s and acknowledges that a dip in home values or in his family income could make his now-larger mortgage a weighty liability. But he thinks about his refinancing this way: "It's no different than if I was putting \$200 a month into an IRA or a

mutual fund. It's more like an investment than an expenditure, because I fully expect a return on it."

In a typical cash-out refinancing, a borrower obtains a new, larger mortgage that reflects an increase in the appraised value of the borrower's home. The old, smaller mortgage is paid off, and the borrower takes all or part of the difference in cash.

If it seems like getting something for nothing, it's not. The new interest rate is usually lower, but the monthly payment often rises because the new loan is bigger.

"You're simply postponing your debt obligation out into the future," says Mr. Sohn of Wells Fargo & Co.

Cash-out refinancings, which have been around a long time but which didn't really take off until the 1990s, tend to boom during periods of lower rates, such as the past six months. A different way to tap home equity is to take out a second mortgage, also known as a home-equity loan. Some borrowers see this alternative as less attractive because a second loan typically comes at a higher interest rate.

To some economists, the popularity of cash-out refinancing suggests Americans are growing more financially sophisticated. Frank Nothaft, an economist at Freddie Mac, one of the two big government-sponsored mortgage companies, says consumers are acting more like corporations, which refinance their debt whenever possible to reduce costs or fund new spending.

Even so, Mr. Greenspan said in his congressional testimony that there are "downside risks to consumer spending" over coming months, including the possibility that the boost from refinancing won't be enough to offset losses from the stock market. If the refinancing boom peters out before the economy recovers, that could lead to a sudden drop in consumer spending, hastening a recession. A further possibility is that if household income falls, consumers who had spent more freely because of cash-out refinancing could suddenly have trouble meeting their larger monthly mortgage obligations.

Such troubles aren't unheard of: In California in the early 1990s, for example, a reeling economy left many homeowners unable to pay their bloated mortgages, forcing many to default on their loans.

Cash-out refinancings are also exacerbating a long-term national decline in the amount of equity homeowners own. According to the Federal Reserve, Americans, on average, own about 55% of their homes, compared with 86% in 1945. The home-equity figure has dropped 10 percentage points in the last decade.

'Poor Man's Savings Account'

Housing "used to be the poor man's savings account," says Jay Q. Butler, director of the Arizona Real Estate Center at Arizona State University in Tempe. But now it's seen as "a short-term asset" that can be tapped again and again, much like a checking account.

Michael Herr, a 33-year-old supervisor for a hair-dryer manufacturer near Phoenix, has refinanced his home three times in four years. The first transaction, in 1998, produced \$25,000 in cash, which Mr. Herr and his wife, Shannon Kaiser-Herr, used to reduce credit-card debt and pay private-school tuition for three of their four children. Their mortgage-interest rate held steady at 9%, but the mortgage grew by almost a quarter, to \$128,000. Their monthly payment rose to about \$1,100, from \$1,050.

A second refinancing boosted the Herrs' loan to \$133,000 and yielded \$5,000 in cash. They have continued acquiring big-ticket items. Last Christmas, Shannon bought Michael a big-screen television for \$2,200. "I don't need it, but I love it," he says. "We like to buy things." Their credit-card debt grew to more than \$40,000 in 2000.

This year, the Herrs, who had combined 2000 income of about \$78,000, went back for a third refinancing. They tapped \$20,000 more of the equity in their home, which was appraised at \$165,000, up 19% from four years ago. Mr. Herr says his mortgage broker, State Mortgage, told him this would have to be the last time. With a new \$160,000 mortgage, the Herrs have only \$5,000 of equity left in

their house. Their interest rate is now down to 7%, but with the bigger loan, their monthly payment is up to about \$1,200.

Most of the \$20,000 in cash they recently obtained went to chip away at credit-card debt, Mr. Herr says. But if there's anything left over, he adds, they might spend it on a vacation.

Home Appreciation

The potential hazards of accumulating too much mortgage debt appears to be generating little apprehension in Phoenix. People here are as optimistic about home values as they once were about technology-stock prices.

Last year, home prices in Phoenix rose 5.3%, on top of a 6.5% jump the year before. In some of the more desirable neighborhoods of nearby Scottsdale and Paradise Valley, home prices rose as much as 25% last year alone.

That kind of appreciation is what prompted J. David Bohl, a retired engineering consultant in Avondale, Ariz., to use a cash-out refinancing to collect \$100,000. He plans to use the money to begin building a vacation home near the Mogollon Rim area, a few hours from town.

Mr. Bohl, 63, and his wife, Maureen, had planned to pay for the house with profits from his stock portfolio. But then the market fell. Their current home's appraised value has grown \$75,000, to \$230,000, since they bought it in 1988. Now, the monthly mortgage payment on their new loan of \$150,000 has climbed 43%, to about \$1,000.

The bigger mortgage and monthly payments worry Mr. Bohl slightly, he says. But the couple has substantial stock investments and, if Wall Street bounces back, they plan to pay off the new loan in just a few years, he says.

The refinancing activity is sending cash into a Phoenix economy that has some mixed signals. Unemployment, at 3.4%, remains extremely low. The national rate is 4.5%. And some sectors, such as construction, are booming.

But several large local employers, including **Motorola** Inc., have announced layoffs. Gains from homes -- whether realized through refinancings or not yet

tapped -- are helping prop up the confidence of residents such as Kathie Kennedy.

The 50-year-old Phoenix-based flight attendant for America West Airlines says she is aware that her employer, like most of the rest of its industry, is reporting poor financial results. But that's not stopping her from using the equity in her home as the foundation of an ambitious retirement plan.

Ms. Kennedy says that with the \$70,000 from the cash-out refinancing she got this year, she is investing in the stock market and considering buying another home for investment purposes. Her current home surged in value by \$134,000 over the past 16 years. Now, her goal is to turn her cash-out windfall into \$250,000 over the next 10 to 15 years.

"I just didn't want to let \$70,000 sit in my home," she says. The strategy nearly doubled her mortgage, to about \$150,000, meaning her monthly payments of \$1,150 are about \$230 higher. She won't reveal her salary but says it is modest enough so that the prospect of making those payments "is a little scary."