BORROWING TO MAKE ENDS MEET SERIES

A House of Cards:
Refinancing the American Dream

Winter 2007

In response to ever-increasing financial pressures, families have come to depend on high-cost credit as a way to bridge the gap between stagnant or decreasing incomes and rising costs. How are families coping with their new burden? To hang on to the American Dream, to be part of the ownership society, homeowners are depleting their home equity to pay off a growing mountain of unsecured debt—a financial strategy fraught with serious consequences.

As mortgage interest rates fell to record levels during the refinance boom, it became more appealing to cash out home equity during the refinancing process to pay down credit card debt and finance current living expenses—a short-term solution that fails to address the long-term economic realities faced by the average family.

As the housing bubble deflates and interest rates on risky adjustable-rate mortgages have risen, more and more homeowners are feeling the pinch. Refinancing for a second or third time is becoming a common Band-Aid. Defaults are also increasing, particularly for subprime mortgages. The added burden of missing a mortgage payment results in putting at risk your home—your family's most important asset. All of these factors lead to a crisis in personal finance: a blurred line between good debt—debt that results in appreciable assets—and bad debt, which does not.

A Dēmos Policy Brief
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Key Findings

- Households cashed out $715 billion worth of home equity between 2001 and 2005. In the three years between 2003 and 2005, owners extracted $150 billion more in equity from their homes than they did in the previous eight—a level three times higher than any other three-year period since Freddie Mac started tracking such data in 1993.

- Households have used cash equity from their homes to cover living expenses and pay down credit card debt, further eroding their homes' cash value, which many families rely on for economic security.

- Between 1973 and 2004, homeowner equity actually fell—from 68.3 percent to 55 percent. In other words, Americans own less of their homes today than they did in the 1970s and early 1980s.

- In 2006, the financial obligations ratio—the percentage of monthly income to the amount needed to manage monthly debt payments—surpassed 19 percent, a record since data started being collected in 1980.

- About $400 billion worth of adjustable-rate mortgages (ARMs), representing about 5 percent of all outstanding mortgage debt, is set to readjust this year for the first time. Another $1 trillion in loans are set to readjust next year.

- Adjustable-rate mortgages made up 31 percent of mortgages in 2005. Interest-only loans, which were uncommon just two years ago, made up about 20 percent of loans.

- In current conditions, a typical borrower with a $200,000 ARM could feasibly see their interest rate climb from 4.5 percent to 6.5 percent, resulting in a 25 percent increase in his or her monthly payment.

- Rising foreclosures signal that many homeowners are already buckling as interest rates rise and home values soften, trends that will continue as more mortgages adjust. According to RealtyTrac, foreclosures in the third quarter of 2006 were up 17 percent from the previous quarter, a 43 percent yearly increase from the third quarter of 2005.

Introduction

As middle-class families navigate an economy that has undergone dramatic changes in just a generation, the family budget is facing new and increasingly profound pressures. The financial obligations ratio—the percentage of monthly income to the amount needed to manage all monthly debt payments—reached a record high of 19.23 percent in the second quarter of 2006, up from 19.15 percent in the first quarter. The debt service ratio—the ratio of outstanding mortgage and consumer debt to personal income—also hit a new record, rising to 14.40 percent.[1]

Home equity, a measure of family financial health, has fallen to its lowest level in 30 years. Steady deregulation of the banking and financial industry since the 1970s has resulted in higher credit card interest rates and fees. Healthcare costs have risen by double digits over the last several years, and housing costs absorb an increasing share of family income. Despite a slow recovery from the recession in 2001, incomes for the middle class have actually *decreased*. Incomes would be declining further if families were not working more hours to keep up with past levels.[2]

In response to financial pressures, families have come to depend on high-cost credit as a way to bridge the gap between stagnant or decreasing incomes and rising costs.[3] How are families coping? To hang on to the American Dream, to be part of the ownership society, homeowners are relying on their home equity. While home equity is a staple of financial stability, for many families an increased reliance on this equity to pay down other debt is a financial strategy fraught with serious consequences. As mortgage interest rates fell to record levels during the refinance boom, it became more appealing to cash out home equity during the refinancing process to pay down credit card debt and finance current living expenses. The weakness of this strategy is that it is a short-term solution that fails to address the long-term economic realities faced by the average family.

What's worse, recent Federal Reserve interest rate increases translate into higher mortgage payments for families who refinanced with an adjustable-rate mortgage. The added burden of missing a mortgage payment results in putting homeowners at risk of losing their family's most important asset. All of these factors lead to a crisis in personal finance: a blurred line between good debt—debt that results in appreciable assets—and bad debt, which does not.

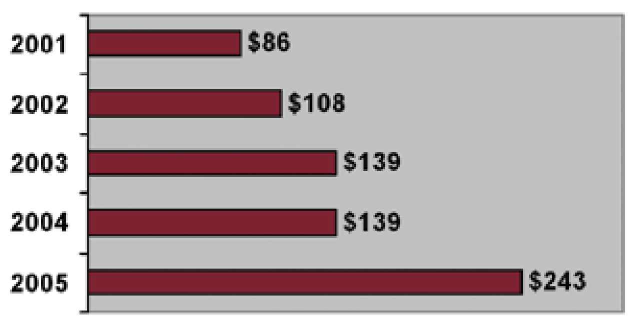
This briefing paper begins with an examination of the refinance boom. The focus then shifts to an analysis of rising debt and debt burdens. Finally, the consequences of leveraging equity, including policy recommendations and conclusions are discussed.

Refinancing 2001–2005: Boom or Beginning of a Cycle?

Pulling together key data points from various sources to understand the scope and impact of the refinance boom, a few trends become clear. Millions of households have replaced more expensive credit card debt and financed current living expenses with mortgage debt by withdrawing equity from their homes.[4] Adjustable-rate mortgages taken since 2001 are beginning to reset and monthly mortgage payments are rising. Refinanced loans and variable rate mortgages continue to be popular home loan products, in part as a way for homeowners to refinance again and get relief from high payments which are soon to be due.

A recent Harvard study on the housing market revealed households cashed out an astonishing $715 billion in home equity between 2001 and 2005 (Figure 1).[5] According to Federal Reserve data, refinancing applications did fall slightly between 2004 and 2005. However, the majority of mortgage loan applications in 2005 were still for refinancing of existing loans, and data from the first half of 2006 shows renewed and steady growth in refinance applications.[6]

Figure 1. Amount of Home Equity Cashed Out, 2001- 2005 (In Billions)



Source: Harvard University, Joint Center for Housing Studies

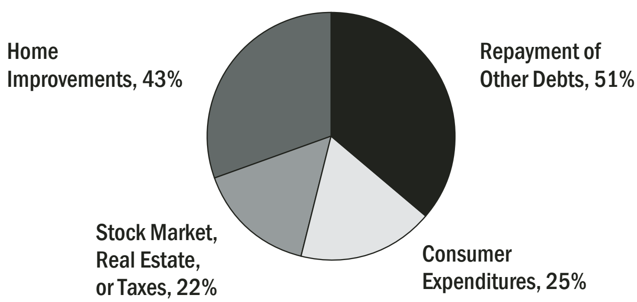
While the number of loan applications declined slightly between 2004 and 2005, the total amount of equity cashed out grew by an astounding 75 percent. Homeowners cashed in a record $243 billion in equity in 2005. Looking at the three years between 2003 and 2005, owners extracted $150 billion more in equity from their homes than they did in the previous eight years.[7]

A majority of households that refinanced by 2001 or early 2002 did so with a fixed-rate mortgage. Of these, 44 percent pulled out equity during refinancing. While the share of those who refinanced with an adjustable-rate mortgage was small in 2001 and 2002, 57 percent of these borrowers withdrew equity.[8] As the boom picked up steam between 2002 and 2003, nearly half of all mortgage debt was refinanced. According to the Mortgage Banker's Association, adjustable-rate mortgage refinancing comprised 17 and 18 percent of all refinancing transactions in 2002 and 2003, respectively.[9]

According to Federal Reserve data, the average amount of home equity extracted in 2001 and early 2002—the early stages of the refinancing wave—was $27,000. Refinancing reached an all-time high between mid-2002 and mid-2003.

What did homeowners do with this newfound cash? A majority of them, 51 percent, used funds to cover living expenses and to repay other non-mortgage debt such as credit cards, which are used increasingly to cover living expenses. Twenty-five percent used funds for consumer expenditures such as vehicle purchases, education, and medical expenses (Figure 2). In other words, a majority of households who refinanced actually converted credit card debt and current living expenses into long-term mortgage debt.

Figure 2. Use of Funds From Refinancings, 2001 and 2002



Percentages add up to more than 100 because each refinancing loan could have been used for multiple purposes. Source: Federal Reserve System, Flow of Funds Accounts of the United States.

Source: Federal Reserve System, Flow of Funds Accounts of the United States.

As this debt becomes due, it threatens the homeowners' delicate balancing act and leaves them on precarious footing as adjustable-rate mortgages are reset and monthly payments rise.

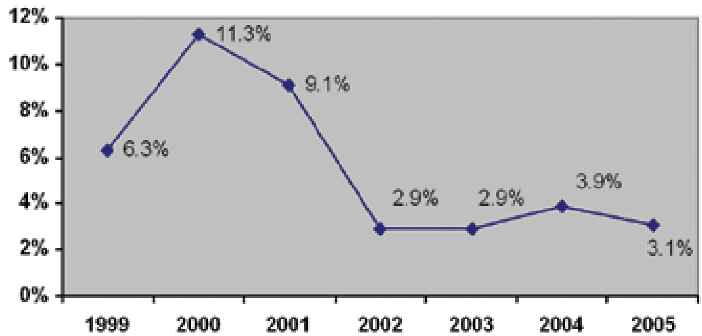
About $400 billion worth of adjustable-rate mortgages, representing about 5 percent of all outstanding mortgage debt, are set to readjust this year for the first time. Another $1 trillion in loans are set to readjust next year. In current conditions, a typical borrower with a $200,000 ARM could feasibly see their interest rate climb from 4.5 percent to 6.5 percent, resulting in a 25 percent increase in their monthly payment. Industry experts predict a spike in refinancing next year as homeowners seek relief from these large increases and look to refinance for the second or third time.[10]

Plundering Assets: The Role of Rising Debt

Amidst the refinance boom, households are experiencing high levels of debt accumulation. According to a Demos analysis of the Federal Reserve's Survey of Consumer Finances, average credit card debt among all families increased by 85 percent, from $2,768 to $5,129, between 1989 and 2004 (2004 dollars). During the same period, middle-income families—those earning between $50,000 and $99,999—saw an average credit card balance increase of 64 percent, to $4,667. Lower middle-income families—those earning between $25,000 and $49,999—had an average increase of 95 percent, to $ 4,831, by 2004. Among those over 65, the average credit card balance increased by 194 percent to $4,906.

The onset of the refinancing boom helped slow the growth of aggregate levels of credit card debt in the short-term as increasing numbers of families used a portion of their homes' equity to pay down outstanding revolving debt. Since the refinancing boom fully took off, aggregate credit card debt has grown by only about 3 percent. In comparison, aggregate credit card debt grew by more than 11 percent in 2000 (Figure 3).[11]

Figure 3. Year-to-Year Growth of Revolving Consumer Credit Outstanding, 1999 - 2005

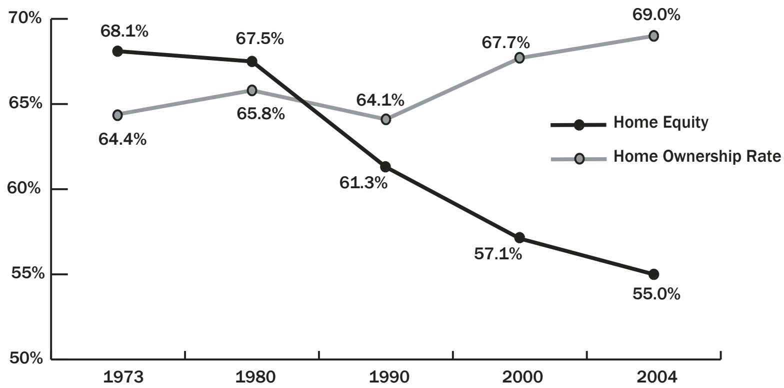


Source: Federal Reserve System, G-19. Dollar figures for revolving consumer credit, October 6, 2006; February 7, 2001; and June 10, 2000 releases.

With the decline of home equity and the rise of debt burdens and interest rates, there is cause for alarm about the ability of families to continue along this path. Declining interest rates made "cash out refinancing" an attractive alternative to maintaining non-mortgage debt and using credit card debt to bridge the gap between wages and expenses. With the increase of interest rates, this strategy has become less viable for homeowners in general and more expensive for those with risky adjustable rate mortgages. Many families who cashed out equity during the refinancing process to pay off credit card debt and finance current living expenses are now left with higher monthly payments and longer loan periods. Some are refinancing for a second or third time to delay the impact of higher interest rates.

Even though homeownership has reached record levels, home equity has fallen since the early 1970s. Despite a booming real estate market that has increased home prices over the last five years across the U.S., between 1973 and 2004, homeowner equity actually fell—from 68.3 percent to 55 percent through the second quarter in 2004 (Figure 4). *In other words, Americans own less of their homes today than they did in the 1970s and early 1980s.*

Figure 4. Homeowner Equity as a Percentage of Household Estate and Homeownership Rates, 1973–2004



Source: Federal Reserve System, Flow of Funds Accounts of the United States and US Census Bureau.

Record Debt Burdens

As home equity has fallen, household debt service burdens have risen to record levels. Between 2001 and the second quarter of 2006, the "financial obligations ratio"—the amount of disposable income needed to pay down debt—averaged 18.72 percent. This latest 2006 figure of 19.23 surpassed any high since 1980, the first year data was collected.[12]

At great risk, families are using their home equity to manage increased financial obligations. High debt service ratios are occurring in an economic climate of stagnant or declining wages. The typical American family experienced negative wage growth of -1.2 percent between 2000 and 2002. Add in rising healthcare premiums and housing costs, and the pinch on the family budget becomes more acute. Since 2000, healthcare premiums have risen nearly 60 percent and housing costs have increased by double digits in nearly every part of the country.[13]

Being "Upside Down" in a House

All homeowners stand to lose if we are indeed nearing the end or even the deflation of the housing bubble, as some analysts predict.[14] Some homeowners will be at greater risk than others. Those who reduced their homes' equity during the refinance boom could suffer devastating effects if home prices begin to fall, especially those who live in regions where housing property appreciated the most. Home prices rose 56 percent between the second quarters of 2001 and 2006.[15] Affordability is increasingly becoming an issue. The number of metropolitan areas in which median house prices are at least four times median household incomes more than tripled from 13 in 2001 to 49 in 2005. The number where median house prices are at least six times greater grew from four to 14.[16]

While home sales remain strong, there are signs of weakening. Year-over-year sales of existing homes turned negative in late 2005. In more than half of states, production of single-family homes declined.[17] Signs of this slowing have persisted through the first two quarters of 2006. As home sales slow, and prices reduce, homeowners could owe more on their mortgage than their house is worth, also known as being "upside down" in a house.

Consumer susceptibility to a slow housing market or declining prices remains high. Families who moved into homeownership with zero or small down payments may also be particularly vulnerable to financial crisis if homes decline in value. Because they have little or no equity in their homes, their loan-to-value ratios are high. Even a small decrease in home values would put these homeowners upside down in their home.

Borrowers with adjustable-rate mortgages are also at greater risk because these types of mortgages are subject to fluctuating interest rates. Adjustable-rate mortgages made up 31 percent of mortgages in 2005. Interest-only loans, which were uncommon just two years ago, made up about 20 percent of loans. As a result of recent increases in the interest rates by the Federal Reserve, homeowners with such mortgages will face increased mortgage payments and could find themselves grappling with the unenviable paradox of having to make higher payments on a devalued asset.

Mortgage Fraud

Appraisal fraud was one of the major contributing factors to the savings and loan scandal of the 1980s—a legacy that continues in today's inflated housing market. The appraisal process is one of the most important steps during a refinancing or home purchase. It is also the step most susceptible to fraud or manipulation. Even though appraisal fraud is underreported, it was the fastest-growing type of mortgage fraud reported by major lenders in 2000.[18]

There was a seven-fold increase in reports of mortgage fraud between 1999 and 2005. In 2005, more than 22,000 cases were reported to the FBI. In fiscal year 2005, federally-regulated institutions reported over $1 billion dollars in losses due to mortgage fraud. Even though some of the increase in reported mortgage fraud is due to increased public awareness, both the FBI and the Mortgage Bankers Association warn that, "mortgage fraud is a burgeoning crime that is affecting more and more companies and communities."[19]

Specifically, appraisal fraud is the practice of inflating home values during a mortgage transaction or refinancing. The end result is, in some cases, mortgage loans that exceed the real market value of the house. In most cases, the practice is the result of direct pressure on the appraiser from the loan originator, broker, or realty agent to inflate home values. If appraisers under pressure to inflate home values during the appraisal process do not do so, they risk losing repeat business from the broker or others involved in the transaction.

Even though appraisal fraud is underreported, data from the Mortgage Asset Research Institute shows that between 2001 and 2005, 20 percent of mortgage fraud cases involved appraisal fraud, on average.[20] This figure underestimates the level of appraisal fraud because a lender rarely verifies that appraisal fraud occurred when more than one type of fraud is discovered, even when the appraisal appears to be false. Appraisal fraud is a significant factor in a growing number of loan defaults and foreclosures, particularly in the subprime market.[21]

The Appraisal Institute reported that more than 7,000 appraisers had been subjected to pressure to inflate property values. Results from the National Appraisal Survey reveal that 55 percent of appraisers report feeling pressured to overstate property values, and a quarter of appraisers report they feel pressured nearly half the time.[22]

Who wins? Third party mortgage brokers, primarily, reap significant rewards in this process with increased commissions or closing fees. The banks providing the loans also benefit, although they may be left in the dark on illegalities. These mortgages are purchased from banks at the inflated appraisal price and bundled into risk pools by governmental, quasi-governmental, or private firms. Government agencies that participate in the securitization of mortgages include Ginnie Mae, Fannie Mae, and Freddie Mac. Because the loans are held for such a short period by mortgage issuers, due diligence is often ignored.

Who loses? Everyone else: home buyers who cash out phantom equity in an overvalued home could find themselves "upside down" after the prices settle or the bubble bursts; anyone with a retirement account, like a 401(k), that invests in portfolios padded with risky bundled mortgage backed securities; and US taxpayers, who could be faced with a massive industry bailout. Combined with a decline in home values and rising costs, individuals and families could be faced with a perfect storm for financial disaster.

From Good Debt to Bad

The notion of good debt was created with the development of the 30-year mortgage, which enabled Americans to borrow for the purposes of a long-term investment. Borrowing for consumption purposes—in many cases, to make ends meet—does not result in an appreciable asset, and therefore has long been considered "bad debt." In light of current refinancing trends, however, the difference between good debt and bad debt is increasingly becoming blurred.[23] Homeowners have used billions in home equity to pay off credit cards or to cover increasing costs of living. If consumers continued spending equity through 2003 at the same pace as they did between 2001 and early 2002, nearly $253 billion of mortgage debt would represent bad debt.

Despite some benefits, combining bad debt with good debt—thereby stretching out repayment of bad debt over twenty or thirty years—may prove to be the worst financial decision a household can make. Consider that combining $15,000 of bad debt into a 30-year mortgage will result in $16,341 in additional interest payments alone, slightly less than keeping the balance on the credit card and paying the minimum (Figure 5).[24]

While this seems counterintuitive, the credit card payment will hover just under $400 the first month and decrease each month afterward while the added cost to the monthly mortgage payment remains constant at $87. While benefits may seem negligible versus a 30-year mortgage, the consequences of missing a mortgage payment are dire. Missing your mortgage payment not only jeopardizes your credit score but also jeopardizes your most valuable asset—your home.

Figure 5. Comparison of Mortgage and Credit Card Interest Payments

	Amount Borrowed	*Annual Interest Rate*	*Monthly Payment Amount*	*Number of Years*	*Total Interest Paid*
Credit Card Debt	$15,000	15.99%	minimum payment = 2.5% or $10, whichever is higher	30	$16,597
Mortgage Debt	$15,000	5.7%	$87	30	$16,341

Source: Demos' Calculations.

While the advantages of adjustable-rate mortgages are apparent—such as lower interest rates and tax deductibility of interest paid—the pitfalls of such loans can be devastating when rates begin to rise, and underscore the dangerous effects of borrowing against a home's value to pay off bad debt.[25] As the Federal Reserve has raised interest rates, mortgage payments for adjustable-rate loans have risen accordingly. As a result, families with adjustable-rate mortgages are experiencing increases in their monthly mortgage payments. The combination of higher mortgage payments coupled with rising costs of basic expenses such as healthcare, childcare, and groceries represent a growing threat to middle-class security.

Policy Recommendations

Major changes in the way the credit card industry operates are needed so families are not faced with risking their nest egg to pay off high cost credit card debt and penalty fees. Today, an increasing number of working families are squeezed by rising costs of housing, healthcare, and stagnant or declining wages. There is an urgent need to begin to address these broad economic challenges. However, the role of the credit card industry can no longer be ignored. As families have become increasingly reliant on credit card debt to bridge the difference between rising costs and stagnant wages, current industry practices ensure that these families fall deeper into debt. In addition, homeowners who refinanced in the midst of the refinance boom may have been at risk of appraisal fraud—the deceptive practice of inflating home values. The full impact of appraisal fraud will become apparent as the housing boom slows. The following policy recommendations are aimed at ensuring that families have a fair chance at keeping their nest egg in the midst of economic challenges, unfair credit card industry practices, and a housing boom fueled in part by appraisal fraud.

Addressing Credit Card Industry Practices

While the long-term goals of increased economic security and opportunity will help families protect their nest egg for future generations by avoiding the pitfalls of debt, certain policy changes at the federal level could help today's homeowners pay down their debt at reasonable rates, over reasonable amounts of time.

The following policy changes would help ensure Americans the opportunity to protect their most important asset while also helping families get ahead and build strong, financially secure futures. Enacting just one of these reforms would help reduce the need for Americans to borrow from tomorrow's nest egg to offset high cost healthcare, education, and declining or stagnant wages.

Enact a Borrower's Security Act. Today there are no legal bounds to the amount of fees and interest credit card companies can charge borrowers. In addition, credit card companies, unlike other lenders, are allowed to change the terms on cards at anytime, for any reason. As a result, cardholders often borrow money under one set of conditions and end up paying it back under a different set of conditions. Legal limits on interest rates and fees have traditionally been established by the states. But because card companies can export interest rates from the state in which they are based, consumers are left unprotected from excessive rates, fees and capricious changes in account terms.

A Borrower's Security Act would restore responsible credit practices to the lending industry by extending fair terms to borrowers. Specifically, legislation is needed to:

- Eliminate universal default terms by requiring that any penalty rate or fee increase must be linked to a material default directly related to a specific account with that lender.

- Limit penalty rate increases to no more than 50 percent above the account's original rate. (For example, a 12 percent interest rate would be increased to an 18 percent penalty rate.) This policy would still provide the issuer with significant additional protection against payment risk. Changes in bankruptcy laws have provided additional protection for credit card issuers in the event of borrower default, further reducing the justification for higher penalty rates.

- Provide at least 30-days' advance notice that the card issuer is invoking the penalty pricing clause.

- Prohibit the retroactive application of pricing changes so that rate changes are applied only to purchases made after the issuer gives notice of the rate change.

- Ensure that grace periods and payment posting rules and practices are not designed to trigger late charges and penalty rates.

Strengthen Current Bankruptcy Laws To Support Hard-Working Families In Severe Economic Distress

Bankruptcy is the last resort for hard-working families who find themselves in dire straits. Many middle class families are left in this situation from unforeseen circumstances such as health problems and unpredictable illness.[26] In 2005 Congress passed sweeping changes to bankruptcy laws which removed many protections available to average families. As financial stability for families becomes increasingly fragile and the safety net of home equity evaporates, these changes must be reexamined and reversed.

Addressing Real Estate Practices.

One of the major contributing factors to the savings and loan scandal of the 1980's was appraisal fraud. This legacy from the scandal continues in today's inflated housing market. The appraisal process is one of the most important steps during a refinancing or home purchase—it is also the step most susceptible to fraud or manipulation.

Even though appraisal fraud is underreported, it was the fastest type of mortgage fraud reported by major lenders in 2000, and the number of cases reported has grown rapidly since then.

Protect Americans from Appraisal Fraud.

Appraisal fraud is the practice of using false home appraisals to complete a mortgage transaction or refinancing. In most cases, appraisal fraud is the result of direct pressure on the appraiser from the loan originator, broker, or realty agent to inflate home values. If appraisers do not inflate home values during the appraisal process, they risk losing repeat business from the broker or others involved in the transaction. This practice results in households borrowing amounts that, in some cases, exceed the true value of the property.

Far worse, appraisal fraud is a key component of "flipping" schemes, a practice where the appraiser, seller, and lender work in concert to inflate property values. In turn, these homes are sold to unsuspecting first-time home buyers who are unable to maintain the monthly mortgage payment at inflated prices. Inevitably, victims of "flipping" schemes end up filing for bankruptcy or end up in foreclosure. Because mortgage loans for most first-time homebuyers are guaranteed through the government's Federal Housing Authority (FHA) program, lenders participating in this scheme are repaid at the inflated appraisal price when these loans enter default status.

While Congress passed comprehensive reforms after the savings and loans financial crisis, further reform is needed to protect consumers from the ruinous effects of appraisal fraud. The Appraisal Institute reported that more than 7,000 appraisers have been pressured to inflate appraisals.[27] Congress should ensure that brokers are prohibited from coercing or intimidating appraisers in order to receive a desired property appraisal value. A fee panel system is a simple and easily implemented solution which guarantees the integrity of the appraisal process. A fee panel system would organize appraisers into a queue; appraisers would then be assigned from the list on a rotational basis. Thus, a fee panel system would remove the lender from the process of selecting an appraiser. Should the lender opt out of the fee panel system and choose its own appraiser, the appraiser would become an agent of the lender. In case of a fraudulent appraisal the lender would also be held legally responsible if it did not participate in the fee panel system.

Conclusion

In response to financial pressures, families have come to depend on high cost credit as a way to bridge the gap between stagnant or decreasing incomes and rising costs. To ease the burden of high cost credit card debt, families have resorted to their home equity to pay down consumer debt and finance current consumption needs. While using home equity may create a short term financial breathing space, this financial arrangement has blurred the line between good debt and bad debt. In other words, there is a component of consumer debt now hidden in mortgage debt across the country. This has led to the permanence of bad debt imbedded in mortgages. The results of this trend can be disastrous—missing a credit card payment has serious implications for a family's financial health, while missing a mortgage payment could end up costing a family their home.

[PERSONAL STORY]

Silvia and Gary Brown

Silvia and Gary Brown have been married for 30 years and have three adult children—two still in college. They own a home, and have always paid their credit card balances in full. That is, until just a few years ago. Now their financial security is at risk, with their home's equity depleted and credit card balances at an all-time high.

In 1999, after having paid off their first mortgage loan, the Browns took out a second home mortgage equal to $100,000 to pay for their children's college education. "It [home ownership] felt great, but it was nice to have the equity to send my kids to college," explains Silvia. As each of their children enrolled in four-year universities—three in as many years—the Browns quickly felt the impact of rising college education costs. Tuition increased successively with each child—$25,000 a year for their first, $27,000 for their second and $31,000 for their third child.

Silvia and Gary stretched themselves thin and depleted much of their home's equity to make tuition payments, even though their children also took large student loans. As their eldest child entered his third year in college in 2002, the Brown's financial health plummeted. Gary had suffered a work-related injury earlier in the year and was forced to take early retirement. As a union member at his trucking firm he received a lifetime monthly pension of $1,500, plus $800 a month in Social Security benefits. But his health insurance only covered work-related medical expenses. At 50, Gary could no longer see his doctor for preventive care or health maintenance.

Gary's reduced earnings increased the strain on an already tight household and healthcare budget: he was the only Brown family member with employer-sponsored health insurance, while Silvia and the children were always covered under expensive family, not group, medical plans. The Browns began using credit cards to bridge gaps in their medical expenses.

Meanwhile, Mrs. Brown's faltering restaurant with three straight years of net losses finally closed in November 2004. Realizing that she would be unable to recover the $120,000 invested in start up costs, she was forced to sell her restaurant for $40,000. To make up the difference the Browns once again turned to home refinancing. They paid a $5,500 fee to readjust their home mortgage for $150,000. And again they turned to credit cards to make ends meet.

By the end of 2004, the Browns had accumulated a total of fifteen credit cards. One with a balance of $10,000 and 0 percent APR is used for medical expenses. Mrs. Brown and two of her children buy into a health care plan at $650 per month that covers emergency visits but not prescription drugs and dental/eye exams. The second credit card with a balance of $10,000 and a 7 percent APR is used for residual business expenses that were not covered by the loan or from the sale of the restaurant. The remaining credit cards have a total approximate balance of $5,000 with an average of 12 percent APR. They are used for everyday expenses such as groceries or gas. With credit card balances quickly increasing, and only being able to make minimum payments on balances, the Browns have had to cut corners. "I'm doing without new eye glasses," Mrs. Brown reveals.

The Browns' monthly budget is $2,300, not enough to begin maneuvering out of debt. Sixty-five percent goes to monthly loan repayment and 28 percent goes to healthcare for Mrs. Brown and her two daughters. This leaves very little to cover costs from prescription drugs and doctor visits not covered by the Browns' limited health insurance and day-to-day expenses such as food or utilities. Very little to none is left to pay down credit card debt.

The Browns' immediate future turned brighter when Silvia got a new job as a legal aid in a law firm, which brings in about $2,000 a month. But even with this new injection of much needed cash, it will take the Browns years to pay off their mortgage and credit card debt. And of course, there is no equity left in their home for an emergency or retirement.

In seven years, Mr. Brown will qualify for Medicaid, reducing some of the dependence on credit cards to cover medical expenses. Silvia's new job does not provide health benefits, so the Browns will continue to pay out-of-pocket for Silvia's health insurance. They must also continue to purchase catastrophic care insurance for each of their children until they find employer-sponsored healthcare.

The Brown's financial future may be bleak. After refinancing their home for a third time in 2002, they owed $150,000 in home mortgage loans. Through 2005, the Browns acquired over $25,000 worth of credit card debt to make ends meet. They are both around 50 years old, lack comprehensive health care, and have zero equity in their home.

Silvia is distressed. "Both times we refinanced, I felt trapped knowing we had no choice but to refinance," she says. "At my age it is not fun to have a $150,000 mortgage. It's what life dealt us and we're doing the best we can to make it work. I'm not going to whine about it. But I'm worried about my retirement—no money for an IRA, and there won't be much left from social security."

Endnotes

1 The Federal Reserve Board, "Household Debt Service and Financial Obligations Ratios," http://www.federalreserve.gov/Releases/housedebt/

2 Economic Policy Institute, "Economy up, people down: Declining earnings undercut income growth," August 2005, http://www.epinet.org/content.cfm/webfeatures_econindicators_income20050831

3 See Tamara Draut and Javier Silva. (2003). *Borrowing to Make Ends Meet: The Growth of Credit Card Debt in the '90s,* Demos: A Network for Ideas and Action. New York, NY. Also, see Tamara Draut and Heather McGhee. (2004). *Retiring in the Red,* Demos: A Network for Ideas and Action. New York, NY.

4 In 1986, with the passage of the Tax Reform Act (TRA), the government significantly limited the deductibility of interest by prohibiting individuals from deducting consumer interest but continued to allow interest to be deductible on mortgages for first and second homes. As a result, interest paid to service credit card debt is not deductible whereas mortgage interest is deductible.

5 Harvard University Joint Center for Housing Studies, *State of the Nation's Housing 2006,* http://www.jchs.harvard.edu/publications/markets/son2006/

6 Federal Reserve Bulletin, "Higher-Priced Home Lending and the 2005 HMDA Data, Table 8 (revised September 18, 2006)," http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf

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23 Student loans still remain an exception.

24 This assumes a 30-year mortgage at a fixed rate of 5.7 percent. Now compare $16,341 to $16,598 in total interest paid if the balance remained on a credit card and the minimum payment was made until the balance was retired. Over time, the savings become negligible.

25 Some of the advantages of mortgage refinancing are offset by closing costs such as points and fees. Also, depending on whether a household itemizes on their tax returns or uses the standard deduction, the full tax advantages of the mortgage interest deduction may not be realized.

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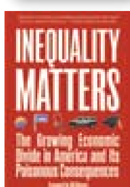

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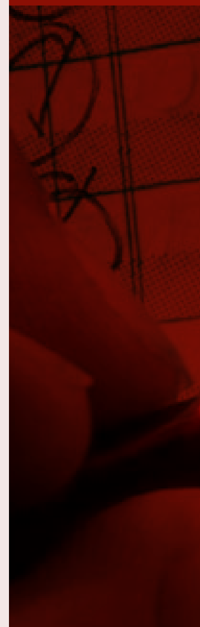
About Dēmos

Dēmos: A Network for Ideas & Action is a non-partisan public policy research and advocacy organization committed to building an America that achieves its highest democratic ideals. We believe this requires a democracy that is robust and inclusive, with high levels of electoral participation and civic engagement; an economy where prosperity and opportunity are broadly shared and disparity is reduced; and a strong and effective public sector with the capacity to plan for the future and provide for the common good. Founded in 2000, Dēmos' work combines research with advocacy—melding the commitment to ideas of a think tank with the organizing strategies of an advocacy group.



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The Economic Opportunity Program addresses the widespread economic insecurity and declining opportunity that characterizes American society today. Our efforts focus on envisioning and ensuring the future middle class by promoting new ideas in the areas of higher education, income and asset-based policy. Our work examining the growth of personal debt among low- to middle-income households is indicative of the new challenges Americans face as they try to get by—let alone get ahead.

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