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Despite rising home equity, you might want to think twice about cash-out refinancing

(iStock)

Warning: Your home is not an ATM.

Pulling cash out of the equity in the home was a factor that led to the market crash in 2008. Nevertheless, cash-out refinance loans are on the rise — again.

Using cash-out refinancing, homeowners pay off an existing mortgage by creating a new mortgage with a higher loan balance. The homeowner keeps the difference between the old mortgage and the new one, and can pocket (or spend) the cash.

As an example, you can refinance a $300,000 loan with a $350,000 one, walking away with $50,000 cash minus closing costs.

The amount of money Americans are pulling out of equity is significant.

In the second quarter of 2017 alone, the nationwide total dollar volume of equity cashed out was $15 billion, up $1.2 billion from the first quarter of 2017, according to Freddie Mac's most recent Quarterly Refinance Statistics report.

The Washington region isn't immune to this trend.

In 2016, 34 percent of refinance loans in our region involved pulling out equity, up from 16 percent in 2013. Freddie Mac releases percentage statistics annually, thus the 2017 numbers are not yet available.

Those numbers are nowhere near the peak in 2006 when cash-out refinancing in our region accounted for 92 percent of all refinance mortgages.

But the current trend is concerning nonetheless.

According to the American Enterprise Institute's International Center on Housing Risk, the July 2017 Refinance National Mortgage Risk Index (NMRI) has climbed back up to the same high risk level experienced in the crash, primarily driven by a leap in cash-out refinancing.

The NMRI determines how likely a borrower originating a loan today would go into default, if we were under the same economic conditions as during the crash.

"We were at a 6.8 percent risk in 2012 when we started measuring refinance risk levels," said Edward Pinto, co-director of the International Center on Housing Risk based in Washington. "Today, that risk level has doubled to 13.6 percent and FHA cash-out loans are at a 26 percent risk level. A risk level of 12 percent is considered extremely high."

Pinto, who is very concerned about the recent increase in cash-out refinance loans, says he believes a severe market correction is inevitable.

"We don't know when the market will crash next, but we are definitely in a boom," Pinto said.
Len Kiefer, deputy chief economist at Freddie Mac, is less concerned with the current rate of cash-out refinancing.

"If you look at the amount of cash out in dollars, adjusted for inflation, it is fairly low where we are today," Kiefer said. Cash out in dollars reached almost $90 billion in 2006.

According to Kiefer, Freddie Mac has been tracking cash out refinancing going back to the 1990s. It is instructive to look at the trends historically to understand how homeowners have behaved over the long term.

"The current trending up is a return to normalcy. As I see it today, it doesn't strike me as particularly alarming," Kiefer said.

How are homeowners able to pull out so much money from their homes?

Credit it to rising home values and high appraisals.

According to the Federal Housing Finance Agency House Finance Index, home prices rose an average of 6.6 percent nationwide from the second quarter of 2016 to the second quarter of 2017. A recent Outlook Report published by Freddie Mac asserts that price growth in many markets has topped 10 percent on a year-over-year basis since the market crash in 2008. This is a result of limited supply and robust demand, the report says.

Rising home prices are good for homeowners, right?

Not necessarily, according to Pinto.

"Homeowners with lower-priced properties and first-time home buyers are being hurt the most," Pinto said. "Lower-priced properties have gone up in value 11 percent year-over-year."

As home prices increase, the amount of equity homeowners think they have increases, Pinto said.

"In addition, homes are being appraised at higher prices for refinancing, without an actual home sale taking place. Thus, the increased value is on paper only and is not based in reality," Pinto said.

Pinto warned that this is unsustainable with no end in sight.

So, what are homeowners doing with the money?

"Home renovations have become a cash-out motivation," Eric Strasser, a mortgage loan consultant with SunTrust Mortgage in Rockville, said in an email. "People realize that in a tight purchase market, they can often improve or customize their current homes rather than selling to buy a new home."

In recent years, homeowners with sufficient equity in their properties have refinanced to take advantage of low interest rates. For some, this was a good financial move, helping lower monthly mortgage payments or consolidate debt, Strasser said.

There are other reasons that Americans are pulling equity from their homes.

Many aging Americans who own homes are choosing to age in place. Some are pulling out equity in their homes to remodel, making their homes more safe and usable considering their future needs.
Other homeowners are paying off or consolidating credit card debt and student loans.

Despite his optimism, Keifer from Freddie Mac agreed that homeowners should be disciplined — that we should not view increased equity in our homes as a financial windfall.

But not all Americans are disciplined with their money.

According to the 2017 Credit Card Debt Study by WalletHub, credit-card debt is trending up toward pre-recession habits. "As of [the second quarter of 2017], outstanding credit card debt is at the second-highest point since the end of 2008, and we're on a collision course with the $1 trillion mark."

Some Americans are pulling out equity from their homes to pay off credit cards, only to rack up balances on credit cards again.

"This is not a virtuous process," Pinto said.