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The Downside of Debt: Borrowers Sober Up

by: Tim Iacono

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There's a good bit of "sobering up" going on around the country these days as Americans are coming to terms with the huge pile of debt they've racked up in recent years.

It's hard to argue with the conventional "wisdom" of earlier in the decade.

If the **value of your home went up \$50,000 or \$100,000** during the course of a year and you went into debt by another ten or twenty grand, what's the big deal? What's wrong with having a little fun? You'd still be ahead by year-end.

Things went on like that for a number of years and people came to believe that **that's just the way the world worked in the 21st century**. Ain't it grand?

Unfortunately, the world doesn't *really* work that way - it's much, much different when asset prices are falling instead of rising. These days you don't hear anyone saying, "*The value of my home just dropped \$60,000 last year and the bank froze my home equity credit line. I better pay down some of this outstanding debt.*" The downside of debt seems to be a lot like the downside of drinking.

According to this [WSJ story](#) from last week, apparently there's still a little liquor left in the cabinet - the bar is apparently still serving drinks.

The credit crunch has made it harder for Americans to indulge in their love affair with debt. So what are they doing?

Borrowing more.

While tighter lending standards have cut off all but the most credit-worthy borrowers from auto loans and home loans, **many people are turning to credit cards and tapping more of their home-equity lines of credit to dig themselves in deeper...**

The rise in borrowing shows just how addicted the U.S. consumer has become to credit. Even as borrowers are cut off in one area, they promptly look for new sources. **Workers have increasingly been raiding their 401(k) plans** to take out loans over the past year, according to plan administrators and nonprofit groups.

Now, mortgage brokers say some clients are calling them in a panic, worried that their bank will freeze their home-equity lines. Deborah McNaughton, president of Legacy Financial Services Inc., a mortgage lender in Placentia, Calif., says several of her clients have recently **borrowed more from their home-equity lines of credit and stashed the money in bank savings accounts...**

For the past several years, William Jordan, president of Sentinel Group Inc., a financial-planning and wealth-management firm in Laguna Hills, Calif., has been **advising clients to pull equity of their homes and put the money into safe, liquid accounts** so they have access to the money. He recently advised one of his clients, Matilda Compean of La Mirada, Calif., to refinance her mortgage

and take out cash after she was having trouble making ends meet.

Borrowing at eight percent and getting a three percent return? That might make sense if you're planning to walk away from the place. In fact, that might make a lot of sense under those circumstances.

Many, many years ago (before my wife and I wised up), I remember owning a home and living paycheck to paycheck figuring that, if one or both of us lost our job, we'd just go out and get the maximum cash advances on all our credit cards, stash the money away, and then stop paying the credit card companies so we could pay all our other bills for the next year or two.

Then, when home prices started going up and all that home equity became like a giant safety net, we were finally able to relax knowing that we had an "equity cushion."

Maybe we'd all be better off without equity cushions.

According to this [report](#) by Gretchen Morgenson in yesterday's *New York Times*, we may be about to find out.

In the last 30 days, lenders have sent several hundred thousand letters advising borrowers that **their home equity lines of credit are frozen**, estimated Michael A. Kratzer, president of FeeDisclosure.com, a Web site intended to help consumers reduce fees on home loans.

Major lenders — including Washington Mutual, IndyMac Bank and the Greenpoint Mortgage Unit of Capital One — say that declining property values are prompting the decisions to cut off credit.

Banks have the right, of course, **to rescind these credit lines at any time** under the terms of the contracts they struck with borrowers. And as home prices have tumbled in many parts of the country, banks are undoubtedly trying to protect themselves from exposure to additional losses.

But these actions are being taken even in areas where property prices are rising, Mr. Kratzer said. What's worse, the letters provide no explanation for how the lenders determined that the property values underlying the equity lines had fallen.

Frozen home equity lines **will surely intensify the consumer spending downturn** and put added pressure on an already weak economy.

Just as responsible individuals spent more freely knowing that there was another hundred thousand dollars available to them if they needed it, they are likely to spend less after their credit line has been taken away.

This is not a good development for a consumption-based economy, though you could see this one coming from miles away.