August 2006 *MoneyMinute* – Your House Is Not a Piggy Bank

By Jennifer Cray

The dramatic increase in real estate values over the past 10 years or so has left Bay Area homeowners feeling a lot better off these days. If you've owned a home for even a few years, its equity is likely to be a significant part of your net worth.

So what's wrong with this? Nothing – except that home equity has a funny way of changing your behavior, whether you're aware of it or not.

Because mortgage lenders have made it ridiculously easy to turn home equity into cash, you can tap your home's value simply by writing a check or using a credit card. The result of these home equity lines of credit: Big-ticket items that you couldn't easily afford on your salary suddenly come within reach. Rather than saving up over time to buy a car, or college tuition, or remodeling projects, you pay for it with your house. The only apparent cost to you: a monthly payment.

And it doesn't feel painful because the rising real estate market has delivered this windfall. In fact, when your home makes as much money as you do in a year, spending that cash feels a lot like cashing in a lottery ticket.

Refinancing a house to fix a variable interest rate, or to get lower payments, gives you another chance to turn equity into cash. Nearly 90% of U.S. homeowners refinancing loans last quarter took cash out in the process, according to mortgage giant Freddie Mac.

But just as your mom used to say, just because everybody's doing it doesn't make it right. Here's the result of turning your house into an ATM machine:

You save less: When your home's value increases tens or hundreds of thousands of dollars a year, the dollars you work hard to save start to look smaller in comparison. Whether or not you're aware of it, saving for the future can feel less urgent when your house looks like a big piggy bank.

Unending house payments: While a lot of people fantasize about the day they'll own their home free and clear, few people dream of making house payments in retirement. Tapping home equity in your working years makes it much harder to achieve the financial independence you'll need in order to stop working someday.

Safety cushion: We have clients who borrowed against their homes when times were good, only to be hit by disability, divorce or unexpected job loss. In retirement, you may have sudden expenses such as long-term care or a medical crisis. Leave the option of taking cash out of your home for emergencies like these.

Buy now, pay forever: Using home equity to finance something that grows in value, such as home improvements or a college education, can make sense if done carefully. But most home equity cash-outs simply fuel consumer spending. Long after you've taken that vacation and that new furniture shows wear-and-tear, you'll still be paying off that loan.

Ups and downs part 1: If the real estate market flattens out, or even declines, as it has in many other parts of the country, that "excess" equity can dry up in a hurry. In a prolonged downturn, like the one in Southern California in the early 1990s, you could find yourself owing more to the bank than your home is worth.

Ups and downs, part 2: Home equity lines of credit usually have variable interest rates that can change every month. That means your payment will rise along with interest rates. Even a percentage point or two can really hurt.

The good life: Borrowing against your house to pay for the good things in life will get you accustomed to a standard of living you'll be hard-pressed to maintain in retirement – especially if you still have a house payment to contend with.

A house is not a retirement plan. Rather, it's what we financial planners call a "use asset." No matter what it's worth, it won't make you rich as long as you still live in it. While it's easy to say that someday you'll move out and downsize to something less expensive, our experience with retiree clients is that few intend to leave their homes anytime soon. They've put a in a lot of effort over the years to make the house just right for them, and now they're quite settled. They're disinclined to give that up and move into something less personal with half the living space.

So next time your bank offers to give you a home equity loan or line of credit, keep in mind that your house is for living, not for spending.

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