

Turn on the home-equity tap again

Contributed by Sam Stamper
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As credit starts up at a trickle, getting a home-equity line can be a smart move - as long as you use it the right way. By Linda Stern, Money Magazine December 14, 2009: 6:46 AM ET

(Money Magazine) -- The home-equity line of credit fueled thousands of extreme kitchen makeovers during the real estate boom. But the housing bust and the credit crisis stopped the HELOC party with a vengeance: Tens of thousands of homeowners had their lines cut or frozen, and most lenders stopped issuing new ones altogether.

But don't give up on the HELOC yet. As housing prices and the economy begin to stabilize, it's coming back. Many lenders are writing lines again, says MortgageBot, a company that processes real estate loans, albeit half as many as it did during the boom days. True, HELOCs are no longer the screaming deal they once were. Lenders used to offer the lines for half a percentage point below the prime rate (currently 3.25%), but now the cheapest you're likely to find is prime plus a point or so. Most lines also have a floor, or the lowest possible rate they can go, of about 4%.

That said, if you have more than 20% equity in your home, a line of credit can still be a relatively cheap way to borrow -- and it's a far better source of emergency cash than your credit card. "Think of a HELOC as a belt and suspenders," says Oakland money manager Marjorie Bennett. To make sure you get the most out of it, follow the rules below. Don't borrow the max

The days when banks would lend you 100% or more of the value of your home are long gone, of course. Most lenders won't approve a line that brings your total housing debt to more than 80% of your home's value, and you'll need a minimum 740 credit score to get that much.

But there are good reasons to borrow less. Depending where you live, you probably can't rely on a rising real estate market to knock down your housing debt. You should aim to keep your total monthly debt payments at no more than a third of your take-home pay. Keep in mind that as the economy recovers, HELOC rates will rise too, so borrow only what you could keep up with if rates jump, says financial adviser Don Whalen of Alpharetta, Ga. If you were to take out a \$75,000 HELOC today, for example, you'd owe \$344 a month in interest; if rates rise a couple of percentage points the monthly tab will jump to \$469. Use it the right way

By now you almost certainly know that using your home-equity line for frivolities like vacation packages and plasma screens is asking for trouble. Other traditional uses may or may not still make sense:

Home improvements. Tapping your HELOC to fund necessary projects like a roof replacement is still worthwhile: You can deduct interest on up to \$1 million when you use HELOC funds to improve a first or second home, which in turn sharply lowers the real cost of the loan. Renovations that won't necessarily pay for themselves, like a media room or a deluxe kitchen? Take a pass.

Car loans. At a 7.3% rate, a three-year new-car loan costs a lot more than a line of credit. A HELOC can be a good substitute -- as long as you expect to pay it back within a few years. You may be able to write off the interest. Though the rules are complicated, in general you can deduct interest on a HELOC for up to \$100,000 of non-home-related uses.

Student loans. Max out government-backed Stafford and PLUS loans first. The interest on these loans is usually tax deductible, and they often offer flexible repayment plans. But if you have to take a private loan, a HELOC can be a cheaper alternative.

Small business. Entrepreneurs have long used HELOCs as easy business lines of credit to smooth out bumpy income. Steer clear of that unless you're confident the business is solid, says Newtown, Pa., financial adviser Jonathan Heller. Make sure you keep it

If you're going to use a HELOC as an emergency fund, you have to make sure your line isn't pulled out from under you. Most banks have stopped freezing existing HELOCs, but that could happen if real estate values drop in your neighborhood. Your best defense is to use your line regularly, even if you take out just \$500 at a time. Even during the worst of the credit crisis, issuers weren't freezing or closing HELOCs that were in use as long as the homeowners weren't underwater, says financial adviser Kevin Reardon of Brookfield, Wis.

If you think you'll need to use your HELOC in a few months and are concerned that it could get chopped, borrow the funds now and park them in an FDIC-insured account to keep them safe. Then start paying the loan back ASAP.