GO EASY ON HOME EQUITY LOANS

Homeowners are unlocking the equity built up in their homes like never before. But before opening the home-equity loan door, be certain you don't overextend yourself and put your home at risk, caution financial planners.

With home values climbing dramatically in many regions in recent years, homeowners have piled up record amounts of home equity-based loans, including a 35 percent increase in 2004, according to SMR Research Corp., a business and market research firm. Homeowners are tapping their equity so heavily that credit card companies are feeling the competition and are getting into the home-equity loan business. And traditional lenders of home-equity loans, such as banks and credit unions, are providing various incentives to encourage people to borrow against their home.

The most popular type of home-equity loan these days is the home-equity line of credit—HELOC for short. HELOCs operate much like the line of credit in a credit card. The lender determines the maximum amount you can borrow against the equity in your home. You can borrow any amount up to that limit and the interest charges apply only to the amount you borrow. Rates typically are around the prime lending rate, which was 5.5 percent in February 2005.

Say the line of credit is $30,000 and you borrow $4,000, leaving $26,000 available for additional borrowing later. The interest charges are based only on the $4,000, not the $30,000 credit limit, just as they would be on a credit card. You might borrow $4,000 today, pay part of it back, then borrow $7,500 a few months later. Flexibility is the key to HELOCs.

And just as credit card interest rates fluctuate, so do interest rates on HELOCs. Lately, after record lows, those rates have risen as the Federal Reserve has raised short-term interest rates.

That's where the second type of home-equity loan comes in: the fixed-rate home-equity loan. Here, you take out a fixed amount at a fixed interest rate and make fixed payments for a specific loan period, much as you would with an automobile loan. Fixed-rate home-equity loans typically

run 1 to 3 percent higher than HELOCs. But while short-term rates have climbed lately, longer rates have held, shrinking the gap between the two types of loans.

Beyond their relatively low rates compared with credit cards, home-equity loans have the added advantage of the interest on loans of up to $100,000 being tax deductible. (Taxpayers subject to the alternative minimum tax can deduct the interest only if the loan is used to buy, build, or remodel their home.)

Financial planners commonly recommend that the line-of-credit loans be used for shorter-term, fluctuating needs, such as college expenses or perhaps emergency funding for unreimbursed medical bills. The idea is to pay off the loan fairly quickly.

The fixed-rate loans tend to be better suited to longer-term needs requiring a fixed amount, such as major home remodeling, but which you can't pay off for a while. They also are often used to consolidate and pay off higher-interest, nondeductible debt such as credit cards and auto loans.

The question of whether to use such loans for investing is a bit trickier. Most financial planners don't recommend taking out a home-equity loan to invest in the stock market. But it may be appropriate for some households to borrow to invest in real estate because they are investing in a similar asset. And loans for home improvement that can add value to the home are also often recommended.

Whichever type of home-equity loan you are considering, and for whatever the purpose, keep the risks in mind.

The biggest risk is that you can lose your home if you can't make the loan payments. In the case of a line of credit, rising interest rates could make it tough for households already financially squeezed. A drop in home values also could put a loan in jeopardy.

Another risk is that homeowners sometimes treat HELOCs like credit cards, using them for frivolous needs. A special concern is when a homeowner uses a HELOC to pay off nondeductible debt, such as credit cards, only to turn right around and start using the cards again. A consolidation loan works only if borrowers get to the root of the problem—their spending habits.

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