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## Time for Advisors to Revisit HELOCs?

by: Donald Jay Korn

Home equity lines of credit are back in fashion. Just a few years ago, planners weren't exactly raving about them. Indeed, many were frozen during the housing market bust, recalls Sean Sebold of Sebold Capital Management in Naperville, Ill. - because the combined amount of a HELOC and first mortgage often exceeded a home's value.

"The banks have not been quick to unfreeze these lines," he says, "because the second lien doesn't get paid if the first does not get paid. Although the real estate market has been performing well lately, banks are not eager to add risk ... without compensation."

But times change. "We love HELOCs!" exclaims Kathy Stepp, a principal and founder at planning firm Stepp & Rothwell in Overland Park, Kan. "Especially now, when keeping a bunch of cash in the bank as an emergency fund nets you roughly 0%."

The HELOC market is thawing slowly. In the Federal Reserve's Senior Loan Officer Opinion Survey in July, a net 1.5% of lenders said they had eased standards for HELOCs, with 4.4% easing and 2.9% tightening.

"Lenders' books are in better shape than they have been in some time," says Keith Gumbinger, vice president at HSH.com, a mortgage information website. "They are looking for profitable lending opportunities. Firming home prices makes lending for second liens less risky, so there is a little more enthusiasm for making these kinds of loans, with restrictive terms and conditions." Those include a strong credit history - a credit score of at least 720 is usually necessary - and ample home equity.

"Lenders generally will not allow you to leverage beyond 80% of your home's value, including the first lien," Gumbinger says. "Before the recent crisis, you could easily borrow to a 90% or even a 100% level."

Suppose, for example, a client with a home valued at \$500,000 has a \$360,000 first mortgage. At the peak of the last housing boom, such a client might have been offered a \$140,000 HELOC, bringing actual and potential housing debt to \$500,000. That same client might now be limited to a \$40,000 HELOC, for total debt of \$400,000. As Greg McBride, senior financial analyst at Bankrate.com, puts it: "HELOC lenders want borrowers to have some skin in the game."

To determine home equity, lenders typically require an appraisal. Gumbinger says many banks now frown upon so-called drive-by appraisals, which were really automated valuation model reports derived by software programs from recent home sales.

### A VARIETY OF BENEFITS

Homeowners who pass all of the tests pay an average interest rate of 4.47% for a \$100,000 HELOC, according to a recent Bankrate survey, and that interest is often tax-deductible. Generally, taxpayers can deduct interest payments on

up to \$100,000 of home equity debt, including HELOCs, regardless of how the money is spent. Indeed, the IRS uses an example of home equity debt paying college tuition or medical bills.

Some HELOCs have a minimum draw, McBride notes, so borrowers are required to tap their credit line upon closing. Yet such restrictions can be avoided by comparison shopping, he says, and a successful applicant can wind up with a low-cost source of cash. "We recommend HELOCs as a matter of course," Stepp says, "and we consider them to be the emergency fund."

A HELOC is also a good way to smooth out cash flow, she adds. "A client might need money for a new car or school tuition or tax payments. That client can keep money invested and tap the HELOC. By using a HELOC, we have avoided the need to sell when the market happens to be down."

Stepp doesn't consider a HELOC to be a good long-term solution, however. "We plan to have clients pay off the balance in, say, 12 or 18 months," she says. "If they can't do so with a bonus or with monthly payments, we will pay off the HELOC when we raise cash in their investment portfolio by rebalancing. We meet with every client quarterly, so we stay on top of those HELOC balances."

At Sebold's firm, all clients are urged to acquire a HELOC, with as large a credit line as the bank will allow. "The need for a specific emergency fund is lessened," he says. "If there is a short-term cash crunch, the HELOC will cover it until we have time to sell assets at the correct time and price."

Sebold's clients generally have significant assets relative to their expenses. "Therefore, our emergency fund recommendation is quite low: One to two months of expenses. Then we can invest clients' money for their long-term objectives without a large need to keep three to six months of cash sitting in a bank earning next to nothing," he says.

## **BIAS TOWARD CASH**

Not every planner has profound love for HELOCs. Sharon Rich, founder of Womoney, a planning firm in Belmont, Mass., sometimes suggests HELOCs to clients, but doesn't use them as cash reserve replacements. "HELOCs have variable rates," she says, "so borrowing might become more expensive. Psychologically, clients like to see money in the bank."

Some clients have asked about cutting back on low-yield cash reserves, says Sharon Appelman, director of financial planning and investment management at Francis Financial in New York. "Using a HELOC as a secondary emergency fund may be a reasonable strategy," she says, "but we're reluctant to consider it as a replacement for sufficient cash reserves." Like Rich, Appelman believes many clients feel more comfortable with a cash reserve in the bank.

Gumbinger argues that HELOC holders still need to sock away cash reserves for emergencies. "In most HELOC contracts," he says, "there is a clause that discusses adverse conditions. If property values or someone's credit has gone south - which might happen because of a job loss or a medical situation - this clause allows lenders to limit new borrowing or disallow it altogether, while also demanding immediate payments sufficient to begin to retire the debt."

In such cases, Gumbinger notes, clients might not only lose the borrowing capability they were relying on, but also face higher monthly payments on any outstanding debt. "That's the reason to have cash handy at all times," he says.

## **INCOME PROBLEM**

Clients approaching retirement who wish to have a HELOC available may want to act soon, because lenders often require proof of income.

Michael Steiner, partner at RegentAtlantic Capital in Morristown, N.J., says a retired client with ample assets recently had trouble refinancing a mortgage because his income was considered inadequate. "Clients who don't have a HELOC should consider opening one before they retire, while they still have sufficient income," he says.

While revised guidelines from Freddie Mac allow lenders to include assets like IRAs and 401(k)s in calculating income eligibility, Gumbinger says "those rules apply to mortgages, which can be securitized. There is no secondary market for HELOCs, which usually stay on the lender's own books."

HELOC lenders have varying criteria for approving applications and some might provide a line of credit to retirees with sufficient assets. Without excessive research, Gumbinger says, planners should be able to help clients track down a lender willing to toss a valuable line to a reliable retiree.

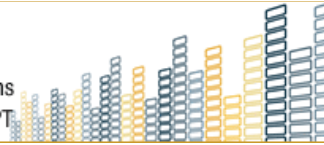
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