# Reasons not to tap your home equity

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You're feeling the need for some extra cash — with inflation and the high cost of living, who isn't these days? — and it occurs to you that a worthy source of funds could be within your own home. In recent years, the old homestead has earned plenty of equity, as its fair market value has increased and you've faithfully made your mortgage payments, building up your ownership stake. (In fact, nearly half of U.S. mortgaged residential properties are "equity rich," meaning their owners' mortgage balance is less than half their home's worth.) So it can be tempting to tap into it via a home equity loan, HELOC or cash-out refinance.

**$1.1 trillion**

The collective increase in the homeowner equity since Q3 2022

Source: CoreLogic

Truth is, though, it may not be a good idea to pull equity out, even if you have sound uses for the funds. The reasons range from the timely (the relatively high interest rate environment) to the eternal (the risks of hocking your house for cash); from current economic forces (an uncertain real estate market) to individual finances (the dangers of a debt overload) . Here's what to consider when tapping home equity — and why you may or may not want to.

## How do you tap into home equity?

Before we delve into the pros and cons, a quick refresher on the basics. There are three primary ways to tap the equity stake you've accrued: a cash-out refinance of your mortgage, a home equity line of credit (HELOC) or a home equity loan.

### Cash-out refinance

With a cash-out refinance (refi for short), you take out a new and bigger mortgage to replace your existing one. The difference between the two loan amounts is the cash you'll pocket at closing, which equates to some of the equity you've accrued in your property (your lender may require you to keep at least 20 percent equity in your home). Your new loan's outstanding principal

will be higher than that of the loan it is replacing, but you can opt for a shorter or longer term.

“For example, if you owe $100,000 on a home that’s worth $200,000, you can take out a new mortgage for $150,000 and take the remaining $50,000 of equity as cash,” says Rick Sharga, president/CEO of CJ Patrick Company, an Irvine, Calif.-based business advisory firm. “But it’s important to realize that this will increase your debt, from $100,000 to $150,000 in this example, and will generally result in you paying more interest over time.”

You’ll also have to pay closing costs, as you would with most refinances.

**HELOC (home equity line of credit)**

A HELOC works as an adjustable-rate revolving line of credit that lets you tap your home’s equity as cash for any purpose you desire. It’s somewhat like using a credit card — only, instead of your debt being unsecured (as it is with plastic), you’ll be required to put your home up as collateral. As with a credit card, you borrow what you need at a time of your choice (though there’s a finite draw period), repay what you owe, and borrow again if you choose.

With a HELOC, your credit limit will be based on your available home equity; you can typically borrow up to 80 or 85 percent of the value of your home (not counting your unpaid mortgage balance). During the draw period — often the first 10 years — you’ll be required to pay monthly interest on any amount you borrow, but your funds will be replenished as you repay the principal. During the repayment period, funds are no longer accessible and you’ll be obligated to repay the principal and interest over 10 to 20 years, on average.

“This is one of the most common ways homeowners access their equity,” says Seth Bellas, a home loan specialist for Churchill Mortgage. “Many people use a HELOC to make a major purchase, do a home renovation, or for debt consolidation. It’s typically more affordable than a cash-out refinance, and the rate and limit are much more attractive than a personal loan or credit card.”

A HELOC has a variable interest rate that changes as the prime rate shifts — often, from month to month — so your overall balance and monthly payments will fluctuate too.

**Home equity loan**

A type of second mortgage, a home equity loan is taken out against the equity in your home. As with the HELOC, your home becomes collateral for the debt

(meaning you could lose it if you don't repay the loan); unlike the HELOC, you borrow a set amount, which is paid out in a lump sum at closing.

"Using the previous homeowner example [owing $100,000 on a home that's worth $200,000], they could borrow $50,000 against the equity in their home and begin making monthly payments on the second loan in addition to their primary mortgage loan's monthly payment," Sharga says. Terms vary, but home equity loans can be repaid over as long as 30 years.

"A homeowner with a very good interest rate on their current mortgage loan might consider this option rather than a cash-out refinance, as the latter could charge a higher interest rate," Sharga continues. Lenders often charge a lower interest rate for home equity loans compared to the rates on personal loans and credit cards. "But second mortgages tend to have higher interest rates than primary mortgages, so borrowers should factor this in before using this option," he adds.

## What is home equity?

Home equity is simply the portion of your property you've paid off — the amount or percentage of it you own outright. It's the difference between your home's appraised/current market value and your outstanding mortgage loan balance. Put another way, it's the sum you would pocket in a home sale after paying off what you owe to your lender (not counting closing costs).

When you borrow to buy a home, your equity stake is comparable to the down payment you make — the actual cash you contribute to the purchase. The larger your down payment, the larger your equity share. Then, over the years, you build more equity as you pay down your mortgage loan's principal balance. Implementing home improvements that up your home's resale value is another way to build equity. If your home's fair market value — the price it would fetch if you listed it tomorrow — also appreciates, your equity climbs, too.

As of Q3 2023 (the latest data available), American homeowners collectively have amassed nearly $32 trillion in home equity, according to the Federal Reserve. Individually, the average mortgage-holding homeowner has an equity stake worth around $300,000. Since lenders typically let you borrow around 80 percent of your stake, that translates into about $240,000 worth of available funds, or "tappable equity," as the financial pros say. Yet, amazingly, only 0.41 percent of available equity at the beginning of Q3 2023 was actually tapped — more than half below the average withdrawal rate between 2010 and 2021, according to data analytics firm ICE Mortgage Technology.

## Reasons not to use your home equity

Just because you can tap your home equity with any of the methods above, it doesn't mean you should — even if you intend to use the money wisely, such as toward a home improvement project that will increase your property's resale value. Some of the reasons have to do with the current economic climate, and some are more evergreen and individual, relating to personal finances.

**Interest rates remain relatively high**

Ponder this reason for postponement: Borrowing money is expensive right now compared to a few years ago. Back at the beginning of 2022, interest rates on home-collateralized loans ran in the 4 to 6 percent range, compared to 8 to 10 percent in January 2024. "Homeowners must reorient to the new reality that home equity borrowing is not low-cost debt" anymore, says Greg McBride, Bankrate's chief financial analyst.

(That explosion in interest rates, starting in mid-2022, is the chief reason for that historically low home equity withdrawal rate, according to ICE Mortgage Technology).

On the positive side, interest rates for home loans and mortgages have stabilized of late, and are forecast to decline further in 2024. Still, "while the peak in rates might have been seen, or is at hand, the Federal Reserve has yet to reverse the steep tightening of recent years aimed at containing historically high inflation," notes Mark Hamrick, senior economic analyst and Washington bureau chief for Bankrate. Translation: the Fed could raise interest rates again if inflation isn't licked. And even if it doesn't, the low-low rate days are over. Hamrick cautions that current continued elevated interest rates on home equity financing options may result in sticker shock if you pursue one of them.

Home equity lines of credit, which charge fluctuating interest, are particularly vulnerable. "Keep in mind that HELOC rates increase every time the Federal Reserve [increases] the federal funds rate. It's risky to take on a debt that, in the short term, will only grow more expensive because of inflation," says Bellas.

**You can fall deeply into debt**

Another reason to kick a home equity tap down the curb is that you'll be piling on to your total debt, possibly making it more challenging to afford repayment of all of your unpaid balances in the months and years ahead. "Tapping into

equity increases your overall debt and what you will owe your lender — both in principal and interest — over time. So it's important to weigh short-term benefits versus long-term costs," notes Sharga.

HELOCs in particular can be a trap. "Many homeowners find it difficult to stay disciplined in paying down the principal on their line of credit, which can make for a significant interest expense down the road," Bellas says. During the initial draw period, "most HELOCs only require you to pay down the interest every month, similar to how a credit card has a minimum payment. By the time the full repayment is due, you will have not only your principal to pay back, but also interest on that principal, making it a pretty steep hill to climb if you aren't in a great financial position."

And your financial position could become less-than-great through no fault of your own. A high degree of uncertainty continues to characterize the current economic environment, Hamrick notes. If the economy stumbles or a negative event emerges in the months ahead, job loss and interrupted incomes could cause difficulty for many individuals and households. "Given the high rates of interest that prevail, taking on more debt could be a less-than-optimal decision for some," he says.

**The housing market and home values are unpredictable**

If you've followed the residential real estate scene closely over the past year, you'll know that sales and asking prices have fluctuated of late, and varied in different parts of the country. "While we tend to analyze the housing market on a national basis, the reality is that local markets differ wildly," Hamrick points out. Overall, though, "with mortgage rates still high and the supply of homes constrained, the outlook for home prices is somewhat uncertain." After pausing for a while, they began to rise again towards the end of 2023, making home affordability — and availability — worse than ever. But, this year, "if rates fall, more 'locked-in" owners might decide to move and put their homes on the market. That could reduce some of the upward pressure that we've experienced with home prices," Hamrick says.

The latter is a cause for concern among homeowners who may overestimate their home's appreciation. No longer can they count on its market value rising steadily, as it has in the recent past during the pandemic. "Homeowners need to be careful in light of a possible recession and home values potentially stagnating or declining in value," Bellas warns.

There is always risk involved in taking equity out of your home, but it's especially keen if your local market prices are moving downwards, Sharga

emphasizes. “You might ultimately find yourself owing more than your home is worth,” he notes. Being in such a state of negative equity is rare, but it can happen, if there’s a sharp prolonged drop in local real estate prices, and you’re carrying a substantial amount of debt.

**You’re putting your home on the line**

With home loan products, the debt you rack up is secured (that is, backed by something) — namely, your home. But that also makes the risk greater. Defaulting or being delinquent on other debts is unpleasant and louses up your credit report and score, but that’s it. Here, on the other hand, you’re essentially mortgaging your property, which is probably the biggest single asset you have. Sharga recommends you ask yourself: Is it worth possibly losing your home to foreclosure in the event market conditions worsen or your personal financial situation deteriorates?

Consider, too, that when you liquidate equity, you dilute your homeownership stake. That makes your property a less valuable asset and decreases your overall net worth.

*Tapping into equity increases your overall debt and what you will owe your lender — both in principal and interest — over time. So it’s important to weigh short-term benefits versus long-term costs.*
*— Rick ShargaCEO, CJ Patrick Company*

## Tips for tapping into home equity

If you are seriously pondering cashing in some of your home’s equity, here are some tips to follow.

- **Have a substantial stake:** Hamrick says homeowners in the best position to use home equity are those who have accumulated a substantial amount of it — meaning the value of their home is much higher than the amount remaining to be paid off on their mortgage. “This typically includes people who have been in their homes for a long time and have not often refinanced. They should also have a high degree of confidence about their job and income security,” he adds. “Those who have only been in their homes a short time should wait until they enjoy a higher level of home equity.”

- **Use it wisely:** “Don’t treat home equity like it’s an ATM for purchases you don’t really need to make,” advises Sharga. “Homeownership is a proven way to build up long-term wealth – even providing financial

security for multiple generations – and shouldn't be wasted on frivolous things. Funds should be used judiciously for things like home improvements, paying down higher interest rate debt, or education."

- **Shop around:** HE loan and HELOC terms vary widely, so definitely explore options and garner quotes from at least three lenders, including both online and brick-and-mortar institutions. Discuss with the loan officer which type of financing would best suit your purposes and timetable.

## Final word on tapping into home equity

You should always do your due diligence and consider carefully before committing to a HELOC, home equity loan or cash-out refinance. Think carefully about your reasons, especially if you want the funds to pay off student loans or credit card balances: Are you basically clearing old debt with new debt? That can be a trap, especially if it means risking an asset like your home.

In addition, many financial experts are concerned about a recession and unpredictable interest rates in the coming months. "While the economy has remained surprisingly resilient over the past couple of years, headwinds remain and uncertainty is still high. A good offense for taking ownership of one's personal finances translates to maintaining a good defense. That means prioritizing emergency savings while paying down debt," recommends Hamrick. "To take on more debt when it is so costly carries additional risk."

Despite all this, drawing out your home equity still might work for you. But weigh the pros and cons carefully before you tap the keg.