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Home Equity Line of Credit?

Here's What You Need to Know Now

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Your Home Equity Line of Credit (HELOC) may have become a whole lot more expensive recently.
Here's why:

Your tax deduction may have been eliminated. The Tax Cuts and Jobs Act of 2017 eliminates the deduction for interest paid on home equity loans and lines of credit unless they are used to buy, build or substantially improve the taxpayer's home securing the loan. This suspension begins in 2018 and is slated to phase out in 2026.

Case Example:
To provide the down payment for a cottage at the beach, Charlie took a $100,000 HELOC in 2017 at a rate of 4% on his primary residence. Charlie is in the 30% tax bracket, so while his HELOC interest totaled $4000, the real after-tax cost was $2,800. The way Charlie looked at it, his HELOC rate was really 2.8% rather than 4%. Enter the new tax law of 2017. Beginning in 2018, purchasing a second home is no longer considered a qualified use of a HELOC for tax purposes. This means the real cost of Charlie's HELOC is now the same as the rate he is being charged by the bank. And there's more…

Short-term interest rates have been rising. Potentially even more impactful than losing the interest deduction on your HELOC, are rising short-term interest rates. Short-term interest rates are highly responsive to the actions of the Federal Reserve raising the fed funds rate. The Federal Reserve has had a policy of small, but steady, rate increases, having raised rates six out of the last seven quarters! Changes have occurred so quickly, you may not even be aware of how much you are paying.

HELOCs are variable rate loans and are many times pegged to the prime rate. The prime rate is the rate banks charge their most credit-worthy customers and is largely determined by the fed funds rate. (Investopedia)

The table below shows the prime rate for each year 2015-2018. (JP Morgan Chase)

Date	Prime Rate
12/17/2015	3.50%
12/15/2016	3.75%
12/14/2017	4.50%
9/27/2018	5.25%

As you can see from the chart, the prime rate has increased 1.75%, or 175 basis points over the past 3 years, with another hike probable by the end of 2018.

Case Example:
Let's catch up with Charlie. He cannot deduct the interest on his HELOC in 2018 and, to make matters worse, as short-term rates have climbed, the rate on his HELOC loan has increased. By October 1, 2018, Charlie's interest rate has risen to 5.25%. With the interest no longer tax deductible, the actual annual cost of his HELOC is now about $5,000, rather than his prior after-tax cost of $2,800!

What are your options?

Match your needs with the proper financing tool.
In discussions around borrowing money, we employ a fundamental standard of finance called the matching principle. The matching principle states that short term needs should be financed with short term debt and longer term needs with long term debt. Although the draw period of a HELOC is typically 10 years, because it is a variable rate loan, it should be considered as a short-term financing tool. This is especially important in a rising interest rate environment.

Many disciplined savers find it useful to view their finances in distinct buckets or categories for the purpose of implementing their budgeting or savings strategies. An example of this could be setting aside money to buy a new car or saving a specific amount each pay period toward a vacation. In some cases, individuals may extend this strategy to employ funds from a HELOC to help meet other obligations or make a specific purchase rather than taking the money from their savings. In the past, when rates were consistently low and the interest was tax deductible, this approach may not have been costly. However, in today's interest rate environment, equity loans are no longer "cheap money". It may be wise to consider paying down a HELOC loan.

Utilize the cash in your "rainy day" or emergency fund.
The good news about short term interest rates rising is that both savings accounts and money market funds are paying a bit more interest. Currently, the top money market funds are paying about 2% interest while the HELOC rate is 5%. (source: Bankrate.com).

If it is many years before your HELOC draw expires, this line of credit will be available to you and can satisfy your cash needs should an emergency arise. It may make sense to use the savings in your "rainy day" or emergency fund to pay off your HELOC. This option may make even more sense now with interest paid on the HELOC not tax deductible in many cases. Note that you are paying down the balance of the HELOC while leaving the line of credit open and available to you. While this strategy may sound contrary to the sound advice of always having an emergency reserve in the bank, remember, you have access to the equity line by simply writing a check. Why would you have savings in a money market account earning approximately 2% while you are paying 5% on the HELOC?

Consider refinancing your mortgage.
If you have both a HELOC and an existing mortgage and a near-term payoff is not realistic or practical, consider refinancing as an option.

In general, while HELOCs are tied to short term rates, such as the prime rate, mortgages are tied to longer term rates, specifically the 10-year Treasury Note. The table below depicts the 10-year Treasury rates (WSJ.com Market Data) and the average U.S. 30-year fixed mortgage rate (FRED Economic Data) along with the prime rate over a 3 year time spectrum. This table serves to illustrate how quickly HELOC rates have increased in comparison to mortgage rates.

Date	Prime Rate (HELOC)	10 Year Treasury	US 30 year Mortgage
12/17/2015	3.50%	2.24%	3.97%
12/15/2016	3.75%	2.60%	4.16%
12/14/2017	4.50%	2.35%	3.93%
9/27/2018	5.25%	3.06%	4.72%

As you can see from the data above, HELOC's have gone up 1.75%, while 30-year loan averages have increased by about .75%. Remarkably, borrowing for the short term (@5.25%) is currently more expensive than borrowing for the long term (@4.72%)!

The yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. (Source: Investopedia). We currently have a flattening yield curve with rates on the short end of the maturity spectrum reacting more quickly to increases in the fed funds rate than rates on the longer end. You may want to consider locking in a mortgage at this time to satisfy the balance of the HELOC.

Another wrinkle to be aware of, the Tax and Jobs Act of 2017 has lowered the cap on the mortgage interest deduction. The deduction of interest on a new mortgage for a first or second home is now capped at $750,000 (previously $1,000,000).

If the mortgage option is out of reach or impractical for you, another option is to talk with your bank and ask if you can convert the HELOC to a home equity loan. While a home equity loan will have a higher rate of interest than a mortgage, due to it being second in line or subordinated to the primary mortgage, it has the benefit of h aving a fixed rate of in terest.

Every situation is different; you may be fortunate and have an extremely low mortgage rate and refinancing may not be appropriate. We are here to help you walk through the analysis to help determine what actions would be most appropriate for you.

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