

HOW A HELOC CAN HELP (OR HURT) YOUR CREDIT SCORE



By: Stephen J. Bronner - August 4, 2021

A home equity line of credit (HELOC) can be a credit nightmare or a credit dream, depending on how you use it.

Tapping into home equity to fund expenses such as debt consolidation, home improvements, and education is now more accessible. In the past year, the average amount of homeowner equity increased to over \$200,000, according to the Homeowner Equity Insights report by housing data firm CoreLogic.

This lending product uses your home's value to back a line of credit that can be paid off over a period of years. It's a risky move if you fail to pay back the debt since your house could be foreclosed on by the bank. However, a HELOC may be an attractive loan option if you're in good financial standing and believe you could make the monthly payments.

Obtaining a HELOC may be a good, albeit risky, way to utilize the wealth of your home. If used responsibly, a HELOC can actually help you boost your score. And as with any debt or loan, if abused, a HELOC will negatively affect a credit score.

Here are the credit score implications of a HELOC and what you'll need to consider before moving forward.

What is a HELOC?

"A HELOC is a revolving line of credit in which a borrower uses the equity in their house to acquire funds that will be repaid over the term life of the loan, similar to taking out a second mortgage," says Nicole Christopherson, real estate broker at California-based NMC Realty.

"What differentiates HELOCs is that the borrower is not advanced the entire sum upfront; it acts more like a credit card," says Christopherson. Borrowers use a line of credit, typically capped at 60% to 70% of a home's value, to borrow funds during the 'draw period.' Repayment periods can be as long as 20 years, and the borrower then repays the balance owed through monthly installments plus interest.

HELOCs are similar to credit cards where lenders can offer different interest rates, credit limits, and minimum payments, according to Ryan Cicchelli, founder of Generations Insurance & Financial Services, a healthcare and retirement planning firm in Michigan. Typically, HELOCs carry lower interest rates than credit cards and can be

easier for individuals with weaker credit scores to get, adds Cicchelli.

How a HELOC Can Damage a Credit Score

"If you are someone with less strength in fiscal responsibility or you try to get a HELOC at a tumultuous time in your life, you could be looking at serious repercussions if approved," says Cicchelli. That is why it's important to examine your credit behaviors before taking on a HELOC.

Here is what to consider:

Credit Check: Whenever a lender checks your credit — known as a hard credit inquiry — it may slightly lower your score. These point-dings stay on your credit report for up to two years. Applying for a HELOC counts as a hard credit inquiry and has similar results.

Variable Payments: HELOC payments can fluctuate due to its variable interest rate. This can make budgeting a challenge if payments become unmanageable. Since on-time payment history accounts for 35% of a credit score, any missed HELOC payment is detrimental.

Credit Utilization: Just because you can borrow a certain amount doesn't mean you should. Using all of your available credit with a HELOC is considered a high-risk behavior for credit reporting. "If you have a \$100,000 line of credit and then pull the whole thing out at once, 'it's treated like maxing a credit line,'" says Mayer Dallal, managing director at Mortgage Bank of California.

Overextending Yourself: If you borrow too much of your available credit line, it doesn't leave room in your borrowing budget for unplanned emergencies such as car repairs or medical expenses. It's recommended you build an emergency savings fund first before borrowing through a HELOC. But, if you don't have an emergency fund and need a HELOC to fund an emergency, leave room in your credit line for other emergencies. If you run out of HELOC funding and a financial emergency arises, you are at risk for missing payments which is the biggest driver of a credit score.

Closing a HELOC: Closing any line of credit may negatively affect your credit score. The effect may be bigger if your HELOC is one of the few lines of credit you have.

How a HELOC Can Improve Your Credit Score

"As long as you do not over-extend yourself, have too many credit lines open with high balances, make timely payments, and manage your HELOC just as well as you should manage any other debts, you will see positive results on your credit report," Cicchelli says. "Falter in any of the areas mentioned above, and you will see the reper-

cussions." Here is how to use a HELOC as an opportunity to improve your credit score.

Credit Utilization: By utilizing the HELOC funds to pay off any debt, you can reduce your credit utilization ratio and boost your credit score, according to Christopherson.

If you know the amount of debt you carry and the amount you can comfortably take on, it can be worthwhile, says Cicchelli.

Credit Utilization: As you pay down your HELOC balance, though, your credit utilization — which accounts for 30% of your score — will decrease over time and improve your score.

On-Time Payments: By paying your HELOC on time and in full each month, this behavior reflects well on credit reporting and can only improve or maintain your credit score.

How to Prepare Your Credit for HELOC

Resolve Other Debts: Too many open credit accounts can decrease your credit score. It's a good idea to pay off other debts before taking out a HELOC. This will help offset overextending your total credit line, negatively affect your credit utilization ratio, and ultimately your credit score.

Existing Equity: One of the most significant factors in obtaining a HELOC, according to Christopherson, is having 15% to 30% of equity already in your home. "This is one of the most significant factors in how much you can ultimately borrow, which is usually 85% of your combined loan-to-value ratio," she says.

Decrease DTI: Your debt-to-income ratio (DTI) is an indicator of how much debt you can take on and is a figure most lenders look at outside of your credit score. Most lenders prefer a DTI to be lower than 43%. If more than 43% of your income is towards debts owed, you will want to work on lowering that amount first before taking on another loan like a HELOC.

Improve your credit score: Ideal credit score to get the best HELOC interest rate is 720+. To improve your overall credit score:

- Make on-time payments on all your accounts.
- Keep old credit accounts open.
- Have a healthy mix of installment, revolving, and open credit.
- Monitor how often you take on new credit accounts.
- Healthy management of credit utilization — your total debt percentage.

Ryan Cicchelli, founder of Generations Insurance & Financial Services, is committed to providing clients with financial security through a personalized, friendly approach. Ryan's top concern is helping clients make informed decisions about all things related to healthcare and retirement.



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