

SmartMoney

CONSUMER ACTION by Aleksandra Todorova

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Is Your Home Equity Line of Credit Next?

HOME EQUITY LINES of credit, or HELOCs, used to be seen as a sort of "helping hand" to homeowners who wanted to finance renovations, pay off debts or use the credit line for an emergency fund. Now, these lines of credit are wreaking havoc on homeowners' financial lives.

Rising delinquencies and falling home prices have caused many lenders to start freezing, reducing or altogether closing HELOCs, in some cases, stripping homeowners of their only form of financial backup. Even worse: By closing lines of credits that are often worth thousands of dollars, lenders can do serious damage to homeowners' credit scores.

"It's a double whammy," says Ron Shevlin, senior analyst at financial-services research firm Aite Group. "Lenders are targeting geographies where housing prices have declined the most — but because those areas are hardest hit by the economy, those are the people who need those lines of credit most in the first place."

Here's who should be worried about losing their HELOC — and why.

Are you too risky for your lender?

Banks were only too happy to hand out HELOCs during the real estate boom. Now, they're scrambling to scale them back — and they're looking for every reason to do so.

Since foreclosing on a delinquent HELOC rarely makes financial sense for the lender, closing or cutting HELOCs is one of the few ways they can mitigate their risk exposure and make sure the borrower doesn't default in the first place. (Even if the home is foreclosed, the lender only gets paid after the first mortgage has been covered. On homes that are "underwater" -- meaning they are worth less than the underlying mortgage or mortgages -- the HELOC lender gets nothing.)

Not only that, but many lenders are not making much money off HELOCs. The cut-throat competition during the mortgage boom had lenders slashing rates to well below the prime rate, with no floor on how low they could go, says Frank Ruzicka, a mortgage banker at Cornerstone Mortgage in St. Louis. "I don't think their models ever predicted that rates would get this low," he says. Ruzicka's own HELOC is now at 3%. His lender, Chase, froze his credit line in October 2008.

Now, the banks are managing HELOC the same way they manage their credit cards: by tracking customers' overall credit behavior, says Bobbie Britting, research director for consumer lending and financial research firm Tower Group. They may, for example, flag accounts of borrowers with delinquencies or negative marks on their credit file, even if their HELOC is in good standing. Or they may reduce or close lines of credit if the borrower's debt-to-income ratio doesn't meet certain criteria or if the borrower has less than 20% equity in their home.

The collateral damage goes beyond a lack of funds

Unpleasant as it is to lose access to much-needed cash or to bounce a check, the potential damage that a closed or slashed HELOC can do to your credit score can be much worse.

Versions of the FICO score formulas developed four years ago and earlier don't distinguish between a HELOC and other types of revolving credit, such as credit-card balances, says Craig Watts, a spokesman for FICO's developer Fair Isaac.

The risk here lies in something called the credit utilization ratio, which is a measure of your total outstanding debt compared with the total amount of available credit. This ratio, which should be below 50% in order to be considered healthy, comprises about 30% of your score. Should a lender close or greatly reduce a \$15,000 HELOC, all of a sudden that's thousands of dollars in less credit available to you, causing your ratio to jump significantly higher and your score to tank.

The good news is that many lenders use newer versions of FICO that don't include HELOCs in utilization ratios, says Watts. But since consumers don't know — and can't control — which version lenders are using, they're still at risk of ending up with a lower score through no fault of their own.

"We look at credit reports every day, and sometimes it leaves you scratching your head wondering why this person is a 683 instead of 740," says Bobby Brown, president of First Security Mortgage Company in Kansas City, Mo. "Then you see a HELOC that's been maxed out [because the lender lowered the limit] and it could definitely be one of the issues."

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