Why tapping into your home's equity can be risky

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Canadian home owners are binging like never before on the equity in their homes, creating a scenario that some fear could bite them back with high-risk debt.

Despite doomsday warnings about consumers using real estate as personal ATMs, many Canadians are signing up for home equity lines of credits (HELOCs) because they are flexible, cheap and easy to obtain.

Many lenders handle HELOCs. The government limits these credit lines to a maximum of 65 per cent of your home's appraised value. However, if the HELOC is being combined with a mortgage, lenders will raise the max to 80 per cent.

“There is nothing inherently wrong with HELOCs,” says Vancouver-based Sheila Walkington, a CFP and co-founder of Money Coach Canada. “But human nature being what it is, they can be too tempting for those that don't have a clear repayment plan or the ability to prioritize wants and needs.”

Dipping into your HELOC to pay the hydro bill is a sure sign you can't afford your current lifestyle, she says. And most financial experts say using a HELOC to fund home renovations or your kid's post-secondary education is marginally more fitting, so long as you have a plan to pay it back over time.

The big problem with HELOCs, says Walkington, is that they're too easy to tap for impulse purchases and their interest-only payment option means there's no push to pay off what you owe. The result for some is a never-ending payment cycle, which is an expensive way to fund an out-of-reach lifestyle or impractical purchases.

“I had one woman tell me she used her line of credit to help her son renovate his kitchen and said it only cost $200 per month,” recalls Walkington. “I don't think it occurred to her that was just the interest and she would eventually have to pay the principal back too.”

Getting riskier

Homeowners could face big problems with interest rates inching upwards as the increases would apply to lines of credit, which are typically a point or two above prime. If interest rates jumped by two or three per cent, those who pay only interest on their lines of credit would see payments jump by a whopping 50 per cent.

Higher interest rates combined with a softened real estate market could result in a dangerous mix, which could see some borrowers' payments go up while their equity heads south.

“If you do overextend yourself and eventually can't pay the minimum monthly payment, the bank can take action to foreclose on your home,” says Walkington. “With rates rising and the real estate market cooling, this could be a reality.”

In June, the commissioner of the Financial Consumer Agency of Canada warned that softening house prices could put HELOC borrowers at greater risk should the real estate market continue to retreat.

“At a time when consumers are carrying record amounts of debt, the persistence of HELOC debt may add stress to the financial well-being of Canadian households,” Lucie Tedesco, Commissioner of the Financial Consumer Agency of Canada, said in a news release. “Consumers carrying high levels of debt are more vulnerable to the impact of an unforeseen event or economic shock.”

In 2016, Canadians owed $211 billion on three million HELOCs, the Canadian consumer protection agency noted in June. The number of households with a HELOC and mortgage secured against their home has jumped by 40 per cent since 2011. Most consumers pay back their HELOC in full when they sell their home. About 40 per cent don’t make regular payments toward the HELOC principal while 25 per cent only pay the bare minimum which is interest only.

The majority of Canadians – 40 per cent – use HELOCs for home renovations and other products, while 34 per cent buy financial investments. About 26 per cent use them to consolidate debt at a lower interest rate.

The FCAC report also points out that lines of credit were a factor in the U.S. that led to many losing their homes during the financial crisis of 2007 and 2008.

Bottom line: if you’re a highly disciplined borrower, HELOCs are a great resource. There are even tax advantages given that these credit lines are a type of mortgage.

“They can be great and flexible for someone who is very responsible with their money,” says Kelley Keehn, a personal finance educator. “But it’s still debt. I think the question is: should you have that debt?”