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Why You Should Apply for a HELOC Now, Before You Need One

Tapping a home equity line of credit may get cheaper soon, and can be a good way to avoid moving and keep that stellar mortgage rate

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U.S. homeowners are sitting on more than $28 trillion of home equity. skynesher/Getty Images

Matthew Willis and his wife never want to move from their 1,700-square-foot house in Knoxville, Tennessee. The couple bought it nearly six years ago, and thanks to a refinance in 2021, their 30-year mortgage has a fixed rate of just 2.25% — a third of what mortgages go for today.

Even if the couple decides to have children, they'll add on to their house, likely tapping into their home equity to pay for the construction, according to the 39-year-old. Because of a surge in demand for real estate during the pandemic years, estimates show the property has already more than doubled in value since they bought it for $139,000.

"It's like a version of Stockholm syndrome, but with my house," said Willis, referring to a phrase psychologists use when hostages develop a psychological bond with captors. "When I need more room, I'm going to add to the value of the house by putting on an addition."

Although home equity lines of credit, or HELOCs, carry pretty high interest rates right now, many are predicting a turning point is coming sooner rather than later. Odds are the Federal Reserve is done increasing its benchmark rate, so people like Willis may want to start planning by applying for a HELOC soon — even if they just let it sit until it's cheaper to draw on.

"If you have the required amount of equity in your home and you qualify today, I tell people to establish the line of credit now so it's there when they want it," said Mark Goldman, a loan officer with C2 Financial Corp., a mortgage broker in San Diego. "If and when the Fed starts cutting rates, the prime rate will go down and the interest on the HELOC will go down."

There's no wait to schedule an appraiser right now — unlike during the mortgage frenzy of the pandemic — and there's typically no charge for carrying a zero-balance HELOC, Goldman said.

U.S. homeowners have these options because they're sitting on more than $28 trillion of home equity following a record run-up in home prices during the pandemic.

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That's over $8 trillion more than they had before the pandemic and more than double what they had in the mid-2000s, when tapping into home equity reached unprecedented levels of popularity after what was at the time the fastest surge in the nation's home prices, according to Federal Reserve data. Home equity is the value of your home minus whatever you owe on it, or put another way, how much you own versus your lenders.

Carrying a balance on any variable rate loan, including most credit cards and HELOCs, is pretty expensive right now because the starting point for the rate is typically the so-called prime rate, which moves with the Federal Reserve's benchmark fed funds rate. Soaring inflation prompted the Fed to raise its benchmark 11 times since March 2022, pushing prime to a 22-year high of 8.5%.

But now that inflation has decelerated, traders are betting that we're at the top of the cycle, and the Fed will begin to lower the benchmark next year. The Fed's latest forecast showed the benchmark dropping by more than 2 percentage points by 2025.

All of that means home equity lending is poised to take off soon, especially given how many people are like Willis, said Keith Gumbinger, vice president of HSH.com, a website for mortgage tools and advice.

Tapping into equity by selling and trading up was a much more popular option during the pandemic (and one reason the volume of outstanding HELOCs reached an 18-year low even before the run-up in interest rates) but sales are now sluggish because no one wants to give up their great mortgage rate.

"Most people in that situation are going to eventually think of getting a HELOC, especially when rates go lower," Gumbinger said.

Willis is already thinking of it. As Goldman (who doesn't know Willis) advises, he may apply for a loan sooner rather than later and leave the line of credit untouched until next year or the year after, he said.

What should you know if you're considering a similar approach?

First, don't confuse a HELOC with a lump-sum home equity loan that carries a fixed interest rate. Those aren't a good option if rates are poised to fall or if you don't know when and if you'll need the money.

Second, consumers who shop around might be able to avoid an origination fee and an appraisal fee, Gumbinger said. Your questions should include: Is there an annual fee? Is there a non-usage fee? Will I get a discount on my rate if I have an account with the bank originating the loan?

"You need to go out and shop the market," he said. "Make sure to read and understand the fine print because there is a lot of variety to HELOCs."

HELOCs typically have an initial 10-year "draw" period, during which borrowers can spend the funds up to the approved limit, followed by a payback period of up to 20 years. Some types of HELOCs charge only interest during the first decade, while others include both principal and interest in the monthly payments.

As for the interest rate, the fixed portion of a HELOC interest rate usually depends on how much equity you'd have left in the home after you tap into it, as well as your creditworthiness.

So for example, someone with stellar credit and lots of equity — meaning a FICO score of at least 760 and enough equity that the primary mortgage plus the new HELOC won't exceed 70% of the home's market value — could get a rate equal to just prime, often referred to as "prime plus zero," according to Goldman. On the other hand, someone with a score of 720 and combined borrowing of 70% to 89% of the home's value might get a rate of prime plus 1% or 2%, Goldman said.

(Lenders won't consider extending a HELOC at all if it means loans would equal 90% or more of the home's value, he said.)

While the most common use of HELOCs is home renovation, there's no real restriction on what people can use the money for. Some people consolidate their debts, others need cash for an emergency or divorce, and still others may use it to foot some of their college tuition bills.

Think twice, though, before using a HELOC to pay off credit card debt, said Melinda Opperman, chief external affairs officer of credit.org, a nonprofit that counsels people with financial problems. Without a change in spending habits, people end up in the same place.

"Those people invariably use the credit lines they've freed up by consolidating their debts, and when those new debts become unmanageable, there is no more home equity to bail them out," she said.

It's always better to use home equity for investment purposes, especially improving and expanding a home, said Lawrence Yun, chief economist of the National Association of Realtors.

“A wise use of a home equity loan would be a home remodeling, which would increase the value of a property,” Yun said. “A silly use would be taking a cruise or buying an extra-large television.”

Plus, interest on a HELOC can only reduce a borrower’s taxable income if the funds are used to improve the home that secures the loan. In the past, the tax advantage applied regardless of how the funds were used.

If home equity borrowing becomes more popular, it may help on a broader level too, helping to fuel consumer spending, which accounts for about two-thirds of the nation’s economy.

Even in the last few years, when homeowners haven’t been as likely to borrow against their homes, the run-up in home equity around the country has helped to bolster spending, Yun said. It’s called the “wealth effect,” meaning people feel more comfortable financially because they know the value of their home has increased, he said.

“One of the reasons the economy has held up reasonably well is that people know they have all this home equity that they could tap,” Yun said. “When more people start using their home equity, it will help consumer spending to keep chugging along.”

Checklist for HELOC Shoppers:

- If you want to wait to use the funds, make sure that there are no fees for zero balances.
- Ask if there is an annual fee for the credit line. Some banks charge a modest fee, such as $50 or $100 a year, like a credit card. Others waive the fee if you have other products with them such as a checking account.
- Know about all the costs for the loan before signing. Some lenders offer no closing costs, while others will charge for appraisals, recording fees or origination fees.
- Shop around, and think small. Sometimes a small credit union will have a better deal for a HELOC than a big bank.

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