

Three Worst Financial Moves

Use a home equity loan to pay off credit-card debt

Lenders love to tout home equity loans and lines of credit as a way to pay off your plastic. You'll even see some personal finance journalists parroting the company line that such loans make sense, because home equity rates are typically lower than the interest rates you'd pay on your cards -- and the interest is usually tax deductible.

Americans have been taking this advice with a vengeance, cashing out more than \$2 trillion of the equity in their homes between 2002 and 2005, according to SMR Research and Freddie Mac. Comparatively low home-equity rates, and stubbornly high credit-card rates, have convinced millions that this is the way to go.

The only way this maneuver really helps you, however, is if you stop using your credit cards to run up debt. Otherwise, you're just digging yourself a deeper hole.

Unfortunately, the ability to live within their means is beyond many people. Nearly two-thirds of the people who borrowed against their home equity to pay off credit cards had run up more card debt within two years, this is often referred as financial suicide

Oh, sure, you can borrow more against your home to pay off the new debt -- thus whittling away the amount of equity that's available to you in an emergency, and ensuring that you continue to pay hundreds or thousands of dollars a year in interest to your lender.

The credit-card balances you should be paying off every month instead get stretched out for years, ultimately costing you more in interest -- even with the tax savings. Financial planner Ross Levin of Minneapolis says home equity lending has its place -- as an emergency source of cash.

He encourages clients to set up home equity lines of credit, which are revolving accounts that work much like credit cards with variable interest rates, in case they lose their jobs or need quick cash to meet some other dire need. Many lenders will set up home equity lines for you at no cost, and the annual fees are usually minimal.

But Levin, like other planners, is adamant about not tapping home equity to pay off credit cards or anything else that won't last as long as the debt.

"The people who need to do a debt consolidation (using home equity loans) tend to need to do it again and again and again," Levin said. These folks never learn to manage their money, and they put their homes at risk in the bargain. While unpaid credit-card debt can be erased in bankruptcy, the penalty for not making your home equity payments is losing your house.

If you've already borrowed against your home equity, pay off the debt as quickly as you can. If you haven't and think you need to, cut up your credit cards first. Don't use your home equity to pay for luxuries or for anything else that won't last as long as the loan.

Borrow from your 401(k)

Companies don't have to offer a loan feature with their 401(k) retirement plans, but according to the Employee Benefit Research Institute, most of them do. Eighty-three percent of American workers covered by 401(k) plans can borrow against their accounts, and about one in five participants had an outstanding loan in 2005. The average balance was \$6,946, said the Investment Company Institute.

Financial services companies have encouraged employers to make loans available, saying the ability to tap retirement funds will increase worker participation in the plans. The idea is that workers are more likely to contribute if they don't feel their money is being locked away.

People who borrow from their workplace retirement funds, meanwhile, love to think it's a smart move, since when they repay the loan they're essentially paying interest to themselves rather than to a credit-card company or other lender.

This is true, but 401(k) borrowers also could be putting their retirements at risk. If they lose their jobs or get fired, the loan must be repaid, typically within weeks. If that's not possible -- and often it's not, since people who lose their jobs don't tend to have a lot of cash sitting around -- the outstanding loan balance is taxed and penalized as a premature distribution.

So in addition to the \$6,800 you borrowed to spend on whatever, you'll be coughing up thousands more for taxes and penalties. It gets worse, since you can't put that money back. Whatever the \$6,800 might have earned in future years is gone forever. Assuming an 8% return that could cost you more than \$75,000 in future retirement funds.

Stretch to buy a house

Beware, home buyers. Everyone around you is conspiring against your financial best interests.

Your real estate agent may be pushing you to buy the most expensive house you can: the higher the price tag, the bigger her commission. Your lender is in cahoots, as well. Not only will a larger loan rack up more fees and interest, but also the lender knows you'll move heaven and earth to pay your mortgage even when you're falling behind on other bills.

Your friends and family also may get into the act, telling you it's okay to stretch to pay that mortgage, since your income will eventually rise and make the payments more comfortable.

Maybe, maybe not. But anyone who's been house-poor knows the emotional, psychological and financial stress of stretching too far.

"You never want to buy as much house as lenders are willing to lend you," declares Delia Fernandez, a Long Beach, Calif. financial planner who specializes in middle-income clients. "Some people think they're willing to sacrifice to live in their dream home, but they should think long and hard about what that really means."

Buying too much house could mean giving up other things you want: vacations, eating out, a college fund for your kids, a sufficient retirement kitty. Or it could mean ever more debt, as you borrow to try to maintain your lifestyle.

Fernandez has had clients who overextended to buy a house, ran up \$50,000 in debt on a home equity line of credit and then had trouble making even the minimum payments on their loans. Now any new purchase is a struggle.

"Sometimes they can't stay in the house, or they let maintenance and repairs go, which doesn't do them any good" since the value of their house declines with deferred maintenance, Fernandez said.

Traditionally, lenders limited the amount you could borrow so that your housing costs --principal, interest, taxes and insurance, or PITI -- equaled 26% to 28% of your total pretax income. Lenders today, however, are often willing to go to 33% or even higher, said mortgage broker Allen Bond.

Bond, president of the California Association of Mortgage Lender's Southern California chapter, has seen lenders approve mortgages that eat up 50% to 60% of the borrower's income.

Mortgage payments, of course, are just part of the costs of owning a house. Homeowners should plan on spending at least 1% of their homes' value each year on maintenance and repairs, according to Eric Tyson, author of "Home Buying for Dummies." Include other costs, such as bigger utility bills, homeowners' association dues and decorating, and the typical homeowner could spend an amount equal to the monthly mortgage payment on such upkeep.

That's why you should limit your PITI to 25% of their total income.

"That's the most comfortable level for most people," she says.

If you're set on buying your dream house, figure out how much more you'll be paying each month for your new home -- and start living now as if you were already shelling out that amount. If you can pull this off comfortably for six months or more, then you can proceed with some confidence. In the meantime, Fernandez said, you can save the difference between what you're spending now and what you'll be spending in the future -- thus bolstering your emergency fund and giving yourself an even larger comfort zone.