Should I Use the Value of My House as My Emergency Fund?

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Q. I don't have an emergency fund, but I have always felt very secure knowing I have a zero balance, low-interest home equity line of credit that would allow me to get, on an emergency basis, close to three times my annual salary. Is this a legitimate substitute for a separate emergency fund? — *Curious*

A. A home equity line of credit (HELOC) is one kind of backup plan, but it's not a foolproof kind of backup plan.

A traditional emergency fund covers anywhere from 3 months to a year's worth of expenses, depending on your personal needs. The money is usually kept in a safe and liquid account.

Chip Wieczorek, a certified financial planner with Tradition Capital Management in Summit, N.J., said it's not advisable or realistic to keep two or three years of living expenses in a savings account with a near 0% yield.

However, he said, home equity lines have pitfalls.

"I advise clients to maintain three to six months of living expenses in a savings account in addition to establishing a home equity line of credit for large unexpected expenses," he said.

Wieczorek said when using a line of credit as an emergency fund, you must be aware that lines have a draw period and a principal pay down period.

A typical HELOC has a seven- to 10-year draw period during which the client can access funds and make interest only payments based on a 20- to 30-year amortization schedule. After the draw period expires, funds can no longer be drawn from the line of credit and both principal and interest payments are required.

"You may think you have two to three years of salary accessible from your line of credit but if the draw period expires, your emergency fund has dried up, Wieczorek said. "Most people do not realize this and should review their HELOC terms on an annual basis."

Also keep in mind that home equity lines are variable and can be frozen by a bank. The interest rate for the line is generally based on an index, such as the prime rate, Wieczorek said.

"This means that the interest rate can increase over time, which would increase your monthly payment as well," he said.

Also, in 2008, major home equity lenders began informing borrowers that their home equity lines of credit had been frozen or restricted.

"Falling housing prices led to reduced equity for borrowers, which was perceived as an increased risk of foreclosure in the eyes of lenders," he said. "Courts have held that a bank may freeze a HELOC in instances where a home's value decreases substantially."

Jerry Lynch, a certified financial planner with JFL Total Wealth Management in Boonton, also referenced 2008 as a problem for many home equity line borrowers.

"It is very possible that the condition that requires you to tap into that credit line — you lost your job or got hurt — may make the bank close the credit line," he said.

Lynch said a mortgage and a home equity line is not a loan on a home, but instead is a loan on your income.

"If that can be shut down, and that was your plan, you need a better plan," he said. "Plan A never works. What's your plan B and C?"

Consider going a more traditional route over time and build the kind of emergency fund you can always count on.

[Editor's Note: If you plan on opening a home equity line of credit, make sure your credit score is in good shape, as it will be a major factor in determining the interest rate you'll pay. You can check your credit scores for free on Credit.com.]

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