The Basics

Smart -- and stupid -- ways to pay for your remodel

Don't get in over your head revamping your kitchen or adding a swimming pool. Here are 6 questions to ask

By Liz Pulliam Weston

Houses can be costly beasts, and not everyone has a pile of cash sitting in a checking account to pay for repairs and improvements.

But if you need to borrow money to pay for major home fix-ups, you should know that there are smart ways and stupid ways to get money:

- The smart ways insure you pay as little interest as possible, get a tax-deduction for what you do pay and don't end up compromising your financial health.
- The stupid ways can leave you house poor -- or even homeless.

To figure out the right financing, you'll need to take a look at your budget, the equity you have in your home, the nature of your project and how long it will take you to pay the money back.

"You need to think about your total financial picture," said financial planner Ross Levin of Minneapolis' Accredited Investors Inc.

Among the questions you should ask:

1. How much will this project cost? Before you borrow anything, have a firm idea of how much you'll need. Use contractor bids as your basic estimate, then add 10% to 20% for potential overruns.

2. Can I afford this? If you can barely afford the minimum payments on the loan, you're getting yourself in over your head. You also could be courting trouble if you're considering a home equity loan or line of credit but you have less than 20% equity in your home. You'll wind up paying higher interest rates and seriously depleting an important financial cushion for emergencies. If the project itself isn't an emergency repair, you may want to put it off until your finances are in better shape.

3. What are my other financial obligations? Before you schedule any non-essential home project, make sure your other financial bases are covered: you're saving enough for retirement and college, you've paid off all credit-card debt and you have at least three months' expenses saved in an emergency fund, for example.

4. Will this project add value? Repairs don't add value -- they simply preserve what you've got. Many home improvements add some value, although you generally won't recoup more than 50% to 75% of what you spend. The less value you're adding, the more you should consider waiting until you can pay cash -- unless, again, you're facing an emergency repair.

5. Can I pay back the loan quickly or will I need several years? The bigger the project, the more likely you'll need years, if not decades, to repay the loan.

6. What's the worst that could happen? Today's adjustable rates have almost nowhere to go but up. If you're taking out an adjustable mortgage or a home equity line of credit with a variable rate, make sure you can afford the payments if rates rise to the maximum level allowed under the loan. (Many home equity lines of credit, which now average around 4%, can rise to 18% or more.) If you can't, consider a fixed-rate loan instead.

Borrowing against equity

Generally, borrowing against the equity in your home -- with a cash-out refinance, a home equity loan or a home equity line of credit -- is the best way to go if you don't have sufficient cash to pay for your project. Here's how they work:

Cash-out refinancing. With this type of financing, you replace your existing mortgage with a larger one and use the extra cash to pay for improvements and repairs. This could be a good choice if:

- Interest rates have dropped since you got your current mortgage
- You'll be in the home long enough to recoup your refinancing costs
- Your project adds lasting value to your home

Home-equity loan. You get a set amount of money, usually at a fixed interest rate, to be repaid over 5 to 15 years. Rates are typically about 1 to 2 percentage points higher than for regular mortgages. Upfront fees and costs are usually minimal. These are good when you need a lump-sum payment and require several years to pay it back.

Home-equity line of credit. These work something like credit cards: you borrow money as you need it and pay a variable interest rate. Rates are usually zero to two percentage points over the prime rate. You can usually establish a HELOC without paying any fees. These are good for smaller projects and those you can pay off quickly.

With all three types of loans, your interest rate will be lower than with most other options, and your interest payments will be tax deductible if you itemize.

The downside: if you fall behind on your payments, you could lose your home. Also, borrowing against your home equity could tempt you to overspend.

Americans are on track to owe a whopping $1 trillion in home equity loans and lines of credit this year, according to SMR Research. That's on top of nearly $100 billion that Freddie Mac says homeowners borrow through cash-out refinancings each year.

This binge of borrowing has some experts worried that Americans are draining away their financial cushion for emergencies and jeopardizing their retirements. (Home equity can be a powerful addition to Social Security and pensions, but not if you spend it all by the time you reach retirement age.)

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Continued from page 1

So if you do borrow against your home, show some restraint and try to pay back the loan as quickly as you can.

Low-equity options

Not everyone has sufficient equity in their homes to borrow against them. Here are some other options:

Title 1 loans. You may be able to borrow up to $25,000 through the Federal Housing Administration's Title 1 program (see link at left). You get the loans from regular banks and other lenders, and the interest rates are negotiable. Your interest payments, though, typically aren't deductible, and you can't use the money for luxuries, like adding swimming pools.

Bottom line: Not a bad choice if you need to make repairs and home equity loans aren't an option.

Construction loans. If the scope of your project is so vast that a home equity loan won't suffice, you may need to consider a construction loan. These short-term, interest-only loans are designed to be replaced by a regular mortgage once the project is completed. They're based on the costs of construction, or the future value of your home, or both.

Bottom line: If you're adding a second story, doubling the size of your home's footprint or gutting your house to the studs and rebuilding, this is probably your best option.

Credit cards. Interest rates on credit cards can be high, and even those low teaser rates can spike upwards if your credit deteriorates -- which it can do almost instantly if you wind up maxing out your cards. Interest generally isn't tax deductible.

Bottom line: Okay for small projects if you can pay off the balance in a few months. If this is your only option for financing, however, there's something wrong with your finances.

401(k) loans. The advantage is you get to pay yourself interest, instead of a bank. The main disadvantage -- and it's a big one -- is that if you lose your job, you have to pay the loan back quickly or owe taxes and penalties on the withdrawal. Your interest payments won't be tax deductible.

Bottom line: Do it only if your job is rock-solid secure. And whose is these days?

Margin loans. Your brokerage typically allows you to borrow against the value of your investments, but a sharp drop in the market could result in a "margin call." That means you either pay the loan back instantly or the brokerage sells the investments that secured the loan. Your interest may be deductible -- consult your tax pro.

Personal loans. If the loan is secured by your signature, rather than your property, it's a personal loan -- even if your bank calls it a home improvement loan. These tend to have high interest rates (in the neighborhood of 14%). Interest typically isn't deductible.

Bottom line: Use only if the repair is an emergency and you don't have other options.

Contractor financing. Some of the most common home improvement scams involve signing people up for ridiculously priced loans to pay for necessary -- or even unnecessary -- home repairs.

Bottom line: Get your money from an independent source.