Line of Credit Suicide: 4 Real Reasons

Four Real Reasons To Rethink your Line of Credit Position

A secured line of credit is something many Investors put into place when looking to get involved in real estate investing. Use of such credit lines is sometimes thought to be a very practical approach to accessing funds for investments. This is one of the biggest mistakes a Real Estate Investor could make. I have personally witnessed the wrath of this financing option. Many Investors are just not aware of the repercussions that this source of funding can bring. If you are refinancing your home or an investment property with the thought of using your line of credit when the perfect opportunity arises, beware!

First, when purchasing or refinancing real estate, the maximum loan to value with a line of credit that can be acquired through a financial institution is 80%. When refinancing, and pulling equity, this limits the amount of funds that could be extracted from the property. With a regular mortgage you can have access up to 90% LTV plus.

Second, the interest rate offered on a line of credit is not as competitive as a variable product that has proven to provide the best overall rate in the long term. When taking the step of utilizing the existing equity in your real property, why not have access to as much as possible at today's low rates which can potentially be less than 2.5%. Here, you will have access to more funds at a better rate. Now you can really make that money work for you.

Third, a line of credit secured on your property will be disclosed on your credit bureau report. There is, of course, no issue with disclosure. However, it is the lender's and the credit bureaus' perspective that we need to concern ourselves with. An underwriter in residential lending will see this as greater debt, even if this line of credit has not been used. The underwriter will have to allocate this loan to your debt service in its entirety based on the underwriting criteria set by the financial institutions. This calculation often adds a larger payment than we actually have and reduces the amount one could qualify for on a residential loan.

After assessing many portfolios, the first recommendation is to refinance these lines of credit and remove them immediately. This will make for one fixed mortgage payment. An Investor can take advantage of a 90% LTV (versus perhaps an 80% LTV) and gain access to more funds with potentially a much lower monthly obligation. This structure will typically allow for a larger mortgage loan approval on future purchases.

As an Investor, one of the most important elements of success is your buying power. If a great deal presents itself, you need to be able to act fast knowing that you can qualify without the concern of a reduction in financing due to the damage a line of credit has done.

Fourth, if you are purchasing an investment property with the thought of paying down the principal by utilizing a credit line, beware! I had recently experienced a situation where a client wanted to purchase an investment property with 20% down. He had really great credit with a score in the high 700`s. His income was great. He was in the perfect position to acquire and had intentions of aggressively moving forward in his real estate investment endeavors.

However, he decided to use a line of credit instead of a mortgage. The result was that this line of credit remained very close to the limit for about one year. He really did nothing wrong. He consistently made all of his minimum payments and was never late.

Today his credit score is in the low 500's! Why?

Because the loan was at the limit for a long period of time. From a credit score/credit bureau perspective, this is a negative and it looks like this person is maxed out on his credit. A high risk! Today, this creditworthy individual is faced with obtaining financing from secondary lenders at a much higher interest rate with the effect of reducing the cash-flow on the investment properties he has acquired.

A credit score will play a very significant role when qualifying for a mortgage. Most residential lenders receive the mortgage loan applications electronically with the credit bureau report attached. For rental property purchases or for those Investors who are self employed, the majority of Banks set a credit score criteria of 680 or greater.

If you are not in the market for residential properties and focused specifically on commercial property, a credit line may not hinder you to this degree as long as the credit line is not close to the limit for a long period of time. Lenders treat commercial underwriting differently. Commercial underwriting is very different from residential as the approval process is based on the property's income and the ability to service the debt. The qualification does not rely on your personal income to service the debt as it does in residential lending. The second important factor is the covenant of the borrower, how strong the borrower is from a net worth perspective and how much of a risk this borrower may be.

This has a huge impact to the approval process and must be taken into consideration when once again securing a line of credit as the line of credit does appear on a credit bureau as additional debt. If you are in the process of securing financing and considering a line of credit, think twice. You need to weigh the pros and cons carefully.

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