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PERSONAL FINANCE

# Fed Rate Increase: When to Tap Your 401(k) or Home Equity to Save on Interest

As interest rates on credit cards and personal loans rise, consider alternate ways to borrow

*By Julia Carpenter* Follow

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The Federal Reserve's 0.75-percentage-point rate increase Wednesday will make it more expensive for consumers to borrow money for everything from cars and homes to refrigerators.

If you need extra cash right now, financial advisers say there are several ways to keep interest payments under control.

Charlotte Geletka, financial adviser and managing partner at Silver Penny Financial, said she's already hearing this concern from clients who are more interested in how to manage borrowing money in a rising rate environment.

Some may have found a dream home in this hot housing market but don't quite have the money to make a competitive offer; many are looking for a lower-interest rate alternative to taking on higher-interest debt; and still others may find their budgets stretched thin by rising costs all around them and want access to credit/cash should they need it.

"The first thing I ask my clients is 'Let's talk about why you're borrowing. What is this helping you to achieve?'" Mrs. Geletka said.

## Personal Loans and Credit Cards

The average interest rate on a personal loan was 10.6% as of July, up from roughly 9% a year ago, according to Bankrate.com. For credit cards, the average annual percentage rate, or APR, for those with good credit is nearing 20%, according to WalletHub's July report on more than

1,500 credit-card offers. Those rates are expected to rise further, based on the Fed's move Wednesday.

Putting the money on a credit card isn't the worst option for smaller purchases that can be easily paid off in a few months, said Malik Lee, founding principal and financial adviser at Felton and Peel Wealth Management. The important thing is making sure you know the APR and set up a payment plan for yourself going into it, he said. Your credit limit may be higher, but don't be tempted to take out more money than you need.

"If you say 'I need $12,000 to make it a couple months,' that's OK," he said. "If you need something more than that, we have bigger fish to fry."

## Retirement Accounts

For bigger ticket purchases, advisers say in some circumstances it can make sense to take loans from retirement accounts or home equity.

Many 401(k) plans allow you to borrow $50,000 or up to 50% of the funds vested in your account, whichever is less. The good thing is that interest rates on these loans, set by the 401(k) plan, tend to be lower than for credit cards or personal loans. And when you pay that interest, most of it goes right back into your account—since you are borrowing from yourself. Borrowers also have greater repayment flexibility and won't have to undergo credit check or front collateral.

But 401(k) loans come with some downsides: removing money will affect your retirement security, as these funds will no longer be invested. Strapped for cash, many who borrow from retirement accounts, also reduce their continuing contributions, compounding the impact. This makes it even harder to make up the money lost, Mrs. Geletka said.

Tapping retirement accounts might be more attractive for younger people who will continue making their same contributions, or higher, that will enable them to make the most of many more market cycles.

"It's not our favorite, but it's available," Mrs. Geletka said of the option.

## Home Equity

For homeowners, another option is taking out a home-equity loan or a home equity line of credit, or HELOC. The home-equity loan comes as a one-time lump sum at a fixed rate, while a

HELOC is a line of credit with a variable interest rate.

Both allow homeowners to borrow against their home equity. The interest rates are typically lower than other loans, and Americans currently have more equity in their homes than ever before. If you use the money for home improvements, that amount can also be tax-deductible.

But putting your home up as collateral puts that investment—and your housing—at some risk.

“The bad thing is you’re using your home like an ATM, and that’s what got people in trouble in 2007 and 2008,” Mrs. Geletka said.

You’ll also be reducing the equity already built in the home. Mr. Lee also reminds people that in the 2008 recession, this is what cost some people their homes. All these options have their pros and cons, but Mr. Lee said that when considering paths with variable interest rates, like HELOC, he recommends carefully monitoring your cash flow and leaving yourself some wiggle room as a hedge against possible default.

“While you’re feeling the pinch with inflation, you can also potentially feel the pinch with your payments, and that can be a double whammy,” he said. “With all this uncertainty, I wouldn’t want to be jumping into anything that isn’t fixed. I’d rather pay a higher rate for fixed. You’re going to be paying more money, but I think the few extra bucks is worth the consistency of knowing what you’ll be paying.”

## Friends and Family

For those fortunate enough to have the option, it can make sense to consider a loan from family or friends.

The pros are obvious, said Nina O’Neal, partner and investment adviser with AIM Advisors. When you’re borrowing from a relative, you can ideally work together to set a much lower interest rate and favorable loan terms. The Internal Revenue Service sets rates for intrafamily loans as a way to prevent people from disguising gifts as loans, and as of July 2022, the rate for a long-term loan is 3.22%, significantly lower than the average mortgage rate, which is 5.54% as of the week of July 21, according to Freddie Mac. For people with poor credit or for people turned down by other lenders, this may be their best, or even only, option. The cons are unfortunately equally obvious, she said—borrowing from friends or family comes with awkwardness, pressure and, in worst-case scenarios, life-changing consequences.

“Ideally, friends and family are a great support network,” she said. “Add in money, and that can become very complicated.”

Ms. O’Neal recommends writing the payment plan together, then treating it as you would any other serious financial document. Get it signed and notarized with a witness, and make sure you’ve included all possible information, including a clear repayment date and outline of all possible repercussions.

Write to Julia Carpenter at julia.carpenter@wsj.com

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