USING HOME EQUITY

There are numerous benefits to owning your own home. Not only does it provide you with a place to live, but you can also often use the accumulated equity for a whole host of money-smart purposes. Borrowing further against your home is serious financial decision, though, and should only be done after careful research and consideration.

Home Equity: Defined and Calculated

Home equity is the part of your home's value that you own outright or, more specifically, the current market value of your home minus your outstanding mortgage balance(s). Equity can be built by making a down payment to purchase the home, paying down the principal of the mortgage through making monthly payments, and the value of your home appreciating (increasing). Appreciation occurs when market demand rises – for example, if you bought the home for $200,000 a few years ago, it may sell today for $250,000 because prices for homes in your area have increased. Your property may also appreciate in value if you made repairs or home improvements.

While most homes appreciate in value over time, it is also possible for the market value of a home to decrease. Economic instability is a general cause of depreciation. There could also be something negative that happens to your home or in your community (such as increasing crime) that brings down the value. If the amount you owe on your mortgage is greater than the value of your home, you are said to be "upside down".

To know how much equity you have in the home, you will first have to find out its value. To get that number, you can either do a comparative market analysis or have your home professionally appraised.

A comparative market analysis is an informal estimate of your home's market value. It is typically done by a real estate agent, who looks at "comps" – comparable homes that have been sold recently. Many agents will do this for free. You can also use a home value calculator, which can be found on many real estate websites.

For a more precise estimate, you may choose to pay a qualified appraiser (which typically costs a few hundred dollars). The appraisal takes many variables into consideration, including your home's:

- Square footage
- Number of bedrooms and bathrooms
- Construction quality, design, and floor plan
- Neighborhood
- Lot size, view, and landscaping

Once you know your home's current market value, subtract the amount you owe on your mortgage(s) to calculate your equity.

Second Mortgage

If you already have a first (primary) mortgage, another loan taken out against your home is called a second mortgage. Second mortgages come in two basic forms: home equity loans and home equity lines of credit. Both types typically come with a higher interest rate than for primary mortgages because the lender assumes greater risk – in the event of foreclosure, the first loan will be repaid before any seconds. However, because the loan is still secured by the property, the interest rate for second mortgages tends to be lower than for unsecured debt, such as credit cards and personal loans.

Home equity loan

With a home equity loan, you receive cash in one lump sum at closing. Once you get the money, you cannot borrow further from the loan. The repayment period is often fifteen years, although it can be as little as five or as great as thirty years. Both the interest rate and the monthly payments for a home equity loan are usually fixed, meaning they do not change over time.

Home equity line of credit (HELOC)

A HELOC is a type of revolving credit. It operates similarly to a credit card. You can withdraw money, up to your credit limit, at any time during the draw period. Some lenders set a minimum required withdrawal amount or charge a transaction fee every time you draw on the line. During the draw period, you typically are only required to pay the interest, although you can choose to pay principal as well. Once the draw period is over, you may have to repay the full principal in one balloon payment, be allowed to repay the principal over a fixed period of time, or have the option of renewing your draw period, depending on how the HELOC is set up.

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The interest rate for HELOCs is usually variable, meaning it can change over time. It is usually calculated as a base index, such as the prime rate (the rate financial institutions give their most creditworthy members), plus a margin. Because the interest rate affects your monthly payments and how much borrowing will cost you, it is a good idea to be aware of how much the rate can increase each adjustment period as well as over the life of the loan.

How much can you borrow?
How much you get from a second mortgage is based on your equity since it is your equity that is serving as collateral for the loan. (Of course, the lender will consider your income as well, and you will need a good credit score to be approved for the loan in the first place.) Every lender sets their own limit, although it is commonly less than the full amount of equity. Still, there are some lenders that may let you borrow up to the amount of equity you have or even more. It is never recommended that you borrow more than your equity, as this puts you upside down. It can be difficult, if not impossible, to sell your home while you are upside down.

What a lender is willing to give you is not the only factor. You should also consider what you can afford to repay. The more you borrow, the higher your monthly payments are. Remember, home equity loans and lines are secured loans. If you do not make the payments, the lender can foreclose on your house, just like if you do not pay your primary mortgage.

Choosing a loan
Looking for a loan with a low annual percentage rate (APR – the cost of borrowing expressed as a yearly rate), is a good idea, since the lower your interest rate, the less borrowing will cost you. You also want to consider the closing costs (fees that are charged to process and disburse the loan). When you apply for a mortgage, the lender is required to give you an estimate of these costs in the Good Faith Estimate. Comfort is relevant too – if a lender is putting excessive pressure on you to borrow and does not answer questions openly, you probably want to go with someone else.

You may be wondering if it is better to get a home equity loan or a home equity line of credit. Because the APR for home equity loans and HELOCs are calculated differently, comparing the two isn't easy. The APR for home equity loans may include points and other finance charges, while the APR for a home equity line is only based on the periodic interest rate. However, you can consider what you will use the funds for. People generally take out a home equity loan to pay for a specific, one-time cost, such as credit card debt or an addition. Conversely, when people expect to use the funds over a period of time, a HELOC is often used.

Tax benefits
For taxpayers that itemize their deductions, the interest that is paid on a second mortgage is deductible. However there are limits – unless the loan proceeds were used to substantially improve the home, you can only deduct the interest paid on the first $100,000 of the second mortgage or the fair market value of the home minus the first mortgage amount, whichever is smaller. More information is available at www.irs.gov.

Refinancing

Refinancing is the process of paying off the existing mortgage(s) with the proceeds from a new loan and using the same property as collateral. The refinanced mortgage becomes your new first mortgage. Refinancing can be done with your current lender or a different one. Unless you take cash out, refinancing does not involve "using home equity" but it is still helpful to understand the situations in which refinancing may be beneficial:

Refinancing to reduce the interest rate
Interest rates constantly fluctuate, and many homeowners refinance their mortgage because the rate they can get today is better than the one on their original loan. A reduced interest rate provides the benefit of lowering the monthly payment, which puts more cash in your pocket. Will it save you money in interest? That depends. Stretching out the future repayment period to 30 years instead of whatever time is left on your existing mortgage will at least partially offset the interest savings (although you can pay extra and get rid of the mortgage quicker than 30 years). Additionally, when you refinance, you have to pay most of the same closing costs you paid the first time around. To determine if refinancing to a lower rate is financially beneficial, you can use the "Should I refinance calculator?" at www.balancepro.net/education/calculators.html.

Refinancing to lower the payment
Getting a lower payment with refinancing can be achieved by lowering the interest rate, extending the repayment period, and/or refinancing for less than what was initially borrowed. While lowering payments can provides relief to those with cash

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flow problems – and possibly prevent foreclosure – remember that having a lower payment means that you may pay more interest in the long run.

Refinancing to get cash out

With a cash-out refinance, you refinance your existing mortgage and also borrow an additional sum from your equity at the same time, giving you cash that you can use for whatever you want. Depending on your new interest rate and how much cash you take out, it is possible that your mortgage payments will increase. Before you take the cash out, you should carefully consider if you can handle the increase in payments.

How much can you borrow?

How much you can refinance for depends on the value of your house and what percentage of your home's value your lender allows you to borrow. Some lenders may let you refinance up to 100% of the value, but you may have to pay for private mortgage insurance until you rebuild 20% equity. Additionally, like with second mortgages, your income and credit score will also be considered.

Reverse Mortgage

Many seniors find themselves with a limited income but a significant amount of equity in their home. A reverse mortgage is a tool that allows you to take the equity out of your house without having to sell it or make payments. (In some circumstance, it can also be used to purchase a home.) Like the name implies, a reverse mortgage is the reverse of a traditional mortgage. With a traditional mortgage, you make payments on your loan to the lender each month, increasing your equity and decreasing your debt. Eventually, if you stay in the home, you will own it free and clear. With a reverse mortgage, the lender pays you instead, reducing your equity and increasing your debt (since the money is a loan against your home's equity). You do not have to pay back the mortgage for as long as you live in the property.

There are several types of reverse mortgages:

- **Home Equity Conversion Mortgages (HECMs)** are the most widely available type of reverse mortgage and are backed by the Department of Housing and Urban Development (HUD). There are no income restrictions, and you can use the money for whatever you like. The amount of money you can borrow depends on your age, your home's value, where your home is located, and the loan's interest rate.
- **Single-purpose reverse mortgages** are offered by some government and non-profit organizations to low or moderate-income seniors. Though borrowing costs tend to be inexpensive, availability is limited, and the cash can only be used for a specific purpose, such as home improvements, repairs, or property taxes.
- **Proprietary reverse mortgages** are private loans and are typically the most costly option. They may be appropriate if your home's value is very high since they can give a bigger cash advance than HECMs.

The basic requirements to qualify for a HECM are:

- Everyone on the title of the home must be at least 62.
- You must occupy the property as your primary residence.
- There must be a significant amount of equity in the home.
- You must complete a counseling session with a housing agency approved by HUD. (You can call (800) 569-4287 or visit https://entp.hud.gov/idapp/html/hecm_agency_look.cfm to find an approved agency.

Unlike with a traditional mortgage, you do not need a good credit score to qualify for a reverse mortgage.

While a reverse mortgage can increase your cash flow, there are a few downsides to consider:

- It typically costs more than a traditional mortgage. The closing costs and mortgage insurance premiums can be quite high. (The HECM Saver comes with lower costs than a regular HECM, but you cannot borrow as much.) It generally does not make sense to get a reverse mortgage if you plan to move within a few years.
- Your total debt increases rather than decreases over time.
- Since you are using some or all of your home's equity, you are leaving less money to your heirs.

Factors to Consider

For some, getting a second or reverse mortgage or refinancing could be the best option, for others, a mistake. Since you are putting one of your most important assets – your house – on the line, it is important to think carefully before acting.

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What will the equity be used for?
By using your home's equity, you are decreasing your wealth and increasing your debt, so make sure you are using the money for a worthwhile purpose. Do you really want to take out a home equity loan so you can go on cruise? Popular uses of home equity include:

- **Consolidating unsecured debt.** Credit cards and personal loans often come with a high interest rate. A loan secured by your home will usually have a better interest rate and smaller monthly payment, and the interest paid will likely be tax deductible. Also, if you have many accounts, consolidating them into one payment can make your life much easier. Still, it is important to keep in mind that you are turning unsecured debt into secured debt. If you do not pay your credit cards, your house cannot be taken from you, but it can if you do not pay your first or second mortgage. Additionally, sometimes, when people pay off unsecured debt with their homes, they just wind up maxing out their old cards again, giving them more debt than before.
- **Financing home improvements.** Perhaps you want to change the cabinets in the kitchen, upgrade the bathroom, or add a whole new room. Home improvements can be expensive, and many people do not have the savings to pay for them. While renovations can increase your enjoyment of the house, as well as its value, remember not to borrow more than what you can afford to pay back. Think about what projects can wait if you have limited funds.
- **A source of savings.** Many people take out a home equity line in lieu of saving. Why not? The money is there when you need it, and you do not have to pay interest until you withdraw the funds. Unfortunately, it does not always work out. Your credit line can be frozen, meaning you will be no longer able to use the funds that were once available to you, or you be in a position where you cannot afford to repay what you borrowed. You could take out the money before you need it and put it in a savings account or invest it, but the money is not really savings, since you need to pay it back. Also, it will cost you if the interest you are charged on the home equity line is higher than the interest you earn from your savings account or investments.

Is the monthly payment affordable?
Never forget, if you cannot make your payments, you can lose your home. If you take out a second mortgage or, in many cases, do a cash-out refinance, your monthly payments will increase. If you are struggling now, taking out a second mortgage or doing a cash-out refinance may only make your situation worse. Even if you want to use your equity for a responsible purpose, it is not a good idea to borrow if you cannot afford to make the payments.

What are the benefits?
In general, the lower the risk to the lender, the less interest you will have to pay. A loan secured by home equity does not have as much risk as a loan without collateral, so the interest rate for home loans is usually lower than that for credit cards and personal loans. The repayment period is usually longer as well, which makes borrowing large sums of money more affordable. Also, in most cases, the interest that you pay on a loan secured by a personal residence is tax-deductible, unlike the interest paid on a credit card or personal loan.

What are the alternatives?
If you need or want money, borrowing against your equity is not the only option. For example, you may be able to use credit cards or personal loans. The interest rates may be higher, but you do not put your home at risk. If you decide you can wait, you can save for your goals and perhaps avoid borrowing completely. Selling your house is another option. It allows you to access your equity without needing to worry about repayment.

The Right to Cancel

If you decide to borrow, but then regret it, you may be able to cancel if you act fast. The Truth in Lending Act, a federal law, gives you the right to cancel a loan secured by your home within three business days following the settlement, receipt of your disclosures, or receipt of your cancellation notice, whichever occurs last. You must notify the lender in writing, and you can only rescind if the loan is secured by your primary residence, not a vacation or second home. In addition, you are not given the right to cancel if you obtain the loan to buy or build your primary residence or are refinancing your loan with the same lender who holds your existing mortgage and do not borrow additional funds.

Summary

Chances are, you worked hard to buy your home. Don't make hasty decisions that can put it at risk. Read all paperwork thoroughly, and make sure you understand all of the terms before you sign anything. If you need to, get legal assistance. When done for the right reasons and under the right circumstances, using your home's equity can be a wise financial decision.

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