Home Equity Borrowing

Consumer Alert!

1-888-995-7856 ALLIANCE Credit Counseling

By Edward Tonini, Director of Education.

"...the amount we owe on home equity loans and lines of credit, $719 billion, now exceeds the balances on our Visas, Mastercards..."
-Liz Pulliam Weston (Author of *Deal With Your Debt*)

"Your home is your castle" so the saying goes. Indeed, for most homeowners their home is their greatest monetary asset. The question of tapping into this source of wealth is a common one. This publication provides a look at the two basic forms of home equity borrowing, typical uses, potential benefits and dangers, some alternative options, and some pointers for preparation.

Definitions

Home Equity refers to the value of your current portion of ownership in a home. It is calculated by subtracting the amount you owe on the home from its current appraised value. For example, if your home could be sold today for $150,000 (regardless of what you paid for it) and you still owe $100,000 on it, your home equity would be $50,000. You can use part of your home equity as collateral for a loan or line of credit (which are basically second mortgages). Collateral is property (in this case, your house) that you pledge to guarantee your repayment of the debt. Debt that has collateral attached to it is referred to as secured debt.

A *Home Equity Loan* (HEL) is a type of installment loan. You receive the money in a one-time lump sum and pay it back in monthly installments over a set time period (typically 5 to 15 years).

A *Home Equity Line Of Credit* (HELOC) has a revolving balance and works like a credit card. You are given a credit limit and you can borrow multiple times up to that limit within a pre-determined time period (called the draw period). You are required to make at least a minimum monthly payment and must repay the full amount by a certain time.

The following summarizes several key differences.

HEL:	**HELOC:**
• Fixed interest rate	• Variable interest rate (typically a little lower than the current fixed rate)
• Minimum payment remains the same	• Minimum payment can go up or down
• Borrow only at one time and only in a lump sum	• Borrow as needed (up to a fixed amount for a fixed period) with flexible access (check, credit card, electronic transfer)
• Monthly payment includes principle and interest	• Monthly payment of only interest may be acceptable during the draw period
• Typically requires paperwork, fees and closing costs (similar to a first mortgage)	• Often can be obtained for little or no cost

If you sell the home before the end of the term, both a HEL and HELOC must be repaid in full.

Common Uses

As with any type of loan or credit, people want to borrow using their home equity for many reasons. However, some uses are better than others.

Education. Education and training typically result in increased employability or higher income. If you have to borrow to pay for education, compare the rates you can get from a government backed student loan to those you can get using your home equity.

Emergency funds. Many financial experts say that one of your first financial goals should be to have an emergency fund of at least $1,000 in an interest-bearing savings account. If you can open a low interest rate HELOC and not be tempted to use it unwisely, it can provide an alternative to tapping higher rate savings accounts or to using credit cards which typically have very costly interest rates.

Home improvements. Borrowing for a home improvement can make sense if the value added exceeds the total cost of the loan. However, very few home improvements pay for themselves. You might be able to get an educated estimate for the potential value of a project by consulting a few experienced local realtors and appraisers.

Investments. Perhaps you've thought about using your home equity to buy

Contents On Back

investment property or stocks. If the return on the investment is higher than the interest you pay, you can come out ahead, but your house is at stake in the gamble.

Automobiles. It's not wise to use credit to buy items that depreciate quickly. However, if you require a vehicle for your job and must use credit to obtain one, the benefits of a potentially lower rate and possible tax deduction can be weighed against the potential loss of your home.

Luxury items. TVs, vacations, and other luxuries should be paid for without using credit.

Debt consolidation. You may be able to pay off several smaller debts with the proceeds from a HEL/HELOC. This would give you just one monthly payment, and that payment could be lower than the sum of the monthly payments on the smaller debts. But read on.

Potential Benefits

1. Lower Interest Rate.

Because the HEL/HELOC is secured, it typically offers a lower interest rate than those for revolving credit (such as credit cards).

2. Tax Deduction.

If you itemize on your tax return, the interest on a home equity loan (up to $100,000) may be deductible.

Potential Dangers

1. Losing Your Home.

A HEL/HELOC is a second mortgage. If you default, the lender has legal authority to sell your home in order to pay the secured debt. High-interest debt, such as a credit card or medical bill, is unsecured. If you had to file a bankruptcy, the unsecured debt could be discharged in whole or in part. If you consolidate unsecured debt with a HEL/HELOC, you are turning it into secured debt.

2. Not Addressing the Real Problem and Getting Deeper In Debt.

Most people who consolidate unsecured high-interest debt by using their home equity don't address their overspending issues and don't cut up their credit cards. They can get a false sense of security when they see the available credit on their cards and then run up the balances again.

3. Being In Debt Longer & Paying More.

High-interest debt, such as a credit card or medical bill, is categorized as short-term debt (meaning you would normally pay it off in 5 years or less). If you consolidate this kind of debt with a HEL/HELOC, you are potentially turning short-term debt into long-term debt. This is because the term of the HEL/HELOC might be as long as 30 years, which can allow you to take much longer to pay off the debt. Depending on how long you take to pay it off, it could cost you more in total interest even if the HEL/HELOC interest rate is lower than the rates on the smaller debts you consolidated.

4. Finding Yourself "Upside-down."

If your home's value drops and you have to sell it, you could end up owing a lot.

5. High-risk Loans.

Balloon loans. With this kind of loan, the schedule of minimum monthly payments does not result in payment of the full principle, and the entire outstanding balance is immediately due at the end of the loan term.
High LTV loans. This is a loan that exceeds a loan-to-value ratio of 100%. For example, a home equity loan for $30,000 where the current value of your home is $100,000 and balance owed is $80,000 would give you a loan-to-value ratio of 110%. If you sold the home, you would still owe $10,000.

6. Beware of Scams.

Equity stripping. This occurs when a lender encourages you to exaggerate your income on a loan application, hoping you'll default on your mortgage so they can foreclose on your home and take the equity.
Loan flipping. Here, a lender encourages you to refinance repeatedly so they can charge you more fees.
Deception. Deception can happen in many ways. A lender might add new charges at the closing or they might fail to provide accurate closing documents and then sell your loan to another lender who demands a higher payment.

Alliance Tip: the *Truth In Lending Act* gives you the right to cancel (in writing) certain real estate loans within three business days without penalty. If you believe you have been victimized by a fraudulent lender, contact an attorney and file a complaint with the Federal Trade Commission (www.ftc.com or 1-877-382-4357).

Other Options

Before borrowing, you should try to explore all your options. Here are a few to consider.

Cash-out refinance. If interest rates have dropped significantly since you obtained your current mortgage, you may want to consider getting a new, larger mortgage that would pay you cash at closing. When finding the total cost, remember to include not only the interest savings over the length of time you expect to stay in the house, but also the added fees and closing costs.

Tapping savings. If the interest rate on your funds in (non-retirement) savings is the same or less than what you would pay with a HEL/HELOC, it would be wise to borrow from yourself.

Financial overhaul. Depending on how much you need and how soon it's needed, you might be able to get the funds by raising your income and lowering your expenses. To explore this further, read our publications: *The Spending Plan* and *More With Less*.

Readiness

If you decide a HEL/HELOC is right for you, prepare yourself before applying. Lenders are going to carefully evaluate your income, the loan-to-value ratio and your credit history.

Lenders traditionally require the loan-to-value ratio to be less than 80%. For example, if the current value of your house is $100,000 and it's paid in full, your maximum loan would be $80,000. If you still owe anything on the house, that amount would have to be deducted. So if you still owed $60,000 on it, your maximum loan would be $20,000.

Your credit scores have a significant impact on the interest rate you are offered. To allow yourself some time to work on any credit issues you find, it would be best to check your reports at least six months before applying for credit. For information on obtaining your credit reports, read our publication *How To Check Your Credit Reports*. For information on clearing up any errors you find, read our publication *How To Dispute Errors On Your Credit Reports*. Finally, a higher credit score can mean a lower interest rate. To find out what you can do to improve your score, read our publication *Raising Your Credit Scores*.

To Find Out More

- *Deal With Your Debt* (Liz Pulliam Weston, Pearson Education Inc.)
- *Home Equity Credit Lines; Home Equity Loans: Borrowers Beware!* (www.ftc.gov/bcp/consumer.shtm)
- *Home Equity Basics* (www.bankrate.com/brm/green/loan/)
- To read our publications referred to above, visit www.knowdebt.org/education.php.