

# Using Home Equity

There are numerous benefits to owning your own home. Not only does it provide a place to live, where you can decorate as you want, but it also provides a source of wealth. Over time, most homes increase in value, and many homeowners use their gains for a whole host of purposes. Using your home's equity can be a money-smart decision, but it is also a serious one that can have negative consequences if not done carefully. This course can help you make an informed choice. It will cover:

- What is home equity?
- Second mortgages
- Refinancing
- Reverse mortgages
- Factors to consider

## Chapter 1: What is Home Equity?

Home equity is the part of your home's value that you own outright. If you have a mortgage, you do not own the whole home – your mortgage lender has an interest in it as well. For example, if you sold your home for \$600,000 and had a \$400,000 mortgage, the lender would get \$400,000, and you would get \$200,000 – your equity in the home. You can calculate your home's equity using a simple equation:

<b>Current market value of home</b>	–	<b>Outstanding mortgage balance</b>	=	<b>Your home equity</b>
\$600,000	–	\$400,000	=	\$200,000

Short of selling your home, how can you determine what the current market value is? To get the 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. By plugging your data into a home value calculator, available on many real estate websites, you can obtain a ballpark figure of what your home is worth. Another option is to ask a local real estate agent to give you an estimate of the price your home could sell for. For a more precise estimate, you may hire a certified appraiser, which typically costs a few hundred dollars. This appraisal takes many variables into consideration, including your home's:

- Square footage
- Construction quality, design, and floor plan
- Neighborhood
- Access to transportation, shopping, and schools
- Lot size, topography, view, and landscaping

You can build equity through making a down payment when you purchase your home, paying down your mortgage balance by making the monthly payments, and experiencing appreciation. Appreciation occurs when market demand rises. For example, if you bought your home for \$200,000 a few years ago, it may sell today for \$250,000 because prices in your neighborhood have increased. Your property may also appreciate if you made repairs or home improvements. While home values tend to appreciate over time, they do not have to. When the value depreciates, your equity decreases. If it depreciates enough, you could have negative equity, where the value of your house is less the amount you owe on your mortgage.

## Chapter 2: Second Mortgages

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 offer higher interest rates than 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, interest rates for second mortgages tend to be lower than for unsecured debt, such as credit cards.

### Home equity loans

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 lines of credit (HELOCs)

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 transaction fees 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 either have to repay the principal in full, 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.

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 determines your monthly payments and how much borrowing will cost you, it is a good idea to find out how much the rate can change and if there is a cap that will prevent it from exceeding a certain amount.

### How much can you borrow?

How much you get from a second mortgage is based on your home equity, since it is your equity that is serving as collateral for the loan. (The lender will likely also consider your credit score, income, and other factors.) Every lender sets a different limit, although it is commonly less than the full amount of equity. For example, a lender may let you borrow up to 80% of your home's appraised value minus the amount left on the first mortgage. 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. This puts you "upside-down", meaning you owe more on your mortgages than what you can sell your property for. 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 to consider. 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.

### **What to look for**

Looking for a loan with a lowest 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. However, you don't want to stop there. Do you remember all of the closing costs that had to be paid when you took out a mortgage to purchase your home? You have these costs when you take out a home equity loan or line of credit too. Consider what fees each lender charges. For example, you may have to pay an application fee, an appraisal fee, and points. Be cautious of loans that come with potentially detrimental features, such as a large balloon payment at the end of the loan or a prepayment penalty.

Should you go with a home equity loan or a 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. Comparing APRs may not be helpful, but you can consider what you will use the funds for. People generally take out home equity loans 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.

## **Chapter 3: 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. Refinancing can be done with your current lender, or a different one. The interest rate that you can get when refinancing is often lower than what you can get with a second mortgage, but this does not always hold true. Refinancing is done for a variety of reasons.

### **Refinancing to reduce the interest rate**

Interest rates constantly fluctuate, and many homeowners refinance their mortgages because the rates they can get today are better than the ones they received when they first got their loans. A reduced interest rate provides the benefit of lowering the monthly payment, which puts more cash in your pocket.

Even if you do get a lower interest rate, refinancing does not always save you money. Refinancing is not a free process – a new loan means you will have to pay most of the same closing costs you paid the first time around. Let's say refinancing to a lower interest rate saves you \$1,000 a year in interest, and you have to pay \$5,000 in closing costs. If you sell the house after a year, refinancing will have actually cost you \$4,000! Generally, the longer you are planning to stay in the house, the more beneficial refinancing to a lower interest rate is.

### **Refinancing to lower the payments**

For those that are struggling, refinancing can be a way to improve cash flow (although refinancing alone is not always enough). The conditions under which you may be able to lower your payments through refinancing include:

- **Getting a lower interest rate.** As discussed above, if you get a lower interest rate, your monthly payments will decrease, since you do not have to pay as much in interest.
- **Extending the repayment period.** Maybe you have a 15-year mortgage and want to switch it for a 30-year loan, or you want to refinance your 10-year home equity loan into a 30-year mortgage. When you pay the same amount over a longer period of time, the monthly payments are lower, although the total amount shelled out for interest is greater.
- **Refinancing for less than what was initially borrowed.** All other things being equal, the lower the loan amount, the lower the monthly payment. For example, if you took out a standard 30-year mortgage for \$200,000 at 6%, your monthly payments would be \$1,199.10. After ten years, the balance would be \$167,371.62. If you refinanced the remaining balance with another 30-year, 6% mortgage, the monthly payment would be \$1,003.48, a monthly savings of almost \$200! However, doing this does increase the total amount of interest paid.

### 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. This is the only type of refinance where you actually use your home equity. You may be able to combine a cash-out refinance with getting a lower payment or interest rate, but if you do not do take cash out, your equity does not change.

Depending on your new interest rate and how much cash you take out, it is possible that your mortgage payments will increase. You should carefully consider if you can handle the increase in payments.

How much you can refinance for depends on the value of your house and the lender's maximum allowed loan-to-value (LTV) ratio. The LTV ratio is the percentage of the home's value that is financed. For example, if the lender has a maximum 95% LTV ratio, you can borrow up to 95% of the home's value. 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.

## Chapter 4: Reverse Mortgages

Many seniors find themselves with limited incomes but a significant amount of equity in their homes. 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. 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:

- **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.

- **Home Equity Conversion Mortgages (HECMs)** are widely available loans that 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. To get a HECM, you must have no mortgage, or the majority of the existing mortgage must be paid. The amount of money you can borrow depends on your age, your home's value, where your home is located, and current interest rates.
- **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 bigger cash advances than HECMs. The money can be used for any purpose, and there are no income limits.

The basic requirements to qualify for a reverse mortgage are:

- Everyone on the title of the home must be at least 62 (for most programs).
- You must live in the home.
- There must be equity in the home.

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

- The loans are usually costly. Origination fees, closing costs, and servicing fees can be high, and you will be charged interest on the outstanding balance.
- Most have variable interest rates. If the rate rises, the loan becomes more expensive.
- Your total debt increases rather than decreases over time.
- Since you are using some or all of your home's equity, your heirs may inherit property with a large outstanding mortgage.

## Chapter 5: 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.

### 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? Think about what you are planning to use the money for, and if it is worth depleting your home's equity. Popular uses of home equity include:

- **Consolidating unsecured debt.** Unsecured debts, such as credit cards and personal loans, often come with high interest rates. A loan secured by your home will usually have a better

interest rate, smaller monthly payments, and the interest may even 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 home equity loan or line. 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, people sometimes borrow so much that they cannot make the payments. Think about what you can afford to borrow and what projects can wait if you have limited funds.
- **A source of savings.** Many people take out home equity lines 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. Credit lines can be frozen, meaning you are no longer able to use the funds that were once available to you, or you may not be in a position where you can 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 refinancing may only make your situation worse. Even if you want to use your equity for a good 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 primary residence is tax-deductible, unlike the interest paid on a credit card or personal loan. For example, if you had a marginal tax rate (the tax rate that is applied to the last dollar you earn) of 25%, paying \$2,000 in interest on a home equity loan would save you \$500 in taxes.

### **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 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 you 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.