

Insider's Guide to Home Equity Loans



Home Equity Basics

Understanding the basics of home equity is the first step to choosing the right loan for your needs.

LowerMyBills designed this guide to help you choose the right loan and get the most out of the loan you select. All loans are not created equal. It pays to get the facts!

Know Your Loan

Home Equity Loans are often referred to as second mortgages because they are secured by the equity that you have in your property. Your first (original) mortgage probably has a term of 30 years, while Home Equity Loans usually have a term of five to 15 years. Common uses for Home Equity Loans include debt consolidation, home improvements, and paying for tuition.

Because it is a secured loan with the property as collateral, a Home Equity Loan generally has lower interest rates and tax advantages that aren't available with a credit card. For the same reason, Home Equity Loans can be risky, because defaulting on payments puts the property at risk of foreclosure. Homeowners must also be prepared to pay the balance of the loan or line of credit when they sell their home.

Two Types of Home Equity Loans

1. Closed-End Loans

- A closed-end loan, also called a term loan, is a traditional type of loan where the borrower receives the full loan amount all at once.

- The homeowner pays off this lump sum over a set period of time with a fixed interest rate and fixed monthly payments.
- Once their loan application has been approved, a borrower may not change the amount they wish to borrow.

2. Home Equity Lines of Credit (HELOC)

- A Home Equity Line of Credit (HELOC) is similar to a credit card, but often offers much lower interest rates.
- Homeowners usually access HELOC funds through lender-issued checks or credit cards.
- With a HELOC, a homeowner may borrow any amount, at any time, up to a set limit.
- Unlike credit cards, many HELOCs require that homeowners take out an initial advance, make transactions with a certain frequency, make withdrawals of a certain amount, or have a minimum outstanding balance.
- All conditions will be specified in the loan contract and should be read carefully.
- Like a credit card, lenders base the schedule of payments on the outstanding balance, not on the maximum credit amount.

What Type of Loan is Right for Me?

To choose the right loan, you'll need to evaluate your own personal needs.

Consider the following scenarios:

Scenario 1 : Mary and Ted need \$20,000 to pay for their daughter's wedding and \$5,000 to send Mary's mother on a cruise. Both expenses will occur within the next two months. Mary and Ted know exactly how much they need, they know that both amounts must be paid in full in a short period of time, and they know they have no future plans to borrow. What is the right type of loan for Mary and Ted?

A closed-end home equity loan would be the best choice for Mary and Ted.

Scenario 2: Samantha is planning on helping her son pay for his college education. She will need to borrow money at the beginning of each quarter over the course of the next four years, but she is not sure about the exact amount. What is the right type of loan for Samantha?

A line of credit (HELOC) will give Samantha the flexibility to borrow what she needs, when she needs it.

Home Equity Loans for Debt Consolidation

The most popular reason for obtaining a Home Equity Loan is to consolidate credit card debt. Since consolidation usually entails borrowing a fixed amount to pay off higher interest debt, a closed-end loan usually works best for this purpose. If you are borrowing relatively small amounts and plan on paying the loan back quickly, a line of credit should cost less than a closed-end loan.

Still Not Sure? Ask Yourself These Questions.

• When do I need the money?

If you are looking to get the money in the shortest time possible, HELOC processing can often be completed in less than two weeks. Typically, getting cash from a closed-end loan will take 2-4 weeks from loan approval.

• How long will I need to pay off the loan?

If you want to be sure you're done paying off a

loan by a set date, then a close-ended Home Equity Loan works best. Either way, you need to be sure you can make the monthly payment. If you choose a longer term loan with the intention of paying it off early, make sure the contract does not contain any prepayment penalties.

• Would a line of credit tempt me to spend carelessly?

A line of credit works a lot like a credit card, but with a much higher limit. Before you get a HELOC, you should be confident that you have the discipline to not over-charge, so you can avoid putting your home at risk.

• How much can I afford to pay each month?

Look at your budget and consider this question carefully before you agree to any kind of loan or line of credit. Make sure that you'll have no problem making your monthly payment, so you don't risk foreclosure.

How Much Should I Borrow?

As with any loan or line of credit, your first consideration should be "is it worth it?" A Home Equity Loan uses your home as collateral, so if you can't make the monthly payments, you put your home at risk. Never agree to a Home Equity Loan if you don't have enough income to make the combined payments on your mortgage and the new loan.

Once you decide that you would like a Home Equity Loan, you should find out how much you are eligible to borrow and how much it will cost to close the loan. You may be eligible for up to 100% of your home's appraised value, minus what you owe on your first mortgage and second mortgage, if applicable. If you have a higher credit score, and are a better risk for the lender, you will be eligible for a greater percentage of your home's appraised value.

Loan Amount - Example:

Appraised value of home	\$200,000
Maximum amount that can be borrowed* (85% of \$200,000)	\$170,000
Less existing mortgage balance	- \$120,000
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Available amount for home equity/ HELOC loan	= \$50,000

*Varies by credit history, 70-125%

In considering the actual credit line or loan amount, the lender will judge your ability to repay by looking at your credit history, other financial obligations, and your income-to-debt ratio.

Interest Rates and Other Charges

When selecting a loan, your first question will probably be, "What's the Annual Percentage Rate (APR)?" The APR is the interest that accrues on your loan each year. Next, you should decide if a Variable or Fixed Interest Rate works best for you. Variable Interest Rates rise and fall depending on economic indexes, such as the prime lending rate. In most states, this rate must be communicated to the borrower upfront. Variable rate loans must also specify a cap or ceiling. This guarantees that you will not have to pay more interest than what was agreed upon in the loan contract. Fixed Interest Rates do not change over the life of the loan. They offer the security of a monthly payment that will not change. However, fixed rates generally lock-in at a higher interest rate than variable rate loans.

Points are a one-time charge levied by the lending institution for a closed-end loan. One point is equal to one percent of the loan value. So if you take out a \$20,000 loan and are required to pay one point, you will pay a one-time charge of \$200. The lender may allow you to roll the points into the cost of your loan, but this can get expensive, considering you are paying interest over the life of the loan. Lenders are not allowed to charge points on Home Equity Lines of credit.

Extra charges and fees vary widely depending on the lender, and can include application fees, appraisal fees, credit checks, collection fees, title search fees, and lien

reports. Make sure you understand which fees your lender requires you to pay up front. In some cases, you may be able to convince your lender to waive some of these charges.

Borrower Beware

• Payable on Demand Loans

These are never a good idea. If you enter into such an agreement, you are allowing the lender to require full payment from you at their demand. Even if you are making the regularly scheduled payments, the lender can call in the loan at any time. This could result in you losing your home.

• Balloon Payments

They may seem appealing when cash is short, but borrowers beware. The payments on this type of loan will be quite low because you are only making payments on the interest until the end of the repayment period. However, a large balloon payment will be required at the end of the loan. Many homeowners find that last large payment difficult to make.

• Teaser Rates

Like credit card teaser rates, lenders may advertise home equity rates that only apply for a specific period of time. Many homeowners have been fooled into signing up for these loans and discover the deception only when their rates go up. It pays to ask your lender in advance how the interest rate will be calculated over the life of the loan.

Glossary of Common Home Loan Terms

Adjustable Rate Mortgage (ARM)

A loan structured so that the interest rate, and therefore payment amount, adjusts periodically based on a financial index, such as the prime lending rate.

Annual Percentage Rate (APR)

The yearly cost of credit on a mortgage, expressed as a percentage.

Application Fee

Fees that must be paid when you submit a loan application. If not listed separately, charges for a credit report and property appraisal may be included in the application fee.

Appraisal

A professional evaluation of the current market value of a property, usually required by lenders before closing a home loan.

Appreciation

The increase in value of a property.

Balloon Loan

Loans that have very low, interest-only, payments until the end of the repayment period, with a large balloon payment required at the end of the loan. Many homeowners find that last large payment difficult to make.

Cash-Out Refinance

A refinance loan for an amount greater than the balance of the mortgage. The extra money is added to the existing mortgage balance and can be used for anything.

Closing Costs

Fees paid upon the closing of a mortgage loan. These charges often include title, appraisal, and origination fees, plus other prepay charges like taxes and insurance escrow fees.

Debt Consolidation Loan

This type of loan allows homeowners to use their home equity to consolidate their debt. Instead of having multiple debt payments at a variety of rates, the debts are added to the mortgage balance -- securing a single, usually lower rate, and fewer monthly bills.

Equity

The appraised value (fair market value) of your home minus your outstanding mortgage balance.

First Mortgage

The primary loan covering the purchase cost of a property.

Fixed Rate Mortgage

A loan with an interest rate that never changes. Payments also stay the same throughout the term of the loan.

Home Equity Loan

A home loan secured by the equity in your property, often referred to as a second mortgage. There are two types:

1. A closed-end loan, also called a term loan, where the borrower receives the full loan amount all at once.
2. A Home Equity Line of Credit (HELOC), which allows homeowners to borrow any amount, at any time, up to a set limit.

Interest Rate

The periodic fee charged for a loan; expressed as a percentage.

Jumbo Loan

Home loans that exceed the conforming limit set for that year. For example, in 2004 the conforming limit was set at \$333,700.

Mortgage Broker

A go-between who matches borrowers with mortgage lenders. The broker does not offer loans, and receives payment from lenders.

Points (or Discount Points)

Points are a one-time charge levied by the lending institution for a closed-end loan. One point is equal to one percent of the loan value.

Second Mortgage (Closed-End Loan)

A traditional Home Equity loan where the borrower receives the full loan amount all at once. The homeowner pays off this lump sum over a set period of time, with a fixed interest rate and fixed monthly payments.

Transaction Fee

A fee that may be charged when borrowers access their Home Equity Line of Credit.

Variable Rate

An interest rate that varies based on shifts in a financial index.

Home Equity Worksheet

Ask the right questions, so you can be sure that you're getting the right loan. We've put together the following list to help you in your conversations with lenders.

Lenders:				
• Is this a Loan or a HELOC?				
• What are the fees associated with this Loan/HELOC?				
• How long is the term of the loan?				
• What is the Annual Percentage Rate (APR)?				
• Are there any continuing costs associated with this loan?				
• What are the minimum and maximum withdrawals I can make?				
• What are the total closing costs and who pays for which items?				
• What is the cap on the variable interest rate loan?				
• If interest rates go down, how low will my loan go?				
• If interest rates go up, how high will my loan go?				
• Will you loan to me if my house is for sale?				
• How do I access the loan or line of credit?				
• Can I lease my house during the time of the loan?				
• Under what conditions can you demand full payment of my loan?				
• Do I have to use my credit line right away? <small>*(HELOC Only)</small>				
• What is the lifespan of my line of credit? <small>*(HELOC Only)</small>				
• How large a line of credit do I qualify for? <small>*(HELOC Only)</small>				