HOME EQUITY LOANS

Quick Guide

This Quick Guide was prepared by Truebridge

Member FDIC

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Home Equity Loans

Home equity loans, sometimes referred to as second mortgages, involve borrowing money and making principal and interest payments over a specified period of time. The debt is secured by your home. Here are some features of home equity loans:

- Your repayment period can vary. Home equity loans often have a repayment period of 15 years, although it could be as short as five years or as long as 30 years.
- You can generally borrow up to 75% to 80% of the current appraised value of your home; this result is then reduced by your outstanding mortgage balance.

SUGGESTION: You may find a lender who is willing to lend you more than 75% to 80% of the current appraised value of your home, minus the outstanding mortgage balance, especially if you can prove that you will be making improvements to the home that will increase its value.

- Interest rates are generally higher than on first mortgage loans.
- Lenders usually offer a choice between fixed-rate and adjustable-rate loans.

IMPORTANT NOTE: The interest you pay on a home equity loan is tax-deductible (on loans up to $100,000) if you itemize your deductions.

Home Equity Line of Credit

Another way to tap the equity in your home is with a home equity line of credit (HELOC). Instead of borrowing a fixed amount of money at one time, you can establish a line of credit against the equity in your home and draw on the money as you need it. The lender will set a limit on the total amount you can borrow and will issue you checks. It is almost like a checking account, except you have to pay back the money! Following are some features of a home equity credit line:

- The maximum credit line is typically limited to between 75% and 80% (but can be more depending on the lender) of the current appraised value of your home; the credit line is then reduced by your outstanding mortgage balance.
- Interest is usually a variable or adjustable rate, which can vary as often as monthly.

IMPORTANT NOTE: With most lines of credit as well as some equity loans, you will receive a variable interest rate. When evaluating these loans, make sure that you consider the worst possible scenario. In other words, be sure that you can handle higher monthly payments during a time of rising interest rates. Find out from your lender what the ceiling is. This is the maximum interest rate they can charge on your home-equity loan.

- You only pay interest on what you borrow, not on the entire line of credit.
- Lenders typically require a minimum monthly payment on any outstanding loan amount.
- Most home equity credit lines are divided into two periods—a draw period and a payback period. A draw period—the period of time you are able to draw from the credit line—typically lasts from 10 to 15 years. The payback period is the period of time you have to pay back the outstanding balance. It usually ranges from 10 to 20 years.

What Makes Home Equity Loans So Attractive?

Home equity loans or credit lines have become increasingly popular. Many lenders promote these loans in various advertising media. Indeed, home equity loans and lines do offer the following advantages to borrowers:

- **Low cost.** The fees associated with these loans are very reasonable. You can probably figure on costs ranging up from about $800, depending on the amount of points involved. You may want to consider paying a point or more to get a lower interest rate. Keep in mind that many lenders allow you to add the costs to the loan, so you don’t have to come up with too much cash out-of-pocket.
- **Tax-deductible interest.** Generally, interest on a home equity loan or credit line is a tax-deductible expense. There are limits; see the section *Home Equity Loans and Taxes.*
- **Easy to obtain.** Your loan could be approved in a relatively short time. You always have three business days to back out of the loan after it has been approved.

Be aware that some lenders may check your credit record periodically to see if you've been responsible with your loans. They have the right to freeze or reduce your borrowing rights if they don't like what they see on your credit report. Lenders also have the right to get a reappraisal on your home to make sure the equity in the home remains intact.

IMPORTANT NOTE: Many home equity loans and lines of credit offer low introductory "teaser" rates. These may have strings attached to them, such as annual fees and other hidden costs and restrictions. Make sure you find out all of the details first.

Loan or Line of Credit?

At first glance, it seems that a line of credit is the best way to go. It offers you flexibility; you don't have to saddle yourself with debt that you may not have a use for right away. You can draw down as you need the money and pay back accordingly. But avoid the temptation to use your home equity line as a source of ready cash for unnecessary spending. If you can't control your spending, don't take out a home equity line.

Only you know yourself and your habits. We can't stress enough that it is dangerous to frivolously tap the equity in your home. After all, your home is probably the most valuable asset you own.

Reverse Mortgage

This section applies to you if you are at least age 62.

A reverse mortgage or reverse annuity mortgage allows you to receive a stream of monthly payments or have a line of credit from a mortgage company. This option allows cash-strapped elderly homeowners the opportunity to use some or all of the equity in their homes while they are still alive.

How it Works

The bank uses your home as collateral and makes monthly payments to you or establishes a line of credit that you can draw upon. The payments to you are based on your age, the home's value, interest rates, and your marital status. Unlike a conventional loan, you don't have to make payments to the bank. Principal, interest, and fees simply accrue against the home's value and are paid when you sell your home.

Generally, to qualify for a reverse mortgage:

- You must be at least age 62
- If married, have a spouse who is at least age 62
- You must owe very little or nothing on your home
- You must agree to accept the terms of the mortgage
- You retain title to the home and full responsibility for its upkeep

IMPORTANT NOTE: Extreme caution should be exercised before implementing a reverse mortgage. Consider the following:

- There are fairly expensive upfront closing costs and possibly monthly service charges too. These costs can be included in the loan.
- For young retirees, the monthly checks are quite small.
- If you outlive the term of the loan, you may be forced to sell your home and move.

Once the reverse mortgage is in place, there are several different ways to tap into the money:

- A line of credit is created and the funds can be drawn upon as needed.
- A monthly payment is received by the borrower over a certain number of years.
- A monthly payment is received by the borrower as long as the borrower occupies the home.

SUGGESTION: Whichever reverse mortgage option you choose, you can change options if your circumstances should change.

After the borrower moves or dies, the home is sold and the accumulated debt plus interest and any other closing fees come due and are paid from the sale of the home.

In a nutshell, elderly homeowners who don't have much of a retirement fund can live off the equity in their home while continuing to live in the home.

Reasons to Tap Your Equity

Convenience and tax-deductible interest make tapping the equity in your home appealing. Just be careful that you don't take a casual view about draining the equity in your home—it could jeopardize your most important asset. If you fail to make the loan payments, you could ultimately lose your home in a foreclosure.

Many people use home equity loans and credit lines to finance a variety of things. Because the interest is generally tax-deductible, this very often makes sense. As you may already know, Uncle Sam has taken away almost all interest expense tax deductions.

Exceptions include mortgage interest (including home equity) and investment interest, and some student loan interest.

Home Improvements

Have you been thinking about putting an addition on your house? Or have you always wanted to finish the basement or add a bathroom? Using the equity in your home to finance its improvement could make a great deal of sense. After all, you are tapping the equity in your home to turn around and build more equity.

The types of improvements that you have always dreamed of can range in price from $100 to $1 million. When you use a home equity loan or a refinance to make major capital improvements to your home, interest on a loan of up to a total balance of $1 million is deductible. Make sure you borrow only what you can afford to pay back.

Automobile Purchases

Because auto loan interest rates are generally higher than mortgage rates, people often tap the equity in their homes to finance the purchase of an automobile. Sometimes the dealer who sells you the car may be offering a promotional financing rate. It would be wise to see how it compares to the rate on an equity loan or refinance. But, you can't just compare interest rates, because there is a tax deduction for the interest on a home equity loan or a refinance. Interest on an automobile loan is not tax-deductible. The following illustration compares an auto loan and a home equity loan with the same terms and shows the effect the deductibility of the home equity interest has on the net annual cost of borrowing.

Auto Loan versus Home Equity Loan Comparison*

	Auto Loan	Home Equity Loan
a) Interest Rate	3.50%	3.50%
b) Amount Borrowed	$15,000	$15,000
c) Annual Interest Charged: Multiply (a) by (b)	$525	$525
d) Marginal Tax Rate	N/A	25.00%
e) Benefit of Tax Deduction: Multiply (c) by (d)	$0	$131
f) Net Annual Cost of Borrowing: Subtract (e) from (c)	$525	$394

**Assumes a 25% marginal tax rate and the same repayment period for both types of loans. Also assumes that there are no fees charged for either loan.*

As you can see from the illustration above, the cost of borrowing is generally less with a home equity loan than with an auto loan since the home equity interest is tax-deductible. However, it may not be wise for you to tap the equity in your home to buy a fancy car that you really can't afford. Also, don't overextend the debt on what is probably your most important asset. You have to feel comfortable with the fact that you are borrowing against your home and that there is a risk that it could be taken away from you if you cannot keep up the loan payments. Also, keep in mind that you may be paying on your home equity loan for 15 years. You may be making payments on an automobile that you have long since sold. (A rule of thumb is that you shouldn't stretch any loan, including a home equity loan, past five years for the purchase of a car.)

Consolidation of Debts

Do you cringe every time you open the mailbox and another credit card bill arrives? Do you have a wide array of debt that is strapping you? Tapping the equity in your home to pay off your high-interest consumer debt may be something that you should consider. By doing this you can accomplish several things:

- **Lower the cost of the debt.** Almost universally, home equity loan and refinance rates are much lower than the interest rates on credit cards, auto loans, and maybe even your student loan. You can save money on the compounding interest by paying them all off with an equity loan; you will shift the borrowed money into a lower interest rate. Also, the interest on a home equity loan of up to $100,000 is tax-deductible no matter what you use the loan proceeds for. See the section *Home Equity Loans and Taxes.*

- **Improve your cash flow.** If you are paying less for the borrowed money, you can pay it back faster and use the remaining money for your other needs or investments.

- **You only have to keep track of one loan**. This can make it easier for you to manage your spending—by knowing exactly how much you are in debt.

IMPORTANT NOTE: Home equity terms can stretch to as many as 15 years. In order to keep your monthly payment low, your temptation may be to go for the longer term. Your best bet when refinancing consumer debt is to limit your loan term to a maximum of five years.

College Tuition

What do you do when your child gets accepted to an expensive school and you really want them to attend? You didn't anticipate the cost when you planned a college fund. A home equity line of credit can be set up in advance, and you can borrow what you need each year for the expenses.

IMPORTANT NOTE: Equity in your home is not counted as an asset when applying for financial aid. Therefore, you should wait until your financial aid application is accepted or denied before tapping into the line of credit.

Taking Out a Home Equity Loan

The Home Equity Loan Process

When you are ready to begin evaluating a home equity loan, there are steps that you should take to make the process a smooth one.

The process consists of two steps:

- Gathering information from potential lenders regarding rates, fees, and loan types
- Determining which loan makes the most financial sense for you

To evaluate which loan makes the most financial sense, you'll need to:

- Compare the loan fees and costs among your different loan choices.
- Evaluate if you should pay points and do a rate versus point comparison.
- Determine if the interest is tax-deductible. (See the section *Home Equity Loans and Taxes.*)
- Determine the after-tax cost of borrowing. If the interest is tax-deductible, it reduces the net cost of borrowing.

Procedures Checklist

You've decided to apply for an equity loan. Here are the procedures you need to follow:

- Fill out an application
- Ask your lender if fees can be included in the loan amount
- Your lender will order an appraisal of your home
- Determine what is tax-deductible

We will walk through each of these procedures in detail.

The Application Process

After you have reviewed your loan options and found the package that makes financial sense, it is time to proceed with the application.

If you choose to get a home equity loan with your current lender because they can give you the best deal, you could save money on the fees. And, the process can be smoother since the lender already has information about you. You also may not need to get a new appraisal on your home when you apply for a home equity loan with your current lender. However, this may be a rare occurrence in these days of fluctuating real estate values.

The lender will typically run a credit report. So it is important that your credit report is in good order and that your mortgage payment record is in good shape.

Fees

Did you know that you may be able to include most, if not all, costs of obtaining a home equity loan in the new loan? Each lender has their own rules, so be sure to ask your lender how it handles the fees. Including the costs in the loan makes it that much easier to go through the process because you won't be required to come up with a lot of out-of-pocket cash. The most significant cost that you can include in the loan amount is the points. Instead of paying them outright, you can finance them with the principal amount. Just remember, there's no such thing as a free lunch! Taking out a bigger loan will mean higher monthly payments.

Lenders must provide people who take out a home equity loan with a reasonable estimate of settlement costs and fees associated with the loan; this is called a "Good Faith Estimate." They must do this within three business days after receiving your application.

Appraisals

As the name "home equity loan" suggests, you must have sufficient equity in your home before you can tap into it! Lenders are not usually willing to lend you more than 75% to 80% of the value of your property (some lenders may lend you more than that, depending on their lending policies, so it is a good idea to shop around); that amount is then reduced by your outstanding mortgage balance. Here's an example.

Let's say your home recently appraised for $350,000. Your mortgage balance is $255,000. You could qualify to take out an equity loan or line of credit of approximately $7,500.

Value of the home	$350,000
75% of the value	$262,500
Minus: Principal balance remaining	–$255,000
Amount you can borrow	**$7,500**

If your home happens to appraise lower than you expect, you may have to wait for the real estate market to improve and your mortgage principal balance to decrease (through your mortgage payments) before being able to get the amount of money you need.

Home Equity Loans and Taxes

There are some special tax rules with regard to what costs can be deducted in connection with an equity loan or credit line. Let's see what tax breaks you'll get from Uncle Sam.

Interest

The beauty of home equity loans and lines of credit is that the interest, on debt up to $100,000, is tax-deductible no matter what you use the money for.

IMPORTANT NOTE: If you are married and filing separately, the limit is reduced to $50,000.

If you borrow against the equity in your home to make major capital improvements to the home, the interest on up to $1 million of debt (counting both your existing first mortgage and the home equity loan) is tax-deductible.

IMPORTANT NOTE: If you are married and filing separately, the limit is reduced to $500,000.

Points

There are three different ways that the IRS treats home equity points.

1. If you are borrowing to make capital improvements to your home, the points are fully deductible in the year you borrow. Now, this gets tricky if only a portion of the loan is used for the improvements. If this is the case, only the portion of the points related to the improvements is deductible in the year you borrow. The remaining points are required to be deducted equally each year over the term of the loan or the line of credit.
2. If you are borrowing for any other reason, the points must be deducted equally each year over the term of the loan or the line of credit.
3. If you pay off your loan early, the points become deductible immediately.

This information should serve as a guide for you—to give you an idea of what's tax-deductible and what's not. You should call your tax professional to clarify anything you don't understand and to verify that the information is still valid under current law. Keep in mind that tax laws are always subject to change, and that the information provided here could change at any time. ♦