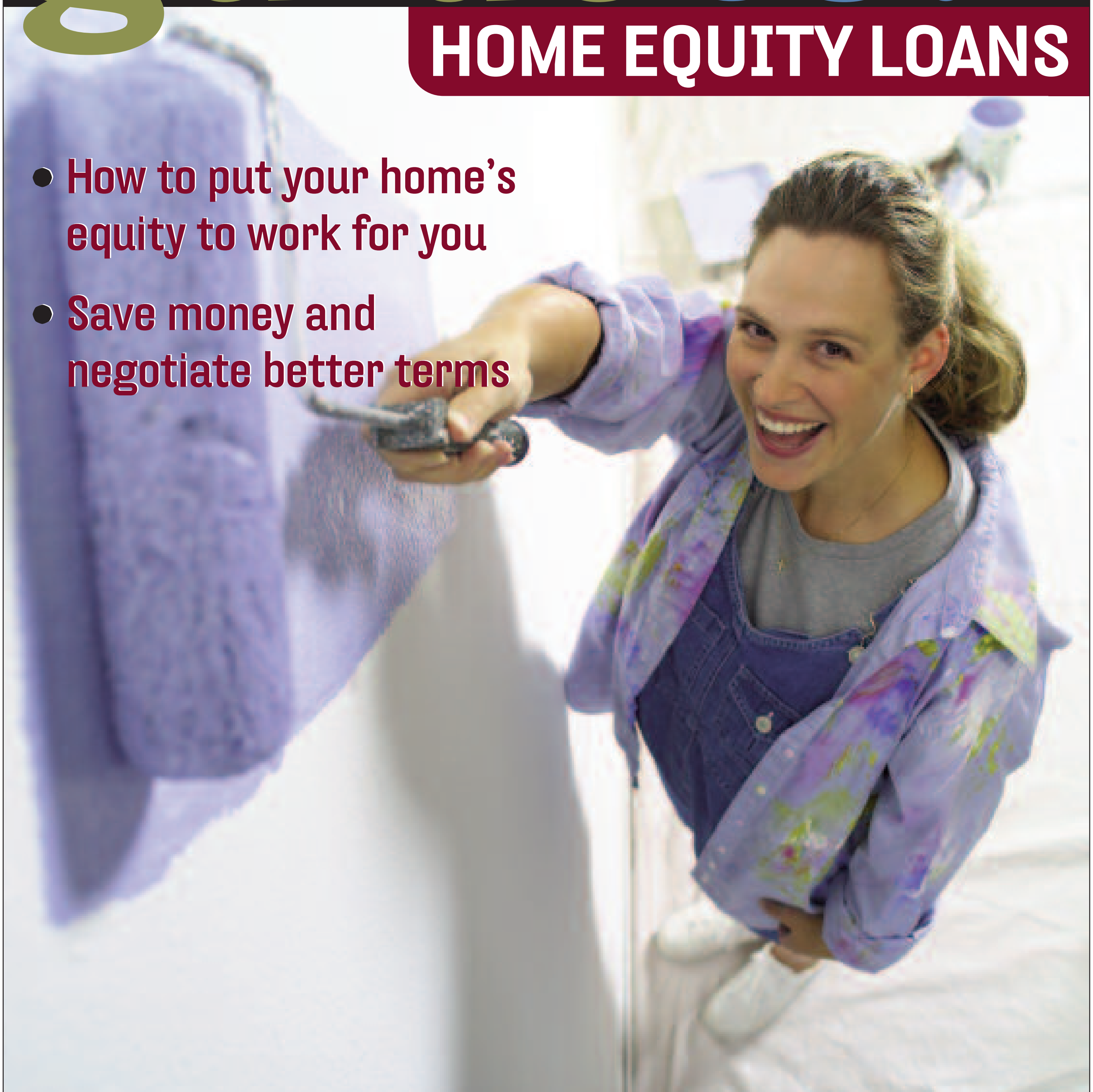
# guide to: HOME EQUITY LOANS

- How to put your home's equity to work for you
- Save money and negotiate better terms





The LendingTree Smart Borrower Center offers a range of articles about mortgages and home equity loans and can help you decide which type of loan best meets your needs.

Guide to

# Home Equity Loans

Chances are your home is your most valuable possession. With a *home equity* loan or *line of credit*, you can use some of that accumulated wealth (known as equity) to take care of your immediate needs – without having to sell your home.

A home equity loan – sometimes called a second mortgage – enables you to borrow a lump sum and secure it with the equity you have built up in your house. Depending on the lender and which state you live in, you may be able to access up to 125 percent of the market value of your home, less any outstanding mortgages.

Home equity loans have several benefits over other types of loans, including lower interest rates and payments that are usually tax deductible (consult a tax advisor for details). However, because they are secured with your home, they also carry an inherent risk, so it's important to understand and feel comfortable with the loan you choose.

**What are some uses for home equity loans?**
Home equity loans are generally used for major expenses, as opposed to day-to-day credit needs, including:

- financing a renovation
- making a major purchase, such as a new vehicle
- buying a vacation property
- sending a child to college
- covering costly repairs, such as a new roof
- consolidating high-interest debt, such as credit cards

**What are the advantages?**
Unlike a personal loan or credit card, a home equity loan is secured with something very valuable – your house. Therefore, lenders assume less risk than with an unsecured loan, which is how the lender can offer you a lower interest rate.

In addition, because a home equity loan is a type of mortgage, the interest is usually tax-deductible. There are limitations, however, so be sure to consult a tax advisor to find out how they apply to you.

**What are the risks?**
While defaulting on any loan is serious, failing to pay off a home equity loan can mean losing your house. That's why you should think very carefully about using this type of loan to start a business, or to make risky investments. If your business fails, or if your portfolio plummets in value, you may be putting your home in jeopardy.

When you use a home equity loan to consolidate your debts, it's important to be disciplined about spending so you don't simply run up your credit cards again.

If you're not comfortable with these risks, an unsecured personal loan may be a better choice.

## WHICH TYPE OF HOME EQUITY LOAN IS RIGHT FOR YOU?

When you borrow against the equity in your home, you can structure the loan in one of two ways: as a traditional loan with a fixed term, or as a revolving line of credit.

### 1. Home equity loans (HELs)

A home equity loan with a fixed term works much like a regular mortgage. You receive a lump sum and the payments are amortized over several years. Here are some typical features of home equity term loans:

- The interest rate and monthly payment generally remain consistent throughout the term of the loan.
- The term is usually shorter than that of a first mortgage (15 years is common).
- The interest rate is usually higher than that of a first mortgage, though lower than an unsecured personal loan.

### 2. Home equity lines of credit (HELOCs)

With a home equity line of credit (HELOC), the lender agrees to advance you money up to a specified limit, and you access the funds as needed.

Some typical features:

- The interest rate is adjustable, and is usually determined by adding a specified number of percentage points (called a margin) to the *prime rate*.
- You pay interest only on the amount you withdraw, not the entire credit limit.
- Minimum monthly payments are a small percentage of the outstanding balance, or only the interest.
- There may be a minimum withdrawal amount for each transaction.
- You may be required to make an initial withdrawal and maintain a minimum balance.
- The line of credit may extend for a specified period such as 10 or 20 years – after which you have a fixed period to pay off the balance, plus interest.

Before deciding whether a loan or a line of credit is right for you, consider the following questions.

### Do you need the money all at once?

A HEL is generally more suitable when you need the money for a specific, one-time purpose, such as buying a car, building an addition, or *consolidating debt*. Because a HELOC is more flexible, it is usually a better choice to meet expenses that will be spread over a long period, such as college tuition, medical bills or a series of home improvements.

### What is your comfort level with variable interest rates?

Think about whether you want a fixed interest rate that offers stability, or an adjustable one that may save you money if the prime rate goes down but may cost you more if it rises.

HELs usually carry a fixed rate and a consistent payment schedule, making them easy to budget. If interest rates go up, you'll feel like you got a great deal. If they drop, however, you may pay more than the going rate.

HELOCs, on the other hand, have a variable interest rate that is almost always lower at the outset, and if the prime rate drops, so will the interest you're charged. Of course, if prime goes up, so does the rate on your line of credit.

If you choose the variable option, make sure you understand exactly how your interest rate will be calculated during the life of your loan. Be aware that very low introductory "teaser" rates apply for only a short period before rising sharply.

### What other fees are involved?

When determining the cost of borrowing money, interest rates are not the only figures to consider. With a home equity loan, lenders usually have a one-time closing fee, which includes charges such as a title search to make certain there are no *liens* on your property. There are usually no *closing costs* with HELOCs, but they may carry an annual fee, and may be subject to a one-time mortgage tax in some states.

Ask your lender to explain all the fees associated with your loan and factor these costs into your decision.

### What is your monthly cash flow?

If you are self-employed or work on commission, your income may vary from month to month, making it hard to budget for the regular payments required by a home equity loan. HELOCs offer more breathing room, allowing you to make larger payments when you're flush with cash and smaller ones when you have a tight month.

### How disciplined is your spending?

A large line of credit with a low interest rate can make it tempting to overspend. If you have had problems managing your budget and credit – and especially if you are using your home equity to pay off previous debts – the lump sum and regular payments of a HEL could be a better choice.

## HOW MUCH CAN YOU BORROW?

Lenders will determine your credit limit – the maximum amount you're allowed to borrow – by taking a percentage of your home's appraised value and then subtracting any existing mortgage. The percentage used in this calculation is called the *loan-to-value ratio* (LTV).

Some lenders will agree to a loan-to-value ratio as high as 80-90 percent. Keep in mind that as the LTV rises, so does the risk to the lender. As a result, you will pay a higher interest rate on home equity loans with high LTVs.

Let's assume that your home is worth $150,000 and you have $50,000 left to pay on your mortgage. If the lender's loan-to-value ratio is 80 percent, the maximum home equity loan you could qualify for is $70,000. Here's how that figure is determined:

Appraised value of home = $150,000

Multiplied by LTV of 80 percent
($150,000 x 0.8) = $120,000

Minus existing mortgage
($120,000 – $50,000) = $70,000

Your home equity and the LTV, however, are only two of the factors that lenders consider. You will also have to demonstrate your ability to pay back the loan with:

- **Sufficient income.** Remember, you're already paying down a first mortgage, so your lender will want to ensure that you can handle a second monthly payment. You will need to show that you have regular employment and enough income to cover both loans.

- **Good credit**. Lenders assume that if you have paid your debts reliably in the past, then you will do so in the future. They will consult agencies such as Equifax, TransUnion and Experian to review your credit history before they approve any loan. It's a good idea to obtain copies of your own credit report several months before applying to give you an opportunity to correct errors that might harm your credit score.

- **Other assets and liabilities**. While a home equity loan is secured with your house, lenders will be more comfortable if you have other assets, such as vehicles, vacation property, or significant investments. They will also want to know whether you have existing debts that may make it difficult for you to carry another loan.

Remember that you may be approved for an amount far higher than you actually need, particularly when opening a HELOC. While you won't pay interest on untapped credit, you may find it an unnecessary temptation.

It's also wise to be aware that your LTV ratio will increase if housing prices in your area fall. For example, let's say your home is assessed at $150,000 and you have $100,000 left on your mortgage. A lender willing to give you a 90-percent LTV may approve a home equity loan for $35,000. However, if housing prices were to drop by more than 10 percent, the value of your house would drop below $135,000. Your total debt of $100,000 plus $35,000 would then exceed the value of your home.

To determine the equity you've accumulated in your own home, complete *Worksheet 1: Calculate Your Home Equity* on the next page.

WORKSHEET 1:

# Calculate Your Home Equity

Before you look for a home equity loan or line of credit, your first task is to determine how much equity you have accumulated in your property.

### Step 1. Determine the market value of your home.

If you recently purchased your house, its fair market value is likely very close to the price you paid. However, if you have been in your home for several years, its market value may have changed dramatically. Use the free Home Price Check from our partner RealEstate.com to help you determine your home's current value. Try looking at real estate advertisements to get an idea of home values in your neighborhood and estimate how yours compares, erring on the conservative side. Remember this is only a preliminary figure – your lender will likely have your property professionally appraised.

Your home's estimated value: ______________________

### Step 2. Add the balances of any existing mortgages and liens.

For many people, this simply involves determining how much principal they have left to pay on their first mortgage. However, if there are other *liens* on your property – for example, if you already have another home equity loan – add these balances as well.

Principal on first mortgage: ______________________

Balance of other liens, if any: ______________________

### Step 3. Subtract current debt from current value.

You can now determine your home equity by subtracting all outstanding debts on your property from its estimated value.

***Example*:**

| | |
|---|---|
| Estimated value: | $150,000 |
| Subtract principal on first mortgage: | – $55,000 |
| Subtract balance of other liens: | – $5,000 |
| **HOME EQUITY:** | **$90,000** |

***Enter your own values from Steps 1 and 2 above:***

| | |
|---|---|
| Your home's estimated value: | |
| Subtract principal on first mortgage: | |
| Subtract balance of other liens: | |
| **YOUR HOME EQUITY:** | |

WORKSHEET 2: HOME EQUITY LOANS

# What to Ask Your Lender

It's crucial that you understand the terms of your contract before you sign. Have this worksheet with you when you talk to prospective lenders and use it to help you compare their offers.

| **Home Equity Loans** | | | | |
|---|---|---|---|---|
| What is the interest rate, and will it change over the term of the loan? | | | | |
| What is the term of the loan? | | | | |
| What will my monthly payment be? | | | | |
| Will there be a lump sum payment (often called a balloon) due at the end of the term? | | | | |
| Is there a penalty if I pay off the loan before the end of the term? | | | | |
| What closing fees and other costs are associated with this loan, and what is your best estimate of their total? | | | | |
| Under what circumstances can you call the loan? (That is, demand payment in full.) | | | | |
| What documentation do I need to provide? (Employment record, homeowners' insurance, etc.) | | | | |
| When will I receive the funds? | | | | |

WORKSHEET 2: HOME EQUITY LINES OF CREDIT

# What to Ask Your Lender

It's crucial that you understand the terms of your contract before you sign. Have this worksheet with you when you talk to prospective lenders and use it to help you compare their offers.

| | | | | |
|---|---|---|---|---|
| **Home Equity Lines of Credit** | | | | |
| What is the initial interest rate, and how will it change over the term of the loan? | | | | |
| Does the rate have a specified minimum and maximum? | | | | |
| What is the minimum payment required each month? | | | | |
| Will the HELOC expire after a specified term, after which payment in full is required? | | | | |
| What documentation do I need to provide? (Employment record, homeowners' insurance, etc.) | | | | |
| When can I access the funds? | | | | |
| How can I withdraw the money (checks, debit-type card, etc.)? | | | | |
| Do I have to make a withdrawal immediately and/or maintain a minimum balance? | | | | |
| Is there an annual fee? If so, how much is it? | | | | |

# Glossary

**Closing costs:** Includes a loan origination fee, points, appraisal fee, title search and insurance, survey, taxes, deed recording fee, credit report charge and other costs assessed at settlement. The closing costs are usually about 2 to 6 percent of the loan amount.

**Consolidating debt:** Taking out a large, lower-interest loan (such as a home equity loan) in order to pay off other debts with higher rates, such as credit cards.

**Home equity:** The difference between the market value of a home and any outstanding mortgage balance. A person who has a $50,000 mortgage on a $150,000 home has accumulated $100,000 in home equity.

**Index:** A published interest rate against which lenders measure the difference between the current interest rate on an adjustable rate mortgage and that earned by other investments (such as one- three-, and five-year U.S. Treasury Security yields, the monthly average interest rate on loans closed by savings and loan institutions, and the monthly average Costs-of-Funds incurred by savings and loans). This is used to adjust the interest rate on the mortgage up or down.

**Lien:** A claim upon a piece of property for the payment or satisfaction of a debt or obligation. Liens may include loans or lines of credit secured with your home, as well as claims made by contractors who performed work on the home but have not been paid in full.

**Line of credit:** A revolving loan that has a set limit agreed upon by the lender and borrower. Unlike a traditional loan, the borrower does not receive the funds as a lump sum – funds are drawn according to need, usually through a checking account or debit-like card – and the borrower pays interest only on the amount withdrawn.

**Loan-to-value ratio (LTV):** The relationship (expressed as a percentage) between the amount of a mortgage loan and the appraised value of the property. A person who has borrowed $75,000 against a $150,000 home is carrying an LTV of 50 percent.

**Prime rate:** The interest rate charged by lenders to their best, most creditworthy customers. A less creditworthy customer may be offered a loan at the prime rate plus anywhere from 2 to 10 percent. Borrowing at below-prime also occurs, but is less common and usually applies to businesses, not individual consumers. The Federal Reserve determines whether to lower or raise the prime rate based on a variety of economic factors.

# The LendingTree® Advantage

Thanks for trusting LendingTree to help you find a loan. We put you in control of your loan by asking lenders to compete for your business. Comparing real loan offers from different lenders just makes sense. Just like you comparison shop for other large purchases, smart consumers know a loan is no different. Except at LendingTree, we do all the work, and you reap the benefits.

## WHY IS LENDINGTREE BETTER?

- **Low rates:** Up to four offers that could lower your monthly payments.
- **Personal service:** 24/7 customer service and online tools to help you make a smart borrowing decision. Our Customer Care Consultants will help you understand your options, and help you select the best loan for you.
- **Our Network:** Our Lender Network has more than 200 lenders. Some are household names, while others are smaller, with regional, product or customer segment specialties that may make them ideal for you.
- **Trust:** Join the 20 million people who started their search for a better loan through LendingTree.

LendingTree. When Banks Compete, You Win®

*Contact us:*
1-800-555-TREE
www.lendingtree.com

# Additional Resources

## WHERE TO LEARN MORE

www.LendingTree.com/smartborrower

The LendingTree Smart Borrower Center offers a range of articles about mortgages and home equity loans and can help you decide which type of loan best meets your needs.

**Additional sources of information:**
The Federal Reserve Board:
www.federalreserve.gov/consumers.htm

Federal Citizen Information Center:
www.pueblo.gsa.gov

Department of Housing and Urban Development:
www.hud.gov

Center for Responsible Lending:
www.responsiblelending.org