Home Equity Loans and Credit Lines “HELOC”

If you’re thinking about making some home improvements or looking at ways to pay for your child’s college education, you may be thinking about tapping into your home's equity — the difference between what your home could sell for and what you owe on the mortgage — as a way to cover the costs.

Home equity financing can be set up as a loan or a line of credit. With a home equity loan, the lender advances you the total loan amount upfront, while a home equity credit line provides a source of funds that you can draw on as needed.

When considering a home equity loan or credit line, shop around and compare loan plans offered by banks, savings and loans, credit unions, and mortgage companies. Shopping can help you get a better deal.

Remember that your home secures the amount that you borrow through a home equity loan or line of credit. If you don't pay your debt, the lender may be able to force you to sell your home to satisfy the debt.

Home Equity Loans

A home equity loan is a loan for a fixed amount of money that is secured by your home. You repay the loan with equal monthly payments over a fixed term, just like your original mortgage. If you don’t repay the loan as agreed, your lender can foreclose on your home.

The amount that you can borrow usually is limited to 85 percent of the equity in your home. The actual amount of the loan also depends on your income, credit history, and the market value of your home.

Ask friends and family for recommendations of lenders. Then, shop and compare terms. Talk with banks, savings and loans, credit unions, mortgage companies, and mortgage brokers. But take note: brokers don’t lend money; they help arrange loans.

Ask all the lenders you interview to explain the loan plans available to you. If you don’t understand any loan terms and conditions, ask questions. They could mean higher costs. Knowing just the amount of the monthly payment or the interest rate is not enough. The annual percentage rate (APR) for a home equity loan takes points and financing charges into consideration. Pay close attention to fees, including the application or loan processing fee, origination or underwriting fee, lender or funding fee, appraisal fee, document preparation and recording fees, and broker fees; these may be quoted as points, origination fees, or interest rate add-on. If points and other fees are added to your loan amount, you’ll pay more to finance them.

Home Equity Lines of Credit

A home equity line of credit — also known as a HELOC — is a revolving line of credit, much like a credit card. You can borrow as much as you need, any time you need it, by writing a check or using a credit card connected to the account. You may not exceed your credit limit. Because a HELOC is a line of credit, you make payments only on the amount you actually borrow, not the full amount available. HELOCs also may give you certain tax advantages unavailable with some kinds of loans. Talk to an accountant or tax adviser for details.

Like home equity loans, HELOCs require you to use your home as collateral for the loan. This may put your home at risk if your payment is late or you can't make your payment at all. Loans with a large balloon payment — a lump sum usually due at the end of a loan — may lead you to borrow more money to pay off this debt, or they may put your home in jeopardy if you can't qualify for refinancing. And, if you sell your home, most plans require you to pay off your credit line at the same time.

HELOC FAQs

Lenders offer home equity lines of credit in a variety of ways. No one loan plan is right for every homeowner. Contact different lenders, compare options, and select the home equity credit line best tailored to your needs.

How much money can you borrow on a home equity credit line?

Depending on your creditworthiness and the amount of your outstanding debt, you may be able to borrow up to 85 percent of the appraised value of your home less the amount you owe on your first mortgage. Ask the lender if there is a minimum withdrawal requirement when you open your account, and whether there are minimum or maximum withdrawal requirements after your account is opened. Ask how you can spend money from the credit line — with checks, credit cards, or both.

You should find out if your home equity plan sets a fixed time — a draw period — when you can withdraw money from your account. Once the draw period expires, you may be able to renew your credit line. If you can't, you won't be able to borrow additional funds. In some plans, you may have to pay the outstanding balance. In others, you may be able to repay the balance over a fixed time.

What is the interest rate?

Unlike a home equity loan, the APR for a home equity line of credit does not take points and financing charges into consideration. The advertised APR for home equity credit lines is based on interest alone.

Ask about the type of interest rates available for the home equity plan. Most HELOCs have variable interest rates. These rates may offer lower monthly payments at first, but during the rest of the repayment period, the payments may change — and may go up. Fixed interest rates, if available, at first may be slightly higher than variable rates, but the monthly payments are the same over the life of the credit line.

If you're considering a variable rate, check and compare the terms. Check the periodic cap — the limit on interest rate changes at one time. Also, check the lifetime cap — the limit on interest rate changes throughout the loan term. Lenders use an index, like the prime rate, to determine how much to raise or lower interest rates. Ask the lender which index is used and how much and how often it can change. Check the margin — an amount added to the index that determines the interest you are charged. In addition, ask whether you can convert your variable rate loan to a fixed rate some time later.

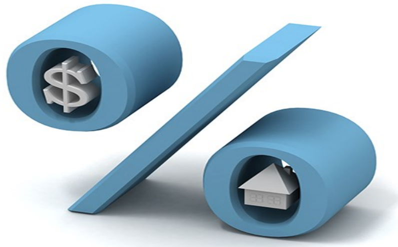
Sometimes, lenders offer a temporarily discounted interest rate — a rate that is unusually low and lasts only for an introductory period, say six months. During this time, your monthly payments are lower, too. After the introductory period ends, however, your rate (and payments) increase to the true market level (the index plus the margin). Ask if the rate you're offered is "discounted," and if so, find out how the rate will be determined at the end of the discount period and how much more your payments could be at that time.

What are the upfront closing costs?

When you take out a home equity line of credit, you pay for many of the same expenses as when you financed your original mortgage. These include: an application fee, title search, appraisal, attorneys' fees, and points (a percentage of the amount you borrow). These expenses can add substantially to the cost of your loan, especially if you ultimately borrow little from your credit line. Try to negotiate with the lenders to see if they will pay for some of these expenses.

What are the continuing costs?

In addition to upfront closing costs, some lenders require you to pay fees throughout the life of the loan. These may include an annual membership or participation fee, which is due whether you use the account, and/or a transaction fee, which is charged each time you borrow money. These fees add to the overall cost of the loan.



What are the repayment terms during the loan?

As you pay back the loan, your payments may change if your credit line has a variable interest rate, even if you don't borrow more money from your account. Find out how often and how much your payments can change. Ask whether you are paying back both principal and interest, or interest only. Even if you are paying back some principal, ask whether your monthly payments will cover the full amount borrowed or whether you will owe an additional payment of principal at the end of the loan. In addition, you may want to ask about penalties for late payments and under what conditions the lender can consider you in default and demand immediate full payment.

What are the repayment terms at the end of the loan?

Ask whether you might owe a large (balloon) payment at the end of your loan term. If you might, and you're not sure you will be able to afford the balloon payment, you may want to renegotiate your repayment terms. When you take out the loan, ask about the conditions for renewal of the plan or for refinancing the unpaid balance. Consider asking the lender to agree ahead of time — in writing — to refinance any end-of-loan balance or extend your repayment time, if necessary.

What safeguards are built into the loan?

One of the best protections you have is the Federal Truth in Lending Act. Under the law, lenders must tell you about the terms and costs of the loan plan when you get an application. Lenders must disclose the APR and payment terms and must tell you the charges to open or use the account, like an appraisal, a credit report, or attorneys' fees. Lenders also must tell you about any variable-rate feature and give you a brochure describing the general features of home equity plans.

The Truth in Lending Act also protects you from changes in the terms of the account (other than a variable-rate feature) before the plan is opened. If you decide not to enter into the plan because of a change in terms, all the fees you paid must be returned to you.

Once your home equity plan is opened, if you pay as agreed, the lender, generally, may not terminate your plan, accelerate payment of your outstanding balance, or change the terms of your account. The lender may halt credit advances on your account during any period in which interest rates exceed the maximum rate cap in your agreement, if your contract permits this practice.

Before you sign, read the loan closing papers carefully. If the HELOC isn't what you expected or wanted, don't sign the loan. Either negotiate changes or walk away. And like a home equity loan, you also generally have the right to cancel the deal for any reason — and without penalty — within three days after signing the loan papers.

The Three-Day Cancellation Rule

Federal law gives you three days to reconsider a signed credit agreement and cancel the deal without penalty. You can cancel for any reason but only if you are using your principal residence — whether it's a house, condominium, mobile home, or house boat — as collateral, not a vacation or second home.

Under the right to cancel, you have until midnight of the third business day to cancel the credit transaction. Day one begins after:

- you sign the credit contract;
- you get a Truth in Lending disclosure form containing key information about the credit contract, including the APR, finance charge, amount financed, and payment schedule; and
- you get two copies of a Truth in Lending notice explaining your right to cancel.

For cancellation purposes, business days include Saturdays, but not Sundays or legal public holidays. For example, if the events listed above take place on a Friday, you have until midnight on the next Tuesday to cancel. During this waiting period, activity related to the contract cannot take place. The lender may not deliver the money for the loan. If you're dealing with a home improvement loan, the contractor may not deliver any materials or start work.

If You Decide to Cancel

If you decide to cancel, you must tell the lender in writing. You may not cancel by phone or in a face-to-face conversation with the lender. Your written notice must be mailed, filed electronically, or delivered, before midnight of the third business day.

If you cancel the contract, the security interest in your home also is cancelled, and you are not liable for any amount, including the finance charge. The lender has 20 days to return all money or property you paid as part of the transaction and to release any security interest in your home. If you received money or property from the creditor, you may keep it until the lender shows that your home is no longer being used as collateral and returns any money you have paid. Then, you must offer to return the lender's money or property. If the lender does not claim the money or property within 20 days, you may keep it.

If you have a bona fide personal financial emergency — like damage to your home from a storm or other natural disaster — you can waive your right to cancel and eliminate the three-day period. To waive your right, you must give the lender a written statement describing the emergency and stating that you are waiving your right to cancel. The statement must be dated and signed by you and anyone else who shares ownership of the home. The federal three day cancellation rule doesn't apply in all situations when you are using your home for collateral. Exceptions include when:

- you apply for a loan to buy or build your principal residence
- you refinance your loan with the same lender who holds your loan and you don't borrow additional funds
- a state agency is the lender for a loan.

In these situations, you may have other cancellation rights under state or local law.