MARYLAND COOPERATIVE EXTENSION
UNIVERSITY OF MARYLAND
COLLEGE PARK•EASTERN SHORE

Fact Sheet

Fact Sheet 696

Choosing and Using A Home Equity Loan

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Borrowing money against the equity in your home, otherwise known as a home equity loan, is a popular, easy way for consumers to get money. It can be an inexpensive, tax deductible way to extend your purchasing power. It can also be a way to put your strongest financial asset, your home, at risk. Before you sign on the dotted line for a home equity loan, it is important to know the factors affecting the cost.

TYPES OF HOME EQUITY LOANS

A home equity loan is a form of second mortgage whereby the lender offers to lend money based on the equity in your home. Home equity loans can be either closed-end or open-end loans.

CLOSED-END LOAN. A closed-end loan is a traditional type of loan often thought of as a second mortgage. In a closed-end loan, the borrower obtains the full loan amount at the time the money is borrowed. Monthly payments are fixed and the loan must be repaid in a specified period of time. Even as the loan balance decreases with payments, the borrower may not borrow more money on that loan.

OPEN-END LOAN. An open-end loan allows the borrower to set up a line of credit from which money can be drawn from time to time, up to a specified limit. The borrower may use special checks or a credit card to gain access to the line of credit. Payments are made on a schedule based on the outstanding amount not on the maximum credit line. If the borrower does not use any of the money for a time, nothing is owed. Some lenders require the borrower to make transactions from time to time, or to always have a minimum amount outstanding, or to pay a fee if their account stays inactive for a specified period of time.

Usually, borrowers are eligible for up to 75 percent of their home's appraised value minus what is owed on the first mortgage. For example—

Appraised value of home	$100,000
Percentage allowed by lender	75%
Percentage of appraised value	$75,000
Less mortgage debt	$40,000
Potential line of credit	$35,000

In determining the actual credit line, the lender will also consider a borrower's ability to repay by looking at his or her income, debts, other financial obligations, and credit history.

INTEREST RATE AND OTHER CHARGES

INTEREST RATES. Interest rates may vary considerably, depending on the home equity loan. Basically, the choice is between a fixed or variable rate.

Variable interest rate. A variable rate changes when interest rates on other economic indicators (indexes) rise or fall. The most common index is the prime lending rate (the rate banks charge their best customers). Under Maryland law, the index must be readily available to the borrower.

Variable rate loans must have a ceiling or cap, which guarantees that you will not have to pay more than an agreed-upon interest rate over the life of the loan. In addition to a cap that applies to the entire life of the loan, a lender may place a cap on the increase allowed over a specified period, usually one year. Lenders may also limit how much your monthly payments may increase and how low your interest rate may fall if interest rates drop. You should find out how often your interest rate can and will be adjusted; some rates are adjusted monthly, others less frequently.

FIXED INTEREST RATE. A fixed interest rate does not change, and you have the security of knowing that your monthly payment will remain the same throughout the life of the loan. Fixed rates are generally higher than variable rates.

POINTS. Points are a one-time charge made by the lender on a closed-end home equity loan. One point equals 1 percent of the loan balance. For example, one point on a $15,000 loan would be $150. Sometimes the lender will allow you to add the cost of the points to the amount of your loan, but that can be expensive, since you will be paying interest on that money throughout the life of the loan. On open-end home equity lines of credit, no points can be charged.

EXTRA CHARGES. When applying for a home equity loan, you may be required to pay fees in addition to interest and points. These closing costs vary widely. Look for a lender who will waive some or all of the fees, or be prepared to pay them in cash. The extra charges include—

- Application fee
- Appraisal fee
- Attorney's fee
- Collection fee
- Credit check
- Insurance premium
- Lien report
- Recording fee
- Survey fee
- Taxes
- Termite inspection fee
- Title search fee

When calculating how much it is actually costing you for a home equity loan, be sure to include these extra charges along with the interest and points you will be paying.

LOAN TERMS TO AVOID

As a home equity borrower you should avoid the following loan terms or have them fully explained in writing.

BALLOON PAYMENTS. Some closed-end loans allow you to pay only the interest on the loan until the end of the repayment period. At that time, the principal must be repaid in full, or you can refinance, sometimes at a higher interest rate. With this kind of loan, payments will be quite low and seem manageable. However, if you cannot plan a way to pay the balloon payment, this type of loan can be very costly.

TEASER RATES. It is important to beware of "teaser" rates. These are advertised interest rates that are very low for a limited amount of time, perhaps for three months. After that the rate rises and may fluctuate according to the index to which the rate is tied. Insist that your lender clearly state how the interest rate will be calculated once the teaser rate expires.

LOANS PAYABLE ON DEMAND. Beware of a home equity loan payable on the lender's demand, even if you are not late with payments. You could lose your home unless you are able to repay the entire loan or refinance the amount at the current interest rate.

TAX DEDUCTIBILITY

One of the most attractive features of a home equity loan is the tax deduction you may be able to take on the interest you pay. The interest on the loan may be fully deducted for amounts you borrow for any purpose up to the original purchase price of your home plus the cost of any home improvements and minus your first mortgage balance. For amounts borrowed beyond this limit, interest may still be deductible if the loan is used for home improvements, education, or medical purposes. To be certain how much interest you can legally deduct on your taxes, consult your tax advisor. You will be asked how you intend to use the money. There is a loophole, however, for large borrowers. If the home equity loan amount is more than $100,000, the interest may still be deductible if the money is used for home improvements, business expenses, or income-generating expenses. It is essential that the borrower check with a tax advisor regarding how much interest can be deducted. The lender is not qualified to give this information. It is up to the consumer to know these rules and regulations.

HOME EQUITY LOANS AND TRUTH IN LENDING

Negotiating your way through the maze of available home equity loans can be tricky. The Truth-in-Lending Act requires the lender to let you know the important terms and costs of the loan, including the annual percentage rate (APR), any miscellaneous charges, payment terms, and information about any variable-rate features. However, it is up to you to read through the information you are given and use it to compare options and make appropriate choices. The Truth-in-Lending Act gives you three days after opening a home equity account to cancel it. If you decide to cancel, do so in writing. Send the cancellation by certified mail, requesting a return receipt.

BORROWER DEFAULT AND FORECLOSURE

If you default on your home equity loan, the lender can foreclose and sell your home to recover the loan amount. The first mortgage holder precedes the home equity lender in getting the proceeds of the sale. If your debt exceeds the sale price, you will be responsible for the portion of debt not repaid from your home sale. You could be in debt for many years.

BEFORE YOU SIGN

Before signing on the dotted line, ask yourself some critical questions:

- Are you putting your home in jeopardy to refinance unsecured debt (credit card debt)?
  Creditors want you to do this because they cannot do much about unsecured debt, but they can take your home when it is used as security.
- Would you rather lose your home than your car?
  You should not turn your car loan into a home equity loan unless you would rather lose your home than your car when you cannot pay.
- Are you financially disciplined enough to open up a line of credit that you can tap into whenever you like, using your home as collateral?
  If so, decide the minimum amount you need to borrow to reach your goal. Do not let the lender talk you into borrowing more than you need. Do not use it as you would a regular checking or savings account.
- Will you be using the equity in your home to pay for something long after it is gone?
  Do not use the equity in your home to borrow for something that will be gone long before it is paid for. In other words, do not borrow for items such as food, clothing, or vacations.
- Do you want to open up this line of credit for the purpose of having a “rainy day” fund?
  If so, choose a loan that requires no points and low up-front and annual fees, even if it has a higher interest rate. Then you will not pay any interest unless you actually use the money.

Consider the following tips before signing your name:

1. Carefully compare rates and payback times. Always comparison shop using the APR.
2. Carefully consider the payback features when considering a loan with a flexible or variable interest rate.
3. Choose a lender that charges no extra fees, closing costs, or points.
4. Do not borrow 100 percent of the equity in your home.
5. Tailor the loan and repayment plan to suit your needs.
6. Review the contract carefully.
7. Comparison shop using the following checklist (next page).

Home Equity Checklist

Before you sign a loan agreement for a home equity line of credit, compare loan packages with a variety of lenders. Ask each lender these questions and then determine which is the best loan for you.

	Lender A	Lender B	Lender C
1. How large a credit line will you extend to me?	______	______	______
2. How long can I take to repay the loan?	______	______	______
3. What are the minimum and maximum withdrawals I can make?	______	______	______
4. Do I access this loan with checks or credit cards?	______	______	______
5. Does this loan have a fixed interest rate?	______	______	______
• If so, what is it?	______	______	______
• What is the annual percentage rate (APR)?	______	______	______
6. Does this loan have a variable interest rate?	______	______	______
• If so, what is it?	______	______	______
• What is the APR?	______	______	______
• How much could the interest rate increase on this loan, i.e., what is the cap?	______	______	______
• How often can this interest rate change?	______	______	______
• What is the index?	______	______	______
• What is the margin?	______	______	______
• Is this loan convertible to a fixed interest rate?	______	______	______
7. What are the total closing costs and who pays for which items?	______	______	______
• How much are the points?	______	______	______
• How much is the application fee?	______	______	______
• How much is the title search?	______	______	______
• How much is the appraisal?	______	______	______
• How much are the attorney's fees?	______	______	______
• What are the other closing costs?	______	______	______
8. Are there any continuing costs?	______	______	______
• Are there annual membership fees?	______	______	______
• Are there any transaction fees?	______	______	______
9. Does this loan have a fixed monthly payment and, if so, how much is it?	______	______	______
10. Does this loan have a varying monthly payment and, if so, how is it determined?	______	______	______
11. Are the monthly payments both principal and interest or interest-only?	______	______	______
12. Is there a final balloon payment?	______	______	______
• If so, how much is it?	______	______	______
• Do I have the option of refinancing?	______	______	______
• Do I have the option of extending the loan term?	______	______	______
13. Is there a penalty for late payments?	______	______	______
14. What are the default provisions of this loan?	______	______	______
15. Are there any other terms of this loan that can be changed without my consent?	______	______	______
16. Is there any penalty for early payment?	______	______	______

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