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WHEN YOUR HOME IS ON THE LINE: What You Should Know About Home Equity Lines of Credit

More and more lenders are offering home equity lines of credit. By using the equity in your home, you may qualify for a sizable amount of credit, available for use when and how you please, at an interest rate that is relatively low. Furthermore, under the tax law - depending on your specific situation - you may be allowed to deduct the interest because the debt is secured by your home.

If you are in the market for credit, a home equity plan may be right for you or perhaps another form of credit would be better. Before making this decision, you should weigh carefully the costs of a home equity line against the benefits. Shop for the credit terms that best meet your borrowing needs without posing undue financial risk. And, remember, failure to repay the loan could mean the loss of your home.

What is a home equity line of credit?

A home equity line of credit is a form of revolving credit in which your home serves as collateral. Because the home is likely to be a consumer's largest asset, many homeowners use their credit lines only for major items such as education, home improvements, or medical bills and not for day-to-day expenses.

With a home equity line, you will be approved for a specific amount of credit --- your credit limit, meaning the maximum amount you can borrow at any one time while you have the plan. Many lenders set the credit limit on a home equity line by taking a percentage (say 75 percent) of the appraised value of the home and subtracting the balance owed on the existing mortgage. For example:

| | |
|--------------------------------------|-------------------|
| Appraisal of home | \$100,000 |
| Percentage | x 95% |
| Percentage of appraised value | = \$75,000 |
| Less mortgage debt | - \$40,000 |
| Potential credit line | \$35,000 |

In determining your actual credit line, the lender also will consider your ability to repay, by looking at your income, debts, and other financial obligations, as well as your credit history.

Many Home equity plans often set a fixed time during which you can borrow money, such as 10 years. At the end of the draw period; the plan may allow you to renew the credit line. But in a plan that does not allow renewals, you will not be able to borrow additional money once the once the draw period has ended. Some plans may call for payment in full of any outstanding balance at the end of the period. Others may allow repayment over a fixed time, for example 10 years. Once approved for the home equity plan, usually you will be able to borrow up to your credit limit whenever you want. Typically, you will be able to draw on your line by using special checks. Under some plans, borrowers can use a credit card or other means to draw on the line.

However, there may be limitations on how you can use the line. Some plans may require you to borrow a minimum amount each time you draw on the line (for example, \$300) and to keep a minimum amount outstanding. Some lenders also may require that you take an initial advance when you first set up the line.

What should you look for when shopping for a plan?

If you decide to apply for a home equity line of credit, look for the plan that best meets your particular needs. Carefully read the credit agreement and examine the terms and conditions of various plans, including the annual percentage rate (APR) and the costs you'll pay to establish the plan. The disclosed APR is based on the interest rate above and will not reflect the closing costs and other fees and charges, so you'll need to compare these costs, as well as the APRs, among lenders.

Interest Rate Charges and Related Plan Features. Home equity lines typically involve variable interest rates rather than fixed rates. A variable rate must be based on a publicly available index (such as the prime rate published in some major daily newspapers or a U.S. Treasury bill rate); the interest rate will change, mirroring fluctuations in the index. Most lenders cite the interest rate you will pay as the value of the Index at a particular time plus a margin such as 2 percentage points.

Because the cost of borrowing is tied directly to the value of the index, it is important to find out what index and margin each lender uses, how often the index changes, and how high it has risen in the past.

Sometimes lenders advertise a temporarily discounted rate for home equity lines - a rate that is unusually low and often lasts only for an introductory period, such as six months.

Variable rate plans secured by a dwelling must by law have a ceiling (or cap) on how high your interest rate may increase over the life of the plan. Some variable-rate plans limit how much your payment may increase, and also how low your interest rate may fall if interest rates drop.

Some lenders may allow you to convert a variable rate to a fixed interest rate during the life of the plan, or to convert all or a portion of your line to a fixed-term installment loan.

Plans generally will permit the lender to freeze or reduce your credit line under certain circumstances. For example, some variable-rate plans may not allow you to get additional funds during any period the interest rate reaches the cap.

Costs to Establish and Maintain a Home Equity Line.

Many of the costs in setting up a home equity line of credit are similar to those you pay when you buy a home. For example:

- A fee for a property appraisal, which estimates the value of your home.
- An application fee, which may not be refundable if you are turned down for credit.
- Up-front charges, such as one or more points (one point equals one percent of the credit limit).
- Other closing costs, which include fees for attorneys, title search, mortgage preparation and filing, property and title insurance, as well as taxes.

In addition, you may be subject to certain fees during the plan period, such as annual membership or maintenance fees and a transaction fee every time you draw on the line.

You could find yourself paying hundreds of dollars to establish the plan. If you were to draw only a small amount against your credit line, those initial charges and closing costs would substantially increase the cost of the funds borrowed. On the other hand, the lender's risk is lower than for other forms of credit because your home serves as collateral. Annual percentage rates for home equity lines are generally lower than rates for other types of credit. The interest you save could offset the initial costs of establishing and maintaining the line. Moreover, some lenders may waive some or all of the closing costs.

How will you repay your home equity plan?

Before entering into a plan, consider how you will pay back the money you borrow. Some plans set minimum payments that cover a portion of the principal (the amount you borrow) plus accrued interest. But, unlike the typical installment loan, the portion that goes toward principal may not be enough to repay the debt by the end of the term. Other plans may allow payments of interest alone during the life of the plan, which means that you pay nothing toward the principal. If you borrow \$10,000, you will owe that entire sum when the plan ends.

Regardless of the minimum payment required, you can pay more than the minimum and many lenders offer a choice of payment options. Many consumers often will choose to pay down the principal regularly as they do with other loans. For example, if you use your line to buy a boat, you may want to pay it off as you would a typical boat loan.

Whatever your payment arrangements during the life of the plan - whether you pay some, a little, or none of the principal amount of the loan - when the plan ends you may have to pay the entire balance owed, all at once. You must be prepared to make this "balloon payment" by refinancing it with the lender, by obtaining a loan from another lender, or by some other means. If you are unable to make the balloon payment, you could lose your home.

If your plan has a variable interest rate, your monthly payments may change. Assume, for example, that you borrow \$10,000 under a plan that calls for interest only payments. At a 10 percent interest rate, your monthly payments would be \$83. If the rate should rise over time to 15 percent, your payments will increase to \$125 per month.

Even with payments that cover interest plus some portion of the principal, there could be a similar increase in your monthly payment, unless the agreement calls for keeping payments level throughout the plan.

If you sell your home, you probably will be required to pay off your home equity line in full immediately. If you are likely to sell your house in the near future, consider whether it makes sense to pay the up-front costs of setting up an equity credit line. Also keep in mind that leasing your home may be prohibited under the terms of your home equity agreement.

Comparing a line of credit and a traditional second mortgage loan.

If you are thinking about a home equity line of credit you might also want to consider a traditional second mortgage loan. A second mortgage provides you with a fixed amount of money repayable over a fixed period. In most cases, the payment schedule calls for equal payments that will pay off the entire loan within the loan period. You might consider a traditional second mortgage instead of a home equity line if, for example, you need a set amount for a specific purpose, such as an addition to your home.

In deciding which type of loan best suits your needs, consider the costs under the two alternatives. Look at the APR and other charges. Do not, however, simply compare the APR for a traditional mortgage loan with the APR for a home equity line because the APRs are figured differently:

- The APR for a traditional second mortgage takes into account the interest rate charged plus points and other finance charges
- The APR for a home equity line of credit is based on the periodic interest rate alone. It does not include points or other charges.

Disclosures from Lenders. The federal Truth in Lending Act requires lenders to disclose the important terms and costs of their home equity plans, including the APR, miscellaneous charges, the payment terms, and information about any variable-rate feature. And, in general, neither the lender nor anyone else may charge a fee until after you have received this information. You usually get these disclosures when you receive an application form, and you will get additional disclosures before the plan is opened. If any term (other than a variable rate feature) changes before the Plan is opened, the lender must return all fees if you decide not to enter into the plan because of the change.

When you open a home equity line, the transaction puts your home at risk. If the home involved is your principal dwelling, the Truth in Lending Act gives you three (3) days from the day the account was opened to cancel the credit line. This right allows you to change your mind for any reason. You simply inform the lender in writing within the three (3) day period. The lender must then cancel the security interest in your home and return all fees - including any application and appraisal fees - paid to open the account.

Glossary

Annual membership or participation fee. An amount that is charged annually for having the line of credit available. It is charged regardless of whether or not you use the line.

Annual percentage rate (APR). The cost of credit on a yearly basis expressed as a percentage.

Application fee. Fees that are paid upon application. An application fee may include charges for property appraisal and a credit report.

Balloon payment. A lump-sum payment that you may be required to make under a plan when the plan ends. Cap. A limit on how much the variable interest rate can increase during the life of the plan.

Closing costs. Fees paid at closing, including attorneys' fees, fees for preparing and filing a mortgage, for taxes, title search, and insurance.

Credit limit. The maximum amount that you can borrow under the home equity plan.

Equity. The difference between the fair market value (appraised value) of your home and your outstanding mortgage balance.

Index. The published rate that serves as a base for the interest rate charged on a home equity line and also serves as the base for the rate changes used by the lender.

Interest rate. The periodic charge, expressed as a percentage, for use of credit.

Margin. The number of percentage points the lender adds to the index rate to determine the annual percentage rate.

Minimum payment. The minimum amount that you must pay (usually monthly) on your account. In some plans, the minimum payment may cover "interest only." In other plans, the minimum payment may include principal and interest.

Points. A point is equal to one percent of the amount of your credit line. Points usually are collected at closing, and are in addition to monthly interest.

Security interest. An interest that a lender takes in the borrower's property to ensure repayment of a debt.

Transaction fee. A fee charged each time you draw on your credit line.

Variable rate. An interest rate that changes periodically in relation to an index. Payments may increase or decrease accordingly.

Where to Go for Help.

The following federal agencies are responsible for enforcing the federal Truth in Lending Act, the law that governs disclosure of terms for home equity lines of credit. Questions concerning compliance with the act by a particular financial institution should be directed to the institution's enforcement agency.

**State Banks that Are Members of the Federal Reserve System
Division of Consumer and Community Affairs Mail Stop**

Mail Stop 801
Federal Reserve Board
Washington, D.C. 20551
(202) 452-3693
www.federalreserve.gov

National Banks

Office of the Comptroller of the Currency Customer Assistance Unit
1301 McKinney St.
Suite 3710
Houston, TX 77010
(800) 613-6743
www.occ.treas.gov

Federal Credit Unions

National Credit Union Administration
Office of Public and Congressional Affairs
1775 Duke St.
Alexandria, VA 22314
(703) 518-6330
www.ncua.gov

Federally Insured Non-Member State-Chartered Banks and Savings Banks

Federal Deposit Insurance Corporation
Office of Compliance and Consumer Affairs
550 17th Street
Room PA-1730, 7th Floor
Washington, D.C. 20429
(202) 942-3100 or (800) 934-FDIC
www.fdic.gov

Federally Insured Savings and Loan Institutions and Federally Chartered Savings Banks

Office of Thrift Supervision
Consumer Programs
1700 G Street, N.W., 6th Floor
Washington, D.C. 20552
(202) 906-6237 or (800) 842-6929
www.ots.treas.gov

Mortgage Companies and Other Lenders

Federal Trade Commission
Consumer Response Center
600 Pennsylvania Avenue, NW
Washington, DC 20580
(202) 326-3758 or (877) FTC-HELP
www.ftc.gov

Home Equity Plan Check List

Ask your lender to help fill out this check list.

Basic Features

Fixed annual percentage rate

Variable annual percentage rate

- Index used and current value
- Amount of margin
- Frequency of rate adjustments
- Amount/length of discount (if any)
- Interest rate cap and floor

Length of plan

Draw period

Repayment period

Initial fees

Appraisal fee

Application fee

Up-Front Charges (including points)

Closing Costs

Plan A

Plan B

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Repayment Terms

During the draw period

Interest and principal payments

Interest only payments

Fully amortizing payments

When the draw period ends

Balloon payment

Renewal available

Refinancing of balance by lender?

Plan A

Plan B

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