

WHAT YOU SHOULD KNOW ABOUT HOME EQUITY LINES OF CREDIT (HELOCs)

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 - in 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. Before making a decision, you should weigh carefully the cost of a home equity line against the benefits. Shop for the credit terms that best meet your borrowing needs without incurring undue financial risk. And remember, failure to repay the amount you borrowed, plus interest, 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, the maximum amount you may borrow at any one time plan. Many lenders set the credit limit on a home equity line by taking a percentage (for example, 75%) of the home's appraised value and subtracting from that the balance owed on the existing mortgage. For example, on a home with an appraised value of \$300,000 and a mortgage balance of \$150,000, a lender may set the credit limit as high as \$75,000 (calculated as $(\$300,000 * 75\%) - \$150,000$).

In determining your actual credit limit, the lender will also 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 set a fixed period during which you can borrow money, such as 10 years. At the end of this "draw period", you may be allowed to renew the credit line. 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 period ("the repayment period"), for example, 10 years.

Once approved for a home equity line of credit, you will most likely be able to borrow up to your credit limit whenever you want. Typically, you will use special checks to draw on your line. Under some plans, borrowers can use a credit card or other means to draw on the line.

There may be some limitations on how you 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 plans may also require that you take in initial advance when the line set up.

DIFFERENCES FROM CONVENTIONAL LOANS

A HELOC differs from a conventional home equity loan in that the borrower is not advanced the entire sum up front, but uses a line of credit to borrow sums that total no more than the credit limit, similar to a credit card. HELOC funds can be borrowed during the "draw period" (typically 5 to 25 years). Repayment is of the amount drawn plus interest. A HELOC may have a minimum monthly payment requirement (often "interest only"); however, the debtor may make a repayment of any amount so long as it is greater than the minimum payment (but less than the total outstanding). The full principal amount is due at the end of the draw period, either as a lump-sum balloon payment or according to a loan amortization schedule.

Another important difference from a conventional loan is that the interest rate on a HELOC is variable. The interest rate is generally based on an index, such as the prime rate. This means that the interest rate can change over time. Homeowners shopping for a HELOC must be aware that not all lenders calculate the margin the same way. The margin is the difference between the prime rate and the interest rate the borrower will actually pay.

HELOC loans became very popular in the United States in the early 2000s, in part because interest paid was (and is) typically (depending on specific circumstances) deductible under federal and many state income tax laws. This effectively reduced the cost of borrowing funds and offered an attractive tax incentive over traditional methods of borrowing (such as credit card debt). Another reason for the popularity of HELOCs is their flexibility, both in terms

of borrowing and repaying on a schedule determined by the borrower. Furthermore, HELOC loans' popularity growth may also stem from their having a better image than a "second mortgage," a term which can more directly imply an undesirable level of debt. However, within the lending industry itself, a HELOC is categorized as a second mortgage.

Because the underlying collateral of a home equity line of credit is the home, failure to repay the loan or meet loan requirements may result in foreclosure. As a result, lenders generally require that the borrower maintain a certain level of equity in the home as a condition of providing a home equity line.

Traditional mortgages in the United States are usually non-recourse loans. Nonrecourse debt or a nonrecourse loan is a secured loan (debt) that is secured by a pledge of collateral, typically real property, but for which the borrower is not personally liable. A HELOC may be a recourse loan for which the borrower is personally liable. This distinction becomes important in foreclosure since the borrower may remain personally liable for a recourse debt on a foreclosed property.

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 meet your particular needs. Read the credit agreement carefully, and examine the terms and conditions of various plans, including the annual percentage rate (APR) and the costs of establishing the plan. The APR for a home-equity line of credit is based on interest rate alone and will not reflect the closing costs or other fees and charges, so you'll need to compare these costs, as well as APR's, among lenders.

Interest rate charges and related plan features

Home equity lines of credit typically involve variable rather than fixed interest rates. The variable rate must be based on a publicly available index (such as the prime rate); the interest rate for borrowing under the home equity line changes, mirroring fluctuations in the value of the index. Most lenders cite the interest rate you'll pay as a value of the index at a particular time plus a "margin", such as one percentage point. Because the cost of borrowing is tied directly to the value of the index, it is important to find out which index is used, how often the value of the index changes, and how high it has risen in the past as well as the amount of the margin.

Lenders sometimes offer a temporarily discounted interest rate for home-equity lines - a rate that is unusually low and may last 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 much your interest rate may increase over the life of the plan. Some variable rate plans limit how much your payment may increase and how low your interest rate may fall if interest rates drop.

Some lenders allow you to convert from a variable interest rate to a fixed 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 permit the lender to freeze or reduce your credit line under certain circumstances. For example, some variable rate plans may not allow you to draw additional funds during a period in which the interest rate reaches the cap.

THE PROS AND CONS OF HELOC LOANS

Pros of HELOCs

HELOC loans offer a few features that can't be found in personal loans or other second mortgages. Here are some of pros of taking out a home equity line of credit:

- **Lower interest rates than most credit cards and personal loans:** Since HELOCs are secured by property, lenders are able to offer substantially lower interest rates. The average HELOC interest rate is 1 percent above the current prime rate – a few HELOCs even offer interest rates set at prime.
- **High credit limits:** If your home has a lot of equity, you will probably receive a very high limit on your HELOC. You do not need to specify how you will use this money. You can use it to start a business, do home renovations, pay tuition, or anything else you please.
- **Tax-deductible interest:** Since a HELOC is technically considered a home loan, most state and federal laws make the loan's interest tax-deductible. Now, that's a feature you won't find in any credit card offer!

- **Revolving credit line:** Unlike home equity loans and home refinancing, HELOCs do not give borrowers an upfront sum of money. Instead, you can take out cash whenever you please. When you have no money withdrawn, you pay no interest.
- **Low fees:** Most borrowers are able to take out a HELOC without paying much (if any) money upfront. Refinancing or taking out a home equity loan could cost thousands – but, lenders commonly open HELOCs with no upfront charge.
- **Flexible repayment:** Many HELOC lenders offer flexible repayment options. As a borrower, you may choose to make interest-only payments during some months, you may turn a HELOC withdrawal into a fixed-interest loan, or you may extend the term of the credit line. Keep in mind that not all HELOC lenders offer these features.

Cons of HELOCs

Not everything about a HELOC benefits the borrower. Here are a few of the cons of taking out a home equity line of credit.

- **Adjustable interest rate:** HELOC loans start out with an adjustable interest rate tied to the prime rate. As the prime rate changes, so does your interest rate. Generally the prime rate is raised or lowered .25% at a time. If the prime rate skyrockets during any given year, be prepared to see a big change on your bill. Most HELOCs adjust their rates regularly, either monthly or quarterly.
- **No periodic rate caps:** Most adjustable rate loans have periodic rate caps (limits on how much interest rates can go up in a set time frame, such as one year). However, it is very difficult to find a HELOC with this feature. If your HELOC does not have a periodic rate cap, your interest rate can rise quickly and unexpectedly. Fortunately, the majority of HELOCs do have lifetime caps, so your interest rate will not exceed a set percentage over the life of the loan.
- **Early closure fees:** If you decide to close your HELOC early, you may be dinged with an early closure fee of several hundred dollars. Fortunately, many HELOCs do not have a prepayment penalty. Instead of closing the line, you can simply pay off the loan and stash your card/checks somewhere for safe keeping.
- **Minimum draw amounts:** Many HELOCs require borrowers to draw a minimum amount of money from the credit line. You can avoid this problem by asking your lender for a HELOC that does not include a minimum draw clause.
- **Possibility of line freezes:** Most HELOC lenders reserve the right to reduce or freeze your HELOC line should the value of your home decrease. Although this is very uncommon in booming markets, it is a possibility. Over 100,000 HELOC customers had their lines frozen with no advance warning in early 2008.
- **Difficulty refinancing first mortgage:** In order to refinance your first mortgage, you must get approval from the HELOC lender. Usually this is no problem; but in some cases (such as a declining market) HELOC lenders refuse. In this instance, the only way to refinance your first mortgage is to payoff and cancel your HELOC or refinance your HELOC with a different lender.

In summary, taking out a HELOC is a big decision. By carefully considering the above risks and benefits, you can make the best financial decision for your situation.

NEGOTIATING YOUR HELOC RATES AND TERMS

Not all HELOCs are created equal. If you don't choose carefully, you could end up paying unnecessary fees or being charged a huge markup. This article shows you how to watch out for common lender "tricks" and negotiate the best HELOC rates and terms.

DETERMINE THE HELOC "MARGIN"

The margin should be your primary concern when shopping for a HELOC loan. Basically, the margin is the difference between the index rate and the interest rate the borrower will be charged. A large number of HELOC lenders use the prime rate as an index. Consider this example: if a borrower is given a 2% margin, he will always be charged 2 points above the prime rate. If the prime rate is at 4%, his interest rate will be 6%. If the prime rate is at 8%, his interest rate will be 10%.

Since HELOCs have adjustable rates, a borrower's interest rate will be in flux throughout the life of the loan. The margin, on the other hand, will always stay the same.

Take note: the margin is not necessarily included in the HELOC's APR. Many HELOC loans come with an introductory rate for the first few months. It is not uncommon for this introductory rate to be used in determining the APR. When the introductory period is over, the borrower will be charged the actual interest rate. Creditworthy borrowers can sometimes find HELOCs at the prime rate (0% margin). Those with poor credit may find that they are given an extremely high margin (6% in some cases).

The margin is not always published. To determine what your HELOC margin is, you must ask the lender.

BEWARE OF HIDDEN HELOC FEES

It is possible to take out a HELOC without paying any fees at all. However, unexpected charges have a way of sneaking into loan documents. When applying for a HELOC, make sure that you won't be responsible for these unnecessary fees:

- **HELOC application fee:** Many lenders do not charge a fee for applying. If your lender does, they should be able to refund the money at closing.
- **Home appraisal charge:** Someone has to pay for an appraisal to be done, but most lenders will absorb this cost themselves.
- **HELOC closing costs:** Closing costs are common for many home loans, but not for the home equity line of credit. Don't agree to pay closing costs, sometimes called "lender fees."
- **HELOC check fees:** You shouldn't be charged extra every time you withdraw from your credit line – you're already going to pay interest on the amount you take out.
- **HELOC annual fee:** This line of credit will be open for 5, 10, or even 20 years. Annual fees can really add up – don't get stuck paying extra money each year.
- **HELOC inactivity fee:** If you choose to save your credit line for emergencies, don't let the lender punish you. The inactivity fee can almost always be waived.
- **HELOC repayment penalty:** You should never be penalized for paying off a line of credit before the end of the term – that's the beauty of choosing a credit line over a more traditional loan.
- **HELOC cancellation fee:** It can be more difficult to get the cancellation fee waived, but it's worth a shot. If your lender insists, you may be out about \$500 should you choose to refinance or sell your home during the life of the HELOC.

REQUEST ADDITIONAL HELOC FEATURES

Many home equity lines of credit come with "special features" that benefit the borrower. You may not be able to have everything on this list added to your HELOC, but it's worth it to ask.

- **Lifetime interest rate cap:** This is the maximum amount that your interest rate can adjust to during the life of the loan. Don't accept a cap that is so high you will not be able to make the monthly payment.
- **Periodic interest rate cap:** Few HELOCs offer this feature, but it's one to look out for. If you know that your interest rate can only adjust so high during a certain time frame (i.e. a year), you won't be surprised by a skyrocketing bill.
- **Interest-only payments:** Many HELOCs allow borrowers to make interest-only payments during the draw period. You may not want to use this feature regularly, but it's good to have in case of emergency.
- **Fixed-rate conversion:** A few lenders allow borrowers to convert withdrawals to a fixed interest rate. When you take out a sum of money, you can specify the preferred term of the fixed-rate loan (5 years, 10 years, etc). This is an especially comforting feature for borrowers concerned about rising interest rates.
- **Low introductory rate:** Most HELOCs come with an introductory rate – the lower, the better.
- **Long introductory term:** Try to push for a long introductory term. That way you'll be able to maximize the benefits of the lower interest rate.

By familiarizing yourself with the basic features and fees involved in HELOC loans, you'll be prepared to make smart choices for your financial future.