

SECTION 3: UNDERSTANDING IF CONVERTING EQUITY TO CASH IS RIGHT FOR YOU

What Is Home Equity?

Home equity is the difference between what your house is worth and the amount you owe on your home, including all mortgage loans and other **liens**, such as for unpaid **property taxes** and judgments that have been recorded against your property. For example, if the current value of your house is \$100,000 and your mortgage loan balance is \$80,000, your home equity would be \$20,000. You can build home equity by paying down your loan balance through regular monthly mortgage payments or having the value of your home increase from making home improvements or due to rising local property values.

How Can You Use Equity Without Selling Your Home?

Your home equity is an asset. As your home equity grows, you are building your financial future. As your financial needs change you have the option of converting your home equity into cash by replacing your old mortgage with a new, larger one or getting a second mortgage, which leaves your first mortgage in place. The loan products that allow you to borrow against your home equity are described below.

- A **cash-out refinance** loan allows you to borrow more money using your home's value as collateral by replacing your old mortgage with a larger one. The additional cash can be used for any purpose. Often, the interest rate for a cash-out refinance is higher than the rate for the loan that is being paid off.
- A **home-equity loan** is where you borrow a set amount of money as a second or junior lien secured by your home's value; your **first mortgage** remains in place and stays unchanged. Second mortgage loans generally have fixed interest rates that are higher than first mortgages and are fully amortized over 10 to 30 years. Some home-equity loans, however, have balloon payments due in five, 10 or 15 years.
- A **home-equity line of credit** is a specialized form of a second lien, where the balance can go up or down and the interest rate is usually variable. A credit line acts somewhat like a credit card. You are approved to borrow up to a certain amount of money in small or large amounts as you need it, rather than all at one time. Usually, the lender gives you a checkbook at closing to make draws whenever you want additional money. You pay interest only on the amount you actually borrow, and normally pay back the loan monthly.
- A **reverse mortgage**, or *home equity conversion mortgage (HECM)*, is available only if all the owners on the **title** to the home are at least 62 years old. A reverse mortgage works like a home-equity line of credit, except that you do not make any payments on the loan balance as long as you are living in

➤ *Important Note About Reverse Mortgages*

If you are eligible for a reverse mortgage, find out more about the process and choose your loan very carefully. Before you make any decisions, set up a meeting with a certified reverse mortgage counselor. You can find a list of qualified HECM counseling agencies at the HUD Web site, www.hud.gov/offices/hsg/sfh/hecm/hecmlist.cfm.

the home. You can draw down funds from the reverse mortgage in one of three ways: regular installments, a lump sum payment, or a line of credit. Unlike the loan balance of a regular mortgage, which decreases with each monthly payment, the loan balance of a reverse mortgage increases over time. A reverse mortgage loan's principal increases with each payment received, and interest and other charges accrue each month on the total funds paid out. The amount is generally not repaid until after you leave or sell the home, or the home passes into an estate. The maximum you or your estate will have to pay the lender when the home is sold is the value of the home, regardless of how much is actually owed to the lender. If the loan balance is less than the sales prices, you or your heirs will be able to keep the difference. If you would like more information about reverse mortgages, please visit AARP's Web site at www.aarp.org/money/revmort.

Choosing the right loan product for you depends on a number of factors, including what you plan to do with the extra money, how much you need and how quickly you plan to repay the money. When you are converting your equity to cash, you are borrowing more money, not saving money. Your new monthly payments will probably be higher, and your interest rate may also be higher. This section will help you determine when it might make sense for you to convert your home equity to cash and which loan product would be the best option for you to do so.

➤ *Important Note
About Using
Home Equity to Pay
for Home Repairs*

If you plan to draw on your home equity to pay for home repairs, be sure to understand all your options before proceeding. If you have a home warranty or manufacturer warranties for major appliances or fixtures, the repairs may be covered under those policies. Repairs required due to damage from fire or storms may be covered under your homeowners insurance policy. If you own a condominium, certain repairs may be covered by your homeowners association's insurance policy. Finally, there may be programs available through a local nonprofit or government agency that offer small grants or low-interest loans to help you make certain home repairs, such as a new roof, furnace or windows.

Is Converting Home Equity to Cash Right for You?

How you choose to handle your home equity is a very personal decision. Home equity gives you the opportunity to access extra money for major financial events by borrowing against it. However, by doing so, you could jeopardize your financial security if you do not borrow wisely, reducing your home equity and increasing your debt load. It is up to you to decide how much mortgage debt is reasonable for you based on your goals, finances, comfort level and other options available to you to reach your goals.

Ideally, you should view your home equity as an opportunity to invest your money safely and wisely for long-term goals, not as an opportunity to do consumer spending. For example, if you invest your equity in home improvements, your property value may increase and you will continue building assets. If you spend the equity on luxuries — like going on a family vacation or shopping spree or buying a new, high-end car — you are just building more debt. Even though the interest rate on a mortgage loan may be lower and the money paid in interest on the mortgage loan may be tax-deductible, the total amount paid in interest may be substantially greater than it would be on other short-term financing options for luxury items.

Deciding to borrow against your home equity is not easy. Review your financial goals and analyze whether borrowing against your home equity is the right option for you to meet any of your long-term financial goals. There are some sound reasons for you to convert some of your equity to cash, but first you need to determine your financial wants and needs and consider the pros and cons of all your financing options. Before you proceed with taking on more mortgage debt, speak with a reputable housing counselor to see if borrowing against your home equity is the right choice for you to meet your financial needs. Common reasons for converting equity to cash include:

Understanding Your Options: Mortgage Refinance and Home-Equity Loans

- *Making home improvements.* Most homeowners eventually find it necessary to repair or remodel their homes. Home improvement projects can be expensive and often require some type of financing. Some home improvements will increase your home's value more than others. Increasing your debt to make home improvements that will have a good payback can be a good investment. For a detailed account of investment returns for popular home improvement projects, see Remodeling Online Magazine's annual "Cost vs. Value Report" at www.remodeling.hw.net.
- *Paying for education for your children.* Some homeowners use their home equity to help pay for their children's college education. Tuition can be expensive and comes with a variety of financing options. Helping pay for your children's education can be viewed as an investment in their future, as college graduates tend to earn more than those with high school diplomas.
- *Paying for education for yourself.* At some point, you may want to improve your job skills or change careers. Paying for adult education can be worthwhile, as it may increase your earning power.
- *Consolidating debt.* Some homeowners are burdened with other consumer debt from unpaid credit card balances, installment loans and medical bills. Using your equity to consolidate all of your nondeductible, high-interest consumer debts into one monthly payment that is tax-deductible may be good, but only if you can curb the spending habits that saddled you with high consumer debt in the first place. Keep in mind that you can lose your home if do not repay a refinance or home-equity loan. Refinance and home-equity loans convert unsecured debt (like credit card debt, medical bills and other unsecured liabilities) to debt secured by your home, allowing lenders to foreclose on your home if you default. Before you decide to borrow against your home equity to consolidate debt, meet with a reputable credit counselor to discuss the pros and cons of various options for reducing your consumer debt.
- *Making investments.* Some homeowners wish to increase the scale or diversity of their investments but lack the cash available to do so. Your equity may represent an opportunity for you to invest in stocks, bonds, a small business or other real estate, all of which can be risky. Most often, homeowners are interested in investing in a small business or buying investment property. Many small businesses fail. The investment real estate market can be volatile. If you plan to resell or rent an investment property and prices slide, you can lose money. If you cannot make your mortgage payments, you will lose both your home and the investment property. If you wish to tap some of your equity to make investments, only do so with relatively sound ventures whose returns are likely to be greater than the interest paid on the mortgage loan. Clearly, it makes little sense to put your home in jeopardy to finance highly risky or speculative investments.

As your home is a major financial asset, wise use of the cash extracted from your home's equity is important. When you borrow against your home equity, you are slowing down your opportunity to build wealth and increasing your liabilities. Be sure to invest your money safely and prudently.

➤ *Important Note About Consolidating Debt*

Using your home equity to consolidate debt often leads to higher total interest costs and larger amounts of total debt. If you wrap your credit card balances and other bills into a 30-year, cash-out refinance loan, you will have a longer term with lower payments and higher long-term costs. Often this means that you are still making payments on items that you no longer have or use. In addition, you may end up running your credit card balances back up to where they were previously and consider refinancing again. If you do that, you will be threatening the opportunity to build wealth through home equity.

Determining the Amount of Equity You Have in Your Home

In order to know how much equity you have in your home, you will need to know your home's market value and your outstanding loan balance. Finding your loan balance is easy — simply call your loan servicer and ask for the amount of your loan balance. Your loan balance may also appear on your monthly loan statement. However, the loan balance listed on your statement may be slightly different than the loan payoff amount, as it may not include unpaid fees or the most current interest charges.

Finding your home's value is more challenging. The most accurate — but probably unnecessary — way to do so is to hire an appraiser. An appraisal usually costs around \$400 and will be included as part of a loan application. To get a fairly accurate estimate of your home's value before applying for a loan, check with your tax assessor's office or a local real estate professional. The difference between your home's value and your loan balance is your home equity. For example, if your home is valued at \$150,000 and you presently owe \$90,000, you have \$60,000 in home equity.

Depending on the loan type and purpose, you may be limited to a specific percentage of your home's value based on your **combined loan-to-value** (CLTV) ratio. Your CLTV is the sum of all the mortgages on your property divided by the value of your home and normally ranges from 70 to 90 percent. Using the example above, let's say the loan product you choose restricts your CLTV to 80 percent. Eighty percent of a \$150,000 home is \$120,000. If you owed \$90,000, you would be able to borrow up to \$30,000 against your home equity.

Which Loan Product Is Right for You?

If you have decided that borrowing against your home equity is right for you, you now need to think about which loan product to use. Consider why you need the money, how often and for long. Below are some rules of thumb about choosing which loan product may be right for you.

- If you need a lot of money that you wish to repay over a long time period, such as for a major home improvement project, you could get a cash-out refinance loan or a long-term home-equity loan. To choose which product is best for you, compare the costs and rates of each. A long-term equity loan may make more sense when you want to keep the first mortgage in place to avoid a prepayment penalty or private mortgage insurance or because it has a low interest rate. Some lenders and contractors offer home improvement loans instead of home-equity loans. Home improvement loans dole out money to you as work on a project progresses and do not require equity, but they can be expensive and cumbersome. In most cases, a home-equity loan will cost less than a home improvement loan. And with a home-equity loan, you will not have the hassle of proving that work has been completed for a drawdown (the disbursement of loan funds) from your lender.
- If you need a large amount of money for immediate use and do not anticipate needing to borrow again in the future, perhaps to pay a large medical bill, a home-equity loan may be the best option because it usually has lower total costs than a cash-out refinance.

Understanding Your Options: Mortgage Refinance and Home-Equity Loans

- If you need to pay for things that will take some time and require multiple payments, such as a large-scale home improvement project or college tuition over four years, a home-equity line of credit may be useful to you. That way you can draw down funds as you need them and only be charged interest on the money you use.

In addition to the guidelines mentioned above, there are some online resources that may help you make a decision about which home-equity loan product is right for you:

- To help you compare the total cost of a new, fixed-rate mortgage that includes “cash out” with the cost of keeping your existing mortgage and getting a new second mortgage, visit the Mortgage Professor’s Calculator at www.decisionaide.com/mpcalculators/refinancetoraisecash/refitoraisecash1.asp.
- To help you figure out whether you would be better off getting a home-equity loan or a home-equity line of credit based on how you intend to use the money, visit the “Ask Bankrate” program at www.bankrate.com/brm/home-equity-advisers/loan-vs-credit.asp.

Important Considerations When Thinking About Converting Your Home Equity to Cash

If are thinking about converting some of your home equity to cash, consider some of the following questions:

- How much equity do you have in your home? Subtract your loan balance from your home’s market value.
- How will borrowing more money affect your home equity? Think about how long it will take you to repay the additional money and rebuild your home equity.
- What LTV ratios do local lenders use for different loan products: cash-out refinance loans, home-equity loans and home-equity lines of credit? Maximum allowed LTV ratios are normally lower for cash-out refinancing and home-equity loan transactions than mortgages for home purchase or straight refinancing.
- How will borrowing against your home equity affect your payments? Since you are borrowing additional money, your payments will be higher. Prepare a realistic spending plan to make sure you can afford them. Be sure to anticipate any personal and financial changes in the near future.
- What interest rates do lenders charge for different loan products? Are the rates for various products fixed or adjustable? If they are adjustable, find out how often rates will be adjusted and if there are interest and payment caps. Base your decision to take an adjustable-rate loan on the maximum payment possible.
- Do any of the loan products require a lump-sum payment in the future? If so, have some realistic plan for making this payment.

Understanding Your Options: Mortgage Refinance and Home-Equity Loans

- What are the up-front costs associated with different loan products? Be sure to include closing costs, points, fees and prepayment penalties. Compare these costs with the costs of alternative types of financing.
- What are the loan terms for different loan products? Keep in mind that a longer term will have lower monthly payments, but higher total loan costs.
- How will borrowing against your home equity affect your tax deductions? In addition to your first mortgage, up to \$100,000 of additional mortgage debt (up to 100 percent of your home's market value) qualifies for interest deductions from your income taxes.

Home-Equity Loan Cautions

Your home is probably your largest financial asset. Proceed cautiously when considering borrowing against your home equity. Choose the right loan amount and product with the right lender for the right reasons. There is often a difference between what you qualify for and your comfort level with repayment. You do not need to borrow all of the money that is offered to you. Any money you borrow must be repaid eventually. When you borrow against the equity in your home, failure to make payments can result in losing your home.

Some lenders offer high-rate, high-LTV mortgages, where the first and second mortgages add up to 125 percent of your home's market value. If you owe more than your home is worth, you may end up trapped. Selling your home would end up costing you money because you would not be able to pay off the loan with the proceeds, meaning that you would be required to pay the deficiency with your own funds. If you could not make the payments, the only alternative would be to give up your home — losing your shelter and seriously damaging your credit.

If you think that converting some of your home equity is right for you, take your time when choosing a loan. Resist high-pressure tactics, shop around, and ask a lot of questions.