

WHEN YOUR HOME IS ON THE LINE

What You Should Know About Home Equity Lines of Credit

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More and more lenders are offering home equity lines of credit. By using the equity in your home, you may qualify for a sizeable 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 line could mean the loss of your home.

What is a home equity line of credit?

A home equity line 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 your home and subtracting the balance owed on the existing mortgage. For example:

Appraisal of home	\$100,000
Percentage	x 75%
Percentage of appraised value	\$ 75,000
Less mortgage debt	<u>\$ 40,000</u>
Potential credit line	\$ 35,000

In determining your actual credit line, 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.

Home equity plans often set a fixed time during which you can borrow money, such as ten years. When this period is up, 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 time has expired. Some plans may call for payment in full of any outstanding balance. Others may permit you to repay over a fixed time, for example ten 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 borrow money and make purchases using the line. However, there may be 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 balance outstanding. Some lenders may also 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, look for the plan that best meets your particular needs. Look carefully at 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 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 Plan Features. Home equity plans 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. To figure the interest rate that you will pay, most lenders add a margin, such as 2%, to the index value. Because the cost of borrowing is tied directly to the index rate, it is important to find out what index and margin the lender uses, how often the index changes, and how high it has risen in the past.

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

Variable rate plans secured by a dwelling must have a ceiling (or cap) on how high your interest rate can climb 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 permit 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 loan to a fixed-term installment plan.

Agreements 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 Obtain 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) A fee for a property appraisal, which estimates the value of your home; (b) An application fee, which may not be refundable if you are turned down for credit; (c) Up-front charges, such as one or more points (one point equals one percent of the credit limit); (d) Other closing costs, which include fees for attorneys, title search, mortgage preparation and filing, property and title insurance, as well as taxes; (e) Certain fees during the plan: for example, some plans impose yearly membership or maintenance fees; (f) Transaction fees every time you draw on the credit line.

You could pay hundreds of dollars to establish the plan. If you were to draw only a small amount against your credit line, those 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. Thus, annual percentage rates for home equity loans are generally lower than for other types of credit. The interest you save could offset the initial costs of obtaining the line. In addition, some lenders may waive a portion 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 any money you might 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 may give you a choice of payment options. Consumers often will choose to pay down the principal regularly as they do with other loans. For example, if you use your loan 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 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.

With a variable 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% interest rate, your initial payments would be \$83 monthly. If the rate should rise over time to 15%, 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.

When you sell your home, you will probably be required to pay off your home equity line in full. 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 line. Also, leasing your home may be prohibited under the terms of your home equity agreement.

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

If you are thinking about a home equity line of credit you might want to consider a more traditional second mortgage. This type of loan provides you with a fixed amount of money repayable over a fixed period. Usually the payment schedule calls for equal payments that will pay off the entire loan within

that time. You might consider a traditional second mortgage loan instead of an equity line if, for example, you want a set amount for a specific purpose, such as an addition to your home.

In deciding what type of loan best suits your needs, consider the costs under the two alternatives. Look at the APR and other charges. You cannot, however, simply compare the APR for a traditional mortgage with the APR for a home equity line because the APRs are figured differently. The APR for a traditional mortgage takes into account the interest rate charged plus points and other finance charges. The APR for a home equity line is based on the periodic interest rate alone. It does not include points or other charges.

Disclosure from Lenders. The Truth in Lending Act requires lenders to disclose the important terms 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 has changed before the plan is opened (other than a variable rate feature), the lender must return all fees if you decide not to enter into the plan because of the changed term.

When you open a home equity line, the transaction puts your home at risk. For your principal dwelling, the Truth in Lending Act gives you three 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 creditor in writing within the three-day period. The creditor must then cancel the security interest in your home and return all fees—including any application and appraisal fees—paid in opening the account.

Glossary

Annual membership or participation fee. An amount charged annually for having the credit line 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 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 base rate for changes that the lender uses to decide how much the annual percentage rate will change over time.

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 to be charged.

Minimum payment. The minimum amount that you must pay (usually monthly) on your account. In some plans, the minimum payment may be "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.

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

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 credit term disclosures for home equity lines. Any questions concerning compliance with the act by a particular financial institution should be directed to its enforcement agency.

State Member Banks of the Federal Reserve System

Division of Consumer and Community Affairs

Board of Governors of the Federal Reserve System

20th Street and Constitution Avenue NW
Washington, DC 20551
(202) 452-3946

National Banks

Compliance Management
Office of the Comptroller of the Currency
250 E Street SW
Washington, DC 20219
(202) 874-4428

Federal Credit Unions

Office of Consumer Programs
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314
(703) 518-6360

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

Office of Consumer Affairs
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
(800) 424-5488; (202) 898-6005; TDD (800) 452-3151; (202) 898-6726

Federally Insured Savings and Loan Institutions and Federally Chartered Savings Banks

Consumer Programs
Office of Thrift Supervision
1700 G Street NW, 5th Floor
Washington, DC 20552
(202) 906-6237

Mortgage Companies

Division of Credit Practices
Bureau of Consumer Protection
Federal Trade Commission
601 Pennsylvania Avenue NW
Washington, DC 20580
(202) 326-3233

Check List

Ask your lender to help fill out this checklist.

<u>Basic Features</u>	<u>Plan A</u>	<u>Plan B</u>
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 caps	_____	_____
<u>Length of plan</u>		
Draw period	_____	_____
Repayment period	_____	_____
<u>Initial fees</u>		
Appraisal fee	_____	_____
Closing costs	_____	_____
Application fee	_____	_____
<u>Repayment Terms</u>		
<i>During the draw period</i>		
Interest and principal payment	_____	_____
Interest only payments	_____	_____

Fully amortizing payments	_____	_____
<i>When the draw period ends</i>		
Balloon payment	_____	_____
Renewal available	_____	_____
Refinancing of balance by lender	_____	_____