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Home Equity Credit Lines

Using a credit line to borrow against the equity in your home has become a popular source of consumer credit. And lenders are offering these home equity credit lines in a variety of ways.

You will find most loans come with variable interest rates, some come with attractive low introductory rates, and a few come with fixed rates. You also may find most loans have large one-time upfront fees, others have closing costs, and some have continuing costs, such as annual fees. You can find loans with large balloon payments at the end of the loan, and others with no balloons but with higher monthly payments.

No one loan is right for every homeowner. The challenge, then, is to contact different lenders, compare options, and select the home equity credit line best tailored to your needs.

Be sure to review the home equity contract carefully **before** you sign it. Do not hesitate to ask questions about the terms and conditions of your financing. To help you do this, you may want to consider the following questions and to use the checklist at the end of this brochure.

Is a home equity credit line for you?

If you need to borrow money, home equity lines may be one useful source of credit. Initially at least, they may provide you with large amounts of cash at relatively low interest rates. And they may provide you with certain tax advantages unavailable with other kinds of loans. (Check with your tax adviser for details.)

At the same time, home equity lines of credit require you to use your home as collateral for the loan. This may put your home at risk if you are late or cannot make your monthly payments. Those loans with a large final (balloon) payment may lead you to borrow more money to pay off this debt, or they may put your home in jeopardy if you cannot qualify for refinancing. And, if you sell your home, most plans require you to pay off your credit line at that time. In addition, because home equity loans give you relatively easy access to cash, you might find you borrow money more freely.

Remember too, there are other ways to borrow money from a lending institution. For example, you may want to explore second mortgage installment loans. Although these plans also place an additional mortgage on your home, second mortgage money usually is loaned in a lump sum, rather than in a series of advances made available by writing checks on an account. Also, second mortgages usually have fixed interest rates and fixed payment amounts.

You also may want to explore borrowing from credit lines that do not use your home as collateral. These are available with your credit cards or with unsecured credit lines that let you write checks as you need the money. In addition, you may want to ask about loans for specific items, such as cars or tuition.

How much money can you borrow on a home equity credit line?

Depending on your creditworthiness (your income, credit rating, etc.) and the amount of your outstanding debt, home equity lenders may let you borrow up to 85% of the appraised value of your home minus the amount you still owe on your first mortgage. Ask the lender about the length of the home equity loan, whether there is a minimum withdrawal requirement when you open your account, and whether there are minimum or maximum withdrawal requirements after your account is opened. Inquire how you gain access to your credit line — with checks, credit cards, or both.

Also, find out if your home equity plan sets a fixed time — a draw period — when you can make withdrawals from your account. Once the draw period expires, you may be able to renew your credit line. If you cannot, you will not be permitted to borrow additional funds. Also, in some plans, you may have to pay your full outstanding balance. In others, you may be able to repay the balance over a fixed time.

What is the interest rate on the home equity loan?

Interest rates for loans differ, so it pays to check with several lenders for the lowest rate. Compare the annual percentage rate (APR), which indicates the cost of credit on a yearly basis. Be aware that the advertised APR for home equity credit lines is based on interest alone. For a true comparison of credit costs, compare other charges, such as points and closing costs, which will add to the cost of your home equity loan. This is especially important if you are comparing a home equity credit line with a traditional installment (or second) mortgage, where the APR includes the total credit costs for the loan.

In addition, ask about the type of interest rates available for the home equity plan. Most home equity credit lines have variable interest rates. These variable rates may offer lower monthly payments at first, but during the rest of the repayment period the payments may change and may be higher. Fixed interest rates, if available, may be slightly higher initially than variable rates, but fixed rates offer stable monthly payments over the life of the credit line.

If you are considering a variable rate, check and compare the terms. Check the *periodic cap*, which is the limit on interest rate changes at one time. Also, check the *lifetime cap*, which is the limit on interest rate changes throughout the loan term. Ask the lender which index is used and how much and how often it can change. An index (such as the prime rate) is used by lenders to determine how much to raise or lower interest rates. Also, check the *margin*, which is an amount added to the index that determines the interest you are charged. In addition, inquire whether you can convert your variable rate loan to a fixed rate at some future time.

Sometimes, lenders offer a temporarily discounted interest rate — a rate that is unusually low and lasts only for an introductory period, such as six months. During this time, your monthly payments are lower too. After the introductory period ends, however, your rate (and payments) increase to the true market level (the index plus the margin). So, ask if the rate you are offered is "discounted," and if so, find out how the rate will be determined at the end of the discount period and how much larger your payments could be at that time.

What are the upfront closing costs?

When you take out a home equity line of credit, you pay for many of the same expenses as when you financed your original mortgage. These include items such as an application fee, title search, appraisal, attorneys' fees, and points (a percentage of the amount you borrow). These expenses can add substantially to the cost of your loan, especially if you ultimately borrow little from your credit line. You may want to negotiate with lenders to see if they will pay for some of these expenses.

What are the continuing costs?

In addition to upfront closing costs, some lenders require you to pay continuing fees throughout the life of the loan. These may include an annual membership or participation fee, which is due whether or not you use the account, and/or a transaction fee, which is charged each time you borrow money. These fees add to the overall cost of the loan.

What are the repayment terms during the loan?

As you pay back the loan, your payments may change if your credit line has a variable interest rate, even if you do not borrow more money from your account. Find out how often and how much your payments can change. You also will want to know whether you are paying back both principal and interest, or interest only. Even if you are paying back some principal, ask whether your monthly payments will cover the full amount borrowed or whether you will owe an additional payment of principal at the end of the loan. In addition, you may want to ask about penalties for late payments and under what conditions the lender can consider you in default and demand immediate full payment.

What are the repayment terms at the end of the loan?

Ask whether you might owe a large payment at the end of your loan term. If so, and you are not sure you will be able to afford the balloon payment, you may want to renegotiate your repayment terms. When you take out the loan, ask about the conditions for renewal of the plan or for refinancing the unpaid balance. Consider asking the lender to agree ahead of time and in writing to refinance any end-of-loan balance or extend your repayment time, if necessary.

What safeguards are built into the loan?

One of the best protections you have is the Federal Truth in Lending Act, which requires lenders to inform you about the terms and costs of the plan at the time you are given an application. Lenders must disclose the APR and payment terms and must inform you of charges to open or use the account, such as an appraisal, a credit report, or attorneys' fees. Lenders also must tell you about any variable-rate feature and give you a brochure describing the general features of home equity plans.

The Truth in Lending Act also protects you from changes in the terms of the account (other than a variable-rate feature) before the plan is opened. If you decide not to enter into the plan because of a change in terms, all fees you paid earlier must be returned to you.

Because your home is at risk when you open a home equity credit account, you have three days to cancel the transaction, for any reason. To cancel, you must inform the lender in writing. Following that, your credit line must be cancelled and all fees you have paid must be returned.

Once your home equity plan is opened, if you pay as agreed, the lender, in most cases, may not terminate your plan, accelerate payment of your outstanding balance, or change the terms of your account. The lender may halt credit advances on your account during any period in which interest rates exceed the maximum rate cap in your agreement, if your contract permits this practice.

For More Information

The FTC works for the consumer to prevent fraudulent, deceptive, and unfair business practices in the marketplace and to provide information to help consumers spot, stop, and avoid them. To file a complaint or to get free information on consumer issues, visit ftc.gov or call toll-free, 1-877-FTC-HELP (1-877-382-4357); TTY: 1-866-653-4261. The FTC enters Internet, telemarketing, identity theft, and other fraud-related complaints into Consumer Sentinel, a secure, online database available to hundreds of civil and criminal law enforcement agencies in the U.S. and abroad.

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