



Opening Doors to Housing Success

If you choose to use a home equity loan, be sure you understand the risks and setup your own repayment plan. To benefit from a home equity loan, you need to plan its use carefully.

Is a Home Equity Loan Right for You?

Home equity loans are big news these days, but are they right for you? First, before you can decide, you need to know the facts about home equity loans. Home equity loans come in two different forms: closed-end home equity loans and home equity lines of credit.

Closed-end home equity loans are very similar to your home mortgage: a specific amount of money is loaned to you and you're required to make scheduled monthly repayments of principal and interest. These loans are often thought of as traditional second mortgages. The date you must repay the loan is set when you borrow the money. Often interest rates are fixed.


In contrast, a home equity line of credit is more like a credit card. Home equity lines of credit allow you to use as much (or as little) of the credit line as you like, up to an approved dollar amount. You can withdraw money when you want to use it. Typically you have between five and 20 years to access this credit line. Once this period has ended, you must stop borrowing and repay the principal and interest. You may have between 10 and 20 years to repay, or you may have a balloon payment. Balloon payments require you to pay the principal in one lump payment. Often the credit interest rate is adjustable and changes as the economy changes.




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Advantages of Home Equity Loans

 **Low rates.** Interest rates tend to be lower than credit card rates or consumer loans.

 **Tax-deductible.** The interest you pay is tax deductible up to \$100,000 or the equity value in your home, whichever is less. Consult a tax advisor for details.

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Is a Home Equity Loan Right for You?

Advantages of Home Equity Loans (continued)

Flexible. The loan allows you to choose when to use the money. Plus, you may be able to decide when to repay the principal.

Disadvantages of Home Equity Loans

Risk of losing home. If you can't repay or refinance the loan, then you may be forced to sell or lose your home. Your home is the collateral for the loan. Being late or missing loan payments can trigger foreclosure within 60 to 90 days.

Rising interest rates. With a variable interest rate, most home loan rates change when the economy changes. This means your monthly payments can rise and fall. Be sure you know what the cap is on the loan's interest rate. The cap sets how high your interest rate can increase each year as well as how much it can increase over the whole loan time period.

Fees. Lenders can charge a variety of fees including origination, application, and withdrawal fees. Be sure to ask about all possible fees.

Success with a Home Equity Loan

Compare loans. Home loans' characteristics vary depending on the financial institution lending the money. Interest rates, fees, repayment conditions, loan amount, and additional costs such as points can all vary. For example, a lender may charge an annual fee for using your home equity line of credit or even a larger fee if your credit line is inactive. Check with several lenders to find the loan that suits you the best. Use the chart on page 4, *Home Equity Loan Comparison*, to help compare loans.

Read all the fine print. Understand the loan conditions before you sign the contract. When can the credit line be frozen? What is the interest rate cap? How often is the interest rate adjusted? Which index is used to calculate the rate? Can the lender demand full payment and how quickly must you pay back the loan?

Plan how you will use your loan. Don't use your loan for items that get used up such as clothing, entertainment and minor repairs. Even if the lending institution offers you a credit card to access your credit line, consider refusing it. A credit card may make using your loan too easy. You may find yourself deeper in debt than you planned.

Setup your own repayment schedule. When you borrow money from a home equity line of credit, you may have the option of making very small payments over a long time. However, it's smart to pay more than the minimum required. For example, if you borrow money to buy a car, you don't want to be paying for it 20 years later. Plan to repay your loan using the following guidelines: 18 months to repay a loan used to consolidate debt; three to four years to purchase a car; no more than seven years to pay for a home improvement.¹



Is a Home Equity Loan Right for You?

Estimate How Much Money You Can Borrow

How much can you borrow? This depends on both the equity value you have in your home and the lender's policies. Your home equity is the difference between its appraised value (the price that you could sell your home) and your mortgage value (what you owe on your loan). Use Table 1 to calculate your home equity value.

Table 1: How much equity do you have in your home?

	Example	Your numbers
Appraised value	\$100,000	
Minus mortgage balance	- \$60,000	
Home equity	\$40,000	

Lenders consider several factors (such as your credit history, ability to repay the loan, and your home's equity) when deciding how much money to lend. Lenders often use one of two methods (shown in Table 2) to calculate how much they are willing to loan you.²

Table 2: How much money can you borrow?

Method 1	Example	Your numbers
Appraised value	\$100,000	
Multiply by .75	X .75	
Equals	\$75,000	
Minus mortgage balance	-\$60,000	
Loan amount	\$15,000	

Method 2	Example	Your numbers
Appraised value	\$100,000	
Minus mortgage balance	-\$60,000	
Equals home equity	\$40,000	
Multiply by .75	X .75	
Loan amount	\$30,000	

The calculations in Table 2 are based on your home equity value. Each lender sets its own guidelines about the

loan-to-value ratio to use; typically it's between 75-85 percent.

- Method 1) 75 percent of the appraised value of your home, less your unpaid mortgage.
- Method 2) 75 percent of your home's equity.

As you can see from the example in Table 2, the amount you can borrow will depend on the method the lender uses. Method 1 is more commonly used. Be aware that Method 2 may result in borrowing more money than you can comfortably handle. For example, home equity loans must be paid off if you sell your home. With a high loan-to-value ratio, such as in Method 2, this might be difficult to do.

If you decide to get a home equity loan, use it wisely. You will have a useful money management tool.

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Sources:

- ¹ Quinn, J.B. (1997). *Making the Most of Your Money*. New York, NY: Simon & Schuster.
 - ² Seiling, S.B. (1989). *A Consumer Guide to Home Equity Loans*. [North Central Regional Extension Publication No. 384]. Washington, D.C.: Cooperative Extension Service.
- For more information, see other *Opening Doors to Housing Success* fact sheets.



Is a Home Equity Loan Right for You?

Home Equity Loan Comparison

Value of your home:

Amount owed on your home:

Home equity value:

	Loan 1	Loan 2	Loan 3
Lender's Name			
Loan amount			
Interest rate information			
Initial interest rate			
Annual cap on interest rate			
Maximum interest rate cap			
Payment information			
Monthly payment requirement			
Prepayment penalty			
Term-to-maturity/Length of loan			
Balloon payment			
Fees			
Points			
Application fee			
Annual maintenance fee			
Annual inactivity fee			
Property appraisal			
Title search			
Other			

Notes
