WHEN YOUR HOME IS ON THE LINE:
What You Should Know About Home Equity Lines Of Credit

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.

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 or 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 the 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 the home and subtracting the balance owed on the existing mortgage. For example:

Appraisal of home	$100,000
Percentage	x75%
Percentage of appraised value	$ 75,000
Less mortgage debt	-$40,000
Potential credit line	$35,000

In determining your actual credit line, the lender also will consider your ability to repay, by looking at your income, debt, 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 10 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 10 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 amount outstanding. Some lenders also may require that you take an initial advance when the line is first set up.

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. 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 is based on interest rate alone and 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 related 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 for borrowing under the home equity line changes, mirroring fluctuations in the index. Most lenders cite the interest rate that you will pay as the value of the index at a particular time plus a "margin," such as 2 percentage points. 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 rate for home equity lines - a rate that is unusually low and may last for only an introductory period, such as 6 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 interest rate during the life of the plan, or to convert all or a portion of your line to a fixed-term loan.

Plans 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 draw additional funds during a period the interest rate reaches the cap.

Costs of establishing and maintaining 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 fee for a property appraisal to estimate the value of your home.
- An application fee, which may not be refunded if you are turned down for credit.
- Up-front charges, such as one or more points (one point equals one percent of the credit limit).
- Other closing costs, including fees for attorneys, title search, and mortgage preparation and filing; property and title insurance; and taxes.

In addition, you may be subject to certain fees during the plan period, such as annual membership or maintenance fees and a transaction fee every time you draw on the credit line.

You could find yourself paying hundreds of dollars to establish the plan. If you were to draw only a small amount against your credit line, those initial charges would substantially increase the cost of the funds borrowed. On the other hand, because the lender's risk is lower than for other forms of credit, as your home serves as collateral, annual percentage rates for home equity lines are generally lower than rates for other types of credit. The interest you save could offset the costs of establishing and maintaining the line. Moreover, some lenders waive some 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 the money you 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 amount when the plan ends.

Regardless of the minimum payment required, you may choose to pay more, and many lenders offer a choice of payment options. Many consumers choose to pay down the principal regularly as they do with other loans. For example, if you use your line 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 it 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.

If your plan has a variable interest 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 percent interest rate, your monthly payments would be $83 monthly. If the rate rises over time to 15 percent, your monthly payments will increase to $125 per month. Similarly, if you are making payments that cover interest plus some portion of the principal, your monthly payments may increase, unless your agreement calls for keeping payments the same throughout the plan period.

If you sell your home, you probably will be required to pay off your home equity line in full immediately. 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 a line of credit. Also keep in mind that renting your home may be prohibited under the terms of your agreement.

Lines Of Credit vs. Traditional Second Mortgage Loans

If you are thinking about a home equity line of credit, you also might want to consider a more traditional second mortgage loan. 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 second mortgage instead of a home equity line if, for example, you need a set amount for a specific purpose, such as an addition to your home.

In deciding which type of loan best suits your needs, consider the costs under the two alternatives. Look at both the APR and other charges. Do not, however, simply compare the APRs, because the APRs on the two types of loans are figured differently.

- The APR for a traditional second mortgage loan takes into account the interest rate charged plus points and other finance charges.
- The APR for a home equity line of credit is based on the periodic interest rate alone. It does not include points or other charges.

Disclosures from lenders.

The federal Truth in Lending Act requires lenders to disclose the important terms and costs 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 (other than a variable-rate feature) changes before the plan is opened, the lender must return all fees if you decide not to enter into the plan because of the change.

When you open a home equity line, the transaction puts your home at risk. If the home involved is your principal dwelling, the Truth in Lending Act gives you 3 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 3-day period. The lender must then cancel its security interest in your home and return all fees - including any application and appraisal fees - paid to open the account.

GLOSSARY

Annual membership or participation fee - An amount that is charged annually for having the line of credit 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 life of 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 for rate changes that the lender used 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.
Security interest - An interest that a lender takes in the borrower's property to assure repayment of a debt.
Transaction fee - A fee charged each time you draw on your credit line.

Variable rate - An interest rate that changes periodically in relation to an index. Payment 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 disclosure of terms for home equity lines of credit. Questions concerning compliance with the act by a particular financial institution should be directed to the institution's enforcement agency.

State Banks that Are Members of the Federal Reserve System

Division of Consumer and Community Affairs
Mail Stop 801
Federal Reserve Board
Washington, DC 20551
(202) 452-33693
www.federalreserve.gov

National Banks

Office of the Comptroller of the Currency
Customer Assistance Unit
1301 McKinney St. Suite 3710
Houston, TX 77010
(800) 613-6743
www.occ.treas.gov

Federal Credit Unions

National Credit Union Administration
Office of Public and Congressional Affairs
1775 Duke Street
Alexandria, VA 22314
(703) 518-6330
www.ncua.gov

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

Federal Deposit Insurance Corporation
Office of Compliance and Consumer Affairs
550 Seventeenth Street, N.W.
Washington, DC 20429
(800) 934-FDIC; (202) 942-3100
www.fdic.gov

Federally Insured Savings and Loan Institutions and Federally Chartered Savings Banks

Office of Thrift Supervision
Consumer Programs
1700 G Street, N.W., Fifth Floor

Washington, DC 20552
(202) 906-6237 or (800) 842-6929
www.ots.treas.gov

Mortgage Companies and Other Lenders

Federal Trade Commission
Consumer Response Center
600 Pennsylvania Avenue, N.W.
Washington, DC 20580
(202) 326-3758 or (800) FTC-HELP
www.ftc.gov

Board of Governors of the Federal Reserve System (FRB)
Consumer Help
P.O. Box 1200
Minneapolis, MN 55480
(888) 851-1920
www.federalreserveconsumerhelp.gov

Consumer Financial Protection Bureau (CFPB)
P.O. Box 4503
Iowa City, IA 52244
(855) 411-CFPB
www.consumerfinance.gov