Home Equity Loans and HELOCs – Getting a Good Deal

From the Wall Street Journal

At some point, you’ll probably need money that you don’t have handy, possibly for a home improvement project or a large, unexpected expense. What do you do if you don’t have the money in your checking account? If you own your home, you have the option of getting a home equity loan or a home equity line of credit.

A home equity loan is basically a second loan (after your mortgage) that you take out on your house. But where the first loan (your mortgage) goes toward the purchase of your home, the second loan (the home equity loan) is a lump of cash the bank gives you to spend as you please.

Once you’re approved for a home equity loan, you receive a check for the total loan amount. Home equity loans have a fixed interest rate and a fixed term (the amount of time you have to repay the loan), usually 10 to 15 years. You make monthly payments on the loan until it’s all paid up.

With a home equity line of credit (HELOC), you’re approved for a total loan amount, but bank does not give you money in a lump sum. Instead, you get a credit/debit card, or a checkbook (or both) and you withdraw money when needed. You only pay interest on the amount you’ve taken out, and you’re only limited by the total amount of the loan. Up to $100,000 of the loan is tax deductible.

HELOCs are trickier than typical home loans that pay you one lump sum up front. Here are some characteristics of these credit lines:
  • Fluctuating Interest Rates – A line of credit with fluctuating rates can make your payments increase, sometimes drastically. Some lenders offer a low “introductory rate,” only to increase it after a month or two.
  • Advance Period Terms – HELOCs with these terms allow you to access the money for a set period of time, say five years. Once that term is up, you can’t withdraw money and you must to repay whatever you borrowed in the next ten years (known as the “repayment period”).
  • Balloon Payment Terms – Some HELOCs only charge you interest for ten years, but then may charge you an additional fee that is due at the end of the loan’s terms. Sometimes this balloon amount tagged on at the end so large, that borrowers refinance to include the balloon amount.

Should You Use Home Equity?

Should you look for a traditional home-equity loan (that pays you right away) or a home-equity line of credit, which that extends a line of credit over time?
Well, if you have a single, discrete expense (like a kitchen remodel), a regular home-equity loan is the right move. You get your money, you pay for the project and you start repaying the loan right away—in monthly payments that remain the same over the life of the loan.

But if you’re looking at a series of payments over a period of time, or want a safety net that you can bail you out at a moment’s notice, a HELOC is the better choice—you’ll only pay for the money you need.

Most home-equity loans and HELOCs use the following formula to determine how much to lend: 75-80% of current home’s value (determined by an appraiser’s visit, which you pay for) minus the amount you owe on your mortgage. When real estate values decline, getting a HELOC gets tougher, but it’s still an option for many homeowners.

Here’s an example that assumes the bank will lend 75% of your home’s value:
Current home value: $400,000
75% of current value: $300,000
Size of your mortgage: $250,000
Amount lent to you: $50,000

Some lenders will lend you even more than 80% of the value of your home – up to 100% or even 125% of the home’s appraised value. But a home equity loan that large is risky, since your home might not appreciate that much by the time you’re ready to sell. Indeed, home values haven’t risen much at all of late. If your home declines in value or rises very little, you could get stuck owing money on your home equity loan, even after you sell the house. Here’s how such a huge home equity loan can become a huge headache:

Current home value in 2008: $400,000
125% of home value: $500,000
Size of your mortgage: $250,000
Amount lent to you: $250,000
Sale price of your home in 2011: $475,000
Mortgage in 2011: $240,000
Total amount owed (mortgage and home loan): $490,000

In this example, you still owe the bank $15,000 more than the home’s sale price. And that’s not even including the closing fees, moving expenses, and other costs associated with selling. Right now, you read about a lot of people who’ve gotten into trouble because they took out more money than their houses were worth, and are unable to pay off the debt.
Where and How to Get a Good Deal

….A benefit of a home equity loans and HELOCs is that your credit score and credit history don’t really have any effect on your loan’s approval, or on the rates that you pay. That’s because your home is the collateral. This may be good if your credit score isn’t so hot, but keep in mind that, if you don’t make payments, the lender can repossess your home. Also, just like a mortgage, up to $100,000 of the interest you pay on a home equity loan is tax deductible. In terms of your credit score, a HELOC is treated as a line of credit, so adding the new account will result in a temporary ding on a score, but if used responsibly, HELOCs add to your credit history, thus raising your score.

The approval process for a home equity loan or HELOC isn’t as strenuous as the mortgage approval process. Generally, all that’s required to apply is an appraisal of your home and verification of your income. This also means that approval comes more quickly. Usually, you can get a home equity loan or HELOC in a matter of weeks– it’s much quicker than the months-long ordeal of securing a mortgage.

But make sure you understand the fees involved, which are less than the fees you pay on a mortgage, but significant nonetheless. This makes sense, since the loan you’re taking out is smaller…. But do check with your mortgage lender – they may be more likely to cut you a deal, since you’re already a customer.

Also, read all the fine print on a HELOC. Some lenders require you to withdraw money—whether you want to or not—several times a year; they may also exact a heavy penalty (up to thousands of dollars) if you decide you don’t want the loan anymore, pay it back entirely and close the line of credit (this is called a “prepayment penalty”). Not all loans have these conditions, so if you’re thinking of getting a HELOC but have no real intention to use it, make sure you can leave it alone without it costing you anything extra.