Your Home Equity Homebuyer Guide

Pursue Your Dreams By Accessing The Value In Your Home

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Pursue Your Dreams

Home Equity: A Powerful Financial Tool

Your home is an investment, perhaps your largest. In addition to providing shelter, a place to make happy memories, and a source of pride, your home can also provide the means to make other dreams come true.

Over the last several decades, Americans are realizing that a home is more than just a property to be bought and sold. It's a sound financial resource that can grow in value — a resource that can be used to help meet other financial needs.

The equity you establish in your home can be managed to help you achieve financial goals. This guide is designed to help you understand how to use your home's equity, so you can put one of your most powerful assets to work for you.

What Is Home Equity?

Equity is the difference between the market value of your home and how much you owe on any loans and all liens associated with your home. For most people, that means the difference between the home's value and what they owe on their mortgage.

Think of your home as a company with two stakeholders: you and your mortgage lender. You contribute money in the form of a down payment — let's say 10% — and the mortgage lender provides financing for the balance of the purchase price.

Your down payment amount represents your initial *equity* in the home. Over time, as you pay down your mortgage balance, your equity can increase. Equity may also increase as your home gains value over time, through improvements or local property appreciation. All of that adds up to an equity resource that can provide financing when you need it.

What Can Home Equity Do For You?

The interest you pay on many credit cards, auto loans, student loans, and personal loans may not be tax deductible. However, the interest you pay on your home's mortgage or home equity financing can be.[1]

Savvy homeowners are learning that using their home's equity can be a smart way to meet important needs. College tuition is a great example. The home your children grew up in could actually help them fulfill their dreams. Equity can even help with more immediate needs. For instance, if you need a new car, you can borrow against the equity in your home to finance that purchase.

One very common use of home equity is to finance improvements that may enhance a property's value. That's almost always a wise decision. Adding a new master bedroom suite or a kitchen remodel can effectively cause the value of your home to appreciate.

1. Consult your tax advisor regarding deductibility of interest.

Another popular reason for home equity financing is debt consolidation. Generally, the homeowner uses their loan or line of credit to pay off high-interest debt, converting several credit balances into a single lower-interest loan that can offer tax deductible interest.[2] By getting out from under higher-interest rate loans and credit card balances, you could get a fresh start on managing your finances.

How Do You Use Your Equity Wisely?

You've worked hard to build the value you have in your home and, like other investments, any decision about when and how to use your home's value need to be made carefully. Everyone views investments, savings, and personal needs differently, but nobody wants to make an unwise financial move.

Your home's equity, put to work in the right way, can make a big difference for you and your family.

If Your First Mortgage Has An Interest Rate Higher Than Current Market Rates

- Refinancing could reduce your mortgage interest rate and give you convenient access to your unused equity through a home equity line of credit.[3]
- Cash out refinancing involves paying off your primary mortgage with a new mortgage at a higher loan amount. The additional cash can be used in any way you choose. Plus, you'd benefit from a lower interest rate that could lower your monthly payments.
- A refinance loan can get you a lower interest rate and access to cash for investing in home improvements.

Where To Start

Calculating Your Home Equity

The first thing you need to do is find out just how much unused equity you have. As previously stated, your available home equity is the difference between what your home is worth and the amount you owe on any liens against the property. This includes your first mortgage, as well as any second mortgages, home equity loans, or home equity lines of credit. Reviewing your loan or line of credit statements will give you a good estimate of the amount you owe. Just keep in mind that this figure will differ slightly from the actual amount required to pay off. In some cases there may be prepayment penalties, and there's almost always additional interest due.

Running The Numbers On Home Equity – Example Below

$250,000 Purchase Price
-$195,734 First Mortgage Unpaid Balance
-$ 10,000 Second Mortgage Unpaid Balance
$ 44,266 Paid Down Equity

(Example assumes 5% appreciation per year for five years. Numbers rounded.)

$318,460 Current Value
-$250,000 Purchase Price
$ 68,460 Amount Of Appreciation

$ 44,266 Paid Down Equity From Original Financing
$ 68,460 Amount Of Appreciation Since Last Financing
$112,726 Total Unused Equity

How Much Is Your Home Worth?

To establish the fair market value of your home, the lender may require an appraisal. Generally, a professional appraiser will review the local real estate market and will probably compare at least three recently sold homes in your area. Ideally, these homes will be in close proximity, size, and amenities (number of bedrooms and baths, etc.) to your home. Then the appraiser will compare the condition of your home to the others and make any necessary adjustments to estimate the fair market value for your home.

If you want to establish the value of your property before talking to your lender, there are a couple of other options that can help you get a ballpark estimate. A real estate agent can help you estimate the sales value of your home. But if you want to go into the loan application process with the most accurate estimate you can get of your current unused equity, hire a professional appraiser. Just keep in mind, if you're having the appraisal done prior to applying for financing, your lender may only accept reports from appraisers whom they've approved. The possibility exists that you may have to pay for a second appraisal.

Which Refinancing Plan Is Right For You?

Refinancing Expertise For You

Once you know how much equity you have in your home, you'll need to decide how you want to go about accessing it. This is an important decision, and a lot of factors go into making it:

- Interest rates
- Discount points
- Closing costs
- Terms
- Financial goals
- Funds needed
- Planned use

This guide will provide you with an overview of the choices available to you. The financing you receive will help you with your unique long- and short-term goals.

Whether you're all set to refinance or just trying to figure out how much equity you have, you need solid financing information and guidance. The financing professional you select can help you choose a mortgage to fit your specific needs. Whatever your financial profile, your mortgage specialist can help you achieve your goals.

Understanding Home Financing Costs

Before you make a final decision on the type of financing you're going to use, it's good to know and understand all the costs connected with your financing plan. Costs will vary depending on the type of financing, the loan size, and your individual situation. Here are some costs you may incur if you refinance your first mortgage loan to take cash out:

- **Application Fee**: Depending on the lender, you may be charged an application fee that covers the processing of the loan.
- **Discount Points**: Many lenders allow you to lower the rate on a loan by paying points up front. Each point is equal to roughly 1% of your total loan amount. The more points you pay, the more you can reduce the interest rate on your loan.
- **Title Search And Title Insurance Fee**: This covers the cost of going through public records to determine the precise ownership of your property. The insurance fee protects you and the lender if somebody disputes the legality of your ownership in the future. Your lender will recommend a title company in your area, or you can select your own.

Appraisal Fee: This covers the cost of hiring the professional appraiser mentioned earlier in the guide.

- **Flood Certification Fee**: This fee covers the expense of determining whether your property is located in a designated flood zone. If it is, your lender will require you to purchase a flood insurance policy.
- **Loan Origination Fee**: Your lender may charge this fee to cover the costs of evaluating, processing, and preparing your loan.

Shortly after applying for your loan, you'll receive a Good Faith Estimate that details the costs associated with your loan. Because these costs can change based on your closing date and loan parameters, your lender will need to give you a final list of costs shortly before closing.

Home Equity Loans And Lines Of Credit

Examples for accessing your home's equity are the home equity loan and the home equity line of credit.[8] A home equity loan allows you to borrow a set amount up front in one lump sum, without refinancing your primary mortgage. It's ideal for a one-time planned purchase or expense. With a home equity line of credit, you can draw against your equity as needed up to your credit limit without reapplying. Here's a comparison of the two options:

Home Equity Loan
Receive a one-time lump sum.
Borrow up to 95% of the available equity (CLTV).[9]
Fixed interest rate and term.
Pay principal and interest on the full amount whether or not you have used the funds.

Home Equity Line Of Credit
Draw available funds as needed.
Borrow up to 95% of the available equity (CLTV).[10]
Variable interest rate.
In most product types, you only make repayments on the funds you actually use. Low monthly payment options are available, you pay interest only on the outstanding balance.

Home equity financing programs also have low or no closing costs depending on the program you select and your state's tax recording policy. If you're considering one of these home equity options, here are a few things to keep in mind:

- Depending on the market, you may pay a higher interest rate on a home equity loan or line of credit than on your primary mortgage loan.
- The home equity loan or line of credit is an additional lien on your property.

Refinance and Renovate

Talk with your home mortgage consultant. If a home equity option isn't right for you, they'll help you explore other options.
For instance, it's common for homeowners to discover that the cost of their proposed home improvements exceeds the amount of equity they have available to them. Instead of cutting back on your improvements, you could look into a loan offering another option.

While most financing is based on your home's current value, a renovation loan amount is based on the future value of your home after improvements (speak with your lender for loan options available). So let's say your home's value
is $275,000, and your current mortgage is $235,000. That limits you to $40,000 in accessible funds — tops. If, you're planning major renovations — a remodeled kitchen, a third bathroom, and a fully expanded second floor, for example — you may actually need $75,000.
A renovation loan can get it for you if you can demonstrate that the improvements justify the larger loan amount. If you're approved for the loan, there are two stipulations:

1) The funds can only be used for home improvement.
You must hire a licensed contractor to manage the work.

Cash Out Refinancing

What Is It?

In simple terms, *cash out refinancing* means replacing your current mortgage with a bigger one that:

1) Pays off your current mortgage.
2) Uses your home's equity to provide additional funds for other purposes.

Let's say you want to add $20,000 in upgrades to your kitchen. Your home is worth $180,000, and you owe $100,000 on your mortgage. That gives you $80,000 of equity. Let's also say that interest rates have dropped to such an attractive level that you've been thinking about refinancing to get a lower rate.

By refinancing your loan for $120,000 instead of just the $100,000 you still owe, you could get a lower interest rate and the $20,000 you need for your kitchen upgrades. The lender can justify giving you that extra $20,000 dollars because you have four times that amount in equity backing up your ability to repay. And even though your total mortgage amount is higher, refinancing to the lower interest rate may actually lower your payments or keep them the same as before.

When To Consider Cash Out Refinancing Over Other Options

How do you know if cash out refinancing is the right move? There's no hard-and-fast answer to that question, but refinancing is probably worth looking into when any of the following "if"

situations apply:

- **If Interest Rates Have Dropped Substantially Since The Last Time You Financed Your Home**: Depending upon your loan amount, a good rule of thumb is to consider refinancing if current interest rates are at least 0.5% lower than the rate on your current mortgage. However, to fully offset your closing costs, you may want to wait until rates have dropped by a full 1 % or more.
- **If You Intend To Stay In Your Home for Several More Years**: The longer you're planning to stay in your home, the more likely it is that refinancing will pay off.
- **If You Can Shorten Your Loan Term**: Shortening your loan term can help you build equity faster and help you pay less in interest over the long term. Mortgage loan terms range from 10 years to 40 years.

Important Questions to Think About

With cash out refinancing, you need to weigh the benefit of what you're going to use the money for against the amount of time it'll take to pay off the loan. Here are some things to think about:

- **What Are The Interest Rates?** The interest rate charged on the loan will dictate much of the cost of the loan. On a cash out refinance, you want to get an interest rate equal to or less than your current financing. Otherwise, it may make sense to look into a home equity loan or line of credit instead.
- **How Much Cash Do You Need?** Refinancing your first mortgage to take cash out is generally best for large sums of money that require a longer period of time to repay or when you can significantly reduce your current interest rate. While you can select a term of anywhere from 10 years to 40 years, determining your loan amount also involves carefully weighing the total amount you'll have to repay after factoring interest into the equation. The longer you take to repay the loan, the more total interest you'll pay.
- **What's The Monthly Payment Amount?** If taking cash out will raise your monthly payment, look carefully at how the new amount could affect your overall budget. Don't borrow more than you can comfortably repay.
- **What's The Effect On Your Taxes?** The interest you pay for home financing is almost always tax deductible.[11] Make sure you factor any potential tax deduction into determining whether a cash out refinance will be more cost effective than other types of financing (credit card, personal loan, auto loan, etc).
- **What's The Total Cost Of Borrowing?** Take a look at how much it will cost you to obtain your financing. This includes closing costs, fees, additional interest charges, and any other charges that may be associated with your loan (e.g. appraisal, title search).
- **What's Your Break-Even Point?** Once you get a clear idea of all the financial obligations involved in refinancing, you'll want to determine your break-even point. At what point will you start to come out ahead? For instance, if it's going to take you 36 months to break even, and you plan to move in two years, you probably shouldn't consider a cash out refinance. It's a fairly complicated calculation, but your Mortgage consultant can help you do the math.

Applying For Your Loan

Your home mortgage consultant will sit down with you and walk through the application process. It is a simple interview, and most of the information you'll need can be taken straight from your credit report. The amount you'll actually need to provide on your own isn't overwhelming.

Depending on the type of loan program you need, your credit, and the size of your requested loan in relation to your income and home's value, the documentation you'll be required to produce can vary.

What Happens Next

After collecting the information needed to process the loan, your Mortgage specialist will send you a commitment letter detailing any additional documentation or other requirements you'll need to meet should your loan be approved. At the same time, the mortgage consultant will order an appraisal, if one is required. At this point, you'll have the option to lock
in your interest rate range on the first mortgage. Discussing these options with your home mortgage consultant is important.

Floating The Rate: You've applied for your first mortgage loan but you've also decided to wait before committing to your loan pricing, perhaps because you think interest rates stand a chance of going down in the short-term. Your first mortgage can stay in a float status up until five days before closing, in most cases. During any float period, you can stay up to date on interest rates by contacting your home mortgage consultant.

Locking In: You and your first mortgage lender commit to an interest rate range for a specified period of time — from 30 to 120 days. During that period, your interest rate range is protected. If you close on the first mortgage during that period, you get the interest rate within that range. If you go beyond the lock-in period without closing, your loan may revert to a "float" status and be priced again based on current market interest rates. The interest rate range you get may be lower, higher, or equal to your lock-in rate, so it's very important to discuss all these options and possibilities with your home mortgage consultant.

There are also some reasons why an interest rate range could change even during a lock-in period. For instance, a change in your credit profile could occur, you might decide to change your down payment, or you might change your mind on how many discount points you want to pay.

Whether you decide to lock or float, you'll be taking a calculated risk. It's an important decision, and you're the only one who can make it. Talk with your home mortgage consultant to get an idea of what interest rates have been doing recently.

Rebuilding the Equity In Your Home

As you access home equity financing, you'll want to think about how you're going to rebuild your equity share, so you have it available should you need it again. Here are two tips on how you could rebuild equity.

- **Shorten The Term Of Your Loan**: If you haven't already secured your term, and you want to rebuild your equity, one of the best things you can do is to shorten the length of your loan. Not only do you pay off the entire loan in fewer years, you also start paying more toward principal sooner than with a long-term loan. Making principal payments adds directly to your equity. Just keep in mind that by shortening the term of your loan you'll be increasing the amount of your monthly payment, possibly significantly. Beware in some limited circumstances, paying the loan before the end of the term could result in prepayment penalties.
- **Make Extra Payments On Your Current Mortgage Loan**: Making just one extra payment a year cuts the principal amount you owe on your loan and reduces the amount of interest you'll pay over the life of the loan. It's a great money-saving strategy. If you're concerned that you're not disciplined enough to make those extra payments happen on your own, speak with your mortgage specialist for advice.

Glossary[12]

Adjustable-Rate Mortgage (ARM) – A mortgage in which the interest rate is adjusted periodically according to a preselected index.

Alternative Financing – A home financing program that accommodates borrowers with special qualifying factors, including poor credit histories.

Annual Percentage Rate (APR) – A yearly percentage rate that expresses the total finance charge on a loan over its entire term. The APR includes the interest rate, fees, points, and mortgage insurance, and is therefore a more complete measure of a loan's cost than the interest rate alone. The loan's interest rate, not its APR, is used to calculate the monthly principal and interest payment.

Appraisal – A report made by a qualified person setting forth an opinion or estimate of property value. The term also refers to the process by which this estimate is obtained.

Appreciation/Depreciation – "Appreciation" refers to the increase in a property's value, except for inflation. When a property decreases in value it is called "depreciation."

Assessed Value – The value that a taxing authority places on real or personal property for the purpose of taxation.

Automated Underwriting – A computerized method of reviewing home mortgage applications for loan approval.

Capital Gains – Used for tax purposes, this is the capital gain you make when you sell your home. For example, if you purchase a property for $100,000 and sell it some years later for $150,000, your capital gain is $50,000.

Closing – The consummation of a real estate transaction. The closing includes the delivery of a deed, financial adjustments, the signing of notes, and the disbursement of funds necessary to complete the sale and loan transaction.

Closing Agent – Usually an attorney or title agency representative who oversees the closing and witnesses the signing of the closing documents.

Closing Costs – The costs paid by the mortgage borrower (and sometimes the seller) in addition to the purchase price of the property. These include the origination fee, discount points, appraisal, credit report, title insurance, attorney's fees, survey, and prepaid items such as tax and insurance escrow payments.

Commission – Compensation for negotiating a real estate or loan transaction, often expressed as a percentage of the selling price or loan amount.

Commitment Letter – A formal offer by a lender stating the terms under which it agrees to loan money to a homebuyer.

Comparable Market Analysis (CMA) – A written analysis of houses having similar characteristics currently being offered for sale as well as comparable houses sold in the past six months. This enables you to determine if you are paying market value for a home, and to identify whether market prices are rising or falling.

Contingency – A condition that must be met.

Conventional Loan – A mortgage not obtained under a government insured program (such as FHA or VA).

Credit Report – A report detailing an individual's credit history.

Debt-To-Income Ratio – A formula lenders use to determine the loan amount for which you may qualify. Also known as the "back-end ratio." Guidelines may vary, depending on the loan program.

Deed – The legal document conveying title to a real property.

Default – The failure to perform an obligation as agreed in a contract.

Down Payment – Money paid to make up the difference between the purchase price and the mortgage amount.

Equity – The ownership interest; i.e., portion of a property's value over and above the liens against it.

Escrow – An item of value, money or documents, deposited with a third party, to be delivered upon the fulfillment of a condition. For example, the deposit by a borrower with the lender of funds to pay taxes and insurance premiums when they become due, or the deposit of funds or documents with an attorney or escrow agent to be disbursed upon the closing of a sale of real estate. In some parts of the country, escrows of taxes and insurance premiums are called impounds or reserves.

Fixed-Rate Mortgage – A mortgage in which the interest rate and payments remain the same for the life of the loan.

FICO Score – A numerical rating developed and maintained by Fair Isaac and Company that indicates a borrower's creditworthiness based on a number of criteria.

Float The Rate – This term is used when a mortgage applicant chooses not to secure a rate lock, but instead allows the note rate pricing to fluctuate until the applicant decides to lock in, usually no later than five days prior to closing.

Foreclosure – A legal procedure in which property mortgaged as security for a loan is sold to pay the defaulting borrower's debt.

Front-End Ratio – Also known as the housing expense-to-income ratio, it compares your proposed monthly house payment (PITI) to your total household gross monthly income.

Good Faith Estimate – A document which tells borrowers the approximate costs they will pay at or before settlement, based on common practice in the locality. Under requirements of the Real Estate Settlement Procedures Act (RESPA), the mortgage banker or mortgage broker, if any, must deliver or mail the GFE to the applicant.

Government Loan – A mortgage insured by a government agency, such as FHA, VA, Farmers Home Administration or a state bond program. The loans are generally made by private lenders, such as Wells Fargo Home Mortgage.

Home Mortgage Consultant – The Home Mortgage representative a homebuyer initially consults about a mortgage loan. Sometimes called a loan officer, account executive, or sales representative.

Homeowners Insurance (also called Hazard Insurance) – A real estate insurance policy required of the buyer protecting the property against loss caused by fire, some natural causes, vandalism, etc. May also include added coverage such as personal liability and theft away from the home.

HUD-1 Settlement Statement – A standard form used to disclose costs at closing.

Index – A published interest rate, such as the prime rate, LIBOR, T-Bill rate, or the 11th District COFI. Lenders use indexes to establish interest rates charged on mortgages or to compare investment returns. On ARMs, a predetermined margin is added to the index to compute the interest rate adjustment.

12. The terms in this glossary refer to your primary mortgage loan and do not necessarily apply to your home equity loans and home equity lines of credit.

Interest Rate – The percentage of an amount of money which is paid for its use for a specified time.

Interim Interest – The interest that accrues, on a per diem basis, from the day of closing until the end of the month.

Leverage – Using credit or borrowed money to increase the rate of return from an investment. For example, by purchasing a $100,000 home with 10% down, you are using just $10,000 to control the investment.

Lien – A legal claim or attachment against property as security for payment of an obligation.

Loan Conditions – These are terms under which the lender agrees to make the loan. They include the interest rate, length of loan agreement, and any requirements the borrower must meet prior to closing.

Loan Payment Reserves – A requirement of many loan programs that, in addition to funds for the down payment and other purchase-related costs, you have saved enough money to cover one or two months of mortgage payments after your closing.

Loan Settlement – The conclusion of the mortgage transaction. This includes the delivery of a deed, the signing of notes, and the disbursement of funds necessary to the mortgage loan transaction.

Loan-To-Value (LTV) – The ratio between the amount of a given mortgage loan and the lower of sales price or appraised value.

Margin – The set percentage the lender adds to the index rate to determine the interest rate of an ARM.

Mortgage – The conveyance of an interest in real property given as security for the payment of a loan.

Mortgagee – The lender on a mortgage transaction.

Mortgage Insurance (MI) – See Private Mortgage Insurance (PMI).

Mortgage Specialist – The Home Mortgage employee responsible for collecting the completed application and all supporting documents before the entire loan packet is submitted to underwriting. Also known as a processor.

Mortgagor – The borrower in a mortgage transaction who pledges property as security for a debt.

Nonconforming Loan – Conventional home mortgages not eligible for sale and delivery to either FNMA or FHLMC because of various reasons, including loan amount, loan characteristics, or underwriting guidelines.

Note – A general term for any kind of paper or document signed by a borrower that is an acknowledgment of the debt, and is, by inference, a promise to pay. When the note is secured by a mortgage, it is called a mortgage note and the mortgagee (lender) is named as the payee.

Origination Fee – The amount charged for services performed by the company handling the initial application and processing of the loan.

Points – A one-time charge by the lender to increase the yield of the loan; a point is 1% of the amount of the mortgage.

Prepaids – Closing costs related to the mortgage loan which are collected at loan closing — including per diem prepaid interest and initial deposits of monthly escrows of taxes and insurance.

Principal – The amount borrowed or remaining unpaid; also, that part of the monthly payment that reduces the outstanding balance of a mortgage.

Private Mortgage Insurance (PMI) – Insurance written by a private company protecting the mortgage lender against loss resulting from a mortgage default.

Processing – The preparation of a mortgage loan application and supporting documentation for consideration by a lender or insurer.

Rate Cap – The limit of how much the interest rate may change on an ARM at each adjustment and over the life of the loan.

Rate Lock – The borrower and the lender agree to protect the interest rates, points, and term of the loan while it is processed.

Truth-In-Lending Statement – A Federal law requiring full disclosure of credit terms using a standard format. This is intended to facilitate comparisons between the lending terms and financial institutions.

Underwriting – Analysis of risk, determination of loan eligibility, and setting of an appropriate rate and terms or