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Business**101**

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Home equity

The sentiment "A man's home is his castle" goes back hundreds of years.

Today, we might be more likely to say, "A man's home is his bank."

(We might also do something about that "man" thing, since the percentage of home buyers who are single women has soared in recent years, to about 20 percent last year. But back on topic …)

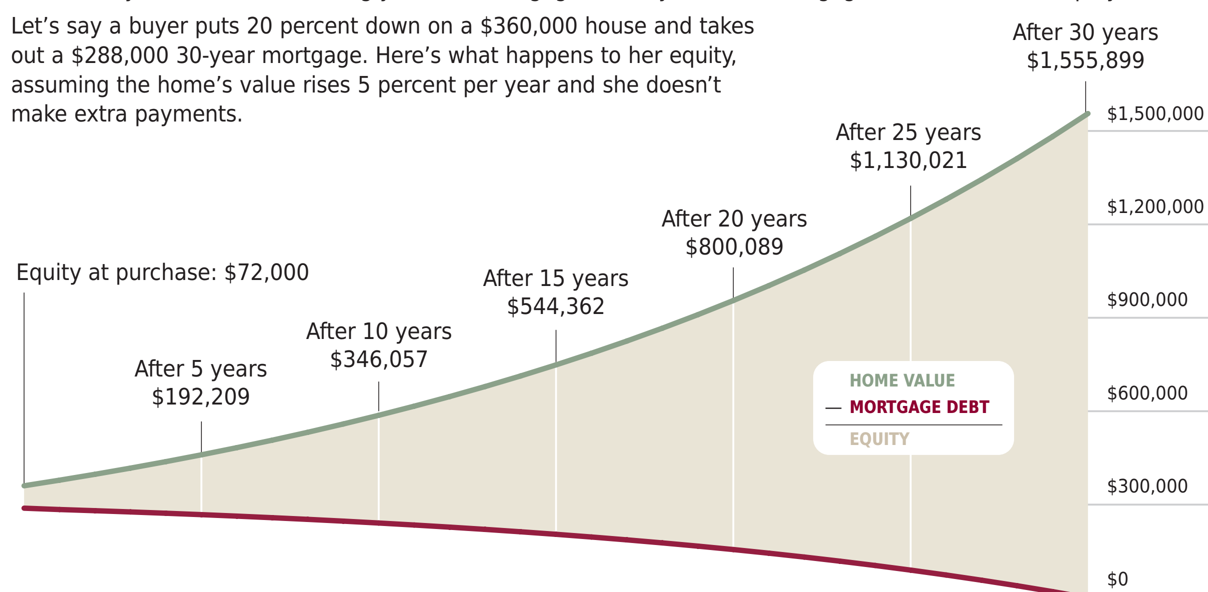
Homeowners these days look at their homes as giant piggy banks. Between home-equity borrowing and cash-out refinancing alone, homeowners took almost $500 billion in equity out of their homes last year. And the trend is likely to continue.

Before you start dreaming about that new kitchen, here's a primer on home equity.

What equity is . . .

Equity is your ownership interest in your home — the difference between what you could sell the property for and how much you owe on it (including your first mortgage and any "second mortgages," such as home-equity loans).

Let's say a buyer puts 20 percent down on a $360,000 house and takes out a $288,000 30-year mortgage. Here's what happens to her equity, assuming the home's value rises 5 percent per year and she doesn't make extra payments.



. . . and how to build it

There are basically two ways to build your ownership stake:

Pay down the principal: Every dime you pay toward principal — the original loan amount, not including interest — increases your equity. So, you can add a little money to your mortgage payment every month. That's not going to do much for you, at least not quickly. And there's a good argument to be made that you could invest that money better elsewhere.

Wait for the rising tide: Most folks simply do nothing — they just wait for rising home prices to increase the value of their house. It's a reliable strategy: Since 1989, the median home price in New Jersey has risen an average of 5 percent per year; since 1999, it has been 10.6 percent per year.

When should you tap it?

There's good debt, and there's bad debt.

In general, good debt builds value, whether you're paying for an addition on the house or a college education for your kids. Some good debt helps you make money (a rental property that brings in income and gives you a tax deduction) or save money (paying off high-interest credit-card bills with a loan that gives you a tax deduction).

Bad debt is just money poured down the drain — putting dinner on a credit card and not paying it off.

You should try to tap your home equity only if it's good debt. Otherwise, you're frittering away the best investment you may ever make — your home.

Assuming you're not blowing your home-equity money on a sweet new video-game system, the pros usually outweigh the cons. But the biggest con is very big.

PROS

- In most cases, the interest you pay is deductible on loans up to $100K.
- Interest rates are lower than many other loans, especially credit-card debt. The chart below shows current rates, for comparison.
- You can use the money for anything, including keeping it on hand for emergencies.

CONS

- You're putting your home on the line. This is the biggie. If you default on a home-equity loan or line of credit, you could lose your house.
- You're spending the equity you have in the house, which can be especially precarious if you are nearing retirement.
- Interest rates on home-equity lines of credit are variable, and with rates rising, that loan is only going to cost you more as time goes on.
- If the value of your home drops, you can end up owing more than the house is worth.
- You may not be able to rent out your home for the duration of the loan.

Prevailing rates yesterday

	FIXED	VARIABLE
Mortgages		
30-year	5.91%	–
15-year	5.58%	–
5/1 ARM	–	5.53%
Home equity		
$30,000 loan	7.88%	–
$50,000 loan	7.83%	–
$30,000 line of credit	–	6.63%
$50,000 line of credit	–	6.92%
Personal bank loans		
48-month new car	6.51%	–
36-month used car	7.32%	–
Education	7.91%	–
Credit cards		
Standard	12.94%	13.77%
Gold	11.21%	12.87%
Platinum	10.07%	13.11%

Four ways to get cash out of your house — without selling it

Costs

All of these loans are mortgages, and as such, they carry many of the same costs as closing on a new home, including:

- Property appraisal ($150-$300), which helps determine how much equity you have in the house — and therefore how much you can borrow against it.
- Application fee ($250-$500), which may not be refunded if you are turned down.
- One or more points, which typically bring down the interest rate on the loan a bit. One point equals 1 percent of the loan; on a $30,000 loan, one point would cost $300.
- Other closing costs, such as attorney's fees and title search (up to $1,000)

Some of these fees may be waived, but be careful — you may pay a higher interest rate, or the fees could just be added to the loan amount.

Home-equity loan

How it works: The borrower gets a lump sum at the start of the loan and pays it back during a specified period of time. The interest rate typically is fixed, which is why the rate for a loan is higher than the rate for a credit line, which is usually variable.

How you pay it back: Like a mortgage or car loan, monthly payments are determined when you take out the loan. If you want to pay it back faster, you can make additional payments on the principal.

Best if: You have a one-time expense coming up, such as renovating the kitchen or consolidating credit-card debt.

Home-equity line of credit

How it works: It's like a credit card, only you're using your home as collateral. You arrange with a bank to have a credit available up to a certain amount for a certain period of time — say, $30,000 for 10 years. You use only what you need, and you repay it as you go. So, if you use $10,000 of that $30,000 credit line, then pay back $5,000, you still have $25,000 in credit available. You access the money with special checks or a credit card. The interest rate is typically variable, but there are limits on how high it can climb.

How you pay it back: Some plans require you to make minimum monthly payments that include both interest and a little bit of principal; others require you to pay interest only. If you go that route, you will have to pay back the principal — the original amount you spent — at the end of the loan. Either way, you have to repay the entire amount, including interest, when the credit line expires. If you don't have the cash, you can do that by refinancing or getting a new loan from a different lender.

More fees: In addition to the usual costs, you may be charged other fees, including a maintenance fee of up to $100 a year, transaction fees each time you tap the credit line and inactivity fees if you don't use it regularly.

Best if: You need the money a little bit at a time — say, while your children are in college.

Cash-out refinancing

How it works: Let's say you want to refinance your mortgage at a lower interest rate, or lock in a fixed rate now that old adjustable-rate loans are going up. Plus, you need some cash to pay off the boat or buy a vacation home. You can refinance your mortgage for more than you owe on the house, and put the difference in the bank. For instance, if you owe $200,000 on a house that's now worth $400,000, you could refinance $250,000 and pocket the extra $50,000.

How you pay it back: Like any mortgage, you make fixed monthly payments.

Best if: You can get a 15-year loan and some cash back for a lower monthly payment than you're making now. If you get another 30-year loan, you will be making payments on that wedding or new kitchen for 30 years — and that's a lot of interest payments.

Reverse mortgage

How it works: A reverse mortgage is just what it sounds like: Instead of paying the bank, the bank pays you. Instead of building equity, you are spending it. But you still own the house. How much you can get depends on your age, the value of your home and prevailing interest rates, but the government-imposed loan limit is about $360,000 in most of New Jersey. You can choose a monthly cash advance, a credit line, or some combination of the two.

How you pay it back: The loan comes due when your home is no longer your primary residence — if you sell it, move out permanently or the last surviving borrower dies. You or your estate must then repay the total funds received and the initial fees and closing costs, plus interest.

Best if: You have to be at least 62 years old, and you should plan to stay in your home for a long time. That's because these loans are expensive — if you get the maximum loan of about $360,000, the origination fee alone would be $7,200. If you only need the money for a few years, it's too expensive. Finally, you will no longer own the home free and clear, so it's best if you're not concerned with leaving the house to your heirs debt-free.

For more information: Reverse mortgages are a lot less common — and a lot more complicated — than the other options addressed here. For more information, start at AARP, which offers a free consumer guide, "Home Made Money: A Consumer's Guide to Reverse Mortgages." You can download the guide online at www.aarp.org/money/revmort, or call (800) 209-8085 for a copy.

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SOURCES: Bankrate.com; AARP; National Association of Realtors; Moody's Economy.com; Motley Fool