Successful HOMEOWNERSHIP

Leader's Guide

MoneyWI$E

A CONSUMER ACTION AND CAPITAL ONE PARTNERSHIP

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Introduction

Buying a home is a major achievement. But successful homeownership does not begin and end when the closing documents are signed. This MoneyWi$e Leader's Guide, created by the national non-profit organization Consumer Action and its Housing Information Project in partnership with Capital One, will prepare you to teach prospective, new and established homeowners what they need to know to be successful at homeownership.

The guide, which is part of a series of MoneyWi$e publications on sustainable homeownership, covers such topics as the financial responsibilities of homeownership and how to better manage them, how to maintain and protect your property, and how to build and preserve your equity—all important steps on the path to successful homeownership.

The Successful Homeownership series also includes a multilingual companion brochure, "Keeping Your Home" (available in Chinese, English, Korean, Spanish and Vietnamese); a lesson plan for classes and seminars; PowerPoint slides (in English and Spanish); and class activities. For information, visit the MoneyWi$e website (www.money-wise.org) or call Consumer Action at 800-999-7981. Our Housing Information website is at www.housing-information.org.

Successful homeownership

What is "successful homeownership"?

Successful homeownership means being able to enjoy the comfort, security and financial rewards that buying a home can offer, for as long as you choose to stay in the property.

There are many steps on the path to successful homeownership, including:

- purchasing the right property for you and your family, at a fair price;
- choosing a mortgage from a reputable lender;
- borrowing only the amount you can comfortably afford to repay;
- understanding and meeting all the terms of your loan agreement;
- being aware of, and prepared for, the costs of homeownership;
- knowing how to manage and, where possible, reduce these costs;
- designing and following a budget that keeps you on track and enables you to achieve your goals;
- keeping your home in good condition through routine maintenance;
- being financially prepared for emergency repairs and major maintenance projects;
- understanding your tax responsibilities, and taking advantage of tax deductions;
- protecting your home with sufficient insurance coverage;
- making upgrades that enhance your enjoyment of the property and provide a good return on your investment;
- preserving the equity in your home; and
- avoiding foreclosure by getting assistance at the first sign of money troubles.

What are the barriers to successful homeownership?

Buying a home you cannot afford is one of the main barriers to suc-

cessful homeownership. If you cannot make the monthly mortgage payments as promised, the lender can repossess your home.

Choosing a loan that is set at a very low introductory rate and payment, but that will increase significantly down the road, can also set you up for failure.

Tapping your equity to make lavish home improvements or to live a lifestyle you cannot afford (new cars, dinners out, extensive travel, etc.) is another sure way to put your home at risk. Do not use your home as an ATM!

Not keeping up with the property taxes and insurance premiums also can put your home in jeopardy. And, not performing routine maintenance or making needed repairs can bring down the value of your home and make it difficult to sell.

Perhaps the biggest barrier standing between homebuyers and successful homeownership is a phone call: Homeowners who are experiencing money troubles greatly increase their chances of keeping their home by contacting a housing counseling agency or other assistance program for help. The sooner you call, the more options you will have for getting back on track and saving your home from foreclosure.

Managing the costs of homeownership

What are the risks in buying a more expensive home than I can afford?

Buying a property that is more expensive than you can comfortably afford can create a great deal of stress as you struggle to make the payments. In the worst-case scenario, the lender could repossess (foreclose on) your home if you are not able to make the monthly payments as agreed.

Remember, just because you qualify for a loan doesn't mean you can afford it. The housing crisis that began in 2007, which resulted in massive foreclosures, was due in great part to lenders approving loans that buyers couldn't afford, and buyers accepting them.

The best way to ensure successful homeownership is to purchase a

home that fits your current budget. As your finances improve, you may be able to afford a larger home with more amenities.

What are the costs of homeownership?

Downpayment. Typically, buyers put 3% to 20% down and finance the rest with a mortgage. Some loan programs allow buyers to put nothing down.

Closing costs. Closing costs can amount to 3% to 6% of the mortgage. On a $200,000 mortgage, that is a cost of $6,000-$12,000.

Mortgage payment. Your monthly mortgage payment will depend on the amount you borrow, the interest rate, and whether or not you are paying interest only or interest and principal. If you take out an adjustable rate mortgage (ARM), your payment will fluctuate over time.

PMI. If you put less than 20% down, it is likely that you will have to pay private mortgage insurance (PMI). PMI protects the mortgage lender against financial loss if you stop making your payments. The PMI premium, which typically is between .5% and 1% of the loan amount annually, is added to your monthly mortgage payment. (For example, if you borrowed $150,000 and PMI is 1%, you would pay $1,500 per year, or $125 per month.)

Property taxes. Property taxes are based on the price you pay for the property. On average, property taxes are about 1.5% of the purchase price of the property per year, but the exact rate varies widely by area. Find out what the property taxes will be on any home you are considering buying.

Insurance. Your homeowners insurance premiums will depend on many factors, including square footage of the home, the type of construction, and location. If you are in a flood zone, you will have to factor in that cost as well. The most accurate way to plan your costs for insurance is to ask an agent.

HOA dues. If you buy a condominium, a townhouse, or even a home in certain developments, you may have to pay mandatory homeowners association dues. The dues are used to maintain common areas and features, such as landscaping. Find out before committing to a

property if there are HOA dues, how much they are, and what they cover.

Repairs and maintenance. As a general rule, you can expect to spend about 1% of the purchase price of your home per year on maintenance and repairs. A $240,000 home, for example, would cost around $2,400 a year, or $200 a month, to maintain. Emergency repairs are more difficult to anticipate and will depend, to some extent, on how old the home and systems are when you purchase the property.

Miscellaneous. This includes expenses such as furniture and capital improvements (installing a swimming pool, adding a bathroom or putting in a garden, for example). You should plan and save for these purchases rather than paying for them on credit.

How can I reduce or better manage my homeownership costs?

Here are some tips for reducing your costs or, at least, making them easier to manage:

- Once you have at least 20% equity in the property, you can request that PMI be cancelled.
- If you are not required to pay your property taxes and insurance monthly through an impound (or "escrow") account, you will have to pay these bills in a lump sum annually or semi-annually. *(For more information, see the "Understanding your tax benefits and responsibilities" section.)* To make it easier, create your own impound account by putting one-twelfth of your annual property taxes and insurance premium in a savings account. (Your insurance company may allow you to set up a monthly payment plan, but it will likely charge a fee for the service.)
- Shop around for the best insurance rates. Consider increasing your deductible. And make sure you're getting all the discounts you're eligible for. *(See "Insuring your investment" for more information.)*
- Set up a maintenance fund and put away at least one-twelfth of 1% of the purchase price each month to be available for upkeep and emergency repairs. Remember, prevention is the key to saving money on home repairs.

- Take advantage of all tax deductions available to you. They can reduce your overall annual cost of homeownership and improve your monthly cash flow, making it easier for you to pay your mortgage and other homeownership expenses. *(See "Understanding your tax benefits and responsibilities" section for information.)*
- Design a budget that accounts for all the monthly and annual costs of homeownership (taxes, insurance, maintenance and so on) as well as contributions to an emergency fund.

How do I make a budget?

A realistic budget is crucial to successful homeownership. It shows you what you can afford, where you can make changes in your spending, and how to achieve your financial goals.

Here are some tools for creating your budget:

- Mint.com is a free, secure online tool that allows you to download all your financial information from your bank and then track and categorize your spending. Mint will create a budget for you based on your spending habits. It also has a tool that compares your spending in specific categories, like groceries, with local and national trends.
- Another tool for those who prefer to manage their finances online is mvelopes.com. The program allows you to create a budget, track your spending, and always know exactly how much you have left to spend in various categories.
- All credit counseling services provide budget worksheets and counseling to consumers and clients. Find a credit counseling agency online at the National Foundation for Credit Counseling (www.nfcc.org). Then download a budget form or ask to have one sent to you.

How big should my emergency fund for living expenses be?

It's sensible to save at least six months' worth of living expenses, including your mortgage, insurance, taxes, and necessities such as food, utilities and transportation costs. In an unstable economy, however, it might make sense to budget for a year's worth of living expenses, just in case you lose your job or have other unforeseen expenses.

Start a savings plan to build up your emergency fund with monthly automatic transfers from your checking account into a dedicated "emergency" savings account.

How do I avoid accumulating too much non-mortgage debt?

Here are some ways to avoid getting deep into debt and jeopardizing your ability to stay on track with your mortgage and the other expenses of owning a home:

- Use cash or a debit card to purchase everyday items such as groceries, gasoline, clothes and restaurant meals. A debit card provides many of the conveniences of credit, but the money you spend comes out of your checking account immediately, so you can't build up debt.
- If you choose to take advantage of a rewards-type credit card to make everyday purchases, be sure you pay the balance in full each month.
- When you want to make a large purchase—a television or a piece of furniture, for example—wait until you have saved enough money to buy it. That way, even if you use a credit card to make the transaction, you will be able to pay the bill in full and avoid finance charges.

What are some strategies I can use to curb impulse buying?

The greatest enemy to your monthly budget is the impulse purchase. If you're in a store or shopping online, the forces of advertising and marketing are sometimes too powerful to overcome. But you can beat them with a few simple strategies:

- Write down what you need every month and limit your spending to those items.
- Plan and save for major purchases.
- Unless you need to make a specific, planned purchase, stay out of the stores and away from your favorite retail websites.
- Keep your goals in mind—visualize them when you are tempted to break your budget.

Understanding your tax benefits and responsibilities

What taxes do I have to pay on my home?

When you own a home, your local government (typically through the county tax collector's office) sends you an annual or semi-annual bill for property taxes. Your taxes are typically based on the value of the property—on average, about 1.5% of the purchase price per year. But, because the exact rate varies widely by area, it's important to ask for a calculation of the property taxes on any home you are considering buying.

There may also be some additional fees and assessments on properties in your county, which will increase your tax bill a bit.

If you make a small down payment (typically defined as less than 20% of the purchase price), many lenders insist that you pay your property tax and insurance through an impound (or "escrow") account. These accounts require you to pay your property taxes and insurance to the lender each month along with your mortgage payment. The lender will use that money to make the lump sum payments to the tax collector and insurance company when those bills come due.

Though some buyers do not like having to pay their taxes and insurance through their lender each month, escrow accounts can make it easier to budget because you don't have to make any large, lump-sum payments.

What will happen if I don't pay my property taxes?

It's very important that you pay your property taxes in full and on time. Late payments typically incur a significant late fee. And unpaid taxes can result in a lien being placed on your property. A lien means that your taxes must be paid first out of any proceeds when you sell your property. The lien amount will include delinquent taxes and any fees and penalties that have been assessed. Liens will appear on your credit report and will hurt your credit score.

In the worst-case scenario, the county or other lienholder could force the foreclosure or sale of your home.

What are the tax benefits of owning a home?

There are a number of tax benefits available for homeowners who itemize their deductions (Schedule A) on their tax returns. These tax breaks reduce the amount of federal and state taxes you must pay, making buying and owning a home more affordable.

Points. You may be able to deduct any "points" you paid for the purchase of your home. (A point, also called an origination fee, mortgage broker fee or discount fee, equals 1% of the total loan amount.) On a "purchase money" mortgage (one used to buy a home rather than refinance it), the points you pay are fully deductible in the year that you purchased the home. On refinance loans, you must deduct the points over the life of the loan. If you paid $3,000 in points on a 30-year mortgage, for example, you can deduct $100 ($3,000 divided by 30) annually.

Mortgage interest. The interest you pay on your mortgage every month is tax deductible. At the end of the year, you will receive a Form 1098 from your lender showing the amount of interest you've paid.

If your lender charges you a prepayment penalty for paying off your old mortgage early, this charge is also deductible as mortgage interest.

If you received a mortgage credit certificate from a state or local governmental agency, you can claim a tax credit (more valuable than a deduction) for mortgage interest.

If you have a second mortgage on your home, you may qualify for a tax deduction on the interest if the loan is less than $100,000 and the total of your two loans does not exceed the value of your home. If the combined loan amounts are greater than the value of your home, you may still qualify for a deduction if you can prove that the loan money was used for home improvements. Consult a tax professional for guidance.

PMI premiums. The premiums for private mortgage insurance are deductible through at least the 2013 tax year. The tax deduction is available on loans for personal residences or non-rental second homes. The loan must have originated on or after Jan. 1, 2007. The

deduction is allowed for both purchase-money and refinance mortgages, but PMI paid for the cash-out portion of a refinance may not be deductible—consult your tax professional. The deduction begins being phased out when your adjusted gross income (AGI) is more than $100,000. This applies to single, head of household and married filing jointly taxpayers. The phaseout begins at $50,000 AGI for married persons filing separate returns. The deduction disappears completely for most homeowners whose AGI is $109,000 (or $54,500 for married filing separately taxpayers).

Property taxes. Homeowners can deduct their property taxes. To find out what you are paying, look on your monthly mortgage statement (if your taxes and insurance bills are paid through an escrow account), take the figure from your property tax bills, or get the amount from your county assessor's office.

Other. There may be additional tax write-offs for homeowners who refinance and take "cash out" in order to do home improvements. Consult a tax professional for more information.

How can my tax deduction improve my monthly cash flow?

Because homeowners typically have to pay less federal and state income tax than they did before they bought their property, many buyers can adjust their tax withholding so that they get more money in each paycheck.

For example, if you paid $2,000 in property taxes and $10,000 in mortgage interest, you would be able to reduce your adjusted gross income by $12,000. If you were in the 28% tax bracket, your tax savings would be approximately $3,360 ($12,000 x 28%).

Instead of waiting for a $3,360 tax refund, you could claim more "exemptions" on your W-4 form at work to have fewer taxes taken out of each paycheck. In this example, your pay increase would be approximately $280 per month!

Consult a tax professional for help calculating the proper withholding. Or visit www.irs.gov for more information.

What is my home's tax basis and why is it important?

Your "basis" is your total investment in the property. It includes the purchase price of the home as well as things like closing fees, the cost of title insurance, inspection fees, transfer taxes, and real estate commissions you paid. (These costs appear on the settlement sheet you get in closing.) It also includes utility connection charges.

Your basis increases by the amount you spend on capital improvements, which are those things that add value to your home—a room addition and landscaping are examples. The cost of repairs and regular maintenance does not add to your basis.

Keeping track of your home's basis is important because that number is used to calculate your tax bill when you sell the property. The higher your basis is, the lower your taxable profit will be.

For example, say you are a single homeowner and your basis is $240,000, and you sell your home for $375,000. Your profit is $135,000. In this case, you would not owe any taxes because the first $250,000 of profit is tax-free for single homeowners and the first $500,000 is tax-free for married couples. (You must have lived in your home at least two years to take advantage of this tax break.)

But, say you have a basis of $240,000 and you sell your home for $550,000. Your profit would be $310,000. But your taxable gain would be $60,000 since you do not have to pay taxes on the first $250,000 of profit ($310,000 minus $250,000 equals $60,000). At the 15% rate, the long-term capital gains tax on that profit would be $9,000. Reducing the taxable profit by keeping track of increases in your basis would result in a lower tax bill.

Your adjusted basis is what you paid for the house plus the cost of capital improvements.

Insuring your investment

Why do I need homeowners insurance?

Very few homeowners could sustain major damage to their property and possessions, or be sued, and afford to pay the costs out of their own pockets. Without homeowners insurance, a disaster or lawsuit could leave you homeless and broke.

If your mortgage lender requires that you purchase and maintain homeowners insurance on the property as part of the loan agreement, you must do so. Canceling your coverage, or allowing it to lapse (not paying the premium when it comes due), could put you in default and give the lender the right to foreclose (repossess the property).

Regardless of whether or not your lender requires it, maintain adequate insurance on your property at all times, even after you pay off your mortgage.

What should my homeowners insurance cover?

A homeowners insurance policy should cover the cost of:

- repairing or rebuilding your home at current construction prices;
- replacing your personal possessions;
- living expenses if your home is damaged and you have to live elsewhere during repairs; and
- defending you in a lawsuit, and any damages you must pay. (This coverage protects you when, for example, your dog bites someone, a visitor falls down your stairs, or a tree on your property falls on the neighbor's house or car.)

How much coverage do I need?

The amount of coverage you need depends on many factors, and varies from homeowner to homeowner. The best way to determine how much of each type of coverage you need is to talk to your insurance agent.

Generally speaking, however, you need enough insurance to cover the cost of rebuilding your home at current construction costs. That cost could be more or less than you paid for the home or what you could sell it for today. It is based on local construction costs and building codes, the square footage of your home, and the features and materials it contains. A "guaranteed replacement" policy ensures that your home will be rebuilt even if the cost to rebuild exceeds the amount of your coverage. Some insurance companies will put a cap on the guarantee, such as 120% of the total dwelling coverage.

The coverage for personal property is usually set at a percentage of the dwelling coverage, say 40%, 50% or 60%. To determine if this is enough coverage, conduct a home inventory. Record everything you own and figure out how much it would cost to replace it all. (If possible, take photos or a video and keep them, along with any receipts, as evidence of your possessions. Keep these records in a safe place outside of your home.)

If you think you need more coverage, contact your insurance agent. (It's a good idea to have coverage that guarantees the replacement of personal items, and doesn't just pay their value at the time of loss.)

Coverage for living expenses varies from company to company. Many policies provide coverage for about 20% of the insurance on your house. If you think you need more coverage, talk to your agent. Some companies offer a policy that provides unlimited coverage for a limited length of time. If you rent out part of your house, this coverage reimburses you for loss of rent while your home is uninhabitable.

Liability coverage is part of most homeowners insurance, but the standard amount may not be enough to protect your assets in case of a lawsuit. Generally, you should have enough liability insurance to cover at least two times the value of your assets including your home. If your assets are greater than your liability protection under your homeowners policy, you may want to consider purchasing an excess liability—or "umbrella"—policy.

What doesn't my homeowners policy cover?

A standard homeowners policy does not provide much coverage for expensive jewelry, antiques, collectibles or art. You may have to purchase a "floater" or "endorsement" to achieve adequate protection for these items. There may also be a limit on reimbursement for stolen or destroyed computers.

Otherwise, a standard homeowners policy provides coverage for loss or damage due to theft, fire, lightning, hail and explosions. It does not cover damage from floods or earthquakes, or damage caused by lack of routine maintenance.

Flood insurance is available only from the federal government (www.floodsmart.gov). Earthquake coverage is available from specialty insurance companies or, in California, also through the California Earthquake Authority (www.earthquakeauthority.com).

You may have difficulty finding coverage for certain other disasters, such as hurricanes and wildfires.

How do I know if I need federal flood insurance?

If you are located in a flood zone, your lender will most likely require you to carry flood insurance. Both the U.S. Geological Survey and the Federal Emergency Management Agency (FEMA) offer maps showing earthquake and flood risks.

Where can I compare costs of different insurance policies?

Premiums for equivalent coverage can vary greatly among insurers, so it pays to compare rates. The quickest and easiest way to do that is to go to an online insurance comparison website such as www.LowerRateQuotes.com. To find similar sites, do an online search for keywords "compare homeowners insurance rates."

You can get more information about buying homeowners insurance from the Insurance Information Institute (www.iii.org) and your state's department of insurance. (You can find your state insurance department online at: www.consumeraction.gov/insurance.shtml.) Most state insurance department websites provide useful consumer information about insurance, including which insurance companies have lawsuits filed against them.

It's important to feel confident that your insurance company will be there and able to pay your claim when you need it. You can find information about the financial standing of insurance companies by visiting the website of one of the insurance rating services, such as A.M. Best (www.ambest.com) or Standard and Poor's (www.standardandpoors.com).

How can I reduce my homeowners insurance premium?

You can save money by taking advantage of any discounts the insurance company offers, for things like smoke detectors, alarm systems,

fire extinguishers and so on.

Another way to reduce your premium, sometimes significantly, is by increasing your deductible. This means that you would pay more of the amount of any claim out of your own pocket. For instance, if you have a $500 deductible, you would have to pay the first $500 of damages. Your insurance coverage would not kick in unless your loss was greater than $500.

If you currently have a low deductible of $100 or $250 and you increase it to, say, $500, $1,000 or $2,500, be sure you can handle the increased risk. In other words, only increase your deductible if you set aside that amount of money so it will be available if you need it.

A higher deductible makes more sense these days because insurance companies are more often penalizing customers who file one or more small claims.

Building and preserving your equity

What is equity?

Equity is your ownership in your home. It is the difference between the market value of the property and what you owe on it. For example, if your property is worth $275,000 and you owe $220,000, your equity is $55,000 ($275,000 minus $220,000). Home equity is the main source of wealth for many Americans.

There are two ways to build equity:

Loan repayment. As you pay down your mortgage, you build equity. In the early years of a mortgage, most of the monthly payment goes toward interest, so you build equity very slowly. The amount that goes toward principal (the amount you borrowed) increases a little bit each month.

Appreciation. Real estate typically appreciates (increases in value) over the long term. How quickly and how much any particular property will appreciate depends on many factors, such as the neighborhood, the features of the home, the local economy and the overall housing market. Property also appreciates when you make improvements to it. For example, adding a second bathroom will most likely

cause your property to appreciate.

What can I do to increase my home's appreciation?

First, always perform all needed maintenance and repairs. A well maintained home retains its value and should sell for more than one that is not.

Second, spend your improvement dollars strategically to get the greatest return on your investment. The best improvements will depend on what other homes in your neighborhood offer. Some experts believe you shouldn't put yourself in a position where your home would be priced for more than 20% more than comparable homes in the area. This means that if the homes in your area appraise at about $100,000, you might not want to undertake a home improvement project that would push your home's selling price over $120,000.

It's a good idea to choose projects that will be universally appealing to future buyers, such as updating a kitchen, adding or remodeling a bathroom, adding a bedroom, and landscaping. Many projects, such as installing a swimming pool, sometimes return less than they cost you.

The best way to determine what improvements will provide the greatest return when you sell is to get the input of a real estate agent who is an expert in your neighborhood.

Keep all receipts for the improvements until you sell the house.

How much can I expect my home to appreciate over time?

It's best not to bank on appreciation. How much a particular home will appreciate depends on many variables. Property values are unpredictable—many influences, such as demographic trends and buyers' tastes, can affect the value of your home.

Your home might even depreciate (lose value), at least for a time. Homes depreciate for a number of reasons, including an economic or housing slump, a local housing glut or a deterioration of your neighborhood. Depending on what state you live in, if your home loses value and you have to sell it for less than you owe, you still

may be required to repay the full mortgage. (A few states, such as California, have anti-deficiency laws, which means a homebuyer who can no longer make payments will not be held responsible for the deficiency—the difference between the sale price of the home and the outstanding balance of the mortgage.)

Many homeowners get into financial trouble by borrowing more money than they can afford based on their home's expected appreciation. Remember, any property can depreciate. And appreciation exists only on paper until you sell your home.

The best way to get your money back in a home is to buy a reasonably priced property in a stable neighborhood, plan to live in it for at least a few years, and invest in home improvements that will make the property more attractive to future buyers.

Do I still have to pay the same property taxes if my home depreciates?

If property values go down in your area, you can appeal your property tax assessment and perhaps lower your taxes.

To find out how to appeal your property tax bill, contact your local assessor's office. You may need to contact a real estate agent or other professional to get an opinion on the current value of your home compared to other dwellings in the area.

How can I tap my home's appreciation?

Appreciation translates into equity. If your home is now worth more than you owe on it, you may be able to borrow against that equity.

Borrowing against your equity can be risky, though. If real estate values plunge, you could end up "upside down" (owing more than the property is worth). If you had to sell your home, you might have to dig into your own pocket to pay back the difference (deficiency).

Do I have to pay taxes on forgiven mortgage debt?

Generally, you are liable for federal taxes on forgiven debt, and in some cases you could be liable for state taxes, too. However, if your mortgage debt was forgiven in calendar years 2007 through 2012, the Mortgage Forgiveness Debt Relief Act of 2007 might help you avoid paying taxes on forgiven mortgage debt for your principal residence.

Mortgage restructuring and foreclosure qualify for tax relief.

Up to $2 million in forgiven mortgage debt can be excluded. The tax benefit applies only for debt forgiven because your home's value declined or your financial condition deteriorated.

What is a home equity loan?

Sometimes referred to as a second mortgage, a home equity loan is based on the equity in your property. The debt is secured by the property, which means that your home serves as collateral for the loan. If you do not repay the loan according to the terms of the agreement, the lender can repossess (foreclose on) your home.

What is a home equity line of credit?

Commonly referred to as a HELOC, a home equity line of credit is a home equity loan that provides the borrower with a revolving line of credit. With a HELOC, you pay interest only on the part of the loan you use rather than the entire loan amount. The amount of available credit shrinks as you use it and grows again as you repay the borrowed money. For example, if you have a $100,000 HELOC and you use $20,000 of it, your available credit would be $80,000. If you pay $4,000 when your bill arrives, you would have access to $84,000.

What are some common features of home equity loans?

Lump-sum home equity loans may charge either a variable or a fixed interest rate. Choose the loan product with the type of interest that you want.

Home equity lines of credit typically charge variable interest rates rather than fixed rates.

The variable rate on either type of loan is based on a publicly available index, such as the "Prime Rate." To determine your interest rate, most lenders apply a margin to the index value. For example, one loan may charge "Prime plus 2%" while another might charge "Prime minus 1.01%."

Before you get a mortgage or home equity loan, make sure you understand what index and margin your lender uses, how often your

rate can change and what the rate cap (maximum) is. You need to understand this information so that you will have a clear picture of how much your future payments could be and so that you can choose the best loan.

Does a home equity line of credit (HELOC) charge any fees?

Yes, typically there are some costs associated with establishing a HELOC. They may be the same as some of the closing costs you paid when you bought the home—an application fee and a fee for a property appraisal, for example. Some HELOCs charge points and closing costs while others do not. Some may charge an annual "maintenance" fee. You also might be charged a transaction fee every time you use the credit line.

Be sure to understand all the costs of establishing the HELOC before you decide to take out the loan. Shop around—some deals are much better than others.

Are there any risks involved in taking out a home equity loan?

While a home equity loan or line of credit can be a sensible way to pay for certain expenses, borrowing against your home's equity is not without risk.

First, if for any reason—unemployment, illness or divorce, for example—you cannot make the payments on your second mortgage, you could lose your home.

Second, because the interest on a home equity line of credit (HELOC) typically carries a variable interest rate, you could see your monthly payment increase. A variable rate loan can be difficult to budget for over the long term, particularly if interest rates were very low when you applied for the loan.

Third, because a HELOC functions much like a credit card, it can be tempting to spend more than you can afford to repay.

If you have a home equity line of credit, use it only for a financial emergency or for major expenses like a car, home improvements or education costs, and only if you can afford to make the monthly payments until the balance is paid off.

When should I refinance my mortgage?

If you have a fixed-rate mortgage with a competitive interest rate, you may not benefit from refinancing. Remember, you will owe closing costs when you refinance. (You can pay them out of pocket, or add them to your loan balance, which means you will owe more on your mortgage in the long run.)

Be aware that refinancing also starts a new repayment period, unless you choose a shorter-term mortgage (a 15-year mortgage instead of a 30-year one, for example). When refinancing, some borrowers take out a shorter-term loan so they can build equity in their homes more quickly and pay off their mortgage sooner.

Experts suggest that homeowners refinance only when interest rates are approximately 2% below the rate on the existing mortgage. However, if the balance of your loan is high, and you intend to stay in the home for a while, it may be worthwhile to refinance even if rates are not quite 2% lower.

If you want to refinance so that you can take some of your equity out of the home, consider your options carefully. Borrowing against your equity could make it more difficult for you to make ends meet each month, putting your home at risk. It also means the equity might not be there when you need it in your senior years.

Should I refinance my variable rate mortgage?

Many people refinance to replace an adjustable rate mortgage (ARM) with a fixed-rate mortgage. While some ARMs will go down over time depending on the economy and interest rates, adjustable rates can also go up. This uncertainty can be frustrating for homeowners. With a fixed-rate mortgage, you can be sure your monthly payment will stay the same over the life of the loan.

These are some factors to consider when looking at refinancing from an ARM to a fixed rate:

Peace of mind. A fixed-rate mortgage has the same payment every month, so you can be sure of your budget.

Costs of refinancing. Anytime you change your loan, there are costs involved. Some lenders allow you to add the costs to the refinancing amount, but this means you have a bigger loan. The cost of refinancing can be several thousand dollars or more.

A lower monthly payment. Depending on interest rates, you may be able to secure a mortgage with a lower monthly payment than you are currently paying.

What if I can't afford to pay all my bills this month?

If funds are limited and you cannot afford to pay all your bills, always pay the loans secured by your home (mortgage, home equity loan, HELOC, etc.) before you pay unsecured creditors (such as credit cards).

At the first sign you may miss a home loan payment, contact a housing counseling agency. A housing counselor can give you information that could help save your home from foreclosure. Counseling services are usually free or low cost. To find a local HUD-approved housing counseling agency, visit www.hud.gov (search for "housing counseling" and your state) or call 800-569-4287 (TDD: 800-877-8339).

Or contact Hope Now (888-995-HOPE or www.hopenow.com), an alliance of government agencies, investors, lenders and counselors dedicated to helping homeowners resolve mortgage issues and keep their homes.

Should I try to pay down (or pay off) my mortgage early?

Mortgage debt is not necessarily a bad thing. Because of tax deductions and low interest rates, having a mortgage that you can afford actually may provide many financial benefits. So before trying to actively pay off your mortgage, consider putting "extra" money into the following:

- building up your retirement accounts;
- paying off your credit card debt;
- establishing or augmenting an emergency fund;
- saving for your children's education; and
- paying down your home equity loan or HELOC.

Another factor in deciding whether or not to pay down your mortgage might be whether your mortgage has a pre-payment penalty. Though most traditional mortgages don't, it's wise to check before refinancing or paying off your loan.

Assistance and information

How do I find a housing counselor?

HUD-certified housing counseling agencies provide one-on-one assistance, educational materials and, sometimes, classes on such subjects as first-time homebuyer preparation, successful homeownership, foreclosure prevention and reverse mortgages. To find a counselor near you, visit HUD online at www.hud.gov and type "housing counseling" in the search field. Then find your state. You also can call 800-569-4287 (TDD: 800-877-8339).

How do I avoid foreclosure?

If you are behind on your mortgage payments or predict that you might have trouble maintaining payments in the future, immediate help is available for you. The Hope Now alliance helps homeowners resolve mortgage issues and keep their homes. Call 888-995-HOPE or visit www.hopenow.com.

What laws are there to protect me when borrowing against my home's equity?

The Truth in Lending Act (TILA) requires lenders to disclose the annual percentage rate (APR), points and total cost of the loan over time.

The Home Ownership and Equity Protection Act (HOEPA) is part of TILA and is designed to stop unfair and deceptive practices by federal and state mortgage lenders on certain "high cost" home loans. This law applies to banks but not to mortgage brokers. The Federal Reserve Board has oversight over TILA and HOEPA.

To file a complaint, go to www.federalreserve.gov/pubs/Complaints.

Consumer Action
www.consumer-action.org

Contact our Hotline:
www.consumer-action.org/hotline/complaint_form

415-777-9635
Chinese, English and Spanish spoken

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