Dollars & $ense

SMART WAYS TO USE THE EQUITY IN YOUR HOME

Regardless of the current housing market, many homeowners have built up substantial equity in their homes that they can borrow against. Equity is the difference between the home's current market value and the remaining debt on the mortgage. As long as the difference is positive (i.e., the market value is greater than the amount due on the loan), the homeowner may be able to arrange an additional loan to finance such things as a down payment on a vacation home or college tuition. But before you turn your home into a checkbook, you should understand how home equity loans and credit lines work.

THE BASICS OF BORROWING AGAINST YOUR HOME

Homeowners looking to tap the equity in their homes can choose either a home equity loan or a home equity line of credit. Most banks let you borrow up to 75 or 80 percent of your existing equity. And unlike other forms of nondeductible consumer debt, when you provide your home as collateral for a loan of $100,000 or less ($50,000 or less if you are married and filing separately), the interest is likely to be tax deductible.

ADDRESS ONE-TIME BORROWING NEEDS

A home equity loan is best used for large, one-time expenses such as financing a major home improvement project, starting a business, purchasing a high-ticket item, or consolidating high-interest rate credit card debt. Such a loan also is better suited to those who don't foresee future borrowing needs.

Home equity loans, which resemble a second mortgage, provide you with a lump sum of money repayable over a fixed term—usually five to 15 years. A home equity loan gives you the security of a locked-in rate and the same monthly payment.

USING LINES OF CREDIT

The flexibility of lines of credit makes them ideal for irregular or unanticipated expenses such as those related to large medical bills or losing your job. A home equity line of credit also can help parents finance a child's college education. It may be particularly helpful for higher income families that don't qualify for financial aid and are certain they will have the resources in the future to pay off the loan.

With a home equity credit line, you're approved for a specific credit limit determined by the lender, typically based on your income, debts, ability to repay and credit history. Once approved, you can borrow any amount—up to your credit limit—on an "as needed" basis. You draw against your credit line by using checks or a special credit card linked to your credit line. Some plans require that you borrow a minimum amount, say $500, each time you draw against your credit line. Home equity lines of credit are usually variable-rate loans with payments that change from month to month based on your outstanding balance and fluctuations in the prime rate.

SOME WORDS OF CAUTION

Using the equity in your home is not a matter to be taken lightly. While these loan products are especially good for consolidating high-interest rate credit card bills, this strategy works only if you stop creating new debt. If you keep charging items on your credit card, you will continue living above your means and put yourself further in debt.

Be aware, also, that while credit card companies cannot foreclose on your home if you have financial difficulties, that does not hold true for home equity lenders. If you don't make the required payments on a loan secured by your home, you risk losing it.

Shop carefully for the best rates and terms that most closely suit your needs. Negotiate with a few lenders, and don't be swayed by low teaser rates that apply only to transferred balances or escalate sharply after a short introductory period. When you find a deal that works for you, be sure to read the loan closing papers carefully before signing.

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