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The Value of Equity

Buying a home is bound to be one of the biggest investments you make during your lifetime. Therefore, it is natural to spend time thinking about the pros and cons of purchasing a home. Some people seek advice and feedback from friends and family, while other research on the internet or in the library.

At some point in this discovery process the term "building equity" will inevitably pop up. Though this term is commonly used, it is not necessarily understood. According to Webster's dictionary equity is defined as "the money value of a property or of an interest in a property in excess of claims or liens against it".

This may seem simple at face value, however many people are ignorant of the ways in which they can use the equity they have accumulated. Therefore, let us look at the different ways in which you can use your home's equity.

Refinance: Basically by refinancing your home you are paying off your current mortgage and getting cash out based upon how much equity you have in your home. If mortgage rates are low, refinancing brings greater advantages because it allows you to lock in a low rate for the duration of the term. Refinancing also comes in handy when you need large sums of cash, whether it is for home improvement or your second son's college tuition.

The down side of refinancing is that there could be numerous additions to the cost of your loan. Mortgage lenders often charge closing costs, discount points, appraisal fees, loan processing fees, document prep and recording fees, underwriting fees, and more. You want to be careful that your need or savings through refinancing exceeds the additional costs that will be added to your mortgage premium.

Second Mortgage: A second mortgage would probably be more useful to a homeowner who does not need a large influx of cash and already has a competitive mortgage rate. The term is much less than a conventional 30-year mortgage - five to 15 years. These installment loans are paid out in one lump sum, so they're good for repaying credit card debt or remodeling projects, or even buying a new vehicle.

You must be sure you will be able to pay this loan back, because it's easier to foreclose on a second mortgage than on a federally insured first mortgage. Find out about closing costs and points in advance, as well as balloon payments, hidden fees, or credit or property insurance tacked on.

A home equity line of credit: A home equity line of credit allows you to borrow money against the value of your home. It works much like a credit card in the fact that you have a pre-set credit limit and are able to borrow against this limit as need dictates. Home equity lines of credit are good for expenses such as debt consolidation, tuitions, major home improvements, and any other expected or unexpected needs that arise. The benefit of a home equity line of credit is that rates are generally lower than other types of debt and you do not make payments unless you use the money; however it is always there if you need it in a pinch.

Some credit lines have variable interest rates, with no cap on how high they go. Make sure you read the fine print and find out exactly how much it could increase, and then do the math. And if you're an impulse buyer, this may not be a wise choice. A home equity line of credit shouldn't be used for frivolous luxury items, unless it's a one-time purchase and not a pattern of behavior.

Reverse Mortgage: A reverse mortgage is a loan against your home that requires no repayment for as long as you live there. This type of loan is generally only available to persons over the age of 62 who own their own home. Homeowners who opt for a reverse mortgage can generally get their money through an immediate cash advance, a line of credit, monthly cash advances, or a combination of the three. As a homeowner draws payments their equity decreases and their debt increases, which is why it is generally referred to as a "rising debt, falling equity" loan.

The debt does not need to be paid until the homeowner no longer occupies the home. The amount to be paid off, either in cash or through sale of the home, is all the sum of all payments received (including any fees) and the interest incurred on the debt.

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