

# Legal Hotline for Michigan Seniors

**1-800-347-5297**

*Celebrating 15 Years of Service*

**3815 W. St. Joseph Street, Suite C-200**

**Lansing, Michigan 48917**

**www.legalhotlineonline.org**

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**This information should be used for informational purposes only and should not be used in place of legal assistance with an experienced attorney.**

## Home Equity Loans

Many consumers are accessing the equity in their homes by obtaining loans to pay for such things as college educations or for making investments. To attract borrowers some lenders are offering loan origination fees. The consumer interested in this type of refinancing should be aware that many home equity loans which are offered by Michigan lenders with an initial low interest rate can go up as high as eighteen percent during the life of the loan.

### **What is a Home Equity Loan?**

A home equity loan is a type of second mortgage that usually establishes a preapproved line of credit that can be drawn on when needed, sometimes by merely writing a check on that account. Traditional second mortgages familiar to most consumers involve borrowing a set loan amount at the start of the contract which is paid back in monthly payments of principal and interest until maturity. The manner in which home equity loans are paid varies from lender to lender. In some cases the monthly payments on a home equity loan might include a percentage of the principal plus interest. In other cases, borrowers pay only interest and a balloon payment of the entire principal is due at the end of the loan.

While other mortgages may have fixed or maximum interest rates, home equity loans are often offered with rates that may increase or decrease without limit up to a ceiling of eighteen percent. These are called “variable rate” interest loans and may be tied to some economic indicator which often fluctuates at the discretion of the lender. The fluctuation can be great at times; for example, in May 1987 the prime rate, an economic indicator, was

at eight percent, however, in 1981 that rate was over twenty percent. These “teaser rates”, as they are sometimes called appear low at the time of loan origination, but before long that rate could be out of sight. Variable rate loans are for experienced borrowers and should only be used after consultation with someone well versed in financial matters and upon whom you can rely.

## **SHOPPING FOR A HOME EQUITY LOAN**

If A decision is reached to get a home equity loan, it’s important to shop for a lender that offers such a loan with a low maximum “cap” or limit on the interest rate that can be charged. Some lenders may offer less favorable terms to non-customers who do not maintain preferred accounts. If this is the case, it may be advantageous to become a customer or open a preferred account with the lender before applying for a home equity loan.

Once a lender is found, a borrower should ask for a “worst-case” scenario of the monthly payments during the life of the loan. There are some lenders who require a single lump sum or balloon payment at the end that may force the borrower to refinance. Borrowers should also ask the lender about monthly service charges or transaction fees, and compare these amounts with different lenders. It is also advisable to Secure estimates of all loan origination fees and closing costs since these can be very expensive.

If no satisfactory lender can be found, a borrower would be wise to consider taking out a second mortgage with a fixed or capped rate. The fixed rate on a second mortgage may be higher than the initial home equity loan interest rate, but the borrower will be protected against unforeseen rate increases and balloon payments that might otherwise put the borrower’s home at risk.

## **OTHER ITEMS TO INVESTIGATE**

Checking with a tax advisor about potential deductions generated by a home equity loan is also a good idea. The amount of funds available for the loan will depend on the appraised value of the home, but the amount of the interest payments which may be deducted from a tax return depends, in part, on the original purchase price of the home plus any permanent improvements made on the home as well as how the funds will be used. If

the value of the home has increased substantially, not all of the interest payments may be deductible. Homeowners who have refinanced their mortgages, obtained second mortgages, or home equity lines of credit since August 16, 1986 are required by the Internal Revenue Service (IRS) to file Form 8598 with their income tax return. When completing this form, consumers will have to know what they paid for their home and the cost of qualified improvements made through 1987.

### **MAKING WISE USE OF THE HOME EQUITY LOAN**

Before withdrawing any funds, borrowers should consider developing a spending plan for the entire period of the loan. If the lender requires the monthly payment to include only the interest on the loan, borrowers should ask to have the monthly payment schedule set up to include principal payments as well. Make sure there is no penalty for prepaying. This will reduce the balance owed at the end of the loan thereby reducing the risk of foreclosure on the borrowers' home. Establishing a contingency plan for paying off the loan more rapidly in case interest rates rise substantially is also advisable.

It's best to avoid paying other credit obligations like credit card debts with a home equity loan. Credit card debts, for example, are not secured by the borrowers' home, therefore, if financial troubles arise in the future, the borrowers will not run the risk of foreclosure for failure to meet these obligations.

### **CONSUMER RIGHTS AND RESPONSIBILITIES**

Like any other contract, be sure everything is clearly understood and filled out before signing it. Under the Federal Truth and Lending Act, homeowners entering into a second mortgage (home equity) contract or a first mortgage contract that is not for the original purchase of property (refinancing a mortgage), have three business days after receiving certain disclosures to rescind the contract. In very limited cases, if the disclosures are not properly made, or if notice of the rights to rescind is not given, the borrowers can cancel the contract for up to three years. When signing for the loan, however, do not assume that the three year cancellation rights will apply.

At closing, the lender must inform the borrowers of their right to rescind, explain how to exercise this right, and provide a form to be used for this purpose. In addition, the contract must clearly spell out all the terms of the loan such as the exact amount to be financed, the finance charge, the annual percentage rate (APR), the total number of payments, the payment schedule, and the total cost of the loan.

Borrowers can rescind by sending a simple cancellation notice to the creditor. The creditor must immediately void the lien on the debtors' home and cancel all interest charges, fees, and other expenses, allowing the debtors to get out of the loan by repaying only what was actually received.

For more information on this or any other consumer protection issue, contact the Michigan Consumers Council. The address is: 414 Hollister Building, 106 W. Allegan St., Lansing, MI 48933; telephone, 517-373-0701 (for the hearing impaired only).

*If you are a senior, you can get specific questions answered at the Legal Hotline for Michigan Seniors. Call 1-800-347-5297 (372-5959 for the Lansing area).*

*The Legal Hotline is a program of Elder Law of Michigan, Inc., a non-profit organization. If you would like to support our work, please consider sending a tax deductible donation to the Legal Hotline, 3815 W. St. Joseph, Ste C-200, Lansing, MI 48917. Thank you.*

