# An Introduction to Housing Wealth:
## What is home equity and how can it be used?

www.reversemortgage.org

***1. What is home equity?***
***2. How can home equity be extracted and used?***
***3. What special home equity options are available to senior homeowners?***

According to the Urban Institute in Washington, DC, "Americans have a staggering amount of untapped equity in their homes." How much? Altogether, $11,030,000,000,000. That's 11 trillion, 30 billion dollars! And when we say "untapped," we mean the equity is not currently being *used* or *extracted* by the homeowners.

Despite this huge wealth possessed by home owners, it isn't *liquid*, or usable-- unless you make the effort to extract it. Extracting equity from your home is a means of making this illiquid asset liquid and usable.

Home equity can be both tapped and used in a variety of ways. Which way is most beneficial will depend on the individual circumstances of the homeowner such as age, wealth, financial and family goals, and work or retirement situation.

## What Is Home Equity?

But, first, what is home equity?

Home equity can be your greatest financial asset; your largest component of personal wealth; and your protection against life's unexpected expenses.

In "accountant-speak," equity is the difference between the value of an asset and the value of the liabilities against that asset. In the case of home equity, it's the difference between the current market value of your house and the money that you owe on it.

Let's say, for example, your home has a market value of $425,000, you made a down payment of $175,000 and you took out a $250,000 mortgage. At that point your equity is $175,000:

| | |
|---|---|
| **Home value** | **$425,000** |
| **Mortgage balance** | **$250,000** |
| **Home Equity** | **$175,000** |

Now, let's say, ten years later, you have paid off $100,000 of your mortgage's principal balance. So your current home equity is as follows:

| | |
|---|---|
| **Home value** | **$425,000** |
| **Mortgage balance** | **$150,000** |
| **Home Equity** | **$275,000** |

When you have a mortgage, you still own your home and the deed is in your name, but whoever holds the mortgage has a *lien* on the property because it is the collateral that has been pledged to the lender as security for the loan.

Each month when you make a mortgage payment, part goes toward interest, part goes towards real estate taxes and homeowners insurance (unless you have opted out of an escrow for taxes and insurance, as is allowed in some states), and part goes toward reducing your loan's principal balance. Your equity increases each month by the amount of your payment that reduces your loan balance; the amount that is attributable to monthly interest payments, on the other hand, does not increase your equity.

Paying off some or all of your mortgage debt, or any other debt you have on the house, will increase the equity in your home, but that is not the only way for your home equity to grow.

The other way is for the home to increase in value. This may be due to a rise in values in the general real estate market in your area, and/or improvements you make to the home, such as adding a room or porch, or renovating a kitchen and bathrooms.

It is important to remember that home value doesn't always go up. Most geographical areas go through cycles, having to do with supply and demand, and the general state of the economy. During a major financial recession such as in 2008-2009, most homes actually lost value, meaning their owners saw their equity decrease. As a result, some homeowners were "under water," meaning they actually owed more on their mortgages than their homes could be sold for.

Over the long term, though, most real estate tends to increase in value. Current economic forecasts from CoreLogic, a property information and data analytics company, project a 4.8 percent increase in home prices year over year from January 2017 to January 2018.

## How Can Home Equity Be Extracted and Used?

There are several types of financial products offered by banks and lending institutions that permit you to tap into your home equity. These are loans that use your home as collateral and will need to be paid back. You'll want to do your research to determine which type of loan is best for you and also take time to compare interest rates and offers, as well as other features of each type of loan, which can vary from lender to lender.

Here we offer a brief explanation of three home equity loan products plus two additional ways to access your equity – selling the house and buying a less expensive one or renting

***Home Equity Loan*.** This is just what it sounds like: a loan that uses all or, more likely, some of your accumulated equity as collateral. The principal and interest are paid back via specified monthly payments over an agreed to period of time. A home equity loan provides you cash now, but also adds a new monthly expense.

***Home Equity Line of Credit.*** This is often referred to by its acronym, HELOC. A line of credit is an amount of money a bank or other financial institution agrees to make available to you as you request draws on it, either partially or all at once. You don't have to ask the bank for a loan each time you want some cash; instead, by setting up the home equity line of credit, the bank has already agreed to let you borrow, up to an agreed to limit. Again, the loan uses the equity in your home as collateral.

For as long as the line of credit is in place, you can keep drawing down funds in any size increments up to your limit and paying it back. Unlike a standard loan, which is for a fixed principal amount and duration, with a fixed or adjustable interest rate, you only pay interest on that part of the line of credit during the time you are actually borrowing the money.

An important feature of a HELOC is that it is usually structured as "open ended credit," which means that if you pay back some of the principal that you had borrowed, you can borrow it again if needed later on.

For example, your HELOC may be for $100,000, but for now you may have used only $25,000. So your current monthly payments and interest are only on the $25,000. This provides financial flexibility and peace of mind to many people who use HELOCs. They know they have ready access to funds if an emergency comes up or an immediate investment possibility presents itself.

Like other forms of home equity loans, lines of credit are often used for improvement of the home itself, thereby increasing the value and, as a result, the homeowner's equity. But once again, when you use the line of credit, you are also adding a monthly expense to your budget.

***Cash-Out Refinancing.*** Refinancing a mortgage is the process of paying off an existing mortgage loan with a new one that has different terms and/or a larger loan amount. Homeowners may choose to refinance their mortgage to take advantage of lower interest rates – and lower monthly payments; to increase or decrease the length of the mortgage -- for instance refinancing a 30-year mortgage into a 15-year mortgage; to change from a mortgage with an adjustable interest rate to one with a fixed rate; or to extract equity from the home by doing a cash-out refinance.

If your home has appreciated in value and/or you now have greater equity in it than when you took out your mortgage, you may wish to refinance and take cash out. With this type of mortgage refinance, you are applying for and taking a new mortgage for an amount greater than what you owe on the home so that you can receive the difference in a lump sum cash payment.

The proceeds are unrestricted, but you should consider that cash-out refinancing comes with new closing costs, new interest rates, and a new payoff date further into the future. And, it will take time to rebuild the equity you've withdrawn from your home.

***Selling Your Home and Buying a Less Expensive One.*** Many people reach a stage in life, such as after children leave home, when they don't need as much room anymore. If you have accumulated significant equity in your current home, you can convert that equity into cash by selling the home and buying a less expensive one. You may have enough equity to purchase the new home with all cash, or maybe opt for a smaller mortgage and lower monthly payment that makes cash available for other purposes.

***Selling Your Home and Renting.*** While home ownership represents a significant investment for most people, it also represents a significant ongoing expense in terms of maintenance, real estate taxes and insurance. Sometimes, selling your home and renting makes more sense. If you have equity in the home you are selling, you can take out the cash.

For all of these options, it always pays to become as educated and informed as possible, and to shop around for the best terms for your particular situation.

## What Special Home Equity Options are Available to Older Homeowners?

Remember that $11 trillion-plus figure in total untapped American home equity? Over half of it, $6.2 trillion, belongs to people 62 and over.

If you are in this age group, you have an additional set of options for tapping the equity in your home. The Federal Housing Administration (FHA), a mortgage insurance entity within HUD, the U.S. Department of Housing and Urban Development, insures a financial product called a Home Equity Conversion Mortgage (HECM) that is only available to homeowners 62 and older. In popular parlance, it is known as a HECM reverse mortgage and more than a million senior homeowners have used one to supplement retirement savings and age in place.

The purpose for creating the HECM was to provide older home owners, mostly retirees, who are no longer earning regular salaries and spending down their savings, access to their home equity without having to increase their monthly expenses. The reason it is called a reverse mortgage is because unlike a regular, or "forward," mortgage in which you pay off a loan and build equity in your home while you live in it, in this case the lender makes your equity available to you. And instead of paying back the loan balance plus interest on a monthly basis (and adding to your monthly expenses) you do not have to pay back your HECM loan until you move out or sell the home.

How much you can borrow from a reverse mortgage is determined by a formula based on the home's appraised value, your age and current interest rates. Like a regular mortgage, this is still a loan, with upfront fees and closing costs and a commitment to pay it back, but it is designed to help seniors live and retire comfortably as they age in place, so it has certain special features. HUD keeps a pretty careful watch over this government-insured program, and it has set up certain requirements to serve seniors. One of them is that each potential borrower goes through a counseling session with a certified professional reverse mortgage counselor to make sure each aspect of the HECM process is understood.

Among the most important features of the HECM program is that the home remains in your name and you own it as long as you continue living in the house, keep up with real estate taxes and homeowner insurance premiums, and maintain the property. When you are ready to sell, you pay back the loan and accumulated interest out of the sales proceeds, but you can never owe more than the market value of the home at that time. If you pass away while still living in the house, your heirs or estate have the option of paying back the loan and keeping the house, selling the house and keeping what is left of the sales proceeds after paying back the HECM, or completing a deed in lieu of foreclosure, which is a way to sign the house over to the lender if they do not want to take on the responsibility for selling the home.

There are no restrictions on how the loan proceeds from a reverse mortgage can be spent, which makes them a versatile tool for homeowners who can choose from different payment options to meet their retirement goals. If you have a specific need for a large amount of cash, you may want to receive your loan proceeds as a lump sum after closing, but this is not the most popular way to use the loan.

Most of today's HECM borrowers select a loan with a variable interest rate that gives them more flexibility in how they receive their funds over time. Some opt to take a payment each month in order to supplement their expected retirement income from Social Security and other sources. This can be done for a specific number of years or for the life of the loan.

As long as you live in the house, keep up your real estate tax and home insurance premiums, and maintain the property, you cannot be forced or told to leave, even if you have drawn down all of the available funds. If you take fixed monthly payments, referred to as "life tenure" payments, they will continue as long as you live in the home, even if the balance due grows beyond the initial principal limit on the loan.

And, because a HECM reverse mortgage may be structured as an "open-ended" line of credit, similarly to a HELOC, if you prefer, you can pay back all or part of the reverse mortgage any time you like and borrow the money again in the future. But you don't have to make any repayments, if you choose not to, as long as you keep living in your house and meeting your loan obligations to maintain the property and pay property taxes and insurance premiums.

A HECM reverse mortgage line of credit can be used in addition to a monthly payment option or on its own. In many ways, this is similar to the traditional HELOC line of credit discussed earlier, but there are important differences. For example, a HELOC is due to be paid off in full at the end of a designated time period, often ten years, and the lending institution can decrease the amount of funds available if the property value decreases. A HECM line of credit, on the other hand, remains in place as long as the borrower remains in the home in good standing and the amount available will never be reduced. A typical line of credit may have a prepayment penalty. A HECM LOC never does.

With a traditional HELOC, interest must usually be paid monthly. With a HECM LOC, you do not have to make monthly principal or interest payments, only keep up-to-date on real estate taxes, homeowner insurance, and properly maintain the home as you would with any mortgage.

A HECM line of credit offers another unique feature. The unused portion of a HECM line of credit "grows" at the same rate the borrower is paying on the used portion, which means over time, the available amount of credit steadily increases. This is not the case with a traditional HELOC where the principal amount you signed up for is all that will ever be available.

Another option for seniors is known as a HECM for Purchase, often shorthanded by the industry as "H4P." This part of the program was created by HUD to allow seniors 62 and older to buy and move into a home that is more suited to their current needs than where they had been living previously. H4P lets senior home buyers finance part of the purchase of their new home with a reverse mortgage instead of paying all cash or taking on a conventional mortgage that would require a monthly principal and interest payment.

There is no "One Size Fits All" in retirement planning. No one financial strategy or home equity solution is right for everyone, and all options should be researched before making the decision that is right for you.

For senior homeowners who want to learn more about converting a portion of their home equity into a liquid asset with a reverse mortgage loan, NRMLA –The National Reverse Mortgage Lenders Association - has published three new guides available to download from its consumer education website reversemortgage.org.

The free resources answer questions about the features and responsibilities of reverse mortgage loans, and explain the different stages of the loan process from pre-application to repayment:

- *Reverse Mortgage Self-Evaluation: A Checklist of Key Considerations*
- *What You Need to Know About Your HECM After Closing*
- *What Do I Do When My Loan is Due?*