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Home Equity Defined

Maybe you are a first-time homeowner and do not yet understand what home equity is all about. Or maybe you have been a homeowner for a while but still have not figured out just why equity matters to you. No matter your situation, this article is aimed at helping you learn the basics about home equity and its implications for homeowners.

First, the definition: home equity is basically the amount or percentage of the home that you, the homeowner, actually own. You can calculate your equity by subtracting the remaining balance of your mortgage loan from the current value of your house. For example, let's say you have a balance of $175,000 on your mortgage, but your home presently appraises at $200,000. So your equity is $25,000 and you own $25,000 worth or 12.5% of the home.

There are two ways to increase your equity or your ownership of the house. The first method is simply to make payments towards the balance of your mortgage. Realize that mortgage payments are made up of both interest and principal portions. Only paying down the principal will decrease your loan balance (although you are still required to make interest payments.) As long as you do not have an interest-only or pay option ARM loan, you are already making a dent each month in your balance just by making your mortgage payments.

The other way that your equity can increase is by price appreciation as time passes. Over time, due to inflation and perhaps speculation, the value of your home will increase automatically. You do not have to do anything to create this type of equity. Let's say your original mortgage loan was for $200,000. During the past several years you have paid off $15,000 of that debt through your monthly mortgage payments. Your equity would be $185,000, but perhaps the market value of your home has increased to $215,000 during the same time period. Now your home equity is equal to the value of your home ($215,000) minus the balance on your home loan ($185,000.) That gives you a total of $30,000 in home equity, $15,000 of which was simply handed to you by healthy market conditions.

So why does this or should it matter to you? There are several reasons. First, the amount of equity you have makes a big difference when you are ready to sell your home. The more you have at the time of the sale, the bigger your profit and the more money you can turn around and put into buying a new home.

Home equity is also important if you need some cash for things like debt consolidation, home improvements, or college tuition. You can use your equity to take out a cash-out refinance loan, a home equity loan, or a home equity line of credit. These are all mortgages that let you borrow additional funds based on how much of your home you currently own.

You may find that home equity is also significant if you find yourself in a financial crisis. The more you own of your home, the more options you have in order to deal with the problem. If you need to sell your house quickly, with little equity built up you may find you must sell for cost or at a loss. Having more equity means you have a better chance of coming out on top. If you simply need cash to pay for your monetary emergency, having home equity will allow you to get an equity loan with out having to sell your home.

Of course, as with any home loan, there are plenty of fees involved with getting a home equity loan. So tapping into your equity is not always the cheapest route to go, but it can be a great resource in times of need.