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Home equity loan pros and cons

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Borrowing against your home equity is one of the cheapest ways to get a large sum of cash. It's also the only type of borrowing where falling behind can cost you your home.

If you need a lump sum for something specific and lasting, like a failing roof, a kitchen renovation or wiping out credit card debt at 20% APR or higher and you can afford a second payment alongside your mortgage without draining your savings, a home equity loan is worth a serious look. If you need the money for something that won't outlast the loan, your income is unsteady or you're planning to sell within a few years, the math works against you.

The main requirement for a home equity loan is enough equity in your home. Lenders typically require that you own 15% to 20% outright. Other criteria include good credit and a low amount of debt relative to your income.

If you check these boxes, home equity loans have several pluses:

· Predictable interest rate: A home equity loan has a fixed interest rate for the full term, so market swings don't affect it. You won't get surprised by a rate increase during repayment.

· Consistent monthly payments: Because the interest rate stays fixed, your monthly mortgage payment stays consistent over the life of the loan. This consistency can make it much easier to plan and budget your monthly expenses.

· Relatively lower interest rates: Home equity loans typically offer lower interest rates than unsecured borrowing like personal loans or credit cards. "While you may pay closing costs or other fees, it's an inexpensive alternative to an unsecured loan," says Laura Sterling, vice president, marketing at Georgia's Own Credit Union in Alpharetta, Ga.

· Extended repayment periods: Terms commonly run five to 30 years, depending on the lender. Spreading payments over a longer term lowers your monthly payment. (It also raises what you pay overall, since interest has more years to accumulate.)

· Larger borrowing potential: Depending on your equity stake, a home equity loan can get you more than a credit card or personal loan would. We're talking five- and six-figure sums, enough to cover a full renovation, pay off high-rate debt or handle an emergency repair.

· Possible tax advantages: If you use the money to buy, build or substantially improve the home that secures the loan, the interest may be deductible. Two conditions apply: You must itemize deductions on your return and the deduction covers combined mortgage debt up to $750,000 if you're single or married filing jointly, or $375,000 if you're married filing separately. "Substantial" means the work adds value, extends the home's useful life or adapts it to a new use. A new roof or a kitchen remodel can qualify, but repainting and routine repairs generally don't. Check with a tax professional before you count on a possible deduction.

Disadvantages of a home equity loan

· Chance of losing your house: If you don't repay the loan, your lender can foreclose. Beyond losing the house, a foreclosure stays on your credit report for seven years and makes it hard to get

another mortgage or most other financing for much of that time.

- Risk of negative equity: If local home values drop, your combined loan balances can exceed what the property would sell for. "If your home value declines, you could owe more on your home than it is worth, making it hard to sell," Sterling says. Selling in that position means bringing cash to closing to cover the gap and not earning anything on the sale.
- Turning ownership into debt: A home equity loan doesn't change your home's value; it changes how much of it you own. That means that you walk away with less when you sell, and you have less equity to fall back on if you need to borrow again later.
- Closing costs: Expect 2% to 5% of the amount you borrow, covering charges like origination and appraisal fees, though some lenders charge just 1% in home equity loan closing costs. On a $50,000 loan, that's $500 to $2,500 in fees, reducing the amount of cash you walk away with. Some lenders waive these costs entirely, which is one more reason to compare offers.
- Long funding time: The process is faster and easier than a first mortgage, but applying and getting the money still typically takes two to six weeks and often involves a home appraisal.
- Minimum equity requirement: You typically can't borrow a home equity loan unless you'd still hold at least 15% to 20% of your home's value after borrowing. If you're a new homeowner and didn't put down much, you'll probably need to wait awhile before you can tap your equity. You'll also need stronger credit and a lower debt load than you would for a personal loan or credit card.

Are home equity loans a good idea?

Whether a home equity loan is right for you depends on five things, and each one has a clear answer.

- How are you using the money? If the expense is a one-time cost that adds lasting value or replaces higher-rate debt, like a structural repair, a kitchen remodel or paying off high-interest credit card balances, a home equity loan is a reasonable fit. If you plan to use the money to pay for a vacation, a wedding, a car or everyday bills, think twice. You'd still be paying for it years after it's gone, with your house as collateral.
- Can you afford the payment? If you can cover the new payment alongside your mortgage, property taxes and insurance and still keep three to six months of expenses in savings, you have the cushion this loan requires. If the payment only works if you get a raise, bonus or side income that hasn't arrived yet, push pause. Missing a home equity loan payment isn't like missing a credit card payment. Remember, your house is collateral.
- How much equity would you have left? If you'd still own 20% or more of your home's value after borrowing, you have room to absorb a price decline or sell if you need to. If you'd drop below 15%, a modest dip in local values can leave you owing more than the house is worth, with no way to sell without writing a check at closing.
- Will the money still be working for you when you sell? If you're putting the money into something that raises the home's sale price, like a kitchen or bath refresh before you list, a short timeline isn't a problem. If the money is going toward something that won't show up in the sale price, like tuition, medical bills or consolidating debt, and you expect to sell within a couple of

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years, price out a personal loan or a 0% introductory APR card first. Paying 2% to 5% in closing costs to borrow for 18 months is a steep premium.

· What's your current mortgage rate? If your existing mortgage rate is well below what lenders are offering now, a home equity loan lets you tap equity without giving up that low rate. If your current rate is at or above today's rates, compare a cashout refinance first. Replacing one loan can cost less than carrying two.

When a home equity loan is the wrong choice

A home equity loan may not be the best financial move for many reasons, starting with how it's structured. The more equity you convert into debt, the less cushion you have if home values take a dive or you need to sell. If home values in your area are declining, you could end up with negative equity, meaning you owe more than your house is worth.

An unstable job and shaky finances are also a red flag. If your income dips and you fall behind, you could lose your home to foreclosure. Another mistake is using a home equity loan to cover everyday expenses or nonessential purchases. Shopping, weddings and depreciating assets like cars are all bad moves.

"I'd say the most important thing to consider is how you'll use the proceeds," says Jeff Ostrowski, Bankrate writer and housing market analyst. "If you plan to renovate your kitchen or spruce up your bathroom, that's a smart move. But if you need funds for a vacation, I'd rethink."

Do all home equity loans have fees?

Yes. Nearly all home equity loans carry fees, though which ones and how much you'll pay vary by lender. Together, they typically come to 2% to 5% of the amount you borrow, or $1,000 to $2,500 on a $50,000 loan. Some lenders waive certain costs entirely, so ask every lender what they're willing to drop.

Here's what you're likely to see on the itemized list:

· Origination fee: This is what the lender charges you to originate, process and underwrite your loan. The amount varies by lender and the amount you're borrowing, typically 0.5% to 1% of the loan amount.

· Appraisal fee: An appraisal determines your home's market value, which then establishes your equity and borrowing power. The cost ranges from $300 to $500, though you may pay more if the house is larger or unique. Many lenders now use an automated valuation model instead of sending an appraiser out, which can cut this fee altogether.

· Credit report fee: The cost to pull your credit report starts at $30 but can be up to $100, if not more. If you're borrowing with more than one person, that fee could double.

· Document preparation/attorney fees: These fees cover the cost of preparing, processing, and finalizing your home equity loan. Fees can range from $100 to $500.

· Title fees: Since the home serves as collateral for a home equity loan, lenders conduct a title search to determine if there are any existing liens or claims on the property. This fee can range from $75 to $250, depending on location; some can be higher.

Next steps

Shopping around is one of the most important parts of choosing a home equity loan.

Start with getting quotes from at least three home equity lenders, using a mix of mortgage companies, national banks, regional credit unions and online lenders. You can start with your current lender, but rates, fees, borrowing limits and loan terms vary across lenders, which is why it makes sense to shop around. Shop inside a short window. Multiple home equity inquiries filed within roughly two weeks generally count as a single inquiry for credit scoring purposes, so comparing lenders doesn't cost you points.

When comparing offers, look at the total cost of the loan and the monthly payments, not just the interest rates. Check out online reviews of customer service and borrower experience, such as Bankrate's home equity lender reviews.

Once you've chosen a lender, the application process is similar to applying for a mortgage: You'll have to submit your financials and employment information. The lender will appraise your home to determine its value and, based on that, how much equity you have to borrow against. After approval, you can move forward with accessing your home equity.

Key takeaways

- A home equity loan gives you a lump sum at a fixed rate, with the same payment every month for five to 30 years, in addition to your existing mortgage payment.
- Rates run lower than personal loans or credit cards because your house secures the debt. That's also the risk: If you fall behind, you can lose the home.
- Most lenders cap your total home debt at 80% to 85% of your home's value, which means you keep at least 15% to 20% of its value as your own stake.
- Closing costs typically run 2% to 5% of the amount you borrow, though some lenders waive them entirely.

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