What is a home equity loan?

A home equity loan is a form of loan which uses the built-up equity of a home as collateral. Borrowers typically use these loans as a means of covering critical expenses.

Building off those “critical expenses”, home equity loans can be great use for the following reasons:

- Using home equity to invest
- Home improvement
- Debt restructuring
- Emergency fund

Home equity loans are not meant to be perfect in all scenarios. While the money from home equity loans can be freely used in other ways, such as for retirement income and the payment of student loans, it’s important to consider the consequences of mismanagement.

If a home has no remaining equity, and the loan cannot be repaid, then foreclosure could be imminent. To that end, just as there are great uses for home equity loans, there are poor reasons as well. For instance, depending on specific circumstances to the contrary, it can be a poor idea to pay off your credit card debt with a home equity loan.

Their flexibility of use aside, there are indeed a myriad of reasons why taking out a home equity loan can make sense. In the spirit of caution, however, there are also reasons against it.

What are the pros of home equity loans?

- Lower interest rates
- Predictable payments
- Tax benefits
- Starting a business

Lower interest rates

Compared to standard personal loans and credit card cash advances, interest rates on home equity loans are quite low. This is due to the fact that the borrower’s home is collateral. From the bank’s perspective, it’s a solid guarantee that the borrower will reliably repay the loan. In other words, the bank assumes that the borrower is unlikely to put his or her home at risk.

Predictable payments

Due to, again, the home acting as collateral, interest rates shouldn’t cause too much worry. Unlike personal loans, which can vary between fixed and variable interest rates, home equity loans will always be fixed. As such, the borrower won’t receive any surprises, and should expect a reliable repayment schedule for the duration of the loan.

Tax benefits

Yes, home equity loans are tax deductible. Specifically, that is so up to the initial $100,000 of paid interest. Bear in mind that this deductibility is a benefit specific to home loans, and not for personal loans or credit cards.

Starting a business

Opening a new business is hard work. Moreover, it can be both personally and financially risky. Outside of the super wealthy, new owners will likely need investors or a loan to get started. If trying to get a loan, banks will see a new business loan as one with a lower-than-optimal likelihood of repayment. As such, strong and secure collateral can be very effective is gaining the bank’s trust. This is where the ‘home’ in home equity loans is helpful.

What are the cons of home equity loans?

- Additional costs
- Accrue more debt
- Possible loss of home

Additional costs

Securing a home equity loan isn't as simple as going to the bank and asking for cash. Through the process of taking out a home equity loan, most financial institutions will charge fees for their 'services' to you. These services can include application processing and house appraisal, and can the costs may manifest as closing and origination fees, which usually total between three and six percent of the loan amount.

Accrue more debt

In order to take out a home equity loan, equity must actually be therein. Depending on the size mortgage taken out upon the purchase of the borrower's home, it may take some time to build up enough new equity to make a home equity loan possible. To that end, it's important to consider that by turning equity back into a loan, the borrower is returning to the debt he or she had just gotten out of.

You can lose your home

As discussed before, it is critically important that one carefully considers the way his or her home equity loan is used. If used with reckless abandon, then there can be long-lasting consequences. Since this loan type depletes a home's built-up equity, there will be nothing left if needed again in the near-future, especially if the borrower delays repayment. In these situations, the bank is well within its right to take ownership of the home, and sell it to cover the remaining debt. This process is called foreclosure, and the borrower can lose his or her home in the process. As such, be careful.

What happens next?

Regardless of one's specific needs, home equity loans are useful in an array of circumstances. Should knowing the pros and cons not be enough to make a complete decision, it would be wise to begin looking into individual companies and banks. In that spirit, then list of the top ten online lenders is a great place to continue researching.