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The Facts of 125% Equity Home Loans: Part III

The first two parts of this article explained the basic terms of a 125% Equity Home Loan and the advantages they bring. The quick synopsis is that 125% equity loans allow homeowners to borrower more than their homes are worth, up to 125%. The benefits are basically that borrowers can get needed cash for debt or financial emergencies. In this article, the disadvantages of this loan program will be explained.

The Disadvantages of 125% Equity Home Loans

In most situations, the cons of this loan are going to outweigh the pros. There are so many risks and fees involved that it is almost always better to look at other solutions before choosing this program. The disadvantages consist of the following points, among others:

Super High Risk – To determine the risk factor of a loan, lenders look at the loan-to-value (LTV) ratio. This is the amount of money loaned, divided by the value of the home. In a conventional loan, this ratio will be under 100%. The lower the percentage, the lower the risk. This is because if the borrower cannot pay back the loan, the home can be sold and the lost funds can typically be recovered. The LTV on a 125% Equity loan is obviously 125% because the amount loaned is more than the home is worth. This creates many hurdles for the borrower to pay back the loan. For one, if the borrower decides to sell the home, they must either list the house for more than its market value to try to repay the loan, or they must come up with extra funds from a different source to pay off the loan. With the housing market dampening these days, and home prices depreciating, trying to sell a home for a price that is as much as 25% inflated may, frankly, be impossible. If you are not planning to stay in your home for many years, you will probably have to sell your home at a loss if you get a 125% equity loan. **High Interest Rates** - Because of the incredible risk to lenders for these loans, you will be required to pay much higher-than-normal interest rates. In some cases, you will have to pay as much as a 13%-18% rate. While this type of rate may be lower than the rate on your credit card, it is still much larger than a normal mortgage or equity rate. Plus by refinancing this way, your loan will reset, adding years and lots more interest onto your mortgage. **No Emergency Reserves** - With a 125% equity loan you effectively wipe out any equity you had in the home and leave nothing left over for a financial tragedy that may occur in the future. If you lose your job, or someone has a medical emergency, because you have maxed out your available home equity, there is a good possibility that you will lose your home when you cannot come up with funds elsewhere. **Does Not Cure Debt Habits** – If you are using a 125% equity home loan to consolidate your debts, be aware that this will not magically save you from your developed spending habits. As scary as it is, many Americans spend more money than they make each year. This means there are a lot of people out there who do not have the discipline to budget their income. If you fall into this category and get a 125% loan, you will need to immediately change your spending mindset. This loan will not free you of your debt problems; in fact, it may increase them if you add new credit card or other debt after getting the loan. Remember the risks listed above. You will have to practice restraint in your shopping from now on, or you will be in prime position to default on your mortgage payment. The result may be that you lose your home. **Additional Fees** - You should also be aware that, just like with a normal mortgage loan, there will be added fees at the close of your 125% equity loan. Your closing costs could be as much as 10% of the money you receive, so be sure to factor that into the financial plan. **No Tax Deductions** – With regular mortgage loans and even traditional refinance loans, all interest on the loans is tax deductible. This is because the government wants to encourage homeownership and home improvement. Mortgages are also by and large safe investments. A

125% equity loan is not so safe though, because if you go into foreclosure, the lender cannot recover all of their funds by selling your home. You will not be able to deduct any of the interest you pay on a 125% loan that is above the market value of your home. Don't try to fudge on this on your tax returns either; the IRS is particularly watchful with these types of loans.

Overall, you should try all other types of loans to solve your financial woes before you turn to the 125% equity home loan. There may be some situations where it is your only option. In that case, you will have to be very careful with your spending and saving. If you are in any doubt about the usefulness of the 125% equity loan for you, consult your financial advisor for a thorough analysis.