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What is a Home Equity Loan Anyway?

In recent years home equity lending has become very popular. Borrowers love it because they can get cash fast. Lenders love it too because they know their borrowers will make their payments, since if they don't they'll lose their home. But what is a home equity loan anyway?

There are two kinds of home equity loans: second mortgages and home equity lines of credit. In both cases you make your house work for you, or, in other words, you get what your house is worth, minus what you still owe on your mortgage, in cash. The amount of the loan is based on the equity you have built up in your home and could amount to as high as 75-85% of the appraised value of your home (if you have good credit), minus the amount of the mortgage you still owe. In this type of loan you are using your home as collateral, meaning that if you are unable to make payments on your loan you will lose your house.

A second mortgage is a home equity loan where you, the borrower, get all the money at once in one lump sum. These loans are usually payable with fixed interest rates on a set schedule. This can be useful for a one-time expense, such as a remodel, a wedding, or debt consolidation. A home equity line of credit (HELOC) is used much like a credit card, in which the money can be withdrawn as needed during the initial draw period, and then must be repaid for the next several years during the repayment period. During the draw period you make small, interest only payments, and then during the repayment period you pay off the principle along with the interest. Many people use this for continuing expenses like tuition payments.

To better illustrate this, let's look at an example: You have been in your home for several years, faithfully making mortgage payments, and thus have built up some equity in your home, along with good credit. Your house is now worth $300,000, and you still owe $100,000 on your first mortgage. Let's suppose you are planning a lavish wedding for your oldest daughter. A second mortgage may be a good option, since 75% of the equity in your home is $225,000, and subtracting the mortgage still owed, your loan could be $125,000, available all at once. Or, let's say that, instead of the wedding, you are paying to send your second daughter to an expensive university, with tuition payments due every semester. You can use a HELOC and withdraw money as needed during the draw period, which is usually 5 to 10 years, depending on the length of the entire HELOC.

As with loans of any kind, it is critical that you use caution in choosing a home equity loan. Be sure to read the agreement before you sign, only choose a loan that has monthly payments you will be able to meet, and keep exact records of what you have paid. Understand all the terms of your loan, including closing costs, continuing costs, interest rate changes, and repayment terms. If you are unable to keep up with your monthly payments you could lose your home, so make sure you weigh the costs before taking out the loan.

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