

Home Equity Credit Explained

There was a time when borrowing money required a little collateral, such as a car. These days, however, both lenders and borrowers are thinking in much bigger terms.

Today, home equity credit is an extremely popular and efficient way to borrow money. Homeowners use their properties as collateral for sizable amounts of credit.

Understanding home equity credit begins with some general knowledge about the lending game. In financial terms, "equity" is the difference between your home's appraised (fair market) value and your outstanding mortgage balance. "Credit" is the amount of money borrowed from the lender. So, "home equity credit" is basically the act of borrowing money by using your home's value as a guarantee. This can be an effective way to access cash when you need it, but there are certain risks involved.

The Popularity of Home Equity Credit

Most modern homeowners also carry a line of home equity credit. This is due to the fact that, in addition to the relatively low interest rates, homeowners can also claim their home equity credit payments as tax deductions.

In the United States, tax changes occurred in 1986 that eliminated deductions for most consumer purchases. As a loophole in this new taxation law, consumers realized that they could borrow against property value, and use the money to make purchases. Home equity loans became a popular method for homeowners to buy products, and still get an allowable tax deduction.

How Does Home Equity Credit Work?

Let's say that you purchased your for \$95,000, with a 20% down payment of \$19,000. In order to pay the remaining \$76,000, you took a mortgage on the property. On the day that you initially closed the sale of your home, you automatically had earned 20% home equity. As you pay off the principal throughout the mortgage term, you continually gain equity, and your home grows in value.

Now, let's say that after several years, you've paid \$12,000 toward the principal amount owing on your property. Remember, your property was valued at \$95,000 when you bought it, but has since increased in value to \$115,000. The equity of your home has actually reached \$51,000: Your beginning equity (\$19,000), plus the principal you have paid (\$12,000) and the increase in your property value (\$20,000).

Using Equity as a Valuable Asset

Home equity credit is an arrangement that benefits lenders and borrowers alike, because your home equity is indeed a very valuable asset. The value of your property can be used as loan security, and you are not required to sell your home. Because most people's homes are also their most valuable assets, lenders regard home equity credit as a secure arrangement. This security benefits the borrower as the interest rates on home equity loans are generally lower than with other types of credit.

What are the Disadvantages to Home Equity Credit?

While home equity loans offer certain benefits to the borrower and the lender, there are some disadvantages to consider. There is a major risk factor involved in using your home as collateral. Should you find yourself unable to keep up on the monthly payments, the lender has legal right to foreclose and force you to sell the home. For this reason, home equity credit is statistically most suitable for middle-aged, stable earners.

Speak to your bank or another reputable financial institution for more information on home equity credit. If the plan is right for you, there may be a tidy sum of money waiting at home for you.