

Borrowers Should Beware Home Equity Loans

Home Equity Loans Can Leave Borrowers Homeless

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A home is often the biggest -- and sometimes the only major -- investment people make. On one hand, it offers homeowners a hefty source of collateral, but on the other hand, if borrowing against the home gets out of control, a homeowner can become a former homeowner -- and not by choice.

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Sandy Shore, a manager of counselor training at the nonprofit financial counseling agency [Novadebt](#), said homeowners should use caution when considering new loans.

"Clients take home equity loans for lots of different reasons. They finance home improvements, pay for weddings and college educations and consolidate debt," Shore said. "When you borrow against your home, you may get some tax advantages, but you may also put your home in jeopardy. I would never advise someone to borrow to finance something that will not have value by the time the loan is paid." For example, she said that rolling a car payment -- which would drag out to 30 years -- or consolidating credit card debt will definitely set borrowers back in the long run.

"The things you bought are long gone by the time the loan is paid, and you have added secured debt to the house," Shore said. "Some consumers become serial refinancers. They use their house to pay off credit cards and then use them again. They may get to the point where the ever-higher equity loan and the credit cards combined are too much to handle."

While some borrowers seek out loans, Shore said that many people with fragile financial situations are sought out by predatory lenders who present credit opportunities in appealing packages, typically hiding the cons of the options, including:

- Variable interest rates, or adjustable rate mortgages, which are loans with rates determined by an index. The rate may initially be less than a fixed mortgage rate, but if they indices change, borrowers may be subjected to substantially higher rates -- which cause payments to increase.

"Record numbers of consumers are facing foreclosure because of this," Shore said.

- Balloon payments, in which the loan doesn't amortize -- or recalculate to encompass both the principal and interest due -- so when the term of the loan ends, money is still owed to the lender. Shore said the new payment will be much higher, particularly if the borrower already has poor credit.
- Prepayment penalties, which require the borrower to have paid a minimum amount of interest -- often six months' worth -- if he or she wants to pay off the loan. Shore said these are intended to "trap the borrower in an unfavorable or unaffordable loan."

Shore also said that borrowers with poor credit are susceptible to "deceptive practices," including high-pressure and misleading sales pitches, excessive fees and interest rates, and being required to purchase unnecessary products -- often high-priced insurance -- as part of the loan balance. Other such practices include payments that increase over time with unrealistic repayment terms, loan flipping with fees that are folded into the loan balance that result in rising balances and decreased equity, and abusive and aggressive collection practices.

With all the dangers, Shore said that borrowers considering a home equity loan to pay off bills should get some professional advice from a credit counselor.

"It is likely that they have already made some financial mistakes and the equity loan will make it worse," she said.

Even if a homeowner can avoid unrealistic payments on a home equity loan and other deceptive practices, Shore warned that there can be other consequences.

"When you use your house as collateral, you are reducing the equity you have in the house," according to Novadebt. "One of the reasons consumers buy a house is to build equity. It may take years to rebuild the equity. For many consumers, their house is their biggest investment. Reducing the equity may have a serious impact on their retirement."

The one situation in which a home equity loan can improve a homeowner's financial situation is for those who borrow and make home improvements.

"Unfortunately, most improvements do not add as much value as the consumer expects, and the improvements may cost more than expected, which may lead to more borrowing," according to Novadebt. Shore recommends referencing the Federal Trade Commission's brochure, ["Need a Loan?"](#) which describes the pitfalls of using a home as collateral and explains potential borrowers' options.

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