Pros and cons of using 3 types of debt: Credit cards, personal loans and home equity

By Chris Kissell | ***Posted: Jan. 26, 2016***

Debt has a bad name, and it is not difficult to see why. At the end of the 3rd quarter of 2015, total household indebtedness in the U.S. stood at $12.07 trillion, according to the Federal Reserve Bank of New York.

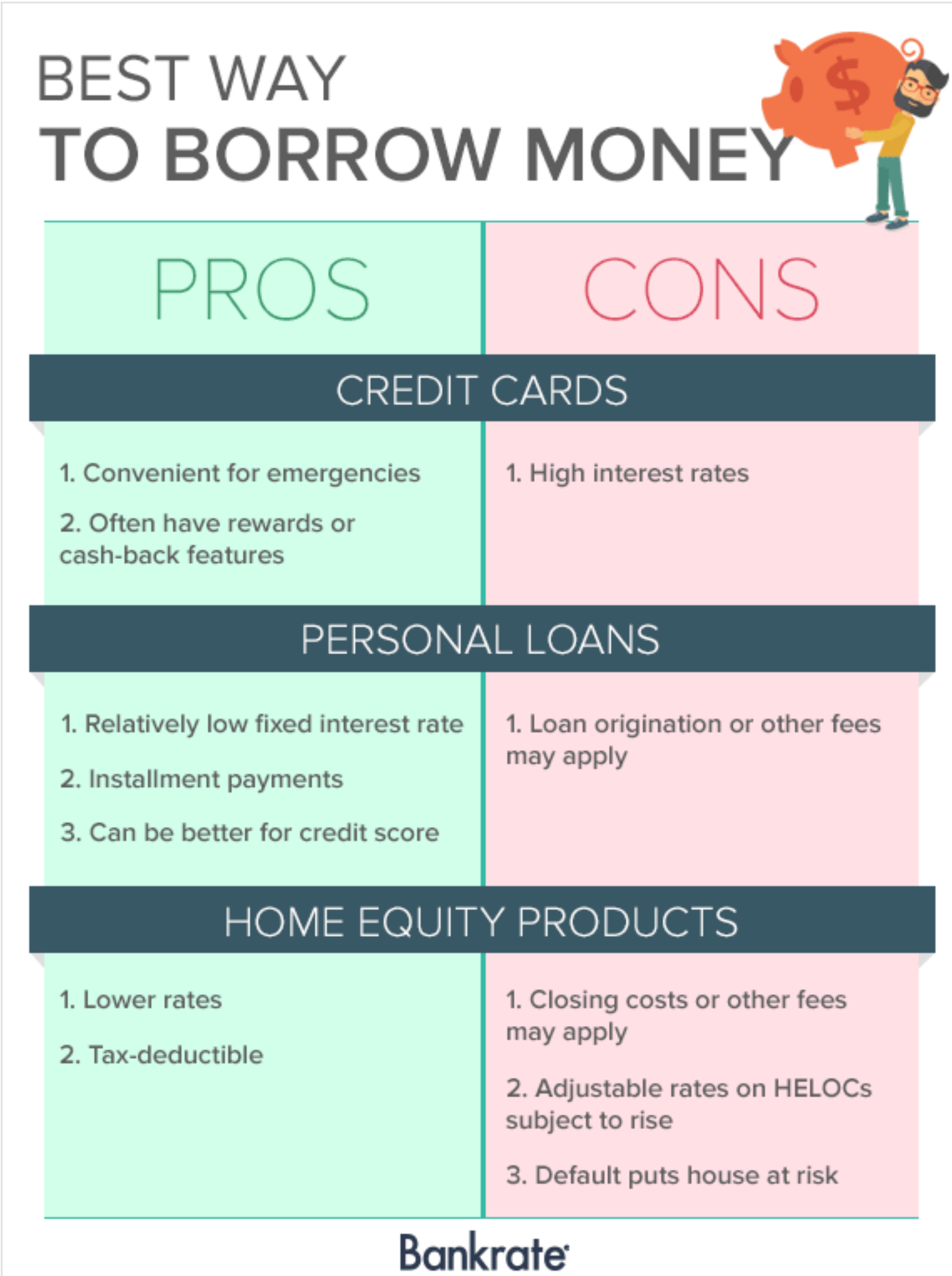
Usually, staying out of debt is your wisest move. But debt can be "a very positive thing" when it is used intelligently, says Craig J. Ferrantino, founder and principal of Craig James Financial Services.

"For people who are confident in their jobs and doing well, debt can truly take them to the next level," he says.

Consumers often rely on 3 common options for financing purchases:

- Credit cards
- Personal loans
- Home equity loans and lines of credit

To figure out which option makes the most sense for various types of expenses, Bankrate tapped the wisdom of a trio of financial advisers.



1. Credit cards

Credit cards are convenient and readily available to most borrowers. But they typically have the highest cost of borrowing among the 3 options.

Still, there are times when credit cards are a good choice, says Herb White, president of Life Certain Wealth Strategies in Greenwood Village, Colorado.

"It makes sense if you are just looking to borrow something for a very short time," he says.

White says credit cards are a quick way to pay in emergencies. They also can make sense for relatively small purchases when you can pay off the balance in full with your next payment.

For example, you can buy a new sofa that is on sale for $2,000 or $3,000 now, even if you won't have the cash on hand until later in the month.

"If you are able to pay that credit card off, you really have use of that money with no interest whatsoever," he says.

Ferrantino says there are also out-of-the-box reasons to use credit cards. For example, parents may want to use a rewards cardto rack up mileage points while paying for college tuition.

"The next thing you know, they've paid for flights to their kid's school," he says.

Brad Jenkins, CEO and chief investment strategist at Jenkins Wealth in Centennial, Colorado, likes the rewards strategy, too, and says it is particularly effective with cash-back programs.

"The credit card company will provide a certain amount of cash back, which in turn creates a lower cost for the financed item," he says.

However, Jenkins emphasizes that credit cards should not be used to incur debt unless the borrower can pay off the card monthly, or in situations where interest rates are very low. High interest rates are a recipe for disaster, he says.

"Before you can blink your eyes, the debt can grow out of control," he says, adding that the borrower often is forced to find alternative means to consolidate the debt, "which just means more borrowing."

2. Personal loans

A personal loan is an unsecured loan that allows you to borrow money at rates that usually are lower than those associated with credit cards.

White says a personal loan often makes sense for larger purchases that may take a little longer to pay off.

"It makes sense if you have to finance something unexpected, or a relatively large purchase," he says. One example might be a basement remodel, White says.

Personal loans are advantageous because they have a fixed interest rate that will not change over the life of the loan. But even though they often sport lower interest rates than credit cards, that doesn't always mean they are the cheaper option, White says.

"People should be careful," he says. "They might have an interest rate that is lower than a credit card. But you need to recognize that there are other fees, like loan origination fees."

He adds that such fees "can be a point or 2," adding to the cost of the loan.

Ferrantino says personal loans also can be a good option for small-business owners who need to make payroll. One overlooked advantage of personal loans is that they are an installment loan, not revolving credit, like a credit card, he says.

That is important because having a low credit utilization rate -- the amount of credit you are using compared with the amount you have available -- is better for your credit score than having a higher rate, according to myFICO.

Borrowing via a personal loan can help keep your credit utilization rate low, Ferrantino says.

Jenkins says personal loans may make sense to finance debt if the borrower needs more than 12 months to repay.

However, he typically does not recommend personal loans as a first choice. Rates may be higher than other options, and borrowers who use personal loans to transfer debt view the loan amount as extra money in their pocket, he says.

"If the borrower consolidated credit card debt into a personal loan, the temptation to rack up debt on the credit cards again is there," Jenkins says.

3. Home equity loans or lines of credit

Home equity loans or lines of credit allow you to borrow from the equity you have built up in your home.

White says that as with personal loans, these products can be used to get rid of debts that have higher interest rates.

Home equity products also offer some unique advantages. Ferrantino notes that the interest incurred typically can be deducted from your taxes. That's not the case with interest associated with credit cards and personal loans.

People who have built up a lot of equity also can borrow substantially more with these instruments than they can with an unsecured personal loan.

"It gives you a lot more horsepower when borrowing," he says.

However, home equity borrowing may involve closing costs and other fees that make it more expensive upfront, Ferrantino notes.

Rates on a home equity line of credit also are adjustable, and are likely to climb as interest rates rise.

Ferrantino also worries that too many people overlook the biggest disadvantage of home equity borrowing: namely, that defaulting on payments puts your home at risk.

"When you put your house at risk -- people don't understand the responsibility of that," he says.

Jenkins agrees that this is a significant danger. However, he adds that unless the home declines in value during the time the borrower is using the loan or line of credit, home equity products offer a way out if the borrower is unable to pay the debt.

"The borrower (can) hopefully sell the property the home equity loan is attached to, and relieve the burden of the debt," he says.