YOUR COMMUNITY

Home Equity Line of Credit vs Home Equity Loan: Which is Right for You?

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A little equity goes a long way, right? Home equity that is. If you've lived in your home for a while, then you've probably built up some. Does your home need some major renovation work? Do you have a child going to college? OR, maybe it might be wise to consolidate some of your high interest credit card debt? A Home Equity Line of Credit (HELOC) or Home Equity Loan might be the right choice to get things done. It's your money and you can use it for anything, you've earned it. (Actually, your house earned it).

But what is home equity? It's simple really. Think of it like this, equity equals your home's value minus the amount you owe on the primary mortgage. For example: if your house is valued at $300,000 and the balance you owe on your mortgage – if you have one – is $200,000, you have built up $100,000 in equity. (You can generally borrow up to 80% of your total equity).

Home equity can increase over time if the property value goes up or your mortgage is paid down. For many homeowners, the home equity they've built up represents a decent chunk of their net worth, making it an asset when it comes to borrowing.

If you chose to borrow on your earned equity, there are basically two ways to do it. Either with a HELOC or a Home Equity Loan. You are using your house as collateral in both cases, but they are indeed different. We'll dive into that later. (As with any line of credit or loan, it's a good idea to weigh all of your options and have a solid financial strategy before you make any decisions. Your savings account is always your best option before accumulating any more debt, if it all possible).

Why You Might Need to Tap into Your Home Equity

1. **Debt Consolidation**
   You may want to consolidate some of your high-interest debts, like a car payment or credit card balance, into something a little more manageable. You'll have one payment and you'll have an opportunity to save money in the long run. It's best to have a plan in this situation and not take on more unnecessary debt. If it makes financial sense, it's a good option.

2. **Home Improvements or Renovations**
   Probably the most common reason why homeowners take out HELOCs or Home Equity Loans. Whether it's a sun room addition or an emergency HVAC replacement, you can't go wrong when you invest equity back into your home. If you're thinking of making an investment specifically so you can sell, take a good look at the market and see if upgrades will actually add value to your house in the near-term, even though they probably will long-term. Also, you may qualify for tax deductions when using a HELOC or Home Equity Loan for home-related improvements that are significant. (You'll need to consult with a tax advisor on this type of deduction).

3. **Paying for College**
   Kids going to college? Tuition and all the extras are expensive. But did you know that a HELOC might have a lower rate than that of a student loan? Check your lending options. In the end, they might be similar. As a parent, though, it's good to have options if needed and, using the equity in your home to fund your children's college costs, might not be a bad idea.

4. **Emergency Expenses**
   You never really know when life might throw you a curve. If you don't have an emergency fund already as part of any savings (many experts suggest to have three to six months of salary stashed away), borrowing against your home equity might help you out of a jam.

What is a Home Equity Line of Credit (HELOC)?

A HELOC is a line of credit, just like a credit card is a line of credit. The collateral for this line of credit is the equity that you've built up in your house. With a HELOC, you are borrowing against the equity. Most importantly for your personal money matters, a HELOC usually has a lower interest rate, although variable, than other types of loans and the interest may be tax deductible if you're using it for home renovations (Again, check with your tax advisor to be sure).

Like a credit card, when you start to repay your balance during your HELOC's term, your amount of available credit is replenished, meaning you can borrow up to your credit line if you need to. Also, know that one of the main benefits of a HELOC is that although you might be approved for a certain amount of credit, you need not use it all. Fact is, you can continually borrow on it, until you reach your credit line limit. And, if you happen to pay it down, you can tap into it again during its term. In that way, it is just like a credit card.

How a HELOC Works

During the "draw period" of your HELOC – a set length of time during which you have access to funds – you borrow from your approved credit line. Whether you are using your HELOC for home renovations, paying off other debt, a vacation, etc., it's good to have a plan, or at least a solid idea, how much you'll need. The minimum payments usually are interest-only, though you may choose to pay principal. The length of the draw period is usually 5-10 years, depending on the terms of the loan and financial institution. For example, you may have a 10 year draw period and a 10 or 20 year repayment period.

If you choose, you can begin to pay back your HELOC as you draw on it, like you might a credit card. During the draw period, your minimum payment is usually interest only since a higher loan to value line calls for payment + interest. Paying more, will go towards the principal. You can do this throughout the entire draw period. When the draw period ends and you're officially in the "repayment period," not only will you not be able to draw on the line anymore, but your minimum payments will be higher because they will include principal payments to any remaining balance.

What is a Home Equity Loan?

A Home Equity Loan is basically a second mortgage to your house that you pay off in monthly installments just like you do with your primary mortgage. Instead of securing a credit line against the equity you've built up in your home as with the HELOC, you're actually borrowing a lump sum.

Because you are putting your house up as collateral, it may be an easier to secure this kind of loan than other types of consumer loans.

How a Home Equity Loan Works

A Home Equity Loan doesn't differ too much than any other consumer loan, such as a car loan or student loan. Once you find a lender whose loan terms appeal to you, you'll pay the loan back – interest and principal – over a period of years with a minimum payment that's based on a fixed interest rate, meaning your loan payment will be the same throughout the terms of the loan. (As mentioned above: with a HELOC, your rate will vary).

HELOC Benefits at a Glance

- **Low Interest Rate**
  Initially, HELOCs typically carry rates that are lower than credit cards or other consumer loans, including Home Equity Loans. (A HELOC rate will vary through its term though).

- **Interest May Be Tax Deductible**
  Did you use your HELOC specifically for home renovations that add value to your home? If so, it's possible that you can get tax deduction. Check with a tax professional to see if you qualify.

- **No or Low Closing Costs and Fees**
  If you shop around you may be able to find a HELOC with no closing costs or origination fees. It's always a good idea to do some research before you jump in.

- **Need-Based Borrowing**
  Don't borrow what you don't need. During the draw period, you may realize you don't need a much as you first thought. Given that there isn't a lump sum payment, as with the Home Equity Loan, you can use your available credit as needed until your draw period comes to an end.

- **Flexible Repayment Options**
  During your draw period, as mentioned above, you may be making interest only payments. It's certainly in your best interest to try to pay more than then minimum if you can. You also don't need to start paying until you first access your funds.

HELOC To Know

- **Variable Rates**
  Interest rates may rise or fall at any time. There's really no way to know when interest rates may rise. Given the changing market, you might end up paying more than was initially thought.

- **Your Home is Collateral**
  As with a Home Equity Loan, you've put up your house as collateral in this transaction. If you can't fulfill your end of the deal, the bank could foreclose. Make sure you know what you're taking on and you can afford to make payments.

- **Increase in Payments**
  Your payments after the draw period will increase significantly, especially if you've just been paying interest. Budget accordingly and anticipate the draw period ending.

Home Equity Loan Benefits at a Glance

1. **Fixed Interest Rates**
   With a fixed interest rate, you'll be able to budget easier: one set rate for the duration of the loan.

2. **Low Rates**
   Interest rates are usually lower than what you'd get with personal loans or credit cards.

3. **Lump Sum Payment**
   You'll receive your funds in one payment. If you know exactly what you need the payment for and how much it costs, you'll have the benefit of having it all at once and budgeting accordingly for pay off.

Home Equity Loan To Know

- **Higher Interest Rates**
  Although you are getting the benefit of a fixed rate, that rate may be higher than that of a HELOC.

- **Your Home is Collateral**
  It's worth mentioning again. Your house is collateral for the loan. Be wise when you borrow.

- **Fees**
  There likely will be fees and closing costs associated with your Home Equity Loan that you probably won't find with the HELOC. When shopping for a lender, take into consideration the costs and fees associated with taking out the loan.

Tax Benefits of Home Equity Borrowing

Is your HELOC being used for significant improvements to your home? Are those improvements adding value? Those are two important questions to ask before considering looking for the tax benefit.

Any sort of deductions may get complicated. Be sure to check with a tax expert to see if your renovation job might qualify for a deduction, or if you're eligible to take "points" deductions.

Drawing on Home Equity and Your Credit Score

Any type of credit or loan you receive, can impact your credit score. If you secure a Home Equity Loan, making regular payments will go a long way to increasing your credit score. Keep in mind that any outstanding loan you have may reduce your ability to borrow. Of course, it's wise to not have too much debt hanging over you in the long run anyway.

HELOC VS Home Equity Loan: They're the Same. But They Aren't the Same.

What? Briefly put, in each case, you are tapping into the equity you've built up in your home. In each case, you will be using the home as collateral. With a HELOC, you are utilizing that equity like a credit card and drawing on funds with a check, debit card, or electronic transfer to a checking or savings account that's linked to the HELOC account, as needed. With a Home Equity loan, you are getting a lump sum payment.

What's the right choice for you? It all depends.

- Do you want a lump sum for a known expense or do you want a line of credit that you can draw on as you need?
- Are you comfortable with a variable rate or one with stability when you borrow?
- Do you want the tax deduction that might come with a significant home improvement?

It's all up to you.

To learn more about your options, talk to an Atlantic Union Bank expert.

Contact Us

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