A Quick Guide to Home Equity Loans

- Home equity loans and lines of credit are contrasted here.
- COMPASS cautions clients against the use of home equity products to fund their living expenses, pay for extravagant travel, etc.
- If the use of home equity is not tied to the purchase or improvement of an asset (e.g., home remodeling), you may want to reconsider increasing the liability side of your personal balance sheet.

If you as a consumer need an additional line of credit, a home equity loan, also known as a second mortgage where your home serves as collateral, is one of several options that you can choose from. There are two major advantages of home equity loans. First, the interest rate on home equity loans is usually lower than credit cards and other consumer loans. Second, you can usually deduct the interest on home equity loans, unlike other loans. There are two types of home equity loans—fixed-rate loans and lines of credit.

A fixed-rate loan provides a single, lump-sum payment to the borrower, and is repaid over a fixed period of time at a pre-determined interest rate. This is useful if you know how much you would need and when you would be able to pay off the loan.

A home equity line of credit (HELOC) is a variable rate loan that works like a credit card. Borrowers are pre-approved for a specific spending limit and can withdraw money when needed via a credit card or special checks. Similar to a fixed-rate loan, the outstanding loan amount must be repaid in full at the end of the term. However, unlike a fixed-rate loan, HELOC interest rates float up or down, generally adjusted based on the current prime rate. A HELOC is a convenient way to cover short-term, recurring costs, such as quarterly tuition for a four-year college degree.

Although home equity loans do provide attractive rates of financing, we caution consumers to think twice about the reasons why one would need an additional line of credit. If you are thinking about using a home equity loan for day-to-day expenses, one should examine whether you are overspending and possibly sinking deeper into debt. If you end up taking out more money than your house is worth, the interest paid on the loan above the value of the home is not tax deductible.

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