

Home Equity Lines of Credit and How They Work

You've certainly heard the ads on television that tell you to 'tap the equity in your home' when you need fast cash for home renovations, emergencies and even family vacations. There are two main types of home equity loans, a standard home equity loan, and a home equity line of credit. Before you decide to tap the equity in your home, you should understand what home equity debt is and how you can use it to finance the important things in your life.

Borrowing against your home equity

Most homes are purchased through mortgages, a loan taken from a bank or lender and then paid back over a course of ten to thirty years. As you pay back that money, a certain portion of what you pay goes to the bank as interest, and the rest is applied to the principal. The amount paid on the principal builds 'equity', which is, in simplified terms, the amount of your home that you own. The amount of equity you have in your home can be used as collateral for a loan to finance college, pay for a wedding or make home improvements, among other things.

A home equity line of credit is not exactly a loan. Rather, it's a promise from a bank or lender that they will loan you money up to a specified amount when you need it at the interest rates agreed upon. Unlike a home equity loan, where the bank loans you a chunk of money and you pay it back, a home equity loan of credit allows you to borrow money as you need it, like a credit card.

Using a Home Equity Line of Credit

For example, if you take out a home equity loan for \$10,000, you'll get a check from the bank for \$10,000 all at once. The interest clock starts clicking as soon as you sign the papers, and if you find that you need to borrow more money, you will need to apply again. If you really only need \$2,000 of that money, you'll still be paying interest on the entire \$10,000 because you have the use of the entire \$10,000.

With a home equity line of credit, the bank promises to lend you up to \$10,000 over the next however many years. You haven't actually borrowed any money when you sign a home equity line of credit agreement. It's more like signing a credit card agreement. You won't owe any interest until you actually use your home equity line of credit to borrow money. Once you've established a line of credit, if you find you need \$2,000, you can draw that money from your home equity line of credit. At that point, you'll owe the bank \$2,000 and will start paying interest on a \$2,000 loan.

There will still be \$8,000 remaining on your line of credit. In other words, the bank has promised that it will loan you up to \$10,000 during the term that the line is in effect, so you can still borrow up to another \$8,000 as long as your loan remains in good standing. Even better, as you repay your loan, that money becomes available to borrow again, just like with a credit card.

So if you use \$2,000 of your line of credit, you'll have \$8,000 remaining. If you then pay back \$500 of it, you'll be able to borrow up to \$8,500 if you need it. You'll only pay interest on the amount that you have actually borrowed, but you'll have up to \$20,000 available to you to use without having to apply for a loan every time you need one.

Why choose a home equity line of credit?

Establishing a home equity line of credit before you need one can be an excellent idea. Unlike a standard home equity loan, you won't be paying any interest on the money that's available to you unless you actually use it, and you'll only be paying interest on the amount that you actually borrow rather than on the entire \$10,000 amount.

There are a few circumstances where a home equity loan makes more sense than a line of credit. Since standard home equity loans generally carry lower interest rates than a home equity loan of credit, it makes sense to use a home equity loan if you will be paying out all or nearly the entire loan amount in a short period of time. In other words, if you need \$10,000 to pay for something up front, then it makes more sense to take out a home equity loan for \$10,000. You'll pay less in interest that way.

If, on the other hand, you predict that you'll need about \$10,000 to complete a project over the next year, but won't need all of it at once, a home equity line of credit makes more sense. While your interest rate on the line of credit may be slightly higher than on a standard loan, you'll only be paying interest on the amount that you actually owe each month.

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