

HELOC vs Home Equity Loan: What's Best?

If you're looking to use your home's equity, you've likely come across two popular options: a Home Equity Line of Credit (HELOC) and a home equity loan. Both allow you to access the value of your home to meet financial goals, but they work in different ways. Choosing the right one depends on your unique financial needs and circumstances. This guide will analyze **HELOC vs home equity loan** options. You'll learn how each option works, their pros and cons, and when you might (or might not) use them.

What Is a Home Equity Loan?

A home equity loan, also known as a second mortgage, is a popular debt with many benefits. With this loan type, you can borrow a lump sum of money by leveraging the equity in your property. Equity is your home's value minus what you owe on it.

Many people prefer home equity loans because of their fixed interest rates. This simply means the interest remains constant over the life of the loan. This guarantees set monthly payments, providing stability and making managing your finances easier.

How Does a Home Equity Loan Work?

When you apply for a home equity loan, lenders assess your home's value and available equity. A typical loan range is usually 80%-90% of your home's combined loan-to-value ratio (CLTV). Your credit score, income, and payment history also affect how much home equity you can get. Once approved, you'll receive the loan as a lump sum, which you repay in fixed installments over a set term, usually 5 to 30 years.

While a home equity loan allows easy access to some cash, you should be responsible. Remember that your home is the loan's security, and any defaults could result in its loss.

Home equity loans are ideal for large, one-time expenses, such as the following:

- Funding major home renovations like kitchen remodels or roof replacements
- Covering unexpected healthcare costs without dipping into savings
- Consolidating debt and paying off high-interest credit card debt with a lower-rate loan
- Education expenses with a predictable repayment schedule, like college fees

What Is a HELOC?

A Home Equity Line of Credit (HELOC) is a revolving line of credit secured by your home's equity. Unlike a home equity loan, which provides a lump sum upfront, a HELOC allows you to borrow money in smaller bits, up to a set credit limit.

How Does a HELOC Work?

A HELOC has two primary phases: **the draw and repayment periods**. During the draw period, which typically lasts 5 to 10 years, you can borrow as much or as little as you need, only paying

interest on the amount you use. After the draw period ends, the repayment period begins, during which you repay both the principal and interest. The repayment phase usually lasts 10 to 20 years.

Due to the flexibility of borrowing, HELOCs are great for managing unexpected expenses like medical bills. However, the ease of getting the money, just like with credit cards, can lead you to overspend if you don't plan well. Also, HELOCs often come with variable interest rates, meaning your monthly payments could change over time.

HELOCs are particularly useful for the following:

- Phased home renovation projects like landscaping or adding rooms that require long-term funding
- Providing quick access to funds for unexpected costs like medical bills or last-minute travel
- Managing short-term financial needs without committing to a lump sum loan

Key Differences Between HELOCs and Home Equity Loans

HELOCs and home equity loans primarily differ in structure, interest rates, and repayment terms. Here are the main differences between the two options.

Structure

A HELOC offers a revolving credit line that allows you to continuously borrow money up to a specific credit limit over some time. In contrast, an equity loan offers you a lump sum of money at a go to be paid back within a specified duration.

Interest Rates

The interest rates for HELOCs are variable, meaning they can change over time. However, the interest rates for a home equity loan are fixed and don't change for the duration of the loan.

Repayment Terms

With home equity loans, you pay the same monthly installments until you clear the loan. However, with HELOCs, your monthly repayment varies depending on your outstanding balance and interest rates.

Purpose

A HELOC is ideal for ongoing expenses or phased projects that require a continuous supply of funds, such as renovations. On the other hand, home equity loans are good for large one-time expenses, such as tuition fees.

Pros and Cons of HELOCs

Like everything else, HELOCs have their good and bad. Here are the main pros and cons of HELOCs.

Advantages of HELOCs

- They offer flexible loan terms, allowing you to borrow what you need when needed without committing to a large lump sum upfront
- HELOCs offer high loan limits, usually five or six figures. They are ideal for large ongoing expenses like medical treatment or home renovations.
- Unlike home equity loans, HELOCs often have lower upfront fees, making them a cost-effective choice for many borrowers
- HELOCs offer lower rates than other loan types, such as credit cards or personal loans

What is The Downside of a HELOC?

- HELOCs usually have variable interest rates. This means your payments can rise if market rates increase.
- The revolving credit nature of HELOCs makes it easy to overspend, which can lead to financial problems
- Interest-only payments during the draw period might lead to higher payments when the repayment phase begins
- Like a home equity loan, defaulting on a HELOC risks your property since the loan is tied to your home

Pros and Cons of Home Equity Loans

Home equity loans have several advantages and disadvantages, which include:

Pros of Home Equity Loans

- Since these loans have fixed rates, they keep your monthly payments steady, making budgeting easier
- The interest on a home equity loan is often lower than on credit cards or personal loans, saving you money
- Great for funding large, one-time expenses with clear upfront costs due to the huge initial lump sum

Cons of Home Equity Loans

- Borrowing more than you need could strain your finances if unexpected costs arise
- Payments start immediately, regardless of how or when you use the funds
- Defaulting on the loan could put your property at risk

When Should You Choose a HELOC or Home Equity Loan?

HELOC and home equity loans allow you to get money against your property, but each option is ideal for a particular scenario.

A HELOC is best suited for the following situations:

- When you're unsure how much you will need, especially with ongoing projects that have unexpected costs
- For phased expenses like ongoing medical treatments that require a constant supply of funds
- When you need good cash flow. The interest-only payments during the draw period mean you'll have more money available compared to home equity loans

A home equity loan is best for the following:

- Fixed costs like debt consolidation or large purchases
- Easier long-term planning due to the fixed monthly payments
- Fixed interest rates provide peace of mind, even if market rates rise

When You Shouldn't Use Either Option

Taking a loan against your home is a big decision, and you should carefully consider your options beforehand. The main issue with these loans is that you can overborrow, leading to financial strain. Additionally, since the loans are tied to your home, defaulting on payment puts your property at risk. However, if you decide to proceed with the loan, carefully consider how to spend the cash.

What Is Not a Good Use of a HELOC?

Avoid borrowing a HELOC for:

- Non-essential expenses like vacations or luxury items. You would rather save or use short-term loans for these types of expenses.
- Short-term needs. Personal loans or credit cards are better for smaller, short-term expenses.
- Risky investments like stocks or startups that don't have guaranteed returns

What Is Not a Good Use of a Home Equity Loan?

- Borrowing against your home for speculative purposes is risky as you can lose your property
- Using home equity for everyday expenses as this can cause long-term financial instability
- Using it for projects without a clear cost breakdown. A lump sum might leave you overfunded or underfunded.

Summary

A home equity loan and HELOC allow you to tap into your home's value, but they serve different needs. A HELOC offers flexibility with a credit line for ongoing expenses, while a home equity loan provides a lump sum for fixed costs. HELOCs suit phased projects, while equity loans work best for large, one-time expenses.

Make the Right Financial Decision with A+FCU

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Contact A+FCU today and take the next step toward making your home's equity work for you.