07/04/2007

Choosing Between a Refinance or Home Equity Loan

Taking cash out of one's home for other needs is a very popular method of financing these days. If you are looking at borrowing some money for your child's college tuition or in order to consolidate all your debts, when it comes to using your home, you have two basic options: refinancing or taking out a home equity loan. Which one is best for your situation will depend on several factors.

Refinance Loans
A refinance loan is a new loan to replace your current mortgage. In order to pull out some cash with a new loan, you would get a cash-out refinance loan, a loan totaling more than you owe on your present mortgage. For example, you owe $80,000 on a $150,000 home. You need $20,000 to spend on college tuition. You take out a cash-out refinance loan for $100,000; the $80,000 pays off your original mortgage and you get to use the $20,000 in cash for your financial venture.

The Good
The advantages of getting a refinance loan over a home equity loan include generally lower interest rates. Because home equity loans get second priority on your home if you go into foreclosure, there are considered riskier than refinance loans and interest rate will typically be a point or two lower on refinance loans.

Another advantage of a refinance loan is that you may even be able to score a lower interest rate than you had on your original mortgage, meaning lower interest fees in the end.

A refinance loan may also be the best choice for you if you need to take out a significant amount of cash. You can generally take out more with a cash-out refinance loan than you can with a home equity loan.

The Bad
You generally have to pay closing costs on a refinance loan, which may add up to several thousands of dollars. This may decrease your profit from the loan.

Also, if you have been paying on your mortgage for many years, say 15 to 20, resetting your mortgage amortization may add lots of interest charges on to your total loan. You may be better off going with a home equity loan if you have less years left on your mortgage than you have already paid.

Home Equity Loans
A home equity loan is also known as a second mortgage because it does not replace or cancel out the original mortgage. It is a loan that allows you to borrow a certain amount of money in cash based on the amount of equity you currently have in your home (home equity = value of the home – the balance on the mortgage loan.) It uses your home as collateral.

The Good

One of the benefits of choosing a home equity loan is that you are often not required to pay closing costs. This can mean thousands of dollars in savings.

Home equity loans are also good because you do not have to pay private mortgage insurance. If you take out more than 80% of your home’s value with a refinance loan you will have to pay an additional couple hundred dollars each year in mortgage insurance.

The Bad

As mentioned above, home equity loans come with higher interest rates than cash-out refinance loans. A related risk is that you now have two loans attached to your property, using it as collateral. If you default on either loan now, you will be in danger of losing your home.