



## Learn These Basics Before Getting a Line of Credit

### Description

When people are in need of money, the last thing that comes to mind is to apply for a line of credit.



Going to a bank for a standard fixed- or variable-rate loan, using credit cards, borrowing from friends or family, or turning to specialist peer-to-peer or social lending or donation sites on the internet are the first things that come to mind. Pawnshops and payday lenders are available in the most desperate of circumstances.

For years, credit lines have been used by businesses to cover working capital needs or take advantage of strategic investment opportunities. Still, they have yet to catch on with individuals. Some of this may be related to banks rarely promoting credit lines and potential borrowers not bothering to inquire. A home equity line of credit, or HELOC, is the only credit line borrowing that may arise. However, that is a loan secured by the borrower's property, which has its own set of concerns and risks.

So, here are some fundamentals of credit lines.

## What Is a Line of Credit?

A bank or financial institution's line of credit is a flexible loan. A line of credit is a defined amount of money that you can borrow as needed and then repay immediately or over a predetermined length of time, similar to a credit card that offers you a limited amount of funds—funds that you can use when, if, and how you please. A line of credit, like a loan, will charge interest as soon as money is borrowed, and borrowers must be approved by the bank, with such approval being a result of the borrower's credit rating or relationship with the bank. It is important to note that interest rates are often changeable, making it difficult to forecast how much money you will end up paying back.

## When a Line of Credit Is Useful

In brief, lines of credit can be helpful in situations where there will be frequent financial outlays but the amounts are unknown ahead of time or the suppliers do not accept credit cards, as well as instances requiring significant cash deposits—weddings, are a notable example. Similarly, during the housing boom, lines of credit were frequently used to support house improvement or refurbishment projects. For example, people would typically seek a mortgage to purchase a home and a line of credit to assist fund any upgrades or repairs required.

## The Problems with Lines of Credit

Lines of credit, like any lending product, have the potential to be both valuable and hazardous. For example, if investors use a line of credit, the money must be repaid (and the terms for such paybacks are spelled out at the time when the line of credit is initially granted). As a result, there is a credit evaluation process in place, and would-be borrowers with poor credit will have a considerably more difficult time getting authorized.

When you're not using the line of credit, some banks will impose a maintenance fee (either monthly or annually), and interest begins to accrue as soon as money is borrowed. Because lines of credit can be drawn on and repaid on an as-needed basis, some borrowers may find the interest estimates for lines of credit more confusing and be shocked at how much interest they wind up paying.

## Comparing Lines of Credit to Other Types of Borrowing

As previously said, there are many similarities between lines of credit and other types of borrowing, but there are also significant variances that borrowers must grasp.

### Credit Cards

Unlike credit cards, lines of credit can be secured with real estate. Before the housing crisis, home equity lines of credit (HELOCs) were extremely popular among loan officers and borrowers. While HELOCs are becoming increasingly difficult to get, they are still available and often have lower interest rates. Credit cards will always have minimum monthly payments, and if those payments are not made, the interest rate will skyrocket. In addition, credit lines may or may not have comparable standards for quick monthly repayment.

## Loans

A line of credit, like a standard loan, a line of credit requires good credit and the return of any borrowed funds and interest on any borrowed funds. Therefore, obtaining, utilizing, and repaying a line of credit, similar to a loan, can improve a borrower's credit score.

If you decide that a loan is the best option for you, finding the best place to borrow money can be tricky, especially if you are in the midst of a financial emergency and must fund urgently. People with less-than-perfect credit may find it even more difficult to obtain cash immediately. Even if you have low credit, there are a variety of emergency loan options available to you.

## Payday and Pawn Loans

The discrepancies, however, are significant. The cash cost for everyone who qualifies for a line of credit will be far lower than the cost of a payday or pawn loan. Similarly, the credit evaluation process for a payday or pawn loan is more straightforward and less demanding (there may be no credit check at all), and you get your funds much, much faster. On the other hand, payday lenders and pawnbrokers rarely offer large sums of money that are frequently accepted in credit lines. On the other hand, banks rarely bother with credit lines as tiny as the usual payday or pawn loan.

## The Bottom Line

Lines of credit, like any other financial product, are neither necessarily good nor inherently harmful. It all depends on how people use them. On the one hand, excessive borrowing against a line of credit can bring you into financial difficulty just as quickly as excessive credit card spending. On the other hand, lines of credit might be cost-effective solutions to month-to-month economic fluctuations or completing a complex transaction such as a wedding or house remodeling. Like with any loan, Borrowers should read the terms carefully (especially the fees, interest rate, and repayment schedule), shop around, and don't be hesitant to ask lots of questions before signing.

### Category

1. Finance

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