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Comparing loan products for big-ticket items

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Cash-strapped consumers in the market for big-ticket items often turn to loans. But if you're already in debt, don't rush into anything.

This isn't the best economic environment to be relying on borrowed money, points out Greg McBride, Bankrate's senior financial analyst.

ADVERTISEMENT "This is a time to figure out how to live within your means and put aside money into a liquid cash cushion on a regular basis," he says. "That will reduce your need to borrow in a pinch."

Still, most consumers would be hard-pressed to use savings to pay for a home in cash. And mortgage lenders hawk loan products such as fixed-rate and adjustable-rate mortgages. Which one is a better choice?

And unfortunately, debts can add up quickly when an unexpected illness strikes. Consumers are often tempted to dip into their 401(k) accounts to pay the bills. Under these circumstances, is it better to take out a 401(k) loan or a personal loan?

U.S. consumers saddled with credit card debt often look to consolidation loans to get them out of a pickle. But does it make sense to substitute one form of debt for another?

We'll explore the pros and cons of some popular loan products to help take some of the guesswork out of borrowing money.

Comparing

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Home equity loans vs. lines of credit

Homeowners looking for cash sometimes tap their home equity -- the difference between the home's market value and its outstanding mortgage debt.

They generally opt for either a home equity loan or a home equity line of credit, known as a HELOC. Each has its merits and drawbacks. If your home value drops, you could end up owing more than your house is worth, as many borrowers and lenders have recently discovered. Further, equity lines of credit have variable interest rates, so your payments could potentially rise faster than your income.

Home equity loans have fixed interest rates over the life of the loan and payments are steady from month to month. The borrower won't suddenly get socked with a huge increase in the monthly payment.

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HELOCs work much like credit cards in that you draw from your line of credit and pay it down over time. Typical draw periods are 10 years to 15 years. The interest rate is variable and often tied to the prime rate.

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Some HELOCs are structured so the borrower makes interest-only payments during the early part of the draw period. After the initial interest-only period, the loan becomes self-amortizing and the payments increase to cover the interest and the principal until the loan is paid off.

HELOC vs. loan

	Home equity loan	HELOC
Pros	<ul style="list-style-type: none"> • Lower interest rate than credit cards. • Can be used for any purpose. • Interest may be tax-deductible. • Fixed interest and payments. 	<ul style="list-style-type: none"> • Lower interest rate than credit cards. • Can be used for any purpose. • Interest may be tax-deductible. • Offers a credit line similar to a credit card; you can draw cash as needs arise.
Cons	<ul style="list-style-type: none"> • If home value declines, you could end up owing more than the house is worth. • You could lose home if you don't make payments. • Currently higher interest rates than HELOCs. 	<ul style="list-style-type: none"> • Lender may freeze credit line. • Access to large lines of credit can be risky. • You could lose home if you don't make payments. • If home value declines, you could end up owing more than the house is worth. • Interest rate is variable and could change drastically.

Consolidation loans versus credit cards

Consumers get into trouble with credit card debt and often turn to consolidation loans to bail them out. The rationale: If you have multiple credit cards with high interest rates, they can be neatly packaged into one fixed-rate loan with a predictable monthly payment.

However, debt substitution can be dangerous for the fiscally undisciplined, says Paula de Vos, a Certified Financial Planner and president of Synergist Wealth Advisors in Carmel, Calif.

"The danger that people run into is taking out a loan and running up their credit cards again," she says.

But for disciplined consumers looking to turn a new leaf on their borrowing habits, the plan can be a viable alternative to making minimum credit card payments. Before taking out a consolidation loan, consumers should first assess their overall debt picture, says de Vos.

"It's hard to look at debt and debt products in isolation," she says. "One should also be considering taxes and ramifications to your other assets and looking at it in a more holistic fashion."

Consolidation loan vs. credit cards

Consolidation loan	Credit card
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- Pros**
- One predictable monthly loan payment versus several with different due dates.
 - Deal with one creditor versus many.
 - Interest may be tax-deductible if you use home equity to consolidate your debt (see separate section on home equity).
 - May come with lower interest rates and lower monthly payments than credit cards.
- Cons**
- Once credit card balances are cleared, it's easy to fall into debt again.
 - Often comes with high fees and rates.
 - If you default on a consolidation loan, you could lose any collateral to which the loan is tied.
 - Can cost more if you stretch out the payments over a long term.
- Paying off multiple credit cards in a disciplined way can be satisfying.
 - Full credit limits prevent more borrowing.
- Paying credit cards off individually may take longer, and may cost more in interest.
 - On "universal default" cards, interest rate can unexpectedly increase.

401(k) loans versus personal loans

Unexpected emergencies often prompt consumers to look for quick cash to bail them out of trouble.

Renters and consumers who don't have home equity to rely on may have to consider getting a personal loan or dipping into their 401(k) plans when they need money. Bankrate's article on tapping your 401(k) plan reveals the folly of doing so.

Personal loans can be either be unsecured or secured with collateral. Secured personal loans will get you lower rates. Interest rates for unsecured personal loans are among the highest for popular loan products, hovering around 14 percent over the last year, according to Bankrate data.

With interest rates on personal loans so high, it's important to shop around for the best rates.

"Learn how to negotiate and don't just stop at your neighborhood branch," says Rita Cheng, CFP, a financial adviser at Ameriprise Financial Services in Bethesda, Md.

Credit unions are a good place to start because they tend to offer good interest rates, she says.

If you go to a credit union for a personal loan, you may want to consider getting a share-secured loan that is secured by a savings account. If you maintain a certain balance, you may qualify for lower rates.

Because personal loans often come with costly fees and interest, you might consider borrowing against your 401(k) account, if your plan allows it.

Many people are under the impression that borrowing against your 401(k) account is relatively risk free.

"People will say if they have to pay back the loan, they are paying interest back to themselves, which may be true," says John Pallaria, Certified Financial Planner and adjunct faculty member in Boston University's CFP Program. "But if they are paying back 6 percent interest and their (mutual) funds are doing 8 (percent), 9 (percent) or 10 percent, there's lost opportunity because the money is out of the plan and not being invested."

401(k) loans versus personal loans

	401(k) loans	Personal loans
Pros	<ul style="list-style-type: none"> • No credit check or loan application. • You're paying yourself back rather than a bank, and the interest rate is lower than with personal loans. 	<ul style="list-style-type: none"> • Does not affect retirement. • Credit union rates can be reasonable, if not low.
Cons	<ul style="list-style-type: none"> • Can jeopardize retirement -- The money you remove from a 401(k) is no longer available to invest and cannot generate compound returns. • Repaid in after-tax dollars, which are then taxed again at retirement. • If younger than 59½, you pay a 10 percent penalty if the loan is not repaid. • Not tax deductible. • If you quit or lose job, loan must be repaid within 60 days or outstanding balance will be subject to income tax and penalty. 	<ul style="list-style-type: none"> • Higher interest rate than a 401(k) loan. • Not tax-deductible.

15-year mortgages versus 30-year mortgages

Financial experts say borrowers should favor 30-year mortgages because the lower monthly payments allow them to direct some money into retirement accounts and have more cash on hand for repairs and unexpected emergencies.

On the other hand, a 30-year fixed-rate mortgage requires you to pay more out in interest over the term of the loan.

If you're interested in paying down your mortgage quickly and you have a substantial amount of money in liquid reserves, you may want to consider a 15-year mortgage.

A 15-year fixed-rate mortgage will typically have a lower interest rate than the 30-year product, but expect a much higher monthly payment.

Bob Walters, chief economist at Quicken Loans in Livonia, Mich., says if you don't have at least a couple of years' worth of payments in cash reserves, you may not be the best candidate for a 15-year mortgage. The larger monthly payment often reduces the amount of money available to pay other debt, such as credit cards.

"I can't tell you how many times I've seen peoples' lives change when they lose their jobs and all of a sudden that 15-year payment is killing them," he says.

15-year mortgages versus 30-year mortgages

15-year mortgage

- Pros
- Home equity builds up more quickly.
 - Interest may be tax-deductible up to certain IRS limits.
 - Lower interest rates.

30-year mortgage

- More money is available each month for other investments and expenses.
 - When your financial situation allows, you can make higher payments toward principal with a 30-year mortgage and pay it off faster at your own pace, as long as the loan doesn't have prepayment penalties.
 - Interest may be tax-deductible up to certain IRS limits.
- Cons
- Higher interest rates.
 - You will pay a lot more in loan interest because of the increased term.
 - Equity builds more slowly than with a 15-year mortgage.

- Less cash is available to pay other debts or to put into savings.
- Job loss could mean consumers get into financial trouble easier with 15-year mortgage.

Adjustable-rate mortgages, or ARMs, versus fixed-rate mortgages

Consumers should take a 30-year fixed-rate mortgage if they do not like the uncertainty associated with a variable interest rate, says Bob Walters, chief economist at Quicken Loans in Livonia, Mich.

"It makes sense for those people to lock that fixed rate in," he says.

During the housing boom, adjustable-rate mortgages, or ARMs, were popular with flippers and homeowners who wanted to turn a quick, easy profit as home prices soared.

But during the ensuing housing bust, many of the speculators vanished or got stuck with ARMs they couldn't afford, as did unwitting homeowners.

ARMs are popular with homeowners who don't plan to stay in their homes for more than a few years or borrowers with substantial financial resources who can repay the loan before the rate resets.

"There's no sense paying for 30 years (for a fixed-rate loan) when you only need money for five years," says Walters.

ARMs have an initial period of one or more years where the interest rate is fixed. During the introductory period, the interest rate is typically lower than that of a comparable fixed-rate loan, thereby making initial monthly payments lower

After the introductory period, the interest rate adjusts and can move up or down, depending on the short-term index it's pegged to – usually the one-year Treasury or a short-term LIBOR index.

ARMs vs. fixed-rate mortgages

ARMs

- Pros**
- Lower payments early in the loan term.
 - Advantageous for borrowers who don't plan to stay in the same home too long.
 - Interest is tax-deductible.
- Cons**
- After the initial fixed-rate period, interest rate can rise significantly.
 - Can be difficult to understand, leaving less savvy borrowers vulnerable.
 - Homeowners with ARMs who had planned to move within a few years may be unable to sell their homes during a housing downturn (and may be unable to make larger payments when the rate adjusts upward).
 - On certain option ARMs, borrowers may end up in a negative amortization situation, owing more on the home than at closing.

Fixed-rate mortgages

- Certainty and security for homeowners who plan to stay in the home for several years.
- Interest is tax-deductible
- Amortization table can tell you how much equity you'll have decades into the future.
- Higher interest rates.
- Even if interest rates head lower, yours will stay the same.

FHA loans versus conventional loans

FHA loans have typically been the saving grace for potential homeowners who don't have a lot of money for a down payment.

Until recently, the FHA required as little as a 3 percent down and allowed the borrower to roll the 1.5 percent FHA insurance premium into the closing costs.

The FHA even allowed sellers and other organizations to gift the down payment.

When the new housing bill was signed into law in July 2008, some of those loopholes were closed.

Borrowers now have to pony up a 3.5 percent down payment to qualify for a loan. In addition, sellers and third-party organizations that financially benefit from the transaction will no longer be allowed to gift the down payment.

"That's the price you pay for the FHA to guarantee that mortgage," says Bob Walters, chief economist at Quicken Loans in Livonia, Mich. "But many people can get FHA loans that could not get a conventional loan," he says.

As lenders restrict access to conventional loans, many borrowers will look to an FHA loan on the path toward homeownership.

If you have the 20 percent down payment required by many lenders today, you may be

better off with a conventional loan because you'll gain equity faster and won't have to pay for private mortgage insurance.

FHA loans vs conventional loans

FHA mortgages

- Pros
- Lower down payment required.
 - Credit score standards are lower.
 - Mortgage insurance is tax-deductible, subject to income limitations.
 - FHA interest rates are competitive with those of conventional loans.
- Cons
- Requires mortgage insurance until 78 percent loan-to-value is reached, vs. 80 percent for conventional mortgages.
 - With lower downpayment required means it builds equity more slowly.
 - FHA loan amounts are capped by the federal government, vary from state to state and are usually lower than can be obtained with a conventional loan.
 - 1.5 percent upfront mortgage insurance premium and ongoing mortgage insurance premiums may end up costing more than private mortgage insurance for a conventional loan.

Conventional mortgages

- Borrowers who get a conventional loan with 20 percent down build equity faster.
- No mandated loan limits.
- Mortgage insurance is tax-deductible, subject to income limitations.
- Mortgage insurance may come cheaper than for an FHA loan, and take less time to get rid of.
- Higher credit score required to qualify, especially in current tight credit market.
- Larger down payment required.

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