Borrowing – Types of Loans

Line of Credit

One type of loan is called a line of credit or credit line. A line of credit allows you to borrow money up to a pre-determined maximum amount. It allows you to borrow money as you need it. The maximum amount you can borrow will be determined by your financial institution when you set up the line of credit.

How it works

A line of credit is revolving credit. This means that you can borrow any amount of money (up to the maximum) at any time and you will only pay interest on the amount you borrow. Then, you can repay it any time and as you repay it, that money becomes available for you to borrow again. So you can withdraw the money, pay it back and then borrow it again if you need it. Unlike many other loans, you don't need to borrow the full amount in advance. You can borrow only what you need, as you need it.

Interest

If you don't borrow any money from your line of credit, you won't have to pay any interest. You only pay interest on the amounts that you've withdrawn. Once you pay it back, you won't have to pay interest on that amount until you borrow it again. Because of this, in many cases a line of credit can be a better fit than a standard loan because you only pay interest on the money you have borrowed until you pay it back which can save you money.

Often the interest rate on a line of credit is variable, meaning that it may go up or down at any time. The interest on a line of credit is generally calculated daily and paid monthly. You will be charged interest on any amounts you borrow for the number of days it is used.

Paying Back a Line of Credit

Your financial institution will usually provide you with a monthly statement that shows how much is owing on your line of credit. You will be expected to make the minimum payment each month or it could affect your credit score. However, often the minimum payment is equal to the monthly interest you owe. If you only pay the monthly interest, your debt will continue to grow and you will never pay off the debt, costing you more and more. It is best to repay the money you've borrowed as soon as you are able, to avoid paying more than you need to in interest charges.

Terms and Conditions

If you are considering a line of credit, be sure you understand the terms and conditions of the line of credit. Some financial institutions may charge a monthly standby fee even if you don't use your line of credit. Others will not. Some may charge a set up fee or an administration fee. It's good to know what fees you will be charged and when.

Types of Lines of Credit

While most lines of credit are fairly generic and are generally used as a backup fund for emergencies, there are a few other specialized lines of credit available.

A Home Equity Line of Credit often referred to as a HELOC is a line of credit that uses your home as collateral. These are often a good choice if you need to do some home improvements. This allows you to only withdraw the money as you need it and they often have lower interest rates because they are secured by collateral.

Many financial institutions offer a student line of credit. This is a line of credit specifically for students in post-secondary education. They allow you to borrow the money you need as you need it to cover costs for tuition, books, everyday expenses, etc. You only have to pay back the money you borrow and it allows you to borrow money repeatedly over the year as you withdraw the money when you need it and pay it back when you are able. Usually, you will be expected to repay at least the interest of the line of credit, even while you're studying. Once you finish school, your financial institution may give you a grace period of 6-12 months after you graduate where you can continue to only pay the interest. After the grace period, you will be expected to pay back both the money you borrowed (the principal) and the interest. Once again, it's important to know and understand the terms and conditions for your student line of credit.