Topic 3: Understand types of borrowing product and how to work out the cost of borrowing

After completing this topic, you will be able to:

- define and understand the effect of the terminology relating to borrowing, including:
  - interest costs – that is, annual percentage rate (APR) and equivalent annual rate (EAR);
  - fees;
  - the total charge for credit; and
  - interest-free credit;
- complete calculations for APR and EAR;
- define the term 'depreciation of goods' and explain how this can affect credit decisions;
- understand the methods, benefits and features of using credit (that is, borrowing), including:
  - store cards; and
  - statements;
- understand different types of borrowing product, such as hire purchase;
- understand borrowing terms and conditions;
- distinguish between different sources of borrowing for the short, medium and long terms;
- compare products in terms of interest rate and other charges;
- understand legal issues, such as secured and unsecured lending, cooling-off periods, joint-name borrowing and age limits for borrowing;
- understand what a 'credit agreement' is; and
- understand what is meant by 'credit scoring' and 'credit history'.

Borrowing

When you want to buy something, you might wait and save up for it – but you may have to wait a long time, which can be inconvenient. The alternative is to borrow money from someone, or somewhere, else, so that you can have the item now.

If you choose to borrow, you get to enjoy the item sooner, but you have to pay back the lender. You also have to pay back the amount that you borrowed, plus interest and sometimes other charges as well.

Case study

Ben has been saving up for driving lessons and a car. He has saved £100 a month from his part-time job and, when he passes his test, he buys a very old car for £800. This is fine for the short journeys that he makes to college, his gym and to go to the shopping centre.

Two years later, Ben gets a full-time job. He has no smart clothes for his new job, and needs to buy a suit and some shirts. He knows that, when he gets his first pay cheque, he will be able to pay for these – but he cannot wait. A solution is for him to borrow in the short term and repay the next month.

Ben starts his job. His place of work is 25 miles away – that is, about a 30-minute car journey or a two-hour train-and-bus journey involving three changes. After a few weeks of trying the latter route, Ben is exhausted: the new job is challenging and enjoyable, but he is exhausted by all of the travelling and getting up really early.

Ben cannot use his car to drive to work, because it is now very old and unreliable. He needs a better car – but he has little saved (he spent his money on his old car) and so he will need to borrow to solve his transport problem. He expects to keep his better car for a few years and can afford monthly repayments. His solution is to borrow for the medium term.

Ben knows that, at some point in the future, he will want to move out of home and get his own flat. Flats in his area cost £100,000. He knows that he will never be able to save up enough for this. So, in the future, Ben knows that he will need a long-term loan to buy his flat – that is, what is known as a 'mortgage'.

There are, however, a lot of different options when it comes to forms of short-term and medium-term borrowing. In this topic, you will look at these different choices and at how to make the best choice.

Interest

Lenders make money by charging interest on their lending. To work out the cost of borrowing, you will need to work out the interest costs. Interest is always stated as a percentage of the amount borrowed and this is the cost per year.

Case study

Alma borrows £2,400 at an interest rate of 10 per cent.

The interest cost each year will be:

£2,400 x 10% = £240

To calculate the monthly cost of borrowing this money, the interest has to be divided by 12:

£240 ÷ 12 = £20

If Alma pays back the loan over one year, she will pay back the money that she borrowed, plus the interest, so the total to repay will be:

£2,400 + £240 = £2,640

This works out at £220 a month:

£2,640 ÷ 12 = £220

Case study

If Ben decides to borrow £9,000 to buy his new car and the interest rate is 6 per cent, the interest cost each year will be:

£9,000 x 6% = £540

To calculate the monthly cost of borrowing this money, the interest has to be divided by 12:

£540 ÷ 12 = £45

If Ben pays back the loan over one year, he will pay back the money that he borrowed, plus the interest, so the total to repay will be:

£9,000 + £540 = £9,540

This works out at £795 per month:

£9,540 ÷ 12 = £795

It will be too expensive for Ben to pay back a loan of this size over 12 months, so he will probably spread the payments over a longer period of time.

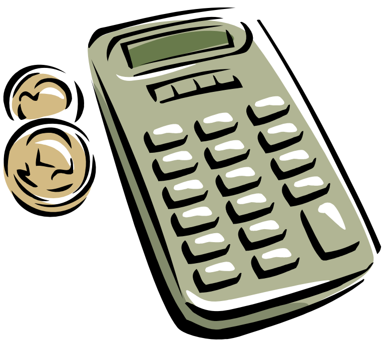
Activity 3a

a) ***If you were to borrow £5,250 at an interest rate of 12.95 per cent, what would be the cost per month of the interest?***

b) ***If you were to borrow £3,760 at an interest rate of 8.4 per cent, what would be the cost per month of the interest?***

c) ***If you were to borrow £18,500 at an interest rate of 6 per cent, what would be the cost per month of the interest?***

Annual percentage rate (APR) and equivalent annual rate (EAR)



Banks do not expect you always to have your calculator with you when you are trying to choose the best way of borrowing and the best provider.

By law, all lenders have to tell you the annual percentage rate (APR) or the equivalent annual rate (EAR) of borrowing from them. This is the true cost of borrowing that amount of money for that period of time. Knowing the APR or the EAR helps you to compare different lending products.

The APR is worked out using a complicated formula that you do not need to know at this stage, but which includes:

- the interest rate;
- the length of time for which you want the loan (known as the 'term'); and
- any fees.

Fixed APR

The APR on a personal loan is 'fixed' – that is, it does not change over the life of the loan. To work out your monthly payments, the bank or building society will show you a table like the one below.

12.9% APR

		12 mths £	**24 mths £**	**36 mths £**	**48 mths £**	**60 mths £**	**72 mths £**	**84 mths £**
£1,000	*Monthly repayment*	89	47	33	26	22	20	18
	Total to repay	1,068	1,128	1,188	1,248	1,320	1,440	1,512
£2,000	*Monthly repayment*	178	94	67	53	45	39	36
	Total to repay	2,136	2,256	2,412	2,544	2,700	2,808	3,024
£4,000	*Monthly repayment*	356	189	133	106	89	79	71
	Total to repay	4,272	4,536	4,788	5,088	5,340	5,688	5,964

Activity 3b

Use the table above to answer the following questions.

a) What is the monthly cost of a loan of £2,000 for 48 months?

b) What is the monthly cost of a loan of £4,000 for 72 months?

c) What is the monthly cost of a loan of £1,000 for three years?

The table also shows the total cost of repaying the loan. For example, if you were to borrow £2,000 for 24 months, the total cost would be £2,256.

What do you think the difference of £256 is? Why do you think knowing the total to be repaid is useful?

Variable APR

If the interest rate on your borrowings can change, the APR is said to be 'variable'. Variable APR means that your interest payments can go up or down each month, depending upon what interest rate is being charged at the time.

The type of borrowing that has a variable APR includes loans other than personal loans, credit cards and store cards. The reason why these have a variable interest rate is that the loan or debt may be outstanding for years and the lender is not prepared to fix the interest rate when it does not know for how long the debt will be owed.

EAR

EAR is the legal way in which interest rates have to be quoted for overdrafts. The calculation includes:

- the lender's interest rate;
- the way in which interest is calculated; and
- any fees.

The reason why the calculation is different for an overdraft from that for any other type of borrowing is that an overdraft is attached to a current account, which might sometimes be in credit. In other words, the account holder might not always be using their overdraft. A lender has to show the EAR for an overdraft so that the customer knows what the charge for the borrowing will be if they use their overdraft all of the time.

Fees

A lender may charge a fee for arranging the borrowing. This is more likely if the lending is specialist or if the loan involves some legal paperwork, such as a mortgage (at which we will look later). There will also usually be fees charged for credit cards and there may be fees for special interest rates.

The fee is included in the APR or EAR calculation.

Other fees can be payable if the terms of the borrowing agreement are broken. Fees are charged for unauthorised overdrafts (that is, overdrafts that have not been previously agreed between the account holder and the provider) and for borrowing above the agreed credit card limit. These fees have to be stated clearly and you might also consider them when choosing the right product for you.

Total charge for credit

The 'total charge for credit' must also be stated by any lender. It is the total cost of borrowing that will be repaid over the borrowing period in money terms. As we saw in the table above, the total charge can be looked up and clearly understood if it is for a loan with equal monthly repayments. The total charge for credit for the loan of £2,000 was £256. But for something like a credit card, it can be more complex.

The total charge for credit has to be stated by credit card providers. In this case, they all assume borrowings of £1,500 paid back by equal instalments.

Did you know?

Capital One Classic Extra Credit Card 'pre-contract information' states that, in calculating the APR and total charge for credit, it is *required by law to assume* that:

- the credit limit will be £1,200 unless it knows the credit limit when this agreement is made, in which case Capital One will use that credit limit;
- the credit is provided for a period of one year beginning with the date of the agreement;
- the rate of interest payable in relation to the whole of the credit under this agreement is that applying to purchases; and

- the credit is repaid in 12 equal monthly instalments, beginning one month after the date of this agreement.

At an APR of 34.94 per cent variable, the total charge for credit is therefore £197.21.

Source: www.capitalone.co.uk

Interest-free credit

The offer of 'interest-free credit' seems almost too good to be true. You might have seen notices in shops that look something like the following.

Interest-free credit!

Nothing to pay for 12 months!

These offers can be used by shops to persuade you to buy, because the deal then looks really tempting – but is it?

Some interest-free deals are exactly as stated and borrowing is repaid at '0% APR' for the entire period of the loan. But some offer interest free for six months and then expect repayment in full. If repayment is not made at the end of the six-month period, the loan then becomes one that has interest charged on it – and the interest rate can be quite high.

These are the types of 'interest-free' deal about which the government warns consumers (Source: www.direct.gov.uk):

Interest-free credit deals allow you to 'buy now pay later'. But if you don't make the payment by the due date, you end up paying interest – usually at a high rate – on the whole amount.

Beware of being tempted to buy goods simply because you get interest-free credit. Many credit companies rely on the fact that you won't be able to make the full payment on time. If you decide to buy this way, keep a note of all your payments and the date you made them.

Some credit cards also have a '0% APR' introductory period, to tempt you to apply for the card. This can be a very good way of borrowing short-term – as long as you know that you can repay the amount borrowed at the end of the introductory period.

Depreciation of goods

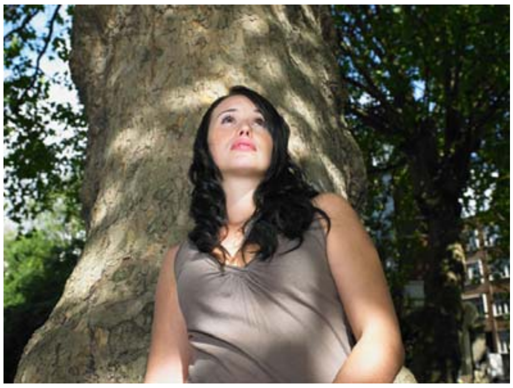
'Depreciation of goods' refers to the fact that the value of goods can drop over time.

A good example is a car: if you buy a brand new car for £12,000, it will be worth quite lot less than that in two years' time. Its value then will depend on the model of the car, how well you have looked after it, how many miles you have driven it and what else is on the market at that time.

How depreciation affects credit decisions

Depreciation affects credit decisions too, because you might end up with a loan balance that is higher than the value of the item that it was used to buy. It is a risk that depends on the level of depreciation of the item and it is the reason why lenders recommend that the loan is for no longer than you will keep the item.

Activity 3c



Prianka wants to buy a car. She finds a nice two-year-old car costing £7,000 and arranges for her building society to lend her £6,000 over four years.

Prianka is going to borrow for four years, but intends to trade the car in for a better one after three years.

a) What is the risk that Prianka is taking?

b) Are the sale proceeds of the old car likely to be enough to repay her borrowings and put down a deposit for a newer one?

If Prianka sells the car after three years and does not get enough to pay the loan off, she will be left with no car and outstanding debt to pay off.

c) How do you think Prianka will be able to afford her next car?

From the lender's point of view, people may be less inclined to continue making payments on a loan if they no longer have the item that the loan was taken out to buy.

When you apply for a loan, the lender will therefore want to know for what you need the money. This is so that you do not find yourself in a situation in which you have different loans outstanding for things that have either become useless or worn out, or which you have sold.

Think about loans for holidays, which you can usually take out over a maximum term of a few months, or perhaps a year. How would you feel if next year you were to want another holiday, but you were still paying for the last?

Methods and benefits of obtaining credit

Overdrafts (short-term)

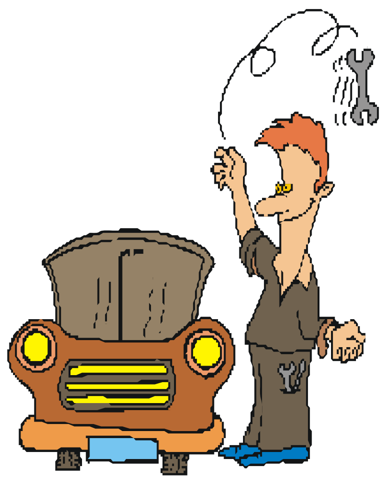
Overdrafts are a very short-term way of borrowing. They describe the situation in which the bank allows you to spend more than is in your account. Most overdrafts are used to 'tide you over' until you next get paid.

Case study

There is still a week to go until pay day and Rob's car has broken down. He has only £50 in his account, but the cost of repairing his car is £150.

Rob could wait until after pay day to get his car repaired – but he needs it to get to work. Fortunately, he has an 'arranged', or an 'authorised', overdraft, so he can use his debit card – or write a cheque – to pay for the repairs and the bank will pay the garage. Rob is now £100 overdrawn.

When Rob's monthly pay of £770 goes into his account a week later, he clears the overdraft and still has £670 to last him for the rest of the month.



The benefits of an overdraft include:

- convenience – that is, you can simply use your debit card or your chequebook; and
- you do not have to apply for the credit again each time that you need it.

The disadvantage is that if you go over your overdraft limit, or if you do not arrange the overdraft in advance with the bank (that is, if you use an 'unauthorised' overdraft), you will pay high charges.

Activity 3d

Visit the website of any bank, and look at the costs of an authorised and an unauthorised overdraft.

How easy do you think it is to spend a lot of money on bank charges if you do not plan your spending?

Credit cards and store cards (short-term)

Credit cards allow you to spend money in shops, online and over the telephone, and then repay the money at the end of the month, or over a longer period if you prefer. You get a statement listing the transactions that you have carried out using your credit card, which also shows the total that you owe the credit card company.

You can choose to repay the whole balance when the statement comes; if you do this, you do not pay any interest at all. Depending upon the point during the interest-free period at which you made the purchases, you could benefit from up to 59 days' interest-free credit.

If you choose to repay a smaller amount, you will pay interest on the amount that you leave outstanding.

Store cards work in the same way as credit cards, except that they can be used only in the store that issued them and they tend to have higher interest rates.

The benefits of credit cards and store cards include that:

- you can repay the money over a longer period of time if you choose; and
- you can get up to 59 days' interest-free credit.

One disadvantage of credit cards is that if you make only the minimum repayment each month, it takes a very long time to pay off the debt.

Activity 3e

The following table shows short-term borrowing rates for five banks and building societies (as at January 2014), including authorised overdrafts, unauthorised overdrafts and credit cards.

Bank name	**Authorised overdraft rate**	**Unauthorised overdraft rate**	**Credit card rate**
NatWest	19.89%	19.89% (+ £6 per day if unauthorised overdraft is over £6)	18.90%
Nationwide	18.90%	18.90% (+ £20 per month)	15.90%
Lloyds Bank	19.94%	19.94% (+ £6 one-off fee if unauthorised overdraft is over £10, + £5 per day if unauthorised overdraft is between £10 and £25 OR £10 per day if unauthorised overdraft is over £25 – to a maximum of eight days in each month)	17.90%
Santander	18.90% plus £1 per day (max 20 days per statement period	£5 per day, to a maximum of 20 days in each month	18.90%
Co-operative Bank	18.90%	18.90% (+ £20 initial charge + £20 per day for the first four days)	12.90%

Using these rates, calculate the following.

a) The cost of borrowing £1,500 from Lloyds Bank for one month using an authorised overdraft

b) The cost of borrowing £2,800 from NatWest for one month using a credit card

c) ***The cost of borrowing £750 from Santander for one month using an unauthorised overdraft***

d) ***The cost of borrowing £1,200 from Cooperative Bank for one month using a credit card***

e) ***The difference between borrowing £1,000 from Nationwide for one month using an unauthorised overdraft and £1,000 from Santander for one month using a credit card***

Personal loans (medium-term)

Personal loans are useful for things such as cars. The term of the loan should be as short as you can afford and should take into account the expected depreciation of the item that you are buying with the money.

Benefits of personal loans include that:

- you can choose from a variety of terms to suit your pocket; and
- the repayments are usually the same each month, so it makes it easier to budget.

Personal loans can be quite a big commitment and can take up a chunk of your wages each month. Before taking out a loan, you should ask yourself whether it might be better to save up for the item you want or, if this is not possible or if you need the item now, whether you should consider saving *some* money so that you do not have to borrow so much.

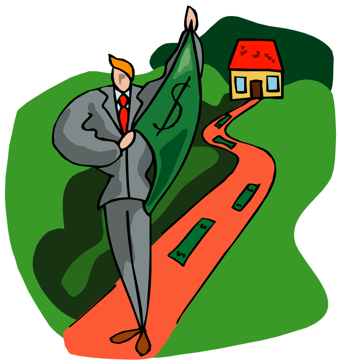
Hire purchase (medium-term)

Hire purchase (HP) is often used for things such as cars. Under an HP agreement, you promise to pay a deposit and then pay instalments each month to the HP company.

During the term of the agreement, the item that you are purchasing belongs to the HP company, not to you; you are only hiring it at this stage.

At the end of the HP period (which may be after three or five years, for example), you have the options of either handing the item back to the HP company or, for a very small final payment, buying it.

Mortgages (long-term)



A 'mortgage' is a larger loan used to purchase a property. The loan is usually for a period of 25 or 30 years, but may be for less. If you take out a mortgage, you will actually own the property – but if you stop making your mortgage repayments, the lender may take the property (that is, 'repossess' it) and sell it to get its money back. For most people, a mortgage is the only way in which they can afford to buy a house.

The benefits of a mortgage are that it enables you to own a house without having to save up to buy it – which would take many years. Mortgages can be taken over a longer period of time, so this keeps the repayments lower. When you sell your house, you pay off the mortgage and then take out a new one for your next house.

A major disadvantage of a mortgage is that you have the debt for a very long time. Also, if you do not make the repayments, you may have your house repossessed.

Comparisons between different borrowing products

When trying to decide which type of credit is the most appropriate for your needs, you first need to consider the following questions.

- How much do you want to borrow?
- For what do you want to borrow the money?
- Will that item depreciate in value?
- For how long do you need to borrow the money (weeks, months, or years)?
- How much can you afford to repay each month?
- Can you afford to save up some money first to reduce the amount that you need to borrow?
- How many other types of borrowing do you already have? Can you afford any more?

The answers to these questions will help you to decide which type of borrowing product you should have. You will then need to find the one that represents the best value for money by checking the APR or the EAR.

Comparing the rates

The whole point of lenders quoting APR and EAR is that you can compare one product with another without wondering if there are any hidden charges.

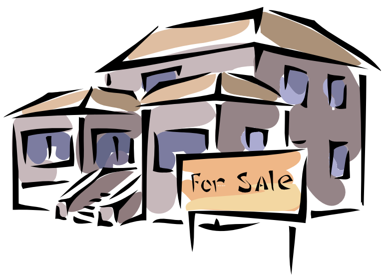
It is quite straightforward: the lowest rate is the best.

Legal issues relating to borrowing

Secured and unsecured lending

Some borrowing products are described as ‘secured’: a mortgage, for example, is secured on the house that it is used to buy. Advertisements for mortgages warn that if you fail to keep up the repayments on your mortgage, you may lose your house.

Great mortgage offers!



Please note: Your home is at risk if you do not keep up your repayments on it.

- **Secured lending**

  This means that you have to have an asset – for example, a home or car – against which the loan can be secured. If you cannot repay the loan, the lender can sell your asset to get its money back. You may be charged less interest on a secured loan, but there may be extra fees.

- **Unsecured lending**

  In this case, the lender does not require that your home or car is used to guarantee the loan, but legally you must still repay the loan. The lender can take court action against you to get its money back, and this could involve substantial costs and affect your credit history (see below).

Personal loans and overdrafts of lower amounts are usually unsecured.

Credit scoring

'Credit scoring' is a method that lenders use to decide whether or not to accept your application. For some cards, it helps the provider to decide on the credit limit.

Each lender has its own credit scoring system, based on its experience. The credit score measures the risk that it will take if it lends to you. Each lender will have a credit score 'pass' mark.

You will generally score more 'points' if you have been in your job for a few years, have lived in your house for a while and are an owner (with a mortgage) rather than a tenant renting a property. Age is also an influence: middle-aged people are considered less risky than the old or young.

Credit history

Your 'credit history' is a record of your previous borrowing and repayments, and a provider will look at this, as well as at your credit score, if you make an application to borrow money.

If you have borrowed, or are borrowing, and have a history of regular repayments, this will score you more points.

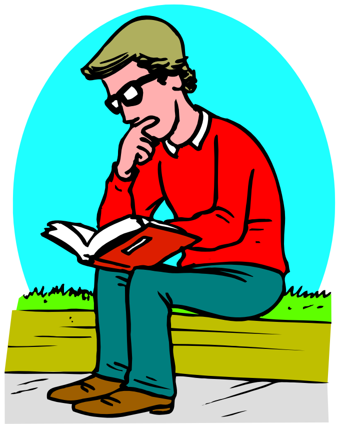
Did you know?

If you have made a lot of applications for credit – perhaps you are looking for the best deal – it can actually count against you. So be careful not to apply for credit until you have decided on the best deal.

When you are shopping around, lenders may want to check your credit report before giving you a quote for the cost of credit. Make sure that you ask the lender to make a 'quotation search' rather than a 'credit application search'. Lenders know that quotation searches do not represent actual credit applications, so they will not harm your credit score in the future.

Source: Financial Services Authority, *Money Advice Service: Credit Scoring*

The credit agreement



A credit agreement must be sent to any borrower as soon as a lender has agreed to lend. This is the legal document that tells you everything about the terms of the borrowing.

The credit agreement has a lot of pages and it is sensible to read them all carefully.

The credit agreement must tell the borrower the following information, among other things:

- who the lender is;
- the amount of credit or the credit limit;
- the duration;
- the APR or EAR;
- the total amount repayable and the repayment arrangements; and
- the total charge for credit.

It will also feature a box in which the borrower must sign to show that they agree to the terms and conditions.

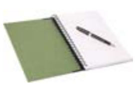
All credit agreements contain terms and conditions: these are all of the things that the lender and the borrower must do. For example, one of the terms might state that the lender must quote the APR and the total cost of the credit. Another, relating to the borrower this time, will be that the borrower promises to make repayments every month and must inform the lender if they move house.

Joint-name borrowing

If more than one person is borrowing – that is, if the borrowing is in 'joint names' – then the lender will expect to see a credit agreement signed by all of the people who are borrowing. In the credit agreement, the lender will state that the parties to the borrowing have 'joint and several liability'.

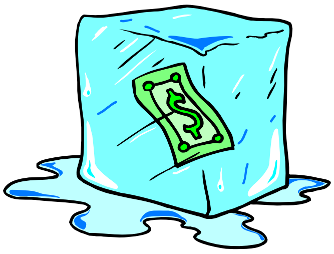
Joint and several liability is the legal way of saying that all parties are liable for the whole debt on a joint account even if they did not agree to it.

Joint and several liability is included in every joint account mandate, meaning that each party to a borrowing arrangement is liable for the full amount of any debt.



Case study

Gavin and Stacey bought a new car, and borrowed £4,000 in their joint names. Their relationship did not work out: Stacey left Gavin and went to work abroad. The bank claimed the whole outstanding amount from Gavin – some £3,000 – because he was jointly and severally liable. Gavin could not make the repayments and had to sell his car.



Cooling-off period

Discussions and an agreement to lend are usually made at the branch of the bank or building society. The credit agreement is then sent in the post as confirmation, signed by the lender. You will be asked to return one copy with your own signature on it.

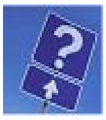
You may, however, discuss borrowings somewhere else (that is, 'at a distance') – particularly online, by phone or by post. In this case, the agreement has to allow you a 'cooling-off period' of 5–14 days. During this time, you can refuse the offer from the lender, without incurring any costs.

The details of any cooling-off period will be included in the credit agreement.

Age limits for borrowing

You have to be aged 18 or over to borrow using any of the products and sources mentioned in this topic. This is because if you do not pay the loan back, the lender needs to be able to take some action against you, which usually means going to court.

Most lenders also have a maximum age for borrowers too – generally 65.



Review questions

1. Calculate the annual interest charge for a loan of £7,500 at an interest rate of 6.25 per cent.

2. What does APR stand for and what does it represent?

3. Why do overdrafts have an EAR instead of an APR?

4. Why do you have to be careful when considering ‘0% finance’ deals?

5. How does depreciation affect credit decisions?

6. What is the difference between a personal loan and a hire purchase agreement?

7. What is the difference between ‘secured’ and ‘unsecured’ lending?

8. What is meant by ‘joint and several liability’?

9. What is the minimum age at which you can apply for a credit card?

Learning activities

Internet

Visit www.dfs.co.uk and look at its four-year interest-free credit offer. Is this a genuine interest-free deal?

Group

Go into some banks and supermarkets, and pick up leaflets about personal loans. Look at the questions. Can you see which ones are similar and will probably be used for credit scoring an application?

Individual

Visit www.nationwide.co.uk/mortgages/default.htm and look at the different mortgage rates offered by Nationwide.

- What do you notice about the initial rates and the APRs?
- What is the warning in capital letters at the bottom of the page?
- Why do you think lenders include this warning on their literature?

Key points for Topic 3

You should now understand:

- ❑ the terminology relating to borrowing, including 'interest costs', 'APR', 'EAR', 'total charge for credit' and 'interest-free credit';
- ❑ how to calculate annual and monthly interest costs;
- ❑ the term 'depreciation of goods' and be able to explain how this can affect credit decisions;
- ❑ the methods, benefits and features of using credit (that is, borrowing), including store cards, credit cards, charge cards and overdrafts;
- ❑ borrowing terms and conditions;
- ❑ the different types of borrowing product;
- ❑ the difference between borrowing in the short, medium and long terms;
- ❑ how to compare products in terms of interest rates and other charges;
- ❑ legal issues, such as secured and unsecured lending, cooling-off periods, joint-name borrowing and age limits for borrowing;
- ❑ what a 'credit agreement' is;
- ❑ what is meant by 'credit scoring' and 'credit history'.