Topic 1(l) Borrowing

Why borrow?

There are times when people want to buy something but do not have enough cash. For example:

Su wants to buy her brother a CD for his birthday

Hector wants to buy a video camera

Kris wants to buy a car

Lia wants to buy a house

In these circumstances they have a choice – they can borrow money to buy now, they can save money to buy later or they can decide not to buy at all. Some items cost so much money that saving up enough cash is not a realistic option for most people because it takes too long, e.g. buying a house, a car or a large piece of furniture. So people need to borrow to be able to buy these items and use them while they are repaying the loan.

Other items are needed immediately, so waiting until enough cash has been saved is not an option, for example, replacing a damaged car tyre or a broken window.

Q ***How do lenders make money from lending?***

The basics

When people borrow money they need to repay:

- the amount they borrowed – called the **principal**;
- **interest** on the amount they borrowed – calculated as a percentage of the principal;
- any fees or charges the lender makes – these are often called 'arrangement' or 'administration' fees.

For example, Kris is considering borrowing £8,000 from the bank. He wants the money for a new car. He has details of the loans that they offer. He could borrow:

- £8,000 – the principal;
- at a cost of 6.7% per year interest rate;
- with a set arrangement fee of £15.

Different approaches to borrowing

Nowadays most people are comfortable using credit, as long as they can afford the repayments.

However, some people have religious beliefs that mean they can only borrow money in a certain way. For example, Muslims are not permitted by their religion to pay interest. This is why there are special Islamic **mortgages** that do not charge interest in the way that other mortgages do. Instead, the bank buys the home and charges the 'borrower' rent for a given period. At the end of this time the borrower exercises their right to purchase.

Think about all the times when people borrow money, e.g. to buy homes, cars, furniture, electrical goods, clothes, holidays, presents, etc. Think about where people can borrow money from, ie the lenders.

List as many different types of lender as you can:

……

……

……

……

Lenders

There are many different sources of borrowing. Different lenders, known as **financial services providers**, offer different ways of borrowing, often called **credit products**.

You may have heard about the different credit products offered by different providers from watching television, seeing advertisements on billboards and in newspapers, and from studying other worksheets.

Match up each of the following loan providers with one type of the credit products they provide from the second column:

Providers	Products
1 Bank	A Store card
2 Family	B 'Interest-free' credit
3 Clothing shop	C Overdraft
4 Electrical shop (selling TVs, washing machines, etc)	D IOU (written or verbal agreement to repay)

Deciding how to borrow money

Once people have decided that they want to borrow money, they need to decide how they will borrow it, i.e. which provider and which credit product they will choose.

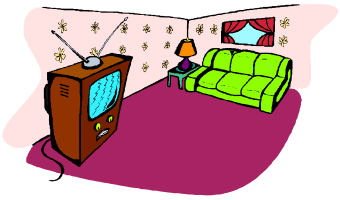
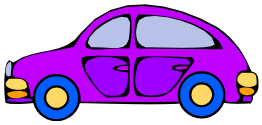
The key factors in deciding how to borrow money are:

- what you are buying;
- the amount of money you need to borrow;
- how long you need to repay;
- how much the credit will cost.

What you are buying

Different lenders specialise in offering loans for different purposes, e.g. building societies specialise in offering **mortgage loans** for buying houses and flats, although they offer other loans as well. Another example is a store credit card that a shop offers to encourage you to buy goods in that particular shop.

Matching borrowing needs to products and providers

You want to buy	Borrowing needs	Products	Providers
Cinema ticket 	***Amount***: a few pounds e.g. £5 ***Repayment period***: next few days	IOU – a promise to repay by a certain time	Family or friends
Clothes 	***Amount***: tens of pounds e.g. £20 ***Repayment period***: a few weeks or months	Store card, other credit card or overdraft	Shop, banks and building societies
Sofa or TV 	***Amount***: hundreds of pounds e.g. £400 ***Repayment period***: several years	In-store credit (e.g. hire purchase), credit card, personal loan	Shop, banks, building societies
Car 	***Amount***: thousands of pounds e.g. £10,000 ***Repayment period***: several years	Car loan	Car dealership, banks, building societies, finance houses

House 	***Amount***: tens of thousands of pounds e.g. £180,000 ***Repayment period***: many years	Mortgage	Banks, building societies, mortgage specialists

Note: a finance house is an organisation that offers credit, e.g. Lombard.

What is the minimum age at which people can borrow from an organisation like a bank?

How different borrowing products work

Some borrowing products are described as **secured** and some as **unsecured**. For example, a mortgage is secured on the house it is used to buy. Advertisements for mortgages warn:

Great Mortgage Offers!

PLEASE NOTE: YOUR HOME IS AT RISK IF YOU DO NOT KEEP UP YOUR REPAYMENTS ON IT

What do you think 'secured' means?

Informal IOUs

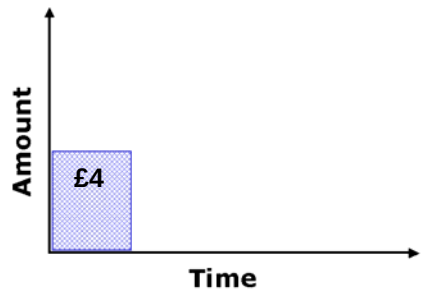
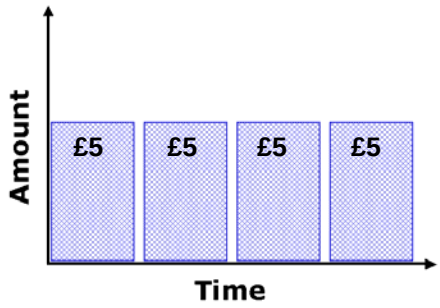
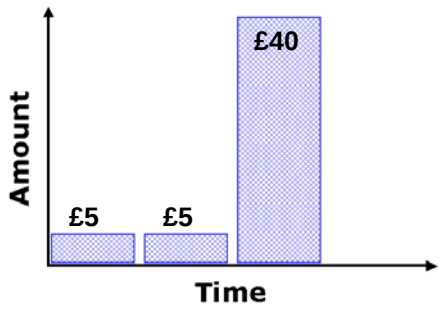
If you lend me £5 now, I promise to pay you back on Friday when I get my allowance.

Can you lend me £3 to buy this T-shirt? I'll pay you back after I've been to the cash point and taken out more money.

An informal IOU (I owe you) is a verbal or written promise made to friends or family to repay the money borrowed. People usually include when they will repay the money in an IOU. (Formal IOUs can be made to businesses, but these agreements are so rare we are not going to cover them in this worksheet.)

Suppose people borrow money from friends or family. Do these lenders usually charge interest on the amount of money borrowed? Do they ask for security?

People borrow money for different amounts of time on an informal IOU:

Borrowing	Repayment diagrams
Borrowing a few pounds for a couple of days and paying it back in one lump sum. *For example:* On Wednesday Hetty borrowed £4 from her mum. On Saturday she repaid her mum the full £4 from her pay packet.	
Borrowing money and paying it back in regular instalments over a period of time. *For example:* Ian borrowed £20 from his brother. He paid it back at £5 per week for four weeks (5 x 4 = 20).	
Borrowing money and paying a small, regular amount back, then making one big payment to repay the remaining debt. *For example:* Lauren borrowed £50 from her father. She paid him back £5 per month in January and February. Then she paid the remaining £40 from money she got for her birthday in March.	

What are the advantages and disadvantages of borrowing using an IOU?

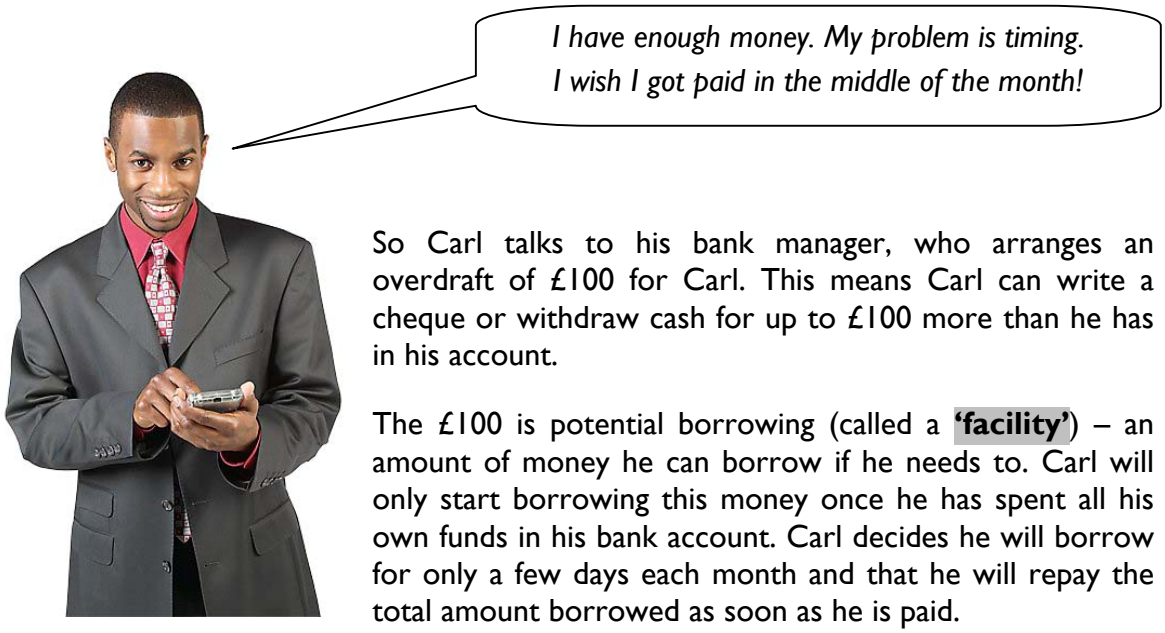
Overdrafts

Overdrafts enable people to take more money out of their bank current account than they have put in. So if you have £50 in your current account and you withdraw £60, you are using an overdraft of £10 (£60 – £50 = £10).

For example, Carl gets paid on the last Friday of every month. He finds it difficult to manage his money because his rent must be paid in the middle of every month. Carl's rent is a large amount so he sometimes runs out of cash before his next payment from work. Occasionally he has written a cheque that has taken more money from his bank account than he has deposited there. These occasions were mistakes because Carl lost track of how much money was in his account at different times in the month.

When accountholders have drawn (taken) money over and above the amount they have, it is called going **overdrawn**. The extra amount of money they have taken is called an overdraft.

Banks and building societies usually charge people a fee for going overdrawn without their permission. Last month Carl had to pay £20 in unauthorised overdraft fees, as well as paying interest on this borrowing.



So Carl talks to his bank manager, who arranges an overdraft of £100 for Carl. This means Carl can write a cheque or withdraw cash for up to £100 more than he has in his account.

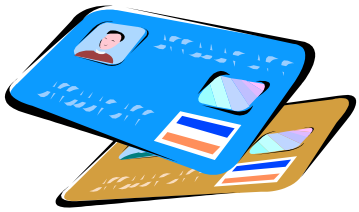
The £100 is potential borrowing (called a **'facility'**) – an amount of money he can borrow if he needs to. Carl will only start borrowing this money once he has spent all his own funds in his bank account. Carl decides he will borrow for only a few days each month and that he will repay the total amount borrowed as soon as he is paid.

As long as Carl keeps within the authorised overdraft amount, he will not pay any penalty fees. The interest he pays on his overdraft is calculated on the amount of this money he uses (i.e. borrows) each day. If he uses £20 for 2 days he pays less interest than if he uses £60 for 2 days.

An overdraft is unsecured borrowing. The bank does not have the right to take any of Carl's possessions to sell if he does not pay back his overdraft.

What are the advantages and disadvantages of an authorised overdraft as a way of borrowing money?

Credit and store cards



Credit and store cards allow you to buy now and pay later. These plastic cards can be used to pay for goods and services in person in shops, restaurants, petrol stations, etc. They can also be used from a distance to buy goods and services on the telephone, by mail order and on the Internet.

Using credit cards and store cards means that the cardholders are borrowing money from the card company. Cardholders are told the maximum amount of money they can borrow on the card. This is known as their **credit limit**. Most cards offer interest-free borrowing on purchases for up to 56 days or until the cardholders receive their next statement, whichever is sooner.

Usually, if cardholders withdraw cash on their credit card they will pay interest from the date they made this cash advance. This makes cash advances expensive compared to other ways of getting cash, such as a cheque or an ATM card.

We will also see later that store cards tend to be more expensive than credit cards.

Q ***Do you think providers only offer credit cards to people who have a full-time job?***

Each month cardholders receive a statement listing all the transactions they have made on their card. Cardholders can decide to repay all the credit they have used during the month or to repay only part of it. Cardholders who repay all their borrowing do not pay any interest. Cardholders who only repay some of their borrowing by the payment date will pay interest on the amount of debt left to continue onto the following month.

Cardholders who make only the minimum repayment each month find that their debt grows very quickly. For example, Fiona has a Visa card from her bank. She spends £100 on the card every month, but only makes the minimum repayment of £10. This is how her debt grows in just three months:

Month	Debt from previous month £	Interest on debt @16% APR	New purchases on card £	Amount owed this month	Repays £	Debt rolled over to next month £
Jan	0	0	100.00	100.00	10.00	90.00
Feb	90.00	14.40	100.00	204.40	10.00	194.40
Mar	194.40	31.10	100.00	325.50	10.00	315.50

Credit cards can be very useful because they allow you to spread borrowing across a few months, but they work out as an expensive way of borrowing money if the debt is not repaid for a long time.

Did you know?

Credit and store card transactions are processed using computer networks owned by payment systems. The two biggest payment systems in the world are **Visa** and **MasterCard**. You will see their logos on credit cards, as well as the name of the bank that has issued the card. You will also see their logos displayed in shops, restaurants, petrol stations, etc. These ads show that you can pay with their type of credit card at that place.

Q ***What are the advantages and disadvantages of credit and store cards as a way of borrowing money?***

In-store credit

Many shops also offer in-store credit, e.g. furniture shops and electrical retailers. These shops have agreements with organisations such as banks and finance houses (companies that offer credit) to provide these products.

Many of the in-store borrowing products sound very attractive because shoppers are told:

Interest-free credit!

Nothing to pay for 12 months!

Easy, low repayments!

Different offers work in different ways.

Method 1: You may remember on page 1 we met Hector, who wanted to buy a video camera. Hector goes to an electrical shop to buy his video camera. The sales assistant explains that Hector could have the camera straight away. He only has to pay a small deposit now, and the rest of the money in six months' time. As long as Hector makes this payment by the deadline, he will have interest-free credit. However, if Hector does not make the payment in six months' time, he will be charged a very high interest rate.

Q ***Would you advise Hector to take the camera under these terms and risk forgetting about paying the balance later?***

Method 2: Another way in which these deals work is by offering customers a **deferred payment** period. Deferred means that payment starts after a certain length of time. Stores give customers the option to pay nothing or to pay in full during the first 12 months after buying the goods. If customers do not pay in full, the store gives

them a three-year loan that they must start paying back as soon as the 12-month deferred period ends. Stores charge interest on these loans, often at high rates.

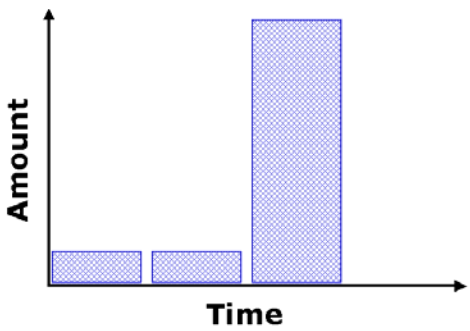
For example, a sofa is priced at £799. The store offers deferred payment. So the customer pays no deposit and makes no repayments for 12 months.

Then the customer can either pay in full the amount of £799 plus a £29 administration fee, or make 36 monthly payments of £41.99.

The full cost of the three-year loan is £1,511.64. This means that 'pay nothing for 12 months' costs the customer an extra £712.64 (i.e. £1,511.64 – £799 = £712.64). This is an extra 89% of the original price.

Method 3: Another way that these deals can work is by offering low repayments at the start of the loan, with one large payment at the end of the borrowing period.

This last payment is called a 'balloon' payment because it is so much larger than the others. Customers can find that paying this last payment is difficult. If they do not make the balloon payment, they are charged a higher interest rate on the amount left to pay and may also be charged a penalty.



The last payment is called a balloon payment

For example, Linda has bought a washing machine costing £299 from a department store. The shop offers her an 'easy payment plan' that means she will pay £20 a month for 11 months and a balloon payment of £168.70 in month 12.

This means she will repay £388.70 in total, at an APR of 30%. If Linda does not make the balloon payment in month 12, she will continue to be charged 2% interest a month until she has paid off her debt. 2% interest a month means that the debt would grow like this:

First month: £168.70 + 2% = £172.07
Second month: £172.07 + 2% = £175.51
Third month: £175.52 + 2% = £179.02

Would you recommend that Linda should agree to this 'easy payment plan'?

If not, what other borrowing products should she consider?

Some in-store credit is secured on the goods that are bought and some is not. Under agreements that are labelled '**hire purchase**', the goods do not become the customer's property until they have finished making all the repayments. If they fail to repay, the store can repossess the goods as they still belong to the shop.

It is very important for customers to read the small print in any credit agreement to see what the repayment conditions are and what the consequences of non-payment will be.

The key point here is that if an offer sounds too good to be true, there probably is a catch!

What are the advantages and disadvantages of in-store credit as a way of borrowing money?

Loans

People can also borrow by getting a loan from a bank, building society or finance house. Some shops and supermarkets also offer loans, through banks that they partner.

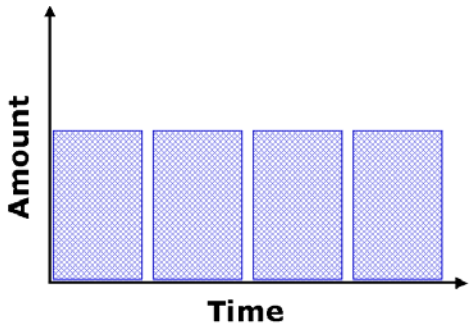
Loans can be made for a specific purpose, such as a car loan. Or they can be general loans made to an individual. To make it clear that these loans are made to a person and not a company, they are called **personal loans**.

A personal loan is a way of borrowing a specific sum of money for a specified period of time. For example, people could borrow £10,000 over three years, or £2,000 over two years, etc. It is up to the borrower to look for the repayment period that will suit them best.

Loans tend to be made for larger sums of money than overdrafts. Overdrafts are designed to be used for short periods of time, e.g. a few days a month, and for smaller sums of money, e.g. a few hundred pounds. Loans are for larger sums of money, e.g. several thousand pounds, and for longer periods of time e.g. 12 months, 3 years, 5 years, 7 years, or 15 years.

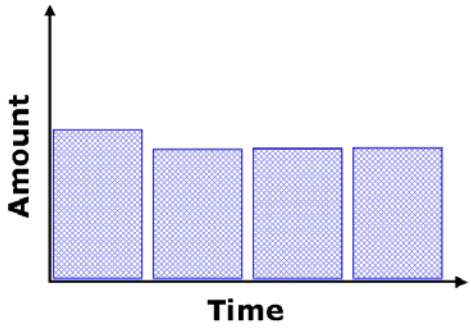
Borrowers make repayments every month, usually by direct debit from their bank account. The amount of these repayments will be the same every month if the loan uses a **fixed interest rate**.

At a fixed interest rate, repayments are always the same



The repayment amounts will go up or down slightly if the loan has a **variable interest rate**. People choose to borrow at a variable rate of interest if they think interest rates are likely to fall.

With a variable interest rate, repayments change according to the Bank of England base rate.



The lender's variable interest rates go up and down if the Bank of England's base interest rate changes. Lenders usually charge several percentage points more than the base interest rate, for example base rate +2%. This is why the base interest rate is reported in the news. People borrowing money on a variable interest rate want to know what will happen to their repayments – for example, will they be paying the same amount of money in repayments (no change in base rate), more money (base rate has increased) or less money (base rate has decreased)?

You may have seen advertisements for personal loans:

> Borrow for any purpose!
>
> Any amount from £1,000 to £15,000.
>
> For 1 to 7 years.
>
> Low interest rates and no fees to pay!

The details you need to know about a loan are:

- the amount you want/can borrow;
- how long the repayment period is;
- what the interest rate is;
- what the other costs are;
- if the lender wants to take **security**;
- what the terms and conditions are, for example do you get charged a fee if you want to repay the loan earlier than planned.

As soon as the loan is agreed, the full amount is transferred into the borrower's account, or is sent by cheque.

Many personal loans are unsecured. However, some are secured on the item that the loan is being used to buy, such as a car. You will also see advertisements for loans for

'homeowners'. These loans are in fact a type of mortgage and are secured on the borrower's home. If borrowers do not repay this type of loan, the loan company can repossess their home.

Lenders can ask for security for any type of loan if they want to. They may also ask for guarantees in some cases. A **guarantee** is when another person promises to repay the loan if the borrower does not repay (**defaults**). For example, Mel wants to borrow £2,000 from his bank. The bank agrees if Mel's dad will guarantee the loan.

What are some of the things people might need or want to buy using a loan?

Did you know?

The government makes special loans available to students through the Student Loans Company Ltd (www.slc.co.uk). Students use these loans for tuition fees and living expenses while they are at university or college. This type of student loan is repaid only when the borrower is earning £15,000 or more.

Mortgages

Mortgages are loans that are used to buy a home such as a house or a flat. Mortgages are secured on the home they are used to buy. This means that if the borrower does not repay the mortgage, the lender can take the borrower's home and sell it to get their money back. Banks and building societies try to be sympathetic to people who are having trouble with their repayments and should not **repossess** the house immediately, but give the borrowers time to pay.

Mortgages are available from banks, building societies and specialist mortgage companies. The most usual repayment period for a mortgage is 25 years, although mortgages can be for a shorter or a longer period of time.

A mortgage is the largest loan most of us take on. Because they are secured loans and the repayment period is so long, the interest rates on mortgages are almost always lower than for other forms of borrowing, (see later for details).

When borrowers take out a mortgage, they must also have a **life assurance** policy that covers the amount of the loan. This is so that the mortgage will be repaid if the borrower dies. For example, George has a mortgage for £100,000. If he dies, his life assurance policy will pay £100,000. This money will be used to repay the amount of money George still owes on his mortgage. Any money left over will go to his family. The mortgage lender will get the rest of the mortgage repayments and George's family will get the house.

What do you think happens when people with a mortgage sell their home and buy another one?

Working out how much borrowing costs

All lenders must quote the costs of borrowing as an **Annual Percentage Rate (APR)**. An APR gives a standard measure of the interest rate and fees involved in taking the credit. An APR is given as a percentage.

For example: 6.7% APR means that if people borrow £100 they must pay back £100 (principal) plus £6.70 in interest and fees. This means that the total repayment is £106.70.

As the method for calculating APRs is always the same, borrowers can use the APR figure to compare products and work out which one will be cheapest for them. (Topic 1(f) *Debt* contains further information.)

Lenders often use loan tables to advertise the loans they offer and how much they cost. See the example from www.egg.com on the next page.

You will notice that the table shows:

- the APR for borrowing amounts from £1,000 to £4,000 is 12.9%;
- the APR for borrowing amounts from £5,000 to £25,000 is 7.9%;
- what the monthly repayment will be for borrowing an amount of money over different periods: 12 months, 24 months, 36 months, etc;
- the total amount that the borrower will repay if they take the loan over that number of months.

Please note that Egg will also make loans for amounts of money that are different from the ones listed above.

The repayment tables are for examples only. Every customer who wants a loan needs to get a personal quote – a price for the amount they want to borrow, over a specific number of months, based on their personal circumstances.

'Personal circumstances' include the person's:

- financial history – for example have they borrowed money before and if so, did they pay it back on time?
- income;

and whether or not they have security to offer, like a home.

Repayment table

12.9% APR								
		12 months	24 months	36 months	48 months	60 months	72 months	84 months
		£	£	£	£	£	£	£
£1,000	Monthly repayment	89	47	33	26	22	20	18
	Total to repay	1,068	1,132	1,200	1,270	1,342	1,416	1,494
£2,000	Monthly repayment	178	94	67	53	45	39	36
	Total to repay	2,135	2,265	2,399	2,539	2,683	2,832	2,986
£4,000	Monthly repayment	356	189	133	106	89	79	71
	Total to repay	4,270	4,529	4,799	5,078	5,366	5,665	5,973

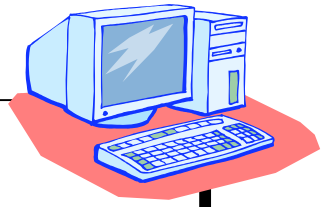
7.9% APR								
		12 months	24 months	36 months	48 months	60 months	72 months	84 months
		£	£	£	£	£	£	£
£5,000	Monthly repayment	434	225	156	121	101	87	77
	Total to repay	5,210	5,409	5,613	5,821	6,035	6,253	6,476
£8,000	Monthly repayment	695	351	249	194	161	139	123
	Total to repay	8,336	8,654	9,081	9,314	9,656	10,005	10,362
£10,000	Monthly repayment	868	451	312	243	201	174	154
	Total to repay	10,420	10,818	11,226	11,643	12,070	12,506	12,953
£15,000	Monthly repayment	1,303	676	468	364	302	261	231
	Total to repay	15,630	16,227	16,838	17,464	18,105	18,760	19,429
£25,000	Monthly repayment	2,171	1,127	780	606	503	434	385
	Total to repay	26,050	27,045	28,064	29,107	30,175	31,266	32,381

Liz wants to borrow £2,000. She can afford to repay about £100 per month. Looking at the repayment table on the previous page:

1. ***Which repayment period do you recommend for her?***
2. ***How much money will she repay in total?***

The actual repayment Liz makes will be decided by her personal circumstances, including her credit history.

Did you know?



Lenders check a customer's credit history by going to credit reference agencies such as Experian, Callcredit and Equifax. These organisations hold records on the way people have used credit in the past, for example whether they have got behind with their repayments.

Customers can check their own credit file by paying the credit reference agency a fee.

The APRs charged for different borrowing products vary greatly, so it is wise for a borrower to shop around. Here are some examples of the APRs quoted on www.moneyfacts.co.uk:

Borrowing product	APRs %	Provided by
Authorised overdraft	6.90	Halifax
	9.37	Yorkshire
	10.05	Intelligent Finance
Unauthorised overdraft	28.80	Halifax
	29.99	Yorkshire
	25.25	Intelligent Finance
Credit card (standard interest on purchases)	6.80	Barclaycard
	11.90	Co-op Bank
	11.80	Yorkshire
Personal loans (£5,000 over 3 years)	6.70	Bradford and Bingley
	7.90	Royal Bank of Scotland
	8.40	Direct Line
Mortgages (fixed rate, 2 years)	7.6	Alliance and Leicester
	7.8	Portman Building Society
	7.5	Britannia Building Society

Looking at the table of APRs:

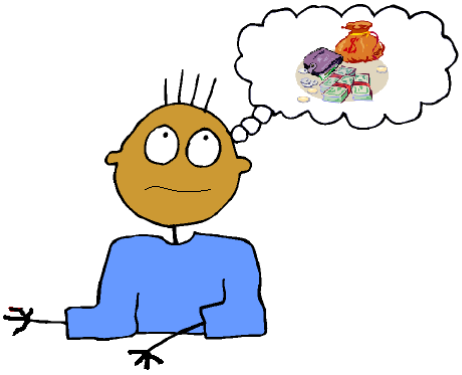
1. ***How much more expensive is an unauthorised overdraft than an authorised overdraft?***

2. ***Do loans tend to have lower APRs than overdrafts?***

3. ***Do loans tend to have lower APRs than credit cards?***

4. ***Do mortgages tend to have lower APRs than loans?***

Before deciding which is the cheapest product, it is important to consider how different options will be used.



For example, Gareth is going to rent a flat with some friends. He needs to pay the landlord a deposit and one month's rent in advance. This is a total of £700. Unfortunately, he has just had to pay for his car to be serviced, so he doesn't have the money in his bank account. He will be paid in 10 days' time. He is considering two borrowing options: getting an overdraft or a personal loan.

Gareth goes onto the websites of various lenders and uses their calculators to compare the costs of overdrafts and personal loans. Here is one comparison he found:

Product	Amount borrowed	Repayment period	Charges	Total repayment
Loan	£1000	2 years	15.4% APR	£1157.04
Overdraft	£1000	10 days	7.75% **EAR**	£1002.05

Source: www.nationwide.co.uk (EAR = Equivalent annual rate, ie the amount of interest and fees if the accountholder was overdrawn by the full amount all year)

As you can see, getting an overdraft is much cheaper than getting a loan, although the percentage charge is more. This is because the overdraft charge is calculated on the 10 days that Gareth needs to borrow the money. The loan charge is based on Gareth taking two years to repay his borrowing.

Paula is about to leave home for the first time and move into a shared house. She wants to borrow a few hundred pounds to buy household items like plates, cutlery, saucepans, bed linen, towels, an alarm clock, bedside light, etc.

Paula is thinking of borrowing by getting either a credit card or an overdraft. If she gets a credit card, she will need to take several months to repay the amount she borrows.

What do you think is likely to be the cheaper option – a credit card or an overdraft?

Store cards tend to charger higher interest rates than credit cards. And both credit and store cards tend to charge higher interest rates than overdrafts.

Comparison of rates quoted on provider websites on 24 July 2007:

	Provider	Credit card interest	Overdraft interest rate (EAR)
Stores	Dorothy Perkins Card	29.9% Service offered by GE Capital Bank Limited	Not applicable
	Debenhams Card	18.9% Service offered by GE Capital Bank Limited	Not applicable
Banks	Barclays	27.9% Barclaycard Initial	15.6% Barclays Bank Account
	Egg	16.9% Egg Card	7.9% Egg Money negative balances
Building society	Nationwide	17.9% Classic Card	7.75% Agreed overdraft

Did you know?

There are three standard measures that help people to compare financial products:

APR (annual percentage rate) is used to quote the interest rate and fees charged on borrowing such as credit cards and loans.

EAR (equivalent annual rate) is used to quote the interest rate and fees charged on overdrafts.

AER (annual equivalent rate) is used to quote the interest rate paid on the savings people have in banks and building society accounts.

Other costs involved with borrowing

As well as interest rates and fees, people need to consider other costs of borrowing. For example, everyone who takes out a mortgage needs to buy life assurance to cover the mortgage amount. The mortgage borrower will need to pay insurance **premiums** (payments) to the life assurance company, as well as repayments to the mortgage lender.

Other lenders also sell insurance to go with borrowing. For example, many providers of personal loans suggest that borrowers buy insurance. This insurance guarantees their repayments are made if the borrowers get ill or lose their jobs.

There are many different types of fee that can be charged as well. For example, lenders often charge a one-off 'arrangement fee' to cover the administration of setting up the borrowing. There can also be fees if a borrower is late with a payment, and fees if the borrower wants to repay the debt early.

Credit and store cards can charge an annual, set fee for supplying the card, as well as charging interest on transactions. Some cards don't charge a fee but the interest rate they charge can be higher than cards with a fee. People who will pay off the full amount borrowed on the card every month should go for a card that has no annual fee. The interest rate will be less important to them as these people intend to avoid paying any interest.

Did you know?

Frequently banks offer very low or 0% interest rates on credit cards when they first launch a new card or are trying to attract new customers. After a time, e.g. six months, the interest rates on these cards increase.

There is usually nothing to stop customers moving their borrowing to another card (called a credit transfer) but few customers do. This is because they are concerned about the work involved with finding a new credit card provider, and making the credit transfer.

So, instead of a few days' effort looking for a better deal, customers put up with higher and higher interest rates.

Loan sharks

Some people are not able to borrow from banks and building societies because they earn very little or have a bad credit history (they borrowed in the past and did not repay their debts on time).

There are lenders who take advantage of these people by offering them loans, but at huge interest rates.

Did you know?

There is no legal maximum for the amount of interest a lender can charge.

Any amount of money lent for any purpose.

Just 1% interest charged per week.

***Contact*: Honest Joe**

Handling charge applies.

If 'Honest Joe' is charging 1% interest per week, how much interest is that per year (52 weeks)?

You probably noticed that the small print says there is a handling charge as well. Suppose this was £5 a week. The amount doesn't sound very large until you multiply it by 52 and find out that the annual charge is £260 – and you're probably paying interest on this too!

If someone borrows £1,000 for three years from Joe, the cost will be:

	Principal	Interest charged	Total repayment cost so far
Year 1	£1,000	52% = £520	£1,520
Year 2	£1,520	52% = £790.40	£2,310.40
Year 3	£2,310.40	52% = £1,201.41	£3,511.81

So by the end of three years the borrower will have repaid £3,511.81.

The borrower also has to pay handling charges for 3 years i.e. £260 x 3 = £780. This gives a grand total of: £3,511.81 + £780 = £4,291.81

So the borrower will have paid £4,291.81 to borrow £1,000.

This example assumes that Joe is using quite a simple method of calculating interest. There are other methods he could use that would mean the interest amount grew even faster.

Review questions

1. What does 'principal' mean in terms of borrowing?
2. What does 'APR' stand for, and what does it mean?
3. Suppose Frank wants to borrow a small amount of money for a few days. Should he ask his bank for an overdraft or a loan?
4. Suppose Victor wants to borrow £3,000 over five years. Should he ask his bank for an overdraft or a loan?
5. What does 'secured' mean when talking about loans?
6. What is the advantage of an authorised overdraft over an unauthorised one?
7. Do people pay interest on their full overdraft limit or just the amount of money they have borrowed?
8. Is Gillian borrowing money when she makes a purchase using her credit card?
9. What do credit cards charge interest on:
    a. all the money spent using the card during the month;
    b. just the money that is not repaid at the end of the month?
10. What is a balloon payment?
11. Tom has a loan with a fixed interest rate. Will his repayment be the same amount every month?
12. Which providers offer personal loans?
13. What is a mortgage used for?
14. How long is the typical repayment period for a mortgage?
15. Tammy is comparing the cost of borrowing using an overdraft or a credit card. She wants to borrow £200 for about eight days. Assuming her next credit card statement will not arrive for another four weeks, which is the cheaper option?
16. Which tends to have the lowest APR – a mortgage or a personal loan?

17. What does 'EAR' stand for when talking about borrowing?

18. What type of insurance must mortgage borrowers buy? Why do lenders insist on this type of insurance?

19. Why should people avoid borrowing from a loan shark?

Case study

What borrowing products do you recommend for each of the four characters we met on page 1?

Sue wants to buy her brother a CD for his birthday.

Sue is 14 years old. She gets an allowance of £20 per month. The CD costs £14.99.

Hector wants to buy a video camera.

Hector is 19 years old. He has a full-time job at a local factory. The video camera costs £299.

Kris wants to buy a car.

Kris is 21 years old. He has a full-time job with a local newspaper. He needs £8,000 to buy the car.

Lia wants to buy a house.

Lia is 25 years old. She has a well-paid job and has already saved the deposit for her house. She needs to borrow £120,000.

Learning activities

Internet

1. Find out more about how the mortgage products that are designed for Muslims work. Go to www.bbc.co.uk, type 'Muslim mortgages' into the search box and then look for articles on Sharia-compliant mortgages.

2. Go to www.bbc.co.uk and search for the advice given by TV and radio programmes about credit.

3. Go to www.moneyfacts.co.uk and compare the 'Best Buy' costs of borrowing using a mortgage, overdraft, loans and credit cards. Note that the introductory rates and the standard interest rates on cards can be very different. Now go to the website of any high street bank and compare their interest rates to the Best Buys on the moneyfacts website. Why is it important to 'shop around' when looking for a borrowing product?

4. Go to the websites of high street and Internet banks and find out what questions they ask when providing a quote for a personal loan. Why do you think they ask these questions?

Group

1. Collect booklets advertising borrowing products from organisations in your area, e.g. banks, building societies and finance houses (like Lombard). Now draw a table comparing interest rates, how much you can borrow, how long the repayment period is and other fees. Which are the cheapest sources of overdrafts, loans, mortgages and credit cards in your area?

2. Suppose that your group works for a bank. You have £100,000 to make loans to customers. You want to earn the most money you can for the bank. Now discuss and decide:

   a. What sort of customers do you want to lend to?

   b. What questions will you ask customers on their application forms?

   c. Are you going to offer just one type of borrowing product or will you offer several different ones (e.g. mortgages and loans)?

   d. Look at the interest rates quoted from www.moneyfacts.co.uk in this worksheet. Decide what APRs/EARs you are going to charge on your products. Give reasons why you have chosen these rates.

Individual

1. Look at advertisements and other information from providers to find the cheapest way of borrowing £800 to buy a car.

2. Watch one of the TV programmes on money management such as *Bank of Mum and Dad* or *Spendaholics* and list the advice for using credit and/or reducing debt.

3. Imagine that you are about to leave home to live in a rented house with friends. At present the house has furniture but does not have items like sheets, a telephone, TV or stereo, light bulbs, cups and plates, etc.

   a. What will you need to buy?

   b. How will you borrow the money you need to buy these things?

   c. How will you make sure you can pay this money back?

Key points for Borrowing

- ☐ People need to borrow when they do not have the cash needed to buy items. Most people need to borrow to buy expensive items like a house or a car. Some people may also need to borrow in an emergency, such as when their car breaks down.
- ☐ Organisations make money from lending because they charge interest and, sometimes, fees.
- ☐ The amount of money someone borrows is called the principal. The interest and fees are quoted as an APR (annual percentage rate), unless the borrowing product is an overdraft. Overdraft interest and fees are quoted as an **EAR (equivalent annual rate)**.
- ☐ There are many different sources of borrowing such as friends and family, banks, building societies, finance houses, credit card companies and retailers.
- ☐ There are different borrowing products available such as overdrafts, loans, mortgages, credit cards, store cards and in-store credit.
- ☐ When deciding which product suits your borrowing needs, you need to consider how much you want to borrow, how long it will take you to repay the debt, what the interest rate and fees will be and what security is needed. You may also need to think about insurance costs – for example, if you take out a mortgage, you also need life assurance to cover the mortgage loan amount.
- ☐ Lenders offer different products depending on how much money people want to borrow. For example, overdrafts tend to be used to borrow a few hundred pounds, while loans are used to borrow thousands of pounds.
- ☐ Different borrowing products are used for different periods of time. For example overdrafts are used for a few days or weeks a month, loans for a few years and mortgages are typically for 25 years.
- ☐ Different borrowing products also cost different amounts of money. Unless cardholders repay the full amount on their credit card statement each month, they will pay interest. APRs on credit cards tend to be higher than the APRs on loans. APRs on loans tend to be higher than on mortgages. If overdrafts are used for a small number of days each month, they can work out cheaper than other borrowing products.
- ☐ Lenders often display example loan repayments in a repayment table. These figures show how much borrowers would repay per month if they borrowed a certain amount of money for a certain length of time. These tables also show the total amount of money that the borrowers would repay. These figures are for illustration. The actual figure that an individual will repay per month may vary slightly from these figures, depending on his or her personal circumstances (credit history, income, etc).
- ☐ Some borrowing deals sound very good until you read the small print. For example, 'nothing to pay for 12 months' deals in stores and advertisements for low weekly interest rates from loan sharks can be very expensive ways to borrow money.