Topic 10

Borrowing products

Learning outcomes

After studying this topic, you will be able to:

- describe the different reasons for personal borrowing;
- understand the level of personal debt in the UK;
- understand how borrowing costs are calculated;
- explain the main features of borrowing products.

Introduction

Discuss

Why do you think people borrow money?

Can you list five possible reasons?

As we saw in Topics 1, 2, 3 and 4, sometimes people need to borrow for a number of different reasons. We can divide those reasons into two broad categories.

- People who **need** to borrow.
- People who borrow to buy or provide something they **want.**

We considered in Topic 3 the difference between needs and wants. Here is a quick reminder.

- A 'need' is something that a person should or must have as part of their life. This includes basics such as food, shelter and clothes. It could also include things they need to maintain their quality of life or to get to work, such as a car. If they didn't have it, it could have a negative impact on their life.
- A 'want' is something that a person would like or would aspire to, rather than something they absolutely need. It's something that would be great to have or do, but it wouldn't have a negative impact on them if they didn't have it.

10.1 Reasons for borrowing

10.1.1 People who need to borrow

When we talk about someone needing to borrow, it is for an important purpose that would affect their life if they didn't have it.

- Their expenditure is sometimes more than their income and they need to borrow to cover the gap for a short period.
- They urgently want to buy something that is important and they haven't got the time to save up for it – it could be something fairly small like a washing machine, or it could be something more expensive, like a car.
- They need to borrow to buy something important, such as a house, that is much too expensive to save up for in a fairly short time.

10.1.2 People who borrow because they want something

When we talk about someone borrowing because they want to buy something, it's different from needing it. These people probably want to buy something but don't want to wait to save up, they haven't got time to save up for it, or they want to buy something that it's not practical to save up for.

For example, they might have seen a great TV in a sale but they don't have enough money to buy it at the moment. We could argue that a TV isn't really important, and not having it wouldn't have a bad effect on their life, but it might be such a great offer that they don't want to miss it.

Did you know?

Attitudes to borrowing have changed over the years. Your great-grandparents' generation, and many of your grandparents' generation, usually saw borrowing as a necessary evil – in other words, they only borrowed when they had to and then with a view to paying back the loan as quickly as possible.

The principle was to buy only what they could afford at that particular time. Unless it was vitally important, they would save up rather than borrow.

This was supported by the fact that banks and building societies were much tighter on lending, so loans were nowhere near as easy to get as they are today.

Obviously, buying a house almost certainly meant borrowing through a mortgage, but most people see mortgages as a 'different' type of borrowing, because they help you to buy somewhere to live.

10.1.3 Good debts and bad debts

Linked to the reasons why people borrow, there is a school of thought that we can divide consumer debt into good debts and bad debts.

✓ **Good debts** are used to buy something that will increase in value or result in something positive happening, such as buying a house or gaining a qualification that will improve someone's prospects. Examples of good debt include:

- mortgages;
- student loans;
- a car loan to use in a business;
- short-term, low-interest borrowing.

✗ **Bad debts** are used to buy things that have no real value, lose value quickly, produce no income or don't really improve the borrower's situation. Examples of bad debt include:

- borrowing for a holiday;
- borrowing to buy clothes;
- using long-term borrowing to buy things that aren't important;
- high-interest borrowing, such as payday loans.

10.2 Borrowing in the UK

One of the issues underlying the financial problems of recent times has been the level of personal borrowing in the UK.

For a number of reasons it became easy to borrow to buy what we wanted. Lenders were quite relaxed about lending, interest rates were quite low and the government seemed to encourage borrowing to boost the economy.

Unfortunately, the global financial crisis put pressure on lenders and borrowers – lenders raised lending interest rates to boost their capital and became less tolerant of borrowers who couldn't meet their repayments. Borrowers faced increased unemployment, lower wage rises, increasing living costs and more expensive borrowing.

To quote from the 2013 report *Maxed out*:

> The global financial crisis has brought hardship to many British households, but it alone has not caused the current debt crisis. Over the past 20 years people have begun to borrow more and save less, making people particularly vulnerable to the current squeeze on household budgets.

The *Maxed out* report shows that half of people in the lowest 10% of earners spent more than a quarter of their income on making debt repayments in 2011. It goes on to state that:

- consumer debt has trebled since 1993, reaching £158bn in 2013;
- more than 8 million households now have no savings at all, affecting around 50% of low-income households;
- outstanding debt on credit cards has almost trebled since 1998, reaching £55.6bn in 2012;
- payday lenders, pawnbrokers and home-collected credit providers loaned £4.8bn in high-cost credit in 2012, rising sharply from an estimated £2.9bn in 2009/10.

(Source: Centre for Social Justice, 2013)

Clearly, the message from all of these figures is that perhaps your great-grandparents were right! However, their world was much different from ours, and so we need to look at what we can do today given modern attitudes to borrowing and saving.

Discuss

Do you think most of the UK's personal debt problems have been the result of good or bad debts?

10.2.1 Lenders and the costs of borrowing

Regardless of the type of product used, borrowing works on a simple principle – in return for the lender agreeing to lend the money, the borrower pays interest on the loan until it is repaid.

If the loan is for £1,000 for one year and the rate of interest is 7% a year, the borrower will pay £70 interest in total. The lender needs to make sure that the £70 covers its costs of providing the loan and the profit it wants to make from the loan.

Each loan must help to pay towards the following main costs of providing a loan:

- The costs of running the business, which will include staff, buildings and computers.
- The cost of raising the money to lend – lenders might have to borrow it first, so they will pay interest on the money they borrow, although they will pay much lower rates than their customers will pay. If lenders raise the money from savers, they will have to pay the savers interest to make it worth their while.
- Providing extra cash as a reserve in case some of the borrowers don't repay the loan.

Once a lender has worked out how much it will cost to provide the loan, it decides how much profit it wants to make. Let's assume that the lender aims to make a profit of 2% on each loan. Table 10.1 uses a simplified example, based on lending £100.

Table 10.1 Calculating the cost of providing a loan

Element of cost	Amount per £100 of lending
Contribution to running the business	£2
Cost of raising £100 (paying 2% interest)	£2
Reserve against borrower non-payment	50p
Total cost to provide the loan	**£4.50**
Required profit 2% on loans	£2
Amount needed per £100 loaned	**£6.50**
Interest rate on the loan	6.5%

Another important factor is the amount of risk that the loan presents. The higher the risk of the borrower not paying back the loan, the higher the return (interest) that the lender would expect to receive for taking the extra risk.

The most important factor is the 'credit rating' of the borrower. The credit rating (or credit scoring) looks at the borrower's previous borrowing record and their financial and personal circumstances in order to arrive at an assessment of the risk they pose. Each lender has a model of a 'perfect customer' – one who is likely to be able to repay the lending and will use the products in a way that creates a profit for the lender. If a potential borrower doesn't match this model, the lender may refuse to lend or may charge a higher rate of interest.

Did you know?

The National Hunter system is rarely mentioned but widely used in the world of credit scoring. It aims to assess potential borrowers for the risk of fraud, by comparing the current lending application with past applications to spot any factual inconsistencies.

(Source: MoneySavingExpert, 2016)

In the context of credit ratings, risk has two meanings.

- The risk of the customer not making payments or failing to repay the loan. That risk is fairly easy to assess – the lender will consider the borrower's income and outgoings, and then look at how well they have managed their borrowing in the past.

  Those who have had problems in the past either will be rejected or may have to pay a higher interest rate because of the increased risk.

  It might seem strange, but those who haven't borrowed in the past may also struggle to get a loan or credit card, or may have to pay a higher rate. This is because the lender doesn't know if they are likely to be a problem and it may think that lending would be risky.

- The risk that the customer will not be profitable for the lender because of the way they would use the product. For example, lenders charge high interest rates where people who owe money on their credit cards don't repay all the borrowing each month. This is very profitable, and lenders base their lending on the fact that most people won't pay it all off.

  However, some people do pay off their credit card in full every month, which doesn't give the lender any profit because they won't pay any interest. In fact, the lender is likely to lose money, because it has to pay costs without receiving anything in return. It isn't unusual for people who have no debts and pay off their credit cards in full to be rejected by lenders for this reason.

  Lenders usually quote one interest rate for borrowing when they advertise their products. However, that rate is often only for borrowers who fit their perfect model, and those who don't fit may face higher rates depending on their exact credit rating.

10.3 The products

So, let's move on to look at the main borrowing products. We will look at mortgages, personal loans, overdrafts, credit cards, store cards, payday loans and credit unions. We will consider the main points of each, who provides them and the implications for the borrower.

10.3.1 Mortgages

- Mortgages are long-term loans to buy property. They are usually for large sums – the average cost of a property in the UK for the 12 months to December 2016 was £205,937, but in London it was £473,073 (*The Guardian*, 2016).
- The loan is 'secured' on the property, which means that the lender has legal rights over the property until the mortgage is repaid. If the borrower doesn't make mortgage repayments, the lender can go to court to get a possession order. A possession order gives the lender the right to evict the owner and family, take the property and sell it to repay the mortgage.
- Mortgages are usually arranged over a period of 25 years, although they can be shorter or slightly longer. The longer the term of the mortgage, the lower the monthly repayment. A longer term means that more interest will be paid in total.
- Lenders expect the borrower to put some of their own money towards the property. This is known as a deposit, and will normally be at least 10% of the purchase price.
- Mortgages are considered to be relatively safe for the lender because the lender has the security of the property, and the interest rates are low compared to most other borrowing products.
- The most common type of mortgage is the 'repayment' mortgage. The borrower makes a payment to the lender each month, consisting of interest on the outstanding loan and a repayment of some of the capital. This means that the amount of the mortgage gradually reduces until it has been totally repaid by the end of the term.
- Payments in the early years are mainly interest, so the capital amount reduces quite slowly. It is not until just over halfway through the term that the capital paid off each month is more than the interest, so it's from this point that the debt starts to reduce quite quickly.
- It is possible to arrange a mortgage where the borrower just pays interest on the loan each month, and the amount of the mortgage stays the same throughout the term. The mortgage must be paid off in one payment at the end of the term, so the borrower also arranges an investment to build up a sum that will be big enough to pay off the mortgage at the end of the term. This is known as an 'interest-only' mortgage.

Typically the borrower of an interest-only mortgage would pay into an individual savings account (ISA) or an endowment policy (a type of savings plan) to build up the capital, but they are not guaranteed to meet the target.

For this reason, interest-only mortgages are not very common, and are really only for those who have quite an adventurous approach to their finances and the risk they can take, or know that they will have money available in the future. The Financial Conduct Authority (FCA), which regulates mortgages, has put in place tough rules that lenders must follow when considering whether to offer an interest-only mortgage. They must be sure that the borrower has a 'credible' way to build up the money needed to repay the mortgage at the end of the term.

- Borrowers have a number of options regarding the type of interest rate they pay on a mortgage. The main options are as follows.

  – A **variable-rate mortgage**, where the interest rate changes whenever the lender changes its rate. It will usually change because the Bank of England base rate changes or because the lender decides to change it for commercial reasons. These are usually the cheapest mortgages to arrange but don't offer the borrower the comfort of knowing what they will have to pay in the future.

  – A **tracker mortgage** is a type of variable-rate mortgage, but this time the rate will only change if the Bank of England rate changes, because it follows (tracks) the base rate. The interest rate is usually set at a percentage above the base rate.

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The interest rate might be the base rate plus 2%, which means it will follow the movement of the base rate but will always be 2% above it.

In January 2017 the Bank of England base rate was 0.25%, so the tracker interest rate would be 0.25% + 2%, which is 2.25%. If the Bank of England base rate changed to 1%, the tracker rate would rise to 3%.

  – A **fixed-rate mortgage** is where the interest rate (and so the monthly payment) is fixed for a number of years – usually for two, three or five years. This is good for people who need to budget carefully, because they know exactly how much they will have to pay each month for a set period.

Example

Let's consider Connor and Emily, a young couple in their mid-20s. They have found a flat they would like to buy, which is on the market for £150,000. They have managed to save £15,000 as a deposit and enough money to pay for the costs involved in buying the flat. They have asked their building society for a mortgage of £135,000 which, together with their deposit, will allow them to buy the flat. The building society has agreed to a 25-year repayment mortgage, with an interest rate of 5% fixed for three years.

The mortgage will cost them £789 a month for the first three years. The amount won't change because the interest rate is fixed. At the end of the three years, the mortgage will move to the lender's standard variable rate, which could be higher or lower than their fixed rate, and will change every time the lender changes its rate. Depending on the lender, they might be able to arrange another fixed-rate period.

By the end of the three-year period, they will have paid off about £9,000 of the mortgage, leaving a debt of roughly £126,000. As long as they keep up the payments that the lender requires, they will have paid off the mortgage by the end of 25 years and will own the flat outright.

Four years after they bought the flat, they had a baby and they decided that they needed to buy a house, having seen one they liked for £260,000. Their flat had increased in value to £175,000 and their mortgage had reduced to £123,000. That means that they had £52,000 of equity, which is the difference between the value of a property and the mortgage on it. They could use the £52,000 as a deposit towards the new house and arrange a new mortgage for £208,000 to cover the rest of the purchase price. Ideally they should arrange a mortgage for 21 years to match the original mortgage, but to keep the costs as low as possible they have decided on another 25-year mortgage.

10.3.2 Personal loans

- Personal loans are offered by banks, building societies and finance companies. They are similar to mortgages, because the loan is taken out over an agreed term, with monthly payments made each month. Typical terms range from 12 months to five years.
- They normally have a fixed rate of interest, which means that the payments stay the same over the term.
- Personal loans are unsecured. This means that the lender does not have the right to sell a property or something else valuable to get its money back if the borrower fails to pay back the loan, or misses payments. This makes personal loans riskier than mortgages and, as a result, interest rates are generally higher.
- Personal loans are normally used to buy things that are quite expensive, where the borrower needs to spread the loan over a reasonable period. Typical items would be cars and large, more expensive, items of furniture.

Case study

Let's look at Danny, who is 20 and wants to buy a car for £5,000.

Danny

I've decided that a personal loan with a term of three years is the best way to raise the money. My bank has offered me the money at an interest rate of 6%, and I can borrow the full amount to buy the car. The interest rate is fixed for the three-year term, so I'd have to pay £152 a month for 36 months, at which point the loan would be paid off.

10.3.3 Overdrafts

- An overdraft occurs when a bank account holder has drawn more money out of their account than they have in it. For example, if the customer had £100 in the account and drew £125 out of a cash machine, they would have an overdraft of £25. They would be 'overdrawn' by £25.

Did you know?

Being overdrawn is often called 'going into the red' or 'in the red' because, in the old days when accounts were written by hand, any debts were shown in red ink.

If the account had a positive balance (it had money in it), the figures were written in black – so they were 'in the black'.

- Overdrafts can be useful if a person has a need for extra money for a short period of time. As we will see, for longer-term borrowing it can be expensive.
- Most banks will allow customers to overdraw as long as it has been agreed beforehand. Many accounts have an automatic overdraft facility, where the customer can overdraw up to a certain amount without having to ask each time. This is known as an **'authorised'** overdraft.
- If the account doesn't have an automatic overdraft facility, the customer will have to ask the bank each time they are likely to need to overdraw.
- If the customer overdraws without agreement, or goes over their overdraft limit, it is called an **'unauthorised'** overdraft and the bank will impose heavy charges.
- Quite often the bank will refuse to allow the payment, in order to avoid an unauthorised overdraft, and will also charge the customer a penalty fee.
- Some banks warn customers by text if they are likely to overdraw.
- Overdrafts are supposed to be short-term borrowing, until more funds come into the account. They can be an expensive way to borrow, because the charges can be very high. The charges vary between banks and between accounts.

Authorised overdraft fees are generally lower. Some banks offer new customers a period, sometimes even as long as 12 months, where there is no charge for an overdraft within the agreed limit.

Unauthorised overdraft fees are much higher, although some accounts don't make any charge for overdrafts up to £25 or where the account is back 'in the black' within one or two days. For larger overdrafts, the fees start piling up.

10.3.4 Credit cards

- Credit cards offer what is called 'revolving credit'. This term is used because the card has no set term. Each time some of the borrowing is repaid, the cardholder can borrow it back again in the future.
- If an application for a credit card is accepted, the cardholder will be given a 'credit limit'. This is the maximum amount of borrowing available at any one time. Each time the cardholder makes a payment to the card company, the payment less interest charged will be taken off what they owe.
- Interest is charged each month on the amount owing on the card, based on the average amount owed during the month.

Typical interest rates vary between 18% and 20% a year, but some cards charge as much as 30% or more for customers with poor credit records.

The cardholder must pay at least a minimum amount on a set date each month, based on the amount owed.

The minimum amount varies between companies, but is typically the greater of 3% of the balance or £5, or a smaller percentage plus interest on the balance, with a minimum payment of £5.

Martin Lewis, the Money Saving Expert, stated:

> “Borrow £3,000 at age 21 and you'll be 50 before it clears! That's what happens if you just make minimum credit card payments – their evil genius can lock you in perpetual debt, boosting banks' profits.”

(MoneySavingExpert, March 2016)

- Most cards have an 'interest-free' period between using the card to buy something and the next monthly payment date. This is typically between 50 and 60 days. If the cardholder pays off the balance in full on the repayment date, no interest is charged. If they don't pay off the full balance on the payment date, interest will be charged at the standard rate.
- If the cardholder fails to pay the minimum amount when a payment is due, they will also face a late payment penalty in addition to the interest, which could be up to £12 for each missed payment.

Example

Let's look at an example of how a credit card works.

- Leo has a brand-new credit card with a credit limit of £4,000, which means that the most he can owe on the card is £4,000.
- He buys a new 50-inch HD smart TV and surround-sound system for £2,000, using his credit card. That means he still has £2,000 of credit available to spend.
- Leo must pay a minimum of 3% of the balance on the credit card payment date. That means he has to pay £60.
- Because he hasn't paid the full balance, he will be charged interest at the equivalent of 20% a year, which works out at £33; that means Leo will now have a balance of £1,973.
- If he doesn't use his card again, next month he will have to pay 3% of the balance, which is £59. But he will be charged £32 interest, which means he will only pay off £27. The balance is now £1,946.
- Assuming that he doesn't use the card again, at the end of the first 12 months the balance will be about £1,700, although he will have paid about £720 over the year. This means he will have paid £720 to reduce the balance by £300, which sounds expensive.
- If he pays just the minimum payment each month, it will take 18 years to pay for the TV and speakers. To pay the debt off in 12 months, he would need to pay £185 each month.

Of course, Leo could be a clever borrower and use the credit card as a short-term way of raising money, planning to pay the whole £2,000 back very quickly.

If he paid the full balance by the next payment date, he will have had £2,000 interest-free for about 60 days.

If he paid it back over four months, he would have to pay £518 a month but would only pay about £70 interest.

- Most credit cards also allow the cardholder to get cash from automated teller machines (ATMs) at home and abroad. This is not a good idea, because interest will be charged on the cash from day one, even if the cardholder pays it all back by the payment date. Most card companies also charge a cash fee of about £2 to get the cash. Sensible advice would be never to use a credit card to get cash unless the situation is desperate.

As you can see, a credit card can be very useful for people who need money for a short term and will be able to pay it back quickly.

For those who would need to borrow the money for a longer period, or could only make fairly small payments each month, it can be very expensive and can go on for ever.

10.3.5 Store cards

Store cards are offered by many of the major shop chains, and work in much the same way as credit cards. They often give cardholders discounts and special offers in the shop but usually charge a higher rate of interest than credit cards. Once again, they are only a sensible option for people who will be able to pay off the balance quickly and want to take advantage of the special offers.

10.3.6 Payday loans

We talked about payday loans in Topic 4, but it is worth mentioning them again. Payday loans are designed for people who run out of money before the next pay day and need to borrow to tide them over until they are paid. Payday loans usually range from £100 to £1,000. In most cases, the lender carries out limited credit checks on borrowers, making the assumption that they will have debt problems or poor credit histories and so are risky for the lender. This means that the interest rates are incredibly high. People who use payday loans often just look at what it will cost in pounds.

Example

A lender charges £24 a month for each £100 borrowed.

So, if the customer borrowed £100 for a month, they would have to pay back £124.

The figure of £24 may not seem too bad in an emergency, but that's the equivalent of paying interest of 1,270% over a year, which is staggering.

In many cases, the borrower can't afford to pay back the loan at the end of the month, and so they ask to extend (or roll over) the loan, or even borrow more. Of course, they are not making any monthly payments either, so the original loan amount doesn't reduce.

Example

Continuing to use the same example, this means that after two months the customer would have to pay back £153.76, because the original £100 loan would now be £124 (with the interest added) and they would then have to pay 24% of that amount for the second month. So suddenly it had cost them £53.76 to borrow £100 for two months

In the past, some borrowers saw their debt increase by 13 times or more over one year as they kept on rolling over the loan. In many cases they faced additional charges if they didn't repay the loan.

The FCA took action in 2015 to prevent some unscrupulous lenders abusing borrowers in this way.

Action on unfair payday lending

The FCA rules include the following:

- A payday lender can charge a borrower a maximum of 0.8% a day (24% a month), including interest and other charges.
- A payday lender can charge a borrower a maximum of 100% of the amount borrowed in interest and charges. So a borrower will never pay back more than twice the amount they borrowed.
- A payday lender can charge a maximum of £15 if the borrower doesn't repay the loan on time.
- Payday loans can only be rolled over twice.

10.3.7 Credit unions

We mentioned credit unions in Topic 1. Credit union loans are a very good alternative to payday loans but they can also be of benefit to people with a good credit record or longer-term borrowing needs. They typically offer loans of up to £3,000. The amount of interest that a credit union can charge is limited by law to no more than 3% a month on the reducing balance, which is equivalent to 42.6% a year. The borrower must make weekly or monthly payments so that the loan is repaid by the end of the term. Of course, each regular payment reduces the amount of the loan and the amount of interest payable.

Many credit unions charge lower rates, typically 1% a month, which is equivalent to 12.7% a year. This would give a total repayment on £100 of £106.70 over 12 months, with a fixed payment of £8.90 each month. Compare that to a payday loan with an annual interest rate equivalent to 1,270% a year!

Credit union loans are usually available for terms of up to five years. Recent developments have led to credit unions offering similar short-term loans to payday loans, repayable within a period up to three to six months. The big advantage is that the amount of interest is limited to no more than 3% a month.

It is easy to join a credit union, and membership typically costs only £2 to £3. Many credit unions insist on a member building up some savings for a few months before they will consider making them a loan.

Summary

Finally, we can recap what we have learned in this topic.

We have learned:

- the difference between borrowing for needs and borrowing to satisfy ‘wants’;
- the extent of borrowing in the UK;
- how lenders work out how much to charge borrowers;
- the main products that people use to borrow.

Key terms

Bad debts – debts that are used to buy things that have no real value, lose value quickly, produce no income or don't really improve the borrower's situation.

Capital – the money or other assets owned by an individual or a business. In the case of a financial service provider (ie bank or lender), it refers to the funds provided by the shareholders, not deposits from customers.

Consumer debt – the amount of debt built up by members of the public rather than the government.

Credit rating – an assessment of the risk that the borrower poses for the lender.

Deposit – a sum of money placed by a customer with a bank.

Good debts – debts that are used to buy something that will increase in value or result in something positive happening.

Endowment policy – an insurance product that pays out a lump sum after a specified term or if the insured person dies before the end of the term. Endowment policies are often used as a way of saving over the long term.

Equity – the difference between the value of a property and the mortgage on it.

Interest – the regular charge a borrower pays for borrowing money, usually shown as an annual percentage rate.

Mortgage – a type of secured loan arranged to buy a flat or house.

Overdraft – when a bank account holder has drawn more money out of their account than they have in it. Most banks allow a customer to overdraw as long as it has been agreed beforehand; this is an 'authorised' overdraft. If the customer overdraws without agreement, or goes over their overdraft limit, it is called an 'unauthorised' overdraft and the bank will impose heavy charges.

Profit margin – the difference between the money received by providing a service and the cost of providing the service.

Secured lending – lending where the borrower has given the lender rights over something that has value – usually a flat or a house – to support the loan and reduce the lender's risk.

Revolving credit – a loan where the borrower can borrow up to a set limit. Each time they pay back some of the loan, they can borrow it back later.

Unsecured lending – lending where the lender doesn't have rights over anything and could be at risk of losing money if the borrower doesn't pay.

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