Topic 11

The implications of borrowing

Learning outcomes

After studying this topic, you will be able to:

- explain the factors to consider when deciding whether to borrow;
- calculate borrowing costs;
- explain the impact of borrowing on a personal budget;
- describe the impact of borrowing on the economy;
- describe the impact of payment default from both personal and societal perspectives.

Introduction

We looked in Topic 10 at some of the reasons why people borrow and the main products they can use. This topic will look at how borrowing can affect a personal budget, what can happen if people fall behind with repayments, some simple examples of how to calculate the cost of borrowing, and how debt problems can have an impact on society.

11.1 The decision to borrow

Borrowing is one solution to a number of problems that we've considered in earlier topics, such as needing to buy something, wanting to buy something or running out of money in the short term. The decision whether or not to borrow is an important one, and people should consider several things before making the decision. Let's put ourselves in the potential borrower's position and look at those factors.

11.1.1 Is borrowing actually necessary?

Are there any other ways to solve the problem? We discussed earlier whether some purchases could wait – although we might want something urgently, we do need to consider whether it really is important or whether we can wait until we actually have the money. In other words, it might be better to save up and buy later rather than borrow now.

If we're thinking about borrowing because we have overspent and run out of money, it could be an indication of a bigger problem. If we borrow to get ourselves out of trouble, that might make the problem worse by the same time next month, and we might have to borrow again. So, while borrowing might be a temporary solution, it's more important to find the root cause of the problem, which is probably that we don't budget effectively or we don't have enough income to support the lifestyle we want. Think back to Topics 4, 5 and 6, where we considered the importance of budgeting and how to go about setting out a budget.

11.1.2 Making an informed decision

If borrowing does seem to be the best solution, then it's important to make sure that the product and arrangement are the best for the borrower. It can be dangerous to jump straight into the first 'deal' we're offered, or the first deal that we find. We saw in Topic 9 the benefits of spending time 'shopping around' when we buy something – exactly the same principle applies to borrowing, but we could argue that it's even more important because of the overall cost. The range of products and the conditions for each arrangement differ so much that it's easy to make a hasty mistake that we'll regret later. This means doing some research to find out the best rates, the lowest costs, the best lenders and the most appropriate product.

There are lots of ways to compare different borrowing options, and computers can be a great help. In the old days we had to visit different lenders or at least ring them to find out what they were offering and how their products compared to others. This took up time and wasn't always very convenient. Today we can do all of that in front of a computer, either by visiting lender websites or by using comparison websites.

Comparison websites allow us to type in our main requirements, including the amount we want to borrow, the term and any special features that are important. Within minutes, the program will compare hundreds of different lenders and products. It will produce a list of products that will suit our needs, together with the costs, conditions and features of the products and the lender's requirements. In most cases, if we are happy with a particular product, we will be able to apply for the loan directly from the comparison website.

Comparison websites include:

- www.moneysupermarket.com
- www.uswitch.com
- www.moneysavingexpert.com – includes helpful information about choosing a loan
- www.comparethemarket.com
- www.confused.com

This list does not include all the available websites, and is not intended to indicate that they are the best. It just provides examples of what is available. Just type 'personal loan comparison' or 'credit card comparison' into a search engine and you'll get loads of results.

Example

Let's go back to the credit card example we looked at in Topic 10, where Leo used his credit card to pay for a TV and surround-sound speakers costing £2,000. If Leo paid the minimum payment every month, it would take him 18 years to pay for the TV and speakers, and the total interest he would pay would be about £2,200. Using his credit card was very convenient and allowed him to buy what he wanted instantly, but a bit of planning and logical thinking might have led him to a different decision. A personal loan at 6% over three years would cost £61 a month, and the total amount of interest paid would be £181.

As long as Leo felt that he could afford the loan repayments, he would have been better off using a personal loan to buy the TV. The trouble is, a credit card is so easy to use that Leo probably didn't even think about it too much.

Research indicates that credit card spending has a totally different psychological effect from paying cash. Cash uses physical notes and coins, and the buyer can see and feel the amount they are spending. Although a debit card is also a piece of plastic, the cardholder does link that spending with what they have in their bank account, and so the feeling is similar to spending cash. A credit card is somehow different and the buyer doesn't have the same feelings.

Research has shown that people are more willing to spend higher amounts using a credit card than cash, and are less likely to remember how much they paid for credit card purchases. In simple terms, credit card spending doesn't seem real and doesn't directly affect their bank account. All of this suggests that keeping to a budget using credit cards is quite difficult (*Psychology Today*, 2013).

Discuss

Let's imagine you are working and have decided to book a Caribbean holiday with your friends, costing £1,500. When it comes to paying the bill, you have a choice between paying the bill in £20 notes or by credit card. Discuss how you think you would feel using each of the two methods.

11.1.3 Consolidating other debts

As we have just discussed, it is very easy to build up debts with a credit card almost without thinking, and the borrower could face paying off that debt over many years. Often, a borrower will feel overwhelmed by the debts, because the high interest rates mean that they are not paying off much of the debt each month. In some cases, it might be sensible to rearrange the debt into a product that has regular payments and a set term – usually a personal loan. Although the regular payments may be higher than the minimum credit card payments, there is certainty that the debt will be paid off after a set time. Of course, the worst thing that could happen is that the individual then starts building up a new debt on the credit card that they can't manage.

It may be that someone has built up several high-interest debts on credit cards, store cards, overdrafts, etc and is struggling to make the payments. It may be sensible, and cheaper in the long term, to arrange a personal loan to pay back all those debts over a reasonable term.

Arranging new borrowing to repay existing debts is known as 'consolidating' debts. Moving debt in this way can be a good way to cut costs, keep payments within budget, and repay the debts by a certain time. However, as we mentioned earlier, it could be tempting to continue spending on the credit card and build up more high-interest debts, which would only make things worse.

11.1.4 Checking affordability

It's very easy to get carried away at the thought of buying something that we always wanted and to ignore the fact that we might not really be able to afford it. Loan repayments will be part of our regular expenditure and so we must include them in our budget calculations.

Sometimes we need to step back for a few minutes and think seriously about affordability – can we really afford it? If the budget will be tight, it's easy to think that we can cut back on other spending in order to afford higher loan repayments, but the reality is that we will find it hard to change spending habits and probably won't cut back. We could reduce the monthly cost of borrowing by going for a longer-term loan, but we would need to be happy that a longer term made sense.

Discuss

Why would it not be sensible to buy a second-hand car with a seven-year loan, but it would be sensible to buy a house with a 25-year mortgage?

After your discussion, see the end of the topic for key points that could have been raised.

When a loan has a fixed interest rate, we know exactly what we will have to pay out each month during the term of the loan. The affordability assessment is quite straightforward – can we afford it or not? When the loan will be on a variable interest rate, part of the affordability check should also be looking at the effect of future interest rate increases. Would we still be able to afford the repayments if interest rates increased?

In fact, the regulator now requires mortgage lenders to look at whether the borrower could still afford repayments if interest-rates went up in the future. If there is any doubt, they can only lend an amount that would be affordable in those circumstances.

Example

With a fairly small loan, the increase may not be too much of a problem. For a loan of £5,000 over three years, the monthly payment would increase by £4 a month if the interest rate increased from 5% to 7%.

With a mortgage, the position is likely to be more challenging, because we're dealing in higher amounts. For a mortgage of £100,000 over 25 years, the monthly payment would increase from £585 to £707 if the interest rate increased from 5% to 7%.

For some time now, interest rates have been low, and it's easy to think that they will always be low. However, in Topic 5 we learned that interest rates haven't always been low, and that in the late 1980s mortgage rates were as high as 15%.

Example

Think back to Connor and Emily's £135,000 mortgage in Topic 10, which would cost them £789 a month at 5% interest.

If the mortgage rate increased to 15%, it would increase their monthly payment to an eye-watering £1,729 a month – £940 a month more!

Interest rates in the 1970s were also very high compared to today and while we all hope, with some confidence, that rates won't be that high again, we do need to be aware of the effect of rate increases.

11.2 Calculating the cost of borrowing

Calculating the full cost of borrowing can be quite complicated, so we will look at the principles and some simple examples, and then look at some of the tools available to help work out the costs.

11.2.1 General principles

With most loans, each repayment pays off some of the balance and covers interest on the outstanding amount. As the amount of the debt reduces, the amount of interest payable each time also reduces. With mortgages, personal loans and credit union loans, the lender does a calculation at the start to work out how much the borrower will need to pay each month in order to pay off the loan and interest by the end of the term. This monthly payment will stay the same unless the interest rate changes. The interest rate on personal loans and credit union loans is fixed at the start, and so the payments will stay the same throughout the term. Mortgage interest rates can change, and so the lender's calculation can only take into account the current interest rate. The regular payment could go up or down if interest rates change.

With credit card borrowing, the amount repaid each month is up to the borrower, as long as it is at least equal to the minimum payment. The lender will calculate how much interest is due on the balance at each payment date and add it to the loan. As we saw in Topic 10, the more the borrower pays each month, the less interest will be charged and the quicker the borrowing can be repaid. Obviously, the quicker the loan is repaid, the lower the total interest payable and the cheaper the loan will work out.

11.2.2 The costs of borrowing

We can look now at some of the costs involved in borrowing.

- Some loans, particularly mortgages and some personal loans, have a setting-up fee. This covers the lender's expenses in arranging the loan and can range from a few pounds for a personal loan, to £1,000 or more for a mortgage. Each lender will have a different view on setting-up fees, but if fees apply they should be taken into consideration when working out the overall cost.
- Most personal loans and fixed-rate or 'special deal' mortgages have an early repayment charge. These apply if the borrower repays the loan before the end of the agreed term, and are designed to compensate the lender for the interest it would lose because the loan ended early. The charge could be a fixed amount, a percentage of the loan outstanding when it is repaid, or equal to a number of months' interest.
- Interest is a major part of loan payments.
  - It's easy to work out on an interest-only loan – that's a loan where no repayment of capital is made during the term and the whole amount

is paid at the end. If the interest rate is 5%, then £5 interest is payable each year for every £100 borrowed. So, if the loan was for £2,000, a total of £100 interest would be paid each year, in monthly instalments of £8.33. At the end of the term the borrower would have to pay £2,000 to settle the loan.

– With a normal loan, each monthly payment comprises some capital repayment and interest on the outstanding balance. It is possible to work out the payments on a calculator, but we don't need to be able to do that. We just need to know where to look for tools that will help us to do it, as described in section 11.2.3.

– With credit cards, the calculation can be quite complex, but we can look at an example of a fairly simple situation. The higher the interest rate charged, the longer it will take to pay off the credit card by paying just the minimum payment.

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Example

Karen has a balance of £2,000 on her credit card, which has an interest rate of 15%. The credit card company requires a minimum payment of 3% of the balance each month, and this is all Karen can afford to pay.

Here's how we do the calculation.

- We divide the annual interest rate by 12 to get the monthly rate – that would be 1.25% a month.
- We work out how much interest Karen will have to pay on the monthly payment date – that would be £2,000 x 1.25%, which is £25.
- Next, we work out how much Karen has to pay as a minimum, which is 3% of the balance. So £2,000 x 3% gives a payment of £60.
- Then, we take the interest from the minimum payment, which leaves us with £35. This is the amount of capital that Karen has repaid for that month. We subtract this from the outstanding loan, which means that at the start of the next month Karen owes £1,965.
- At the next payment date, we do the same calculation but this time we start off with a balance of £1,965.
- Interest is £24.60 (rounded), and the minimum payment is £59 (rounded), so Karen will have paid off £34.40, leaving a balance of £1,930.60 for next month's calculation.

This is a simplified version of the calculation, and doesn't allow for any new spending, but it does give you a good idea of how the credit card works.

Of course, if Karen makes a larger payment each month, the amount of interest charged will be less, which will result in faster repayment and lower total interest charges.

If Karen continues to make minimum payments only, it will take 14 years and seven months for her to pay off the card. Isn't that frightening?

11.2.3 Using tools

When a lender offers a loan, it must provide information about the interest rate, setting-up fees and total costs of the borrowing. That's great but doesn't really help us if all we want is information.

That's where online calculators can help, because they will allow us to type in amounts and interest rates and then calculate how much it will cost. Many lenders provide calculators on their own websites, but these are usually based on their interest rate and product costs.

The Money Advice Service provides a loan calculator that allows the individual to put in their own figures to work out the costs. It is available at:

www.moneyadviceservice.org.uk/en/tools/loan-calculator

There are also calculators available at:

- This is Money:
  http://www.thisismoney.co.uk/money/cardsloans/article-1633405/Loan-repayment-calculator.html
- Moneyfacts:
  http://moneyfacts.co.uk/loans/loan-calculator
- The Money Advice Service also offers online calculators for:
  - credit cards – available at:
    http://www.moneyadviceservice.org.uk/en/tools/credit-card-calculator
  - mortgages – available at:
    http://www.moneyadviceservice.org.uk/en/tools/mortgage-calculator

Discuss

Go to the This Is Money loan calculator and enter details for this example:

A loan of £2,000 at 6% interest over a three-year term. You will need to enter the information as in Table 11.1.

Table 11.1 Using an online calculator to work out interest

Loan amount box	2,000
Annual interest rate box	6
How long for box	3 years

Click the calculate button.

You should have the following figures:

Monthly repayment	£60.84
Total charge (interest paid)	£190.38
Total repayment	£2,190.38

Now try these loans on the calculator:

1. A loan of £500 at 7% over a two-year term
2. A loan of £6,000 at 5.5% of the over a five-year term

Answers are given at the end of this topic.

Once we've worked out the approximate cost of a loan at a certain interest rate, we can then look through the various products offered and we'll know roughly how much they will cost.

11.3 Consumer debt and the country's economy

We looked in Topic 6 at the benefits of personal spending for the economy in general. In view of this, most governments are happy with reasonable levels of consumer borrowing, because they can boost the economy by increasing the amount of money for people to spend. However, high levels of consumer borrowing can create a false picture of the economy, because it hides the fact that the money has not been generated by the country and by workers producing more or generating more real earnings.

The UK enjoyed a period of economic growth in the last decade, largely fuelled by consumer spending. The problem was, the spending was mainly funded by money borrowed at low interest rates. As Dhaval Joshi, an economist at RAB Capital, explained early in the financial crisis in 2009, growth based on borrowing can't go on for ever; eventually it is unsustainable. In addition, the most damaging point for an economy is when borrowing slows down, rather than when it stops. Joshi said: "However much you borrow and spend this year, if it is less than last year, it means your spending will go into recession." (*The Guardian*, 2009)

'Recession' (or recede) means going backwards, and in economic terms it means that industrial production, employment, real income and trade fall. Think back to Unit 1, where you investigated recession as part of the economic cycle.

We all know that houses must be built on solid foundations to make them strong and prevent them being blown away in a storm. The economy is exactly the same, and unless growth is built on solid foundations, such as manufacturing output, real earnings and sensible management, a financial 'storm' could seriously damage it. If you think about it, a family budget is the same. A controlled amount of borrowing is sensible to provide important things that we may not be able to pay for now. If we borrow large amounts to buy all sorts of nice but unimportant things, it might look as if we're prosperous and doing well, but it's all built on shaky foundations. It will only take a 'storm', such as reduced income, increased interest rates, losing a job or similar events for disaster to occur.

When things go wrong with the economy in general, high levels of consumer borrowing can have a really bad effect.

There are a number of ways in which things can 'go wrong'.

- There may be problems in the banking sector, as we have seen in the past few years. If lenders find it hard to raise money to lend, or if regulators require them to build up their own savings (or reserves) to protect them from going bust, they will cut back on their lending. They will not provide as many loans as before, may charge higher interest rates, and will be less tolerant when people have problems paying off their borrowing. This is exactly what happened as a result of the financial crisis that started in 2008.

- People generally don't like financial uncertainty. When there are problems in the economy, they can become worried about unemployment, the cost of living and the amount of debt they have. One reaction is to reduce their spending while they still have a reasonable income, and use the money to reduce their debts by paying off credit cards and loans more quickly. Again, many people took this approach during the financial crisis. That means there is less money available in the economy for spending.
- As we saw in Topic 5, if interest rates increase sharply, those with debts will have less disposable income to spend because their repayments will increase. Many with high levels of debt will struggle to meet their loan payments. As a result, they are likely to cut back on spending so that they can make their debt repayments, which will result in less money to spend in the economy.
- Governments may cut back on spending in times of financial crisis and may raise taxes. Firms tighten their belts by freezing pay or giving low pay rises, cutting their spending, reducing investment in the business and perhaps cutting their workforce. We've been in this situation for the last few years, and most people have seen a reduction in their income once we take inflation into account.

If things do go wrong, new borrowing becomes less attractive because people are wary of what can happen if they are affected by the problems. In addition, existing borrowing is likely to suck money out of the economy, either because people want to pay debts off as quickly as possible or the cost of repayments reduces their disposable income.

11.4 The effect of debt problems

11.4.1 Personal issues

Too much debt can cause lots of problems with budgeting and can affect the borrower's standard of living. Unfortunately, for a number of reasons some people can't manage their debt at all, sometimes through no real fault of their own, and fail to make debt repayments on a regular basis.

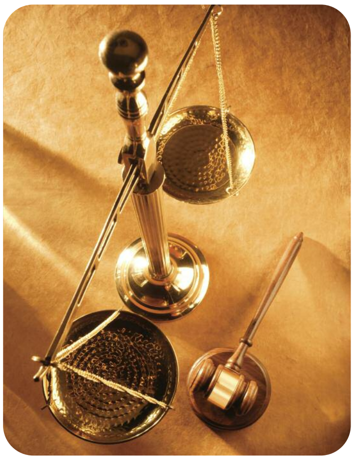
When the borrower fails to make payments on debt, they are said to be in 'default'. The first thing they should do if they are having problems making payments is to contact the lender to discuss possible solutions. Most lenders will be sympathetic and will try to help as far as possible, although we must remember that they are businesses. One possible solution is for the borrower to make reduced payments for a short period, although this can't go on for ever.

When first deciding whether to lend, lenders search the records of credit reference agencies, such as Experian, Equifax and Callcredit, which are organisations that collect information about how people manage various financial accounts. Most major organisations share information about customers' accounts, and pass the information on to the credit reference agencies. The information includes bank and utility company (electricity, gas, etc) accounts and borrowing. It will show how somebody conducts the account, whether they have missed payments and whether the borrower has county court judgments or other court orders against them.

So, what happens if somebody is in default and can't come to an arrangement with the lender? The first step will probably be the lender requesting that the whole loan is repaid immediately – this is often referred to as 'calling in' the loan. Of course, if the borrower can't afford to make the repayments then it's very unlikely that they could repay the loan immediately.

11.4.2 Legal consequences

11.4.2.1 County court judgments



The lender's next step is likely to be court action to get the money back. The borrower will be responsible for all fees and costs associated with any court action, which will just add to the debt. Cases are held at the local county court, and if the court agrees that the debt is outstanding, it will issue a county court judgment (CCJ).

The CCJ will require the borrower to repay the debt and will set out how this will be done – through regular payments or as a lump sum – and the time allowed for the debt to be settled. The payments are based on a court assessment of how much the borrower can afford to repay each month.

If the borrower doesn't make the payments, the court could agree to appoint a bailiff, who has legal rights to enter a debtor's property and seize their possessions so that they can be sold to settle the debt. Alternatively, the court could impose an administration order, which requires a certain amount of the debt to be paid through regular payments over a set period. In many cases, the court will insist that the payments are taken directly from the individual's pay.

11.4.2.2 Individual voluntary arrangements

Sometimes debts become too much for an individual to handle and they need to sort out a way to satisfy lenders and creditors. An individual voluntary arrangement (IVA) is an agreement between an individual and their creditors where the creditors agree for the individual to pay a proportion of the debt over an agreed period, which is usually five years.

An IVA will only be possible if the debtor has enough income left after essential expenditure each month to go towards the debt. The process is supervised by a specialist known as an insolvency practitioner, and the majority of the people owed money must agree to the arrangement. Once agreed, the debtor will make regular payments to each creditor towards the money they owe.

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Tom owes £15,000 to a number of organisations and can't meet his payments. He has reached an agreement with his creditors to pay 60p for each £1 he owes, over a five-year period. The arrangement is based on an assessment of what Tom can afford, and will not make life easy for him because the payments will be as high as possible while allowing him to live.

Over five years his creditors will each receive 60% of the money Tom owes them, which means he will pay off £9,000. No interest will be charged during the payment period on the money Tom owes. At the end of the five years, as long as Tom has made the payments as required, the debts will be written off and Tom will not owe any more money.

An IVA might sound like an easy option but it is actually very tough, because the payments will take up a lot of the individual's income and will leave just enough for them to live on, but not enough for them to be able to enjoy any treats or luxuries. In addition, if the individual receives any lump sums during the five years, or has pay rises, they must inform the insolvency practitioner, who might insist that some or all of it is used towards paying off the debt.

11.4.2.3 Bankruptcy

If the individual's debts are more than their assets, they have no way of repaying the debts and they cannot meet loan repayments, then they are said to be insolvent. If somebody is 'insolvent', they can apply to (petition) the court to be declared bankrupt – or their creditors may apply if the debts are £5,000 or more. Bankruptcy is official recognition that they will not be able to pay off the debts, and it starts the process of trying to recover as much money as possible to pay off as much of the debt as possible.

If the court agrees to the petition, it will issue a bankruptcy order and appoint a trustee in bankruptcy to manage the debtor's affairs. The bankruptcy order usually applies for 12 months, and during that time the trustee can seize the debtor's assets and possessions, including in most cases any flat or house they own. They can then sell the seized assets to help to pay the debts. The trustee will also take a proportion of any income that the debtor receives during the bankruptcy to pay towards the debts, leaving the bankrupt with enough income to live on, but little more. Any lump sums – such as lottery wins or inheritances – that the bankrupt receives during the 12 months will also be taken by the trustee to pay towards the debts.

At the end of the 12-month period, as long as the bankrupt has done everything required of them, they will be 'discharged'. Discharge means that they are no longer subject to the bankruptcy order, the remaining debt will be written off and they can keep all future income. Bankruptcy leaves a big stain on an individual's credit record. It will be recorded on the individual's credit reference file and they must declare the bankruptcy whenever they apply for credit. Any application for credit from a discharged bankrupt may lead to a refusal to lend or to the lending being at a much higher interest rate.

11.4.2.4 Debt relief order

A debt relief order is an arrangement where all the individual's debts included in the order will be frozen for 12 months, during which time the debtor will not have to make any payments. All the debts included in the order are written off at the end of the 12 months.

Only a limited number of people can apply for a debt relief order. They are people who:

- owe £20,000 or less; and
- have assets of no more than £1,000 plus a car worth £1,000 or less; and
- have spare income after household expenses of less than £50 a month.

11.4.3 Debt problems and future borrowing

Debt problems form part of the data kept by credit reference agencies. CCJs, IVAs, debt relief orders and bankruptcy are recorded on the borrower's credit record for six years, even if the debt has been repaid or the arrangement has finished.

Lenders will always search these records when assessing a borrower's credit rating, and previous credit problems will be viewed negatively. The lender may decide not to lend or they may decide to agree to lend but at a higher interest rate, depending on the extent of the problem.

The longer the time between the debt arrangement or problem ending and the application for credit, the more sympathetic the lender is likely to be, as long as the borrower has conducted their finances well during that period.

11.5 The effect on society

We looked in section 11.3 at the effects of large amounts of personal debt on the economy, but the effects can go deeper than that. High levels of debt can also affect society as a whole.

- Society in general may have to support those people with heavy debts through state benefit payments, charity, food banks, and so on.
- Local authorities and housing associations are responsible for providing what is called 'social housing' for those who have lived in the area for some time but can't afford to buy their property.

Social housing used to be the responsibility of local authorities, which were called local councils, and so that type of housing has traditionally been called 'council housing'.

The supply of social housing is very limited, which means that in most areas there are lots of people waiting for flats or houses. In extreme cases where people can't pay large debts, such as mortgages, or have been declared bankrupt, they may lose their homes. This will put pressure on local authorities, which will be responsible for rehousing them or making sure that they have shelter. As families usually take priority over single people and couples, the need to rehouse them could cause other people to wait even longer.

- The money to support those with heavy debt problems must come from somewhere, and usually it comes from local authority budgets. This means that other services may be cut back to find the money.

Summary

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

We have learned about:

- the factors to consider when making the decision to borrow;
- calculating the cost of borrowing and how to use the tools available;
- the effect of borrowing on the economy;
- the impact of borrowing problems on individuals and society.

Key terms

Assets – personal possessions and investments that have a value if sold.

Bankruptcy order – a court order to recover debts from an insolvent person, under the supervision of a trustee in bankruptcy.

Consumer borrowing – borrowing by members of the public rather than the government.

County court judgment (CCJ) – a court order for the repayment of a debt.

Credit reference agencies – companies that collect data on the conduct of people's financial accounts.

Debt consolidation – rolling up existing debts into one new loan.

Debt relief order – an arrangement for someone with debts not exceeding £20,000, limited assets and little disposable income to write off the debts after 12 months.

Individual voluntary arrangement (IVA) – an agreement between a debtor and their creditors to pay some of the debts over a set term, usually five years.

Insolvency – when an individual's debts exceed their assets and they cannot meet the loan repayments on the debt; they are said to be 'insolvent'.

Payment default – when the borrower fails to make payments on a credit agreement.

Recession – a period of at least six months when the amount of goods and services that a country is producing is shrinking. This has wide-scale negative effects on the economy.

Suggested discussion points from page 4

Why would it not be sensible to buy a second-hand car with a seven-year loan, but it would be sensible to buy a house with a 25-year mortgage?

- A car, like lots of things, loses value fairly quickly. That would mean that it would probably be worth less than the amount left on a long-term loan after a few years!
- It is normally sensible to buy things that either lose value quite quickly, or have no real value anyway, over the shortest term possible.
- Another example would be a holiday. It wouldn't be a good idea to pay for a holiday with a two- or three-year loan, because we'd be paying for it for years after we've enjoyed it. The only exception might be a special holiday, such as a honeymoon or a special wedding anniversary, but even then we would want to pay it off as quickly as possible.
- Buying a house is different, because:
  - we need somewhere to live and if we didn't buy a house we'd have to pay rent to live somewhere;
  - houses are so expensive that the only way to be able to afford the monthly repayments is by arranging a mortgage over the long term;
  - in most cases, the difference between the monthly cost of the mortgage and rent is not much, and the mortgage allows us to buy something that has value now and should increase in value in the future.

Answers to discussion point on page 9

1. £22.39 x 24 payments. Total cost £537.27, interest £37.27.
2. £114.61 x 60 payments. Total cost £6,876.42, interest £876.42.

Bibliography and further reading

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