



Principles of Borrowing

ALL LOANS, whether it is a car loan, home loan or personal loan, consist of three main components: The interest rate, security and term.

The Interest Rate

The interest rate is the lender's charge for the use of their money. The interest rate is usually expressed in terms of a percentage of the amount loaned on a per annum (p.a.) basis. The interest charged is mostly on a compounding basis (i.e. interest-on-interest) and could be either on an annual/ monthly/ daily compounding basis (another term used is yearly/ monthly/ daily rest.)

There are two different types of interest rates: fixed or variable.

Fixed Rates are just that: fixed and unchanging. If your fixed interest rate is 6% p.a., it will be 6%p.a. for the entire tenure of the loan.

Variable Rates can change over time and are usually pegged on a standard

market rate, such as the Base Lending Rate, BLR (current BLR = 6.75%). For instance, you may take out a loan with a variable rate at BLR + 1%. This means that you'll pay one percent more than the BLR, or a total of 7.75% p.a.

The Security

All loans are either secured or unsecured. This refers to whether the lender requires you to put up assets, often referred to as collateral, to secure your loan.

If you have a secured loan, it means your lender will be able to resort to foreclose the collateral in the event you default on the loan. Because there is an exit repayment alternative, interest on secured loans are lower compared to interest on unsecured loans.

When you finance the purchase of your car through a bank loan, you are actually a hirer (not owner) of the car you are driving until you have fully repaid your loan! Similarly, in the case of a housing loan, the bank will have an 'ownership claim' on the house until you have fully repaid the

housing loan.

In an unsecured loan there is no collateral that the bank can foreclose in the event of default. Given this risk, unsecured loans almost always have higher interest rates than secured loans. In order to mitigate their risk, lending institutions sometimes require that an additional person co-sign for unsecured loans, or guarantee the loan amount.

The Term

The term of a loan is the length of time that the borrower has to pay back the loan. Most personal/ car loans have terms of 3 to 9 years whereas home loans stretch much longer, up to 30 years! The term is the maximum length of time the borrower has to repay their loan; loans can be paid off before the term is up (but there may be penalties for early settlements!)

The Basic Principles of Borrowing

Having understood the components of a loan, here are some



basic principles of borrowing.

Principle 1: Borrow for something that you need – not want.

We have talked about the difference between a need and a want and when it comes to borrowing, it is even more important we understand this difference. You should only borrow for something that you really need but don't have the cash to pay for it. For example, to purchase your home, to send your children for further education and to a lesser extent, buy a car.

Principle 2: Borrow an amount that is within your repayment capacity

This may sound like common sense but unfortunately, it isn't common practice. Many people over-commit themselves into debt thinking that the economy will continuously expand and the good times are here to stay. Needless to say, when the crunch comes, these people will be left struggling to keep up with their repayments, as repossession of cars and foreclosures begin to happen. A case in point is the subprime loan crisis in the US.

It is advocated that one should keep one's total loan repayments to less than 1/3 of one's gross income.

Principle 3: Avoid borrowing to finance depreciating assets

This might ruffle some feathers but it is nevertheless a good principle

to abide to. Depreciating assets are things that lose its value over time, like a car (unless you are investing in a classic car), furniture and most of the household items and gizmos. It doesn't take an economics professor to tell you that borrowing at a relatively high cost (maybe as high as 20% p.a. for some items) to purchase these "assets" just doesn't make good economic sense. These items would depreciate very quickly in value whilst your loans reduce rather slowly. In the event of default, the items would be repossessed and you are obligated to top-up the shortfall as your depreciated assets are not sufficient to cover the outstanding loans.

Try to purchase these items with cash through your savings rather than borrowing. Otherwise, don't buy unless it makes good business sense.

Principle 4: Avoid being a guarantor

A guarantor steps into the shoes of a borrower in the event, for whatever reason, of a default. Unless one is prepared to honour this commitment, one should avoid being a guarantor.

Principle 5: The borrower has a moral and absolute commitment to repay

Have you met any persons in your life whom have borrowed from you but have yet to repay? How do you feel? Frustrated? Cheated? Betrayed? Yes, it is certainly not a very good feeling and you should never give any excuses for not repaying your debts once you have made a promise.

If you have a problem repaying, talk to the lender to work out a feasible repayment plan but never keep quiet or run away. Otherwise, don't borrow!

Conclusion

If you need to borrow, by all means, borrow! However, be sure that you clearly understand the principles before committing into it. Once you borrow, you are literally making a commitment to repay and kindly ensure that you, as a responsible individual, fulfil that commitment at all times.