

# What borrowing means

**T**O borrow or not to borrow. That's normally not an option! Most of us will need to borrow to buy our first car or first home, or for some, even to get married!

But not many understand the basic principles of borrowing.

## A loan's main components

All loans, whether it's a car loan, home loan or personal loan, consist of three main components — interest rate, security and term.

The interest rate is the lender's charge for the use of the loan. It 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 (interest-on-interest) and can be either on an annual, monthly or daily compounding basis (another term used is yearly or monthly or daily rest). There are two types of interest rates: fixed or variable.

Fixed rates are just that — fixed and unchanging. If your fixed interest rate is six per cent p.a., that will be the rate for the entire tenure of the loan.

Variable rates, on the other hand, can change over time and are usually pegged on a standard market rate such as base lending rate (the current BLR is 6.75 per cent).

For instance, you may take out a loan with a variable rate at BLR+1 per cent. This means that you'll pay one per cent more than the BLR, or a total of 7.75 per cent p.a.

Next, 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 can foreclose the collateral in the event you default on the loan. As there is an exit repayment alternative, interest on secured loans is lower than interest on unsecured loans.

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

In an unsecured loan, there is no collateral that the bank can foreclose in the event of default. Given this risk, unsecured loans usually have a higher interest rate than secured loans.

So to mitigate their risk, lending institutions sometimes require that an additional person co-sign for unsecured loans, or guarantee the loan amount.

The term of a loan is the length of time that the borrower has to repay it. Most personal or car loans have terms of three to nine years, whereas home loans stretch much longer and can typically last up to 30 years!

The term is the maximum length of time the borrower has to repay his loan. Loans can be paid off before the term is up, but there may be penalties for doing so.



## Basic principles of borrowing

### Principle 1: Borrow for something that you need, not want

We have previously discussed the difference between a need and a want. When it comes to borrowing, knowing that difference is most important. You should only borrow for something that you need but don't have the money to pay for it, for example, a house,

sending your children for further education or, to a lesser extent, a car (we'll talk about this later).

### Principle 2: Borrow within your repayment capacity

This may sound like common sense, but unfortunately, it isn't common practice. You are advised to keep your total loan repayments to less than one-third of your gross income.

**Principle 3: Avoid borrowing to finance depreciating assets**

This may ruffle some feathers, but it's a good principle to abide to.

Depreciating assets are things that lose their value over time, for example, a car (unless you're "investing" in a classic car), furniture and most household items and gizmos. It doesn't take an economics professor to tell you that borrowing at a relatively high cost (say, 20 per cent p.a. for some items!) to buy such assets doesn't make good economic sense.

In the event of default, these assets will be repossessed and you're obligated to top-up the shortfall as your depreciated assets are not sufficient to cover the outstanding loans.

So try to buy such items with cash through your savings rather than a loan. Otherwise, don't buy!

**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 you are prepared to honour this commitment, you should avoid being one.

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

Have you met anyone who has borrowed money from you but has yet to repay? How do you feel? Frustrated? Cheated? Betrayed? Yes, it's not a 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 about working 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 do so. But be sure that you understand the principles. Once you borrow, you are literally making a commitment to repay, so be sure that you can fulfil that commitment.

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