The Consumer Council

Title: What's the true cost of borrowing?

Learning outcomes:

Students will be able to:

- Identify different types of borrowing;
- Understand how different types of borrowing suit different people according to their personal and financial circumstances;
- Discover how the cost of borrowing rises the longer you take to repay; and
- Explain what is meant by the term 'interest'.

Curriculum links:

(GCSE) Money matters – evaluate methods of paying for goods and services

(GCE) Financial Management Issues for the Consumer – evaluate a range of credit options in relation to personal circumstances; costs; flexibility; debt potential

Resources:

Consumer Council resources pack 'Consumer Skills for Life' – available to download from: http://www.consumercouncil.org.uk/education/adult-education-training/

- **Buying a Car on Hire Purchase**
- **Buying a TV and DVD player on Credit**
- **Comparing Loans**
- **Saving up v Buying on Credit**
- **Understanding Payday Loans**
- **Understanding Credit Report**

Money Advice Service

https://www.moneyadviceservice.org.uk/en/categories/borrowing-money

https://www.moneyadviceservice.org.uk/en/categories/overdrafts-and-personal-loans

Experian Ltd

http://www.experian.co.uk/consumer/what-is-a-credit-score.html

Credit Crossroads – Students and Young People leaflet

Getting Credit: A Beginner's Guide and the Creditability computer game.

Money Saving Expert

http://www.moneysavingexpert.com/credit-cards/minimum-repayments-credit-card?dd

Activity 1.

Different types of borrowing

Q. Identify the different **places or people** you can go to borrow money

Q. What are the risks associated with each of these and the things you would need to consider before borrowing money?

Places and people you can borrow from	Associated risks / things to consider before borrowing money
Family and friends	You may be putting friends or family members in an awkward position by asking them for a loan. There's also the risk that if you can't repay the loan quickly enough it can put a strain on the relationship.
Banks and building societies (overdraft facilities)	This is linked to your current account and means you can take out more money than you actually have in the bank. An **authorised overdraft** is set up in advance with the bank and a limit is agreed. When funds come into your account (e.g. wages) the overdraft is repaid. You will be charged interest on the overdraft amount. An **unauthorised overdraft** is where you haven't got an arrangement with your bank and spend more money than you have in your account or where you go over the agreed limit of your authorised overdraft. You will pay extra charges which can soon add up and this may also affect your credit rating**.
Pawnbrokers	Pawning means that you leave something of value with the pawnbroker for them to keep as security and they then lend you money with added interest, usually charged at a higher interest rate than banks or building societies. When you pawn something you'll be asked to sign a credit agreement which includes a receipt for the pawned item. Pawnbrokers by law must be licensed by the Office of Fair Trading.
Credit unions	To borrow money from a credit union you must first become a member and show by saving regularly over a set period that you will be able to afford the repayments. This

	is an excellent way of getting credit as the interest rate is usually lower than that charged by other lenders.
Doorstep lenders	Doorstep lenders come to your home to collect repayments. This might offer some consumers a level of convenience and familiarity they prefer but it is one of the most expensive ways to borrow money. You should always check the APR*, ensure the lender is legal (i.e. licensed by the OFT and therefore regulated by law) and be clear how long you will be making repayments and how much the loan will cost you in total.
Illegal lenders (loan sharks)	Loan sharks are unlicensed lenders. Their interest rates will be extremely high and they may use violence or intimidation to collect debts. Do all you can to avoid borrowing from a loan shark. Seek help and information from Citizens Advice or an independent advice centre who may be able to suggest alternative courses of action.

Q. What types of **products/credit options** exist that enable people to borrow money?

Q. What are the risks associated with each of these and the things you'd need to consider before borrowing?

Products/Credit options you can borrow money against	**Associated risks / things to consider before borrowing money**
Student loans	You start repaying a student loan after you leave your course, get a job and are earning over £15,000 a year, (approx £1,250 a month). If you fail to make repayments the Student Loans Company has the right to accelerate your debt. This means they can get a court order to make you repay the total loan in a single payment.
Payday loans	These are short-term loans that you can take while waiting for your next payday. This may seem like a good way of getting your hands on your wages more quickly but the interest rates charged are often extremely high. Rates higher than 1000% APR* are not uncommon. This type of

	borrowing is not suitable for people wanting to repay their loans over a long period, as they are designed to be short-term loans to deal with short-term personal cash flow problems. If loans take a while to be paid back, debts can quickly escalate. The lender should be licensed by the Office of Fair Trading.
Personal loans	Most banks, building societies, credit unions and specialist lenders offer personal loans. These can be used to buy anything from a new laptop to a second-hand car. There are a lot of things to consider before taking out a loan, including your ability to make the repayments, what you could lose if you can't repay, which in some cases could be your home if this has been used to secure a loan. Repayment periods, interest rates and other charges vary so it's essential you spend time deciding what's best for you and your circumstances.
Credit cards	Credit cards are different from debit cards because they allow you to spend money now and pay it back later when the bill comes in. If you pay back the full amount each month, you will normally avoid paying interest charges, but if you only pay the minimum amount, you will be charged interest on any money that you still owe (the balance). These charges soon add up and a lot of people get into serious debt this way. *See Activity 4.*
Store cards	A lot of the big department stores and retailers offer store cards which work in a similar way to credit cards except that they tend to charge higher rates of interest. Even though discounted offers and 0% interest periods can be tempting, check the APR* to see what you'll end up paying if you don't settle the bill on time.
Hire purchase (HP)	This type of deal means you are hiring the goods (a car for example) with an option to buy once you've paid all the instalments. Until you pay the last instalment, you do not own the goods and you cannot modify

	or sell them until you do. If you don't keep up with repayments, in some circumstances the lender can take the goods back. It can be easier to get accepted for this type of loan but it can be a more expensive way of borrowing.

*** What is APR?**

APR stands for the Annual Percentage Rate of charge. You can use it to compare different credit and loan offers. It includes important factors such as

- The interest rate you must pay;
- How you repay i.e. the length of time you have in which to make repayments (term);
- The frequency and timing of repayments;
- The amount of each repayment; and
- Certain fees associated with the loan.

Generally, the lower the APR, the better the deal, but there are other things you will need to consider. For more information visit

http://www.moneymadeclear.org.uk/products/loans/what_is_apr.html

**** What is meant by credit rating or credit scoring?**

This is a system your card issuer or anyone organising customer finance uses to decide whether to give you credit and to set your credit limit. Credit scoring works by awarding points to the information you provide on your application form and to the information recorded on your credit report (held by a credit reference agency).

Lenders often use credit scoring to assess whether or not you will be able to pay back a debt on time and in full.

Factors influencing your credit rating include whether you're on the electoral register (you should register as soon as you're old enough to vote); whether you pay your bills on time and whether you go into an unauthorised overdraft.

What are interest charges?

Q. Why are you charged interest on money you borrow?

When you borrow money from a bank or other type of lender you have to pay back the loan amount plus interest. This is because the bank is charging to lend you the money.

Activity 2. Working out interest charges

'Interest' means the percentage (%) that you will pay on the money you have borrowed.

Example

Your car breaks down and costs £200 to fix. You haven't been paid your monthly salary yet so your bank balance is low. This means the £200 has to come out of your authorised overdraft which has a 6% interest rate.

To discover how much this will cost you in full, you first have to work out how much 6% of £200 is.

The full calculation looks like this:

200 ÷ 100 (to find what 1% would be) x 6 (to find what 6% would be) = £12

so that's (200 ÷ 100) x 6 = £12

Now add the £12 of interest to the original amount borrowed (£200) and you will get the total cost of the amount borrowed = **£212**

An interest rate of 6% is good but some types of borrowing can charge much higher rates of interest.

Q. Work out what you pay back if you borrowed the same amount (£200) but were charged the following interest rates

15%	**£30**	**= you will pay back £230**
20%	**£40**	**= you will pay back £240**
53.9%	**£107.8**	**= you will pay back £307.80**
433.4%	**£866.80**	**= you will pay back £1066.80**

N.B. The last two interest rates would be typical of the kind offered to people with a low credit rating.

Activity 3. Delayed repayment

If you borrow money and are being charged interest, the amount you will eventually need to pay back can grow significantly. This will be affected by how long you take to repay the loan. The longer the term of the loan, the more you pay in the end. This is because each year you are not only charged interest on the loan but **interest on the interest** from the previous year.

Q. Imagine you take out a personal loan for £1000 to buy a new computer for college, with an annual interest rate of 20%. You don't make any repayments for the first three years. How much will you need to pay back after three years? **£1728** ***See Appendix A***

Q. What are the advantages of being able to borrow money in this way to pay for expensive items?

Q. What are the disadvantages of borrowing money in this way to pay for expensive items?

Activity 4. Minimum Repayments

When you borrow on a credit card or store card, the bill that arrives at the end of each month will show the full amount owing but it also gives a minimum amount that you can choose to pay in order to keep up repayments.

The minimum repayment is often equivalent to 2% or 3% of the outstanding debt, or set at a minimum of £5.

Q. Why might some consumers consider the option to only make the minimum repayment?

They can't afford to pay any more than the minimum but still want to keep up with repayments.

Also, some consumers don't understand how minimum repayments work and what this can mean for the length of time it takes to repay the loan and how this will affect the overall cost.

Q. Why can it be dangerous to only be making the minimum repayment each month?

Because if you're only paying 2% - 3% of the overall debt, all you're doing is paying off the interest and not making any dent in the original amount you borrowed.

Q. Look at the table in Appendix B. If you borrowed £3000 on your credit card at 17.9% to take a gap year holiday (aged 18), and only made the minimum repayment each month when the bill came in, how old would you be before the debt was repaid (assuming you didn't spend any more on the card)? **(59 years old!!)**

Based on a loan of £3,000 at 17.9%

Repayments per month	Time taken to repay	Interest cost
Minimum (2% or £5)	41 years	**£6,300**
£60	7 years	**£2,100**
£80	4 years 6 months	**£1,250**
£120	2 years 7 months	**£700**
£240	1 year 3 months	**£315**

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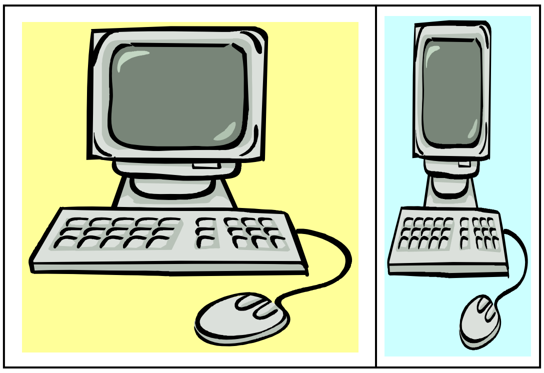
Avoiding the debt spiral

If you find yourself in a situation where you can't repay the full amount of credit in one go, draw up a budget, work out how much you can afford to pay each month and set up a direct debit to ensure you keep up the repayments.

Review your financial situation as and when your circumstances change. So, if you get a pay rise you should think about increasing your repayments or if circumstances temporarily change for the worse, you may need to reduce the amount you repay.

The key message is to avoid falling into the trap of only making the minimum repayment because the quicker you repay the loan the less it will cost you in the long run.

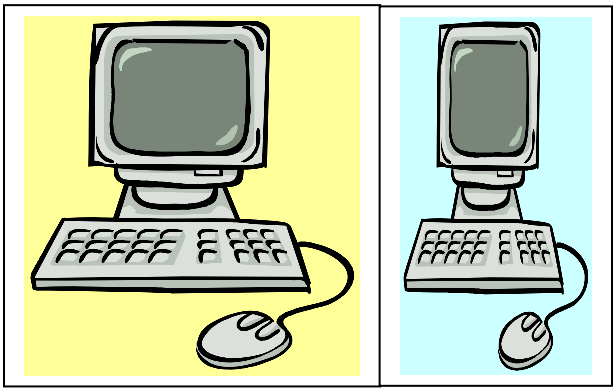
APPENDIX A



£0 £1000 £1200

YEAR ONE

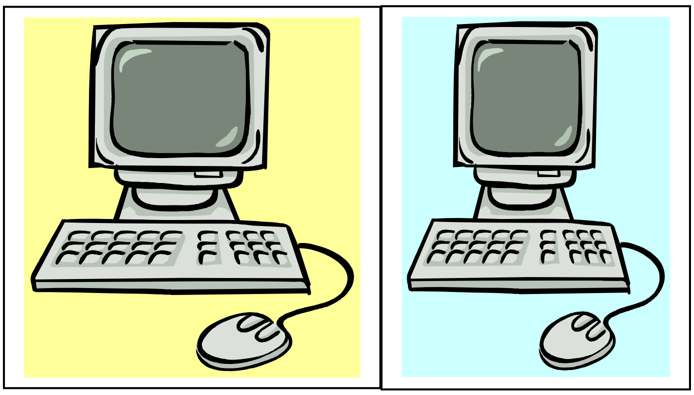
Loan amount (£1000) + interest (£200) = **£1200**



£0 £1000 £1400

YEAR TWO

£1200 + this year's interest = £240 = **£1440**



£0 £1000 £1800

YEAR THREE

£1440 + this year's interest = **£1728**

So, you would pay a staggering £728 on top of the £1000 you borrow from the bank.

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APPENDIX B

Based on a loan of £3,000 at 17.9%

Repayments per month	Time taken to repay	Interest cost
Minimum (2% or £5)	41 years	**£6,300**
£60	7 years	**£2,100**
£80	4 years 6 months	**£1,250**
£120	2 years 7 months	**£700**
£240	1 year 3 months	**£315**