Financial Capability Episode 4 – Understanding Borrowing and Credit

LLOYDS BANK

Arun:

Hello, my name is Arun Aggarwal and welcome to My Future Finances. In this series of six episodes, we'll be drawing on your experiences of managing money and exploring the key issues that affect your money and your futures. Now, these episodes are all British Sign Language enabled, and will have captions and transcripts.

Arun:

To borrow or not to borrow. Helping you explore and understand the options and empowering you to stay in control.

Arun:

It can be complex but with the help of our expert Iona, we hope that you can feel more empowered to stay in control. Whether it's managing your student loan, your overdraft, or understanding the importance of your credit rating and how to monitor it.

Arun:

Now, it may seem like an obvious question, but we use the terms 'credit' and 'borrowing' quite a lot, Iona is there much difference?

Iona:

Well Arun, there is no such thing as an obvious question when it comes to money. It's actually a really good question because technically there is a difference between 'credit' and 'borrowing'. Borrowing refers to a loan that is a fixed sum, that you repay over a specific period of time, that could be a mortgage or a personal loan. Whereas credit refers to a revolving loan, when someone is being lent money on an on-going basis. So, they use that money, they either repay it fully or partially, and then maybe they use the money again, so long as the credit keeps being made available. So, here we're talking about bank overdrafts and credit cards, things like that. So, it's not to be confused with being 'in credit', which refers to people being in the black and having a surplus in their bank account and not owing any money. So, it's good to clear that up. And also remember that you have to be over the age of 18 to take out any credit or to borrow money. But, whatever kind of debt you are dealing with, just know that it will have to be repaid and unless you are being lent money in an interest free period, you will usually have to pay interest on top of any debt that you owe. Now, it's important to stress that credit and borrowing are not inherently a bad thing so long as you manage it really carefully and you have a specific reason to take on that debt. The danger comes when you are using debt for its own sake, when you are spending more than you otherwise would, and you're going outside your budget. So, it's crucial to be informed, cautious and clear eyed about any debt that you take on.

Arun:

So, that actually really clears things up and that leads me to perhaps another obvious, although you might say good question, and that is why borrow money in the first place?

Iona:

Well, I think people borrow money for all sorts of reasons. So, there are some really worthwhile things in life that would not be possible unless we borrowed money to achieve them. So, for instance, buying a home or going to university. But broadly speaking, I'd say borrowing falls into two categories 'planned' and 'unplanned'. So, 'planned debt' is manageable, it's used for a specific reason, it's been budgeted for, and you can afford it. So, that means it's used for a beneficial and thoughtful purpose that will help you move forward in life i.e. buying a home or a car. 'Unplanned debt' is usually expensive, open-ended. It can be used either for its own sake because it's available or simply because you're struggling to get by. Now, there may be a very understandable reason as to why you need debt to survive. Perhaps because you're on a really low income or you've been hit by an unexpected bill that you need to cover, but it could also just be down to you not being in touch with your finances and resorting to debt, instead of exploring other options like saving.

So, you've got to be really honest with yourself and understand what's driving that unplanned debt because unfortunately unplanned debt does not usually help you move forward in life. In fact, often it holds you back because the debt itself doesn't solve the underlying problems. It just adds to those problems because you've got to repay it back with lots of interest that you haven't budgeted for and then you might start missing payments. The debt gets bigger and it starts to spiral out of your control. So, borrowing is not always bad, but it can be a risky financial behaviour because it's very easy to get into. But very difficult to get out of.

Arun:

Should we always avoid borrowing or using credit or are there any upsides to it?

Iona:

So, despite what I've said about borrowing, it's really important to remember that most of us will need to borrow money at some point during our lives. It's pretty difficult to avoid and what counts is, how we borrow and what we borrow for.

Arun:

I guess now we're going to drill down a little bit more as to how we might choose the right kind of borrowing products. So, a number of people have asked what exactly is APR and AER? Do they really make much of a difference when I make my borrowing choices?

Iona:

They do matter. Well, actually, I should say only one of the matters when you're making borrowing choices. So, let me explain because it can be quite confusing. APR stands for Annual Percentage Rates and that's the interest rate that you pay on your debts. Whereas AER is the Annual Equivalent Rate and that's the interest that you earn on savings. So, they are completely different, and APR is the only thing that you need to think about when it comes to borrowing. That's all that matters. Now, APR is just a standard percentage rate that's used to help people compare the cost of borrowing on various products. So, let me give you an example. Mortgages typically come with an APR in the low single digits. So, we're talking two, three, four, five percent. Whereas an overdraft with a bank could be as much as forty percent, so you can see the real difference in APR between a mortgage and an overdraft. The higher the APR, the more interest you'll pay. So, the more expensive the debt will be. It's important to stress that the APR that you pay on your debt often depends on your credit score, which lenders use to assess how reliable you are as a borrower. So, those with a poorer credit rating will likely pay a higher interest rate and those with a better credit rating will pay a lower interest rate. Now, you don't need to be a maths genius to understand debt interest, but you do need to know what interest rate you will actually pay on a debt because that's not always obvious when you first apply for credit or a loan. So, you need to understand in advance what that rate will be and also if there are additional fees that aren't included in the interest rate.

Arun:

I guess my next question is, if I do need to borrow, how am I supposed to decide on what kind of borrowing I use and for which purpose?

Iona:

Well Arun, I guess it really depends on your life and your needs. I mean, we've already spoken about the need to distinguish between planned and unplanned borrowing, really important, but let's maybe go into the various kinds of debt that are available for different goals in the future. So, a mortgage is a loan to buy a house. This is when you borrow a large amount of money, usually over a long period of time, to purchase a property or a piece of land. If you don't keep up the repayments, you may lose the property or land. So, having a mortgage is a big financial responsibility that needs to be prioritised. There are lots of different mortgage products out there, and it's usually a good idea to talk to, say a mortgage broker, about your options. Then there are student loans and overdrafts, something that we discussed previously. Hopefully, we now understand by this point how they work. There are also personal and business loans that we can take out from the bank when we want to set up a business or move into self-employment. Then there are bank overdrafts, which people sometimes use when they have a big expense or bill and not enough surplus money in their bank account to pay for it. And credit cards are used by many people to extend their day-to-day spending and sometimes to pay for specific big purchases and they can be a useful way to build up a credit history so long as they are carefully managed. And then there are credit unions, which require you to save with them before they will lend you money often at very good interest rates. There are also payday loans which involve lower sums than conventional loans, a few hundred pounds, but they are much more expensive. And finally, there is store and catalogue credit, which is when you spread the cost of your buying over many months but pay a pretty high interest rate in the process. And the latest version of that is Buy Now Pay Later and this is used by lots of younger people who are shopping online, they don't have the money to pay for all the stuff that they've piled up in their carts, they may end up returning a few things they've bought if they're clothes, for instance. So, they only pay what they keep at a later date. So, that's how buy now pay later work.

Arun:

So, you kind of touched on it just then talking about credit history, but can borrowing or using credit in a manageable way ever be helpful or useful to me?

Iona:

Well, the thing about debt is that we don't want to just get into it for its own sake. That is never a good idea and it's definitely not a substitute for responsible budgeting and spending. But at the same time, we might have goals in the future that would justify taking on manageable debt. So, we have to build a credit history in advance of that, that will put us in a good position to be accepted for that kind of borrowing further down the line. And what's more, if we do

have a good credit history, we are more likely to pay a good interest rate on that debt so that it's less expensive. So, the key is to make sure that you aren't in any chronic unplanned debt. If you are, you need to come up with a repayment plan by looking at where you can maximise your income, make savings and spend more wisely. Now there are lots of apps out there on the market that set themselves up as debt coaches that will help people pay off expensive debts and build their credit rating. So, it may be worth looking at those. But, there's a lot of useful information and guidance out there from debt charities like Step Change. And, they can also help you for free if you really get into trouble with your debts. And there are lots of easy things that you can do to build your credit rating, like getting on the electoral register or closing old accounts that you're not using anymore, and it's a really good idea to check your credit rating for free, or you can do it very cheaply, with a number of credit reference agencies, because that way you can make sure the information they hold about you is accurate and if it isn't, you can get it changed because that can really affect your credit score as well. If you do borrow or take on credit, try to pay it off on time in full come what may, because that will go down well with lenders and give you better peace of mind too. And don't forget, a good way to build up your credit worthiness is to use your credit cards for bigger purchases, over a hundred pounds, because that way you can get your money back if say the product doesn't arrive or the company goes bust, thanks to Section 75 of the Consumer Credit Act.

Arun:

In terms of borrowing then, what would you say your top three things to remember to be if we want to stay in control?

Iona:

First thing is, not all credit is bad. It's how you use it that counts. Second thing understand what APR is, Annual Percentage Rate, and the higher the APR, the more expensive your debt will be. And if you do take out credit, finally, make sure you pay it back in full on time. Don't let it run away from you and keep an eye on your credit score to make sure that it's accurate and in good health.

Arun:

Short and sweet. I love it. What tools are out there then to help us?

Iona:

So, there are lots of different tools out there, but I think the most important thing is to use credit rating agencies and check in with your credit score on a regular basis. Remember that you don't just have one credit score. You have lots of different credit scores because credit rating agencies will all rate you in a different way. So, it's worth checking in with a few of them to find out how they all see you. And as I said before, making sure that there aren't any errors on your credit history and that you are doing all those basic things like registering on the electoral register, to make sure that your credit score is the best that it can be.

Arun:

I didn't realise that we have more than one score. That's quite interesting. What tools are out there then to help us?

Iona:

So, there are various organisations out there that can help you manage your debt responsibly. For instance, Citizens Advice is really helpful when it comes to borrowing and credit issues. And then there's also Step Change and other debt advice charities out there. And if you are really struggling with your debt and it's having an impact on your mental health, then you might want to talk to a charity like Mind as well, because there's a really strong link between being in control of your money and having good mental wellbeing. So, never struggle alone.

Arun:

Wonderful. Thanks so much for chatting to me Iona and join us again when Iona and I will chat more about money management.