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Types of Loans and Low-Risk Borrowers

Occasionally people need to borrow money for a major or minor purchase. Because there are so many different types of loan products available, the decision to borrow should be made carefully and according to your needs.

As a borrower, you want to appear to the bank as a low risk to default on or fail to pay the loan. Any lender assumes some risk, but no one wants to risk losing money, especially those who are in the business of lending. So banks and other lenders use a number of characteristics to assess the risk level of the loan or borrower, which appear on your credit report or on your loan application. When a consumer fills out an application for credit or a loan and sends it in, the first thing the issuing company does is check the consumer's credit report. A credit report lists all of the debt a consumer has, the condition of the debt, and the consumer's employment and wage information. It also rates the consumer's risk level with an indexed number. Banks or credit card companies generally have a credit number, or score, below which they will not grant loans or lines of credit.

Credit reports protect both consumers and lenders. They help lenders assess the levels of risk associated with borrowers. Since the reports are actually created by the lenders, they protect borrowers by informing them if someone is fraudulently borrowing money under their name. Consumers should obtain their own credit report periodically in order to know their credit worthiness and also to check to make sure that no fraudulent debt appears on the report. Federal law requires credit reporting agencies to provide credit reports to borrowers free of charge once a year.

The characteristics that indicate risk levels to lenders include:

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- Credit inquiries. A high number shows you have made a lot of applications and creates the impression of high risk.
- Credit cards. If you have a lot, that's considered high risk. If you have high balances or are close to your limits, that's a risk.
- Collection items. If you have gotten behind on payments and collection efforts have begun on a loan, you are considered high risk.
- Delinquency. If you have been refused or have been unable to pay a loan or credit card, you are considered high risk.
- Debt-to-income ratio. This is a number that compares your total indebtedness to your income, or ability to pay. Lenders usually prefer a 36 percent debt-to-income ratio, with no more than 28 percent of that debt dedicated toward servicing the mortgage on your house. A debt-to-income ratio of 37–40 percent is often viewed as an upper limit, although some lenders will allow ratios in that range or higher.

There are two advantages to presenting yourself as a low-risk borrower. One is that you will be more likely to obtain credit. The other is that lenders reserve their best (lowest) interest rates for lower-risk borrowers.

There are two basic types of loans: secured, meaning loans for which the borrower has offered something of value (collateral) to secure the loan, and unsecured. Lenders have quite an array of loan products, both secured and unsecured, to fit many needs. Here are a few of them:

- Automobile loans may be obtained for the purchase of either a new or used car. For new cars, the term may be as long as 72 months, but the longer the term, the higher the interest rate that you will pay. For used cars, the term is usually shorter. Shop around for lower rates, because many different types of lenders make these loans. Automobile loans are secured loans, which means that the lender will hold title to (legal ownership of) the car until the loan is paid off. If the borrower does not pay the loan, the car may be seized by the lender (repossessed) until the delinquency (past due amount) is resolved. If the loan contract contains an acceleration clause, the lender may demand payment of the entire loan immediately if the car is repossessed. Any type of loan can have an acceleration clause.

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- Construction loans can be obtained to finance construction of a business, home, or vacation home. Generally they are converted to mortgages at the end of the construction period. They are secured by the real property (land and buildings) they are borrowed for.
- Credit cards are a widely used type of loan. About 78 percent of U.S. households have one or more credit cards, and the total number of cards reached 1.5 billion in 2006. In 2008, more than 84 percent of the student population had at least one credit card. Banks, department and specialty stores, and oil companies, among many others, issue credit cards. Credit cards are plentiful and convenient, but they are also a significant reason for high debt loads and bankruptcy. Credit cards are easy to apply for. Usually a paper form is filled out by the consumer, but applications may also be filled out online. Some companies issue what they call pre-approved accounts, but really those notices, which frequently are sent by mail, are better understood as invitations to apply for cards. Shred or otherwise destroy any type of notice like this that you receive but do not use.
- Lines of credit are arrangements between a lender and a borrower that establish a maximum loan balance that the bank will permit the borrower to maintain. The borrower can draw down on, or spend, the line of credit at any time, as long as he or she does not exceed the maximum set in the agreement. The advantage of a line of credit over a regular loan is that interest is not usually charged on the part of the line of credit that is unused, and the borrower can draw on the line of credit at any time. A potential disadvantage is that the line of credit may be classified as a demand loan, which means that any outstanding balance will have to be paid immediately at the lender's request.
- Mortgages are loans made to borrowers to buy homes or businesses. Because this is usually the largest purchase a typical family or individual will make, they are different from car loans. Usually the term is much longer. Typical mortgages

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will be financed for 15-, 20-, or 30-year terms. Their interest rate may be fixed, meaning that it stays the same during the entire term, or can be adjustable, meaning that the monthly payment can go up or down depending on a number of factors in the credit market. Adjustable rates effectively transfer part of the interest rate risk from the lender to the borrower. A mortgage uses the home purchase as security for the loan. A related type of loan is a home equity loan, which is granted to individuals or families that already have a home and, in some cases, a mortgage as well. In this type of loan, the home owner can borrow money against the value of his home, usually minus the amount of the unpaid mortgage. This type of loan is often used by longtime home owners to make property improvements such as remodeling all or part of a home. But these, too, use the home as security for the loan.

- Payday loans are short-term cash loans based on the borrower's personal check held for future deposit or on electronic access to the borrower's bank account. Borrowers write a personal check for the amount borrowed plus the finance charge, and receive cash. In some cases, borrowers sign over electronic access to their bank accounts to receive and repay payday loans. Lenders hold the checks until the next payday, when loans and the finance charge must be paid in one lump sum. To pay a loan, borrowers can redeem the check by paying the loan with cash, allow the check to be deposited at the bank, or just pay the finance charge to roll the loan over for another pay period. Payday loans range in size from $100 to $1,000, depending on state legal maximums. The average loan

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term is about two weeks. Loans typically cost 400 percent annual interest (APR) or more. The finance charges range from $15 to $30 to borrow $100. For two-week loans, these finance charges result in interest rates from 390 to 780 percent APR. Shorter-term loans have even higher APRs. Payday loans are extremely expensive compared to other cash loans. A $300 cash advance on the average credit card, repaid in one month, would cost $13.99 in finance charges and an annual interest rate of almost 57 percent. By comparison, a payday loan costing $17.50 per $100 for the same $300 would cost $105 if renewed one time, or at 426 percent annual interest.

- Small business loans are designed to help people own their own businesses. There are two types of financing: equity financing and debt financing. When looking for money, you must consider your company's debt-to-equity ratio—the relation between dollars you've borrowed and dollars you've invested in your business. The more of their own money owners have invested in their business, the easier it is to attract financing. If your firm has a high ratio of equity to debt, you should probably seek debt financing. However, if your company has a high proportion of debt to equity, experts advise that you should increase your ownership capital (equity investment) for additional funds. The federal government has an agency, the Small Business Administration, specifically set up to help and encourage existing and prospective small business owners.
- Student loans are low-interest loans for students and parents to help pay for the cost of a student's education after high school. They may be obtained through commercial institutions or through the federal government. All or part of the federal loans may be eligible for cancellation if certain conditions are met. For example, if you are a new borrower and are a full-time teacher in a low-income elementary or secondary school for five consecutive years, you may be able to have as much as $17,500 of your subsidized or unsubsidized loans cancelled.

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- Subprime lending refers to loans that are for borrowers with blemished or limited credit histories. The loans carry a higher rate of interest than prime loans to compensate for increased credit risk.

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