Financial Foundations: Borrowing

Borrowing is an integral part of our financial journey however if not managed well it can have a detrimental effect on our financial position instead of enhancing it.

This webinar addresses the basics of borrowing to help you get on the right footing when using credit:

- Why borrow?
- Types of credit
- Be aware

Why borrow?

A common reason for people getting into financial difficulty is because they have borrowed for the wrong reason or they have the wrong type of borrowing for their original purpose.

There are three main reasons we borrow money

- *To have and enjoy things now rather than later.* Whether it’s a home/property, a car, furniture, computers, or simply that new pair of shoes or the latest electronic gadget, we are not always prepared to save up to buy them because the time taken to save means we potentially miss an opportunity. The decision to borrow shouldn’t be taken lightly and the ongoing costs and impact on our budget need to be carefully considered.

- *To invest,* or boost our wealth generation potential. Whether it’s an investment property, share portfolio, etc. effectively investing is a way to increase our wealth so we can buy more in the future. By borrowing to invest we can increase the amount of the investment thus potentially earning greater returns. Care needs to be taken that the costs to borrow don’t outweigh those returns.

- *Cash flow timings.* Another reason people borrow is to alleviate a mismatch in cash flow timings. This is when you will have the cash in a few days’ time but need it today. This is where credit cards, pay day advances etc are useful. Care needs to be taken though that these short term cash needs are repaid quickly and don’t continue to accumulate, and that that activity doesn’t become a regular routine.

Types of Credit

A cardinal rule of borrowing is to “Match the life of the loan to the life of the asset”. This essentially means that it shouldn’t take longer to pay off the borrowing than the thing that we’ve purchased will last.

**Short term debt**

Short term debt includes things such as credit cards, overdrafts, and pay-day lender advances. All of which should be repaid with 12 months. Generally used for a mismatch in cash flow timings, or for low value purchases of everyday items.

This form of credit is often unsecured and attracts higher interest charges and fees.
Mid-term debt
Mid-term debts include things such as personal loans, car loans, and rent-to-buy facilities. Generally used for larger assets such as vehicles, or furniture, that have a useful life of between 1 and 10 years, or for irregular events such as a wedding or an overseas holiday. The term of the credit is often between 2 and 7 years depending on the asset being purchased and the borrower’s capacity to repay.

Mid-term debt may be secured or unsecured. Unsecured loans will generally attract higher interest rates than secured loans.

Long term debt
Long term debt is used for long term, high value assets such as property. They are generally secured by the asset being purchased and repaid over 20-30 years.

Be aware
There are a number of things to be aware of when you start using credit/borrowing.

Costs: As well as interest on the loan there are often other costs such as set-up fees, monthly maintenance or administration fees, exit costs, and penalties for not meeting agreed terms and conditions. Make sure you take all of these into account when deciding to borrow, and deciding who to borrow from.

Repayments: When you borrow you are entering into a contractual agreement to repay that loan so it’s important to be able to meet the repayment arrangements and ensure you have the money available when it’s due. If you’re unable to make a repayment it is better to let your financier know earlier and enter into a new arrangement with them. Where possible, depending on the loan agreement conditions and your personal capacity, pay as much as you can rather than just the minimum required to help reduce your interest costs.

Credit history: Your credit history is an accumulated record of all your interactions with credit providers – from banks to phone companies. It records all credit enquiries (even if you don’t go ahead with the credit), your repayment history, and any defaults or judgements. It’s vitally important to your future ability to borrow that this credit history is good. It pays to take care of it (ie make your repayments on time) and to check it regularly for accuracy.

Any information provided is of a general nature. Before making any decisions please ensure you seek appropriate professional advice to ensure it is appropriate to you.