Personal Loans

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the characteristics of a personal loan. You will explore how technical skills can help you review your options before you use your problem solving skills to make any final decisions. Specifically, this lesson will cover:

1. Importance of Personal Loans

A **personal loan** is typically a small-dollar debt that can be used to pay bills or make purchases.

> ↱ EXAMPLE Let's say that your friend Justin makes $22,500 per year. Although he generally makes enough to cover his living expenses from his paychecks that he receives every two weeks, this month he needs an extra $350 to pay all of his bills. What advice would you give Justin if you knew that he has a steady job but just not enough cash coming in this month?

The good news is that Justin has several options (see the illustration below).

TERM TO KNOW

Personal Loan

Typically a small-dollar debt that can be used to pay bills or make purchases.

1a. Cash Advances

Some people might suggest that Justin use his credit card to pay the bills or take a **cash advance** on his credit card from an ATM. Although it's true that he will pay a fee for the cash advance and pay interest on the loan, accessing cash this way is far better than taking a payday or car title loan. After all, the typical payday loan in the United States carries an APR of nearly 400%! But if Justin doesn't have a credit card, he'll need to pursue other borrowing options.

DID YOU KNOW

According to the Federal Reserve Survey of Consumer Finances, about 25% of adults living in the United States do not have a credit card, especially young adults who are just starting their careers.

TERM TO KNOW

Cash Advance

Service provided by credit card companies that allows cardholders to withdraw cash.

1b. Borrowing Options

Without a credit card, Justin has a few other borrowing options. He can:

- Ask a friend or family member for a loan (this option may not be available).

- Request an advance on his paycheck (many employers will absolutely reject this option).
- Contact the companies he owes money to, explain his situation, and ask for a modification to his billing plans (this could have a negative impact on his credit score, which would hurt his ability to get a credit card or other lower-cost financing in the future).

This example highlights a common situation facing many Americans today. People like Justin often feel trapped into using either a payday or title loan borrowing option because they simply do not know where to turn for a short-term small-dollar loan. However, there are many personal loan options for those who need to occasionally borrow money.

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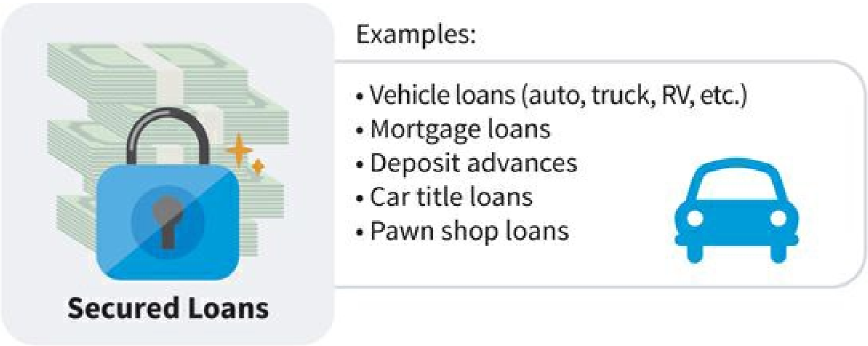
2. Types of Personal Loans

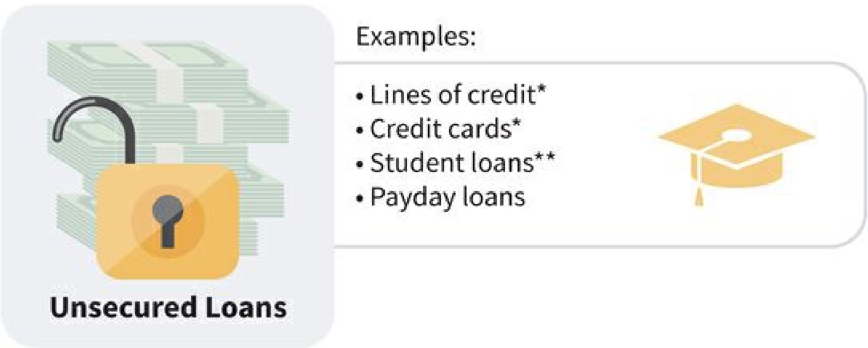
As with any financial decision, you need to use your problem solving skills to consider the options that are available. A personal loan may make sense for a given set of circumstances, but you need some key facts before you can make a choice.

2a. Key Lending Terms

To understand personal loans from a bank's or credit union's perspective, it's important to first review a few key lending terms. As shown in the illustration below, personal loans can be secured or unsecured.

- A **secured loan** is one that is backed by collateral. Think of collateral as property (such as a car or valuable item) that can be seized by the lending institution if the borrower fails to repay the loan.
- **Unsecured loans** are sometimes called signature loans because there is no collateral involved in the lending process. As a result, an unsecured loan is considered to be riskier than a secured loan and therefore carries a higher interest rate.





*Lines of credit and credit cards can be secured loans when other assets (e.g., savings or checking accounts, certificates of deposits) are required as collateral.

**Tax refunds and other federal government payments may be seized to offset federal student loans that have been sent to collection.

TERMS TO KNOW

Secured Loan

A loan that is backed by collateral.

Unsecured Loan

Sometimes called signature loans because there is no collateral involved in the lending process.

2b. Installment Credit

Let's say that Ana wants a loan to buy some furniture. If she obtains a secured loan from a bank using the furniture as collateral, the bank can repossess the furniture if she fails to pay back the loan. Ana's furniture loan is an example of a collateralized installment personal loan.

- With an **installment loan**, the borrower receives the full amount of the loan upfront in a single lump sum.
- Usually, the interest rate is fixed, as is the payback period (this is in contrast to credit cards, where the minimum payment from month to month changes based on the unpaid balance owed on the credit card).
- Loan repayment periods for installment loans generally last from 1 to 5 years.

HINT

When borrowing money for the purchase of an asset, such as furniture or an automobile, a best practice is to make sure that the loan repayment period is shorter than the expected useful life of the asset.

TERM TO KNOW

Installment Loan

The borrower receives the full amount of the loan upfront in a single lump sum. These loans are designed to be repaid over a fixed period of time through regular payments and consist of two general types: fixed installment loans and variable installment loans.

2c. Line of Credit

A personal installment loan makes sense for someone like Ana who needs to purchase something that costs more than what she has in the bank. Someone like Justin, however, probably doesn't need an installment loan. His problem is one of cash flow. Justin needs a short-term loan to cover a few bills. A solution for Justin is a **personal line of credit**. Usually, lines of credit are unsecured, which means that if Justin fails to pay back the loan, the lender can't repossess any of Justin's property. Here's how a line of credit works:

1. The bank tells the customer (borrower) how much may be borrowed in total.
2. The borrower is then given a debit card or a checkbook.
3. The borrower can then access the line of credit as needed.
4. Interest is only paid on the money borrowed.

Obviously, the more money Justin borrows, the more he'll need to pay back on a monthly basis. In effect, line-of-credit personal loans look similar to credit cards in allowing someone to maintain a revolving balance month to month.

HINT

A credit card may be a safer borrowing option than a line of credit because of federal regulations protecting consumers from credit card fraud.

TERM TO KNOW

Personal Line of Credit

A loan issued by a bank that is accessed by a customer via a debit card or check; interest is only paid on the money borrowed.

2d. Deposit Advance

It's now time for a reality check. Obtaining a personal loan or line of credit from a lending institution is relatively difficult and based on having a high credit score. Fortunately for someone like Justin, lending institutions are increasingly offering deposit-advance services for those who have less-than-stellar credit scores. A **deposit advance** is a short-term loan that is automatically repaid when the next qualifying electronic deposit is made (such as the next paycheck). These loans compete directly with payday loan services but at a much lower cost. Here's how a deposit advance works:

- To qualify for a deposit-advance loan, a borrower must have a checking account and a history of having paychecks, federal benefits, or other deposits made electronically.
- When a loan is needed, the borrower pays the bank approximately $10 for every $100 borrowed.
- The borrower then has 35 days to pay back the loan.
- If the loan is unpaid at that time, the lending institution will remove any money from the account and likely charge an overdraft fee – a fee for insufficient funds in the account.

HINT

Although the APR on a deposit-advance loan is approximately 100%, it is much lower than the APR on payday loans (up to 400%).

Personal loans can be a lifesaver for many consumers. Before taking a personal loan, however, realize that personal loans have many restrictions and can be expensive. It's therefore important to carefully compare personal loan options to know the costs and payment schedules, the APRs associated with the loans, what penalties may be applied, and what happens if the loans are not repaid.

Technology: Skill Tip

Strong technology skills can help you compare personal loans. There are several websites like Bankrate and Lending Tree that allow you to review terms and conditions before you make a decision.

TERM TO KNOW

Deposit Advance
A short-term loan that is automatically repaid when the next qualifying electronic deposit is made (such as the next paycheck).

2e. Peer-to-Peer Lending

The marketplace has stepped in to help people make loans to each other rather than through a company. **Peer-to-peer (P2P) lending** allows a borrower and lender to come together via the Internet. Popular P2P lending platforms include LendingClub, Peerform, and Prosper.

HINT

Even though the lending sites do charge a loan origination fee, P2P lending offers a way for many consumers to obtain a lower-cost loan.

- These services allow people 18 years of age or older to enter their personal information into a database.
- Each of the service providers creates a “lending score” that is driven by a borrower's credit report.
- Those who have at least a 650 credit score can then ask lenders (known as investors) for a loan.
- Loans can range from $1,000 to $40,000.
- Interest rates vary but generally do not exceed 32% APR.

TERM TO KNOW

Peer-to-Peer Lending
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SUMMARY

In this lesson, you learned about the **importance of personal loans** for paying bills or making purchases when your income might fall short. One type of short-term loan is a **cash advance** on a credit card, but there are other **types of personal loans** when you need cash in a pinch. These **borrowing options** include:

- **Installment Credit**. Goods purchased act as collateral and the loan interest rate is fixed.

- **Line of Credit**. Similar to credit cards, but has fewer fraud protections.
- **Deposit Advance**. Tied to a direct deposit checking account. Charges overdraft fees and has relatively high interest rates.
- **Peer-to-Peer Lending**. Third party providers that bring lenders and borrowers together online.

By **understanding the key lending terms** and definitions surrounding personal loans, you'll be in better shape to avoid taking on high-cost consumer loans that you studied earlier in the course. Strong technical skills can help you review those key terms. You can then use your problem solving skills to make the right choice for you and your situation.

TERMS TO KNOW

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