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A primer on personal loans

To borrow money, an individual can turn to a range of sources, each with different interest rates, depending on how one plans to use the money, says **LARRY HAVERKAMP**

THERE are two types of personal loans: term loans, and lines of credit. Both are useful, but the structure and pricing are different. Which is better depends on how you intend to use the money.

Term loans are for a specific period, like one to five years. These loans are not overly expensive and the rules are clear-cut on whether you qualify and exactly how much you can borrow.

The general guideline is you can borrow four times your monthly salary if you earn between $2,500 and $10,000 per month and have no rollover debt on your credit cards.

The major downside to these loans is they are tricky. It's because of the way the interest rates are quoted. Banks use a "flat" rate of interest to make the loans appear cheaper than they really are.

When I say "appear cheaper", I mean much cheaper, like half of what you really pay, called the "effective interest rate" or EIR. This is explained elsewhere on the page.

Lines of credit are the second type of personal loan. Their big advantage is they allow you to pay down or pay off your loan at any time. You can later re-activate it when you need the money again.

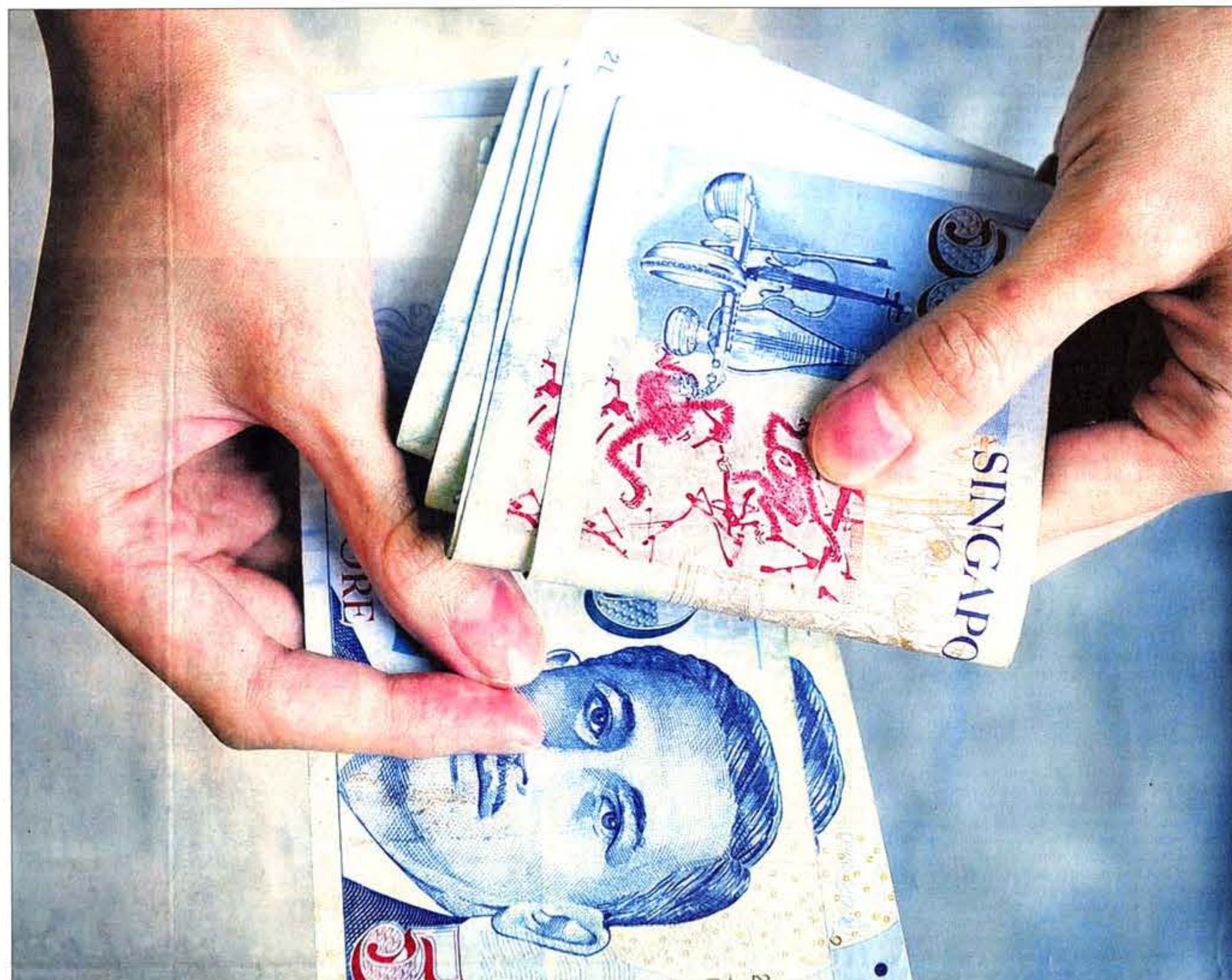
If you like, you can borrow $10,000 for a week and then pay it off. Whenever the balance owed is $0, no interest is charged. A month later, you can re-borrow the $10,000 or any other amount up to your line of credit limit.

It is the perfect loan for short-term cash needs. By contrast, a term loan requires that you borrow the money for the full term of one to five years with a penalty for early repayment.

The downside to the line of credit is its higher interest rate, but it need not be more expensive if you don't borrow for extended periods.

If you borrow infrequently and keep a $0 balance most of the time, it is less expensive than a term loan.

The standard charge for a line of credit is 17.8 per cent interest for incomes over $30,000 per year ($2,500 per month). Line of credit loans correctly quote the effective interest rate (EIR) so there is no flat-rate problem.



Show me the money: *Both term loans and lines of credit are useful, but the structure and pricing are different.* THE NEW PAPER FILE PHOTO

Balance transfer

The balance transfer is a good way of beating the high interest rates on lines of credit.

Banks often encourage their own customers to use the bank's balance transfer facility to reduce interest charges from 17.8 per cent to 0 per cent for up to 12 months, plus a one-time administrative fee of about 5 per cent.

Balance transfer within the same bank is a good deal because you can lower your borrowing cost to 0 per cent immediately, and it will apply the first time you use your line of credit.

Banks do this to encourage customers to use their credit line and get comfortable with it, while the one-time administrative fee encourages customers to use their line of credit quickly, before the 0 per cent offer expires in a year or less.

A similar type of balance transfer encourages customers to bring over their line of credit debt of say, $10,000 from bank B to bank A.

Bank A pays bank B, so you immediately owe the $10,000 balance to bank A at a rate of, say, 0 per cent interest for one year.

At the end of that time, the balance reverts to the standard rate of 17.8 per cent.

Of course, when that happens, you can do it again and apply for another bank's balance transfer.

It will once again lower your interest rate to 0 per cent (plus a one-time fee of about 5 per cent).

Balance transfer is also available for credit cards. Those savings are even greater since the annual interest rate will drop from 26.8 per cent to as low as 0 per cent for up to 12 months (plus a one-time fee of about 5 per cent).

A possible loophole

The two biggest loan categories are home and auto loans.

Demand for both has declined because of new lending restrictions which are intended to hold down the price of homes and the number of cars on the road.

These restrictions appear to be working.

A big question is: Will personal loans develop as a way around other loan restrictions?

For example, will borrowers use them to make higher downpayments so they can buy the flat or car they have their eye on?

If this is happening, no one is talking about it, mostly because it is outside the rules.

Borrowers are not permitted to take personal loans to use as equity (downpayment) to buy a home or car.

For home loans, there is no way around the new Total Debt Servicing Ratio (TDSR).

It was introduced at the end of June and prohibits banks from approving a home loan that pushes the buyers' monthly debt service to more than 60 per cent of their monthly gross income.

For the Mortgage Service Ratio (MSR), however, it is another story.

Many home buyers – like those taking a mortgage as their only big debt – will not be affected by TDSR as they will not go above the 60 per cent total debt ceiling.

It is quite possible, however, they would be constrained from buying their dream home by the new MSR.

MSR restricts monthly home loan payments to no more than 30 per cent of the buyers' monthly gross income.

In that case, buyers would still benefit from a personal loan to finance a larger downpayment. But because it is actually debt, it is not allowed if it pushes the MSR over 30 per cent.

As for car loans, these are not affected by TDSR. But car buyers are only allowed to borrow up to 50 or 60 per cent of the total cost of the car. The rest has to be paid in a downpayment.

Again, a personal loan that is secretly used for a larger downpayment is not permitted, but the buyer may be unable to buy the car without it.

What's new about the new lending rules is they are not easy to enforce.

That's because it is hard to know what happens to the money once it leaves the bank.

Suppose someone borrows $10,000 for a once-in-a-lifetime boat cruise to Alaska and they never take the trip.

How do you monitor that? How would a bank ever know if the borrower uses the money to make a larger downpayment for a home or car?

There are no statistics on how often this happens since no one wants to talk about doing what's prohibited.

Incentives to do it, however, are greater than ever. For many who are short on cash, a personal loan may be the only way to get the money to buy a car or a four-room instead of a three-room flat.

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The two biggest loan categories are home and auto loans. Demand for both has declined because of new lending restrictions which are intended to hold down the price of homes and the number of cars on the road.

The interest rate at which you're really paying

WHAT is the "flat rate", which some banks have recently renamed "applied interest rate" or AIR?

It is what you would pay at if the loan required you to pay only interest over the term of the loan and then repay the principal on the last day.

The flat rate also fails to add administrative fees to the interest rate you pay.

The fact is that personal loans are structured so that the principal is repaid in instalments.

But as the balance owed declines, interest payments fall with them. This plus the administrative fees result in the flat rate quoted by banks being less than half of what you really pay, called the effective interest rate (EIR).

The difference is greatest for persons with lower incomes.

DBS/POSB, for example, offer a one-year term loan for persons earning between $20,000 and $30,000 per year. The flat rate is 11 per cent, but it translates into an EIR of 28 per cent, according to the POSB website. That's a huge difference.

The most misleading is when bank officers discuss personal term loans with customers. They typically talk in terms of the flat rate of interest but never mention the more expensive EIR. I talked to five bank call-centre reps and every one told me – incorrectly – that the AIR was all I had to worry about. They didn't say a word about the EIR.

In bank advertisements, both the flat rate and EIR are shown. This is an improvement but it is also confusing to see two interest rates.

Some might think they are paying at the lower rate since the higher rate (EIR) is usually in a smaller font or a footnote. Others might average the two interest rates and think that is close to what they pay at. Of course, both are wrong.

There is no rule requiring banks to tell their customers that the flat rate is irrelevant, and the effective interest rate – which is about twice as much – is what they really pay at. *(see table)*

The spread between the flat rate and EIR depends on the lending rate, how long you are borrowing, and the bank's administrative charges. Flat rates apply to more than personal term loans.

Banks have also made them the industry standard for auto loans, so watch out for those too.

Strangely, banks quote flat rates only for those two types of loans.

Others – like the all-important home loans – do it correctly and quote only the EIR.

Watch the rate

Flat vs effective interest rates for loans

Loan tenure	AIR (flat rate)	EIR
1-year	5.38%	17.57%
2-year	5.88%	15.04%
3-year	6.18%	14.25%
4-year	6.18%	13.48%
5-year	6.18%	12.95%

Note: These rates are for POSB/DBS Loan Assist for incomes over $30,000 per year. The EIR includes a 4% administrative charge. Note that the EIR is more than double the AIR for all tenures.

BT graphics: Jennifer Chua, Cai Haoxiang

The non-bank personal loans

BESIDES term loans and lines of credit, there are three other non-bank personal loans.

The first are pawnbroker loans. These are collateralised loans and charge 20 per cent compound interest. They give loans from 60 to 80 per cent of the value of the collateral pledged and usually require gold jewellery or Rolex watches as collateral.

The second type are moneylender loans.

Borrowing limits are $3,000 for incomes under $20,000 per year; two times monthly income for persons earning $20,000 to $30,000 per year; and four times monthly income for persons earning from $30,000 to $120,000 per year.

Persons earning less than $30,000 per year have the yearly interest rate capped at 13 per cent with collateral and 20 per cent without it.

It's a reasonable interest rate for persons with low incomes who may not be good credit risks and are unable to qualify for a bank loan.

The problem is moneylenders prefer to make loans to persons with a low credit rating and earning more than $30,000 per year since the sky is the limit on the interest they can charge for those loans.

A list of 206 registered moneylenders in Singapore can be found at the website of the Insolvency & Public Trustee's Office (Ipso), a Ministry of Law department.

The link is *http://www.ipto.gov.sg/moneylenders/information-for-borrowers/list-of-licensed-moneylenders-in-singapore.html*

Finally, a third category of non-bank loans are loan shark loans. Loan sharks require no collateral and again, the sky's the limit on interest rates. The lowest loan shark rates are 10 per cent per month, which is 120 per cent simple interest per year.

Other loans

Typical personal loan interest rates

Type of loan	Annual Interest Rate (EIR)
Term loan[1]	15%
Line of credit	18%
Pawnshop[2]	20%
Moneylender	20%
Loan shark[3]	120%

[1] Interest rate is for a 2-year loan for yearly income over $30,000
[2] Pawnshop loans are the only ones requiring collateral
[3] Simple interest

Note: Figures are rounded

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