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Money — Budget it!

Loans and Credit Cards

What is a loan?

A loan is simply when one person gives another person money with the expectation it will be paid back in the future. Often, the borrower will repay the lender gradually, over time, until the debt is fully repaid. One of the main roles played by a financial institution is to loan money to its customers. Here are some common terms and concepts related to loans:

Deposit or Down-payment

When a loan is being used to buy something large, like a car or a house, the borrower may be required to contribute some of their own money to that purchase. In other words, they can't borrow the full cost of the purchase. The amount that the borrower contributes to the purchase is called the deposit or down-payment. For example, if they're buying a house for $500,000, the borrower may contribute $100,000 of their own money – that's the down payment – and borrow the other $400,000. Some loans require this kind of deposit, while others don't.

Installments

An "Installment" is a periodic payment that the borrower makes toward the loan. The payment might be made monthly, weekly or something in-between. The payment is determined when the money is first borrowed, and it's made up of two parts:

1. The first is the principal – this is the money that goes toward paying down the loan.
2. The second is the interest. Interest is a charge on top of the value of the loan, that acts as a cost of the loan. Interest is paid according based on an interest rate. The interest is generally stated as a percentage of the loan amount per year – for example, 5%. The interest rate varies from loan to loan and from lender to lender.

Secured and unsecured loans

Loans can be broadly classified as either secured or unsecured.

A secured loan is one where the borrower has to guarantee repayment by pledging property, such as a car or a house. This property is called security or collateral. The lender then has the right to sell that property to get their money back if the borrower doesn't repay their loan. Because secured loans are less risky for the lender, they're typically given in larger amounts and have lower interest rates. While the borrower benefits from the larger loan amount and lower interest rate, they also take on the risk that they might lose the property they pledged if they aren't able to repay their loan.

An example of a secured loan is a mortgage.

An unsecured loan is one where the borrower doesn't pledge any property to the lender. Because the lender doesn't have anything to sell if the borrower doesn't repay the loan, an unsecured loan involves more risk for the lender. Because of this, unsecured loans are given out in smaller amounts and have higher interest rates. Most personal loans are unsecured.

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Mortgages

A mortgage is a loan that a borrower takes out to buy a house. Mortgages are secured loans, and the house acts as a collateral or security for the loan. If the borrower doesn't repay their loan, the lender can sell the house to get their money back. Because homes tend to increase in value over time, mortgages represent a lower level of risk for the lender. As a result, the lender will usually charge a lower interest rate. A mortgage can be considered long-term or short-term, depending on the length of time required for the mortgage to be paid. Generally, mortgages take years to repay – often from 15-25 years or more.

Auto loans

A car loan is a secured loan that is given out by a financial institution or car dealership for the purpose of buying an automobile. If the borrower doesn't repay their loan, the lender can sell the vehicle to get their money back. However, because automobiles lose value over time, the lender might not get enough money from selling the automobile to repay the loan. As a result, auto loans have more risk for the lender. Because of this risk, the lender will usually charge a higher interest rate.

Personal loans

A personal loan is a 'small expense' loan that is mostly used by people to pay for their day to day expenses. They come in smaller amounts and may be more easily approved by the lender.

Credit card loans

When you buy something with a credit card, you've taken out a loan. This is a credit card loan, and just like any other loan, it comes with interest charges and fees. Credit cards are offered by credit companies and most banks today. Credit Card loans are unsecured – which means if you don't repay your credit card loan, the lender doesn't have anything to sell. That means that credit card lending is riskier for the lender. Because of this, the interest rates on credit card loans are higher than on many other kinds of loans – sometimes 20% a year or higher.

Payday loans

A payday loans is another type of unsecured loan. To get a payday loan, you must have employment and income, but your credit status (your history of successfully repaying debts in the past) is less important. Payday loans are also generally available on short notice Because these loans are often offered to people with a poor history of repaying debt, they represent a high risk for the lender. For this reason, they often charge a very high rate of interest – payday loans are almost always the most expensive way to borrow money.

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What is interest?

Interest is an extra charge that's basically what the borrower is paying to borrow money. In other words, it's the cost of the loan. The interest charged is based on what's called the interest rate. The interest rate is stated as a percentage of the loan and it's the extra amount that needs to be paid each year For example, if you borrow $100 for one year and the interest rate is 10%, you'll need to repay the $100 loan over the course of a year, plus an extra $10 in interest. The interest rate varies from loan to loan and from lender to lender.

There are two types of interest – *simple interest* and *compound interest*.

With the example above, let's imaging you're borrowing that money for more than a year. If you pay the $10 interest at the end of the year, your debt is still $100. In year two, your interest will again be $10. This is called simple interest.

But what if your loan doesn't require you to pay the interest every year? For example, you only have to pay it at the end of your loan term. Then that $10 of interest is added to your loan amount after the first year. Then, at the start of year two, your loan is for $110 – the original $100 plus the $10 of interest you haven't paid yet. Now, in the second year, interest will be charged on $110 instead of $100. So, in the second year your interest will be $11 instead of $10. This is called compound interest.

Compound interest will cause the amount of your loan to grow each year. As your loan grows bigger, you're charged more interest each year, which in turn makes the loan even bigger. Over time, if you allow your loan to continue to compound in this way, you can end up owing a lot more than when you started. So, you're generally better off to pay your interest when it comes due.

Source: wiki.kidzsearch.com/wiki/Interest