Loan Terminology

AT SOME POINT in your life, you will probably need a loan to purchase an item or to pay for an unexpected expense. It may be a new vehicle, a new home, or a needed vehicle or home repair. What type of loan should you get? What do all the terms mean in a loan application and loan agreement? Knowing the terminology used in lending and the differences between various loans will assist you greatly when shopping around for a loan.

Objectives:

1. Describe basic loan terminology.
2. List the different loans available to consumers, and describe why they are important.

Key Terms:

borrower
consumer
delinquency
fixed interest rate
interest
lender
loan
principal
secured loan
unsecured loan
variable interest rate

Lending Terminology

A **loan** is an agreement to repay borrowed money with interest over a specified period of time. At least two parties are involved in any loan: the lender and the borrower. The **lender** is the institution or individual supplying the funds for the loan. Meanwhile, the **borrower** is the institution or individual receiving the funds from the loan. The borrower will typically send a monthly payment to the lender until the loan is satisfied.

LOAN COST

The cost of a loan is typically calculated using an interest rate. **Interest** is the amount charged to the borrower for the use of borrowed money. It is calculated by multiplying the interest rate, expressed as a percent, by the loan principal. **Principal** is the original loan amount on which interest is calculated. Your interest rate will be based on your creditworthiness. A higher credit rating will result in a lower interest rate. Remember you will pay more if you have a higher interest rate.

Two basic types of interest rates are fixed and variable. A **fixed interest rate** is a set rate charged throughout the life of the loan. This type of rate will not change, so it is the best rate for budgeting purposes. In contrast, a **variable interest rate** is a rate that will change throughout the life of the loan. It will typically change quarterly, semi-annually, or annually.

LOAN FEES

Almost all loans will have associated penalty fees. One such fee would be due to delinquency. **Delinquency** is a situation that occurs when a borrower is late making a loan payment. Each loan may have a slightly different point at which delinquency occurs. For instance, one company may give you 10 days after the due date before charging a penalty. Another loan company, however, may give you 15 days. An additional consequence of delinquency is negative credit reporting. The lender will notify the three credit bureaus of your delinquency, which could lower your credit score. Other fees that may apply are application fees and returned check fees.

Loan Types

A **consumer** is a person or group that purchases products for personal use and not for resale or use in manufacturing. Many of the major purchases (e.g., home, car, and large appliances) consumers make are made with loans. Without loans, home ownership would not be a viable option for many people. For others, loans provide the opportunity to purchase a larger home or nicer vehicle with the option to pay over time. Also, loans are important to consumers in terms of economic development. When money is used to purchase larger items, jobs are created to fulfill the demand for more goods.

SECURED LOAN

Two basic types of loans are secured and unsecured. A **secured loan** is a borrowed sum backed by an asset or collateral. Generally, these loans are backed or secured by a home, vehicle, or savings account. They are often lower in interest because if you default on your loan, the lender can simply recover the asset to repay the debt. Home loans and vehicle loans are two

ON THE JOB...

CAREER CONNECTION: Loan Officer

Loan officers are responsible for evaluating an individual's loan application and for deciding whether or not the potential borrower receives a loan. According to the U.S. Bureau of Labor Statistics, loan officer positions will increase 14 percent from 2010 to 2020, and the median pay is $27.16 per hour. Most loan officers are employed by banks and other financial institutions. It is possible to find a job as a loan officer with only a high school diploma, but a college degree and licensing may be necessary for advancement and for evaluating commercial and/or home loans.

major categories of secured loans. Home loans are typically called mortgages and are generally 15 or 30 years in duration. Various credit and down payment requirements exist for home loans, and typically you must have good credit and a down payment to qualify. However, programs are available for people in other situations. Vehicle loans are typically between three and five years in duration. Vehicle loans can be obtained with no down payment, but it is recommended to have at least a small down payment.

UNSECURED LOAN

An **unsecured loan** is a borrowed sum not backed by any asset. It is issued by examining the creditworthiness of the borrower. You do not need any collateral for an unsecured loan. Personal loans make up a large portion of unsecured debt. They generally have a higher interest rate than secured loans, but they do not require any type of property for collateral. Since personal loans require no collateral, you generally must have good credit to qualify.

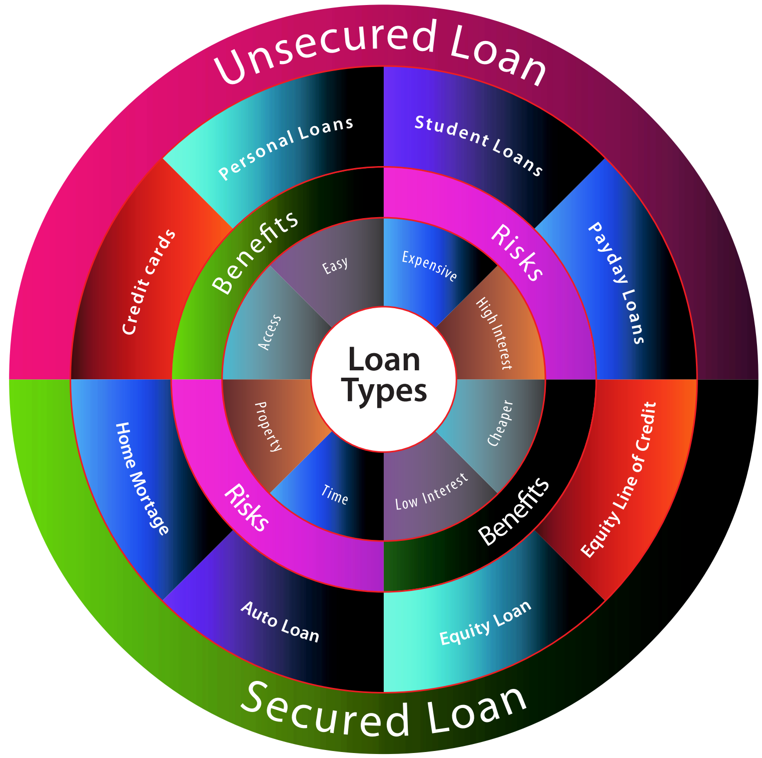

FIGURE 1. Secured and unsecured loans can be obtained from banks and credit unions.

Summary:

Loans are important to consumers. Two parties are involved in any loan:

the lender and the borrower. The cost of a loan is typically calculated using an interest rate. Secured and unsecured loans are the two basic types that you will encounter. Knowing the terminology involved in lending and knowing what loan would best fit your situation will be an advantage for you when it is time to apply for a loan.

Checking Your Knowledge:

1. What are the two basic types of loans?
2. What is the difference between a secured and unsecured loan?
3. What are the two most common types of secured loans?
4. Why are loans important to consumers?
5. Why is it important to avoid delinquency on a loan?

Expanding Your Knowledge:

Contact a loan officer from a local bank or credit union, and schedule an interview. You could conduct the interview in person, via Skype, or via email. Be prepared to ask questions about credit criteria, secured vs. unsecured, and interest.

Web Links:

Borrowing

http://www.mymoney.gov/borrow/Pages/borrow.aspx

Credit Education

https://www.philadelphiafed.org/consumer-resources/publications/establish-use-and-protect-credit

Loan Calculator

http://www.bankrate.com/calculators/mortgages/loan-calculator.aspx

Loan Officer

http://www.bls.gov/ooh/business-and-financial/loan-officers.htm