

Debt Management

Structuring The Loan

Structuring The Terms Of Your Loan

Often it is necessary to borrow money in order to make large purchases like cars, home improvements, college expenses and emergency purchases. Fortunately, our financial institutions make such loans readily available, and fairly easy to get. However, such loans can be fairly complex financial transactions. The more you know before going into a loan, the better prepared you will be to select the loan that best meets your objectives.



Structure Your Loan Carefully

How your loan is structured helps the lending institution determine how much risk they are assuming, and, in turn, what interest rate they will charge. There are three basic loan features that define your loan: whether the loan is paid back in installment payments or as a lump sum, whether the loan is secured or unsecured, and whether the interest rate on the debt is variable or fixed.

Installment Loans Versus Lump-Sum Payment

When you take out a loan, you promise to repay the loan, plus interest, based on a contractual agreement. When you choose an installment loan, you borrow a lump sum of money, then pay back a fraction of what you borrowed at regular intervals over an extended period of time. In this manner you pay back both the loan principal and interest gradually. If you prefer, you may choose to borrow a lump sum of money, then pay back the entire loan principal and all accrued interest in a single payment at some future date in a single, lump sum payment.

Secured Versus Unsecured Loans

When a lending institution analyzes the risk they associate with a debt, one of the first things they look at is whether the loan is secured or unsecured. A secured loan is a loan based on your ability to provide collateral of similar value to the amount being loaned to you. In the event of a default, the bank can sell the collateral and recoup most, if not all, of the amount loaned. A home loan is the best example of a secured loan -- the bank will loan the majority of the purchase price of the home, but retains a lien against the home for as long as the loan is outstanding. In contrast, an unsecured loan is based solely on a promise of repayment. Because the lender holds no collateral, unsecured loans hold significantly more risk for the lender. This added risk is usually reflected in a higher interest rate being charged on the funds borrowed.

Fixed Versus Variable Interest Rate

The interest rate you pay on a loan is based on many factors including your credit rating, your payment history, and whether your loan is based on a fixed or a variable interest rate. Fixed interest rate loans carry a rate attached to them that does not change over the period of the loan -- it is the same rate the last day of the loan as it was the first. Because the lender cannot change the rate as market conditions change, they usually have higher interest rates to begin with than a variable interest rate loan. The variable interest rate loan, in contrast, begins slightly lower than the fixed rate, but it is "adjusted" from time to time to reflect current economic factors. If rates drop, the variable loan rate will normally drop. If rates rise, the variable loan rate will normally rise. Because of the initially lower interest rate, the monthly payment on a variable rate loan is lower than its fixed counterpart. This lower payment often allows you to qualify for a higher loan balance.
