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LOANS

LOANS AND INTEREST

There are many financial organisations which provide loans as part of their business. Lenders include banks, insurance companies, credit unions and building societies. Many shops and businesses also provide loans.

The lender wants to earn interest on the money they lend. There are traditionally two main ways of calculating interest on a loan:

- simple or flat interest—where you pay the same amount of interest each month and it's based on the total you borrowed, not on how much you still have to pay (the outstanding amount)
- reducible or effective interest—where you only pay interest on the amount of the loan still outstanding.

A simple rate of interest can seem less than reducible interest but the effective rate (equivalent reducible) for simple interest is close to double the rate of reducible interest by the end of the term of the loan.

Changes to the credit legislation in 1985 prohibited the calculation on consumer loans using the flat interest rate method. All consumer loan interest is now calculated in the same way, that is as reducible or effective interest.

Today lenders can calculate interest charges on a daily basis. The interest is calculated by multiplying the debt that you owe each day by the annual interest rate and then dividing it by 365. The interest charges are usually added to your loan account each month.

When borrowing money it is important to:

- read the contract
- calculate the cost of credit
- look at all possible alternatives
- select the agreement most suited to your needs.

CAR LOANS

Buying a car is something many people do at least once in their lives. For many people, the only way to buy a car is to take out a car loan. If you need to take out a loan you can save significantly on the interest you will pay by having a deposit.

A car dealer may offer to organise a car loan for the car buyer, and while this may save some time, it may not be good value. The buyer needs to compare interest rates, terms and conditions. It is important to read the contract thoroughly and to think carefully about whether to add the cost of car insurance to the loan. This can make the loan very expensive as the buyer will be paying interest on the insurance costs as well as the car costs.

For a lender to loan money to a young person, some security for the loan is generally required. This can take the form of property, such as the car, or a guarantor. If the car is taken as security, it may be repossessed if the borrower cannot make the repayments on the loan. If the borrower has a guarantor as security for the loan, that person is responsible for repaying the loan if the borrower can't make the repayments.

A car loan contract is like any other contract in that it is legally binding. Before signing a contract, it is important to compare loan products. If there is anything in a contract that is not understood, it is important to seek legal advice.

The *Money Stuff* Car Challenge (www.moneystuff.fairtrading.nsw.gov.au) takes the user through the process of buying a used car from a private seller or car dealer, including taking out a loan to buy the car.

HOME LOANS

Another common purpose for taking out a loan is to buy a house or flat. There are a large number of lenders who offer home loans. Generally, the home itself is the security for a home loan.

Most personal house and car loans are repaid in equal instalments for a fixed period of time. Although payments are equal, the division of each payment between interest and principal varies with each payment. To see how much is being paid in interest and principal each payment period, it is possible to set up an 'amortisation schedule'.

Key words

interest rate	guarantor	credit provider	repossession	financial services
credit product	credit contract	repayment	principal	security
default notice	average annual interest rate			

ACTIVITY OUTLINE

Discuss: What are loans? How do we use loans? Who are the lenders? What experiences have you heard about with loans, or more generally with credit?

Introduce WORKSHEET E1 and discuss the two main ways of calculating interest on loans. Walk students through the sample calculation of simple interest. Ensure that the concept of an effective rate of interest is understood and walk the students through the formula and sample calculation. Students should be able to work through the additional examples of both the simple and effective interest rates provided.

Ask the students if they know anyone with a car loan. Who is the lender? How much is the borrower paying in interest? Introduce WORKSHEET E2 and walk the students through the formula and sample calculation for working out repayment amounts. Allow time for students to complete the worksheets and ask individual students to provide their answers and explain their working.

Discuss: What do you know about housing loans? Guide the students through WORKSHEET E3. In addition to calculators, students will need access to spreadsheet software and/or to internet loan calculators.