FIRST COMMAND
EDUCATIONAL
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FINANCIAL READINESS FOR LIFE

# PERSONAL LOANS

## WHAT IS A PERSONAL LOAN?

A personal loan is a debt incurred by an individual person as opposed to a business or commercial entity. Personal loans are short-term loans you can receive from banks, credit unions, or private lenders like marketplace or nonbank peer-to-peer lenders. Personal loans are often unsecured, meaning they are not backed by collateral such as a car, home, or other assets.

When borrowers are approved for a personal loan, they are issued a check or the funds are deposited into their bank account. In most cases they are required to pay the loan back over a fixed time at a fixed interest rate. A personal loan is normally repaid in monthly installments like a car loan or home mortgage. The longer the term and the lower the interest rate, the smaller the monthly payment.

Personal loans are commonly used for:

- Major purchases or expenses: Personal loans can be used to cover large expenses for moving costs, vacations, weddings, funerals, vacations, etc.
- Emergency expenses: Small personal loans can help cover unplanned or unexpected expenses such as medical bills, car repairs, etc.
- Home improvements: Personal loans can be used to pay for major home improvements that help increase the value of your home, including the purchase of new appliances.
- Alternative to a payday loan: If you need money for an emergency, using a personal loan instead of a payday loan may save you hundreds of dollars in interest charges. While the maximum interest rate for personal loans is approximately 36 percent, payday loan interest could be as high as 400 percent.

- Debt consolidation: If you have several different debts and find it difficult to pay them, combining them into a personal consolidation loan can result in a single payment, most likely at a lower interest rate and lower monthly payment. This can also help to get you out of debt more quickly.

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If you need money in a hurry, personal loans can be a good option because the approval and funding process is relatively fast. However, before you go out and apply for one, be sure it is what you need for your situation. Learn how a personal loan works so that you don't end up with debt you can't afford.

## TYPES OF PERSONAL LOANS

Sometimes personal loans are called installment loans, but they are the same thing. Payments for personal loans, called installments, are usually made each month for a certain time until the balance is paid in full.

There are different types of personal loans available:

**Secured loans** require collateral. Collateral is an asset of value such as a car, house, property, etc., that the borrower commits to assure payment of the loan. Failure to pay the loan will result in seizure of the collateral by the lender. Interest rates are typically lower for this type of personal loan.

**Unsecured loans** are the most common personal loans They do not require collateral but are backed by a borrower's creditworthiness, i.e., the borrower must have a relatively high credit score. Because there is no collateral, lenders usually charge higher interest rates. If the borrower defaults on the loan, the lender cannot automatically seize any of the borrower's assets but can refer the loan to a debt collection agency or file a lawsuit to collect the unpaid debt.

## PARTS OF A LOAN

Understanding what's involved in a personal loan can help you avoid problems later.

Personal loans consist of the following:

- Principal: Amount that you borrow
- Interest: What the lender charges you for lending you the money (usually calculated as an Annual Percentage Rate (APR). APR is a combination of your interest rate and any loan fees.
- Fees: Additional costs of the loan, e.g., origination fee, late payment fees, etc.
- Loan or repayment term: Length of time over which a borrower will repay the loan.
- Monthly payment: Dollar amount paid each month, divided into the payment for interest and payment for the principal.
- Total finance charge: Total cost of the loan minus the amount initially borrowed
- Total to be repaid: Principal plus interest and fees

The loan payment amount depends on the loan principal amount, the interest rate, and the loan term. The principal amount is usually spread equally over the loan repayment term. Although the number of years in your term might differ, you will generally make 12 monthly payments each year. The monthly payment is based on the total cost of the loan and the length of time

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over which you will repay the loan. A $10,000 loan with a repayment term of 10 years will have lower monthly payments than a $10,000 loan with a repayment term of 5 years since the payments are distributed over a longer time.

## EFFECT OF CREDIT SCORE ON LOAN TERMS

Almost everyone has a credit file created and maintained by at least one of the three major credit bureaus: TransUnion, Equifax, and Experian.

These credit files, or credit history, are used to calculate a credit score that represents a person's creditworthiness. Credit scores range from 300 to 850, and are generally categorized as:

- 300-579: very poor
- 580-669: fair
- 670-739: good
- 740-799: very good
- 800-850: exceptional

Because personal loans are often unsecured, they may come with higher APRs than other types of loans. For unsecured loans, lenders pay extra attention to a borrower's credit score. In some cases, lenders may not offer a loan at all because of the extra risk of a person with a poor credit history. Taking a secured loan can often help lower the loan's APR, even for someone with bad credit.

### Will taking a personal loan hurt my credit score?

Lenders make a "hard" check on a person's credit record when a loan application is submitted, which can decrease the credit score. This temporary setback, however, will improve as the borrower starts making timely loan payments. Be aware that more significant decreases in your credit score can occur if you are late with your payments or fail to make any at all.

### Can I obtain a personal loan with bad credit or a low credit score?

If you have poor credit, a "bad credit loan" may be your only option, though it may not have a favorable interest rate. Before applying for a high-interest bad credit loan, consider taking some of the following steps:

- Obtain your credit score and review your credit report to identify problem areas or accounts that you need to address. Look for errors or outdated debt information that should no longer be in your report. If you find discrepancies, have your credit report corrected and updated before applying for a loan.
- Look for and research possible lenders and compare their loan terms. Start with your current bank or credit union; they are already familiar with your financial status and your

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existing relationship with them may provide an advantage. You can also research reputable online lenders that serve those with average to poor credit histories.

- Consider consolidating your existing debts. Even though you might end up with a high-interest loan, instead of making several payments on debts with different interest rates you will make just one payment with a single interest rate possibly than your original loans, as well as a lower monthly payment. This can make it easier to pay off the loan.
- Identify a possible cosigner. Having a cosigner with a good credit history and financial stability can increase your chances of being approved and possibly get you a lower interest rate. However, your relationship may suffer if you fail to repay the lender and the cosigner must pay off the loan.

You should avoid loans that seem too good to be true or too easy to acquire, such as payday loans or vehicle title loans. These loans can be tempting if you have bad credit, but they usually come with extremely high interest rates that create serious debt problems or perpetuate an existing one.

## UNDERSTANDING INTEREST

Interest is the price you pay for borrowing money. The interest rate on a personal loan is based on factors such as the type of loan, repayment term, value of your collateral, and your credit history. There are other factors that can affect the interest rate that are not directly related to the loan and are outside the control of the lender and borrower such as the state of the economy, inflation, and government regulations.

There are two basic methods to calculate an interest payment

**Simple vs. compound interest**

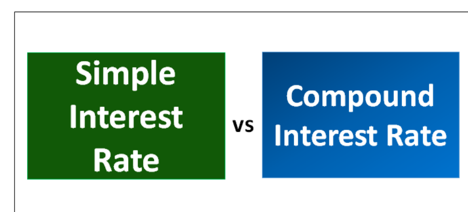
Some loans use simple interest, charged only on the principal, and some use compound interest, charged on the unpaid interest as well as the principal. Compound interest payments will always be higher than simple interest payments on a loan with otherwise similar parameters. Simple interest and compound interest are calculated according to the following formulas:

Simple Interest: Based only on principal

- Total interest = principal x APR x number of years

Compound Interest: Based on principal plus interest not yet paid

- Total interest = (principal x $(1 + \text{APR})^{\#\text{ of years}}$) - principal

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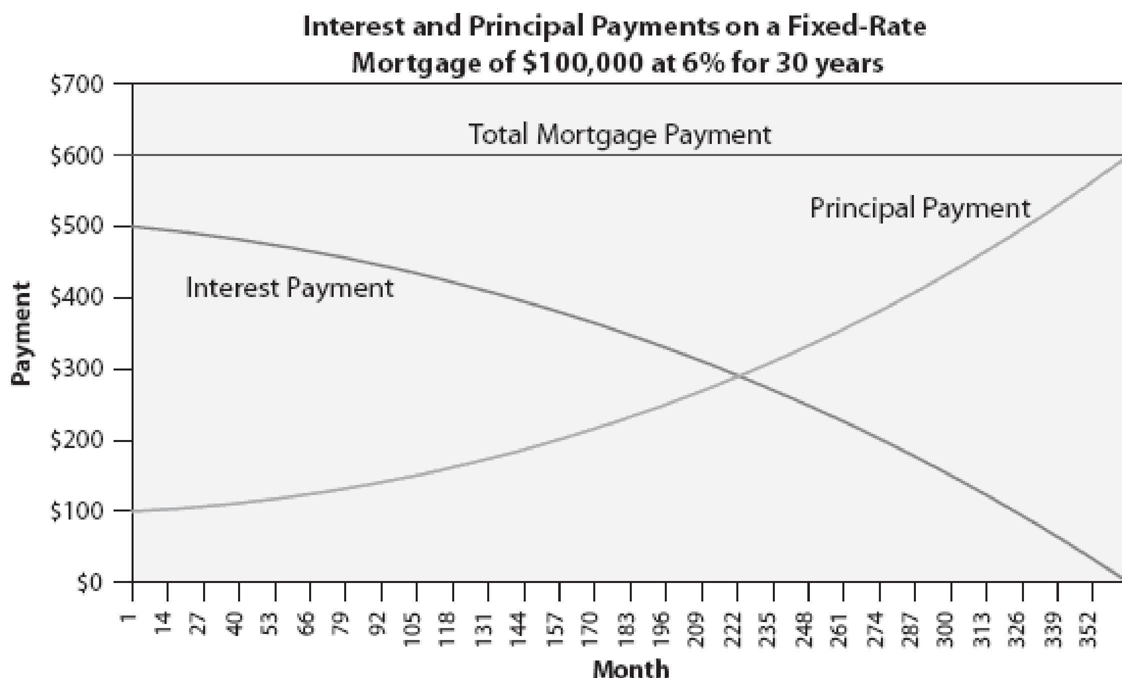
Simple interest is usually applied to short-term or informal loans, while compound interest is common for commercial loans.  The results for a loan with a principal of $10,000, 6% APR, and term of 5 years would be:
Simple interest: $10,000 x .06 x 5 = $3,000
Compound interest: ($10,000 x $(1.06)^5$) - $10,000 = $13,382.26 - $10,000 = $3,382.26

**Amortization**
The real cost of interest can be explained using an accounting principle known as amortization.  How does amortization work?

When a loan is repaid, the monthly payment remains constant while the interest part gradually decreases from month to month.  This is because the interest amount is recalculated on the balance of your principal, not your monthly payment.  With every monthly payment, a smaller portion of your total payment pays for interest, while a larger portion pays for principal.

This diagram shows what happens under amortization.  This example is based on a $100,000 mortgage with a $6% interest rate and 30-year term.  The *Total Mortgage Payment* is $600.00 per month, represented by the line at that level.  You can see the line representing the *Interest Payment* portion starts at $500 per month and gradually decreases to $0 during the payment period, while the line representing the *Principal Payment* starts at $100 and gradually rises to $600 during the payment period.




Amortization reinforces the benefit of paying off debt early.  When you pay more than you owe each month, you can quickly lower your total principal and therefore decrease your calculated

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interest amount.  Also, by making extra payments not only do you save on interest, but the payment term can be shortened.

An amortization schedule is a loan payment table that states the amount to be applied to principal and the amount to be applied to interest for each payment for the payment term.  An amortization schedule can help you determine how much you can save by paying more than the required monthly payment.  If you are looking for a loan, you can use an amortization schedule to compare each loan option.

You can find amortization schedules on the web.  An example of an amortization schedule is shown below.

Amortization Schedule

| Date | Interest | Principal | Balance |
|---|---|---|---|
| Apr, 2021 | $820 | $215 | $187,285 |
| May, 2021 | $819 | $216 | $187,069 |
| Jun, 2021 | $818 | $217 | $186,852 |
| Jul, 2021 | $817 | $218 | $186,634 |
| Aug, 2021 | $817 | $219 | $186,415 |
| Sep, 2021 | $816 | $220 | $186,195 |
| Oct, 2021 | $815 | $221 | $185,975 |
| Nov, 2021 | $814 | $222 | $185,753 |
| Dec, 2021 | $813 | $223 | $185,530 |
| **2021** | **$7,349** | **$1,970** | **$185,530** |
| Jan, 2022 | $812 | $224 | $185,306 |
| Feb, 2022 | $811 | $225 | $185,082 |
| Mar, 2022 | $810 | $226 | $184,856 |
| Apr, 2022 | $809 | $227 | $184,630 |
| May, 2022 | $808 | $228 | $184,402 |
| Jun, 2022 | $807 | $229 | $184,173 |
| Jul, 2022 | $806 | $230 | $183,944 |

**Factors that affect loan interest rates**

Generally, most lenders determine the borrower's interest rate using the following criteria:

- Credit score:  Good credit can make it easier to qualify for a personal loan with a lower interest rate.  Lenders will review your credit score and your credit history for late payments and delinquent or defaulted accounts.
- Annual income:  Income plays a significant role in determining personal loan interest rates. A high income assures the lender that you are capable of repaying the loan.  A steady income also reassures lenders that the borrower is likely to fulfil the loan payment obligations.

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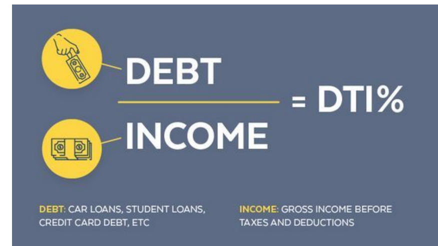
- Debt-to-income (DTI) ratio: Your DTI ratio is the amount of your monthly debt divided by your monthly gross income. Generally, a low DTI ratio indicates to lenders that you can manage the added payments for a new loan.
- Repayment term: Generally, loans with shorter repayment terms offer lower interest rates. A longer repayment term typically means a higher interest rate.
- Cosigner: If you don't meet the qualification requirements, having a family member in good financial health as a cosigner can increase your chances of approval—potentially with a better interest rate.




The number of months it takes you to repay a loan can make a significant difference in your interest costs. Shorter loan terms generally require higher monthly payments, but you'll also incur less interest because you're minimizing the repayment timeline. Longer loan terms may reduce the amount you must pay each month, but because you're stretching the repayment out the amount of interest paid will be greater over time

**How to get the best loan interest rates**

There are various ways to increase your chances of obtaining a favorable interest rate on a loan. They include:

- Improve your credit score: The most competitive interest rates are generally available to those with the highest credit scores.
- Consider shorter repayment terms: Short-term loans come with lower interest rates, although monthly payments may be higher.
- Reduce your debt-to-income ratio: Your debt-to-income (DTI) ratio plays as significant a role as your credit score in getting favorable interest rates. As we saw earlier, your DTI ratio compares your monthly debt payment to your monthly gross income. In other words, it measures the percentage of your gross income going to your debts. You can qualify for lower interest rates by paying down your debt and lowering your debt-to-income ratio.

## DECIDING WHETHER TO GET A PERSONAL LOAN

A personal loan, with its predictable monthly payments and fixed interest rates lower than credit cards or lines of credit, can be a good option when you need to borrow a large amount of money. When used responsibly, a personal loan can be a great way to consolidate debt, meet emergency expenses, etc.

When deciding whether to get a personal loan, look at your credit score. Most lenders require a credit score not lower than 660 for a personal loan. A credit score lower than this could cause the interest rate to be too high to make the loan a reasonable option.

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Also, consideration should be given to whether the monthly loan payment fits in your budget. Realize that some loans will require payments for many years. If you don't have room in your budget for the payments reconsider the amount you need to borrow as well as options for borrowing the funds. Also, high early-payment fees charged by some lenders discourage attempts to pay off the loan earlier than agreed to. Finally, you should only borrow the amount you need.

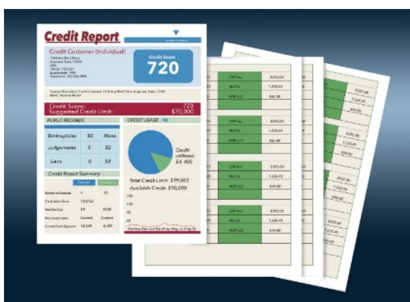
While personal loans can be useful, they aren't ideal in every situation. A personal loan may not make sense for a purchase that would qualify for a purposed loan such as a mortgage, car loan, student loan, etc. These loans are specifically designed to fund certain expenses and have features and benefits for the subject of the loan. Consider why you need the funds and look for a loan designed specifically for that purpose.
You also may want to think twice before applying if your income isn't stable. As well as lacking a steady flow of income to make monthly payments, you could find it difficult to qualify for a competitive interest rate. Some lenders take your income and employment into consideration when you apply, so it's important to evaluate your financial health before considering a personal loan.

If you're unsure if you can afford a loan, check a personal loan calculator to see how much you'd pay. Personal loan calculators can be found on the web, including on the First Command Educational Foundation website at https://www.fcef.com/education/calculators/.

**Applying for a loan**

Before discussing a loan with a lender, here are some things to consider:

- Determine the need for the loan and the amount needed. Identify the specific need for the loan, e.g., debt consolidation, emergency expenses, etc., and estimate the amount you need. Knowing the purpose and amount of the loan helps a lender recommend the best loan type for your situation and provide more favorable interest rates.
- Determine how much you can afford to borrow and how long you will need to repay the loan: Even though the lender will decide the amount of the loan that you qualify for based upon their evaluation of your financial status and how much additional debt you can incur, you should have a good idea of how much monthly payment your budget can bear and for how long. Be sure to borrow only what you need even if you qualify for more. Remember, eventually you will have to pay it all back...with interest.




- Assess your credit report and credit score: Review your credit report and check for errors, discrepancies, or outdated information. Look for accounts that need attention. Errors and past-due accounts adversely affect your credit score. Contact the credit bureaus to correct errors and merchants or lenders to discuss ways to improve your payment status.

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- Evaluate your debt load: If you do not need funds right away, evaluate your debt and try to develop a strategy to reduce it. Reduced debt will help improve your credit score as well as your debt-to-income ratio, which increases the probability of being qualified for a loan.

**Research lenders for the best loan rates and terms**

Look for lenders that offer loans that meet your specific needs and financial situation. Check whether they have the loan type that you want and if you meet eligibility requirements. Compare loan interest rates, fees, terms, and eligible loan amounts. Research each lender's business history with the Better Business Bureau, Consumer Financial Protection Bureau, and your state attorney general's office. Confirm that the lender is authorized to do business in your state.

You can generally get personal loans from banks, credit unions, and online lenders; there is no one best source. If you have an account and long-standing relationship with a bank or credit union, check there first. If you have made relatively sound financial decisions in the past but have had some recent problems with credit and debt, your bank or credit union will be familiar with your financial situation and may be more understanding and work closer with you to get you approved.

**Information and documents the lender may require**

After you have conducted your research and selected a lender, start the application process. Depending on the type of lender you may be able to take care of the entire application process online, or you may need to visit your local bank or credit union branch. Every lender differs regarding what information is required on an application.

Most lenders allow you to become prequalified and will let you know the potential interest rate and loan terms before you actually apply, without a hard inquiry on your credit report. However, if a lender does not offer opportunities for prequalification, they usually submit a hard inquiry as part of the loan application process. If you submit loan applications to multiple lenders, do it within a 45-day period so that all the inquiries count as a single inquiry on your credit report.

To see if you prequalify for a loan, you'll need to answer basic questions that include personal information such as your name, address, and Social Security number and depending on the lender, certain other information. During this stage you won't be asked for additional documentation. However, the lender will ask for supporting documents when you submit the actual loan application.

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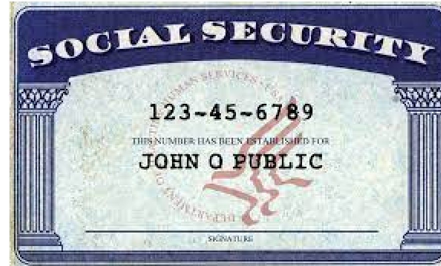
When applying for a loan, be prepared to supply the required information and documents, such as:

- Loan application
  Each lender will have its own application that asks for basic personal information, loan amount requested, and loan purpose.  If you are using an online lender, the application process is usually done entirely online.  If you are using a traditional bank or credit union, applications can generally be completed either in person or online.
- Personal identification (usually any two of these)
  - Driver's license
  - Social Security number
  - Passport
  - State-issued ID
  - Certificate of citizenship
  - Birth certificate
  - Military ID




- Employer and income verification
  - If traditionally employed:
    - Pay statement
    - Form W-2 and/or 1099
    - Employer's contact information
    - Income tax returns
    - Bank statements
  - If self-employed:
    - Income tax returns
    - IRS Form 1099
    - Bank statements
    - Proof of residence
    - Utility bill
    - Lease or rental agreement
    - Proof of insurance of your home, apartment, vehicle, etc.
    - Voter registration card.

Every lender has its own process and requirements for approving borrowers.  Most will base approval on factors such as credit score, debt-to-income ratio, income, etc.

After the lender notifies you that you've been approved for a loan, you'll need to finalize the loan documents and accept the terms. When you've done so, you'll typically get the funds within a week—but some online lenders will send it to you, perhaps with a direct electronic transfer to your bank account, within one or two business days.

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## REPAYING A LOAN

As soon you receive your funds, create a plan to pay it off. Note when your first payment is due and consider setting up automatic payments from your bank account. Some lenders offer interest rate discounts if you make automatic payments.

Also think about adding extra to your payments each month. Many lenders allow you to pay your loan off early without charging a prepayment penalty. Although personal loans are much cheaper than using credit cards, you can save on interest by paying the loan off early. Let your lender know that the extra money is for paying off the principal, otherwise the lender may apply the funds to your next payment. If you get a raise or receive a cash gift, use those funds toward your loan payment. However, using extra funds to pay your loan off early may not be a good idea if you have other higher interest debt to pay or if you need to establish your emergency fund.

Making steady and regular loan payments will help your credit history, raise your credit score, reduce your debt, and keep you from defaulting on your loan. If you anticipate you will not be able to make a payment, discuss your options with your lender. If you have financial problems, your lender may offer a revised payment plan. Depending on the lender, defaulting on a loan could occur as soon as you fail to make one payment or possibly after missing a series of monthly payments. If you default on your loan, you will accumulate late fees and see a drop in your credit score. Also, your loan could also be referred to a collection agency. If you default on a personal loan, your credit score will definitely drop.

## PREDATORY LENDING

Normally, personal loans can be a good way to get funds for major unplanned expenses, but they also provide financial scammers and predatory lenders an opportunity to take advantage of those in serious financial straits and who don't understand how loans work.

Predatory lending is any lending practice that benefits the lender more than the borrower. It usually hinders the borrower's ability to repay the debt through unfair and abusive loan terms and the use of deceptive and coercive tactics by the lender. While predatory lending practices may not always be illegal, they can leave victims with uncontrollable debt and bad credit.

A common practice among predatory lenders is "loan churning," which starts with the lender providing a loan the borrower can't afford. When the borrower is unable to pay back the loan on time, the lender offers a new loan with another set of fees and interest. Under stress from defaulting on the initial loan, the borrower succumbs to the offer and agrees to a second loan.

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This starts the loan cycle again with borrowers constantly paying interest and fees without significantly reducing the loan principal.

Predatory lenders target persons who need immediate funds to cover emergency situations, those with credit problems, and those who may have recently lost employment, most of whom do not qualify for conventional loans. Predatory lending may take the form of payday loans, car loans, tax refund anticipation loans or any type of consumer debt.

**Payday loans**

Payday loans are short-term unsecured personal loans that generally must be paid by your next payday, typically within two weeks.. The high interest rates on these loans tend to trap borrowers in a debt cycle because they have to repeatedly renew the loan and pay the related interest and fees until hopefully, they can pay off the principal and get out of debt. These loans may be obtained through brick-and-mortar locations or online lenders. Payday loans may also be called cash advance loans, check advance loans, post-dated check loans, or deferred-deposit loans.

Will a payday loan affect your credit score? Since payday loans are not normally reported to the credit bureaus your payments will not help improve your credit history. However, if your check bounces or you default on the loan, the lender will send your account to a collection agency. Your loan will then appear in your credit report and negatively affect your credit score for up to seven years.

Income tax refund anticipation loans and vehicle title loans appear similar to payday loans but work differently.

- Income tax refund anticipation loans are not technically payday loans because they are repayable upon receipt of the borrower's income tax refund, not the next paycheck. However, their features and expenses are similar to payday loans. Although they may be quick and easy, they can be a very expensive way to expedite your refund.
- A car title loan is available to borrowers who hold the clear title to a vehicle, which is used as collateral for the loan. The lender bases the amount of the loan on a percentage of the resale value of the vehicle. If the borrower defaults, the lender will recover costs by repossessing and reselling the vehicle.

<u>Payday Loan Debt Consolidation</u>

When you obtain a payday loan debt consolidation loan, you get a new loan with a reputable lender with a lower interest rate and longer payment term, pay off the payday loan, and then pay the new loan with more affordable monthly payments.

If you have a low credit score your consolidation loan may have a higher interest rate, but it should be lower than the interest rate and fees associated with your payday loans. Debt

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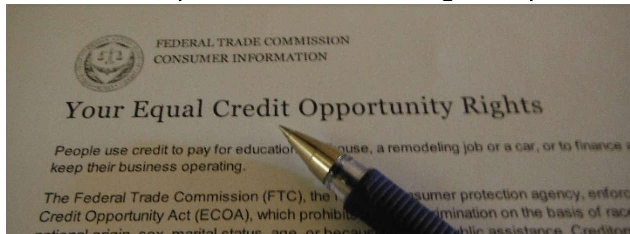
consolidation loan payments are reported to the credit bureaus, so that making on-time payments can help improve your credit history and increase your credit score.

## LEGAL PROTECTION FOR BORROWERS

Federal laws protect consumers against predatory lenders.




Equal Credit Opportunity Act (ECOA): Makes it illegal for a lender to impose a higher interest rate or higher fees based on a person's race, religion, sex, age, marital status, national origin, or receipt of public assistance.

- Truth in Lending Act: Requires lenders to provide a disclosure form to borrowers that includes a box that the lender must check if a prepayment penalty is in included in the loan agreement.

In addition, 25 states have anti-predatory lending laws, and 35 states, including some with anti-predatory lending laws, limit the maximum prepayment penalty a borrower is required to pay.

## PROTECTION FOR MILITARY BORROWERS

Under the Military Lending Act and Department of Defense rules, payday loans (and certain other financing) must include certain protections when offered to full-time active duty members, those under a call or order for more than 30 days, Guard members pursuant to an order to full-time guard duty for 180 or more consecutive days, members of service reserve components, and their dependents. For example, for payday loans the military annual percentage rate cannot exceed 36%. Most fees and charges, with few exceptions, are included in the rate.

Besides payday loans, vehicle title loans, and refund anticipation loans, the MLA addresses a broad range of closed-end and open-end credit products such as non-mortgage-related consumer credit transactions like credit card accounts , payday alternative loans (PALS) that federal credit unions make, and lines of credit.

The MLA does not apply to a residential mortgage secured by the property, a motor vehicle loan secured by the vehicle, a loan for other personal property secured by that property, certain other exempt transactions, or transactions where the borrower isn't covered by the MLA.

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The MLA also establishes a maximum "Military Annual Percentage Rate" (MAPR) of 36% for all loans covered by the MLA that includes most application and certain other fees not normally counted as finance charges. Also, credit agreements that violate the law are void, and creditors that offer payday loans may ask loan applicants to sign a statement about their military affiliation.

Specifically, the MLA requires:

- A 36% APR cap that includes interest, fees, credit service charges, credit renewal charges, credit insurance premiums, and other fees in connection with the loan
- Written and oral disclosure of interest rates and fees before loan is issued
- No automatic rollover loans, unless terms are more favorable for borrower
- No mandatory waivers of consumer protection laws
- No mandatory allotments
- No prepayment penalty
- Lenders must verify whether a credit applicant is covered by this law

## BEFORE BORROWING

A loan can be very helpful for a large or long-term purchase but can be very expensive for short-term needs. Before you borrow money, check whether you can make the purchase without borrowing. Evaluate your spending and make a budget. If you must borrow money, shop around for the best terms you can find and know how much the loan will cost. Remember too, that your credit score has a lot to do with the terms you will receive. Finally, don't borrow more than you need to. You MUST pay it back, with interest!

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