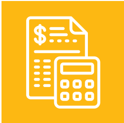
FIRST TIMER'S GUIDE TO BORROWING

Everything you need to know to get started.

No matter how hard you work, budget, and save, there are times in life when you just need a little extra cash. And because money can be hard to come by, sometimes the best option in those situations is to take out a loan.

Any time you change your financial status—in this case, by taking on debt—it's important to understand the ins and outs and implications of your choices. Borrowing isn't about getting money for free, it's about entering into a contract with your financial institution so they can provide you with a service. And that can come at a price. But it can make a lot of financial sense, too. It's just a matter of knowing the facts when it comes to borrowing money.



The Basics of Borrowing

First things first, what exactly does it mean to borrow money? When you borrow money from a financial institution it means you're entering into an agreement where your financial institution agrees to provide you with a set amount of money and you agree to pay it back based on a pre-determined set of criteria, better known as terms.

The terms of your loan include how much money you can borrow and the details about repayment, including how long you have to pay back what you owe, how much your monthly payments are, and what interest rate you will be charged.

Borrowing money from a financial institution isn't free—you're charged a fee known as interest in exchange for being able to access the services and funds you need.

WHAT ARE SOME OF THE DIFFERENT TYPES OF BORROWING?

Borrowing includes everything from credit cards to mortgages. It can be used to buy a new car, fund your education, and so much more. This guide will cover the basics of personal loans.

WHO CAN QUALIFY FOR A LOAN?

The short answer? Anybody who is at least the age of majority (19 in Nova Scotia, New Brunswick, and Newfoundland and Labrador and 18 in Prince Edward Island).

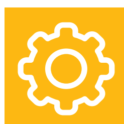
The longer answer is that your entire financial picture is taken into consideration when applying for a loan of any size or type. Factors include your income, employment status, credit history, personal situation, and more.

HOW DO I KNOW IF BORROWING IS RIGHT FOR ME?

Borrowing money is a big decision. It means you're taking on increased debt, so there are a lot of things to think about before you make an application. The biggest factor is whether you can afford it. In other words, do you have room in your budget to take on an extra payment. Our personal loan calculator tool can help you determine how much your payment could be.

Once you've determined that, it's also good to think about why you're borrowing money in the first place. Are you borrowing money to pay for something like school or a vehicle? Or are you borrowing so you can take a vacation with your friends? While all those reasons can be perfectly valid for wanting to borrow some extra cash, it's important to think about how you'll be spending the money you borrow.

Sometimes borrowing can even be a great solution for tackling debt. It may seem counterintuitive, but a loan can come with a lower interest rate than a credit card, so borrowing to clean up existing debt or restructure your payments could actually make a lot of sense.



Types of Loans

There are many different types of loans, but the main ones we'll cover are some of the different types of personal loans as well as lines of credit.

PERSONAL LOAN: Typically, personal loans are used to finance fixed-cost items like a vehicle, a piece of equipment, a piece of property, etc. Personal loans tend to be one offs—an agreed upon amount of money is paid back on an agreed upon timeline at an agreed upon interest rate. Once those terms have been met, the loan is considered complete.

FIXED RATE VS VARIABLE RATE LOANS: A fixed rate loan has the same interest rate for the entirety of the borrowing period, while variable rate loans have an interest rate that changes over time.

DID YOU KNOW?

If you have a line of credit that you've paid back, don't close it down. It's always a good idea to have access to extra funds when/if you need them. Having a line of credit that you don't use can even be beneficial to your credit score.

HOME EQUITY LOAN: A home equity loan is a type of loan where you use the equity of your home as collateral. The loan amount is determined by the value of your property, which is determined by an appraiser from the lending institution.

LINE OF CREDIT: A line of credit (LOC), by comparison, is more about having access to a set amount of funds when/if you need them. For instance, you would leverage a line of credit to pay for school, a wedding, or an unexpected expense, but you probably wouldn't use a line of credit to pay for something like a car.

As you pay down your LOC, you also have access to more funds. For instance, if you have a $5,000 LOC but have only borrowed $2,500 on it, you still have access to $2,500. Likewise, if you pay down your LOC to $0, then you once again have access to the full $5,000 amount.

Interest Rates

Every loan comes with an interest rate. But how high (or low) that interest rate is depends on a variety of factors. An interest rate is essentially the cost of borrowing money—it's a premium charged on funds being lent. Financial institutions are businesses and interest rates serve as a source of revenue when it comes to offering the service of lending money.

HOW IS AN INTEREST RATE CALCULATED?

The Bank of Canada determines what the prime—or baseline—interest rate is based on a variety of factors like inflation, strength of the dollar, and the overall economic outlook. The rate is fixed, but eight times per year, the Bank of Canada has scheduled announcements where they can opt to adjust the interest rate or keep it as is.

What that means is the interest rate can vary by financial institution. Typically, interest rates are determined based on the prime rate, plus a premium that compensates for the risk that is involved in lending money. The higher the risk associated with the loan, the higher the interest rate tends to be.

How to Get a Loan

You've done your homework, you've talked to your financial institution, and you're ready to sign on the dotted line. Here's what else you need to know.

THE APPLICATION PROCESS

The first step to borrowing is connecting with your financial institution. This could either be through a meeting or online. Come prepared to talk about what loan option might be right for you, how a loan can fit into your budget, and any questions you may have about the formal application process.

To make sure you're prepared, here's a checklist of information and documents you should have:

INFORMATION

- **THE BASICS:** your name, address (including how long you've lived there), age/date of birth, marital status, dependents
- **EMPLOYMENT HISTORY:** current position, name of company, how long you've worked there, annual salary
- **DETAILS ABOUT YOUR NET WORTH:** a list of assets (property, vehicles, RRSPs, etc.) and a list of current debts (mortgages, credit cards, other loans, etc.)
- Reason for borrowing
- Requested amount

DOCUMENT CHECKLIST

- Government issued ID
- Social Insurance Number
- Letter of employment/T4 slip/ Notice of Assessment/two most recent pay stubs
- Investment/RRSP statements (if applicable)
- Mortgage documents (if applicable)

Once your application is complete, it's also standard to run a credit check. Once the credit check is complete and the application is reviewed, you'll get the verdict of whether or not you qualify for the loan. This can take as little as a few hours to a few days. How long the process takes depends on your situation and factors like when the application was received, whether there was any missing/incomplete information, etc.

CREDIT CHECK

An important part of determining whether or not you qualify for a loan is a credit check. Using a service like Equifax, your credit union will do a basic credit check to get a sense of your financial history and standing. But beware—frequent credit checks can actually damage your credit, so make sure you know when the last credit check you had was before you open another query.

HOW MUCH WILL I BE ELIGIBLE FOR?

There are no set criteria for how much money you may (or may not) be eligible to borrow. It depends entirely on your unique situation and what the money is going to be used for. The best way to go about making sure you get what you need is to go into the process with a number in mind. If you know you need a certain amount of money to pay for tuition and books, or the asking price for your new ride, ask for it. Having a clear number in mind can help set expectations in the negotiation process.

WHAT FACTORS ARE CONSIDERED IN APPROVING OR DENYING A LOAN?

There are a variety of different factors that are considered in your loan application. Things like your net worth (including what assets and other debts you may by carrying), employment status/income, and your credit history. But the most important factor to consider is whether or not you can afford to take on more debt. If the answer is no, then your application might not be successful.

If you find yourself in that situation, credit unions will work with you to evaluate areas you can work on and provide advice so the next time you apply, you'll have a better chance of being successful.

WILL I NEED A CO-SIGNER?

Typically, a co-signer is useful—or in some cases, necessary—when a loan application is not as strong as it could be. This could be for a variety of reasons: the amount you're asking for might be too high, you don't have enough assets to support the ask, or your income might be too low. Regardless of the reason, a co-signer can add strength to a loan application.

When it comes to student lines of credit, 99.9% of the time, having a co-signer is required. It's recommended that a co-signer be a family member or somebody else you have a close relationship and a lot of trust with. A co-signer is putting their financial reputation on the line, so having a good level of trust is incredibly important.

Once You're Approved

Once you've been approved for a loan, you'll receive something known as a lending package. This is an important set of documents that include details like the terms of your loan (how long you have to pay it back, the monthly amount due, interest rate, etc.). *Keep these documents in a safe place.* They act as the contract between you as the borrower and your financial institution as the lender. This package will also contain information about your loan insurance.

WHAT IS LOAN INSURANCE AND WHY SHOULD I TAKE IT?

Taking out a loan of any size is a big financial responsibility. And just like you purchase car or house insurance with the hope that you'll never need to use it, loan insurance works in the same way. Most loans have life, disability, and critical illness insurance available as an option.

That way, if something happens and you're not able to meet the terms of your loan, you're covered in certain situations. The monthly amount of the insurance is typically not enough to make a significant difference on your payments should you choose to decline the coverage, so opting to have the insurance just makes good sense.

WHAT HAPPENS IF I CAN'T MEET THE TERMS OF MY LOAN?

Having a budget is always important, but it's especially important when you're considering taking on new debt in the form of a loan. Before you sign any papers, you should know that you can financially afford to take out a loan. But, because life happens, there may be a situation (like, say, a global pandemic) where your financial circumstances change quickly and you're not able to make your payment terms.

If this happens, there are a couple of things to keep in mind:

First, call your financial institution and explain the situation. Credit unions in particular will try to figure out a solution that works for everyone. This could mean a reduction in payment, a slight delay in when your payment is due, or in more severe cases, a deferral in your payments. There is always a solution—but ignoring the situation is not the answer.

Not meeting the terms of your loan can result in late payment charges. It can also negatively impact your credit score if your payment remains overdue. The specific implications of a late or missed payment will be outlined in your lending package.

CAN I PAY OFF MY LOAN EARLY?

Maybe you get a raise or a bonus at work, or maybe you find yourself with some extra money. If that's the case, paying off your debt as quickly as possible is always a good idea. Some loans (like mortgages) carry a penalty for paying them off early, whereas a more flexible loan like a line of credit typically won't carry any penalties for early payment. The best option is to have a look at the terms of your loan agreement to see what your situation is.

Conclusion

Taking out a loan can be a great way to make a large purchase, provide coverage for those times that life happens, or to invest in yourself through post-secondary education opportunities. But it's also a big decision. Borrowing money is the easy part. Paying it back is what takes effort and consideration.

Credit unions like to get to know their members and their unique needs and situations. By working with a credit union, you can expect that human touch, refreshingly honest financial advice, and the knowledge that decisions about your financial future and situation are being made locally.

Glossary of Terms

AMORTIZATION PERIOD (LENDING): The period of time it will take to fully pay off the principal amount of a loan. This should not be confused with the term of the loan, which is usually shorter.

CO-BORROWER/CO-SIGNER: A secondary borrower on the loan or line of credit, in which this person receives a direct benefit from the loan proceeds. In addition, this person is fully liable for the loan. Any additional borrower(s) whose name(s) appear on the loan or line of credit documents and whose income and are used to qualify for the loan or line of credit. Under this arrangement, all parties involved have an obligation to repay the loan or line of credit.

CREDITOR INSURANCE: Insurance that pays certain debts of a borrower if certain events happen. For example, creditor life insurance pays off the borrower's loan or line of credit if the borrower dies. Creditor disability insurance makes loan payments on the borrower's behalf if the borrower becomes disabled.

LOAN DEFERRAL: A loan deferral is when a borrower does not have to pay interest or repay the principal on a loan. The duration of a deferment period can vary and is established in advance, usually by a contract between the two parties.

DEMAND LOAN: Repayment in full of a demand loan can be called in by the lender at any time and is repayable early at the option of the borrower.

EDUCATION LINE OF CREDIT: A line of credit used for education expenses for a variety of post-secondary programs. Only the interest portion of the outstanding balance must be repaid on a monthly basis until one year of graduation or six months of leaving school.

FIXED RATE LOAN: A loan where the interest rate and payment amount do not change during the term.

GROSS HOUSEHOLD INCOME: This amount is the total salary, wages, commissions, and other assured income, before deductions, by all household members who are co-applicants for the loan or line of credit.

GUARANTOR: A person on the loan or line of credit who guarantees payment on behalf of the borrower in the event that the borrower is unable to make the payments. The guarantor does not receive any direct benefit from the loan proceeds.

HOME EQUITY: The current market value of a home, minus the amount of any debts registered on the property, such as liens or mortgages. It is essentially the amount of ownership that has been built by the owner through mortgage payments and appreciation of their home. For example, if the market value of a property is $250,000 and the mortgages on the property total $200,000, the owner's home equity is $50,000 ($250,000 - $200,000 = $50,000).

HOME EQUITY LINE OF CREDIT: A secured line of credit borrowed against the equity in your home. Funds are borrowed once, but can be accessed any time, up to the limit specified. The credit limit is usually larger than other forms of unsecured borrowing.

INSTALLMENT LOAN: A loan that is repayable either in fixed instalments of principal, plus interest, or in blended instalments of both principal and interest.

INTEREST: A charge for money borrowed generally stated as a percentage of the amount borrowed.

INTEREST RATE: Interest is the price of money or the 'cost' to secure the borrowed funds, typically expressed as an annual percentage of the loan outstanding.

INTEREST-ONLY: Payments made by the borrower on the loan that only go towards interest that is accrued on the loan. No payments are made to the principal.

LENDING PACKAGE OR LOAN AGREEMENT: A lending agreement (loan agreement) is a formal contract between a lender and a borrower which includes all the details of the loan, such as the principal amount, interest rate, amortization period, term, fees, payment terms, and any covenants.

PRIME RATE: The prime rate is the interest rate that a lender publicly announces as its reference rate for certain variable interest rate loans and lines of credit. The prime rate can change at any time. For example, the variable interest rate on loans and lines of credit is based on the Prime Rate. This means the interest rate on these types of loans and lines of credit will change whenever the Prime Rate changes.

PRINCIPAL: The amount owing on a loan. Interest is calculated on the principal.

RENEWAL/RENEWING: Extending the term of your loan when it matures. Often the interest rate and other terms of the loan offered for the renewal are different from the interest rate and terms of your original lending agreement.

RRSP LOAN: A loan designed to help you maximize your RRSP contributions, including any unused contribution room.

SECURED LOAN: A loan may be fully or partially secured by real estate or other property or investments which have a realizable value at least equivalent to the amount of the loan taken.

SECURITY: Property, either real estate or an investment product, pledged as collateral for a loan or line of credit to help the borrower obtain a lower interest rate and a higher borrowing limit from the lender.

TERM: The period of time your borrowing agreement is in effect. A loan term is usually between six months and five years long. Not to be confused with amortization period. For example, a mortgage (an example of a secured loan) could have a term of five years and an amortization period of 25 years.

TOTAL DEBT SERVICE (TDS) RATIO: The percentage of gross income needed to cover monthly payments for housing, other debts, and financing obligations.

VARIABLE RATE LOAN: A loan with an interest rate that can vary during the term, in accordance with changes in market interest rates. For example, the interest rates for most variable rate products change whenever the prime rate changes.