



## **What You Should Know BEFORE You Borrow Money**

**By Patty Baldwin and Lori Chambers**

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## Introduction

It happens to everyone. At some time you will need to borrow money. In fact, there are situations where it would be to your benefit to borrow. Taking advantage of a buyers' market in real estate or a good investment based on the stock market are good examples. Borrowing money can be a prudent decision.

However, there are some questions that need answering before borrowing. When is the right time to borrow? What is the right type of loan? What are the short and long term consequences of borrowing money?

In "*What You Should Know BEFORE You Borrow Money*" we will look at the answers to these and other questions. This is not a financial textbook. You won't find any technical jargon. Just plain English and written for the every day person.

We believe we have compiled the best information possible to make certain that you have all the facts before making a decision to borrow money.

Again, if you are looking for a "textbook" or financial jargon that most folks don't understand, you will not find that here. This is a primer to help people who have never borrowed money and need to understand what is expected of them AND their lender. And yes, there are many people who have never borrowed money. This is for all of them.

With that said, let's begin.

## When and Why Borrow Money

This isn't a "trick" question. You might be thinking, "you borrow money when you need it." That's partially true. Of course you borrow money when you need it, that's the purpose of borrowing.

However, make certain you approach money lending with the right attitude and for the right reasons. Borrowing money to buy a new suit of clothes may sound frivolous. But, if that new suit of clothes is to be worn on a special job interview or evaluation, it might be considered an investment rather than frivolity.

Borrowing money for a dream vacation that will create family memories for a lifetime may seem to be a good idea at the time. But when the bills come due and it's time to "pay the piper" those sunny memories can fade quickly. It may be a better idea to scale down the vacation. Instead of flying the entire family across the country to attend a theme park, you might consider one or several "mini vacations" closer to home.

An overnight camping trip can result in special memories as well. Many of us live in areas where there are special attractions within a few hours drive. Maybe you have a gallery or historic monument that you have said, "We really need to visit that Museum someday." Plan your trips with plenty of time for sightseeing and special meals.

The point here is whether you "want" to borrow money for something you "desire" rather than having a "need" to borrow money for a necessity. Saving money on a vacation one year may result in the ability to have that vacation of a lifetime down the road when funds are more readily available without having to create debt.

There's no doubt about it, money just doesn't seem to stretch as far as it should these days. The dollar is shrinking and is worth much less than it was when we were children. It seems as though we are working two or three times harder just to survive. No matter how difficult it gets, however, borrowing money for daily incidentals is never a good idea.

All too often people find themselves in a situation where they run out of money before they run out of the month. There may be little or no cash for essentials like bread, milk or (heaven forbid!) toilet paper. This type of situation often drives them to the neighborhood “quick cash” outlet to borrow a few dollars to tide them over until payday. This type of borrowing is the worse type of loan you can get and we will discuss this type of borrowing in depth in a following chapter.

If you find yourself in that type of situation, try changing your habits to avoid being placed in this position. There are any numbers of ways you can grab an extra few dollars, many of them just by eliminating wasteful habits. Here are a few to consider:

- Stop buying the television guide. Yep, try using the newspaper listings or printing out the television listing from the computer. Sound silly? The popular television guide that we used to pick up for around .75 cents is now \$2.49. That means you are spending almost \$130 a year just so you don't have to flip through the channels!
- Don't buy anything from a convenience store. There's a reason they are called “convenience.” Drive or walk a few blocks further and shop at a grocery or discount store. You'll pay less for just a little “inconvenience.”
- When you do go to the grocery store, stop near the front door and pick up some of the automated coupons that are available. Or, if you've cut them out of the flyer before you go shopping. . .USE THEM! You can usually knock off at least a few dollars on your grocery purchases.
- Always prepare a list before you shop and vow to stick to the list.
- Never buy anything on impulse. . .yeah right! Seriously, grocery and discount store marketers bank on you spending extra money that you had not planned on. Pay close attention to avoiding the end caps (the displays at the ends of long aisles) and checkout lanes. Those are strategically placed to draw your attention and make you spend money that you had no intention of spending.



- Use cash or your debit card for making purchases. Do not buy incidentals or groceries on a credit card. The point here is to save you money not create more interest.
- Save your aluminum cans. Buy yourself a “can crusher” for around \$15 or \$20. Smash those cans and store them in plastic yard bags. Keep them on hand to turn in at the recycling center. You can usually have enough on hand to pick up a few extra bucks when you need it.
- If you know you are going to run out of cash before your next payday, have a quick yard or garage sale. Just have a few items that you are willing to part with available at all times. It’s possible to have a sale of this type without any paid advertising. Most people can just put a few signs up in the neighborhood. There is almost always a yard or garage sale going on in most neighborhoods every weekend.

If you are in a desperate situation and must have immediate cash here are a few other methods to generate quick cash. We are not advocating any of these methods but they are available.

- Borrow against a paid up life insurance policy.
- Pawn jewelry
- Borrow from a relative
- Paint numbers on street curbs for extra cash
- Mow lawns
- Baby-sit
- House sit

- Create simple crafts to sell at a flea market
- Cut and sell firewood
- Walk dogs

Those are just a few examples of how to come up with a few dollars other than having to take out a “quick cash” or “payday” loan.

The time to borrow money is when it is absolutely necessary or advisable. What are some reasons why you might want to borrow money?

- Buying a home
- Home remodeling
- Purchase investments
- Education
- Budget Building Tools That You Can Use

Many people dread the task of building a budget because they view it as overwhelming and frustrating. But it will make the job easier if you look at it in another light, an important tool to financial freedom.

- Does it feel as though there is no way to get out of the red and into the black, much less plan ahead for retirement or a vacation?
- Are you tired of getting paid on Friday and being broke on Saturday?
- Do you have piles of useless junk that you wish you’d never bought?

If this sounds like you, we’ve got good news! There is a lot of help out there for you in different formats and you will be able to choose which one suits you the best.

One option is to use software like Quicken or Microsoft Money—they are both great options and tools for budgeting. Money management software will take you through the steps and allow you to create or add to categories of spending so you will be able to look at the annual picture. It will then break down what you need to look at every month so that you can be prepared. This software helps with your budget because it lets you see your money all in one place, as well as giving you prompts when it's time to pay your bills. In fact, some programs will enable you to have payments automatically deducted from your bank account. This is a great feature if you're trying to build your credit report!

As you spend money, you will be able to change the categories; this will allow you get a better picture of where you need to cut back, or where you need to invest more. Many money management software programs often also have companion websites where you can set up an account and further manage your budget or investments.

If you need something a little more “hands on” to get yourself back into the black, you have many options. You can contact a credit counseling office in your area or online and find out what resources they have available to you. Many offices have free classes on budgeting.

Many people have such a hard time with budgeting because they simply don't know where their money is going! There are some great new websites such as [www.MoneyPants.com](http://www.MoneyPants.com) that help with this issue. These web sites will track all of your spending and then help you set up your goals. There is a low monthly fee to use any website that will help you with this, but they are generally very user friendly, and in the case of Money Pants, even fun to use. You will have access to someone who can answer questions and a message board where you can find a lot of other information. One great feature is that they will email you with reminders when you have a bill due.

As you can see, building a budget doesn't have to be an awful task. By doing it right, you will get to watch, step-by-step how your financial picture changes. Just imagine, by taking this step, you may one day soon be debt free, or even own your own home. The

key is to take your time, do the process in small bites, and be sure to take advantage of all the help out there. You'll be on your way in no time!

- Business startup
- Purchase a car
- Pay off credit cards

The most important thing to remember is borrowing money for incidentals or daily needs is ill advised. Reserve borrowing for those items that will ultimately return some type of investment.

## What Type Of Loan Do I Need?

There are many different types of loans available. We will take a look at a brief description of each of them and in the next chapter we will look at the pros and cons of each.

### Secured Loans

A secured loan is any loan that contains a provision for the collection or return of an asset when the payments are in default. Secured loans are usually made for homes or cars.

A secured loan on a home is either a first or second mortgage.

### Mortgage

A mortgage is a loan borrowed to finance a home or other real property. A mortgage requires that the property is guaranteed as security to the lender for repayment of the loan. The lender holds the title on the home until the loan is paid off plus interest. If you fail to make the mortgage payments the loan is considered in default and the lender has the legal right to seize the home and sell it in order to service the debt.

The mortgage lender will provide the amount of money required to purchase the home. This is the actual amount of the purchase, also referred to as the “principal.”

The mortgage lender charges interest in exchange for allowing you the use of their money. That is how the lender earns their income. The amount of interest can vary depending on the terms and size of the loan you select.

### *Are You Ready for a Home Mortgage Loan?*

**Buying a Home and Committing to a Mortgage can be very scary!**

A home mortgage loan is the largest debt that most Americans will take on in their lifetime. As such, making the decision to take out a mortgage is not one that most first

time homebuyers take lightly. Not only will your monthly mortgage payments probably be the largest bill that you face each month, but the total amount of debt realized with a home mortgage loan can have a staggering and sobering effect on the first-time home buyer.

Many people can remember the months leading up to the decision to fill out a mortgage application. They may have had nightmares about losing their job, not being able to keep up with their payments and finding themselves homeless. And those would be the good nights when they were able to sleep at all!

### **Committing to a Home Mortgage Doesn't Have To Cost You Your Sleep.**

In hindsight, they might realize that the fear that they faced when considering a home mortgage loan was irrational and the stress which they put themselves under was unwarranted. However, it surely doesn't seem that way at the time!

Let's take a closer look at common mortgage fears. The major fear is that you won't be able to carry the debt responsibility and you will lose your house. Okay: worst case scenario, you are not able to keep up with the payments, the lender forecloses and you do lose your home. What are you really losing? Something that you do not have right now anyway! Therefore, even with the worst case scenario, you will not be any worse off than you are right now. Furthermore, it is important to realize that the chances of the lender foreclosing are pretty slim. The lender doesn't really want your home, he wants you to make good on your home mortgage loan, and will usually work with you to make that happen.

You should also remember that the fear of losing your home is one that you already faced and survived. You were taking that same chance when you signed your first lease on an apartment. If you were not able to pay your rent your landlord would have made you leave your home.

Taking out a mortgage can be less scary once you realize that this is a fear you have already faced and conquered.

## **Knowing You Can Afford the Mortgage Will Allay a Lot of Fears**

You can lessen the amount of fear that you will experience when you sign on the dotted line of a mortgage application if you are confident that you will be able to handle the monthly payments. Therefore, it is important to take stock of your financial situation before applying for a mortgage.

Sit down with a real estate agent and honestly discuss your financial situation. This includes all your income and your expenses. It makes sense to determine how much of a home mortgage loan you can comfortably afford, and that is essential for having financial confidence and avoiding common mortgage fears.

Now, quit worrying and go out and look for your new home!

## **Second Mortgage**

Just as the name implies, this is a mortgage that is “secondary” to the primary mortgage. A second mortgage is the same as a “regular” mortgage with a few differences.

A second mortgage is generally considered “riskier” than a primary mortgage. This is because if a mortgage goes into default, the primary lender is paid first and whatever is left, if anything goes to the second mortgage lender.

A second mortgage is usually written for a shorter duration than a primary mortgage. Sometimes a second mortgage may require a large payment at the end, which is called a “balloon payment.”

Two different types of second mortgages are “home equity” and “line of credit.” Let’s take a look at how they differ.

### ***Home Equity***

This is the “traditional” type of second mortgage loan. The loan is written based on the “equity” or value that exceeds the actual balance of the primary mortgage. Equity loans

are most often written when a large amount of cash is desired in one lump sum disbursement.

### *Line of Credit*

There is a big difference between a home equity loan and line of credit second mortgage.

The payment as well as the interest will change periodically with a line of credit and the interest is predicated to the prime rate. The interest will normally be the prime rate plus a percentage.

The amount of the loan is capped at a certain amount and is available in increments over a period of time. This allows the borrower flexibility insofar as when they borrow and for what use. You can borrow the entire amount at once or you can use it incrementally over months or years depending on how your loan is written.

Home equity loans are normally used to obtain a loan for a current need and lines of credit are usually for a future time period.

Both types are normally used for things like debt consolidation, home improvements, paying off credit cards and large purchases like cars or boats where the consumer would rather pay off the purchase outright.

So, there are several terms that you are going to want to familiarize yourself with when you are shopping for a mortgage loan:

- **Balloon Payment-** a balloon payment is usually a large payment due at the end of a loan. Monthly payments are used to pay mostly interest and little principal. So if you aren't sure where the money will come from to repay, this could be risky.
- **Closing costs-** Closing costs are all the other fees included in getting the loan. It could include credit report fees, land surveys, appraisals, title searches, title insurance etc.



- **Equity-** Equity is the difference between what your home appraises at and what you actually owe on it. So if your home appraises for \$200,000 and you only owe \$150,000 then your equity in the home would be \$50,000.
- **Line of Credit-** It is a pre-approved amount of money you can borrow. You only borrow what you need when you need it.
- **Principal-** The principal is the actual amount of money you borrow.
- **Reverse Mortgage-** A reverse mortgage is a home loan that you do not have to repay for as long as you live in the home. Repayment on the loan is due when the last surviving homeowner dies, resells, or permanently moves away.

## **Vehicle Loans**

While vehicle loans are normally for cars, sometimes they may be for motorcycles, boats or recreational vehicles. It used to be a fairly simple process to purchase a car. Today, prices are staggering and you can easily pay five figures for a four-year-old car.

### ***Title Loans***

This type of loan requires you to forfeit the title to your vehicle until the amount of the loan is fulfilled.

### ***Unsecured Loans***

An unsecured loan requires no security. There are several types of unsecured loans. Some of the terms you may hear are:

## **Personal Loans**

This type of loan may be secured or unsecured. Just as any other secured loan, there is some type of collateral.

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