



Co-funded by the
European Union



FinPower

BORROWING

Prepared by: DOBA BUSINESS SCHOOL

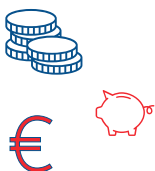


Table of contents

INTRODUCTION	2
LEARNING OBJECTIVES	2
WHAT IS BORROWING?	2
Why do people borrow?	3
CONSIDERATIONS BEFORE BORROWING	4
Basic terminology.....	4
DIFFERENTIATION IN LOAN DURATION	5
UNDERSTANDING INTEREST RATES AND COSTS	6
A practical example.....	7
INTEREST RATE AGREEMENT	8
CHOOSING BETWEEN FIXED AND VARIABLE RATE LOANS.....	9
Fixed vs. variable rate loans: differences explained.....	10
Fixed vs. variable rate decision making real life examples	11
TYPES OF LOANS.....	14
A BANK GUARANTEE / LIABILITY CREDIT.....	15
LEASING TRANSACTIONS	15
Types of leasing contracts.....	16
ALTERNATIVE METHODS OF BORROWING MONEY	17
MASTERING BORROWING - STRATEGIES FOR FINANCIAL EMPOWERMENT	18
CONCLUSION.....	23
REFERENCES	24

INTRODUCTION

Most of us will find ourselves in a situation where we require financial assistance at some point in our lives. Whether it's for purchasing a home, dealing with a financial emergency, or managing periods when our expenses exceed our income, borrowing offers a convenient solution to access funds today, which can be repaid over the course of days, months, or even years. Borrowing itself is not inherently problematic, as long as it is done at a reasonable interest rate and within your financial means. Difficulties can arise when you overextend yourself or borrow at exorbitant interest rates.

LEARNING OBJECTIVES

The learning objectives of this module are: to know different types of loan and borrowing basics, to understand interest rates and costs, to know responsible borrowing strategies and to maintain responsible borrowing habits.

At the end of this module participants will be able to:

- understand the various types of loans, their features, and their suitability for different financial needs.
- calculate the total cost of borrowing, including interest and fees, for different loan options.
- manage and improve their credit score.
- make informed borrowing decisions aligned with their financial goals.
- demonstrate responsible borrowing behaviors and attitudes.
- learn and get information about the responsible borrowing practices.

WHAT IS BORROWING?

Borrowing is a financial practice where individuals or entities obtain funds from a lender with the agreement to repay the borrowed amount along with interest or other charges over a specified period. It enables individuals to access resources they currently lack, allowing them to make purchases, investments, or cover expenses they otherwise couldn't afford. Borrowing plays a crucial role in personal and business finance, facilitating growth, investment, and the achievement of financial goals (Bloomenthal, 2020).

Key points of borrowing include (Consumer Financial Protection Bureau, n.d.):

- **Types of Borrowing:** Borrowing can encompass various types, such as secured loans (backed by collateral like a house or car), unsecured loans (not tied to collateral), revolving credit (like credit cards), and long-term borrowing (e.g., mortgages or bonds).
- **Interest Rates:** Borrowing typically involves paying interest on the borrowed amount. Interest rates can be fixed (stay the same throughout the loan) or variable (change over time), affecting the overall cost of borrowing.

- **Creditworthiness:** Lenders evaluate borrowers' creditworthiness based on factors like credit scores, income, and existing debts. A good credit history often results in more favorable borrowing terms.
- **Responsible Borrowing:** Responsible borrowing involves careful consideration of one's financial capacity to repay the borrowed funds, budgeting, and understanding the terms and conditions of the borrowing agreement.
- **Sources of Borrowing:** Borrowing can come from a variety of sources, including banks, credit unions, online lenders, or even family and friends.
- **Risk and Reward:** Borrowing can be a useful tool for achieving financial goals, but it also carries risks if not managed wisely. It's essential to weigh the potential benefits against the costs and potential risks.

More to read about is available here:

- Bloomenthal, A. (2020). "Borrowing Base." <https://www.investopedia.com/terms/b/borrowing-base.asp>
- Consumer Financial Protection Bureau (n.d). "Borrowing Basics: What You Need to Know." <https://www.consumerfinance.gov/consumer-tools/>
- Consumer Financial Protection Bureau (n.d). "Borrowing Money: What to Know Before You Owe." <https://www.consumerfinance.gov/know-before-you-owe/>

Why do people borrow?

People borrow money for various reasons, including (Haughn, 2023; Johnson, 2023):

- **Major Purchases:** Borrowing is frequently used to finance significant purchases such as homes, vehicles, and education. Mortgages, auto loans, and student loans are common examples.
- **Business Ventures:** Entrepreneurs and businesses often rely on borrowing to start, expand, or operate their enterprises. Business loans and lines of credit can provide the necessary capital.
- **Emergencies:** Unforeseen emergencies, like medical bills or unexpected home repairs, can create a sudden need for funds that borrowing can cover.
- **Debt Consolidation:** Some people use loans to consolidate multiple debts into a single, more manageable payment, potentially reducing interest rates and simplifying finances.
- **Investments:** Borrowing to invest can potentially yield higher returns, such as taking out a margin loan to buy stocks.
- **Home Improvement:** Homeowners may borrow for renovations and improvements that can increase the value of their property.
- **Education:** Student loans are commonly used to cover the costs of higher education, including tuition, books, and living expenses.
- **Travel:** Financing vacations or travel experiences through personal loans or credit cards is another reason people borrow.
- **Maintaining Liquidity:** Businesses often borrow to maintain cash flow, bridge temporary financial gaps, or take advantage of opportunities.

- **Life Events:** Borrowing can help fund life events like weddings, moving, or starting a family.
- **Etc.**

More to read about is available here:

- Haughn, R. (2023). "The top 9 reasons for personal loans." <https://www.bankrate.com/loans/personal-loans/top-reasons-to-apply-for-personal-loan/#three>
- Johnson, H. (2023). "Top 10 Reasons People Borrow Money." <https://www.investopedia.com/top-reasons-personal-loan-7508655>

CONSIDERATIONS BEFORE BORROWING

Basic terminology

When applying for a loan, it's crucial to understand the terms involved. A loan essentially means borrowing money that you must repay, synonymous with debt. The principal refers to the initial amount borrowed, such as a €5,000 loan. Interest, on the other hand, is the extra cost of borrowing, expressed as a percentage of the principal. For instance, a 7% interest rate means paying 7 cents per euro borrowed. Higher interest rates mean pricier loans. The loan term specifies the duration for repayment, which can vary from 5 months to 30 years for mortgages. Understanding these terms is essential before committing to a loan.

Further, before you decide to borrow money, it's essential to consider the following factors (Consumer Financial Protection Bureau n.d; Mabs, n.d.; Zetl, 2021):

- **Purpose of Borrowing:** Clearly define why you need to borrow. Is it for a necessary expense, an investment, or a discretionary purchase? Understanding the purpose helps you select the right type of loan and determine the amount needed.
- **Budget and Affordability:** Calculate how the monthly loan payments will fit into your budget. Make sure you can comfortably afford the repayments without straining your finances.
- **Creditworthiness:** Your credit history and credit score play a significant role in loan approval and the interest rates you'll receive. Review your credit report and work on improving your creditworthiness if necessary.
- **Interest Rates:** Different types of loans come with varying interest rates. Understand whether the interest is fixed or variable and compare rates from different lenders to secure the most favorable terms.
- **Loan Terms:** Carefully read and comprehend the terms and conditions of the loan, including the duration of the loan, repayment schedule, and any associated fees. Longer loan terms may result in lower monthly payments but higher overall costs due to interest.

- **Collateral:** If the loan is secured, determine what assets or collateral you are willing to put at risk. Failure to repay a secured loan can result in the loss of the collateral.
- **Lender Choice:** Consider various lenders, such as banks, credit unions, online lenders, and peer-to-peer lending platforms, and compare their offers to find the most suitable option.
- **Alternative Funding:** Explore alternative sources of funding, such as grants, savings, or partnerships, before committing to borrowing. Reducing the amount you need to borrow can save you money in the long run.
- **Future Financial Goals:** Evaluate how the loan will impact your long-term financial goals. Will it help you achieve your objectives or hinder your progress?
- **Repayment Strategy:** Have a clear plan for repaying the loan. Setting up automatic payments can help ensure you meet your obligations on time.

Taking the time to consider these factors is crucial for responsible borrowing and managing debt effectively.

More to read about is available here:

- Mabs (n.d.). Before you borrow. <https://mabs.ie/managing-money/before-you-borrow/>
- Consumer Financial Protection Bureau (n.d). "Borrowing Basics: What You Need to Know." <https://www.consumerfinance.gov/consumer-tools/>
- Consumer Financial Protection Bureau (n.d). "Borrowing Money: What to Know Before You Owe." <https://www.consumerfinance.gov/know-before-you-owe/>
- Zetl (2021). "10 Things to Know Before Applying for a Loan." <https://www.zetl.com/blog/10-things-to-know-before-applying-for-a-loan/>

DIFFERENTIATION IN LOAN DURATION

Loan duration refers to the period over which a loan is repaid. It determines the timeframe for repayment and impacts the total cost of borrowing. Borrowers have various options for loan durations, ranging from short-term to long-term.

Short-term loans are loans with a repayment period of up to one year. They are typically used for immediate financing needs or short-term expenses like working capital, inventory purchases, or cash flow shortages. These loans often come with higher interest rates but offer quick access to funds.

Medium-term loans are loans with a repayment period ranging from one to five years. They are commonly utilized for mid-range financing needs such as equipment purchases, business expansion, or capital improvements. These loans strike a balance between short-term flexibility and long-term stability.

Long-term loans are loans with a repayment period exceeding five years. They are used for significant investments like real estate acquisitions, large-scale projects, or business acquisitions. These loans come with extended repayment

periods, lower monthly payments, and the ability to spread out the cost of borrowing over time.

Principle of Maturity Matching

The principle of maturity matching involves aligning the duration of the loan with the expected lifespan of the financed asset. This practice is crucial as it minimizes default risk and optimizes capital allocation efficiency. For example, financing a long-term asset with a long-term loan ensures revenue generation to cover loan payments, reducing financial strain on the borrower.

UNDERSTANDING INTEREST RATES AND COSTS

Interest rates are a fundamental aspect of borrowing and comprehending them is crucial when evaluating different loan options. The interest rate, along with associated fees, significantly impacts the total cost of borrowing. To make informed decisions, borrowers must consider the interest rate type, credit processing fee, and the annual percentage rate (APR).

Interest Rate Types (Banton, 2023; Pomroy, 2023):

- **Fixed Rate:** With a fixed-rate loan, the interest rate remains constant throughout the loan term. This offers predictability, as borrowers know exactly how much they'll pay each month.
- **Variable Rate:** Variable-rate loans have interest rates that can fluctuate over time. These rates often start lower than fixed rates but can increase, making monthly payments uncertain.
- **A credit processing fee** is a charge levied by the bank to cover the expenses associated with processing a loan application. It encompasses tasks such as conducting credit checks, preparing loan documents, and facilitating the disbursement of funds.
 - o It's important to clarify the two primary methods used to calculate processing fees:
 - **Percentage of the loan amount:** This method involves charging a percentage of the total loan amount. For example, if you're borrowing €10,000 and the processing fee is 2%, the fee would be €200.
 - **Flat fee:** In some cases, banks may impose a fixed processing fee, irrespective of the loan amount. This fee remains constant regardless of the size of the loan.
 - o Notarization serves as the legal foundation for the loan agreement, ensuring its validity and enforceability. By notarizing the loan, both the borrower and the lender gain legal protection and clarity regarding their rights and obligations.
- **Annual Percentage Rate (APR):** The APR is a comprehensive measure of the total cost of borrowing, including both the interest rate and any associated fees. It provides an accurate comparison between loan offers.

A practical example

The aim of the following example is to illustrate how a loan's principal, interest rate, and term impact the total repayment amount. By analyzing the monthly repayment structure and understanding the breakdown between principal and interest, borrowers can effectively plan their finances and explore strategies for reducing overall interest costs, such as making additional payments.

Example:

Imagine you took out a €5.000 loan for 3 years with a 5% interest rate:

- Loan: 5.000 EUR
- Fixed interest rate: 5%
- Loan term: 3 years
- No additional fees

So, the principal borrowed is €5.000, the interest rate is 5%, and the loan term is 3 years.

If you repay €150 monthly for three years, you'll pay a total of €5.395 to the loan ($€150 \times 36 = €5.395$)

Of this, €5.000 is the principal borrowed, and €395 is the total interest paid.

Typically, loan repayments are made monthly or weekly, with each payment clearly communicated in advance. Each payment covers both interest and a portion of the principal. This consistency allows you to plan accordingly. Your lender will inform you of the due date and amount owed, ensuring you'll pay off the principal and interest by the end of the term. If you wish to pay off your loan faster, consider paying more than the minimum required, reducing overall interest costs.

More to read about is available here:

- Banton, C. (2023). "Interest rates: different types and what they mean to borrows." <https://www.investopedia.com/terms/i/interestrate.asp>
- Pomroy, K. (2023). "How to Compare Loan Offers." <https://www.experian.com/blogs/ask-experian/how-to-compare-loan-offers/>
- D'Amore, G. (2022). "How to Calculate Total Interest Paid on a Car Loan." <https://www.wikihow.com/Calculate-Total-Interest-Paid-on-a-Car-Loan>

INTEREST RATE AGREEMENT

Variable interest rates, as the name suggests, fluctuate based on market conditions. They're typically tied to reference rates like LIBOR or the prime rate. On the other side, fixed interest rates stay constant throughout the loan term, providing borrowers with predictability and stability in their monthly payments.

When it comes to agreeing on the interest rate, there are several key components we need to understand. First up, we have the reference interest rate. This serves as the baseline and is often influenced by broader economic factors. Then, there's the margin, which is the additional percentage added to the reference rate to determine the final interest rate. We also have weighting percentages specification, rounding provisions, interest rate adjustment periodicity, and the first interest rate adjustment date, all of which play crucial roles in shaping the agreed-upon interest rate. Weighting percentages specification refers to the allocation of weights to different components that contribute to the determination of the overall interest rate. For instance, in a variable interest rate loan, the weighting percentages might assign more importance to the reference interest rate compared to the margin. These specifications outline how much each factor influences the final interest rate calculation. Rounding provisions dictate how the calculated interest rate is rounded to a specific digit or interval. This ensures clarity and consistency in the representation of the interest rate. For example, rounding provisions may specify rounding to the nearest tenth of a percentage point or rounding to the nearest whole number. Interest rate adjustment periodicity refers to the frequency at which the interest rate can be adjusted, particularly in variable interest rate loans. It determines how often the interest rate may change based on fluctuations in the reference rate or other market conditions. Common periodicities include monthly, quarterly, semi-annually, or annually. And the first interest rate adjustment date marks the initial point at which the interest rate can be modified after the loan agreement is established. It sets the timeline for potential adjustments to the interest rate, especially in variable rate loans. This date is crucial as it determines when borrowers may experience changes in their monthly payments based on shifts in market conditions.

Understanding these aspects is vital for borrowers as it allows them to comprehend the nuances of their loan agreements and anticipate how changes in interest rates may impact their financial obligations.

Reference interest rates play a pivotal role in the global financial landscape, influencing various aspects of borrowing, lending, and monetary policy. Three key reference rates include EURIBOR, the ECB key interest rate, and swap rates. Understanding these rates is essential for individuals and businesses alike, as they impact everything from mortgage rates to investment decisions.

EURIBOR (Euro Interbank Offered Rate) is a benchmark interest rate widely used in the Eurozone to determine the interest rates on various financial products, including loans, mortgages, and derivatives. It represents the average interest rate at which a large panel of European banks lend to each other in the interbank market, denominated in euros. EURIBOR rates are published daily for

various maturities (e.g., 1 week, 1 month, 3 months, 6 months, and 1 year) by the European Money Markets Institute (EMMI). EURIBOR serves as a reference rate for millions of contracts, influencing borrowing costs for consumers and businesses across the Eurozone. It's important to understand that EURIBOR rates are influenced by factors such as the European Central Bank (ECB) monetary policy, market demand for credit, and overall economic conditions in the Eurozone.

The ECB Key Interest Rate, also known as the main refinancing rate, is the interest rate at which the European Central Bank (ECB) provides short-term liquidity to commercial banks in the Eurozone. So, it refers to the interest rate set by the European Central Bank (ECB) for conducting monetary policy in the Eurozone. It influences borrowing costs for banks and, in turn, affects interest rates for consumers and businesses throughout the Eurozone. Changes in the ECB Key Interest Rate can have significant effects on financial markets, including bond yields, exchange rates, and stock prices. Learners should be aware that the ECB Key Interest Rate is announced by the ECB's Governing Council at regular monetary policy meetings, and any changes reflect the ECB's assessment of economic conditions and inflationary pressures. Understanding the ECB Key Interest Rate is crucial for borrowers, as it indirectly affects the interest rates they pay on loans and mortgages, making it an essential factor to consider when managing personal finances.

Swap Rates (for Fixed Rate Agreements): Swap rates represent the interest rates used in interest rate swaps, where parties exchange interest rate payments. For fixed-rate agreements, swap rates indicate the rate at which one party agrees to pay a fixed interest rate in exchange for receiving a floating interest rate based on a reference rate like EURIBOR. These rates are crucial for determining the cost of fixed-rate financing.

CHOOSING BETWEEN FIXED AND VARIABLE RATE LOANS

To determine whether to opt for a fixed or variable rate loan, several factors must be considered:

Firstly, it's crucial to understand the fundamental difference between fixed and variable interest rates. A fixed interest rate remains constant throughout the loan term, ensuring consistent monthly payments. Conversely, a variable interest rate fluctuates over time, potentially leading to changes in monthly payments based on market conditions.

Next, a thorough risk assessment is necessary. Fixed-rate loans provide stability but may come with slightly higher initial rates. However, they shield borrowers from future rate increases. On the other hand, variable-rate loans often start with lower initial rates, but they carry the risk of future rate hikes, potentially leading to significant increases in monthly payments.

Personal circumstances play a significant role in the decision-making process. Individuals should evaluate their financial situation, future plans, and risk

tolerance. If stability and predictability are paramount, a fixed-rate loan may be the preferred choice. Conversely, if borrowers are comfortable with potential payment fluctuations and anticipate favorable or decreasing interest rates, a variable-rate loan could be more suitable.

Lastly, seeking professional advice is advisable. Consulting with a financial advisor or lender can provide personalized guidance tailored to individual circumstances and current market conditions.

In summary, the decision between a fixed and variable rate loan hinges on understanding the risks, considering personal circumstances, and seeking expert advice to make an informed choice.

Fixed vs. variable rate loans: differences explained

Here are some differences between fixed and variable rate of loan:

Fixed Interest Rate:

Choosing a fixed-rate loan means your payments will remain consistent throughout the loan term, making it easier to plan your finances. This is beneficial if you're on a tight budget or if you prefer knowing exactly how much you'll pay each month. When you opt for a loan with a fixed interest rate, you're essentially locking in your interest rate for the entire duration of the loan.

One of the main benefits of a fixed-rate loan is protection against future interest rate hikes. Even if market interest rates rise, your interest rate and monthly payments will stay the same, providing peace of mind and financial stability.

Choosing a fixed-rate loan offers a significant advantage in cash flow planning due to the predictability of monthly payments. Since the interest rate remains constant throughout the loan term, borrowers can accurately forecast their financial commitments over time. This stability allows for precise budgeting, making it easier to allocate funds for other expenses and investments. Whether managing personal finances or running a business, knowing exactly how much needs to be set aside each month provides a sense of control and confidence in financial planning.

While fixed-rate loans offer predictability with monthly payments and protection against rate increases, early repayment may result in higher costs. Lenders often charge penalties or fees for early repayment, offsetting potential interest savings for borrowers. Therefore, borrowers should carefully consider the terms and conditions related to early repayment before making any decisions.

Variable Interest Rate:

On the other hand, if you believe interest rates might decrease in the future or if you plan to pay off the loan relatively quickly, a variable-rate loan could offer lower initial rates and potentially save you money over time. However, it's important to be aware that if interest rates rise, your monthly payments could also increase, which may be challenging to budget for.

Choosing a loan with a variable interest rate means that your interest rate can fluctuate over time based on changes in the market.

Variable-rate loans often start with lower initial interest rates compared to fixed-rate loans. This can result in lower initial monthly payments, potentially saving you money in the early stages of the loan.

If market interest rates decrease over time, borrowers with variable-rate loans may benefit from lower interest payments, resulting in reduced monthly payments and overall interest costs.

Variable-rate loans can offer flexibility for borrowers who expect their financial situation to improve or who plan to pay off the loan quickly. Additionally, some variable-rate loans come with caps that limit how much your interest rate can increase over time, providing a degree of protection against significant rate hikes.

Variable-rate loans present challenges in cash flow planning due to the uncertainty surrounding monthly payments. With interest rates subject to market fluctuations, borrowers face the risk of unpredictable changes in their repayment obligations. While initial lower rates may offer short-term savings, the potential for rate increases introduces volatility into cash flow projections. This uncertainty makes it harder to accurately budget for future expenses and can lead to financial strain if monthly payments unexpectedly rise. As a result, individuals and businesses relying on variable-rate loans must adopt a more flexible approach to cash flow management, constantly adjusting their budgets to accommodate fluctuations in interest rates.

In summary, fixed-rate loans provide stability, predictability, and ease of financial planning, while variable-rate loans offer initial cost savings, potential long-term benefits from rate decreases, and flexibility. The choice between the two depends on individual preferences, risk tolerance, and financial goals.

Fixed vs. variable rate decision making real life examples

WHEN TO CHOOSE A LOAN WITH FIXED AND WHEN WITH VARIABLE RATE?

Scenario 1: Financing a Home Purchase

Considerations:

- You're purchasing a home and plan to stay in it for the long term.
- Stability and predictability of monthly payments are crucial for budgeting.
- Interest rates are currently at moderate levels but could fluctuate in the future.

Task: Decide whether to finance the home purchase with a fixed-rate or variable-rate mortgage. Explain your reasoning based on the stability of fixed payments versus the potential for lower initial rates and flexibility of variable rates.

Solution: In this scenario, opting for a fixed-rate mortgage would be the most appropriate choice. Since the borrower plans to stay in the home for the long term and values stability and predictability in monthly payments, a fixed-rate loan provides assurance that the interest rate and monthly payments will remain constant throughout the loan term. This protects the borrower from potential future interest rate hikes and allows for easier budgeting and financial planning.

Scenario 2: Funding a College Education

Considerations:

- You're financing your child's college education.
- You anticipate needing the funds over several years.
- Interest rates are currently low but could rise during the loan term.

Task: Determine whether to finance the college education with a fixed-rate or variable-rate student loan. Justify your decision considering the long-term nature of the loan and potential interest rate changes.

Solution: For financing a college education, a fixed-rate student loan would be the recommended option. Given the long-term nature of the loan and uncertainty regarding future interest rate changes, a fixed-rate loan provides peace of mind and stability for both the borrower and the student. Consistent monthly payments make it easier to plan and manage expenses over the duration of the education.

Scenario 3: Renovating a Home

Considerations:

- You're renovating your home to increase its value and improve your living space.
- The renovation project is expected to be completed within a year.
- Interest rates are currently low but could fluctuate during the renovation period.

Task: Choose between a fixed-rate or variable-rate loan to finance the home renovation. Discuss the advantages of each option considering the short-term nature of the loan and potential interest rate fluctuations.

Solution: In this scenario, a variable-rate loan may be the more suitable choice for financing the home renovation project. Since the renovation is expected to be completed within a relatively short period, the borrower may benefit from the lower initial interest rates offered by variable-rate loans. Additionally, the flexibility of variable rates may be advantageous, especially if the borrower anticipates paying off the loan quickly or believes that interest rates will remain favorable during the renovation period.

Scenario 4: Consolidating Debt

Considerations:

- You're consolidating high-interest credit card debt into a single loan.
- You want to pay off the debt as quickly as possible.

- Interest rates are at historic lows but could increase in the future.

Task: Determine whether to use a fixed-rate or variable-rate loan for debt consolidation. Explain your decision considering the goal of paying off the debt quickly and potential interest rate changes.

Solution: When consolidating high-interest credit card debt into a single loan, opting for a fixed-rate loan would be advisable. The primary goal in debt consolidation is typically to pay off the debt as quickly as possible and to avoid further financial strain. With a fixed-rate loan, the borrower can lock in a stable interest rate, making it easier to predict and manage monthly payments. This provides certainty and helps to avoid potential interest rate increases that could hinder debt repayment efforts.

TYPES OF LOANS

There are various types of loans available to borrowers, each catering to different needs and circumstances (Axelton, 2012; Nicastro, 2023; Push, 2023). Below some of the most typical are explained.

Personal loans are financial products provided by banks, credit unions, or online lenders to individuals for various personal expenses. These loans are typically unsecured, meaning they don't require collateral, and can be used for purposes such as debt consolidation, home improvements, or unexpected expenses.

Mortgage loans are long-term loans used to finance the purchase of real estate, typically homes or investment properties. These loans are secured by the property being purchased, serving as collateral for the loan. If the borrower fails to repay the loan, the lender can foreclose on the property.

Car loans are loans provided by financial institutions or dealerships to finance the purchase of a vehicle, such as a car, truck, or motorcycle. These loans can be secured or unsecured, depending on the lender and borrower's creditworthiness. Secured loans use the vehicle as collateral.

Business loans are loans provided to businesses for various purposes, including startup costs, expansions, working capital, or equipment purchases.

Student loans are specifically designed to finance education expenses, including tuition, books, and living expenses for students attending college or university.

Payday loans are short-term loans typically due on the borrower's next payday, often with high interest rates and fees. These loans are usually used for emergency expenses.

Consolidation loans are used to combine multiple debts into a single loan, often with a lower interest rate or monthly payment. This can simplify debt management and potentially save money on interest.

Home equity loans allow homeowners to borrow against the equity in their home, using the home as collateral. These loans are often used for major expenses like home renovations or debt consolidation.

Loans can be secured or unsecured, depending on the lender and the borrower's creditworthiness and financial stability.

As explained the landscape of loans encompasses a wide array of options tailored to meet diverse financial needs. Whether it's a personal loan for unexpected expenses, a mortgage loan for purchasing a home, an auto loan for a vehicle, or a business loan for entrepreneurial endeavors, the offerings vary not only from country to country but also from one financial institution to another.

This diversity highlights the importance of thorough research and careful consideration when seeking financing. Borrowers must weigh factors such as

interest rates, loan terms, fees, and repayment schedules to ensure they choose the loan that best aligns with their financial goals and circumstances. Additionally, borrowers should be mindful of their creditworthiness and financial stability, as these factors play a crucial role in the loan approval process.

More to read about is available here:

- Push, A. (2023). Different types of personal loans?" <https://www.lendingtree.com/personal/different-types-of-personal-loans/>
- Axelton, K. (2021). 8 Different types of loans you should know <https://www.experian.com/blogs/ask-experian/types-of-loans/>
- Nicastro, S. (2023). Types of Personal Loans <https://www.nerdwallet.com/article/loans/personal-loans/personal-loan-types>

A BANK GUARANTEE / LIABILITY CREDIT

A bank guarantee is a commitment made by a bank on behalf of a customer to fulfill a contractual obligation if the customer fails to do so. It serves as a form of assurance to the beneficiary (e.g., a supplier or contractor) that they will receive payment or performance as specified in the contract, even if the customer defaults. Bank guarantees are often used in international trade, construction projects, and other business transactions to mitigate risks and build trust between parties.

A liability credit, also known as a standby letter of credit or surety credit, is a financial instrument issued by a bank to provide assurance of payment or performance on behalf of a customer. Similar to a bank guarantee, a liability credit serves as a guarantee to a beneficiary that they will receive compensation or fulfillment of contractual obligations in the event of the customer's default. Liability credits are commonly used in commercial transactions, real estate projects, and legal agreements to secure performance and facilitate transactions.

By offering bank guarantees and liability credits, banks play a crucial role in facilitating trade, investment, and contractual agreements by providing financial security and confidence to parties involved in transactions.

LEASING TRANSACTIONS

A leasing transaction is defined by the extensive transfer of ownership risk to the lessee (the customer) and encompasses the repayment of the purchase price, including financing costs and interest.

A leasing transaction involves the transfer of the right to use an asset (such as equipment, machinery, vehicles, or real estate) from the lessor (the owner or

financier) to the lessee (the customer) in exchange for periodic payments over a specified lease term. Unlike traditional financing arrangements, leasing typically does not involve the transfer of ownership of the asset to the lessee at the end of the lease term. Instead, the lessee gains the right to use the asset for the duration of the lease while assuming responsibility for maintenance, insurance, and other operating expenses. The lessor retains ownership of the asset and may offer various lease structures, such as operating leases or finance leases, to meet the lessee's specific needs and preferences. Leasing transactions are commonly used by businesses to access equipment or facilities without incurring the upfront costs associated with outright purchases, providing flexibility, and preserving capital for other investments or operational needs.

Leased assets encompass a variety of items that can be leased to lessees for their use. The types of leased assets include:

1. Vehicles:
 - Vehicles such as cars, trucks, vans, and commercial vehicles can be leased for business or personal use. Leasing allows lessees to access vehicles without the need for significant upfront payments and provides flexibility in fleet management.
2. Movables (ahead in commercial business):
 - Movables refer to movable property or assets that can be leased, including office and business equipment, office automation devices, production machinery, and other movable assets necessary for business operations. Leasing such assets enables businesses to acquire essential equipment without the burden of ownership.
3. Real Estate (ahead in commercial business):
 - Real estate properties, including commercial buildings, office spaces, retail units, warehouses, and industrial facilities, can also be leased to tenants. Leasing real estate provides tenants with the flexibility to access space for their operations without the long-term commitment and capital investment required for property ownership.

By leasing these assets, lessees can benefit from access to essential resources while preserving capital, managing cash flow, and avoiding the risks associated with ownership. Lessors, on the other hand, generate revenue by providing assets on lease and may offer various lease structures to meet the diverse needs of lessees.

Types of leasing contracts

Leasing contracts can be categorized into different types based on their characteristics and terms. The two primary types of leasing contracts are operating leasing and finance leasing, each serving distinct purposes and offering unique features.

1. Operating Leasing (Short-term):
 - Emphasizes the transfer of the asset for use rather than financing.
 - Governed by rental agreements according to legal statutes such as the Allgemeines Bürgerliches Gesetzbuch (ABGB).

- Typically used for capital goods required for a limited period, such as vehicles.
- Lessee does not have the right to sell the asset.
- Ownership acquisition is not intended, and there is no agreed residual value at the end of the lease term.

1. Finance Lease (Long-term):

- Functions as an alternative form of financing akin to a loan.
- Acquisition and financing costs are amortized over the lease term.
- Involves a fixed term agreement.
- Ownership acquisition may be possible after the lease term, although not specifically agreed upon.
- Lessee bears the risk of the asset's residual value at the end of the lease term.

Based on the scope of the leasing contract models, there are further distinctions:

- Full Amortization Contract (Full-Pay-Out Leasing):
 - Involves repayment of the full purchase price and interest during the lease term.
 - Similar to traditional credit financing.
 - Lease term must be within 40% to 90% of the asset's normal useful life
- Partial Amortization Contract (Residual Value Leasing):
 - Only a portion of the purchase price and interest is repaid during the lease term.
 - Lower installment payments as repayment is based on the acquisition costs reduced by the residual value.
 - Offers a purchase option at the agreed residual value.
 - Financing costs are higher due to the deferral of the residual value.

Understanding the differences between the leasing contract types is essential for lessees and lessors to choose the most suitable arrangement based on their needs and financial objectives.

ALTERNATIVE METHODS OF BORROWING MONEY

In addition to traditional borrowing methods, there are alternative avenues available for accessing funds. Some of these alternative methods of borrowing money are as follows:

Overdraft Account:

Overdraft protection allows account holders to withdraw more money than is available in their bank account, up to a predetermined limit. While convenient, overdrafts often come with high fees and interest rates.

Pawnshops:

Pawnshops offer short-term loans in exchange for collateral, typically valuable items like jewelry, electronics, or musical instruments. If the borrower fails to repay the loan, the pawnshop retains the collateral.

Family and Friends:

Borrowing money from family or friends is a common alternative method. While offering flexible terms and potentially lower interest rates, it can strain personal relationships if not handled carefully.

Salary Advances:

Some employers offer salary advances or employee loans, allowing workers to access a portion of their future earnings before payday. However, this option may impact future paychecks and should be used judiciously.

When discussing alternative borrowing methods, it's important to emphasize the need for careful evaluation of terms, fees, and potential risks associated with each option.

MASTERING BORROWING- STRATEGIES FOR FINANCIAL EMPOWERMENT

Below we will explore essential principles and practical tips to help learners navigate the world of borrowing with confidence. From understanding and mitigating loan risks to optimizing borrowing decisions and evaluating early repayment options, each slide provides valuable insights to enhance your financial literacy and decision-making.

Responsible borrowing strategies

Responsible borrowing involves making informed decisions that align with your financial goals and demonstrating prudent behaviors and attitudes when taking on debt. Here are some key strategies to ensure responsible borrowing (Ebnb, 2019):

- **Set Clear Financial Goals:** Define your financial objectives, whether it's buying a home, starting a business, or consolidating debt. Having specific goals helps you focus your borrowing decisions.
- **Budget and Plan:** Create a comprehensive budget to understand your income, expenses, and savings goals. Determine how much you can comfortably allocate to loan payments without straining your finances.
- **Evaluate the Necessity:** Before borrowing, assess whether the expense is a necessity or a discretionary purchase. Avoid taking on debt for non-essential items.
- **Research Loan Options:** Compare various loan options, interest rates, terms, and fees. Understand the different types of loans and their suitability for your specific needs.
- **Review Your Credit Profile:** Check your credit report and credit score regularly. A good credit history can result in lower interest rates and better loan terms. Work on improving your credit if needed.
- **Understand the Total Cost:** Consider the annual percentage rate (APR) that encompasses both the interest rate and any associated fees. This provides a comprehensive view of the total cost of borrowing.

- **Shop for the Best Terms:** Obtain loan quotes from multiple lenders to find the most favorable terms. Don't rush into a loan agreement without comparing offers.
- **Read the Terms and Conditions:** Thoroughly review the terms and conditions of the loan agreement. Ensure you understand the repayment schedule, interest rate type, and any penalties for late payments or early repayment.
- **Maintain a Sensible Debt-to-Income Ratio:** Keep your total debt, including the new loan, within a reasonable percentage of your income. This ensures you can manage your debt payments.
- **Develop a Repayment Plan:** Create a solid plan for repaying the loan. Make sure you adhere to the agreed-upon schedule and pay more than the minimum, when possible, to reduce the total interest paid.
- **Avoid Overborrowing:** Only borrow the amount you need to achieve your goals. Avoid taking on excess debt that might lead to financial strain.
- **Monitor Your Debt Load:** Regularly review your financial situation to ensure your borrowing aligns with your long-term goals. Be prepared to adjust your strategies if your circumstances change.
- **Practice Responsible Financial Behavior:** Cultivate responsible borrowing behaviors, such as making payments on time, not taking on more debt than you can handle, and being proactive in addressing financial challenges.
- **Seek Financial Guidance:** Consult with financial advisors or counselors if you're uncertain about your borrowing decisions. They can provide valuable insights and guidance.

Responsible borrowing is a critical component of sound financial management. By setting clear goals, conducting thorough research, and adhering to these strategies, you can make informed borrowing decisions that align with your financial objectives and maintain responsible borrowing behaviors and attitudes.

Types of borrowing you should avoid

In managing personal finances, it's essential to recognize certain types of borrowing that may lead to financial hardship. Two such examples are payday loans and buy now, pay later services. While they may offer short-term solutions or convenience, they often come with significant drawbacks that can exacerbate financial challenges. It's crucial to understand the risks associated with these borrowing options to make informed decisions about managing finances effectively.

Payday Loans

Payday loans are small, short-term loans designed to cover financial gaps until the borrower's next paycheck. They often carry extremely high interest rates, with the median rate reaching around 1,300%, making them a very expensive borrowing option. Borrowers may end up paying back significantly more than the amount borrowed due to these high-interest rates. Using payday loans can create a cycle of debt, as a significant portion of the borrower's next paycheck goes towards loan repayment.

Buy Now, Pay Later (BNPL) Services

BNPL services allow consumers to make purchases and delay payments or split them into smaller installments. While convenient, BNPL services can make budgeting difficult, as borrowers need to keep track of multiple payments each month. Some BNPL providers report customer payments and borrowing to credit agencies, potentially affecting the borrower's creditworthiness. Missed payments on BNPL services can lead to serious consequences, including negative marks on the borrower's credit report and collections accounts. These examples illustrate the importance of understanding the risks associated with different borrowing methods and making informed decisions when seeking financial assistance.

How long you should borrow for?

When deciding on the duration of your borrowing, consider the purpose and amount you need. The loan term should not exceed the lifespan of the asset purchased with it. Keep in mind that every purchase made with a loan accrues interest, making it more expensive, and this cost increases with the loan term.

- Short-Term Borrowing (1 year or less): Utilize options such as overdraft limits, deferred payment credit cards, installment cards, or short-term loans. The recommended level of short-term borrowing is 10%. While overdraft limits may incur the highest costs, sometimes it's more advisable to opt for a personal loan.
- Medium-Term Borrowing (over 1 up to 5 years): Typically used for purchasing consumer goods like cars, home renovations, extended vacations, or education. The recommended level of medium-term borrowing is 10%.
- Long-Term Borrowing (over 5 years): Involves borrowing for periods exceeding 5 years. The recommended level of long-term borrowing is 30%, often used for real estate financing. If this need doesn't apply, the acceptable level of medium-term borrowing can increase to 30%.

Aligning the duration of your borrowing with the purpose and lifespan of the asset purchased ensures financial prudence and minimizes unnecessary interest costs.

Role of thumb for real estate and car purchase

When it comes to buying real estate and a car, it's advisable to follow some general guidelines:

1. Real Estate Purchase:

- A popular personal finance advice suggests that if we cannot afford to buy a house or apartment with a 30-year fixed-rate mortgage at a 30% debt-to-income ratio, then we cannot afford that property.

2. Car Purchase:

- The recommended rule for borrowing for a car purchase is:
- 20/4/10: Save at least 20% of the vehicle's purchase price as a down payment, take a loan for a maximum of 4 years, and ensure that the monthly payment does not exceed 10% of your net income. If this rule

doesn't work out for you, it means the chosen car is too expensive for your budget.

Following these rules of thumb can help ensure that your real estate and car purchases are financially manageable and aligned with your long-term financial goals.

Assess your exposure to risk

During the repayment of a loan, you are exposed to risks that depend on the characteristics of the loan, changes in the economic and macroeconomic environment, and the form of insurance:

1. **Interest Rate Risk:** Fluctuations in interest rates can affect the cost of your loan, especially if it has a variable interest rate. Over a longer repayment period, significant changes in the reference interest rate (such as EURIBOR) can lead to a substantial increase in your installment payment, making the loan more expensive.
2. **Currency Risk:** If you borrow in a currency different from the one you receive income in, you are exposed to currency risk. Fluctuations in exchange rates can impact the cost of your loan and your ability to repay it.
3. **Liquidity Risk:** This risk arises when you may not have sufficient regular funds to repay the loan if there are unexpected financial challenges or changes in your income.
4. **Asset Loss Risk:** This risk pertains to the possibility of losing assets that were used as collateral for the loan if you fail to meet repayment obligations.

The first rule of borrowing advises borrowing in the currency of your income to mitigate currency risk. However, if you opt for a loan with a variable interest rate, be aware of the potential for significant fluctuations in the reference interest rate (e.g., EURIBOR), which can increase your installment payments. In extreme cases, this could lead to financial difficulties if you do not have enough regular income to cover the increased payments.

Are you responsibly indebted?

We are responsibly indebted when, despite the debt we are paying off, we continue to regularly meet all other monthly obligations without compromising our lifestyle. Assessing our indebtedness provides valuable insights for the future: if our debt is not excessive, we have the option of further borrowing. However, if our debt exceeds a reasonable level relative to our income and age, we need to focus on reducing it. Determining whether we are over-indebted is simple with the calculation of different indicators. Some of them is debt to income ratio.

Debt-to-Income Ratio (DTI) measures the percentage of a person's monthly income that goes to debt payments. It represents the relationship between total regular monthly debt payments and monthly net income, indicating one's capacity to regularly repay debts (liquidity). It is advisable for the DTI not to exceed 40%.

Calculating the debt-to-income (DTI) ratio involves a simple formula. It's a measure used by lenders to determine a person's ability to manage monthly payments and repay debts. Here's how you calculate it:

1. **Add Up Monthly Debt Payments:** Start by adding up all your monthly debt payments. This includes things like mortgage or rent payments, car loans, student loans, minimum credit card payments, and any other debts you have.
2. **Calculate Gross Net Income:** Next, calculate your gross monthly income. This includes all sources of income before taxes and other deductions. Make sure to include income from all sources such as salary, bonuses, commissions, rental income, alimony, and any other regular sources of income.
3. **Divide Debt Payments by Gross Monthly Income:** Finally, divide your total monthly debt payments by your gross monthly income, then multiply the result by 100 to get a percentage.

For example, if your total monthly debt payments amount to €2,000 and your gross monthly income is €6,000, the calculation of the debt-to-income ratio is 33.33 %.

A lower DTI ratio indicates that you have a lower level of debt in relation to your income, which is generally considered favorable by lenders as it suggests you have more room in your budget to comfortably make debt payments.

A low debt-to-income (DTI) ratio demonstrates a good balance between debt and income. In other words, if your DTI ratio is 15%, that means that 15% of your monthly gross income goes to debt payments each month. Conversely, a high DTI ratio can signal that an individual has too much debt for the amount of income earned each month.

Typically, borrowers with low debt-to-income ratios are likely to manage their monthly debt payments effectively. As a result, banks and financial credit providers want to see low DTI ratios before issuing loans to a potential borrower. The preference for low DTI ratios makes sense since lenders want to be sure a borrower isn't overextended meaning they have too many debt payments relative to their income.

Early repayment of a loan

Consideration of early loan repayment becomes pertinent if one possesses adequate funds or identifies a more advantageous financing avenue.

The primary condition for contemplating early repayment entails ensuring that surplus savings, excluding retirement and emergency reserves, match or exceed the outstanding loan balance. The decision-making process hinges on comparing the loan's interest and servicing expenses against the returns on savings. Opting for early repayment is advisable if the loan proves costlier than the returns generated by savings.

Furthermore, early repayment becomes viable upon discovering a more favorable financing alternative. However, it's imperative to assess not solely the monthly installments and interest rates but also factor in any additional expenses associated with the approval, arrangement, and insurance of the new loan.

More to read about is available here:

- Ebnb (2019). 7 ways to be a responsible borrower. <https://www.epnb.com/insights/7-ways-to-be-a-responsible-borrower/>
- Stanbic Bank (2023). Responsible borrowing: a path to financial stability and wellness. <https://www.stanbicbank.com.gh/gh/personal/about-us/news/responsible-borrowing>
- Financial Wellness and Penn (n.d.). Responsible debt habits. <https://sfs.upenn.edu/financial-wellness/browse-topics/debt/responsible-debt-habits>
- The Philipinestar (2020). Helpful habits for responsible borrowing. <https://www.philstar.com/business/business-as-usual/2020/01/06/1982294/helpful-habits-responsible-borrowing>

CONCLUSION

In conclusion, this module has provided a wealth of knowledge on the intricacies of borrowing, offering valuable insights that empower learners to make informed financial decisions. By understanding considerations before borrowing, different loan durations, and the implications of interest rates and costs, individuals are equipped with the tools to navigate borrowing options effectively. The exploration of interest rate agreements, the choice between fixed and variable rate loans, and various types of loans such as bank guarantees and leasing transactions further enriches learners' understanding of borrowing mechanisms. Moreover, the module sheds light on alternative methods of borrowing and strategies for financial empowerment, fostering a holistic understanding of borrowing practices. Ultimately, learners emerge from this module with a heightened financial acumen, enabling them to approach borrowing with confidence and prudence, thereby enhancing their financial well-being.

REFERENCES

- Axelton, K. (2021). *8 Different types of loans you should know*. Retrieved from <https://www.experian.com/blogs/ask-experian/types-of-loans/>
- Banton, C. (2023). *Interest rates: different types and what they mean to borrows*. Retrieved from <https://www.investopedia.com/terms/i/interestrate.asp>
- Bloomenthal, A. (2020). *Borrowing base*. Retrieved from <https://www.investopedia.com/terms/b/borrowing-base.asp>
- Consumer Financial Protection Bureau (n.d). *Borrowing basics: what you need to know*. Retrieved from <https://www.consumerfinance.gov/consumer-tools/>
- Consumer Financial Protection Bureau (n.d). *Borrowing money: what to know before you owe*. Retrieved from <https://www.consumerfinance.gov/know-before-you-owe/>
- D'Amore, G. (2022). *How to calculate total interest paid on a car loan*. Retrieved from <https://www.wikihow.com/Calculate-Total-Interest-Paid-on-a-Car-Loan>
- Ebnb (2019). *7 ways to be a responsible borrower*. Retrieved from <https://www.epnb.com/insights/7-ways-to-be-a-responsible-borrower/>
- Financial Wellness and Penn (n.d.). *Responsible debt habits*. Retrieved from <https://srfs.upenn.edu/financial-wellness/browse-topics/debt/responsible-debt-habits>
- Haughn, R. (2023). *The top 9 reasons for personal loans*. Retrieved from <https://www.bankrate.com/loans/personal-loans/top-reasons-to-apply-for-personal-loan/#three>
- Johnson, H. (2023). *Top 10 Reasons People Borrow Money*. Retrieved from <https://www.investopedia.com/top-reasons-personal-loan-7508655>
- Mabs (n.d.). *Before you borrow*. Retrieved from <https://mabs.ie/managing-money/before-you-borrow/>
- Nicastro, S. (2023). *Types of Personal Loans*. Retrieved from <https://www.nerdwallet.com/article/loans/personal-loans/personal-loan-types>
- Pomroy, K. (2023). *How to compare loan offers*. Retrieved from <https://www.experian.com/blogs/ask-experian/how-to-compare-loan-offers/>
- Push, A. (2023). *: Different types of personal loans?* Retrieved from <https://www.lendingtree.com/personal/different-types-of-personal-loans/>
- Stanbic Bank (2023). *Responsible borrowing: a path to financial stability and wellness*. Retrieved from <https://www.stanbicbank.com.gh/gh/personal/about-us/news/responsible-borrowing>
- The Philippinestar (2020). *Helpful habits for responsible borrowing*. Retrieved from <https://www.philstar.com/business/business-as-usual/2020/01/06/1982294/helpful-habits-responsible-borrowing>

- Zetl (2021). *10 Things to Know Before Applying for a Loan*. Retrieved from <https://www.zetl.com/blog/10-things-to-know-before-applying-for-a-loan/>



FinPower



Co-funded by
the European Union

Funded by the European Union. Views and opinions expressed are however those of the author(s) only and do not necessarily reflect those of the European Union or the European Education and Culture Executive Agency (EACEA). Neither the European Union nor EACEA can be held responsible for them. Project Number: 2022-1-AT01-KA220-ADU-000087985

PROJECT ID NUMBER: 2022-1-AT01-KA220-ADU-000087985