

LOANS

A loan is when a bank lends money to a person, and the person pays it back over time with interest. Loans are used to purchase high cost items or services that a person cannot afford to pay for all at once. Loans are usually needed to purchase items such as automobiles, homes and boats, or to pay for services such as school tuition and home improvements. To qualify as a bank, the bank is legally required to make commercial loans. Banks issue loans as a benefit to customers. In order to issue loans, banks must raise deposits. Banks try to keep an equal balance between loans and deposits.

The loan process starts when a person has a need for money. The person contacts a bank and inquires about borrowing the money. The person must first fill out a loan application, which usually consists of questions such as the amount and purpose of loan as well as information such as monthly income, job history, monthly bills, and assets owned. Merely applying for a loan does not guarantee approval for a loan. Banks use the application to determine if the loan requested is reasonable for the purpose of the loan, and to judge the ability of the customer to repay the loan.

In addition to the loan application, the bank will order a credit report on the person or persons applying for the loan. As you will learn in the credit section of this study guide, your personal credit history is one of the most important items banks examine in the credit approval process. Your credit report lists your current loan obligations and shows the bank how you have handled your loan responsibilities in the past.

The information the bank obtains from your application and credit report helps to determine if you qualify for the loan. In reviewing this information the bank looks for five basic things, which is sometimes referred to as the “**Five Cs of Credit**”.

Character: Character is a very important factor banks use to consider a loan request. Your character is evaluated by looking at how you have handled you money and loans in the past. Your Credit Report is the primary tool banks use to determine your character. A good credit history showing payments made on time usually tells the bank that a person is a good credit risk.

Capacity: Your capacity is the measure a bank uses to determine if a person has the ability to repay the loan as agreed. A person’s monthly income and expenses are items banks look at in measuring a person’s capacity.

Capital: Capital is the money or assets a person owns or has access to. A person with limited capital may be required to provide a **co-signer** on the loan. In the event a person does not repay the loan as agreed, the bank may call upon the co-signer to repay the loan.

Collateral: Collateral is some form of security or assets that are pledged to the loan and can be used in case the borrower does not repay the loan. An example of collateral is a title to a car. If a person does not repay the loan as agreed, the bank may take possession of (or repossess) the collateral and sell it to pay on the loan.

Conditions: Conditions include what is happening that may affect the borrower's ability to repay the loan in the future. The key questions are what can go wrong, from job changes to illness and accidents to family status changes, and how this may affect the repayment of the loan. After your loan application and credit report are reviewed, the bank then determines the worthiness of the loan you are requesting. At this point the bank will then approve or decline the loan.

Types of Loans

Banks offer many different types of loans, which may be used for a variety of purposes. You may remember some of them from the bank products section you studied earlier. Most banks offer these three basic types of loans:

Installment Loans

For an installment loan, a lump sum of money is issued to the borrower for a specific purpose and repaid over a specified period of time. Installment loans may be secured (collateral is pledged to the bank) or unsecured (no collateral) and typically have a fixed interest rate for the term (time or length) of the loan. The following are examples of installment loans:

- Auto Loan (secured by automobile)
- Personal Loan (usually unsecured loans such as Student Loans)

Revolving Loans

With a revolving loan, the borrower has the ability to borrow up to a certain dollar amount on an ongoing basis. As the balances of revolving loans are repaid, the borrower may continue to borrow up to the set dollar amount. Like installment loans, revolving loans may also be secured or unsecured. A credit card is an example of revolving loan.