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By: Joe the Investor

The key premise to keep in mind is that if someone lends you money, they want you to be able to pay it back. They would like you to pay it back slowly so that the lender makes money with the interest. Paying back the principle shows that you have credibility, but it does not make the lender money. What is considered when a loan is created? The factors are:

Interest rate

The interest rate can be fixed or variable. A *fixed* rate stays the same for a certain length of time. The rate can change once the period of time has expired. A *variable* rate is tied to a market interest rate like the prime rate or bank rate and will vary typically each day or each month. If you want a predictable interest payment every month because your income is fixed or you cannot afford to pay more than a certain amount, a fixed rate would give you more predictability in your budget. A fixed rate is also advantageous if you think interest rates will rise and you want to lock in a rate beforehand. If you have flexibility in your ability to pay and you are okay with changing interest payments, then a variable rate may be suitable for you. If interest rates are declining or remaining flat, a variable rate will tend to be lower than a fixed rate because you would pay a higher rate in exchange for the reduced risk of interest rates changing.

Closed Versus Open Loan

A *closed* loan is one in which the term or payment schedule is fixed for a certain amount of time. If you want to discharge this loan, you would typically pay all of the interest for the contracted term up front, which means penalties are large if there is a lot of time left before the loan expires. Do not enter into a closed mortgage unless you play to keep the loan for the entire time or if it is worth it for you to pay this penalty. An *open* loan is one in which you can terminate at any time and not suffer severe penalties. The fees and penalties will vary in this case, so make sure the conditions are understood before signing anything.

How do you determine what to get? The questions to ask are: What is your time horizon for the loan? In other words, for how long do you need to borrow the money? If you are buying a house and expect to live in it for 30 years, you can be very flexible in how long your mortgage can be. If you are planning to buy a house and sell it within a year, getting a five year closed mortgage is not a good idea, even if the rate is cheaper. If you have a five year fixed rate mortgage and want to discharge it after 1 year, using a rate of 3% and $100,000 principle borrowed, you would be paying $3000 per year for the 4 years of interest that you have not paid yet *at the time the loan is discharged*.

Fees to Set Up a Loan

A loan is a contract between the borrower and the lender which will stipulate the terms, conditions and costs of the loan. There will usually be a set-up fee to obtain a loan and termination fee to discharge the loan. There may be fees to renew the loan, renegotiate the terms or penalties charged if the borrower does not make a payment on time. The best way to assess these fees is to account for them in an “all-in” accounting to see what the total fees would be from the beginning of the loan period to the end of the period. You would also need to ask some questions about how you personally make payments. Are you very organized and rarely miss paying your bills? If so, penalties for non-payment are not a big issue. If missing payments is a habit, you may want to buy loan insurance or have some forgiveness clauses built into the contract so you are not heavily penalized. Are you planning to make lump sum payments or additional payments throughout the year? You will need to clarify whether these are allowed and whether there is a limit to the frequency or amount of these payments. Do you want the ability to terminate or change the loan at any time? If you do, you will need to make the contract flexible to allow for these changes. Keep in mind that the more concessions you ask for, the more the loan will cost which would typically be reflected in the terms or a higher interest rate.

Equity in the Loan

If you are borrowing money to buy something, the lender usually does not want to lend you 100% of the money to make the purchase. They want you to put up some of the money upfront, so that if the price of the asset goes down right after you borrow the money, the lender does not lose their principle. On a mortgage, this amount of money is called the *down payment*. The lender typically uses a ratio of what you are borrowing to the price of the asset to reduce the risk they are taking in making the loan. This is called the *loan to value* ratio. The more conservative the lender, the lower this ratio will be which translates into “if you want the loan, you will have to supply more of the funds so the lender can have less risk.” The percentage of the item that you have paid for is called the *equity*.

What to Consider in Making the Payments

If you are looking for a loan of any kind, there are things you can evaluate to figure out the best deal you can get. What is the maximum payment I can make assuming all things stay the same? Your lender will probably give you this figure when you ask for approval of a loan. A second way to look at it is to calculate your income and expenses each month and see what is left. The expenses have to include the one off things like travel, repairs, renovations or an unexpected expense. The unexpected can be dealt with in two ways. You can have a reserve account with cash to deal with these expenses, or use a reserve line of credit. Both accounts would ideally be replenished when possible.

What if some of the variables change? The variables in question are income changes or expense changes. The unexpected expenses are covered in the paragraph above and a contingency fund may be useful to smooth some of these over. An income decrease can be covered by insurance in some cases. Another way of dealing with income declines is by having a payment that is less than the maximum so that if your income is reduced, your mortgage situation will not change.

What Is the Item Worth For Which I Am Borrowing Money?

Since the lender is using the asset as collateral in case you do not pay the loan back, the lender wants to know what this asset is worth. A key thing to remember is that the lender wants to know what the item is worth throughout the life of the loan, and particularly at the end of the loan period. If you are borrowing money to buy a house, it is assumed that prices generally rise over time. This is not true for a machine, a car or a recreational vehicle. Lenders can find out the value of the item through appraisals, prices for comparable items or market research.

Proof of Income

A lender wants to know if you are able to pay back the loan. If you have a standard job and can prove your income easily with a T4 slip, a call to your employer, a tax return or a bank account statement, obtaining a loan should be relatively straightforward since the risk of not being able to pay is small. Using a credit score is showing that you have paid back loans in the past and can be relied upon in the future. If your income is variable or not identifiable, the criteria for obtaining a loan may be more difficult. The lender will have to look at the whole situation more closely as to how you will pay the loan back and what the risk of non-payment is in the whole picture. As an example, if you are borrowing money to start a business that has no track record, but you own a house that far exceeds the value of the loan, the house can be used as collateral instead of the business. If your income is variable, but you have investments that generate stable income, this is another possibility.

Obtaining a loan may depend on what you are borrowing the money for rather than your ability to pay and the risk of non-payment. If you are borrowing money for a rental property and it is a self-sustaining asset, the numbers for the rental property will pay for the loan by themselves. If you have a business that has a track record for many years with stable income, this may also be a game changer in terms of qualifying for a loan.

The underlying themes in getting a loan for the lender is: Can I trust you the borrower to pay the loan back on time? Is the thing you are borrowing money for increasing in value over time? What risks are there that the current circumstances will change, putting me at risk? Will I make enough money to make this loan worthwhile? If you can address these concerns, it will go a long way to understanding what you need to know when negotiating a loan.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what your options are. **Note: This site is intended for people who want to learn about the world of investments and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**