

Unit 10: Other Financial Products

Student Workbook

Unit 10

Unit Aim: Review a range of personal financial products.

Relevance of this unit to the course:
The products featured in this unit will be reviewed in unit 11.

Learning Objective	Learning Outcomes	Chapter Section
10.1.1	Know the differences between bank loans, overdrafts and credit card borrowing	1
10.1.2	Know the difference between the quoted interest rate on borrowing and the effective rate of borrowing	1
10.1.3	Be able to calculate the effective annual rate of borrowing, given the quoted interest rate and frequency of payment	1
10.1.4	Know the difference between secured and unsecured borrowing	1
10.2.1	Understand the characteristics of the mortgage market including: • Interest loans • Loan to value	2
10.2.2	Know the definition of and types of mortgage, including: • Repayment • Interest only • Offset	2
10.3.1	Know the basic principles of life assurance and the definition of the following types of life policy: • Term Assurance • Whole of life	3

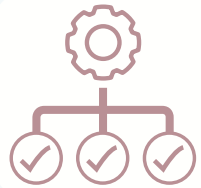
How to use this student workbook

Throughout this student workbook, look out for the different icons to support your learning:

Understand and learn – these sections will help you to develop your knowledge and understanding of the assessed learning objectives.



Apply and practise – Practise and test your newly acquired learning by undertaking a range of activities to help you prepare for the multiple choice assessment at the end of the course.

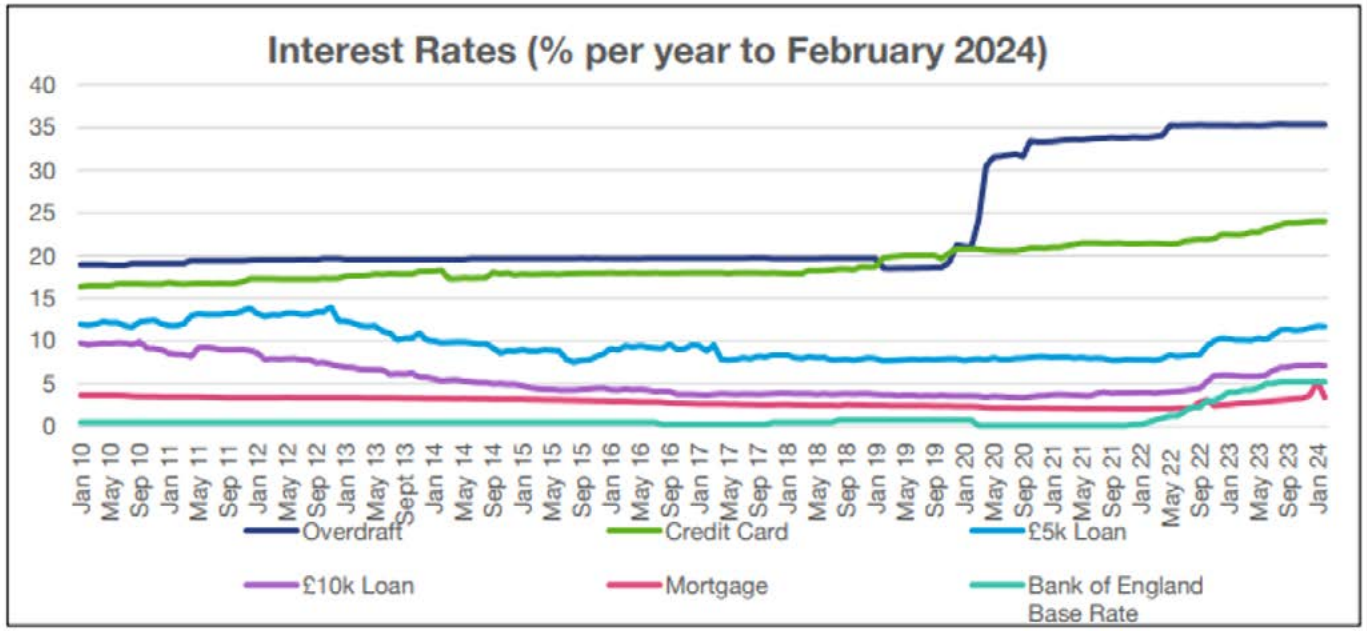


Further your knowledge – Consolidate your understanding of key concepts by reading and interacting with current, credible resources to help further enhance your learning.



Introduction – The cost of credit

The graph below shows the differences in the cost of borrowing for a number of common borrowing products in the UK.



Source: Bank of England

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Introduction – The cost of credit

Take a look at the graph on the previous page showing the average cost of credit for different UK credit products. Complete the activities below:

Summarise the data

Compare these rates against the Bank of England base rate

Explain why overdraft interest rates increased significantly in 2020

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Module Learning Outcome 10.1 – Loans

10.1.1: Understand the differences between bank loans, overdrafts and credit card borrowing

10.1.2: Understand the difference between the quoted interest rate on borrowing and the effective rate of borrowing

10.1.3: Be able to calculate the effective annual rate of borrowing, given the quoted interest rate and frequency of payment

10.1.4: Identify the difference between secured and unsecured borrowing

Borrowing Money

Borrowing comes in many different forms, each designed to meet specific financial needs. In this section we are going to explore the differences in overdrafts, credit cards and loans. Using chapter 10 in the course workbook and any other research, **complete** the following table:

Type of borrowing	Definition	Advantages for the consumer	Disadvantages for the consumer
Overdrafts			
Credit cards			
Loans			

Overdrafts

There are two types of overdraft

- **Authorised** – these are agreed with the bank in advance. The bank set the spending limit, interest rate payable and may also add on other fees.
- **Unauthorised** – these have not been agreed in advance or spending has exceeded the agreed limit. These are often charged at a higher rate of interest with higher fees added.



Case study – overdraft rates

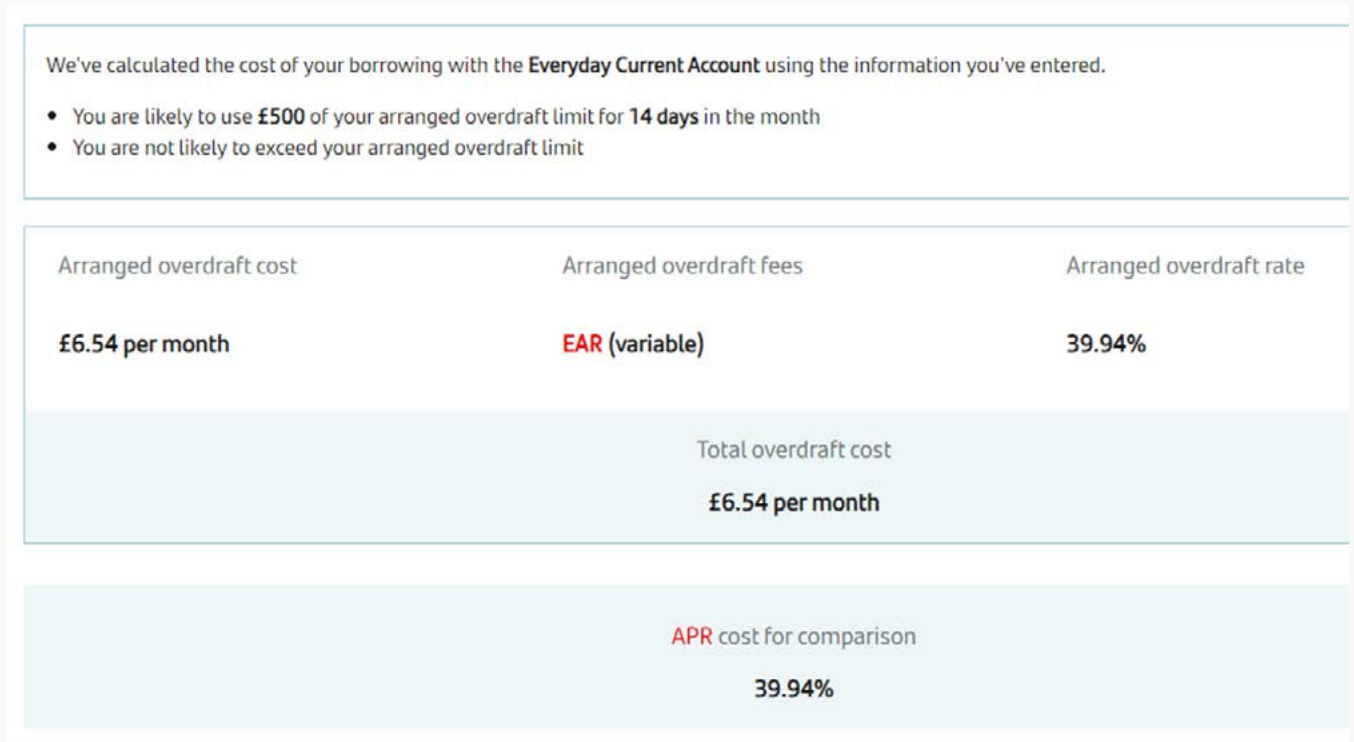
Mai has had some expensive bills lately and whilst these have all been paid, they have left her a little bit short of money for her next months' bills. She thinks that she only needs to borrow for about 2 weeks before she gets paid and she will also receive her annual bonus in her next month's pay too.

She decides that an arranged overdraft would be most suited to her needs so she goes onto her online banking to explore how much this will cost her.

Mai is not sure what the information means so she asks you to **explain** the overdraft details to her.



Case Study – Overdraft rates



In your opinion, **what guidance** would you give to Mai about this option. What other options might also be available to her?

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Credit Cards – how they work

- The retailer is paid by the credit card company for the goods sold
- Customers are typically issued with a monthly statement by the credit card company showing how much has been spent on the card over a given period of time along with any repayments made in the previous month
- Customers can choose to pay all the money owed to the credit card company, or just a percentage of the total sum owed
- If the customer pays the bill IN FULL, they will not incur any interest or charges as long as the payment is received within the given time period
- If the customer only pays of a proportion of the outstanding balance, they will incur interest charges on the remainder of the balance
- Customers may be offered 0% interest credit cards depending on their CREDIT WORTHINESS and affordability criteria. Credit worthiness involves checking a customers credit score and report to determine how much to lend to them and what APR to charge based on their previous experience of borrowing money.

Case study – a credit card dilemma

You have a credit card balance of £1,800. You want to switch to a new credit card company. You are determined not to put any more spending on your new card at all. You just want the cheapest cost over the life of the two year deal. Use the information to work out which offer you should choose.

OPTION 1 – Bank X is offering:

- ☐ Minimum agreement period of two years
- ☐ 0% introductory rate for 14 months on all balance transfers
- ☐ 2.98% fee payable upon transfer of balance
- ☐ 16.6% APR on the balance from month 15 onwards

OPTION 2 – Bank Y is offering:

- ☐ Minimum agreement period of two years
- ☐ 3.5% monthly introductory rate for first 12 months on all balance transfers
- ☐ No fee payable upon transfer of balance
- ☐ 12% on the balance charged monthly from month 13 onwards

Answers

Bank X - 24 month deal	
Balance transferred	1,800.00
Fee of 2.98% on balance transferred	53.64
New balance after addition of 2.98% transfer fee	1,853.64
Introductory interest rate quoted on new balance for first 14 months	0.00%
16.6% APR interest charge on new balance for remaining 10 months	256.42
Total cost of Virgin deal	310.06

Bank Y- 24 month deal	
Balance transferred	1,800.00
Fee of 0% on balance transferred	0.00
New balance after 0% transfer fee	1,800.00
Introductory Monthly Interest rate charge on new balance for first 12 months	3.50%
APR equivalent on balance for first 12 months	3.56%
3.56% APR interest charge on balance for first 12 months	64.08
New balance after interest charged at 3.56% APR introductory rate	1,864.08
Interest rate quoted on new balance for remaining 12 months	12.00%
APR equivalent on new balance for remaining 12 months	12.68%
12.68% APR Interest charge for remaining 12 months	236.37
Total cost of Magic Bank deal	300.45

Loans

Loans can be secured or unsecured.

A secured loan requires something that gives the lender security in case you cannot pay the loan back. This security is usually your home but could also be a guarantor. A guarantor is a person who agrees to be responsible for the loan if you cannot make the repayments. If you fail to repay the loan, the provider can get their money back by selling the security or requesting the guarantor pays. An example of a secured loan is a mortgage.

An unsecured loan does not involve security, but as the lender is taking a greater risk, the interest rate payable may be higher. Student loans and personal loans are examples of unsecured loans.

Scenarios

Read the scenarios below then **decide** which type of borrowing (credit card, loan, overdraft) might be most suitable for the customer and **explain** your reasons for this. **Discuss** what the drawbacks of your chosen option might be too for the customer.

SCENARIO 1

Jerome wants to purchase a new PC. He has a full time permanent job, a decent salary and whilst doing an eligibility check, discovers that is credit score/report is healthy.

☐ Credit card

☐ Loan

☐ Overdraft

Explanation and drawbacks

Scenarios

Read the scenarios below then **decide** which type of borrowing (credit card, loan, overdraft) might be most suitable for the customer and **explain** your reasons for this. **Discuss** what the drawbacks of your chosen option might be too for the customer.

SCENARIO 2

Simone has been saving for a while for a new electric bike, she's almost achieved her target but is short by about £300. She's seen a great deal online so wants to buy it quickly before the deal ends.

☐ Credit card

☐ Loan

☐ Overdraft

Explanation and drawbacks

Scenarios

Read the scenarios below then **decide** which type of borrowing (credit card, loan, overdraft) might be most suitable for the customer and **explain** your reasons for this. **Discuss** what the drawbacks of your chosen option might be too for the customer.

SCENARIO 3

Mo has just got a new part time job and is looking at buying a second hand car to get to work. He can't afford to buy it outright.

☐ Credit card

☐ Loan

☐ Overdraft

Explanation and drawbacks

Quoted interest rate vs the effective annual rate (EAR)

Interest on borrowing is expressed in a number of different ways. These are:

- **QUOTED RATE** – Often referred to as the **Annual Percentage Rate (APR)**. This is the rate "quoted" or "advertised" by the lender and expressed as an annual figure. It also includes any fees and admin costs that the lender also might add to the product. APR's are used by customers to compare lending products.

- However, APRs can be misleading as interest is usually **COMPOUNDED**. This means that the interest on borrowing is calculated not only on the initial principal(borrowed) amount but also on the accumulated interest from previous periods. In other words, you're charged interest not just on the original amount borrowed but also on any interest that has accrued since the loan was taken out.

- **EFFECTIVE ANNUAL RATE (EAR)** – This reflects the amount of compound interest that has been added to lifetime of the borrowing so it is a much more accurate figure. The EAR is usually higher than the APR due to the compounding effect.

Calculating EAR from the quoted rate

- **Watch** the YouTube video about how the effective annual rate is calculated.

- **Read** the section about EAR in chapter 10 of the course workbook along with the case study showing how the formula for calculating the effective annual rate is used.



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Calculating the EAR – practice questions

1. A lender has advertised a new credit card with a rate of 3.99% APR. In the terms and conditions it states that interest will be charged monthly. **Calculate** the effective annual rate (EAR).

2. The Moneybags Credit Card Company quotes its interest rate at 12% APR, charged on a quarterly basis. **Calculate** the effective annual rate (EAR).



Module Learning Outcome 10.2.1

Understand the characteristics of the mortgage market including:

- Interest loans
- Loan to value

Mortgages

Read the section about mortgages in chapter 10 of the course workbook and:

Define the term mortgage

Explain how potential home owners are assessed in a mortgage application. What factors are taken into account?

1.

2.

3.

4.

Loan to Value (LTV)

Lenders will look at the size of the loan being requested in a mortgage application in relation to the value of the property. This is to determine their level of risk. The higher the loan to value ratio, the more risky it is to lenders. If the risk is deemed to be high, the borrower may have to pay a higher rate of interest.

For example

Sian wants to buy a flat for £250,000 and needs to borrow £210,000. Her LTV will be

$$\frac{\text{Amount to borrow}}{\text{Value of the property}} \times 100 = \mathbf{84\%}$$

In other words, Sian needs to borrow 84% of the value of the property.

An LTV of 84% might impact on Sian's mortgage options as this would be deemed to be high. Mortgage providers prefer larger deposits so the loan to value ratio would be smaller and therefore less of a risk to the mortgage provider.

Who would you lend to?

Lou is looking to move from their flat into a 2 bedroom house. They have found a buyer and will make £60,000 profit when the sale goes through. The 2 bedroom house is valued at £230,000. Lou earns £48,000 per year.

What is the LTV ratio?

What recommendations would you make to Lou about their mortgage options?

Would you lend the required amount to Lou?

Who would you lend to?

Roisin and Oscar have saved £20,000 deposit for their first home. They have seen a flat valued at £210,000. Both work full time and currently have a joint income of around £70,000 a year. Oscar's contract is temporary.

What is the LTV ratio?

What recommendations would you make to Roisin and Oscar about their mortgage options?

Would you lend the required amount to Roisin and Oscar?

Mortgage interest rates – match the term to the definition

1. Variable rate
2. Fixed rate
3. Capped rate
4. Tracker rate
5. Discounted rate

A – This is when mortgage repayments are set for a given period of time. If interest rates change, the amount payable remains the same.

B – This is when the interest rate on the borrowing in linked to the Bank of England base rate. You will pay the base rate plus a certain percentage.

C – This rate changes in line with the Bank of England base rate.

D – The interest rate is reduced by a certain amount for a given period of time, usually to attract switchers.

E - This protects borrowers from rates rising above a particular rate.

The current UK housing market

Watch the Channel 4 broadcast (March 24) about the UK housing market and answer the following questions

- Summarise the trends in the UK housing market
- What challenges does the UK housing market currently face?
- What challenges do home owners currently face?



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Module Learning Outcome 10.2.2

Define and understand types of mortgage, including:

- Repayment
- Interest only
- Offset

Types of Mortgage

Read the section about mortgages in chapter 10 of the course workbook and the example case studies.
Summarise the different types of mortgages below.

	Definition	Advantages	Disadvantages
Repayment mortgage			
Interest only mortgage			
Offset mortgage			
Buy to let mortgage			

Non-payment of a mortgage

- If the borrower fails to make the agreed repayments and/or the interest payments on the mortgage, the borrower is described as **in default**.
- The lender can then **re-possess** the property, **sell the property** (often at auction) and then reimburse itself with the proceeds.
- Any money left over after repayment of the outstanding loan is returned to the former property owner.
- A second mortgage is sometimes taken out on a single property.
- If the borrower defaults on his borrowings, the **first mortgage ranks ahead of the second** one in terms of being repaid out of the proceeds of the property sale.

Other mortgage fees and charges

When arranging a mortgage there are many other fees and charges to consider. These include:

Booking Fee – Sometimes charged just to apply for a mortgage – not normally refundable, even if you don't get accepted for the mortgage.

Broker Fee – Charged by a mortgage broker if you use one for advice or to arrange the mortgage for you.

Arrangement Fee – Charged to set-up the mortgage itself. AKA product fee or completion fee.

Valuation Fee – Charged by the mortgage provider to value the property to ensure it is worth the amount being borrowed.

Early Repayment Charge – The lender may impose this charge if you want to repay all or part of the mortgage early.

Exit Fee – Charged by the lender when you repay the mortgage, even if you are not repaying it early.

Can you think of any other costs, expenses and/or taxes that are paid when purchasing property?

Money Saving Expert has produced a comprehensive guide to mortgages.

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Module Learning Outcome 10.3.1

Understand the basic principles of life assurance and the definition of the following types of life policy:

- Term Assurance
- Whole of life

Life Assurance

Read the section about life assurance in chapter 10 of the course workbook and **answer** the following questions:

1. What is life assurance?

2. What is the difference between whole of life and term assurance?

Life assurance – True or False?

	True	False
1. Term assurance provides permanent cover.	○	○
2. Whole-of-life policies are normally taken out for the insured sum itself.	○	○
3. Term assurance pays out a lump sum if death occurs within a specified period.	○	○
4. A life policy is an insurance policy in which the event insured is a death.	○	○
5. Life cover is often used to pay off the principal in a mortgage in the event of a death.	○	○



End of Unit 10
Multiple Choice Assessment

Test your knowledge

1. What happens when an individual's current account balance falls below zero?

- A. The account is described as being in overdraft
- B. The account is frozen until the balance is replenished
- C. The bank refuses to honour any further transactions
- D. The bank charges the individual a fixed fee

2. How are authorised overdrafts different from unauthorised overdrafts?

- A. Authorized overdrafts are charged a lower rate of interest
- B. Authorized overdrafts are not subject to fees
- C. Authorized overdrafts are agreed upon in advance with the bank
- D. Both a) and c)

Test your knowledge

3. What is one advantage of paying the full balance each month on a credit card?

- A. The customer does not have to pay any interest
- B. The customer is rewarded with cashback on all purchases
- C. The customer can defer payments to a later date
- D. The customer can transfer balances from other cards without paying a fee

4. What is the effective annual rate?

- A. The annual percentage rate (APR)
- B. The quoted rate divided by the appropriate frequency
- C. The true cost of borrowing
- D. The interest rate charged on credit cards

Test your knowledge

5. What is the purpose of the annual percentage rate (APR)?

- A. To make comparisons easier between different lenders
- B. To calculate the borrower's creditworthiness
- C. To determine the true effective rate of borrowing
- D. To determine the fees charged by the lender

6. What amount is paid out under a Term Assurance contract in the event of the policyholder surviving to the end of the policy term?

- A. The amount insured plus accrued bonuses
- B. Nothing
- C. The amount insured only
- D. The greater of the amount insured or the value of underlying investments

Test your knowledge

7. A credit card company is quoting a flat rate of annual interest at 18% per annum, charged half-yearly. What is the effective annual rate?

- A. 18.18%
- B. 18.09%
- C. 19.18%
- D. 18.81%

8. How would 'effective annual rate of interest' be described to a new and unsophisticated borrower?

- A. This is the rate of interest that you actually pay on the loan, regardless of its duration
- B. This is the rate of interest that applies only if the loan is of a year's duration or more
- C. This is the adjusted rate of interest after including payment protection insurance
- D. This is the rate of interest that is quoted to you at the time you take out the loan

Test your knowledge

9. A mortgage which takes account of your monthly salary payments and any savings held with the same institution is known as:

- A. Repayment mortgage
- B. Lifestyle and income mortgage
- C. Offset mortgage
- D. Interest only mortgage

10. A £5,000 loan is taken out over a three year period by a higher rate taxpayer. If the quoted interest rate is 8% p.a., charged on a quarterly basis, what is the effective annual rate of borrowing?

- A. 8.02%
- B. 8.16%
- C. 8.24%
- D. 8.00%

Test your knowledge

11. Under which ONE of the following types of mortgage does the monthly payment normally comprise a combination of interest and capital?

- A. ISA
- B. Endowment
- C. Repayment
- D. Pension-linked

12. A credit card company is quoting a flat rate of annual interest at 16% per annum, charged half-yearly. What is the effective annual rate?

- A. 16.53%
- B. 16.64%
- C. 16.08%
- D. 16.98%

Test your knowledge

13. A credit card company quotes its interest rate at 10% per annum, charged on a quarterly basis. If money is borrowed at the outset and no repayments are made for a year, the effective annual rate over the year will be (rounded to two decimal places):

- A. 10.50%
- B. 12.50%
- C. 10.38%
- D. 10.08%

14. Which of the following is not true about unsecured loans?

- A. The loan is not linked to the item that is purchased with the loan
- B. The lender is more likely to lose its money in comparison with secured loans
- C. They are typically used to buy consumer goods
- D. A mortgage is an example of an unsecured loan

Test your knowledge

15. Which of the following statements about Loan-to-Value ratios is false?

A. The higher the loan-to-value ratio, the more risky the mortgage is deemed by lenders

B. Mortgages with higher loan-to-value ratio are likely to be subject to higher rates of interest

C. The lower the loan-to-value ratio, the more risky the mortgage is deemed by lenders

D. Borrowers with larger deposits and therefore lower Loan-to-Value ratios tend to be offered lower rates of interest on their mortgage

Test your knowledge

16. A mortgage which charges interest at 2% above the base rate of interest is known as which of the following

- A. A variable rate mortgage
- B. A fixed rate mortgage
- C. A capped mortgage
- D. A tracker mortgage

17. The difference between a lender`s quoted interest rate and its effective annual rate, NORMALLY relates to what key factor?

- A. Tax relief on the interest payments
- B. Frequency with which interest is levied
- C. Payment protection insurance to cover interest during sickness
- D. Discounts for making interest payments early

Monitoring my progress – Unit 10

My multiple choice assessment mark is / 17

I am happy with the progress that I made on the multiple choice assessment

◯ Yes ◯ No

To improve my knowledge and understanding, I now need to….

1.

2.

3.

Need more help?

If you feel that your multiple choice score can be improved further, complete the end of unit 10 multiple choice questions in the course workbook.



Answers

Page 12-13
Answer = Bank Y

Page 15-17
Scenario 1 - Credit card (0% if possible)
Scenario 2 - Overdraft
Scenario 3 - Loan

Page 20
QUESTION 1 –
3.99% divided by 12 months = 0.3325% per month on outstanding balance

- This interest is added to the balance, making it bigger each month
- Interest is then charged the next month on the larger balance

Take 0.3325% and express this as 1.003325
Then multiply to the power of 12 months: 1.00332512 = 1.04064

- re-expressed as a percentage is 4.06%

Effective Annual Rate (EAR) is 4.06%
QUESTION 2 –
12% / 4 = **3% interest charged every 3-months**
Turn 3% interest into a decimal: **3 100 = 0.03**
Add 1 to the decimal = **1.03**
Multiply the number to the power of the number of periods interest is charged:
1.03 = 1.03 x 1.03 x 1.03 x 1.03
1.03 = **1.1255088**
Minus the 1 = **0.1255088**
Turn 0.1255088 back into a % - 0.1255088 x 100 = **Effective Annual Rate (EAR) is 12.55%**

Page 24
LTV ratio – 73%

Page 25
LTV ratio – 90%

Page 26

1. Variable rate - C
2. Fixed rate - A
3. Capped rate - E
4. Tracker rate - B
5. Discounted rate – D

Page 31
Other costs:

- Estate agent fees
- Land registry fees
- Legal fees
- Cost of moving (home movers/haulage, possible storage costs)
- Taxes
- Stamp duty
- Capital gains (if BTL)

Page 33

1. False
2. False
3. True
4. True
5. True

Test your knowledge
1A
2 A and C
3A
4C
5A
6B
7D
8A
9C
10C
11C
12B
13C
14D
15C
16D
17B