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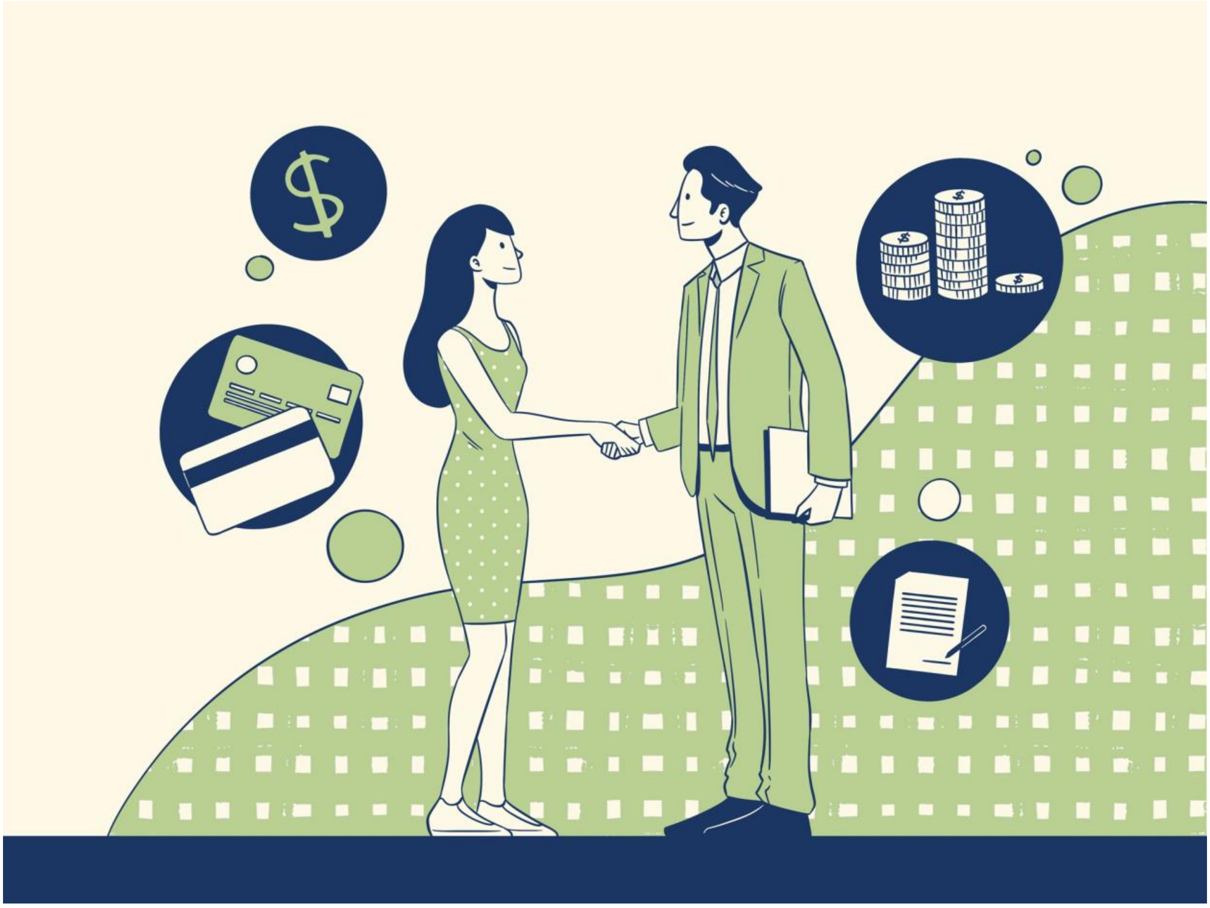

A month ago, my editor assigned me to investigate a potential news story about personal loans and I realised I was clueless when it came to the topic — if there was ever a need for me to take out one in the future, I would not know where to start.

This was slightly concerning, given that I hit my mid-20s this year and will probably move on to my next season in life soon, which means possibly taking out a loan for big-ticket items such as a wedding or home renovation.

While Googling about loans, I learnt that one in three young adults in Singapore had "unmanageable debt", according to a study by the Citi Foundation-SMU Financial Literacy Programme for Young Adults, which surveyed 1,068 respondents aged between 18 and 30 from March to April last year on topics such as debt and savings.

They had asked the respondents to provide an estimate of their total amount of debt, including credit cards, student loans and other debts, but excluding mortgage and property loans.

They then compared this against their monthly household incomes to measure their ability to repay their debts.

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Curious, I approached the director of the programme, Professor Aurobindo Ghosh, to find out why such a significant proportion of young Singaporeans had unmanageable debt, and he said that there are three common reasons:

Firstly, a lack of clear understanding of budgeting and tracking expenses, exacerbated by the fact that the distinction between needs and wants is getting blurred with more targeted advertisements on social media and elsewhere.

"'Keeping up with the Joneses and Yolo (You Only Live Once) attitudes might lead young people to take up unsustainable debt to meet personal consumption expenditure," said Prof Ghosh, who is also an assistant professor of finance education at Singapore Management University (SMU).

Secondly, the pandemic might have also reduced real income, or income after accounting for inflation, which could have led young people to spend higher amounts or borrowing money to make up for the shortfall.

Finally, rampant use of borrowing tools including credit cards and buy-now-pay-later schemes without understanding the implications of borrowing might also increase the total amount of debt for young adults who are also more likely to use technology, Prof Ghosh said.

Having learnt all this, I then spoke to some financial experts to better understand loans.

WHAT IS A PERSONAL LOAN?
A personal loan is an unsecured loan, meaning that it is not backed by an asset. It is different from a housing and car loan, for which, in the event that a borrower is unable to return the amount, the bank has the ability to seize the asset.

A personal loan can be used for a range of purposes such as home renovations or purchasing electronics, and how much you can borrow is based on your ability to repay it, which is influenced by factors such as your monthly salary and credit report.

WHAT IS A CREDIT REPORT?
Banks may request for your credit report to assess your "creditworthiness", or your ability to pay back a loan before granting you one, explained Ms Lorna Tan, the head of financial planning literacy at DBS Bank.

For banks in Singapore, only two credit bureaus are allowed to obtain such information: Credit Bureau Singapore and Experian Credit Bureau Singapore.

The credit report includes information such as records of all credit checks made on you, credit repayment trend for the past 12 months, including late payments on credit card bills, default records and bankruptcy records, if any.

A few factors could affect your credit rating:

Credit you have now: The number of accounts open or active that provide you with a loan
Credit history: A long-established record of your ability to repay debts shows that you are a reliable borrower
Enquiry activity: Too many new applications or enquiries show that you are trying to take on more debt
Recent credit: If you have recently taken multiple new loans within a short period, you may be overextending yourself.

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Until now, I did not realise that enquiry activity was a factor that affected one's creditworthiness. Indeed, Ms Tan advised to “only enquire about credit when you need it”.

But Mr Erik Ligtenberg, the chief operating officer of Lendela, said that this is problematic as the interest rates for many personal loans shown on bank websites are usually generic ones.

Borrowers would have to apply directly to the bank in order to receive a customised interest rate based on their circumstances and credit rating.

“People end up getting ‘punished’ for shopping around and ‘punished’ for comparing different loans as these activities show up on the credit report,” said Mr Ligtenberg, whose company allows users to receive customised interest rates from various banks by submitting a single application on its website.

TIPS FOR FIRST-TIME BORROWERS
1. Be clear about the type of loan you need

“When choosing a loan, it is important that it is fit for purpose,” said Ms Tan.

For instance, if you simply need a short-term loan to facilitate payments until the next pay cheque, a credit card might be enough instead of taking a personal loan.

On the other hand, for someone who is pursuing further studies, a study loan may be better instead of borrowing through credit cards, which have higher interest rates.

2. Pay attention to the effective interest rate

Ms Tan said that financial organisations often display the “lowest” rate on their websites, which is usually the applied (flat) interest rate to attract borrowers.

But Ms Tan suggests looking at the effective interest rate (EIR) instead, which takes into consideration the effects of compounding interest, which would be “a better gauge that reflects the true cost of borrowing”.

For example, a bank may say that a loan is 2 per cent interest per year. But if the interest compounds monthly, you will end up having to pay a higher interest rate than the nominal interest rate of 2 per cent.

3. Take note of additional fees

Borrowers should also take note of other fee payments such as processing fees, late payment fees and early redemption fees. These are additional costs on top of the interest rate you would have to pay.

4. Have a clear plan on how to service the loan

“Robust financial planning is crucial before you apply for a loan,” urged Ms Tan.

“Know how much you can repay each month and how this could affect household expenses over the long term. This will enable you to avoid the debt trap from spiralling debts that snowball over time.”

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Ms Tan suggested using the "non-mortgage debt service ratio" as a guideline. This is a measure of your ability to pay off your debts, excluding housing debt.

It is calculated from dividing the total annual non-mortgage debt payment by total annual take home pay. A healthy ratio would be 15 per cent and below.

5. Set up alerts
This may sound like a given, but setting up calendar reminders to avoid being late on card payments can help avoid the sting from late payment fees. Opting for Giro payments, where a fixed amount of money is transferred every month from your bank account to a billing organisation, is another option.

“If you have more than one credit card, align the payment date on the same day for easy monitoring,” Ms Tan added.

CONSIDER WISELY
Despite all these tips, Ms Tan urged young people to first consider carefully if they need a loan "as it comes at a cost".

Indeed, many friends I spoke to said they would only take a loan as a last resort as they are afraid of the interest rates, and that borrowing seemed "dangerous".

A friend of mine added: "I think loans create more inequality because people who are more well-off with more assets can get a higher loan, while those who are less well-off struggle to find banks that are willing to lend them money."

I share the same sentiments, and foresee myself only taking a loan for an emergency or if there is no other choice.

But at least I am not as daunted by it now that I know what to look out for before committing to one.