BUTTERFIELD

Understanding the Basics of Credit

What is Credit?

Credit is a form of borrowing that allows a customer to obtain something on a promise to repay in the future. While there are a variety of credit types, the most common are Credit Cards, Mortgage loans (to finance the purchase of a property), Personal Loans, and Leases (car, for example). Regardless of type, all forms of credit come with a cost, i.e., interest, and fees (the amount the bank charges for the use of money).

What do banks consider when extending credit?

When applying for credit, five principal characteristics are typically evaluated to indicate to the bank your ability to repay a loan or extension of credit:

- **Character**: an applicant's overall trustworthiness, personality and credibility to determine whether the applicant is responsible and likely to make on-time payments on loans and other debts. This may include a borrower's work experience, references, prior lending history, credentials and overall reputation.

- **Capacity**: is the borrower's ability to repay a loan based on the applicant's available cash flow. When evaluating this element of credit, the bank will consider whether the borrower can cover new loan payments on top of their existing debt service.

  This is typically referred to as **Debt Service Ratio or Debt to Income** and compares how much you owe (bills, rent, insurance, etc.) each month to how much you earn (pay check, bonus, tips). As a rule of thumb, the lower your debt-to-income, the better as it indicates more available money to cover additional loans you may take out.

  > **For example:** If your total monthly debt is BMD $1,500 and your gross income (prior to taxes) is BMD $3,500, your DSR is ($1,500/$3,500)= 0.44 x 100 = 44%. In the case of mortgage loans, banks typically limit debt to 45% of total income.

- **Capital**: When applying for a mortgage or other loan, the bank will also evaluate the level of funds you contribute. For mortgages and auto loans, or other major purchases, the bank will look at the down payment size the borrower is committing to the purchase. This is typically evaluated based on a **Loan to Value (LTV)** calculation.

  > For qualified borrowers, the bank will generally fund up to a percentage of the property, generally 70% of the Appraised Value or purchase price (whichever is the lesser of the two). This is because a higher LTV (that is, the value of the home you want to buy and the loan you'll need to buy it, as a percentage), the more risk to the bank as a lender, should market prices decrease.

- **Conditions**: In addition to evaluating a borrower's personal finances, the bank will consider financial conditions, including the economy or other factors that may impact loan repayment and the terms of the loan. This typically includes the loan interest rate, amount of principal, and intended use of the loan proceeds.

- **Collateral**: This is an asset that a borrower pledges to secure the lender's (bank's) interest in making the loan. If the borrower defaults on the loan, the lender can repossess or otherwise seize the asset to recoup the unpaid amount. For example, when taking out a mortgage, the real estate serves as the collateral; with an auto loan, the collateral is the car.

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Basics of Borrowing Money

When you borrow money, the amount the bank is lending you is often referred to as **the principal** loan amount (or the amount you pay back) plus interest rate charges. **Interest rates** can be fixed or variable and are considered the amount charged by a lender to a borrower for the use of the money. The **term** is the time period in which you agree to pay back your loan (amortisation period). If you shorten the term of your loan, your monthly payments will likely be higher, but you may pay less in interest charges over time. On the flip side, if you take out a loan with a longer loan term, your monthly payments may be lower, but you'll incur more interest charges over the duration of the loan.

A **fixed interest rate** is set when the loan is taken out and remains the same throughout the payback period. Payment amounts are set in advance, so you'll know precisely how much your payments will be.

A **variable interest rate** can fluctuate monthly or quarterly based on the base interest rate. The base rate is an index or benchmark that reflects changes in the economy. If interest rates fall or rise, so will your rate (although not at the same time).

Simple Loan Tips

- *Don't spend more than you make*
- *Understand the terms and conditions of your loans*
- *Charge only what you can pay in full*
- *If you can't pay the credit balance in full each month, always make the minimum payments*

Interest rates and changes to them impact your payments and/or the ultimate amount due. The primary reason why interest rates may change is due to the base rates (the bank's benchmark rate) changing, the economic climate or the housing market. The details for how we may change interest rates can be found in the terms and conditions you will have reviewed and agreed to when applying for your loan. Interest rates will differ due to various factors, including the amount borrowed, deposit amount, and type of mortgage (variable, fixed).

Interest rates can affect your current and future finances – especially when it comes to borrowing, saving and investing money. That becomes even more apparent when **compound interest** is involved. Compound interest is the interest calculated both on the original balance and from previously accumulated interest. For loans, compound interest means the interest you pay to your lender builds upon itself, so repaying the loan takes more time. On the other hand, savings with a compounding interest account (such as Butterfield's Super Saver account) receive interest payments that will turn into higher payments with each successive compounding period.

When looking to borrow money, it is also important to understand the difference between secured and unsecured loans.

- **Secured loans**, such as auto loans, are backed by an asset. These loans typically offer lower interest rates, as the risk to the bank is lower.
- **Unsecured loans**, such as personal loans and credit cards, do not require collateral and may charge higher interest rates as they may be riskier for the bank.

Other factors to consider

- To avoid over-indebtedness (which limits your access to credit), it's essential to ensure funds are available to pay your bills. Planning goes a long way to help stay on top of debt. Try creating a list of all your outstanding credit and write down when payments are due and what the interest rate is for each. A good general rule is to repay the debt with the highest interest rate first and always try to determine where you can make more than the minimum monthly payment.
- Banks do not want to see their customers in financial difficulty and provide a number of resources and supportive measures to assist those who might need help in managing their money.
- Butterfield offers support to make banking easier for customers, including those who may be vulnerable or in distress.

- Our Mortgage Servicing Team will give the customer a call back during onboarding to confirm the additional support that we will provide, as necessary.
- Disclosure of vulnerabilities, if made, will not negatively affect an application but will help us ensure our customers get the best service both during the mortgage application process and after completion.

Disclaimer: The information provided is not intended to be, and does not constitute, financial advice or an investment recommendation. Butterfield accepts no liability for errors or actions taken on the basis of this information.