

Staying Connected

For the Alumni of the ECCB's Savings and Investments Course



FINANCIAL FITNESS

Loan Tips

Negotiate from a position of strength not weakness. *Be prepared and know exactly what your objectives are before you begin.*

So you got the loan, but do you understand what you just committed yourself to? *Understanding loan covenants before you sign on the dotted line can help you better comply or, better negotiate more suitable covenants. The bottom line concerning loan covenants is to research, negotiate and determine what best fits your specific overall current and future financial plans.*

Buyer Beware! *Never sign for a loan until you have read the entire document, and never under any circumstances sign a blank document or a document with empty lines that could be filled in later.*



Experience has often been said to be the best teacher. However no one ever said that the teacher had to be limited to one's personal experience.

This brings us therefore to the issue of the US mortgage crisis. What went wrong? and are there lessons to be learnt by OECS credit institutions, depositors, borrowers, investors and regulators?.

Traditional model of credit

In the business of credit, success for both borrower and lender depends on repayment. It is for this reason that banks as a matter of standard operations

consider several C's of credit as it relates to the borrower—*bis/ her character, collateral, capital, credit worthiness, capacity to repay, cash flow and commitment.*

Traditionally banks are in the business of minimising risk and generally shy away from borrowers deemed inherently risky due to their financial or other circumstances. In fact one mantra for lenders is **“if the cash can't flow the loan don't go”**

This emphasis on sound credit policies as a key component of a bank's risk management practices is key in securing depositors' funds.

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Don't Sign Your Financial Rights Away

Pay as much attention to loan covenants as you would to the rate of interest.

- How knowledgeable were you about your loan covenants before you signed on the dotted line?

- Did you go over every word of every clause with your lender before signing?

- Were you 100% clear on what you could or could not do and your obligations under the terms of the agreement ? or

-Did you, in ignorance, sign your financial rights away and in so doing impair your ability to steer your finances in the direction that best suited your needs?

As borrowers most of us focus on the interest rate and forget to be as astute with our loan covenants. Failing to do this however can be quite costly.

Take for example the following covenant:

“The Borrower may prepay any outstanding principal sum in excess of

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According to Wikipedia, "moral hazard" is the prospect that a party insulated from risk may behave differently from the way it would behave if were fully exposed to the risk.

What went wrong



What would happen if banks were able to transfer all or part of the risks involved in credit?

Here lies the issue of "moral hazard" and the resulting **misguided lending to ineligible borrowers**, a phenomena which precipitated the meltdown of the US housing market and the US financial crisis.

Problems arose in the US when banks became less risk averse and adopted loose credit policies (*conducting no or inadequate credit analysis of prospective borrowers and pushing 100% plus financing*) lending to borrowers who were unlikely to be able to repay the loans.

Banks adopted a more risky stance because they were able to:

1. Avail themselves of deposit insurance which in essence transferred the credit risk to the depositors. *To date deposit insurance is not a feature of the ECCU financial landscape.*
2. Transfer the credit risks to investors via the securitisation of the mortgage. *The mortgages were packaged as asset backed securities and sold to other financial institutions that in turn bundled and repackaged these sub-prime mortgages with a diversified portfolio of other mortgages. These were then*

sold to naïve investors around the globe who were unaware that their AAA rated collateralised mortgage obligations and collateralised debt obligations included bad loans.

When those risky home owners began to default on their loans the entire system began to unravel.



Lessons to be learnt

One of the lessons to be learnt by all is quite simple-**unmanageable credit is unmanageable** for all parties, regardless of how the credit is bundled, repacked and reassigned. At some point in time the infrastructure of this credit will unravel because of the lack of soundness of its financial foundation.

We all know that the ads of 100% financing and no money down go against the concept of prudent borrowing and prudent lending. To the lender, a down payment demonstrates that the borrower has not squandered past income. To the borrower, a down payment means less debt.

In this part of the world we are very familiar with the sayings "*don't hang your hat where you hand cannot reach*" or "*don't bite off more than you can chew*". So we should avoid this double edged sword of 100% financing and other similar offerings that go contrary to credit risk management best practices?

The second lesson to be learnt is **not to invest in instruments or institutions whose risks we do not understand**. Understanding what we are getting into and the

risks involved should be at the forefront of any financial decision that we make.

As investors we therefore have to take an active role in educating ourselves on the various risk-return profiles of each investment opportunity.

Rather than being blind-sighted by institutions promising double-digit returns, our investment decisions should be guided by careful planning and research. This means asking some key questions about the nature of each investment, the source of returns and the associated risks, the level of disclosure and corporate governance as well as the governing regulatory body.

We all should be wary of investing in institutions that do not publish financial statements and are not regulated. In short, if we do not understand fully what we are getting into we should not venture.

The third lesson is that **regulation should be proactive not reactive**. Obviously regulation has to provide market players with adequate room to allow for market innovation and development. However, this should not be at the expense of the investors and customers that regulation is supposed to protect.

The fourth lesson - **financial institutions are all interconnected— any prolonged failings in one area will eventually have a contagion effect on the entire system**. Hence the need for closer coordination among the various regulatory bodies.

It is for this reason that the Eastern Caribbean Central Bank which is responsible for the supervision and regulation of commercial banks is working with all other regulators and stakeholders to improve the regulatory and supervisory capacity of the entire financial system.

The goal is to provide a comprehensive regulatory and supervisory framework for the

financial system in the Eastern Caribbean Currency Union.

The US mortgage crisis affords us the opportunity to learn some much needed lessons. We do not have to learn the hard way. It is therefore up to us to take stock of what we are doing and make the right decisions to ensure our financial success.



October is Financial Literacy Month

Manage your Money...Live your Dreams

Don't Sign Your Financial Rights Away Cont'd



that required to pay the next scheduled installment (of principal and interest) due under the Loan Agreement, by paying to the lender an additional sum equal to twelve months interest on the amount so prepaid."

On first glance it appears that the borrower can make unrestricted additional payments to the loan principal and thus has the flexibility to reduce both the loan duration and interest payments.

However on further reading, it becomes clear that the lender imposes a penalty if the borrower were to pursue this

route. Essentially the lender by way of this covenant is saying if you want to prepay you can, **but it is going to cost you.**

Clearly this clause is overly restrictive and is one to which borrowers should never agree.

Almost every loan agreement made will carry some type of covenant, either restrictive or protective in nature.

- **A restrictive covenant** - imposes limitations on what the borrower can do.
- **Protective covenants** - identifies all actions that the borrower, must agree to.

The bottom line is to ensure that you only agree to covenants that best suit your current and future needs and goals.

So, if during the loan negotiation process your lender presents you with a covenant that causes you serious discomfort, do voice your objections and request an amendment or a relaxation of the restriction. Verbal assurances from your loan officer do not count.

Even after the specific provision is eliminated, peruse the entire amended document to ensure that a similar provision has not been include in another part of the loan agreement.

It is in the borrower's interest to ensure that the loan agreement reflects exactly the terms that the both the borrower and the lender have agreed to.

Do voice your discomfort with any covenant that is overly restrictive and request an amendment or a relaxation of the restriction.



Time equals Money

*Save yourself Time and Money
by making additional payments to your loan principal*

.A \$280,000 mortgage loan at 8.50% for 25 years gives you a monthly payment of \$2,254.64.

Loan amount	\$ 280,000.00	Scheduled payment	\$ 2,254.64
Annual interest rate	8.50 %	Scheduled number of payments	300
Loan period in years	25	Actual number of payments	300
Number of payments per year	12	Total early payments	\$ -
Start date of loan	8/30/2008	Total interest	\$ 396,390.75
Optional extra payments			

If you paid **\$200 extra each month** you will payoff your mortgage in 19 years and 6 months, **saving you 102,501.19 in mortgage interest.**

Loan amount	\$ 280,000.00	Scheduled payment	\$ 2,254.64
Annual interest rate	8.50 %	Scheduled number of payments	300
Loan period in years	25	Actual number of payments	234
Number of payments per	12	Total early payments	\$ 28,200.00
Start date of loan	8/30/2008	Total interest	\$ 293,889.56
Optional extra payments	\$ 200.00		

Even if you do not have the wherewith all to make regular additional monthly payments to the principal you will still save a considerable amount in interest payments if you made one or more additional payments. For example if you made two extra loan payments of \$2,254.64 - one on the 12th and the second on the 24th month of your loan schedule—and made no further additional payments you will payoff your mortgage in **23 years and 11 months**, saving you **\$27,030.38** in mortgage interest.

Loan amount	\$ 280,000.00	Scheduled payment	\$ 4,509.28
Annual interest rate	8.50 %	Scheduled number of payments	300
Loan period in years	25	Actual number of payments	287
Number of payments per	12	Total early payments	4,509.28 \$
Start date of loan	8/30/2008	Total interest	\$ 362,360.73
Two extra loan payments	\$ 2,254.64		

NOTE: The earlier you make those additional payments the more you save in interest. Borrowers who plan to make monthly or periodic additional payments to the principal of their loans should **AVOID** loan covenants that penalise the borrower for making unscheduled payments (prepayments).