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E-NEWSLETTER

WHAT INFLUENCES INTEREST RATES YOU PAY ON LOANS?

Few variations exist in how lenders determine your eligibility and what interest rates they charge on your personal loans. Lenders often adjust interest rates based on risk, but many borrowers do not realize the significant influence they have on this process.

For a start, it is important to read the terms and conditions of any loan offer as the same loan type may have different conditions depending on the offering institution. Qualification criteria may differ even for loans with standard or regulated interest rates.

Your credit history comes first

In this current period of risk-based pricing, the foremost thing a lender will do is request your credit report irrespective of the type of loan you have applied for. The report will indicate how many debt obligations you currently have and how consistent you have been with past debt repayments. Lenders are wary of over-indebted individuals with bad credit history regardless of their earning capacity. Should the loan be approved eventually, such high risk customers are charged high interest rates as a strategy of recovering a substantial amount of the loan, in the shortest time possible, before the customer defaults or goes bankrupt.

It is important to note that availability of credit scores makes interest rate determination easier for lenders. Most lenders simply compare the credit score of an applicant with their internally set standard rates. This internal classification sometimes incorporate socio-economic factors that add to the credit behaviour of individuals in a particular environment. This aspect of evaluation is called ***behavioural scoring***.

Your income and loan type

Your earning capacity greatly influences how much interest rate you get from lenders. Every lender wants to be assured that a loan applicant has enough income to cover repayments, even if the loan is secured (i.e. backed up by a collateral that can be taken over in the event of default). Logically, unsecured loans have higher interest rates than secured ones.

For an unsecured loan which makes income the sole means of repayment, lenders would want to ascertain if the applicant has a low debt-income ratio. Debt-income ratio is the amount of debt owed as compared to the total monthly income. A low ratio attracts a low interest rate and otherwise for high ratios.

Other factors

Amount to be borrowed is usually in inverse proportion to the interest rate charged when you compare many facilities. Larger loans come with lower interest rates than smaller ones. This makes sense since interest rate is a percentage of a borrowed amount; a small interest rate on a very large loan will yield high earnings and vice versa.

The **employment stability** of a borrower also contributes significantly to the tenure and interest rate of a loan offer. A borrower who is known for job hopping or contract jobs poses high credit risk, hence usually gets short term loans with high interest rates.

Overall, economic conditions such as liquidity requirements (Cash Reserve Ratio) and Monetary Policy Rate set by the CBN, inflation rate and foreign exchange rates influence the cost of borrowing at any particular point in time.