

# Secured loans - A guide

## WHAT IS A SECURED LOAN?

A **secured loan** is a loan in which the borrower pledges some asset such as a car or property as collateral for the loan, which then becomes a **secured debt** owed to the creditor or lender who gives the loan.

## WHAT IS COLLATERAL?

In a lending agreement, **collateral** is the borrower's pledge of specific property to the lender to secure repayment of the loan. The loan is then said to be **secured against the property**. The collateral serves to give the lender some insurance or protection or guarantee against the borrower's default. If the borrower should default on the loan i.e. fail to pay back to the lender the principal and interest as they fall due under the terms of the lending agreement, then the borrower forfeits or gives up the property pledged as collateral and the lender becomes the owner of the collateral.

The process of taking possession or control of the property is usually called repossession.

## WHAT IS A MORTGAGE?

The term mortgage is commonly used nowadays to describe a type of secured loan called a mortgage loan. A mortgage is a loan usually taken out with a bank or building society to buy property. The term of a mortgage is often quite long, perhaps twenty five years and the mortgage is usually to be repaid by monthly instalments with perhaps one large final instalment at the end of the term.

The borrower in signing the mortgage agreement agrees to give the property



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as security i.e. agrees that, in the event of failure to keep up with the repayments in the lending agreement, the lender has the right to take back and sell the property, albeit they will have to go to court first before they can do this. All mortgages are thus secured loans.

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## WHAT TYPES OF MORTGAGES ARE THERE?

There are **two main types** of mortgage: it is an informal and flexible arrangement to suit you.

- **Repayment** mortgage where the **repayments** go towards paying the **interest** on the money that was borrowed **and** towards repaying the **capital** i.e. repaying the money that was borrowed.
- **Interest only** mortgage where the **repayments** go towards paying the **interest only** on the money borrowed. At the end of the term of the mortgage, the capital is repaid in a lump sum with the required funds coming from the borrower's savings or an insurance policy taken out at the same time as the mortgage was taken out.

## WHAT DOES A MORTGAGE COST?

The cost of a mortgage depends on the interest rate charged by the lender. There are many types of interest rates such as **fixed interest rate** or **variable interest rate**. A borrower should consider carefully what type of interest rate suits them best and should obtain financial advice before taking out a mortgage.

## IS FINANCE PROVIDED UNDER A HIRE PURCHASE AGREEMENT A SECURED LOAN?

**Hire Purchase (HP) Agreements** entered into are usually based on secured loan agreements where the loan taken out for the purchase of a vehicle is secured on the vehicle itself. The HP agreement which the borrower signs clearly lays out the nature of the security and the rights of both the lender and the borrower in respect of termination of the agreement and repossession of the vehicle in the event of the borrower's default i.e. failure to make the repayments as and when they fall due. Not all so called 'car loans' however are HP Agreements and many such loans are simply unsecured loans.



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## WHAT IS THE DIFFERENCE BETWEEN A SECURED LOAN AND AN UNSECURED LOAN?

**Unsecured loans are not attached to any collateral.** The lender has no assets to go after if the borrower of an unsecured loan defaults on the repayments. The unsecured loan provider cannot sell the borrower's house, for example, like they could do if the loan was a mortgage or a loan secured on the borrower's property.

The principle effect of this difference is that the **lender is taking a greater risk** when making unsecured loans. The **size of the unsecured loan tends to be less** than what a borrower could obtain if the debt was secured on property. Lenders are generally unwilling to make unsecured loans of greater than perhaps £25,000 although this can vary somewhat from lender to lender. Furthermore lenders charge substantially **higher interest rates on unsecured loans** than they do when the loan is secured. **Unsecured loan terms also tend to be much shorter** than the terms agreed for mortgages or other secured loans.

From the borrower's point of view, **the advantage of an unsecured loan is that the borrower's property is not at risk** if they default on payments but the disadvantages of the **higher interest rates and shorter loan duration** make it less attractive. There is also the possibility that in the event of default the lender may through the court seek to secure the unsecured loan on the borrower's property. This process is sometimes called **registering a charge** on the property. Even if the lender of the unsecured loan does not seek to register such a charge on the borrower's property, they can still report defaults on unsecured loan repayments **to the credit reporting companies** thus **impairing the borrower's credit rating** and making it more difficult for the borrower to obtain further credit from other lenders and may make it difficult for the borrower to obtain a mortgage at standard or High Street interest rates and they may be forced to look for their mortgage from sub prime lenders at exorbitant interest rates and with penal terms and conditions attached.

## A HYPOTHETICAL CASE: THE PROBLEMS

The current recession is adversely affecting many people in the UK and Ireland, both small self employed business owners and PAYE employees. Many small businesses which were thriving in the good times are now struggling to survive. While the business may be viable in its own right, the **servicing of the owners' personal and business debt** which was incurred during the good times **can now be a millstone around the neck**. **Repayments** of mortgage, secured loans and unsecured debts can prove to be too great a burden for the business and its owners to sustain and **may threaten** their ability to continue **trading** or even to stay in business.

Take a hypothetical small business such as a corner shop run by a husband and wife team. They have a **mortgage** on their own home and the monthly repayments are significant. The property is in substantial **negative equity**. They also own the premises where their corner shop is located and are repaying a **secured loan** which they took out several years ago to upgrade and modernise their business. The secured loan term has another ten years to run. If they were forced to sell the business premises there would be a substantial shortfall to the secured loan provider and the likelihood is that they would be unable to secure an alternative business premises. Would the new owners of their business want to employ them? The husband and wife also have a certain level of **personal unsecured debts** not connected to the business mainly **comprising credit card debts and overdrafts**.

While the **turnover** of the corner shop business has taken a **sharp downturn** in the last few years and profit margins have shrunk due to local competition, it is still **trading reasonably well**. The couple have just about managed to keep their **suppliers payments up to date** within the normal range of thirty days credit terms apart from a few longstanding suppliers with whom they



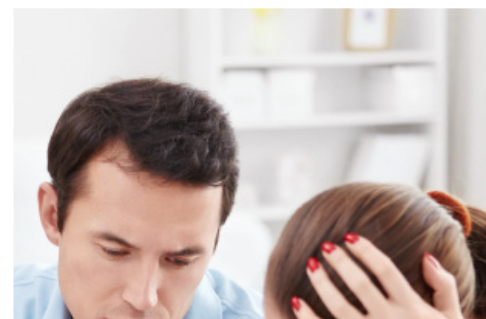
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enjoy up to ninety days credit based on their personal trusting business relationship. The business **tax returns and payments** are also **up to date** and there have been **no issues with HMRC** in relation to their tax affairs.

The couple have sacrificed a lot to **'keep the show on the road up to this point'**. They have been working extremely **long hours**, seven days a week. They have **reduced their own wages** several times and now find that they are barely able to live on what they pay themselves. They recognise that they need to employ at least one more person to cover some of the shifts they themselves are working and to enable them to take some time off every week. Should one of them become ill and be unable to work the business might not survive. They also realise that if they had some **working capital** they could increase their order levels and benefit from price break offers from their suppliers, thus **reducing their business costs**. They could also **increase their stock levels and their turnover** thus improving their **profitability**.

The couple recognise that the **repayments of their mortgage and their secured loan** are placing an **unsustainable burden** on their finances. If only they could reduce



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these payments on an ongoing basis then the additional money available to them would enable them to improve the business, reduce business costs, increase turnover and maximise profits. If they cannot reduce these repayments, they will be **forced to default** on them sooner rather than later. At this point they are struggling to keep up their payments on their unsecured personal debts and on some of their credit cards they are only managing to make minimum monthly payments. What are they to do? What options can they pursue?

## A HYPOTHETICAL CASE: THE CURRENT SITUATION

Let us call our couple **James and Elizabeth** and consider what they should do. It is clear that if they continue on as they are going that they will **begin to default** on their borrowings, both secured and unsecured loans. The burden of their debt repayments is threatening their business but their **case is not hopeless**. They have many good things going for them. First of all their **business is profitable**. They have a **good track record** over many years and have **survived five years of recession** which has badly affected the retail sector with many large retailers failing in that period. They have not defaulted - so far - on any of their personal or business debts. They are **up to date with their tax** returns and their payments. They enjoy **good relationships** with their suppliers and customers. They have **no rent** to pay as they own their own premises, albeit it is **vulnerable to repossession** if they should begin to default on their secured loan repayments. Their **credit ratings are unimpaired** and their **reputation is impeccable**. It is clear that if they can **restructure their finances** there is a good chance that their **business can survive** and indeed thrive.



## A HYPOTHETICAL CASE: SEEKING ADVICE AND ESTABLISHING THE FACTS

James and Elizabeth should **discuss their predicament** with a reputable adviser such as their **accountants** to help determine what their **options** may be. If they can manage to stay in business for a few more years they can look forward to the economy recovering with a resulting increase in sales and greater profits. The first thing an adviser will seek to do is to **establish the facts** relating to their finances. Most of the **key information** should be readily available:

- **Trading accounts** for the previous three years
- **Business projections** for the current year
- **Business plan** for the next three years
- **Cash flow** projections for the current year and the next year, if available
- Business **creditors**, amounts owing and when due
- Business **debtors**, amounts owing and due
- **Stock** records
- **Tax** records including VAT
- Household **income and expenditure** statement



- **Personal creditors**, amounts due and when due
- **Mortgage statement** for residential property
- **Valuation of residential property** (an internet valuation should suffice at this point)
- **Secured loan statement** for business premises
- **Valuation of business premises** (an internet valuation should suffice at this point)
- **Proof of earnings** for both James and Elizabeth

## A HYPOTHETICAL CASE: EVALUATING THE OPTIONS

It is clear that James and Elizabeth must do something to **reduce the monthly payments** on their mortgage and secured loans. They are **not personally insolvent** but unless they can **restructure their finances** they may be faced with personal insolvency in the next few years. Having established the facts of their situation their **next step** should be to consider how to deal with their mortgage provider and with their secured loan provider. These **options** will include:

- Checking out whether their mortgage deal is the best one available to them. It may be that by **switching** to an alternative **mortgage** provider James and Elizabeth may be able to secure **better terms**. For example they may be able to secure **lower interest rates** or **extend the term** of the loan by a number of years and as a result they may be able to **reduce their monthly payments** to a more manageable level. It may even be possible to do both: secure lower interest rates and extend the term of the mortgage with the resultant **'double whammy'** effect on monthly mortgage payments.
- The same process applies to their **secured loan**. Given their good credit history with no defaults it may be that an alternative loan provider may be able to offer **better borrowing terms** and be prepared to do so for an **extended loan term**.

Since switching from one loan provider to another may result in **certain charges** being incurred it is important to check the terms of the current mortgage and secured loan to see if this applies. For example there may be an **early redemption penalty** for settling your mortgage early or within the first few years of taking out the mortgage.

The same applies to the terms of the secured loan. It is also important to check if the new loan providers have special charges which you incur when switching your secured loans to them or indeed for early settlements of these new loans in due course.

- Once they have established what is available on the market from alternative lenders, James and Elizabeth should now consider **entering into negotiations** with their current mortgage and secured loan providers. Armed with the information listed above in the section 'Seeking Advice and Establishing the Facts' and knowing what is available in the market from alternative loan providers and having taken advice from a reputable financial adviser, they should arrange to **meet with their lenders**.

It is in their current secured lenders' interests that James and Elizabeth should continue in business and **not default** on their repayments. If they were to become insolvent then these lenders could be left with substantial losses.

Once the lenders **understand the personal circumstances** in which James and Elizabeth find themselves and given that they want to address their financial difficulties honestly and openly, then the **lenders are obliged to help** them identify and implement realistic and practical solutions so that they may be able to

**sustain their business.** While getting the agreement of secured creditors to **write off part of the debts** may be beyond the ability of even the best negotiators, the possibility remains that if that is what it takes to keep James and Elizabeth in business, there may be some circumstances where **secured creditors might consider that possibility.**

It appears that in the Republic of Ireland, some of the new insolvency solutions being implemented there do allow for even secured debt to be partially written off.

James and Elizabeth should also consider what reliefs they might be able to **negotiate with their unsecured lenders** by perhaps for example seeking to enter into an informal repayment plan with them with a view to reducing regular payments, freezing

interest and penalties, extending the term of their unsecured loans and even in some circumstances having part of their unsecured debts written off. Such a **debt management plan** could be self administered by James or Elizabeth or could be implemented with the help of some of the professional service providers who specialise in these matters.

### TAKING THE NEXT STEP

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A fee is only payable where further services are requested. All fees will be explained in detail and discussed prior to commencement of any service or debt repayment plan. Repaying debt over a longer period may increase the total amount to be repaid. Your ability to obtain credit will be affected in the short term and might be affected in the medium to long term. Creditors may still contact you with promotional material or to fulfil contractual obligations to you but they should deal with us in all aspects relating to the outstanding debts. Interest and Charges will only be frozen at the creditors' discretion.

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