

Chapter 22: Credit, Debt, and the Cost of Borrowing

Comic strip idea:

Credit allows people to use money or goods now and pay later. It can finance education, housing, equipment, business activity, or emergency needs. It can also create serious hardship when the cost is unclear, repayment exceeds income, or borrowing is used repeatedly to cover a continuing shortage. Financial literacy therefore requires understanding not only the advertised interest rate, but the total cost, repayment schedule, risks, and legal protections involved.

Borrowing is neither automatically good nor automatically bad. The relevant questions are why the money is needed, whether the loan improves future capacity or only postpones a problem, what alternatives exist, and whether repayment remains affordable under less favorable conditions.

A. Why Households and Enterprises Borrow

Borrowers use credit to manage timing differences between income and expenses. A farmer may need inputs before harvest. A worker may need transport or relocation expenses before the first salary. A household may finance a durable asset over several years. A microenterprise may borrow to purchase equipment or inventory.

Debt is more likely to support financial well-being when it finances a useful asset or activity, its cost is reasonable, and repayment fits expected cash flow. Debt is more dangerous when it covers recurring deficits, speculative activity, or purchases whose benefits disappear long before the loan is repaid.

Common Uses of Borrowing: Benefits and Risks		
A loan can be helpful, but its value depends on how it is used and whether it can be repaid.		
1 Possible use	2 Potential benefit	3 Main risk
 Education or skills	 May increase future earning capacity.	 Completion and employment are uncertain; repayments may begin before income rises.
 Business equipment	 May raise output or reduce costs.	 Demand may be weak and equipment may lose value.
 Housing	 Provides long-term use and possible asset ownership.	 Large commitment, interest-rate risk, and foreclosure risk.
 Emergency expense	 Provides immediate liquidity.	 Borrower may accept high cost under pressure.
 Routine consumption gap	 Maintains consumption temporarily.	 Repeated borrowing may create a debt cycle.
 Key idea: Borrowing is most useful when it supports long-term well-being or productive capacity and when repayment remains manageable.		

B. Basic Loan Terms

The principal is the amount borrowed. Interest is the price paid for using the lender's money. The maturity is the period until final repayment. The installment is the amount paid on each due date. Fees, insurance charges, penalties, and other costs may increase the total amount paid.

A loan should be compared using its effective interest rate and total repayment, not only the stated or flat rate. The BSP explains that the effective interest rate reflects the true cost of a loan because it considers the timing of payments and applicable charges. The Truth in Lending Act requires creditors to disclose finance charges and the effective cost of credit before a transaction is completed (BSP, 2012; "Republic Act No. 3765," 1963).

C. Simple Interest, Compound Interest, and Amortization

With simple interest, interest is calculated on the original principal. With compounding, interest may be calculated on both the principal and accumulated interest. In installment loans, each payment may include both interest and principal. Early payments often contain a larger interest component because the outstanding balance is still high.

A flat-rate quotation can appear lower because interest is calculated using the original principal even though the borrower gradually repays it. The effective rate corrects this by measuring the cost relative to the balance actually available and the timing of payments.

Question to ask	Why it matters
How much cash will I actually receive?	Processing fees or advance deductions may reduce the usable loan proceeds.
How much will I pay in total?	The monthly installment alone may hide a high total cost.
What is the effective interest rate?	It provides a more comparable measure of the true cost.
Are rates fixed or variable?	Variable rates can increase future installments.
What happens after a late payment?	Penalties, collection fees, and compounding may rapidly increase debt.
Can I repay early without penalty?	Prepayment rules affect the borrower's ability to reduce interest.

Case Study: The "Zero-Interest" Installment

A mobile phone is offered through a twelve-month "zero-interest" installment plan. The cash price is ₱18,000, but the installment price is ₱20,400 and a processing fee of ₱600 is charged. The monthly payment may appear affordable, but the borrower should compare the total ₱21,000 cost with the cash price and consider late-payment penalties. A product can have no separately stated interest while still carrying a financing cost.

Guide Questions

- What is the difference between the cash price and total installment cost?
- Why is the monthly payment an incomplete measure of affordability?
- What information should be disclosed before the buyer agrees?

D. Common Forms of Credit

Credit products differ in purpose, duration, collateral, cost, and regulation. Banks and cooperatives may offer salary, personal, housing, or enterprise loans. Credit cards provide a revolving credit line. Pawnshops provide loans secured by movable property. Microfinance institutions and lending

companies serve borrowers who may lack conventional collateral. Online lenders and buy-now-pay-later products can offer speed and convenience but require careful review of fees, data practices, and collection rules.

Informal credit may be accessible and flexible, especially where formal services are absent, but it can also be expensive or linked to unequal trading relationships. A farmer who borrows from a trader may be required to sell the harvest to the same trader at a weak bargaining position. Credit policy should therefore consider market power, not only interest rates.

E. Credit Cards and Revolving Debt

A credit card is a payment instrument and a revolving loan. Paying the full statement balance by the due date can avoid finance charges on eligible purchases, but paying only the minimum keeps the remaining balance subject to interest and fees. Repeated minimum payments can extend repayment for a long period.

The Philippine Credit Card Industry Regulation Law requires responsible issuance, disclosure, confidentiality, fair collection, and complaint handling. Credit-card issuers must assess applicants' capacity and cannot rely on unclear consent ("Republic Act No. 10870," 2016).

Cash advances usually carry different fees and may begin accruing interest immediately. Cardholders should also understand annual fees, foreign-currency charges, installment conversion, late fees, and the consequences of missing payments.

Case Study: The Minimum-Payment Trap

Ana has a ₱30,000 credit-card balance. The statement offers a low minimum payment, which reduces the amount due immediately but leaves most of the balance unpaid. She continues using the card for groceries because cash is limited. Interest and new purchases keep the balance from falling.

Ana's problem is not solved simply by telling her to stop spending. She needs to stop adding nonessential charges, identify the cause of the recurring cash shortage, compare restructuring options, and prepare a repayment amount that is realistic. If income is inadequate for essential needs, debt counseling and social support may be necessary alongside budgeting.

F. Evaluating Capacity to Repay

Capacity to repay depends on stable net income after essential expenses and existing obligations. Lenders may use debt-service ratios, but households should also perform their own stress test. A loan that is affordable in a good month may become difficult after overtime falls, prices rise, or a family member becomes ill.

Affordability test	Question
Normal-month test	Can the payment be made after essential expenses and existing debt?
Low-income-month test	Can the payment still be made if irregular income falls?
Interest-rate test	What happens if a variable rate increases?

Emergency test	Will any reserve remain for medicine, repairs, or job interruption?
Opportunity-cost test	Which savings, education, health, or business goals will be postponed?

Collateral reduces the lender's risk but increases the borrower's potential loss. A loan secured by land, a home, a vehicle, jewelry, or business equipment can lead to the loss of an essential asset if payments fail. A guarantor or co-maker may also become legally responsible.

G. Over-Indebtedness and Debt Cycles

Over-indebtedness occurs when a borrower cannot meet obligations without repeatedly borrowing, selling essential assets, or sacrificing basic needs. Warning signs include using one loan to pay another, missing utilities or rent to meet installments, receiving frequent collection demands, or depending on new credit for food and transport.

Debt problems often arise from a combination of behavior and circumstances. Poor disclosure, aggressive marketing, unstable income, medical expenses, disasters, job loss, and high-cost credit can interact. Effective policy therefore combines borrower education with responsible lending, fair collection, accurate credit information, social protection, and accessible dispute resolution.

Case Study: Three Loans for One Microenterprise

A small food seller needs ₱20,000 for equipment and working capital. An informal lender offers immediate cash with daily collection. A cooperative offers a lower effective rate but requires membership and records. An online lender promises approval in minutes but deducts fees before releasing the money and requests extensive phone permissions.

The borrower should compare usable proceeds, total repayment, payment frequency, effect on daily cash flow, data practices, penalties, and access to restructuring. The fastest loan may not be the most useful if daily collections remove the working capital needed to operate.

H. Credit Information, Data, and Privacy

Credit-information systems can reduce information gaps by recording repayment history. A good record may improve access to formal credit, while missed payments may limit future options. However, data should be accurate, relevant, secure, and open to correction. Borrowers should know which institution holds the information and how to dispute errors.

Digital lenders may request access to contacts, messages, location, or files. Permission should be limited to what is necessary for the service. The Financial Products and Services Consumer Protection Act and data-protection rules require responsible handling of consumer data. Consent obtained through confusing or coercive design should not be treated as meaningful consent.

I. Collection Practices and Consumer Protection

A borrower remains responsible for a valid debt, but lenders and collectors must use lawful and fair methods. Threats, public shaming, disclosure to unrelated contacts, deceptive messages, and harassment can cause serious harm. Borrowers should document communications, request written account information, use the provider's complaint system, and escalate unresolved issues to the appropriate regulator.

Consumers should receive clear disclosures before signing, including the amount financed, finance charges, effective interest rate, payment schedule, security, fees, and consequences of default. They should not sign blank documents or rely only on verbal assurances.

J. Debt Repayment and Restructuring

A repayment plan begins by listing each balance, effective rate, minimum payment, due date, security, and penalty. One strategy prioritizes the highest-cost debt because it reduces interest. Another pays the smallest balance first to create quick progress. The appropriate method depends on cost, motivation, legal consequences, and cash flow.

When payments are no longer feasible, early communication with the lender may allow restructuring, a longer maturity, a temporary reduction, or consolidation. A lower monthly payment is not automatically cheaper; extending the term may increase total interest. Any restructuring agreement should be written and understood.

K. Monetary Policy and Household Credit

BSP policy rates influence market interest rates, but the effect on individual loans varies. Existing fixed-rate loans may not change immediately. Variable-rate products can adjust according to contract terms. Banks also consider funding costs, credit risk, competition, collateral, and operating expenses. A policy-rate cut therefore does not guarantee that every borrower will receive cheaper credit.

Higher interest rates can reduce borrowing and spending, which may help control inflation, but they also raise financing costs for households and firms. Borrowers should understand whether a long-term obligation is exposed to future rate changes.

Let's Review

Credit can improve welfare when it finances useful activities and repayment fits realistic cash flow.

The effective interest rate, total repayment, fees, penalties, and timing of payments provide a better picture than the advertised rate or monthly installment alone.

Over-indebtedness can result from unstable income, emergencies, unfair products, and repeated borrowing as well as poor planning.

Responsible credit markets require informed borrowers, transparent products, careful lending, fair collection, data protection, and accessible remedies.

Key Idea: Borrowing shifts purchasing power from the future to the present. It is useful when the benefit justifies the full cost and repayment remains affordable even when conditions worsen.

References

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