Best ways to borrow

Use credit wisely and you could save hundreds of pounds – we show you how

Whether you're one of the millions who spent too much over the festive period or you're planning to make a big purchase in the January sales, now is a good time to take stock of your finances. To help you to get your bank balance back on track, we explain how best to borrow money and pay off debt, and give you tips on how to avoid paying over the odds.

For example, a £1,500 payment on a store card from B&Q with an interest rate of 26.8 per cent would cost £402 in interest over 12 months. But the same purchase on a Best Buy credit card from Egg, charging 7.9 per cent, would cost just £119 in interest – saving you £283. Better still, you could save the entire £402 and avoid paying any interest by using a 0 per cent credit card deal, or one of the 0 per cent credit deals offered by lots of stores.

By choosing the right way to pay, you could be better off by hundreds of pounds.

Interest-free credit

Some of the larger home furnishing and electrical stores commonly offer interest-free credit – which almost sounds too good to be true. However, thanks to tough advertising regulations that *Which?* helped to get introduced, companies can advertise '0 per cent' or 'interest-free' credit only if you end up paying no more than the original purchase price.

Other companies offer interest-free, buy-now, pay-later finance deals where you start to make payments after, say, 12 months. Of course, at the end of this 'pay-later' period you still have the debt to pay off. So keep an eye on your future spending to ensure you will have enough spare cash available when the time comes to pay back the money you owe.

Store cards

Some retailers offer a discount if you take out a store card when you buy something. Be warned – although you may think you're

CREDIT COSTS ARE PILING UP

We're borrowing more money than ever before – be careful your debts don't cause your finances to collapse

Source: Bank of England

INTEREST-FREE CREDIT WORKED FOR ME

Aine O'Callaghan *32, behavioural therapist*

When Aine wanted to buy a new sofa, she took advantage of a three-year, interest-free credit offer that was available from furniture store DFS.

Aine told us: 'The DFS offer is a great deal. It really does mean that I can repay the debt and pay no interest at all. I could have paid nothing for a year as well but decided to start paying it back straight away.'

Get extra protection

Why cash isn't always best

Even if you can afford to pay cash for an expensive purchase, it's worth using a credit card, finance or store credit for goods or services between £100 and £30,000 because of the extra protection it gives you. Under Section 75 of the Consumer Credit Act 1974, if something goes wrong with your purchase you can claim your money back from either the card or loan company, or the company you bought the goods or service from.

If you can, pay off the debt on the loan as soon as possible to avoid paying interest.

saving money, store cards are usually best avoided, as interest rates are often higher than a typical credit card. This means you're likely to find that any initial savings you make from the discount will be wiped out once you've taken into consideration the interest you pay.

For instance, if you wanted to get a 10 per cent discount on, say, a sofa that costs £1,000, you could use a Creation card (a store card accepted at a range of retailers). This will reduce the purchase price to £900, making you think that you are saving £100. But with an interest rate of 30.9 per cent (or 27.8 per cent if you pay by direct debit) over a year you would end up paying £1,038 for your sofa – £138 more than the purchase price. Using a Halifax Flat Rate Online card with a 5.9 per cent interest rate would mean missing out on your10 per cent discount, but the final cost would be £1,031 – £7 less than with the Creation card.

Only take out a store card to get a discount if you can repay all the money when you get your first statement, as this means you avoid paying any interest. If you can't do this, avoid taking out store cards altogether. The Competition Commission is so concerned about high-interest store cards that it has made companies charging interest rates of more than 25 per cent display a warning on statements that cheaper credit is available elsewhere.

SWITCHING FOR BETTER DEALS

Roger Scammell *senior service engineer*

Each year, UK shoppers spend billions of pounds at Christmas and in the January sales. If you're one of the many who has overspent over the festive period and have a debt to clear, you could do worse than follow the example of Roger Scammell from Wallingford. He has successfully used 0 per cent transfers on credit cards to avoid interest over the last few years.

'You have to be organised and watch out for the sneaky ways companies make money, like transfer fees and insurance,' Roger told us. 'I'm also running out of cards to switch to and may just pay them all off.'

Be warned – although you may think you're saving money, store cards are usually best avoided

Credit cards

The cheapest credit cards, such as Barclaycard Simplicity, Egg Money MasterCard and Halifax Flat Rate Online, all have interest rates of less than 10 per cent – see 'Money Monitor', p40, for more details.

Several other cards don't charge interest on new purchases for a set period of time; this is usually five or six months, but some, including GE Money Transformation and &more, allow you up to 12 months. If you haven't paid the money back at the end of the introductory period, you will be charged at a higher rate, typically 15 to 25 per cent.

You can get around this by switching to another card that has a lower rate of interest. If, like Roger Scammell (see above) you want to switch to a card offering a 0 per cent balance transfer without a fee, be aware that fewer companies now do this – only Ulster Bank, and Norwich & Peterborough (see p40). If you do switch to one of these deals, you could lose your 0 per cent interest rate if you miss a payment, so always check that you have set up a direct debit.

Personal loans

Taking out a personal loan is a good idea only if you need to borrow at least £5,000, to make a big purchase or pay off a costly overdraft or credit card debt, say. Consolidating debt can be risky if you transfer balances from credit or store cards to a loan and then carry on borrowing on the cards.

The benefit of an unsecured loan is that the best interest rates are low (typically from 6 to 8 per cent) and the amount you pay back each month stays the same. The downside is that rates are high for smaller amounts. A loan of £1,000 will usually cost you 14.9 to 19.9 per cent in interest.

When comparing loans, you should look at the total cost of the loan including interest. For instance, a £5,000 loan over three years at a rate of 6 per cent would cost £463 in interest, while a loan at 7 per cent would cost you £77 more in total over the three years.

The cheapest personal loans, from the likes of Masterloan (5.7 per cent), Abbey (5.8 per cent), Moneyback Bank (5.8 per cent) and Northern Rock (5.9 per cent), all have rates under 6 per cent. However, all of these companies use risk-based pricing to decide what interest rate you'll pay. This means that the rate you actually get could be much higher than advertised as it is based on your credit score.

ALTERNATIVES TO BANKS

ZOPA

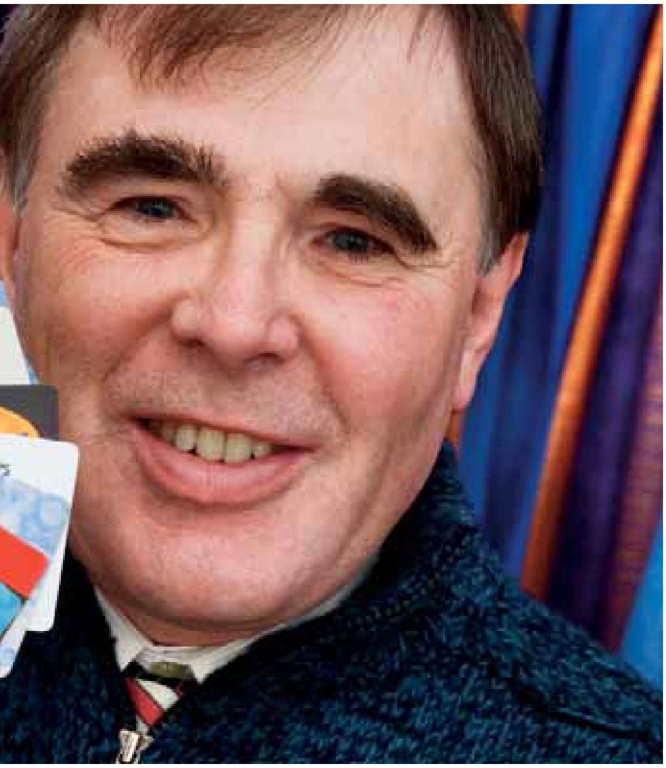
Zopa is an online service that lets you borrow and lend money without going to a bank. Money invested is lent to at least 50 borrowers to lessen the impact of someone not paying it back. Borrowers and lenders pay Zopa a 0.5 per cent fee for each loan.

Interest rates for borrowers depend on credit scores. For people with the best credit scores, interest rates range from 5 to 10 per cent with typical rates of 7 per cent. If you lend money, the return you get depends on the credit score of the people you lend to. The average return is 6.75 per cent after taking into account bad debt of 0.05 per cent. Zopa is a novel idea and might be worth a look if you want to borrow or lend money without involving a bank.

CREDIT UNIONS

Credit unions let people in a local area or workplace save and lend money. Credit union loan rates can be a maximum of 26.8 per cent, but most charge no more than 12.7 per cent – lower than many credit cards and store cards.

Before you can borrow, you may need to save money with the credit union. Savings earn dividends instead of interest – equivalent to about 2 or 3 per cent and up to a maximum of 8 per cent per year. If a credit union goes bust, you can get most of your money back from the Financial Services Compensation Scheme – up to a maximum of £31,700.



Under the advertising regulations, if companies advertise typical interest rates at least two thirds of people accepted have to get the advertised rate or lower. But companies can get around the regulations by not advertising their interest rates at all – Halifax and HSBC do this some of the time. This is known as 'personal pricing' and it is a worrying trend, as it makes it difficult for people who like to shop around for the best deal.

As well as watching out for interest rates, you should also check whether there will be a penalty if you pay back the loan early – this is usually one or two months' interest. The best loan without early repayment penalties, and with an interest rate that isn't based on your credit score, is from Goldfish with a rate of 7.9 per cent.

Companies can get round regulations by not advertising their interest rates

Expensive insurance

Companies aggressively sell payment protection insurance (PPI) to people who take out a personal loan or credit card. When we visited the websites of the nine cheapest loan companies, we found that five companies – Direct Line, Eskimo Loans, Lombard Direct, Moneyback Bank (Alliance & Leicester) and Northern Rock – automatically included PPI in their quotes.

While not illegal, we don't think PPI should be automatically added to quotes. It's unnecessary for people with other insurance in place, can be difficult to claim on and is expensive. For example, PPI on a £5,000 loan over three years from Norwich & Peterborough adds £1,351.

The websites of Abbey, Alliance & Leicester, Smile and the AA all gave the option of a quote with and without PPI.

Paying back debt

If you spent too much over Christmas, now is a good time to sort out your finances. Start by cutting up any store cards you used, as interest rates tend to be higher than with even the most expensive credit cards.

Still owe money on the store card? Then either pay it off or transfer the debt to a credit card to take advantage of a 0 per cent deal. Most 0 per cent cards now charge fees on balance transfers, so choose one of our Best Buys that doesn't charge a fee.

You could also borrow money from your bank on your overdraft. The best accounts, including Alliance & Leicester and Nationwide (see p40), have rates of less than 10 per cent. Make sure you arrange your overdraft in advance – unauthorised borrowing rates can be as high as 30 per cent and you'll incur extra charges for bounced cheques or failed payments.

If your debts are spiralling out of control, you must talk to your bank. For free advice, contact National Debtline or the Consumer Credit Counselling Service.

Contacts

Association of British Credit Unions
0161 832 3694; www.abcul.org
Competition Commission
020 7271 0243
www.competition-commission.org.uk
Consumer Credit Counselling Service
0800 138 1111; www.cccs.co.uk
Consumer Direct
0845 404 0506
www.consumerdirect.gov.uk
National Debtline 0808 808 4000
www.nationaldebtline.co.uk
Zopa www.zopa.com

Checklist

Paying for next Christmas

- **Avoid store cards** Store card rates can be as high as 30 per cent. If you're tempted by a 10 per cent discount when you take out a store card, pay in full when you get the first statement to avoid interest charges.
- **Save now** Start saving for next Christmas. Put your money into a savings account or Isa.
- **Christmas clubs** Christmas clubs are best avoided, since you don't get interest on your savings and aren't protected if the company goes bust, as Farepak customers discovered last year – see 'Money Monitor', *Which?*, December 2006, p38.

Making a big purchase

- **Interest-free credit** Don't be scared of interest-free credit for expensive items such as furniture or kitchens, but check there really is no interest to pay.
- **Credit cards** A credit card that charges 0 per cent on new purchases can be a good bet. Make sure you pay the money back before you're hit by much higher standard interest rates.
- **Transfer debt** You can transfer debt from one credit card to another. There are still a few cards available that don't charge the typical 2 or 3 per cent for each transfer – see 'Money Monitor', p40.
- **Personal loans** Personal loans have some of the lowest interest rates but are best used when you want to borrow a large sum of money, as rates are higher for smaller amounts.
- **Say no to PPI** Watch out for payment protection insurance on credit cards and personal loans. It is unnecessary and expensive and gives limited cover – and is best avoided.
- **Protect your home** Your home is at risk if you secure a loan against it. Use your home as security only as a last resort.

All rates are correct at the time of going to press