Lending with a Purpose

7 Steps to Loaning Money to Family and Friends

DCU[SM] Friends & Family Lending
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Family and Friend Loans – Risks and Rewards

For as long as there's been money, family members and friends have been lending it to each other. Many of us borrowed from a parent for our first car or home. Some have borrowed to get through a financial challenge. Some have borrowed from relatives and friends to help their small business get started or get bigger. These are known as private loans and it can feel good to help.

When it goes well…

For these loans to work well, a few things need to happen…

- The lender needs to have the willingness and financial capacity to make the loan.
- The borrower and the lender need to completely agree up front on fair terms.
- The borrower needs to willingly pay back everything they owe on or ahead of time without reminders.
- The borrower and the lender protect each other's privacy and personal information.

When it goes well, the lender would willingly do it again and the borrower remains grateful.

When it goes bad…

Things can and do go bad on these loans, such as...

- The borrower pays late or not at all.
- The borrower does not keep the lender informed if there will be a problem.
- The lender made the loan without being able to afford it.
- One of the parties is careless with personal information or shares loan information without permission.

Such instances can result in hard feelings, strained family relationships, and damaged friendships.

A matter of trust

Lending money to someone carries risks…

- the loss of all or some of the money you've lent,
- your relationship with that person, and
- your relationship with people close to that person.

Be honest with the borrower. If you cannot afford to make the loan or losing the money would significantly alter your lifestyle, tell them so. Creating a financial hardship for yourself will not serve either of your interests.

But if you can spare the resources, lending money to your children, a sibling, a parent, a niece, or nephew may be worth considering if you know that person to be trustworthy and responsible. You may even consider loaning to a friend or two if you feel the same way about them.

Good rule of thumb – if you would not cosign a loan application with that individual, it's probably not a good idea to loan them money.

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Being a borrower carries risks, too. If you have any doubt about being able to pay the loan back on time, don't do it at all. It's not worth risking your relationship with a relative or friend and it's not work risking your credit rating if you borrow at a credit union or bank.

Doing it right

If you decide to enter a private loan relationship with relatives or friends, this guide is designed to help you do it in a way that is open, respectful, and legal. We encourage you to read this entire guide before you make or request a loan with a friend or family member.

Underwriting Your Loan – The Five Cs of Credit

The five Cs of credit is a method used by lenders to determine the creditworthiness of potential borrowers. The system weighs five characteristics of the borrower and helps gauge the chance of default. Default means a violation by the borrower of any term of the loan agreement – typically late or missing payments. The five Cs of credit are:

- **Credit history** – This is a record of how credit obligations have been handled in the past. Character can fill in if credit history and credit score are not available
- **Capacity** – The ability to repay a loan (Is the income and or the collateral sufficient to repay the loan?)
- **Capital** – Savings, investments, and other assets other than income that could be used to help repay the loan
- **Collateral** – An asset pledged as security for the loan in case of default (car, boat, property, stock etc.)
- **Conditions** – What are the current economic conditions and terms offered by the borrower

All five Cs are important and not all are simple to assess.

- **Credit History** – Used as evidence of character (one of the original five Cs). It shows how borrowers have handled credit obligations. This can be expressed as a credit score. Most traditional lenders use the FICO® Score computed by Fair Isaac. With private loans, you probably won't have access to credit reports and credit scores. You'll need to rely on your own assessment of the borrower's character. That's easier if you already know them well.
- **Capacity** – A measure of someone's ability to pay. Ask to see a recent pay stub and copies of recent monthly bills. They help you determine if the borrower is employed and has sufficient net pay to cover your loan and all other obligations. We have provided you two worksheets that will help you with assessing a borrower's capacity to pay: see *Debt-to-Income Ratio Sample* form and *Worksheet*, Appendix 2 and 3, respectively. There is also a discussion of Debt-to-Income in this workbook, see page 6.
- **Capital** – Ask for copies of recent credit union, bank, and investment statements to prove what capital is available.
- **Collateral** – Many private loans are not secured by anything other than someone's personal commitment to repay – also known as unsecured or signature loans. If you are helping someone buy real property (a home or land), a car, or other tangible property

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with high value, you may want to consider securing your loan with the property being purchased by filing a security interest. Additionally, the borrower can agree to give the lender a security interest in assets unrelated to the loan. We recommend you talk to an attorney if you want to set up a legally binding security interest in collateral.

- **Conditions** – Lenders want to know what the borrower will do with the loan. They will also want to consider the local economic conditions that may impact the borrower's ability to repay. For example, knowing that your borrower is employed by a large company that is growing, might be useful information.

It is also critically important that borrower and lender protect the privacy of all financial information shared between them.

The ABCs of Borrowing

Do you have a passion you want to fulfill by borrowing money? Borrowing money from friends, family, a family business, or trust is a real and serious commitment and must be managed responsibly. Borrowing for the right reason can increase your chances of getting a loan.

Why would I borrow from family or friends?

There are many good reasons to borrow from family and friends. The following are a few examples:

- Buying a home
- Buying or repairing a car
- Getting a college or technical education
- Lowering your monthly payments (debt-to-income)
- Loan to a family business
- Medical procedures
- Supplement an existing bank loan
- Home improvements
- Consolidating credit card, personal, or education loans

If I have a good reason to borrow, what do I need to know?

Be prepared to answer some basic personal and financial questions about your loan request. Be honest and straightforward with your answers.

- How will I use the money?
- How will I pay back the loan?
- What are my personal income and expenses?
- If I am borrowing for my business, what are my business income and expenses and do I have a written business plan?
- Am I offering collateral as security for the loan?
- How will this loan help me achieve my personal or business goal?

Now that you have a little more information, are you willing and prepared to take the next steps?

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Why do I need the loan? How much money do I need?

Approach borrowing from a family member or friend the same way you would approach a credit union or bank. Start a loan application. Writing the answers to the following questions will get you started in the right direction:

- What is the purpose of this loan?
- How much money do I need to borrow?
- How many months do I want to make payments?
- Where is the loan repayment coming from?
- If I am late making payments, what is a fair late fee?
- Can I offer any collateral?
- How often am I going to make a payment?
- What interest rate am I willing to pay?
- What monthly payment can I afford to pay?

How much can I afford to borrow?

Debt-to-Income ratio

This ratio is a common way to understand if someone can afford the payment on the new loan. You add all your current monthly payments to the new loan payment then divide the total by your monthly net income (your net pay or "take home" pay). Total payments should include all loan payments, credit cards, car loans, other loans, housing expenses, mortgage payments, property taxes, interest, insurance, and condo or neighborhood association fees.

Here is the formula to calculate Debt-to-Income:

X = total monthly payments
Y = new monthly loan payments
Z = total monthly income
(X + Y) / Z = Debt-to-Income

Debt-to-Income Ratio Example:

Monthly Expenses	Current Payment	Proposed Payments
Credit Card Payments	$300	Paid off
Education Loan	$500	Paid off
Rent	$800	$800
New Consolidated Loan	n/a	$350
Total Expenses	$1,600	$1,150
Net Income after taxes	$3,500	$3,500
Debt-to-Income (Payment Expenses/Net Income)	**45.7%**	**32.9%**

See Appendix B for a more complete debt-to-income sample and Appendix C for a blank Debt-to-Income worksheet.

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How do I use my debt-to-income ratio?

Lenders have different requirements, but a debt to income ratio of 35% or less is preferred. Once you calculate your debt-to income ratio, you can use it as evidence to justify your loan request and your ability to repay the loan.

One of the benefits of a private loan is a family or friend lender might be more willing to advance money with a higher debt-to-income ratio than a bank. Knowing your debt-to-income ratio demonstrates that you understand how to borrow and will likely help your lender make their decision to make you a loan.

Can I reduce my debt-to-income ratio?

Yes. Here are some ways you can reduce the amount of your monthly obligations:

- Refinance existing loans at a longer term or lower interest rate so payments are smaller
- Consider paying off debt by making extra principal payments and postponing any major purchase
- Don't add new debt – purchase by cash or debit card
- Consider using layaway programs
- Reduce expenses through conservation – turn off lights, turn down your heat, save water
- Choose less expensive cable TV or mobile phone plans

No matter what you plan to borrow for, understanding how debt and income work together will help you make great borrowing decisions your entire life!

Private loans can help with financial goals

Private family loans can help with making financial gifts and transferring assets between family members. Consult with your Certified Public Accountant, estate planner, or tax attorney to learn how this can work and how these arrangements can be made.

Okay, we both said yes! Now what's next?

Now that we have made the decision to move forward with a loan, what do we do next?

Step 1: Fairness and transparency are your guide

When you are borrowing from friends and family members, treat your lender better than a bank. Make certain the loan agreement fair to the borrower and lender. Give them a reason to be thrilled with the decision to help out. Here are some ways you might do just that.

If you are the borrower, provide your financial information to your lender and periodically update them on your personal and financial progress. News of a raise at work, or a promotion, or that you are paying the loan off early is the kind of news lenders want to hear. Even if you are making the payments as agreed, the family member or friend who made the loan will appreciate staying well informed.

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Step 2: Should we use a legal agreement or handshake?

A legally binding agreement can be written or oral. If you are lending money, we highly recommend a written and signed note that clearly describes the loan's terms. Even written agreements are subject to interpretation, so before making or receiving a loan, get it in writing. This is another good time to get advice and help from an attorney.

Step 3: Loan Agreements

Some loans use loan agreements to describe certain terms and conditions that supplement the note. Complex business loans often have terms and conditions that define a loan default, valuation of collateral, and audit requirements. For most family and friend loans, this is probably overkill. However, if this loan is part of buying real property, business assets, or an estate planning process, then a comprehensive written loan agreement makes sense.

Step 4: Promissory Note

A note is a formal promise to pay based on the terms in the note. The borrower and lender need to agree to some basic items to document a loan with a note. They need to know the following to continue the conversation:

1. Legal names of the borrower and lender
2. The start date of the loan (the day the lender provides the money to the borrower)
3. The amount of the loan
4. Description of the collateral if any
5. How many payments need to be made to pay off the loan?
6. What is the interest rate, if any?
7. What is the interest rate if the loan is in default?
8. Is the lender going to gift funds annually to help pay off the loan?
9. The date the loan becomes due (some notes are on demand)
10. The payment terms: bi-weekly, monthly, quarterly, annually
11. Is the loan fully or partially amortized?
12. Are there late penalties or fees?
13. What happens if the borrowers' payment check is returned (bounces)?
14. Who pays the costs of collecting the loan if the loan is in default?
15. How will a default be handled?

The above list is not all-encompassing and is meant only as a guide.

Step 5: Loan Payment Types

Loan payments can be calculated in a variety of ways, here are some examples:

- **Fully amortized loan** – A loan with a fixed monthly payment for the life of the loan. The payment amount is the approximate amount necessary to pay the loan in full on the last payment.

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- **Interest only loan** – A loan that only the interest is due each month and at the end of the loan term the entire principal plus any outstanding interest is due in one large payment.
- **Partially amortized loan** – A loan in which the monthly payment is not high enough to pay the loan off in full at the end of the loan term, and at the end of the loan term there is some principal due plus any outstanding interest.
- **Principal and interest due at loan maturity** – The loan principal and all the accumulated interest are paid in full at the end of the loan term. This is a type of loan sometimes used for projects, construction, and farming.

You can find sample note documents and loan payment calculators on the ZimpleMoney.com website. The note documents and the calculators are free to use and will help borrowers and lenders reach an agreement that can be documented and signed.

Before entering into any contract, have a competent attorney review and document your agreement. You can also consider using websites such as RocketLawyer.com or LawDepot.com to document your agreements.

Step 6: Interest Rates

All 50 states have rules defining how much interest a private lender can legally charge. These rates change periodically. Consider searching the Internet for the most current rates allowed for the states where the parties reside. You might also try reviewing the following sites:

- www.usurylaw.com/usury-rates
- www.lectlaw.com/files/ban02.htm
- www.usurylaw.com

Each month, the IRS provides various prescribed rates for federal income tax purposes. These rates, known as Applicable Federal Rates (or AFRs), are regularly published as revenue rulings. The website URL is as follows:

- http://www.irs.gov/app/picklist/list/federalRates.html

The AFR rules establish a minimum rate of interest on a loan. If a loan has an interest rate that is too low, then the IRS may consider the difference between the AFR and the rate being charged income to the borrower/payer. The IRS rules can be complicated when making a loan, so please check with an attorney and CPA familiar with interest rates.

Step 7: Sharing the Risk

Sharing the risk and minimizing concentrated investments is a fundamental principal of lending and investing. If you are considering a loan to friends or family members, you might ask the borrower who else might be able to participate in the loan. If there is consistent encouragement from family or a peer group, there will be a higher likelihood of the loan being paid off.

Managing your loan and portfolio

Software companies like ZimpleMoney.com provide lenders and borrowers software tools that help you manage financial agreements online.

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ZimpleMoney provides a loan workspace for borrowers and lenders to manage their private, interfamily or business financial agreements. It is like having bank software and financial tools for your private and personal use.

Conclusion

Making a loan to a family member or friend can be a viable investment option for people with the capital and willingness to help others.

As a family and friend lender, you have an opportunity for a quadruple benefit:

1. Your loan directly benefits a family member or friend or the business they own,
2. If you choose to charge interest, you have the opportunity to earn an interest rate that can be better than you can get on your savings,
3. Depending on the rate you both agree to, the borrower could receive financing at a lower interest rate than they would otherwise pay, plus
4. The good feeling of knowing you're helping someone important to you.

Any lending activity must be done following the rules of the state in which you live. Find local legal counsel to provide you advice when making a loan.

Use software from companies like www.ZimpleMoney.com that provide tools to manage family and friend loans and other financial agreements.

Be a responsible lender and more importantly a responsible borrower.

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Options for Managing Your Friends and Family Loan

As a member of DCU, you have several options to repay friends and family loans. In choosing, consider the details and complexity of your loan arrangement. Free ways to move money (the loan payments) require the borrower and lender(s) to track everything manually. DCU Friends & Family Lending, Powered by ZimpleMoney, has modest fees, and its software automates the loan and payment accounting, freeing you from the time and hassles associated with making and tracking loans.

DCU People Pay

This is a free DCU service that allows you to move money to anyone that has an email address. You can access it through Account Manager within the DCU Mobile Banking app or Online Banking. Currently you can send $500 per transaction and up to $1,500 per day. You will need to handle your own loan recordkeeping.

Member-to-Member Transfers

This free service allows you to move money to another member's account (one on which you are not a joint owner). These can be set up within the DCU Mobile Banking app. You will need to handle your own loan recordkeeping.

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This site is specially designed to help the lender and borrower manage a larger, more complex loan. We think it's the best choice if one or more of these conditions are true:

- The loan amount is $5,000 or more (though you can do smaller ones)
- There is more than one lender on the loan
- You want interest calculated for you
- You want the borrower's payments to be sent electronically and disbursed to the lenders' accounts
- You want or need detailed records of the loan along the way

This service can calculate interest to match virtually any type of loan you want to set up. Both the borrower and lenders can pull reports on the loan at their convenience. There are modest fees to manage the loan and process payments. Most of them are automatically discounted if the borrower or lender is a DCU member. You don't typically see these fees in a credit union or bank loan because the interest you pay covers those costs. Typically, the lender and borrower agree up front which party pays the fees. Fees can be paid by the borrower or lender. Some lenders include the costs as part of the interest charges. Others keep the interest lower and pass the fees through to the borrower.

ZimpleMoney powers this service for DCU. There are support tools on the site and ZimpleMoney typically answers email support questions within one business day.

Borrowing from DCU is an option, too

If the risks of borrowing from family or friends make you nervous, consider applying for a conventional loan from DCU. Applying is easy and a loan from DCU will put your payment record of repayments on your official credit history.

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Appendix A – Borrowing/Lending Questionnaire

Starting the conversation – questions you need to answer for the lender:

1. What is the purpose of the loan?
2. How will you use the money?
3. How you can pay back the loan?
4. What are my personal income and expenses?
5. If I am borrowing for my business, what are my business income and expenses?
6. Am I offering any collateral for the loan?
7. How will this loan help me achieve my personal or business goal?
8. Where is the money coming from to repay the loan?

Note the loan terms you agree to:

1. The start date of the loan (the day the lender provides the money to the borrower)
2. The amount of the loan
3. What is the collateral, if any?
4. How many payments need to be made to pay off the loan?
5. What is the interest rate?
6. What is the interest rate if the loan is in default?
7. How are late payments handled? Is there a late fee and how much is it?
8. Is the lender going to gift funds annually to help pay off the loan?
9. The legal names of the borrower and lender(s)
10. The date the loan becomes due (some notes are due on demand)
11. The payment terms: (bi-weekly, monthly, quarterly, annually)
12. Is the loan fully or partially amortized?
13. Are there late penalties?
14. What happens if the borrower's check is returned (check bounces)?
15. Who pays the costs of collecting the loan if the loan is in default?
16. What rights do the lender and borrower have if the loan is in default?
17. Are there processes the borrower or lender must follow if the borrower is in default?

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Appendix B – Debt-to-Income Ratio – Sample Form

Monthly Income (List net income for all borrowers)	
Borrower: Monthly net pay	$3,500
Co-Borrower: Monthly net pay	n/a
Other Household Income	$100
Rental Income	$300
Alimony	n/a
Social Security	$600
Other Income	n/a
Total Monthly Net Income	**$4,500**

Monthly Expenses (List minimum monthly payment)		
	Current	**Proposed**
1st Mortgage	$1,000	$1,000
2nd Mortgage (Home Equity Loan)	n/a	n/a
Real estate taxes and home owners' insurance	$100	$100
Auto Loan	$250	$250
Other installment loans	n/a	n/a
Credit cars	$250	Paid
Student loans	$350	Paid
New Loan	n/a	$250
Total Debt Payments	**$2,250**	**$1,600**

Debt-to-Income Ratio		
	Current	**Proposed**
Total Debt Payments (divided by)	$2,350	$1,600
Total Income	$4,500	$4,500
Debt-to-Income Ratio	**42.2%**	**35.5%**

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Appendix C – Debt-to-Income Ratio Worksheet

Monthly Income (List net income for all borrowers)	
Borrower: Monthly net pay	
Co-Borrower: Monthly net pay	
Other Household Income	
Rental Income	
Alimony	
Social Security	
Other Income	
Total Monthly Net Income	

Monthly Expenses (List minimum monthly payment)		
	Current	**Proposed**
1st Mortgage		
2nd Mortgage (Home Equity Loan)		
Real estate taxes and home owners' insurance		
Auto Loan		
Other installment loans		
Credit cars		
Student loans		
New Loan		
Total Debt Payments		

Debt-to-Income Ratio		
	Current	**Proposed**
Total Debt Payments (divided by)		
Total Income		
Debt-to-Income Ratio		

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