Investopedia.com

Personal Loans: To Lend Or Not To Lend?

by Andrew Beattie (Contact Author | Biography)

Lending and borrowing money from a bank follows procedural guidelines that have evolved over centuries. Personal lending, that is making or taking loans with friends and family, has been going on for just as long, but firm guidelines haven't developed because each circumstance is unique. There is, however, a way to make family loans safer and more secure for all parties involved.

Reasons Against Personal Loans

There are strong reasons against giving a personal loan to family or friends. The biggest has to do with your own personal finances. Most people aren't really liquid enough to lose that money, and by assuming that all the money loaned will be lost, you'll quickly realize what size of loan you can reasonably make. If you're dipping into a retirement account, emergency fund or other necessary fund to make the loan, it's not a loan you should be making.

Family strife, tax problems and complacency - especially complacency - are some of the other things to worry about. If your family or friends come to you for loans simply because you lend at a low (or no) rate, you are hurting your own finances to subsidize theirs. (For more on discovering your own financial worth, see time value of money.)

A loan from a bank or credit union will help them build a good credit score, as well as financial responsibility. On the other side of the coin, when interest rates begin eating away at a borrower's paychecks, the bad habit of living outside of their budget may be broken.

The Difference Between a Loan and a Gift

The reasons against personal loans often evaporate in the face of emotional considerations, when one of your loved ones "needs the money." In this case, you have to make a clear distinction between a gift and a loan. A gift has no expectation of repayment; a loan should be paid back in full, including any interest, and must be written down. Giving a gift is a personal choice based mostly on emotion; making a loan has to be done in a logical manner. (For further reading, check out *8 Ways To Help Family Members In Financial Trouble*.)

Before Saying Yes

Before you give them the keys to the safety deposit box, however, you're entitled to ask some questions:

What is the money for? Regardless of whether the loan is large or small, you have a right to know how it will be used. If the reason doesn't sit well with you (a vacation, rather than a mortgage payment), point your prospective debtor to the nearest bank.

How long will it take to pay back? If the loan is a bridge loan to the next paycheck, you may feel comfortable with a zero-interest, no terms handshake. If the loan is of a significant size or will take more than a month to pay off, get it in writing. Memories of the original agreement usually fade over time, so you will need documentation.

What's the prospective debtor's current financial situation? Although this is often overlooked, you have a responsibility to yourself and the other party to make sure that he or she is in a decent financial situation *before* loaning money. It can be uncomfortable, but remember that the borrower came to you for money - not the other way around.

Think like a bank and, if their situation is too far gone, say no.

This doesn't mean you shouldn't help. Maybe you can offer to help pay for a financial planner rather than give a loan. One of the major flash points in personal loans is that the lenders realize too late that they've poured cash into a leaky boat. This leads to meddling after the fact. Since you no longer have bargaining power when the deal is done, nothing can be gained but resentment. (Learn more about finding a trustworthy financial planner in *Advice For Finding The Best Advisor*.)

Coming to Terms
Verbal contracts hardly ever end well. Problems crop up even with small, short-term loans. For example, if the payment comes two months late and you had to put all your groceries on the credit card, then you actually lost money because of the loan - money you'll never get back, because there were no terms. Writing up contracts for even the smallest loans will discourage people from constantly coming to you. Both parties should work together on the terms before signing. The following are some necessary aspects of any solid loan.

Interest Rate
The Internal Revenue Service (IRS) can be nasty when it comes to no-interest personal loans, especially large ones. Charging near the market interest rate will replace the interest you're losing by pulling that money out of a savings account or money market fund for the duration of the loan.

Repayment Schedule
This should outline the size and date of each payment. It should also state what happens in the case of a missed payment. You may choose not to have any penalties for late payments, but that can result in the loan payments taking the lowest priority in the monthly budget - and possibly being bumped in favor of less-than-necessary expenses like a night out on the town.

Conditions
Clear conditions need to be written up in the case of the death of either the lender or debtor. With family members, this is especially important because of the dispersion of the estate. If one child has received a $10,000 loan, and the estate pays $30,000 to each child regardless, then you've just turned your wake into a family feud. You may want to add additional conditions according to the situation. For example, if you're lending to help someone buy a home, you can secure the loan to the property. (Before signing any loan agreement, read *How To Read Loan And Credit Card Agreements*.)

Make it Official

After getting the loan in writing, it's worth running it through a professional. Your lawyer or accountant will probably have some good advice on conditions and may act as a third party for the signing. Small loans, especially those less than $300, may not be worth the cost of notarizing the contract, but large loans should be part of the legal record.

Conclusion

Personal loans can be a nightmare, if either of the parties fail to approach it seriously. If you don't feel up to going through all of aforementioned steps, but still want to make the loan, there is an alternative. Third-party companies have sprouted up to act as intermediaries in personal lending. For a fee, they will handle the contracts and set up automatic payment withdrawals. Some even report to credit agencies, thus helping the debtor build up a good score (providing more incentive to avoid a missed payment). This adds a fee burden to the debtor's loan, but it is better than going forward with a poorly thought-out arrangement.

If all goes well, you will be able to close out the loan, having helped a loved one, without harming yourself. In the worst-case scenario, you've only loaned money you were prepared to lose and, if you choose, you have a legal document to back up a claim. (For more information on other types of loans that may be available, take a look at *Different Needs, Different Loans*.)

by Andrew Beattie, (Contact Author | Biography)

Andrew Beattie is a freelance writer and self-educated investor. He worked for Investopedia as an editor and staff writer before moving to Japan in 2003. Andrew still lives in Japan with his wife, Rie. Since leaving Investopedia, he has continued to study and write about the financial world's tics and charms. Although his interests have been necessarily broad while learning and writing at the same time, perennial favorites include economic history, index funds, Warren Buffett and personal finance. He may also be the only financial writer who can claim to have read "The Encyclopedia of Business and Finance" cover to cover.

**** This article and more are available at Investopedia.com - Your Source for Investing Education ****