ICICI BANK CUSTOMER FIRST SERIES

A consumer education initiative

TIMES BUSINESS ASSOCIATE COMMUNICATION

EMI is all I care about

The best home loan option is the one that fits our ability to pay, month after month.

The world is divided into two classes of people – those who like math and those who don't. The latter are in a majority. Several give up calculations in sheer exasperation. There is hope even for the numerically challenged. We could simplify and deal with the choices purely from our point of view. We can look at the EMI and our ability to pay and make our choice of home loan, from this perspective. The products in the home loan market then need to be evaluated for what they translate into, as EMIs over the entire period of the home loan.

FIXED FOR LIFE

Let's not fool ourselves about our ability to predict interest rates into the future. The fixed vs floating debate is about what kind of EMI we like. The EMI of a fixed rate loan is known in advance. This is the cash outflow we need to plan for. As our incomes and inflation move up over the years, a fixed EMI is attractively stagnant and is easier to plan for. If we have a fixed EMI, any reduction in interest rates in the market, will not benefit us. What we did not have in the first place, we could not be losing. So let's stop fretting about falling rates soon after we signed our fixed rate loan. We agree to close our eyes to market swings and focus on the fixed EMI and that is that.

FLOATING ALONG

The EMI of a floating rate loan changes with changes in market interest rates. If market rates increase, our dues increase. When rates fall, our dues also fall. Floating rate is a deceptive attraction. When the rates fall they look like a bargain, and when rates go up they look unfair. In a loan cycle of 15 to 20 years, there is merit in choosing the market rate. Provided we can take the swings in rates from time to time. If they were available then, someone who took a floating rate loan in 1996 at 17%, would be gleeful at the rate having halved. In a floating rate loan, we chose market-adjusted rates and a changing EMI or tenor, or both. If our income also enjoys a market-linked change over time, we will be able to manage the changing EMI.

EMI SPLIT

There are various combinations in which EMIs come. Some home loans feature both fixed and floating rates.

One part of the loan is set on a fixed rate basis and another is set on a floating rate basis. There are loans where the EMI is fixed for an initial period, after which it floats. These are for borrowers who want to have the best of both. In the last five years, so much has been the swing in rates that people have begun to like such combos. A regularly changing EMI is what they settle for. These borrowers like to manage a changing EMI, in return for the satisfaction of not locking into fixed or floating. Their incomes should have the same flexibility as their home loan, else they could be in for surprises every now and then.

I AM NEEDIN' IT

There are loans where the EMI for an initial period is low and then it increases as the ability to pay also increases over time. These are for young borrowers, who like to keep the initial commitment low and can enhance their payment as their incomes grow. An EMI is a large proportion of the salary when one takes a loan, but becomes a smaller proportion as they move up the career ladder. There are choices that feature higher EMIs for an initial period and lower EMI for the remaining period. These are for older borrowers, wanting to pay more earlier and at the peak of their income cycle. They do not like a large EMI closer to their retirement.

EMI is a cash outflow to the borrower. Wisdom is in keeping it in line with the ability to pay, and attitude to risk. If we are able to take a call on how our income and spending is likely to pan out, we will be able to decide how the EMI will fit in that scheme. The option with the best fit, whatever be its name, is what could work.

EMI is income to the lenders. They can figure the math to toggle it over the period of the loan and offer choices. For those that insist on the math, we shall do it here, next week.

Centre for Investment Education and Learning

Kindly send us your suggestions and comments by visiting the "Email Us" link at www.icicibank.com

DID YOU KNOW?

Most banks arrive at your EMI based on a standard multiplier, which works out to not more than 50%-60% of your assessed monthly income.

FAQs

Why does the number of EMIs change in a floating rate loan?

In a floating rate loan, the amount due from the borrower changes when interest rates change. To simplify the repayment process and continue the repayment instructions the borrowers may have given their bank, the amount of EMI is not changed. The number of EMIs increases when interest rates go up, and reduce when interest rates fall.

Why can we not predict the future interest rates?

Interest rate is a macro-economic number. It depends on inflation, money supply and such macro factors. These change over time and cannot be predicted accurately. Interest rates, which depend on these factors, therefore cannot be predicted.

Why is the home loan repaid as an EMI?

A home loan is a large amount and is usually several multiples of a borrower's annual income. Therefore it cannot be paid like a conventional loan, where interest is paid first, and principal is returned at the end of the period. The repayment is staggered over time, and is made up of both interest and principal, therefore is easier to pay.