Credit 101

Can You Believe?

With a partner, fill in the following:

_____ % of students with a credit card don't repay the entire balance each month.

_____ % of teenagers say they have never discussed using credit cards responsibly with a family member.

_____ % of teenagers say they are pretty familiar with credit cards.

_____ % of teenagers have access to a parent's credit card.

_____ % of teenagers aged 18-19 already have a credit card in their own name.



Credit Benefits

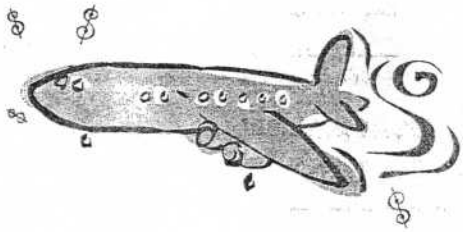
Now that you know some of the costs, you may be wondering if using credit is worthwhile. As with many financial tools, it depends on your situation. Credit does have potential benefits, if you use it responsibly. And that's the key. Here are some examples of responsible credit use.

Access to cash in an emergency. When you need money to pay for something in an emergency, like a tow truck if your car breaks down, having credit can get you back on the road quickly.

The ability to use it now. Credit allows you to own or benefit from the use of large purchases now, such as a car or a house. Without credit, most families would probably not be able to buy a home or even a new car.

Safety and convenience. If you can charge a purchase on a credit card, you can avoid carrying large amounts of cash. When you're traveling, major expenses like hotel rooms, airfare and car rentals can all be put on credit cards. Also, many purchases can be made over the phone from catalogs or on the Internet with a credit card.

Earn bonus points or miles. Credit card issuers frequently advertise that cardholders can earn bonus miles or points on purchases or receive cash back periodically. Although this feature seems like an attractive benefit, it usually isn't free. Cardholders typically pay for credit card bonuses through a higher interest rate or fee. Smart consumers weigh the value of bonus miles against the higher cost of using a particular card.



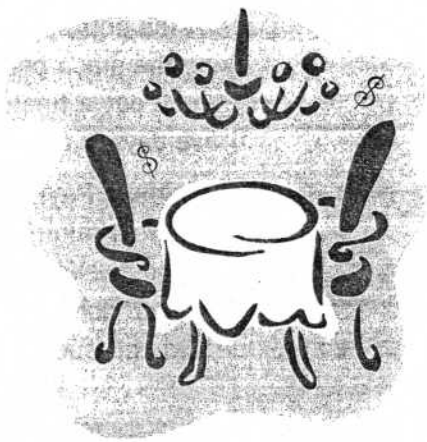
Sources of Credit



Where do you get credit? Lots of places. Banks and credit unions offer credit cards, car loans, personal loans, and home loans. Auto dealers often provide financing for cars, and many department stores offer their own credit cards. Colleges, financial institutions, and the federal government offer student loans for education. Let's look more closely at the specifics of some of these forms of credit.

Credit Cards

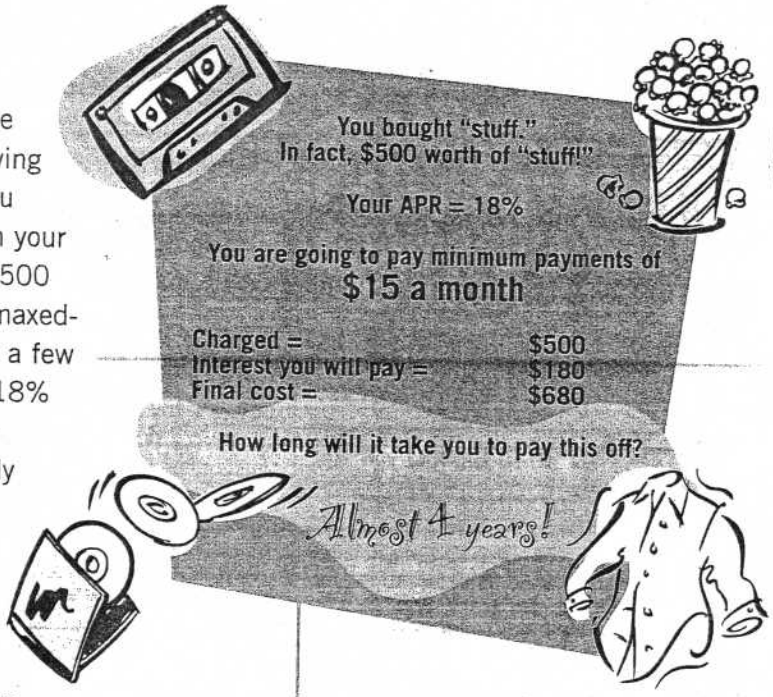
A credit card is synonymous with "buy now, pay later." Credit card companies have made it easy and convenient to use their cards for purchases and to get cash when you want it. Gas stations, restaurants, movie theatres—everywhere you turn you see signs saying credit cards are accepted. Unfortunately, ease of use often translates into big bills down the road.



Unlike many forms of credit, there is no loan term with credit cards. That means you can pay the balance owed over a varied and extended time, and that's where many people get into trouble. Of course, the longer you take to pay the balance owed on your credit card, the more it costs you in finance charges.

How can you use credit cards to your advantage? It helps to know some basic terms:

- **Annual Percentage Rate (APR).** We've already learned something about APR, but credit cards can carry APRs that run as high as 20%. At that rate, you know what damage compounding can do to your wallet, so compare all costs on credit cards and look for the lowest rates, especially if you do not expect to pay your balance in full each month.
- **Annual Fee.** Some cards charge an annual fee, and some don't. To save money, look for cards with no annual fees.
- **Grace Period.** Most cards offer a grace period, which is the number of days during which no interest or finance charges will apply. The key is to pay off the entire balance of your card during the grace period. If you don't, you'll pay a finance charge. Twenty-five days is a typical grace period.
- **Minimum Payment.** Many cards require a minimum monthly payment of about 2% of your credit card purchases. Some set a minimum dollar payment, such as $15 per month. While making small payments like these may seem easy, remember that the remainder of your balance due is now compounding at the card's APR. The best strategy is to pay your balance in full each month; that way you avoid interest charges altogether.
- **Credit Limit.** All cards come with a limit establishing how much you can charge. This maximum is called the credit limit. Once you've reached your limit—say $500—your card is "maxed out." At that point, you can't make any new purchases until you pay down the balance owed. Higher limits may sound good, but you need discipline to avoid running up big loan amounts. If you're tempted to overspend, remember that big purchases quickly compound into big interest payments with high APRs. You're the one who will pay for it.

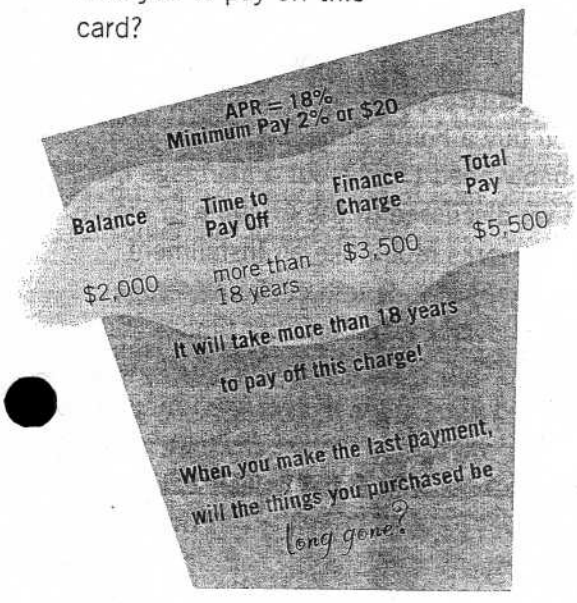




How Long Can It Take? Imagine you've graduated. You're living on your own, and you have a credit card in your own name. With a $500 credit limit, you've maxed-out your card in just a few days. At an APR of 18% and an "easy" minimum payment of only $15 a month, how long will it take you to pay off your card?

Almost four years! Plus you'll have paid about $180 in finance charges. And this assumes you don't make any new purchases on the card for almost four years. Is that so bad? It depends on your plan. Would you have been wiser to have waited and saved the money for the purchases and saved that $180 in interest?

Now let's look at the same scenario, but with different dollar amounts. Assume you have a $2,000 credit limit, and it's maxed out. But you don't plan to make any more purchases until the card is paid off. This card requires a minimum payment of 2% of the balance, or $20, whichever is greater. How long will it take you to pay off this card?



It will take more than 18 years! Total finance charge? Over $3,500. You'll spend about $5,500 over 18 years so you can enjoy $2,000 worth of purchases today. That's the price of choosing instant satisfaction over delayed gratification. Many times you are going to be better off saving your money and paying cash instead of borrowing.

Installment Loans

If you need a loan for a large purchase, such as a car or an appliance, you can take out an installment loan. Installment loans require you to make payments on a regular basis, usually monthly, until the loan is paid off. Banks and credit unions offer installment loans for many purposes, while car dealers offer them only for auto purchases.

"Paper or Plastic?
Consumers with a credit card spend up to 33% more than if they shopped with cash instead."

Interest rates on installment loans are generally lower than credit card rates. Credit cards let you vary how much you borrow and pay back from month to month. With installment loans, however, you typically meet with a loan officer and borrow a set amount. After that, the loan amount, loan term, and your payments are fixed for the life of the loan.

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Assignment 5.2

The Impact of Different Loan Factors

Using a financial function calculator or a loan calculator from the Internet, complete the chart for the following loans. Notice that loan length and monthly payments are the two variables.

Loan balance	Interest rate	Monthly payment	Loan length	Finance charge
a. $5,000	10%		4 years	
b. $5,000	10%		6 years	
c. $5,000	12%		6 years	
d. $5,000	12%	$200		
e. $1,000	8%		2 years	
f. $1,000	19%	$20		
g. $1,000	12%		5 years	

Consumer loan terms typically run from two to six years.

For example, consider an auto loan. Assume you borrow $10,000 at 9% interest for 48 months. Your payment will be about $249 per month. At the end of four years, you will have paid the lender about $11,950. Thus, borrowing increased the cost of the car about 20%.

If you can, it's usually best to pay off a loan early. But with any type of loan, it's a good idea to check for prepayment penalties. These are penalties for paying off your loan early. Lenders sometimes charge prepayment penalties because they will be losing the interest you would have paid over the remainder of your loan.

Student Loans

If you're heading off to college, you may need some help paying for it. If so, you might be interested in a student loan. In addition to banks and credit unions, the federal government also makes loan dollars available to pay for higher education.

Student loans, especially those offered by the government, usually carry low interest rates—in the 4% to 8% range. Depending on your income level, some of the borrowing programs allow you to delay making payments until you finish your education. Another way the government encourages you to further your education is by giving you a tax break for education costs when you file your taxes.

Mortgages

If you buy a home some day, you'll probably need to take out a mortgage loan like we discussed in the example in Figure 5.2. It works much like an installment loan, except the length of the mortgage extends over a long period of time—usually 15 to 30 years—and the amount borrowed is usually much larger. Interest rates on mortgages are usually lower than installment loans, and, like education loans, you get a tax break on interest paid to a lender.

Setting Limits on Credit

With so much credit floating around, it's wise to set some reasonable and responsible limits. Here are some rules of thumb to help you. You'll want to adjust them to fit the goals and values reflected in your financial plan.

- **How much is too much?** A maximum of 20% of your net income—your take-home pay after taxes—should go toward all of your loan payments (excluding a mortgage). That means your credit card payments, car loan, and any other loans you have should add up to less than 20% of your pay. To be safe, keep it to 15% or less.

  For instance, assume your take home pay is $1,000 per month from a full-time job. No more than $200 a month should be going toward your car payment, credit card payments, etc. That's not much, and it's another reason to seriously consider your career plan, since it will have a direct effect on your income.

- **What about home loans?** Most lenders don't want to see more than 33% of your take-home pay going for a mortgage payment. Assuming you take home $1,000 a month, the most you could spend on a mortgage would be about $333.

Comparing Credit Offers

You can use a chart similar to the one in Assignment 5.1, "Shopping for the Best Credit Card," for any type of loan or credit. Remember to check for:

- **the APR**
- **the loan term, or length of the loan**
- **the maximum amount of the loan**
- **the minimum payment amount**
- **any annual or up-front fees**
- **any prepayment penalties**
- **additional fees, such as those for exceeding your credit limit, making a late payment, or bouncing a check to the lender, and**
- **the amount of income you need to qualify for the credit.**



Credit Reports

Having a high school diploma or college degree is the first step towards ensuring a successful career. Similarly, your credit report can be your first step in guaranteeing future loans when you need them. Your credit report will be with you for a long time, so make it shine!

Your Credit Record

A **credit report** is simply your credit history, a record of your personal (or family) financial transactions. When you apply for a loan, lenders review it to see how well you have managed credit in the past. Your credit report contains information about loans you've applied for, loan amounts you received, and whether you paid your bills on time or not at all. In short, it's your credit scorecard, and it reflects your credit history for the past seven to 10 years.

Every potential lender will thoroughly examine your credit report, and many employers check it when making hiring decisions. When you apply for a car loan or a credit card, the first place the lender looks is your credit report.

How do you build a good **credit history?** When you use a checking account, don't bounce checks. When you open a savings account, make additional deposits—regardless of the size—on a reg-

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ular basis. Lenders like to see consistent patterns in saving. Always pay your bills on time; it shows lenders you are responsible.

When you're still in school, it's often tough to get credit on your own. One way to get started is to ask a parent or trusted adult to co-sign with you, perhaps for a credit card. Having a co-signer is a financial responsibility: if you don't pay your bill, your co-signer is on the hook—legally and financially.

"Credit Reporting Agencies.
Three major companies collect information to create credit reports. Equifax, Experian (formerly TRW), and Trans Union. You can order a written copy of your credit report for around $10. You can also access your report on the Internet for a similar fee."

Once you have established credit, make your payments on time. If you handle a little credit responsibly, lenders are more willing to extend larger amounts in the future. There are other things you can do to qualify for more credit, which are discussed in the next section.

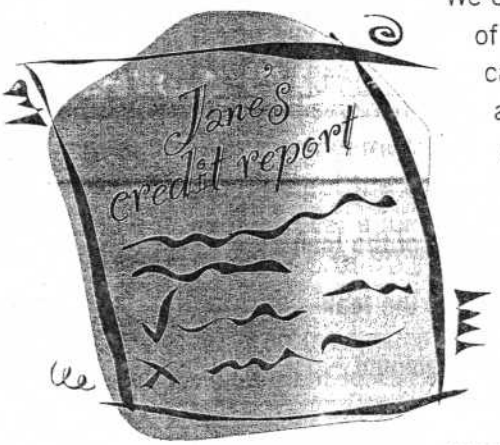
Credit Scoring

Many lenders use a mathematical model to produce a credit score for you. The score helps lenders predict the likelihood that you will pay your bills as promised. Your score will change over time as your financial situation changes. The factors that go into the score vary from lender to lender, but the following are generally included:

- **Capacity.** Lenders want to know if you have the ability to repay a loan, so they look at your income and employment history. A pattern of rising income and/or steady employment gives a lender more confidence. On the flip side, if you already have high loan amounts, lenders may worry that you won't be able to make your payments.
- **Character.** In essence, lenders want to know if you are trustworthy. One way they measure your character is by looking at your credit record. Paying bills on time shows personal financial responsibility. If you have used credit in the past, they want to see that you made your payments on time.
- **Capital.** Lenders take comfort in knowing you have personal items of value. In a worst-case scenario when you don't pay your bills at all, a lender might sell your personal possessions to repay the loan. Typical items of value include a car, an investment account, and, in some states, your home.

Debt

When you decide to use credit, the amounts you borrow add up to become your debt. **Debt** is the entire amount of money you owe to lenders. We discussed the upside of debt earlier—you can enjoy an item or a service now. The downside of debt is that it puts a claim on your future income, and if you take on too much debt, it can derail your financial plan—and your future.



Top Ten Questions to Ask Yourself Before You Sign on the Dotted Line.

1. **Do I really need this item right now or can I wait?**
2. **Can I qualify for credit?**
3. **What is the interest rate (APR)?**
4. **Are there additional fees?**
5. **How much is the monthly payment and when is it due?**
6. **Can I afford to pay the monthly payments?**
7. **What will happen if I don't make the payments on time?**
8. **What will be the extra cost of using credit?**
9. **What will I have to give up to pay for it? (Opportunity cost)**
10. **All things considered, is using credit worth it?**

Rights and Responsibilities

When you sign the application for a loan or a credit card, you are legally obligated to uphold what's written in the agreement. That means you're agreeing to repay a loan and interest on time. These are your personal financial responsibilities. If you fail to keep your part of the bargain, lenders may take legal action against you to recover what they can.

As a consumer, you also have rights that lenders must respect. For instance, by law lenders must put in writing the total cost of using their credit. They must also be truthful in their advertisements.

With certain types of credit, you are legally allowed to cancel a credit agreement with a lender within three days—assuming you return the money borrowed. With credit cards, your responsibility to pay is limited to $50 if someone uses your card without your permission, for example, if it is stolen.



How to Get Out from Under Excessive Debt

Getting out from under excessive debt is a lot harder than getting into debt, but the rules are simple. In fact, there's only one: spend less than you earn! Applying it, however, is not always easy because you have to delay gratification today to clean up yesterday's mess.

This is one place where your budget comes in handy. If you consistently spend less than you earn, you can use the additional money to pay off your debt.

If you have several loans, try to make the minimum required payments on all of them. If you can't, always try to send at least some money to all of your lenders. Talk with them, and let them know you are doing what you can to pay them back.

If there's money left after you've made your minimum payments, use it to begin paying off one loan at a time. Start with the loan with the highest interest rate—not the loan with the largest balance. You want to pay down the high-interest-rate loans first, because you know how compounding can work against you!

When that loan is paid off, apply the money to the loan with the next-highest interest rate. Keep the process going until your overall debt is back under control. So remember, if you find yourself drowning in debt—focus on your budget, spend less than you earn, and begin to pay off your consumer loans.

If you find yourself unable to manage your debt problems, it could be helpful for you to seek the services of a nonprofit credit counselor to help you in creating a debt recovery plan—and sticking to it.

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Assignment 5.3

A Plan to Get Out of Debt

Using the credit information below, prioritize the order of the debts to be paid.

a. a car loan with a balance of $6,000, monthly payments of $250, and an interest rate of 8.9%

b. a bank credit card with a balance of $800, minimum monthly payments of $20, and an interest rate of 19.5%

c. a student loan with a balance of $30,000, monthly payments of $175, and an interest rate of 6%

d. a store credit card with a balance of $2,300, minimum monthly payments of $70, and an interest rate of 15.9%

e. a credit union credit card with a balance of $3,500, minimum monthly payments of $110, and an interest rate of 12%

Bankruptcy

Sometimes debt can overwhelm responsible people. Illness, divorce, business losses, and other events beyond their control can bring borrowers to the point at which they can no longer make loan payments. They fall further and further behind as compounding interest on their debt grows. As a last resort, they have to consider bankruptcy.



Bankruptcy is a legal process that allows someone deeply in debt to create a plan to get out of it. Unfortunately, in 2000, about 1.2 million Americans filed for bankruptcy. Many of these bankruptcies were the result of unforeseen and unavoidable misfortune. For these people bankruptcy provides a "clean slate" and a chance to rebuild their lives. But for many others, bankruptcies were the actions of irresponsible borrowers who simply decided to default on their obligations. Because of the growing incidence of bankruptcy abuse, Congress is considering changes in the law.

- **Chapter 7 bankruptcy** allows you to effectively erase most of your debt. To qualify, you typically must be unemployed or have a very low income. In addition, you must go through financial counseling as part of the process.
- **Chapter 13 bankruptcy** allows you to pay back some of your debts, but with more time. A court typically oversees the repayment plan to ensure accountability.

Bankruptcy is very costly to everyone involved, including:

- Lenders, who must absorb loan losses they can't recover by raising rates on other loans and services;
- Responsible borrowers, who must pay higher rates to help lenders recover losses on bad loans;
- People who've declared bankruptcy, whose actions remain on their credit records for up to 10 years, and who might find it harder and more expensive to borrow from wary lenders in the future.

Top Ten Ideas to Get Out and Stay Out of Debt

1. **Cancel all your credit cards except one, and pay that one off every month.**

2. **Use a debit card or a charge card instead of a credit card.** Debit cards offer all the convenience of credit cards but money is deducted from your account immediately when the card is used. A charge card requires that you pay your balance in full each month.

3. **Never use credit to purchase consumer goods, depreciating assets, or items with no income-producing potential.** Meals, clothing, and vacations are some good examples.

4. **Never use credit if repayment will strain your finances.** Limit you installment debt (other than your home mortgage) so that monthly payments do not exceed 10 percent of your income.

5. **Always shop carefully to find the lowest interest rates.** Even small differences in interest rates can make a large difference in the total amount of interest you pay over time.

6. **Begin establishing a cash reserve fund immediately.** Without adequate cash reserves, you will have great difficulty getting out of debt, because every time you have an emergency you will be forced to borrow money.

7. **Do not cash in your investments to pay off your debts.** In doing so, you will not be able to realize the long-term value of investing — the time-value of money. Continue making at least the minimum monthly payments on your installment debts, but do not take on additional credit.

8. **Use debt consolidation loans with great care.** You cannot borrow your way out of debt. Debt consolidation loans may allow you to stretch your payments over a longer time period, thereby reducing your total payments each month, but you will lose flexibility in your repayment plan and you may end up paying more interest in the long run.

9. **Use credit as necessary to purchase assets which are likely to appreciate, to start or grow a business, or to purchase education which will enhance your earning ability.**

10. **Understand that the abuse of credit is one of the leading causes of financial failure.**

