



Using Credit

Chapter 6

Learning Goals

LG1

Describe the reasons for using consumer credit, and identify its benefits and problems.

LG2

Develop a plan to establish a strong credit history.

LG3

Distinguish among the different forms of open account credit.

LG4

Apply for, obtain, and manage open forms of credit.

LG5

Choose the right credit cards and recognize their advantages and disadvantages.

LG6

Avoid credit problems, protect yourself against credit card fraud, and understand the personal bankruptcy process.



How Will This Affect Me?

- ▶ The ability to borrow funds to buy goods and services is as convenient as it is seductive. It is important to understand **how to get and maintain access to credit** and convenient transactions via credit cards, debit cards, lines of credit, and other means. This chapter reviews the common sources of consumer credit and provides a framework for choosing among them. It also discusses the importance of developing a good credit history, achieving and maintaining a good credit score, and protecting against identity theft and credit fraud. The chapter will help you understand the need to use credit intentionally, in a way that is consistent with your overall financial objectives.

Financial Facts or Fantasies?

One of the benefits of using credit is that it allows you to purchase expensive goods and services while spreading the payment for them overtime.

It's a good idea to contact your creditors immediately if, for some reason, you can't make payments as agreed.

Excluding mortgage payments, most families will have little or no credit problems so long as they limit their monthly credit payments to 25 to 30 percent their monthly take-home pay.

When you apply for credit, most lenders will contact a credit bureau and let them decide whether or not you should receive the credit.

Credit card issuers are required by truth-in-lending laws to use the average daily balance in your account when computing the amount of finance charges you'll have to pay.

You use a check rather than a credit card to obtain funds from an unsecured personal line of credit.



The Basic Concepts of Credit



► Why We Use Credit

- Avoid paying cash for large outlays
- Meet a financial emergency
- Convenience
- Investment purposes



Improper Uses of Credit

- Meet basic living expenses
- Make impulse purchases
- Purchase non-durable goods
- Consistently paying only minimum payments



Rule of Thumb

- Product should outlive the payment schedule
- **Watch your increasing use of Credit!**

Minimum Payments Mean Maximum Years

- Calculations are based on a minimum 3 percent payment and 15.0 percent annual interest rate.

Original Balance	Years to Repay	Interest Paid	Total Interest Paid as a percent of Original Balance
\$5,000	61.4	\$3,434	68.6%
\$3,000	14.0	\$2,005	68.0
\$1,000	8.8	577	57.7%



Establishing Credit

Build a good credit history by

- Not getting overextended
- Fulfilling all credit terms
- Paying on time
- Notifying creditors if unable to pay
- Being truthful

Actions to take

- Open checking and savings accounts
- Get on card and make small purchases



Five C's of Credit

- **Character**—Willingness to abide by terms of loan
- **Capacity**—Ability to service the debt
- **Collateral**—Own something of value to support loan
- **Capital**—Unencumbered assets available
- **Condition**—Impact of current economy on loan

How Much Credit can you Stand?

➤ Debt Safety Ratio =

Monthly consumer credit payments

Monthly take-home pay

Monthly consumer credit payments (excluding mortgage) should **not exceed 20%** of monthly net income.



Credit Cards and Other Open Account Credit

- Credit extended to consumer prior to a purchase
- Consumer can buy up to a specified credit limit
- Offered by retailers and financial institutions
- Monthly credit statements
- Pay balance in full to avoid interest



Bank Credit Cards

- Most popular open account credit
- Line of credit depends on applicant's financial status and ability to pay
- Cash advances and balance transfers
- Interest rate and fees



Other Fees

- High interest – Prime rate + a percentage
- Annual fees
- Transaction fees
- Late-payment fees
- Over-the-limit fees
- Balance transfer fees
- Foreign transaction fees



Special Types of Bank Credit Cards

- Reward cards
 - Frequent flyer programs
 - Auto rebate programs
 - Other merchandise rebates
- Affinity cards
- Secured (collateralized) credit cards
- Student credit cards



Debit Cards

- Looks like a credit card but works like writing a check by accessing checking account at time of purchase
- No line of credit
- Greater liability exposure if fraudulently used
- **Prepaid cards** is a debit card with a fixed amount available—it does not access checking account



Retail Charge Cards

- Second largest category
 - Department stores
 - Oil companies
- Build loyalty
- Preset credit limits



Revolving Credit Lines

- Open account credit offered by banks or other financial institutions
- Usually offer higher credit lines and lower interest rates than credit cards
- Access money by writing checks



Forms of Revolving Credit

- Overdraft protection lines
- Unsecured personal credit lines
 - Available on as-needed basis
- Home Equity credit lines
 - Secured by equity in owner's home
 - Interest tax deductible (if itemize deductions)
 - Principal limited to \$100,000 or equity in home



Obtaining and Managing Open forms of Credit

- Steps in Opening an account
 - 1. Credit card application
 - 2. Credit investigation
 - 3. Credit bureau
 - 4. Credit Scoring, FICO Score

FICO Scores, Fair Isaac & Co

- Uses only credit information
- Five major components and their weight:
 - Payment history, 35%
 - Amounts owed, 30%
 - Length of credit history, 15%
 - New credit, 10%
 - Types of Credit used, 10%
- Range of scores, 300 – 850, median 713 in 2015
- In 2015, if you have a FICO of 760-850, you could obtain a mortgage rate of 3.4%; if 620-639, rate would be 5%



Computing Finance Charges

Truth in Lending Act: **Lenders MUST disclose**

Annual percentage rate (APR)

- True rate of interest over life of loan
- Includes all fees and costs

Method used in computing finance charges

Computing Finance Charges

- Average Daily Balance (ADB)—method of computing finance charges by applying interest charges to the average daily balance
- ADB excluding new purchases—most consumer friendly
- ADB including new purchases—most frequently used, no grace period on new purchases if balance is carried forward

Average Daily Balance

Number of Days (1)	Balance (2)	(3) Calculation [1 * 2]
5	\$1,582	\$7,910
7	\$2,332	\$16,324
15	\$2,732	\$40,980
4	\$2,457	<u>\$9,828</u>
Total	31	\$75,042

Average Daily Balance = $\$75,042 / 31 = \$2,420.71$

Finance Charge: $\$2,420.71 * .015 = \mathbf{\$36.31}$

Rate is $18\%/12 = .015$ per month



Managing Your Credit Cards

- ▶ Review statements monthly to verify entries
- ▶ Pay by due date
 - ▶ Entire amount to avoid finance charges
 - ▶ Minimum monthly payment—Try to pay more
- ▶ You can get lower rates for immediate or long term borrowing from other sources than credit cards. Use Credit cards for short-term borrowing



Shop Around for Best Deal

- Annual fees
 - Rate of interest charged on balance
 - Length of grace period
 - Method of calculating balances
-
- Trade-offs: If you pay entire balance, rate does not matter, but desire no annual fees and long grace period
 - If you carry a balance, rate is more important than annual fee

Average Interest Rates

Type of Credit Card	Average Annual Percentage Rate (APR)
Balance transfer cards	15.88%
Cash back cards	16.43%
Low interest cards	11.03%



Avoiding Credit Problems

- Use discipline when purchasing – Follow your budget
- Reduce number of cards
- Be selective in accepting preapproved credit
- Limit new charges
- Pay more than the minimum, preferably entire balance
- Pay off cards with highest finance charges first
- Transfer balances to card with the lowest rate



Credit Card Fraud

- Don't give account number to organizations who call you
- Use secure internet sites
- Never put credit card info on checks
- Destroy old cards and shred old statements
- Report lost or stolen cards immediately



Bankruptcy – Paying the Price for Credit Abuse

- Bankruptcy options
- **Chapter 13** – wage earner plan, debt restricting with payment plan to pay off in 3 to 5 years
- **Chapter 7** – straight bankruptcy, wipe the slate clean. About 70% of personal bankruptcy are Chapter 7
- In 2015, about 900,000 filed for personal bankruptcy, 1.3 million were in process
- Bankruptcy will negatively affect your credit for up to 10 years, that is basically **no credit for 10 years.**