# CHAPTER 6
# Consumer Credit

# Chapter 6
# Consumer Credit

## What You'll Learn

- **Section 6.1**
  - Explain the meaning of consumer credit.
  - Differentiate between closed-end credit and open-end credit.
- **Section 6.2**
  - Name the five C's of credit.
  - Identify factors to consider when choosing a loan or credit card.
  - Explain how to build and protect your credit rating.
- **Section 6.3**
  - Discuss how to protect yourself from fraud and identity theft.
- **Section 6.4**
  - Identify ways to manage debt problems.

ASK STANDARD & POOR'S

## Credit Payments

- **Q:** My brother is going to college and has three credit cards with balances totaling $5,000. He is having trouble paying the minimum monthly payments. What should I tell him?
- **A:** He needs a plan to pay down these debts. Have him contact the credit card companies and tell them that he wants to pay the debt and maintain good credit. They may accept payments of interest only for a few months while he finds ways to increase his income or cut spending.

Go to **finance07.glencoe.com** to complete the Standard & Poor's Financial Focus activity.

# Section 6.1
# What Is Consumer Credit?

**Before You Read**

**PREDICT**

What is your definition of credit?

## Main Idea

There are advantages to using consumer credit if you use it correctly.

**credit**

an arrangement to receive cash, goods, or services now and pay for them in the future

**creditor**

an entity that lends money

**consumer credit**

the use of credit for personal needs

## Using Consumer Credit Wisely

When you borrow money or charge an item to a credit card, you are using credit. A creditor can be:

- A financial institution
- A merchant
- An individual

Consumer credit is a major force in the American economy, and the use of credit is a basic factor in personal and family financial planning.

# Section 6.1
# What Is Consumer Credit?

## Credit Uses and Misuses

Using credit may increase the amount of money you can spend now, but the cost of credit decreases the amount of money you will have in the future.

That is because you will be paying back:

- The money you borrowed
- Any charges for borrowing that money

## Factors to Consider Before Using Credit

Before you decide to finance a major purchase by using credit, consider:

- Do you have the cash you need for the down payment?
- Can you afford the item?
- Could you put off buying the item for a while?
- What are the costs of using credit?

Make sure the benefits of making the purchase now outweigh the costs of credit.

## Advantages of Credit

Using consumer credit allows you to:

- Enjoy goods and services now and pay for them later.
- Combine several purchases, making just one monthly payment.
- Keep a record of your expenses.
- Shop and travel without carrying a lot of cash.

If you use credit wisely, other lenders will view you as a responsible person.

**THINK FIRST** Everyone likes to have nice things, but using credit unwisely can lead to problems. *What should you consider before using credit?*

## Disadvantages of Credit

Always remember that credit costs money. If you fail to repay a credit card balance:

- You can lose your good credit reputation.
- You may also lose some of your income and property, which may be taken from you in order to repay your debts.

You should always approach credit with caution and avoid using it for more than your budget allows.

## Types of Credit

There are two basic types of consumer credit:

- Closed-end credit
- Open-end credit

You may use both types during your lifetime because each has advantages and disadvantages.

**closed-end credit**

credit as a one-time loan that you will pay back over a specified period of time in payments of equal amounts.

## Closed-End Credit

Closed-end credit is used for a specific purpose and involves a definite amount of money. Examples of closed-end credit include:

- A mortgage
- Vehicle loans
- Installment loans for purchasing furniture or large appliances

These types of loans usually carry lower interest rates than open-end credit carries.

**open-end credit**

credit as a loan with a certain limit on the amount of money you can borrow for a variety of goods and services

**line of credit**

the maximum amount of money a creditor will allow a credit user to borrow

## Open-End Credit

Examples of open-end credit include:

- Department store credit cards
- Bank credit cards (Visa or MasterCard)

You can use your credit card to make as many purchases as you wish, as long as you do not exceed your line of credit.

# Section 6.1
# What Is Consumer Credit?

## Sources of Consumer Credit

Many sources of consumer credit are available, including:

- Commercial banks
- Credit unions

# Section 6.1
# What Is Consumer Credit?

## Loans

A loan is borrowed money with an agreement to repay it with interest within a certain amount of time. Before going to your local bank to take out a loan, you might want to consider:

- Inexpensive loans (family members)
- Medium-priced loans (commercial banks, savings and loan associations, credit unions)
- Expensive loans (finance companies, retail stores, banks)
- Home equity loans

# Section 6.1
# What Is Consumer Credit?

**grace period**
a time period during which no finance charges will be added to your account

**finance charge**
the total dollar amount you pay to use credit

## Credit Cards

Most credit card companies offer a grace period. If you pay your balance before the due date stated on your monthly bill, you will not have to pay a finance charge.

The cost of a credit card depends on:

- The type of credit card you have
- The terms set forth by the lender

## Types of Cards

Debit cards allow you to electronically subtract money from your savings or checking account to pay for goods or services.

Other types of cards include:

- Smart cards
- Travel and entertainment (T&E) cards (American Express)

# Section 6.2
# The Costs and Methods of Obtaining Credit

**Before You Read**
**PREDICT**

How would you qualify for a credit card or loan?

## Main Idea

You should consider the costs of credit and your own credit standing when applying for credit.

## Can You Afford a Loan?

Taking out a loan can be a substantial financial burden. Before you take out a loan, make sure that you can afford it:

- Add up all your basic monthly expenses and then subtracting the total from your take-home pay.
- Consider what you might have to give up to make the monthly loan payment.
- Use the debt payments-to-income ratio formula to decide whether you can safely take on the responsibility of credit.

**net income**

the income you receive (take-home pay, allowance, gifts, and interest)

## Debt Payments-to-Income Ratio

The debt payments-to-income ratio is the percentage of debt you have in relation to your net income. Experts suggest that you spend no more than 20 percent of your net income on debt payments, which include:

- Credit card payments
- Loan payments

You can calculate your debt payments-to-income ratio by dividing your total monthly debt payments by your monthly net income.

# Section 6.2
# The Costs and Methods of Obtaining Credit

## The Cost of Credit

If you are thinking of taking out a loan or applying for a credit card, your first step should be to figure out:

- How much the loan will cost you
- Whether you can afford it

Two key factors in your decision will be:

- The finance charge
- The annual percentage rate (APR)

**annual percentage rate (APR)**

the cost of credit on a yearly basis, expressed as a percentage

## The Finance Charge and the Annual Percentage Rate (APR)

The finance charge, or total dollar amount you pay to use credit, is calculated using the annual percentage rate (APR).

All organizations must state the true APR that they charge their customers. This makes it easy to compare the cost of credit.

**Figure 6.4** Annual Percentage Rate Table for Monthly Payments

| | Annual Percentage Rate—APR (Finance Charge per $100 Borrowed) | | | | |
|---|---|---|---|---|---|
| **Number of Monthly Payments** | **7.0%** | **7.5%** | **8.0%** | **8.5%** | **9.0%** |
| 6 | $2.05 | $2.20 | $ 2.35 | $ 2.49 | $ 2.64 |
| 12 | $3.83 | $4.11 | $ 4.39 | $ 4.66 | $ 4.94 |
| 18 | $5.63 | $6.04 | $ 6.45 | $ 6.86 | $ 7.28 |
| 24 | $7.45 | $8.00 | $ 8.55 | $ 9.09 | $ 9.64 |
| 30 | $9.30 | $9.98 | $10.66 | $11.35 | $12.04 |

**Finding the Finance Charge**

If you borrow money and do not pay it back right away, you will probably have to pay a finance charge.

**What is the finance charge that you would pay if you borrowed $100 for 18 months at an APR of 9 percent?**

# Section 6.2
# The Costs and Methods of Obtaining Credit

## Tackling the Trade-Offs

When you select your financing, you will have to make trade-offs. The various features you will have to choose between include:

- The length of the loan
- The size of monthly payments
- The interest rate

## Major Trade-Offs

Some of the major trade-offs you should consider are:

- Term versus interest costs (choosing long-term financing despite the increased interest charges)
- Lender risk versus interest rate (taking a more expensive loan because of its minimum down payment or low fixed payments)

## Reducing Lender Risk

To reduce lender risk and increase your chance of getting a loan at a lower interest rate, consider the following options:

- Variable interest rate
- A secured loan
- Up-front cash
- A shorter term

**simple interest**
the interest computed only on the principal, the amount that you borrow

## Calculating the Cost of Credit

The most common method of calculating interest is the simple interest formula. There are other variations of this formula, including:

- Simple interest on the declining balance
- Add-on interest

Simple interest is based on three factors:

- The principal
- The interest rate
- The amount of time the principal is borrowed

## Cost of Open-End Credit

The Truth in Lending Act requires that open-end creditors:

- Inform consumers how the finance charge and the APR will affect their costs.
- Explain how they calculate the finance charge.
- Inform you when finance charges on your credit account begin to accrue.

## Cost of Credit and Expected Inflation

Inflation reduces the buying power of money.

Because of this, lenders incorporate the expected rate of inflation when deciding how much interest to charge.

**minimum monthly payment**

the smallest amount you can pay and remain a borrower in good standing

## The Minimum Monthly Payment Trap

Lenders often encourage you to make the minimum monthly payment because it will then take you longer to pay off the loan.

If you pay only the minimum amount on your monthly statement, you need to:

- Plan your budget more carefully.
- Understand that the longer it takes for you to pay off a bill, the more interest you pay.

# Section 6.2
# The Costs and Methods of Obtaining Credit

## Applying for Credit

When you are ready to apply for a loan or a credit card, you should understand the factors that determine whether a lender will extend credit to you.

## The Five C's of Credit

When a lender extends credit to consumers, it expects that some people will be unable or unwilling to pay their debts.

Most lenders use the "five C's of credit" to determine who will receive credit. These C's are:

- Character
- Capacity
- Capital
- Collateral
- Credit history

 

## Character: Will You Repay the Loan?

Creditors want to know what kind of person they will be lending money to. Some questions a lender might ask to determine your character are:

- Have you used credit before?
- How long have you lived at your present address?
- How long have you held your current job?

They want to know that you are trustworthy and stable.

Common CENTS

## One Is Enough

When you turn 18, you may start receiving applications for credit cards. Be a smart consumer and compare interest rates, annual fees, and any other fees. Decide which credit card best suits your needs and apply for that one. Toss any other applications you get into the trash.

*Why should you get the best (or lowest) interest rate for a credit card?*

## Capacity: Can You Repay the Loan?

Your income and the debts you already have will affect your ability to pay additional debts.

A creditor may ask several questions about your income and expenses, such as:

- What is your job and how much is your salary?
- Do you have other sources of income?
- What are your current debts?

  

## Capital: What Are Your Assets and Net Worth?

Lenders want to be sure that you have enough capital to pay back a loan. That way, if you lost your source of income, you could repay your loan:

- From your savings
- By selling some of your assets

A lender might ask:

- What are your assets?
- What are your liabilities?

# Section 6.2
# The Costs and Methods of Obtaining Credit

## Collateral: What If You Do Not Repay the Loan?

Creditors look at what kinds of property or savings you already have, because these can be offered as collateral to secure the loan.

A creditor might ask:

- What assets do you have to secure the loan (a vehicle, your home, or furniture)?
- Do you have any other assets (bonds or savings)?

**credit rating**

a measure of a person's ability and willingness to make credit payments on time

## Credit History: What Is Your Credit History?

Lenders will review your credit history to find out whether you have used credit responsibly in the past. Some questions a creditor might ask about your credit history are:

- Do you pay your bills on time?
- Have you ever filed for bankruptcy?

The information gathered from your application and the credit bureau establishes your credit rating.

# Section 6.2
# The Costs and Methods of Obtaining Credit

## Credit and Equal Opportunity

The Equal Credit Opportunity Act (ECOA) gives all credit applicants the same basic rights.

It states that a lender may not discriminate against you on a basis of:

- Race
- Nationality
- Age
- Sex
- Marital status
- Redlining (discrimination against you based on the race or nationality of the people in the neighborhood where you live)

# Section 6.2
# The Costs and Methods of Obtaining Credit

## What If Your Application Is Denied?

If your credit application is denied, the ECOA gives you the right to know the reasons.

If the denial is based on a credit report from a credit bureau, you are entitled to:

- Know what specific information in the report led to the denial.
- Contact the credit bureau and ask for a copy of your credit report.
- Ask the bureau to investigate any inaccurate or incomplete information and correct its records.

# Section 6.2
# The Costs and Methods of Obtaining Credit

## Your Credit Report

When you apply for a loan, the lender will review your credit history closely. The record of your complete credit history is:

- Your credit report, or credit file
- Collected and maintained by credit bureaus

Most lenders rely heavily on credit reports when they consider loan applications.

  

# Section 6.2
# The Costs and Methods of Obtaining Credit

## Credit Bureaus

A credit bureau is an agency that collects information on how promptly people and businesses pay their bills.

Credit bureaus get their information from:

- Banks
- Finance companies
- Stores
- Credit card companies
- Other lenders

## Your Credit File

A typical credit bureau file contains your:

- Name
- Current and previous address
- Social Security number and birth date
- Employer, position, and income
- Previous employer
- Homeowner or renter status
- Checks returned for insufficient funds
- Detailed credit information

# Section 6.2
# The Costs and Methods of Obtaining Credit

## Fair Credit Reporting

Fair and accurate credit reporting is vital to both creditors and consumers.

The Fair Credit Reporting Act:

- Regulates the use of credit reports
- Requires the deletion of out-of-date information
- Gives consumers access to their files as well as the right to correct any misinformation that the files may include
- Places limits on who can obtain your credit report

## Who Can Obtain a Credit Report?

Your credit report may be issued only to properly identified persons for approved purposes. It may be:

- Supplied in response to a court order or by your own written request
- Provided for use in connection with a credit transaction or some other legitimate business need

You may obtain a copy of your credit report free of charge if you have been denied credit.

## Time Limits on Unfavorable Data

Most of the information in your credit file may be reported for only seven years. If you have declared personal bankruptcy, that fact may be reported for ten years.

A credit reporting agency cannot disclose information in your credit file that is more than seven or ten years old unless:

- You are being reviewed for a credit application of $75,000 or more.
- You apply to purchase life insurance of $150,000 or more.

# Section 6.2
# The Costs and Methods of Obtaining Credit

## Incorrect Information

If you think a credit bureau may be reporting incorrect data from your file:

- Contact the bureau to dispute the information.
- Be sure the credit bureau changes or removes the incorrect items.

If you challenge the accuracy of an item on your credit report, the bureau must remove the item unless the lender can verify that the information is accurate.

 

# Section 6.2
# The Costs and Methods of Obtaining Credit

## Legal Action

You have a legal right to sue a credit bureau or creditor that has caused you harm by not following the rules established by the Fair Credit Reporting Act.

If the agency or the user is found guilty, the consumer may be awarded:

- Actual damages
- Court costs
- Attorneys' fees

**Before You Read**

**PREDICT**

How could you protect your credit?

## Main Idea

You must take action to protect your credit if you discover billing errors, have purchase disputes, or experience identity theft.

# Section 6.3
# Protecting Your Credit

## Billing Errors and Disputes

If you want to protect your credit rating, your time, and your money, you need to know how to correct mistakes that may pop up in your credit dealings.

To dispute billing errors, you should:

- Notify your creditor in writing.
- Include any information that might support your case.
- Pay the portion of the bill that is not in question.

## Protecting Your Credit Rating

According to law, a creditor may not:

- Threaten your credit rating or do anything to damage your credit reputation while you are negotiating a billing dispute
- Take any action to collect the amount in question until your complaint has been answered

# Section 6.3
# Protecting Your Credit

## Defective Goods and Services

According to the Fair Credit Billing Act, you may tell your credit card to stop payment if:

- You purchase a defective item.
- The store will not accept a return.

You must have made a sincere attempt to resolve the problem.

## Credit and Stolen Identity

When imposters use your personal information for their own purposes, they are committing a crime, sometimes called “identity theft.”

You may not even know that your identity has been stolen until you:

- Get bills for a credit card account you never opened
- See charges to your account for things that you did not purchase

# Section 6.3
# Protecting Your Credit

## Protecting Your Credit from Theft or Loss

Lost credit cards are a key element in credit card fraud. To protect your card, you should:

- Be sure that your card is returned to you after you make a purchase.
- Keep a record of your credit card number.
- Notify the credit card company immediately if your credit card is stolen.

# Section 6.3
# Protecting Your Credit

## Keeping Track of Your Credit

You can take steps to stop or prevent identity theft by:

- Immediately closing any accounts accessed by an identity thief
- Insisting on password-only access when opening new accounts
- Stopping payment on stolen or misused checks
- Canceling a lost or stolen ATM card and getting another one with a new PIN

Stay alert to new instances of identity theft.

## Government Agency Protection

If you continue to experience identity-theft problems after taking these steps, contact the Privacy Rights Clearinghouse of the Federal Trade Commission (FTC).

The FTC:

- Cannot resolve individual problems for consumers
- Can against against a company if it sees a pattern of possible law violations

# Section 6.3
# Protecting Your Credit

## Protecting Your Credit Information on the Internet

Although you cannot control fraud or deception on the Internet, you can take steps to recognize, avoid, and report it. These steps include:

- Using a secure browser
- Keeping records of your online transactions
- Reviewing your monthly bank and credit card statements
- Reading the privacy and security policies of Web sites you visit
- Keeping your personal information private
- Not downloading files sent to you by strangers

**cosigning**

agreeing to be responsible for loan payments if the other person fails to make them

## Cosigning a Loan

Think carefully before cosigning a loan. If you cosign a loan and the borrower does not pay the debt, you may have to pay:

- Up to the full amount of the debt
- Any late fees or collection costs

If the debt is not repaid, that fact will appear on your credit record.

## Complaining About Consumer Credit

If you believe that a lender is not following the consumer credit protection laws:

- First try to solve the problem directly with the lender.
- Use more formal complaint procedures if that fails.

## Consumer Credit Protection Laws

If you decide to file a lawsuit against a creditor, you should be aware of the various consumer credit protection laws listed here:

- Truth in Lending and Consumer Leasing Acts
- Equal Credit Opportunity Act (ECOA)
- Fair Credit Opportunity Act
- Fair Credit Reporting Act
- Consumer Credit Reporting Reform Act

# Section 6.3
# Protecting Your Credit

## Your Rights Under Consumer Credit Laws

If you believe that you have been refused credit because of discrimination, you can take one or more of the following steps:

- Complain to the creditor.
- Let the creditor know that you are aware of the law.
- File a complaint with the government.
- Sue the creditor if all else fails.

# Section 6.4
# Managing Your Debts

**Before You Read**

**PREDICT**

What corrective steps would you take if you were experiencing the debt troubles listed here? (See next slide.)

## Main Idea

If you experience the warning signs of debt problems, there are several options available to manage your finances.

**Video Clip: Credit Problems**

 

## Signs of Debt Problems

Some people who seem to be wealthy are just barely keeping their heads above water financially. They may:

- Lack self-discipline and do not control their impulses
- Use poor judgment
- Fail to accept responsibility for managing their money

 

# Section 6.4
# Managing Your Debts

## The Warning Signs

The following are some warning signs of being in financial trouble:

- You make only the minimum monthly payment on credit cards.
- The total balance on your credit cards increases every month.
- You miss loan payments or often pay late.
- You use savings to pay for necessities such as food and utilities.
- You borrow money to pay off old debts.
- You exceed the credit limits on your credit cards.

## Debt Collection Practices

Creditors will often turn their bad debts over to debt collection agencies.

The Federal Trade Commission, however, enforces the Fair Debt Collection Practices Act (FDCPA), which:

- Prohibits certain practices by debt collectors
- Does not erase the legitimate debts that consumers owe
- Does control the ways in which debt collection agencies do business and deal with consumers in debt

 

# Section 6.4
# Managing Your Debts

## Financial Counseling Services

If you are having trouble paying your bills and need help, you have several options. You can:

- Contact your creditors and try to work out an adjusted repayment plan.
- Contact a non-profit financial counseling program, such as the Consumer Credit Counseling Service, which operates nationwide.

# Section 6.4
# Managing Your Debts

## Consumer Credit Counseling Service

The Consumer Credit Counseling Service (CCCS) is concerned with preventing problems as much as it is with solving them.

As a result, its activities are divided into two parts:

- Aiding families with serious debt problems by helping them manage their money better and setting up a realistic budget
- Helping people prevent indebtedness by teaching them the importance of budget planning, educating them about the pitfalls of unwise credit buying, and encouraging credit institutions to withhold credit from people who cannot afford it

# Section 6.4
# Managing Your Debts

## Other Counseling Services

In addition to the CCCS, you can sometimes find nonprofit credit counseling services through:

- Universities
- Credit unions
- Military bases
- State and federal housing authorities

These organizations usually charge little to nothing for their assistance.

 

**bankruptcy**

a legal process in which some or all of the assets of a debtor are distributed among the creditors because the debtor is unable to pay his or her debts

## Declaring Personal Bankruptcy

As a last resort, an individual can declare bankruptcy. Declaring bankruptcy is a last resort because it severely damages your credit rating.

## The U.S. Bankruptcy Act of 1978

You have two choices in declaring personal bankruptcy:

- Chapter 7 (a straight bankruptcy)
- Chapter 13 (a wage-earner plan bankruptcy)

Both choices are undesirable, and neither should be considered an easy way to get out of debt.

## Using a Lawyer

Choosing a bankruptcy lawyer may be difficult. Some of the least reputable lawyers make easy money by handling hundreds of bankruptcy cases without considering individual needs.

You should get recommendations from:

- Friends
- Family
- Employee-assistance programs

 

## Effects of Bankruptcy

People have varying experiences in obtaining credit after they file for bankruptcy.

Since bankruptcy reports are kept on file in credit bureaus for ten years, you should take the extreme step of declaring bankruptcy only when you have no other options.

The best way to solve your financial problems is to avoid them by maintaining good credit.

 

## Key Term Review

- credit
- consumer credit
- creditor
- closed-end credit
- open-end credit
- line of credit
- grace period
- finance charge
- net income
- annual percentage rate (APR)
- collateral
- simple interest
- minimum monthly payment
- credit rating
- cosigning
- bankruptcy

## Reviewing Key Concepts

1. Explain the concept of consumer credit.

Consumer credit is the use of credit for personal needs.

## Reviewing Key Concepts

2. Differentiate between open-end credit and closed-end credit.

Closed-end credit is credit as a one-time loan that you pay back over a specified period of time in payments of equal amounts. Open-end credit is credit as a loan with a limit on the amount of money that you borrow for goods and services.

## Reviewing Key Concepts

3. Identify the five C's of credit using a graphic organizer. Then rate yourself.

The five C's of credit are:

- Character
- Capacity
- Capital
- Collateral
- Credit history

## Reviewing Key Concepts

4. Discuss the factors to consider when choosing a loan or credit card.

When choosing a loan or credit card, consider factors such as:

- Length of the loan
- Amount of monthly payments
- Interest rate

 

## Reviewing Key Concepts

5. Identify ways you can build a good credit rating.

To build and protect good credit:

- Pay your bills and loans promptly.
- Manage your personal finances carefully.
- Correct mistakes related to your credit bills and credit reports.
- Dispute billing errors in writing and pay amounts that are not in question.

## Reviewing Key Concepts

6. Discuss the steps you should take if your identity is stolen.

If your credit or identity is stolen:

- Contact all your credit card companies.
- Close and open new bank accounts.
- Change all PINs.
- Notify law enforcement agencies and credit bureaus.

## Reviewing Key Concepts

7. Explain the role of the Consumer Credit Counseling Service.

The Consumer Credit Counseling Service:

- Aids families with serious debt problems by helping them manage their money better and setting up a realistic budget
- Helps people prevent indebtedness by teaching them the importance of budget planning, educating them about the pitfalls of unwise credit buying, and encouraging credit institutions to withhold credit from people who cannot afford it

## Newsclip: Student Credit Cards

Many credit card companies offer credit cards to students 18 and over. As a result, many students have heavy debts. Debt advisors say students should have a low minimum limit.

**Log On** Go to finance07.glencoe.com and open Chapter 6. Learn more about managing credit, and then write a list of ways to avoid credit card debt.