Credit Basics

Advanced Level

***Your present self impacts your future self.* When borrowing, you are spending future income.**

You have used **credit** if you receive money, goods or services in exchange for your promise to pay back a definite sum of money at a future date. Credit involves borrowing. Credit availability depends in large part on whether lenders trust that you will pay back the loan as agreed. Lenders consider you more creditworthy as they gain confidence that you will pay back loans. Sources of credit include but are not limited to depository institutions, private mortgage companies, finance companies, automobile dealerships, credit card companies, retail stores, insurance agents, payday loan companies and pawn shops.

Using Credit Responsibly

You are responsible for yourself.

When you borrow, you are spending future income. You pay back a loan by making regular payments (usually monthly) over time. The lender also typically expects you to pay back interest in addition to the amount borrowed.

For example: Toby was approved for a $10,000 loan at an 8% interest rate to purchase a used automobile. The loan terms require him to make monthly payments of $313.36 for the next three years (36 months) to pay back the loan. In addition to paying back the original $10,000 borrowed, Toby will also be paying a total of $1,280.96 in interest. So, the total amount repaid over the 36 months will be $11,280.96.

Credit is an effective financial tool when managed responsibly. But, not managing your credit wisely and over-obligating your future income can lead to a decrease in your future quality of life and negative financial well-being.

The amount owed for credit is a liability on the Statement of Financial Position and decreases total net worth (assets – liabilities)

Net Worth = Total Assets − Total Liabilities

Statement of Financial Position	
Liabilities	
Home mortgage balance	
Installment loan balance for automobile	
Student loan balance	
Credit card balance	
Money owed to others	
Other:	
Total Liabilities	$
Net Worth = Total Assets - Total Liabilities	$

Before you borrow, carefully evaluate the reason(s) for using credit. Are you going to apply for credit to pay for higher education, purchase a home or buy a new car? Borrowing to pay for higher education is a way you can invest in your human capital. This investment may pay off in the future with a better job and higher wages. Similarly, borrowing for a new home or a new car can make sense by securing more comfortable housing or more reliable transportation. But, you should think through any purchase that requires you to borrow.

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Do you have the option of using your savings or maybe dipping into an investment account as an alternative to borrowing? You may discover one or both of these options are better suited for you. Examine possible penalties for withdrawing funds from your investment account. Those potential penalties may sway your decision.

Remember that a loan is a legal contract. Once you enter into this contract you are required to make payments in the future according to the agreement. Take a look at the impact that your loan payments will have on your budget. Can you manage this monthly payment along with your other financial responsibilities? Financial experts recommend that the total amount borrowed (excluding any mortgage loans) should be less than 20% of your annual net income. Your monthly loan payments (including payments for auto loans, education loans, credit card payments, but excluding any mortgage payments) should not be more than 10% of your monthly net income. Keeping the total amount of credit owed within these limits is a part of using credit responsibly.

Why should individuals limit their total amount of debt?

Types of Credit

There are two types of credit:

- **Closed-end credit** (also known as installment credit) is a loan which you must repay in a specified number of equal monthly payments. Examples of closed-end credit include automobile loans, mortgages, and education loans.
- **Open-end credit** (also known as revolving credit) is extended as a line of credit established in advance, so you do not have to apply for credit each time credit is desired. Credit cards are the most common type of open-end credit. A unique feature of open-end credit is that you can pay the loan balance in a single payment or a series of equal or unequal monthly payments. Your lender will typically require a specified minimum monthly payment towards your outstanding balance.

How will you use credit responsibly?

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The following table outlines examples of different types of credit and the most common sources for each type:

Type of Credit	Example	Other Information	Most Common Sources of Credit
Closed-end credit	Mortgage loans	Includes home equity loans	Depository institutions Private mortgage companies
	Automobile loans		Depository institutions Automobile dealerships
	Personal loans		Depository institutions
	Education (student) loans		Government and depository institutions
Open-end credit	Credit cards	There are many different types: ▪ Secured ▪ Retail store	Depository institutions Credit card companies Retail stores
Alternative	Payday loans	▪ A short-term loan that provides immediate cash by securing a borrower's written check or receiving authorization for automatic withdrawal from the borrower's depository institution account. ▪ For example, James writes a check for $350 to the payday lender. The lender gives James $290 in cash and keeps $60 for fees. The lender holds the check until the agreed upon date, usually the borrower's payday before cashing it. ▪ Also known as cash advance loans	Payday lenders
	Rent-to Own	▪ Tangible items such as furniture, electronics or household appliances are leased with the condition that the item will be owned by the renter if the term of rent is completed. The cumulative end amount a consumer pays to lease an item is typically much higher than if the consumer bought the item from the onset.	Rent to Own retail stores
	Pawn loans	▪ A loan based on the value of personal property. The personal property is held until the borrower repays the loan, including any fees. If the owner fails to repay the loan the lender keeps the item.	Pawn shops
	Title loans	▪ The borrower gives the lender his/her automobile title in exchange for a set amount of cash. The lender holds the title until the loan is repaid. If the loan is not repaid as agreed, the lender keeps title to the item.	Title loan companies
	Refund anticipation loans	▪ Short-term cash advance secured by a taxpayer's expected tax refund. If the tax refund is less than expected, the borrower owes the lender the difference.	Varies

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How to Obtain Credit

Shopping for Credit

As with the purchase of any good or service, it pays to shop for credit. Comparing offers across different lenders provides you with the opportunity to find the best credit terms to fit your needs. Consider the following:

- Interest rate – What is the annual interest rate?
- Fees – Are there fees associated with the application process and/or the use of the credit? Are there any fees for repaying the loan early?
- Missed or late payment – What does the credit contract indicate are consequences of missed or late payments?
- Default – What is the consequence of not paying back in full the borrowed amount?

Credit scoring models recognize that a person may want to shop around to find the best credit terms for them. Therefore, multiple inquires for the same type of loan, like a mortgage or automobile loan, are counted as a single inquiry if conducted within any 14-day period. This minimizes or eliminates any impact on a credit score.

Applying for Credit

The exact process to obtaining credit varies depending on the lender and type of credit. However, most lenders require two steps:

1. Credit application: A **credit application** is a form requesting information about the applicant (you). Depending upon the lender, credit applications may be completed in person or online. Credit applications usually ask for the following categories of information, but specific questions will depend on the type of credit and the lender:
    a. Personal information: Name, address, social security number, etc.
    b. Amount of credit requested: The lender will ask how much you want to borrow, and may also ask how long you need to pay it back and how you intend to use the loan.
    c. Information regarding your ability to repay the loan: Lenders will probably ask about your income, and may require proof. They will also want to know of any additional debt.
2. Credit history check: Most lenders will check your credit history by obtaining a copy of your credit report and/or credit score to determine how likely you are to repay the credit (your credit worthiness). Alternative lenders such as payday and title loans commonly advertise credit approval with no credit history check. However, the trade-off to no credit history check is often higher interest rates and fees.

To obtain credit if you are under the age of 18, you must have an adult co-signer. If you are between the ages of 18 -21, to obtain a credit card you must have a co-signer or proof of sufficient income to make payments. Make sure co-signers understand that they are equally responsible for the credit, and that it will appear on their credit report as well.

You are responsible for your present self and future self.

You are responsible for understanding your responsibilities as a borrower, including the terms of a credit contract. Before signing a credit contract, shop around for the best credit terms for you and consider the future implications of paying back the amount borrowed.

Credit Basics Note Taking Guide

	Total Points Earned
	Total Points Possible
	Percentage

Name ______________________

Date ______________________

Class ______________________

Managing Credit Responsibly

Credit is...

Individuals must pay back...

Credit availability depends on...

What are three credit sources?

Why are you spending future income when using credit?

What are two examples of the purpose of credit providing long-term benefits.

What can happen if credit is not managed responsibly?

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What are three <u>benefits</u> to using money saved or invested instead of credit?

What is a <u>disadvantage</u> of doing this?

Summarize why reading a contract carefully is important and what a person should consider.

Describe the recommended amount to borrow.

Types of Credit

Closed-end Credit

Definition:

Features:

Examples:

Open-end Credit

Definition:

Features:

Examples:

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What are features of alternative credit?

Describe each type of alternative credit.

Payday loan:

Rent-to-Own:

Title loan:

Pawn loan:

Refund anticpation loan:

Shopping for Credit

What is a credit application?	What types of information does it include?	Why might a lender check a persons credit history?	What is the trade-off to no credit history check?

Why should a person shop around with different lenders?	How could shopping around impact their credit score?

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Can They Handle the Debt?

	Total Points Earned
	Total Points Possible
	Percentage

Name ____________________

Date ____________________

Class ____________________

Directions: Complete the following calculations to determine if the individual in each scenario is within the recommended amount to borrow. As a reminder, the total amount you borrow is recommended to be *less than* 20% of your annual net income and your monthly payment 10% of your monthly net income. Housing payments, including rent and mortgages, should not be counted as part of the monthly 10%, but other debt, such as car loans and insurance, education loans and credit card payments, should be counted.

1. Dominik has a monthly net income of $1,860. His fixed monthly expenses consist of a rent payment of $450. He is paying off a student loan of $280 per month. Dominik would like to buy a new flat screen television set using a retail credit card. What is the largest monthly payment Dominik can afford for the television set so that his credit card payments and student loan keep him within a recommended limit of 20%?

2. Usha and Parker have a combined monthly net income of $4,500. They both chip in to pay their $675 rent each month. They also have one outstanding student loan balance of $6,280 and recently added a balance of $1,700 to their shared debt for the laptop they bought last month. How much more debt can Usha and Parker take on and still be within recommended limit?

3. Yen has a net salary of $3,722 each month. Her fixed monthly expenses consist of $500 for rent. She also makes a monthly car payment of $299, not including her monthly car insurance premium of $173. Are these payments within Yen's recommended limit?

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Alternative Lending Hazards

	Total Points Earned
10	Total Points Possible (for participation)
	Percentage

Name ______________________

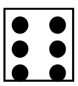
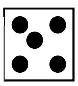
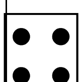
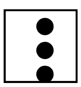
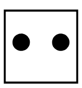
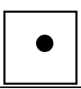
Date ______________________

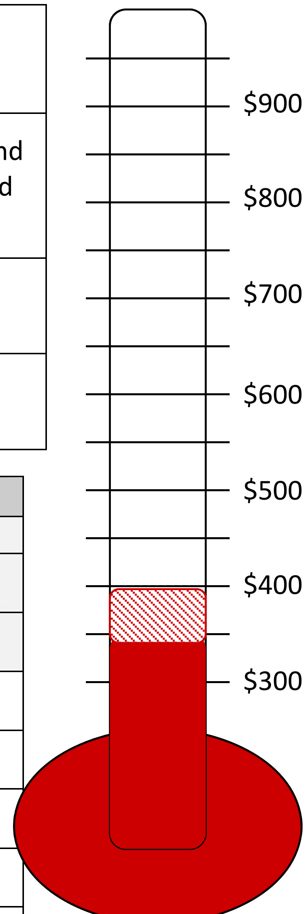
Class ______________________

Scenario: Mario needs $300 to pay his car payment, so he decides to take out a payday loan on January 1. He gets paid every two weeks, so he writes a post-dated check for $350.

Directions: Roll a die. The number on the die represents various payment and loan possibilities that arise each pay period, or every two weeks. After each roll, refer to the key and record the roll, payday loan activity, pay period loan cost, and calculate the sum of the total loan cost in the chart below and on the thermometer. Record the costs Mario has incurred following the example below.

Key:

 or 	=	Mario cannot pay back the payday loan after receiving his paycheck, so he rolls over the loan and adds $50 on to his total amount due.
 or 	=	The payday loan lender cashes the check Mario wrote for the loan and there are insufficient funds in the account. He defaults and is charged a total of $50 fees from the lender and his financial institution.
	=	Mario pays back the initial loan, but needs to take out a second loan for $350 to pay other expenses.
	=	Mario pays back the payday loan in full.



Date	Roll	Payday Loan Activity	Cost	Total Cost
Example:				
January 1	-	Takes out a new loan	$350	$350
January 15	5	Rolls over the loan	$50	$400
January 29				
February 12				
February 26				
March 12				
March 26				
April 12				
			Total Cost	

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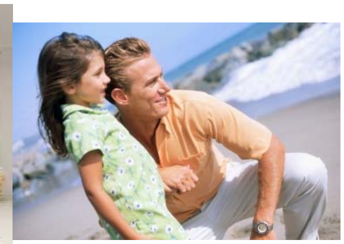

BIG BLING CREDIT CARD

Disclosure and Agreement

$5,000 Line, with 2.99% Introductory Rate and 10,000 Free Frequent-Flyer Miles

Make $1000 in qualified purchases the first month for 5,000 Extra Miles!

Know ye all by these here present: Herewith this agreement is made this day between “Big Bling” Lending, hereafter known as the Pre-dator of this agreement and the undersigned, a fully consenting party, herein known as the Borrower, to these terms and conditions. Education and self-knowledge being the purpose and sine qua non of this contract, it is the goal of this Agreement to clearly and unconditionally establish that objective and to pedagogically present the following terms and conditions with the maximum degree of unadulterated obfuscation.

Accordingly, said Borrower shall have the unrestricted right and privilege of the use of this credit card upon prompt payment as outlined below or until it is revoked by the Pre-dator subject to the following terms and conditions. These rights are not transferrable without the express and written consent of the Pre-dator.

Borrower agrees to accept a Pre-dator approved 10,000 Free Frequent-Flyer miles in return for his/her acceptance of this credit card agreement. Flights must be booked on airlines approved by the Pre-dator, who is not responsible for loss or damages, and subject to promotional availability.

The maximum amount of this line of credit shall be $5,000 unless a greater amount is negotiated and approved by the Pre-dator. The interest rate (calculated as an Annual Percentage Rate or APR) shall be at the introductory rate of two point 99 percent (2.99%) per annum annual percentage rate is in effect for an introductory period of three months, at which time the rate shall change to the regular rate of ten times the Introductory rate per annum and said rate shall apply to the entire amount borrowed both before and after the introductory period. I fully understand that the any excess cost is what I am paying for the frequent flyer miles. Additionally, it is understood that the borrower has already been advanced the amount of two thousand dollars ($2,000) on this line and that the current Annual Percentage Rate for cash advances of twenty-nine point 99 percent (29.99%) shall apply to this advance. The minimum monthly payment shall be the monthly amount of interest calculated (.025%) plus 3% of the end of grace period outstanding balance.

Over the Limit Fee: Should borrow exceed maximum amount of line, Pre-dator shall impose a monthly charge of two percent of the end of month Outstanding Balance.

Late Payment Fee: Should borrow fail to make minimum payment due by the end of the grace period, Pre-dator is entitled to impose a fee of ten dollars ($10) for each week payment is delinquent.

Should the borrower fail to meet the terms of this agreement, Pre-dator reserves the sole right and condition to impose additional conditions upon this agreement regardless of any usury laws, included but not limited to penalties for late payments, exceeding the credit limit, and cancelling this contractual agreement prior to the end of the introductory or promotional period. Should said borrower attempt transfer this agreement into a more favorable one, the Pre-dator shall have the unconditional right to assess damages in an amount to be determined under the Uniform Code of Commercial Conduct to the highest degree of penalty possible. The cost of any attorney’s fees shall be the sole and unconditional obligation of the borrower. Borrower acknowledges and consents that any purchases under this agreement are the sole and undivided responsibility of the borrower and that no claim, counterclaim or adverse action cannot be imposed upon the Pre-dator without due notice. All conditions and obligations are as required will be adjudicated under the laws of this state.

FORCE MAJEURE: Pre-dator’s failure to perform any term or condition of this Agreement as a result of conditions beyond its control such as, but not limited to war, strikes, fires, floods, acts of God, governmental restrictions, power failures, damage or destruction of any network facilities or servers or any other reason whatsoever, shall not be deemed a breach of this Agreement.

Witness my hand and seal this, __________ day of, __________ month, __________ year.

____ ____

Print name **Signature**

Which is the Best Deal?

	Total Points Earned
15	Total Points Possible
	Percentage

Name ____________________

Date ____________________

Class ____________________

Scenario: Cesar has started his first job with a monthly net income of $2,740. He currently has an education loan for $230 per month. Cesar wants to purchase a reliable vehicle to get to and from work. His dream vehicle is a new truck. After talking to the automobile dealership and conducting extensive research, he has selected one that costs $25,000 after his $3,000 down payment. He has shopped around for a loan and has three options.

Directions: Review the information below to help Cesar choose an automobile loan by answering the following questions.

	Option 1	Option 2	Option 3
Lender	Car Dealership	Local Credit Union	Online Auto Loans
Annual Interest Rate	4.2%	1.79%	4.64%
Number of Months	48	60	72
Monthly Payment	$566.72	$435.90	$398.46
Fees	$0	$30 application fee	$45 application fee
Incentives and Requirements	$2,500 cash back provided to borrower	Must have an account with the credit union	APR increases to 11.36% for a missed payment
Total Amount Paid	$27,202.56 total payment less $2,500 = $24,702.56	$26,154.00 total + $30 application fee = $26,184	$28,691.28 total + $45 application fee = $28,736.28
Total Cost	-$297.44 (because of the cash back)	$1,184.00	$3,736.28

1. What is an advantage and disadvantage of each loan option? (6 points)

	Option 1	Option 2	Option 3
Advantage			
Disadvantage			

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2. Which loan option would you recommend for Cesar? Provide three reasons to explain your recommendation. (4 points)

3. Do you feel this truck is affordable for Cesar or should he consider other alternatives? Provide at least two reasons supporting your answer. (3 points)

4. How can you use a credit analysis process like this in your own life? (2 points)

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