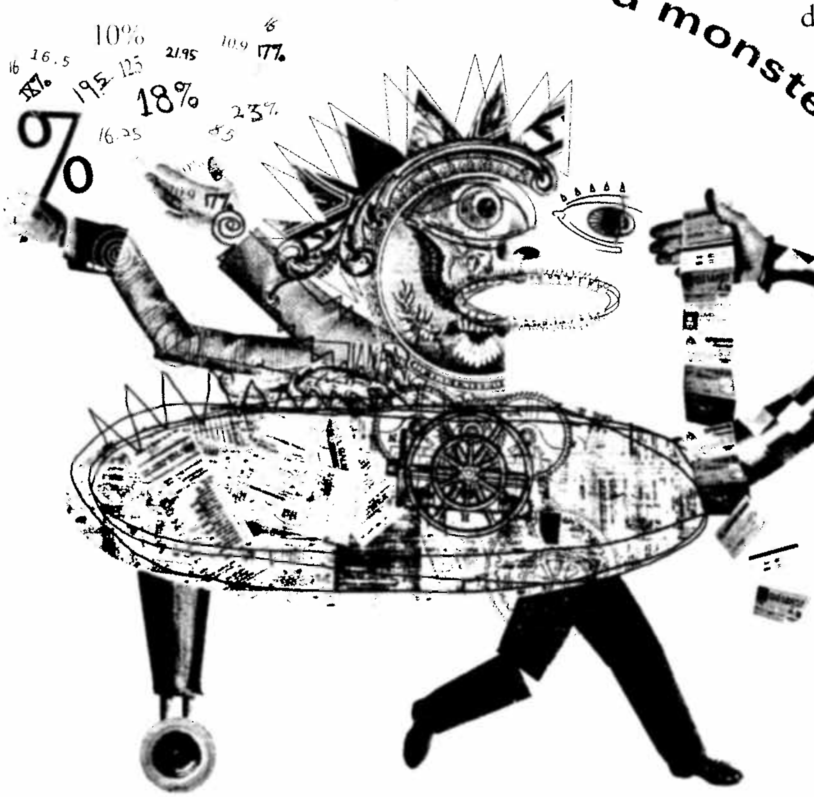
Credit and Debt

Credit gives extra punch to your purchasing power; but reckless handling of credit can bury you in debt.

Seems like everyone wants to lend you money. Each year, credit-card companies bombard American consumers with alluring offers of easy money. "Congratulations—you are qualified to receive $10,000!" "You will not be turned down!" "Why postpone your dreams? Apply today."

Why do they want to lend you money? Because that's how they make money. Banks and other financial institutions lend money to both businesses and consumers. Borrowers, in return, pay fees, and those fees can be hefty. If you must borrow—for a car, for college, or for other expenses that you lack the cash to cover—learn how to borrow wisely.



Are You Credit Worthy?

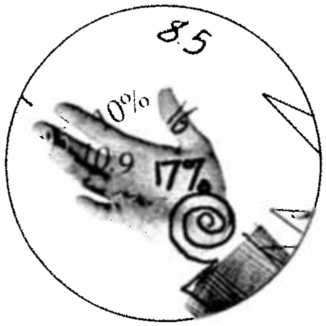
Loans, credit cards, and other methods of deferred payment are known as **credit**. For a bank or other institution to extend you credit, it must be confident that you will repay all the money you borrow, plus any additional interest and fees. You, on the other hand, must understand what you're getting into before you sign on the dotted line.

Creditors, the folks who lend you money, aren't going to give you money just on your word. They are going to ask many questions about your financial past and demand evidence of your financial health to determine if you are able and willing to pay them back.

The Four Cs Creditors look for *capacity, capital, character,* and *collateral* when judging your credit worthiness. *Capacity* is your ability to repay the debt. Creditors will want to know where you work, how long you've worked there, and how much money you make. They will also want to know how much you spend. *Capital* is your regular income plus the money in your savings and checking accounts.

Character is your willingness to repay your debts. Creditors will obtain a record of your past borrowing, your bill-paying habits, and your ability to live within your means. Much of this information they will obtain from an organization called a **credit bureau.** If you fail to maintain a good **credit rating,** you will find it very difficult to obtain credit. Creditors will also look for signs of stability in your life. How long have you lived at your current address? How often have you moved in the past few years? Do you own or rent your home?

Some loans require **collateral,** which is property used to secure a loan. If you default on the loan or fail to repay it, the creditor takes ownership of the collateral. Often the item that the loan is used to purchase serves as collateral. This is usually the case with car loans and home mortgages. If you fail to keep up with your car payments, you may find yourself walking to work.



Four Steps to Establishing Credit

1. **Maintain savings and checking accounts.** While these are not credit, they can be used to show that you know how to manage your money. You can use your canceled checks to prove that you pay bills promptly.
2. **Get a department-store charge card.** Store cards, which can be used only to make purchases from that particular retailer, are usually easier to obtain than bank credit cards or other forms of credit. Responsible use of a store charge card can help you establish good credit.
3. **Use your bank deposits as collateral for a credit card.** Your limit, or the maximum amount you're allowed to borrow, would not exceed the amount of your deposits.
4. **Have someone with good credit cosign your credit application.** A cosigner agrees to pay your debt if you fail to do so. With a cosigner, you can use someone else's good credit to establish your own.

Information Creditors Can't Use The federal government has passed laws protecting consumers from being discriminated against when applying for credit. The Equal Credit Opportunity Act forbids creditors from using age, gender, marital status, race, color, religion, national origin, or public assistance income when establishing your credit worthiness. Nor can creditors discriminate against you for exercising certain rights, such as filing a billing error notice with a creditor.

Maintaining Good Credit As you begin to make purchases with loans and credit cards, credit might seem to you like free money, but it's not. When you borrow money from a financial institution, you are, in effect, renting money. Eventually you have to pay it all back, along with interest and fees, called **finance charges.** Finance charges can be quite expensive and add up rapidly. If you're not paying attention, you can quickly lose control of your debt.

Making late payments, missing payments, or borrowing more than you can pay back will damage your credit history. A poor credit history can haunt you for seven years or more. If you are irresponsible with your credit card, you're going to have a hard time financing that new car you plan to buy.

To maintain good credit, you need to develop good credit behavior. Don't overborrow or overspend, make sure you pay your bills promptly, and protect your credit cards from loss or theft. It is also crucial for you to understand the different forms of credit available to you and how their finance charges are calculated. That way, you can make sound decisions that will keep you out of financial hot water.

Types of Credit

Different forms of credit are suited to different purposes. You know that you shouldn't use your credit card to pay for a new car. And you wouldn't take out a loan to pay for dinner and a movie on Friday night. There is much more you need to know, however, about credit.

Loans Loans come in two forms: single-payment loans and installment loans. Single-payment loans are short-term loans paid off in one lump sum. Installment loans, on the other hand, are repaid at regularly scheduled intervals, or installments, usually monthly. Each installment payment is for the same amount. Each payment is applied to both the principal (the amount borrowed) and the interest (the fee for borrowing the

money). Although you pay the same number of dollars each month, at first, more of the payment goes toward interest than principal. An automobile loan is an example of an installment loan. (See "Buying a Car" on pages 520–521.)

Loans that require collateral are called secured loans. Loans that don't require collateral are called unsecured loans. Credit for these loans, also known as signature loans, is based on the borrower's references and credit rating. A Guaranteed Student Loan is an example of an unsecured loan.

Credit Cards One of the most popular forms of credit in the United States today is the credit card. It is a form of open-ended, or revolving, credit. A credit card lets you borrow money on an ongoing basis, up to a prearranged limit, to buy goods and services. Any amount you pay back you are able to reborrow.

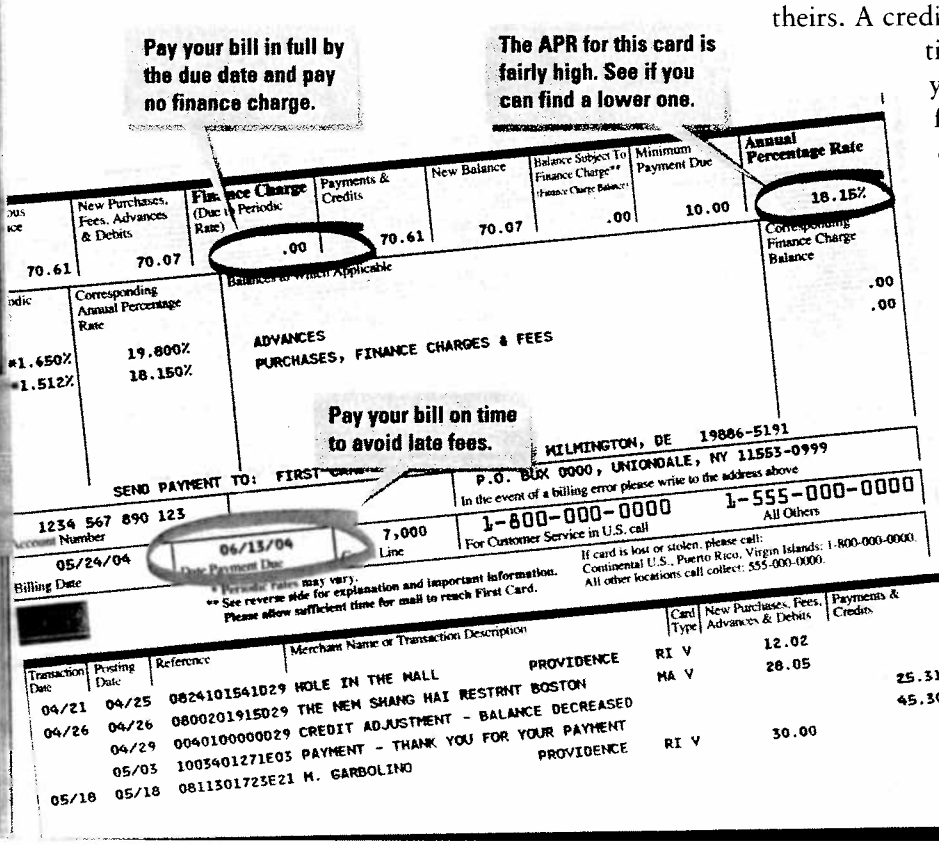
Many people find credit cards more convenient than cash. You can order movie tickets, buy clothes, pay for a meal, or just about anything else using a credit card. Bank cards such as Visa and MasterCard are the most widely accepted.

As a cardholder you receive a monthly bill and are required to pay at least some portion of the balance (the amount you owe) each month. Annual fees, interest rates, and other charges vary greatly among credit card issuers, so you should carefully compare the terms of several card offers before making any commitments. Some nonprofit organizations on the Internet offer listings of good credit card deals and guidance in applying for them.

Another form of credit is a travel and entertainment (T&E) card. It is similar to a credit card, but the borrower is required to pay the total amount owed each month. Because you pay your debt in full each month, you aren't charged interest. Usually you are required to pay an annual membership fee. American Express and Diners Club are popular travel and entertainment cards.

Finance Charges and Terms

As a borrower, you pay for the privilege of borrowing money. Interest is the primary fee for borrowing money. Just as a bank will pay you interest to use your money, you must pay your creditors to use theirs. A creditor, however, may charge you additional fees. The total dollar amount you pay to use credit is called the finance charge. It includes interest and other fees that may apply.



Annual Percentage Rate An important number for you to understand when applying for credit is the **annual percentage rate (APR).** The APR tells you what your credit will cost. It is the finance charge expressed as an annual rate. Comparing the annual percentage rates, rather than the interest rates, offered by lenders is a good way to compare loans. Be sure you understand how your lender calculates the APR for the credit cards you are considering.

Comparing APR

EXAMPLE a $100,000, 30-year home mortgage

	Plan A	Plan B
Interest rate	7.5%	7.5%
Points	0	2.0
Other closing costs	$1,500	$1,000
APR	7.6527	7.8046

Comparing Terms on an Installment Loan

EXAMPLE a $13,500 loan with 12.5% interest

	3-year loan	5-year loan
Number of monthly payments	36	60
Amount of each payment	$451.62	$303.72
Total interest paid	$2,758.32	$4,723.20

Terms Another important factor to consider is the term, or length, of your loan. For example, if you arrange to pay for your new car in three years rather than five, your monthly payments will be higher, but in the end, you will pay less interest.

How to Choose a Credit Card

When selecting a credit card, be sure you understand all the terms of the credit-card offer before you make a commitment.

What is the APR? You may want to choose the card with lowest APR, especially if you carry a balance on your account.

Is the APR fixed or variable? A fixed APR will stay the same. A variable APR will rise and fall as the prime rate or other economic indicator changes.

What is the periodic rate? The periodic rate is the interest rate that is applied to your account balance each billing period.

How are finance charges computed? Most creditors use your average daily balance to determine the finance charge. The average daily balance is calculated by adding up all daily balances and dividing them by the number of days in a billing period.

Is there a grace period? Many creditors will charge you no interest if you pay your bill in full before the due date.

What fees does the creditor charge? Many credit cards charge an annual membership fee, as well as fees for late payments, cash advances, or exceeding the credit limit.

Know Your Rights Credit card issuers and other lenders are required by **Truth in Lending laws** to disclose certain information. Institutions extending loans must tell you the exact finance charge on your loan. Credit card issuers must disclose monthly interest rates, the APR, and the method of finance charge calculation.

The Fair Credit Reporting Act protects you from errors on credit reports issued by credit bureaus. You are entitled to know the reason for any negative activity on your report and to have any errors corrected. Similarly, the Fair Credit Billing Act lets you dispute and correct billing information.

If you find yourself in debt and subject to debt collection, be aware that debt collectors must ensure the accuracy of the bill in question and allow you to dispute the bill if you believe it to be in error. Debt collectors may not threaten, harass, or otherwise abuse you in pursuit of the debt.

Check Your Understanding

1. **Key Terms** **(a)** Name two types of **credit** and explain how they are different. **(b)** How does **collateral** discourage borrowers from defaulting on a loan? **(c)** How do the Equal Credit Opportunity Act and **Truth in Lending laws** protect consumers?
2. **Analyzing Information** Analyze the credit card offers your household receives in the mail or that you see advertised. Make a chart comparing their features and finance charges. Identify and explain which credit card is the best deal.