



CH. 6 | USING CREDIT

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WHY WE USE CREDIT

- Spread out large cash outlays
- Meet a financial emergency
- Convenience
- Investment purposes

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YOU SHOULD NOT USE CREDIT TO ..

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

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MINIMUM PAYMENTS MEAN MAXIMUM YEARS

- Calculations are based on a minimum 3% monthly payment with a minimum fixed dollar amount of \$15.00 for low balances and 18.0% APR.

Original Balance	Years to Repay	Interest Paid	Total Interest Paid as % of Original Balance
\$ 5,000.00	16.58	\$ 4,698.32	93.97%
\$ 3,000.00	13.83	\$ 2,698.32	89.94%
\$ 1,000.00	7.75	\$ 698.35	69.84%

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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

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HOW MUCH CREDIT CAN YOU AFFORD?

- Debt Safety Ratio =
$$\frac{\text{Monthly consumer credit payments}}{\text{Monthly take-home pay}}$$
- Monthly consumer credit payments (excluding mortgage) **should not exceed 20%** of monthly net income.

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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
 - ✓ High interest (Prime rate + a percentage)
 - ✓ Annual fees, transaction fees, late-payment fees, over-the-limit fees, balance transfer fees, foreign transaction fees and so forth
- Some offer rewards (e.g. frequent flyer mileage, cash back, etc.)

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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.

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RETAIL CHARGE CARDS

- Second largest category
 - ✓ Department stores
 - ✓ Oil/gas companies
 - ✓ Hardware stores
- Build loyalty
- Preset credit limits

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REVOLVING CREDIT LINES

- Open account credit offered by banks or other financial institutions
 - ✓ Overdraft protection lines
 - ✓ Unsecured personal credit lines
 - ✓ Home equity line of credit (HELOC)
- Usually offer higher credit lines and lower interest rates than credit cards
- Access money by writing checks

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MANAGING YOUR CREDIT CARDS

- Review statements monthly to verify entries.
- Pay by due date
 - ✓ Pay the entire amount to avoid finance charges.
 - ✓ Try to pay more than the minimum monthly payment.
 - ✓ You can get lower rates for immediate or long-term borrowing from other sources than credit cards.
- Shop around for best deal: Annual fees, rate of interest charged on balance, length of grace period, method of calculating balances, rewards, etc.

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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
- Average Daily Balance (ADB): Method of computing finance charges by applying interest charges to the average daily balance
- ADB including new purchases: Most frequently used, no grace period on new purchases if balance is carried forward

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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

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FICO SCORES, FAIR ISAAC & CO

- 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 with an average of 711 in 2020

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FICO SCORE RANGES

- 800-850: Exceptional
- 740-799: Very good
- 670-739: Good
- 580-669: Fair
- 300-579: Very poor

Average FICO® Score by Generation		
Generation	2019	2020
Generation Z (18-23)	667	674
Millennials (24-39)	668	680
Generation X (40-55)	688	699
Baby boomers (56-74)	731	736
Silent generation (75+)	757	758

Source: Experian. Table compares annually representative samples from 2019 and October 2020.

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IMPROVING YOUR CREDIT SCORES

- Build your credit file.
- Make sure you don't miss loan or credit card payments by more than 29 days.
- Catch up on past-due accounts; a late payment can remain on your credit report for up to seven years.
- Maintain low balances on credit cards and lines of credit relative to their credit limits.
- Limit how often you apply for new accounts.

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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.

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AVOID CREDIT PROBLEMS

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

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PERSONAL BANKRUPTCY

- People who follow the bankruptcy rules receive a discharge — a court order that says they don't have to repay certain debts.
- However, bankruptcy information stays on a credit report for 10 years and can make it difficult to get credit, buy a home, get life insurance, or sometimes get a job.
- **Chapter 13 & Chapter 7:** Each must be filed in federal bankruptcy court. Filing fees are several hundred dollars. Attorney fees are extra and vary.

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TWO MAIN TYPES OF PERSONAL BANKRUPTCY

- **Chapter 13** allows people with a steady income to keep property, like a mortgaged house or a car, that they might otherwise lose through the bankruptcy process. In Chapter 13, the court approves a repayment plan that allows you to use your future income to pay off your debts during three to five years, rather than surrender any property.
- **Chapter 7** is known as straight bankruptcy; it involves liquidating all assets that are not exempt. Exempt property may include automobiles, work-related tools, and basic household furnishings. About 70% of personal bankruptcy are Chapter 7.

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