

CHAPTER 6

Introduction to Consumer Credit

Personal Finance 7e

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Use and Misuse of Credit

- Before you use credit for a major purchase, ask yourself some questions.
 - ♦ Do I have the cash for the down payment?
 - ♦ Do I want to use my savings for this purchase?
 - ♦ Does this purchase fit my budget?
 - ♦ Could I use the credit I'll need in some better way?
 - ♦ Can I postpone this purchase?
 - ♦ What are the opportunity costs of postponing this purchase?
 - ♦ What are the dollar and psychological costs of using credit for this purchase?

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Good Debt, Bad Debt

- Good Debt:
 - ♦ Student loan
 - ♦ Mortgage
 - ♦ "People first, then money" debts
- Bad Debt:
 - ♦ Credit card debt arising from overspending
 - ♦ Excessive car loan

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Advantages of Credit

- Current use of goods and services.
- Permits purchase even when funds are low.
- A cushion for financial emergencies.
- Advance notice of sales.
- Easier to return merchandise.
- Convenient when shopping.
- One monthly payment.
- Safer than cash.



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What is Consumer Credit?

- Credit is an arrangement to receive cash, goods or services now, and pay for them in the future.
- Consumer credit is the use of credit for personal needs, except a home mortgage, by individuals and families.
- Three ways consumers can finance purchases.
 - ♦ Draw on their savings.
 - ♦ Use present earnings.
 - ♦ Borrow against expected future income.
- Each finance alternative has a trade-off.
- Consumer credit is a major force in our economy.

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Advantages of Credit (continued)

- Needed for hotel and car reservations and shopping online.
- To take advantage of float time/grace period.
- May get rebates, airline miles, or other bonuses.
- Indicates financial stability.



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Disadvantages of Consumer Credit

- Temptation to overspend.
- Can create long-term financial problems and slow progress toward financial goals.
- Potential loss of merchandise due to late or non-payment.
- Ties up future income.
- Credit costs money - more costly than paying with cash.



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Credit Cards



- Eight out of ten American households carry one or more credit cards.
- One-third are convenience users. They pay their balance off in full each month.
- The other two-thirds are borrowers, carrying a balance over and paying finance charges.
- Some use cards for cash advances - expensive.
- Co-branding - linking a credit card with a business offering rebates on products and services.
- Smart cards have an imbedded computer chip.
- Debit cards are not credit cards.

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How to Protect Yourself From Identity Theft

- Sign up for a credit-monitoring service, such as Credit Watch from Equifax. For \$40 a year they scan your report daily and send you e-mail alerts.
- Remove your name from direct mail and telemarketing lists.
- Protect yourself by shredding old credit slips, account statements, and credit offers you receive in the mail.
- Stop preapproved credit card offers by calling 1-888-567-8688.

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Protecting Yourself Against Credit Card Fraud

- Sign new cards as soon as they arrive.
- Treat the cards like money - keep them secure.
- Shred anything with your account number on it.
- Don't give your number over the phone unless you initiate the call, and don't put it on postcards.
- Get your card and a receipt after every transaction and compare receipts to bills when they arrive, checking for errors.
- Notify the card issuer if you don't get your billing statement, or if your card is lost or stolen.
 - ◆ If stolen call 1-888-EXPERIAN.
- Check your credit report every few years.

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Types of Credit

- Closed-End Credit.
 - ◆ One-time loans for a specific purpose that you pay back in a specified period of time, and in payments of equal amounts.
 - Mortgage, automobile, and installment loans for furniture, appliances and electronics.
- Open-End Credit.
 - ◆ Use as needed until reaching line of credit max.
 - Credit cards, departments store cards, and home equity loans.
 - ◆ You pay interest and finance charges if you do not pay the bill in full when due.

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When You Make Purchases Online

- Use a secure browser - look for padlock.
- Keep records on your online transactions.
- Review your monthly statements.
- Read policies of the websites you visit concerning refunds, site security, and privacy.
- Keep personal information private unless you know who is gathering it and why.
- Shop at businesses you know and trust.
- Never give out your password to anyone online.
- Don't download files sent by strangers.

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Measuring Your Credit Capacity

- Before you take out a loan, ask yourself...
 - ♦ Can you afford the loan?
 - ♦ What do you plan to give up in order to make the payment?



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Cosigning a Loan



- The creditor will give you a notice that tells you...
 - ♦ You are being asked to guarantee the debt, so consider if you can afford it if the borrower defaults.
 - ♦ If the borrower does not pay you may have to pay up to the full amount and also any late or collection fees.
 - ♦ If a payment is missed the creditor can collect the debt from you without first trying to get it from the borrower.

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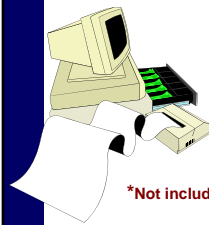
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General Rules of Credit Capacity

Debt Payments-to-Income Ratio

$\frac{\text{monthly payments}^*}{\text{net monthly income}}$

Consumer credit payments should not exceed a max of 20% of your net income.



*Not including house payment which is a long-term liability

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Cosigning a Loan (continued)

- If you do cosign, consider...
 - ♦ Can you afford to pay the loan? If not, your credit rating could be damaged.
 - ♦ Liability for this debt may prevent you from getting other credit that you want.
 - ♦ If you put up property as collateral you could lose it if the loan goes into default.
 - ♦ Check your state's law to learn about cosigner's rights.
 - ♦ Request that a copy of overdue payment notices be sent to you.

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General Rules of Credit Capacity

(Continued)

Debt To Equity Ratio

$\frac{\text{total liabilities}}{\text{net worth}^*} = \text{Should be } < 1$



*Excluding home value

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Build and Maintain Your Credit Rating

- Limit your borrowing to your capacity to repay.
- Live up to the terms of contracts.
- Check to see what is in your credit report.
 - ♦ Credit bureaus collect information.
 - ♦ Experian, Trans Union and Equifax.
 - ♦ Mix-ups and errors in credit reports have improved recently, but the FTC still gets a lot of complaints about credit bureaus from consumers.
 - ♦ Bureaus get information from banks, finance companies, credit card companies, merchants and other creditors.

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Fair Credit Reporting Act

Is your credit report accurate?

- If you are denied credit based on your report, you can get a copy of your credit report free within 60 days of your request.
- Credit card companies must correct inaccurate or incomplete information.
- Only authorized persons have access to your report.
- Adverse data can be reported for seven years and bankruptcy for ten years.



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Avoiding and Correcting Credit Mistakes

Fair Credit Billing Act

- Notify creditor of error in *writing* within 60 days.
- Include your explanation of the error and your account number to the billing inquiries address.
- They must respond within 30 days.
- Credit card company has two billing periods but no longer than 90 days to correct your account or tell you why they think the bill is correct.
- The disputed item won't affect your credit rating while in dispute.

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What If You are Denied Credit?

- Check your credit file at the credit bureau.
- If you are denied credit because of something in your report you have 60 days to request a free copy.
- Ask the creditor to clarify the specific reason for denial of credit. If you believe the denial is valid...
 - ◆ Apply to another creditor with different standards.
 - ◆ Take steps to improve your creditworthiness.
 - ◆ You have the right to provide a 100 word explanation in your file.
 - ◆ See www.consumercreditrepair.com.
- Seek help if you think there is discrimination.

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Avoiding and Correcting Credit Mistakes

Fair Credit Billing Act (continued)

- You can withhold payment on damaged or shoddy goods or poor services if you have paid for them with a credit card, as long as you make a sincere attempt to resolve the problem with your creditor.



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What Creditors Look For: 5 Cs

- Character - Do you pay bills on time?
- Capacity - Can you repay the loan?
- Capital - What are your assets and net worth?
- Collateral - What do you have of value that you pledge to the lender that they can repossess if you fail to honor the terms of the agreement?
- Conditions - What economic conditions could affect your ability to repay the loan?



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What if Your Identity is Stolen?

- Contact the fraud department of each of the three major credit bureaus and tell them to flag your file with a fraud alert, including a statement that creditors should call you for permission before opening any new accounts in your name.
- Contact creditors to check for any accounts that have been tampered with or opened fraudulently.
- File a police report and keep a copy.
- Check www.consumer.gov/idtheft for help.



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Complaining About Consumer Credit

- First try to solve the problem directly with the creditor.
- If that does not work there are more formal complaint procedures.
- There are a variety of consumer credit protection laws and federal agencies who administer and assist with complaint procedures. See the Exhibit 6-12 "Summary of Federal Consumer Credit Laws" in your text.



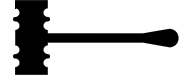
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Protection Under Other Consumer Credit Laws

- Equal Credit Opportunity Act.
 - ♦ Specifies your rights if you have been refused credit due to discrimination.
- 1977 Consumer Credit Reporting Reform Act.
 - ♦ Places burden of proof on credit issuers.
 - ♦ Sets \$8.00 maximum cost for a credit report.
 - ♦ Allows consumers to opt out of prescreened lists.



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Truth In Lending Rights

The Truth In Lending Act requires creditors to provide you with accurate and complete credit costs and terms.



- ♦ Provides specific cost disclosure requirements for the annual percentage rate (APR) and the finance charges as a dollar amount.
- ♦ Regulates disclosure of other terms and conditions.
- ♦ Regulates advertising of credit terms.

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Fair Debt Collection Practices Act

Collection agencies...

- Can't be abusive or threaten.
- Can't call you at work if you say not to.
- Can't tell boss and friends.
- Can't call you at odd hours.
- Must follow set procedures.
- The act does not apply to creditors that try and collect the debt themselves.



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