

CHAPTER 7

Choosing a Source of Credit: The Cost of Credit Alternatives

Personal Finance 7e

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Trade-Offs of Financing Choices

- Term (length of loan) versus interest cost.
- Lender risk versus interest rate. To reduce the lender's risk and thus the interest rate you can...
 - ◆ Accept a variable interest rate.
 - ◆ Provide collateral to secure the loan.
 - ◆ Make a large down payment up front.
 - ◆ Have a shorter loan term.



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Sources of Consumer Credit

- Inexpensive loans.
 - ◆ Parents or family members.
 - ◆ Loans based on assets, such as a CD.
- Medium-priced loans.
 - ◆ Commercial banks, savings and loan associations, and credit unions.
- Expensive loans.
 - ◆ Finance and check cashing companies .
 - ◆ Retailers such as car or appliance dealers.
 - ◆ Bank credit cards and cash advances.



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Calculating the Cost of Credit

- Simple interest.
 - ◆ Computed on principal only and without compounding. The dollar cost of borrowing.
 - ◆ $I = P \times r \times T$
- Simple interest on a declining balance.
 - ◆ Interest is paid only on the amount of original principal not yet repaid.
- Add-on interest.
 - ◆ Interest is calculated on the full amount of the original principal, then added to the principal, and then the total of both is divided by the number of payments to be made.

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The Cost of Credit



- Finance charge is the total dollar amount you pay to use credit. It includes interest costs and fees, such as service charges, credit-related insurance premiums, or appraisal fees.
- The annual percentage rate (APR) is the percentage cost of credit on a yearly basis.
- The APR provides the true rate of interest so you can make comparisons with other sources of credit. This rate lets you compare like with like when shopping for rates.
- It is important to shop for credit.

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Cost of Open-End Credit



- Adjusted balance method.
 - ◆ Finance charges are assessed after payments made in the billing period have been subtracted.
- Average daily balance method.
 - ◆ Creditors 1) add your balances for each day in the billing period, then 2) divide this total by the number of days in the billing period, then 3) multiply this average by the monthly interest rate. New purchases may be excluded from the average daily balance calculation, but generally are *included* if you carry over a balance.

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Cost of Open-End Credit (continued)

- Two-cycle average daily balance method.
 - ◆ May include or exclude new purchases.
 - ◆ Creditors use average daily balance for two consecutive billing cycles.
- Previous balance method.
 - ◆ Method of computing finance charges that gives no credit for payments made during the billing period. For example...
 - APR 18%; Monthly rate $1\frac{1}{2}\%$.
 - Previous balance \$400; Payments \$300
 - Finance charge \$6.00 ($1\frac{1}{2}\% \times \400)



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Credit Card Tip



Shopping wisely for a credit card can make a difference. For example, you save \$57 in the first year when you switch a \$1,000 balance from a 19.8% interest rate card to a 14% card, and you are out of debt a year and a half sooner.

Ask the issuer for a lower rate or to waive the annual fee.

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Choosing and Using a Credit Card

- If you plan to pay each month in full, look for a card with no annual fee.
- If you plan to carry a balance, look for a low interest rate, and determine the method used for computing interest.
- The interest you pay on consumer credit is not tax deductible, and is related to the inflation rate.
- Avoid the minimum monthly payment trap.
- Early repayment: The Rule of 78s.
- Credit insurance pays off loan if person dies or if they become ill or disabled.

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Credit Card Tip



When you charge more than your credit limit allows, your credit card issuer may charge you an Over the Limit fee of up to \$70.

Your card issuer may allow you to exceed your credit limit without telling you, and you may not know you have done so until you receive your bill. It is up to you to know your credit limit and how much available credit you have left.

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Credit Card Tip



When can a smaller annual fee cost you MORE?

Sometimes a low annual fee card comes with a high interest rate. It pays to look at all the fees and charges when choosing a credit card that's right for you: the annual fee, interest rate, grace period, the over-limit fee, and other special fees and charges.

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Managing Your Debts

- Notify creditors if you can't make a payment.
- The Fair Debt Collection Practices Act regulates debt collection agencies.
 - ◆ If a debt collector calls you, within five days they must send you a written notice of amount owed, the creditors name, and your right to dispute the debt.
 - ◆ You can dispute the debt or pay it.
 - ◆ The debt collector has 30 days to verify the debt (See Exhibit 7-2). If not sent, you can insist the communication about the debt cease.

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Reasons for Indebtedness

- Emotional problems such as the need for instant gratification.
- The use of money to punish and get even.
- The expectation of instant comfort among young couples who overuse the installment plan.
- Keeping up with the Joneses.
- Overindulgence of children.
- Misunderstanding or lack of communication among family members.
- The amount of finance charges makes it difficult to repay and the charges pyramid.

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Consumer Credit Counseling Services

- If you can't pay your bills, postpone further credit purchases, talk with your creditors, or seek help from a non-profit credit counseling service.
 - ◆ CCCS is non-profit and supported by contributions from banks, merchants, etc.
 - ◆ Provides education about credit.
 - ◆ Provides help with spending plan.
 - ◆ Provides debt counseling services for those with serious financial problems.
 - ◆ Can develop a debt consolidation plan and negotiate reduced interest rates.



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Warning Signs of Debt Problems

- Paying only the minimum balance each month.
- Increasing the total balance due each month.
- Missing or alternating payments or paying late.
- Intentionally using overdraft protection or taking frequent cash advances.
- Using savings to pay routine bills such as food.
- Getting second or third payment notices.
- Not talking to your partner about money or talking *only* about money.
- Depending on overtime to meet routine expenses.

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Alternative Counseling Services

- Besides the CCCS universities, local county extension agents, credit unions, military bases, and state and federal housing authorities provide nonprofit counseling services.
- You can check with your financial institution or consumer protection office to see if it has a listing of reputable, low-cost financial counseling services.
- www.consumercredit.com is the website of the nonprofit American Consumer Credit Counseling.
- Sometimes the answer is bankruptcy.

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Warning Signs of Debt Problems (continued)

- Using up your savings.
- Borrowing money to pay old debts.
- Not knowing how much you owe.
- Going over your credit limit on credit cards.
- Having little or no savings for the unexpected.
- Being denied credit due to a credit report.
- Getting denied a credit card revoked by the issuer.
- Putting off medical or dental visits because you can't afford them now.

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Declaring Personal Bankruptcy

- Personal bankruptcy rate is the highest it has ever been, and is increasing annually.
- Bankruptcy was designed as a last resort but has become an "acceptable" tool of credit management.



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Bankruptcy

- Stays on your credit report for 10 years, making it difficult to get credit. Potential employers may look at your credit report.
- Chapter 7.
 - ◆ Submit a petition to the court that lists assets and liabilities, and pay a filing fee.
 - ◆ Many, but not all, debts are forgiven.
 - ◆ Assets are sold to pay creditors.
 - ◆ Can keep some assets.
 - ◆ Idea is a fresh start.
 - ◆ Most filed are this type.

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After Chapter 7 You May No Longer Owe...

- Retail store charges.
- Bank credit card charges.
- Unsecured loans.
- Unpaid hospital or physician bills.

After Bankruptcy You Still May Owe...

- Certain taxes and fines.
- Child support and alimony.
- Educational loans.
- Debts from willful or malicious acts.

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Chapter 13 Bankruptcy

- A voluntary plan proposed to the bankruptcy court for those to want to pay a portion of their debt over a period up to five years.
 - ◆ Must have a regular income.
 - ◆ Can't have more than \$250,000 in income or \$750,000 in debt.
 - ◆ Payments are made to a trustee.
 - ◆ Trustee distributes money to your creditors.
 - ◆ Court may allow you to keep all of your property.
- Costs to the debtor include court costs, attorney's fees and trustee's fees and costs.

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