



Chapter 7

Choosing a Source of Credit: The Cost of Credit Alternatives

The Cost of Credit

- Finance charge is the total dollar amount you pay to use credit. It includes interest costs, service charges, credit-related insurance premiums, or appraisal fees.
- The annual percentage rate (APR) is the percentage cost of credit on a yearly basis.
- APR: True rate of interest so you can compare rates with other sources of credit.
- It is important to shop for credit.

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Sources of Consumer Credit-See Exhibit 7-1

- Inexpensive loans.
 - Parents or family members.
 - Loans based on assets- using CD as collateral.
- 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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Trade-Offs of Financing Choices

- Term: Longer loans-lower payments, but more total interest .
- Lender risk versus interest rate. Some ways to reduce the lender's risk and the interest rate:
 - 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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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, added to the principal, and the total of both is divided by the number of payments to be made.

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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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Cost of Open-End Credit

- Adjusted balance method.
 - Finance charges are calculated 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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Choosing and Using a Credit Card

- Paying in full each month: cards with no annual fees.
- Revolving credit: Select a card with a low interest rate, & a fair method for computing interest.
- Interest paid 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-favors lenders.
- Credit insurance: Loan paid off if insured dies or becomes disabled--Expensive.

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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.
 - You request verification of the debt within 30 days; (See Exhibit 7-2). If not sent, you can insist communication about the debt cease.
 - If verification sent, you may pay the debt or give notice that you will not pay.

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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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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.
- Amount of finance charges makes it difficult to repay.

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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 a credit card revoked by the issuer.
- Putting off medical or dental visits because you can't afford them now.

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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 and budgeting.
 - 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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Declaring Personal Bankruptcy

- A record 1.6 million people declared bankrupt in 2004.
- Bankruptcy was designed as a last resort but has become an "acceptable" tool of credit management.

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Alternative Counseling Services

- 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. Avoid those with large fees.
- www.consumercredit.com is the website of the nonprofit American Consumer Credit Counseling.
- Bankruptcy-Last resort.

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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.
 - 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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Class Activity

- Go online and research bankruptcy laws in your state. You might try www.washlaw.edu or www.law.cornell.edu.
- What kinds of property can a debtor exempt under Chapter 7 in your state?
- Do you feel bankruptcy laws are too lenient?

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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 unsecured debt or \$750,000 in secured debt.
 - Payments are made to a trustee.
 - Trustee distributes money to your creditors.
 - Court may allow you to keep property & pay less than full amount of debts.
- Costs to the debtor include court costs, attorney's fees and trustee's fees and costs.

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Class Activities

- Invite a banker to class to discuss credit with you.
- Invite someone from Consumer Credit Counseling Service to come to your class to discuss credit and budgeting.

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