

Chapter 4



Going into Debt

Chapter Overview

Chapter 4 explains the advantages of buying items on credit and why people decide to use credit; six types of lending institutions; how credit ratings are determined; and borrowers' responsibilities.



Section Overview

Section 1 explains or describes the importance and uses of consumer credit and loans in the economy, the advantages of repaying loans over the long term, and why and how consumers decide to use credit. ↓

Objectives

- What are the advantages of repaying installment debt over a long period? ↓
- Why do people go into debt? ↓
- What factors should you consider when deciding whether or not to use credit?

Terms to Know

- credit ↓
- principal ↓
- interest ↓
- installment debt ↓
- durable goods ↓
- mortgage



Introduction

- Americans use credit to make many purchases. ↓
- The total amount of funds borrowed and lent each year is enormous. ↓
- In addition to individuals borrowing funds, the federal, state, and local governments all borrow funds, too. ↓
- The nation's economy, in fact, depends on individuals and groups being able to buy and borrow on credit. ↓
- In this section, you'll learn what credit is and why people use it.

Introduction (con't.)

- In 2001, the typical American household carried an average credit card balance of \$7,500. ↓
- What is a credit card? ↓
- What kinds of things might you purchase with a credit card?



What Is Credit?

- To receive funds for services or goods with the intent of paying back those funds in the future. ↓
- Principal is the amount originally borrowed, and interest is the amount added on for the privilege of borrowing.



Installment Debt

- A loan paid back in equal payments over time ↓
- Used for purchase of durable goods or manufactured products that last over three years ↓
- Longer payback periods have lower payments but higher total interest. ↓
- Mortgages on houses are a popular form of installment debt.

Installment Debt (cont.)

Increase in Borrowing

More and more Americans are choosing to buy durable goods on credit.

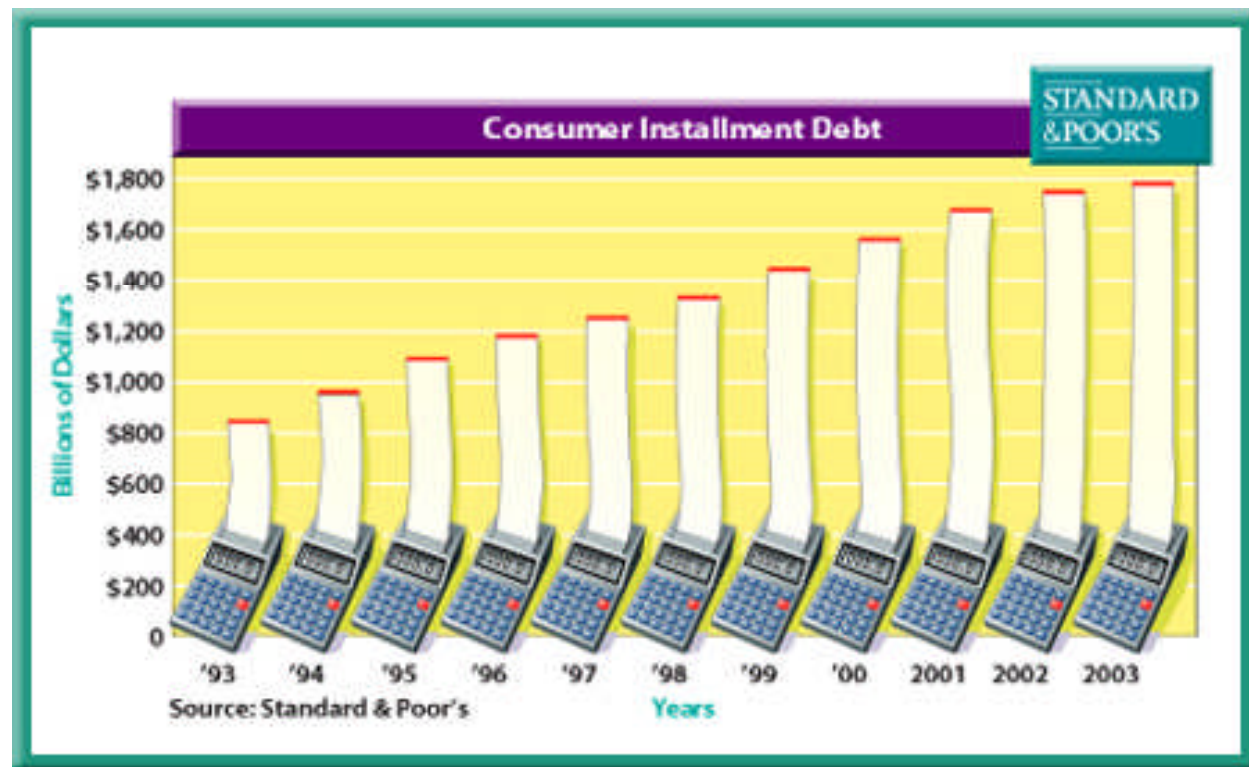


Figure 4.1

Installment Debt (cont.)

Pay Now or Pay Later

Your monthly payment is lower if you choose the 36-month loan.



Figure 4.2

Why People Use Credit

- As a necessity when buying durable goods ↓
- To satisfy an immediate need ↓
- To avoid waiting to enjoy the product ↓
- To spread the payments out over the lifetime of the product



Deciding to Use Credit

- Consider the benefit of having the product now instead of later. ↓
- Consider costs of interest and inability to buy other items. ↓
- You do not have to accept every offer of credit.



Section Overview

Section 2 describes the credit choices available to consumers and how to calculate annual percentage rates and finance charges. ↓

Objectives

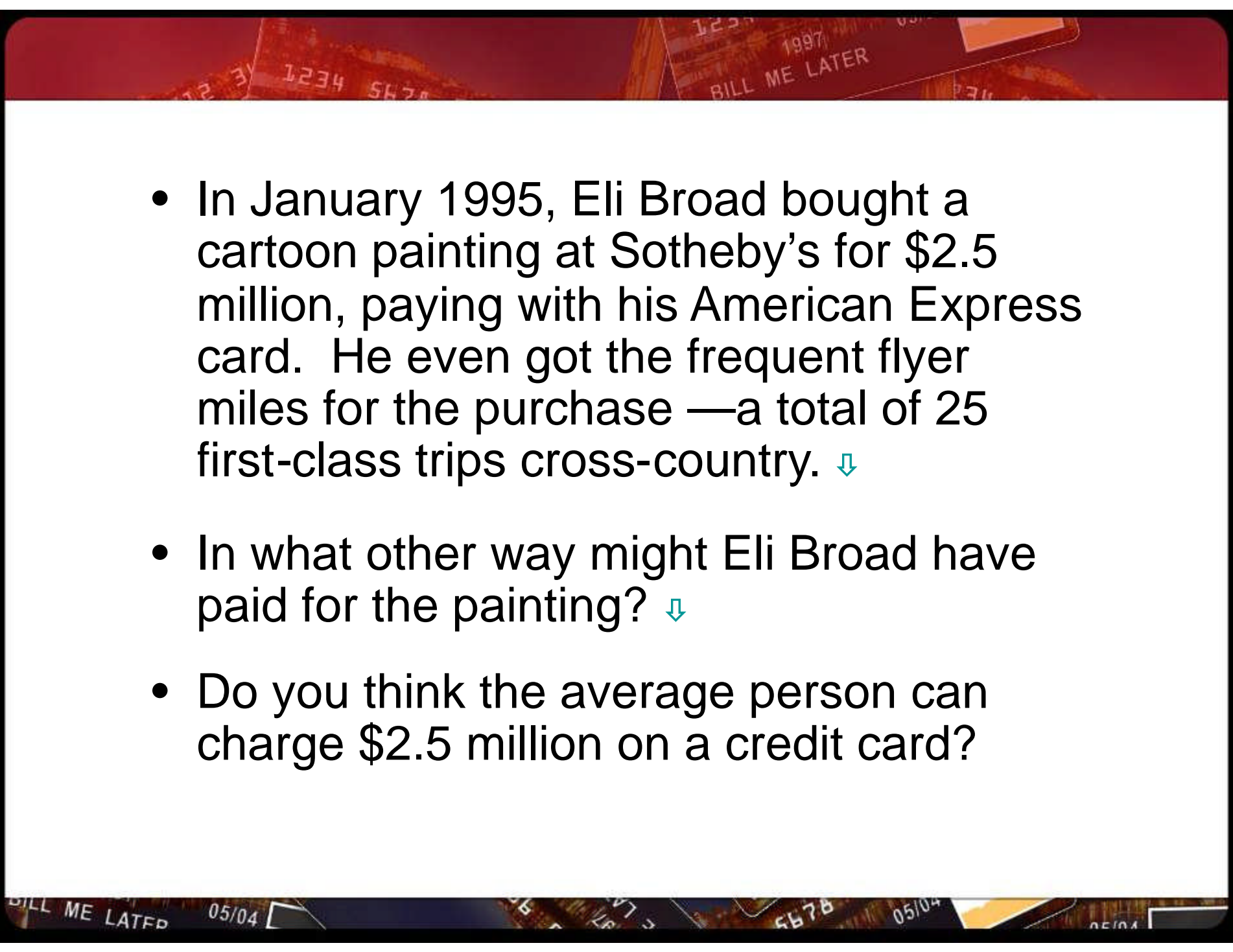
- What are the six types of financial institutions?
- What three kinds of charge accounts are available from stores?
- How are credit cards used?
- How do a finance charge and an annual percentage rate differ?

Terms to Know

- commercial bank ↓
- savings and loan association ↓
- savings bank ↓
- credit union ↓
- finance company ↓
- charge account ↓
- credit card ↓
- finance charge ↓
- annual percentage rate (APR)

Introduction

- There are two major types of credit—using credit cards and borrowing money directly from a financial institution. ↓
- Although lending institutions differ in their services, they all charge interest on the funds they lend. ↓
- In this section, you'll learn what those financial institutions are. You'll also learn about charge accounts and credit cards—and why you should be aware of the high interest rates they charge.

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- In January 1995, Eli Broad bought a cartoon painting at Sotheby's for \$2.5 million, paying with his American Express card. He even got the frequent flyer miles for the purchase —a total of 25 first-class trips cross-country. ↓
 - In what other way might Eli Broad have paid for the painting? ↓
 - Do you think the average person can charge \$2.5 million on a credit card?

Types of Financial Institutions

- Commercial Banks offer the widest range of services. ↓
- Savings and Loan Associations often have lower interest rates than commercial banks. ↓
- Savings Banks were created to serve small savers who weren't being served by larger commercial banks.

Types of Financial Institutions (con't)

- Credit Unions are owned and operated by their members; generally have higher interest rates for savings and lower rates for loan. ↓
- Finance Companies collect debt for stores' installment loans; generally have very high interest for loans.

Charge Accounts

- Enable consumer to buy something and pay for it later ↓
- Regular charge accounts have credit limits, a 30 day billing cycle, and charge no interest if the bill is paid in-full each month. ↓
- Revolving charge accounts have a minimum payment due each month and interest is charged on the outstanding balance.

Charge Accounts (cont.)

- Installment charge accounts require equal payments spread over time and part of each payment goes to principal and part to interest.



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05/04

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Credit Cards

- Can be used in many different stores and places ↓
- Have high interest rates due to the large number of delinquent loans ↓
- Some offer lower rates with special conditions to attract customers.

Finance Charges and Annual Percentage Rates


- A finance charge is the entire cost of borrowing including interest and all fees. ↓
- Finance charges can be computed in 4 different ways. ↓
- The Annual Percentage Rate is the cost of credit expressed as a yearly percentage. ↓
- Knowing the APR allows consumers to compare costs regardless of dollar amounts or length of credit agreement.

Finance Charges and Annual Percentage Rates

Figure 4.10 Computing APR

Suppose that you charge \$200 worth of clothes. The interest rate charged to you, let's say, is 10 percent, but the annual fee for the credit card is \$5.

Your APR will be \$20 of interest plus the \$5 fee, or 12½ percent. The APR is normally larger than the interest rate because it includes the noninterest cost of extending credit



	None	\$5.00
Amount Charged	\$200.00	\$200.00
Interest at 10%	\$20.00	\$20.00
Annual Membership Fee	none	\$5.00
APR	10%	12.5%

Debit Cards

- Debit cards are not a loan. ↓
- Debit cards transfers funds directly from person's bank account to the store.



Section Overview

Section 3 explains or describes the factors that establish a person's credit rating, the difference between a secured loan and an unsecured loan, and the responsibilities a borrower assumes on taking out a loan.



Objectives

- What four factors determine a person's credit rating? ↓
- What are your responsibilities as a borrower?

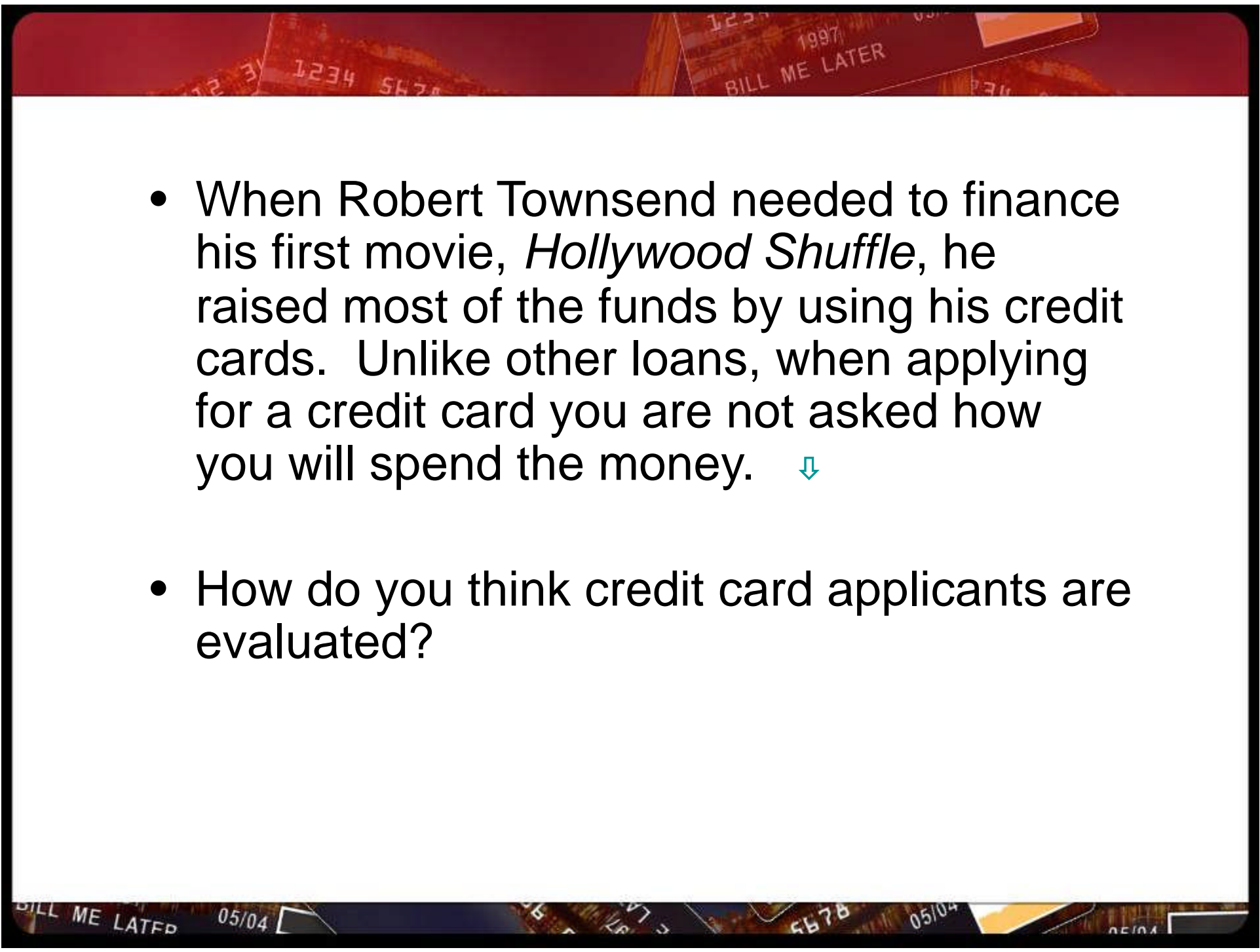
Terms to Know

- credit bureau ↓
- credit check ↓
- credit rating ↓
- collateral ↓
- secured loan ↓
- unsecured loan



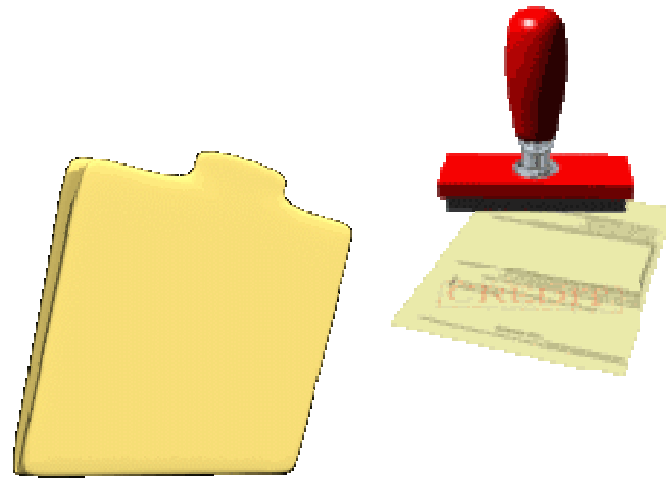
Introduction

- How can you obtain credit? ↓
- Perhaps more important, how can you dig yourself *out* of debt if you've spent more than you can handle? ↓
- In this section, you'll learn what makes a person a good risk for credit. You'll also learn ways to handle your debts before they get out of control.

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- The slide features a decorative border at the top and bottom. The top border is a solid dark red color. The bottom border is a collage of several credit cards, showing details like the text 'BILL ME LATER', the date '05/04', and the number '5678'.
- When Robert Townsend needed to finance his first movie, *Hollywood Shuffle*, he raised most of the funds by using his credit cards. Unlike other loans, when applying for a credit card you are not asked how you will spend the money. ↓
 - How do you think credit card applicants are evaluated?

Creditworthiness

- Fill out an application. ↓
- The agency, store, or bank hires a credit bureau to do a credit check.



The Credit Rating

- Tells how risky it is for a bank to lend someone money ↓
- Considers a person's income, debt, character, and personal wealth ↓
- Secured loans are backed up with collateral in the event of non-payment. ↓
- Unsecured loans need no collateral, but sometimes require a cosigner who becomes responsible for repaying the loan in event of non-payment. ↓

Responsibilities as a Borrower

- Pay on time. ↓
- Repay all of your debts, or suffer the consequences of a bad credit history. ↓
- Keep records so as not to go over your credit limit. ↓
- If debt becomes unmanageable, concentrate on paying high-interest debts first, and try to pay more than the minimum amount required.

Section Overview

Section 4 describes state usury laws and federal laws that regulate the credit industry and explains why a person who cannot repay debts might file for bankruptcy. ↓

Objectives

- How has the Equal Credit Opportunity Act affected consumer credit? ↓
- What are the state usury laws? ↓
- Why might a person declare personal bankruptcy?

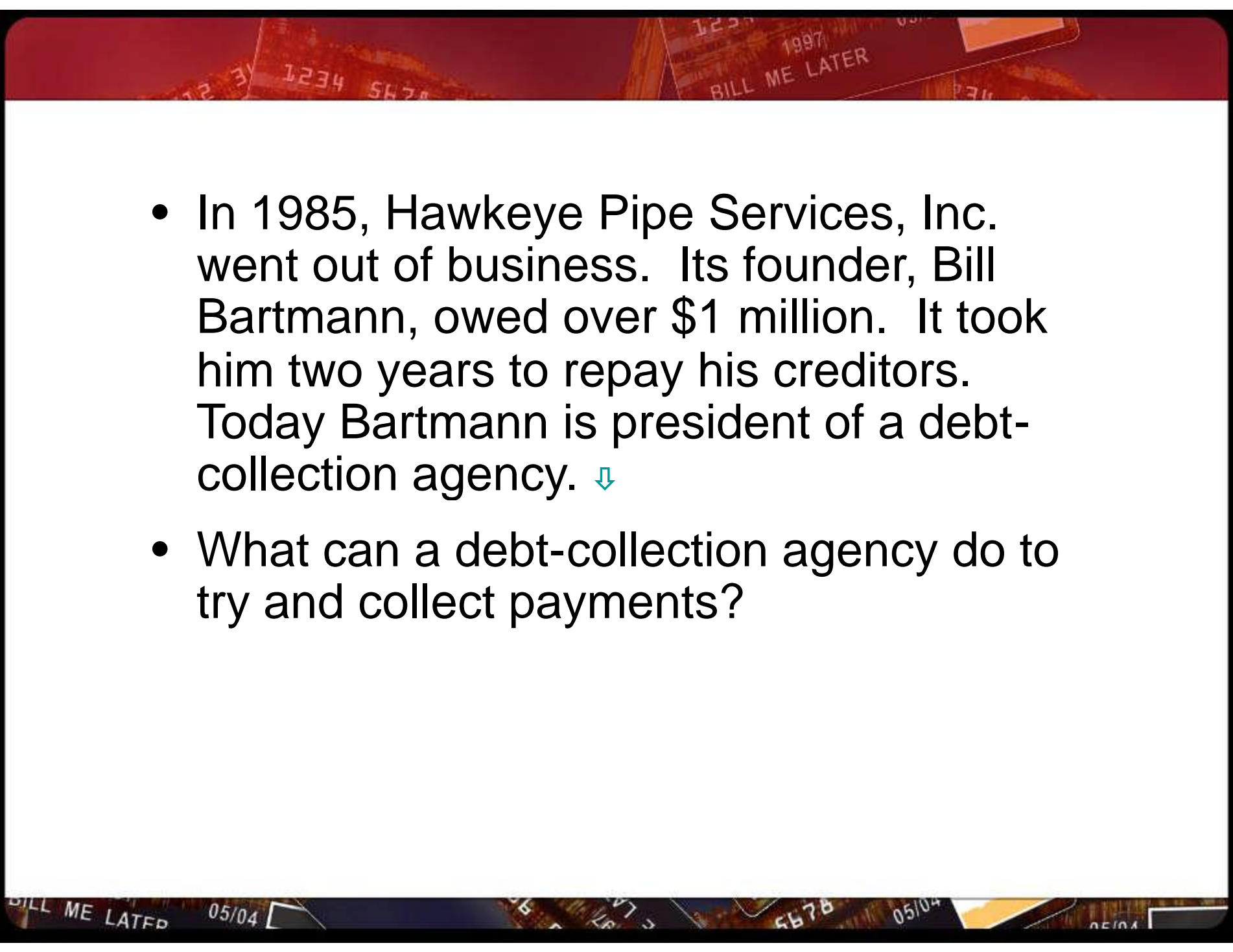
Terms to Know

- usury law ↓
- bankruptcy



Introduction

- To protect consumers, the federal and state governments regulate the credit industry. ↓
- Some states have set a maximum on the interest rates charged for certain types of credit. ↓
- The federal government has also passed laws designed to increase the flow of credit information to consumers. ↓
- In this section, you'll learn about these laws and how they protect consumers from unfair credit practices.

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- In 1985, Hawkeye Pipe Services, Inc. went out of business. Its founder, Bill Bartmann, owed over \$1 million. It took him two years to repay his creditors. Today Bartmann is president of a debt-collection agency. ↓
 - What can a debt-collection agency do to try and collect payments?

The Truth in Lending Act

- The first law that expanded the government's role in protecting users of consumer credit ↓
- Ensures that consumers are fully informed about costs and conditions of borrowing

The Equal Credit Opportunity Act

- Creditors cannot discriminate solely on basis of race, religion, national origin, gender, marital status, or age. ↓
- After 1974, a woman no longer had to have her father or husband sign for her to get a credit card or other loan.

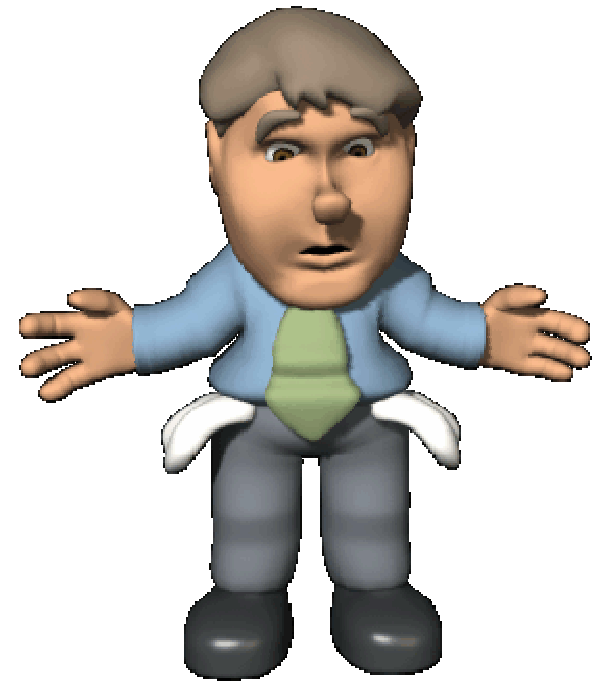


State Usury Laws

- Restrict the amount of interest that can be charged for credit, setting up maximum interest rates. ↓
- Interest ceilings can lead to a shortage of credit if general interest rates rise, hurting both the lender and the consumer.

Personal Bankruptcy

- For people who absolutely cannot repay their debts ↓
- Debtors give up most of what they own to be distributed among creditors. ↓
- Creditors are forced to forgive entire debt. ↓
- It remains on a person's credit history for 10 years.



Chapter Summary

Section 1: Americans and Credit

- **Credit** is the receiving of funds either directly or indirectly to buy goods and services today with the promise to pay for them in the future. ↓
- The amount owed—the debt—is equal to the **principle plus interest**. ↓
- Many people buy **durable goods** and obtain **mortgages** using **installment debt**. ↓
- People go into debt because they do not want to wait to purchase an item with cash, and they want to spread the debt payments over the life of the item being purchased.

Chapter Summary

Section 2: Sources of Loans and Credit

- The major financial institutions that lend consumers funds include **commercial banks, savings and loan associations, credit unions, and finance companies.** ↓
- A **charge account** allows a customer to buy goods or services from a particular company and pay for them later. ↓
- A **credit card**, often charging high interest, may be used at stores, restaurants, or other businesses.

Chapter Summary

Section 2: Sources of Loans and Credit (con't.)

- **Finance charges** tell you the monthly cost of credit in dollars and cents. ↓
- The **annual percentage rate** tells you the annual cost of credit in percentages.

Chapter Summary

Section 3: Applying for Credit

- After you have filled out a credit application, a **credit bureau** will perform a **credit check** and determine your **credit rating**. ↓
- Before granting you credit, a creditor looks at your capacity to pay, your character, and any **collateral** you may have. ↓
- Your responsibilities as a borrower include paying on time, keeping records of your debt, and not spending more than you can repay.

Chapter Summary

Section 4: Government Regulation of Credit

- Legislation states that those who provide credit cannot deny you such credit solely on the basis of your race, religion, national origin, gender, marital status, or age. ↓
- A **usury law** restricts the amount of interest that can be charged for credit, but also leads to a shortage of available credit. ↓
- People who cannot repay their debts may have to file personal **bankruptcy**.

Chapter 4

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