LESSON 7.2 BORROWING MONEY

Managing Your Income

Standard 7

The student will identify the procedures and analyze the responsibilities of borrowing money.

Lesson Objectives

- Identify potential sources of credit.
- Compare credit sources.
- Evaluate credit practices.
- Calculate credit costs.
- Demonstrate the ability to make good credit choices.

Personal Financial Literacy Vocabulary

Annual percentage rate: The percentage cost of credit on an annual basis.

Introduction

Jason did not understand how it happened. He had a job and got a credit card his

sophomore year in high school. At first, it was easy to keep up and pay the balance each month. But after he got a car, the expenses started to grow. First, he had to replace two tires, then the battery died, and now he is paying for a limo, tux, flowers and everything else needed for the senior prom. Suddenly, the amount charged on his credit card was more than he could pay. He was so worried that he decided to stop opening the monthly statement. Then he got a letter saying his interest rate had doubled and his payments were increasing. He was afraid to tell his parents because they warned him about using credit cards.

What should Jason do?

Lesson

Borrowing money is serious business. When shopping for a loan, you should consider comparing lenders because the type of lender you choose determines the terms of your loan agreement. Building a good relationship with a banker in your local community can be a helpful way to get a loan. Traditional financial institutions such as banks and credit unions tend to have lower interest rates than others, and they can be helpful in assisting you when needed.

Regardless of what lender you choose, they will want to know something about you before giving you a loan. Your character, your credit score, and several other factors play a role in whether or not you qualify for a loan and what kind of interest rate they give you. Your eligibility and the interest rate charged can vary greatly from one lender to another.

Annual Percentage Rates

One of the most important features to understand about interest rates is how they are calculated. In its simplest form, interest is calculated as the dollar amount of interest charged divided by the amount of money borrowed. For example, if you borrow $1,000 that must be repaid at the end of one year at 6 percent interest, you would pay the $1,000 plus $60 in interest. (6% of $1,000 is $60)

Calculating interest on most loans, however, is more complex because few loans are repaid in just one year with just one payment. Most loans require you to make a series of payments for a specific amount of time. (Note: Interest rates on credit cards are more complex and discussed later in this lesson.)

Interest rates are always stated as APR, or the annual percentage rate (the percentage cost of credit on an annual basis, which must be disclosed by law). Suppose you decide to borrow that same $1,000 at 6 percent and repay it in three months instead of one year. If you signed a contract agreeing to pay back $1,060, you would still pay the full amount, but your APR would be different because interest rates are calculated for the entire year. However, if your loan allows for pre-payment or an early pay-off, you would only pay the amount of interest accrued over the three month period of time.

To find your APR, follow these steps:

Divide the number of months in the year (12) by the number of months you are borrowing the money (3 in this example). 12/3 = 4

Multiply the rate of interest paid (6 percent in this example) by 4 (the answer in step 1). 6 x 4 = 24

In this situation, your annual rate of interest for this loan is 24 percent.

Now, suppose you borrow $1,000 for two years at 6 percent.

Divide the number of months in the year (12) by the numbers of months you are borrowing the money (now, it is 24). 12/24 = .5

Multiply the rate of interest paid (again, it is 6 percent) by .5. 6 x .5 = 3

Your annual rate of interest for this loan is only 3 percent.

The APR does not reflect the total amount of interest paid in one year. Instead, it simply standardizes rates so you can compare them from one year to the next.

The annual percentage rate (APR) is the actual rate of interest charged on an installment loan, a loan that is repaid with a fixed number of periodic equal-sized payments. Most loans from banks, retail stores, and other lenders are installment loans. Lenders are required to report the APR in boldface type on the front page of all loan contracts. In addition, lenders are required to disclose all terms and conditions of the loan when you borrow the money.

Unfortunately, the way the APR is calculated can vary, which sometimes causes confusion. That is the reason it is important to read all of the fine print and ask whatever questions you have before signing any loan agreements.

Credit Card Interest Rates

Credit card interest rates are a bit more complex because different types of charges may have different interest rates. For example, if you get a cash advance with your credit card, you will pay a higher interest on that charge than when using your credit card to make a purchase. They may also have a different interest rate for balance transfers. Your statement should show the different rates and balances for each type of transaction. However, it is even more important to understand what you will be charged before making a transaction with your credit card. That information is available on the issuer's web site as well as in the materials they mail you periodically.

When calculating interest rates, most credit card companies still relay on an average daily balance even if they apply it differently. Because the number of days vary from month to month, they generally use a daily periodic interest rate (DPR). The DPR is found by dividing the APR by 365 (the number of days in the year). That number is multiplied by the average daily balance and by the number of days in the statement billing cycle.

Suppose your average daily balance is $1,000. The APR is 12 percent. The days in the billing cycle is 30.

> You would first need to calculate the DPR: 12/365 = 3 percent
>
> Then, multiply the percent times the average daily balance: 1,000 x .03 = 30
>
> The interest on your credit card for that month would be $30

Most credit cards have a grace period before adding interest to new charges. A grace period is usually 20-30 days and may apply only if you pay your balance in full. In some cases, your grace period will not take effect until you have paid your bill in full for one or two months. Each credit card company may have somewhat different policies, so it is important to understand their specific requirements for starting your grace period.

Following are the reasons credit card companies can increase your interest rate:

- You are more than 60 days late on your payment.
- You have late or missed payments on other accounts unrelated to your credit card.
- Your credit score drops.
- You have a variable rate credit card.
- Your promotional rate ends.

Payments on Credit Cards

Interest rates on credit cards range from very low (even as low as zero percent on special offers) to very high (over 25 percent). Because credit cards are open-ended, card companies have more flexibility to change your interest rates than other lenders. The Credit Card Accountability Responsibility and Disclosure Act of 2009, commonly called the CARD Act, requires credit card companies to give you at least 45 notices of any increases in interest rates. Also, they cannot make rate changes retroactive; increases only apply to future purchases. Of course, calculating the minimum payment for that credit card is a different formula than calculating the interest. The standard method for computing minimum payments is usually based on the total balance of your account and generally runs between one and three percent. Therefore, it is possible that your minimum payment on a credit card is less than your monthly interest, which is one reason that credit card balances can balloon so quickly when you only make minimum payments.

Because your credit card account may have different interest rates for different types of purchases, the CARD Act requires them to apply your payment to the charges with the highest interest rate first. Therefore, when you pay more than the minimum each month, your overall balance should start to drop, unless you keep adding more charges. Increasing your payments to cover more than minimum greatly reduces your cost of using credit when you stop paying interest on your interest.

Suppose your monthly interest payment is $30 and your monthly balance is $1,000, as shown in the example above. If your credit card company uses the standard minimum payment of one percent, your minimum payment is only $10. Thus, you are adding $20 a month to your overall balance even if you are not making additional purchases. If you increase your monthly payment to $40 a month, you are now paying all of your interest plus $10 a month on your balance. Unless you add more charges, you can pay off that card in about 30 months. If you double that payment to $80 a month, you can pay it off in about one year. Of course, that assumes you make all of your payments on time and you stop adding more charges.

In some cases, credit card companies will set a “minimum” minimum payment – or set the lowest amount they consider an acceptable payment each month. These payments tend to vary from one card to another, so it is always best to read the fine print to determine the minimum payment policy for your specific card or cards. Such information should be included on your monthly statement.

Types of Lenders

You have many options available when you decide to borrow money. However, they are not all the same nor do they use the same criteria when making loans. They will vary greatly in several ways, such as interest rates, terms of the loan, and payment structures. It is important to carefully read and consider their general practices before submitting a loan application. Following are some of the various different types of lenders and a brief description of what they do. Before borrowing, be sure you comparison shop to find the best arrangement for your specific need.

Commercial Banks. Commercial banks generally offer a greater variety of credit than other lenders, including credit cards, lines of credit, term loans, and installment loans—both on a secured or an unsecured basis. Most banks make loans for several purposes: buying cars, boats, real estate, and homes; taking vacations; paying off other loans; investing in a business; paying taxes; or many other reasons. As a general rule, banks tend to be rather selective, choosing to make loans to individuals and businesses with established credit histories. While most banks prefer that you have an account with them before applying for a loan, it is not always required. The size of the bank can often determine what size of loans it provides its customers.

Credit Unions. Credit unions are cooperative associations that hold deposits and make loans to their members. To borrow money from a credit union, you must meet their membership requirements and purchase a credit union share to activate your membership or use any of their services. Credit unions are similar to commercial banks, offering most types of consumer credit. Their rates are often lower than banks, primarily due to differences in structure and federal requirements. Also, they tend to specialize in individual loans rather than commercial or business loans, which means they tend to make smaller loans than many of the large commercial banks.

REMINDER

Credit unions are cooperative associations that hold deposits and make loans to their members. Consumer finance companies primarily make installment loans and second mortgages.

Consumer Finance Companies. Consumer finance companies primarily make installment loans and second mortgages. They tend to make a large number of debt consolidation loans, especially to high-risk customers. Financial companies are generally more willing to make relatively small loans that most banks avoid because of the risk and expense. They are also more willing to approve loans for applicants with poor or no credit histories than banks or credit unions; however, the interest rates they charge are also much higher. In addition, they tend to charge higher fees and require collateral for many of their loans.

Sales Finance Companies. Sales finance companies were formed to lend money to customers of a specific company. For example, Ford Motor Credit Company provides loans if you want to buy a vehicle at a Ford dealership. Oftentimes, sales finance companies offer borrowers special interest rates or financing offers to stimulate business at the affiliated company. In those cases, their loans tend to have lower interest rates than similar loans from banks or credit unions. Loans from sales finance companies are generally convenient and relatively easy to get.

Life Insurance Companies. While you may not think about borrowing from a life insurance company, it can be a good source of funds if you have a policy with cash value. Life insurance loans tend to have relatively low interest rates compared to rates at other types of lenders. If you decide to borrow against your insurance policy, however, any unpaid loan amount will be deducted from the face value when paid to the beneficiaries.

Brokerage Firms. Brokerage firms are a source of credit for investors who have securities on deposit in a margin account. A margin account allows you to borrow money to buy stocks, but the funds may also be used for other purposes. The maximum you can borrow depends upon the market value of your investments and the amount the brokerage firm is willing to lend. You may also have to use your securities as collateral for the loan.

Pawn Shops. Pawn shops (often called pawn brokers or pawn dealers) offer short-term, single-payment loans secured by the personal property you leave with them. If you do not repay your loan and the interest by the due date, pawnbrokers can sell your property to get their money. While they provide quick access to cash for people with bad credit or with no other source of funds, borrowing from a pawnbroker tends to be extremely expensive because of the high interest rates they charge. Borrowing from pawn shops tends to be very high risk and is not recommended unless no other source is available.

Payday Lenders. Payday lenders provide short-terms loans designed to be repaid when you get your next paycheck. Generally, they are small loans for amounts between $100 and $500. However, the annual percentage rates are extraordinary — often as high as 400%! Payday lenders are frequently used by individuals who have no other options due to previous credit problems and low credit scores. In addition, people without bank accounts or those using check cashing services may use payday lenders because they have no relationship with a bank or any other lender. Some people view payday loans as a predatory lending practice because of unfair or abusive credit practices; however, others say they serve a purpose for those without any other options. As a general rule, most experts recommend avoiding payday lenders because they are a high-risk option.

Conclusion

While borrowing money is convenient, it can also be expensive and great more debt to overcome in the future. Making good choices about borrowing includes borrowing only what you need, understanding the terms of the loan, and choosing the best lender. Knowing what is expected of you and the lending company will help prevent future problems.

Consumer credit and credit cards can be great tools to use when you use them carefully, but they can become a financial burden when abused or misused. A good rule to use when deciding whether or not to use a credit is this: If you cannot afford to pay off your credit card bill each month, then rethink your decision to charge your purchase. Only you can weigh the cost of buying on credit and paying tomorrow against the benefit of having it today.

FINAL NOTE: So, what should Jason do?

1. He needs to stop spending. The only way to get out of debt is stop making more of it.

2. He needs to talk to his parents and explain what has happened.

3. He needs to have a plan for paying off the debt. That may include getting another job or finding a way to cut his expenses so he make his payments.

4. Most importantly, he needs to realize he is not the first person to have this problem and he will not be the last one. There is no need to panic. Instead, he needs to accept responsibility for his mistake and take control of his spending to ensure it does not happen again.

Name:_______________________________Class Period: _______________________________

It Is In Your Interest Review 7.2

Answer the following questions and give the completed lesson to your teacher to review.

1. Which of the following types of lenders offers loans to high risk customers for very high interest rates?
   a. Payday Loan Companies
   b. Credit Card Cash Advance
   c. Home Equity Bank Loans
   d. Credit Unions

2. What is the definition of a daily periodic interest rate?
   a. Annual interest rate
   b. Fractional amount of the daily interest rate
   c. The annual interest rate divided by 365
   d. Annual interest rate divided by the daily interest rate

3. What is the definition of a minimum payment?
   a. One twelfth of your total balance
   b. The lowest amount you are required to pay each month
   c. The dollar amount required to avoid foreclosure
   d. The dollar amount specified in the CARD Act

4. Interest rates on credit cards
   a. are the same for everyone.
   b. vary depending upon several factors.
   c. vary based on a person's age and income.
   d. are the same, regardless of which company issues them.

5. Which of the following statements is true?
   a. All credit card companies have the same policies on grace periods and minimum payments.
   b. All lenders have the same types of loans.
   c. Using credit cards is always better than using cash.
   d. Credit cards are loans that need to be repaid

Name:________________________________Class Period: ________________________________

Types of Lenders Activity 7.2

Match the types of lenders in the left column with their unique description in the right column by placing the number for the lender in the blank provided.

1.	Commercial banks	_______A.	More willing to make loans that commercial banks and credit unions frequently avoid.
2.	Credit Unions	_______B.	Source of credit for investors who have securities on deposit in a margin account.
3.	Consumer Finance Companies	_______C.	Generally offer a greater variety of credit than do other lenders.
4.	Sales Finance Companies	_______D.	Offer short-term, single-payment loans secured by personal property left in the possession of the lender.
5.	Life Insurance Companies	_______E.	A source of credit for certain policyholders who own policies that include a savings component, or cash value.
6.	Brokerage Firms	_______F.	Formed to lend money to customers of an affiliated company.
7.	Pawnbrokers	_______G.	Loans often for amounts between \$100 and \$500, and interest rates can be extraordinary.
8.	Payday Lenders	_______H.	Cooperative associations that accept savings from and make loans to member individuals.