

Honors Personal Finance

THEME 3 Part 1: Managing Credit

Why We Use Credit

- To avoid paying cash for large purchases. Ex: house, car, etc.
- To meet a financial emergency.

Ex: plane ticket to visit sick relative, or borrow money during time of unemployment.

Why We Use Credit

- For convenience.
Ex: using a credit card is easier than writing a check.
- For investment purposes.
Ex: margin loans, sharing the investment cost with the broker.

Improper Uses of Credit

- Many people use credit to live beyond their means.
- The credit crisis of 2007-2009 bore this out. Credit was so easy to come by, everyone had it and most shouldn't have.

Improper Uses of Credit



Improper Uses of Credit

- Credit addiction is just as real and devastating as other addictions.
- It's been said that some people are "hooked on plastic".
- Many over-spenders don't believe they have a problem. "I still have my card, and can pay the minimum amount due".

Improper Uses of Credit

SCENARIO:

- Interest Rate 17%
- Minimum Payment 2.5% or \$10.00



Balance	Time to Pay Off	Interest Charged	Total Pay
\$1,000.00	12 years	\$979.00	\$1,979.00
\$2,500.00	19 years	\$2,941.00	\$5,441.00
\$5,000.00	24+ years	\$6,210.00	\$11,210.00

Improper Uses of Credit

- The best way to steer clear of this debt is to avoid using credit:
 - ① To meet basic living expenses.
 - ② To make impulse purchases, especially expensive ones; and
 - ③ To purchase nondurable goods and services

Improper Uses of Credit

- The best approach is to only charge what you have the money to cover.

Establishing Credit

- When trying to obtain credit there are two approaches:
 - ① Manual Underwriting or
 - ② Use Established Credit

Establishing Credit

Manual Underwriting - a human being must manually refer to the entire guideline handbook (depending on the type of loan) to **manually** make sure it meets all guidelines.

If you decide not to chase after a FICO score, manual underwriting is your best option.

Establishing Credit

- Manual underwriting requires the mortgage applicant to provide considerable amounts of paperwork such as pay stubs, tax returns, judgments (if any), monthly bills, letters of employment, etc.

Establishing Credit

- Those that decide to establish a credit history can follow these steps:
 - ① Open checking & savings accounts
 - ② Employment history
 - ③ Residence history
 - ④ Utilities in borrower's name
 - ⑤ Department store, gas, credit card

Establishing Credit

- Maintaining a good credit rating is just as important as building one.
- Your credit score or FICO score is what future lenders will base a large part of their decision to loan money on.

Establishing Credit

- Your score is calculated and recorded by 3 different Credit Reporting Agencies.
- Equifax, Experian, & TransUnion. By law, people are entitled to a free copy of their credit report from each of these companies once every 12 months.

Establishing Credit

- The most popular credit score is the FICO score. The score ranges from about 300 to 850, with the higher score reflecting a lower risk for the lender.

Establishing Credit

Credit Score Chart	
Score	Grading
720 and Above	Excellent
680 to 719	Good
620 to 679	Average
580 to 619	Poor
500 to 579	Bad
Less than 500	Miserable

Establishing Credit

- Most lenders use the 5 C's of credit to help them evaluate credit risks.

Maintaining Credit

- How to maintain a good credit rating:
 - ✓ Establish a good credit history.
 - ✓ Pay monthly balance on time.
 - ✓ Use credit cards sparingly and stay within the limit.
 - ✓ Do not move balance to other cards.
 - ✓ Check credit report regularly.

How Much Credit is Ok?

- **Credit Tips:**
- Excluding rent or mortgage the maximum percentage of disposable income going toward loan payments is 20%.

20%

How Much Credit is Ok?

- Sound financial planning dictates that we need to have a good idea of how much credit you can comfortably tolerate.
- By following the 20% rule, and maintaining a solid debt safety ratio, you can better avoid creating a monthly repayment burden.

Rule of Thumb [20%]

- Y = Monthly Take Home Pay
- X = Monthly Car Payment
- Y = 5X
- Ex: Y = \$250 * 5
- **Y = \$1250 min. month take home**

How Much Credit is Ok?

Debt Safety Ratio - the proportion of Total monthly consumer credit obligations to monthly take-home pay.

$$\text{Debt Safety Ratio} = \frac{\text{Total Monthly Consumer Credit Payments}}{\text{Monthly Take-Home Pay}}$$

How Much Credit is Ok?

Credit Guidelines Based on Ability to Repay

Monthly Take-Home Pay	Low Debt Safety Ratio 10%	Manageable Debt Safety Ratio 15%	Maximum Debt Safety Ratio 20%
\$1,000.00	\$100.00	\$150.00	\$200.00
\$2,000.00	\$200.00	\$300.00	\$400.00
\$3,000.00	\$300.00	\$450.00	\$600.00
\$4,000.00	\$400.00	\$600.00	\$800.00
\$5,000.00	\$500.00	\$750.00	\$1000.00

Credit Advantages

- Convenient
- Immediate
- No need for cash
- Zero liability on fraud
- Helps on reservations
- Bonuses, points

Credit Disadvantages

- It is a loan
- Interest rate
- Additional fees
- Easy to overspend
- Can promote impulse purchases
- Risk of identity theft
- Responsible if lost

Warning Signs of Credit Abuse

- Delinquent Payments
- Default Notices
- Repossession
- Collection Agencies
- Judgment Lien
- Garnishment

Class Activity

- Try and be one of the first 5 to complete the following:
- What is the minimum monthly salary needed to afford a car payment of \$490.

• **\$2450**

**DEBT
LESSON****Current as of December 2014**

U.S. household consumer debt profile:

Average credit card debt: **\$15,611.00**

Average mortgage debt: **\$153,192.00**

Average student loan debt: **\$32,264.00**

Current as of December 2014

- In total, American consumers owe:
- **\$11.74** trillion in debt
- **\$882.6** billion in credit card debt
- **\$8.14** trillion in mortgages
- **\$1.13** trillion in student loans

Financial Consequences of Debt

- Overspending
- Paying high interest rates
- Lowers credit score
- Difficulty getting a loan

How-To Guide: Reduce Your Debt

- A Debt Snowball is a debt elimination strategy popularized by Dave Ramsey.
- Reduce your debt by paying the minimum monthly payment to all debts, except the one with the smallest balance, which you'll try to pay down as fast as you can.

How-To Guide: Reduce Your Debt

- The basic steps in the Debt Snowball debt reduction plan are as follows:
- List all debts from smallest balance to largest. Some people (including me) advocate paying the highest interest rate debt first, but that's not the Debt Snowball method.

How-To Guide: Reduce Your Debt

- Pay the minimum payment on every debt, except the smallest debt.
- Pay as much as you can towards that smallest debt until it is paid off.

How-To Guide: Reduce Your Debt

- Once the smallest debt is paid in full, repeat the process by paying as much as you can toward the second smallest debt.

Credit Cards

- Paying the bill in full each month eliminates these high interest rates. Sometimes late payments fall under a:

Grace Period – a short period of time, usually 20 to 30 days, during which you can pay your credit card bill in full and not incur any interest charges.

Special Types of Credit Cards

1. **Reward Card** – a bank credit card that combines features of a traditional bank credit card with an additional incentive, such as rebates and airline miles.

Special Types of Credit Cards

Marriott Rewards Premier Credit Card

EARN 50,000 BONUS POINTS
 AFTER YOU SPEND \$1,000 ON YOUR FIRST 3 MONTHS FROM ACCOUNT OPENING

Annual Fee
 \$125 (Annual Fee for the first year after that, \$85)

APPLY NOW

Card Benefits | **Additional Benefits** | **Other Details** | **Pricing & Terms**

- 50K BONUS POINTS**
 Earn 50,000 bonus points after you spend \$1,000 in your first 3 months from your account opening with your Marriott Rewards Premier Credit Card.
- 5 POINTS PER DOLLAR**
 Earn 5 points per dollar on all of your U.S. Marriott Rewards network, including our exclusive luxury hotel partner, The Ritz-Carlton®.
- 2 POINTS PER DOLLAR**
 Earn 2 points per dollar on all other U.S. Marriott Rewards network hotels, and at our hotel partners & restaurants.
- 1 POINT PER DOLLAR**

Special Types of Credit Cards

- These are more like cash. Typically you buy a **Stored Value Card** with a certain value.
- Examples are:

 - School ID
 - Cash Card,
 - Gift & Phone Cards

Special Types of Credit Cards

- A **Smart Card** is a card with a “brain” in it, the brain being a small embedded computer chip. The card can receive information and process it.

Special Types of Credit Cards

- **Debit Cards** are cards that can be used for purchases and for cash withdrawals directly from your personal bank account.

Credit Types

- Though cards are the most visual form of credit, there are several other types.

Credit is often placed in one of two categories:

Types of Credit	
Installment Credit	Revolving Credit
<ul style="list-style-type: none"> • Fixed payments • Set period of time to repay • Set or varying interest rates 	<ul style="list-style-type: none"> • No stated payoff time • Limit to credit • Minimum monthly payments • Interest rates vary or not • Finance charges

Loans

Closed Ended Credit – is used for a specific purpose, for a specific amount, and for a specific period of time. Payments are usually of equal amounts.

- Ex: Mortgages and Auto Loans

Credit Types

- **Installment Loan** a loan in which the amount of payment and the number of payments are predetermined, such as an automobile loan.
- **Examples: Car loans and mortgages**

Managing Credit Cards

- **Step 3** – Making Payments.
- The best advice for any credit card holder is to pay the total in full every statement, before the due date.
- This will keep you from incurring any additional charges.

Managing Credit Cards

- Making just the: **Minimum Monthly Payment** – a specified percentage of the new account balance that must be paid in order to remain current. will cause interest rates to begin applying to the remaining balance.

Bankruptcy

- When debt gets beyond your control this may be your only option.

Bankruptcy – a legal process to get out of debt when you can no longer make all your required payments.

Reasons for Bankruptcy

- Medical Expenses
- Job Loss
- Business Losses
- Natural Disaster
- Credit Card Debt

Bankruptcy Types

- **Chapter 7**
 - LIQUIDATION
 - makes up about 70 percent of non-business bankruptcy cases
 - wipes out all allowable debts and allows certain personal property exemptions.

Bankruptcy Types

- **Chapter 13**
 - REORGANIZATION
 - makes up for about 30 percent of non-business bankruptcy filings
 - is a court-approved repayment plan.

Bankruptcy Types

- **Chapter 9**: may only be applied to municipalities such as cities or towns and allows for their reorganization.
- **Chapter 11**: is the third most common type of bankruptcy filing. Used to reorganize businesses but may be used by individuals as well.

Bankruptcy Types

- **Chapter 12**: is used exclusively to adjust the debts of a family farmer or family fisherman.
- **Chapter 15**: applies to cross-border cases, in which the debtor has assets and debts both in the United States and elsewhere.

Changes to Bankruptcy Law

- New law in effect October 17, 2005.
 - ① New limits on personal bankruptcy.
 - ② Requires those filing to get counseling before they are allowed to file.
 - ③ Bars filers with above-average income from filing Ch.7 (liquidation).
 - ④ New debt may not be discharged.

Things to Do BEFORE Filing:

- Reduce your spending
- Talk with your creditors.
- Talk with a nonprofit counseling agency.
- Talk with an attorney & understand the consequences of bankruptcy.
- Consider consolidation carefully.

TIPS TO REMEMBER

- Keep track of your daily expenses.
- Save money on a regular basis.
- Make changes right away if you see yourself starting to get into financial trouble.
- Pay attention to your household finances, especially if married.

END of NOTES