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
- 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	® Buzzle.com 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%.

#### **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 PaymentY = 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.

Total Monthly Consumer Credit Payments

Debt Safety Ratio = 

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: \$155,192.00

Average student loan debt: \$32,264.0

#### **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 <u>Dave Ramsey</u>.
- 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.

# How-To Guide: Reduce Your Debt • An Illustration Of The Debt Snowball • The Debt Snowball

### **CREDIT CARDS**

& Other Types of Open Account Credit

#### **Credit Cards**

Open Ended Credit – loans are made on a continuous basis as you purchase items, and you are billed periodically to make at least partial payment.

 Ex: Store Credit Cards, Bank Credit Cards, Construction Loan, and Home Equity Line of Credit

#### **Credit Cards**

 This credit is extended so long as the consumer does not exceed the

Credit Limit – a specified amount beyond which a customer may not borrow or purchase on credit.

#### Credit Cards

• The most popular type of open account credit is the

Credit Card – Plastic cards with electronic information that can be used by the holder to make purchases or obtain cash advances using a line of credit made available by the card-issuing financial institution.

#### **Credit Cards**

• When applying for a credit card you are acquiring a:

Line of Credit- the maximum amount of credit a customer is allowed to have outstanding at any point in time.

• The amount of the line depends on the applicant's history.

#### **Credit Cards**

**Cash Advance** – a loan that can be obtained by a bank credit cardholder at any participating bank or financial institutions.

 This loan begins to accrue interest immediately. The interest rate national average is 16%.

#### **Credit Cards**

 The thing to remember about credit cards is the difference between credit card use, and credit card abuse.

#### **Credit Cards**

- The biggest danger from credit card abuse is the debt that can grow to extreme, because of the high interest rates.
- Interest rates on balances carried over are on average 18.99%.

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

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



### **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

Finance charges

• Ex: Mortgages and Auto Loans

and for a specific period of time.

Closed Ended Credit - is used for a specific purpose, for a specific amount,

Payments are usually of equal amounts

#### **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

### **Credit Types**

- Revolving Credit a type of credit that does NOT have a fixed number of payments.
- · No stated payoff time
- Limit to credit
- Minimum monthly payments
- Finance charges
- Example: credit card

### Credit Types - Student Loans

Student Loans offered to students to assist in payment of the costs of professional education. These loans usually charge lower interest than other loans, and are also usually issued by the government.

#### Credit Types - Student Loans

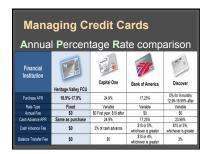
• Allows a person to finance their education and defer payments until after graduation.

#### **Credit Types - Home Equity Line**

 Home Equity Credit Line is credit extended to an individual based on the value controlled by the home owner.

#### **Managing Credit Cards**

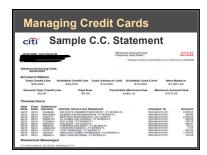
- Step 1 Read and review the terms of each credit card you are considering.
- Compare items such as: APR, rewards or incentive programs, annual fee, late fees, etc.





### **Managing Credit Cards**

- Step 2 Read and review the statement each month.
- The statement contains items such as: billing cycle, payment due date, minimum amount due, total payment due, all account activity for current period, etc.



#### **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

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
  - REORGANIZATON
    - 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**