

Credit Use and Credit Cards

Chapter 6

Objectives of this chapter

- Installment vs. Noninstallment credit
- Cost of credit
- Pros and cons of credit
- Types of charge accounts
- Process of obtaining credit
- Managing accounts properly

Five Criteria for being granted Credit

1. Character – honesty and reliability
2. Capital – your financial net worth
3. Capacity – income available to make payments
4. Collateral – property offered and pledged to secure repayment
5. Conditions – economic conditions

Installment vs. Noninstallment

- Credit: goods, services or money are given now with a promise to pay for them in the future.
- Installment credit – borrower promises to pay a specific amount for a specific period of time.
- Noninstallment credit – single payment and open-ended payments

More about noninstallment

- Open ended means that credit is extended in advance of any transaction. For example credit cards, service credit, charge accounts.
- Credit limit – pre-approved maximum amount.

Why People Use Credit

1. For convenience
2. For emergencies
3. For identification (renting a car, cashing a check, renting skis) merchants are NOT allowed to put your credit card # on a check
4. Make reservations (hotels) credit card blocking

Why People Use Credit

5. To consume expensive products earlier (computer, auto) The product should last as long as the loan.
6. To enjoy the “good life” raise current level of living in anticipation of higher income later.
7. Take advantage of free credit (future value)

Why People Use Credit

8. To consolidate debts (debt consolidation loan)
9. For protection against ripoffs and fraud (making use of the Fair Credit Billing Act)
10. To obtain an education

Reasoning against Using Credit

- Interest is costly: Interest, finance charges, annual percentage rates.
- Fair Credit and Charge Card Disclosure Act of 1988 this requires that key pieces of information be told to the consumer.
- Usury law (laws pertain to the state the lender is in not the state the borrower is in)

Reasons against using Credit

- Additional fees are common
 - Transaction fees
 - Late payment fees
 - Over-the-limit fees
 - Punitive interest rates
 - Cost of securing the loan (points, fees)

Reasons against using Credit

- High Priced Add-ons unavailable
 - Credit life insurance
 - Term life insurance
 - Credit disability insurance
 - Unemployment credit insurance

Reasons Against using Credit

- Liability for lost credit cards
 - Truth in Lending Act limits cardholder's liabilities to \$50
 - Liability only if you receive notification of your liability which you accepted, the company provides you will information on how to contact them and the card was used illegally BEFORE you contacted the company.

Reason against using Credit

- Liability
 - Credit card insurance that will pay the \$50 for you. Usually homeowners or renters insurance will pay for such losses anyway. Sometimes the fee is as much (or more) than the \$50 is.

Reasons against using Credit

- It is tempting to overspend
 - Easier to charge it and pay over time than it is to save over time and then pay for it.
 - The average US citizen owns 9 credit cards.
- Privacy is a concern
 - Identity snatching
 - Government surveillance of your purchases

Reasons against using Credit

- Use of credit reduces financial flexibility
 - Reduces future buying power
 - Opportunity cost

Making minimum payments

- Perma-debt at 18% APR the finance charges for \$500 for 20 years would total \$1,800 ($.18 * \$500 * 20$)
- Minimum repayment is mathematically guaranteed to keep one in debt for a long, long, long time.
- Skip payments means the interest is just adding up more and more.

Types of open-ended credit accounts

- Revolving credit card accounts at retail stores
 - Option to pay the bill in full or spread repayment over several months.
 - If later payments are chosen a fixed dollar minimum or percentage of outstanding balance must be paid each month.
 - Ex: JC Penney, Best Buy (average 15 mos.)

Revolving Credit Card Accounts

- Offers through some 6000 commercial banks, savings and loans, credit unions.
- Participating merchants pay about 2-8%
- Cash advance usually have high APRs and interest is assessed as soon the cash is received.
- Automatic overdraft loans.

Revolving Credit Cards

- Convenience Checks
 - Use checks to access their credit card accounts
- Prestige
 - Higher maximum limits and free traveler's checks
- Travel and Entertainment Account
 - American Express, Diner's Club
 - Annual fee, need to pay back in full

Secured Credit Cards

- Application fee of \$30 or more
- You deposit \$300 to \$600 into a savings account.
- When you pay off the whole amount you can get the deposit back with interest.
- Don't choose the 900 ones – very expensive
- Can improve credit ratings

Competition for Credit Cards

- Fixed or variables interest rates
- Introductory or teaser rates
- Co-branded card is issues by a company for example Ford Motor and Mastercard – pay reduced prices on the merchandise sold. Or proceeds go to...Humane Society, university

Line of Credit

- Home improvement loans
- Don't need to reapply each time

Other forms of credit
