Introduction

Spending and Credit

Just about every adult in America uses credit. The Federal Reserve Board's Survey of Consumer Finances provides some interesting figures for U.S. household uses of one form of credit: credit cards. In 2007, 73 percent of all households in the United States had a credit card, but only 46 percent of households carried a balance from one month to the next. Many families use these cards as a convenience and pay their balances off each month.

For those U.S. households maintaining a balance on their credit cards, the median amount owed in 2007 was $3,000. Median figures mean that half of the households had more debt and half had less. On the other hand, the Federal Reserve Board reports that, for households maintaining balances on their credit cards, the average balance was much higher: $7,300.

Some people are afraid of using credit. "Neither a borrower nor a lender be" is an old adage such people might quote. Other people are fearless about using credit, especially credit cards. They might say, "Hey, it's only plastic! Let's go for it!"

There are problems with both viewpoints. Used in a smart way, credit can be a tremendous help to you now and in the future. Used in a stupid way, credit can result in harassment from creditors, broken relationships, and bankruptcy.

What is credit? Credit means obtaining the use of money that you do not have. To obtain credit, you must convince someone else (usually a financial institution like a bank, savings and loan, credit union, or a credit card company) to provide a loan to you in return for your promise to pay the borrowed money back later, plus an additional charge called interest.

Can using credit help you? You bet! But loans have to be repaid. Lenders charge interest for the use of their money. As people pay off their loans, plus interest, the money that goes for repayment is money they do not have for spending on things they may wish to have today.

Credit that is used unwisely can harm you financially, but you should not be afraid of using credit if you understand the basics. The key is to be smart about the use of credit.

What do lenders look for when they approve a loan to an individual? Ordinarily, they look for the "Three Cs":

- **Character:** Will the applicant be responsible and repay the loan? Your history of credit use is stored in your credit report. Credit reporting agencies use a scoring formula to summarize your creditworthiness. This number is your credit score. Credit scores are used by lenders to determine whether or not you qualify for loans; credit scores also determine in part the interest rate you will be offered. Insurance companies use credit scores in determining how risky you are to insure. Landlords use credit scores in their tenant-screening process. Some employers use credit scores in their evaluation of job candidates.

- **Capacity:** Does the applicant have enough income to comfortably make the payments on the loan amount requested?

- **Collateral:** Will the loan be secured, or guaranteed, by collateral that can be used to repay the debt in case the borrower defaults on the loan?

Consumers sometimes make mistakes in using credit. They are not perfect. People in the lending business also make mistakes. They are not perfect either. The world of finance can be complicated. Some business people take advantage of consumers. Several state and federal laws are designed to protect credit consumers from dishonest business practices. Among the more important consumer-credit protection laws are the Truth in Lending Act and the Fair Credit Reporting Act.

And then there are the scheme artists and swindlers. Unfortunately, the credit and finance industry sometimes attracts unsavory sorts who prey on people's greed or financial fears. If you receive a phone call describing a fantastic loan and a debt repayment plan that sounds too good to be true, it probably is. Hang up the phone. And try to avoid businesses that provide financial services but at very high costs—such as payday loans and rent-to-own plans.

NAME: ____ CLASS PERIOD: ____________

What Is Credit?

Credit allows people to obtain the use of money that they do not have. To obtain credit, a prospective borrower must convince someone else (a lender) to provide a loan in return for the borrower's promise to pay the money back, plus an additional charge called interest. People obtain loans to buy cars, homes, and major appliances, to improve their homes, to pay for college education, and so forth.

Credit decisions—whether to borrow money, and for what reasons—can be difficult. Like all difficult decisions, credit decisions involve examining the advantages and disadvantages facing the individual making the choice. The hard part, of course, is figuring out whether the advantages of using credit outweigh the disadvantages.

There are many advantages to using credit. Credit can help people acquire assets. Assets are goods or services that usually retain or increase their value. Ordinarily, a home or post-secondary education is considered an asset. Credit also can help people lead happier lives by enabling them to obtain the goods and services they wish to have now while paying for them in the future. And credit can help people in an emergency.

There are also disadvantages to using credit. Some people make the mistakes of using too much credit in relation to their income; they may then incur heavy burdens of debt from which it is difficult to recover. Many new college graduates, for example, spend a lot of the income from their first jobs repaying large credit card debts they have rolled up while in college. As they spend a great deal of their current income paying for previous purchases, they are left with less money to buy things they would like to have in the present. And if they miss payments or default on loans altogether, they may face serious negative consequences, including the inability to get credit at a later time when it would otherwise make sense to borrow money for a major purchase.

Financial institutions (commercial banks, savings and loans, credit unions, and consumer finance companies) hold money that they, in turn, lend out to others. The owners of financial institutions expect to be compensated when they make a loan. This compensation is called interest. Interest is the price a borrower pays to a lender for use of the credit provided by the lender. Interest is the reward lenders receive for allowing others to use their funds.

Both sides in a credit transaction expect to benefit. Borrowers are able to purchase something that may be of value to them today and/or in the future. Lenders are repaid the money that they lent, plus interest.

An important factor in determining the rate of interest to be charged is the amount of confidence the lender has that the amount of the loan, plus interest, will be repaid in the agreed-upon time. Higher-risk loans—loans where it is uncertain that the borrower can repay—usually result in higher interest rates. Lower-risk loans—loans where it seems evident that the borrower can repay—usually result in lower interest rates.

A loan for an intangible item, like a vacation, is likely to cost more in interest than a loan for a tangible item, like a home. Secured loans (those that are backed by other assets, like your home or your car), are likely to have lower interest rates than unsecured loans (those that are not backed by other assets). An asset used to back a loan is called collateral.

Questions:

a. Why use credit?

b. What are the advantages of using credit?

c. What are the disadvantages of using credit?

d. What institutions are sources of credit?

e. What is interest?

f. Who most often wins in a credit transaction?

g. How does risk influence the rate of interest?

h. What is an unsecured loan?

i. What is collateral?

NAME: ______________________________ CLASS PERIOD: __________

Common Forms of Credit

Types of Credit	Lender	Advantages	Disadvantages
Home Mortgage	• Commercial bank • Savings and loan • Credit union • Consumer finance company	• Homes can increase in value. • Interest rates for mortgage are relatively low. • The interest paid is tax-deductible.	• Mortgages are usually long-term commitments. • Obtaining a home loan involves extensive credit checks.
Car Loans	• Commercial bank • Savings and loan • Credit union • Consumer finance company	• Cars can make it easier to work and earn an income.	• Cars lose their value relatively quickly. The car you purchase on credit may have little value when the last payment is made.
College Loans	• Commercial bank • Credit union • Savings and loan associations	• A college education is usually a good investment.	• Students sometimes borrow more than is necessary. • New graduates can face difficulty in repaying large loans.
Personal Loans	• Commercial bank • Savings and loan • Credit union • Consumer finance company	• Personal loans allow individuals to purchase today that boat or vacation they want.	• Personal loans have relatively high interest rates. • Some people may borrow more than their income should allow.
Credit Cards	• Commercial bank • Savings and loan • Department stores • Other financial institutions • Credit union	• Credit cards are convenient to use and useful in an emergency. • Credit cards provide a record of charges.	• Credit cards may have relatively high interest rates. • Some card holders may borrow more than their income should allow.

Questions:

a. What are the advantages of home loans and college loans compared to credit card and personal loans?

b. What are the disadvantages of credit cards and college loans?

NAME: ______________________________ CLASS PERIOD: __________

Credit Research

Directions: Outside of class, identify one example of each of the four types of financial institutions listed below. Try to find examples from within your community. As necessary, look beyond your community by using the Internet. After you have identified the four examples, get in touch with a representative from each one. You may do this by telephone, in person, or via the Internet. Ask each representative what the current annual percentage rate (APR) is, at his or her institution, for each of the five types of loans listed. The APR is the best way to compare the cost of credit from one lender to another. Record the information in the correct places on the chart and report the results to class.

Credit Research Results

Loans	**APR for a 4-year car loan**	**APR for a college loan**	**APR for a 30-year home mortgage**	**APR for a credit card**	**APR for a personal loan to pay for a vacation**
Institutions					
Commercial Bank					
Savings and Loan					
Credit Union					
Consumer Finance Company					

Questions:

a. Which local institutions offered the best APR for each type of loan?

b. Which local institutions offered the highest APR for each type of loan?

c. How did the loans from online lenders compare to loans from lenders in your community?