



## Chapter 6. Short Term Credit Management



### Chapter Objectives

- ✦ To evaluate reasons for and against using credit and decide whether or not credit is appropriate for you.
- ✦ To be able to take the necessary steps to establish credit and develop a credit history.
- ✦ To identify what is meant by revolving credit and how it is used.
- ✦ To understand how to use credit cards properly and to know your legal rights as a borrower against credit mistakes.
- ✦ To learn how installment credit works.
- ✦ To compare the various sources of credit and to learn what to do if you experience credit problems.



### Major Topics

- ✦ Arranging and Using Credit
- ✦ Revolving Credit
- ✦ Installment Credit
- ✦ Obtaining Credit and Resolving Credit Problems



### Reasons for Using Credit

- ✦ As a Shopping Convenience
  - ❑ Especially good for record keeping, rebates, other benefits
- ✦ To Increase Total Consumption
  - ❑ Actual borrowing
- ✦ As an Inflation Hedge
  - ❑ Buy now to avoid higher future prices
- ✦ As a Source of Emergency Funds
  - ❑ If you don't have 3-6 months of liquid assets ...



### Disadvantages of Using Credit

- ✦ Temptation to overspend
  - ❑ All too common. Keep in mind credit needs to be repaid with interest! It's not free money!
- ✦ Credit costs
  - ❑ Some can be very high
- ✦ Less flexibility with future budgets
  - ❑ When you borrow, you are borrowing against your future income.



### How to Get Credit

- ✦ Consider what the lender looks for (3 C's)
  - ❑ Character: previous obligations
  - ❑ Capital: financial assets
  - ❑ Capacity: future obligations
- ✦ Begin a credit record.
  - ❑ Open savings and checking accounts.
  - ❑ Open a retail charge account.
  - ❑ Qualify for a small installment loan.
  - ❑ Make sure your credit records follow you.
  - ❑ Have a telephone installed.
- ✦ Review your credit report.
- ✦ Repair a bad credit record.



## Special Concerns for Spouses Establishing Credit

- ✦ Make sure your credit history is in your name. Don't use a social title. ex., Mrs.Edward Hall
- ✦ Inform creditors that you wish to maintain your own credit history.
- ✦ Know the difference between a joint and individual credit account.
  - ✦ Joint Credit Account:
    - Both spouses responsible for debt.
    - Divorced or separated spouses should cancel joint accounts.
  - ✦ Individual Credit Account
    - Only you are responsible for debt.
    - Account will appear only on you credit report.



## The Role of the Credit Bureau

- ✦ Does not decide who receives credit.
- ✦ Stores information on past use of credit
- ✦ Stores information on legal actions against you.
- ✦ Sells credit reports to lenders.



## Contents of a Credit Report

- ✦ Existing credit accounts
- ✦ Information on each credit account includes
  - ✦ credit limit, loan amount and account balance
  - ✦ who is responsible for paying the account
- ✦ Public record information
  - ✦ bankruptcies, tax liens and monetary judgments
- ✦ Who has obtained a copy



## Credit Report

- ✦ The three largest credit bureaus
  - ✦ Equifax: <http://www.equifax.com>
  - ✦ Trans Union: <http://www.transunion.com>
  - ✦ Experian: <http://www.experian.com>
- ✦ Now consumers can obtain credit reports for free once a year.
  - ✦ For more information about credit, visit Federal Trade Commission Website at <http://www.ftc.gov/bcp/online/edcams/credit/index.html>
  - ✦ For your free credit report, visit <https://www.annualcreditreport.com/cra/index.jsp>
- ✦ Credit report and credit score are used for many purposes (insurance, job, rental, etc.) these days. In addition, identity theft is becoming a major consumer fraud issue. You need to be diligent about checking your credit report. It is a good idea to obtain one credit report every four months, rotating among the three credit bureaus.



## If You are Denied Credit

- ✦ Obtain a copy of your report.
- ✦ Correct any mistakes.
- ✦ Submit your own statement on disputed claims.
- ✦ Have adverse information that is old removed from report.
- ✦ Have those who received report notified of any incorrect entries.



## Credit Accounts

- ✦ Revolving credit account
  - ✦ An open-end account with an established line of credit and rules for minimum payments.
- ✦ Retail installment account
  - ✦ An closed-end account that has a separate installment contract for each purchase



## Revolving Credit Account

- ✦ Credit limit determined by credit record and net worth.
- ✦ Partial payment must be made each month.
- ✦ Interest charged on unpaid balance.
- ✦ Account may never actually be paid off.



## Required Information on Revolving Charge Account

### Truth in Lending Act

- ✦ Annual percentage rate (APR) applied to balance.
- ✦ Method for calculating interest.
- ✦ Grace period, if any.
- ✦ Minimum monthly payment, and penalties for late payment.
- ✦ Permission to investigate credit history.



## Interest Computation Methods

- ✦ Previous balance method
  - ✦ Rate applied to balance at end of previous month.
- ✦ Adjusted balance method
  - ✦ Equal to the previous balance less any payments or returns made during the current billing cycle
- ✦ Average daily balance method (most common)
  - ✦ including current purchases
  - ✦ excluding current purchases
- ✦ Two-cycle average daily balance method
  - ✦ Eliminates a grace period in the previous month when you fail to completely pay off the balance in the present month.
  - ✦ Can go back two periods to collect interest on unpaid balance.



## Major Issuers of Credit Cards

- ✦ Bank Credit Cards
  - Discover    MasterCard    Visa
- ✦ Travel & Entertainment Cards
  - ✦ American Express
- ✦ Other Cards
  - ✦ Department store chains
  - ✦ Major gasoline retailers



## Credit Card Cost Comparison

- |                              |                              |
|------------------------------|------------------------------|
| ✦ Annual membership fee      | ✦ Annual percentage rate     |
| ✦ Variable rate information  | ✦ Grace period               |
| ✦ Balance computation method | ✦ Cash advance fee           |
| ✦ Late payment fee           | ✦ Over-the-limit penalty     |
| ✦ Copy charge                | ✦ Replacement fee            |
|                              | ✦ Fees for optional services |



## Credit Card Benefit Comparison

- |                                  |                             |
|----------------------------------|-----------------------------|
| ✦ Credit limit                   | ✦ Credit life               |
| ✦ Disability insurance           | ✦ Rebates & discounts       |
| ✦ Accident insurance             | ✦ Frequent flyer miles      |
| ✦ Rental car collision insurance | ✦ Credit card registry      |
| ✦ Warranty protection            | ✦ Purchase price protection |
| ✦ Merchandise loss protection    |                             |



### *Payback Period*

*\$3,000 Credit Balance @ 19% APR*

| Monthly Payment | Months | Total Interest |
|-----------------|--------|----------------|
| \$60            | 100    | \$2,991        |
| 75              | 64     | 1,790          |
| 100             | 42     | 1,102          |
| 125             | 31     | 804            |



### *Protect Against Credit Card Fraud*

- ❖ Record card numbers, expiration dates and phone number for card company.
- ❖ Destroy old bills, receipts and credit cards.
- ❖ Check sales receipt and compare with credit card statement.
- ❖ Be careful giving out your card number.
- ❖ Report lost and stolen cards immediately.



### *Correcting Credit Mistakes*

- ❖ Notify the creditor in writing within 60 days after bill was mailed.
- ❖ Pay parts of the bill that are not in dispute.
- ❖ Creditor will notify you within 30 days of its decision.
- ❖ If no error is found, you must pay or you will be reported as delinquent.
- ❖ If you still challenge in writing the creditor must report that information.
- ❖ Provide credit bureau with your explanation of the dispute.



### *Other Credit Terms*

- ❖ Chargeback
  - ❖ a disputed amount charged back to the merchant by the credit card company.
- ❖ Credit blocking
  - ❖ a reduced credit limit based upon an expected purchase



### *Debit Cards*

- ❖ Bank deposit is immediately reduced
- ❖ You do not have the protections afforded credit card purchases
- ❖ Lost or stolen credit cards are covered by the Electronic Funds Transfer Act
  - ❖ you can lose up to \$500 if you fail to notify issuer within two days after learning of theft
  - ❖ if you wait 60 days your losses may be unlimited



### *Installment Credit*

- ❖ Repay the debt by
  - ❖ A series of uniform payments called installments
- ❖ Elements of a retail installment contract
  - ❖ Promissory note
  - ❖ Security agreement

## Methods for Charging Interest

- ✦ Simple Interest Method
  - ❑ percentage rate applied to outstanding loan balance
- ✦ Discount Method
  - ❑ interest deducted from credit extended you
- ✦ Add-on Method
  - ❑ interest added to amount borrowed at beginning of loan

Figure. A 12-month installment loan with annual simple interest of 12 percent

| Monthly | Outstanding | Monthly    | Finance | Loan      |
|---------|-------------|------------|---------|-----------|
|         | Balance     | Payment    | Charge  | Repayment |
| 1       | \$1,000.00  | \$88.85    | \$10.00 | \$78.85   |
| 2       | 921.15      | 88.85      | 9.21    | 79.85     |
| ...     | ...         | ...        | ...     | ...       |
| 11      | 175.07      | 88.85      | 1.75    | 87.10     |
| 12      | 87.97       | 88.85      | 0.88    | 87.97     |
| Total   |             | \$1,066.19 | \$66.19 | \$1,000   |

## Discount Method

- ✦ Need \$1,000
- ✦ Borrow \$1,136.36 at 12% simple interest
  - ❑  $1000/(1-12\%)=1136.36$
- ✦ Monthly payment:  $1136.36/12=\$94.72$

## Add-on Method

- ✦ Need \$1,000
- ✦ Total payments= \$1,120 for 12% simple interest
  - ❑  $1000*(1+12\%)=1,120$
- ✦ Monthly payment:  $1120/12=\$93.33$

## Annual Percentage Rate (APR)

- ✦ Same as annual simple interest.
- ✦ Takes into consideration fees and methods of computation
- ✦ In the previous example:
  - ❑ Simple interest: APR=12%
  - ❑ Discount: APR=24.28%
  - ❑ Add-on: APR=21.46%
- ✦ In credit shopping, compare APRs!!!

## Sources of Credit

- ✦ Banking Institutions
  - ❑ Overdraft protections
  - ❑ Unsecured personal loans
  - ❑ Home equity line of credit
- ✦ Consumer Finance Companies
  - ❑ Specialized loans (GM cars)
- ✦ Other
  - ❑ Life insurance policies
  - ❑ Margin accounts on stocks and bonds
  - ❑ Pawnbroker



## A Credit Management Strategy

- ✦ Use the grace period.
- ✦ Avoid expensive credit on revolving charge accounts.
- ✦ Take a broad view of credit sources.
- ✦ Carefully consider the use of variable rate loans.



## If You have Personal Debt Problems – Credit Counseling

- ✦ National Foundation of Credit Counseling
  - ✦ <http://www.nfcc.org>
  - ✦ The only Utah location is in St. George
    - Credit Counseling of Utah, 163 West 1600 South #2  
Saint George, UT 84770 (800) 451-4505
- ✦ Utah State University Family Life Center: Housing and Financial Counseling
  - ✦ <http://www.usu.edu/fchd/hfc.cfm>



- ✦ What a counselor will do:
  - ✦ Develop a budget and a repayment plan to repay debt
  - ✦ Negotiate a more reasonable repayment plan with the lenders

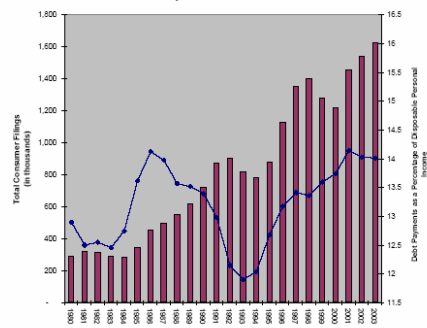


## Last Resort - Bankruptcy

- ✦ Bankruptcy statistics
  - ✦ American Bankruptcy Institution: <http://www.abiworld.org/>



Influence of Total Consumer Debt on Bankruptcy Filings Trends by Year 1980-2003



## ✦ Straight Bankruptcy (Chapter 7)

- ✦ Primary form of bankruptcy.
- ✦ Discharges all debts and provides a fresh start.
- ✦ Homeowner's equity and some personal assets may be partially protected.
- ✦ Cannot file again for 6 years.
- ✦ Record remains on credit report for 10 years.





- ✦ Wage Earner Plan (Chapter 13)
  - ❑ Repayment schedule established by court.
  - ❑ Debtor may retain property.
  - ❑ Lenders receive partial or total repayment over 3-5 year period.
  - ❑ Remains on credit report for 7 years.



### *Utah's Bankruptcy Situation*

- ✦ National Rank is #1 in 2003 and previous years – 1 in 36.5 households filed for bankruptcy in 2003:  
<http://www.abiworld.org/statcharts/HouseRank.htm>
- ✦ Utah-specific laws:  
<http://www.utahbankruptcylaw.com/>



### *Assignment for Chapter 6*

- ✦ If you have never obtained a copy of your credit report, you should try to get a copy. For a free copy go to <https://www.annualcreditreport.com/cra/index.jsp>
- ✦ Take a close look at the credit cards you have. What's the interest rate? What is the balance computation method? What's the grace period? Compare your credit cards using the list of costs and benefits.