

Personal Finance

Class 4: Managing Your Personal Finances

Choosing a source of credit.

Assignment presentations.

Sources of Consumer Credit

- WHAT KIND OF LOAN SHOULD YOU SEEK?
 - Inexpensive loans
 - Parents or family members
 - Loans that use your assets (CDs or value of whole life insurance) as collateral

Sources of Consumer Credit

- Medium-priced loans
 - Commercial banks, savings and loan associations, and credit unions

- Expensive loans
 - Finance and check cashing companies
 - Retailers such as car or appliance dealers
 - Bank credit cards and cash advances

The Cost of Credit

- TRUTH IN LENDING LAW is the federal law that requires creditors to disclose the annual percentage rate (APR) and the finance charge as a dollar amount
- FINANCE CHARGE is the total dollar amount you pay to use credit. It includes interest costs, service charges, credit-related insurance premiums, or appraisal fees

The Cost of Credit

- The ANNUAL PERCENTAGE RATE (APR) is the percentage cost of credit on a yearly basis
 - Your key to comparing costs, regardless of the amount of credit or how much time you have to repay it
 - APR is the true rate of interest so you can compare rates with other sources of credit. It is important to shop for credit.

The Cost of Credit

- TACKLING THE TRADE-OFFS

- **Term versus interest costs**

- Longer loans with lower payments results in more total interest

- **Lender risk versus interest rate**

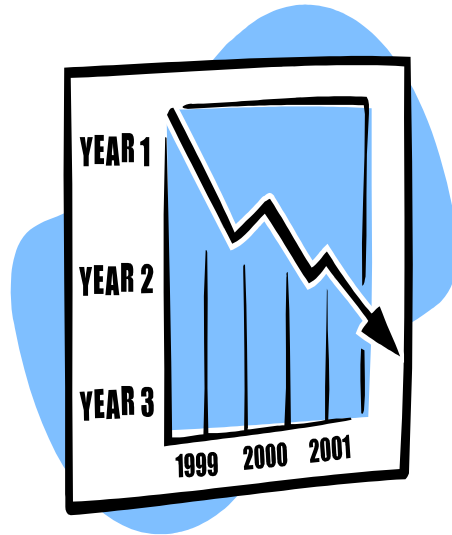
- Some ways to reduce the lender's risk and the interest rate:

- Accept a variable interest rate
 - Provide collateral to secure the loan
 - Make a large cash down payment up front
 - Have a shorter loan term

The Cost of Credit

- CALCULATING THE COST OF CREDIT
 - **Simple interest**
 - Computed on principal only and without compounding
 - The dollar cost of borrowing
 - $I = P \times r \times T$

The Cost of Credit



– Simple interest on the declining balance

- Interest is paid only on the amount of original principal not yet repaid
- The more frequent your payments, the lower the interest you will pay

– Add-on interest

- Interest is calculated on the full amount of the original principal. It is then added to the principal, and the total of both is divided by the number of payments to be made to arrive at the payment amount

The Cost of Credit

– Cost Of Open-End Credit

- Credit cards, department store charge cards, and check overdraft accounts
- Adjusted Balance Method
 - Method of computing finance charges where they are calculated after payments made in the billing period have been subtracted

The Cost of Credit

- Average Daily Balance Method
 - The fairest method of computing finance charges
 - Creditors add your balances for each day in the billing period
 - Then they divide this total by the number of days in the billing period
 - Then they multiply this average by the monthly interest rate
 - New purchases may be excluded from the average daily balance calculation, but generally are *included* if you carry over a balance.

The Cost of Credit

- Two-cycle Average Daily Balance Method
 - May include or exclude new purchases
 - Method of computing finance charges that uses the average daily balance for two consecutive billing cycles
 - *The Credit CARD Act of 2009 bans this method*

The Cost of Credit

- Previous Balance Method
 - Method of computing finance charges that gives no credit for payments made during the billing period
 - For example...
 - APR 18%; Monthly rate $1\frac{1}{2}\%$
 - Previous balance \$400; Payments \$300
 - = Finance charge
 - = $1\frac{1}{2}\% \times \$400$
 - = \$6.00

The Cost of Credit

– **COST OF CREDIT AND INFLATION**

- Borrowers and Lenders are concerned about the goods and services that dollars “can” buy (purchasing power of dollars) rather than the actual credit used
- Inflation erodes the purchasing power of money
- Each percentage point increase in inflation means a decrease of approximately 1% in the quantity of goods and services you can purchase with a dollar

– **COST OF CREDIT AND TAXES**

- Interest paid on consumer credit is not tax deductible

The Cost of Credit

- **AVOID THE MINIMUM PAYMENT TRAP**

- If you make only the minimum payment each period, you will pay more in interest and it will take you longer to pay off your balance

It would take 61 years to pay off a \$5,000 credit card balance if you make only the minimum monthly payment. You'd pay almost \$16,000 in interest. (Assuming a 14% interest rate and minimum payment of 1.5% of the outstanding balance.)

The Cost of Credit

- EARLY REPAYMENT

- The Rule of 78s favors lenders
- Formula requires that you pay more interest at the beginning of the loan, when you have the use of more of the money, and pay less and less interest as the debt is reduced

- CREDIT INSURANCE

- Ensures Loan is paid off in the event of death, disability, or loss of property
- Three types include credit life, credit accident and health, and credit property
- Premiums are quite high

The Cost of Credit

- CREDIT CARD ACCOUNTABILITY, RESPONSIBILITY, AND DISCLOSURE ACT OF 2009 (THE CREDIT CARD ACT)
 - Limits increases in the APR in the first year
 - Restricts issuers from charging higher interest rates on existing balances
 - Teaser rates must be for at least 6 months
 - Issuers must mail statements at least 21 days before payment is due
 - Disclosure statement must be clear and timely
 - Card issuers must post card agreements on the internet

The Cost of Credit

- Requires statements to report the due dates, potential late fees, and warn about the costs of making only the minimum payments
- Sets a consistent due date for card payments each month
- Restricts the penalties for going over the credit limit
- Prohibits card issuers from issuing cards to consumers under 21 with out a cosigner or independent means to repay debt

Managing Your Debts

- NOTIFY CREDITORS IF YOU CAN'T MAKE A PAYMENT



Managing Your Debts

- FAIR DEBT COLLECTION PRACTICES ACT
 - regulates debt collection agencies
 - If a debt collector calls you, within five days they must send you a written notice of amount owed, the creditors name, and your right to dispute the debt
 - You can dispute the debt or pay it
 - You may request verification of the debt within 30 days; (See Exhibit 7-2). If not sent, you can insist that communication about the debt cease
 - If verification sent, you may pay the debt or give notice that you will not pay

Managing Your Debts

- REASONS FOR DEBT

- Emotional problems such as the need for instant gratification
- The use of money to punish or get even
- The expectation of instant comfort among young couples who overuse the installment plan
- Keeping up with the Joneses
- Overindulgence of children
- Misunderstanding or lack of communication among family members
- Amount of finance charges makes it difficult to repay

Managing Your Debts

- WARNING SIGNS OF DEBT PROBLEMS
 - (Exhibit 7-4)
 - Paying only the minimum balance each month
 - Increasing the total balance due each month
 - Missing or alternating payments or paying late
 - Intentionally using overdraft protection or taking frequent cash advances
 - Using savings to pay routine bills such as food
 - Getting second or third payment notices
 - Not talking to your partner about money or talking *only* about money
 - Depending on overtime to meet routine expenses

Managing Your Debts

- Using up your savings
- Borrowing money to pay old debts
- Not knowing how much you owe
- Going over your credit limit on credit cards
- Having little or no savings for the unexpected
- Being denied credit due to a credit report
- Getting a credit card revoked by the issuer
- Putting off medical or dental visits because you can't afford them now

Managing Your Debts

- THE SERIOUS CONSEQUENCES OF DEBT
 - Robbing Peter to pay Paul can affect family health
 - May result in neglecting the educational needs of children
 - May result in heavy drinking
 - May result in neglect of children
 - May result in marital difficulties
 - May result in drug abuse
 - May result in bankruptcy

Consumer Credit Counseling Services

*** If you cannot pay your bills, then postpone further credit purchases, talk with your creditors, or seek help from a non-profit credit counseling service*

- CONSUMER CREDIT COUNSELING SERVICE (CCCS)
 - a non-profit which is supported by contributions from banks, merchants, etc.
 - Provides education about credit and budgeting
 - Provides help with spending plan
 - Provides debt counseling services for those with serious financial problems
 - Can develop a debt repayment plan and negotiate reduced interest rates

Consumer Credit Counseling Services

Characteristics of the Typical Client of the Consumer Credit Counseling Service	
Age:	38
Sex:	Male 43%, female 57%
Marital status:	Single 31%, married 48% Separated, divorced, or widowed 21%
Number in family:	3.3
Buying or own home:	38%
Average monthly gross income:	\$2,562
Average total debt:	\$20,045
Average number of creditors:	10.5

Source: Consumer Credit Counseling Service (Houston), www.cccsintl.org/info/stats.html, February 28, 2005.

Consumer Credit Counseling Services

- ALTERNATIVE COUNSELING SERVICES

- Universities, local county extension agents, credit unions, military bases, and state and federal housing authorities provide nonprofit counseling services
- You can check with your bank or consumer protection office to see if it has a listing of reputable, low-cost financial counseling services
- Avoid those service providers with large fees
- www.consumercredit.com is the website of the nonprofit American Consumer Credit Counseling
- Bankruptcy is a *last resort*

Declaring Personal Bankruptcy

- BANKRUPTCY
 - is a legal process in which some or all of the assets of a debtor are distributed among the creditors because the debtor is unable to pay his or her debts
 - Women account for 36 percent bankruptcies
 - A record 2.0 million people declared bankrupt in 2005
 - Bankruptcy was designed as a last resort but has become an “acceptable” tool of credit management
 - Declaring bankruptcy is a last resort because it severely damages your credit rating

Declaring Personal Bankruptcy

- BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

What does it include?

- Executive Office for U.S. Trustees must develop a financial management training curriculum to educate individual debtors on how to better manage their finances
- Debtors must complete an approved instructional course in personal financial management
- Clerk of each bankruptcy district must maintain a list of credit counseling agencies and instructional courses on personal financial management

Declaring Personal Bankruptcy

- **Chapter 7 Bankruptcy**

- Submit a petition to the court that lists assets and liabilities, and pay a filing fee
- Known as a Straight Bankruptcy
- Many, but not all, debts are forgiven
- Most assets are sold to pay creditors
- Can keep some assets
- Fresh start
- Most filings used to be this type

Declaring Personal Bankruptcy

- After **Chapter 7 Bankruptcy**,
You May No Longer Owe...
 - Retail store charges
 - Bank credit card charges
 - Unsecured loans
 - Unpaid hospital or physician bills

Declaring Personal Bankruptcy

After **Chapter 7 Bankruptcy**,
You May Still Owe...

- Certain taxes and fines
- Child support and alimony
- Educational loans
- Debts from willful or malicious acts

Declaring Personal Bankruptcy

– Chapter 13 Bankruptcy

- A voluntary plan proposed to the bankruptcy court for those to want to pay a portion of their debt over a period up to five years
- Known as a Wage-Earner's Plan
- Must have a regular income
- Payments are made to a trustee
- Trustee distributes money to your creditors
- Court may allow you to keep property & pay less than full amount of debts
- Costs to the debtor include court costs, attorney's fees and trustees' fees and costs

According to Fair Isaac Corporation (FICO), a personal bankruptcy can cause an immediate drop of up to 260 points on your credit report. This damage is serious, harmful and long lasting.