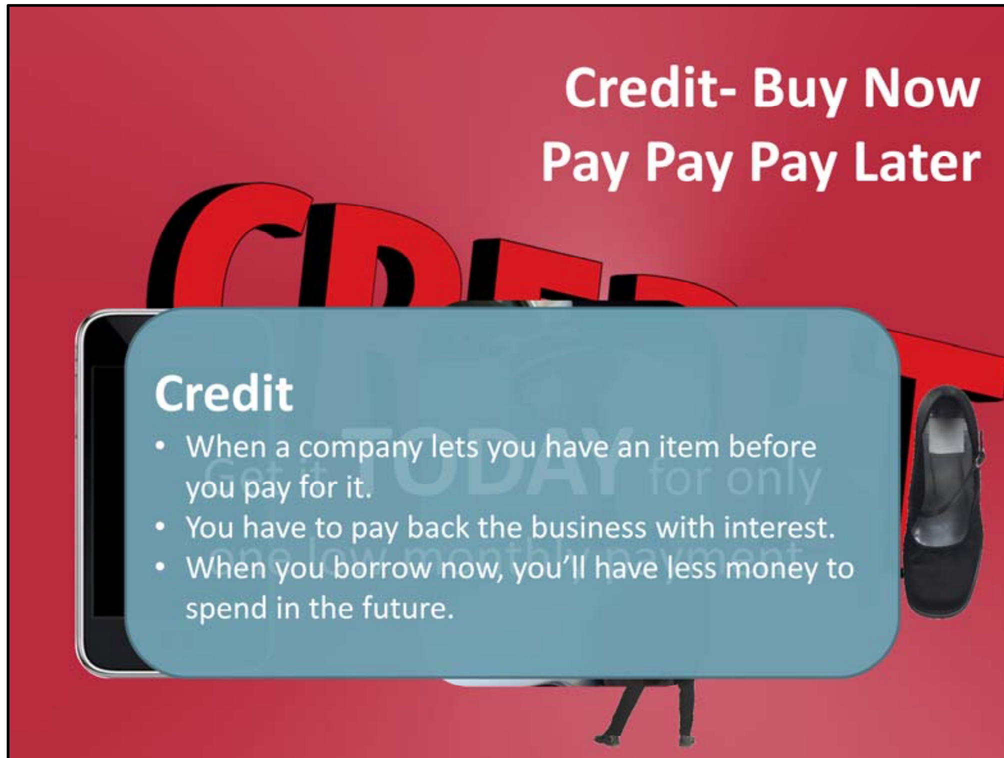


Is there something you really want to buy right now, but you don't have the money? A new phone? A new car? A new pair of shoes? What if you could get it *today* for one low monthly payment? Would you take it?

Any time a business lets you have an item before you pay for it, you are purchasing the item on credit, meaning you are going to use it now and pay for it later. You are essentially borrowing money from the business which you will pay back, most likely with interest. How much you pay in interest every month, also known as the finance charge, is extra money that you pay for the convenience of getting the item now.

When you consider buying something on credit, you need to consider just how much extra you're going to pay in borrowing costs to see if it's worth it. Remember, by borrowing now, the opportunity cost is that you will have less money to spend in the future. You may think you have enough to make the payments on an item, but what happens when the unexpected car repair happens and you can't afford to fix it? You might have to borrow that money as well because you can't pay the bill. It's easy to see how a lot of small charges can snowball into big debts.

While paying cash is the best way to buy things, sometimes that just isn't possible. Let's look at the different costs and conditions of the various types of credit so that when you do need to borrow to pay for something, you'll be able to make a well-informed, responsible choice about what kind of credit to use and where to get it.

While there are a variety of different types of credit, they can all be categorized as one of three types: open-end, closed-end, and service credit. Let's take a look at each to see how they differ.

Let's say you want to be able to borrow money whenever you want, up to a limit, for any type of purchase and then pay back the loan later. You don't have to tell the lender what you're going to buy: they will lend you the money as long as you don't go over your credit limit, and make your loan payments on time. Does this sound like a good deal?

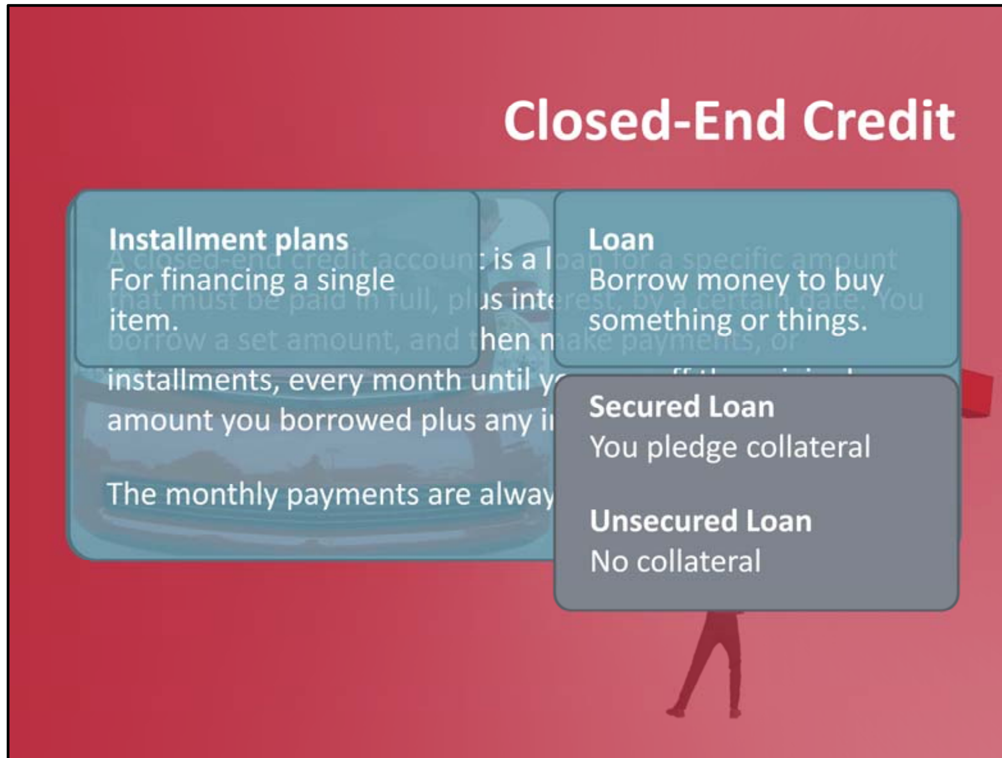
This may sound familiar to you because this is how most credit cards work. You can use your card wherever it's accepted to buy products up to your credit limit. As long as you pay back the loan on time, you can continue to use the card. This type of arrangement is known as open-end credit. Open-end credit falls into two categories: 30-day accounts and revolving accounts.

Thirty-day accounts are accounts where the borrower has to pay back the full amount borrowed each month. American Express is an example of this type of credit account, although they also have cards which function as revolving accounts. When you have to pay the balance each month on a card, it is called a charge card, as opposed to a credit card where you can carry a balance.

Another example of a thirty-day account would be a vendor who sells to other businesses. Suppose you own and operate a landscaping business. When you have a job where you have to plant trees, bushes, flowers, and sod, you may need to purchase all of the items from a plant nursery on credit and then pay the vendor when you get paid for completing the job. This particular type of business account is usually referred to as accounts payable.

The second type of open-ended credit called a revolving account is more common. Most credit cards are revolving accounts. If you have a credit card, you can use it where it's accepted to make as many purchases as you like, up to your credit limit. At the end of the billing cycle, which is usually monthly, you can either pay the balance in full or pay part of the balance. The minimum payment you must make is determined by the credit card company and is based on the amount of money you owe, or the balance of the account. Like a revolving door, you can keep going around and around with this type of account. Charge, pay, charge more, pay more, etc.

As long as you pay at least the minimum amount, there is no set ending date for you to pay off the outstanding balance. You can keep borrowing indefinitely as long as you don't miss a payment or exceed your credit limit.
Before you run out and get a credit card with the highest credit limit you can find, there are a number of other issues you need to consider. We'll look at credit cards more in depth in another presentation.



If you were going to buy a new car, you'd want to know how much the monthly payment was going to be every month and how many months it would take for you to pay off the loan before you borrowed the money. A car loan is an example of a closed-end credit account.

A closed-end credit account is a loan for a specific amount that must be paid in full, plus interest, by a certain date. You borrow a set amount, and then make payments, or installments, every month until you pay off the original amount you borrowed plus any interest. The monthly payments are always the same.

We looked at a couple of different types of closed-end credit earlier in this topic: installment plans and loans. Interest rates on closed-end loans are usually lower than interest rates on open-end credit.

Installment plans enable you to finance the purchase of a single item, like a computer, from the company that sells the product. You then pay back a set amount over a set number of payments until you have paid off the loan.

Loans are similar to installment plans except that instead of financing a particular item, you borrow money to buy something or some things. Remember that when you borrow money through a secured loan, you are pledging collateral which the lender can take if you don't pay back the loan. Car loans and home mortgages are secured loans. Unsecured loans have no collateral to back them up and are made solely on the borrower's credit rating, although lenders can take other means to recover their assets if the lender stops making loan payments.

We'll look more at loans later in this presentation.

Service Credit

When you use a service now, and pay for it later.

Examples
Utilities
Communications

When you take a shower are you borrowing water or did you already pay for it? What about your cell phone, did you have to pay in advance for all the services you're going to use this month, or do you pay at the end of the month for what you actually used?

Most likely, you paid for these services after you used them and the service provider let you use the service now and pay for it later. This is an example of service credit. Most companies that offer service credit to their customers charge no interest or penalties as long as the bills are paid in full within 25 to 30 days. The most common examples of service credits are things like utilities (water, electricity, gas), communications services (phone and Internet), and television programming. Some of these services might not vary from month to month, but you still don't pay for them until after you use them. Other providers, like utilities, offer the option of paying the same amount every month even though you might use much more or less during certain months, so that you don't have to pay large bills the three or four months that you are a heavy user of the service.

Some other examples of service credit are doctors, hospitals, dry cleaners, and many small businesses. They do the work first and bill you later. If you don't pay for the work within the time specified, they may charge interest or finance charges until you pay off the balance in full.

Where can you get credit? All over the place! Since all credit is not the same, you need to shop around to find the best deal for you. We'll see how to find the best deal shortly, but let's first look at some of the places where you can get credit. Roll over each graphic to learn more.

Many retail stores offer credit cards to their customers, some that can only be used for in store purchases, and some that are also MasterCard® or Visa® credit cards that can be used wherever they are accepted. These store cards often offer special bonuses to users such as discounts on merchandise or other rewards usually related to making more purchases from the store. Many of these cards may charge a higher interest rate if you carry a balance.

Banks and credit unions offer major credit cards as well as loans—both secured and unsecured. When you have an account at one of these financial institutions, they may offer you a lower interest rate on these products since you are already a customer, and you may be more likely to have your loan application approved since they have a history of working with you.

Credit cards are another avenue to get credit. You might receive credit card offers in the mail, or you can apply for one at a bank or online. Visa® and MasterCard® cards are generally issued by banks, while Discover® and American Express® cards are issued by their respective companies. What that means for you is that there are many banks, or even businesses, where you can apply for a Visa® and MasterCard® each of which may have significantly different terms. Shop around before you apply for a card, and look online since most banks will post their card rates and terms at their website. Since Discover® and American Express® cards are issued by the corporate parent, the terms for these cards don't vary as much. Remember that your local bank where you have an account might offer you the best deal, or at least come close to it.

Finance companies specialize in lending money to people for purchasing specific goods and services, usually items that are expected to last several years like a refrigerator, furniture, a computer, or a car. They generally fall into two types: consumer finance companies and sales finance companies. Consumer finance companies make small loans to individuals and operate independently of the company that manufactures the item being purchased. HFC Beneficial is one of the biggest consumer finance companies. You can borrow money from them to finance all kinds of small purchases. Sales finance companies are usually related in some way to the company manufacturing the item. Say you go to buy a new BMW®. You can finance your purchase through BMW Financial Services, which is a sales company set up to help people finance their BMW® purchases. You can't buy a Mercedes® using their loan. Be very careful about making all of your payments on time when you deal with a finance company. Finance companies are more likely to contact you repeatedly or repossess your assets if you fall behind in your payments.

Pawn shops or pawnbrokers are businesses that give you high interest loans based on the value of some personal possession of yours. With a pawn shop, the pawnbroker appraises your item, for example jewelry, coins, camera, or a computer. The pawnbroker then lends you money based on its value, usually about 25% of the value of the item. The pawnbroker holds the item for a certain period of time, usually one to six months during which time you can get your item back by repaying the loan plus interest. If you don't pay back the loan and claim your item, the pawnbroker will sell it and keep the profits. Unlike other types of loans, there are no negative consequences to your credit rating if you don't pay it back since the pawnbroker gets to keep your collateral.

With a payday loan, you are borrowing money from your next paycheck. These lenders charge high interest rates because people who use this type of credit are generally having credit problems and need money before their next payday, so they are considered high risks. When you get your next paycheck, you have to pay back the loan plus the interest. Due to the high interest rates, you should use this option only in a true emergency.

With title loans, you pledge your car title as a guarantee that you will repay the loan. In order to get this loan, you can't have a loan on your car. You wouldn't have your title if you have a loan on it because the lender keeps the title until you pay off your car loan. Again, this is a riskier loan for the lender so they charge a higher interest rate and they are much quicker to take your car if you don't pay the loan back. Again, use this option only in a true emergency.

When you borrow money from someone you know who is not in the business of making loans, you are borrowing from a private lender. The nice thing about private lenders is that they often don't charge interest for the loan, although they might. The bad thing about borrowing from a private lender is that it can create problems if either party doesn't stick to the agreement. Issues with money can ruin relationships!

There are a few other sources of credit as well. Colleges and the federal government offer student loans. Some life insurance policies build cash value as you pay into them that the policy owner can borrow from. You may not have to repay these loans, but interest will be charged and the value of the policy decreases by the amount of the loan when the policy holder dies. If you have investments, like a certificate of deposit or a tax sheltered annuity, you may be able to borrow money against them at a low interest rate also. Basically, you are borrowing from your investment and paying it back at a low interest rate. There can be penalties associated with this kind of borrowing, so read the fine print before you sign on the dotted line.

A Closer Look - Loans

Do I need it right now, or can I wait until I have the money?

Costs & Conditions of Borrowing
- ✓ Annual Percentage Rate (APR)
  - Variable or Fixed?
  - Compound or Simple Interest?
- ✓ Finance Charges

Regardless of where you intend to borrow money, your first question should be "do I need the item right now, or can I wait until I've saved up the money?" It's going to cost you more to finance a purchase than if you pay cash, so be sure it's necessary.

Any time you are financing a purchase, you should consider all of the terms and conditions, and the costs, of borrowing money. This includes loans where interest rates and terms can vary greatly.

Lenders make money by charging interest on loans. Since loans are closed-end, you have a set number of payments for the loan, so you can actually figure out the exact amount a loan will cost in advance. By law, the lender has to tell you the APR and the total cost of the loan before you can "sign on the dotted line."

Loan APR's are usually fixed for the life of the loan, so you won't have to worry about variable interest rates as much, although some mortgages have variable interest rates. Of course, a lower interest rate means you'll pay less in finance charges for the loan, so go with the lowest fixed interest rate you can find and qualify for. Remember businesses that deal with people with poor credit, like finance companies, payday lenders, pawn shops, and title lenders, charge higher interest rates and finance charges.

Loans may charge compound interest or simple interest. Simple interest is a set amount of money that you pay back for the use of the loan. When you are considering getting credit, simple interest is better than compound interest because you don't pay interest on your interest! You only pay interest on the principal – the amount that you borrowed.

A Closer Look - Loans

Costs & Conditions of Borrowing Continued:

- ✓ Monthly Payments
- ✓ Length of Time to Repay the Loan
- ✓ Total Amount Required to Pay off the Loan
- ✓ Annual Fees
- ✓ Transaction Fees
- ✓ Loss Incurred If Loan not Repaid

Since you know how much each payment will be for the life of the loan, make sure it fits into your budget for the entire term of the loan. Monthly payments are determined by how much you borrow, the interest rate, and how long it will take you to pay back the loan, also known as the term of the loan. Credit unions often charge their members lower interest rates and lower fees to process the loan, so you may end up with a lower monthly payment.

The monthly payment is also a function of how long the term of the loan is. If you take longer to pay back the loan, your monthly payment will be lower, but it will cost you more to borrow the money. The smaller monthly payments may seem more attractive, but the extra cost in interest may not be worth it. Always look at the loan payment schedule provided to you by the lender, and take notice of the total amount of interest you will repay with the loan. You have to decide if the cost is worth the benefit of purchasing the item. Remember, you are committing your future income to this purchase for a number of years! Make sure you can afford it.

Annual fees and transaction fees need to be considered into the cost of your loan as well. Does the lender charge a fee every year? Do they charge to do the paperwork for your loan, which is sometimes called an origination fee? Origination fees are usually associated with home loans, but they do add to the cost of the loan. Are there transaction fees? These can be monthly service fees just for processing your loan payments. Does the lender charge an early payment penalty? Some lenders charge you a percentage of the loan if you pay it off early. Any fees that you have to pay on your loan increases the total cost of the loan. The lender has to tell you about all of these fees before you agree to the loan. Don't sign anything that you don't understand or don't agree with! Once you sign your name, you are obligated to pay and your signature indicates agreement!

Finally, what will you lose if you don't pay the loan on time or if for some reason you fail to pay back the loan at all? Remember with secured loans, you promised a specific asset as security for the loan. If you don't repay the loan as you promised, you risk losing the asset. Can you afford to lose your home or your car? With unsecured loans, the lender can ask the court to give them other assets you own, like jewelry, your home, or your car. In addition, not repaying a loan or paying late on a loan, can negatively affect your credit rating and your ability to get credit in the future. When you don't meet your financial obligations, you cause real harm to your future ability to get credit.

How to Choose?

PACED Decision Making Model

- P – Define the **P**roblem
- A – Identify the **A**lternatives
- C – List your **C**riteria
- E – **E**valuate the pros and cons
- D – Make a **D**ecision

In other modules, we talked about how to make good, responsible choices using a decision-making model, like the PACED model. Remember, PACED has five steps to help you make a decision. You can use these five steps to evaluate whether or not to finance a purchase and what your financing options are if you decide to go ahead.

Step 1 – P: Define the Problem. Decide what you want or need to buy and decide how much you can afford to spend. Keep in mind that you are probably going to be committing to payments for several years, so make sure you consider the impact on your future earnings.

Step 2 – A: Identify the Alternatives. What credit options are available to you? Should you get a loan? How much do you qualify for? Should you use a credit card?

Step 3 – C: List your Criteria. What features are important to you? Do you want a low interest rate? Are there rewards or promotional incentives that appeal to you? How long will it take to pay back the debt? Is the monthly payment low enough for you to afford comfortably without stretching out the loan and causing you to repay more?

Step 4 – E: Evaluate the pros and cons. Look at your alternatives—a credit card, a secured loan, an unsecured loan, a payday loan, etc. You may want to make a decision grid so that you can list each of the pros and cons for every alternative.

Step 5 – D: Make a Decision. Which alternative is best for you? Remember the marginal cost rule: with which alternative do the benefits outweigh the costs?

A Tool or a Trap?

Credit can be a great tool to help you buy things you need now, but can't afford.

Credit can be a great tool to help you buy things you need now, but can't afford. When used responsibly, credit can help you through those times when you need extra money, or when you want to buy things like a car or a house that may be difficult to save up for in advance.

Credit can also be a trap that can limit your choices in life and put serious strains on your personal relationships and health. It can be one of the greatest impediments to your financial dreams, so you need to use it only when necessary and you have no other options.