CHAPTER 8

Paying for Credit


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Chapter 8 discusses paying for credit, types of loans, and managing credit wisely. You will learn about payment options and their advantages and disadvantages. You will discover the various types of consumer loans and debt options. You will also take a careful look at some tips for using credit wisely.

ONLINE RESOURCES

Personal Financial Literacy Web site:

- **Data File**
- **Vocabulary Flashcards**
- **Beat the Clock: Paying for Credit**
- **Chapter 8 Supplemental Activity**

Search terms:

- money order
- wire transfer
- mortgage
- student loan
- balloon payment
- rebate

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8-1

Payment Methods

OUTCOMES

- Describe manual and electronic options for making payments.
- Explain the advantages and disadvantages of manual payment options.
- Explain the advantages and disadvantages of electronic payment options.
- Name the primary advantage of wire transfers.
- Discuss prepayment penalties and why a loan might be repaid early.

MANUAL PAYMENTS

When you use some form of credit, you must decide how you will make payments on the account. When you make a payment on an account, you are reducing the amount you owe. Several payment options can be used. Each payment method has advantages and disadvantages.

Cash

Cash is a traditional payment option. Many people prefer to deliver cash to local stores and banks rather than mail a check. An advantage to using cash is that cash is accepted everywhere for payments. Be sure to get a receipt for any payment you make in cash. The receipt serves as proof of payment and is another advantage to this payment method. A disadvantage to paying with cash is that carrying large amounts of cash can be unsafe. You may be robbed, or you may lose the money. Another disadvantage is that the cash must be delivered in person. Never send cash through the mail.

Personal Checks

A personal check is another traditional payment option. The check can be mailed or delivered in person. Before you write the check, compare the bill with your receipts to be sure everything is correct. For revolving credit accounts, pay the outstanding balance if you can. If not, choose a payment amount that is more than the minimum required, if possible.

Paying by check has some advantages. Checks are easy and inexpensive to use. Mailing checks is relatively safe. Cancelled checks or bank statements showing checks that have been processed provide proof of payment. A disadvantage of paying by check is that the check can get

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lost or delayed in the mail. If the check does not reach the creditor before the due date, you may be charged a late fee. You can explain that the check was delayed in the mail and ask to be excused from paying the late fee. However, the creditor may not accept this excuse. Some creditors will waive at least one late fee.

When paying by check, you should plan ahead so that checks are written and mailed in time to reach the creditor by the due date. Be sure to mail payments from a secure location. Leaving mail in the unlocked box outside your house may not be a safe option. Instead, you can take the mail to a post office or mailbox that is secure.


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Be sure to verify charges before you pay credit bills.

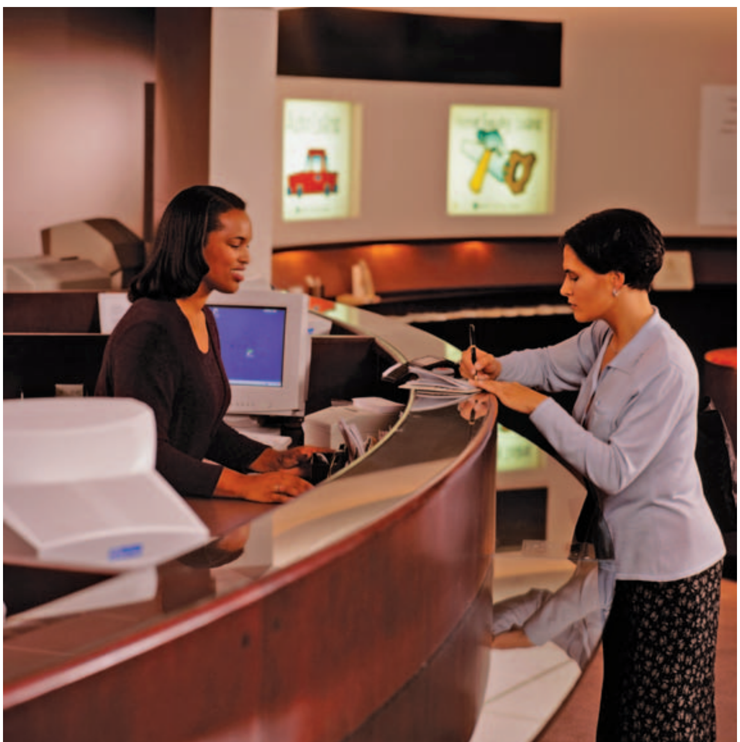
Money Orders

A **money order** is a type of check that directs payment of a sum of cash to a payee (a person or company). A money order typically has two parts. One part is the check that is sent to the payee. The other part is a receipt keep by the person buying the money order. The amount of the money order is printed on both parts. Money orders can be purchased at banks, U.S. post offices, and some stores. There may be a limit to the amount for which the money order is issued. For example, a postal money order may be limited to $1,000.

An advantage to using a money order is that it is prepaid. The payee is guaranteed payment because this type of check cannot bounce. A money order can also be sent safely by mail.

A disadvantage to using money orders is that getting one can be inconvenient. At some locations, you may have to stand in line and pay for the money order using cash. At other locations, you may be able to pay by personal check. Another disadvantage is that you must pay a fee for the money order. Often the fee is based on the amount of the money order. For example, a $100 money order might cost $5 (or more) for a total of $105.

Money orders can also be purchased on the Internet. To find a Web site that sells money orders, search using the term *money order*. At the Web site, you will need to enter the amount of the money order and select a delivery method, such as U.S. mail. You will also need to enter the recipient's name and address. Then you enter your name, address, and credit card information. Fees for buying a money order online are about the same as when buying one in person. For example, a $100 money order might cost $6.48 for a total of $106.48.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Money orders can be purchased at banks and other locations.

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Bank Checks

A cashier's check is another payment option. You can purchase a cashier's check at a bank or credit union. You can pay for the check in cash or have the money taken from your account with the bank. An advantage to using a cashier's check is that it is prepaid. The payee is guaranteed payment. Unlike a money order, a cashier's check can be written for large amounts. A cashier's check can also be sent safely by mail. A disadvantage to this payment option is that you may have to pay a fee for the cashier's check. Some checking accounts include this service as a part of the account.

A **certified check** is a personal check for which payment is guaranteed by the bank on which it is drawn. To use this payment option, you write a check and have the bank certify it. The bank sets aside from your account the amount of the check. This amount will be used only for payment of the certified check. When the check is presented for payment, the money is waiting. An advantage to using a certified check is that it is prepaid. The payee is guaranteed payment. A certified check can also be sent safely by mail. A disadvantage to this payment option is that you may have to pay a fee for having a check certified. It may not be convenient to go to the bank and wait for service.

ELECTRONIC PAYMENTS

Using your checking account, you can set up electronic payments for some credit accounts. There are several types of electronic payments, such as online payments, online banking, payment by telephone, and automatic withdrawals. Electronic payments have several advantages. All of these methods save you postage. Once set up, they are quick and easy to use. Many people make most of their payments in this manner.

Electronic payments also have disadvantages. You will be charged fees for using some types of electronic payment services. You must monitor the balance in your checking account carefully. Be sure enough funds are available to cover the electronic payments. Otherwise, you may have to pay overdraft fees. If funds are not available, the bank might refuse the payment. Then you would have to pay late fees to the creditor.

Online and Telephone Payments

You may be able to make payments online at the creditor's Web site. At the Web site, you access your account with a user name and password. Then you enter your bank account information. This includes the bank routing number and checking account number. A sample screen for entering data is shown in Figure 8-1.1 on page 224. Now you are set to make online payments. When you want to make a payment, you authorize a withdrawal from your checking account. There usually is no fee for this service. You can choose the date the money is withdrawn from your account.

Some creditors allow you to authorize payments from a checking account by telephone. You must supply information such as your account number with the creditor. You will also need to give the creditor the bank routing number and your checking account number. Some banks allow

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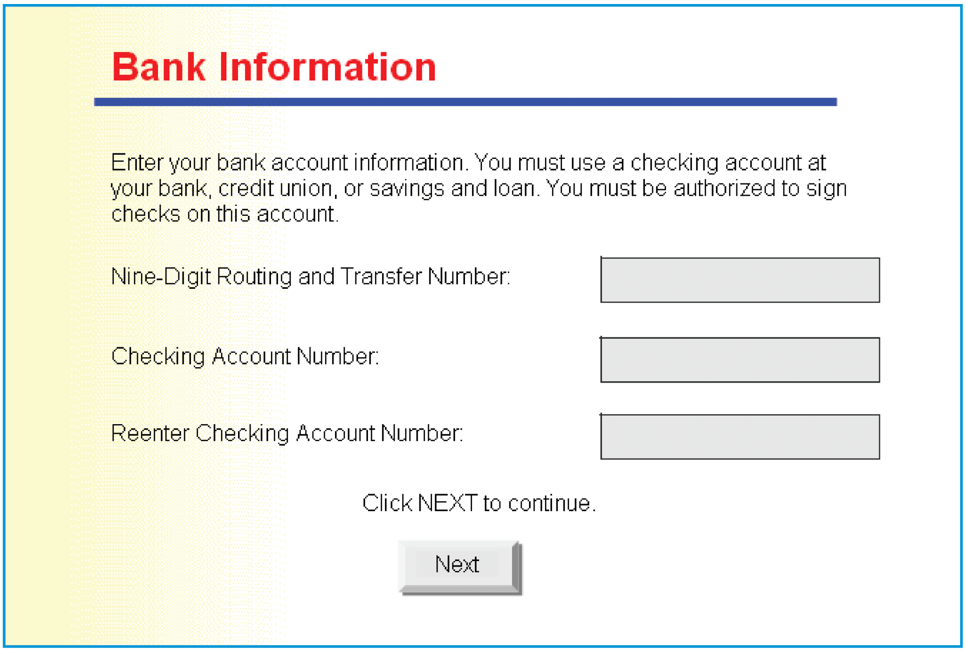
FIGURE 8-1.1

You must enter your bank account information to set up online payments.


Bank Information

Enter your bank account information. You must use a checking account at your bank, credit union, or savings and loan. You must be authorized to sign checks on this account.

Nine-Digit Routing and Transfer Number:

Checking Account Number:

Reenter Checking Account Number:

Click NEXT to continue.

Next

you to make payments and manage your account using the telephone. A fee may be charged for this service, especially if you must speak to a person who assists you with the process.

Online Banking

Another type of online payment is made through your bank or credit union. This service, called **online banking**, allows you to make payments and manage your account using the bank's or credit union's Web site. Convenience is the main advantage to online banking. A disadvantage is that banks or credit unions may charge a monthly fee based on the number of payments you make. A major drawback to this method is that all of your creditors may not be set up to receive electronic payments. In this case, the bank creates a check and mails it to the creditor. In order to avoid late fees, you must allow mailing time when you authorize the payments.

Automatic Payments

Automatic payments occur when you ask the bank to transfer money electronically from your checking account to some other account. For example, many people choose to pay their car insurance premiums with automatic payments. The payment is made automatically each billing period. An advantage to this option is convenience. You do not have to remember to pay the bill each month. Another advantage is that you may get a discount for using this payment method. A disadvantage to this method is that you must be sure to keep enough money in the account to cover the automatic payment. If you do not, you may have to pay overdraft or late fees.

Wire Transfers

A **wire transfer** is the process of sending money electronically rather than using paper checks. This service is available from companies such

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as Western Union. Banks and other financial institutions also do wire transfers for their customers. The sender pays the amount of the money transferred plus a fee. The money is delivered to a designated location where the recipient can collect it. For example, Western Union has sites called agent locations. They are businesses such as grocery stores, drugstores, and travel agencies. Customers can send a wire transfer or receive money from a wire transfer at these locations. The fee for this service depends on the amount of the transfer. For a wire transfer of $100, the fee could be $15 or more.

An important advantage to using wire transfers is that the transaction is completed very quickly. Money is transferred in just minutes, and you are assured that it arrives safely. A disadvantage to using wire transfers is that they can be inconvenient to purchase in person. You have to go to a bank or business that offers wire transfers. At some locations, you may have to pay cash for the amount being wired.

Wire transfers can also be arranged online and by telephone. Companies such as Western Union have Web sites and telephone numbers you can use to make a wire transfer. You pay for the transfer using a credit or debit card. This method may be more convenient than visiting a business to complete the transfer.

PREPAYMENT PENALTIES

Some types of loans may have penalties for early repayment. A **prepayment penalty** is a fee charged when you repay a loan before the agreed-upon time. For example, suppose you borrow money and agree to repay the loan over a 15-year period. A short time later, you decide to pay the entire loan balance. The loan agreement may specify a 30- to 90-day interest penalty. The lender has certain costs related to setting up the loan. These costs are spread over the life of the loan. If the loan is repaid early, the lender charges a penalty fee to cover these costs.

An example of a 60-day interest penalty on a $10,000 loan that is paid off after one year is shown in Figure 8-1.2.

Repaying a debt early may be a wise choice, even with a prepayment penalty. If the penalty amount is less than the interest you would pay if you paid on the original schedule, paying off the debt would be to your advantage.

INSTALLMENT PAYMENT PLAN

Terms: $10,000, 5-year loan at 8% interest, with a 60-day interest penalty for early repayment

Initial Balance	$10,000.00
Monthly Payment	$ 202.76
Current Loan Balance (at payoff after 1 year)	$ 8,305.60
60-Day Interest Penalty	$ 110.74
Balance to Be Paid	$ 8,416.34

FIGURE 8-1.2

PREPAYMENT PENALTY EXAMPLE

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Building Communications Skills

FORMAL SPEAKING

The purpose of a formal speech is to convey information, to entertain, or to persuade. When preparing a speech, begin with a clear statement of the goals you want to accomplish. These goals will guide you as you prepare the content of the speech.

Use an outline to develop the content. The outline should have three main parts: the introduction, the body, and the conclusion. The introduction briefly explains your topic. The body gives the details or substance of the speech. The conclusion is a summary or request for action.

As you develop the content, consider the listeners who will hear the speech. Why will these people be listening? What do they have in common (age, place of work or residence, hobbies, other interests)? How much do they already know about the topic? Answering these questions will help you create content that will accomplish your goals.

Many formal speeches are presented using electronic slides. Projection equipment and software such as *Microsoft PowerPoint*® are often used. The slides help illustrate points and add interest to the speech. Slides should list only the main points being covered. If more detailed information must be shared, use a handout for that material.

A time limit is often set for formal speeches. Practice delivering the speech so you can stay within the required time limit. As you deliver the speech, make eye contact with members of the audience. Use an appropriate tone, rate, and volume. Speaking with confidence and enthusiasm will help you keep the audience interested. Pause briefly after important points to allow listeners to think about the point.

Effective formal speaking often takes lots of practice and refining of skills over time. After you make a speech, evaluate yourself. Think about what you did well and what you could do better the next time. You may also want to ask the audience to evaluate the speech.

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8-1 Activity 1 Can You Recall?

Answer these questions to help you recall what you have read. If you cannot answer a question, read the related section again.

1. List four types of manual (not electronic) ways to make payments on a credit account.
2. What are the advantages and disadvantages of making payments using cash?
3. What are the advantages and disadvantages of making payments using a personal check?
4. What is a money order? What are the advantages and disadvantages of making payments using a money order?
5. How is a cashier's check different from a certified check? What are the advantages to using these methods of payment?
6. What are some advantages of using electronic payments? What are some disadvantages?
7. What types of activities can customers do using online banking? Give one advantage and one disadvantage to making payments using online banking.
8. What types of information must customers provide to set up online payments at a creditor's Web site?
9. What is a wire transfer? What is its primary advantage?
10. What is a prepayment penalty? Why might you still wish to pay off a loan early, even when there is a prepayment penalty?

8-1 Activity 2 Payment Options

Critical Thinking

Assume the following options are available to you for paying bills:

- Pay in person with cash.
- Send a personal check by mail.
- Make an online payment (at the creditor's Web site).
- Use the online banking payment system (at your bank's Web site).
- Set up a monthly automatic payment from your account.
- Buy and mail a money order.
- Secure and mail a cashier's check.
- Send a wire transfer.

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What payment method would you choose for each of the following payments and why?

1. Monthly cell phone bill
2. Monthly electric utility bill
3. Monthly credit card bill
4. Monthly loan payment to your credit union
5. An online purchase of a book from a merchant with whom you are not familiar
6. $100 cash for your brother who is in another town and needs the money right away

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8-2

Consumer Loans

OUTCOMES

- Describe types of consumer loans.
- Explain how a personal loan differs from a secured loan.
- Explain how a fixed rate mortgage differs from an adjustable rate mortgage.
- Describe the purpose of a mortgage calculator.
- Explain the purpose of a student loan.
- Describe rent-to-own agreements and give their advantages and disadvantages.

TYPES OF LOANS

In addition to using credit cards, you can borrow money in the form of a loan. An **installment loan** is a type of debt in which you borrow money for a period of time. The loan has an agreed-upon interest rate and repayment plan. Many loans have monthly payments. Creditors make money by charging interest on the amount borrowed.

Personal Loans

Loans that are based on personal creditworthiness are called **personal loans**. The borrower submits a loan application asking for a fixed amount of cash. The amount of the loan that a creditor will approve is based on factors such as the following:

- The purpose for which the money will be used
- The borrower's credit payment history
- The borrower's existing debts and current payments to other creditors
- The borrower's monthly and yearly income
- The borrower's job security (whether the job is likely to continue)

Borrowers who already have a lot of debt may be denied a personal loan. If granted a loan, the borrower may be charged a high interest rate. This is because a personal loan represents a bigger risk to the lender than a secured loan.

Secured Loans

A **secured loan** is a debt agreement in which the borrower pledges property of value as security. This property is called collateral. A house or a car owned by the borrower is often used as collateral. If the borrower fails to repay the loan as agreed, the lender can sell the property and use

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A consumer may need a loan to pay for an expensive item.

the proceeds to repay the loan. Secured loans are often used to buy durable goods. Durable goods are assets (items of value) that will last longer than a year. The goods being purchased, a riding lawn mower, for example, may serve as collateral for the loan.

Some borrowers do not have property that can be used as collateral. In this case, another person may agree to serve as a cosigner on the loan. A **cosigner** is a person who agrees to repay the loan if the borrower does not repay the loan. The cosigner typically must have property that can be used as security for the loan or a very good credit rating.

CAR LOAN

Many people who buy cars borrow money in the form of a car loan. This type of debt is a secured loan. The car itself serves as collateral. The creditor holds the title to the car until the loan is paid in full. If the borrower cannot make the payments as agreed, then the car is repossessed and sold by the creditor to pay off the debt.

HOUSE LOAN

A **mortgage** is a loan that is used to secure financing for the purchase of a house or other real estate. The mortgage usually requires 10 to 30 years of monthly payments. A mortgage is a form of secured loan. If you do not make payments as agreed, you can lose the house. Some mortgages have prepayment penalties. The borrower must pay an extra fee if the loan is repaid before a set period of time, such as 5 years.

Many mortgages have fixed interest rates. The interest rate does not change over the life of the loan (typically 10 to 30 years). With a fixed interest rate, the payment also does not change over the life of the loan.

Another type of mortgage is the adjustable rate mortgage (ARM). With an **adjustable rate mortgage**, the interest rate on the loan can change over time. As interest rates go up or down in the economy, the mortgage rate can change as well. If the rate goes up, the payment amount increases. The term of the loan may also increase. Typically, there is a limit to the amount the loan interest rate can go up or down each year. Often an adjustable rate mortgage starts with a lower rate. This lower rate allows the borrower to afford the payments. A higher rate and higher payments may be charged in later years.

Some mortgages have a balloon payment. A **balloon payment** is a large sum that must be paid at a set time. The balloon payment is typically the last loan payment. For example, a mortgage may have equal monthly payments of $800 for 10 years and a final balloon payment of $5,000. Like adjustable rate mortgages, balloon payments are often used so the loan will have lower monthly payments. This allows people who could not otherwise afford to buy a house to purchase a home. The buyer may sell or refinance the loan before the balloon payment is due. At that time, the buyer may qualify for a fixed rate mortgage with more favorable terms.

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Most secured loans also have closing costs. **Closing costs** are expenses you must pay in order to get a loan. They include charges for items such as appraisal fees, credit report fees, loan origination fees, recording costs, and inspection fees. Closing costs can be hundreds or even thousands of dollars. Before agreeing to a loan, be sure to ask about all the costs you will be expected to pay to get the loan.

If a mortgage is for more than 80 percent of the value of the home, the borrower is typically required to purchase mortgage insurance. This insurance will pay the lender if the borrower does not repay the loan. The loan agreement may also require the borrower to carry a homeowner's insurance policy.

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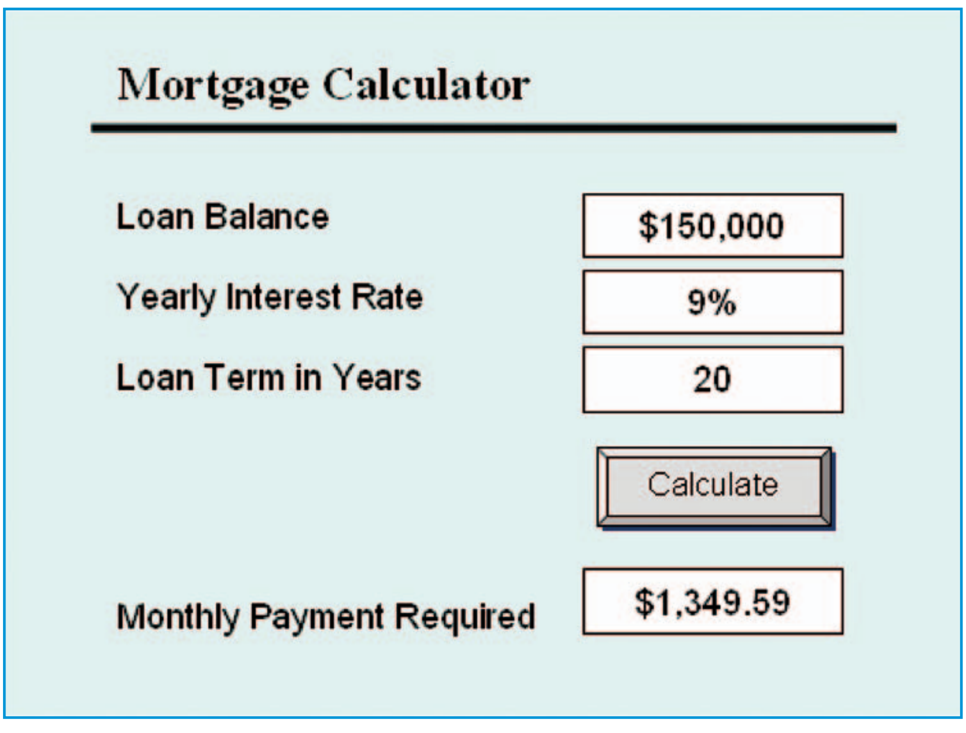
Many people who buy houses finance the purchase with a mortgage loan.

AMORTIZATION

Repaying a debt by making regular payments of principal and interest over a period of time is called **amortization**. A formula can be used to calculate payments on an amortized installment loan. The formula is more complicated than the formula you learned earlier for simple interest. This is true because payments reduce both the principal and the interest amounts. Interest is charged on the outstanding balance, which decreases over the life of the loan. Amortization tables and calculators are available on the Internet. An example calculator is shown in Figure 8-2.1. These tools can help you quickly calculate loan payments. The payment is based on the principal, interest rate, and number of monthly payments.

FIGURE 8-2.1

MORTGAGE CALCULATOR



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Focus on . . .

Unused Credit

When you have credit standing by in case you need it, it can actually cost you in ways you never suspected. For example, you may have five or six credit cards with zero balances. On the surface, this seems to be a very good thing. Lots of credit is available to you, but your outstanding debt is zero.

Suppose you now apply for a loan for a car or another large purchase. Because you have five or six credit cards with potential for debt of $25,000 or more, the lender may be reluctant to extend more credit to you. The lender may ask you to close several of those unused credit accounts. Then the lender will feel more secure about your ability to repay the loan.

Having some credit available is useful. If you have too much, however, you may find yourself at a disadvantage when applying for a loan.

A mortgage calculator can also be used to show how much of each payment made goes toward repaying the principal and how much goes toward paying interest.

You may see two different rates given for a loan offer. The loan interest rate is used to compute monthly payments on the principal borrowed. The term *annual percentage rate* (APR) takes into account the other loan fees, such as closing costs, that the borrower must pay as part of the loan payments. Comparing the APRs for two different loans gives you a better picture of the total charges you must pay for each one. When comparing the APRs for loan offers, be sure the same fees are covered in the APR numbers. APR calculators are available on the Internet.

Student Loans

A **student loan** is debt that is used to finance education costs. Student loans can be secured from banks and other financial institutions. Students who meet certain criteria can also get student loans from the U.S. government. On some student loans, called subsidized loans, interest is paid by the federal government while the borrower attends school at least half-time. The borrower repays the loan after finishing or leaving school. To qualify for student loans, you must fill out a loan application. If you live with your parents, they will also have to fill out paperwork showing income and assets. To get a subsidized loan, the borrower must show proof of financial need. Other loans are available and are not related to financial need. The borrower must pay all interest on these loans.

Many students take out several student loans to pay for attending college or other schools. After they complete their education, they often have these loans consolidated. Several loans are rolled into a single loan with one payment. This makes it easier to pay off the debt over a long period of time.

If you decide to get a student loan, compare the terms for loans from various sources. Information about student loans from the U.S. government

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FIGURE 8-2.2

Student loans are available for those who qualify.

Source: U.S. Department of Education, Federal Student Aid, Direct Loans, http://www.ed.gov/offices/OSFAP/DirectLoan/index.html (accessed June 5, 2006).

and other sources is available online. Figure 8-2.2 shows the Web site for the Direct Loan program. The National Student Loan Data System for Students Web site is also provided by the U.S. Department of Education. This site is a central database of information for student aid. The site will help you compare sources of loans and grants for education. Links to both sites are provided on the Web site for this textbook.

LEASE/RENT-TO-OWN

Another way of buying is by leasing or renting to own. You select an item, such as a television. You take the item home and use it just as if you had purchased the item. Each week or month, you make rent payments. At this point, you do not own the item. However, the rent-to-own agreement may state that if you make a certain number of payments, you will then own the item.

There are advantages to this type of agreement. You do not have to make a large down payment at the time of purchase. Some lease or rent agreements require that no cash be paid at the time you sign the agreement. You can try the item before you buy it. If you decide you do not want the item, you can return it and end the rent agreement according to the terms of the contract. The contract also provides you with a guaranteed price that will not go up later.

The disadvantages of this option usually outweigh the advantages. You may not have much choice in the models or features available for items. If you decide not to buy the item, no part of your rent payments is returned to you. The main disadvantage, however, is that the total price you will pay for the item if you make payments until you own it is often much higher than if you buy the item outright. For example, suppose you rent-to-own a television that sells for $220. You make weekly payments of $10. After making 78 weekly payments, you own the television. You will have

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paid a total of $780 for an item that sells for $220. This amount compares to paying a loan interest rate of 220 percent. A better option would be to take out a personal or secured loan at a bank to get money to buy the television. You could also charge the purchase on a credit card. In both cases, the interest rate would be much lower.

Success Skills

Building a Positive Reputation

Your personal behavior can have a big effect on the success of your personal relationships and activities. Your behavior also affects your success at school and work. *Reputation* is a word that means the opinion others have of you, especially as it relates to character or personal behavior. People form opinions about you, in part, from seeing the way you behave. They also form opinions from what others say about you. For example, a classmate may tell another person that you are prompt after noticing that you always come to class on time. Another person may notice that you did not do your part of a group task. This person may think that you are lazy or not cooperative.

Building a positive reputation is an important success skill. People may form opinions about you based on your reputation even before they meet you. This can be good or bad, depending on your reputation. Suppose you have a reputation for being a hard worker and treating others fairly. People will likely welcome you to their group or team. You will have a better chance of getting a job than another person with similar skills who has a poor reputation. Suppose you have a reputation for submitting work late that is poorly done. Others may not want to be on your team. You may find it difficult to get a good recommendation from former teachers or employers. This might keep you from getting a job or from being accepted to a college.

Follow these suggestions to build a positive reputation and be successful in your relationships:

- Treat others with courtesy and respect.
- Be fair and honest in your dealings with people.
- Be courteous to everyone, but choose your friends carefully.
- Be reliable. Always be on time for classes and appointments. Complete work or projects on time.
- Be willing to listen to new ideas and learn new skills.
- Show appreciation for the talents and accomplishments of others.
- Do your best whatever the task, but be willing to admit that you do not know all the answers all the time. Ask for help when you need it.
- Show maturity. For example, a mature person can admit that he or she made a mistake. A mature person can also accept disappointments or criticism tactfully.
- Be a team player. Do your share and be willing to help others.

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8-2 Activity 1 Can You Recall?

Answer these questions to help you recall what you have read. If you cannot answer a question, read the related section again.

1. What is a personal loan? What factors affect the amount of a personal loan for which you may be approved?
2. How is a secured loan different from a personal loan? Give two examples of secured loans.
3. Explain how a fixed rate mortgage differs from an adjustable rate mortgage.
4. What is a balloon payment? Why might this type of payment be included in a loan agreement?
5. What types of fees are typically included in loan closing costs?
6. What is the purpose of a mortgage calculator?
7. What is the purpose of a student loan? From what sources are student loans available?
8. Describe how a rent-to-own agreement works. What are the advantages and disadvantages of this purchase method?

8-2 Activity 2 Compare Buying and Leasing Options

Consumers often do not have enough money to pay the full price of items they want or need to buy. Using credit makes buying these items possible. Different forms of credit have different costs. In this activity, you will compare paying for an item using a credit card, renting to own an item, and leasing an item.

1. You have decided you need a laptop computer. The purchase price of the computer is $1,200. You can charge this item on your credit card and pay for it over the course of 1 year. The interest rate is 18.99 percent. Each month for 11 months, you will pay $110. In the last month, you will pay the remainder of the outstanding balance. (For the purposes of this problem, assume there will be no other charges or fees on the credit card bill.) The credit card company uses the adjusted balance method to compute interest. What is the total amount (purchase price plus interest) that you will pay if you use this method to buy the computer?
2. Another option for buying the computer is to get it from a rent-to-own company. With this type of arrangement, you pay fixed monthly rental payments. At this point, you are renting the computer; you do not own it. You can stop renting and return the item at any time.

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If you continue renting until you have paid a certain set amount, you will own the computer (and make no more rental payments). You must pay a monthly rental fee of $200. You will own the computer after you make 12 payments. What is the total you will pay for the computer using this option?

3. Another option you can choose is to lease a computer for 1 year. You will be required to make monthly payments of $125 for 1 year. At the end of that time, you can return the computer to the leasing company, lease it for another year, or lease a newer computer instead. What is the total amount that you will pay for 1 year if you choose this option?
4. Which of the three options—charge to a credit card, rent-to-own, or lease—would you choose? Why would you choose this option?

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8-3

Credit Tips

OUTCOMES

- Explain why using credit may tie up future income.
- Discuss why you should consider the state of the economy when planning credit purchases.
- List the terms typically included in a credit offer.
- List ways you can reduce and avoid credit costs.

USING CREDIT WISELY

When you begin using credit, plan to use it wisely. Go slowly; do not use too much credit at first. It is very important to establish credit when you do not need it so that it will be available to you when you do. Build a solid credit history by paying all credit bills on time. Later, when you want to use credit, you will be considered a low (good) risk. You may also be able to borrow at lower interest rates than someone who is considered a high (bad) risk.

Buying items using credit can tie up future income. For example, suppose you buy an item for $500 using a credit card. If you pay the entire amount in one billing cycle, future income is not tied up with this debt. However, suppose you pay the $500 plus interest over six billing cycles. Part of your income for the next 6 months must be used to pay for the item you purchased this month. You may have to forgo buying some items you want or need during the next 6 months because the money must be used to pay an existing debt.

As your earnings go up over time, save more money rather than spending the full amount of the pay increase. Think about future needs rather than only things you might want, but not need, in the present.

You may feel secure in your job and your prospects for the future. However, you should always have a back-up plan for handling expenses if you are out of work for a time. Save a cash fund, and have some unused credit available. If the worst happens, you will have money to pay bills until you begin earning money again. You will also have some credit available to make purchases.

Consider the Economy

When the economy is doing well and people can get jobs easily, consumers may feel optimistic about the future. This optimism often leads to increased

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Using credit to buy items can tie up future income.

buying. When credit is used to buy more items, future income may be tied up as well. During good economic times, interest rates are usually rising. Thus, rather than buying on credit, this could be a good time to save money.

The opposite is true when the economy is slowing down. People are being laid off, and jobs are scarce. People may feel pessimistic, and this can lead to decreased buying. Because people are buying less, prices may be dropping. Thus, this could be a good time to buy because you can get better values. If you do not spend all of your money (and credit) during the optimistic stage, you will have money available to spend when prices may be more favorable.

Study Credit Offers

If you are like many people, you will receive credit offers soon after you begin working. These offers are mailed, e-mailed, or found in advertisements. Carefully examine each offer and compare the terms and conditions if you are considering the offer. A credit offer typically includes these terms:

- **Interest rates.** Are they fixed or variable? How often can they change? What will cause them to change? Fixed rates often do not stay fixed and can be changed with some notice from the creditor. However, they are usually better than variable rates, which can rise without advance notice.
- **The grace period.** The **grace period** is the amount of time you have before a credit card company starts charging you interest on your new purchases. Most credit offers allow for a grace period of at least 20 days. The longer the grace period, the longer you have to pay without being charged interest on the purchase amount.
- **Method of computing interest.** Many creditors use the two-cycle average daily balance method. This means if you have a balance anytime during the two-cycle billing period, you will be charged a finance

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charge. A billing cycle is typically about 1 month. This method is not good for consumers.

- **Annual fee.** Some credit cards charge an annual fee or a membership fee. This fee can be $25 to $50 or more. Once your credit is established, you should be able to find a credit card offer that does not require an annual fee.
- **Minimum finance charge.** Some credit cards require a minimum charge of $1 or more for each billing period.
- **Transaction fees.** If you transfer balances from other credit accounts, you may be charged a transaction fee. This fee is usually a percentage, such as 3 percent of each transaction. There is often a minimum of $5 and a maximum of about $75.

Technology Corner

APPLYING FOR A LOAN ONLINE

Getting a loan online can be a very attractive option. You give personal information and fill out an application. When you submit the application electronically, you may have an answer quickly. You can fill out the application in the privacy of your own home and at a time that is convenient for you.

Be cautious about applying for a loan online. Deal with lenders you know. Do not respond to online offers. Instead, go to the Web site of a reputable lender by keying a URL in the browser's address box. If you do not know the URL, call the lender and ask for this information. You may be required to create an account with a user name, password, and other data before you can fill out an application. A sample screen for entering information to set up an account is shown in Figure 8-3.1 on page 240.

You will need the same type of information as you would to complete a paper application. Thus, you need to gather all the data and have the data ready. You will need to give very sensitive and private information in the credit application. Be sure the Web site is secure to lessen the chances that your information will be stolen. A secure Web site will have a message to tell you that the site is secure. The message is often next to a padlock icon. You may be required to provide written documents, such as pay stubs, to verify the information in the loan application.

Before accepting the loan, read the entire contract. Study the conditions, rates, and other items in the agreement. Print everything so that you will have a complete copy of the application and all of the loan documents. Some lenders will assign a loan advisor to your account. You can contact this person by phone or e-mail to ask questions about the loan or the application process.

Once your loan is approved by the lender and you agree to the loan terms, you must sign the loan papers. Some lenders have an online process in which borrowers can provide an electronic signature. Figure 8-3.1 shows a Web page at which students can learn about using an electronic signature when applying for a loan. Some lenders will send a notary public to an agreed-upon location, such as your home or work site. This person will witness you signing the documents and will return them to the loan company. Once the loan documents are signed, the funds are released to you.

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FIGURE 8-3.1

Students can apply for a PIN at the Federal Student Aid Web site.

Source: U.S. Department of Education, Federal Student Aid, PIN Registration, http://www.pin.ed.gov/PINWebApp/pinindex.jsp (accessed June 12, 2006).

- **Cash advance fees**. Some credit cards allow you to take cash advances at ATM machines and at banks. There is often a fee for this type of transaction. It is usually a percentage, such as 3 percent with a minimum amount of $5 or more.
- **Late fees and over-the-limit fees**. The fee for late payments can be $15 to $50 or more. The fee may depend on the balance on your card. The over-the-limit fee is usually a flat amount, such as $35 or more. Having late fees or over-the-limit fees can cause the interest rate you are charged to rise.

Some credit card offers state that the company reserves the right to change the account terms at any time for any reason. This includes raising interest rates. When an interest rate goes up, you must accept the change or cancel the card. Thus, being in a flexible position is important. You want to avoid being in the position of having to accept higher rates and fees.

REDUCE AND AVOID COSTS

When you use credit, there is usually a cost. You may want to pay cash for small purchases instead of using credit to avoid credit costs. When you do use credit, try to pay the full account balance each billing cycle. If you do, you will not have to pay any interest. Here are several other ways you can reduce your costs:

- Keep the number of credit cards and accounts you have to a minimum. Avoid having an account at every store in town and with every bank card available. Only carry with you the cards you will be using. Having a bank card is a good idea because it is accepted at many different businesses. Using a bank card also eliminates the need to have several individual store accounts.

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The method used to pay for a large purchase is as important as the item being purchased.

- Comparison-shop when getting a loan. Compare the costs of credit from at least three different sources. When planning a large purchase, such as a car, arrange the financing ahead of time. That way, you will know the dollar amount you can spend and the interest rate you can get. You can then compare any offers that the seller might have.
- Consider financing and special deals arranged by the seller. A **sales finance company** is a type of lender that makes loans for the purchase of consumer goods, such as cars or household appliances. The finance company may also purchase time-sales contracts from merchants. The finance company often works closely with the seller. This makes it easy for customers to arrange financing at favorable terms. For example, GMAC (General Motors Acceptance Company) is a sales finance company. One of the services offered by GMAC is loans for the purchase of automobiles. When buying a car, you may be offered a sales incentive, such as 0 percent interest on a loan or $2,500 cash back on a purchase. These deals are worth considering.
- Use credit to take advantage of sale prices. With the help of credit, you can buy things on sale that you would not buy if cash were your only option. Thus, you can avoid higher prices and save money.
- Time your credit purchases. If you buy right after the closing date of your billing cycle, you may be able to delay payment for 2 months after the purchase. Most credit accounts have a 25- to 30-day billing cycle.
- Take advantage of cash rebates and rewards. Many credit cards offer rebate programs. A rebate is a partial refund of the purchase price

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of an item. For example, a 5 percent rebate would give you back 5 percent of the purchases you made during the month or year. This increases your spending power. Be careful, however, not to overspend because of this reward. Some credit accounts also offer gift certificates and other incentives. Choose the reward that benefits you the most, and use cards that have rewards rather than those that do not.

Ethics

Unethical Loan Practices

Some people use unethical loan practices. They take advantage of people who can least afford to pay. Because some people have poor credit ratings or have not used credit wisely in the past, they may not be able to get loans from legal sources. They may decide to take out illegal loans, and the interest may be very high.

A loan shark is one source of illegal loans. A loan shark is a person who offers illegal unsecured loans at very high interest rates. Because the borrower is desperate, she or he borrows the money. At such a high rate, however, the debt grows rapidly and is very difficult, if not impossible, to repay. The borrower may receive threats of violence if the loan is not repaid.

Many people have lost money in advance-fee loan scams. In this type of scam, a lender agrees to make a loan if the borrower pays an up-front fee. The lender may promise to refund the fee or to apply it to loan payments once the loan has been secured. The fee may be several hundred dollars. The borrower may have a bad credit history and may be desperate for the loan, so he or she agrees and pays the fee. Later, the borrower learns that the lender is not reputable. The borrower may be told that the loan has been denied and that the fee will not be refunded as promised. In some cases, the borrower may not hear from the lender again. However, money may be illegally withdrawn from the borrower's bank account using information provided on the loan application.

An unethical practice related to home mortgages is called equity stripping. In this situation, a person with a home needs money. A lender points out that the person has built equity (monetary value) in the home. A loan is arranged using the home as collateral. The borrower may not have enough monthly income to make the loan payments. However, the lender approves the loan anyway. The lender may even encourage the borrower to overstate her or his income to get the loan. Once the borrower starts missing payments, the lender will foreclose and take the home.

These examples are just a few of the ways you can be deceived by unethical or illegal lenders. Whenever you come upon a deal that sounds too good to be true, it probably is. There are always people looking to take advantage of others. Beware of offers for loans with terms that sound unreasonable. They may sound good, but in reality they are deceptive, unethical, and sometimes illegal.

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8-3 Activity 1 Can You Recall?

Answer these questions to help you recall what you have read. If you cannot answer a question, read the related section again.

1. Explain why using credit may tie up future income.
2. Explain how your credit history relates to the interest rate you may have to pay for credit. Why are some people who really need credit unable to get it?
3. Why should you consider the economy when planning credit purchases?
4. List the terms typically included in a credit offer.
5. Why is it important for you to be able to cancel a credit card whenever you wish?
6. List three ways you can reduce or avoid credit costs.
7. Describe one unethical loan practice.

8-3 Activity 2 Research Loan Offers

1. Find three advertisements of offers for loans. The loans can be personal loans, secured loans, or student loans. Newspapers, magazines, and the Internet are places where you may find loan offers. You could also ask about loans available at local banks or credit unions.
2. Find the following information for each loan offer:
   - Type of loan (secured, unsecured, or student loan)
   - Interest rate charged
   - Length of the loan in months or years
   - Application fees, closing costs, and other fees
   - Penalties that may apply, such as a prepayment penalty
3. Evaluate each offer. Do you think the lender is reputable? Are any of the terms questionable? Which offer has the most favorable terms for the borrower?

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EXPLORING CAREERS IN HEALTH SCIENCE

Do you enjoy working with other people? Are you interested in helping people stay healthy? Do you like to analyze problems and search for solutions? If the answer is yes, a career in health science might be right for you. Jobs in this area are varied. Some workers, such as nurses, work directly with patients to provide health care. Others are employed in labs or research facilities to run diagnostic tests or develop new drugs. Support staff are needed in hospitals, labs, and other places to make patient care possible.

Jobs in this career area are found in government and businesses. Health care is one of the largest and fastest-growing industries in the United States. The need for jobs in health science is expected to grow. Job outlook varies by job.

Skills Needed

Some of the skills and traits needed for a career in health science include the following:

- Math and science skills
- Communications skills
- Computer/technology skills
- Ability to work well with others
- Decision-making skills
- Problem-solving skills

Job Titles

Many jobs are available in the health science field. Some job titles for this career area include the following:

- Billing clerk
- Clinical laboratory technician
- Dietitian
- Medical records technician
- Medical scientist
- Paramedic
- Pharmacist
- Physician
- Registered nurse

Explore a Job

1. Choose a job in the health science field to explore further. Select a job from the list above, or choose another job in this career area.
2. Access the *Occupational Outlook Handbook* online. A link to the site is provided on the Web site for this textbook.
3. Search for more information about the job you selected to answer these questions:
   - What is the nature of the work this job involves?
   - What is the job outlook for this job?
   - What training or qualifications are needed for this job?
   - What are the median annual earnings for this job?

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CHAPTER 8 Review

Summary

- Cash, personal checks, money orders, and bank checks are manual or traditional methods of making payments.
- An advantage to using a money order or a bank check is that the payee is guaranteed payment.
- Online payments can be made at some creditors' Web sites. Online banking, payment by telephone, and automatic withdrawals are available for some accounts.
- A wire transfer is the process of sending money electronically rather than using paper checks.
- A prepayment penalty is a fee charged when you repay a loan before the agreed-upon time. Repaying a loan early may be to your advantage even when there is a prepayment penalty.
- An installment loan is a type of debt in which you borrow money for a period of time. The loan has an agreed-upon interest rate and repayment plan. Personal loans, secured loans, and student loans are three types of installment loans.
- A personal loan is granted based on your creditworthiness. A secured loan is a debt agreement in which the borrower pledges property of value as security for the loan.
- Many mortgages have fixed interest rates and payments over the life of the loan (typically 10 to 30 years). An adjustable rate mortgage has a variable interest rate that goes up or down at the discretion of the lender.
- A student loan is debt used to pay for education. You must qualify based on creditworthiness. For some student loans, you must also qualify based on need.
- Lease or rent-to-own agreements are another option for buying items. The total price you will pay for the item if you make payments until you own it is often much higher than if you buy the item outright.
- It is very important to establish credit when you do not need it so that it will be available to you when you do. Build a solid credit history by paying all credit bills on time.
- Buying items using credit can tie up future income if the debt is paid over several months or years.
- During good economic times, interest rates are usually rising. This could be a good time to save money. When the economy is slowing down, prices may be dropping. This could be a good time to buy because you can get better values.
- Carefully study and compare credit offers. Fixed versus variable rates, the method of computing interest, all types of fees, and grace periods are some items that should be carefully examined.
- To reduce and avoid costs, keep the number of credit cards and accounts you have to a minimum. Comparison-shop for loans and other types of credit. Use credit to take advantage of sales. Use credit cards that have rebate or rewards programs.

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Key Terms

adjustable rate mortgage
amortization
automatic payments
balloon payment
certified check
closing costs
cosigner
grace period
installment loan
money order
mortgage
online banking
personal loans
prepayment penalty
sales finance company
secured loan
student loan
wire transfer

ACTIVITY 1
Review Key Terms

Use the key terms from Chapter 8 to complete the following sentences:

1. A type of mortgage loan called a(n) ____________ has an interest rate that can change over time, at the discretion of the lender.
2. A debt instrument called a(n) ____________ is used to secure financing of a house purchase.
3. A loan for which property has been pledged as collateral called a(n) ____________.
4. A large payment, called a(n) ____________, is much larger than other loan payments and must be paid at a set time, often as the last loan payment.
5. ____________ are loans that are based on personal creditworthiness (that have no collateral).
6. A(n) ____________ is the process of sending money electronically rather than using paper checks.
7. The amount of time you have before a credit card company starts charging you interest on your new purchases is called the ____________.
8. A type of lender that makes a loan for the purchase of consumer goods, such as cars or household appliances, is called a(n) ____________.
9. A personal check for which payment is guaranteed by the bank on which it is drawn is called a(n) ____________.
10. A service that allows you to make payments and manage your bank account using the bank's Web site is called ____________.
11. A(n) ____________ is a type of prepaid check that directs payment of a sum of cash to the payee.
12. A fee charged for repaying a loan before the agreed-upon date is called a(n) ____________.
13. A(n) ____________ is debt used to finance education costs.

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14. Payments that are made by transferring money electronically from a checking account to another account (such as a creditor's) every billing period are called ____________.
15. Expenses the borrower must pay to get a loan, such as appraisal fees, credit report fees, recording costs, and inspection fees, are known as ____________.
16. A(n) ____________ is a person who agrees to repay a loan if the borrower does not repay it.
17. A type of debt in which you borrow money for a period of time with an agreed-upon interest rate and repayment plan is called a(n) ____________.
18. Repaying a debt by making regular payments of principal and interest over a period of time is called ____________.

ACTIVITY 2
Math Minute

1. The following charges are part of the closing costs for a loan. What is the total amount of the closing costs?

Appraisal fee	$500.00
Lender's inspections fee	$250.00
Credit report fee	$ 50.00
Loan origination fee	1 percent of the loan amount of $250,000.00
Notary public fee	$ 60.00
Document recording fees	$ 75.00
Title search	$250.00
Survey fee	$250.00
Flood certification	$ 30.00
Buyer's attorney fees	$750.00
Mortgage insurance	0.5 percent of the loan amount of $250,000.00

2. Albert Morrison took out a loan for $90,000.00 at 10 percent interest for 15 years. Albert's monthly payments are $967.14. Part of each payment is applied to the loan balance, and part is for interest. He has made payments for 2 years (24 payments). He now wants to repay the loan early. The current principal balance owed is $84,257.19. The loan has a $468.00 interest penalty for early repayment. Will Albert save money by repaying the loan (current balance plus penalty) at this time? If so, how much will he save?
3. Sue Thomson bought a house for $178,750.00. She is getting a mortgage for $145,000.00. If a mortgage is for more than 80 percent of the value of the home, Sue's lender requires that the borrower purchase mortgage insurance. Will Sue have to purchase mortgage insurance?

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ACTIVITY 3
Mortgage Payments

1. Open the *Excel* file *CH08 Loan Payment Calculator* from the data files. Read the instructions provided in the file for using the loan payment calculator. (If you do not have *Excel*, search for a mortgage calculator on the Internet.)
2. Joe Chin bought a house for $180,000.00. He made a 20 percent down payment. Joe secured a loan for the balance of the purchase price at 6.5 percent interest for 30 years. What will the monthly payments on the loan be?
3. Louisa Perez bought a house for $300,000.00. She made a 10 percent down payment. Louisa secured a loan for the balance of the purchase price at 5.95 percent interest for 30 years. What will the monthly payments on the loan be?
4. Mary Roberts bought a house for $255,000.00. She made a 5 percent down payment. Mary secured a loan for the balance of the purchase price at 6.75 percent interest for 15 years. What will the monthly payments on the loan be?

ACTIVITY 4
Group Presentation

TEAMWORK Critical Thinking INTERNET www.thomsonedu.com/school/pfl

1. Work with two or three classmates to complete this activity.
2. Choose a topic related to using credit, and get approval of the topic from your teacher. A few suggested topics follow:
   - The housing market in your local area or state
   - The employment market in your local area or state
   - The new and used car markets in your local area or state
   - Interest rates in the economy
   - Loan scams or deceptive practices
   - Making payments online or online banking
   - Comparison of interest rates and other credit terms for different lenders in your area
3. As a group, do research on your topic. Use local newspapers, magazines, and the Internet.
4. As a group, create an outline of the main points you want to include in your presentation. Then write down the details you want to cover. Include how the information you found could or should affect use of credit by consumers in your area.
5. Prepare electronic slides, transparencies, posters, handouts, or other visual aids that you can use during the speech delivery.
6. Decide which person will present each part of the speech. Practice as a group. Review the Building Communications Skills: Formal Speaking feature in this chapter to help you prepare.
7. Deliver the presentation to your class.

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ACTIVITY 5
Reducing Credit Costs

Critical Thinking

Enrique is thinking about buying a large, flat-panel television. He will need to borrow money to make the purchase. He can arrange the financing ahead of time, or he can use the installment sales plan at the store.

1. What steps can Enrique take to minimize his total costs when choosing the television?
2. What steps can Enrique take to minimize his total costs when choosing a source of credit?
3. What steps related to his credit account can Enrique take to minimize his costs following the purchase?

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