**TOPIC 4 CREDIT**

**LVL I: As you read, answer the questions that follow.**

1. What is credit?
2. What are some purchases that would require a loan?
3. What is credit worthiness?
4. What are the three C’s of Credit?
5. What does a credit report tell you?
6. What does a Credit Score tell someone?
7. What actions help your credit score?
8. What actions hurt your credit score?
9. What is APR?
10. What is the difference between a fixed and variable rate?
11. Which one would you want?
12. What is simple interest?
13. What is compound interest?

**SSEPF4 Evaluate the costs and benefits of using credit.**

**Credit** refers to borrowing money. People borrow money for a variety of reasons. When considering a loan, borrowers identify the benefits and the cost of using credit. If the benefits of using credit outweigh the costs, taking a loan is rational. If the costs of borrowing outweigh the benefits, the loan should be avoided.

1. **Describe factors that affect credit worthiness and the ability to receive favorable interest rates including character (credit score), collateral, and capacity to pay.**

As a rule, we should spend only what we earn and avoid borrowing. However, some purchases are very difficult to make without the use of credit and the benefits of making those purchases using credit may outweigh the costs in the long-run.

For example, if someone cannot go to college without a student loan, the higher future income potential and lower risk of unemployment may make the student loan a wise idea. If someone lacks a reliable car to get them to a great job, the benefits of a low-interest car loan may outweigh the costs because of the higher income earned at the new job.

The key is to be wise in borrowing. Do not borrow more than you need and make sure the payments are affordable given your income. If you want to secure a loan from a financial institution like a bank, your credit rating must be good. **Credit worthiness** is a measure of a variety of factors used to determine whether a person will repay a loan. While there is no guarantee a person making $400,000 annually will pay a $2,000 loan, evaluation of their credit worthiness indicates they have the income required to handle the loan. Annual earned income is a major factor in determining credit worthiness. If income is high, lenders believe the borrower can use some of that income for debt repayment. However, the amount of current debt is another big factor affecting credit worthiness. Making $400,000 a year is less attractive to lenders if you already owe $500,000.

The **“Three C’s of Credit”** are **character**, **capacity**, and **collateral**. Since most lenders do not know potential borrowers personally, they evaluate a potential borrower’s character using the information on the borrower’s **credit report**. A credit report is available through three main private companies: Transunion, Equifax, and Experian. It details a person’s borrowing and repayment history for the last seven years reported to the company’s by a person’s previous and current lenders. Potential lenders request credit reports on potential borrowers to assess the borrower’s character and capacity.

A potential borrower who has “paid as agreed” on all credit accounts has good credit character. The credit report also shows some aspects of capacity. While income is one factor in assessing capacity, the amount it takes to service current debt is also a concern. If debt to income ratio is high, the borrower may not be able to handle additional debt payments.

Finally, collateral is something of value a borrower can use to back the loan if the borrower can no longer pay the scheduled payments. For example, a home mortgage is available to people with lower incomes because the bank can seize the home if the mortgage is not paid.

Many people obtain a credit card to start building a positive credit history. To get low interest rates for borrowing and sometimes even to get a job, people need a good credit report and good credit score. In some cases, no credit history affects people negatively just as a poor credit history does. A **credit score** is a number calculated by the credit reporting companies based on a variety of factors. While the exact calculation is proprietary, the companies release general guidelines about how the score is calculated. Payment history, amount of open credit used, and the number of open credit accounts are some of the factors determining a credit score. By making small purchases and paying the entire amount each month, a potential borrower shows a lender how they use credit wisely.

Using credit wisely and sparingly is essential to a healthy financial life. Some people find they are unable to make wise credit use decisions. Using credit cards impulsively, some find they are unable to pay the entire amount owed month and begin to accrue high amounts of interest on the unpaid balance. As the balance owed increases, it takes years to pay the loan for a small purchase. If borrowers have late payments, interest rates skyrocket and lenders charge late fees. Current law requires credit card companies to show borrowers the difference in total payments they will make if they pay only the minimum payment due versus paying the debt within three years. The image below shows an example as it looks on a credit card statement. This borrower will save $204 by paying the bill in three years and far more if paying the balance in full.



[http://www.keywordsuggests.com/S917OVYzI\*c\*si91FqCXCl9h9WlqZKCv7JXZ\*kZ2QCo/](http://www.keywordsuggests.com/S917OVYzI%2Ac%2Asi91FqCXCl9h9WlqZKCv7JXZ%2AkZ2QCo/)

1. **Compare interest rates on loans and credit cards from different institutions.**

Wise potential borrowers shop for the best interest rates on loans. While the exact rate offered to a borrower will vary with the borrower’s character, capacity, and collateral, the internet allows borrowers to compare the best rates offered by different financial institutions. The table below looks at a snapshot of rates for a variety of loan products available from different lenders in April 2017.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Lender**  | **30-year Fixed** **Rate Mortgage**  | **5-year Fixed Rate** **Auto Loan**  | **Home Equity Lump Sum Fixed Rate Loan**  | **Credit Card (no annual fee)**  |
| **Institution A**  | 4.0% 4.081% APR  | 3.24%  | 4.79%  | 13.74% – 23.74% variable annual percentage rate  |
| **Institution B**  | 4.125% 4.2182% APR  | 2.49%  | 4.49%  | 11.99% - 21.99% variable annual percentage rate  |
| **Institution C**  | 4.125%, 4.186% APR  | 3.12%  | 4.75%  | 17.90% - 26.74% variable annual percentage rate  |

Assuming the borrower qualified for the best rates available, a wise decision would be Lender A for the mortgage and Lender B for the three remaining products.

1. **Define annual percentage rate and explain the difference between simple and compound interest rates, as well as fixed and variable interest rates.**

The **annual percentage rate (APR)** is the annual rate charged for borrowing funds. Expressed as a percentage, APR represents the actual yearly cost of the borrowed funds over the full term of the loan. In the table for SSEPF4b, although the stated interest rates for Lender B and C were the same for mortgages, Lender C had a higher APR making it a more expensive loan.

Interest rates on loans are **fixed** or **variable**. A fixed interest rate on a loan will not rise or fall during the term of the loan. Obtaining a fixed interest rate when rates are low is usually desirable. When rates are high, borrowers may choose a variable interest rate in the hope that rates will fall in the future. Sometimes, lenders will only offer fixed rates to their best customers. Lenders sometimes offer risky borrowers variable rates. If the borrower proves the ability to make the payments, the person can refinance for a fixed rate in the future.

Interest is also **simple** or **compound.** Simple interest applies only to the original amount borrowed called the principal. **Compound** interest applies to both the principal of the loan as well as accrued interest on the principal. Compound interest makes a loan more expensive and is less desirable for borrowers than simple interest loans.

**LVL II APPLICATION**

1. The Rule of 70 is used to determine how long it will take your investments to double in value. To calculate the number of years it will take to double your money, divide 70 by the expected rate of return (the compounding interest rate). In other words, $\frac{70}{rate of return}=time for investment to double in value$.

If, at 18 years old, you have $2,000, and you place it in an investment that promises a 10% rate of return, how long will it take for your investment to grow to $4,000? How much money will you have at age 30 if you leave your money in the same investment without contributing any additional funds to the investment? How much money will you have at 37? What about at age 51?

**LVL III DO THE FOLLOWING**

1. Use numeric examples to illustrate why it makes more sense financially to pay more than the minimum payment due on a credit card.
2. Create a rational-decision making chart that compares 5-year fixed rate auto loan options from three different lending institutions.