Virginia Cooperative Extension Service

VIRGINIA TECH AND VIRGINIA STATE • VIRGINIA'S LAND GRANT UNIVERSITIES

YOU AND YOUR MONEY!

THE MONEY MANAGER SERIES

Publication 354-011 January, 1984

USING CREDIT

by

Dr. Gerald A. (Jerry) Bird
Extension Specialist - Financial Management
Department of Housing, Interior Design and Resource Management
College of Human Resources

SHOULD YOU BUY ON CREDIT?

"Should you buy on credit?" This is not a question that can be answered by a simple Yes or No. It may depend upon the situation. What kind of product or service is being purchased? Is the product or service really needed? Would a less expensive item do just as well? What is the dollar cost of the credit? Can you afford to make the payments? Could you save now and pay cash for the item later? "Should you buy on credit?" It is not an easy question to answer.

There are many reasons to buy on credit. If a refrigerator breaks down and cannot be repaired, it has to be replaced. If there is not enough money in savings to purchase the item for cash, then credit has to be used. The same is true in buying most major household appliances and cars.

Products or services that are quickly used up, probably should not be purchased on credit. It is rather discouraging to make payments on something already used and discarded. The pleasures of a fine meal in a restaurant will be long forgotten when the credit card payments are still being made two months later!

The use of credit is neither good nor bad in itself. Much depends on the use made of credit and the ability to repay the credit. Most persons do use credit. It has become a necessary part of modern life. The high prices of appliances, furnishings, cars, and homes usually require the use of credit.

ADVANTAGES OF CREDIT

Probably the biggest advantage of buying on credit is being able to buy goods and services when needed and repaying the loan later. The cost of credit is reduced as the interest is tax deductible if you itemize deductions.

Credit cards are convenient to use and are safer to carry than large amounts of cash. They are readily accepted by most stores. In addition, a credit card can provide an "emergency fund" when traveling or if savings are not available.

DISADVANTAGES OF CREDIT

Easy credit becomes a temptation to buy more than is needed. It also encourages buying more than can easily be repaid. Buying on credit limits choices in the future. Finally, buying on credit adds to the cost of purchases. This also limits future choices. Part of future income goes to pay for past purchases while part goes to pay interest charges.

Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, and September 30, 1977, in cooperation with the U.S. Department of Agriculture. Mitchell R. Geasler, Director, Virginia Cooperative Extension Service, and Vice Provost for Extension, Virginia Polytechnic Institute and State University, Blacksburg, Virginia 24061; M. C. Harding, Sr., Administrator, 1890 Extension Program, Virginia State University, Petersburg, Virginia 23803.

SOURCES OF CREDIT

Once the decision has been made to make a purchase on credit, it must be decided where the credit is to be obtained. If a major appliance is being purchased, it could be charged on a bank charge or store credit card, financed by the store, or the money could be borrowed from a bank, savings and loan association, credit union, or consumer finance company.

This may seem confusing, but some choices can be eliminated if you do not have credit cards or cannot qualify for a loan from the sources that offer the lowest interest rates.

Let us assume that you can qualify for credit from any of the above sources. You are probably aware that there are differences in the interest rates charged among the different financial institutions and by the charge cards.

It does make a difference where you borrow, so shop for credit just as you might shop around for the best price and quality of car, appliance, furniture or stereo.

COMPARING LOANS

In shopping for credit, compare loans two ways. Compare both the interest rate and the finance charge (the dollar cost of credit).

For example, a $500 appliance could be financed many ways. Five examples are listed below.

FINANCING A $500 APPLIANCE FOR 18 MONTHS

Store A	payments of $33.84 per month for 18 months.
Store B	payments of $32.62 per month for 18 months.
Bank	payments of $31.90 per month for 18 months.
Credit Union	payments of $31.19 per month for 18 months.
Finance Company	payments of $36.35 per month for 18 months.

At a glance, it may appear that there is little difference among the five choices above. But check the finance charge (the dollar cost of credit) in the chart below. Paying only a few dollars extra each month for 18 months can be expensive.

DISCLOSURE OF CREDIT TERMS

	monthly payment	# of months	amount repaid	finance charge	interest rate
Store A	$33.84	18	$609.12	$109.12	26%
Store B	32.62	18	587.16	87.16	21%
Bank	31.90	18	574.20	74.20	18%
Credit Union	31.19	18	561.42	61.42	15%
Finance Company	36.35	18	654.30	154.30	36%

WHICH IS THE BEST LOAN?

The loan at the finance company costs only $5 a month more than the credit union loan. But the interest rate is more than double of both the credit union and bank loans! The credit union loan is the best loan (lowest cost) when both the interest rate and the finance charge are considered. The extra cost of the loan at the finance company is $92.88, the difference in the finance charge for each loan ($154.30 - $61.42).

The bank loan is only slightly more expensive than the credit union loan and would be considered as good a source for the loan. If you do not belong to a credit union, then the bank loan would be the best possible source.

The high interest rates and finance charges of the finance company make it the least desirable source of credit. But there is a situation where even the finance company could be a "good" source of credit. Persons with a poor credit rating may be unable to qualify for the other sources of credit. The finance company may then be their only choice for credit.

But the high cost of the credit may also make it difficult to repay the loan. It is important to consider if the item to be purchased at such high interest rates is worth taking on a large amount of debt.

HOW MUCH CREDIT CAN YOU AFFORD?

"How much credit can I afford?" is a question that each individual or family must answer. No two families spend their money the same way. They have different amounts of financial resources (income and savings), as well as different wants, needs, and plans for the future. They must decide individually how much credit they can afford and how they will use that credit.

There are no hard and fast rules as to how much credit can be afforded, but some common limits are suggested. One limit is not to use more than 20 percent of take-home pay for repayment of debts. This is in addition to the home mortgage which may already take 30 to 40 percent or more of take-home pay.

If take-home pay is $1,000 a month or $12,000 a year, the limit for repayment of credit is .20 X $1,000 = $200 a month. As the percent of income spent for the home mortgage goes up, less should go for other credit. If the mortgage is 40 % of take-home pay, perhaps other credit should be no more than 10 - 15 %.

Another guide is that your total outstanding debt (other than the home mortgage and auto loan) should not be more than one month's take-home pay. If the monthly take-home pay is $1,000, this should be the limit of total debt.

Perhaps the final guide to be considered is the ability to repay the credit. Go back to the family spending plan or budget developed in an earlier lesson. The amount left over after all other bills are paid and some money is saved, is the amount that can be used to repay a loan or credit card. If there is no money left over, no more credit should be taken out.

THE CREDIT BUREAU

The record of how you have used credit is on file with the credit bureau. The credit bureau provides this information to the grantors of credit. Merchants and financial institutions like banks and savings and loan associations lend money based on how well you have used credit in the past.

You supply some of the information to the credit bureau when you apply for credit. Other information is supplied by the merchants and other creditors on a regular basis on how promptly you have paid your debts to them.

UNFAVORABLE INFORMATION

Unfavorable information can be kept in a credit file for seven years. This would include a record of making payments late. Usually paying a bill only a few days late will not affect your credit record. Not paying a bill for one or two months can affect your credit record.

It is important to tell a creditor if you are unable to pay a bill on time. Let them know if you lose all or part of your income. Creditors are often willing to wait for a payment or work out a new payment plan.

YOUR CREDIT FILE

You do have the right to find out what information is in your credit file. The Fair Credit Reporting Act, a federal law, gives you this right. If you are denied credit, the creditor must inform you if this is based on information in a credit report. You will be given the name and address of the credit bureau.

What if there is incorrect information in your file? You may request that the credit bureau check the facts again. What if you disagree on the facts placed in your file by a creditor? In that case, you may put your own statement in the file, giving your side of the disagreement.

You cannot be charged for looking at your credit file within 30 days after the date of being denied credit. You may review your file at any time, but a fee may be charged.

EQUAL CREDIT OPPORTUNITY ACT

Another federal law, the Equal Credit Opportunity Act (ECOA) also protects your credit rights. This law states that everyone has the right to apply for credit without discrimination on the basis of sex or marital status. This means that you will be judged only on the basis of your "credit-worthiness." Your credit history at the credit bureau and your income are the two biggest factors which determine "credit-worthiness."

One of the main purposes of the ECOA is to assist married women in establishing their own credit histories. Creditors are required to report the payment history of a charge account in the names of both the husband and the wife.

In the event of divorce or widowhood, the woman retains her credit history built up during her marriage. The woman can then obtain credit on her own if she has sufficient income to repay the debt.

The law says that a woman has a right to her own credit, if she is creditworthy. This includes both married and non-married women. Married women may establish credit in their own name, if they are creditworthy on their own without considering their husband's income.

Creditors must consider income from reliable alimony, child support or part-time employment if you include this information on a loan application. Creditors are forbidden to ask about birth control practices, your plans to have children, assume that you will have children or that your income will be interrupted by child bearing and child rearing.

ECOA AND AGE

Creditors use a variety of information to be sure that people are likely to repay a debt before making the loan. They will ask questions about your income, your expenses, your debts, and your reliability. Do you have savings and investments? Do you own your own home? How long have you lived at your current address? What is your credit history?

The ECOA does not prevent a creditor from using such criteria. It also does not give anyone an automatic right to credit or require that loans be made to people who are not good credit risks.

Under the law, a creditor may also ask how old you are. However, your age may not be used as the basis for denying credit to you. You may not be turned down for credit just because you are over a certain age.

A GOOD CREDIT RATING

The very best way to develop a good credit rating is to have a good employment record and have both a checking and savings account. Then, open a small charge account with a local retail store, or get a secured loan from a financial institution for the purchase of something like an appliance or car. You may also take out a small loan using something you already own as security for the loan (car, stereo, or appliance).

Pay these obligations promptly and you will be on the way to developing your own credit history. As your credit history and credit-worthiness develop, you will be able to secure additional credit. Be carefull. Don't over-extend yourself or you may hurt what you have worked so hard to build.

PROTECTING YOUR RIGHTS

Credit is used by nearly everyone as they use it to pay for goods and services in their personal or business life. Since credit is so important to us, it is equally important that our credit rights are protected. To do this, Congress has passed a number of laws to correct serious problems with the granting and using of credit.

In addition to the Equal Credit Opportunity Act and the Fair Credit Reporting Act, there are three other important laws. These are the Truth in Lending, Fair Credit Billing, and Fair Debt Collection Practices Acts.

TRUTH IN LENDING

Truth in Lending requires creditors to disclose certain credit information. It makes it easier for you to compare interest rates and to shop around for the best credit deal.

Before signing a credit contract, be sure all blank lines and spaces are filled in. Do not sign if there are any blanks or if you are told that some information will be filled in later. This is against the law. All credit information must be read to you before signing the contract.

For the sale of goods in your home, the law gives you three days to think about the deal and cancel the contract if you wish. The seller must provide written information about your right to cancel.

A credit contract must contain the following information:

* Annual percentage rate (interest rate)
* Finance charge (the dollar cost of credit)
* Number and amount of payments
* Due date of payments
* Description of any property securing (guaranteeing) the loan, such as appliances, home, or a car

CREDIT CARDS

Truth in Lending also protects against the unauthorized use of your credit cards. If your credit cards are lost or stolen, the maximum amount you would have to pay for charges made by someone else is $50. If you notify the card issuer <u>before</u> the cards are used by someone else, you are not liable for any of the unauthorized charges.

FAIR CREDIT BILLING ACT

The Fair Credit Billing Act requires prompt correction of billing errors on charge accounts. Possible errors include the following:

* An incorrect price
* Listing of an item not purchased by you or someone authorized to use the account
* A charge poorly identified, for a different amount or on a different date than on your charge slip
* Failure to properly credit payments or returns to your account
* Accounting mistakes

IF THERE IS AN ERROR

If you think your bill is wrong or want more information about it, follow these steps:

1. Notify the creditor in writing within 60 days after the bill was mailed. Be sure to give your name and account number, a statement that you believe the bill contains an error and an explanation of why you believe there is an error and the amount of the suspected error. Send copies of the billing statement and purchase receipt. You should keep the originals.

2. While you are waiting for an answer, you do not have to pay the amount in question (the "disputed amount") or any minimum payments or finance charges that apply to it. But you are still obligated to pay all parts of the bill that are not in dispute.

3. The creditor must acknowledge your letter within 30 days, unless your bill is corrected before then. In no more than 90 days, your account must either be corrected or you must be told why the creditor believes the bill is correct.

4. If the creditor made a mistake, you do not pay any finance charges on the disputed amount. Your account must be corrected and a statement sent of any amounts that you do owe. If no mistake was made, you will have to pay the accumulated finance charges.

OTHER RIGHTS

The law also provides that you may withhold payment of any balance due on defective merchandise or services purchased with a credit card, provided you have made a good faith effort to return the goods or resolve the problem with the merchant from whom you made the purchase.

If the store that honored the credit card did not also issue the card, there are two limitations. The original amount of the purchase must have been for more than $50 and the sale must have taken place in your state or within 100 miles of your current address.

FAIR DEBT COLLECTION PRACTICES ACT

This act makes it a federal offense for debt collectors to threaten consumers with violence, to use obscene language, or to contact consumers at inconvenient times or places. It does not prevent the collection of debts, but rather it limits the methods that can be used to collect payments.

You cannot be contacted by telephone early in the morning or late at night unless you agree to it. Debt collectors may not contact you at work if your employer does not allow it. They may not make false statements that they are an attorney or work for a credit bureau or represent any government agency. Collectors may not threaten to publish a list of creditors who say you will not pay your debts or in any way advertise your debts.

In addition, debt collectors may not say that you will be arrested if you do not pay the debt or threaten any action which is illegal. They may not say that your wages will be garnisheed or your property seized or sold unless the creditor actually intends to do so.

FOR MORE INFORMATION

If you desire additional information about these or other laws regulating credit, contact:

Regional Director
Federal Deposit Insurance Corporation
908 E. Main St., Suite 435
Richmond, VA 23219

Truth in Lending
Federal Trade Commission
Washington, D.C. 20580

****

ACTIVITIES

1. Find the total amount of credit you owe and the total of monthly payments (except for the home mortgage). Is this more or less than the credit limits suggested on page 3? Discuss as a family whether the total credit owed is too much, or is an acceptable amount.

2. Examine all of the sources of credit you are now using (loans, credit cards) and compare the interest rates you are now paying. Are you using lower cost sources of credit? Before you borrow again, shop around for the least expensive loan.

3. Make an appointment to review your credit file with the credit bureau. If you haven't had a credit check by a creditor for several years, this would be a good chance to be sure information in your file is accurate. Check your telephone directory for the nearest credit bureau or ask at your bank, savings and loan association or credit bureau.

4. Keep a list of credit card purchases each month so that you will know the total amount charged and will be prepared to pay. Check each billing statement for errors.

Please return by ____________________

Name ______________________________

Address ____________________________

____

____

CHECK YOUR DECISIONS ABOUT USING CREDIT

Please complete and return this form to your Extension Agent[1].A certificate signifying completion of The Money Manager Series will be sent to you.

Directions: As a result of completing this lesson, I/We plan to do the following. (Circle the appropriate response)

Yes	Maybe	No	Have Already Done This	
______	______	______	______	1. Examine the sources of credit I/we now use and the interest rates paid.
______	______	______	______	2. Examined the total of monthly credit payments and total credit owed and compared it to the credit limits suggested on page 3.
______	______	______	______	3. Shop for the lowest cost credit.
______	______	______	______	4. Reviewed our credit file with the credit bureau.
______	______	______	______	5. Examined carefully the monthly statements from your credit cards for errors.

****

[1]The name and address of your Extension Agent is:

COOPERATIVE EXTENSION SERVICE
U.S. DEPARTMENT OF AGRICULTURE
Virginia Polytechnic Institute
and State University
Blacksburg, Virginia 24061