UNIVERSITY OF FLORIDA
EXTENSION
Institute of Food and Agricultural Sciences

FCS5206

Show Me the Money
Lesson 3: Using Credit Wisely[1]

Adapted by Josephine Turner[2]

Overview

Credit can be a valuable resource when it is used in a responsible and limited way. If abused, it can tie up income and even lead to future credit problems. This lesson provides you with some guidelines for determining how much debt you can safely afford. With careful planning, you can manage to stay within your budget when you borrow.

As with most financial matters, there are several factors to consider before assuming further debt responsibilities. These factors are outlined in detail, beginning with a table that will help you determine how much credit you can afford. The lesson provides insight into credit qualification process, tips on how to "comparison shop" for credit, and how to determine the "real" cost of buying on time. A timetable will show various options for loan repayment schedules, and you will discover the methods for calculating loan interest. Before you purchase on credit, you will want to know the most commonly used forms available and understand how they work. The lesson will show you this, and some of the possible danger signals of credit abuse.

Finally, once you have discovered what is involved in obtaining credit, you will want to look at the section entitled "What Else You Should Know About Credit." It includes information on establishing a credit history, obtaining copies of your credit report, credit rights, women and credit, and some additional tips for using credit wisely.

The Credit Decision

It is important to think carefully before you purchase something on credit. Do you need it? Is it worth the extra cost? And most importantly, can you pay back the money?

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1. This document is FCS5206, one of a series of the Department of Family, Youth and Community Sciences, Florida Cooperative Extension Service, Institute of Food and Agriculture Sciences, University of Florida. This material was adapted for use in Florida with permission of the University of Idaho Cooperative Extension System. Publication: July, 2001. Please visit the EDIS Web site at http://edis.ifas.ufl.edu.

2. Josephine Turner, Ph.D., CFP, professor, Family and Consumer Economics, and reviewed by Nayda I. Torres, Ph.D., professor and chair, Department of Family, Youth and Community Sciences, Cooperative Extension Service, Institute of Food and Agricultural Sciences, University of Florida, Gainesville, 32611, and Patricia Goodgame, extension agent II, Volusia County.

No matter which form of credit you are considering—department store charge account, credit card, car loan, or mortgage—never borrow unless you realistically can meet the pay-back requirements. If the repayment schedule is not fixed, such as with a department store revolving charge, plan to pay off the debt in six months or sooner. In many cases, it is to your advantage to repay within the same billing period to avoid finance charges. How you use credit is a personal decision. Analyze your family needs realistically. Set priorities. Look at credit use as part of your total spending plan (refer to Lesson 1).

Remember, credit is not extra income. It is obligating future income now. When determining how much credit you can safely assume, consider these factors:

The size and stability of your income
Whether additional credit payments will cut into money needed for emergencies or unexpected jumps in the price of necessitates
The amount of debt you already have

How Much Credit

A common consumer rule-of-thumb is to limit non-mortgage credit payments to 15 to 20 percent of your take-home pay. While this may serve as a rough guideline for some, it may not apply to others. Personal values and economic situation also should influence your credit decisions. Plan credit use according to you needs, goals, and financial limits.

With that in mind, make sure the amounts you borrow can be paid safely out of current and future income. This means analyzing your financial situation in terms of the money you earn and the expenses you must meet. Since credit payments usually are made monthly, it is helpful to consider income and expenses monthly when determining how much credit you can afford.

Worksheet 1 can help to determine debt commitments for some families. If current credit payments are **less than or equal to 10 percent** of take-home pay, these families can continue to use credit carefully. If credit payments are **between 10 and 20 percent** of take-home pay, one must avoid taking on more credit. Calculate here how much credit you can afford with this method.

How much credit can you afford?

Your monthly take-home pay	$
10% of take-home pay (pay x .1)	$
20% of take-home pay (pay x .2)	$
Monthly credit payments owed (not including mortgage)	$

For example, let's assume your monthly take-home pay was $2,000. Ten percent of your income would be $200; 20 percent would be $400. If you monthly credit payments were to reach $350, you should avoid taking on more credit debt. Please remember that some families have little or no discretionary income and therefore cannot afford credit.

Qualifying for Credit

Your chances of qualifying for a credit card or loan increase if you have

- ✓ No major blemishes on your credit report such as bankruptcy, bills turned over to a collection agency for nonpayment, repossession, or a 90-day delinquency;
- ✓ Active accounts to show that the information you have provided is valid; creditors prefer that you have at least two active open accounts including one that has been active for at least 2 years;
- ✓ No recent late payments (late payments sometime, but not always, can disqualify an applicant);
- ✓ A verifiable address; some issuers do not give cards to an applicant using a post office box or General delivery address;
- ✓ Consistent payment to all of your accounts of at least the minimum amount owed;
- ✓ No more than 90 percent of your available credit lines used up; and
- ✓ No more than two or three credit card applications pending at one time.

Shopping for Credit

How much you pay for credit is influenced by several factors, including how much you borrow with or without collateral, and the status of your credit record. To keep costs down, shop for credit just as you would shop for products.

Credit costs vary from one financial institution to another, so its is important to compare prices. Never assume all creditors charge the same rates. Before assuming a debt, learn the interest rate, the finances charges, the monthly payment amount, and the time you have to repay (also known as the life of the loan.) In addition to this information, determine the total cost of the loan. Your lender should be able to help in this mater.

The Truth in Lending Act (TILA or Regulation Z), a federal law, requires that you be told exactly what credit costs. Both the finance charge and the annual percentage rate (APR) should be marked clearly on the written disclosure statement. The finance charge is the total dollar amount you must pay for credit. It includes interest, service charges, and, if purchased, credit life insurance premiums. (Credit life insurance covers the borrower by repaying the loan if it is still outstanding at the time of death.)

The APR is the yearly charge for credit stated as a percentage. It is the rate you pay per dollar of credit you use. The lowest APR is usually the best credit choice. However, other terms, such as the amount of the payments, whether there is a 20 to 30-day grace period, and the total cost of the loan also should be considered.

A couple of other options to consider when “loan shopping” include a passbook saving loan (if you have a savings account), or borrowing against an insurance policy with a cash value. In either case, you will want to investigate the cost, and determine the advantages and disadvantages of assuming these types of credit.

In addition to the source of the loan and the APR, another factor to consider when loan shopping it is how much time you have to repay the loan. The table below shows the difference in monthly payments and total dollar cost for contracts with repayment periods of 12, 18, and 24 months. The amount borrowed ($300) and the annual percentage rate (18 percent on the declining balance) are the same for all three plans. As you can see, the total finance charge at the 12-month rate ($30.00) is almost doubled ($59.28) when the same amount is borrowed for 24 months.

How Credit Costs Increase Over Time

Repayment period	12 mo.	18 mo.	24 mo.
Amount financed	$300.00	$300.00	$300.00
Annual Percentage rate	18.0%	18.0%	18.0%
Monthly payment	$27.50	$19.14	$14.97
Finance charge	$30.00	$44.52	$59.28
Total amount to be repaid over the life of the loan	*$330.00*	*$344.52*	*$359.28*

Balance Calculation Methods

How much your credit cards cost you also depends on the method the card issuer used to calculate the finance charge. Because balances on credit cards are constantly changing, once new purchase are made and part or all of the balance is repaid, it is not a simple matter to determine how to charge interest. Among the four main ways that credit card balances are calculated, the most common are the "Average Daily Balance" method (including new purchases) and the "Two-cycle Average Daily Balance" (excluding new purchases). Cost to consumers varies.

- ☐ **Average daily balance, excluding new purchases.** This balance is figured by adding the outstanding balance for each day in the billing cycle, and then dividing by the number of days in the cycle.

- ☐ **Average daily balance, including new purchases.** This balance is calculated by adding the outstanding balance (including new purchases and deducting payments) for each day in the billing cycle, then dividing by the number of days.

- ☐ **Two-cycle average daily balance, excluding new purchases**. This balance is the sum of the average daily balances for two billing cycles. It is calculated by adding the outstanding balance from the previous month, excluding new purchases and deducting payments made for each day of the billing cycle, then dividing by the number of days. A second balance is extrapolated for the current billing cycle.

- ☐ **Two-cycle average daily balance, including new purchases.** Several issuers use the two-cycle average daily balance method. It is used primarily to back-charge interest on a balance on which no finance charges were paid (because the previous balance was zero). This method only affects consumers who sometimes pay their balance in full, and sometimes carry over a balance.

Credit Card Tip:
Shopping wisely for a credit card can make a difference.
For example, you save
$57 in the first year when you switch a $1,000 balance
from a 19.8 percent interest
rate card to a 14 percent interest rate card,
and you are out of debt a year and a half sooner.

When comparing credit cards be sure to read through the balance calculation method used. That will help you to determine which credit card is best for you.
Here's an example of the four methods applied to consider a consumer who starts the first month with a zero balance and charges $1,000, of which she pay off only the minimum amount due. The next month, she charges another $1,000. In the third month, she pays off the entire balance due.
This next table shows the finance charges at the end of the year for the different balance calculation methods

Balance calculation methods	Total finance charge
Average daily balance (excluding new purchases)	$66
Average daily balance (including new purchases)	$132
Two-cycle average daily balance (excluding new purchase)	$131
Two-cycle average daily balance (including new purchases)	$196

The Bottom Line:

Know how your creditor/s calculate finance charges.

Types of Credit

The two most commonly used forms of consumer credit are installment credit and credit cards.

Installment Credit.

- The buyer signs a conditional sales contract for the amount of the item being purchased. Installment payments are predetermined and stated in the contract. *Read the contract carefully before signing.*
- Payments usually are made on a monthly basis.
- A finance charge is added to the purchase price and included as part of each installment payment.
- The seller retains title to or a security interest in the goods purchased.
- Failure to make payments can result in repossession.

Credit Cards. These are available for use at individual stores or companies or for use at a variety of sellers. A credit line usually is given that limits the total amount of debt at any one time.
Credit cards are a popular form of credit because payment schedules are flexible. Usually there is a minimum monthly payment, but there is no penalty for early payment of the entire balance. In fact, it is wise to pay the total balance each month to avoid interest payment.

If conditions for using credit do not appear on the application, you will receive them when you get the credit card. Carefully study and be prepared to follow the conditions. Credit card conditions tell how to correct billing errors, where and how to report lost or stolen credit cards, and your liability should such misfortune occur. If you are not willing to comply with the restrictions regarding the use of the card, destroy or return the card to the company.

If you decide to keep the card, sign it immediately. This decreases the chance of it becoming a shopping tool for a dishonest person. Treat your card as carefully as you would cash. Be sure you get it back after each use.

While charging, make sure the amounts charged are correct, and the total shows clearly before you sign the sales receipt. Keep your records so that you can compare them to your credit statement. If errors, occur, have them corrected immediately.

Be prepared for credit card theft. Keep a list of your credit card numbers in a secure place. The list should include the name and phone number of each card issuer **(see Worksheet 2).** Report lost or stolen cards immediately. By doing so you will limit your liability to a maximum of $50 per card.

Danger Signals

The following situations may indicate you are headed for excess debt and credit problems:

☹ You pay only the minimum balance due on credit accounts.
☹ You can't pay all the bill due each month, so you pay some and ignore others.
☹ You draw from savings to pay everyday expenses.
☹ You are always out of cash and tend to charge items you used to pay for on the spot.
☹ Your are embarrassed to shop at stores where you are behind in payments.
☹ You use cash advances regularly to pay bills.
☹ You get payday loans on a regularly basis.

What You can do to Make it Right

If you can't pay a debt, let the creditor know. The worst thing you can do is to ignore a bill. Give specific reasons why you can't pay. Suggest an alternative payment plan that you can handle. Almost every creditor will be receptive to such an offer, since it provides some hope that the money will be paid back. The creditor's remedies—repossession, hiring a collection agent, or garnishing wages—are

unpleasant and costly. Be realistic about your long-term repayment plan. If you don't meet these new commitments, many creditors will take immediate legal action.

Credit History and Credit Bureaus

Credit bureaus are reporting agencies that receive and file records of credit transactions. If you have credit, you probably have a file at a credit bureau. In addition to credit transactions, specific information (from public records) is recorded in your file. This information can include, but is not limited to, any contract suit, judgment, tax lien, or bankruptcy that has been claimed. When you apply for credit, the creditor usually asks the credit bureau for a report on you. Your credit file will indicate if you might be a good credit risk. Credit bureaus do not make decisions about granting credit; they only provide the report. Increasingly, credit bureaus use a credit scoring system in which a statistical measure is used to rate applicants on the basis of various factors relevant to creditworthiness. Factors include: length of residence, home ownership, telephone, years at current job, annual family income, age, bank accounts, loans, credit cards, payment history. Lending decisions, however, are made solely by the creditor and standards vary from one creditor to the next.

Obtaining Your Credit Reports

It is a good idea to periodically check the accuracy of information in your file at the credit bureau. If you are denied credit, you can find out what's in your file at no cost—if the inquiry is made within 60 days from the date credit is denied. The credit bureau is allowed to charge you a fee if you ask for a copy of your report in most other instances.

To order a copy of your credit report, contact:
Equifax (credit report for a fee) 1-800-685-1111
Experian (credit report for a fee) 1-888-397-3742
Trans Union (credit report for a fee) 1-800-851-2674

If you find what you think to be incorrect information in your file, ask the credit bureau to check it out. Wrong information must be removed from your record. If you and the creditor disagree about the accuracy of the information, you can file a 100-word statement telling your version of the facts. This statement must be added to your file and shared with other creditors requesting your credit report.

Credit Rights

Consumer credit laws can help you shop for credit, apply for it, keep up your credit standing, and resolve credit-related problems. When shopping for credit, the creditor must tell you in writing, and before you sign any agreement, the finance charge and the annual percentage rate. Creditors also must tell you the method of calculating the finance charge.

When **applying for credit**, your race, color, age, gender, marital status, and certain other factors may not be used to discriminate against you. The law does not guarantee that you will be granted credit (you still must pass the creditor's tests of credit worthiness). Creditors also may not ask your gender on an application form (unless you are applying for a loan to buy or build a home), and they may not ask about your birth control practices or whether you plan to have children. The creditor must count all of your income, even from a part-time job. You do not have to disclose income from child support or your

income, even from a part-time job. You do not have to disclose income from child support or alimony payments, but if you do, creditors must count them if you can prove they are steady and reliable.

In cases of **billing errors**, the law sets out a procedure to correct them. First, you must notify the creditor in writing within 60 days after the bill was mailed. Identify the error and explain why you believe the bill is wrong. Pay all parts of the bill that are not in dispute. While waiting for an answer, you do not have to pay the disputed amount or any finance changes that apply to it. The creditor must acknowledge your letter within 30 days. Within two billing periods, the creditor must either correct your account or explain why the bill is correct. If no error is found, the creditor may bill you for the finance charges that have accumulated while you were disputing the bill.

Women and Credit

By law, women have equal credit opportunity and may not be discriminated against because of gender or marital status. However, this does not give an automatic right to credit—a woman must also be "credit worthy."

Typically, a woman needs to have an income of her own in her own name. Sometimes it is difficult for women to establish financial identify because they are in and out of paid employment due to the varied nature of the roles they perform. For instance, if a woman marries, she can lose her financial identity by using only her husband's name on credit accounts.

A woman should maintain her credit and financial identity by:

- ✓ Keeping at least one credit card or charge account in her own name;
- ✓ Having her own savings account in addition to a joint one;
- ✓ Making sure she uses, and is co-responsible for, the accounts; and
- ✓ Making sure joint charge accounts are in both name (thus building up credit history in each separate name).

If you recently married and wish to retain a separate credit file, write to your creditors and indicate your name change (if any) and indicate your preference to keep the account in your name only.

What Else You Should Know About Credit

Past credit patterns will affect whether you can get a future loan and how much it will cost you. Your habits establish your credit history, which is determined by:

How promptly you pay your bills.
How much income your have.
How long you have lived or worked in the same place.
How much you owe.
How much wealth you have accumulated (i.e., items you own that could be considered collateral).

Summary of Suggested Activities for Using Credit Wisely

Examine your current debt commitments (use **Worksheet 1**).
Make a list of your credit cards and store it in a safe place (use **Worksheet 2**).
Get a recent copy of your credit report and review it for accuracy.
Establish credit in your own name, if you have not already.

Worksheet 1 Your Credit Status Worksheet

This worksheet will help you analyze your current debt commitments (excluding any home mortgage loan). The average consumer probably will not want to commit more than 15 to 20 percent (or about one-sixth) of income ***after taxes*** to installment payments.

Loan	Amount still owed	Source of loan	Annual percentage rate	Months left to pay	Monthly payment
Vehicle 1					
Vehicle 2					
Education debt					
Automatic overdraft on checking					
Installment loans:					
Credit Card debt:					
Other debts:					

A. Monthly take-home income $_____

B. Total monthly payments (total last column) $_____

C. Monthly take-home income divided by 6 (about 17 percent) $_____

If B is greater than C, you have about as much debt as you can easily carry with your income.

Before using more credit, pay off some of your debts, especially those with the highest interest.

Worksheet 2

Your Credit Cards

Make a list of your credit cards and keep it in a safe place at home.
If your credit cards are lost or stolen, you will need this information.

Card account number	Address of company to notify if lost	Phone number to call if lost or stolen	Name(s) on card	Credit limit, expiration date, etc.