

CHAPTER 2: Loans and Debt



Did You Know?

The average FICO credit score in the U.S. is 700, which is considered good, but 46% of Americans may not check their score at least once a year, which can be risky.²

Credit Scores and Reports

As you probably know, most service providers and lenders allow customers a set amount of time to pay their bills. When you receive your billing notice, or **statement**, a due date or pay-by date is typically included on the bill. In addition, the bill will include an explanation of the fees you will be charged if the payment for the bill is late. Sometimes these fees are a set amount (\$25.00 or more in some cases), while other times they are a percentage of the amount due. In either case, the end result of a late bill payment is a higher cost to you.

But there can be long-term consequences too. Late bill payments may be recorded in your **credit history**, which can lower your **credit rating** and thus reduce your ability to get loans and credit in the future.

When you apply for a **loan**, such as a mortgage or credit card, or sign up for services like cable television, lenders need to estimate how likely you are to pay your bills on time. To help them, there are three major **credit bureaus** that collect data about the loans and credit cards you already have, what your balances are on each card, and a detailed history of all the monthly payments you've made over the last several years.

This information is all pulled together in a **credit report** along with a corresponding **FICO score**, which is like a test grade on a scale from 300 to 850. A high score

² www.fico.com/en/blogs/risk-compliance/us-average-fico-score-hits-700-a-milestone-for-consumers/ and https://nfcc.org/wp-content/uploads/2016/04/NFCC_BECU_2016-FLS_datasheet-with-key-findings_041516.pdf
Infographic source: https://mgic-connects.com/mortgage-infographics/breaking-down-your-credit-score/

Breaking down your CREDIT SCORE

[According to FICO® model(s). Learn more at myfico.com]

Your Credit Score is determined by 5 factors of differing importance:

<p>35% PAYMENT HISTORY How often do you pay your accounts on time? Late payments may lead to a lower score.</p>	<p>15% LENGTH OF HISTORY How long have you had credit history? A longer history of responsible credit use will likely lead to a higher score.</p>	<p>10% TYPES OF CREDIT USED Do you have more than one credit line? Having experience with different types of credit (e.g., a car loan and a credit card) can help your score.</p>
<p>30% AMOUNTS OWED How much of your total credit have you used? Less is more! Lowering debt can be the key to a better credit score.</p>	<p>10% NEW CREDIT Have you opened new credit lines lately? Opening several accounts in a short time can lower your credit score.</p>	

MORE CREDIT SCORE FACTS REVEALED:

<p>45% of College Students don't know their credit score. <small>(creditcards.com)</small></p>	<p>52% ADULTS IN AMERICA haven't viewed their credit score in THE PAST YEAR. <small>(capitalone.com)</small></p>	<p>9 OPEN CREDIT CARDS is the average per consumer. <small>(creditcards.com)</small></p>	<p>20% OR LESS What's your credit limit? Using more than 20% of your credit limit may lower your credit score. EXAMPLE • USE \$10,000 OR LESS \$50,000 credit limit <small>(creditcards.com)</small></p>
<p>18 YEARS is the average consumer's oldest open credit line. <small>(FICO Score Trends Service)</small></p>		<p>300- 850 is the range of credit scores. 699 is the average National Credit Score. <small>(creditcards.com)</small></p>	

43% of women

32% of men

said it was important to know a partner's credit score before getting seriously involved.
(bankrate.com)

0% The percent your age, race, income or job title impact your credit score.
(myfico.com)

indicates that you have a history of paying your bills on time, that you do not have access to more credit than you can afford to pay, and that you do not pose a great risk of failing to repay the money you borrow. Typical guidelines for credit scores are as follows:

FICO SCORE	RATING
Below 579	Poor
580-669	Fair
670-739	Good
740-799	Very Good
800-850	Exceptional

Lenders will also ask for evidence of your income, to make sure you have enough money to repay your debt. All this information is used to determine whether or not you are approved for a loan, the amount of the loan, the interest rate you will pay, and other terms of the loan, such as a required **down payment**, which contribute to its overall cost. Not surprisingly, the better your credit rating is, the easier it is to get a low-interest rate loan for major purchases such as cars and homes.

Credit History

Having too much debt or missing payments can lower your credit score, but if you don't have any credit history at all, it's hard for lenders to know whether or not you will be responsible about paying them back. Thus, it is important that you build a positive credit history by maintaining at least one credit account, in good standing, for at least six months. This can be a revolving credit card that you use for small purchases and pay off every month, or an **installment loan**, like a car or student loan, where you pay the same amount each month over a set period of time. Students can build credit through a **secured credit card**, which requires an upfront deposit, or by becoming an **authorized user** on a parent's card.

Consumers are entitled to one free copy of their credit report every twelve months from each of the three credit bureaus. These can be obtained at www.annualcreditreport.com. You may also pay to receive monthly updates. While this can be costly, it is a good way to protect yourself from adverse affects of **identity theft**.



Identity Theft Is On the Rise

With billions of dollars lost through identity theft every year, it is important to know how to prevent it and repair your credit history if you are a victim.

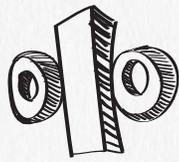
One of the most important things you can do to prevent identity theft is to check your credit reports at least once a year. This will allow you to review any accounts that have been opened or closed in your name, and any changes to personal information such as your address. Be sure to report it to the credit bureau immediately if you see something that is incorrect.

Taking simple, common sense precautions when handling important personal information such as Social Security numbers, banking data, and credit card information will help you protect your identity. Be careful where and how you share this information: never give this information out over the phone, via text, social media, or messaging app, or write it in an email. Don't store it on your computer without special encryption software, like a password protection program. If you use a smartphone for banking or making purchases, keep your phone secured with a strong password, fingerprint or facial recognition software. Some phones will also allow you to delete their contents remotely if the device is stolen.

Over the past few years, we've heard numerous accounts of social media and news sites and even large employers having their databases accessed by hackers. It's a good idea to maintain a separate email address for banking and shopping from the one you use for social media and news. Make sure your passwords vary and change them frequently.

If you are a victim of identity theft, it is important that you contact your bank and all other financial institutions immediately and let them know what has happened. You should also review your transaction records for fraudulent purchases. Finally, it is imperative that you contact one of the three major credit bureaus to make them aware of the identity theft. (If you contact one agency, they are required to report it to the other two). Working with the credit bureaus and financial institutions, you can repair any damage that has been done, but it is a long, time-consuming process.

Interest Rates and Selecting a Lender



Interest rates are set partly by the economy and partly by your creditworthiness. They can be **fixed** or **variable**. Fixed interest rates stay the same from month to month, which means that you pay the same amount every month. Variable interest rates change based on the financial market, so the amount of interest you pay can go up and down from month to month. This means that your total monthly loan payment can go up or down, as well.

Interest rates are only one factor to consider when applying for a loan. Some other important factors are loan fees charged to the borrower for processing and completing the loan, and repayment terms on the loan, such as penalties for early repayment.

You should always research all these factors when selecting a lender. Luckily, we have the **Truth in Lending Act** to help us. This is federal legislation designed to make sure consumers understand a loan's interest rate and terms,

including any processing fees they might be charged upfront. It requires lenders to show both the interest rate and the **Annual Percentage Rate (APR)** for a loan. This latter rate represents the actual yearly cost of the loan, including any upfront fees. A \$5,000 loan with a 5% annual interest rate that charges no upfront fees would have an APR of 5%. A \$5,000 loan with a 5% annual interest rate that charges \$500 in upfront fees would have an APR of 5.5%. The APR makes it easier to compare loan offerings when you are selecting a lender.

It is also important to select a reliable lender, such as a bank or credit union. Beware of loans from **loan sharks**, which are not regulated, and be aware that companies that offer **payday loans** tend to lend small amounts of money (\$500 or less) and charge very high interest rates. Regulations for payday loans vary from state to state. These loans are really just cash advances against the next paycheck you will receive from your employer, and can be very costly.

How Loans and Interest Affect You as a Consumer and Taxpayer

Companies throughout the world borrow substantial amounts of money. The interest rates determine how much these loans will cost them each year. The costs of these loans, in turn, are folded into the cost of the goods they manufacture (along with the price of materials and labor, etc.), and ultimately passed on to the consumer in the purchase price. When you think about how many different companies are involved in the manufacture and sale of even simple household items, like clothing, and then you imagine that each of them may be paying interest on loans, you can see how interest rates can have a big impact on day-to-day life.

Countries, states, cities, and towns also borrow substantial amounts of money. The interest rates they pay on their loans affect the amount of taxes they have to raise and the amount they have available to spend on programs like education and defense.

Of all of the practices in finance and investments, the practice of charging or paying interest is probably the most important, with a major impact on world affairs. Since interest rates change little from day to day, and often quite a lot from year to year, there are many people who spend a great deal of their time monitoring interest rates.



Activity 1

DEBT AND CREDIT

PART 1



Imagine that you need \$700 to go on a school-sponsored trip in early September. You have \$400 in savings and ask a classmate to lend you the extra \$300. Your classmate will consider lending you the money, but wants to make sure you will pay it back, so he asks you to provide the following information:

- How much money do you earn per week, and how much of that money is already budgeted to other expenses?
- Can you show evidence that you are responsible about paying your bills and debts? For example, have you ever borrowed money before? How quickly did you pay it back? Have you ever made a late payment?
- Are you currently attempting to borrow money from anyone else?

The following chart describes three scenarios for this situation. Mark the items listed for each scenario with a + or a – to indicate whether they would positively or negatively affect your classmate’s decision to lend you the money. Mark an x for items that you think are neutral. Then answer the questions below.



SCENARIO A

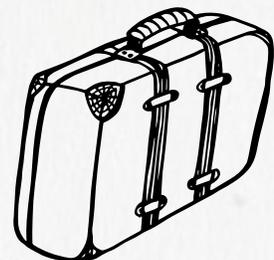
- __ You have a part-time job that pays \$160 per week.
- __ Your current expenses are a phone bill of \$20 per month and car insurance that is \$60 per month.
- __ Last year, you borrowed \$75 from your cousin and repaid it within 2 months.
- __ Two years ago, you missed a payment on your phone bill, but caught up and have paid all of your other bills on time for the past 3 years.

SCENARIO B

- __ You have a part-time job that pays \$160 per week.
- __ Your current expenses are a phone bill and car insurance that total \$120 per month, plus a credit card with a \$2,000 balance.
- __ Last year you borrowed \$75 from your cousin and took 6 months to pay it back.
- __ You typically pay your bills on time, but were more than 30 days late paying your phone bill last month.

SCENARIO C

- __ You have a part-time job that pays \$160 per week.
- __ You have no current expenses.
- __ You have no record of having borrowed money or repaid it.

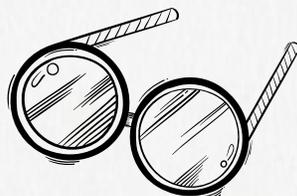


1. In which scenario do you think your classmate would be most likely to lend you the money?

- A B C

2. Least likely?

- A B C



PART 2

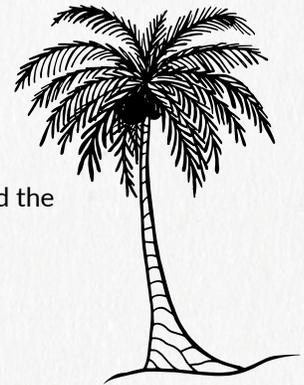
Let's assume that you fit the profile for scenario A. Your classmate decides to lend you the money under the following terms:

- You have until the end of the year to repay the loan.
- Your interest rate is 2% per month.
- Interest is charged at the beginning of each month before payments are credited.

MONTH	BEGINNING BALANCE	TOTAL MONTHLY PAYMENT	MONTHLY INTEREST PAYMENT	ENDING BALANCE
SEPT.	\$300.00	\$60.00	\$6.00	\$246.00
OCT.	\$246.00	\$160.00	\$4.92	\$90.92
NOV.	\$90.92	\$80.00	\$1.82	\$12.74
DEC.	\$12.74		\$0.25	\$0.00

You think the interest rate is high, but it encourages you to pay your classmate back in a timely manner. The chart above shows your monthly payments.

1. How much will you have to pay in December in order to repay the loan in full? \$_____
2. What was the total amount of money you had to pay your classmate by the time you repaid the loan? How much of that was interest?
Total Paid: \$_____ Total Interest: \$_____
3. How would the cost of this loan be different if interest were calculated at the end of each month, after the month's payments had been credited?



PART 3

Now, suppose that, instead of paying as much as you can each month, you decide to pay off the loan in four equal monthly installments. Use the online loan calculator at tools.finra.org/loan to find out whether this is a good decision.

1. The loan calculator asks for an annual interest rate. At 2% per month, what is the annual interest rate for your loan? _____%
2. According to the calculator, what is your monthly payment? \$_____
3. What is the total amount you will pay? \$_____ How much of that is interest: \$_____
4. Is this a good decision compared to paying as much as you can each month? Why or why not?

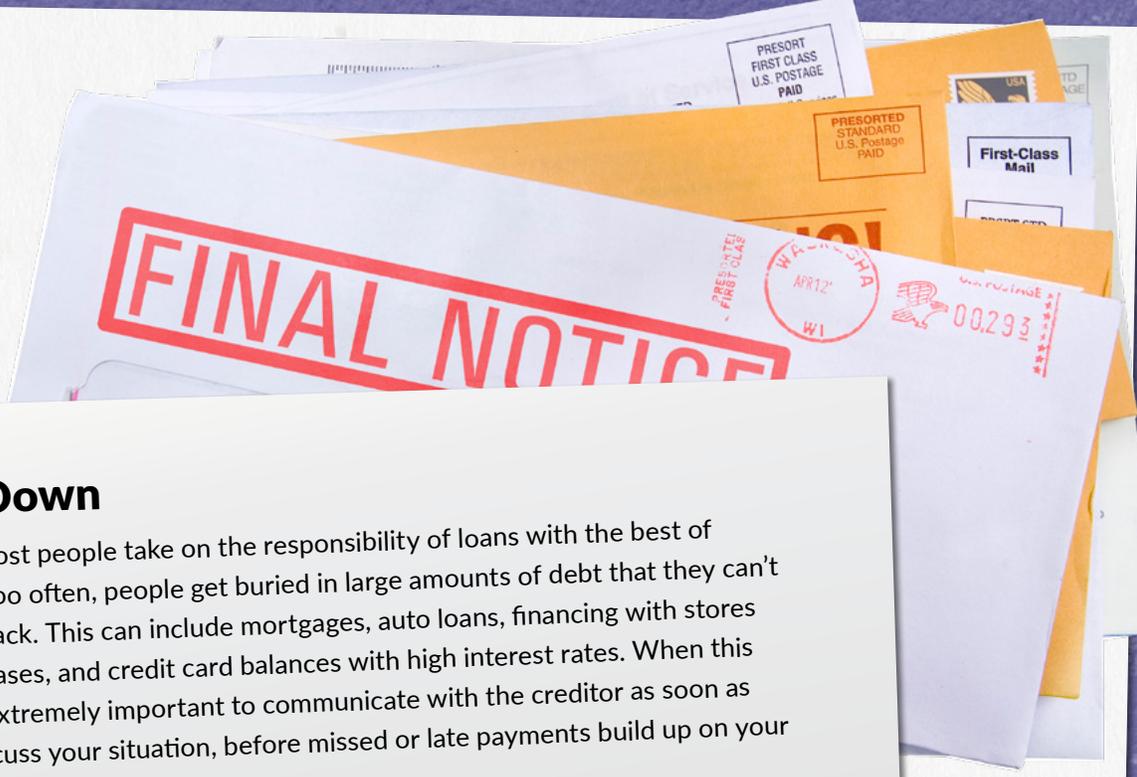
PART 4

Let's give the situation one more twist. Your classmate tells you that the interest rate will increase by one percentage point each month. Fill in this chart with the same monthly payments shown in the chart for Part 2. Then answer these questions.

MONTH	BEGINNING BALANCE	MONTHLY INTEREST RATE	TOTAL MONTHLY PAYMENT	MONTHLY INTEREST PAYMENT	ENDING BALANCE
SEPT.	\$300.00	2%	\$	\$	\$
OCT.	\$246.00	3%	\$	\$	\$
NOV.	\$93.38	4%	\$	\$	\$
DEC.	\$17.12	5%	\$	\$	\$

1. How much will you have to pay in December in order to repay the loan in full? \$_____
2. What is the total amount of money you will pay to your classmate when you have repaid the loan? How much of that is interest?
Total amount paid: \$_____ Total interest: \$_____
3. How does changing the interest rate each month change the total amount you have to pay over the life of the loan?





Loaded Down

Even though most people take on the responsibility of loans with the best of intentions, all too often, people get buried in large amounts of debt that they can't afford to pay back. This can include mortgages, auto loans, financing with stores for large purchases, and credit card balances with high interest rates. When this happens, it is extremely important to communicate with the creditor as soon as possible to discuss your situation, before missed or late payments build up on your credit report.

There are a number of avenues consumers can take to get back on track. If you are carrying balances on credit cards with high interest rates, you may be able to negotiate a better interest rate. In some circumstances, you may be able to **refinance** a car or home loan. Sometimes when there is an emergency, like the loss of a job or a death in the family, lenders may be willing to give you a **grace period** for making reduced payments until you are back on your feet.

One common way to cope with credit card debt is with a **balance transfer** — credit card companies will often offer to let you transfer your debt from one card to another. You will pay an initial fee, and then, for a short period of time, you won't have to pay interest. After that introductory period is over, you will pay a pre-determined rate on the remainder of the balance.

When debt gets really overwhelming, consumers may turn to **credit counseling** to help them sort out their budget, provide money management advice, and set a plan for paying off debts. Credit counseling agencies are typically non-profit organizations, and their job is to help consumers manage their debt. **Debt settlement** companies, on the other hand, are for-profit companies that seek to renegotiate debt with your lenders and service providers on your behalf. They charge fees and could get you into more debt than you started with. It is best to try and work with your lenders directly to negotiate better terms.

Bankruptcy is a last resort after all other options have been exhausted. This is a legal proceeding in which consumers declare in court that they don't have the resources to pay their debts. If the case is successful, the consumer will use their current assets to pay what they can, and the remainder of the debt will essentially be erased. While this may sound like a great deal, filing bankruptcy can take up to six months and remains on your credit report for as long as 10 years.

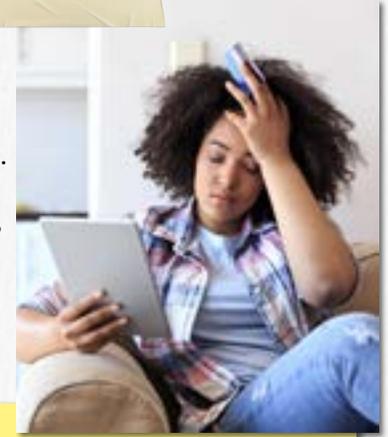
Activity 2

MANAGING DEBT

PART 1: WEIGHING YOUR OPTIONS

Imagine that you have two credit cards: Card A has an APR of 19.99% and a balance of \$5,000. Card B has an APR of 8.99% and a balance of \$7,000. You decide to set aside \$800 per month to pay down the debt on both cards. What is the best way to allocate your monthly payments? Find out by answering the questions below, using this online credit card payoff calculator:

www.creditcards.com/calculators/payoff.



OPTION 1

- If you pay \$400 per month on each card, how long will it take to pay them both off? _____ months
- How much interest would you pay in total?

Interest on Card A \$ _____ + Interest on Card B: \$ _____ = Total Interest: \$ _____

OPTION 2

Let's say that the minimum payment for each card is \$100. You decide to pay off one card at a time, while only making the minimum payment on the other. When the first card is paid off, you will put all of your monthly payments towards paying off the second. Which card should you pay off first? Use this chart and the online calculator to help you work out the math:

	PAY OFF CARD A FIRST	PAY OFF CARD B FIRST
How many months will it take to pay off the first card, if you pay \$700/month?		
How much interest will you have paid on the first card?	\$	\$
What will the balance on the second card be at that time, if you've continued to pay \$100 a month? (Assume interest is compounded monthly.)	\$	\$
How much interest will you have paid on the second card?	\$	\$
How many more months will it take to pay off the second card at that point?		
How much additional interest will you have paid?	\$	\$
TOTAL MONTHS:		
TOTAL INTEREST:	\$	\$

Which card would you pay off first and why?

OPTION 3

Now suppose that you receive a balance transfer offer from another credit card company that you can use to pay off both of your current credit cards. The terms are:

- Transfer fee of 3% or \$25 for each transfer, whichever is higher
- No interest for 9 months
- After that, an annual interest rate of 9.99%



1. What would the transfer fee be for each card? Card A: \$ _____ Card B: \$ _____
2. What would be the balance on this new card if you transfer the balances from both of your current cards plus the combined transfer fees? New balance: \$ _____
3. If you continue to pay \$800 per month toward paying off your credit card debt, how long would it take to pay off this new card? Remember that you will pay no interest for the first 9 months. _____ months
4. What is the total amount you would pay in interest and fees? \$ _____
5. Comparing these three options, which do you think is the most financially responsible plan of action? Why?

PART 2: LOAN CONSOLIDATION

Now imagine that you have two loans, in addition to the credit card debt described in Part 1. You pay \$320 per month toward an auto loan, which has a current balance of \$15,000 and an interest rate of 7%. You also pay \$100 per month toward a furniture purchase that you financed at an interest rate of 1.9%, which has an unpaid balance of \$1,000.

1. What is your total debt, including credit card debt? \$ _____
2. What are your total monthly debt payments, assuming that you chose Option 1 above to manage your credit card debt? \$ _____
3. If your net monthly income is \$4,000, what percentage of this income is going toward monthly debt payments? _____ %

You apply for a consolidation loan to help pay off your debt. The new loan, for \$28,000, has an annual interest rate of 6% and your new monthly payment is \$350. Answer the questions below using the loan consolidation calculator at

www.bankrate.com/calculators/credit-cards/credit-card-loan-consolidation-calculator.aspx.

4. How long will it take you to pay off the loan? _____
5. What is the total amount you will pay on the loan, including principal and interest? \$ _____
6. How much less will you spend each month on debt payments? \$ _____
7. Assume that you put this extra money each month into a retirement fund earning 5% interest per year. What is your investment worth by the time you pay off the loan? Use the calculator at www.investor.gov/additional-resources/free-financial-planning-tools/compound-interest-calculator to find out \$ _____
8. Was the consolidation loan a smart financial decision? Why or why not?
