Starting Point

Go to www.wiley.com/college/bajtelsmit to assess your knowledge of consumer credit. Determine where you need to concentrate your effort.

What You’ll Learn in This Chapter

▲ Consumer credit options
▲ Credit card types
▲ Credit card risks

After Studying This Chapter, You’ll Be Able To

▲ Compare advantages and disadvantages of using consumer credit to make purchases
▲ Assess the various types of consumer credit
▲ Take steps to protect and establish good consumer credit
▲ Evaluate credit card alternatives, including terms and costs
▲ Predict the hazards of credit card use, including the risk of identity theft
INTRODUCTION

Learning how to manage consumer credit effectively by reducing reliance on high-cost borrowing is an important component of financial success. In this chapter, we first look at the types of consumer credit and then how to apply for credit. This chapter examines the advantages and disadvantages of credit and how to protect your credit and correct credit mistakes. Finally, it discusses credit cards in more detail, including their risks.

5.1 What Is Consumer Credit?

Any time you receive cash, goods, or services now and arrange to pay for them later, you are buying on **credit**. If you use credit for personal needs other than home purchases, you're using **consumer credit**. You can borrow from a friend or family member, a firm with which you do business, or a financial institution (e.g., bank, credit union, insurance company). The most common types of consumer credit are

- Credit card accounts.
- Automobile loans.
- Home equity loans.
- Student loans.

In each case, the lender lets you have the use of the money now and expects you to repay it with interest, often over a specified time period. Before you decide to borrow funds to make a purchase, whether through a credit card or a consumer loan, you should be careful to evaluate the short-term and long-term effects on your monthly cash flow.

The future payments, including the original purchase price and interest charges, will reduce your net monthly cash flow and thus your ability to make contributions to savings. Interest charges will increase the total cost of the product you are purchasing. Thus, in deciding whether to pay cash, take money from savings, or borrow the funds to make a purchase, you need to be sure to consider the trade-offs between the cost of borrowing and the lost earnings on savings.

Many types of consumer credit—most credit cards, for example—require that you pay interest rates that are much higher than what you can earn on your savings. If you have to pay 18 percent interest on your credit card and you're earning only 5 percent on a savings account, you'd be better off taking the money from savings than borrowing the funds for the purchase. Sometimes, though, consumer loan rates are lower than the rate you're earning on your invested dollars, making it preferable to borrow.
5.1.1 Advantages of Consumer Credit

Consumer credit allows you to spread the cost of more expensive purchases over time. It can offer a convenient and safe alternative to carrying cash and also provides a source of emergency cash. Let’s look more closely at the advantages of consumer credit:

▲ **Buy now, pay later:** Most people strive to improve their standard of living over time. The ability to purchase large-ticket items on credit—with borrowed funds—can sometimes make this dream a reality sooner. Being able to buy more expensive items now and pay for them over time makes it possible to fit purchases into your budget. You don’t have to save up the entire purchase price of a car, for example, before buying one. Instead, you can essentially enjoy the use of the product while you are paying for it. This type of arrangement is advantageous as long as (1) you can afford the payments without sacrificing other worthy financial goals, and (2) the product you purchase lasts at least as long as the time period over which you make payments.

▲ **Convenience and safety:** Instead of carrying large amounts of cash, you can simply carry a credit card. It’s convenient, and although a card can be stolen, it’s not as easy as cash for a thief to use. If you pay off your balance monthly before the due date, you can take advantage of free credit offered by the card issuer and still have the convenience and safety of not carrying cash. It’s important to note, however, that debit cards offer similar advantages.

▲ **Source of emergency cash:** Credit lines can be a source of funds to meet emergency needs (see Chapter 4). In deciding whether to use credit in this way, you need to consider whether you’ll be able to repay the debt in accordance with the credit terms and how the payments will affect your household cash flow.

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**FOR EXAMPLE**

**Cash vs. Credit**

Suppose you plan to purchase a car for $10,000. You have sufficient savings to make this purchase and are earning 5 percent interest per year on your savings account. If the car dealer is offering 3 percent interest on a car loan, you may be better off taking out the loan, making payments from the savings account, and earning the 2 percent difference. The advisability of this strategy depends on the terms of the loan (discussed in detail in Chapter 6) and any restrictions on your savings withdrawals.
5.1.2 Disadvantages of Consumer Credit

The primary reasons for limiting your use of credit include the impact on your household financial health, the costs associated with borrowing, the potential for overspending, and the impact on your insurance premiums. Let's look more closely at these disadvantages:

▲ Financial statement impact: The more you borrow, relative to your total wealth, the worse your liquidity and debt ratios look. This means that you may limit your financial flexibility if you take on too much credit. You may also expose your household to too much risk because you're committing your family to greater fixed expenses; if you or your spouse were laid off, you might not be able to meet these expenses. In addition, if you're planning to buy a home, high levels of consumer debt may make it more difficult for you to qualify for a mortgage.

▲ Increased costs: When you use consumer credit as a means of spreading the cost of a purchase over time, you nearly always pay more for your purchase in the long run because of the financing costs of the loan. Credit is never free. Lenders charge interest for the use of their funds and commonly also charge additional fees and penalties, as discussed in more detail later. Even when retailers offer zero-interest financing, you can be sure that they're making money on fees or, alternatively, that you could get a better deal on the price if you didn't take the cheap financing.

▲ Risk of overspending: The availability of consumer credit increases the risk that you will overspend. Without credit cards, if you don't have enough cash in your pocket or your checking account, you can't make a purchase. If you have a credit card, you can more easily convince yourself to spend. Instead of buying one sweater at that great sale price, why not buy one in each of the three colors? Why make yourself choose between those two CDs, when you can buy both? Retailers even use advertising to reinforce the painlessness of making credit purchases. Next to the full price, you might see: "Only $25 per month if you take advantage of in-store credit."

▲ Higher insurance premiums: For the past several years, insurance companies have been using consumer credit history as a factor in pricing individual auto and homeowner's insurance policies. Thus, if you have a lot of outstanding debt or a history of making late credit card payments, you may pay a higher insurance premium than those with better credit.

5.1.3 Consumer Credit and the Economy

In addition to offering certain advantages to consumers, credit benefits the U.S. economy as a whole. When consumers spend more, businesses profit, employment increases, and the economic outlook improves. Yet, many experts believe
that the level of household debt in the United States, relative to income and wealth, may be cause for concern.

Because of easy credit and changing attitudes about debt, the average household is relying more on borrowed funds today than in the past. In 2003, for example, Americans added $30 billion to total revolving credit. Increasing levels of household debt have adversely affected personal balance sheets, particularly in conjunction with the decline in household wealth caused by the stock market decline in recent years.

Figure 5-1 shows aggregate U.S. household debt relative to aggregate household wealth and income over time. The trend is clear: The ratio of debt to assets has increased more than 30 percent over the past two decades, from 13.8 percent to 18.1 percent. Americans have been taking on more debt relative to total wealth. Interestingly, the home mortgage share of total debt has remained relatively stable over time—around 75 percent—so this implies that households have increased their use of all kinds of debt. Of more serious concern, though, is the even greater change in household debt relative to aggregate disposable income. The increase from 72 percent to 104 percent represents nearly a 50 percent increase in only 17 years. Households generally can achieve a higher standard of living in the short run by borrowing to finance current consumption, but in the long run, the bills must be paid. Because incomes are rising more slowly than debt, household budgets are likely to feel the strain very soon.
The average U.S. household has eight credit cards and owes more than $8,000 on them. About 50 percent report having difficulty making their minimum payments. The total amount of consumer credit outstanding in the United States increased 372 percent in the 20 years from 1983 to 2003, from $445 billion to $2.1 trillion.

Bad credit can hurt much more than your ability to get a loan. Prospective landlords and employers check your credit before doing business with you. Most insurers now use credit information in pricing auto and homeowner’s insurance policies; this means that late payments on credit cards or large outstanding credit balances can now cause your premiums to increase or your policy to be canceled.

5.2 Types of Consumer Credit

To buy something, you must do one of the following:

▲ Use current cash flow.
▲ Take money from savings.
▲ Borrow the money and repay it later.

Most people who choose to borrow for their consumer purchases use some type of consumer credit. Consumer credit is usually placed in different categories, based on the type of contractual arrangement. The two general types of credit arrangements are closed-end credit and open-end credit:

▲ Closed-end credit: This is credit that a lender approves for a specific purpose (e.g., the purchase of a television or a car). It must be paid back with interest either in a single payment or according to an installment agreement, with equal payments per period ending at a specific time. This type of credit is often called a consumer loan. The types of consumer loans and their unique characteristics are discussed in Chapter 7.

▲ Open-end credit: In contrast to closed-end credit, open-end credit, also called revolving credit, is generally not earmarked for a particular purchase,
and the payment period is not specified in advance. Instead, the lender preapproves an amount of credit, called a **credit limit** or credit line, in advance of any purchase. You can then use this credit as you wish until you've reached your credit limit. Credit cards, such as Visa and MasterCard, are familiar examples of this type of credit. Personal loans, home equity lines of credit, and other delayed-payment arrangements offered by retail and government service providers (e.g., utility companies) are also open-end credit arrangements.

Table 5-1 provides examples of these two types of credit arrangements.

### Table 5-1: Types of Credit

<table>
<thead>
<tr>
<th>Closed-End Credit</th>
<th>Open-End Credit</th>
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<tbody>
<tr>
<td><strong>Type</strong></td>
<td><strong>Examples of Issuers</strong></td>
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<tr>
<td>Mortgages</td>
<td>Depository institutions, insurance companies</td>
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<tr>
<td>Car loans</td>
<td>Depository institutions, auto manufacturers, such as General Motors and Ford</td>
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<td>Student loans</td>
<td>Depository institutions</td>
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<td>Installment contracts</td>
<td>Consumer finance companies</td>
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**SELF-CHECK**

1. Define **open-end credit** and **closed-end credit**.
2. List some examples of closed-end credit.
3. List some examples of open-end credit.
5.3 Applying for Credit

You can apply for credit by filling out a credit application form or responding to an interview that requests information related to your creditworthiness—usually details about income, assets, and debts. If you’ve developed a personal income statement and balance sheet, the requested information will be easy to supply.

5.3.1 The Five C’s of Credit

Although lenders use ratios in assessing your creditworthiness, they’re concerned with much more than just your monthly cash flow. The factors they consider are often summarized using the “five Cs of credit”:

▲ **Capacity:** A lender’s assessment of your ability, or capacity, to repay your debts is usually based on your household cash flow. Lenders may evaluate your capacity by looking at your sources of income and your expenses. They may use the debt payment ratio, the mortgage debt service ratio, or other measures that consider your expenses relative to your income.

▲ **Capital:** Lenders are also interested in your household’s net worth, or capital. If total assets are greater than total debts, lenders consider that you could, if necessary, liquidate other assets to pay back the loan. In addition, lenders know that people who have more at stake are less likely to default on a loan because they don’t want to risk their other assets being taken to repay the debt.

▲ **Collateral:** A loan protected by collateral (e.g., a car or home) is safer to the lender than one that is not. Therefore, the pledge of collateral makes you a better credit risk to the lender. The more valuable the collateral, the better the lender likes it.

▲ **Character:** Your previous credit, employment, and education history tell the lender about your character. Are you the type of person who honors an obligation? Do you have experience with making payments on debt? If you’ve previously borrowed money and repaid it on time, you’re considered a better credit risk. Similarly, if you own a home, have held a job for a period of time, and have lived in the same area for a while, the lender assumes that you’re less likely to default.

▲ **Conditions:** Every loan and every borrower represents a unique situation, and lenders sometimes take individual factors into consideration. Economic conditions, such as employment opportunities in the area, and special circumstances may make it more or less likely that you’ll default on the loan. If you have insufficient credit history, a lender might still approve a loan to you if you have a **cosigner**—a person
who agrees to take responsibility if you don’t make your payments as agreed. This significantly reduces the lender’s risk, but it’s fairly risky for the person who cosigns because he or she is effectively taking responsibility for the debt. To ensure that cosigners recognize these risks, the Federal Trade Commission (FTC) requires lenders to provide the following notice: “You are being asked to guarantee this debt. Think carefully before you do. If the borrower doesn’t pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility. You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increase this amount. The creditor can collect this debt from you without first trying to collect from the borrower. The creditor can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become a part of your credit record.”

It may seem that some lenders do not carefully evaluate the creditworthiness of applicants. For example, college students are often inundated with credit card offers that ask for little more than their name, address, and signature. Although students may not seem to be the best credit risks, their rates are generally high, and lenders know that parents often step in to pay their children’s debts. When credit offers are received over the telephone or through the mail, it’s possible that the lender has already prescreened your income and credit, using credit bureau information.

In other cases, the lender checks your credit after receiving a signed application. On university campuses, students are commonly offered a free T-shirt or an entry in a prize drawing for filling out an application. Credit card lenders even offer student organizations the opportunity to use credit card applications as fundraisers; for example, an organization might be paid a $5 fee for each completed application it obtains. Even though you might be tempted to take the T-shirt and cancel the card later, it’s a better idea to simply say no. It will be a lot harder to do so when your brand-new credit card arrives, with a $1,000 credit line. And if you don’t cancel your card quickly enough, your application acceptance may obligate you to pay an annual fee.

Applications for consumer loans are usually more involved than those for credit cards. Because depository institutions prefer to make loans to the best credit risks, they ask for more detailed information on your income and assets. To streamline the application process, consumer lenders sometimes have online application forms or take your information over the phone. Again, the more organized your finances, the simpler it is to complete these forms.
5.3.1 If You Are Denied Credit

If you apply for a credit card or a consumer loan and are denied, you have the right to know why. Most lenders send a form letter that specifies the reason. These are the most common reasons:

- Adverse information in your credit report.
- Insufficient income relative to expenses.
- Insufficient collateral.
- Insufficient job history.
- Insufficient residency at current address.

Notice that each of these reasons is related to one or more of the five C's of credit. If you're denied on the basis of accurate information, such as a poor record of making credit payments on time, there's little you can do to immediately change this. Your only option is to apply to another lender.

The lenders that are most likely to overlook your past credit problems are also the ones that charge the highest rates of interest. It might, thus, be worthwhile to reconsider your financial situation and take steps to correct the problems noted by the lender before making additional applications. For example, if your credit record reflects late payments made within the past 12 months, you should resolve to pay your existing obligations on time so that you can show a 12-month history of on-time payments in the future. If you haven't worked at your current job for a long enough period of time, you should consider reapplying after the requisite time period has passed. If your current monthly payments are too large relative to your income, you could consider applying additional funds to debt reduction before seeking additional consumer financing.

SELF-CHECK

1. Define cosigner.
2. What are the five C's of credit?
3. Give an example of a common reason for being denied credit for each of the five C's.

5.4 Protecting Your Credit and Correcting Credit Mistakes

Because financial transactions are complex and many consumers don't understand them very well, Congress has passed many laws to protect consumers in credit transactions. These laws address consumers' rights to obtain credit, to
receive full information about its cost, to have their credit information fairly and accurately reported, to be billed accurately, and to have their debts collected according to acceptable standards.

5.4.1 Rights in Obtaining Credit

In seeking credit, you have the following rights:

▲ **The right to full and accurate information**: Perhaps the most important consumer credit right is the requirement that creditors provide you with full and truthful information, written in plain English, including the true cost of consumer credit.

▲ **The right to freedom from discrimination**: Under the Equal Credit Opportunity Act, lenders can’t discriminate against you based on certain protected characteristics—race, sex, marital status, religion, age, national origin, or receipt of public benefits. However, it’s not against the law to deny credit based on income and credit history.

▲ **Special concerns for women**: Historically, it was common for women to be denied credit. Upon divorce or the death of a spouse, many women found themselves without access to credit at all. Today, lenders can’t consider either marital status or gender. It’s much easier for women to obtain credit and establish a credit history than it once was. It’s important for a woman to develop a credit history in her own name. If a woman only has a history of joint credit with her spouse and she later divorces or is widowed, a lender could deny her credit based on having an insufficient credit history. However, if she has had credit in her own name, the Equal Credit Opportunity Act prohibits lenders from requiring her to reapply when her marital status changes.

5.4.2 Credit Reporting

Lenders evaluate your creditworthiness in part by checking your outstanding debt obligations and your history of making payments. This information is reported by your creditors and compiled by companies called **credit bureaus**.

Your consumer credit rights under the Fair Credit Reporting Act of 1971 include the right to know what is contained in your credit report, to have information reported fairly and accurately, and to dispute items on the report that you disagree with. To ensure that your credit report is correct, you need to take responsibility for regularly checking it for any errors.

What is included in your credit report? Many consumers are surprised to find that their credit report contains a lot more than just information on credit accounts. Typically, your report includes previous, current, and future credit history; specific information about average balances, late payments, and overlimit
charges; employment and income history; and home mortgage amounts and payments.

The three major credit bureaus are Equifax Credit Information Services (www.econsumer.equifax.com), Experian (www.experian.com), and TransUnion (www.transunion.com). You can get a free credit report by contacting a credit bureau.

A credit report includes a list of every request for your credit report in the past two years. When you apply for new loans, credit cards, or insurance, the financial institution nearly always checks your credit with one or more of the major credit bureaus. If there have been too many recent requests for your credit report, lenders may be concerned that you’re applying for a lot of other loans, an indication of potential future credit problems.

Based on the information in their files, credit bureaus classify individuals according to their credit risk, commonly using a credit scoring system such as the FICO system developed by Fair, Isaac and Company, Inc. This system and others use statistical models to calculate your probability of repayment. Each system weights factors differently, but the FICO system scores each person from 300 to 850, based on payment history (35 percent), debt (30 percent), length of credit history (15 percent), variety of debt sources (10 percent), and recent credit activity (10 percent). A score of 700 to 800 is considered good. If your credit score is too low, you can use one or more of these methods to raise it:

▲ Correct outdated and incorrect information in your credit report.
▲ Consistently make timely payments.
▲ Reduce your total debt.
▲ Develop a longer credit history.
▲ Include a mix of types of credit, not just credit cards.
▲ Close accounts that you haven’t used recently.

5.4.3 Correcting Errors on a Credit Report

You have the right to view your credit report (for free if you’ve recently been turned down for credit because of information in the report), and a credit reporting agency must notify you whenever new negative information is added to your file. Negative credit information must be removed from your file after 7 years, with the exception of bankruptcies, which remain on record for 10 years. If there is incorrect information in your file, you can notify the credit bureau, and it will investigate and make corrections, if warranted.

The burden of proof for accuracy of credit information is placed on creditors rather than consumers. Lenders must certify that disputed information has been accurately reported. Even if the negative information is correct, you still have the right to add an explanatory statement. For example, if you’re notified
that your credit card issuer reported late payments during a specific period of time, you can request that a note be included on your report, explaining any extenuating circumstances, such as unemployment or illness.

Despite the extensive regulation of credit reporting, many reports contain some inaccurate, misleading, or outdated information, which isn’t always easy to get corrected. If you have a common name, such as John Smith, your credit report may include negative information about a different John Smith’s credit. If you divorce, you should notify credit bureaus so that your credit will not be affected by the possibly poor credit habits of your ex-spouse.

5.4.4 Billing Statements and Debt Collection

Lenders are required to provide you with full information related to all charges made to your account, and they must clearly explain any finance charges and how they are calculated. If you find an error on a bill, specific rules identify your right to contest the bill. Within 60 days of the billing error, you should do the following:

1. Send a written notice to the credit issuer, including copies of verifying documents, explaining why you believe the item to be incorrect. Under the Fair Credit Billing Act (FCBA), the company must immediately credit your account by that amount, pending resolution of the dispute.
2. Withhold payment for the disputed item. The issuer cannot charge you interest or penalties on this amount while it is in dispute.
3. Check your credit bureau file to see whether a notice has been sent relating to this item or your nonpayment.

When borrowers fall behind on their payments, lenders attempt to collect past-due amounts by using a variety of strategies, including sending past-due notices in the mail and making telephone calls. If you’re extremely delinquent, your creditor might employ the services of a debt collection agency. The Fair Debt Collection Practices Act of 1978 gives you the right to be treated fairly and civilly by debt collectors. It specifically prohibits actions that would be considered abusive or deceptive and establishes acceptable procedures for debt collection.

**SELF-CHECK**

1. List ways to improve your credit score.
2. Define credit bureau.
3. What are your legal rights in obtaining credit?
5.5 Credit Cards

Credit cards are a familiar type of open-end credit. The term credit card is used to cover a variety of types of cards, some of which actually don't involve credit. In general, a credit card is a plastic card printed with an account number and identifying the holder as a person who has entered into a revolving credit agreement with a lender.

5.5.1 Types of Cards and Contract Terms

Some credit cards, in addition to allowing purchases, permit the holder to borrow cash in a transaction called a cash advance. You can get a cash advance at a participating financial institution, from an automated teller machine (ATM), or by writing a convenience check, a check supplied by the lender to make cash advances easier. The following are the common types of credit cards:

▲ Bank credit cards: A bank credit card allows the holder to make purchases anywhere the card is accepted. Although these cards carry a brand name from a particular service provider (e.g., Visa, MasterCard, Discover), the lender is usually a depository institution, such as a bank or credit union. Nearly all financial institutions offer credit cards, and they pay transaction fees to the service providers for managing payments to retailers and billing of account holders. Nonfinancial companies also offer these types of cards in collaboration with financial institutions to encourage spending on their products. Even alumni associations and other affinity groups (e.g., charitable organizations, political groups, fraternities, sororities) can issue credit cards. A retailer incurs a cost for accepting bank credit card purchases, usually ranging from 1.5 to 5 percent of the purchase, with the highest fees charged by American Express and Discover.

▲ Retail credit cards: Some businesses offer retail credit cards that can be used only at their own outlets. Retailers ranging from Home Depot to Neiman Marcus offer such cards. Issuing their own cards offers several advantages to retailers. The cards may encourage greater spending at their stores. They can be quite profitable because of their high rates of interest and annual fees. The cards also offer a marketing opportunity because cardholder mailing lists can be used to advertise special sales and discounts.

▲ Travel and entertainment cards: Some credit cards are designed primarily to allow business customers to delay payment of certain travel and entertainment expenses to coincide with their company's reimbursement system. These travel and entertainment (T&E) cards are thus a type of credit card, but they generally require that balances be paid in full each month. Diners Club and American Express are the best known.
Debit cards: As discussed in Chapter 4, a debit card allows you to subtract the cost of your purchase from your checking or savings account electronically. Although these cards are a convenient substitute for cash and checks, they are not a means of borrowing—if you don't have enough money in your account, the transaction will be denied, and you may be required to pay a fee. Some debit card issuers offer overdraft protection, and others offer credit as an alternative.

Smart cards and other new technology: A smart card is embedded with a computer chip that can store substantially more information than the magnetic strip on a traditional credit card. Smart cards actually store electronic cash. These funds have already been withdrawn from a bank account and are essentially “on deposit” in the card. During the 2003 holiday season, 6 out of 10 people received a gift card. Many experts believe smart cards will eventually replace the multitude of other cards and identification we now carry. The storage capacity of the chips used on these cards makes it possible for issuers to include additional security features and could permit recording of much information—driver’s license, credit cards, checking and savings accounts, health club memberships—in one place.

Credit card agreements are legal contracts subject to numerous terms and conditions, which you effectively agree to when you apply for a card. These are some of the key contract terms you should be familiar with:

Annual fees: Some credit cards charge an annual fee. Although competition has caused many lenders to eliminate these fees altogether, some cards charge as much as $300 per year. You should avoid cards that impose annual fees unless the cards offer other financial benefits that offset this cost. Suppose you have a card with a $1,000 balance, on which you pay 10 percent annual interest, or $100 per year. If you pay a $50 annual fee in addition to your interest charges, your total costs for the account are actually $150. The annual fee therefore increases your annual cost to 15 percent of your balance. Compensating features might include insurance, rebates, discounts, frequent flier miles, or other services. The value of these perks, however, usually doesn’t come close to compensating for the fee.

APR: The most important feature of a credit card is generally the interest rate charged on borrowed funds. In Chapter 4, you learned how to compare interest rates on investments by using annual percentage yield (APY). In the same way, you can compare the costs of borrowing by using the annual percentage rate (APR). Although lenders must report the APR on all types of loans and credit arrangements, credit card advertising normally emphasizes the nominal rate, which is generally lower
than the APR. Therefore, you need to look carefully to ensure that you’re comparing different types based on the APR. APR takes into account all the finance charges associated with the account, even if these are not technically called “interest”—annual fees and charges for credit reports, for example. The APR is calculated as follows:

\[
\text{APR} = \frac{\text{Total annual finance charges} + \text{Annual fee}}{\text{Average loan balance over the year}}
\]

Finance charges can vary tremendously and may even be negotiable, so it pays to shop around. The average rate on a standard card in November 2006 was 14.8. Many issuers offer a below-market teaser rate to attract new customers and to encourage current cardholders to transfer balances from other cards. Although this might seem to make financial sense, the cards may also carry high annual fees and commonly have clauses that allow the rate to increase substantially if you make payments late, exceed your credit limit, or experience a change in credit status.

▲ Credit limit: The credit limit, or credit line, is the maximum amount you are allowed to borrow under the terms of your credit card agreement. Lenders usually start new cardholders with relatively low limits, such as $300, and then increase them with responsible card usage. Some people have credit limits of $50,000 or more, but the average is closer to $5,000 per card.

FOR EXAMPLE

When Low Rates Aren’t Such Good Deals

A card issuer recently advertised an attractive 6.9 percent rate. But the low rate applied for only six months and did not apply to cash advances. Some other important conditions were buried in the fine print. At the end of the teaser period, the rate reverted to the issuer’s “normal” rate of 18.9 percent. If any payments were late during the six-month low-rate period, the rate would immediately increase to 18.9 percent for the first offense and to 22.9 percent for the second late payment. In a case involving another credit card, an Illinois doctor was surprised to find that the interest rate on his MasterCard went from 6.2 percent to 16.99 percent in one month. When he checked with his financial institution, he was told that the change was due to a “change in his credit status.” This surprised him because he had always paid his bills on time and stayed within his credit limit. It turned out that the change the lender was referring to was the fact that the doctor had obtained a new home mortgage.
▲ Transaction, billing, and due dates: Credit card statements are issued monthly. The date you use your credit card to make a purchase is called the transaction date. The lender closes off reporting of transactions on a predetermined billing date, and any new charges you make after that date appear on the next bill. Federal law requires that the bill be mailed to you at least 14 days before the due date, the date on which partial or full payment is due. This date is usually 20 to 25 days from the billing date. If you find it more convenient to have your payments due on a different date, you can ask the lender for a change in your billing cycle. Many credit cards do not calculate interest on new charges (other than cash advances) until the due date; this period of time is therefore called the grace period. When you make payments, the lender credits you as they are received. If you return purchases, these credits appear on the next month's statement as a reduction in the total amount owed. Most cards charge interest on new transactions beginning on the due date, so in this case, you could avoid all interest on the $100 by paying the bill by May 15. If you did that, you would have had the benefit of the credit for nearly two months without owing any interest. With some cards and with all cash advances, interest begins to accrue from the transaction date, so you must carefully read your agreement.

▲ Minimum payment: According to most credit card agreements, you must make a minimum payment each month to be in good credit standing. This amount is calculated according to the terms of your agreement with the lender, but it is the greater of $15 or a specific percentage of the outstanding balance. The minimum payment is always at least as great as the amount of interest due on the account for the period, but it isn't much more. Making only the minimum payment thus makes very little dent in your overall debt. If you have card debt of $1,000 at 16 percent interest, stop using the card, and pay the minimum payment of $15 a month, it will take almost 14 years to repay the debt!

▲ Penalties and fees: Credit card issuers generally assess penalties, including penalties for paying late and exceeding the credit limit. Late payment penalties range from $10 to $50. Although most credit card issuers charge the same fee to everyone who pays late, some have graduated fee schedules, based on the amount that is past due. If you make charges that cause your balance to exceed your credit limit, the lender assesses an overlimit charge, which can be as much as $50. Because both making a late payment and going over your credit limit violate the terms of your loan, these may affect your ability to get future credit. Fees for cash advances and for ATM usage are also relatively common. For example, some issuers charge as much as $70 per transaction for balance transfers, and many assess a $12 to $20 fee for making payments over
the phone. It might be worth incurring that fee if you would otherwise
be making your payment late and consequently paying a higher late pay-
ment penalty. Fees and penalties, although specified in the terms of your
original agreement, can change, but your lender must give you written
notification when they do.

5.5.2 Choosing Cards Based on APR

One of the big disadvantages of credit cards and other open-end credit accounts
is the high interest rates commonly charged. In fact, credit cards generate more
than $50 billion in finance charges a year for lenders. When you’re comparing
different credit card offers, you need to understand how finance charges are cal-
culated and what factors increase your monthly costs. The finance charge is the
dollar amount of interest charged by the lender in a particular billing cycle. It
is calculated as follows:

\[
\text{Finance charge} = \text{Periodic rate} \times \text{Account balance owed}
\]

In this calculation, the periodic rate is equal to the stated rate of interest divided
by the number of billing periods per year, usually 12. For example, if your nom-
inal rate is 18 percent, then your periodic rate is \( \frac{18}{12} = 1.5 \) percent per month.
The periodic rate must be disclosed by the lender and specifically identified on
your monthly bill.

Whereas the periodic rate is a known value, the account balance owed pre-
sents more of a problem because issuers use different methods to calculate this
amount. The most common method for calculating the account balance owed is
based on the average daily balance without a grace period—that is, including
any new purchases. In this method, the lender calculates the balance owed on
each day of the billing period, adding any new charges made and subtracting
any payments received during the period. The lender adds these daily balances
together, determines the average, and uses this value to calculate finance charges.

Although lenders are required to explain how finance charges are determined,
the complexity of these calculations makes it easy for them to disguise differences
between credit cards. Most people simply consider the nominal rate in making
comparisons, and few read the fine print on their statements. Low-rate cards, and
those that offer other perks, often employ a less favorable method for calculating
interest so that the lender can make up for the lower rate in other ways. For
example, the Discover Card, which advertises that it will “pay you cash” for each
purchase—1 to 2 cents per dollar charged added back to your account—often
uses a two-cycle method for calculating finance charges. For example, if you used
your card to make a large purchase last month in order to get the 2 cent rebate,
you would likely find that, unless you paid the balance fairly quickly after the
purchase, your finance charges on those borrowed funds for the month of pur-
chase and the month after would exceed the rebated amount.
There are two important rules to remember in comparing credit card terms:

▲ Always compare the rates based on APR rather than the nominal, or stated, rate.
▲ Read your credit agreement carefully to determine how finance charges are calculated.

In general, the best deals are on cards that calculate the finance charge using either the average daily balance with a grace period or an adjusted balance method, in which the finance charge is applied to the balance owed at the close of the last billing cycle minus a credit for payments made during the current billing cycle. Both of these methods give you access to short-term free borrowing.

If your credit card balances are gradually increasing, you'll have the highest monthly finance charge with the average daily balance without a grace period method. Because your personal financial plan probably includes a debt reduction goal, note that consumers who are gradually reducing their outstanding credit card debt should avoid cards that use the previous-balance method or the two-cycle method because both place more weight on your previous balance, which is always greater than your current balance as you continue to pay off the debt.

**SELF-CHECK**

1. List the types of credit cards available today.
2. Define cash advance, APR, grace period, and finance charge.
3. Cite the two important rules to remember when comparing credit card terms.

**5.6 Advantages and Disadvantages of Credit Card Use**

Section 5.1 notes that using consumer credit involves both advantages and disadvantages, both for individuals and for the economy. Although credit cards offer these same advantages, as well as some others discussed in this section, the high costs of interest and fees tend to outweigh the benefits of this form of borrowing, from the perspective of personal financial planning.

**5.6.1 Advantages of Using Credit Cards**

Like other forms of consumer credit, credit cards provide the opportunity to delay payment for purchases, the convenience and safety of not carrying cash, and a source of emergency funds. In addition, they may offer the following advantages:
5.6 ADVANTAGES AND DISADVANTAGES OF CREDIT CARD USE

▲ Method of identification: Most people use their driver’s license for identification; a credit card is a secondary method for verifying your identity. Some cards now include photos to make them more useful for identification and to reduce the risk of fraudulent card use.

▲ Means of record keeping for business expenses: Credit cards provide a convenient way to organize business-related and tax-deductible expenses. Using a credit card for business expenses makes it easier to submit requests for payment to your employer. Similarly, if you have tax-deductible business expenses that you need to keep separate from household expenses, a credit card helps with record keeping. Some cards even provide an end-of-year summary that separates total annual expenditures into various categories, such as restaurants, hotels, and airfare.

▲ Ability to make remote purchases: Credit cards enable you to pay for purchases remotely—by phone, through a catalog, or over the internet. Today, it’s practically impossible to get by without having a credit card. In fact, most airlines, car rental companies, and hotels will not accept reservations from you unless you have one. Many people worry about the safety of making purchases over the internet, but transaction verification—a feature offered by both MasterCard (“Shop Safe”) and Visa (“Verified by Visa”)—reduces the risk.

▲ Ease of returning merchandise: Some retailers let you return merchandise without a receipt if you paid by credit card because the record of a credit card purchase can be pulled up at a cash register terminal. If you received faulty merchandise, some credit card issuers promise they’ll credit your account and deal with the seller directly on your behalf.

▲ Free credit: Some credit cards—those that calculate finance charges without including new charges during the billing cycle—allow you the opportunity to borrow without paying for the privilege. Of course, you must repay the borrowed funds by the end of the grace period to avoid the finance charge.

▲ Other advantages: Credit card issuers sometimes offer additional benefits, including travel insurance (if you are injured on a trip you paid for using the card), rebates (cash back for purchases made), frequent flier miles, and discounts on specific merchandise. Some features may require a one-time or monthly fee. Also, cards that have these features may charge higher interest rates than others.

5.6.2 Disadvantages of Using Credit Cards
Like other forms of credit, credit card debt can weaken your household financial statements and may enable you to overspend. The interest and fees on credit cards
FOR EXAMPLE

Consolidating Debt
Suppose your marginal tax bracket is 25 percent and you have $5,000 in credit card debt on which you're paying 15 percent interest, or $750 a year. If you take out a home equity loan at 6 percent interest to pay off that debt, your annual interest costs will be only $300, and because the interest is deductible, your effective after-tax interest cost will be $300 \times (1 - 0.25) = $225. If you apply the annual $525 (= $750 - $225) savings to debt reduction, the net benefit will be even greater.

can significantly increase the cost of what you buy. Also, credit card ownership can increase the amount of junk mail you receive, expose you to the risk of loss of privacy, and increase the risk of identity theft. Let's look at the details of these disadvantages:

▲ **Most expensive way to borrow:** The rates of interest credit card users pay are higher than those most other types of borrowers pay, and they're higher than the rates earned on most investments. In addition, they're relatively insensitive to market interest rate movements, so as rates fall on auto loans and savings accounts, double-digit credit card rates continue. Also, credit card interest is not tax deductible. In contrast, the interest on certain types of consumer loans (e.g., home equity loans, some student loans) is tax deductible, which further increases the difference in cost between credit cards and other financing.

▲ **Negative effects of credit card marketing:** Financial institutions spend a lot of money attempting to entice you to add more cards to your wallet. This means more unsolicited mail, e-mail, and telephone calls. It also means more gimmicky attempts to get your attention, such as cards emblazoned with photos of famous people or your alma mater. Unfortunately, the latest target group is young teenagers. Some believe that this presents ethical issues similar to those raised in lawsuits against cigarette manufacturers. Here's another scary fact from the Consumer Credit Counseling Service: Within the first year of being a credit cardholder, one in five college freshmen owes more than $10,000. Credit card marketing also has a significant negative impact on the environment.

▲ **Loss of privacy:** Credit cards reduce the privacy of your financial information because your credit card provider may sell your credit and financial information to other companies that want to solicit you. Some
5.6 ADVANTAGES AND DISADVANTAGES OF CREDIT CARD USE

legislation specifically prohibits telephone calls to the phone numbers on “do-not-call lists,” which has significantly reduced unwanted calls. Telemarketing is still big business, though, and marketers are challenging the laws. To be added to the federal do-not-call list, you can log on to www.donotcall.gov. Many states have their own lists. Finally, some individuals have reduced the calls they receive by putting on their answering machines a message requesting removal from any telemarketer’s list.

▲ Fraud and identity theft: Identity theft is the nation’s fastest-growing crime, with an estimated 10 million victims per year, with most cases involving credit cards. Say that you receive your credit card billing statement and see one or more charges you didn’t make. Or you check your credit bureau report after a credit denial and see a loan listed that you never applied for. Both scenarios are commonly referred to as identity theft. Fraudulent credit card charges often involve online or telephone orders because it’s easier to use someone else’s identity in a venue where no additional identification, such as a driver’s license with a picture, is required. The negative outcomes of identity theft can be severe: Your credit may be damaged, and it takes time and effort to correct this. And it’s not just credit card information that is at stake. It takes very little information to steal your identity. With your Social Security number, name, and address, a thief can apply for credit cards, mobile phones, loans, bank accounts, apartments, and utility accounts. You might even be the victim of someone you know. About 6 percent of the cases reported to the FTC involve family members. If your lender thinks you’ve been the victim of fraud, it temporarily puts a hold on the card, disallowing any credit purchases until the issue has been resolved. Although you certainly benefit from these antifraud mechanisms, sometimes your own behavior can trigger the antifraud system, such as using your card at the same retailer more than once on the same day (because that could be an indication that a store employee stole your number) or using a card that has been inactive for some time. Figure 5-2 provides some tips for avoiding identity theft.

SELF-CHECK

1. List the advantages of using credit cards.
2. List the disadvantages of using credit cards.
Consumer credit has many advantages, but it also has disadvantages. Types of consumer credit include open-end and closed-end credit. When applying for credit, it's important to remember the five C's of consumer credit that are used to evaluate your creditworthiness. You should protect your credit because it affects your future access to credit. Credit cards can be helpful but are tremendously profitable for lenders, so you need to be careful in choosing and using them. You can avoid identity theft by guarding your financial information and canceling unused accounts.

**KEY TERMS**

**Annual percentage rate (APR)** The standardized annual cost of credit, including all mandatory fees paid by the borrower, expressed as a percentage rate.

**Average daily balance** The average of the balances owed on each day of the billing cycle.
Bank credit card: A credit card issued by a depository institution.

Billing date: The last day of a billing cycle. Credit card transactions made after the billing date appear on the next month’s bill.

Cash advance: A cash loan from a credit card account.

Closed-end credit: Loans for a specific purpose paid back in a specified period of time, usually with monthly payments.

Consumer credit: Credit used for personal needs other than home purchases.

Convenience check: A check supplied by a credit card lender for the purpose of making a cash advance.

Cosigner: A person who agrees to take responsibility for repayment of a loan if the primary borrower defaults.

Credit: An arrangement to receive cash, goods, or services now and pay later.

Credit bureau: A company that collects credit information on individuals and provides reports to interested lenders.

Credit limit: The preapproved maximum amount of borrowing for an open-end credit account. Also known as a credit line.

Due date: The date by which payment must be received by the lender if the account holder is to avoid late penalties and, in some cases, interest on new transactions.

Electronic cash: Money in digitized format.

Finance charge: The dollar amount of periodic interest charged by a lender on a credit account.

Grace period: The time before interest begins to accrue on new transactions.

Late payment penalty: A penalty fee charged to an account for making a payment after the due date.

Minimum payment: The minimum amount that must be paid by the due date to maintain good credit standing and avoid late payment penalties.

Open-end credit: Preapproved continuous loans that can cover many purchases and usually requires monthly partial payments. Also known as revolving credit.
## CONSUMER CREDIT

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td>Overlimit charge</td>
<td>A penalty fee charged to an account for exceeding the credit limit.</td>
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<tr>
<td>Periodic rate</td>
<td>The stated rate divided by the number of billing periods per year.</td>
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<td>Retail credit card</td>
<td>A credit card that can be used only at the sponsoring retailer's outlets.</td>
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<tr>
<td>Smart card</td>
<td>A card that stores identification and electronic cash in a computer chip.</td>
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<tr>
<td>Travel and entertainment</td>
<td>A credit card that requires payment of the full balance each billing cycle.</td>
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<td>(T&amp;E) card</td>
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<tr>
<td>Teaser rate</td>
<td>A short-term below-market interest rate intended to encourage new customers to apply for a credit card.</td>
</tr>
<tr>
<td>Transaction date</td>
<td>The date on which you make a credit card purchase.</td>
</tr>
</tbody>
</table>
ASSESS YOUR UNDERSTANDING

Go to www.wiley.com/college/bajtelsmit to assess your knowledge of consumer credit.

Measure your learning by comparing pre-test and post-test results.

Summary Questions

1. A home equity loan is considered a type of consumer credit. True or false?
2. Credit cards should be compared based on APY. True or false?
3. If a bank loans you money for a new car, this is a type of:
   (a) closed-end credit.
   (b) open-end credit.
   (c) revolving credit.
   (d) cash advance.
4. Credit cards, such as MasterCard and Visa, are examples of:
   (a) closed-end credit.
   (b) open-end credit.
   (c) collateralized credit.
   (d) wholesale credit.
5. Which of the following is not one of the five C's of credit?
   (a) conditions
   (b) capacity
   (c) credibility
   (d) capital
6. When lenders evaluate your sources of income and your expenses, they are considering your:
   (a) capacity.
   (b) capital.
   (c) collateral.
   (d) character.
7. Under the Consumer Credit Reporting Reform Act of 1997, the burden of proof for accuracy of credit information is placed on consumers rather than creditors. True or false?
8. A credit card that calculates finance charges without including new charges during the billing cycle allows a cardholder to borrow without paying interest if he or she pays the entire bill by the end of the grace period. True or false?
9. Making the minimum payment on a credit card bill:
   (a) ensures that the bill will be repaid in the minimum time period.
   (b) ensures that late payment penalties will not be imposed.
   (c) does not reduce the overall debt significantly.
   (d) gives you the best credit standing available.
10. Which of the following is an advantage credit cards have over other forms of consumer credit?
    (a) buy now, pay later
    (b) source of emergency cash
    (c) safe alternative to cash
    (d) ease of returning merchandise

**Applying This Chapter**

1. Discuss the pros and cons of using consumer credit for purchases for your holiday shopping.
2. You have a $750 balance on your credit card. You want to purchase a new stereo system for your car. However, your credit limit is $1,000. What is the most you can finance on your card?
3. Suppose you get turned down by a lender for making late payments on your mortgage. How do you improve your credit history?
4. You have a FICO score of 300. Give some possible reasons and some possible solutions.
5. What is the potential problem with teaser rates for credit cards?
6. The total annual finance charges on your credit card account are $200. You also pay an annual fee of $50. If your average outstanding balance during the year is $1,000, what is the APR?
7. When might it be a good idea to do a balance transfer?
8. Carrie Chandler opens her June credit card bill and sees that her balance is a bit higher than she thought it would be. When she carefully examines the bill, she sees that there was a $75 payment to “Shoppers Cooperator” that she knows she did not authorize. Looking back at her May bill, which she unfortunately didn’t look at very carefully the previous month, she sees a $75 payment to the same company that month, too. Explain the steps that Carrie should take to resolve this problem.
YOU TRY IT

Calculating APR
You’ve just received a credit card solicitation in the mail that offers a 4 percent APR. Your current card, which has an outstanding balance of $5,000, has an APR of 14 percent. What factors should you consider in making the decision to transfer your balance? How much interest will you save the first month by switching cards, assuming that you make no additional charges and both cards calculate interest based on the average daily balance?

Comparing Cards
If you hold any credit cards, use your most recent statements to evaluate them. Make a table that compares their features, including annual fee, APR, method of finance charge calculation, and penalty fees. If you carry a balance forward on one or more cards, make a plan for paying off your cards, starting with the one with the highest costs and least desirable features.

Your Credit Score
Using the information in Section 5.4.2, contact a credit bureau and obtain a copy of your credit report. What can you do to improve or maintain your credit score?