MP-343

Using Consumer Credit

TEXAS A&M UNIVERSITY
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". . . So the loan company is demanding money. Why not just borrow enough from them to pay it?"

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Using Consumer Credit

"Credit is so convenient!"

WANDA MEYER ELSIE SHORT
Extension Specialists in Home Management
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Consumer credit is a business transaction that allows an individual to get money, goods or services and pay for them at some future time. Credit can be a useful tool. It may enable the family to attain some of its major goals more quickly and easily. It may permit the purchase of furnishings and equipment when the family is young and needs are greatest, and allow the family to enjoy the goods as it pays for them.

ADVANTAGES IN USING CREDIT

...e things as ...e them."

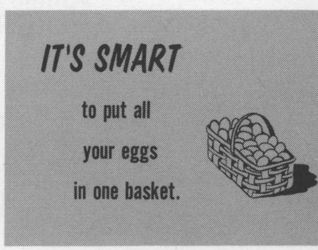
Credit provides one or more of the following advantages:

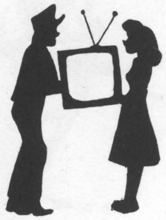
Convenience. This is especially true of charge accounts and service credit such as that given by doctors, dentists, oil companies, public utilties and paper boys.

Help in emergencies. All families eventually face emergencies, such as illness, accident or death. These situations may create a financial crisis which requires the use of credit.

Saving. Credit may be a means of saving for some families in that they increase their ownership of goods rather than cash. Some families find it difficult to save regularly and pay cash for the things they want. By buying "on time," these families commit themselves to setting aside a certain amount of money each week or month for items they buy.

Consolidation of debts. Families who often use installment credit may find themselves paying high interest rates on several time payment accounts at one time. A bank loan may be obtained to consolidate these debts and reduce interest rates. Interest on a bank loan is less than the carrying charges on installment purchases.





"I get better service."

Reduction of family expenditures. For example, the purchase of a television set may cut costs of family entertainment.

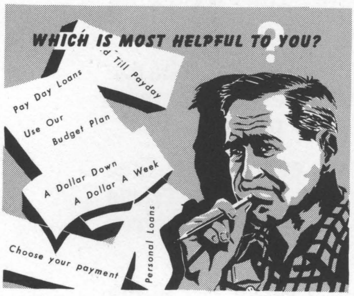
Better service on equipment. Some families prefer to buy equipment for their homes on the dealer's installment plan because they get faster and more satisfactory service on that equipment. The dealer usually attempts to keep such merchandise in good repair because, under the installment sales contract, he holds title to the equipment until it is paid for.

Charged purchases easier to return. It is easier to return charged purchases than cash purchases.

Bargains. At times, credit is used to take advantage of special sales when cash is not available.

Credit rating. A credit rating may be of great value in getting credit.

DISADVANTAGES IN USING CREDIT

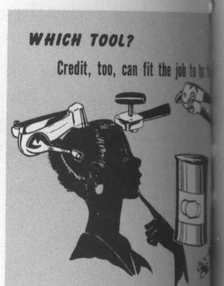


Debt. There are disadvantages of credit. When a person signs a credit contract, he mortgages his future income. The use of too much credit may lower the level of living. Research shows that people usually buy more when they do not have to pay cash. They may be careless occasionally about what they buy since it is easier to return charged goods than cash purchases.

More expensive goods. Goods bought at stores with charge accounts are usually more expensive because of the costs of investigating each person's credit rating and of keeping records of payments; loss through lack of payment of accounts; and difficulty in collecting from some customers. This cost of credit, although hidden, is included in the price.

KINDS, COSTS, SOURCES

Consumer credit may be divided into two main types — sales credit and borrowed cash. There are variations of each.



SALES CREDIT

Forms of sales credit are known as open or charge accounts, budget accounts, revolving accounts or installment accounts.

Charge accounts. The open or charge account is the type of credit you use when you say "charge it, please." It does not involve notes, contract forms or interest payments. Charge accounts are paid at the end of 30, 60 or 90 days. Some attractive features of this type of credit are that the shopper does not have to carry large sums of money; he may make several purchases and pay by one check later. It saves time for individuals who want to order by phone, and it allows the family to take advantage of sales when cash is not available. There is no charge for this type of credit, other than the markup on all goods necessary to cover the costs of this service. A disadvantage is that charge accounts can lead to careless and needless buying.

Budget accounts. The budget, thrift or extended payment plan, allows the customer to make several purchases and take 3 to 6 months to pay for them, rather than the usual 30 days. The total bill may be easier to pay when divided over a period of several months. It allows the customer to take advantage of sales and cut prices even though he does not have the cash on hand to pay for the purchases. There is no charge for this credit unless it takes more than 90 days to pay. However, a down payment must be made and the buyer is burdened with payment for several months. It is easy to overbuy with this arrangement.

Revolving accounts. When this type of credit is offered, the store decides how much credit to allow the customer, based on his income and credit rating. After the account is established the customer may charge purchases as long as he does not exceed his credit limit. The customer makes set monthly payments on his account, usually one-sixth of the balance due. The interest rate usually is $1\frac{1}{2}$ percent per month, or an annual rate of 18 percent. The customer may be tempted to overbuy and be constantly in debt.

Installment accounts. Installment credit, also known as "dealer credit" and "buying on time" is a longer term credit. Payments on an account of this type run from 1 to 36 months and usually are associated with big purchases such as washing machines, home freezers or automobiles. The borrower signs a formal contract in which he agrees to make a down payment; then pays a certain amount each week or month until the merchandise is paid for. The title remains with the dealer until the debt is paid in full. Installment credit enables an

Read the fine print!

individual or family to have things "now," rather than wait until cash is available. It may be looked upon as a form of saving in that goods are accumulated instead of cash.

This type of credit has disadvantages. If the family is not careful, too much income may be tied up in time payments, and not enough left for current living expenses. The purchaser commits himself to payments far into the future during which emergencies may arise and the cash may be needed for other things. Failure to make the payment may result in repossession of the goods by the dealer — without refunding previous payments. Be sure to read the terms of the contract.

Installment credit costs more than any other sales credit. It is expressed more often as "carrying charges" rather than interest rates. It may add as much as 10 to 20 percent to the cost of the article, and the customer may be unaware that he is paying the charge.

BORROWED CASH

Consumers may borrow cash to purchase goods and repay it in installments or in a single payment at the end of the stated length of time. Borrowing money involves the use of legal contracts. Sometimes security or collateral is required for the use of this type of loan. Interest charged for the use of the money varies, but usually it is less than the cost of installment credit. Sources of borrowed cash include banks, life insurance policy loans, small loan or personal finance companies and credit unions.

Banks. When lending cash, a banker may make a promissory or collateral note. Banks usually are more willing to grant the loan if the borrower can furnish collateral. Interest rates vary from 6 to 8 percent; they are higher usually on unsecured loans. They are even higher when the bank follows the practice of discounting the loan. That is, the amount of interest charged usually is withheld from the amount given the borrower. For example, if $100 were borrowed at 6 percent, the borrower would get only $94. Annual interest rate become higher, too, when the interest is added to the principle, and the total is divided into equal monthly payments.

Life insurance policy loans. Life insurance companies lend money to policyholders whose policies have a cash surrender value. The policyholder builds up the fund himself, usually making payments on his insurance 2 or 3 years before he has the privilege of borrowing on it. The amount which can be borrowed on the policy, the cash value, is shown in tabular form on the policy. Interest rates vary from 4 to 6 percent. There may be no set time in which the borrower may repay the loan, except that it must be repaid before the policy becomes due. If the policyholder should die, the beneficiary is paid only the remainder after the amount of the loan plus any unpaid interest is deducted from the face value of the policy. Customers are discouraged from borrowing on their insurance for other than emergencies because borrowing jeopardizes the protective feature of the insurance.

The life insurance policy may be used as security for a bank collateral loan. However, the insurance rate on a bank collateral loan is higher than borrowing directly from the insurance company because the interest rates are higher.

Small-loan or personal finance companies. Credit from these sources is the most expensive type. Interest rates advertised as 2, 2½ or 3 percent actually are monthly rates, which make an annual rate of 24 to 36 percent if payment is on the total sum borrowed. It is slightly lower if the interest is refigured each month on the unpaid balance of the loan.

It pays to investigate the habits and practices of all companies considered as sources of credit.

Credit Unions. A person must be a member to borrow from a credit union. This is done by a membership fee, usually around 25 cents. A minimum investment of at least one share is required. Shares usually sell from $5 each. Once a member, two kinds of service are available: (1) savings facilities and (2) loan service. Members deposit money in a credit union much as they would in a savings bank. These savings may be used to buy shares on which dividends of 3 to 6 percent a year are paid. Loans are made to members out of the funds accumulated from these savings. The maximum interest rate is 1 percent per month on unpaid balances, including all charges and fees, a true annual rate of 12 percent per year limit. Some are as low as ½ to 1 percent per month. Rates can be low because the cooperatives have little or no expense for rent, salaries, investigations, collections or federal income tax.

HOW MUCH DOES IT COST?

Check the cost of credit before you decide to buy. Suppose you are shopping for a clothes dryer. The price of the one you've selected is $219.95, no downpayment, $11.00 per month for 24 months. Multiplying the monthly payment, $11 by the months, 24, you find that you will be paying $262 — or $219.95 for the clothes dryer and $44.05 interest. To determine the rate of interest you would pay, use the following formula:

R = rate

M = number of payments in 1 year

I = carrying charges

B = unpaid balance at the beginning of the credit period

N = number of payments, not counting downpayment

$$R = \frac{2 \text{ X} M \text{ X } I}{B(N+1)}$$

$$R = \frac{2 \text{ x } 12 \text{ x } \$44.05}{\$219.95 \text{ x } 25}$$

$$R = \frac{105720}{549875}$$

$$R = 19.04\%$$

DECISION FOR THE INDIVIDUAL FAMILY

Many times urgent need for money faces a family and the choice of where to borrow may be hasty and unwise. Individuals or families should shop for credit just as they would for any other merchandise.

There is no set rule a family can follow in determining how much consumer credit it can use profitably and safely. It depends upon many things — the present debt load, present income, managerial ability and personal feeling toward the risk and responsibility of debt. Each family should decide for itself if credit is a resource and what its limit should be.

There are several guides a family can use to help make decisions regarding credit.

Discuss these points with your family:

1. Will using credit be more sensible than saving and paying cash?

2. Will the use of credit advance the long-time goals of the family? Is this a planned-for purchase or is it impulse buying?

3. Will the article purchased on credit give lasting satisfaction?

4. Consider not only the satisfaction gained but also the future adjustments necessary to repay the debt. Can current living expenses be met as well as the monthly credit payment?

Observe these rules when shopping for credit:

1. Know the dollar and cents cost of credit.

2. Get acquainted with lenders before the need for credit arises.

3. Study the different types of credit. Investigate all sources available. Compare the costs, services offered (insurence, delivery, installation, service, etc.) and risks involved in all sources. Choose the one that costs least and best suits your needs.

4. Get your "money's worth." Quality merchandise at reasonable prices is more important than getting the article on credit with low or no financing charges.

5. Contract for only the amount of credit you need. Generally, make as large a down payment as possible and repay the loan in as few payments as possible. This will reduce your costs of financing.

6. Get credit from a source whose responsibility, integrity and fairness is well known. Read and understand the terms of the contract you are signing.

7. Use your maximum credit capacity only in a crisis. Keep everyday credit totals well within safe limits, leaving a margin for emergencies.

HOW TO INSURE A GOOD CREDIT RATING

A good credit rating is an asset. Here is how to keep yours in good standing.

—Pay on or before the date you promise to pay.

—Do not commit yourself to regular payments if your income is irregular.

—Include credit purchases in your plans for spending. If you do not have a plan for spending MAKE ONE! This is the only way to determine how much credit you can safely use and avoid getting too deeply in debt.

—Visit your lender and arrange for a renewal before date of payment if an emergency arises and payment must be postponed.

DEFINITIONS

Legal credit contracts. A family planning to borrow money should be familiar with the most common legal credit contracts. A legal credit contract is a document drawn up by the lender and signed by the borrower, which gives the terms of the contract and the credit transaction. Four credit instruments commonly enter into individual or family finance; the promissory note, the collateral note, the chattel mortgage and the installment sales contract. The first three are used to borrow cash and the fourth is used with installment credit.

Promissory note. A promissory note represents an unconditional promise to pay to the person or organization issuing the loan a certain amount of money on a certain date, at a specified rate of interest. The note may be signed by the borrower only, or by the borrower and one or two co-signers. All signers are equally responsible for the full amount of the note. The promissory note is ordinally a 60 to 90-day note and can be renewed as often as the lender is willing.

Collateral note. The collateral note is similar to the promissory note, except it is backed by collateral such as a bond, stock shares, notes receivable or life insurance policy. It is a promise to pay the lender a given sum by a given date at a given rate of interest. It is signed by the borrower. The collateral is listed on the note with a statement that if the note is not paid by the date specified, the lender has the legal right to sell the collateral at the best price he can get at the time, for the purpose of paying the loan.

Chattel mortgage. The chattel mortgage is a loan secured by a pledge of movable property, sometimes referred to as "goods and chattels." In some instances, this is the borrower's household possessions. The mortgage records full information of the chattels pledged, amount of the loan, interest rate, maturity date and other data pertinent to the individual transaction. Chattel mortgages usually are filed with the county clerk in the county in which the security is located.

Installment sales contract. The main feature of this type of contract is that until the goods are paid for, the seller retains the title to the merchandise and the buyer has the use of it. If the buyer fails to make payments as agreed, the seller may repossess the merchandise without refunding any previous payments. If a purchase through an installment contract involves a large amount of money, the family should have a contract lawyer read the contract before signing.

OTHER DEFINITIONS

Budget. A budget is a plan for a month or year, set up to balance total expected spending with total available income or money to spend.

Chattel. A chattel is a movable possession, such as furniture, automobiles, livestock or farm machinery.

Collateral. Collateral may be property or possessions of any kind, when set aside or deposited as security for the performance of a contract or payment of an obligation.

Conditional sales. Conditional sales are sales under a payment contract where title remains with the seller until final payment is made, but the property is transferred to the buyer at once.

Credit rating. A person's credit rating is the appraisal of one's credit standing, ability and willingness to pay obligations.

Credit standing. Credit standing is one's present credit worthiness as determined by past credit performance.

Repossession. Repossession is the taking back of goods by the seller when the buyer has failed to meet payments; also the voluntary giving up of such goods in case of inability to pay as promised.

Title. Title is ownership.

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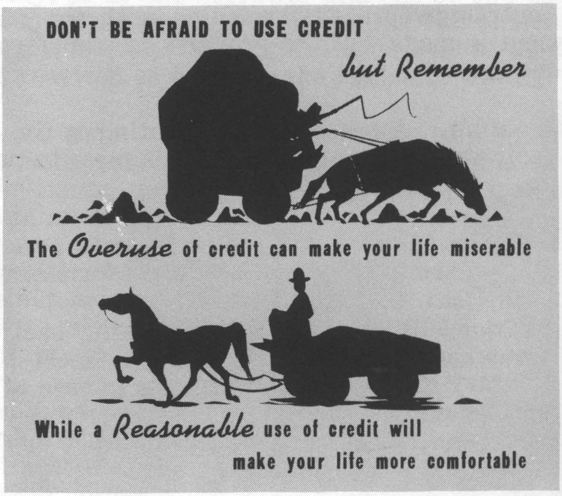

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