Borrowing Basics

Participant Guide

Building: Knowledge, Security, Confidence

FDIC Financial Education Curriculum

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WHAT IS CREDIT?

Credit is money you borrow to pay for things. It is usually referred to as a loan.

You make a promise to pay back the money you borrowed plus some extra. The extra amount is part of the cost of borrowing money.

If you use credit carefully, it can be useful to you. If you are not careful in the way you use credit, it can cause problems.

"Good credit" means that you make your loan payments on time to repay the money you owe. If you have a good credit record, it will be easier to borrow money in the future.

WHY IS CREDIT IMPORTANT?

- It can be useful in times of emergencies.
- It is sometimes more convenient than carrying large amounts of cash.
- It allows you to make a large purchase, such as a car or a house, and pay for it over time.
- It can affect your ability to obtain employment, housing, and insurance depending on how you manage it.

TYPES OF LOANS

Consumer installment loan

A consumer installment loan is used to pay for personal expenses for you and your family. Examples are:

- Auto loans. The automobile you are purchasing is used as collateral for the loan.
- Unsecured loans for short-term needs, such as buying a computer.

Credit cards

Credit cards give you the ongoing ability to borrow money for household, family, and other personal expenses.

Having a credit card does not mean you have the money to pay for a purchase. You need to be able to pay your monthly credit card bill.

Home loans

Home loans are secured by your home. There are three main types of home loans.

- Home purchase loans are made for the purpose of buying a house. These loans are secured by the house you are buying.
- Home refinancing is a process by which an existing home loan is paid off and replaced with a new loan.   Reasons homeowners might want to refinance their home loan include getting:
  - A lower interest rate.
  - Money for home repairs.
  - Money for other personal needs.
- Home equity loans are secured by a property of the borrower. The amount of equity is the value of the property minus the debt. Home equity loans generally can be used for any reason.

PRACTICE EXERCISE:
TYPES OF LOANS

Purpose

This exercise gives you an opportunity to practice identifying the type of loan best suited for the purchase of specific items.

Instructions

- Read the description of the purchase to be made.
- Fill in the blank with the most appropriate loan type for that purchase.

Types of Loans

Consumer installment loan

Credit card

Home loan (purchase, refinance, or equity)

Description of Purchase

Finance a college education ________________________

Make small purchases in a department store, for example, a $50 household appliance ________________________

Make home improvements ________________________

Consolidate debts ________________________

Buy a refrigerator ________________________

THE COST OF CREDIT

When you get a loan, there are generally two costs you must pay: Fees and interest.

Fees

Fees are charged by financial institutions for activities such as reviewing your loan application and servicing the account. Examples of fees include:

- Maintenance fees
- Service charges
- Late fees

Interest

Interest is the amount of money a financial institution charges for letting you use its money.

The rate of interest can be either fixed or variable.

- Fixed rate means the interest rate stays the same throughout the term of the loan.
- Variable rate means the interest rate might change during the loan term. The loan agreement will show the details of the rate changes.

Truth in lending disclosures

Credit terms can be confusing because of the various rates and fees lenders charge.

The Federal Truth in Lending law requires banks to state charges in a clear and uniform manner so consumers can easily compare the actual cost of borrowing.

Lenders must disclose the:

- Amount financed.
- Annual percentage rate (APR).
- Finance charge.
- Total payments.

PRACTICE EXERCISE: BORROWING MONEY RESPONSIBLY

Purpose

To help you make wise decisions about borrowing money.

Instructions

- Read each questions carefully.
- Answer the question.
- Be prepared to explain your answer.

Questions

1. Would you use credit to pay overdue bills? ___

2. Would you use credit to make a purchase even if you could pay cash? ___

3. Would you use credit if you really wanted something but could not afford the monthly payment? ___

THE TRUE COST OF ALTERNATIVE FINANCIAL SERVICES

Getting credit is not cheap. However, getting a bank loan is usually less expensive than other alternatives. We are going to take a look at three of these alternatives.

Rent to own services

Rent-to-own services let you use an item for a period of time by making monthly or weekly payments. If you want to purchase the item, the store will set up a plan for you to rent it until you pay enough to own it.

The store is the legal owner of the item until you make the final payment. If you miss a payment, the store can take the item back. If this happens, you will not own the item, and you will not get your money back.

Rent-to-own agreements are technically loans, so no interest is charged. However, the difference between the cash price and your total payment is like the interest you pay on a loan. Generally, using rent-to-own services is more expensive than getting a consumer installment loan to buy the item outright.

Pay-day loan services

Pay-day loans are usually made to people who need money right away and plan to pay it back with their next paycheck.

Pay-day loans should be used only for emergencies. If you cannot fully repay the loan within a few pay periods, you should consider a longer term loan from a financial institution.

If you do not have the money to pay the loan within the agreed-upon time period, the lender will renew the loan and charge you additional fees. This increases the total amount you owe.

Refund anticipation loan services

Refund anticipation loans are short-term loans secured by your income tax refund. Although the business preparing your income tax return will give you the money, you are actually receiving a loan from a bank or finance company.

Because you do not have to pay any fees associated with obtaining a refund anticipation loan at the time you receive the money, you may not realize how much this loan is really costing you.

When you electronically file (e-file) your tax return and request direct deposit, your refund is often deposited in your bank account within 2 weeks. Sometimes refund anticipation loans take just as long, yet cost you substantially more money.

HOW CREDIT DECISIONS ARE MADE

When you apply for credit, the lender will review the “Four Cs” to decide whether you are a good credit risk (whether you are likely to pay back the loan).

Capacity

Capacity refers to your present and future ability to meet your payments.

Capital

Capital refers to the value of your assets and your net worth.

Character

Character refers to how you have paid your bills or debts in the past.

Banks will use credit reports to obtain character information. You can request a copy of your credit report by contacting any of the three credit reporting agencies.

- Equifax
- Experian (formerly TRW)
- TransUnion

More information about credit reports is covered in the Money Smart module To Your Credit.

Collateral

Collateral refers to property or assets offered to secure the loan.

CHECKLIST FOR CREDIT DECISIONS

Here are some questions you might be asked when applying for credit:

Capacity

- How long have you been in your job?
- How much money do you make each month?
- What are your monthly expenses?

Capital

- How much money do you have in your checking and savings accounts?
- Do you own a house?
- Do you have investments or other assets (e.g., a car)?

Character

- Have you had credit in the past?
- How many credit accounts do you have?
- Have you ever:
  - Filed for bankruptcy?
  - Had any outstanding judgments?
  - Had property repossessed or foreclosed upon?
  - Made late payments?

Collateral

- Do you have assets to provide as collateral to secure the loan beyond your capacity to pay it off?

QUESTIONS TO ASK YOURSELF BEFORE APPLYING FOR CREDIT

- Do I need this?
- Do I need this now?
- Can I wait until I have cash to pay for it?
- Can I get credit?
- How much more will I pay if I buy on credit?
- Can I afford the monthly payments?
- What is the total cost of the credit?
- Are there any fees?
- What is the annual percentage rate?

TIPS FOR MANAGING YOUR CREDIT

Once you get credit:

- If possible, pay off your entire bill each month. If you cannot, try to pay more than the minimum balance due. This will reduce finance charges and total interest paid.

- Pay on time to avoid late fees and to protect your credit history. If you cannot pay on time, call your creditor immediately to explain the situation. The creditor may waive the late fees or be willing to make other payment arrangements.

- Always check your monthly statement to verify that it accurately lists the things you bought. Call your creditor right away if you suspect errors in your statement.

- Ignore offers creditors may send you to reduce or skip payments. You will still be charged finance charges during this period.

- Think about the cost difference if you purchase your item with cash versus if you purchase your item with credit.

WHAT DO YOU KNOW? – BORROWING BASICS

Instructor: ___________________________________ Date:________________________

This form will allow you and the instructors to see what you know about borrowing both before and after the training. Read each statement below. Please circle the number that shows how much you agree with each statement.

	Before-the-Training				**After-the-Training**			
I know:	Strongly Disagree	Disagree	Agree	Strongly Agree	Strongly Disagree	Disagree	Agree	Strongly Agree
1. How to define credit.	1	2	3	4	1	2	3	4
2. Why credit is important.	1	2	3	4	1	2	3	4
3. How to distinguish between secured and unsecured loans.	1	2	3	4	1	2	3	4
4. Three types of loans.	1	2	3	4	1	2	3	4
5. The costs associated with getting a loan.	1	2	3	4	1	2	3	4
6. Why it is important to be wary of rent-to-own, pay-day loan, and refund anticipation services.	1	2	3	4	1	2	3	4
7. How to determine if I am ready to apply for credit.	1	2	3	4	1	2	3	4

EVALUATION FORM

This evaluation will allow you to assess your observations of Introduction to the Borrowing Basics module. Please indicate the degree to which you agree with each statement by circling the appropriate number.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
1. Overall, I felt the module was: [ ] Excellent [ ] Very Good [ ] Good [ ] Fair [ ] Poor					
2. I achieved the following training objectives:					
a. Define credit.	1	2	3	4	5
b. Explain why credit is important.	1	2	3	4	5
c. Distinguish between secured and unsecured loans.	1	2	3	4	5
d. Identify three types of loans.	1	2	3	4	5
e. Identify the costs associated with getting a loan.	1	2	3	4	5
f. Explain why it is important to be wary of rent-to-own, pay-day loan, and refund anticipation services.	1	2	3	4	5
g. Determine if I am ready to apply for credit.	1	2	3	4	5
3. The instructions were clear and easy to follow.	1	2	3	4	5
4. The overheads were clear.	1	2	3	4	5
5. The overheads enhanced my learning.	1	2	3	4	5
6. The time allocation was correct for this module.	1	2	3	4	5
7. The module included sufficient examples and exercises so that I will be able to apply these new skills.	1	2	3	4	5
8. The instructor was knowledgeable and well-prepared.	1	2	3	4	5
9. The worksheets are valuable.	1	2	3	4	5
10. I will use the worksheets again.	1	2	3	4	5
11. The students had ample opportunity to exchange experiences and ideas.	1	2	3	4	5

	None					Advanced
12. My knowledge/skill level of the subject matter before the module.	0	1	2	3	4	5
13. My knowledge/skill level of the subject matter upon completion of the module.	0	1	2	3	4	5

Continued on next page…

EVALUATION FORM (Continued)

Instructor Rating

Please use the response scale and circle the appropriate number.

Response Scale: **5 Excellent** **4 Very Good** **3 Good** **2 Fair** **1 Poor**	**Name of Instructor**
Objectives were clear & attainable	**5 4 3 2 1**
Made the subject understandable	**5 4 3 2 1**
Encouraged questions	**5 4 3 2 1**
Had technical knowledge	**5 4 3 2 1**

What was the most useful part of the training?

____

____

____

What was the least useful part of the training?

____

____

____

GLOSSARY

Annual Percentage Rate (APR)
The APR is the cost of your loan expressed as a yearly percentage rate. The law requires that the APR appear in 18-point font on most credit card applications so that it is easily seen.

Attachment
An attachment is a lien against personal property.

Asset
An asset is something valuable that you own. A property is usually your home.

Bankruptcy
Bankruptcy is a legal declaration of insolvency. Bankruptcy will not fix credit record problems and will be part of your credit history for 10 years. A new law now requires that you get credit counseling before you can file for bankruptcy.

Capacity
Capacity refers to your present and future ability to meet your payments.

Capital
Capital refers to the value of your assets and your net worth.

Character
Character refers to how you have paid your bills or debts in the past.

Consumer Installment Loan
A consumer installment loan is used to pay for personal expenses for you and your family. Examples are automobile loans and unsecured loans for short-term needs, such as buying a computer.

Collateral
Collateral is security you provide the lender. Giving the lender collateral means that you pledge an asset that you own, such as your home, to the lender with the agreement that it will be the repayment source in case you cannot repay the loan.

Credit
Credit is money you borrow to pay for things. It is usually referred to as a loan. You make a promise to pay back the money you borrowed plus some extra. The extra amount is part of the cost of borrowing money.

GLOSSARY (Continued)

Equity
Equity is the value of the home minus the debt, usually in the form of a home loan.

Fees
Fees are charged by financial institutions for activities such as reviewing your loan application and servicing the account.

Finance Charge
The total dollar amount the loan will cost you. It includes items such as interest, service charges, and loan fees.

Foreclosure
Foreclosure is a legal proceeding initiated by a creditor to take possession of collateral that secured a defaulted loan.

Garnishment
Garnishment is a process granted by a court order by which a lender obtains directly from a third party, such as an employer, part of an employee's salary to satisfy an unpaid debt. Part of the employee's salary is taken out in each pay period until the debt is fully paid.

Home Equity Loan
Home equity loans are secured by a property of the borrower. The amount of equity is the value of the property minus the debt. Home equity loans generally can be used for any reason.

Home Purchase Loans
Home purchase loans are made for the purpose of buying a house. These loans are secured by the house you are buying.

Home Refinance Loan
Home refinancing is a process by which an existing home loan is paid off and replaced with a new loan.

Interest
Interest is the amount of money financial institutions charge for letting you use their money. The interest rate can be either fixed or variable. Fixed rate means the interest rate stays the same throughout the term of the loan. Variable rate means the interest rate might change during the loan term, as written in the loan contract.

GLOSSARY (Continued)

Judgment
A court order requiring a debtor to pay money to the creditor. The judgment places a security lien on the debtor's property until the judgment is satisfied (the debt is repaid).

Lien
A lien is a creditor's claim against property to secure repayment of a debt.

Pay-Day Loan
Pay-day loans are usually made to people who need money right away and plan to pay it back with their next paycheck.

Penalty APR
The terms of your credit card agreement may provide that the creditor will permanently increase the interest rate on your credit card by a large amount if you do not pay your credit card bill on time. This is called the penalty APR.

Refund Anticipation Loan
Refund anticipation loans are short-term loans secured by your income tax refund. Although the business preparing your income tax return will give you the money, you are actually receiving a loan from a bank or finance company.

Rent-to-Own Service
Rent-to-own services let you use an item for a period of time by making monthly or weekly payments. If you want to purchase the item, the store will set up a plan for you to rent it until you pay enough to own it.

Repossession
Repossession is the seizure of collateral that secured a loan in default.

Universal Default
Your credit card interest rate can be raised to the highest possible rate if you are late on any other account. For example, if you have five credit cards and you are late on one, the interest rate for the other four cards may be increased by a large amount.

Unsecured Loan
An unsecured loan is not backed by collateral. Credit cards are examples of unsecured loans.

FOR FURTHER INFORMATION

Federal Deposit Insurance Corporation (FDIC)
Division of Supervision & Consumer Protection
2345 Grand Boulevard, Suite 1200
Kansas City, Missouri 64108
1-877-ASK-FDIC (1-877-275-3342)
Email: consumer@fdic.gov
www.fdic.gov

U.S. Financial Literacy and Education Commission
MyMoney.gov is the U.S. Government's website dedicated to teaching all Americans about financial education.

Whether you are planning to buy a home, balancing your checkbook, or investing in your 401k, the resources on MyMoney.gov can help you.

Throughout the site, you will find important information from 20 Federal agencies.

www.mymoney.gov
1-888-My-Money (1-888-696-6639)