PART 2:
MANAGING YOUR MONEY

Chapter 7

Using Consumer Loans: The Role of Planned Borrowing

Learning Objectives

- Understand the various consumer loans.
- Calculate the cost of a consumer loan.
- Pick an appropriate source for your loan.
- Get the most favorable interest rate possible on a loan.
- Know when to borrow.
- Control your debt.

Single-Payment Versus Installment Loans

Single-Payment

- Single lump-sum payment at maturity.
- Pay back principal and interest.
- Have short maturities – less than 1 year.
- Used as a bridge or interim loan.

Installment

- Repayment of principal and interest at various intervals.
- With each payment, the interest portion decreases and principal increases; called loan amortization.
- Used for financing cars, and other big-ticket items.

Secured Versus Unsecured Loans

Secured

- Guaranteed by a specific asset.
- If loan payments are not covered, the asset is seized.
- Collateral reduces risk, so lower interest rate.

Unsecured

- Requires no collateral.
- Large loans given only to those with excellent credit.
- Quite expensive, since lender only has the borrower's promise to pay.

Variable-Rate Versus Fixed-Rate Loans

Variable-Rate

- Adjustable rate tied to market interest rate.
- Based on prime rate or 6 month T-bill.
- Borrower pays prime plus additional percent.
- Adjust monthly or annually, has rate caps.
- Borrower risks rate increase.

Fixed-Rate

- Isn't tied to changing market interest rates.
- Maintains a single rate for duration of loan.
- Most consumer loans are fixed.
- May cost more than variable rate.
- Lender risks rate increase.

The Loan Contract

- Security agreement states if purchased item will be used as collateral.
- Note states payment schedule and rights of borrower and lender if default.
- A note is standard on all loans, security agreement is standard on secured loans.

The Loan Contract

Insurance Agreement Clause

- Must purchase insurance to pay off loan if death.

Acceleration Clause

- If one payment is missed, entire loan is due immediately.

Deficiency Payments Clause

- If default on secured loan, lender reposes item and borrower is billed for difference if necessary.

Recourse Clause

- Define lenders actions if default (attach wages).

Special Types of Consumer Loans

- Home Equity Loans – secured loan using equity in home as collateral.
  - Advantages:
    - Interest is tax deductible up to $100,000.
    - Carry lower interest than other consumer loans.
  - Disadvantages:
    - Puts your home at risk.
    - Limits future financing flexibility.

Special Types of Consumer Loans

- Student Loans – low, federally subsidized interest, based on financial need to those progressing towards a degree.

- Federal Direct/Stafford Loans:
  - Federal government makes direct loan to student/parents through financial aid office.

- PLUS Direct/PLUS Loans:
  - Loans are made by private lenders such as banks and credit unions to parents.

Special Types of Consumer Loans

- Automobile Loans – loan secured by auto.
  - Duration usually for 24, 36, or 48 months.
  - Low rates used as marketing tool on slow selling vehicles.
  - Repossession if default on loan.

Cost and Early Payment of Consumer Loans

- Truth in Lending Act requires written notification of total finance charges and APR before signing.
- APR is the annual percentage rate showing the simple percentage cost of all finance charges over the life of the loan, on annual basis.

Cost and Early Payment of Consumer Loans

- Finance charges include all costs associated with the loan:
  - Interest payments
  - Loan processing fees
  - Credit check fees
  - Insurance fees

Payday Loans

- Payday loans:
  - Given by check cashing companies.
  - Aimed at those who need money until their next "payday."
  - Cost comes in form of a fee - $20-$30 for a 1- or 2-week loan.
  - Banned in some states.

Cost of Single-Payment Loans

- Two ways loans are made:
- Simple Interest Method:
  - Interest = principal x interest rate x time.
  - Stated interest and APR are the same.
- Discount Method:
  - Entire interest charge is subtracted from loan principal before receiving the money.
  - Pay entire principal amount at maturity.
  - Stated interest and APR will differ.

Cost of Single-Payment Loans

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Cost of Installment Loans

- Repayment of both interest and principal occurs at regular intervals.
- Payment levels are set so loan expires at a preset date.
- Use either simple interest or add-on method to determine what payment will be.

Cost of Installment Loans

Simple Interest Method

- Most common method of calculating payments.
- Monthly payments are the same, but portion to principal increases over the loan.

Add-On Method

- Interest charges are calculated using original balance.
- Charges are added to loan and are paid off over loan's life.
- Can be costly, should be avoided.

Early Payment

- If installment loan is repaid early, determine amount of principal still owed.
- Most common method for add-on loan is Rule of 78 or sum of the year's digits.
- Rule of 78 determines what proportion of each payment goes towards principal.

Relationship of Payment, Interest Rate, and Term of the Loan

- How does the duration of loan and interest rate affect size of payments?
  - As interest rates rise, so do the monthly payments and finance charges.
  - Increasing the maturity will lower the monthly payments, but result in higher total finance charges.
  - Lenders charge a lower interest rate on shorter-term loans.

Sources of Consumer Loans

- Inexpensive sources:
  - The least expensive source of funds is your family.
  - Home equity loans and other secured loans are inexpensive.
  - Insurance companies that lend the cash value of life insurance policies also offer low rates.

Sources of Consumer Loans

- More Expensive Sources:
  - Credit unions, S&L's, and commercial banks.
  - Exact cost depends on type of loan (secured or unsecured), length of loan, and fixed or variable rate loan.
- Most Expensive Sources:
  - Retail stores, finance companies, or small loan companies.

How and When to Borrow

- How do you get a favorable rate?
  - Have a strong credit rating.
  - Loan must be relatively risk-free.
    - Use variable rate loan.
    - Keep loan short-term.
    - Provide collateral.
    - Apply large down payment.
  - Debt affects future financial flexibility.

How and When to Borrow

Borrow If:

- After-tax cost of borrowing < after-tax lost return from using savings to purchase the asset.

Pay Cash If:

- After-tax cost of borrowing > after-tax return from using savings for purchase.

How and When to Borrow

- When you borrow to invest:
  - Hope to receive an income stream that offsets the cost of borrowed funds.
  - Borrow with the goal of building wealth.
  - Earnings > cost of borrowed funds.

Controlling Your Use of Debt

- Determine how much debt you can comfortably handle.
  - This changes during different stages of life.
    - Earlier years, debt builds up.
    - Later years, income rises and debt declines.

Controlling Your Use of Debt

- Debt Limit Ratio measures the percentage of take-home pay committed to non-mortgage debt.
  - Total debt can be divided into consumer debt and mortgage debt.
  - Ratio should be below 15%.

Controlling Your Use of Debt

28/36 Rule

- A good credit risk when mortgage payments are below 28% of gross monthly income, and total debt payments are below 36%.

Debt Resolution Rule

- Debt resolution rule helps control debt obligation, excluding borrowing for education and home financing, by forcing you to repay all outstanding debt obligations every 4 years.
- Logic is that consumer credit should be short-term.

What To Do If You Can't Pay Your Bills

- Go to creditors to get help resolving your situation or see a credit counselor.
- Consider using savings to pay off debt.
- Use a debt consolidation loan to lower monthly payment and restructure debt.
- Final alternative is personal bankruptcy.

What To Do If You Can’t Pay Your Bills

- Personal bankruptcy doesn’t wipe out all obligations.
- Chapter 13 The wage earner plan
- Chapter 7 Straight bankruptcy
- Chapter 11 For businesses or those exceeding debt limitations or lack regular income.
- Chapter 12 Available to family farmers.

Chapter 13: The Wage Earner Plan

- To file for Chapter 13, you must have:
  - Regular income
  - Secured debts under $922,975
  - Unsecured debts under $307,675
- Repayment schedule is designed to cover your normal expenses while meeting repayment obligations.
- For creditors, it means controlled repayment with court supervision.

Chapter 7: Straight Bankruptcy

- Allows individuals who don't have any chance of repaying debts to eliminate them and begin again.
- While you will not lose everything, courts confiscate and sell most assets to pay off debts.
- Some debts remain including child support, alimony, student loans, and taxes.

Chapter 7: Straight Bankruptcy

- To qualify, you must pass a “means test” and cannot file Chapter 7 bankruptcy if:
  - Income is higher than median in your state.
  - Have more than $100 in monthly disposable income.
  - Have sufficient disposable income to repay at least 25% of your debt over 5 years.