PART 2:
MANAGING YOUR MONEY

Chapter 6

Using Credit Cards: The Role of Open Credit

Learning Objectives

- Know how credit cards work.
- Understand the costs of credit.
- Describe the different types of credit cards.
- Know what determines your credit card worthiness and how to secure a credit card.
- Manage your credit cards and open credit.

A First Look at Credit Cards and Open Credit

- Credit involves receiving cash, goods, or services with an obligation to pay later.
- Open credit (revolving credit) is a line of credit extended before the purchase.
  - Pay back debt at whatever pace you like, paying a specified minimum balance each month.
- Unpaid balance plus interest carries over to next month.

Interest Rates

- The main determinant of the cost of a line of credit is the annual percentage rate (APR). This is the true simple interest rate paid over the life of the loan.
- APR is calculated the same way by all lenders, but there can be a difference in what is included.
- The Truth in Lending Act requires disclosure of APR in bold print for all consumer loans.

Interest Rates

Variable Rate Cards

- Are tied to another interest rate, usually the prime rate.
- Charge prime plus a percentage.
- In 2005, the national average APR was 13.4%.

Fixed Rate Cards

- The interest rate may change once the card company notifies the cardholder.
- In 2005, the national average APR was 12.9%.

Calculating the Balance Owed

- The method of determining the balance (balance calculation method) varies from one credit account to another.
- Remember: If you pay off your outstanding balance each month and don't carry a balance, there is no interest charge.
- 71% of cardholders ages 25-34 **<u>don't</u>** pay off their credit cards every month.

Calculating the Balance Owed

- 3 ways to determine interest charges on unpaid balances:
  - Average daily balance method
  - Previous balance method
  - Adjusted balance method
- There are numerous variations on these methods, including a two-cycle average daily balance.

Calculating the Balance Owed

Average Daily Balance Method

- The most common method - used by 95% of bank card issuers.
- Sum of daily balances/number of days in billing period.
- Interest payments are based on this balance.

Calculating the Balance Owed

Previous Balance Method

- Interest payments are charged against what was owed at the end of the previous billing period, with no credit given for the current month's payments.
- This method is very simple – but very expensive.

Calculating the Balance Owed

Adjusted Balance Method

- Interest is charged against the previous month's balance only after subtracting payments.
- Results in lower interest charges than the previous balance method.
- A favorable variation of the previous balance method.

Buying Money: The Cash Advance

- Cash advances at ATMs are just like taking out a loan.
  - Begin to pay interest immediately.
- Higher interest rate charged on cash advances and an up-front fee of 2-4% of the amount advanced.
- May be required to pay down the balances for purchases before paying down the higher interest rate cash advance.

Grace Period

- Grace period of 20-25 days is common, interest is then charged on outstanding balance.
  - About 25% of credit cards do not have a grace period.
- Finance charges may not be assessed against credit card purchases for nearly 2 months.
- No grace period with cash advances.
- Usually, if previous balance is not paid off, then the grace period does not apply.
  - Pay interest immediately on new purchases.

Annual Fee

- Some issuers impose an annual fee for using the credit card.
  - Typical charge of $10-$100, but AmEx charges $300 for Platinum card.
- Over 70% of biggest credit card issuers do not charge an annual fee.
- Many don't charge the fee if the card is used at least once a year.
- Merchant pays a percentage of the sale, called the "merchant's discount fee."

Pros and Cons of Credit Cards

Advantages

- Necessary part of today's society
- Convenience
- Source of temporary funds
- Use product before paying for it
- Bill consolidation
- Extended warranties

Disadvantages

- Too easy to spend money
- Lose track of spending
- Spend more than original amount due to interest
- Obligating future income
- Less budget flexibility when paying off credit card expenditures

Bank Credit Cards

- Credit card issued by a bank or large corporation.
- Visa and MasterCard don't issue cards themselves.
  - They are a franchise.
- Wide acceptance of bank cards with over 7,000 to choose from.
- Co-branded or "rebate" cards have a brand name on the card (GM) and may charge an annual fee.
- Discover Card is issued by one bank, no annual fee.

Bank Card Variations

- There are several different card classes, referring to credit levels of cardholder.
  - Standard – limits $500-$3000
  - Gold - $5000 and up, plus incentives
  - Premium or prestige – as high as $100,000 plus benefits

Bank Card Variations

- Affinity card
  - Credit card issued in conjunction with a charity or organization.
  - Card bears sponsor's name and the sponsor receives a portion of the annual fee or percent of purchases.
- Secured credit card
  - Regular bank card backed by collateral.
  - Asset lost if you can't pay off the charges.

Travel and Entertainment Cards

- Travel and entertainment cards (T&E)
  - Initially aimed at business customers, providing a means of paying for travel and other business expenses.
  - Do not offer revolving credit, requiring full payment of balance each month.
  - Have an interest-free grace period.
  - Issuers receive annual fee, up to $300 per year, and the merchant’s discount fee.
  - American Express, Diners Club, and Carte Blanche are the primary issuers.

Single-Purpose Cards

- A single-purpose card can be used only at a specific company.
  - Companies issue these to avoid merchant's discount fees.
  - Terms vary greatly for each issuer, with some offering revolving credit.
  - Typically, they don't charge an annual fee.

Traditional Charge Account

- A traditional charge account is offered by a business.
  - Utility companies and doctors provide services to you and bill you later.
  - This payment system is a type of open credit account – one without cards.
  - You are expected to pay monthly bill in full.

Getting a Credit Card

- Should a student get a credit card?
- Yes!
  - It can be used for emergencies.
  - By using it prudently, a student can build up a solid credit history.

Credit Evaluation: The Five C’s of Credit

- Creditworthiness is determined by 5 C’s:
  - Character Sense of responsibility
  - Capacity Current income and borrowing
  - Capital Size of financial holdings/investments
  - Collateral Assets offered as security
  - Conditions Impact of economic environment on your ability to repay

Your Credit Score

- A credit bureau is a private organization that maintains credit information on individuals, which it allows subscribers to access for a fee.
  - Experian, Trans Union, and Equifax are examples.
- They compile a credit report on you and assign a credit score.
- Your credit information not only impacts whether you get a loan, it affects your interest rate.

Determining Creditworthiness

- Your credit information translates into a three digit number – your credit score – which measures your creditworthiness.
- Involves the numerical evaluation or "scoring" of applicants.
- Reduces the lender's uncertainty, enabling the lender to make credit available to good risk customers at lower interest rates.

How Your Credit Score is Computed

- A credit score is referred to as a FICO score.
  - Based on models developed by Fair Isaac Corporation.
- The models begin with information on your report, using it to calculate your score.
- Scores range from 300-850, median 723
  - The majority are between 600 and 800.
  - They vary from one credit bureau to another.
- Visit www.myfico.com/ScoreEstimator.html to get an estimate of your score.

How Your Credit Score is Computed

- What is a good score?
  - The national average is 678.
  - This is often the minimum for receiving credit.
- A good credit score doesn’t just mean that you’ll get a loan, it also means you’ll pay less for it.
- A low FICO score may result in a credit card rate twice that of a high FICO score.

What's in Your Credit Report?

- Identifying Information: Name, address, date of birth, SS number, and employment information.
- Trade Lines or Credit Accounts: Type of account, balance, date opened, payment history, and current status.

What's in Your Credit Report?

- Inquiries: Lists everyone who has accessed your report in the last 2 years.
- Public Record and Collection Items: Bankruptcies, foreclosures, law suits, wage attachments, and liens.

Factors That Determine Your Score

- Your Payment History (35%)
- Amount You Owe and Your Available Credit (30%)
- Length of Credit History (15%)
- Types of Credit Used (10%)
- New Credit (10%)

Factors That Determine Your Score

Your Payment History

– Lenders want to know how you have handled credit payments in the past.

Amount You Owe and Your Available Credit

– Shows the amount you owe on your mortgage, car loan, and all other outstanding debt, along with your total available credit.

Factors That Determine Your Score

Length of Credit History

- The longer the credit accounts have been opened, and the longer you have had accounts with the same creditor, the higher your credit score.

Types of Credit Used

- The wider the variety of credit, the higher the score.
- Using different types of credit indicates you know how to handle your money.

Factors That Determine Your Score

New Credit

- New applications for credit will lower your score.
- Those moving towards bankruptcy take all available credit to stay afloat.

Monitoring Your Credit Score

- Monitor your score to ensure there are no errors.
- The Fair and Accurate Credit Transactions Act (FACT Act) allows you to request one free copy of your credit report each year.
- Visit www.annualcreditreport.com to receive information about your free credit report.

The Credit Bureau and Your Rights

- Congress passed the FACT Act in 2003.
  - Allowing individuals a free credit report annually.
- Contact the bureaus regarding incomplete or inaccurate information in your report.

The Credit Bureau and Your Rights

- You have the right to have a statement in your file presenting your view.
- Bankruptcy information can only remain in your file for 10 years.

If Your Credit Card Application is Rejected

- If your credit card application is rejected, you have 2 choices:
  - Apply for a card with another financial institution.
  - Find out why you have been rejected.
    - Set up an appointment with credit card manager.
    - Address the problem.