# HOME ECONOMICS GUIDE

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# Shopping for Consumer Credit


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Credit means buying now and paying later. Credit also means becoming indebted to someone for something. With credit you may use a product, a service, or money and pay for it later. By so doing, you incur a debt which must be paid. Whenever you become indebted you are charged an additional amount for the use of the product, the service, or money before you pay for it. This additional charge is called the **finance charge.**

Two terms are essential in understanding credit—**finance charge** and **annual percentage rate,** commonly called the **APR.**

The finance charge is the total of all costs which you must pay, directly or indirectly, for credit. The annual percentage rate is the relative cost of credit in percentage terms.

Lending institutions are required by the truth-in-lending law to give this information to the borrower in writing. Rates quoted orally might not be the same as rates quoted in writing. Insist on the proper rate quotation and disregard other rates that may be given. The annual percentage rate will be the rate by which you can compare the cost of credit.

The type of credit agreement, the source, and your credit rating are all factors which determine the amount that you pay for consumer credit.

## Types of Consumer Credit

- **Charge accounts,** also known as regular 30-day accounts, are accounts which are due in full at a specified future date, usually 15 to 30 days from date of billing. Generally, there is no charge if payment is made within the specified period. An example of this type of credit is your monthly utility bill.
- **Revolving credit accounts** differ from a regular charge. A maximum balance per customer is established and new purchases may be made as long as the balance remains below the maximum. Also, a monthly minimum payment of only a portion of the balance, usually 10 percent, is required, but any amount above that may be paid. A finance charge is made on the unpaid balance.
- **Credit cards** are of several types. *Single-use* credit cards are issued by department stores and oil companies. This kind of credit card is issued for the convenience of the consumer and to promote brand or store loyalty. It provides the easy credit features of the revolving charge account with the convenience of the regular 30-day charge. Most goods and services available from the issuing company can be charged on the card. If the bill is paid within the allowable period, usually 25 to 30 days from the date of the billing, there is not direct charge for using credit. After that period, however, a charge is made on the unpaid balance.

*Travel and entertainment* credit cards were originally designed for people who traveled a great deal and wanted to charge most expenses. An annual membership fee, usually beginning at $20 a year, is paid for this card. There is no additional finance charge if the account is paid within 30 days of billing. After this time, however, a charge is made on the unpaid balance.

*Bank* credit cards are in wide use now. These cards may be issued by one bank, a group of banks, or an independent credit card company. They offer the convenience and ease of credit features of the regular 30-day charge and the revolving charge account. Small cash loans, as well as goods and services, may be charged to this account and repayment must be made just as for any other purchase. Many cards are now charging interest from the day of purchase, assessing a minimum finance charge for each billing period when the card is used, or charging an annual fee.

A bank card also offers an extended payment supplement. This means you can borrow an amount over your regular credit limit for a specific item. This type of credit must have special approval from the card-issuing company and the card holder must specify the repayment period prior to approval. All transactions related to a sale under the extended payment supplement are identified separately on the monthly statement.

- The **installment sale** is a familiar type of credit which offers many variations. It is generally used for major purchases, but may also be used in the purchase of smaller items. An installment sale involves a contractual agreement in which a down payment or trade-in is usually made and a predetermined amount is paid periodically until the entire debt is satisfied. The finance charge is added to the price of the merchandise and included as a portion of the subsequent payments. Rates vary widely, depending on the seller, the merchandise purchased, and the debtor's credit rating.

Contracts vary from sale to sale and the customer should read and understand all terms of the contract before signing.

*Mindy Martin, graduate student in Family and Consumer Economics, assisted with the revision of this publication.*



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● **Cash Loans** may be obtained from a variety of sources with an even wider variety of finance charges. They may be repayable in regular installments or by a single payment made for the loan, plus the finance charge, at the end of the time period. The lending agency, the credit rating of the debtor, the purpose of the loan and the collateral available are determining factors in the total finance charge.

## Sources of Consumer Credit

● **Banks** lend money for a variety of reasons. Some small loans may be made on the debtor's signature only (unsecured), while large loans usually require some security (secured).

Most consumer bank loans are repaid on the installment basis, much like an installment sales plan. The annual percentage rate compares favorably with other sources, but standards for qualifying for a loan may be higher than those of other creditors.

Many banks also offer an automatic overdraft or advance to their checking account customers. To use this feature, the customer must qualify in advance for such a loan and a ceiling is placed on the amount a customer may borrow. To activate such a loan, all the customer has to do is write a check for more than the amount that is in the checking account. Repayment is made either through regular installments or from the next deposit into the account.

● **Savings and loan associations** have recently been allowed by law to expand their consumer lending options. In addition to the traditional cash loans secured by the borrower's savings account, savings and loans can now offer credit cards, overdrafts, or NOW accounts (Negotiable Order of Withdrawal—interest bearing checking accounts), and other types of consumer credit.

The annual percentage rate and qualification standards for a loan are comparable to those at commercial banks.

● **Credit unions** make consumer loans from money deposited by members. In addition to consumer loans, some credit unions are now in the mortgage market. Loans from credit unions are usually the lowest cost loans available to persons who are members.

Many credit unions offer share draft accounts that operate much like a checking account. Those credit unions that offer this account also offer automatic overdrafts or advances much the same as commercial banks and savings and loans.

● **Consumer finance (small loan) companies** specialize in small cash loans to all income and occupation groups. The debtor need not have as high a credit rating as is usually demanded by other institutions, although most loans are made on signature only. Because of this added risk, finance charges are usually higher than those of most other lending agencies. Debts are repaid in monthly installments which include the finance charge. The debtor may be required to purchase life insurance payable to the loan company, which increases the cost of the loan.

● The cash surrender value of a **whole life insurance policy** has been one of the least expensive sources of loans available. The policyholder can borrow 90 to 100 percent of the amount of the cash surrender value of the policy. However, the amount outstanding on the loan is deducted from the face value of the policy if the insured dies before repaying the loan. No demand for payment is made, so it is easy to ignore the loan and not return the policy to its full face value, thus decreasing the amount of coverage of the policy.

The cash surrender value of a whole life policy is the savings that has been built up within the policy because the insured pays premiums that are larger than the amount needed to provide the protection. Policy values and premiums are based, in part, on the assumption that the cash value is invested by the company. When the insured borrows from the cash value, he becomes the investment outlet for those funds, and thus must pay interest on the loan. The interest charged on such loans has been quite modest—less than the company could earn by investing the money elsewhere. However, the high interest rates that have prevailed in recent times are causing companies to develop policy loan provisions that will require policyholders to pay closer to market rates on cash value loans; thus such loans will no longer be as attractive to the policyholder as they have been.

● **Friends and relatives** are sometimes a loan source; however, such loans frequently result in friction between the parties involved. No generalizations can be made as to usual interest rate. These loans, if used, should be entered into with a contract which clearly states all terms of the agreement; signed by the parties involved.

●**Unlicensed lenders,** commonly known as loan sharks, operate outside the law. The finance charge made by these illegal lenders is frequently over 1,000% per year. This type of loan should never be considered.

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