F1 – PROJECT-STAGE 12: PERSONAL CREDIT RATING AND PERSONAL CREDITS FOR CONSUMPTION

TCHE322

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Schedule of lectures

Project topic covered

- Personal credit ratings
- Consumption credits

Groupwork project activities

- Analyze the pros and cons of different consumption loans offered by different organizations
- Make decision

Personal finance planning process

1. Define financial goals.

2. **Develop financial plans** and strategies to achieve goals.

3. Implement financial plans and strategies.

4. Periodically develop and implement budgets to monitor and control process toward goals.

5. Use financial statement to evaluate results of plans and budgets, taking corrective action as required.

6. Redefine goals and revise plans and strategies as personal circumstances change.

Essential Information of personal financial plans *

1. A summary of the goals
2. Significant assumptions and justification
3. **Estimates**
4. **Recommendations**
5. A description of limitations on the work performed
6. The recommendations in the engagement should contain qualifications to the recommendations if the effects of certain planning areas on the client's overall financial picture were not considered.

- Asset acquisition
- Liability and insurance
- Savings and investment
- Employee benefit
- Tax
- Retirement and estate

** Adapted from Paragraph .35, Statement on Standards in Personal Financial Planning Services No. 1*

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Using Credit

LEARNING OUTCOMES

1 Describe the reasons for using consumer credit and identify its benefits and problems

2 Develop a plan to establish a strong credit history

3 Distinguish among the different forms of open account credit

4 Apply for, obtain, and manage open forms of credit

LEARNING OUTCOMES *(continued)*

5 Choose the right credit cards and recognize their advantages and disadvantages

6 Avoid credit problems, protect yourself against credit card fraud, and understand the personal bankruptcy process

The Basic Concepts of Credit

- Why we use credit
  - *Avoid paying cash for large outlays*
  - *Meet a financial emergency*
  - *Convenience*
  - *Investment purposes*
- Improper uses of credit
  - *Meet basic living expenses*
  - *Make impulse purchases*
  - *Purchase non-durable goods*

Credit Crisis on Borrowers

- Households were unable to repay the mortgages
- Monthly consumer credit payments (excluding mortgage) should not exceed 20% of monthly net income

$$\textbf{Debt Safety Ratio} = \frac{\textbf{Monthly consumer credit payments}}{\textbf{Monthly take-home pay}}$$

Establishing Credit

- Open checking and savings accounts
- Build a strong credit history
    - *Inform the lender if there is a delay in payment*
    - *Limit your usage to your abilities to repay*

Exhibit 6.2 Credit Guidelines Based on Ability to Repay

According to the debt safety ratio, the amount of consumer credit you should have outstanding depends on the monthly payments you can afford to make.

	Monthly Consumer Credit Payments		
Monthly Take-Home Pay	***Low* Debt Safety Ratio (10%)**	***Manageable* Debt Safety Ratio (15%)**	***Maximum* Debt Safety Ratio (20%)**
$1,000	$100	$150	$200
1,250	125	188	250
1,500	150	225	300
2,000	200	300	400
2,500	250	375	500
3,000	300	450	600
3,500	350	525	700
4,000	400	600	800
5,000	500	750	1,000

Credit Cards and Other Open Account Credit

- Credit extended to consumer prior to a purchase
- Consumer can buy up to a specified credit limit
- Offered by retailers and financial institutions
- Monthly credit statements
- Pay balance in full to avoid interest

Bank Credit Cards

Line of credit

Cash advances

Interest rates and fees

Special Types of Bank Credit Cards

Reward cards	Frequent flyer programs	Auto rebate programs
Other merchandise rebates	Affinity cards	Secured (collateral) credit cards
	Student credit cards	

Computing Finance Charges

- ***Annual percentage rate (APR)***
  - *True rate of interest over life of loan*
  - *Includes all fees and costs*

Avoiding Credit Problems

- Use discipline when purchasing
- Reduce number of cards
- Be selective in accepting preapproved credit
- Limit new charges
- Pay more than the minimum
- Pay off cards with highest finance charges first
- Transfer balances to card with lowest rate

Credit Card Fraud

- Don’t give account number to organizations who call you
- Use secure internet sites
- Never put credit card information on checks
- Destroy old cards and shred old statements
- Report lost or stolen cards immediately

Bankruptcy – Paying the Price for Credit Abuse

- **Personal bankruptcy**: Petition for request for protection from creditors
- **Wage earner plan:** Debt restructuring
- **Straight bankruptcy**: Wipe the slate clean and starting anew

KEY TERMS

- Debt safety ratio
- Open account credit
- Credit limit
- Bank credit card
- Line of credit
- Cash advance
- Base rate
- Grace period
- Reward credit card
- Affinity cards
- Secured cards
- Student credit card
- Retail charge card
- Debit card
- Revolving line of credit
- Overdraft protection line
- Unsecured personal credit line
- Home equity credit line
- Credit investigation
- Credit bureau
- Annual percentage rate
- Average daily balance

SUMMARY

- Consumer credit plays a major role in the personal financial planning process
- Different forms of credit are used for the sake of convenience
- Credit cards and other forms of credit need to be used wisely
- Understanding the advantages and disadvantages of credit cards are very important

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Using Consumer Loans

LEARNING OBJECTIVES

1. Know when to use consumer loans and be able to differentiate between the major types
2. Identify the various sources of consumer loans
3. Choose the best loans by comparing finance charges, maturity, collateral, and other loan terms
4. Describe the features of, and calculate the finance charges on, single-payment loans

LEARNING OBJECTIVES *(continued)*

5 Evaluate the benefits of an installment loan

6 Determine the costs of installment loans and analyze whether it is better to pay cash or to take out a loan

Consumer Loans

- Formally negotiated contracts that specify the borrowing terms and repayment
- Types
  - *Auto loans*
  - *Loans for other durable goods*
  - *Education loans*
  - *Personal loans*
  - *Consolidation loans*

Exhibit 7.1 Federal Government Student Loan Programs at Glance

More and more college students rely on loans subsidized by the federal government to finance all or part of their educations. There are three types of federally subsidized loan programs, the basic loan provisions of which are listed here. These loans all have low interest rates and provide various deferment options and extended repayment terms. (*Note: Loan rates and terms shown here are for the 2014–2015 school year.*)

	Type of Federal Loan Program		
Loan Provisions	**Stafford Loans***	**Perkins Loans**	**PLUS Loans**
Borrower	Student	Student	Parent
Interest rate	4.66% (undergrad) 6.21% (grad/professional)	5%	7.21%
Borrowing limits	*Dependent students:* $23,000 (undergrad); 5.41% (grad/professional); $65,500 (grad/professional) *Independent students:* $57,500 (undergrad) $65,500 (grad/professional)	$27,500 (undergrad) $60,000 (grad/professional)	No total dollar limit: Cost of attendance minus any other financial aid received
Loan fees	1.072% of loan origination fee	None	4.204% of loan amount
Loan term	10–25 years	10 years	10 years

*Data are subsidized undergraduate Stafford loans and unsubsidized graduate or professional Stafford loans, and interest rates are as of August of 2014. Stafford loans can be subsidized or unsubsidized and the lifetime limits can differ. Subsidized Stafford loans also have annual borrowing limits. Perkins loans have annual limits of $5,500 per year of undergraduate study and $8,000 per year of graduate school.

Source: http://www.fastweb.com and http://www.staffordloan.com, accessed August 2014.

Consumer Loans

Single-payment loan	Installment loan	Fixed-rate loans	Variable-rate loans
• *Payment is due in full after specified period*	• *Repaid in a series of fixed, scheduled payments*	• *Interest rate and payments remain the same*	• *Interest rate and payments change periodically*

Acquiring Consumer Loans

- Commercial banks
- Consumer finance companies
- Credit unions
- Savings and loan associations
- Sales finance companies
- Life insurance companies

Managing Credit

- Finance charges
- Loan maturity
- Total cost of the transaction
- Collateral
- Other loan considerations
    - *Payment date, prepayment penalties, late fees*

Keeping Track of Debt

- List all outstanding consumer debt
- Include
  - *Installment loans*
  - *Student loans*
  - *Single-payment loans*
  - *Credit cards*
  - *Revolving credit lines*
  - *Overdraft protection lines*
  - *Home equity credit lines*

Single-Payment Loans

- Repaid in full on a given due date
- Payment consists of principal and interest charges
- Interim interest payments must be made at times
  - *Payment at maturity = principal + unpaid interest*
- Can be secured or unsecured
- Can be taken out for any purpose

Features of the Loan

Loan collateral

Loan maturity

Loan repayment

Loan Collateral

- **Lien**: Legal claim permitting the lender to liquidate the items serving as collateral to satisfy the obligation
- **Chattel mortgage**: Mortgage on personal property given as security for the payment of an obligation
- **Collateral note**: Legal note giving the lender the right to sell collateral

Loan Repayment

- **Prepayment penalty**: Additional charge you may owe if you decide to pay off your loan prior to maturity
- **Loan rollover**: Process of paying off a loan by taking out another loan

Calculating Financial Charges

Simple interest method

- Interest is charged on the actual loan balance outstanding

Discount method

- Interest is computed and then subtracted from the principal, with the remainder goes to the borrower
- Finance charges paid in advance
- Annual Percentage Rate is higher than stated interest rate

Simple Interest Method and Annual Percentage Rate

- Simple interest
  - *Finance charge = principal loan amount x stated annual interest rate x term of loan*
    - $F_S = P \times r \times t$
- Annual percentage rate
  - $\text{APR} = \dfrac{\text{Average annual finance charge}}{\text{Average loan balance outstanding}}$

Discount Method

- Calculates finance charges in which interest is computed and then subtracted from the principal, with the remainder being disbursed to the borrower
  - $F_d = F_s = P \times r \times t$
  - *Where,*
    - *Fd = Finance charge calculated using discount method*
    - *Fs = Finance charge calculated using the simple interest method*
    - *P = Principal amount of loan*
    - *r = Stated annual rate of interest*
    - *t = Term of loan*

Installment Loans

- Repaying the debt in a series of installment payments
- Convenient loan repayment
- Types
  - *Car loans*
  - *Home furnishings*
  - *Appliances*
  - *Entertainment centers*
  - *Camper trailers*

Methods of Computing Finance Charges

Simple Interest

- Interest is charged on the outstanding balance
- Loan principal declines with monthly payments
- Amount of interest being charged decreases

Add-on method

- Financial charges on original loan balance
- Adding the interest to that balance

Prepayment Penalties

- Additional charge one may owe if he/she decides to pay off their loan prior to maturity
- **Rule of 78s**
  - *Known as sum-of-the-digits method*
  - *Calculating interest that has extra-heavy interest charges in the early months of the loan*

Loan or Cash Dilemma

- Paying cash - Purchase costs more to borrow the money than one can earn in interest
- Loan - Purchase costs less to borrow the money than one can earn in interest

KEY TERMS

- Consumer loans
- Collateral
- Single-payment loan
- Interim financing
- Installment loan
- Consumer finance company
- Sales finance company
- Captive finance company
- Cash value
- Loan application
- Lien
- Chattel mortgage
- Collateral note
- Prepayment penalty

KEY TERMS

- Loan rollover
- Loan disclosure statement
- Simple interest method
- Discount method
- Add-on method
- Rule of 78s

SUMMARY

- Consumer loans are important to the personal financial planning process
- Consumer loans can be used for any purpose
- Various sources provide consumer loans
- Single-payment loan and installment loans are types of consumer loans

Groupwork project activities

- Analyze the pros and cons of different consumption loans offered by different organizations
- Make decision