Credit and Credit Cards

What's Next Project

Credit Cards

They are all around you. Most people have at least one. Some have many. They are credit cards. A credit card allows you to pay for merchandise or services by borrowing against a line of credit. You then make monthly payments on the outstanding balance.

For example, suppose a bank offers you a credit card with a line of credit of $10,000. That means that you can purchase up to $10,000 of merchandise or services. Rather than being withdrawn immediately from your bank account as would occur with a debit card, the amount is essentially lent to you by the credit card company.

Each month, you will receive a bill from the credit card company. You have the option to pay the entire amount. However, you may also make a minimum payment. The minimum payment is the lowest amount that you are required to pay on your credit card debt.

A credit card company may allow you a grace period. The grace period is the length of time from when you make a purchase to when the company begins charging you interest on that purchase. If there is not a grace period, interest will start accumulating immediately.

After the grace period ends, the credit card company begins charging interest on your balance. The interest you pay on the money you owe to the credit card company is known as the finance charge. Many companies compute a monthly finance charge based on your average daily balance for the month and charge-interest on that amount. Others calculate finance charges on the average daily balance plus any new purchases.

This finance charge is expressed as an annual percentage rate (APR). The APR is often between 10% and 21%. An APR of 18%, for example, does not mean you are paying 18% every month. It is what you would pay over the course of a year. Instead, you would pay 1/12 of 18%, or 1.5%, every month.

You should compare the APR for different credit cards before selecting one. Some credit card companies may offer an introductory rate. An introductory rate is a temporary, lower APR that usually lasts for 6 months before converting to a normal rate: Make sure you know when the introductory rate ends so you are not fooled into thinking the APR is lower than it truly is.

FYI

You should look for a card with a grace period of 25 days or more and try to pay off the balance before that period ends. You avoid finance charges if you pay your entire balance at once.
**Situation A**

1. A credit card company uses your average daily balance to compute your finance charge. You charge $100 on May 2 and $200 on May 20. What is your average daily balance?

2. If the APR on this credit card is 18%, what would the finance charge be for May?

**Situation B**

3. A credit card company uses the outstanding balance at the beginning of the billing cycle to compute the finance charge. As of February 1, which is the beginning of the billing cycle, you have a credit card balance of $5,000. On February 5, you pay off the entire balance and do not use the card again during the month. What will the finance charge be when you receive your bill at the end of the billing cycle if you are charged an APR of 12%?

**Situation C**

4. In addition to interest, a credit card company charges a transaction fee of 2.5% of the amount. If you take a cash advance of $3,000, what transaction fee will you pay?

**Situation D**

5. You have a credit card balance of $500 due on August 18. You send a check for $250 but your check does not arrive until August 20. The bank charges a late fee of $35. You do not add any additional charges to the card, and the company uses your average daily balance to compute your finance charge. If the APR is 20%, what will be the total charges on the next bill?
Credit Reports and Credit Applications

Your credit report determines whether you receive a credit card, as well as the APR you are given should you qualify for credit. A credit report is a summary of your financial history that indicates if you pay your bills on time, how much money you have in your bank accounts, and how much money you owe.

At present, there are three major companies that maintain credit reports: Equifax, Experian, and TransUnion. These companies, otherwise known as credit bureaus, collect financial information and organize it into a report that can be made available to people and agencies from which you may want credit.

A typical credit report includes the following information:
- Your name and social security number
- Your current and previous addresses
- Information about your current and past loans
- Your public record information (bankruptcies, court judgments, liens)
- A list of companies that have reviewed your credit
- Your payment history
- The length of your credit history
- Your current and previous employers

Potential lenders look at your credit report to find out how you handle debt. It helps them decide if you are a good candidate to lend money to and whether they will get their money back. A good credit report can be very helpful in life when you want to finance a car, a home, or an education. Not only will it help you obtain a loan, but it will help you to secure a lower interest rate.

A bad credit report can cause you many problems by preventing lenders from working with you. Even if you do obtain a loan or credit card, you will likely pay higher interest rates than if you had a good credit report.

Another problem can be lack of credit. The best way to develop credit is to apply for a credit card. Once you have one; use it wisely and pay off your balance in full each month. Over time, you will establish yourself as someone who can handle debt and repay loans.

FYI

You should check your credit report regularly for any mistakes. The Fair Credit Reporting Act (FCRA) entitles you to a free annual credit report. The three nationwide consumer reporting companies mentioned on this page will provide free annual credit reports only through

annualcreditreport.com

1-877-322-8228

Annual Credit Report Request Service, P.O. Box 105281, Atlanta, GA 30348-5281.
A credit report is summarized by a credit score. A credit score is a number that represents a measure of your credit risk. It is calculated through a complex mathematical formula that takes various aspects of your credit history into account. The credit score gives lenders a way to compare you with other consumers and to calculate the interest rate at which you may borrow money.

Credit scores range from 300 to 900. To get the most favorable interest rates, you'll need a credit score of 720 or higher. On average, a person with a credit score of 520 will get interest rates on loans that are three to four percentage points higher than a person with a score of 720.

Your credit report and score are very important information. Not just anyone can gain access to this information. The Fair Credit Reporting Act (FCRA) specifies who can access your credit report and why. According to the FCRA, a company must have a legitimate reason to view your credit report. Any organization or individual who obtains a copy of your credit report under false pretenses can be fined and jailed for up to a year.

The types of companies that can access your credit report include lenders, insurance companies, landlords, potential employers, and government child support agencies. Keep in mind that any time your credit report is viewed it is reported on your credit report. The more report inquiries that show up on the report, the lower your credit score becomes.

ACTIVITY:
Computing Finance Charges and Fees

Study the credit report on the next page and answer the questions below.

6. What is the name of the individual described in the report? ______________________________

7. On what date was the credit report prepared? ________________________________________

8. Which of the credit card accounts has been closed? ____________________________________

9. What amount was turned over to Pro Collections Agency? ______________________________

10. When did the individual file bankruptcy? ____________________________________________

11. What organizations requested a credit report in 2003? ________________________________

12. Why was the individual’s checking account closed in 2002? ____________________________
**CREDIT HISTORY**

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Account Number</th>
<th>Whose Account</th>
<th>Date Opened</th>
<th>Months Re-viewed</th>
<th>Date of Last Activity</th>
<th>*High Credit</th>
<th>Terms</th>
<th>Items as of Date Reported</th>
<th>Date Reported</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sears</td>
<td>1125151</td>
<td>J</td>
<td>05/86</td>
<td>66</td>
<td>12/03</td>
<td>3500</td>
<td>0</td>
<td>0</td>
<td>R1</td>
</tr>
<tr>
<td>Citibank</td>
<td>2953900</td>
<td>I</td>
<td>11/86</td>
<td>48</td>
<td>11/03</td>
<td>9388</td>
<td>48M</td>
<td>0</td>
<td>H1</td>
</tr>
<tr>
<td>AMEX</td>
<td>3554112</td>
<td>A</td>
<td>06/87</td>
<td>24</td>
<td>10/02</td>
<td>500</td>
<td>0</td>
<td>0</td>
<td>Closed Account</td>
</tr>
<tr>
<td>AMEX</td>
<td>51511</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Chase</td>
<td>5422977</td>
<td>I</td>
<td>05/83</td>
<td>48</td>
<td>01/04</td>
<td>5000</td>
<td>340</td>
<td>3000 680</td>
<td>R3</td>
</tr>
</tbody>
</table>

*Amount in H/C Column is Credit Limit

**********PRIOR PAYING HISTORY**********

**********COLLECTION ACCOUNTS**********

**********COURTHOUSE RECORDS**********

**********ADDITIONAL INFORMATION**********

Former Address 456 Jupiter Rd., Atlanta, GA 30245
Former Address P.O. Box 2138, Savannah, GA 31406

Last Reported Employment Engineer, Space Patrol

**********COMPANIES THAT REQUESTED YOUR CREDIT HISTORY**********

03/04/04 EQUIFAX
12/16/03 PRM VISA
06/11/03 NATIONS BANK

02/12/04 MACYS
08/01/03 AM CITIBANK
04/29/03 GE CAPITAL
Analyzing your CREDIT SCORE

1. Credit Score Analysis

   General range: 300-850

   **Above 700:** Low risk to lenders; demonstrates good financial health

   **Below 600:** High risk to lenders; you could get higher interest rates or get turned down for a loan or credit application

2. A good credit score can help you:
   - Lower your interest rates.
   - Speed up credit approvals.
   - Reduce deposits required by utilities.
   - Get approved for apartments.
   - Obtain better credit cards, car loans, and mortgage offers.

3. What makes up your credit score?
   Note: These percentages are approximations; they are not exact.

   **35% -- Payment History**
   Late payments, bankruptcies, and other negative items can hurt your credit score, but a solid record of on-time payments helps your score.

   **30% -- How Much You Owe**
   Credit scores look at the amounts you owe on all your accounts, the number of accounts with balances, and how much of your available credit you are using. The closer you are to your credit limit, the lower your score will be.

   **15% -- Length of Credit History**
   A longer history of using credit responsibly will increase your score. However, you can get a high score with a short credit history if you made all of your payments on time, or paid off your credit cards quickly.

   **10% -- New Credit**
   If you recently applied for or opened new credit accounts, your credit score will weigh this fact against the rest of your credit history.

   **10% -- Other Factors**
   Several minor factors also can influence your score. For example, having a mix of credit types on your credit report -- credit cards and installment loans, such as a home or car loan -- are normal for people with longer credit histories and can add slightly to their scores.

4. How to boost your score:
   - Pay your bills on time. Late payments or defaults can really hurt your score.
   - Keep balances low on credit cards. High debt levels can hurt your score.
   - Apply for and open new credit accounts only when you need them. The most important way to improve your score in this area is to pay down your revolving credit, like credit cards.
   - Check your credit report regularly for accuracy, and contact the creditor and credit reporting agency to correct any errors.
If you have missed payments, get current and stay current. The longer you pay your bills on time, the better your score.

Specific Actions to Raise a Credit Score:

**Action, Score Change:**
- Pay off accounts, +80
- Build history of paying on time, +40
- Pay down credit balance, +40
- Pay down further and no new accounts, +50
- Pay all overdue payments and keep loan current, +20
- Six months of on-time payments, +30

Source: [http://www.myfico.com](http://www.myfico.com)
Part 1: Angela just started college, and has been provided with a number of credit card offers. She applies for and is granted two credit cards. However, Angela doesn't realize what is necessary for responsible credit management. She starts out with a credit score of 750. See what happens to her score when she mismanages her credit. Why does each of the actions below affect her credit score? (5 points for the first chart)

<table>
<thead>
<tr>
<th>Action</th>
<th>Score Impact</th>
<th>Why does her action affect her score?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angela enjoys going to concerts, buying clothes, and going out to eat. She runs up the balance on her two new credit cards almost to their limits.</td>
<td>-80</td>
<td></td>
</tr>
<tr>
<td>Angela is very busy with college and a part-time job. Without realizing it, she misses monthly payments on both cards.</td>
<td>-100</td>
<td></td>
</tr>
<tr>
<td>Angela continues to spend as she needs textbooks for the second semester. With this expense, she spends to the limit of one of the two cards.</td>
<td>-80</td>
<td></td>
</tr>
<tr>
<td>Angela decides she needs to earn more money to pay off her credit cards, but needs to drive to get to her new job. She takes out a loan to buy a new car.</td>
<td>-20</td>
<td></td>
</tr>
<tr>
<td>Busy with school and the new job, Angela misses a loan payment on her new car.</td>
<td>-75</td>
<td></td>
</tr>
</tbody>
</table>

18. Starting Score: 750. Angela's New Credit Score: __________

Part 2: Angela realizes that she hasn't acted as responsibly as she could have with her credit cards. What can she do now to improve her credit score? Use the "Analyzing your CREDIT SCORE" information to find follow-up actions for Angela, and compute how much impact each one will improve her score. (10 points for the second chart)

<table>
<thead>
<tr>
<th>Action</th>
<th>Score Impact</th>
<th>Follow-up Action</th>
<th>Score Impact</th>
</tr>
</thead>
<tbody>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

29. Angela's New Credit Score with Follow-up Actions: __________
Use the information about each of the following credit cards to complete the chart at the bottom of the page.

**Card #1**
Card #1 has no annual fee, and an initial APR of 0%. The card also includes rewards: with every $1,000 spent, you get a $10 gift certificate to a local burger chain. After six months, the APR jumps to 19.1%.

**Card #2**
Card #2 also has no annual fee, and an initial APR of 0%. The cardholder can also take money out on the card at the ATM. However, when these types of transactions are made, the APR jumps to 24.1%. In fact, the rate will go to 24.1% after three months for all purchases. This card also features rewards: after spending $35,000 on the card, you get a free domestic airline flight.

**Card #3**
Card #3 also has no annual fee, although the APR is 12.9%, with no different initial APR. No rewards are offered.

**Card #4**
Card #4 is a little different. There is an annual fee of $150, but no APR. With this card, you have to pay off your balance every month. This card also features a rewards program: you get one "point" for every dollar spent on the card, and points can be redeemed for magazine subscriptions and other items.

**Card #5**
Card #5 isn't officially a credit card. There is no annual fee, no APR, and no balance carried. This card takes money directly from your savings or checking account.

*******************************************************************************(20 points possible for the chart)******************************************************************************

<table>
<thead>
<tr>
<th>Credit Card</th>
<th>Initial APR</th>
<th>APR</th>
<th>Annual Fee</th>
<th>Rewards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Card #1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Card #2</td>
<td></td>
<td></td>
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<tr>
<td>Card #3</td>
<td></td>
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<tr>
<td>Card #4</td>
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</tr>
<tr>
<td>Card #5</td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>
Taking Out a Loan

You want to buy a car, but you don't have enough money. What do you do? You might take out a loan. A loan is a sum of money lent to a borrower at a specified interest rate. When you accept a loan, you agree to pay it back over a set period of time. The amount of money you borrow is called the principal, and the interest is the cost of borrowing the money. The length of time determined for paying back the loan is known as the term of the loan.

It is best to take out a loan only for a large expense, such as a car, college tuition, or a house. Taking out loans for smaller purchases or taking out many loans at once can cause financial and credit problems for you.

The interest rate on a loan is determined by the lender. In addition to interest, a lender may charge other fees such as an-application fee or a fee to check your credit. These fees are often called points.

You can generally obtain a loan from a bank or credit union. The best way to compare loan offers is to look at the APR offered by each institution and the fees.

**Installment Loan**

One common type of loan is an installment loan. When you accept an installment loan, you borrow all of the money at once. You then repay the money in set amounts, called installments, on a regular schedule over a period of time.

Installment loan customers often make payments using a coupon book that has a slip for each payment. Each slip lists the date and the amount, due. For some installment loans, the bank will send a reminder each month before the due date. The reminder usually lists information about the loan and has a portion that can be returned with payment.

**ACTIVITY:**

**Analyzing an Installment Loan**

*Mr. Ramos borrows $5,000 at 8.2% for 5 years in order to make some improvements to his home.*

50. What is the principal? ______________________________

51. What is the interest rate? ______________________________

52. What is the term of the loan? ___________________________

**Line of Credit**

A line of credit is a type of revolving credit. It allows you to write checks for the amount you want to borrow up to a limit set by the lender. For example, you may receive a line of credit of $10,000. The credit does not cost anything until you write a check. Once you write a check, you begin to pay interest on the amount you borrowed. So, for example, if you write a check for $6,000, you will pay interest on that amount. You still have $4,000 available to borrow. If you then make a payment of $1,000, you have $5,000 available to borrow.
Types of Loans
There are many different types of loans to consider. Here is a brief review of some of them.

**Unsecured Loan**
You can obtain an unsecured loan solely on your promise to repay it. This type of loan is risky for the lender and usually involves a higher interest rate than other types of loans.

**Secured Loan**
When you obtain a secure loan, you must put up property as collateral. If you fail to repay the loan, the lender can take your collateral. Home equity loans are common types of secured loans. In this type of loan, an individual uses a home as collateral and borrows against the value of the home.

**Fixed Rate Loan**
When you obtain a fixed rate loan, the interest rate and monthly payments stay the same over the length of the loan.

**Adjustable Rate Loan**
If you obtain an adjustable rate loan, the interest rate can change. It usually changes with the federal interest rate. As a result, the monthly payments change as well. There is usually a limit on the change that can occur.

ACTIVITY:
Potential Line of Credit

* A lender sets the limit on a home equity line of credit at 75% of the appraised value of a home minus the balance owed on the existing mortgage.

* Suppose a homeowner has a home appraised at $200,000 with an existing mortgage balance of $95,000.

53. What credit limit would the lender set for this individual? ______________________________