

Video 4 - Get the Credit You Deserve

VIDEO SUMMARY

This video explores the costs and benefits of using credit. Credit instruments allow consumers to take advantage of sales, keep good financial records and use a convenient payment method. Credit also helps people guard against financial emergencies. As the Credit Wise Cats discuss in the video, credit also has a down side. Many people carry debt loads beyond their ability to repay. College students who borrow to finance their schooling are making a long-term investment in human capital that helps them earn higher incomes over their lifetime. However, many college students also use credit cards to pay for food, entertainment, clothing and other consumer goods that they would otherwise not have the financial resources to purchase. The danger is that irresponsible use of credit can allow a person to live beyond his or her means in the short run. When used in excess, consumer credit can create some significant problems for people. These problems can ultimately escalate to the declaration of personal bankruptcy.

What is the difference between a credit report and a FICO score? Is it better for a person to have a lot of cards he or she doesn't use, or to have no credit at all? Is it true that bankruptcy is a good way to get out of paying off debt? Does a late payment count against a person if he or she pays off the bill the next month? Is the annual percentage rate (APR) really more important than the monthly payment? These are all questions the video seeks to answer. Managing credit is not difficult if a person knows the "rules of the game" and understands that credit is not "free" money that you don't have to pay back.

Lesson 4.1 - Make Credit Work for You

BACKGROUND INFORMATION

Everyone has a financial life, but some people have better financial lives than others. During the last 30 years the availability of credit products has increased exponentially. Closed-end loans for houses, cars, appliances and other durable goods have been joined by revolving open-ended credit cards from banks and retail outlets. The number of people having access to credit has also increased. Many low-income workers now have access to mortgage lending, which allows them to own their own homes. Purchasing power has increased as many consumers have learned to use credit to their advantage.

At the same time, many others have found themselves mired in debt and have had to declare bankruptcy. Personal bankruptcy has doubled in the last decade, with more than 1.66 million bankruptcy filings in 2003. Revolving debt, consisting mostly of credit-card debt, has increased from \$54 billion in 1980 to more than \$780 billion in November 2004. Fifty-five percent of college students get their first credit card in their freshman year, and 83% have at least one card. Forty-five percent of college students have some form of credit-card debt, with an average debt of over \$3,000. This does not include student loans. On the other hand, 48% of all card holders carry a balance of less than \$1,000. About 10% carry in excess of \$10,000.

Why are there such vast differences in how individuals handle credit? Why are those with six-figure incomes just as likely to have credit problems as someone with substantially lower income? How people handle their finances, make choices about allocating their income, and develop habits for managing money can partly be attributed to having the knowledge and information to make sound economic decisions. There are many myths and misunderstandings

about credit that lead people to make poor or irresponsible choices. A lack of financial knowledge can lead to trouble for the unaware consumer. To build wealth, a person has to learn to handle credit wisely.

VOCABULARY

Annual percentage rate – APR; the interest rate charged, expressed as a percent per year, for the use of credit

Credit – borrowing to buy something with the promise to make payment at a later time

Credit report – a written record collected by a credit agency that tracks a borrower's credit payments, whether or not these payments are made on a timely basis, and how long the borrower has had various credit accounts

Finance charges – the interest paid on unpaid credit balances

Installment plan – a closed-end loan for a specific product such as furniture or appliances

Open-ended credit – a form of credit that allows a person to borrow funds to make purchases for which there is no predetermined repayment period

Revolving credit – an open-ended account with a limit to how much one can borrow but no time limit for repayment

MATERIALS

- ✓ Visuals 4.1.1, 4.1.2 and 4.1.3
- ✓ One copy of Activity 4.1.1 for each group of three students; cut the True and False cards ahead of time.
- ✓ One copy of Activity 4.1.2 for each student

PROCEDURE

Before viewing the video:

1. Ask the students what they know about credit. *Answers will vary.* Explain that responsible use of credit can help a person, and irresponsible use can lead to major trouble.
2. Tell the students they are going to play a game called “Credit Myths and Realities” to see how much they know. Divide the class into groups of three and give them the “True” and “False” cards that have been prepared in advance. Distribute one copy of the Activity 4.1.1 Score Sheet to each group.
3. Display Visual 4.1.1. Have each group appoint one team member to be the cardholder and one team member to keep score. Tell the students that you are going to read various statements about credit. Each group is to decide whether each statement is true or false and enter the answer on their group’s copy of Activity 4.1.1.
4. After reading all the statements about credit, tell the students that you are now going to read the statements again, one at a time, and will say, “Cards up” after reading each statement. When the teacher says “Cards up,” each group is to answer “True” or “False” by holding up the appropriate card. Tell the students they will answer all the statements before the class discusses them.
5. Display Visual 4.1.2, showing and reading only one question at a time, and say “Cards up” after each statement. Allow the students to hold their cards up long enough for the class to quickly look around the room and see how many of each card have been raised. Make sure one member of each team is keeping track of the team’s responses.
6. After the quiz is over, review the answers as a class. Have the students calculate the scores for their team: add five points for correct

responses; deduct five points for incorrect ones.

- **Statement 1:** A person’s credit score helps determine whether or not a person gets credit, the amount a person can borrow, and what interest rate a person has to pay for the use of credit. *True*

A person’s credit score is the rating most lenders use to calculate how much of a risk that person is to not pay back borrowed funds.

- **Statement 2:** Using a credit card, Sandy buys a \$1,000 entertainment system. She pays \$20 a month (which is the minimum the credit card company requires) and 18.9% interest. She will have the system paid off in four years and two months (50 months). *False*

The \$1,000 entertainment system will take her nine years and two months to pay off and ultimately cost her \$1,982.80 (\$982.80 in interest, on top of the \$1,000 price tag).

- **Statement 3:** The following criteria are used to determine a person’s credit score: payment history, personal income, new credit issued, length of credit history and types of credit. *False*

Personal income is not used in calculating a credit score.

- **Statement 4:** Most financial experts advise people not to use credit to buy furniture and appliances. *False*

Furniture and appliances are durable goods that last for long periods of time. Their usefulness often lasts much longer than the time it takes to pay for them.

- **Statement 5:** Financial planners use a rule called the “20-10 rule,” which recommends that you should not be in debt more than 20% of your yearly after-tax income and that your monthly payments should not be greater than 10% of your monthly net income. *True*

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- **Statement 6:** Having a lot of credit cards will not affect your credit score if you do not owe anything on the cards. *False*
You can lose points on your FICO score, because lenders may view unused credit as potential debt.

- **Statement 7:** Three years ago Sam missed a payment on his car. He caught up and has paid the car off. The missed payment will not affect his credit score. *False*
Any missed payment is recorded and stays as part of your credit history for seven years. Late payments can also result in losing points on your FICO score.

- **Statement 8:** Buying impulse items like sodas and burgers using credit and making the minimum payment has no effect on one's budget. *False*
Items like sodas and burgers are consumables as opposed to durables. One does not receive long-term benefits from borrowing to pay for such items, so credit should be used cautiously in purchasing consumables.

- **Statement 9:** The best indicator of how much credit will cost you for any loan or credit card is the annual percentage rate (APR). *True*

- **Statement 10:** Managing credit wisely increases the choices a person has related to housing, transportation, leisure activities and general standard of living. *True*

7. Explain that the students will now watch a video that contains a discussion of the use of credit. Show Video 4.

After viewing the video:

8. Tell the class that they will now discuss the costs and benefits of credit. Discuss the following:

A. What are the benefits of credit? *Get the use of a good or service instead of*

waiting, can take advantage of sales, keep better track of purchases, convenient, safer to carry than cash

B. What are the costs of credit? *Using credit adds to the purchase price if you do not pay it off within a grace period; the opportunity cost is that you give up future consumption; finance charges; late fees. For example, in question 2 of Visual 4.1.2, Sandy's \$1,000 entertainment system cost an additional \$982. That is \$982 she could have spent on other things. Sandy's total cost also assumes that she doesn't charge anything else on her card and that she remains satisfied with the system for the 9+ years.*

C. How much debt is too much debt? *Answers will vary.*

D. Has anyone ever heard the 20-10 rule discussed? *Answers will vary.*

9. Display Visual 4.1.3. Review the 20/10 rule with the class.

10. Distribute one copy of Activity 4.1.2 to each student. Keeping Visual 4.1.3 on display, instruct the students to read Activity 4.1.2 and write down their answers to the cases in the activity. Remind the students to refer to Visual 4.1.3, if they need to, as they are considering the cases in Activity 4.1.2.

Case 1 Discussion: *Josh can safely carry \$4,000 in debt ($\$20,000 \times .20$). Since his monthly net is \$1,666.67 ($\$20,000/12$), his monthly payments should not exceed \$166.67.*

Case 2 Discussion: *Sara can safely carry \$6,400 in debt ($\$32,000 \times .20$). Her monthly net is \$2,677, so her monthly payments should not exceed \$267. Given her current payment practices, this leaves her with less than \$100 per month to pay for her car.*

Case 3 Discussion: *The Welches now have a debt load of \$12,890 and could safely carry*

\$13,000. They are already over the 10% of their monthly net (their monthly payments should not exceed \$542), so buying the boat puts them outside both limits.

Case 4 Discussion: *The Jacksons can carry \$23,000 in debt ($\$115,000 \times .20$). Their monthly net is \$9,583, so their monthly payments should not be greater than \$958.30. At this time they are below their debt load at \$21,730 but are paying \$1,000 in monthly payments, roughly \$42 above the 10% limit.*

Visual 4.1.1 - Rules of the Game

- 1. There are three people on a team. Each team should appoint one person to immediately hold up a “True” or “False” card when the teacher says, “Cards up!” A slow response will count against the team.**
- 2. Another team member should be chosen to enter the team’s answer on the Activity 4.1.1 score sheet.**
- 3. The teacher will read all the statements aloud, then repeat one, after saying “Cards up” to indicate that students are to respond.**
- 4. After all the statements have been read, the teacher will discuss each statement and indicate the correct response.**
- 5. Each team will correct its score sheet. If the answer is correct, the team earns five points. If it is not, five points are deducted.**
- 6. A perfect score is 50. At the end of the game, each team should write its total points at the top of the score sheet.**

Visual 4.1.2 - Credit Myths and Realities – True or False?

- 1) A person's credit score helps determine whether or not a person gets credit, the amount a person can borrow, and what interest rate a person has to pay for the use of credit.**
- 2) Using a credit card, Sandy buys a \$1,000 entertainment system. She pays \$20 a month (which is the minimum the credit card company requires) and 18.9% interest. She will have the system paid off in four years and two months (50 months).**
- 3) The following criteria are used to determine a person's credit score: payment history, personal income, new credit issued, length of credit history and types of credit.**
- 4) Most financial experts advise people not to use credit to buy furniture and appliances.**
- 5) Financial planners use a rule called the "20-10 rule," which recommends that you should not be in debt more than 20% of your yearly after-tax income and that your monthly payments should not be greater than 10% of your monthly net income.**

Visual 4.1.2 - (continued) Credit Myths and Realities

- 6) Having a lot of credit cards will not affect your credit score if you do not owe anything on the cards.**
- 7) Three years ago Sam missed a payment on his car. He caught up and has paid the car off. The missed payment will not affect his credit score.**
- 8) Buying impulse items like sodas and burgers using credit and making the minimum payment has no effect on your budget.**
- 9) The best indicator of how much credit will cost you for any loan or credit card is the annual percentage rate (APR).**
- 10) Managing credit wisely increases the choices a person has related to housing, transportation, leisure activities and general standard of living.**

Visual 4.1.3 - 20-10 Rule

To calculate a safe debt load, use the following guidelines:

1. Do not carry debt that is more than 20% of yearly net income.

- *Example:* If you earn \$2,000 a month after taxes, your yearly net income is \$24,000:

$$20\% \text{ of } \$24,000 = \$4,800 \text{ total debt.}$$

2. Housing debt is not part of the 20%, but cars, student loans and credit cards are.

3. Monthly payments on non-housing debt should not be more than 10% of net monthly income.

- *Example:* If you take home \$2,000 per month after taxes, monthly payments should be no more than

$$10\% \text{ of } \$2,000 = \$200.$$

4. Housing payments are not part of the 10% rule, but payments for cars, student loans, and credit cards are.

Activity 4.1.1

TRUE

FALSE

Activity 4.1.1 - (continued) Score Sheet

Team: _____

- | | | | | |
|-----|-------|-------------|-------|--------------|
| 1. | _____ | TRUE | _____ | FALSE |
| 2. | _____ | TRUE | _____ | FALSE |
| 3. | _____ | TRUE | _____ | FALSE |
| 4. | _____ | TRUE | _____ | FALSE |
| 5. | _____ | TRUE | _____ | FALSE |
| 6. | _____ | TRUE | _____ | FALSE |
| 7. | _____ | TRUE | _____ | FALSE |
| 8. | _____ | TRUE | _____ | FALSE |
| 9. | _____ | TRUE | _____ | FALSE |
| 10. | _____ | TRUE | _____ | FALSE |

Total: _____

Activity 4.1.2 - How Much Debt Is Too Much Debt?

Name: _____

Using the 20-10 Rule, determine whether the person or family has an excessive debt load. Show each step. The amounts for the income are after taxes. (They refer to net income.) Remember, mortgage debt is not included in the 20-10 rule.

Case 1: Josh Sammons has just graduated from high school and found a full-time job that earns him \$20,000 per year. He wants to move out of his parents' house. To do this, he needs transportation to his job, since there is no public transportation in his town. His parents will let him have his bedroom furniture and supplies for his kitchen and bathroom. He wants to buy a car, some furniture for his living room and a table and chairs for the dining area. Calculate Josh's safe debt load.

Case 2: Sara Raynes is a single woman in her late twenties who has a college degree. She works in a medical center as a medical technologist. Her yearly net income is \$32,000. Her car is five years old, and she wants to replace it. Since she has graduated from college, she has been paying back a student loan with a monthly payment of \$100. She has a credit card with a balance of \$1,500, and she has been paying \$70 per month on the card. How much will Sara be able to safely carry as a car payment?

Case 3: The Welches are in their late thirties. They have two children. Their yearly net income is \$65,000. They have a car payment of \$325 per month with an outstanding balance of \$8,500. Each of them has a credit card, one with a balance of \$3,100 and the other with a balance of \$1,290. They pay \$200 per month on the first one and \$90 on the second one. They have been looking at a small motorboat that costs \$4,500 and would have to pay \$225 per month for it. Calculate their safe debt load. What would be your advice, based on the 20-10 rule?

Case 4: The Jacksons are partners in an engineering firm, and their combined salaries produce \$115,000 in yearly net income. They have three children, two in high school and one in college. They have two cars, with outstanding loan balances of \$9,000 and \$6,500 and monthly payments of \$275 and \$340. They have several credit cards, with balances of \$2,260, \$2,875, \$850 and \$245. They pay \$125, \$200, \$125 and \$60 for each of these. According to the 20-10 rule, are they in trouble?