



What You Should Know About...

Using Credit

- ▶ CREDIT CARDS
- ▶ ARRANGING A LOAN
- ▶ INTEREST RATES



For most people, using credit is an essential part of daily life. You might already use credit—through credit cards or a loan—without knowing exactly how it works. While it's easy to do that, you'll want to learn as much as you can regarding this very important subject.

Credit, or the ability to borrow money, can be a powerful tool in reaching your financial goals. Or, it can be a hidden enemy for those who do not have a spending plan or do not develop and maintain responsible credit management behaviors and skills.

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How credit works

Chances are you're familiar with credit. It's a convenient way to make purchases—from small, regular ones like groceries to large, unique ones like homes or cars. But you may not be sure what happens when you use a credit card or take a loan, the two most common examples of using credit. Learning more can help you cut costs and avoid using more credit than you can afford.



The cost of using credit

When you use credit, you're borrowing someone else's money. You agree to pay it back at a certain time, or on a certain schedule. And for the convenience of having someone else's money available when you need it, you pay a fee. That fee is known as interest and is usually charged as a percentage of what you borrowed.

That means the more you borrow, the more you'll have to pay in interest. What borrowing will cost you is also affected by how long you take to pay the money back.

Paying on time

With most types of credit, you agree to make payments on a certain schedule, and if you're late or don't pay what's due, you'll have to pay a penalty or late fee. That makes borrowing more expensive. If you have trouble repaying, it's possible that you've borrowed more than you can afford, or perhaps your circumstances have changed. And if you ignore the problem, it will only get worse, as penalties and interest build due to late or missed payments.

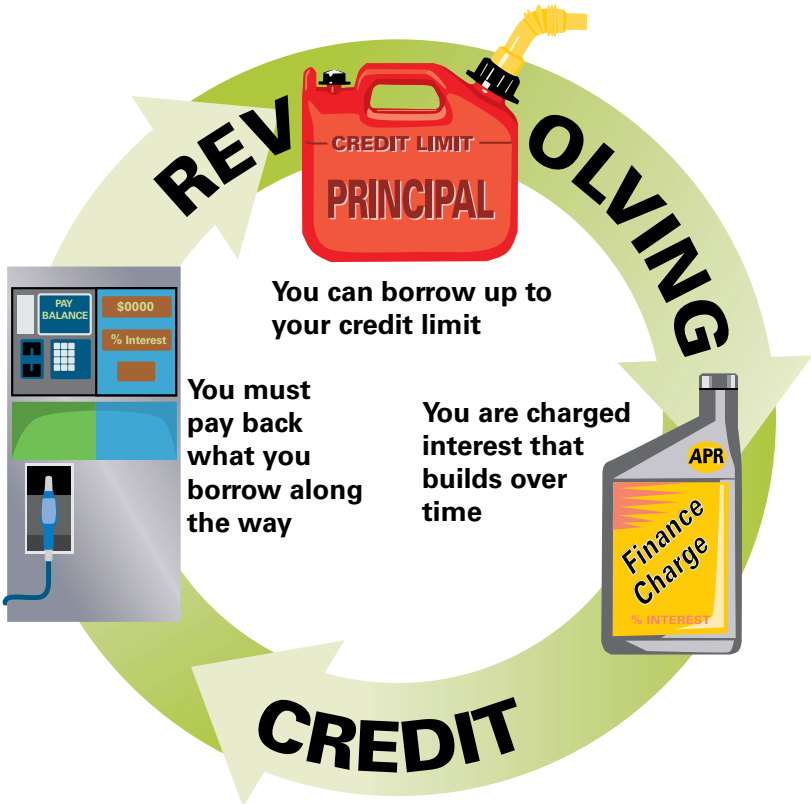
Credit cards

The money you spend when you use a credit card isn't really yours—you're actually borrowing it from the bank or other financial institution that issues the credit card, in an arrangement called revolving credit. You have access to a fixed amount of money, called your credit limit. Once you repay any of the money you have spent, you can borrow that amount all over again.

What you borrow, or what you spend, is called principal. For the privilege of using the principal,

you pay the credit card issuer a finance charge, which is the interest that accumulates on any unpaid balance. For example, if you have a balance of \$600 on a card with an annual interest rate of 18%, your monthly finance charge will be \$9. It's calculated by multiplying a month's worth of interest—1.5%—times the balance.

Every credit card company has to disclose the interest rate it charges on the balance you carry, and different cards charge different rates so it's worth shopping around. Some list their



monthly or daily interest rates, but you can compare different cards by looking for the **annual percentage rate (APR)**, which all card issuers are required to disclose. A card's APR doesn't include any late fees, annual fees or other charges, so if you're comparing rates, be sure to take into account all additional fees.

Secured credit cards

Another option you can consider is a secured credit card, which means that your card is attached to a savings account that is pledged to the bank that issues the card. You deposit a sum of money that you won't be able to touch, but you can charge up to that amount on your card. The deposit account is in your name, but if you don't pay your bills, the card's issuer can take what you owe out of your account. Secured cards may be a

good choice if you've had credit problems, and are having trouble being approved for a credit card. If you regularly pay what's due on a secured card, you may be able to qualify for a regular, unsecured card after a certain period of time.

TIP

If you have a secured card and believe you've demonstrated your credit-worthiness, don't hesitate to ask for a regular card. Even if you have to wait a bit longer, you may help speed up the process by indicating to the lender that you're interested in receiving a regular bankcard, and may be shopping for such a card with other lenders.

Charge cards

Charge cards let you make purchases as you would with a credit card, and usually don't impose a credit limit or state an APR. But you have to pay off the entire amount you've charged each month, rather than carrying a balance as you can with a credit card. Some well-known charge cards are issued by American Express, Diner's Club and Carte Blanche.

Choosing a credit card

Used wisely, credit cards can help you make the most of your financial resources. You can use cards to make some purchases more easily and securely—like travel reservations or concert tickets—and they can even help you budget and save. But to enjoy these benefits, you need to choose a card that’s right for you, and use it carefully.

The right credit card

To find the best card for you at the lowest cost, you need to consider these three major factors:

- Interest rate
- Grace period
- Annual fee

Not all cards charge an annual fee, so you may be able to avoid that cost entirely. But be sure to read the fine print: Some no-fee cards start charging a fee after the first few months.

A card’s **grace period** and interest rate probably have the greatest effect on the cost of credit. A grace period is the number of days before a company starts charging interest on new purchases. If there’s no balance due on your card, no interest will be charged from the statement closing date through the day payment is due. But if there’s a balance, the grace period is eliminated. And some cards have no grace period, which means interest starts being charged on that purchase immediately.

If you pay your bill in full every month, having a grace period may



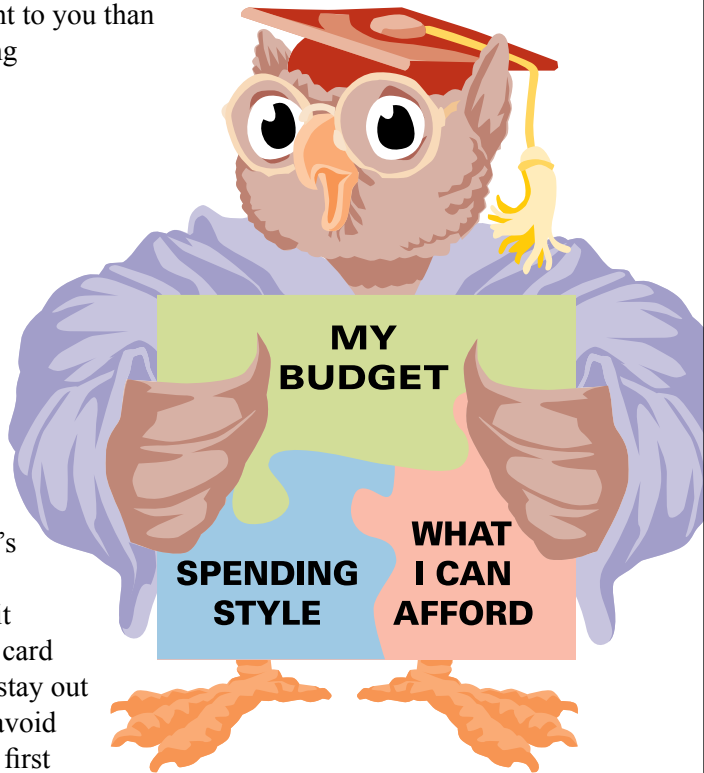
Affinity cards

You might also be tempted by affinity cards: cards that give you travel miles, cash back, discounts or make charitable donations to a favorite cause. Before signing up for one, be sure it fits your credit needs first—and that the interest and fees won't outweigh the potential benefits. You might also want to calculate how much you'll have to spend to actually qualify for a free airline ticket or other reward.

mean you never pay interest. And the longer that period is, the easier it may be to pay in full each time. But if you regularly carry a balance, finding a card with a lower interest rate will be more important to you than finding one with a long grace period.

Using a credit card wisely

The freedom a credit card offers may be exciting at first, but it's important to take the responsibility of credit seriously. Using your card wisely may help you stay out of credit trouble and avoid getting into debt. The first



step is matching your spending style to what you can afford to repay when the bill arrives or within a few months.

To avoid overspending, it's always recommended that you create a budget for your household, and keep your spending in those guidelines. If you're unsure if or when you'll have the money to pay off a purchase you need to put on a credit card, it's probably safest not to make that purchase.

Write it down

You should save your credit card receipts and write down how much you've spent, so that your monthly bill isn't a big surprise. Tracking your spending will also help prevent you from going over your credit limit, which can incur hefty fees.



What the FTC says

To learn more about credit cards, check out this article from the Federal Trade Commission.

www.ftc.gov/bcp/online/pubs/young/readycrdt.htm



Billing mistakes

If you notice a mistake on your bill, by law you have 60 days to notify the lender about the error—whether it's an unauthorized charge, an incorrect payment, or a computer mistake. Your lender must acknowledge your notification in 30 days, and must resolve your issue within up to two billing cycles, but not more

than 90 days. You can still use your card while you're disputing a charge, as long as you pay the rest of your bill. You will not have to pay for those purchases or charges you are disputing, but you will have to continue to pay undisputed charges or new charges made after your dispute is filed. The law that protects your rights when it comes to billing mistakes is the Fair Credit Billing Act.

Limit your credit

You may find it easier to control your spending if you limit yourself to having just a few credit cards, and don't carry them with you all the time. The fewer cards you have in your pocket, the less likely you may be to buy something on impulse.

Loan sources

Credit cards are a convenient way to manage your regular expenses, but what if you need more money for a one-time expense? If you want to make a purchase that requires more money than you have in your bank account or can charge on a credit card, it might be time to apply for a loan. For instance, loans might help you buy a car, buy a home, pay for college tuition or start a small business.

If a loan seems to you like a much bigger commitment than a credit card, you're right—it's usually a bigger responsibility because it involves more money. If you take a loan you're using

credit, but instead of borrowing a different amount each time you use the card, you borrow a specific amount up front, called the **principal**. You pay back that amount over time, along with interest. But you can't make just a minimum payment, the way you can with a credit card. You'll receive a bill each month for the amount of your payment—which may be fixed or variable depending on the loan you selected and the way that the interest payment is calculated—and you have to send in the full monthly payment.

If you need a loan you have many sources to choose from.

That's good news, since shopping around might help you find a better deal. Furthermore, thanks to an increasingly competitive marketplace, many financial institutions

are offering products and services that weren't traditionally part of their businesses. The following general guidelines can help you get a sense of what your choices

| Type of lender | Pros |
|-----------------------------|---|
| Retail or traditional banks | <ul style="list-style-type: none"> • Widely available • May offer better rates for existing customers |
| Savings & loans | <ul style="list-style-type: none"> • Might offer lower rates than traditional banks |
| Savings banks | <ul style="list-style-type: none"> • Might offer lower rates than traditional banks |
| Credit unions | <ul style="list-style-type: none"> • Can be easy to establish if you're a member |
| Consumer finance companies | <ul style="list-style-type: none"> • May not need an unblemished credit history |
| Sales financing companies | <ul style="list-style-type: none"> • Can be easy to apply for a loan • May offer favorable terms during promotional periods |
| Small loan companies | <ul style="list-style-type: none"> • Can be easy to apply for a loan • May not need good credit rating |
| Insurance companies | <ul style="list-style-type: none"> • May be able to borrow up to 95% of the cash value of a policy |
| Brokerage firms | <ul style="list-style-type: none"> • Can be easy to apply for a loan • Might offer low rates and flexible repayment |

are, but the actual products a lender offers may vary, so you should research a wide variety of options.



Cons

- You need to have a good credit rating
 - Might not offer the lowest rates possible
- You need to have a good credit rating
 - Might not exist in some states
- You need to have a good credit rating
 - Might not exist in some states
- Need to be a member of the organization or group
- Rates may be higher due to additional risk the lender may face
- Rates may be higher due to additional risk the lender may face
 - If you default on the loan you may lose the item you purchased as well as payments you've made
- Often offers higher rates
 - May require you to have a cosigner
- Must own the policy
 - Reduces benefit to survivors
- If value of investments changes, might need to pay more
 - Margin requirements may change

For a loan you're considering, don't forget to ask:

- What interest rate is offered, as an annual percentage rate (APR)?
- Is there a prepayment penalty if you decide to pay off the loan earlier than scheduled?
- Is the interest fixed or adjustable?
- If the interest is adjustable, which index is it tied to, and what is the margin?
- If the interest is fixed, what would each monthly payment be?
- What other fees would you have to pay? Are they included in the APR?
- What's the term of the loan? Would a different term save you money or make it easier to pay?

Applying for a loan

You'll probably notice that the process of applying for a loan is more complex than applying for a credit card. That's because a loan usually



involves a greater sum of money than you can borrow with a credit card. But knowing what to expect can make the process less intimidating.

When you apply for a loan, the bank or other potential lender will review your credit report and credit score, and you'll have to provide additional information, including:

Employment: You'll have to list the name of your employer as well as your salary, and you'll be asked to provide pay stubs and tax information. Lenders want to make sure you have enough income to repay your loan.

Savings and credit accounts: You'll have to give information about all of your assets and liabilities, such as bank accounts, credit card accounts and investment accounts. Lenders like to have a full picture of any assets you might have available to help you repay your new loan as well as your existing loans.

References: You might be asked to give the names of a contact at work or a professional such as your lawyer who can recommend you as a candidate for the loan.

The lender will consider several factors, including how much debt you carry compared to your total income, whether you have previous experience with that lender, and your credit report and credit score. That's why it's so important to be sure you always repay what you owe on time, and it's exactly what the lender expects, too.

If you're 62 or older, you might have trouble getting credit, especially if you've already retired or if you don't have much of a credit history because you've made purchases in cash for most of your life. It may help if you begin to establish a credit history by getting a credit card and paying the bills regularly. You may also want to explain any source of income other than a job—such as Social Security, savings accounts and other assets—when applying for credit.

Types of loans

Understanding the differences between certain terms and types of loans is a big help when you're ready to borrow. For instance, if you buy a house or a car—two of the most common reasons you might take out loans—your loan is secured. A **secured loan** means that you guarantee the loan with some collateral. If you don't make payments and **default** on the loan, the lender can repossess the collateral—your house in the case of a mortgage, or your car in the case of a car loan.



An **unsecured loan**—sometimes called a personal, signature or note loan—on the other hand, isn't guaranteed by any collateral. Your promise to repay is the only basis on which the lender makes the loan. Since the lender is taking a bigger risk, the interest rate may

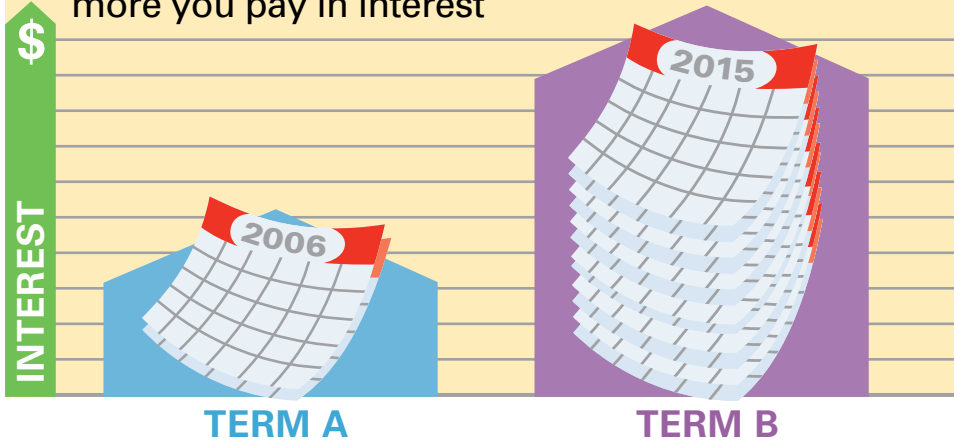


be higher, or you may be asked to find a cosigner who agrees to pay the loan if you default.

The term of the loan

Whether your loan is secured or unsecured, it will have a **term**, which means how many months or years you'll have to repay the loan. The longer the term, the smaller each payment will be. But the tradeoff is that the longer you take to pay the money back, the more you'll pay in interest. You'll have to weigh the extra cost against how much you can comfortably afford to pay each month.

The longer the term, the more you pay in interest



For example, if you take out a \$20,000 car loan, you may be able to choose between a 36-month and a 48-month term, both assuming you pay 8% interest.

| Number of months | 36 | 48 |
|---------------------|-------------|-------------|
| Monthly payment | \$626.73 | \$488.26 |
| Total of payments | \$22,562.28 | \$23,436.48 |
| Total interest paid | \$2,562.28 | \$3,436.48 |

Adjusting the rate

You may be able to choose whether your loan has a **fixed** or an **adjustable interest** rate. Fixed-rate loans mean you'll pay the same interest rate for every year of the loan. Adjustable-rate loans, on the other hand, charge an interest rate that can change periodically. An adjustable loan's rate is pegged to a particular

index, or nationally published interest rate that changes regularly. That rate plus the **margin**, or the number of points above the index that your lender charges, is your interest rate. Different lenders use different indexes and margins, so all adjustable loans don't cost the same, even if you borrow the same amount.

How do I decide between an adjustable or fixed rate loan?



| | Fixed-rate loan | Adjustable-rate loan |
|-------------|--|--|
| Pros | <ul style="list-style-type: none"> You know exactly what each month's payment will be, which can help you budget for them You won't have to worry about increasing payments if interest rates rise If interest rates are low when you apply for the loan, you can lock in that favorable rate | <ul style="list-style-type: none"> If interest rates fall, your monthly payments may be smaller If interest rates are high when you apply for the loan and then drop, your rate may be reduced Initial interest rate may be lower than with fixed |
| Cons | <ul style="list-style-type: none"> You won't benefit from lower payments if interest rates fall | <ul style="list-style-type: none"> Can be harder to budget, since you don't know what your payments will be When interest rates rise you'll have to pay more interest |

The cost of a loan

When you're ready to apply for a loan, you may be eager to get the process started, but it's worth taking the time to shop around. The most important thing to look at is the different APRs you're offered. It makes sense that you'll want to spend less on what you borrow by finding a lower APR. The lenders will be assessing you as well, checking into your income, job history, any debt you carry and your credit history. This evaluation is meant to determine how likely you are to pay the loan back on schedule, so the lender knows how much risk it is taking on.

It probably seems natural that a potential lender would scrutinize your background and financial history before choosing to extend you credit. But you can be selective, too. It's important that you research the terms of the loan you're being offered, to make sure that the lender, its products and its services also fit your needs.

One of the best ways to weigh different loans is by comparing the cost of borrowing the money, which includes the interest rate you're offered and any fees the lender charges. A simple way to compare the combined cost of interest and fees is by checking out the loan's annual percentage rate (APR), which tells you the percentage of the principal you'll have to pay on a yearly basis for the privilege of borrowing.



Comparing costs

Generally speaking, the better your credit score, the more likely you are to be offered a favorable interest rate. That's because lenders consider people who have repaid their debts in the past to be less of a repayment risk. If your credit score isn't great the lender might decide not to lend to you at all, or might offer you a higher interest rate to compensate for the risk it's taking.

Shopping around might produce a better deal. It can help to check with your bank or a lender you already have an account with, since they might offer better terms or a small discount to current customers.

TIP

0% Interest

What if you're offered an interest-free loan? That can be a really good deal, because you can pay for something over time without a finance charge. But you'll want to be careful you understand the terms. For example, with some interest-free loans you risk having to pay a substantial fee plus the accumulated interest if you're ever late with a payment—even if it arrives only a day or two after the due date.

Truth in lending

Every lender you're considering is legally required to give you the following information about your loan:

- Finance charge, or the dollar amount of the interest and any fees you'll pay
- Amount financed, or the total amount you're borrowing
- Total of payments, or the total amount you'll repay the lender
- Annual percentage rate (APR), or the annual interest you're charged
- The payment schedule

This is known as a Truth in Lending disclosure, and it's meant to protect you against surprises about how much your loan will cost.

Repaying the loan

With fixed-rate loans, your monthly payment stays the same over the life of the loan. Early on in the term of your loan, however, most of your monthly payment is paid towards interest, with a small portion of your payment allocated toward your principal balance. That gradually changes, though, and toward the end of your loan term your monthly payments mostly go towards repaying the principal. The full amount that borrowing costs will be disclosed in the Truth in Lending information.

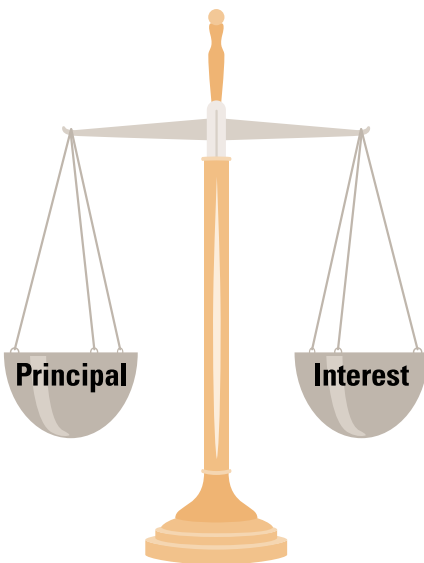
If your monthly loan payment is \$500, for example, \$5 of your

first payment might go toward the principal, while \$495 goes toward interest. In the last payment, the situation could be reversed, with \$5 going toward interest and \$495 paying down the remaining principal.

With adjustable-rate loans, your monthly payment may change as the interest rate changes due to changes in the index rate. That can benefit you if interest rates fall and your payment is smaller. But in some periods interest rates may rise, which means your payment will probably be larger.

Late loan payments

Just as with a credit card, if you're late with your monthly repayments, you'll face stiff penalties. And the negative information will probably be available in your credit report, which damages your credit score and might make it harder for you to get a loan in the future. If you research your loan carefully and budget for the payments, though, a loan can be a great benefit to your financial life.



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