Personal Financial Skills:

WORKBOOK 4: Getting a Loan





Consumer Credit C C Counseling Service C S

Personal Financial Skills

Realizing Your Financial Goals

Whether you want to buy a home, start a business or pay off your debt, personal financial skills are the first step to taking control of your financial future. The Personal Financial Skills workbook series will help you learn the necessary skills to maintain a family spending plan, use checking and savings accounts, build or repair your credit history, and apply for a loan. Regardless of your age, occupation or financial management experience, you will find useful skills and tips throughout this self-study material. Enjoy!



The Fannie Mae Foundation creates affordable homeownership and housing opportunities through innovative partnerships and initiatives that build healthy, vibrant communities across the United States. The Foundation is specially committed to improving the quality of life for the people of its hometown, Washington, DC, and to enhancing the livability of the city's neighborhoods.



The Home Depot is the largest retailer in the home improvement industry. Our goal is to provide the highest level of customer service, the broadest selection of products and the most competitive prices. We are a values-driven company and our eight (8) core values include the following: Excellent customer service • Taking care of our people • Giving back • Doing the "right" thing • Creating shareholder value • Respect for all people /Entrepreneurial spirit • Building strong relationships.



Consumer Credit Counseling Service empowers people to enjoy a lifetime of economic freedom. CCCS educates all segments of society in the wise use of credit and provides an impartial forum for resolving debt problems. Named Agency of the Year for 1999 and 2000 by the National Foundation for Credit Counseling, CCCS Atlanta is the nation's premier debt-management service organization, characterized by excellence, integrity and technological innovation.

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So, you want to take control of your financial future -

You've come to the right place. This self-study workbook series will help you to develop critical skills for financial independence. There are four workbooks:

Workbook 1: Developing a Spending Plan

Workbook 2: Working with Checking and Savings Accounts

Workbook 3: Understanding Credit and Your Credit Report

Workbook 4: Getting a Loan

Developing personal financial skills is the first step to taking control of your financial future. We have written these workbooks to help you learn financial skills that will give you the ability to plan your future. The following steps will help you use this workbook as a guide for your independent learning:

- 1. Begin each chapter by quickly scanning the headings. This will give you a basic idea of what you will be studying.
- Each chapter has a number of subsections. Each subsection begins with study objectives stated as questions. To complete this workbook you will need to be able to answer these questions. As you read and find the answers, underline or highlight them for later reference. It is important to underline and write in this book to reinforce your learning.
- 3. All bold terms are defined in the workbook glossary. Refer to the glossary to assist you.
- 4. A short self-assessment follows each subsection. This will help check and reinforce what you have read. Answer each question and then check your answers at the bottom of the exercise.
- 5. At the end of each chapter you will find a Knowledge Review. Use this opportunity to review the concepts discussed in this workbook.
- 6. You will need a pencil and a calculator to complete this workbook.

Workbook Objectives

Getting a Loan

In this workbook you will learn about:

- different types of financial institutions
- the lending process
- completing a loan application
- evaluating loan rates, fees, and terms
- ways to avoid predatory lending
- the importance of insurance

Have you ever applied for a loan? What do you know about the types of financial institutions that offer lending products and services? Do you understand how financial institutions evaluate loan applications? Do you know how loan rates, terms, and fees will affect the cost of your loan? If you are interested in getting a loan, this workbook will provide you with the information you need to understand the lending process.

Your Loan Experience Exercise

Answer the following questions to find out how much you know about applying for a loan.

1. What are the differences between a loan fund and a bank?

2. Have you ever applied for a loan? _____

- 3. List three pieces of information that are required to complete a loan application.
- 4. How does the interest rate affect the cost of credit?
- 5. How does the size of your **down payment** affect the cost of credit?
- 6. How do you know whether a lender has charged you excessive rates or fees?

Types of Financial Institutions

Study Objectives

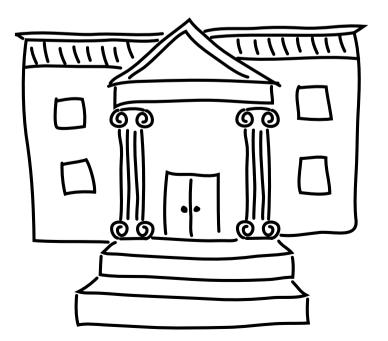
Underline/highlight the answers to these questions as you read:

- 1. What are the different types of financial institutions?
- 2. Which types of financial institutions offer depository services?
- 3. What is FDIC and NCUSIF insurance?

Financial institutions are businesses that provide services such as checking accounts, savings accounts, and loans. Banks, savings and loans, credit unions, finance companies, and loan funds are all types of financial institutions. As you learn to manage your finances, your needs will change. Different types of financial institutions are available to meet different needs and provide a range of products and services.

Examine the chart on page 5 to learn about the differences among financial institutions. In addition to loans, some financial institutions offer **depository services**. This means that you can open a checking account or savings account at these institutions. Also pay attention to the financial institutions that are either **Federal Deposit Insurance Corporation (FDIC)** or **National Credit Union Share Insurance Fund (NCUSIF)** insured. The

government regulates these financial institutions and insures customer deposits for up to \$100,000 per account. After you read through the chart, try to identify a local financial institution in each category.

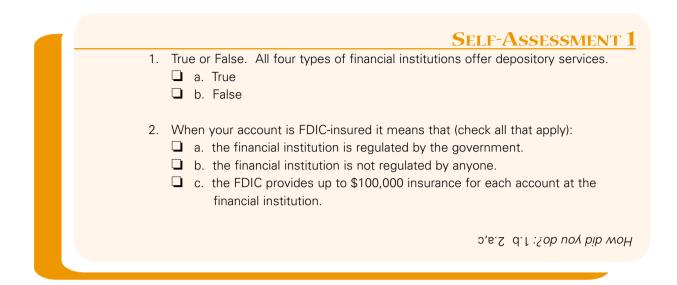


Financial Institutions Table

	Mission	Depository Products	Credit Products/ Terms	Insured	List Local Institutions
Banks/ Savings Banks	These for-profit financial institutions are the largest source of deposits and credit in the economy. Business decisions are driven by the desire to make a profit.	Provide depository services to individuals and organizations.	 Deposits are used to make personal, business, and real estate loans. Fees and interest rates are set by the market. 	FDIC*	
Credit Unions	These nonprofit cooperative financial institutions exist to serve their members' financial needs.	Provide members with depository services.	 Provide members with credit services. Specialize in meeting family credit needs (auto, mortgage, home equity, and emergency loans). 	NCUSIF**	
Finance Companies	These for-profit businesses make consumer and commercial loans. They focus on serving borrowers who are considered too risky for banks, such as individuals with poor credit histories.	None	 Consumer finance companies make small installment and home equity loans. Business finance companies finance assets (e.g., inventory, equipment). Sales finance companies make loans for large items such as refrigerators, cars, and mobile homes. Finance companies usually charge higher rates of interest and more fees than other lenders. Terms are often short-term. 	No	
Loan Funds	Loan funds are pools of money established to make loans in situations where conventional sources of financing do not exist. As the loans are repaid, the money is lent out again. Lending practices in these organizations are usually guided by a community development mission.	None	 Provide individuals, businesses, nonprofits, and housing organizations with loans (typically specialize in housing or small business loans). Prefer lending to organizations that do not have access to capital through mainstream sources. Structure, terms, and underwriting of loans are more flexible than main- stream sources of capital. Often seek projects that result in job creation. 	No	

* The Federal Deposit Insurance Corporation (FDIC) insures accounts at federal government-regulated financial institutions for up to \$100,000 per account.

**Nations Credit Union Share Insurance Fund (NCUSIF) insures accounts at federal government-regulated credit unions for up to \$100,000 per account.





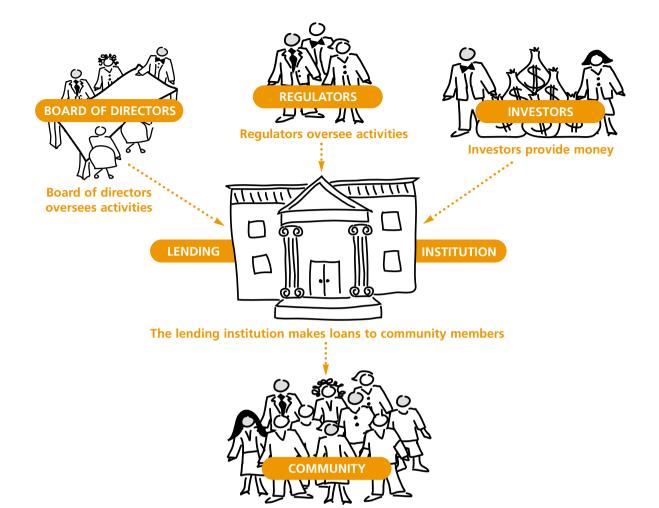
Underline/highlight the answers to this question as you read:

1. What is most important to a financial institution when they make a loan?

The Credit System

As you learned in *Workbook 3: Understanding Credit and Your Credit Report*, credit is used to start businesses, build houses, buy houses, and make needed purchases. Before you apply for a loan, it is useful to learn about the credit system and the criteria used by financial institutions to make loan decisions.

People gain access to credit from many sources, such as banks, loan funds, credit unions, car dealers, and pawnshops. Working with a traditional lending institution (e.g., a bank, a loan fund, a credit union) provides you more consumer protection than an informal source of credit (e.g., a pawnshop, a check-cashing company). The diagram on the following page describes how lending institutions work.



While different lending institutions offer different types of products and services, they also have some things in common. Lending institutions are

- Accountable for their activities. Most lending institutions' activities are overseen by at least one outside organization. The regulating and oversight organizations (e.g., government regulators, boards of directors, and investors) make sure that the lending institution makes loans that will be repaid. They also monitor the lending institution so that it does not take advantage of borrowers.
- Dependent on borrowers' loan repayment to stay in business. Lending organizations need to be repaid in order to have money to lend to other community members as well as to repay their own debts to investors.

Whether you seek credit from a bank, a community loan fund, a community credit union, or a car dealer, the important thing to remember is that lending decisions are based on your ability to repay the loan.

1. Lending decisions are based on:

- □ a. the number of loans the lender needs to make each month.
- **b**. an applicant's relationship with the lender.
- **c**. an applicant's ability to repay a loan.

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Self-Assessment 2

Study Objectives

Underline/highlight the answers to these questions as you read:

- 1 What are the five C's of credit?
- 2 What is a nontraditional credit history?
- 3 What is a debt-to-income ratio?

Evaluating a Loan Application

When a financial institution evaluates a loan application, it is assessing an applicant's ability to repay a loan. This process is often referred to as evaluating the five C's of credit—character, capacity, capital, collateral, and conditions.

Character

Lenders look at a person's **credit report** as well as the person's checking and savings accounts to assess how well the person handles financial obligations. An applicant's **credit history** is one of the most important factors in establishing his or her ability to

repay a loan. If a person does not have any established credit, lenders will look at a **nontraditional credit history**. To build a nontraditional credit history:

- Keep copies of your paid bills.
- Keep copies of the canceled checks used to pay bills.
- Ask those people/organizations to whom you pay bills to write a letter stating how long you have been a customer and paid your bills on time.

If a person has a poor credit history, it is important to take steps to repair it. In addition, an applicant can assemble a nontraditional credit history to demonstrate improved ability to handle financial obligations.

Lenders also consider as part of character the length of time someone has lived at his or her current residence. Lenders often feel most comfortable lending to people who have demonstrated stability in their residence.

Capacity

Lenders look at the amount a potential borrower can afford to pay. This aspect of the evaluation will assess your current income and expenses. Lenders will consider all verifiable sources of income, including employment checks, government checks, and alimony. Expenses include all outstanding loans, credit card debt, child support, and any other expenses you pay each month.

A lender assesses an applicant's capacity by calculating the relationship between the applicant's debt and income. The loan officer will divide the applicant's total debt by his or her total income to come up with a **debt-to-income ratio** (total debt/total income = debt-to-income ratio). The acceptable debt-to-income ratio depends on the type of lending institution and the type of loan. It is generally accepted that a person's total debt should not exceed 45 percent of the person's total income each month. For example:

Robert earns \$1,600 a month. He pays \$500 a month for rent. His car payment is \$175 a month. He pays his ex-wife \$200 a month alimony and the minimum payment of \$35 on each of two credit cards.

Total monthly debt = \$500 + \$175 + \$200 + \$35 + \$35 = \$945

Total monthly income = \$1,600

Debt-to-income ratio = \$945/\$1,600 = 59%

Robert's debt-to-income ratio is too high for most lenders to feel comfortable lending to him. A lender will not want to place any additional financial burden on Robert's monthly income. He will likely need to pay off some of his debt before a lender is willing to make him a loan.

Debt-to-Income Ratio Exercise

Sheri earns \$1,500 a month. She pays \$300 a month for rent. She pays her entire credit card bill each month (approximately \$100 per month) and does not owe any money. She pays \$50 a month for her car payment and \$50 a month to repay a student loan. Calculate Sheri's debt-to-income ratio.

1. Calculate Sheri's debt-to-income ratio.

Total monthly debt =	······
Total monthly income = $\frac{1}{2}$	

Debt-to-income ratio = \$_____/ \$____ = ___%

2. Based on Sheri's debt-to-income ratio, do you think a lender will feel comfortable giving Sheri a loan? _____

See page 33 for the answers.

Capital

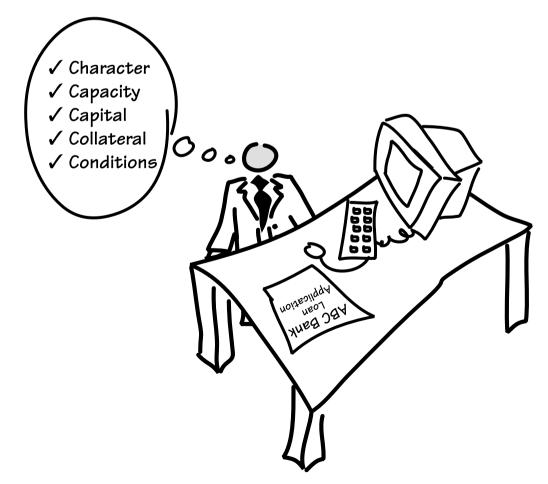
Depending on the type of loan, lenders are interested in how much of your own money you plan to invest in a purchase. In addition, lenders consider all items of value owned by the loan applicant. They are interested in the applicant's resources in case there is a problem repaying the loan. From the lender's perspective, someone who owns property or items of value can sell them to repay a loan.

Collateral

Lenders often ask a borrower to commit something of value to guarantee repayment of a loan. If a borrower is unable to repay a loan, the lender accepts ownership of the item as repayment. When evaluating a loan application, lenders look at the value of the borrower's collateral. Often borrowers use their home, car, or savings account as collateral for a loan. A lender never wants to repossess a borrower's collateral. Repossession is the last resort.

Conditions

Lenders are interested in any conditions that may affect the applicant's ability to repay the loan (e.g., change in the economy, loss of a job, emergency medical bills). The consistency of an applicant's employment is quite important in this part of the evaluation. If you have been at a job for less than two years, you may be asked to provide additional information about your work history.



Evaluating a Loan Application Exercise

1. Character:

As a loan officer for the Pay-Us-Back (PUB) Loan Fund, you make recommendations to the loan committee about who should receive a loan. This month the following applications are on your desk. Use the five C's of credit to assess the applicants' credit worthiness.

1. Kavitha is a 25-year-old single mom. She makes \$22,000 a year (\$1,833 per month). She has been working at Home Depot for three years. She has \$600 in her savings account at Example Bank. She has one credit card and has made her credit card payments on time. Her monthly expenses are \$800.

Kavitha is applying for a \$1,200 loan to purchase a computer. She would like to use the money in her savings account as collateral for the loan.

a. Using the five C's of credit, what observations can you make about Kavitha's ability to repay a loan?

2. Capacity:	Character: credit history
	Capacity: repayment sources, debt-to- income ratio
3. Capital:	Capital: personal investment,
4. Collateral:	alternative repayment sources
	Collateral: personal valuables to guarantee repayment
5. Conditions:	Conditions: situations that affect repayment

b. What questions would you like to ask Kavitha?

c. Given what you know, do you recommend making Kavitha a loan? ____

2. Juan is a 32-year-old man. His ex-wife lives in a nearby community with their 10-year-old son. He makes \$24,000 a year (\$2,000 per month) working at Home Depot. He has been at his job for one year. Juan's credit history indicates a few late payments on bills, but nothing that is currently outstanding. He has no savings. He pays \$500 for child support each month. His other monthly expenses cost around \$700 per month.

Juan is applying for a \$1,000 loan to purchase mechanic's tools. He would like to fix friends' and family members' cars to earn some extra money.

a. Using the five C's of credit, what observations can you make about Juan's ability to repay a loan?

credit history	1. Character:
Capacity: repayment sources, debt-to-	
income ratio	2. Capacity:
Capital: personal investment,	
alternative repayment sources	3. Capital:
Collateral: personal valuables to	
guarantee repayment	4. Collateral:
Conditions: situations that affect repayment	
	5. Conditions:

b. What questions would you like to ask Juan?

c. Given what you know, do you recommend making Juan a loan? _____

See page 33 for suggested answers.

Preparing for a Loan Application Exercise

Now that you've evaluated other people's loan applications, how can you prepare a strong application for yourself? Under each of the five C's of credit, list some actions that will help you develop a strong loan application.

1. Character:	Character:
	credit history
2. Capacity:	Capacity: repayment sources, debt-to- income ratio
3. Capital:	Capital: personal investment, alternative repayment sources
4. Collateral:	Collateral: personal valuables to guarantee repayment
	Conditions: situations that affect repayment
5. Conditions:	

See page 34 for suggested answers.

	Self-Assessment 3
1.	 The five C's of credit: a. evaluate an applicant's ability to repay a loan by examining their credit history, repayment sources, personal investment, and other issues affecting their financial situation. b. help a lender to understand an applicant's financial situation, but they do not affect the loan decision.
2.	 True or False. If you do not have an established credit history, you should present a nontraditional credit history with your loan application. a. True b. False
3.	 A debt-to-income ratio is (check all that apply): a. an applicant's total debt divided by their total income. b. a ratio used to evaluate an applicant's ability to afford repaying a loan.
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Study Objectives

Underline/highlight the answers to this question as you read:

1. What type of information is needed to complete a loan application?

Applying for a Loan

Before you are ready to apply for a loan you should order and review a copy of your credit report. Review *Workbook 3: Understanding Credit and Your Credit Report* for an explanation of this process.

There are a number of steps in the loan application process. The following diagram outlines the steps to arriving at a loan decision.



Completing a Loan Application

To gain access to credit from a lending institution, you must complete a loan application. Lenders use loan applications to collect information about applicants. They collect information that will help them evaluate the applicant's ability to repay a loan. This information usually includes the following:

- *loan purpose:* What is the applicant going to use the money for?
- *repayment history:* What is the applicant's credit history?
- *repayment sources:* How is the applicant going to repay the loan? What is the applicant's income? Savings? Are there any co-applicants who will be pooling resources?
- *other debts:* Does the applicant owe any other money? Are there any other loans that the applicant will be paying off at the same time, using the same repayment sources?

Loan applications can take some time to complete. Every loan application asks for similar information, as well as authorization to get a copy of your credit report.

The following information is necessary to complete a loan application:

- name and Social Security number;
- address and length of time at the current address;
- place of employment and length of time on the job;
- monthly income from all verifiable sources;
- monthly expenses;
- all debts (e.g., loans, credit cards), including the lender's name and the account number. If you apply with a **joint applicant**, similar information will be needed from both people.

Some additional information may also be requested during the loan application process, such as:

- pay stubs covering the past 30 days;
- copies of your income tax returns for the past two years;
- paperwork that shows the cost of what you are buying, if you are borrowing to make a purchase.

accurate information. A lender will verify all of the information that you provide on your loan application. If you have had credit problems or other difficulties, share them with the lender and explain steps you have taken to correct the situation. If you have credit problems that you have not addressed, discuss actions you can take to deal with them. It is the lender's job to gather information that proves that you will repay a loan.

The following is an example of a loan application	The	following	is an	example	of a	loan	application	1:
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Self-Assessment 4

- 1. To complete a loan application, you will need to provide (check all that apply):
 - □ a. the loan purpose.
 - □ b. your name and Social Security number.
 - c. copies of your income tax returns for the last two years.

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Underline/highlight the answers to these questions as you read:

- 1. What is the purpose of the credit interview?
- 2. What is credit scoring?
- 3. What are common reasons for credit denials?
- 4. What are some ways to work toward getting a loan?

<u>Credit Interview</u>

After you complete a loan application, you will go through an interview with a loan officer. It is the loan officer's job to review the loan application with you and be sure that it is complete. The loan officer will probably ask you some specific questions about your loan request. For example, the officer will want to know how you will use the money. It is the loan officer's responsibility to establish that the loan will be used for a legal purpose. Be cooperative and provide all of the information requested.

Credit Scoring

Many lenders use computer models to evaluate loan applications and give them a credit score. A credit score is used to predict how likely an individual is to repay a new loan based on the financial institution's experience with millions of consumers. There are many different computer models used to calculate a credit score. In general, however, the computer model assigns points to information in a credit report. For example, making payments on time every month is a positive credit score. Regularly charging the maximum amount available on a credit card is negative. The computer adds the positive and negative points, and the resulting number is a credit score. Each lender decides what credit score range it considers to be a good or poor risk.

Creditors use credit scoring because it is a fast, objective way to evaluate a credit report. Credit scoring also protects you. This is because your age, health, race, religion, gender, national origin, marital status, income, and employment are not considered in determining your credit score. If a lender has turned you down for a loan because of a poor credit score, you should:

- Request a written explanation from the lender. Law requires the lender to explain the reason for the denial.
- Make a plan to address the issues.

Also, remember that the lender, not a credit score, makes the final decision to approve a loan application. A credit score is simply a tool used by the lender. The lender may take into consideration any special reasons for your past credit problems. In addition, the lender will look at more than just your credit score—such as your equity investment in a home, job history, income, savings, and the type of loan you are requesting—before making a decision.

Credit Denials

Sometimes credit applications are not approved. Some common reasons that loan applications are denied are:

- **Poor credit history:** Lenders review an applicant's credit history to evaluate his or her record of paying bills on time. A credit history is seen as a good indicator of whether someone will repay a loan. Take the time to review your credit report and correct any mistakes.
- **Too many open credit cards:** Credit cards may be viewed as opportunities for the applicant to acquire additional debt. If the account stays open, the lender considers the credit available to the applicant. Discuss with a lender whether closing out old credit cards will positively affect your credit application.
- **Too much debt:** Lenders compare the applicant's debt and income. If a lender feels that an applicant is carrying too much debt relative to income, the lender is not likely to make a loan and add to the applicant's debt burden. Pay off some debt.
- **Employment history:** To a lender, steady employment signifies an income stream to repay a loan. Stay in your job or a job in a similar field for at least two years.
- Loan request is too high: An applicant's financial situation determines the size of the loan that will be approved. If an applicant requests more than this amount, the application will be denied. Discuss an appropriate loan size with your lender.
- Too many credit report inquiries: There are two types of credit inquiries. Promotional or "uninvited inquiries" are a result of creditors purchasing your name from a credit bureau because you fit a desired profile for their product. When the creditor sends you a promotional offer, a "promotional inquiry" is placed on your credit report. Other inquiries result when you express interest in using credit for a purchase. Lenders look at the number of this second type of inquiry on your credit report within a six-month period. Too many inquiries signify that an applicant may be trying to get credit from a number of places. Lenders worry that people are either denying the applicant credit or the

Too many credit cards

Loan request is too high

Poor credit history

Too much debt

applicant is amassing credit from a number of sources. Either way, the lender sees the inquiries as increasing the risk associated with lending the applicant money.

Do not authorize anyone to run a credit check on you unless you are going to make a purchase. Check your credit report for unauthorized inquiries and have them removed. See *Workbook 3: Understanding Credit and Your Credit Report* for an explanation of this process.

If you are denied credit, the lending organization is required to provide you with a reason for the denial within 30 days. You are also entitled to a free copy of your credit report. If the denial reason is at all unclear, ask the lender to explain it.

Getting to YES

Lenders are in the business of making loans that will be repaid. Applying for credit can be a frustrating process. Recognize that credit denials and requests for additional information may not be acts of bias or discrimination. Try to understand how the credit decision is being made and what you can do to satisfy the lender's criteria. Most lenders will be very willing to work with you and discuss ways that you can strengthen your loan application. For example:



Karen applied for an \$11,000 car loan. Her credit application was denied. When she spoke with her lender, he explained that she did not make enough money to support the debt. Karen and her lender then discussed how much money she could afford to borrow. Ultimately, the lender made Karen a \$5,000 car loan. Karen was able to buy a used model of the car she wanted.

Eric applied for a \$5,000 home equity loan. His credit application was denied. When he discussed the application with his lender, he was told that his credit report showed a

number of late payments and too many open credit cards. Eric explained that his son had been hurt in a car accident and the insurance money did not come on time to pay the hospital. Everything had been dealt with and there were no other late payments on his report. At the lender's suggestion, Eric closed three of his credit card accounts that he did not use. Eric was able to borrow the \$5,000 he requested.



If you are having trouble getting a loan, you might want to discuss with a lender how the following actions might strengthen your loan application:

• Use collateral to secure your loan. Collateral is something of value that the lender can take and sell if you are unable to repay the loan. Be sure you are comfortable with your ability to repay the loan or you may lose your collateral if you cannot make your loan payments.

- **Put a substantial down payment on your purchase.** Your personal investment is important to a lender. A significant down payment can improve your chances of receiving a loan. For instance, if you want to make a \$6,000 purchase and are able to make a \$3,000 down payment, it may improve your chances of getting the loan.
- Request a friend or a family member with good credit to co-sign or be a co-applicant on your loan. Make sure you can repay the loan before you consider asking someone to co-sign and put his or her own credit history at risk.
- Establish a nontraditional credit history. To build a nontraditional credit history:
 - Keep copies of your paid bills.
 - Keep copies of the canceled checks used to pay bills.
 - Ask those people/organizations to whom you pay bills to write a letter stating how long you have been a customer and paid your bills on time.
 - Clean up your credit history. If you have a poor credit history, no one can make it go away. Yet, there are steps you can take to rebuild your credit history:
 - Pay your bills on time.
 - Stay at your job and at the same residence for an extended period of time.
 - Pay down existing debts.
 - Open a checking or savings account.
 - Open a secured card or take out a secured loan from a local lender and repay it. This will begin to establish a positive repayment history.
 - Be patient. Reestablishing your credit takes time.



Self-Assessment 5

1. True or False. Credit scoring is based on a lender's experience with borrowers repaying their loans.

🖵 a. True

- 🗅 b. False
- 2. True or False. It will be difficult to get a loan if you do not pay your bills on time.
 - 🗅 a. True
 - 🖵 b. False
- 3. True or False. Lenders are in the business of denying loan applications.
 - 🗅 a. True
 - 🖵 b. False

d.E E.S E.f : Sob uoy bib woh

Study Objectives

Underline/highlight the answers to these questions as you read:

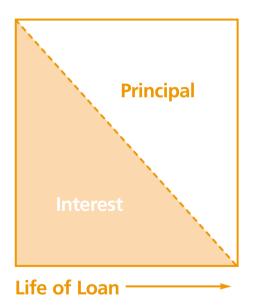
- 1. How does the monthly loan payment change over the life of the loan?
- 2. How do the interest rate, term, down payment, and fees affect the cost of a loan?
- 3. What is a payment factor table?

Loan Rates, Terms, and Fees

When you borrow money, the lender charges you for using the funds (**interest**). Usually, the cost of borrowing the money is paid for in small amounts over the life of the loan. Every monthly payment includes repayment of some of the borrowed amount (**principal**) and some of the cost of borrowing the money (interest).

Monthly payment = Principal payment + Interest

When you start to repay a loan, your monthly payments are mostly the interest and a small amount of the principal, because interest is repaid first. **Throughout the life of a loan, a greater percentage of your monthly payments become principal and less is interest.**



There are several factors that affect the cost of credit and the monthly payment on a loan. These variables are interest rate, terms, down payment, and fees. Review the following examples to see how the cost of credit can change.

Interest rate	8%	14%
Loan amount	\$3,000	\$3,000
Number of monthly payments	48	48
Monthly payment	\$73.24	\$81.98
Total amount of payment	\$3,515.46	\$3,935.01
Cost of credit	\$515.46	\$935.01

The longer the term of the loan, the lower the monthly payment but the greater the cost of the credit.

Number of monthly payments	36	60
Loan amount	\$3,000	\$3,000
Interest rate	12%	12%
Monthly payment	\$99.64	\$66.73
Total amount of payments	\$3,587.15	\$4,004.00
Cost of credit	\$587.15	\$1,004.00

The higher the down payment, the lower the loan amount and the cost of the credit.

0% = \$0

\$3,000

\$3,000

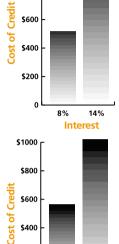
\$79.00

\$792.07

\$3,792.07

12%

48



\$1000

\$800

\$200

15% = \$450

\$3,000

\$2,550

\$67.15

\$673.26

\$3,223.26

12%

48

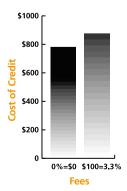
0

36 60 months months

Term

\$1000 r \$800 Cost of Credit \$600 \$400 \$200 0 0%=\$0 15%=\$450

Down Payment



The higher the loan fees, the higher the cost of the credit.

Down payment

Monthly payment

Cost of credit

Number of monthly payments

Total amount of payments

Purchase price

Loan amount

Interest rate

Loan fees	\$0 = 0%	\$100 = 3.3%
Loan amount	\$3,000	\$3,000
Net loan proceeds	\$3,000	\$2,900
		(\$3,000 – \$100)
Interest rate	12%	12%
Number of monthly payments	48	48
Monthly payment	\$79	\$79
Total amount of payments	\$3,792.07	\$3,792.07
Cost of credit	\$792.07	\$892.07

Payment Factor Table

You can calculate monthly payments or the cost of credit for an installment loan (e.g., car loan, boat loan) by using a computer program or a **payment factor table**. You can multiply the amount you want to borrow by an identified payment factor to calculate your monthly loan payment.

Interest						1	FERM, IN	YEARS						
Rate	1	2	3	4	5	6	7	8	9	10	15	20	25	30
3.00%	0.08469	0.04298	0.02908	0.02213	0.01797	0.01519	0.01321	0.01173	0.01058	0.00966	0.00691	0.00555	0.00474	0.00422
4.00%	0.08515	0.04342	0.02952	0.02258	0.01842	0.01565	0.01367	0.01219	0.01104	0.01012	0.00740	0.00606	0.00528	0.00477
5.00%	0.08561	0.04387	0.02997	0.02303	0.01887	0.01610	0.01413	0.01266	0.01152	0.01061	0.00791	0.00660	0.00585	0.00537
6.00%	0.08607	0.04432	0.03042	0.02349	0.01933	0.01657	0.01461	0.01314	0.01201	0.01110	0.00844	0.00716	0.00644	0.00600
7.00%	0.08653	0.04477	0.03088	0.02395	0.01980	0.01705	0.01509	0.01363	0.01251	0.01161	0.00899	0.00775	0.00707	0.00665
8.00%	0.08699	0.04523	0.03134	0.02441	0.02028	0.01753	0.01559	0.01414	0.01302	0.01213	0.00956	0.00836	0.00772	0.00734
9.00%	0.08745	0.04568	0.03180	0.02489	0.02076	0.01803	0.01609	0.01465	0.01354	0.01267	0.01014	0.00900	0.00839	0.00805
10.00%	0.08792	0.04614	0.03227	0.02536	0.02125	0.01853	0.01660	0.01517	0.01408	0.01322	0.01075	0.00965	0.00909	0.00878
11.00%	0.08838	0.04661	0.03274	0.02585	0.02174	0.01903	0.01712	0.01571	0.01463	0.01378	0.01137	0.01032	0.00980	0.00952
12.00%	0.08885	0.04707	0.03321	0.02633	0.02224	0.01955	0.01765	0.01625	0.01518	0.01435	0.01200	0.01101	0.01053	0.01029
13.00%	0.08932	0.04754	0.03369	0.02683	0.02275	0.02007	0.01819	0.01681	0.01575	0.01493	0.01265	0.01172	0.01128	0.01106
14.00%	0.08979	0.04801	0.03418	0.02733	0.02327	0.02061	0.01874	0.01737	0.01633	0.01553	0.01332	0.01244	0.01204	0.01185
15.00%	0.09026	0.04849	0.03467	0.02783	0.02379	0.02115	0.01930	0.01795	0.01692	0.01613	0.01400	0.01317	0.01281	0.01264
16.00%	0.09073	0.04896	0.03516	0.02834	0.02432	0.02169	0.01986	0.01853	0.01753	0.01675	0.01469	0.01391	0.01359	0.01345
17.00%	0.09120	0.04944	0.03565	0.02886	0.02485	0.02225	0.02044	0.01912	0.01814	0.01738	0.01539	0.01467	0.01438	0.01426
18.00%	0.09168	0.04992	0.03615	0.02937	0.02539	0.02281	0.02102	0.01972	0.01876	0.01802	0.01610	0.01543	0.01517	0.01507
19.00%	0.09216	0.05041	0.03666	0.02990	0.02594	0.02338	0.02161	0.02033	0.01939	0.01867	0.01683	0.01621	0.01598	0.01589
20.00%	0.09263	0.05090	0.03716	0.03043	0.02649	0.02395	0.02221	0.02095	0.02003	0.01933	0.01756	0.01699	0.01678	0.01671
21.00%	0.09311	0.05139	0.03768	0.03097	0.02705	0.02454	0.02281	0.02158	0.02067	0.01999	0.01831	0.01778	0.01760	0.01753
22.00%	0.09359	0.05188	0.03819	0.03151	0.02762	0.02513	0.02343	0.02222	0.02133	0.02067	0.01906	0.01857	0.01841	0.01836
23.00%	0.09408	0.05237	0.03871	0.03205	0.02819	0.02572	0.02405	0.02286	0.02200	0.02135	0.01982	0.01937	0.01923	0.01919
24.00%	0.09456	0.05287	0.03923	0.03260	0.02877	0.02633	0.02468	0.02351	0.02267	0.02205	0.02058	0.02017	0.02005	0.02002
25.00%	0.09504	0.05337	0.03976	0.03316	0.02935	0.02694	0.02531	0.02417	0.02335	0.02275	0.02136	0.02098	0.02088	0.02085

To use the payment factor table:

- 1. Identify the payment factor by locating the interest rate and length of time you will have the loan (in years).
- Calculate the monthly payment by multiplying the loan amount by the payment factor.
 Monthly payment = Loan amount x Payment factor
- 3. Calculate the total cost of the loan by multiplying the monthly payment by the number of months of the loan.

Total cost of loan = Monthly payment x Number of months

4. Calculate the cost of the credit by subtracting the loan amount from the total cost of the loan.

Cost of credit = Total cost of loan – Loan amount

Example

If you borrow \$1,500 at a 9 percent interest rate and agree to repay the loan over five years, the costs are as follows:

\$1,500
9%
5 years or 60 months
.02076
\$1,500 x .02076 = \$31.14
\$31.14 x 60 months = \$1,868.40
\$1,868.40 - \$1,500 = \$368.40

Interest Rates, Loan Terms, and Fees Exercise

Answer the following questions. Use the chart on page 21 and the payment factor table on page 22 to assist you.

- 1. Carrie borrows \$1,500 from the Bank to remodel her kitchen. She agrees to pay 8 percent interest on a five-year loan. Using the payment factor table, calculate the cost of Carrie's credit.
 - a. Loan amount \$_____
 - b. Interest rate 8%
 - c. Time

5 years or _____ months

- d. Monthly loan payment
 - Identify the payment factor ______
 - Multiply the payment factor by the loan amount
 \$_____ x ____ = \$____
- e. Total cost of loan \$_____ per month x _____ months = \$ _____
- f. Cost of credit \$_____ \$1,500 = \$_____
- Keith wants to buy a chainsaw that costs \$150. The store offers him a payment plan of \$20 a month for 15 months. If Keith uses the payment plan to purchase the chainsaw, how much will he pay?
- 3. Maria wants to buy a \$5,000 car. She has saved \$300 toward this purchase. The interest rate for her loan is 8 percent.
 - a. If Maria makes a down payment of \$300, how much money will she need to borrow to purchase the car? _____
 - b. Will Maria's cost of credit go down if she uses her \$300 as a down payment?_____
- 4. Sonya has a credit card with a 26 percent interest rate. If she pays the total amount due within 30 days of receiving her bill, she is not charged any interest.

One day, Sonya charges \$71.00 on her credit card. The next day, she sends the credit card company a check for the full amount. What percent interest did Sonya pay for her purchase? _____ percent

- 5. Toby is borrowing \$3,000 to remodel her house. Credit Union A offers her a loan with an 8 percent interest rate over five years (60 months). Credit Union B offers her a loan with a 10 percent interest rate over three years (36 months).
 - a. Which credit union is offering the loan with the least expensive monthly payment (monthly payment = loan amount x payment factor)?_____
 - b. How much less? _
 - c. Which credit union is offering the loan with lowest total cost (total cost of loan = monthly payment x number of months)?

Personally Evaluating the Deal Exercise

Your financial situation affects your approach to borrowing money. Every borrower needs to evaluate all the costs and terms associated with a potential loan. Borrowers must decide on the best loan product based on their own personal financial situation. For example:

Karime wants to borrow \$3,000 to buy a car. After paying his bills each month and accounting for the cost of living, he has exactly \$68.50 to put toward a car payment. Lender A offers him a four-year loan at 8 percent with monthly payments of \$73.24. Lender B offers him a five-year loan at 12 percent with monthly payments of \$65.97. Karime does some basic calculations to evaluate the two offers.

Lender B
\$3,000
12%
5 years
\$66.73
\$4,003.80
\$1,003.80

What should Karime do?_____

See page 36 for suggested answers.

Evaluate the Total Cost of a Loan

While it is exciting to get approved for a loan and gain access to credit, it is important to evaluate the costs. It can be deceiving to focus on any one factor that affects the price of the credit (e.g., interest rate). It is often worthwhile to "shop" for a good deal. This involves talking to a number of lenders about the total cost of borrowing a certain amount of money. Lenders are required by law to disclose the total cost of a loan. A lender may offer an appealing package from one perspective, but the total cost of the credit may not be competitive with that offered by other lenders. Make sure to talk about all of the costs involved and calculate the total cost of the credit.

Beware of loans with a large **balloon payment** at the back end. Balloon loans offer lower interest rates for shorter-term financing, usually five, seven, or 10 years. At the end of this term, they require refinancing or paying off the outstanding balance with a lump-sum payment. If the original loan does not guarantee a new loan with reasonable rates, the refinanced loan can cost you even more money because of loan fees and the uncertainty of rates in the future. Also, pay attention to loan fees. Loan fees increase the cost of credit. A fee is any charge added to the price of the loan. Loan fees vary with each lending institution and may include fees for the application, origination, appraisal, title search, or title insurance, or fees triggered by late loan payments. In most cases, loan fees should not exceed 5 percent of the loan amount unless you are paying for a lower interest rate.

If you have any questions, make sure you talk to a trusted adviser who has lending experience before you agree to the cost and terms of a loan.

	Self-Assessment 6
1.	 Over the life of a loan: a. a greater percentage of your monthly payments become principal and less is interest. b. a greater percentage of your monthly payments become interest and less is principal.
2.	 The higher the interest rate: a. the lower the cost of credit. b. the higher the cost of credit.
3.	 The longer the term: a. the lower the cost of credit. b. the higher the cost of credit.
	d.£ d.S &.f :5ob uoy bib woH

Study Objectives

Underline/highlight the answers to these questions as you read:

- 1. What is a predatory lender?
- 2. How can you avoid predatory lenders?

Predatory Lending

While most lenders conduct honest business, some do not. **Predatory lending** is when a lender directs a borrower away from loans with more affordable interest rates. Instead, the applicant is offered a loan with a high interest rate, questionable fees, or unnecessary charges. Predatory lenders often target lowand moderate-income persons, people of color, and the elderly.

Predatory lenders have many of the following traits:

- They offer loans based solely on the equity in a home and not on the borrower's ability to repay the loan.
- They charge unusually high interest rates for a loan.
- They add excessive points to the loan without lowering the interest rate.
- They include excessive fees.
- They tack on unnecessary costs such as prepaid, single-premium life insurance.

Avoid predatory lenders:

- Turn away loan offers from anyone who calls you on the telephone or comes to your door without an invitation. Throw away mail from companies offering to arrange a loan for you. Advertisements promising easy money should be viewed with caution. Remember, if an offer sounds too good to be true, it probably is.
- Be wary of high-pressure sales pitches, such as claims that an offer is good only for a limited time. If the offer is good—and legitimate—today, it should still be good tomorrow. Take time to check it out.
- If you're thinking about consolidating your debts into a home equity loan, talk to a local nonprofit housing or consumer credit-counseling agency first. These agencies have your best interest in mind. They may be able to help you work out credit arrangements to avoid debt consolidation altogether. If debt consolidation is the most appropriate choice, they can help you select the best available options. Without their assistance, you may choose a bad loan and end up losing your home.
- **Avoid loans that include extras you don't need.** Loans should not include unnecessary costs. Consult an adviser to discuss any additional costs that are being added to the loan.

- Never sign an agreement that you do not completely understand, and do not take a lender's word that an agreement is "standard." If the agreement seems unreasonable or uses terms that are unfamiliar to you, ask for a complete copy of the loan agreement. Get a second opinion from someone you trust before you sign the loan agreement. Ask your adviser or local nonprofit housing or consumer credit counselor to review it.
- **Speak to people you trust who have borrowed money.** Word of mouth can be a way to learn about predatory lenders.
- *Fill in all blank spaces.* If an answer is not required, write "N/A" (not applicable) in the blank. Do not sign a document until you have completed every space. Someone could fill in the blank later and make you responsible for something without your knowledge or agreement.
- **Investigate current interest rates.** Interest rates vary depending on the financial institution, the type of loan, your credit history, and your ability to repay. Call around to a number of financial institutions to discuss the interest rates and loan options that are available. If the interest rate seems excessively high, check with a trusted adviser before you agree to it.

As you investigate loan options, be sure not to agree to anything that you do not understand. Do not hesitate to call on community resources, such as Consumer Credit Counseling Service (call toll-free at **1-866-499-8771**) or nonprofit housing agencies. Many of these community contacts will provide free services and can be valuable resources.

SELF-ASSESSMENT 7

- 1. A predatory lender:
 - **a**. hangs around a borrower's home in order to get their business.
 - b. takes advantage of borrowers' inexperience and directs them away from loans with affordable interest rates.
 - C. sells predatory loans.
- 2. You can avoid predatory lenders by (check all that apply):
 - □ a. never signing an agreement that you do not understand.
 - □ b. avoiding high-pressure sales situations.
 - **C**. researching all of your options.

Pow did you do?: 1.b 2.a,b,c

Insurance

When you take out a loan to make a purchase (e.g., car, house) most lenders will require you to insure the item. Insurance is a tool to protect you when something goes wrong. It can be purchased for almost anything. The basic types of insurance are:

Homeowner's insurance

Homeowner's insurance protects your housing investment. To receive a traditional mortgage, you will likely need the following:

- Property damage coverage reimburses you for damage or loss to your house and belongings. It usually covers natural disasters (e.g., fire) and man-made disasters (e.g., theft, electrical fire). Areas that are prone to certain types of weather may offer policies that exclude common circumstances in that area. In these cases, you will need to purchase a separate policy to cover the possibility of property damage.
- Liability insurance protects you from people who might sue you for injuries or property damage. For example, if a dead tree on your property falls and damages the neighbor's property, you may be liable. This type of insurance would help cover the costs of repairing the damage to your neighbor's property.

Renter's insurance

Renter's insurance is similar to homeowner's insurance. It is for those who do not own their house. This type of coverage will reimburse you for damage or loss of your personal property due to events such as fire, theft, or water damage.

Automobile insurance

Automobile insurance is very important and in many states mandatory. It is essential to have enough coverage to fully cover any costs in the event that you cause harm to a person or property. If you do not have adequate insurance, an injured party can gain access to your assets such as savings or property. Everyone who drives a car should have the following types of insurance:

- Bodily injury liability covers injuries suffered by others hurt in an accident while you are driving.
- Property damage liability covers damage done by your car to the property of others.
- Collision coverage pays for damage done to your car in an accident. You will want enough coverage to fully replace your car.
- Comprehensive coverage pays for damage done to your car in an event other than an accident, such as theft or fire.
- Uninsured or underinsured motorist insurance covers your expenses in the event that you are in an accident with someone who either does not have automobile insurance or is underinsured to cover the damages.

Health insurance

Health insurance helps pay your medical bills. There are two basic types of coverage. A basic plan covers regular medical expenses such as doctor visits and prescriptions. There is usually a set dollar limit on this coverage. Major medical coverage covers more expensive procedures.

Credit life insurance

This insurance repays the lender for the balance of a loan in the event of the borrower's death or disability. This type of insurance can be purchased from the lender when you take out a loan. Be aware that it will add to the total cost of your loan and make payments higher.

A lender should not ask for a premium to be paid up front. This practice is frequently seen among predatory lenders. Investigate your options before you choose a policy.

Disability insurance

Disability insurance protects you against a loss of income if you are unable to work for a long time because of injury or illness. Before you purchase this type of insurance, be sure to investigate the coverage you already have, such as employer-provided sick leave, worker's compensation, Medicaid, and Social Security.

Life insurance

A life insurance policy provides money to your beneficiary (typically a surviving spouse or dependents) in the event of your death. If you have dependents or major financial obligations, you might consider purchasing life insurance. Be sure to clearly identify the beneficiary of your plan. The insurance company will only compensate people you identify. You can change your beneficiaries at any time. The following types are available:

- Term insurance offers you coverage for a specific period of time. It is often the least expensive option, but the cost increases as you age.
- Cash-value insurance provides your dependents with a cash payoff at your death, as well as providing you with a tax-deferred savings program. There are a variety of programs, such as whole life, universal life, and variable life. While the monthly premium is higher than on term insurance, it will never go up for your entire lifetime. Part of the money you pay goes toward insuring your life. The other part is invested by the insurance company and becomes an additional savings account for your use.

Before you purchase any type of insurance, be sure to research the options that are available. Call different insurance companies and investigate different types of coverage. If you have any questions or would like more information about a particular type of insurance, you can call the National Insurance Consumer Helpline at 1-800-942-4242.

Self-Assessment 8

- 1. What type of insurance protects you against the loss of income if you are unable to work a long time because of injury or illness?
 - a. health insurance
 - □ b. credit life insurance
 - □ c. disability insurance
- 2. What type of automobile insurance coverage pays for damage done by your car to the property of others?
 - □ a. bodily injury liability coverage
 - □ b. property damage liability coverage
 - □ c. collision coverage
- 3. What type of insurance reimburses you for damage or loss to your house and belongings?
 - a. life insurance
 - □ b. disability insurance
 - **c**. homeowner's insurance

D.E d.S D.I Sob uoy bib woh

Summary Points

- Financial institutions are businesses that provide services such as checking accounts, savings accounts, and loans. Banks, savings and loans, credit unions, finance companies, and loan funds are all types of financial institutions.
- The Federal Deposit Insurance Corporation (FDIC) or National Credit Union Share Insurance Fund (NCUSIF) insure checking and savings accounts at government-regulated financial institutions for up to \$100,000 per account.
- All financial institutions make loan decisions based on an applicant's ability to repay a loan.
- The five C's of credit include character (credit history), capacity (repayment sources, debt-to-income ratio), capital (personal investment, alternate repayment sources), collateral (personal valuables to guarantee repayment), and conditions (situations that affect repayment).
- Be honest and forthcoming on your loan application. Take the time to collect all of the necessary information and discuss any questions you have with a representative at the financial institution or Consumer Credit Counseling Service (1-866-499-8771).
- Throughout the life of a loan, a greater percentage of your monthly payments become principal and less is interest.
- The higher the interest rate, the greater the cost of the credit.
- The longer the term of the loan, the lower the monthly payment but the greater the cost of the credit.
- The higher the down payment, the lower the loan amount and the cost of the credit.
- The higher the loan fees, the higher the cost of the credit.
- Predatory lenders take advantage of inexperienced borrowers by directing them away from affordable loans.
- Always research your loan options and discuss any questions with industry experts such as Consumer Credit Counseling Service (call toll-free at 1-866-499-8771).
- Many lenders will require you to have insurance before they will make you a loan. Research your insurance options and discuss any questions with industry experts such as the National Insurance Consumer Helpline at 1-800-942-4242.

To review the concepts covered in this session, complete the Journal or the Self-Assessment exercise.

<u>Journal</u>

Take a few moments to write down the most important or useful ideas you learned in this workbook. What concepts do you want to remember?

Self-Assessment

Answer the following questions. Use the information in this workbook to help you.

- 1. What are some differences between a credit union and a finance company?
- 2. All financial institutions make lending decisions based on an applicant's ability to ______.
- 3. How can a person create a nontraditional credit history?
- 4. Why do lenders care about an applicant's debt-to-income ratio?
- 5. What is credit scoring?
- 6. The ______ the interest rate the lower the cost of credit.
- 7. The longer the term, the _____ the monthly payment but the _____ the cost of credit.
- 8. The higher the loan fees, the _____ the cost of credit.
- 9. List three ways to avoid a predatory lender:

Debt-to-Income Ratio Exercise

1. Calculate Sheri's debt-to-income ratio.

Total monthly debt = \$300 + \$100 + \$50 + \$50 = \$500 Total monthly income = \$1,500 Debt-to-income ratio = \$500/\$1,500 = 33%

2. Based on Sheri's debt-to-income ratio, do you think a lender will feel comfortable making Sheri a loan?

Yes

Evaluating a Loan Application Exercise

1. Kavitha is a 25-year-old single mom. She makes \$22,000 a year (\$1,833 per month). She has been working at Home Depot for three years. She has \$600 in her savings account at Example Bank. She has one credit card and has made her credit card payments on time. Her monthly expenses are \$800.

Kavitha is applying for a \$1,200 loan to purchase a computer. She would like to use the money in her savings account as collateral for the loan.

- a. Using the five C's of credit, what observations can you make about Kavitha's ability to repay a loan?
 - 1. Character:
 - Good credit history
 - Good work history (three years at job)

2. Capacity:

- Total monthly debt = \$800
- Total monthly income = \$1,833
- Debt-to-income ratio = \$800/ \$1,833 = 44%
- 3. Capital:
 - \$600 in bank account
- 4. Collateral:
 - \$600 in bank account
- 5. Conditions:
 - Good work history indicates a consistent source of income
- b. What questions would you like to ask Kavitha? Do you have any additional sources of income that might help you repay this loan?
- c. Given what you know, do you recommend making Kavitha a loan? Yes. She has demonstrated strong financial management skills by paying her bills on time and establishing a savings account.
- 2. Juan is a 32-year-old man. His ex-wife lives in a nearby community with their 10-year-old son. He makes \$24,000 a year (\$2,000 per month) working at Home Depot. He has been at his job for one year. Juan has a credit history indicating a few late payments on bills, but nothing that is currently outstanding. He has no savings. He pays \$500 for child support each month. His other monthly expenses cost around \$700 per month.

Juan is applying for a \$1,000 loan to purchase mechanic's tools. He would like to fix friends' and family members' cars to earn some extra money.

a. Using the five C's of credit, what observations can you make Juan's ability to repay a loan?

1. Character:

• Moderate credit history indicated by some late payments

2. Capacity:

- Total monthly debt = \$700 + \$500 = \$1,200
- Total monthly income = \$2,000
- Debt-to-income ratio = \$1,200/\$2,000 = 60%

3. Capital:

• No savings

4. Collateral:

• No valuables identified for collateral

5. Conditions:

- Additional work history will help evaluate Juan's ability to remain employed
- b. What questions would you like to ask Juan?
 - Is there any way for you to decrease your expenses?
 - Do you have any collateral to secure the repayment of the loan?
 - How much money will you earn each month fixing people's cars?
- c. Given what you know, do you recommend making Juan a loan?
 - No. Juan is probably not ready for a loan. His debt-to-income ratio is too high and his repayment history is not strong enough.

Preparing for a Loan Application Exercise

1. Character:

- Establish a good credit history by paying bills on time
- Establish a good credit history by opening a secured credit card account or a store credit card and by paying bills on time

2. Capacity:

- Maintain a stable residence
- Save money each month

3. Capital:

- Open a checking and/or savings account
- Save money each month

4. Collateral:

• Establish the value of your possessions

5. Conditions:

- Maintain stable employment
- If you are applying for a business loan, educate your lender about potential markets for your product

Interest Rates, Loan Terms, and Fees Exercise

- 1. Carrie borrows \$1,500 from the Bank to remodel her kitchen. She agrees to pay 8 percent interest on a five-year loan. Using the payment factor table, calculate the cost of Carrie's credit.
 - a. Loan amount \$<u>1,500</u>
 - b. Interest rate 8%
 - c. Time 5 years or <u>60</u> months
 - d. Monthly loan payment
 - Identify the payment factor .02028
 - Multiply the payment factor by the loan amount

\$<u>1,500</u> × <u>.02028</u> = \$<u>30.42</u>

- e. Total cost of loan 30.42 per month x <u>60</u> months = 1.825.20
- f. Cost of credit \$<u>1,825.20</u> \$1,500 = \$<u>325.20</u>
- 2. Keith wants to buy a chainsaw that costs \$150. The store offers him a payment plan of \$20 a month for 15 months. If Keith uses the payment plan to purchase the chainsaw, how much will he pay? <u>\$300</u>
- 3. Maria wants to buy a \$5,000 car. She has saved \$300 toward this purchase. The interest rate for her loan is 8 percent.
 - a. If Maria makes a down payment of \$300, how much money will she need to borrow to purchase the car? <u>\$4,700</u>
 - b. Will Maria's cost of credit go down if she uses her \$300 as a down payment? Yes
- 4. Sonya has a credit card with a 26 percent interest rate. If she pays the total amount due within 30 days of receiving her bill, she is not charged any interest.

One day, Sonya charges \$71.00 on her credit card. The next day, she sends the credit card company a check for the full amount. What percent interest did Sonya pay for her purchase? <u>0</u> percent

- 5. Toby is borrowing \$3,000 to remodel her house. Credit Union A offers her a loan with an 8 percent interest rate over five years (60 months). Credit Union B offers her a loan with a 10 percent interest rate over three years (36 months).
 - a. Which credit union is offering the loan with the least expensive monthly payment (monthly payment = loan amount x payment factor)? <u>Credit Union A</u> Credit Union A monthly payment = \$3,000 x .02028 = \$60.84 Credit Union B monthly payment = \$3,000 x .03227 = \$96.81
 - b. How much less? <u>\$35.97</u> \$96.81 - \$60.84 = \$35.97
 - c. Which credit union is offering the loan with lowest total cost (total cost of loan = monthly payment x number of months)? <u>Credit Union B</u> Credit Union A total cost of loan = \$60.84 x 60 months = \$3,650.40 Credit Union B total cost of loan = \$96.81 x 36 months = \$3,485.16

Personally Evaluating the Deal Exercise

Karime has a number of options:

- 1. The package that Lender B has offered works within his current budget, so he can accept it.
- 2. He can see that Lender A's offer will cost him less money over the life of the loan. Karime can go back to his budget and consider ways to decrease his monthly expenses by \$7.27 so that he can afford the larger monthly car payment.
- 3. Karime can go back and negotiate with either of the lenders to see if they are able to offer him a more appealing loan package.

There is no right or wrong answer. As a borrower, you need to evaluate what makes sense for your personal situation.

Knowledge Review Answers

Self-Assessment

- 1. What are some differences between a credit union and a finance company?
 - Credit unions are nonprofit financial institutions while finance companies are for-profit.
 - Credit unions offer depository and credit products while finance companies only offer credit products.
 - Deposits at credit unions are NCUSIF-insured.
- 2. All financial institutions make lending decisions based on an applicant's ability to repay the loan.
- 3. How can a person create a nontraditional credit history?

To build a nontraditional credit history:

- Keep copies of your paid bills.
- Keep copies of the canceled checks used to pay bills.
- Ask those people/organizations to whom you pay bills to write a letter stating how long you have been a customer and paid your bills on time.
- 4. Why do lenders care about an applicant's debt-to-income ratio?

The debt-to-income ratio indicates whether a borrower can afford a monthly loan payment. The financial institution evaluates the applicant's income relative to expenses. If a high percentage of an applicant's income is already being used for existing financial obligations (more than 45 percent), then the financial institution will not want to increase the applicant's monthly expenses.

5. What is credit scoring?

Credit scoring is a process used by financial institutions to evaluate loan applications. It uses the financial institution's historical experience with borrowers to predict whether the borrower will be able to repay the loan.

- 6. The *lower* the interest rate the lower the cost of credit.
- 7. The longer the term, the *lower* the monthly payment but the *higher* the cost of credit.
- 8. The higher the loan fees, the *higher* the cost of credit.

9. List three ways to avoid a predatory lender:

To avoid predatory lenders:

- Turn away loan offers from anyone who calls you on the telephone or comes to your door without an invitation.
- Be wary of high-pressure sales pitches, such as claims that an offer is good only for a limited time.
- If you are thinking about consolidating your debts into a home-equity loan, talk to a local nonprofit housing organization or call Consumer Credit Counseling Service (1-866-499-8771).
- Avoid loans that include extras that you do not need.
- Never sign an agreement that you do not completely understand, and don't take a lender's word that an agreement is "standard."
- Speak to people you trust who have borrowed money.
- Fill in all the blank spaces on applications and documents that you complete.
- Investigate current interest rates at a number of financial institutions.

Account statement – This is a record of your account activity over a specific period of time.

Annual percentage rate (APR) – The annual interest rate that reflects all of the costs of financing. This rate probably will be higher than the original interest rate quote, because it includes all other costs of getting credit, such as loan fees.

Assets – Financial assets are cash or something that can be converted into cash, such as a savings account, stocks, or real estate.

Automated teller machine (ATM) – ATMs are machines that provide many of the same services as a financial institution. Many financial institutions own ATMs to provide convenient service to their customers. There are various fees attached to using an ATM for financial transactions.

Available balance – This is the amount of money immediately available in your account. This amount does not reflect any withdrawals or deposits that have not yet cleared your account.

Balloon payment – This is the payment that is due at the end of a balloon loan. A balloon loan offers a low interest rate for short-term financing. At the end of the term, the loan requires refinancing or paying off the outstanding balance with a lump-sum payment.

Bounced check – A check that is returned to you because there is not enough money in your account to cover it.

Canceled check – Once a check has been processed and subtracted from the account on which it was written, it is called a canceled check. Canceled checks are often used as "proofs of payment," in place of receipts.

Cashier's check – This type of check is as good as cash. To issue a cashier's check, the financial institution will deduct funds from your account and write the check from its own account. There is usually a fee for a cashier's check.

Check register – A tool for keeping track of the daily balance in your checking account.

Clears – A check you write clears when the amount of the check has been withdrawn from your checking account by the financial institution.

Co-borrowers – Two or more persons who legally agree to take out and be responsible for paying off a loan together.

Collateral – Something of value that the borrower commits to guarantee repayment of a loan.

Commitment letter – A formal offer by a lender stating the terms under which a financial institution agrees to lend money. Sometimes it is called a "loan commitment."

Contingency – A condition that must be met before a contract is "legally binding," that is, before you must legally complete what was agreed to in the contract.

Credit – Credit is when you borrow funds with the intent to repay them.

Credit bureau – An organization that keeps records of people's repayment histories (i.e., credit reports).

Credit history – A list of your debts and regular monthly expenses, including how much you owe and how timely you make your payments.

Credit inquiry – When you apply for credit, the lender will request a copy of your credit report. Each time your credit report is requested from the credit bureau it is documented on your report as an "inquiry."

Credit rating – A rating that indicates how good a credit risk you are. Credit ratings are based on your personal credit history.

Credit report – A report that reflects a person's credit history. The lender orders this report from a credit bureau when you apply for a loan.

Credit score – A process used by lenders to evaluate a loan application. A credit scoring system is based on the lending organization's historical experience with borrowers.

Customer agreement – A document provided by financial institutions that describes the costs and features of their accounts.

Debit – A withdrawal from an account. If you write a \$25 check, your account will have a debit of \$25 when the check clears.

Debit card – A card that can be used at an ATM to conduct financial transactions or at a point of sale terminal (POS) to buy something.

Debt-to-income ratio – A ratio that compares a loan applicant's total monthly debt to their total income (total monthly debt/ total monthly income = debt-to-income ratio). Lenders use a debt-to-income ratio to help them determine an applicant's capacity to repay a loan. It is generally accepted that a person's total debt should not exceed 45 percent of the person's total income each month.

Debts – Money you owe.

Deposit – To put money into your account.

Depository services – Checking and savings account services offered by some financial institutions.

Default – Failure to pay back money. If you do not make agreed-upon payments, you default on your loan.

Direct deposit – Funds deposited directly into your account. With your agreement, payroll earnings, Social Security benefits, retirement earnings, and other checks you receive on a regular basis may be direct-deposited into your account.

Down payment – The part of a purchase price that you pay when you buy an item such as a car or a house. The lender usually seeks a down payment to show that you are willing to invest in a purchase.

Economy – The way a society organizes to meet the physical needs of its people.

Electronic funds transfer (EFT) – Money transactions to or from checking and savings accounts that do not require paper (checks or cash) but use computer technology. Examples include direct deposit, ATM, and debit card transactions.

Emergency reserve fund – Money you put into an account and save for an emergency.

Endorse – Endorsing a check is when you sign the back of a check that is made out to you in order to release the funds.

Expenses – The amount of money you spend on a regular basis.

Federal Deposit Insurance Corporation (FDIC) – The organization that insures accounts at federal government-regulated financial institutions for up to \$100,000 per account.

Fixed expenses – Monthly household costs that do not change.

Flexible expenses – Monthly household costs that you can control, such as groceries.

Forgery – When a person purposefully tries to withdraw money from your account by pretending to be you.

Gross annual income – Total yearly income from all sources before taxes are deducted.

Hold – The number of days a financial institution will hold a check before crediting your account.

Installment credit – This type of credit allows you to borrow a specific amount of money at one time for a defined purpose. You make a set payment each month.

Interest – A fee paid for the use of money. A financial institution will pay you interest for keeping your money at their location. You will pay interest to a financial institution for the use of borrowed funds.

Joint applicant – When two or more people apply together for a loan.

Loan processing – The steps a lender takes to decide if a buyer can qualify for a loan.

Long-term goals – Savings goals you can accomplish by consistently setting aside money for several years.

Luxury expenses – Monthly costs that you choose, such as new clothes and going out for meals.

Market economy - An economic system where goods and services must be purchased from others.

Market value – The expected sale price of something.

Minimum balance - Necessary amount of money on deposit to qualify for special services.

Minimum payment – Smallest possible monthly payment.

Monthly statement - Account summary mailed monthly to a customer.

National Credit Union Share Insurance Fund (NCUSIF) – Insures accounts at federal governmentregulated credit unions for up to \$100,000 per account.

Net income – Your total income after taxes are taken out.

Noninstallment or service credit – Some businesses and utility companies offer this type of credit. It allows you to pay for a used service at a later date.

Nonsufficient funds (NSF) – A term meaning that the amount of money in your account is less than the amount you would like to withdraw. Also referred to as insufficient funds.

Nontraditional credit history – A credit history you can prepare if you do not have credit cards or have never had a loan. It can include receipts and canceled checks from your monthly payments for rent, utilities, and other bills.

Overdraft protection – A line of credit to cover nonsufficient funds.

Overdrawn – When more is withdrawn from an account than the existing balance.

Payment factor table – A table that you can use to calculate monthly payments and the cost of credit for installment loans.

Personal identification number (PIN) – Your password to your account at a financial institution. You can use your PIN to gain access to your account at an ATM or point of sale terminal (POS).

Point of sale terminal (POS) – A terminal consumers use to make purchases with a debit card at business locations.

Predatory lender – A lender that directs a borrower away from loans with more affordable interest rates. Instead, the applicant is offered a loan with a high interest rate, questionable fees, or unnecessary charges.

Principal – The amount you can actually borrow.

Promotional inquiry – When a company requests a copy of your credit report to "pre-approve" you for a credit card or special offer, it is recorded on your report. This type of inquiry is listed separately from credit inquiries that you request. Potential creditors will only see the credit inquiries that you initiate.

Purchase and sale agreement – A written contract that the buyer and seller sign. It includes all of the terms and conditions of the sale.

Qualify – To determine how much money you are able to borrow.

Reconciling – To balance your checkbook by comparing your check register with your account statement.

Repossess – When a financial institution takes ownership of an item that was purchased using credit because the borrower is not able to repay the loan.

Revolving credit – This type of credit allows you to borrow money at any time up to a set limit. As you pay the borrowed money back, it becomes available again to borrow (e.g., credit cards).

Savings goals - Statements about things you wish you could afford.

Secured credit – This type of credit requires that you provide something of value to guarantee repayment of a loan.

Secured credit card – This type of credit card requires that you deposit a certain amount of cash in a savings account to guarantee your credit card.

Service charge – Financial institutions sometimes charge fees for specific services. These fees will vary depending on the type of account you have. Ask about service charges and fees before you select a financial institution or a type of account.

Short-term goals – Savings goals you can accomplish in a few weeks or months by consistently setting aside money.

Signature card – A card that you sign when you open an account. This card is kept on file at the financial institution and used to verify your signature when you cash checks. This helps to prevent unauthorized people from gaining access to your account.

Spending plan – A strategy for saving and spending money. It can be used as a guide to help you track the flow of money through your household and how that money needs to be divided to meet expenses and savings goals.

Stop payment – An order by a customer not to release issued funds (i.e., not to cash a check).

Terms – The conditions of a loan, including the type, size of down payment, amount you can borrow, interest rate, and length of time to repay.

Tracking – To become aware of the flow of money through your household.

Unsecured credit – This type of credit does not require you to provide something of value to guarantee repayment of a loan.

<u>Notes</u>

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4000 Wisconsin Avenue, NW North Tower, Suite One Washington, DC 20016

www.fanniemaefoundation.org



2455 Paces Ferry Road, NW Atlanta, GA 30339-4024

www.homedepot.com



100 Edgewood Avenue, NE Suite 1800 Atlanta, GA 30303

www.cccsatl.org