



UNIT 2

USING AND ABUSING CREDIT

The establishment of a strong credit history is an important part of becoming a homeowner or tenant. While most students may not be able to rent or buy right now, there are things they can do today to prepare for the eventuality later on, and building a strong credit history is one of them. Credit history is particularly important—it will be an important part of a future loan application; it is often viewed a measure of trustworthiness when applying for a job; and, landlords often use credit history when reviewing an applicant for possible rental.

In this unit, students will learn about the different types of credit, the characteristics that lenders look for when lending credit, the concept of creditworthiness, interest rates, and computation of repayment of credit debt. Activities include the use of spreadsheets, analysis of actual credit offers, and evaluation of sample creditors. The use of credit cards will receive special attention in this unit as it is currently one of the first and easiest ways for students to use or abuse credit.

Student Learning Objectives:

- Students will identify and analyze different types of credit.
- Students will analyze samples of credit card offers to determine which offers are most beneficial to consumers. The analysis will focus on fees, interest charges, and grace periods.
- Students will identify the importance of capital, capacity, and character in applying for and receiving credit. They will apply these concepts by analyzing their own creditworthiness and completing sample credit applications.

Key Concepts:

annual percentage rate (APR)	credit history
capital	credit report
capacity	finance charge
creditor	grace period
credit application	interest

LESSON 2-1: TYPES OF CREDIT

According to the Consumer Federation of America, a typical teenager spends several thousand dollars a year on cars, clothes, food, and entertainment. This amounts to nearly \$80 billion annually nationwide. With all this spending, more than 40 percent of American teenagers use their parents' credit cards and 11 percent have their own. The typical cardholder has at least nine different credit cards.

There are many different types of credit available to qualified consumers in the United States. This includes retail, mortgage, cash, and service. Credit does not provide free money or extra income. However, the credit record that can be built with credit accounts will stay in effect for a long time. Keeping up with payments and keeping credit manageable will help build a favorable credit history and facilitate access to long-term mortgage credit.

In this lesson, students will collect samples of credit offers from newspapers, magazines, direct mail advertisements, and the World Wide Web. The samples will be used to discuss the types of credit that are available to consumers in the United States.

Materials Needed:

- Collect samples of credit offers from newspapers, magazines, the World Wide Web, and direct mailings. You may want to ask students to collect these samples.
- Duplicate *Activity Sheet 2-1: Credit, Credit, Everywhere* for each member of the class.

Teaching the Lesson:

1. Introduce the lesson by asking students to list all of the different kinds of credit that are available to consumers in the United States. (*Student answers may include: retail credit—installment, revolving and open charge; mortgage credit, service credit—utility payments, the consumer is billed after services are received; and cash credit—a consolidation loan.*)
2. In the 1950s, expensive restaurants wanted a better way for customers to pay for their dinners, so they invented the credit cards to make this possible. Restaurant customers used these first credit cards to meet their needs, but eventually the cards became more important. A credit card today can be used to purchase just about anything, including some college tuitions! Issuing credit is a big business and it is everywhere.
3. Distribute copies of *Activity Sheet 2-1: Credit, Credit, Everywhere* to everyone in class and review the directions. Distribute previously

collected credit offers from newspapers, magazines, the World Wide Web, and direct mailings among the students.

4. Ask students to look at the different offers and determine the **annual percentage rate** or **APR**, a measure of the annual cost of credit which includes **interest**—the payment for the use of someone else’s money—and may also include other charges as well. The APR is expressed as a percentage and is applied to the outstanding balance owed.
5. Other factors students should evaluate include the **grace period**—the time in which the borrower can pay off all new purchases without incurring finance charges; **fees**—annual membership, late payments, and exceeding the credit limit; **cash advance charges**—charged when borrower receives cash against the line of credit and paid in addition to the interest rate; and **minimum payments**—the minimum amount the borrower is required to pay the issuer each month.
6. Have students complete the activity sheet based on the credit offers they have collected. Discuss the student responses to the activity sheet. What types of credit did they find advertised most often? Was a particular type of advertising used for a specific type of credit? What assumptions can students make about the different types of credit?

Debriefing the Lesson

Explain to the students that many types of credit are available to consumers in the United States. Careful use of this credit can lead to a strong credit history that will help when purchasing a home. The information about a person’s credit remains on his/her report for seven years; therefore, it is important to use credit wisely.

If you have not already done so, tell student that it pays to shop around to find the best deal on credit, especially on credit cards. The fine print is especially important as a number of additional fees will drive up the cost of credit. For example, a recent Visa Card offer through AOL charges 3% of the amount of a cash advance, but not less than \$10. Late payment fees, over-the-credit-limit fees, return payment fees, and return check fees are \$29 *each*—so is pays to not abuse the terms of the credit card.

Some tips from the ReliaStar Financial Corporation include paying bills on time; keeping all receipts, and comparing each purchase when the bill comes; not charging what you cannot pay for at the end of the month, except in emergencies; and, not charging to the card’s limit. Martha Skoog of the Federal Reserve Bank of Philadelphia summed up the importance of creditworthiness, “credit is not a right to be expected; it is a privilege to be protected.”

LESSON 2-2: THE C'S OF CREDIT

Creditors focus on the C's of Credit: capital, capacity, and character of credit applicants to determine their creditworthiness whether they are applying for a home loan, a home improvement loan, a car loan, or requesting a credit card. In this lesson, students analyze their own creditworthiness and complete sample credit/loan applications.

Materials Needed:

- Duplicate *Activity Sheet 2-2: Your Credit History* for each student.
- Obtain copies of loan applications from local banks and lending institutions.

Teaching the Lesson:

1. Ask students to review the information they learned about the types of credit in Lesson 2-1. Explain to them that a **creditor**—a person or firm that extends credit by loaning money, by selling property or goods on credit, or by furnishing credit cards— tries to determine if an applicant is creditworthy, or a good risk. Because credit is a form of trust between the creditor and the borrower, the creditor wants to select the most creditworthy applicants.
2. In order to determine an applicant's creditworthiness, the lender examines the applicant's credit history. A good **credit history** helps to make future purchases. This information is used to determine an applicant's ability and commitment to pay their debts.
3. The creditor also examines the applicant's **credit report**—a record of how bills have been paid; how much money is owed and to whom; financial stability; current and past residential addresses, employment status, and payment history. It does not include income, bank balances, or personal details such as ethnicity, religion, gender, political preferences, medical history, or other information that does not relate to credit.

The information reported includes the three C's of credit: capital, capacity, and character. **Capital** is savings and assets that can be used as collateral for loans. **Capacity** is the applicant's present and future ability to meet financial obligations. Does the applicant have a steady job? How long has she/he worked? How much does she/he already owe? **Character** refers to the applicant's trustworthiness. Have bills been paid promptly? Is the credit record good? Does the applicant appear to be willing to repay?

4. Distribute copies of *Activity Sheet 2-2: Your Credit History* to each student. Review the directions and allow students time to complete the activity.

5. Next, distribute copies of sample loan applications to each student. Tell students they will be applying for a small loan (purposes could include—a new car, a college or educational loan, a boat, a stereo equipment, a computer, etc.). Have them complete the applications with the information they know about themselves.
6. Discuss student responses to the activity sheet and loan applications. Ask students to discuss the costs and benefits of a lender granting or denying credit to them. What are some of the criteria and methods that could be used to make credit decisions?
7. To complete the lesson, you might want to invite a loan officer to discuss with the class how decisions are made regarding credit and loans. The speaker could also discuss the steps and decisions that students could make in building a strong credit history.

Debriefing the Lesson

Remind students that a strong credit history is an essential component in purchasing a home or renting a living space. According to experts from the Consumer Credit Counseling Service it is recommend that no more than 15-20% of monthly income be committed to credit card payments and other loan payments (excluding rent/mortgage). No more than 40% of the monthly income should go to paying all debts.

The credit record students build now and in the near future will have a direct impact on their financial futures. Companies use credit history to determine future credit, evaluate the ability to responsibly manage credit, qualify for a new or larger line of credit, determine job offers or promotions, or to issue a state or government license or contract.

UNIT RESOURCES:



Community Resources:

- Have students conduct research to determine the average number of credit cards held by members of their community. How does their research compare to the national averages? What are the benefits and costs of credit and lending in our economy? What recommendations would they make to others regarding credit applications and the number of credit cards held by individuals?
- Have students research further information on the Federal Reserve's Truth in Lending regulation, the Equal Credit Opportunity Act, the Fair Credit Billing Act, the Fair Debt Collection Practices Act, the Credit Card Fraud Act, and the Fair Credit Reporting Act. Students could create informational brochures to distribute to community groups.



Teacher Resources:

- All Credit Cards Are Not the Same. American Express Company. Free pamphlet, that provides basic information about credit cards. Other titles include: How to Lay the Groundwork for a Strong Financial Future; Ready, Set, Credit; Understanding Credit Card Grace Periods.
- Charge It! Board game where players use plastic to rent cars, buy sporting goods, buy concert tickets, etc. The first player to acquire the right combination of “paid up” credit cards, purchased items, and cash wins the game. Available at <http://socialstudies.com>.
- Give Yourself Credit: A Consumer’s Guide to Credit Protection Laws. San Francisco Federal Reserve Bank. Free pamphlet, that explains how to apply for credit, obtaining credit, financing an automobile, financing a home purchase, and obtaining a home improvement loan.
- How to Establish, Use, and Protect Credit. Federal Reserve Bank of Philadelphia. One in a series of free pamphlets on credit; available in classroom quantities. Titles include: Your Credit Rating; Plastic Fraud: Getting a Handle on Debit & Credit Cards; Paying Off a Loan Early: Things You Should Know; What Your Credit Report Says About You; Frauds & Scams: Protect Yourself & Your Money; and Your Credit Rights.



World Wide Web Resources:

<http://home3.americanexpress.com/corp/consumerinfo/glossary.asp>

Comprehensive glossary of Credit Terms provided by the American Express Company

<http://www.capitalone.com/credit101/> Site that features information about credit basics, definitions of basic terms credit history, descriptions of good credit practices and managing and safeguarding credit.

<http://www.consumercredit.com/> The American Consumer Credit Counseling non-profit organization. Site features consumer information about credit, budgeting, savings, and money management

<http://www.creditinfocenter.com/creditreports/scoring> Site that pieces together to outline of how credit scores are calculated.

<http://www.ftc.gov/bcp/menu-credit.htm> List of Federal Trade Commission publications related to credit. Documents are available free of charge in both text and PDF formats. Titles include: Avoiding Credit and Charge Card Fraud; Credit and ATM Cards: What to Do If They’re Lost or Stolen; Credit and Your Consumer Rights; Credit Repair; Credit Scoring; Fair Credit Reporting Act; and ID Theft.

ACTIVITY SHEET 2-1 CREDIT, CREDIT EVERYWHERE

Directions: Using the information provided and the sample credit offers that you have collected (possible sources include: Internet, direct mail, grocery store circulars, newspapers, magazines, etc.), answer the following questions.



Credit can be individual (based on single person's assets, income, and credit history), or joint (based on the assets, income, and credit history of both applicants). Types of credit available to consumers in the United States include:

Retail Credit—used to buy goods and services from retail stores; includes:

Installment Credit—used to purchase a single item such as a car, jewelry, furniture, medical expenses, education, etc. The credit must be repaid in a specific time and the payments are the same each month.

Open Charge Credit—the balance of this credit must be paid at the end of the billing period (usually 30 days).

Revolving Credit—account that has a limit on the amount of money that can be spent (credit limit); the monthly amount paid depends on the total amount owed and the finance/interest charges due each month.

Mortgage Credit—used to buy a house; includes a complex process and complex application process

Service Credit—used for utility payments (water, electric, phone, etc.); the consumer is billed after services are received

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1. What types of credit were most often advertised? What method of advertising did you find most effective? Least effective?
 2. Which offers had the best deals concerning the factors of grace periods, fees, cash advance charges, and minimum payments?
 3. What generalizations can you make about the types of credit offered and the interest rates charged?
 4. What advice could you offer to other consumers regarding the types of credit available?

ACTIVITY SHEET 2-2 YOUR CREDIT HISTORY

Directions: Using the C's of Credit that are described below, evaluate your credit history.



Capital—assets such as a house, car, savings account, or other financial resources.

1. What type of capital or assets do you have that could be considered in a loan or credit application?

Capacity—the ability to repay debt; will the applicant's present income stay the same or increase in the future?

2. What is your capacity that could be considered in the application?

Character—the applicant's history; are bills paid on time; are there previous defaults on credit?

3. Examine your character/credit history. How will this factor into the loan officer's consideration of your application?

4. What are the costs and benefits of financial decisions that you have made in the past? What are actions that you will take to ensure your credit worthiness?
