AMERICAN FINANCIAL SOLUTIONS

a nonprofit credit counseling agency

KEYS TO CREDIT AND BORROWING

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CREDIT AND BORROWING

This lesson is about borrowing money and using credit. It will provide insights into:

- **The requirements for borrowing**
- **The way in which payments and interest are calculated, and**
- **How to qualify for a loan**

You will need a pencil, paper and a calculator before beginning this workbook.

For most people, paying for college, purchasing a home and even purchasing a car are expenses that will prompt us to consider borrowing money. Paying for these items in one lump sum is typically an expense we cannot afford. However, these are important expenses that can help us improve our assets and our ability to make money.

A typical example of this is paying for a college education. A student borrows in order to complete an educational program, with the expectation that a college degree will enhance job prospects in the future and facilitate paying off the student loan.

Similarly, the cost of an automobile is well beyond the limit of most working adults. An automobile loan makes it possible to acquire reliable transportation and pay for it over the first several years of ownership.

WHY BORROW MONEY?

- To pay for an education
- To purchase an automobile
- To purchase a house
- Other types of loans

A house costs hundreds of thousands of dollars — making it virtually impossible to pay for with a check or credit card. Yet, every day, there are people purchasing homes, using mortgage financing to make their dream of home ownership a reality.

These, and other types of loans, are paid off in installments — monthly payments that gradually pay off the loan — making long term purchases possible.

BORROWING—A TEST OF YOUR MONEY MANAGEMENT SKILLS

- **Can you manage a budget?**
- **How is your credit rating?**
- **Have you paid off loans before?**
- **Do you have a strong banking relationship?**
- **Can you make the payments on an installment loan?**

In order to qualify for a loan, you must have a demonstrated history of good financial management skills.

Here are some questions you must ask yourself. Can you manage a budget? You must answer yes to this question before you even consider borrowing money, because installment payments must be paid on time, without exception.

How is your credit rating? If you don't have a strong credit rating, you will pay a higher interest rate —which affects the cost of the loan and makes the loan payoff more challenging. It also means you will have less money available for other items you need or would like to enjoy.

In addition, having poor credit or no credit may: make it difficult to rent a home, increase the rates you pay for insurance, increase deposit requirements on utilities and even impact employment possibilities.

Have you cultivated a strong relationship with your bank— either by having borrowed from them previously, or by having other types of accounts such as savings, checking and retirement accounts?

The bottom line is can you and will you make the payments on an installment loan? And that is exactly what a lender wants to know.

CREDIT TERMS

- **Revolving credit accounts — VISA, department store accounts, gas card**
- **Installment credit with repayment of principal and interest — auto loan, house loan, student loan**
- **Secured loans**

It is important to understand credit terms. Let's talk about 3 different types of Credit: Revolving Credit; Installment Credit and Secured Credit.

Revolving Credit allows you to borrow up to a set credit limit. When you pay the money back, your limit is restored. Interest will be charged if you do not pay off the entire balance each month. Examples of types of revolving credit are Visa cards, MasterCard's, department store cards and gas cards.

Installment Credit allows you to borrow a specific amount of money at one time for a definite reason - for example, when you purchase an automobile or house. You make a fixed payment each month. Each payment consists of two items: principal and interest, with the interest computed on the remaining loan balance.

Secured Credit requires you to provide collateral to support the loan. Generally when you buy a car or a house, the lender will hold the title until you have finished paying it off. If you miss payments, the lender can take the item back from you.

LOAN TERMS

- **Principal — the amount you borrow**
- **Rate of Interest — the rate you pay on the unpaid balance**
- **Time — the time period over which you must pay the money back**

Let's address a few basic things about installment loans.

The amount of money you borrow is called the **loan principal**. This is the amount you borrow, and for that matter, the amount you must pay back. For example, Bob purchases an automobile that costs $20,000 and he writes a check for a down payment of $5,000. He then gets a loan from his bank for the remaining $15,000. This $15,000 is the principal of the loan.

The second item is the interest rate. The **interest rate** is expressed as a percentage. On a 12% loan, you would pay 12% per year on the unpaid balance of the loan. Since most installment loans require a monthly payment, 12% per year is equal to 1% per month.

To calculate 1% of something, simply move the decimal point two places to the left. For example: 1% of $1,000 is equal to $10.00.

The time period may vary for the loan. On an automobile, for example, the time period can be between three and six years. On a home, the time period is usually 15 - 30 years.

INSTALLMENT LOAN BASICS

- **Fixed rate of interest over the life of the loan**
- **Equal monthly payments**
- **Each payment includes: interest + principal**
- **Interest is calculated on the unpaid balance**

Now we'll discuss some general characteristics of an installment loan.

First, the interest rate stays constant over the life of the loan. Therefore…if you borrow at 6% for 4 years, your interest rate will stay constant — even if interest rates in the general economy increase to 8% over that period of time.

Second, each payment you make over that 4-year period (a total of 48 payments), is for exactly the same amount. You can plan your budget around paying that same amount each month over the life of the loan.

Third, each payment consists of interest plus principal.

Because the interest is calculated on the unpaid balance of the loan, the interest component is high at the beginning of the loan, and gradually diminishes over the life of the loan. Conversely, the repayment of the principal gradually increases over the life of the loan.

We'll demonstrate how the payments work with a simple example on the next page.

BASIC INSTALLMENT LOAN EXAMPLE:

Principal = $1,000

Rate = 6% per year

Time = 3 years, with a payment at the end of each year

Here is a basic installment loan example: Bob borrows $1,000 for three years at 6% interest with installment payments made annually.

This is not meant to be a realistic scenario, because in a real installment loan the payments are made monthly, and the term of the loan may be substantially longer than three years. But, let us go through the calculations for this loan to demonstrate the pattern of the calculations.

You will need to calculate the loan payment. We will show you how to derive this figure from a table. For now, we'll just tell you that the loan payment is $374.11.

To reiterate, Bob borrows $1,000 and makes a payment at the end of year one for $374.11, a second payment at the end of year 2 for the same amount, and a final payment of $374.11 at the end of the third year.
At that point, the entire loan will be paid off.

Let's take a look at the details of this loan.

DETAILS OF THE LOAN

Period	Payment	Interest at 6%	Principal Reduction	Loan Balance
0				$1,000.00
1	$374.11	$60.00	$314.11	$685.89
2	$374.11	$41.15	$332.96	$352.93
3	$374.11	$21.18	$352.93	$0.00

This would be a good moment to grab your calculator. Bob starts in time period zero with a loan of $1,000.

One year later, Bob makes his first payment of $374.11. The interest portion of this payment is $60, which is 6% of the unpaid balance; that is 6% of $1,000. If $60 of the payment is for interest that means that the rest of the payment ($314.11) goes to reduce the loan balance. Bob's new loan balance at the end of year one is $1,000.00 - $314.11 which equals $685.89.

At the end of year 2, Bob makes the second payment of $374.11. The interest is calculated as 6% of $685.89, or $41.15. The remainder of the payment ($332.96) reduces the loan balance to $352.93.

Bob makes one more payment of $374.11. This time, the interest is 6% of $352.93, or $21.18. The principal reduction is $352.93, bringing the loan balance to zero.

LOAN AMORTIZATION TABLE—ONE MORE LOOK…

Period	Payment	Interest at 6%	Principal Reduction	Loan Balance
0				$1,000.00
1	$374.11	$60.00	$314.11	$685.89
2	$374.11	$41.15	$332.96	$352.93
3	$374.11	$21.18	$352.93	$0.00
	Payments constant stay	Interest paid decreases each year	Amount of money applied toward the principal increases each year	

Look at the pattern of the various items in the loan amortization table. The payment stays constant at $374.11.

The interest portion of the pay amount, because the principal of the loan is at its highest amount. And then, the interest portion decreases.

The principal repayment starts out at its lowest amount, and then increases.

The interest costs over the term of the loan amount to $122.33. This is the total cost to borrow 1,000 at 6% interest for three periods.

LOAN AMORTIZATION EXERCISE

Here is a little exercise to test your knowledge of the loan amortization process. See if you can fill in the payment, interest, principal reduction and loan balance for periods two and three. The data for year one is given, just to get you started

Terms of the loan: $1,000 at 8% for three years, with payments annually. Payment is $388.05. Can you finish the table?

Period	Payment	Interest at 6%	Principal Reduction	Loan Balance
0				$1,000.00
1	$388.05	$80.00	$308.05	$691.95
2				
3				$0.00

Exercise solution

Here is the solution to the exercise. Notice once again, that the payment stays constant, the interest expense decreases over the loan term, and the principal repayment increases.

As mentioned earlier, this example is of limited use other than to demonstrate installment concepts.

Let's take a look at a table that will help you to estimate your monthly payments on a loan

Period	Payment	Interest at 6%	Principal Reduction	Loan Balance
0				$1,000.00
1	$388.05	$80.00	$308.05	$691.95
2	$388.05	$55.36	$4332.69	$359.26
3	$388.05	$28.74	$359.31	$0.00

You can use the monthly payment calculator below to calculate the monthly payment on a loan.

For Example: Bob borrows $10,000 at 8% for five years on an automobile loan. Use the table to figure out the monthly payment. Go down the interest rate column on the left, and find 8%. Go across the top of the table to the 5-year column. Find the factor in the table where 8% and 5 years intersect.

The monthly interest factor is .02028. Multiply this factor times the loan amount to derive the monthly payment. .02028 times $10,000 is $202.80.

Bob will make 60 payments of $202.80 for the car loan. How much does Bob pay in total? Multiply 60 times $202.80, which equals $12,168. Bob is paying $12,168 for the $10,000 car loan. His total interest cost is the difference between $12,168 and $10,000, or $2,168.

MONTHLY PAYMENT CALCULATOR

Loan Percent	1 year	2 years	3 years	4 years	5 years	6 years
3%	0.08469	0.04298	0.02908	0.02213	0.01797	0.01519
4%	0.08515	0.04342	0.02952	0.02258	0.01842	0.01565
5%	0.08561	0.04387	0.02997	0.02303	0.01887	0.01610
6%	0.08607	0.04432	0.03042	0.02349	0.01933	0.01657
7%	0.08653	0.04477	0.03088	0.02349	0.01980	0.01705
8%	0.08699	0.04523	0.03134	0.02441	0.02028	0.01753
9%	0.08745	0.04568	0.03180	0.02489	0.02076	0.01803

Example:

Bob’s borrows $10,000 for 5 years at 8% on an auto loan

What is Bob’s payment? .02028 x $10,000 = $202.80

How much will Bob pay in total? 60 times $202.80 = $12,168

What is the total interest paid? $12,168 - $10,000 = $2,168

EXAMPLE OF A FOUR-YEAR LOAN

Staring with a principal value of $20,000, with an interest rate of 6%, a 4-year loan staring in January 2012 will yield a monthly payment of $469.70.

THE LOAN FOR THE FIRST YEAR

Month	Principal	Interest	Balance
January	$369.70	$100.00	$19,630.30
Febuary	$371.55	$98.15	$19,258.75
March	$373.41	$96.29	$18.885.34
April	$377.27	$94.43	$18,510.07
May	$377.15	$92.55	$18,132.92
June	$379.04	$90.66	$17,753.88
July	$380.93	$88.77	$17,372.95
August	$382.84	$86.86	$16990.12
September	$384.75	$84.95	$16,605.37
October	$386.67	$83.03	$16,218.96
November	$388.61	$81.09	$15,830.09
December	$390.55	$79.15	$15,439.54

YEARLY STATISTICS

Year	Total Principal	Total Interest	Balance
2012	$4,560.46	$1,075.94	$15,439.54
2013	$4,841.74	$794.66	$10,597.79
2014	$5,140.37	$496.03	$5,457.42
2015	$5,457.42	$178.99	$0.00

LOAN

Monthly Payment $469.70

Total Interest (no pre-payment) $2,545.63

Average Interest each month $53.03

This is an example of a four year loan at 6% interest. We include this amortization table for a four year loan as an example, so you can see the gradual payoff, the interest charges, and total interest for this loan.

The loan is for four years at 6%, with monthly payments. Can you use the monthly payment table on the preceding table to calculate the loan payment? Your calculation will give you a payment of about $469.80. If you use Excel or other calculation tools, you'll find that the payment is actually a little less, at $469.70 per month.

In reconciling the calculations, remember that on a 6% loan, the interest rate is 6% per year, or ½ percent per month. In calculating the interest expense each month, therefore, use .005, which is 6% divided by 12 months.

It is helpful to generate an amortization table for your loan, to keep track of the interest charges for the year, and to watch your equity increase month by month.

WHAT ARE THE INTEREST RATES RIGHT NOW?

- **Interest rates vary depending on the type of loan and loan term**
- **Visit your bank, your bank's website, or a site such as Bankrate.com for current rates on various loan types**

If you are thinking about borrowing, an important question to ask is "What interest rate will I pay?"

The answer depends, first of all, on when you borrow the money as interest rates fluctuate from day to day. In the mid 2000's, interest rates were high and it was relatively easy to get credit. However, after 2008, lenders increased credit restrictions making it more difficult for consumers to get a loan.

Another aspect of the equation is the type and term of loan you are interested in. For example, mortgage loan rates will differ somewhat in interest rate from home equity loans or automobile loans.

It also depends on the lender. You can find out what local banks are charging for various types of loans by visiting them — or by using the internet to visit their websites. One particular website, www.bankrate.com provides rate information about many types of loans.

Finally… your credit rating has a major effect on the interest rate you pay — so it pays in real dollars to maintain the best possible credit rating.

THE INTEREST DECISION

Before you use credit for a major purchase, consider all of the costs associated with that loan. The reality is that all borrowed money must be paid back. And in most cases, the payback consists of both the principal (the amount you borrowed) and the interest (the extra charge for the use of the money). Be sure you fully understand how a payment plan works, and the amount of interest being charged.

Below we have outlined the costs of some major purchases.

Loan Comparison – Mortgage

Notice in the mortgage example that an interest rate change of 3.5% equates to a payment difference of $567. The extra amount you would pay over 30 years is almost enough to purchase another home!

Ex: Mortgage, 30 year loan on a $250,000 home

	4.5% Interest	8% Interest	Difference
Monthly payment	$1,266.71	$1,834.41	$567.70
Total paid over 30 years	$456,016.78	$660,388.12	$204,371.34

Loan Comparison – Auto Loan

Here we look at a comparison of an auto loan and the importance of the interest rate to the loan and your pocket book.
The purchase price of the vehicle is $20,000 and the loan term is five years (60 months).

	Example A	Example B	Example C
Interest rate	5%	10%	15%
Monthly payment	$377.42	$424.94	$475.80
Total amount repaid	$22,645.20	$25,496.40	$28,548.00

As you can see the total amount repaid increases as the interest rate on the purchase goes up. This is one example of why having good credit can save you money. The interest rate difference between example A and example C is 10%. That equates to paying an extra $98.38 every month and $5,902.80 over the five year period! What other ways could you use that extra money?

Loan Comparison – Credit Card

In this example we look at the cost of maintaining a balance on a credit card. When it comes to your credit score, using more than 30% of your available credit limit can have a negative impact on it. Leaving a balance on your credit card can have a negative impact on your pocket book as well.

Below we show **one** credit card with a starting balance of $500.

We assume that:

- The card will **never** be used again and
- That the owner will make only **minimum** monthly **payments** (3% of the balance)

	Example A	Example B	Example C
Interest rate	5%	15%	29%
Interest repaid in $	$39	$151	$529
Total debt repaid	$539	$651	$1029
Time to pay off	3 years	3years, 8 months	5 years, 9 months

A credit card debt is paid much like an installment loan. A portion goes towards the principal of the debt (what you borrowed) and the rest goes towards interest.

It is also easy to fall into the trap of buying more than you need, because you are buying with credit. Sales people will often try to talk you into buying a more elaborate model than you had in mind, at a higher cost. Statistics show that people spend 30- 40% more on average when paying with a credit card.

It is important to think about your overall cash needs before you sign on the dotted line. A $500 payment each month for five years, for example, means that you will have $500 less each month for food, clothing, and other necessities.

Remember… that time is on your side; in most cases you don't have to decide on a purchase today. Be selective in assessing your needs and be willing to postpone some purchases until a later time. Try fitting a potential payment into your budget before you make the purchase.

CREDIT DECISIONS

- **Is the purchase really necessary? (What problem does it solve and what are the alternatives?)**
- **Consider other financing alternatives or saving for the item**
- **Don’t borrow long-term for a short-term benefit**
- **Disregard sales pressure; make your own decision**

If you are contemplating using credit, here are some important aspects for you to consider.

First, is this purchase really necessary?

What problem is solved by making the purchase? For example, if you are considering purchasing a car, why do you need it? Could the need be solved by riding public transportation, moving closer to work, or car-pooling with a friend? If the auto purchase is due to a repair issue, is it possible to obtain a smaller loan to fix the vehicle rather than taking out a loan large enough to buy a new car?

Second, have you researched alternative sources of financing?

Can you save for the item by setting aside a little each month? Is it essential to have the item right now? If you do need it now, have you compared financing methods? We suggest you avoid getting into long term debt to finance a short term benefit. For example, borrowing $1,500 for a television, and paying for it over a five year period might not be the wisest use of your credit or your money!

Finally, try to disregard sales pressure when making credit decisions.

Think about what you must forego in the future in order to meet payment requirements of a loan. It is not up to the lender to tell you how much you can afford to borrow. You know your budget – stick to it.

There are two questions that many people find helpful when deciding whether to make credit purchases.

- How many hours will I need to work to pay for this item?
- What else could I use this money for?

IMPORTANT CREDIT GUIDELINES

Here are some important guidelines to remember when using credit:

- Only borrow what you can comfortably afford to repay
- Always make your payments on time to avoid late fees
- Do not go over the limit on your revolving credit accounts. You have to opt-in to over-the-limit protection, but remember if you do you will be charged an additional fee for all transactions that exceed your credit limit
- Try to pay off your revolving credit in full each month to avoid interest and keep balances at less than 30% of the available credit limit
- If you fall behind, contact your creditor immediately to explain the problem. They may be able to work out a new payment plan with you or make special arrangements until you are back on your feet.

QUALIFYING FOR A LOAN—THE “FIVE C’S OF CREDIT”

It is important to understand how banks evaluate customers who are seeking loans. There are five characteristics that banks and other financial institutions examine in deciding who qualifies for a loan. These are the 5 C’s of Credit:

Character, Credit Capacity, Capital, Collateral and Conditions

Let’s review each of these characteristics.

1. CHARACTER

- Stability
- Consistency
- Evidence of good credit
- Spotless record of payments
- Standing in the community
- Time in current residence
- Banking history

The first of the five C’s is **Character.** Character might include personal characteristics such as consistency, stability, and standing in the community. This usually includes a person’s credit history, banking history, length of time at their current residence and length of time with their current employer. Banks and other financial institutions will generally examine credit reports from the three credit reporting agencies (Experian, TransUnion and Equifax) as reliable indicators of character.

It is vital to your credit–worthiness to strive for a spotless record of payments on the debts you already have, because you will be evaluated for future loans based on that record. If you have some blemishes on your credit record, take the appropriate steps to resolve them or dispute them if they are errors. For more information on how to do this see our workbook *Understanding Credit Reports and Scores...*

If you do not have an established or substantial credit history, take the following steps:

- Keep copies of paid bills and canceled checks used to pay bills.
- Ask organizations to which you regularly pay bills to write a letter that demonstrates how long you have been a customer and that you make your payments on time.

2. CREDIT CAPACITY

- Do you have enough “extra income” to take on new debt?
- How much debt is “too much?”
- What is your debt-to-income ratio?
- Debt to Income Ratio = Total Debt divided by Total Income

The second of the Five C’s is **Credit Capacity**—which is an evaluation of your current income and expenses. What is your current capacity to handle more debt? In order to qualify for more debt, you must prove that your current income is both stable and of sufficient size to merit additional borrowing and that your expenses do not exceed an acceptable debt to income ratio.

To calculate your borrowing capacity, you should determine your debt-to-income ratio.

If you take home $2,000 per month and pay out $500 per month for debt payments, your debt-to-income ratio would be 25%

Although every bank will have its own standard, a typical limit for this measure is about 36%. So if your income is $2,000 per month, the bank would be reluctant to lend to you if your total debt payments exceed $720 per month.

It is wise to measure your own debit to income ratio before applying for a loan.

3. CAPITAL

Capital consists of assets of value you own, that provide additional confidence to the lender

- Real Estate
- Investments such as stocks and bonds
- Retirement plan assets
- Bank accounts

Capital is the third of the Five C's. It consists of the amount of your own money you plan to invest in a purchase and assets you already own, that could be sold to pay off debts in an emergency. The bank has no interest in acquiring these assets, but such assets provide confidence that your loan will be repaid.

The existence of real estate, stock investments, retirement plan assets, IRA plans, and additional bank accounts makes you a more desirable loan candidate, because you own the capital to liquidate the loan.

4. COLLATERAL

Collateral consists of assets you pledge, in case the loan cannot be paid. These may include:

- Compensating bank balances
- An interest in the item the loan is for (automobile, house, etc.)

The fourth C is **collateral**. If the bank has concerns about the credit worthiness of a candidate, collateral may be required. For a person who has no credit history or a poor credit history that they are trying to rebuild, pledging an amount of money equivalent to the loan amount could help them to secure the loan and establish good credit by making all payments on time.

Their money would be held in a savings account and would earn interest during the time of the loan. The interest continues to accrue to the borrower, but the bank is placed in a no lose position, if the loan is not paid off. This is called a secured loan or a secured credit card.

When taking out a home loan or an auto loan, the lender will hold the title to the property until the loan is paid off.

5. CONDITIONS

- Market interest rates, or economic conditions
- Your financial history, credit score, etc.
- National/international events
- Your work history
- Miscellaneous factors

The fifth of the five C's consists of **conditions** that may exist, or which are emerging. These could include economic conditions such as interest rate fluctuations, aspects of your credit history, credit report or credit score, your work history, or other miscellaneous factors like emergency medical bills.

You may or may not have control over all of these factors, but you should strive to make the best of those you do control.

THE LOAN APPLICATION

5 QUESTIONS YOUR LENDER WILL ASK.

When borrowing money, you will be required to fill out a loan application. Here is a list of typical questions the lender will ask. In addition to documenting how much money you want to borrow, the lender will require information regarding:

- Your personal information, including current address and previous addresses, date of birth and social security number
- Employment information — for your current job and for previous jobs you have held, including length of employment
- Your income per month, from all sources
- Bank or brokerage references, including account numbers
- A list of credit references, showing who you owe money to, balances remaining, and payment amounts

Basically they want to know your 5 C's of Credit.

EVALUATE THE COST OF THE LOAN

- **Compare lenders**
- **What is the total cost of the loan**
- **Beware of loans with a large balloon payment**
- **Pay attention to loan fees**
- **Discuss terms with a trusted person.**

It is wise to compare several lenders before deciding who to borrow from. Lenders must disclose the total cost of the loan including interest rate and any additional fees or requirements.

Some mortgage lenders offer Balloon loans which offer lower interest rates for a period of time – usually 5-10 years. At the end of this term, they require refinancing or paying off the remainder in a lump sum. This is a far more risky because of the uncertainty of loan fees and future interest rates on the refinance.

Remember in our earlier example of a mortgage loan, a 3.5% difference in interest rate equated to more than a $500 difference in mortgage payment. Pay close attention to other fees that lenders may charge. If you have questions, discuss the loan with a trusted advisor before agreeing to terms.

CREDIT DENIALS

Why might a loan application be denied?

- **Credit problems**
- **Too much existing debt**
- **Unstable employment**
- **Loan amount too high**
- **Unfavorable conditions**

Now let's discuss some reasons why a loan application is denied. Here are some of the most common reasons:

- Too many blemishes on the credit report
- Debt to income ratio is too high
- The applicant's time on the job is too short to show stability
- The applicant is trying to borrow too much money

A combination of these conditions makes it risky to lend money to this particular applicant.

If you are turned down for a loan

- Request an explanation from the lender
- Address problems or strive to correct the information
- Ask if lender will consider collateral
- Ask if lender will consider a smaller loan
- If loan application is free of negatives, try a different lender
- Be wary of predatory lenders

Start by requesting an explanation from the lender, If you are denied. If problems exist in your credit report, you should be able to request a free copy of the same report the lender used to evaluate your financial situation.

You may consider requesting a smaller loan or offering collateral. Remember, that if you do offer collateral and are unable to pay, you could lose that item. If you feel that your credit report and personal information are favorable, you might consider applying to a different lender.

Be wary of Predatory Lenders

Although most lenders conduct honest business, there are others who will agree to loan money to people with less than perfect credit but they might:

- Charge high interest rates
- Charge excessive fees
- Add on the cost of unnecessary insurance

Never sign an agreement you do not completely understand. We address predatory lending in more detail in our workbook Identity Theft and Predatory Lending.

PLANNING FOR AN AUTO LOAN OR HOME LOAN

- Carefully budget in advance
- Save for the down payment — make it count (it's interest free)
- Consider additional expenses of your purchase
- Make sure it is a payment you can live with

There are two typical types of purchases that may have long term consequences regarding your financial life. These are automobile loans and home loans.

Start planning for these purchases at least a year in advance. It will take time for you to organize your finances, search for your automobile or home and determine how much you can afford. Also, by planning ahead, you can take the necessary time to evaluate current prices, interest rates, and additional costs that you will incur.

Another reason to plan in advance is to accumulate your down payment. A down payment reduces the amount you need to finance through a bank, and therefore the interest you must pay. Your down payment is not subject to interest charges.

Take advantage of online payment calculators, or use Excel to map out a payment plan for your automobile or home loan. Then ask, "Can I afford it?" and, "What plan do I have if my finances suddenly change?"

THE AUTOMOBILE

OTHER COST CONSIDERATIONS

Consider Additional Costs beyond the Installment Loan

- Sales taxes
- Insurance
- Licensing costs
- Gasoline, tune-ups, repairs
- Parking fees

We have concentrated on a major cost of borrowing — the interest costs.

However, in budgeting for a major purchase, like an automobile there will most likely be substantial up-front costs for sales taxes, extended warranties, and licensing. And remember to budget for ongoing costs of tune-ups, repairs, gasoline and insurance. If you live in a metropolitan area, you may also incur parking fees and yearly emissions inspections. Automobiles are expensive. Make sure you have money in your budget to cover both the financing costs and the cost of operating a vehicle.

BUYING A HOME

OTHER COST CONSIDERATIONS

The mortgage is only the beginning ...other costs to consider:

- Closing Costs
- Property Taxes
- Home Insurance
- Repairs/Upgrades/Remodels
- Utilities: Heating, Electricity, Water/Sewer, Garbage

As with financing an automobile, planning is vital when purchasing a home. The mortgage is only the beginning. Once you become a home-owner, you will find that there are a number of costs that must be borne.

Among these are closing costs — such as title search and transfer, loan fees and appraisal fees.

Ongoing costs of home ownership include property taxes, home insurance, repairs, upgrades and remodels, and of course… utility costs – heating, electricity, water, sewer and garbage pick–up.

Therefore, the mortgage is only the beginning. Your budget must include the costs of keeping your home safe and comfortable.

Buying a home is a major undertaking. Seek the advice of others, par-ticularly trusted family
members and friends, when considering buying a home. And spend the necessary planning time up-front to accumulate a strong down payment and home maintenance budget.

Managing Your Home Loan

- **Understand your loan agreement**
- **Make your payments on time**
- **Maintain adequate insurance on the home**
- **Be aware of changing interest rates**
- **Contact your lender if you run into trouble**
- **Learn about income tax rules regarding deductibility of interest**

A home loan involves a significant financial commitment, so you must be vigilant in how you manage it.

First, carefully review your loan agreement; call your lender if there are any items that you do not understand.

It is vital that you make your payments on time. Consider using an automatic payment plan or a computerized bill paying service, in order to assure yourself that your payments will be on time. Make sure you have adequate insurance on the property, with appropriate deductibles and coverage items for your geographical area. For example, flood and earthquake insurance may be advisable or even required.

Be aware of the how interest rates are changing. For example, if interest rates should decline sharply, you might be in a position to consider refinancing, particularly if you plan to continue living at your current residence.

As with any loan, be sure to contact your lender if you run into financial problems — the lender may be willing to work with you to avoid default on the loan.

Carefully review your loan agreement; call your lender if there are items that you do not understand.

Become familiar with income tax laws regarding the deductibility of mortgage interest — review IRS publication 936 on Home Mortgage Interest Deduction before filing your income tax return.

SUMMARY OF THIS WORKBOOK

- Reasons to Borrow Money
- Loan Terms — principal, rate, time
- How an installment loan works
- The Five C's of Credit
- Questions your lender will ask
- Managing your loan

Let's recap the main points of this workbook. We started by discussing the reasons why people borrow money. We then examined the terms of a typical loan — principal, interest rate and time. We also looked at examples of how an installment loan works.

We discussed the characteristics that lenders look for in borrowers — the Five C's of credit, and then examined the typical questions that financial institutions ask on loan applications.

We concluded with a few suggestions on how to manage a home loan.

Feeling comfortable with your budget and in knowing how to manage your finances can help you be successful in maintaining a clear credit record, and obtaining a loan to help you in your financial future.

QUIZ—Understanding Credit and Borrowing

1. Bob borrows $10,000 for 5 years at 6% interest. The principal of this loan is:

a. $10,600

b. 6%

c. $10,000

d. $10,000 minus 6%

2. One percent of $1,000 is:

a. $100

b. $10

c. $1

d. $5

3. On an installment loan, the payments will be:

a. Increasing each month

b. Decreasing each month

c. The same each month

4. The portion of the installment payment that goes toward interest will be:

a. Increasing each month

b. Decreasing each month

c. Remaining the same

d. Installment payments do not have interest

5. In order to obtain the lowest possible interest rate from a lender you should:

a. Have a strong credit rating

b. Have borrowed from this lender before

c. Have no other loans

d. Have less than 3 credit cards

6. Capacity is one of the Five C's of Credit. It refers to:

a. Your standing in the community
b. Your ability to handle more debt
c. The amount of your biggest debt
d. Your net worth

7. Before taking out a loan it is wise to:

a. Discuss it with a trusted friend or relative
b. Compare lenders
c. Ask the lender to disclose the total cost of the loan
d. All of the above

8. You may be denied a loan if:

a. Your credit score is high
b. You have too much existing debt
c. You apply to a lender who does not know you personally
d. You have not checked your credit

9. Before applying for a loan you should:

a. Save for the down payment
b. Carefully budget to be sure you can afford the payment
c. Calculate any other expenses that the item you are purchasing might incur
d. All of the above

10. If you are having trouble making your mortgage payments the first step you should take is to:

a. Make partial payments until you can afford the full payment again
b. Contact your lender immediately and explain your financial situation
c. Call your realtor
d. Apply for a loan

PARTICIPANT CONTACT INFORMATION

If you would like to receive a certificate for completing this course, please:

- Complete the quiz on the preceding pages
- Complete the form below
- Mail both items to:
  American Financial Solutions
  Attn: Education
  263 4th Street
  Bremerton, WA 98337
- Or fax to: (888-282-5811)

Keys to Credit and Barrowing

Please print your name (as it will appear on your certificate):

Name: ______________________________

Please select your preferred method to receive your Certificate of Completion

Email: ______________________________

FAX: ______________________________

US Mail:

address ______________________________

city ______________________________

state ______________________ zip ______________________

WORKBOOK REVIEW:

- Differences in types of credit
- Calculating payments and interest
- Qualifying for a loan
- The Five C's of Credit

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