



MODULE
02

BORROWING:

Use—Don't Abuse

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NEFE HIGH SCHOOL FINANCIAL PLANNING PROGRAM

About the NEFE High School Financial Planning Program Series

By picking up this booklet, you are on your way to making your dreams come true and headed down the path to financial independence. This program series includes six topic modules to introduce you to the fundamentals of mindful money management behaviors. Use what you learn in each module to develop sensible habits to confidently manage your money and adapt to unexpected events.

Program Modules

- 1. MONEY MANAGEMENT: Control Your Cash Flow:** goal setting – decision making – spending plan & budget – money management tips
- 2. BORROWING: Use—Don't Abuse:** application process – loans – credit cards – costs – credit score – debt – rights & responsibilities
- 3. EARNING POWER: More Than a Paycheck:** earning potential – career plan – life stages – employee benefits – take-home pay – lifestyle
- 4. INVESTING: Money Working for You:** savings – investing – goals – options – risks & rewards – time value of money – diversification – plan
- 5. FINANCIAL SERVICES: Care for Your Cash:** account types – fees – service options – transaction tracking – automation – identity protection
- 6. INSURANCE: Protect What You Have:** risk management – costs – claims – insurance types – coverage decisions – insurability factors

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Use the tips and strategies in this guide to do the following:

- » Weigh the benefits and risks of borrowing.
- » Compare the costs and terms of borrowing options.
- » Start the journey to establishing a good credit rating.
- » Explore the rights and responsibilities of borrowers and lenders.
- » Protect yourself from identity fraud.

MEET MARIAH AND JESSE

Mariah is upset. Her mom said “no way!” to helping her get a credit card. Mariah pointed out that she has a part-time job at the mall to pay the bills and that she’s a junior now and will be going off to college soon—but her mom wouldn’t even discuss it.

Jesse dreads the thought of having to drive the family clunker next year when he gets his license. He doesn’t have a job, but he’s been saving for a few years and has \$2,500 now, which he was hoping to use to spend on a truck—until he actually started checking out truck prices.

Jesse’s older brother said their parents might agree to cosign a loan for him if he gets a job before then. Jesse isn’t sure he wants the responsibility of a car payment every month, so he wants to figure out how much the payments would be before he proposes the cosigning idea.

Both Mariah and Jesse will join us as we talk about borrowing and debt.



THE SIREN SONG OF BORROWING



What Do YOU Think?

Are these good reasons to borrow money?

- » Taking out a \$5,000 student loan for college tuition
- » Charging dinner and movie tickets during a night out with your friends
- » Buying a laptop that's on sale using the store's financing program
- » Getting a loan to pay your credit card bills
- » Charging repairs to get your car running again
- » Borrowing cash from a friend to buy some magazines

“Compound interest is the eighth wonder of the world. He who understands it, earns it ... he who doesn't ... pays it.”

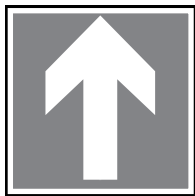
*~ Nobel Prize-winning physicist
Albert Einstein*

Credit cards, auto loans, home mortgages, pawn shops ... you've probably heard a lot about these forms of credit over the years—good and bad. But credit itself is actually neither. **Credit** is merely a tool to buy something now and pay for it later.

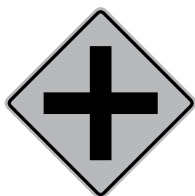


How we use credit is what's good or bad.





After all, none of your favorite products would exist if businesses hadn't borrowed money to make the products. For example, small, short-term loans known as **microloans** help hardworking people fund businesses in low-income communities as part of a plan to reduce poverty.



Borrowing also can be a lifesaver in an emergency—you can't just tell a rupturing appendix to wait until payday. By accepting a credit card payment, the hospital essentially lets you take a loan from the credit card issuer to pay for the emergency appendix surgery.

On the other hand, too many people eagerly “buy now” without thinking about their ability to “pay later.” So, they end up owing money for purchases they might not even remember making or really didn't need in the first place. They also pay more than what each item cost.

Even if you don't need to borrow money today, you'll soon be flooded with tempting offers for car loans, credit cards, cash-advance loans, cellphone service, and more. Boosting your borrowing IQ now will prepare you to make smarter decisions whenever you decide to take the credit plunge.



Activity 2.1: Borrowing Fitness Test

Do you have what it takes to be a responsible borrower? Find out by answering the questions below.

Do you ...

- _____ **1** Repay money loans from friends and family before they have to ask you for it?
- _____ **2** Often borrow money to pay for something you can't afford right now?
- _____ **3** Return library books and other borrowed items before they're due and return them in good condition?
- _____ **4** Frequently ask for an advance on your paycheck or allowance?
- _____ **5** Replace money you borrow from your savings account or from other spending-plan funds?
- _____ **6** Borrow items from your parents or siblings without asking for or getting permission first?
- _____ **7** Know how much money you owe others right at this very moment?
- _____ **8** Ever make monthly or weekly payments late?

The more "yes" answers you have on the odd-numbered questions and "no" answers on the even-numbered questions, the more fit you are to be a smart borrower! If you didn't do well, don't worry. It's never too late for a bad-habit makeover.

REAP THE REWARDS

There are many reasons why people borrow money instead of paying cash, such as:

- » **Convenience.** Using a credit card can be more practical when shopping online. When shopping in person, it's safer and easier than carrying around a large wad of cash.
- » **Instant gratification.** You didn't budget for the purchase and don't want to wait until you have the money to buy the item.
- » **Protection.** It's easier to get refunds on credit card purchases. Some cards also insure purchases in case an item is damaged, lost, or stolen shortly after buying.
- » **Emergencies.** When you don't have enough money in your emergency fund, borrowing can be a temporary fix for unexpected expenses like patching a leaking roof.
- » **Spreading out payments for expensive items.** Most people would never be able to buy a house, car, or college education if they had to save all the money for it first.
- » **Investments.** Borrowing money to invest in a business or property can be an opportunity to use a little money to make more money.
- » **Credit history.** Just like you need diplomas and job references, you need good credit references. Building a good credit history can help you qualify for deals on loans, credit cards, insurance, and more.
- » **Special offers and perks.** Some people like to earn discounts or loyalty rewards that credit issuers occasionally offer.



While these reasons may be popular, they're not always smart. We'll talk more about that shortly. First, let's take a big-picture look at borrowing.



Activity 2.2: What is the Reason?

- 1 What do you think is Mariah's reason for getting a credit card?

- 2 What do you think is Jesse's reason for using a loan to buy a truck?

- 3 Finally, which of the Reap the Rewards reasons have prompted you to borrow money from friends or family?

CREDIT MAKES THE WORLD GO 'ROUND

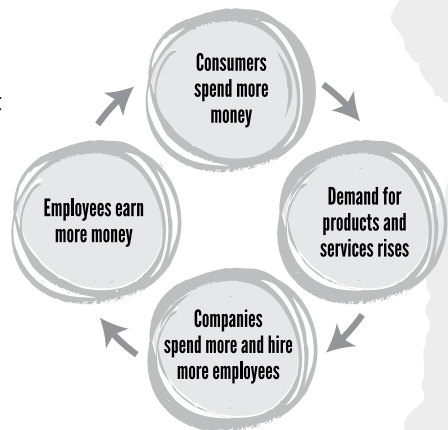
Who's in the driver's seat of the U.S. economy? You!

Consumer spending fuels a whopping 70 percent of our nation's economic growth.¹ When consumers spend more money, demand for products and services increases.

To meet the new demand, companies buy more equipment, hire more workers, and give more pay raises. That means, these employees now have more money to spend ... and the cycle of economic growth continues.

Borrowing is one way consumers can spend more when their income isn't increasing. That can help the economy grow.

But, as we've seen in recent years, too many consumers borrowing more than they can afford ultimately can end up hurting the economy.



¹ Flow of Funds Accounts in the United States, Federal Reserve, Dec. 8, 2011

NOT-SO-FLEETING INTEREST



If a friend offers you \$100 in exchange for you paying him \$120, would you say “yes”? Or tell him to take a hike?

What if he offers you \$100 now in exchange for you repaying him \$20 a month for the next six months?

If you desperately need \$100 now, you might say “yes.”

You also might agree to the exchange if you could use that money to make more than \$120. For example, you might borrow the \$100 to buy a few video games you plan to resell online for more money. Then, paying your friend the extra \$20 wouldn't seem like such a big deal.

Otherwise, you'd probably say “no thanks” to either of the offers above. After all, why should you pay him more than he gave you?

Yet, you're making a similar deal every time you get loans and credit cards. This is known as *using credit* or *buying on credit*.

Credit means someone is willing to loan you money—called **principal**—in exchange for your promise to repay the money later, usually with interest.

Interest is the amount you pay to use someone else's money, usually a percentage of the principal. The higher the interest percentage rate, the higher the total amount you pay to buy something on credit.

When you take out a loan, it's a good idea to know how the interest is calculated. Your payments will be different depending on the interest formula used by the creditor.

Simple Interest Rate Formula:

$$I = P \times R \times T \text{ where}$$

I = interest

P = principal

R = interest rate (decimal number)

T = time (number of years)

The **simple interest formula** is a quick way to calculate interest. First you multiply the annual interest rate by the amount borrowed, and then the amount is multiplied by the number of years (or partial years) you take to repay what you borrowed.



Activity 2.3: Simply Tell the Total

Use the simple interest formula to calculate the interest and total amount to be repaid for the purchases below.

| Description | Principal (P) | Annual Interest Rate (R) | Time in Years (T) | Interest (I) | Total Amount to be Repaid |
|---------------|---------------|--------------------------|-------------------|--|---------------------------|
| Cash loan | \$100 | 40.0% | 1/2 year | 100×0.4 $\times 0.5 =$ \$20 | $\$100 + \$20 =$ \$120 |
| Big-screen TV | \$700 | 7.0% | 2 years | | |
| College loan | \$12,000 | 3.5% | 15 years | | |

It's likely that you will arrange to make manageable monthly payments to repay a loan rather than waiting to repay a larger lump sum when the amount is due. As you make a payment, a bit of the principal is paid. This actually changes the amount of interest you owe on the unpaid balance.

As you pay down the amount you borrowed, it isn't practical for you to recalculate what you owe after each loan payment is made. Lenders typically use the **amortization calculation formula** to figure out an average payment amount for each period, which is usually each month.

This helps you plan to make the same payment each time even though the amount of interest owed changes as the balance of what you owe drops.



Activity 2.4: What is the Average Payment?

Figure out the average monthly payments for the same purchases shown in Activity 2.3 using the amortization calculation formula.

Amortization Calculation Formula:

$$A = P \frac{r(1+r)^n}{(1+r)^n - 1}$$

A = payment amount

P = initial principal (loan amount)

r = interest rate per period (decimal)

n = total number of payments or periods



Do your own amortization calculations using spreadsheet software to generate an amortization payment chart, or use an online loan payment calculator.

Sample Amortization Chart: Monthly payments when \$100 is borrowed at 40 percent annual interest to be repaid in six equal payments.

| Monthly Payment | Payment Amount | Principal Repaid | Interest Paid |
|-----------------|-----------------|------------------|----------------|
| 1 | 18.66 | 15.33 | 3.33 |
| 2 | 18.66 | 15.84 | 2.82 |
| 3 | 18.66 | 16.37 | 2.29 |
| 4 | 18.66 | 16.92 | 1.74 |
| 5 | 18.66 | 17.48 | 1.18 |
| 6 | 18.66 | 18.06 | .60 |
| Totals | \$111.96 | \$100.00 | \$11.96 |



Study the sample amortization chart above. How does the total interest paid compare with simple interest calculations in Activity 2.3?

Let's take a closer look at how interest impacts your wallet.

THE LIFETIME LAPTOP

Jesse found a great deal on a laptop. It regularly sells for \$650, but right now it's only \$500. Even better, he won't have to spend his savings on it because the ad says he can pay just \$10 a month for it.



His brother reads the fine print for the store's financing program to find the interest rate. He tells Jesse to enter "18" for the interest percentage rate and "10" for the monthly payment in an online loan payment calculator.

Jesse's shocked to see that it'll take him seven years and 10 months to pay off the laptop. He'll pay \$431 in interest charges ... bringing the total cost of the laptop to \$931.

Even worse, he realizes that the loan will last longer than the life of the laptop!

He thinks about buying the laptop with his savings instead of using the store loan. But he decides to skip the sale and keep saving his money to buy a truck.

Car dealers and stores often try to dazzle you with a low monthly payment so you'll overlook what's really important—the interest rate and total interest you will pay. After all, asking you to pay back just \$10 a month sounds much more appealing than asking you to pay 18 percent interest for more than seven years!

The good news is that lenders are required to tell you the **annual percentage rate (APR)** in writing before you sign on the dotted line. The APR is the interest rate calculated in a consistent way so it's easier to compare different borrowing options. It also may include fees and loan costs to give you a truer estimate of the total cost.

| |
|---|
| Regular Price of the Laptop with Cash |
| \$650 |
| Total Price of "Discounted" Laptop with Interest |
| \$931 |



Activity 2.5: Choose the Best Deal

Jesse has his eye on a used truck. Of the three options below, which do you think is the better deal if he borrows \$5,000?

- 1 7 percent APR payable in two years
- 2 5.5 percent APR payable in three years
- 3 4.75 percent APR payable in four years

Don't Get Teased!

Many loans and credit cards offer an **introductory APR** or “teaser” rate for a short period to tempt you to borrow. These cut your immediate borrowing costs—but always check when the introductory rate will expire and what your new APR will be afterward.

Another problem with interest rates is that they may climb, causing you to owe more money than you planned on.

Fixed interest rates stay the same for the life of the loan or account. You know that the monthly payment will stay the same, too.

Adjustable or **variable interest rates** change at specified times, such as every month or year. As the rate goes up or down, your payment amount will change, too.



Pay your bills on time. One late payment could prompt a credit-card issuer to increase your interest rate to a higher APR.

Are You Smarter Than an 18-Year-Old?

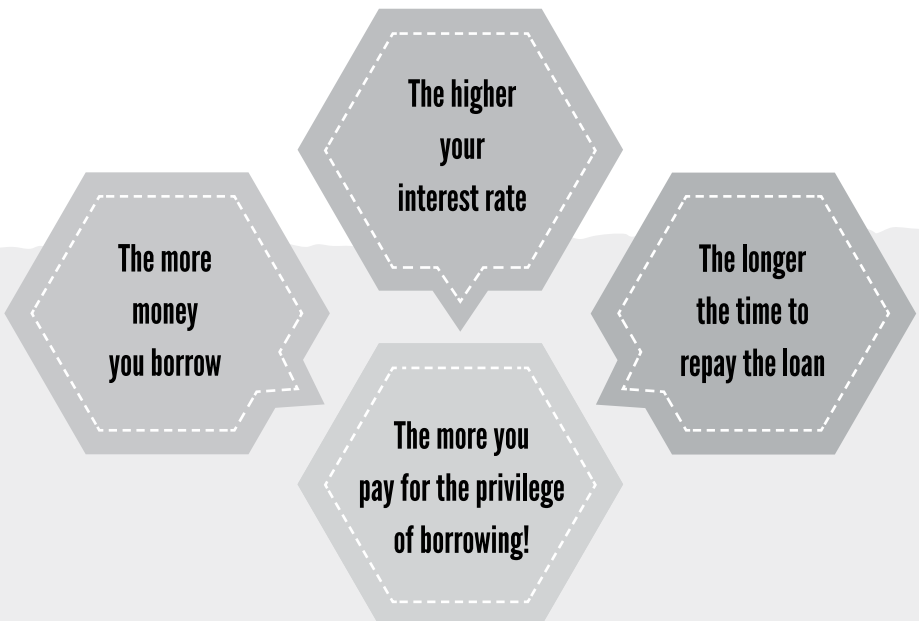
Sixty-eight percent of 18-year-olds said they don't understand how credit card interest and fees work.² Read on and YOU will know more than they did!

² 2011 Teens & Money Survey Findings, Charles Schwab & Co. Inc.

GOTCHA! COSTS OF BORROWING

By far, the interest rate you pay on the borrowed amount is the most expensive part of borrowing money. But it's not the only one.

Although credit cards have no set payoff date, loans have a **maturity date**, the final payment date of a loan. The amount of time you're obligated to make payments is called the **loan term**. The longer the loan term, the lower your monthly payment will be—but the more interest you'll pay over the life of the loan.



Of course, virtually all loans and credit cards have late-payment fees. But a host of other items can affect how much you pay, as well.

Credit Card and Credit Line Terms

Annual Fee. A yearly fee for having an open account. The lower the fee, the better; no fee is best.

Cash-Advance Fee. In addition to any ATM fees, this is a fee for withdrawing cash on your credit account.

Over-the-Limit Fee. Your **credit limit** is the maximum amount you can borrow at any one time. Exceed this and a fee will be applied to your account each time you go over your limit.

Grace Period. The amount of time before interest starts accumulating on charged purchases. Be sure the lender receives your payment before the grace period ends.

Other Fees. If possible, avoid setup fees or maintenance fees if you don't use the card. Check the terms of your agreement.

Installment Loan Terms

Loan Term. Longer loans typically have lower payments but accumulate more interest, while shorter loans do the reverse.

Origination Fee. A charge to process your loan. Lower is better; none is best of all.

Prepayment Penalty. Always check before making a loan commitment to know about any extra charges if you make early payments.

Down Payment. Money you pay upfront toward the purchase to reduce the loan amount. Some car and mortgage loans will require a down payment for approval.

Discount points. Some lenders offer interest rate discounts as incentives. For example, you might have a lower rate if you make automatic bank transfer payments.

THE DARK SIDE OF DEBT

Mariah's mom pulls her aside and admits she might have overreacted the other night about Mariah getting a credit card. She says it was because she got into trouble with a couple of credit cards in college. She explains:

"I'd use the cards all year long and then work all summer to pay them off—even though it sometimes meant skipping trips and other fun with my friends.

After graduation, I couldn't do that. With rent and payments for a car loan and a student loan, my new salary didn't go very far. I fell behind on my payments.

I ended up moving back home for a year and working a second job to pay off my bills and get back on my feet again. But even then, it wasn't over.

The first apartment I applied to after that turned me down because of my bad credit history. And the interest rate on my next car loan was shocking. It was a while before I could get a decent loan or credit card again. So, you can see why I wasn't thrilled with the idea of you getting a credit card."

Surprised to hear all this, Mariah apologizes for getting so mad the other night. But she quickly gets excited when her mom says she's changed her mind and will help Mariah get a card with a low credit limit.



While Mariah was stunned to learn about her mom’s experience, such credit nightmares are not that unusual. The dangers lurking behind a buy-now, pay-later mindset are real. They include:

- » **Overspending.** You’re much more likely to surrender to temptation when you pull out the plastic instead of handing over cash. It’s also harder to keep track of your spending when you’re using several accounts.
- » **Overwhelming Debt.** Monthly payments increase your fixed expenses, leaving you with less to live on. Also, when you make only the minimum payments on credit card debt, interest keeps growing on the unpaid balance. This means you pay even more interest over time.
- » **Legal Actions.** If you can’t make your payments, the lender can take your property or take money from your wages (aka **garnish**) to collect on the debt.
- » **Identity Theft and Fraud.** Each time you use a credit card or apply for a loan, there is a chance that someone will steal your information to run up debt in your name. We’ll talk more about identity theft later in this guide.

Debt is the total amount that a person owes to others.

In short, those who take borrowing too lightly are likely to end up facing some pretty serious consequences.



Activity 2.6: Good and Bad Uses of Credit

Now that you know the pros and cons of borrowing money, look back at the “What Do YOU Think?” examples on page 4. Are your answers the same?

You may see that the answers aren’t so black and white now. After all, the borrower’s financial situation, how the person handles credit, and the credit terms are all important to each borrowing decision.

DIAL 'B' FOR BORROW

There are many options for borrowing money. But they all boil down to four main types of accounts:

Revolving credit lets you borrow up to a maximum dollar amount whenever you want, without applying for credit each time. And there's no set payoff date.

In the case of a credit card, you can choose to repay the full amount each month and owe no interest. But if you make only the minimum payment, the interest charges will really add up. Credit card interest rates are typically costly. Keep track of what you buy so you don't charge more than you will repay each month.

Installment credit is also known as **closed-ended credit** because the entire loan amount is paid to you at once. Then, you repay the loan, with interest, in a set number of equal payments by a specific payoff date.

Installment loans are often used for big-ticket items such as a car or home. If you want to borrow more money or change the loan terms, you must take out a new loan.

Cash loans (aka personal loans) often have no specific purpose and simply pay the borrowed funds directly to you. You may have to repay the amount borrowed plus interest all at once, although some lenders allow you to make payments over time for large amounts.

Avoid paying high interest and fees by comparing interest rates when borrowing cash. Getting a cash advance from your credit card or a payday loan is typically more expensive than borrowing cash from a bank or credit union.

“When a man is in love or in debt, someone else has the advantage.”

~ Radio host Bill Ballance

Service credit lets you pay in full, usually monthly, for a service as charges add up. You use service credit when you contract for phone service or electrical service. However, the service provider can deny your application for service based on your credit history or require a deposit before approving you.

As with revolving credit, you will not pay interest or late fees if your payment for services reaches the lender by the due date.

BEWARE OF COMPOUND INTEREST

When a revolving credit balance or service credit balance is not paid by the due date, interest is charged on the unpaid amount. Left unpaid, interest **compounds** each time it is calculated on the original principal plus any interest that accumulated from previous periods.



Study the example below to figure out how much is owed if a credit card balance isn't paid until the end of Month 4.

| Month | Principal | 20% APR | Balance |
|-------|------------|---|------------|
| 1 | \$1,000.00 | $(\$1,000 \times .2 \times 1/12) = \16.67 | \$1,016.67 |
| 2 | \$1,016.67 | \$16.94 | \$1,033.61 |
| 3 | \$1,033.61 | \$17.23 | \$1,050.84 |
| 4 | | | |

STEALING FROM YOUR FUTURE SELF



Remember that every time you take out a loan or make credit card purchases for more than you will repay in full that month, you're actually borrowing from two people: the lender and your future self. Smart borrowers know that **every dollar borrowed today is a dollar less to spend from the next paycheck.**

KNOW WHEN TO SAY WHEN

Maybe you're wondering, "So, how much debt is OK?"

The 20–10 Rule offers a quick guide:

| \$ Total of | Should be LESS than | of Your |
|------------------|---------------------|--------------------|
| Amount Borrowed* | 20% | Annual Net Income |
| Monthly Payments | 10% | Monthly Net Income |

*Includes credit cards but not mortgages

Of course, the 20–10 Rule is just a guideline. Only YOU know your expenses and what you can afford. And only YOU know how much debt you're comfortable with.



Activity 2.7: Know the Limit

Use the 20–10 Rule to calculate the debt limits for Mariah's and Jesse's older siblings. If you earn any income now, also compute your debt limits.

| Borrower | Annual Net Income | Maximum Total Debt (20% Annual Net Income) | Maximum Monthly Payments (10% Monthly Net Income) |
|------------------------|-------------------|---|--|
| <i>Mariah's sister</i> | <i>\$6,500</i> | $\$6,500 \times .20 =$ <i>\$1,300</i> | $(\$6,500 / 12) \times .10 =$ <i>\$54.17</i> |
| <i>Jesse's brother</i> | <i>\$24,750</i> | | |
| <i>Jesse's sister</i> | <i>\$35,800</i> | | |
| <i>Me</i> | | | |

BE A SHREWD BORROWER

Before you can decide how to borrow, you have to decide *if* you should borrow.

That's easier to do when you're at home looking at your spending plan than when you're at the store staring at something you want to buy. So, to help guide your decision in the heat of the moment, here's a SHREWD checklist of questions to ask yourself:

- » **Sincere need or want.** Do I truly need it and want it?
- » **Happy to pay.** Will I still be glad I bought it or still use it when payment time comes?
- » **Room.** Is there room in my spending plan for the payments? And (if applicable) on my credit card?
- » **Extra cost.** How much more will it cost me to charge or borrow for this? Is it worth it?
- » **Waiting cost.** Is there anything I would lose by waiting until I save enough money?
- » **Discipline.** Will I be disciplined enough to pay this off or make the required on-time payments?

If all the answers are "yes," then it's time to narrow down the options to find the best deal for you.



Keep in mind that just because you have been approved for credit, it doesn't mean you have to use the credit.

DECIDE ON THE BEST DEAL

Jesse wants to find out what the auto loan options are like if he makes a down payment with his savings. He has surfed a bunch of car websites to check prices and thinks that borrowing \$5,000 would enable him to buy a decent used truck that he won't be embarrassed to drive.

Now, he's going to use the DECIDE process to evaluate two potential loans.

| Action Steps | Jesse's Results |
|---|--|
| 1. Define your goal. What do you want to achieve? | <i>Find the best deal on a \$5,000 used-car loan.</i> |
| 2. Establish your criteria. What are the features you absolutely must have? Which ones would you like to have? | <i>A low APR and low monthly payment are musts. I'd also like to pay it off before I start college.</i> |
| 3. Choose two to three good options. Remove any options that don't meet your must-have criteria. | <i>1. Credit union loan with APR of 3.49% for 48 months 2. Bank loan with APR of 6.32% for 36 months</i> |
| 4. Identify the pros and cons. Calculate what the total costs are for each option. If you have a lot of criteria and options, you may want to make a chart to quickly compare the features of each option. | <i>1. The monthly payments for the credit union loan are only \$111.76 and I'll pay less interest overall (\$364.37). I already have an account there, too, so it'll be easy to make payments. The downside is the four-year loan term, which means I'd have to make payments while I'm in college. 2. The bank's shorter loan term means I'll pay off the loan right before college. But the payments are \$152.86 and I'll pay more interest, (\$502.96). There's a \$50 application fee, too.</i> |
| 5. Decide what's best. Which option best matches your criteria? | <i>Overall, I'll save more money with the credit union loan and I can always try to pay it off earlier without any penalty.</i> |
| 6. Evaluate the results. Afterward, note what you do and don't like about your choice so you can add that to your criteria for next time. | <i>I'll do this after I get my truck!</i> |

Jesse is smart to go loan shopping before setting foot on the car lot. He might find lower interest rates elsewhere. This is especially true because car dealers will sometimes make loans with higher rates to make up for reducing the purchase price on the car or agreeing to a trade-in offer.

Also, be wary of ads promising zero percent or other unbelievably low interest rates. These loans typically come with strings attached—such as having to buy specific cars or models, make a large down payment, or have a near-perfect credit record.

Challenge 2-A: DECIDE the Best Deal for You

Pick a situation where you or your family currently use or expect to use credit in the near future. For example, this might be a phone plan, car loan, school loan, apartment rental, or cash loan.

Gather information from two to three different businesses that provide credit for the situation you chose. Use the DECIDE process to select the best option for your (or your family's) criteria.

KEEPING SCORE WITH YOUR CREDIT

Mariah and her mom are visiting her community bank so Mariah can apply for a credit card. The bank's customer-service representative, Frank, explains that Mariah is not able to have her own credit card account because she is a minor. However, he hands over a credit card application and suggests that Mariah's mom consider opening the account with Mariah added as an authorized user or as a joint account holder.

“ A bank is a place that will lend you money if you can prove that you don't need it. ”

~ Comedian Bob Hope

An **authorized user** is able to use the credit card account but is not legally liable for the balance due on the account.

Someone who is a **joint account holder** is equally responsible for the balance of the account along with the other person named on the account and is legally liable for any amount due.

Mariah watches as her mother completes the first section of the application, which asks for the following information:

- » Full name
- » Address and phone number
- » Date of birth
- » Social Security number
- » Current employer
- » Monthly income
- » Bank name and account number
- » Monthly rent or mortgage payment

While her mom fills out the application, Mariah asks Frank how the bank decides whom to approve. He explains that lenders may use credit scores or look at five key criteria known as the 5 C's of credit.

CONQUER THE 5 C's OF CREDIT

Capital. You will need money to borrow money. Lenders appreciate when a borrower is able to cover some of the loan costs with existing cash on hand such as savings account or checking account funds. Having the ability to make a down payment or pay for closing costs may give the lender confidence that you can manage your funds to repay on time.

Frank notes that Mariah's mom owns a home and has a savings account.

Capacity. No one wants to loan money to someone who has no way to pay it back. So, lenders want to make sure you have more money coming in than going out. A history of steady employment and increasing income makes them feel more confident about lending to you.

Frank points out that Mariah's mom has a good income and she has been with her employer for five years. It's also a plus that her mom's total debt is less than 20 percent of her income.

Character. Even wealthy people can be irresponsible with their money. That's why lenders request **credit reports** on applicants to see how they have used credit in the past. This is a way for lenders to check your reputation for repaying what you owe.

Mariah's mom has established a history of paying bills on time. Also, keeping her debt low over the past 10 years adds points in her favor.

Collateral. Lenders consider what possessions you can use for collateral to make loans less risky for them. If you don't pay, you may have to give the lender your collateral as partial compensation for what you owe. For example, your car might be identified as collateral when you sign an auto loan. But financial assets like a savings account may be used, too.

With credit cards, there's no collateral, so Frank will focus more on the other C's.

Conditions. Lenders may be more lenient about past credit troubles if you can prove you are moving past a bad experience—say, identity theft or unemployment—and you are making progress rebuilding a good credit history. They also will consider what's happening in the local economy and how this might affect your ability to repay a loan.

Fortunately, Frank says, current conditions are not an issue for Mariah or her mom, and her application is approved! Their cards with a \$300 account credit limit should come in the mail next week.



Activity 2.8: Put Your Best Foot Forward

How creditworthy do YOU look to a lender? Identify specific evidence to show how you meet any or all of the 5 C's of credit.

If you don't have evidence now for any of the categories, list what you will do in the near future so you can make a positive impression on a lender in each category.

CRACK THE CODE ON CREDIT REPORTS

Would you want to loan money to someone who never pays you back? No! And you probably wouldn't want to loan it to someone who took forever to pay you back.

Lenders, too, don't want to loan money to people who aren't responsible about paying it back. However, if you have never done business with a lender, the lender will need to find a way to check out your borrowing reputation. Therefore, they turn to **credit reports**, which detail how a person has used credit in the past.

In other words, your credit report serves as your credit references. Credit reporting companies provide the service of updating your credit history so that the information is available for reference when you seek new borrowing sources.

The first time you apply for a credit card or loan in your own name as an adult, that lender will forward your information to credit reporting agencies. As you use credit, your file will eventually grow to include the following details:

- » Where you live and work, recent past and present
- » Loan amounts, credit limits, and balances on all of your credit accounts
- » Whether you have been on time or late with payments
- » If you have recent inquiries indicating that you may have taken on additional debt which has not yet been reported.
- » Whether anyone's taken collection or legal action against you for your debts

Credit agencies then sell this information to lenders, apartment complexes, insurance companies, employers, and other businesses with a legitimate need to see how creditworthy you are.



You're lucky to be starting off with a clean credit slate, because it's far easier to maintain a good credit history than to fix one you've trashed.

THAT'S A RELIEF!

Federal student loans do NOT require a credit history, but more-expensive private student loans may.

Once you get a loan or credit card, any late payments or other missteps become part of your credit history. This can wreak havoc on your ability to borrow, as well as to get an apartment, a job, a cellphone, and more—for seven to 10 years.

Even if you get approved, your bad references can cause you to be charged higher interest rates or require a deposit payment before getting service.

COSIGN COMMITMENT

If you are unable to provide acceptable information for a lender to approve your credit or loan application, the lender might require someone to **cosign** on the agreement. A **cosigner** agrees to repay the debt if you don't and will need to be approved by the lender.

Before you agree to cosign for someone else, be sure you trust that person to use the credit responsibly, or you might be stuck making payments that aren't for things you want or even use. And that debt obligation and credit history will be part of your credit history, too.

DID YOU KNOW?

Debit cards and prepaid credit cards are not reported in your credit history. Using these cards cannot help you build credit references because no credit is offered through these types of cards.

ACE YOUR CREDIT SCORE

On the way home, Mariah asks her mom how long a credit report is because Frank seemed to look hers over so fast.

Her mom explains that Frank probably just checked a **credit score**—a three-digit number based on the person's credit report. A credit report doesn't rate credit use, so credit scores tell lenders at a glance how likely someone is to be a responsible borrower.

When Mariah's mom recently purchased a credit score, it indicated that her credit history is in a low-risk category. This is likely what helped her get approved for the new credit card account.

But it took a lot of time and discipline for Mariah's mom to build a strong history that will score well. She fell behind on everything after college, which put her in a **subprime borrower** category—in short, someone lenders see as a big credit risk. And if they do let you borrow with a subprime score, they make you pay for it with high interest rates.

Because missed payments are removed from the credit report after seven years, they weren't factored into her mom's credit scores at all now. But seven years is a long time to pay for mistakes in borrowing!



A credit score is a short number with big power.

A great score can save you money by qualifying you for the best terms and interest rates. While it's not as good as cash sitting in the bank, it means that you are more likely to be able to borrow money if you ever urgently need it.

On the other hand, bad credit scores or no credit history often has these downsides:

- » More rejections for apartments, cellphone service, credit cards, and loans
- » Large deposit payments when you start up service credit accounts for utilities
- » Higher insurance payments for cars and other property coverage
- » Much higher interest rates for any money you borrow—which can translate into thousands of extra dollars over a few years

Basically, having bad credit scores makes many aspects of your life more difficult and expensive. And rebuilding your creditworthiness can take years.

THE CREDIT GRADING SCALE

Many lenders choose to use scoring as a tool to help them predict if a borrower will repay what is owed and pay on time. The score gives a lender an indication of a borrower's creditworthiness based on credit history data.

The contents of your credit report at a specific time are used to calculate credit scores. As your history is updated and changed, your credit scores will be recalculated based on the current facts at that point in time.

What's a "good" score? That depends on the scoring model used by the lender to measure risk for a specific lending purpose, and, most importantly, what factors in the credit history most impacted that risk.

So, rather than focusing on a specific number, look at where your history falls in the range of risk and the factors that affected your score. If your scores are low, focus on what you need to change in the way you use credit. No matter which scoring model is used, your risk level and your risk factors will be fairly consistent.

LAY THE FOUNDATION FOR GOOD CREDIT

Even if you don't need loans or credit right now, it's still worthwhile to build strong habits for the future. Start strengthening those responsible borrowing habits by:

- » Returning items you borrow from friends, family, and the library—promptly and in good condition!
- » Avoiding overdrafts in your checking and savings accounts—start by tracking all of your deposits and withdrawals (especially any debit card activity) and verifying your account activity regularly.
- » Repaying yourself with interest if you borrow money from your savings account.
- » Managing your cash flow so you rarely need to borrow money—don't be the friend who's always short when the bill comes!



CHECK YOUR CREDIT!

When you begin to use credit, each of the three U.S. credit reporting agencies—Equifax, Experian, and TransUnion—compiles a report on you. It's smart to check these reports regularly to make sure there are no errors and no suspicious activity.

By law, you're entitled to one free copy of your credit report from each of these companies each year. (In other words, you can get a total of three free reports a year.) To get a credit report when you start using credit, just visit www.annualcreditreport.com or call 877-322-8228.

Challenge 2-B: Building Creditworthiness

What actions can you take now to practice sensible borrowing habits and build a good reputation as a borrower?

THE LAW AND ORDER OF DEBT

You probably don't think of a loan or credit card application as a contract, but it is. By signing on the dotted line, you're entering into a **contract**, a legal agreement between you and the lender about what each of you must or must not do.

“If you think nobody cares if you're alive, try missing a couple of car payments.”

~ Newspaper columnist Earl Wilson



SPY ON CREDIT TERMS

The Consumer Financial Protection Bureau has a database of credit card agreements from more than 300 issuers, at www.consumerfinance.gov/credit-cards/agreements/. Find out what the agreement will include before you spend time applying.

Each of these six elements is needed to make a contract binding:

- » **Offer**—It's what the lender is agreeing to provide and expects in return, including the price and how long the contract will last.
- » **Acceptance**—By signing the contract, clicking an online "I Accept" button, or using what is offered, you're telling the lender you know and accept the terms.
- » **Genuine Agreement**—This means the offer and acceptance are valid and neither side has used fraud or threats. So, if you lie on your application, the lender can later say there was no genuine agreement and ask you to immediately repay the entire amount.
- » **Consideration**—This is the legal term for the object of value each person gives to the other, usually as money, property, or services.
- » **Capacity**—This means the legal ability to enter into a contract. The mentally incompetent, minor children, and anyone under the influence of drugs or alcohol do not have legal capacity.
- » **Legality**—Obviously, you can't have a valid legal contract that involves breaking the law.

Ignorance is no excuse. Your signature means you agree to uphold all the terms of the contract, whether you read them or not.

PORTRAIT OF A BORROWER

As mentioned earlier, you have a *responsibility* to know and honor the terms of your borrowing agreements. As a borrower, you are responsible for:

- » Reading the terms and knowing what you're expected to do.
- » Repaying the borrowed money plus interest—on time.
- » Reviewing your monthly billing statements and promptly disputing any fraudulent charges.
- » Watching for updates to your agreement from the lender. By using the card after a deadline specified in the update, you're often automatically agreeing to the new terms.
- » Promptly notifying the lender about any name, address, or phone-number changes.
- » Paying any fees, penalties, or collection costs, when applicable.

On the other hand, you also have *rights* lenders must respect, such as:

- » The right to see the APR and any other fees in writing before you accept the loan or credit card.
- » The right to be notified about upcoming changes in terms and to opt-out of the agreement if you don't like the changes.
- » The right to know how the lender is going to use your personal information, and to opt-out from having it sold to or shared with others.
- » The right, if the lender denies your application or offers less-favorable terms than it offers other customers, to know the reason(s).

Furthermore, it's the *lender's* responsibility to make sure that all the required information is provided to you.

Of course, the lender also has rights. The most important one is the right to enforce the contract by legal means if you fall behind in your payments or otherwise break the terms of the contract.

If you don't have enough money to pay your debt, a lender can garnish your wages or take possession of your collateral. These actions will hurt your future ability to get credit or cause you to pay more interest.

LAWS YOU CAN COUNT ON

As a borrower, you are protected from unfair treatment or abuse by creditors and credit agencies, including protection from discrimination, harassment by debt collectors, and changing of credit terms without your knowledge. Other laws give you rights to take action when you need to challenge billing errors or unauthorized charges.



To find out more about fair credit billing and reporting laws, go to the Federal Trade Commission website for the latest information, at <http://business.ftc.gov/legal-resources/all>.



Activity 2.9: Rights and Responsibilities of Borrowing

Look at a credit card agreement, loan contract, or service agreement to find at least two rights and two responsibilities of the borrower, and do the same for the lender.

A CASE OF MIS-TAKEN IDENTITY

A Few Figures on Fraud⁴ ...

| | |
|--|--|
| 1 in 25 | Americans who were the victims of identity fraud in 2010 |
| \$631 | Average out-of-pocket cost to an identity theft victim |
| 33 | Average hours victims spent to resolve identity fraud issues |
| 46% | Share of identity fraud due to new account fraud |
| <small>⁴ 2011 Identity Fraud Survey Report: Consumer Version, Javelin Strategy & Research; Study: Social Security Numbers May Be Hackable, Christopher Joyce, National Public Radio, July 6, 2009</small> | |

Jesse asks his parents if they have ever been victims of identity fraud.

His dad explains that someone opened a credit card in his name last year, ran up a \$12,000 balance and never paid. He didn't even know about it until recently when a debt collector called demanding the money.

He's spent hours on the phone trying to prove he didn't open the account and to have it removed from his credit report. It's all still a mess—and until it's straightened out, it hurts his credit.

Jesse asks who the thief is and how he was able to open the account. His dad says they'll probably never know for sure.

Identity theft and fraud are big business—costing victims, companies, and governments more than \$37 billion dollars a year. Lenders and businesses then end up passing along some of the losses to consumers in the form of higher prices and interest rates.

But the victims of identity fraud pay the biggest price, spending many frustrating hours trying to clear their good name.

Identity Theft: Your identification documents are taken or online personal files are hacked without your permission.

Identity Fraud: Your personal information is used to make purchases, withdraw cash, or set up new accounts without your approval.

A TRIPLE-D APPROACH TO FRAUD

There's no 100 percent, surefire way to protect yourself from identity theft and fraud. The Federal Trade Commission recommends the **Deter, Detect, and Defend**⁵ strategy to reduce your chances of becoming a victim. (You can also find additional tips in *Module 5: Financial Services*.)

DETER. Thwart thieves by safeguarding sensitive information, especially your:

- » Social Security number
- » Full birth date
- » Credit card and debit card numbers
- » Bank account numbers
- » Passwords and personal identification numbers (PINs)

The first two are paradise for identity thieves, allowing them to easily open accounts in your name (aka **new account fraud**). The other three make it a cinch for crooks to run up charges on or drain your existing accounts.

⁵*Deter. Detect. Defend: Avoid ID Theft*, www.ftc.gov/idtheft, May 2010



Pay attention to your gut. Crime victims often say that they had a “bad feeling” but ignored it because they didn't want to seem “silly.” Protecting yourself is never silly. If a person, website, email, or situation seems sketchy to you, just say “no”!



Keep It to Yourself!

Social networking sites are becoming prime hunting grounds for identity thieves.

From postal to email addresses, potential passwords, and more, sites such as Facebook offer a wealth of data that cybercriminals can use to hack into or create new financial accounts in your name.

Here's how to stop them in their tracks:

- » **Stay mum.** In your profiles, don't list your real birth date, mailing address, or anything you use as a password or to answer a security question for your financial accounts.
- » **Become a control freak.** Use privacy settings to limit the personal information people outside your network can see.
- » **Pick a strong password.** Hackers pretending to be you can scam your friends. Create a non-obvious password that includes a mix of numbers, symbols, and letters (both capitals and lowercase).
- » **Stay cautious.** Messages sent via social networking sites may be even less secure than typical email when it comes to viruses, malware, and fraudulent links to scam your information.
- » **Just hit "ignore."** If you can't bring yourself to reject a stranger's "friend" request, just ignore it. Scammers will quickly move on to someone else.
- » **Watch your apps.** Facebook and other social sites do not screen new apps for security issues and viruses. Search an app's name online before adding it, to see if there are any reported problems.



Activity 2.10: Take Preventive Action

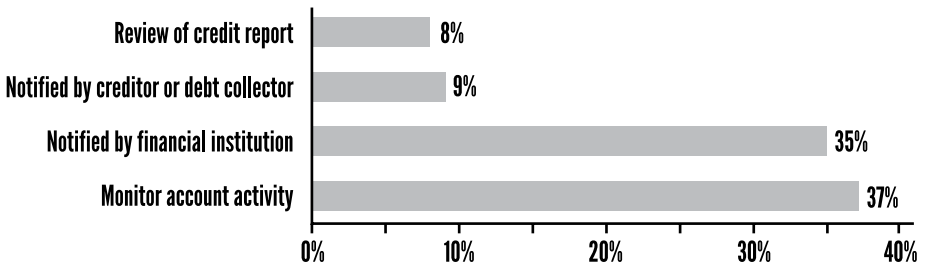
For each of the suggestions above, evaluate what you do now to deter thieves from stealing your personal information.

To the left of each bullet, write your rating as "+" if the advice matches your actions most of the time, "-" if you never carry out the action, or "+/-" if you sometimes do the action but could be more careful.

DETECT. You are your own best detective, and the sooner you find problems, the less damage you'll have to clean up. Here's a simple "early warning system" to follow:

- » **Regularly review your accounts and billing statements.** The number-one way consumers discover fraud is by reviewing their account information.⁶ Look specifically for unfamiliar charges or amounts and any other suspicious activity.
- » **Sign up for email or text-messaging alerts** from your financial institutions. Changing a mailing address is the most common way thieves take over existing accounts. Getting alerts for any account changes will help you halt problems fast.
- » **Regularly review your credit report.** Look for surprises, such as accounts you didn't know about or activity on accounts you haven't used.

How Customers Discover Fraud



⁶ 2011 Identity Fraud Survey Report: Consumer Version, Javelin Strategy & Research

THAT'S CRAZY!

Only 34 percent of Americans have ordered their credit report in the past year.⁷ Even if there's no fraud on their accounts, there may be errors that lower their credit score and cost them money.

⁷ The 2011 Consumer Financial Literacy Survey, The National Foundation for Credit Counseling

DEFEND. If the worst happens, stay calm and act fast. If you contact a credit card issuer soon after the theft, the company can't hold you liable for more than \$50 in unauthorized purchases. And many offer "zero liability," so you might not have to pay anything at all.

- » **Document what happened.** Collect and write down information that can be used as evidence.
- » **Notify the lender immediately.** Read your agreement, and follow the steps to report your problem.
- » **File a police report.** With an ID Theft report, credit reporting companies can remove fraudulent accounts within 30 days.
- » **Report fraud to the Federal Trade Commission (FTC).** The FTC works with protective agencies around the world to shut down identity theft rings.
- » **Request a fraud alert.** Contact Equifax, Experian, or TransUnion if you suspect you have been a victim of fraud. Your fraud alert will automatically be shared with the other two credit-reporting companies.

Look online (www.hsfpp.org) for sample action plans involving two common scenarios: finding unauthorized charges on a credit card and discovering that your wallet or purse has been stolen.

ADDING IT UP

Both Mariah and Jesse now understand that borrowing creates a serious—and potentially expensive—obligation. However, they're taking different paths for the moment.

Mariah is learning to manage her new credit card under her mom's watchful eye. She is paying in full each month to avoid accumulating debt and is building great credit references for when she wants to apply for a car loan or rent an apartment.

Jesse has decided he won't be ready for the burden of a monthly car payment. He figures that he'll have enough of that once he's out on his own—so, he might as well keep saving money for his goals.

"No man's credit is as good as his money."

~ Novelist E.W. Howe

As you've seen, credit can be a valuable tool in your financial toolbox, if you understand five key things:

- 1 The cost of credit is real.** You'll pay more for the same item in the end if you borrow to buy it instead of using cash. Choose the borrowing option carefully.
- 2 Credit does *not* give you permission to live beyond your means.** If you can't repay a purchase in a reasonable amount of time, you shouldn't borrow money to obtain it.
- 3 Fine print is your friend.** Always read to find out what all of your obligations are, as well as the true cost of borrowing in interest, fees, and penalties.
- 4 Pay as much as you can, as early as you can.** This reduces your overall finance charges, prevents penalties, and keeps your credit report in good standing.
- 5 Good credit is priceless.** It opens many doors and saves you money by unlocking the best terms and interest rates when you borrow.

Challenge 2-C: Credit Code of Behavior

Although you might not need or even be able to use credit now, you are on your way to developing the knowledge and positive habits that will help you avoid the pitfalls of debt problems.

Consider how you will use what you learned about credit when you borrow, now and after you turn 18.

Write out a personal Credit Code of Behavior. Include guidelines you will follow before considering whether or not to use credit. Include self-imposed rules and habits you will apply as you take on the responsibilities of using credit.

APPENDIX – MONEY MANAGEMENT AIDS

SMART Goal Guide

Goal Setting

S**Specific****M****Measurable****A****Attainable****R****Relevant****T****Time-Bound**

Stop, Drop, and Think Before You Buy Test

- » Do I need this or do I want it?
- » If I don't need it, why do I want it?
- » Exactly when will I use (or wear) it?
- » Can I find it for less somewhere else?
- » What will I have to give up or put off by buying this now?

DECIDE Steps

- 1 Define what you want to achieve.
- 2 Establish your must-have and nice-to-have criteria.
- 3 Choose a few options that match your criteria.
- 4 Identify and compare the pros and cons of each option.
- 5 Decide the most logical option for your situation.
- 6 Evaluate the results and make adjustments for next time.

See an example on page 22.

Financial Planning Process

Analyze your values, money management habits, and your financial situation.

Set SMART financial goals.

Plan what needs to be done with checkpoints and plan strategies to cope with unexpected events.

Carry out your plan and track your progress using systems that work for you.

Monitor and reflect on your progress; adjust your plan as your situation changes.

Additional NEFE Resources for Teens and Young Adults

Entering the Real World

www.onyourown.org

Just starting out on your own? This blog can help! From lessons learned with real people to money tips, strategies, and options, On Your Own supports you on your path to financial independence.

Prep for College or Workplace

www.cashcourse.org

CashCourse is a website that can help you prepare financially for college or the workforce. It includes worksheets, calculators, and an easy-to-use Budget Wizard to help you manage your money.

Spending Habits

www.spendster.org

Spendster is a YouTube™-like website that showcases people's stories of impulse buying, overspending, or just plain wasting money on stuff they don't need. Watch their video confessions, and then submit your own spending story.

Money Management Tips

www.smartaboutmoney.org/40moneytips

What are the *40 Money Management Tips Every College Student Should Know?*

Find out by downloading this booklet and learning how to stretch your financial resources, whether you're just starting out on your own or heading off to college.





HIGH SCHOOL FINANCIAL PLANNING PROGRAM

“You want to establish good credit right away and try to keep it for future purposes.”

Student ~ 2009

This **NEFE** program will equip students in Grades 8-12 with fundamental personal finance skills to prepare them for financial independence and mindful money management decisions and behaviors.

IN PARTNERSHIP WITH:



United States
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