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Consumer Credit

Cooperative Extension, South Dakota State University

consumer credit

WHAT IS CREDIT?

Many families use credit to increase personal satisfaction or to raise their level of living rather than to increase income. Credit is a transaction which enables you to get goods and services *now* with the agreement to pay in the future. The use of credit changes the time when you spend your money—you are spending the money you hope to have in the future, not what you have now.

WHAT TO CONSIDER BEFORE USING CREDIT

It is not easy to judge whether or not to use credit. When we desire something very much we can usually convince ourselves that we must have it right away.

To help evaluate whether or not to use credit, consider the following:

Do you have well-defined plans for the future?

Have you considered present and future needs?

What resources do you have—income, credit, property, health, knowledge, skills and services, and opportunities provided by the community?

What do you already owe? Will your future income cover all of your debts?

Is your income such as to allow taking on this obligation within the time limit?

Will the immediate satisfaction from this purchase mean fewer opportunities and satisfactions later?

Will this purchase on credit place you in a better position or will it take too large a part of next year's income, thus depriving the family of necessities?

Is the credit being used for really necessary things or for luxury?

How large is the down payment?

How often, how many, and what size payments need to be met?

What interest rate will be paid? How much does this add to the cost of the item purchased?

What happens in case of default in payment? Are there repossession charges?

Will you get a refund if early payment is made?

What property is required for collateral?

Do the services of using credit justify the cost?

Would it be better to wait and pay cash? Saving ahead to pay cash would mean getting interest on the money in a savings account as well as eliminating credit charges.

Where will the money be obtained?

WHAT KINDS OF CONSUMER CREDIT

Charge Accounts:

Advantages

No notes, written contracts or other written promises to pay.

Convenient for buying every day needs. Do not need to carry money when shopping; pay lump sum later.

Saves time—phone order and have it delivered.

Enables you to take advantage of sales.

Establishes credit rating which is helpful in applying for credit elsewhere when you change residence.

Easier to return unsatisfactory goods, since no change of money takes place.

Monthly statements from the store give itemized list of purchases. This helps in keeping records and can be filed for future reference.

The store is usually more prompt in replacing, repairing or "making right" a purchase made.

Disadvantages

Charge accounts lead to careless and needless buying.

Encourages the spending of "maybe" income.

Goods may cost more at stores where charge accounts are allowed or encouraged because of additional bookkeeping.

Many stores are charging additional interest for the use of credit.

Uncollected charge accounts increase the cost of the service to the customers who pay their bills.

Installment Credit:

The use of installment credit:

Involves a formal legal contract.

Usually requires a down payment, then specified payments at stated times in the future.

Runs from a few months to several years.

Advantages

You may use the goods while paying for them but if you fail to live up to the contract the seller can take the merchandise away from you.

Forced "savings" for those who can't discipline themselves to save and buy with cash at a lower cost.

Raises the standard of living. Helps young people to get started.

By Isabel McGibney, Extension Home Management Specialist

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Disadvantages

Encourages over-spending for goods and services not needed. Goods are usually higher priced.

A dealer can repossess the item if payments are not met on time.

The cost is higher because of bookkeeping involved each time payment is made, plus insurance coverage on purchase.

Cost of investigating a prospective buyer.

Charges to cover loss to the store of returned, used, and partially paid-for goods.

Encourages high-pressure selling.

Often compels too drastic economics, causing you to deny yourself necessities in order to meet payments.

Cash Loans

Loans provide you with cash which in turn enables you to buy goods and services. The borrowed money is paid back later—in one lump sum or, more usually, in several smaller amounts. Loans involve the use of legal contracts. The repayment includes the sum borrowed plus interest. Sometimes collateral is required. Interest rates may be very high—especially on small loans.

You may get loans from banks, credit unions, life insurance policies, and personal-finance companies.

Credit unions are voluntary cooperative savings and loan associations. They are organized within definite groups. They are operated by the members for the service of members. They may be state or federal chartered.

Life insurance policies—A loan may be made on the loan value of the policy at a definite rate of interest, which is usually stated in a table in the policy. A loan may be made directly from the life insurance company or from a bank using the life insurance policy as collateral. Sometimes banks will lend at a lower rate of interest than the insurance company.

Personal-finance companies — These companies often lend on the borrower's promise to pay rather than his assets; therefore, greater risk and expense are involved. Due to the greater risk, the interest rate is considerably higher. However, this is governed by "Small Loans Law," South Dakota (1953). Small Loan Law permits a maximum of 3% on sums up to $300 and ¾% on sums up to $2,500 *per month* of the *unpaid principal*.

Note: On a yearly basis this would be 36% on sums up to $300 and 9% on sums up to $2,500.

It is always to your advantage to borrow through legally established lending agencies with good reputations. Illegal lenders (without a license from the state) charge from 12% to 700% for small loans.

COST OF CREDIT

Credit is not free. It is cheaper to pay with cash. But often the convenience of buying on time is worth a reasonable additional charge.

When an emergency occurs it is sometimes necessary to use some form of credit. It is wise to establish a good credit reputation.

When you use credit you pay for:

The amount of money borrowed
The length of time it is borrowed
The risk assumed by the creditor
The creditor's extra charges

Shop for credit. The chief consideration when getting credit is the cost. Not all lenders make the same charges or offer the same terms.

Many times it is not easy to determine the exact cost of credit.

HOW TO FIGURE INTEREST RATES

Interest may be charged on total amount of the loan for the entire period of time.

Suppose you want to buy a home freezer and will have to borrow $100. The store will carry the balance of $100 for a year with 12 monthly payments of $9.42.

Here is how to figure the annual interest rate:

$$\frac{\text{total financing charge}}{\tfrac{1}{2}\text{ of original loan}} \times \frac{\text{No. of payments}}{\text{No. years}} \times \frac{1}{\text{No. of payments}+1}$$

Example: $9.42 x 12 months	$113.04
Original amount of loan	100.00
Total financing charge	**$ 13.04**

$$\frac{\$13.04}{\$50.00} \times \frac{12}{1} \times \frac{1}{13} = \text{about 0.24 or an annual interest rate of } 24\%$$

Interest may be charged on the unpaid balance after each payment is made.

Suppose you are interested in a radio priced at $125 in cash. But on the installment plan you could buy it for $10 down and $10 per month for 12 months. You are told the rate on the unpaid $115 would be 6%. This sounds reasonable enough. Six per cent of $115 is $6.90. This is the carrying charge, or Dollar Cost—what you pay in addition to cash price for the credit privilege. This places the radio cost at $131.90. But remember the debt decreases every time you make a $10 monthly payment so you have use of the full $115 only the first month. This is roughly equivalent to an average of one-half the original unpaid balance, or $57.50. If you paid 6% interest on only the unpaid balances each month, you would pay about $3.63. This is about half of the $6.90 you actually pay, which means you are really paying about 12% interest instead of 6%.

Or all interest is paid in advance (discounted loan).

For example, if you borrow $100 at 6 per cent, you will sign a note for $100, but will receive $94 in cash. Additional charges for investigations, late payment, or service fees may be added.

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