CHAPTER 4

Going Into Debt

Why It's Important

How do credit cards work? What happens if you can't pay back the amount of credit you've borrowed? This chapter will explain what you need to know before applying for credit and going into debt, and how to use credit wisely.

To learn more about using credit, view the **Economics & You** *Chapter 10 video lesson:* **Going Into Debt**

ECONOMICS Online

Chapter Overview Visit the *Economics Today and Tomorrow* Web site at ett.glencoe.com and click on ***Chapter 4—Chapter Overviews*** to preview chapter information.

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SECTION 1

Americans and Credit

Cover Story

The Washington Post, May 10, 1999

Debt is not itself a bad thing. Used properly, credit allows young families to buy their own homes and acquire other trappings of middle-class life without waiting until middle age. Homeownership, in turn, gives these families a stake in their communities and encourages them to take an active role in keeping it a good place to live.

But easy credit—and plainly credit is very easy today—creates a temptation to push the envelope, to live at a higher level than the borrower can safely afford.

Reader's Guide

Terms to Know
- credit
- principal
- interest
- installment debt
- durable goods
- mortgage

Reading Objectives
1. What are the advantages of repaying installment debt over a long period?
2. Why do people go into debt?
3. What factors should you consider when deciding whether or not to use credit?

Americans use credit to make many purchases. The total amount of funds borrowed and lent each year is enormous. In addition to individuals borrowing funds, the federal, state, and local governments all borrow funds, too. The nation's economy, in fact, depends on individuals and groups being able to buy and borrow on credit. In this section, you'll learn what credit is and why people use it.

What Is Credit?

Credit is the receiving of funds either directly or indirectly to buy goods and services today with the promise to pay for them in the future. The amount owed–the debt–is equal to the principal

credit: *receipt of money either directly or indirectly to buy goods and services in the present with the promise to pay for them in the future*

principal: *amount of money originally borrowed in a loan*

interest: *amount of money the borrower must pay for the use of someone else's money*

installment debt: *type of loan repaid with equal payments, or installments, over a specific period of time*

durable goods: *manufactured items that have a life span longer than three years*

plus interest. The **principal** is the amount originally borrowed. The **interest** is the amount the borrower must pay for the use of someone else's money. That "someone else" may be a bank, a credit card company, or a store.

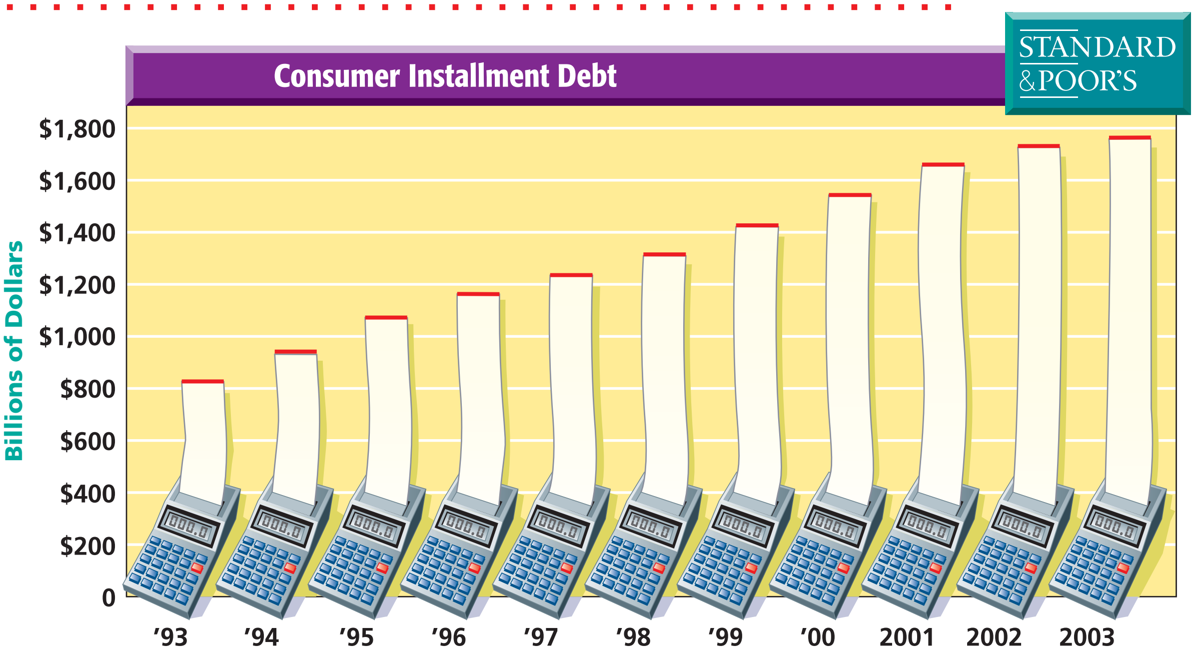
Any time you receive credit, you are borrowing funds and going into debt. Taking out a loan is the same as buying an item on credit. In both cases, you must pay interest for the use of someone else's purchasing power.

Installment Debt

One of the most common types of debt is **installment debt.** Consumers repay this type of loan with equal payments, or installments, over a period of time; for example, 36 equal payments over 36 months. Many people buy **durable goods,** or manufactured items that last longer than three years, on an installment plan. Automobiles, refrigerators, washers, and other appliances are

FIGURE 4.1

Increase in Borrowing More and more Americans are choosing to buy durable goods on credit. ***By how much did consumer debt increase between 1993 and 2003?***



Source: Standard & Poor's

For an online update of this graph, visit ett.glencoe.com and click on ***Textbook Updates—Chapter 4.***

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considered durable goods. People can also borrow cash and pay it back in installments. **Figure 4.1** shows how consumer installment debt owed each year in the United States has steadily increased.

The length of the installment period is important in determining the size of the borrower's monthly payments and the total amount of interest he or she must pay. A longer repayment period results in a smaller monthly payment. For example, **Figure 4.2** shows that if the repayment of a loan is spread over three years, the monthly payments will be smaller than if the loan were repaid in two years. There is a trade-off, however. The longer it takes to repay an installment loan, the greater the total interest the lender charges.

The largest form of installment debt in this country is the money people owe on mortgages. A **mortgage** is an installment debt owed on real property—houses, buildings, or land. See **Figure 4.3.** Interestingly, most people who owe a mortgage on their home do not consider themselves deeply in debt. Because people must have housing, they think of a mortgage as being a necessary monthly payment not similar to other kinds of debt. A mortgage is a debt, however, because somebody has provided the owner with funds to purchase property. In return, the owner must repay the loan with interest in installments over a number of years.

FIGURE 4.3

Installment Debt Mortgages make up the largest form of installment debt in the country. Most mortgages are repaid in monthly installments for 15 to 30 years.

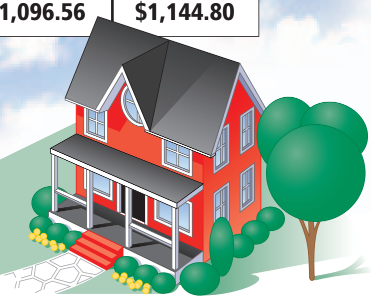
mortgage: *installment debt owed on houses, buildings, or land*

FIGURE 4.2

Pay Now or Pay Later? Your monthly payment is lower if you choose the 36-month loan. ***How much more interest will you pay, however, if you spread the loan payment over 36 months rather than 24 months?***

$1,000 Installment Loan at 9% Interest

Term of Loan	24 Months	36 Months
Monthly Payments	$45.69	$31.80
Total Interest	$96.56	$144.80
Total Payments	$1,096.56	$1,144.80



Why People Use Credit

In a sense, people feel forced to buy items on credit because they believe they require these items immediately. They do not want to wait. Of course, consumers are not really "forced" to buy most goods and services on credit. They could decide instead to save the funds needed to make their purchases.

Some might say that you would be better off saving and waiting to buy a pickup truck. During the years you are saving for the truck, however, you forgo the pleasure of driving it. Many people do not want to postpone purchasing an important durable good. They would rather buy on credit and enjoy the use of the item now rather than later. See **Figure 4.4.**

Another reason for going into debt is to spread the payments over the life of the item being purchased. For example, people do not buy a truck or car to have it sit in the garage. What they buy is the availability of the vehicle each day, week, month, and year that they own it.

FIGURE 4.4

Spreading Payments

Suppose you want to buy a pickup truck that costs $15,000. You have a choice. You could borrow $15,000 right now and buy the truck, but you would have to make interest payments on the borrowed funds for three to five years. However, you can also enjoy using it at the same time you are paying for it. Alternatively, you could start saving now, earn interest on your savings, and pay cash for the truck in several years.

Suppose you buy the pickup truck for $15,000 and plan to keep it for five years. At the end of that time, it will be worth only $5,000. Over that five-year period, however, you will get approximately $2,000 worth of use per year, or $166 per month. By buying on the installment plan, a person makes monthly payments that more or less correspond to the value of the use he or she receives from the product.

Deciding to Use Credit

The decision to borrow or use credit involves whether the satisfaction the borrower gets from the purchases is greater than the interest payments. It is basically a question of comparing costs and benefits. The benefit of borrowing is being able to buy and enjoy the good or service now rather than later. The cost is whatever the borrower must pay in interest or lost opportunities to buy other items.

The benefit of borrowing is something only you can decide for yourself. You and every other borrower, however, should be aware of the costs involved. **Figure 4.5** can help you decide when to use credit. It can also help you avoid the improper use of credit by overspending.

FIGURE 4.5 Checklist for Buying on Credit

No hard-and-fast rules can tell you whether or not to buy on credit. The following list of questions, however, can help you determine if you are making a wise decision.

1. Do I really require this item? Can I postpone purchasing the item until later?
2. If I pay cash, what will I be giving up that I could buy with this money? This is an opportunity cost.
3. If I borrow or use credit, will the satisfaction I get from the item I buy be greater than the interest I must pay? This is also an opportunity cost.
4. Have I done comparison shopping for credit? In other words, after you have determined that you are not going to pay cash for something, you should look for the best loan or credit deal, including the lowest interest rate and other conditions of repayment.
5. Can I afford to borrow or use credit now?

Practice and **assess** key skills with *Skillbuilder Interactive Workbook, Level 2.*

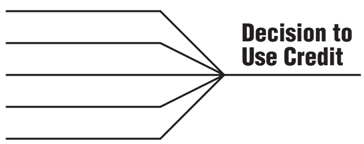
SECTION 1 Assessment

Understanding Key Terms

1. **Define** credit, principal, interest, installment debt, durable goods, mortgage.

Reviewing Objectives

2. What are the advantages of repaying installment debt over a long period?
3. Why do people go into debt?
4. **Graphic Organizer** Create a diagram like the one below to list the factors you should consider when deciding whether to use credit.



Applying Economic Concepts

5. **Opportunity Cost** Think of an item that you have been saving for. How long will it take you to save the funds needed to purchase this item? What are you giving up buying in the meantime? Explain why you are giving up buying that particular item.

Critical Thinking Activity

6. **Synthesizing Information** Imagine that you are shopping for a used car. If you borrow $10,000 to buy a used car, and the simple interest rate on the loan is 11 percent, what will your total payment be at the end of 24 months? At the end of 36 months? *For help in understanding interest rates, see page xxii in the Economic Handbook.*

SECTION 2

Sources of Loans and Credit

READER'S GUIDE

Terms to Know

- commercial bank
- savings and loan association
- savings bank
- credit union
- finance company
- charge account
- credit card
- finance charge
- annual percentage rate (APR)

Reading Objectives

1. What are six types of financial institutions?
2. What three kinds of charge accounts are available from stores?
3. How are credit cards used?
4. How do a finance charge and an annual percentage rate differ?

COVER STORY

KIPLINGER'S PERSONAL FINANCE MAGAZINE, NOVEMBER 2000

If the coming holidays will be supercharge season for your credit cards, it's more important than ever to know when payments are due. Card issuers have hair triggers when it comes to assessing late fees, so if your check arrives even one day late, you'll probably be slapped with a $29 penalty....

Fortunately, you may now get some breathing room. When Citibank recently acquired 13 million Universal card accounts, it declared that payments would never be due on holidays or weekends.

There are two major types of credit—using credit cards and borrowing money directly from a financial institution. Although lending institutions differ in their services, they all charge interest on the funds they lend. In this section, you'll learn what those financial institutions are. You'll also learn about charge accounts and credit cards—and why you should be aware of the high interest rates they charge.

Types of Financial Institutions

You should comparison shop when you have decided to apply for a loan. See **Figure 4.6.** To gather information, check various lending agencies in person, over the phone, or at their Web sites.

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Commercial Banks The first place you might think to go for a loan is a **commercial bank.** Commercial banks today control the largest amount of money and offer the widest range of services. These services include offering checking and savings accounts and loans to individuals. They also transfer funds among banks, individuals, and businesses.

Savings and Loan Associations A **savings and loan association (S&L),** like a commercial bank, accepts deposits and lends funds. S&Ls make many single-family and multi-family dwelling mortgage loans. They also finance commercial mortgages and auto loans. Their interest rates for loans are often slightly less than those for commercial banks.

Savings Banks **Savings banks** were first set up to serve the small savers who were overlooked by the large commercial banks. Most savings banks, like S&Ls, lend funds for home mortgages, although they do make personal and auto loans. Since 1980, savings banks, like commercial banks, have also been able to offer services similar to checking accounts.

Credit Unions Union members and employees of many companies often have a credit union. A **credit union** is owned and operated by its members to provide savings accounts and low-interest loans only to its members. Credit unions primarily make personal, auto, and home improvement loans, although larger

commercial bank: *bank whose main functions are to accept deposits, lend money, and transfer funds among banks, individuals, and businesses*

savings and loan association (S&L): *depository institution that accepts deposits and lends money*

savings bank: *depository institution originally set up to serve small savers overlooked by commercial banks*

credit union: *depository institution owned and operated by its members to provide savings accounts and low-interest loans only to its members*

A Savings Bank

B Finance Company

C Commercial Bank

FIGURE 4.6

Financial Institutions Financial institutions differ in several factors, including differences in interest rates and loan repayment terms.

credit unions offer home mortgages as well. In general, credit unions offer higher interest rates on savings and charge lower interest rates on loans than other financial institutions.

finance company: *company that takes over contracts for installment debts from stores and adds a fee for collecting the debt; a consumer finance company makes loans directly to consumers at high rates of interest*

Finance Companies A **finance company** takes over contracts for installment debts from stores and adds a fee for collecting the debt. The consumer pays the fee in the form of slightly higher interest than he or she would pay to the retailer. Retailers use this method to avoid the risks involved in lending money to consumers.

A *consumer finance company* makes loans directly to consumers at relatively high rates of interest—often more than 20 percent a year. The people who use consumer finance companies are usually unable to borrow from other sources with lower rates because they have not repaid loans in the past or have an uneven employment record.

CAREERS

Consumer Loan Officer

Job Description
- Analyze loan applications
- Make decisions regarding the extension of credit

Qualifications
- Bachelor's degree in finance, economics, or a related field

Salary: $41,420

Job Outlook: Above average

—*Occupational Outlook Handbook,* 2002–03

Charge Accounts

A second major type of credit is extended directly to an individual, without that person having to borrow money first. This credit may be in the form of a charge account or a credit card. As shown in **Figure 4.7,** a **charge account** allows a customer to buy goods or services from a particular company and pay for them later. Department stores, for example, offer three types of charge accounts: regular, revolving, or installment.

charge account: *credit extended to a consumer allowing the consumer to buy goods or services from a particular company and to pay for them later*

Regular Charge Accounts A *regular charge account,* also known as a 30-day charge, has a credit limit such as $500 or $1,000. A *credit limit* is the maximum amount of goods or services a person or business can buy on the promise to pay in the future. At the end of every 30-day period, the store sends a bill for the entire amount. No interest is charged, but the entire bill must be paid at that time. If it is not, interest is charged on the unpaid amount.

Revolving Charge Accounts A *revolving charge account* allows you to make additional purchases from the same store even if you have not paid the previous month's bill in full. Usually you must pay a certain portion of your balance each

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FIGURE 4.7

Charge Accounts Many stores issue their own charge cards, which consumers may use to purchase goods in their stores. ***What is a credit limit?***

month—one-fifth of the amount due, for example. Interest is charged on the amount you do not pay. Of course, if you pay everything you owe each month, no interest is charged. This type of account also has a credit limit.

Installment Charge Accounts Major items such as sofas, televisions, and refrigerators are often purchased through an *installment charge account.* The items are purchased and paid for through equal payments spread over a period of time. Part of the amount paid each month is applied to the interest, and part is applied to the principal. At the end of the payment period, the borrower owns the item he or she has made payments on.

credit card: *credit device that allows a person to make purchases at many kinds of stores, restaurants, and other businesses without paying cash*

Credit Cards

A **credit card,** like a charge account, allows a person to make purchases without paying cash. The difference is that credit cards can be used at many kinds of stores, restaurants, hotels, and other businesses throughout the United States and even foreign countries. As shown in **Figure 4.8,** Visa, MasterCard, and others issue cards through banks. These cards can be used to purchase items in stores that accept them, or they may be used to borrow funds up to a certain limit. This gives consumers access to loans at all times without having to apply for them.

FIGURE 4.8

Credit Card Trade-Off Although using credit cards is convenient, it is also costly. Stores must pay a certain percentage of credit purchases to the company that issued the card. The stores include this cost in the prices they charge customers, making prices higher for everyone. ***What is the difference between a credit card and a charge account?***

Finance Charges and Annual Percentage Rates

The terms *finance charge* and *annual percentage rate* tell the consumer the same thing—the cost of credit. Each, however, is expressed in a different way.

finance charge: *cost of credit expressed monthly in dollars and cents*

Finance Charges The **finance charge** is the cost of credit expressed in dollars and cents. It must take into account interest costs plus any other charges connected with credit. For example, yearly membership fees for the use of a credit card are included in the finance charge.

The way finance charges are computed is an important factor in determining the cost of credit. Store charge accounts and credit cards use one of four methods to determine how much people will pay for credit: previous balance, average daily balance, adjusted balance, or past due balance. Each method applies the interest rate to an account's balance at a different point during the month. The different methods can result in widely varying finance charges. See **Figure 4.9.**

annual percentage rate (APR): *cost of credit expressed as a yearly percentage*

Annual Percentage Rates The **annual percentage rate (APR)** is the cost of credit expressed as a yearly percentage. Like the finance charge, the APR must take into account any noninterest costs of credit such as a membership fee. **Figure 4.10** on page 94 shows how a sample APR affects the cost of credit.

Knowing which creditor is charging the most for credit would be very difficult without some guide for comparison. The APR provides that guide by allowing consumers to compare costs regardless of the dollar amount of those costs or the length of the credit agreement. Suppose creditor A is charging an APR of 16 percent, while creditor B is charging 17 percent, and creditor C is charging 18½ percent. On a yearly basis, creditor C is charging the most for credit and creditor A the least.

Economic Connection to... History

The First Credit Card

In 1958 the Bank of America mailed 60,000 BankAmericards to customers in Fresno, California. Each card had a credit line of $300 to $500 and could be used at 300 stores in the area. The next year, the bank mailed out 2 million cards and persuaded 20,000 stores to accept them.

Initially, BankAmericard proved a financial disaster. Unpaid accounts ran above 20 percent, and credit-card fraud was rampant. By early 1960, the losses on BankAmericard approached $9 million. The bank quickly addressed these problems, and within a year BankAmericard was turning a profit. ■

FIGURE 4.9 Different Methods of Computing Finance Charges

Type of Method	How Finance Charge Is Computed	**Example** (Based on opening balance of \$300, \$150 paid halfway through month, monthly interest rate = 1.5%)
Previous Balance	Charge is computed on the month's opening balance, even if the bill has been paid in full by the time the finance charge is figured. There is no benefit in paying off a debt early with this method.	• Amount on which interest is due: \$300, despite payment • Calculation: \$300 × .015 = \$4.50 • Finance charge: \$4.50 • Balance due: \$154.50
Adjusted Balance	Payments made during the month are deducted from the opening balance. Charge is then computed on the balance due the last day of the month. With this method you can save the most money if you pay your bill as soon as possible.	• Amount on which interest is due: \$150, balance on last day of billing period • Calculation: \$150 × .015 = \$2.25 • Finance charge: \$2.25 • Balance due: \$152.25
Average Daily Balance	Charge is applied to the sum of the actual amounts owed each day during the billing period, divided by the number of days in that period. Payments and credits–return of goods–are subtracted on the exact date of payment. With this method you can save the most money if you pay your bill as soon as possible.	• Amount on which interest is due: \$225 • Calculation: 15 days × \$300 = \$4,500 15 days × \$150 = \$2,250 30 days total = \$6,750 \$6750 ÷ 30 = \$225 \$225 × .015 = \$3.38 • Finance charge: \$3.38 • Balance due: \$153.38
Past Due Balance	No finance charge is applied if full payment is received within a certain period, usually within 25 days after the date of the last billing statement. If full payment is not received, then a finance charge for the unpaid amount is added to the next month's bill.	• Amount on which interest is due: \$0 • Calculation: \$150 × 0 = 0 • Finance charge: \$0 • Balance due: \$150.00 (Finance charge of \$2.25 (.015 × \$150) will be added to next month's bill)

FIGURE 4.10

Computing APR Assume you charge $200 for clothes in a year. The interest rate charged to you, let's say, is 10 percent, but the annual fee for the credit card is $5. Your APR will be $20 of interest plus the $5 fee, or 12½ percent. The APR is normally larger than the interest rate because it includes the noninterest cost of extending credit.

Credit Card Charge of $200 at 10% Interest

Amount Charged	$200.00	$200.00
Interest at 10%	$20.00	$20.00
Annual Membership Fee	none	$5.00
APR	10%	12.5%

Debit Cards

There is another method of payment, known as a debit card. A *debit card* does not provide a loan. Instead, it makes cashless purchases easier by enabling customers to transfer funds electronically from their bank accounts directly to the store or restaurant where they purchased goods. Debit cards were first available in the 1970s but did not catch on with the public until the 1990s. At that time, banks combined credit cards with their debit cards.

Practice and **assess** key skills with ***Skillbuilder Interactive Workbook, Level 2.***

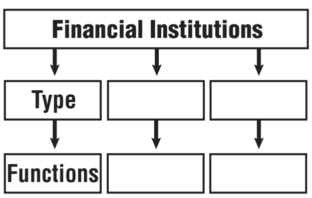
SECTION 2 Assessment

Understanding Key Terms

1. **Define** commercial bank, savings and loan association, savings bank, credit union, finance company, charge account, credit card, finance charge, annual percentage rate (APR).

Reviewing Objectives

2. **Graphic Organizer** Create a diagram like the one below to list the six types of financial institutions and describe their main functions.



3. What three kinds of charge accounts are available from stores?
4. How are credit cards used?
5. How do a finance charge and an annual percentage rate differ?

Applying Economic Concepts

6. **Annual Percentage Rates** What would be the APR if you charged $1,000 on a credit card whose interest rate was 20 percent with an annual fee of $30?

Critical Thinking Activity

7. **Making Generalizations** Poll five adult family members. Ask: (1) Do you own a credit card? (2) Have you used an installment charge account? (3) Do you own a debit card? Tally your results, then write a generalization about the use of credit.

CONTENTS

Technology Skills

Using a Database

A computerized database program can help you organize and manage a large amount of information. After entering data in a database table, you can quickly locate the information according to keywords.

1. Determine what facts you want to include in your database—names, addresses, and phone numbers, for example—and research to collect that information.
2. Follow the instructions in the DBMS that you're using to set up fields. Then enter each item of data in its assigned field.
3. Determine how you want to organize the facts in the database—chronologically by the date, alphabetically, or by some other category.
4. Follow the instructions in your computer program to sort the information in order of importance.
5. Evaluate that all the information in your database is correct. If necessary, add, delete, or change information or fields.

Learning the Skill

An electronic database is a collection of facts that are stored in a file on the computer. The information is organized into categories called *fields*. For example, one field may be the names of your clients. Another field may be the street addresses of your clients. All the related fields make up a *record*. Together, all the records make up the database.

A database can be organized and reorganized in any way that is useful to you. By using a database management system (DBMS)—or special software developed for record keeping—you can easily add, delete, change, or update information. When you want to retrieve information, the computer searches through the files, finds the information, and displays it on the screen.

Practicing the Skill

Follow the steps listed on the left to build a database that organizes information about your friends.

Using a database can help organize population statistics, clients' names and addresses, and even baseball card collections.

Application Activity

Research and build a database on types and services of financial institutions. Explain why the database is organized the way it is and how it might be used in this class.

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SECTION 3

Applying for Credit

READER'S GUIDE

Terms to Know

- credit bureau
- credit check
- credit rating
- collateral
- secured loan
- unsecured loan

Reading Objectives

1. What four factors determine a person's credit rating?
2. What are your responsibilities as a borrower?

COVER STORY

BUSINESS WEEK, MARCH 15, 1999

Jason Britton, now 21 and a senior at Georgetown University in Washington, racked up $21,000 in debt over four years on 16 [credit] cards. "When I first started, my attitude was: 'I'll get a job after college to pay off all my debt,'" he says. He realized he dug himself into a hole when he couldn't meet the minimum monthly payments. Now, he works three part-time jobs. His parents are helping pay his tuition and loans.

How can you obtain credit? Perhaps more important, how can you dig yourself *out* of debt if you've spent more than you can handle? In this section, you'll learn what makes a person a good risk for credit. You'll also learn ways to handle your debts before they get out of control.

Creditworthiness

Several factors determine a person's creditworthiness. When you apply for credit, you usually will be asked to fill out a credit application. After you have filled out the application, the store, bank, or other lending agency will hire a **credit bureau,** a private business, to do a **credit check.** This investigation will

credit bureau: *private business that investigates a person to determine the risk involved in lending money to that person*

credit check: *investigation of a person's income, current debts, personal life, and past history of borrowing and repaying debts*

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reveal your income, any current debts, details about your personal life, and how well you have repaid debts in the past.

The Credit Rating

The information supplied by the credit bureau provides the creditor with a **credit rating** for you. This is a rating of the risk—good, average, or poor—involved in lending funds to a specific person or business. If you have a history of poor credit use—usually late in paying debts—you will receive a poor credit rating. The creditor reviewing the credit check will be less willing to lend you money.

Though past history of credit use is important in deciding a person's creditworthiness, the creditor also looks at three other factors that a credit check reveals. These are your capacity to pay, your character, and any collateral you may have. See **Figure 4.11.**

credit rating: *rating of the risk involved in lending money to a specific person or business*

Capacity to Pay

Capacity to pay is related to income and debt. If your employment has been spotty, your capacity to pay will be considered questionable. The amount of debt that you are already carrying is also a factor. If your debts are large, creditors will be reluctant to loan you more.

FIGURE 4.11

Creditworthiness When a creditor looks at your creditworthiness, three factors are considered: your ability to hold a steady job, your character, and any collateral you have that may secure a loan.

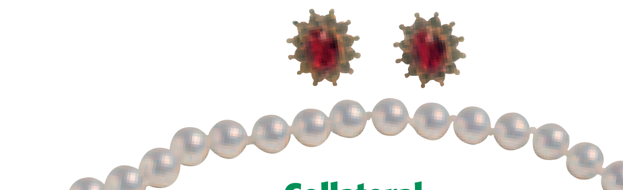

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FIGURE 4.12

Cosigning a Loan

If someone you know asks you to cosign a loan, think carefully. If he or she does not make payments, you are responsible for the debt. ***When is a cosigner needed?***

Character *Character* refers to a person's reputation as a reliable and trustworthy person. The creditor may look at your educational background, whether or not you have had any problems with the law, and any other factors that might indicate your strength of character.

Collateral Lenders also consider **collateral,** or the size of your capital or personal wealth. Collateral is important because it indicates your past ability to save and accumulate. It also indicates your present ability to pay off a loan, even if you lose your job, because you could sell some of your belongings in order to make the payments.

Secured Loans Usually when a financial institution makes a loan, it will ask for collateral from the borrower. The collateral may be the item purchased with the loan money, such as a house or car. It may be something of value the borrower already owns. The borrower then signs a legal agreement allowing the lender to claim the collateral if the loan is not repaid. A loan that is backed up with collateral in this way is called a **secured loan.**

Unsecured Loans Usually a young adult will have little to offer as collateral. When dealing with a trusted customer, financial institutions will sometimes lend funds on the person's reputation alone. Such a loan is called an **unsecured loan.** It is not guaranteed by anything other than a promise to repay it.

A bank will sometimes lend funds to a person without a financial reputation if he or she has a cosigner. As shown in **Figure 4.12,** a *cosigner* is a person who signs a loan contract along with the borrower and promises to repay the loan if the borrower does not.

collateral: *something of value that a borrower lets the lender claim if a loan is not repaid*

secured loan: *loan that is backed up by collateral*

unsecured loan: *loan guaranteed only by a promise to repay it*

Responsibilities as a Borrower

After you have applied for credit and obtained it, you have taken on certain responsibilities. After all, the businesses that gave you credit expect to earn a profit.

If you do not pay your debts on time, the business that lends you funds may have to hire a collection agency to help get back the money loaned to you. If you never pay off your debt, the lending institution has to write it off and take a loss. These costs are passed on to all consumers in the form of higher interest rates charged.

Another negative thing happens when you do not pay your debts: you get a bad credit history. You may then have a difficult or impossible time when you really need credit for something else—to purchase a house, for example.

Another responsibility as a borrower is to keep a complete record of all the charges you have made. You also must notify the credit-card issuer immediately if your card is lost or stolen.

What if you've lost control of your debt? Financial planners advise you to make a list of everything you owe, what the interest rate is, and what the payments are. Concentrate on paying the high-interest credit cards first, and pay more than the minimum payment, or it will take you years to reduce the debt.

Global Economy

Loans for the Poor

In the mid-1970s, Muhammad Yunus, an economics professor, took a trip through Bangladesh. He saw a woman weaving bamboo chairs but earning only a few pennies a day, most of which went to pay the high interest rates on loans she took out to buy raw materials.

Yunus realized that if the woman could get loans at reasonable interest rates, she could make a living wage. So, Yunus started his own bank, the Grameen—or "Village"—Bank. Today, with more than 1,000 branch offices throughout Bangladesh, it has lent money to 2.6 million people, most of whom are women. Each loan averages $160, and over 98 percent of these loans have been repaid on time. ■

Practice and **assess** key skills with ***Skillbuilder Interactive Workbook, Level 2.***

SECTION 3 Assessment

Understanding Key Terms

1. Define credit bureau, credit check, credit rating, collateral, secured loan, unsecured loan.

Reviewing Objectives

2. Graphic Organizer Create a diagram like the one below to describe the four factors that determine a person's credit rating.

3. What are your responsibilities as a borrower?

Applying Economic Concepts

4. Creditworthiness Which of the four factors determining a person's credit rating do you think is most important in deciding whether a person is creditworthy? Explain.

Critical Thinking Activity

5. Finding the Main Idea What is the main idea of the following excerpt?

Banks now assign point values to each item on a credit application, such as how much debt you owe, how much credit you have available, your repayment history, and your age. Your total score will determine whether you're approved.

BusinessWeek

SPOTLIGHT ON THE ECONOMY

A Hard Lesson on Credit Cards

Check It Out! In this chapter you've learned about your responsibilities as a borrower. In this article, read to learn what pitfalls to avoid when applying for credit cards.

The moment college students step on campus, they become highly sought-after credit-card customers. To establish relationships card marketers hope will extend well beyond the college years, they are offering students everything from free T-shirts to chances to win airline tickets as enticements to sign up. As a result, college students now have heavy card debts.

As long as they are over 18, students can get a card without asking mom or dad to co-sign. Since card issuers' pitches may be confusing, experts dish out this advice:

- *Beware of teaser rates.* Credit-card marketers may advertise a low annual percentage rate (APR), but it often jumps substantially after three to nine months.
- *Pay on time.* Because students move often and may not get their mail forwarded quickly, bills can get lost. Then the students fall prey to late-payment fees. If one or two payments are overdue, many cards bump interest rates up as well.
- *Shun cash advances.* Students are often unaware that rates on cash advances are much higher than those on card balances.
- *Don't ask for extra credit.* Instead, find a card that has a restrictive credit line. Another option: Get a secured credit card. Its credit limit depends on your savings at the issuing bank.

Debt advisers say students should hold only a credit card on which they can carry a small balance and a charge card they must pay off monthly. They should pay more than the minimum on credit cards. And they should not charge purchases they can pay for in cash, such as pizza and gas.

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Think About It

1. **How are students enticed to get credit cards?**
2. **Describe six ways to avoid credit card debt.**

CONTENTS

SECTION 4

Government Regulation of Credit

Cover Story

San Diego Union-Tribune, June 23, 2003

California consumers will learn next month whether their favorite shopping sites are steeled against computer fraud—or haunts of hackers and identity thieves. When a retailer discovers its credit card numbers have been stolen, it must e-mail customers, essentially saying, "We've been hacked, and the hacker may have your credit card number."

Although the FBI and Federal Trade Commission have hunted down Web site operators involved in fraudulent sales and auctions, proponents of the laissez-faire approach worry that regulations would hamper innovation in a fledgling industry.

Reader's Guide

Terms to Know

- usury law
- bankruptcy

Reading Objectives

1. How has the Equal Credit Opportunity Act affected consumer credit?
2. What are state usury laws?
3. Why might a person declare personal bankruptcy?

To protect consumers, the federal and state governments regulate the credit industry. Some states have set a maximum on the interest rates charged for certain types of credit. The federal government has also passed laws designed to increase the flow of credit information to consumers. In this section, you'll learn about these laws and how they protect consumers from unfair credit practices.

The Truth in Lending Act

The Truth in Lending Act of 1968 was the first of a series of major federal laws that greatly expanded the government's role in protecting users of consumer credit. An important aspect of the government regulation of credit is to make sure that everyone has equal access. **Figure 4.13** presents the important points about this act and other major federal government laws to regulate credit.

The Equal Credit Opportunity Act

In 1974 Congress enacted the Equal Credit Opportunity Act (ECOA) as an addition to the Truth in Lending Act of 1968. Among other things, those who provide credit cannot deny you such credit solely on the basis of your race, religion, national origin, gender, marital status, or age. In addition, no one is allowed to discriminate against you in offering credit simply because your income might come from public assistance benefits.

Historically, credit discrimination against married women has been the norm. The 1974 act made it illegal for a creditor to require the signature of an applicant's spouse unless an application for credit was made jointly by husband and wife. If a married woman qualifies on her own for the amount and terms of credit requested, she does not have to get her husband to sign the credit application. See **Figure 4.14** on page 104.

State Usury Laws

usury law: *law restricting the amount of interest that can be charged for credit*

A law restricting the amount of interest that can be charged for credit is called a **usury law.** Some states set up different maximum rates for different types of consumer credit. Maximum rates on charge accounts and credit cards, for example, are often about 18 percent a year, or $1\frac{1}{2}$ percent per month. Consumer finance agencies, in contrast, are often allowed to charge higher rates because their loans involve higher risks.

The maximum rates from usury laws were controversial in past years when interest restrictions in many states were as low as 6 or 10 percent. When interest rates in general began to rise in the early 1970s, many lenders complained that they could not keep within such restrictions and still make a profit. In states that were slow to raise interest restrictions, some lenders cut back

CLICK HERE

ECONOMICS Online

Student Web Activity Visit the *Economics Today and Tomorrow* Web site at ett.glencoe.com and click on ***Chapter 4—Student Web Activities*** to learn more about the Fair Debt Collection Practices Act.

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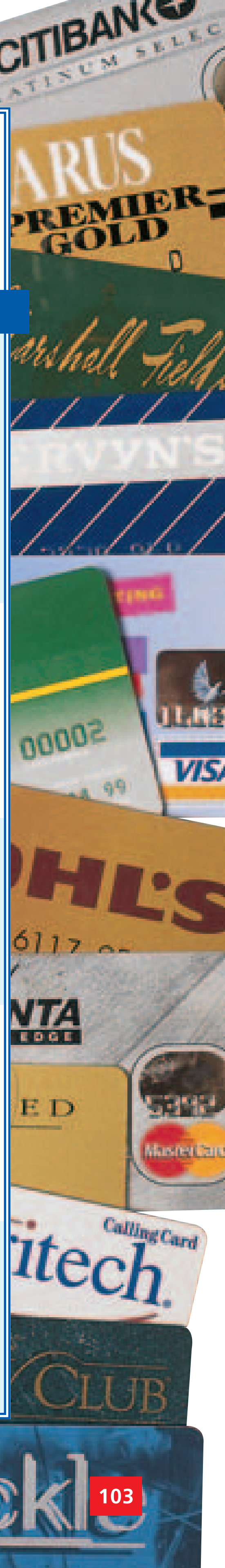
FIGURE 4.13

Major Federal Laws Regulating Consumer Credit

Name of Law	Main Purpose	Major Provisions
Truth in Lending Act (1968)	Ensures that consumers are fully informed about the costs and conditions of borrowing.	• Creditors must keep borrowers informed of a credit agreement's annual percentage rate, the way charges and fees are calculated, and the payment schedule. • Consumers have a 3-day cooling-off period in which to cancel certain contracts. • Consumers are liable for only the first $50 in unauthorized purchases made on a credit card before it is reported lost or stolen.
Fair Credit Reporting Act (1970)	Protects the privacy and accuracy of information in a credit check.	• If refused credit, a consumer can request from the lender the name and address of the credit bureau issuing the report. • The credit bureau, if requested, must provide at least a summary of a consumer's credit file. • If the consumer claims part of the file is in error, the bureau must correct the record or explain it.
Equal Credit Opportunity Act (1974)	Prohibits discrimination in giving credit on the basis of sex, race, religion, marital status, age, or receipt of public assistance.	• Questions about age, sex, and marital status can be asked only if those questions relate directly to a person's ability to repay a loan. • Loan applicants must receive notice of a decision within 30 days. If the loan is denied, the lender must give the reasons.
Fair Credit Billing Act (1974)	Sets up a procedure for the quick correction of mistakes that appear on consumer credit accounts.	• Consumers have 60 days to notify a creditor of a disputed item on a billing statement. The creditor must correct the mistake or explain the charge. • While the mistake is checked, the consumer can withhold payment of the disputed sum. • Under certain circumstances, a consumer can withhold payment for defective merchandise.
Fair Debt Collection Practices Act (1977)	Prevents abuse by professional debt collectors; does not apply to banks or other businesses that collect their own accounts.	• Collectors can contact a person other than the debtor only to discover the debtor's location. • The debtor cannot be contacted at an inconvenient time or place. • All harassing behavior is prohibited, including the threat of violence, annoying phone calls, etc.



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on the amount of credit they offered. Others stopped lending completely. Many consumers, particularly those who were poor credit risks, found it hard to obtain credit.

People opposed to raising interest restrictions claimed that people with lower incomes would not be able to afford credit. Supporters of higher rate restrictions claimed that low rates made credit less available because it was less profitable for lenders. Low rates actually hurt those they were supposed to help.

Personal Bankruptcy

Every day in the United States, thousands of families get into financial trouble because they have ignored the total costs of all their borrowing. They have too many credit cards, too many charge accounts, and own a home that has too large a mortgage. Just because someone offers you credit or allows you to borrow does not mean that you should accept. Buying on credit is a serious consumer activity. See **Figure 4.15.**

If debtors take out too many loans, use too many credit cards, and pile up debts that they cannot pay off, they may have to file personal **bankruptcy.** When a bankruptcy is approved through a bankruptcy court, debtors must give up most of what they own, which is then distributed to their creditors. The Constitution authorizes Congress to establish bankruptcy laws. Certain debts, such as taxes, must continue to be paid, however.

bankruptcy: *the inability to pay debts based on the income received*

If you declare personal bankruptcy, be aware that the bankruptcy proceedings remain on your credit record for 10 years. During this period, it is very difficult to reestablish credit and borrow funds for items such as a new car or home. That is why

FIGURE 4.14

Women and Credit Changes in laws regarding credit have improved a woman's opportunities to borrow money. ***What law made it illegal for creditors to deny credit on the basis of marital status?***

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choosing bankruptcy to get out of your credit "mess" should be a last resort. Also, when you declare bankruptcy, you are making sure that your creditors will never be paid off (at least not in full) for what they loaned out.

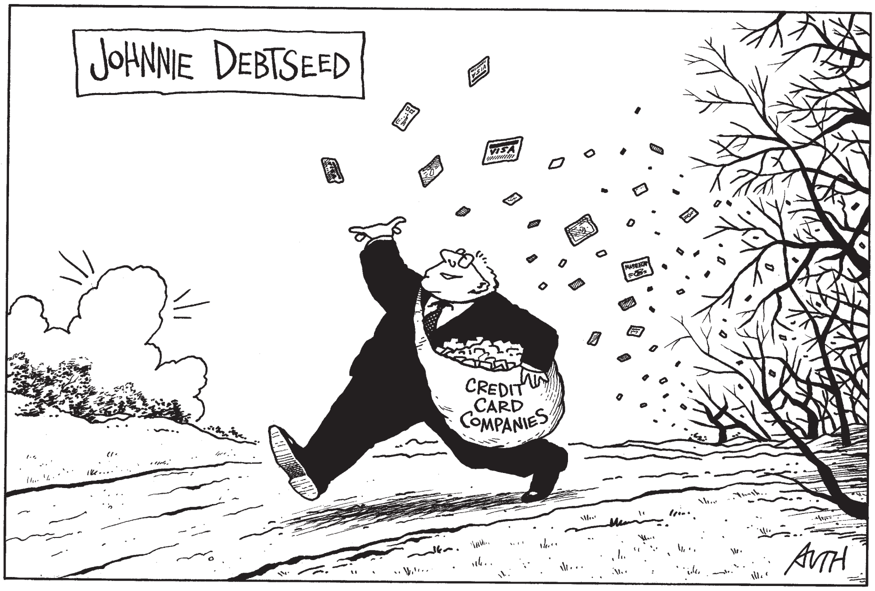


FIGURE 4.15

Using Credit Just because credit card companies make it easy to obtain credit does not mean that you should accept their offers. ***What are some questions you should ask yourself before buying on credit?***

Practice and **assess** key skills with ***Skillbuilder Interactive Workbook, Level 2.***

SECTION 4 Assessment

Understanding Key Terms

1. Define usury law, bankruptcy.

Reviewing Objectives

2. Graphic Organizer Create a chart like the one below to describe how the Truth in Lending Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act, and the Fair Credit Billing Act have affected consumer credit.

Legislation	Effect on Consumer Credit

3. What are state usury laws?

4. Why might a person declare personal bankruptcy?

Applying Economic Concepts

5. State Usury Laws The effect of a usury law is often a shortage of available loans. What circumstances might create a *surplus* of available loans?

Critical Thinking Activity

6. Making Comparisons Research the two types of bankruptcy known as Chapter 7 and Chapter 13. Which requires debtors to set up a repayment plan? Which deletes the debt completely? What are the long-term effects of each type on one's future?

People & Perspectives

Kenneth Chenault

ENTREPRENEUR (1951–)

- Chairman and chief executive officer of the American Express Company
- Board member of several companies, including IBM and Quaker Oats
- Board member of several educational, sports, and charitable organizations
- Recipient of many awards recognizing business achievements and charity work

After working as a lawyer and a business consultant, Kenneth Chenault accepted a position at the American Express Company in 1981. An energetic worker and imaginative problem solver, Chenault rose steadily through company ranks. In 1997 he was named president and chief operating officer, and in 2001 he became chairman and chief executive officer.

Chenault believes that it is not so much *what* or *who* you know, but what you *do:*

> "*Having a solid track record, building relationships with the people that you work with, and then impressing them with your abilities will make people in a position to help your career take note. As a result, you will earn the respect of the people who know your work well....*"

As an African American, Chenault has faced obstacles in his career. Taking a practical approach to the situation, he believes, helps people to confront and overcome such obstacles:

> "*Everyone, regardless of their ethnic, religious, age, gender, . . . or other differences has to contend with obstacles. So you have to isolate what you can control, from what you can't. You can't control people's biases. You can control your own performance, your own behavior and the values you choose to uphold.*
>
> *I also think it's important to cultivate a measure of resilience. And, perhaps unfortunately, the best teacher of resilience is failure. There is nothing quite like overcoming failure with your character and values intact, to reinforce the fact that learning from your mistakes can be one of life's most important lessons.*"

Checking for Understanding

1. **What, according to Kenneth Chenault, is the key to success?**
2. **What advice does Chenault give people for confronting and overcoming obstacles?**

CHAPTER 4 Summary

ECONOMICS Online CLICK HERE

Chapter Overview Visit the *Economics Today and Tomorrow* Web site at ett.glencoe.com and click on ***Chapter 4—Chapter Overviews*** to review chapter information.

SECTION 1 Americans and Credit

- **Credit** is the receiving of funds either directly or indirectly to buy goods and services today with the promise to pay for them in the future.
- The amount owed—the debt—is equal to the **principal** plus **interest.**
- Many people buy **durable goods** and obtain **mortgages** using **installment debt.**
- People go into debt because they do not want to wait to purchase an item with cash, and they want to spread the debt payments over the life of the item being purchased.

SECTION 2 Sources of Loans and Credit

- The major financial institutions that lend consumers funds include **commercial banks, savings and loan associations, credit unions,** and **finance companies.**
- A **charge account** allows a customer to buy goods or services from a particular company and pay for them later.
- A **credit card,** often charging high interest, may be used at stores, restaurants, or other businesses.
- **Finance charges** tell you the monthly cost of credit in dollars and cents.
- The **annual percentage rate** tells you the annual cost of credit in percentages.

SECTION 3 Applying for Credit

- After you have filled out a credit application, a **credit bureau** will perform a **credit check** and determine your **credit rating.**
- Before granting you credit, a creditor looks at your capacity to pay, your character, and any **collateral** you may have.
- Your responsibilities as a borrower include paying on time, keeping records of your debt, and not spending more than you can repay.

SECTION 4 Government Regulation of Credit

- Legislation states that those who provide credit cannot deny you such credit solely on the basis of your race, religion, national origin, gender, marital status, or age.
- A **usury law** restricts the amount of interest that can be charged for credit, but can lead to a shortage of available credit if interest rates rise.
- People who cannot repay their debts may have to file personal **bankruptcy.**

CHAPTER 4

Assessment and Activities

ECONOMICS Online

Self-Check Quiz Visit the *Economics Today and Tomorrow* Web site at ett.glencoe.com and click on ***Chapter 4—Self-Check Quizzes*** to prepare for the Chapter Test.

CLICK HERE

Identifying Key Terms

Write the letter of the definition in Column B that correctly defines each term in Column A.

Column A

1. principal
2. usury law
3. collateral
4. annual percentage rate
5. unsecured loan

Column B

a. restricts the amount of interest that can be charged for credit
b. requires only a promise to repay
c. amount of money borrowed in a loan
d. something of value that a borrower uses as a promise of loan repayment
e. cost of credit expressed as a yearly percentage

Recalling Facts and Ideas

Section 1

1. What do you have to pay when you borrow?
2. How is taking out a loan similar to buying an item on credit?
3. What type of goods do people typically use installment debt to buy?
4. Why do people use credit?

Section 2

5. What are the six types of basic lending institutions in our economy?
6. What are some of the most common types of credit cards used today?
7. When you take out a loan, what do you call the total cost of credit expressed in dollars and cents?

Section 3

8. When you make an application for a loan, what are four factors that a creditor analyzes to determine whether you are creditworthy?
9. What is the difference between a secured and an unsecured loan?
10. What are your responsibilities as a borrower?

Section 4

11. What does the Equal Credit Opportunity Act of 1974 prohibit?
12. What are three important federal laws regulating consumer credit?
13. How can usury laws be harmful to the people they are trying to help?

Thinking Critically

1. **Making Comparisons** In deciding whether to pay cash or use credit for a purchase, what are the costs involved and the benefits of each choice?

2. **Synthesizing Information** Imagine that you need both a car loan and a home mortgage. Use a chart like the one below to help decide which of the six types of lending institutions discussed in this chapter would be most appropriate for each loan.

Financial Institution	Services	Car or Home Loan?

3. **Drawing Conclusions** If you declare personal bankruptcy, your creditors clearly lose. What ethical concerns should you have before ever taking this action?

Applying Economic Concepts

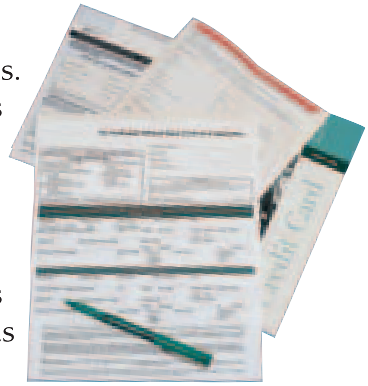
The Role of Government Sometimes credit cards are lost or stolen. The owner must take steps to keep his or her card from being used by an unauthorized person. Research the Truth in Lending Act to find out what a credit card holder must do when his or her card is lost or stolen.

Cooperative Learning Project

Work in small groups to create a loan application that is appropriate for high school students, and circulate it in class. After going over the application, analyze why it is or is not difficult to decide who should receive loans. Is it difficult to decide who should *not* receive loans?

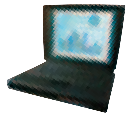
Reviewing Skills

Using a Database Call various retail stores and gas stations and ask them to send you a credit card application. Analyze the applications, then prepare a database that organizes the answers to the following questions.



1. What questions asked on each application are virtually the same?
2. What questions asked on the gas station applications are different than those asked on the retail store applications?
3. Were any questions asked that you think violate the Equal Credit Opportunity Act? Explain.

Technology Activity



Using the Internet If you ever wish to borrow money, your credit rating will be important. You can determine what your credit rating is by going to the Internet.

Enter the words *credit rating* in your search engine. You will find numerous sites that will give you a credit check on yourself. A wealth of online credit reporting services are available, and some of these reporting services are free.

Analyzing the Global Economy

The first banks arose in Europe during the Middle Ages. Indeed, the word *bank* comes from the *banca,* or bench, that moneychangers set up at medieval fairs to exchange currencies, transfer funds, receive deposits, and arrange loans. Research these early financial institutions and the interest rates they charged their customers.

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