LESSON I:

TERMS AND BASICS

CREDIT AND DEBT

The term **credit** refers to any transaction in which a good or service is rendered before payment is made. It's a loan in which you, the **consumer**, receive a credit or advancement on a purchase. When you use credit, you create a **debt**, or money owed, to the **lender** (the company that gave you the loan).

There are two types of debt. **Installment debt** is a set amount of money that is received at one time and paid back with fixed payments, usually monthly. Common installment debts include mortgages, auto loans, and personal loans. With **revolving debts**, there is still a fixed amount of money the lender has agreed to lend, but it's usually not taken out in one lump sum. Monthly payments are not fixed with revolving debts. Instead, monthly payments are based on what remains of the debt, or the **balance**, and any interest or fees (this will be discussed more in "Interests and Fees"). Credit cards are a form of revolving debt.

When you accept a lender's credit, you are entering into a contract with them. In this contract the lender sets the terms for paying back the loan. As discussed above, some terms involve a fixed payment plan while others may change month-to-month. Lender terms may be different, but they are the same in one very important way: unlike a loan from your Uncle Bob, *credit usually comes with strings attached*.

INTEREST AND FEES

When purchases are made using credit, the lender wants to get something out of the deal. They aren't loaning out money because they're nice people… they have a business to operate! To make money on the deal, these institutions will generally charge a percentage of the amount loaned every month until the loan is paid back. This is known as **interest**. When we, as borrowers, research different lenders to find the best interest rates, we are typically looking at the **A.P.R.** or **annual percentage rate** of the loan. The A.P.R. is the interest the company will charge over a year's time, plus any additional fees. The longer a person takes to pay back the loan, the more money the credit card earns.

THE CREDIT TRAP

Let's look at an example:

Say you want to purchase a brand new 55-inch, high definition television. The television costs $1000. You don't have $1000, but you have a credit card. The credit card has a 16% A.P.R. (the current average) on purchases. You get to take that television home today, and you don't have to pay any money. However, the next time that credit card statement rolls around, you'll need to pay a minimum payment on the $1000 you owe. This minimum payment will include a portion of the **principal** (what you currently owe, or the original loan amount minus payments already made) and the A.P.R.

So, what's the big deal? 16% of $1000 is only $160 and that's over the course of a year. That's not so bad! Well, this is only true if you pay the loan off in its entirety that first month. If you pay the minimum payment (which many people do), you will end up paying interest EVERY month over the life of your loan.

In this example, if you only pay $25 every month, it will take you fifty-eight months (that's over four and a half years!) to pay off the T.V., and you'll end up paying about $438 in interest. In total, your $1000 television will cost you $1438. For that amount, you could have purchased a much bigger T.V.!

In some ways, credit is a beautiful part of our capitalist economy; it allows us to make expensive purchases like cars and homes. Credit is what allows us to provide for our families when times are tough, pay for unexpected emergencies, and pursue our dreams. But, as helpful as credit can be, it can also become our worst enemy.

The credit trap is what causes someone to have "bad credit." If you are unable to pay back a loan according to the parameters set up by the lender, it is recorded by a credit bureau and goes on your credit report. In fact, ALL your credit activity is recorded and stays on your credit report for a very long time.

QUIZ QUESTIONS

LESSON I: TERMS AND BASICS

1. On a bill or statement, this is what remains of a debt, and it may include interests and fees.
   A. Balance
   B. Loan
   C. Credit
   D. Principal

2. On a bill or statement, this is the amount of the debt remaining and does not include interest or fees.
   A. Balance
   B. Loan
   C. Credit
   D. Principal

3. The yearly interest and fees a lender will charge on an unpaid debt is called the…
   A. Annual percentage rate
   B. Principal
   C. Loan
   D. Balance

4. The company that issues a loan is known as the…
   A. Consumer
   B. Buyer
   C. Lender
   D. Principal

5. Any transaction in which something is given before payment is made is called …
   A. Interest
   B. Debt
   C. Credit
   D. Balance

6. A home mortgage is a type of …
   A. Installment debt
   B. Revolving debt

7. True or False: Paying the minimum amount on a credit card bill is the fastest way to get out of debt.
   A. True
   B. False

LESSON I: ANSWERS

1. A
2. D
3. A
4. C
5. C
6. A
7. B