8-1 Payment Methods

OBJECTIVES

- ***Describe manual and electronic options for making payments.***
- ***Explain the advantages and disadvantages of manual payment options.***
- ***Explain the advantages and disadvantages of electronic payment options.***
- ***Name the primary advantage of wire transfers.***
- ***Discuss prepayment penalties and why a loan might be repaid early.***

Chapter 8 discusses paying for credit, types of loans, and managing credit wisely. You will learn about payment options and their advantages and disadvantages. You will discover the various types of consumer loans and debt options. You will also take a careful look at some tips for using credit wisely.

MANUAL PAYMENTS

When you use some form of credit, you must decide how you will make payments on the account. When you make a payment on an account, you are reducing the amount you owe. Several payment options can be used. Each payment method has advantages and disadvantages.

CASH

Cash is a traditional payment option. Many people prefer to deliver cash to local stores and banks rather than mail a check. An advantage to using cash is that cash is accepted everywhere for payments. Be sure to get a receipt for any payment you make in cash. The receipt serves as proof of payment and is another advantage to this payment method. A disadvantage to paying with cash is that carrying large amounts of cash can be unsafe. You may be robbed, or you may lose the money. Another disadvantage is that the cash must be delivered in person. Never send cash through the mail.

PERSONAL CHECKS

A personal check is another traditional payment option. The check can be mailed or delivered in person. Before you write the check, compare the bill with your receipts to be sure everything is correct. For revolving credit accounts, pay the outstanding balance if you can. If not, choose a payment amount that is more than the minimum required, if possible. Paying by check has some advantages. Checks are easy and inexpensive to use. Mailing checks is relatively safe. Cancelled checks or bank statements showing checks that have been processed provide proof of payment. A disadvantage of paying by check is that the check can get lost or delayed in the mail. If the check does not reach the creditor before the due date, you may be charged a late fee. You can explain that the check was delayed in the mail and ask to be excused from paying the late fee. However, the creditor may not accept this excuse. Some creditors will waive at least one late fee. When paying by check, you should plan ahead so that checks are written and mailed in time to reach the creditor by the due date. Be sure to mail payments from a secure location. Leaving mail in the unlocked box outside your house may not be a safe option. Instead, you can take the mail to a post office or mailbox that is secure.

MONEY ORDERS

A money order is a type of check that directs payment of a sum of cash to a payee (a person or company). A money order typically has two parts. One part is the check that is sent to the payee. The other part is a receipt keep by the person buying the money order. The amount of the money order is printed on both parts. Money orders can be purchased at banks, U.S. post offices, and some stores. There may be a limit to the amount for which the money order is issued. For example, a postal money order may be limited to $1,000. An advantage to using a money order is that it is prepaid. The payee is guaranteed payment because this type of check cannot bounce. A money order can also be sent safely by mail. A disadvantage to using money orders is that getting one can be inconvenient. At some locations, you may have to stand in line and pay for the money order using cash. At other locations, you may be able to pay by personal check. Another disadvantage is that you must pay a fee for the money order. Often the fee is based on the amount of the money order. For example, a $100 money order might cost $5 (or more) for a total of $105.

Money orders can also be purchased on the Internet. To find a Web site that sells money orders, search using the term money order. At the Web site, you will need to enter the amount of the money order and select a delivery method, such as U.S. mail. You will also need to enter the recipient’s name and address. Then you enter your name, address, and credit card information. Fees for buying a money order online are about the same as when buying one in person. For example, a $100 money order might cost $6.48 for a total of $106.48.

BANK CHECKS

A cashier's check is another payment option. You can purchase a cashier's check at a bank or credit union. You can pay for the check in cash or have the money taken from your account with the bank. An advantage to using a cashier's check is that it is prepaid. The payee is guaranteed payment. Unlike a money order, a cashier's check can be written for large amounts. A cashier's check can also be sent safely by mail. A disadvantage to this payment option is that you may have to pay a fee for the cashier's check. Some checking accounts include this service as a part of the account.

A certified check is a personal check for which payment is guaranteed by the bank on which it is drawn. To use this payment option, you write a check and have the bank certify it. The bank sets aside from your account the amount of the check. This amount will be used only for payment of the certified check. When the check is presented for payment, the money is waiting. An advantage to using a certified check is that it is prepaid. The payee is guaranteed payment. A certified check can also be sent safely by mail. A disadvantage to this payment option is that you may have to pay a fee for having a check certified. It may not be convenient to go to the bank and wait for service.

ELECTRONIC PAYMENTS

Using your checking account, you can set up electronic payments for some credit accounts. There are several types of electronic payments, such as online payments, online banking, payment by telephone, and automatic withdrawals. Electronic payments have several advantages. All of these methods save you postage. Once set up, they are quick and easy to use. Many people make most of their payments in this manner. Electronic payments also have disadvantages. You will be charged fees for using some types of electronic payment services. You must monitor the balance in your checking account carefully. Be sure enough funds are available to cover the electronic payments. Otherwise, you may have to pay overdraft fees. If funds are not available, the bank might refuse the payment. Then you would have to pay late fees to the creditor.

ONLINE AND TELEPHONE PAYMENTS

You may be able to make payments online at the creditor's Web site. At the Web site, you access your account with a user name and password. Then you enter your bank account information. This includes the bank routing number and checking account number. Now you are set to make online payments. When you want to make a payment, you authorize a withdrawal from your checking account. There usually is no fee for this service. You can choose the date the money is withdrawn from your account. Some creditors allow you to authorize payments from a checking account by telephone. You must supply information such as your account number with the creditor. You will also need to give the creditor the bank routing number and your checking account number. Some banks allow you to make payments and manage your account using the telephone. A fee may be charged for this service, especially if you must speak to a person who assists you with the process.

ONLINE BANKING

Another type of online payment is made through your bank or credit union. This service, called online banking, allows you to make payments and manage your account using the bank's or credit union's Web site. Convenience is the main advantage to online banking. A disadvantage is that banks or credit unions may charge a monthly fee based on the number of payments you make. A major drawback to this method is that all of your creditors may not be set up to receive electronic payments. In this case, the bank creates a check and mails it to the creditor. In order to avoid late fees, you must allow mailing time when you authorize the payments.

AUTOMATIC PAYMENTS

Automatic payments occur when you ask the bank to transfer money electronically from your checking account to some other account. For example, many people choose to pay their car insurance premiums with automatic payments. The payment is made automatically each billing period. An advantage to this option is convenience. You do not have to remember to pay the bill each month. Another advantage is that you may get a discount for using this payment method. A disadvantage to this method is that you must be sure to keep enough money in the account to cover the automatic payment. If you do not, you may have to pay overdraft or late fees.

WIRE TRANSFERS

A wire transfer is the process of sending money electronically rather than using paper checks. This service is available from companies such as Western Union. Banks and other financial institutions also do wire transfers for their customers. The sender pays the amount of the money transferred plus a fee. The money is delivered to a designated location where the recipient can collect it. For example, Western Union has sites called agent locations. They are businesses such as grocery stores, drugstores, and travel agencies. Customers can send a wire transfer or receive money from a wire transfer at these locations. The fee for this service depends on the amount of the transfer. For a wire transfer of $100, the fee could be $15 or more. An important advantage to using wire transfers is that the transaction is completed very quickly. Money is transferred in just minutes, and you are assured that it arrives safely. A disadvantage to using wire transfers is that they can be inconvenient to purchase in person. You have to go to a bank or business that offers wire transfers. At some locations, you may have to pay cash for the amount being wired. Wire transfers can also be arranged online and by telephone. Companies such as Western Union have Web sites and telephone numbers you can use to make a wire transfer. You pay for the transfer using a credit or debit card. This method may be more convenient than visiting a business to complete the transfer.

PREPAYMENT PENALTIES

Some types of loans may have penalties for early repayment. A prepayment penalty is a fee charged when you repay a loan before the agreed-upon time. For example, suppose you borrow money and agree to repay the loan over a 15-year period. A short time later, you decide to pay the entire loan balance. The loan agreement may specify a 30- to 90-day interest penalty. The lender has certain costs related to setting up the loan. These costs are spread over the life of the loan. If the loan is repaid early, the lender charges a penalty fee to cover these costs. Repaying a debt early may be a wise choice, even with a prepayment penalty. If the penalty amount is less than the interest you would pay if you paid on the original schedule, paying off the debt would be to your advantage.

8-2 Consumer Loans

OBJECTIVES

- ***Describe types of consumer loans.***
- ***Explain how a personal loan differs from a secured loan.***
- ***Explain how a fixed rate mortgage differs from an adjustable rate mortgage.***
- ***Describe the purpose of a mortgage calculator.***
- ***Explain the purpose of a student loan.***
- ***Describe rent-to-own agreements and give their advantages and disadvantages.***

TYPES OF LOANS

In addition to using credit cards, you can borrow money in the form of a loan. An installment loan is a type of debt in which you borrow money for a period of time. The loan has an agreed-upon interest rate and repayment plan. Many loans have monthly payments. Creditors make money by charging interest on the amount borrowed.

PERSONAL LOANS

Loans that are based on personal creditworthiness are called personal loans. The borrower submits a loan application asking for a fixed amount of cash. The amount of the loan that a creditor will approve is based on factors such as the following:

- The purpose for which the money will be used
- The borrower’s credit payment history
- The borrower’s existing debts and current payments to other creditors
- The borrower’s monthly and yearly income
- The borrower’s job security (whether the job is likely to continue)

Borrowers who already have a lot of debt may be denied a personal loan. If granted a loan, the borrower may be charged a high interest rate. This is because a personal loan represents a bigger risk to the lender than a secured loan.

SECURED LOANS

A secured loan is a debt agreement in which the borrower pledges property of value as security. This property is called collateral. A house or a car owned by the borrower is often used as collateral. If the borrower fails to repay the loan as agreed, the lender can sell the property and use the proceeds to repay the loan. Secured loans are often used to buy durable goods. Durable goods are assets (items of value) that will last longer than a year. The goods being purchased, a riding lawn mower, for example, may serve as collateral for the loan. Some borrowers do not have property that can be used as collateral. In this case, another person may agree to serve as a cosigner on the loan. A cosigner is a person who agrees to repay the loan if the borrower does not repay the loan. The cosigner typically must have property that can be used as security for the loan or a very good credit rating.

Car Loan. Many people who buy cars borrow money in the form of a car loan. This type of debt is a secured loan. The car itself serves as collateral. The creditor holds the title to the car until the loan is paid in full. If the borrower cannot make the payments as agreed, then the car is repossessed and sold by the creditor to pay off the debt.

House Loan. A mortgage is a loan that is used to secure financing for the purchase of a house or other real estate. The mortgage usually requires 10 to 30 years of monthly payments. A mortgage is a form of secured loan. If you do not make payments as agreed, you can lose the house. Some mortgages have prepayment penalties. The borrower must pay an extra fee if the loan is repaid before a set period of time, such as 5 years.

- Fixed Rate Mortgage: Many mortgages have fixed interest rates. The interest rate does not change over the life of the loan (typically 10 to 30 years). With a fixed interest rate, the payment also does not change over the life of the loan.
- Adjustable Rate Mortgage: Another type of mortgage is the adjustable rate mortgage (ARM). With an adjustable rate mortgage, the interest rate on the loan can change over time. As interest rates go up or down in the economy, the mortgage rate can change as well. If the rate goes up, the payment amount increases. The term of the loan may also increase. Typically, there is a limit to the amount the loan interest rate can go up or down each year. Often an adjustable rate mortgage starts with a lower rate. This lower rate allows the borrower to afford the payments. A higher rate and higher payments may be charged in later years.
- Balloon Mortgage: Some mortgages have a balloon payment. A balloon payment is a large sum that must be paid at a set time. The balloon payment is typically the last loan payment. For example, a mortgage may have equal monthly payments of $800 for 10 years and a final balloon payment of $5,000. Like adjustable rate mortgages, balloon payments are often used so the loan will have lower monthly payments. This allows people who could not otherwise afford to buy a house to purchase a home. The buyer may sell or refinance the loan before the balloon payment is due. At that time, the buyer may qualify for a fixed rate mortgage with more favorable terms.

Most secured loans also have closing costs. Closing costs are expenses you must pay in order to get a loan. They include charges for items such as appraisal fees, credit report fees, loan origination fees, recording costs, and inspection fees. Closing costs can be hundreds or even thousands of dollars. Before agreeing to a loan, be sure to ask about all the costs you will be expected to pay to get the loan.

If a mortgage is for more than 80 percent of the value of the home, the borrower is typically required to purchase mortgage insurance. This insurance will pay the lender if the borrower does not repay the loan. The loan agreement may also require the borrower to carry a homeowner's insurance policy.

Amortization. Repaying a debt by making regular payments of principal and interest over a period of time is called amortization. A formula can be used to calculate payments on an amortized installment loan. The formula is more complicated than the formula you learned earlier for simple interest. This is true because payments reduce both the principal and the interest amounts. Interest is charged on the outstanding balance, which decreases over the life of the loan. Amortization tables and calculators are available on the Internet. These tools can help you quickly calculate loan payments. The payment is based on the principal, interest rate, and number of monthly payments.

A mortgage calculator can also be used to show how much of each payment made goes toward repaying the principal and how much goes toward paying interest. You may see two different rates given for a loan offer. The loan interest rate is used to compute monthly payments on the principal borrowed. The term annual percentage rate (APR) takes into account the other loan fees, such as closing costs, that the borrower must pay as part of the loan payments. Comparing the APRs for two different loans gives you a better picture of the total charges you must pay for each one. When comparing the APRs for loan offers, be sure the same fees are covered in the APR numbers. APR calculators are available on the Internet.

Student Loans

A student loan is debt that is used to finance education costs. Student loans can be secured from banks and other financial institutions. Students who meet certain criteria can also get student loans from the U.S. government. On some student loans, called subsidized loans, interest is paid by the federal government while the borrower attends school at least halftime. The borrower repays the loan after finishing or leaving school. To qualify for student loans, you must fill out a loan application. If you live with your parents, they will also have to fill out paperwork showing income and assets. To get a subsidized loan, the borrower must show proof of financial need. Other loans are available and are not related to financial need. The borrower must pay all interest on these loans. Many students take out several student loans to pay for attending college or other schools. After they complete their education, they often have these loans consolidated. Several loans are rolled into a single loan with one payment. This makes it easier to pay off the debt over a long period of time. If you decide to get a student loan, compare the terms for loans from various sources. Information about student loans from the U.S. government and other sources is available online. The National Student Loan Data System for Students Web site is also provided by the U.S. Department of Education. This site is a central database of information for student aid. The site will help you compare sources of loans and grants for education.

LEASE/RENT-TO-OWN

Another way of buying is by leasing or renting to own. You select an item, such as a television. You take the item home and use it just as if you had purchased the item. Each week or month, you make rent payments. At this point, you do not own the item. However, the rent-to-own agreement may state that if you make a certain number of payments, you will then own the item. There are advantages to this type of agreement. You do not have to make a large down payment at the time of purchase. Some lease or rent agreements require that no cash be paid at the time you sign the agreement. You can try the item before you buy it. If you decide you do not want the item, you can return it and end the rent agreement according to the terms of the contract. The contract also provides you with a guaranteed price that will not go up later. The disadvantages of this option usually outweigh the advantages. You may not have much choice in the models or features available for items. If you decide not to buy the item, no part of your rent payments is returned to you. The main disadvantage, however, is that the total price you will pay for the item if you make payments until you own it is often much higher than if you buy the item outright. For example, suppose you rent-to-own a television that sells for $220. You make weekly payments of $10. After making 78 weekly payments, you own the television. You will have paid a total of $780 for an item that sells for $220. This amount compares to paying a loan interest rate of 220 percent. A better option would be to take out a personal or secured loan at a bank to get money to buy the television. You could also charge the purchase on a credit card. In both cases, the interest rate would be much lower.

8-3 Credit Tips

OBJECTIVES

- ***Explain why using credit may tie up future income.***
- ***Discuss why you should consider the state of the economy when planning credit purchases.***
- ***List the terms typically included in a credit offer.***
- ***List ways you can reduce and avoid credit costs.***

USING CREDIT WISELY

When you begin using credit, plan to use it wisely. Go slowly; do not use too much credit at first. It is very important to establish credit when you do not need it so that it will be available to you when you do. Build a solid credit history by paying all credit bills on time. Later, when you want to use credit, you will be considered a low (good) risk. You may also be able to borrow at lower interest rates than someone who is considered a high (bad) risk.

Buying items using credit can tie up future income. For example, suppose you buy an item for $500 using a credit card. If you pay the entire amount in one billing cycle, future income is not tied up with this debt. However, suppose you pay the $500 plus interest over six billing cycles. Part of your income for the next 6 months must be used to pay for the item you purchased this month. You may have to forgo buying some items you want or need during the next 6 months because the money must be used to pay an existing debt.

As your earnings go up over time, save more money rather than spending the full amount of the pay increase. Think about future needs rather than only things you might want, but not need, in the present. You may feel secure in your job and your prospects for the future. However, you should always have a back-up plan for handling expenses if you are out of work for a time. Save a cash fund, and have some unused credit available. If the worst happens, you will have money to pay bills until you begin earning money again. You will also have some credit available to make purchases.

CONSIDER THE ECONOMY

When the economy is doing well and people can get jobs easily, consumers may feel optimistic about the future. This optimism often leads to increased buying. When credit is used to buy more items, future income may be tied up as well. During good economic times, interest rates are usually rising. Thus, rather than buying on credit, this could be a good time to save money. The opposite is true when the economy is slowing down. People are being laid off, and jobs are scarce. People may feel pessimistic, and this can lead to decreased buying. Because people are buying less, prices may be dropping. Thus, this could be a good time to buy because you can get better values. If you do not spend all of your money (and credit) during the optimistic stage, you will have money available to spend when prices may be more favorable.

STUDY CREDIT OFFERS

If you are like many people, you will receive credit offers soon after you begin working. These offers are mailed, e-mailed, or found in advertisements. Carefully examine each offer and compare the terms and conditions if you are considering the offer. A credit offer typically includes these terms:

- Interest rates. Are they fixed or variable? How often can they change? What will cause them to change? Fixed rates often do not stay fixed and can be changed with some notice from the creditor. However, they are usually better than variable rates, which can rise without advance notice.
- The grace period. The grace period is the amount of time you have before a credit card company starts charging you interest on your new purchases. Most credit offers allow for a grace period of at least 20 days. The longer the grace period, the longer you have to pay without being charged interest on the purchase amount.
- Method of computing interest. Many creditors use the two-cycle average daily balance method. This means if you have a balance anytime during the two-cycle billing period, you will be charged a finance charge. A billing cycle is typically about 1 month. This method is not good for consumers.
- Annual fee. Some credit cards charge an annual fee or a membership fee. This fee can be $25 to $50 or more. Once your credit is established, you should be able to find a credit card offer that does not require an annual fee.
- Minimum finance charge. Some credit cards require a minimum charge of $1 or more for each billing period.
- Transaction fees. If you transfer balances from other credit accounts, you may be charged a transaction fee. This fee is usually a percentage, such as 3 percent of each transaction. There is often a minimum of $5 and a maximum of about $75.
- Cash advance fees. Some credit cards allow you to take cash advances at ATM machines and at banks. There is often a fee for this type of transaction. It is usually a percentage, such as 3 percent with a minimum amount of $5 or more
- Late fees and over-the-limit fees. The fee for late payments can be $15 to $50 or more. The fee may depend on the balance on your card. The over-the-limit fee is usually a flat amount, such as $35 or more. Having late fees or over-the-limit fees can cause the interest rate you are charged to rise.

Some credit card offers state that the company reserves the right to change the account terms at any time for any reason. This includes raising interest rates. When an interest rate goes up, you must accept the change or cancel the card. Thus, being in a flexible position is important. You want to avoid being in the position of having to accept higher rates and fees.

REDUCE AND AVOID COSTS

When you use credit, there is usually a cost. You may want to pay cash for small purchases instead of using credit to avoid credit costs. When you do use credit, try to pay the full account balance each billing cycle. If you do, you will not have to pay any interest. Here are several other ways you can reduce your costs:

- Keep the number of credit cards and accounts you have to a minimum.
- Avoid having an account at every store in town and with every bank card available. Only carry with you the cards you will be using.
- Having a bank card is a good idea because it is accepted at many different businesses. Using a bank card also eliminates the need to have several individual store accounts.
- Comparison-shop when getting a loan. Compare the costs of credit from at least three different sources. When planning a large purchase, such as a car, arrange the financing ahead of time. That way, you will know the dollar amount you can spend and the interest rate you can get. You can then compare any offers that the seller might have.
- Consider financing and special deals arranged by the seller. A sales finance company is a type of lender that makes loans for the purchase of consumer goods, such as cars or household appliances. The finance company may also purchase time-sales contracts from merchants. The finance company often works closely with the seller. This makes it easy for customers to arrange financing at favorable terms. For example, GMAC (General Motors Acceptance Company) is a sales finance company. One of the services offered by GMAC is loans for the purchase of automobiles. When buying a car, you may be offered a sales incentive, such as 0 percent interest on a loan or $2,500 cash back on a purchase. These deals are worth considering.

- Use credit to take advantage of sale prices. With the help of credit, you can buy things on sale that you would not buy if cash were your only option. Thus, you can avoid higher prices and save money.
- Time your credit purchases. If you buy right after the closing date of your billing cycle, you may be able to delay payment for 2 months after the purchase. Most credit accounts have a 25- to 30-day billing cycle.
- Take advantage of cash rebates and rewards. Many credit cards offer rebate programs. A rebate is a partial refund of the purchase price of an item. For example, a 5 percent rebate would give you back 5 percent of the purchases you made during the month or year. This increases your spending power. Be careful, however, not to overspend because of this reward. Some credit accounts also offer gift certificates and other incentives. Choose the reward that benefits you the most, and use cards that have rewards rather than those that do not.

FOCUS ON: Unused Credit

When you have credit standing by in case you need it, it can actually cost you in ways you never suspected. For example, you may have five or six credit cards with zero balances. On the surface, this seems to be a very good thing. Lots of credit is available to you, but your outstanding debt is zero. Suppose you now apply for a loan for a car or another large purchase. Because you have five or six credit cards with potential for debt of $25,000 or more, the lender may be reluctant to extend more credit to you. The lender may ask you to close several of those unused credit accounts. Then the lender will feel more secure about your ability to repay the loan. Having some credit available is useful. If you have too much, however, you may find yourself at a disadvantage when applying for a loan.

Chapter Summary

- ***Cash, personal checks, money orders, and bank checks are manual or traditional methods of making payments.***
- ***An advantage to using a money order or a bank check is that the payee is guaranteed payment.***
- ***Online payments can be made at some creditors' Web sites. Online banking, payment by telephone, and automatic withdrawals are available for some accounts.***
- ***A wire transfer is the process of sending money electronically rather than using paper checks.***
- ***A prepayment penalty is a fee charged when you repay a loan before the agreed-upon time. Repaying a loan early may be to your advantage even when there is a prepayment penalty.***
- ***An installment loan is a type of debt in which you borrow money for a period of time. The loan has an agreed-upon interest rate and repayment plan. Personal loans, secured loans, and student loans are three types of installment loans.***
- ***A personal loan is granted based on your creditworthiness. A secured loan is a debt agreement in which the borrower pledges property of value as security for the loan.***
- ***Many mortgages have fixed interest rates and payments over the life of the loan (typically 10 to 30 years). An adjustable rate mortgage has a variable interest rate that goes up or down at the discretion of the lender.***
- ***A student loan is debt used to pay for education. You must qualify based on creditworthiness. For some student loans, you must also qualify based on need.***
- ***Lease or rent-to-own agreements are another option for buying items.***
- ***The total price you will pay for the item if you make payments until you own it is often much higher than if you buy the item outright.***
- ***It is very important to establish credit when you do not need it so that it will be available to you when you do. Build a solid credit history by paying all credit bills on time.***
- ***Buying items using credit can tie up future income if the debt is paid over several months or years.***
- ***During good economic times, interest rates are usually rising. This could be a good time to save money. When the economy is slowing down, prices may be dropping. This could be a good time to buy because you can get better values.***
- ***Carefully study and compare credit offers. Fixed versus variable rates, the method of computing interest, all types of fees, and grace periods are some items that should be carefully examined.***
- ***To reduce and avoid costs, keep the number of credit cards and accounts you have to a minimum. Comparison-shop for loans and other types of credit. Use credit to take advantage of sales. Use credit cards that have rebate or rewards programs.***