

CHAPTER 5

Credit Management



Objectives

After reading this chapter you will understand the following:

1. The five C's of credit.
2. How to apply for a credit card.
3. How to understand your credit report.
4. The computation of credit card finance charges.

5.1 Five C's of Credit

To better manage your use of credit it is important to understand what factors lenders use to determine your credit worthiness. The “**Five C's**” are the basic components of credit analysis and they are capacity, capital, collateral, conditions and character. They are described here to help you understand what the lender looks for. **Capacity** to repay is the most critical of the five factors, it is the primary source of repayment - cash. The prospective lender will want to know exactly how you intend to repay the loan. The lender will consider the cash flow from the business, the timing of the repayment, and the probability of successful repayment of the loan. Payment history on existing credit relationships - personal or commercial- is considered an indicator of future payment performance. Potential lenders also will want to know about other possible sources of repayment. **Capital** is the money you personally have invested in the business and is an indication of how much you have at risk should the business fail. Interested lenders and investors will expect you to have contributed from your own assets and to have undertaken personal financial risk to establish the business before asking them to commit any funding. **Collateral**, or guarantees, are additional forms of security you can provide the lender. Giving a lender collateral means that you pledge an asset you own, such as your home, to the lender with the agreement that it will be the repayment source in case you can't repay the loan. A guarantee, on the other hand, is just that - someone else signs a guarantee document promising to repay the loan if you can't. Some lenders may require such a guarantee in addition to collateral as security for a loan. **Conditions** describe the intended purpose of the loan. Will the money be used for working capital, additional equipment or inventory? The lender will also consider local economic conditions and the overall climate, both within your industry and in other industries that could affect your business. **Character** is the general impression you make on the prospective lender or investor. The lender will form a subjective opinion as to whether or not you are sufficiently trustworthy to repay the loan or generate a return on funds invested in your company. Your educational background and experience in business and in your industry will be considered. The quality of your references and the background and experience levels of your employees will also be reviewed

capacity

to repay is the most critical of the five factors, it is the primary source of repayment - cash

capital

is the money you personally have invested in the business and is an indication of how much you have at risk should the business fail

collateral

or guarantees, are additional forms of security you can provide the lender. Giving a lender collateral means that you pledge an asset you own, such as your home, to the lender with the agreement that it will be the repayment source in case you can't repay the loan

conditions

describe the intended purpose of the loan. Will the money be used for working capital, additional equipment or inventory?

character

is the general impression you make on the prospective lender or investor. The lender will form a subjective opinion as to whether or not you are sufficiently trustworthy to repay the loan or generate a return on funds invested in your company.

The **FICO** mortgage **score** is between 300 and 850. Higher **scores** indicate lower credit risk. Each individual actually has 65 credit **scores** for the **FICO scoring** model because each of three national credit bureaus, Equifax, Experian and TransUnion, has its own database. FICO breaks that information into categories. Those five components each get different weights. “FICO scores give the most attention to how you have paid back lenders in the past and how much you are using of the credit available to you, as shown on your credit report.

1. **Payment history: 35 percent of the total credit score** is based on a borrower’s payment history, making the repayment of past debt the most important factor in calculating credit scores. According to FICO, past long-term behavior is used to forecast future long-term behavior.
2. **Credit utilization: 30 percent of the total credit score is based on a borrower’s credit utilization – that is, the percentage of available credit that has been borrowed.**

Since FICO views borrowers who habitually max out credit cards – or who get very close to their credit limits – as people who cannot handle debt responsibly, a borrower should maintain low credit card balances. FICO says people with the best scores tend to average about 7 percent credit utilization ratio, but that 10 to 20 percent usage is OK. That rule of thumb applies to each individual credit card as well as the overall level of debt. As you see, the first two factors make up nearly two-thirds of your score. So if you pay your bills on time and don’t carry big balances, you’re two-thirds of the way toward a good credit score. The final credit score pieces can move you from a good score to a great one. The remaining one-third of your score is determined by how long you have managed credit, to what degree you have pursued new credit recently and the variety of credit types you have successfully handled.

3. **Length of credit history: 15 percent of the total credit score** is based on the length of time each account has been open and the length of time since the account’s most recent action. As a result, it is impossible for a person who is new to credit to have a perfect credit score. A longer credit history provides more information and offers a better picture of long-term financial behavior. Therefore, to improve their credit scores, individuals without a history should begin using credit, and those with credit should maintain long-standing accounts.

4 and 5. New credit and credit mix: Each comprise 10 percent of the total credit score.

Borrowers, even those new to credit, should avoid opening too many credit lines at the same time, since such behavior could suggest they are in financial trouble and need significant access to lots of credit. FICO suggests that borrowers only take on additional credit when they must have it or when it makes sense financially. Credit mix, meanwhile, is somewhat of a vague category, but experts say that repaying a variety of debt indicates the borrower can handle all sorts of credit. According to FICO, historical data indicates that borrowers with a good mix of revolving credit and installment loans generally represent less risk for lenders. Knowing the various weights given to components of a FICO credit score give borrowers a better idea where to focus their attention.

5.2 Applying for a Credit Card

Your first credit card is independence, convenience and opportunity all rolled into one. By handling it responsibly, your first credit card can help you build credit and improve your ability to borrow money in the future. Here are 7 basic steps to making the most of your first credit card.

1. Know your credit score

When you go to borrow money, the first things the lender looks at are your credit history and credit score. The score is basically a measure of how reliable you are about borrowing and paying back money. The higher your score, the lower your interest rate and the better your loan terms.

2. Use your first credit card for important stuff, not impulse purchases

One rule of thumb for building a strong credit history is to spend no more than 50% of your available credit line. Using your card as ready cash can burn through your available credit in a hurry. Keep your card for planned purchases, take your time hunting down the best deals, and make sure you have a plan to pay off the purchase before you swipe your card.

3. Pay on time

This may seem pretty obvious, but you may not be aware of the consequences of missing a payment. One missed or late payment can lead to interest charges and late fees, not to mention a potential ding on your credit history.

4. Paying more than the minimum

Paying more than the minimum amount due each month can strengthen your creditworthiness and you can also save on interest by increasing your payments.

Example: You buy a tablet for \$300 with a card that charges 18% interest. Your minimum payment is \$20.

What you pay:	# of payments:	Total cost with interest:
\$20 minimum	18	\$345
Entire amount	1	\$300

5. Keep on top of your credit history—check your credit report once a year

Three major credit bureaus keep track of your credit history: Equifax, Experian and TransUnion. You're entitled to a free report from each of them once a year. To get your free credit report, simply visit AnnualCreditReport.com or call 877.322.8228. Check your reports to make sure there are no mistakes (errors can hurt your credit score).

6. Take advantage of online banking

Using online or mobile banking can help you keep up with your account anytime, anywhere. Instead of waiting for a monthly paper statement, you can spontaneously check on account activity, review your spending habits and spot opportunities to cut back. Depending on your card issuer, you may even be able to get automatic alerts telling you when you're close to your total credit line, when bill payments are due and more.

7. Protect yourself from fraud

Review your bank's privacy and security policies to find out how you're protected in case your credit card number is stolen. Learn how to protect yourself from fraud and what to do if you become a victim. A few simple tips: Never give out your credit card number over the phone unless you initiated the call, memorize your passwords and PIN numbers and keep them in a safe, secure location and check your account often to monitor for unusual activity.

5.3 Understanding your Credit Report

A credit report is divided into four sections: identifying information, credit history, public records and inquiries. Information is just that – information to identify you. Look at it closely to make sure it's accurate. It's not unusual for there to be two or three spellings of your name or more than one Social Security number, Sweet says. That's usually because someone reported the information that way. The variations will stay on your credit report; "If it's reported wrong, we leave it because it might mess up the link. Don't be concerned about variations."

Other information might include your current and previous addresses, your date of birth, telephone numbers, driver license numbers, your employer and your spouse's name.

The next section is your credit history. Sometimes, the individual accounts are called trade lines.

Each account will include the name of the creditor and the account number, which may be scrambled for security purposes. You may have more than one account from a creditor. Many creditors have more than one kind of account, or if you move, they transfer your account to a new location and assign a new number. The entry will also include:

- The kind of credit (installment, such as a mortgage or car loan, or revolving, such as a department store credit card).
- Whether the account is in your name alone or with another person.
- Total amount of the loan, high credit limit or highest balance on the card.
- How much you still owe.
- Fixed monthly payments or minimum monthly amount.
- Status of the account (open, inactive, closed, paid, etc.).
- How well you've paid the account.

The reports will also show your recent payment history and whether you paid as agreed each month. TransUnion and Experian credit reports also include the amount of each payment. Other comments under an account might include account closed by consumer, internal collection, charged off or default. "Charged off means the creditor has given up, thrown in the towel. "He's made efforts to collect and written it off." The next section is public records, which "is never a good story. The report lists only financial-related data such as bankruptcies, judgments and tax liens, all of which can trash your credit. Arrests, lawsuits and other information aren't included.

The final section is inquiries. That's a list of everyone who asked to see your credit report. There are two types of inquiries, hard ones and soft ones. Hard inquiries are initiated by you when you fill out a credit application. Soft inquiries come from companies that want to prescreen you for credit offers, potential employers or current creditors monitoring your account. The soft inquiries only show on reports given to consumers.

There's a chance you may find a mistake in your credit report. One in five consumers had an error on their credit report from the three major credit bureaus, according to a 2013 government study. One in 20 had an error so bad that it cost them more money on loans or insurance. If you find a mistake – such as an account that isn't yours or an erroneous amount – you'll need to dispute it with the credit bureau. The reports list a Web address for the credit bureaus' online dispute form. The credit bureaus will investigate your dispute by contacting the creditors, which have 30-45 days to respond to your dispute. The disputed item will show up as disputed on your credit report until it's resolved. If you feel your dispute is not handled well, you can file an online complaint with the Consumer Financial Protection Bureau, which will help facilitate the dispute process.

Enacted in 1975, the **Fair Credit Billing Act** is a federal law that aims to protect consumers from prejudicial or unfair billing practices. The Fair Credit Billing Act provides mechanisms to quell address billing errors in "open end" credit accounts, such as charge card accounts and credit cards.

The **Equal Credit Opportunity Act** (ECOA) is a United States law (codified at 15 U.S.C. § 1691 et seq.), enacted 28 October 1974, that makes it unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex, marital status, or age (provided the applicant has the capacity to contract); to the fact that all or part of the applicant's income derives from a public assistance program; or to the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act.

The **Consumer Credit Protection Act**, is a United States law Pub.L. 90–321, 82 Stat. 146, enacted May 29, 1968, composed of several titles relating to consumer credit, mainly title I, the Truth in Lending Act, title II related to extortionate credit transactions, title III related to restrictions on wage garnishment, and title IV related to the National Commission on Consumer Finance. The restrictions on wage garnishment guard employees from discharge by their employers because their wages have been garnished for any one indebtedness.

Fair Credit Billing Act

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Equal Credit Opportunity Act

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Consumer Credit Protection Act

The restrictions on wage garnishment guard employees from discharge by their employers because their wages have been garnished for any one indebtedness.

finance charges

A finance charge is the fee you pay for carrying a balance on your credit card. Paying finance charges increases the cost you pay for having a credit card, especially if you never completely pay off your balance.

5.4 Finance Charges

A finance charge is the fee you pay for carrying a balance on your credit card. Paying finance charges increases the cost you pay for having a credit card, especially if you never completely pay off your balance. Credit card companies compute finance charges using different methods. For example, one method adds: (1) previous balance, (2) a finance charge on the previous balance, and (3) new purchases. Then, the company subtracts payments and credits. Understandably, this approach is called the previous **balance** method.

Example 1:

The account balance on April 1st is \$50.51. On April 15th, a payment of \$15.00 is made. On April 25th, a purchase of \$19.27 is made. What is the finance charge if the annual rate is 18%? What is the new account balance?

Finance charge = previous balance * annual rate/12

Finance charge = \$50.51 * 18%/12 = \$50.51 * 0.015 = \$0.76

New balance = previous balance + finance charge + new purchases - payments/credits

New balance = \$50.51 + \$0.76 + \$19.27 - \$15.00 = \$55.54.

Some companies use the **unpaid balance** method. Using this method the finance charge is calculated after payments and credits have been subtracted from the previous balance. Then the company adds the amount spent on new purchases.

Example 2:

The account balance on April 1st is \$50.51. On April 15th, a payment of \$15.00 is made. On April 25th, a purchase of \$19.27 is made. What is the finance charge if the annual rate is 18%? What is the new account balance?

Unpaid balance = previous balance - payments/credits

Unpaid balance = \$50.51 - \$15.00 = \$35.51.

Finance charge = unpaid balance * annual rate/12

Finance charge = \$35.51 * 18%/12 = \$35.51 * 0.015 = \$0.53.

New balance = Unpaid balance + finance charge + new purchases

New balance = \$35.51 + \$0.53 + \$19.27 = \$55.31

Other companies use the **average daily balance** method with no new purchases included. This method calculates an average balance for each day of the billing period and divides this amount by the number of days in the billing period. This method is illustrated below:

Example 3:

The account balance on April 1st is \$50.51. On April 15th, a payment of \$15.00 is made. On April 25th, a purchase of \$19.27 is made. What is the average daily balance for the account? What is the finance charge if the annual rate is 18%? What is the new account balance?

Date	Payments	Old Balance	Number of Days	Sum
4/1 - 4/14		50.51	14	707.14
4/15	15		1	35.51
4/16 - 4/30		35.51	15	532.65
Total			30	1,275.30

Average daily balance = $1,275.30 \div 30 = \$42.51$.

Finance charge = annual rate/12 * average daily balance for the month

Finance charge = $18\%/12 * \$42.51 = 0.015 * \$42.51 = \$0.64$

New balance = Previous balance - payment/credits + finance charge + new purchases

New balance = $\$50.51 - \$15.00 + \$0.64 + \$19.27 = \$55.42$.

Chapter 5 Summary

To better manage your use of credit it is important to understand what factors lenders use to determine your credit worthiness. The “Five C’s” are the basic components of credit analysis and they are capacity, capital, collateral, conditions and character. Your first credit card is independence, convenience and opportunity all rolled into one. By handling it responsibly, your first credit card can help you build credit and improve your ability to borrow money in the future. A credit report is divided into four sections: identifying information, credit history, public records and inquiries. Credit card companies compute finance charges using different methods. For example, one method adds: (1) previous balance, (2) a finance charge on the previous balance, and (3) new purchases. Then, the company subtracts payments and credits.

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Chapter 5 Problems

Q5.1.

The debit card:

- A. debits your account at the moment you buy goods or services.
- B. credits your account at the moment you buy goods or services.
- C. is a new type of a credit card issued by VISA International.
- D. is really like a travel and entertainment card.
- E. is declared illegal in many states.

Q5.2.

The borrower’s attitude toward his or her credit obligations is called:

- A. capacity.
- B. capital.
- C. character.
- D. collateral.
- E. conditions.

Q5.3.

A bank that is looking at your past payment records on your loans is most likely examining which aspect of the 5Cs of lending?

- A. character
- B. capacity
- C. collateral
- D. capital
- E. conditions

Q5.4.

The borrower's financial ability to meet credit obligations is called:

- A. capacity.
- B. character.
- C. capital.
- D. collateral.
- E. conditions.

Q5.5.

A term that refers to the borrower's assets or net worth is called:

- A. capacity.
- B. character.
- C. capital.
- D. collateral.
- E. conditions.

Q5.6.

A valuable asset pledged to assure loan payments and subject to seizure upon default is called:

- A. capacity.
- B. character.
- C. capital.
- D. collateral.
- E. conditions.

Q5.7.

A loan officer is examining your income and the amount of your existing debt payments in deciding whether to make a loan to you today. Which aspect of the 5Cs of lending is the loan officer most likely looking at?

- A. Character
- B. Capacity
- C. Capital
- D. Collateral
- E. Conditions

Q5.8.

Which federal credit law sets the procedure for promptly correcting billing mistakes?

- A. Fair Debt Collection Practices Act
- B. Equal Credit Opportunity Act
- C. Fair Credit Billing Act
- D. Fair Credit Reporting Act
- E. Truth in Lending Act

Q5.9.

Which federal credit law protects you against an unauthorized use of your credit card?

- A. Fair Credit Reporting Act
- B. Fair Credit Billing Act
- C. Equal Credit Opportunity Act
- D. Fair Debt Collection Practices Act
- E. Truth in Lending Act

Q5.10.

Which federal consumer credit law prohibits credit discrimination based on sex and marital status?

- A. Truth in Lending Act
- B. Fair Credit Reporting Act
- C. Fair Credit Billing Act
- D. Equal Credit Opportunity Act
- E. Fair Debt Collection Practices Act

CHAPTER 6

Major Life Purchases: Home and Car



Objectives

After reading this chapter you will understand the following:

1. When should you rent or buy a home?
2. The true cost of home ownership?
3. How to compute loan amortization?
4. The difference between buying and renting a car?

6.1 Buying Versus Renting a Home

Buying instead of renting a home needs to make sense financially. You can use many amortization calculators or online see how many years it will take before the cost of buying equals the cost of renting. It's called the breakeven horizon, and it varies by area of the country. If you plan to stay in your home past your breakeven horizon, then buying makes financial sense. If you think you'll move earlier, then renting may be the way to go. Buying a house involves raising a down payment and paying a monthly mortgage, which lasts anywhere from 5 to 30 years, depending on the home loan you can afford and are offered. There are other costs as well, but let's focus on the big money. The major cost when deciding to buy a home is the down payment and monthly mortgage cost. The **down payment** is the lump sum you'll pay upfront that funds equity in the property and proves to lenders that you've got skin in this homeowner game.

Down payments vary. In the days that led up to the housing collapse in 2008, some lenders dismissed the down payment altogether – and we see how well that ended. Today, 20 percent is preferred and often gets you the best rates, but some loans allow down payments as low as 3 percent. Sometimes parents or friends can offer help with the down payment. If you have a choice, take a gift rather than a loan, not only for obvious reasons, but because lenders will add that debt to other monthly obligations and potential mortgage payments to determine your debt-to-income ratio, which generally can't top 43 percent to qualify for a home loan.

The monthly **mortgage** payment is what you'll pay each month. In most cases, a mortgage includes the loan principal and interest (both amortized over the life of the loan) plus homeowners insurance and property taxes (pro-rated). When credit was tight, getting a mortgage at any rate was reserved for only the most credit-worthy borrowers. Things have loosened, but lenders still want to know that you're a responsible, gainfully employed and credit-worthy candidate.

6.2 True Costs of Home Ownership

Up Front Cost of Home Ownership and Recurring Costs

When you initially begin making a deal for a new home to show the seller you're serious about buying the property, it's customary to accompany your purchase offer with an “**earnest money**” check. Earnest money generally ranges from 1% to 3% of the home's purchase price, depending on local market conditions and the seller's preference. After accepting the offer, the seller deposits the earnest money funds into an escrow account, and the amount is credited against your closing costs. Your down payment is the percentage of the home's purchase price that you pay upfront, typically at closing. You need to specify a down payment amount in your purchase offer, though you can change it prior to closing if the seller agrees. Your down payment amount varies widely based on your credit profile, local market conditions, and the type of mortgage loan you're approved for, but typically ranges from 3.5% (chiefly for FHA loans) to more than 20% of the purchase price.

To ensure that the offer price matches the actual value of the home, lenders require a home **appraisal** prior to approving the loan. Appraisal costs, typically \$300 to \$500, are paid during or before the appraisal. Licensed home inspectors are trained to find potential problems and defects that might not be apparent to an inexperienced buyer doing a

casual walk-through. For this reason, buyers are strongly encouraged to get one, even though private lenders rarely make loan approval conditional on a completed home inspection. The cost is similar to the appraisal and is usually paid at the inspection.

Since property owners pay **property taxes** upfront, usually in six-month increments, you need to compensate the seller for taxes paid on the period between the closing date and the end of the current tax period. This expense varies widely based on your local tax rate and the closing date. You could be responsible for nearly six months of property taxes, or practically none at all. Lenders require proof of **homeowners insurance** prior to closing. You almost always need to pay the first year's premium upfront, either on the date you purchase the policy or at closing. Homeowners insurance costs vary based on the value, style, location, and contents of the home, as well as your credit score, policy deductible, and coverage limits.

0 Appraisal, inspection, taxes, and insurance are just a few of the many line items bundled into your closing. Other closing costs include loan origination charges, credit report fee, flood certification fee, lender's and owner's title insurance, recording taxes, state and local transfer taxes, first month's mortgage interest, and closing fee. As a rule of thumb, you can expect your total closing costs to range from 2% to 4% of the purchase price, with the ratio falling as the purchase price increases.

If your mortgage lender is a private company and your down payment is less than 20% of the purchase price of your home, your monthly escrow payment initially includes a **private mortgage insurance (PMI) premium payment**. PMI protects your lender from financial loss if your home is foreclosed upon and sold at a discount relative to your purchase price. If you have good credit, your lender may assess PMI premiums until your loan-to-value (LTV) ratio – the ratio of your current mortgage balance to your home's total value – reaches 78%. However, lenders generally honor borrowers' PMI cancellation requests once LTV reaches 80%. If you pose a higher credit risk, your lender may require you to carry PMI until your LTV is lower. Monthly PMI payments typically range from \$50 to \$200, depending on your loan's balance and PMI rate.

As a homeowner, you're responsible for paying all utilities and local services on your property: water, gas, electric, garbage and recycling, cable and Internet, and perhaps more. These costs vary widely by location and usage. You're also responsible for all home maintenance and upkeep costs, such as replacing worn-out fixtures and appliances, exterior painting and finishing, interior cleaning, and mechanical maintenance (such as HVAC cleaning and inspection). As a general rule of thumb, you can expect to pay 1% of your home's value per year on maintenance and wear-related replacements and repairs.

mortgage

payment is what you'll pay each month. In most cases, a mortgage includes the loan principal and interest (both amortized over the life of the loan) plus homeowners insurance and property taxes (pro-rated)

down payment

The down payment is the lump sum you'll pay upfront that funds equity in the property and proves to lenders that you've got skin in this homeowner game.

earnest money

Earnest money generally ranges from 1% to 3% of the home's purchase price, depending on local market conditions and the seller's preference. After accepting the offer, the seller deposits the earnest money funds into an escrow account, and the amount is credited against your closing costs

Special Costs of Homeownership

Homeownership also comes with somewhat less-predictable costs that occur only once or at irregular intervals. If you're a first-time homebuyer, your new home is probably larger than your previous space. That means you need to buy furniture and fixtures, even if you owned some or all of the furnishings in your rental. If you're a repeat buyer, furnishing isn't quite so costly. Regardless, your furnishing expenses are likely to vary in accordance with your budget. Purchasing secondhand furniture and fixtures is a great way to reduce this expense. Whether you hire a team of movers or rent a truck and take a do it yourself (DIY) approach, moving can range in cost from around \$100 or \$200 to more than \$1,000, depending on how much you have to move and what you can accomplish on your own. You're responsible for paying to repair any damage that isn't covered by insurance. For instance, if your basement sustains water damage due to exterior flooding and you don't carry a flood insurance policy, any mold remediation costs are yours to pay out-of-pocket. Even less costly repairs and replacements can add up. For instance, a child or pet denting a wall, knocking over and breaking a lamp, or soiling a carpet beyond repair can get expensive.

Types of Home Loans

Fixed Rate Mortgages - A mortgage in which the interest rate remains the same throughout the entire life of the loan is a fixed rate mortgage. These loans are the most popular ones, representing over 75% of all home loans. They usually come in terms of 30, 15, or 10 years, with the 30-year option being the most popular. While the 30-year option is the most popular, a 15-year builds equity much faster. The biggest advantage of having a fixed rate is that the homeowner knows exactly when the interest and principal payments will be for the length of the loan. This allows the homeowner to budget easier because they know that the interest rate will never change for the duration of the loan.

One Year ARMs - A mortgage loan in which the interest rate changes based on a specific schedule after a "fixed period" at the beginning of the loan, is called an adjustable rate mortgage or ARM. This type of loan is considered to be riskier because the payment can change significantly. In exchange for the risk associated with an ARM, the homeowner is rewarded with an interest rate lower than that of a 30 year fixed rate. When the homeowner acquires a one year adjustable rate mortgage, what they have is a 30 year loan in which the rates change every year on the anniversary of the loan.

Balloon Mortgages - Balloon mortgages last for a much shorter term and work a lot like a fixed-rate mortgage. The monthly payments are lower because of a large balloon payment at the end of the loan. The reason why the payments are lower is because it is primarily interest that is being paid monthly. Balloon mortgages are great for responsible borrowers with the intentions of selling the home before the due date of the balloon payment. However, homeowners can run into big trouble if they cannot afford the balloon payment, especially if they are required to refinance the balloon payment through the lender of the original loan.

VA Home Loan - A mortgage loan program established by the United States Department of Veterans Affairs to help veterans and their families obtain home financing. The Department of Veterans Affairs does not directly originate VA loans; instead, they establish the rules for those who may qualify, dictate the terms of the mortgages offered and insure VA loans against default. VA loans offer up to 100% financing on the value of a home. To qualify for a VA loan, borrowers must present a certificate of eligibility, which establishes their record of military service, to the lender. VA loans, FHA loans and other loans insured

by departments of the United States government are securitized by the Government National Mortgage Association (Ginnie Mae). These securities carry the guarantee against default of the United States government

fixed rate mortgage

a mortgage in which the interest rate remains the same throughout the entire life of the loan

amortization

is the systematic process of paying the principal along with interest as stated in a contract. In real estate the most common type of loan is an amortized loan. An amortize loan involves a series of equal payments that are made up of the principal and interest.

6.3 Amortization

The time value of money calculations has many applications. When it comes to purchasing a home there are many applications of the time value of money procedure that can be utilized. **Amortization**¹ is the systematic process of paying the principal along with interest as stated in a contract. In real estate the most common type of loan is an amortized loan. An amortize loan involves a series of equal payments that are made up of the principal and interest. As the loan term progresses more of the payment is applied to the principal amount. The schedule of loan payments are easily shown on an amortization schedule (Table 5.11), computer program or financial calculator. The terms of the loan depicted on the loan amortization schedule in Table 5.11 is \$15,000.00 borrowed for a 1 year term with monthly payments at a 5 percent interest rate. You notice that the payment is equal through the term of the loan. You also notice that the amount applied to the principle increased each month.

Table 6.11 Amortization Schedule

<u>Time Period</u>	<u>PMT</u>	<u>Principal Paid</u>	<u>Interest Paid</u>	<u>Total Interest Paid</u>	<u>Remaining Balance</u>
Jan-14	\$1,284.11	\$1,221.61	\$62.50	\$62.50	\$13,778.39
Feb-14	\$1,284.11	\$1,226.70	\$57.41	\$119.91	\$12,551.69
Mar-14	\$1,284.11	\$1,231.81	\$52.30	\$172.21	\$11,319.87
Apr-14	\$1,284.11	\$1,236.95	\$47.17	\$219.37	\$10,082.93
May-14	\$1,284.11	\$1,242.10	\$42.01	\$261.39	\$8,840.83
Jun-14	\$1,284.11	\$1,247.28	\$36.84	\$298.22	\$7,593.55
Jul-14	\$1,284.11	\$1,252.47	\$31.64	\$329.86	\$6,341.08
Aug-14	\$1,284.11	\$1,257.69	\$26.42	\$356.28	\$5,083.39
Sep-14	\$1,284.11	\$1,262.93	\$21.18	\$377.47	\$3,820.46
Oct-14	\$1,284.11	\$1,268.19	\$15.92	\$393.38	\$2,552.26
Nov-14	\$1,284.11	\$1,273.48	\$10.63	\$404.02	\$1,278.78
Dec-14	\$1,284.11	\$1,278.78	\$5.33	\$409.35	\$0.00

1 **amortization** the systematic process of paying the principal along with interest as stated in a contract

With a financial calculator, there is a multi-step process that can be utilized to find the balance, principal and interest payments as any point in time during the amortization process. To demonstrate the methods used consider the following problem. Avis borrows \$180,000 from a bank at 5% interest for a 30 year terms. Using a Texas Instruments BAI Plus we can find out how much total interest Avis pay in the first 6 years of the loan.

Table 5.12 Loan Amortization: Calculation Method

<u>Example 29 Sol. Step 1</u>		<u>Example 29 Step 2</u>		<u>Example 29 Step 3</u>	
Value	Function	Value	Function	Value	Function
180,000	PV	None	2 ND	161,883.56	Bal
30 x 12 = 360	N	None	PV/Amort	18,116.44	PRN
5/12= 0.41667	I	1	P1	51,455.64	INT
966.28	CPT PMT	72	P2		

Example 29 utilizes the TI BAI Plus Calculator Buttons, presented in table 5.12.

- Step 1:** Find the payment amount and keep this amount on the calculator display.
- Step 2:** Press the [2nd] key and [PV] key to enter the Amortization function. Under P1 enter 1 to demote month 1 or the term. Use the down arrow key to enter 72 under P2, denoting the 72nd month.
- Step 3:** Use the down arrow to display the remaining balance, the total principal and total interest paid from month 1 through month 72.

6.4 Purchasing a Car

These eight steps could save you thousands of dollars on a new car. They'll also make the process quicker and stress-free.

Step 1: Research Vehicles and Pick the Features You Want

Not sure what car you want yet? Once you have a short list, it's time to figure out how you'll pay for the car.

Step 2: Get Pre-Approved for a Car Loan

A pre-approved car loan starts you on the right foot. You get an idea of how much you can afford and you'll have an interest rate that you can then compare to the dealership's financing, which might actually have the lowest annual percentage rate. Look for a loan application on the mobile web pages of your bank, credit union or a third-party lender. It's a good idea to do your own research on which lender works best for you. To begin the loan-approval process, have at hand your employer and salary information and balances of other debt you may have. Make sure you will be ready to shop within about two weeks of seeking pre-approval. This will reduce the number of "hard" inquiries to your credit history.

Step 3: Plan your Trade-In Strategy

You can skip this step if you don't have a trade in. If you do, keep reading.

It's important to get your trade-in value before you go to the dealership. This will help set your expectations for what the car is worth and gives you a reference point for any offers you'll receive. Those devices make it easier to sit in the car and double check whether you have options that can affect the car's value — things like heated seats or a sunroof. Be honest about the condition of your car. Most cars fall into the "clean" or "fair" category. Very few cars are "outstanding," no matter how much their owners babied them.

When you're done appraising, you'll see three figures. The trade-in value is what the dealer may offer you — that's a figure to keep in mind when you're at the dealership. The private-party value is what you might expect to get if you sell the car yourself. Dealer retail is a little different: It is what you might expect to pay for the car if you were to buy it at a dealership.

There's an alternative to trading in a car or selling it yourself: Have used-car retailer CarMax appraise the car and make you an offer. The offer is good for seven days, at which point you can ask the dealership to beat that price or you can sell your car to CarMax.

Step 4: Locate and Test-Drive the Car

By now, you've settled on a few car candidates. You should see them in person before making a decision. Hundreds of dealerships throughout the country list their car inventories online, and in many cases, you can sort by color, trim level and features. This is a better way to shop than configuring a car at the automaker's website and hoping you will find one with that set of options in the real world. If you find a vehicle online, call the dealership's internet sales department to request more information. In either case, keep these do's and don'ts in mind:

- Do verify that the car you want is still in stock. It might have been sold recently, and online inventories can take a while to catch up.
- Do ask the salesperson if there are any dealer-installed options. Many new vehicles are sold with add-ons such as nitrogen in the tires, all-weather floor mats or theft protection packages. These can easily add a thousand dollars to the sale price.
- Don't just show up at the dealer on a busy weekend or late at night. Waits may be long and you may not get the salesperson's full attention.
- Do schedule an appointment for a test-drive. Early in the week and in the morning are good times. Having an appointment means the car will be waiting for you when you arrive.
- Don't just drive around the block. Take the time to see how you and your family fit in the car and see how it handles on a variety of roads.
- Do ask yourself the following questions: Are the controls easy to use? Is there enough cargo space? Will a child seat fit? (Bring it with you and test it.)
- Don't feel obligated to buy the car the same day. Feel free to take a night to think it over.

Step 5: Get a Sale Price and Ask About Extended Warranties

Once you have a target car, it's time to focus on getting a price. We recommend using one of these two ways to get a price quote on a car:

- 1: Call, text or email the internet sales department of three dealerships that have the car you want. Ask each for the total selling price, including any additional accessories that may have already been installed on the car. The best price will be obvious. You also can take that quote and ask the other dealerships to beat it. If you plan on leasing, this is the way to go.
- 2: Make sure you ask the salesperson to email or text you a breakdown of the "out-the-door price," with all the taxes and fees factored in. That lets you see the total amount you'll be spending.

You also should ask for a preview of products the dealership plans to offer you after you buy a car — things like paint protection, an extended warranty and possibly a pre-paid maintenance plan. Usually, you won't hear about these until much later in the shopping process, but we suggest you get some information now to relieve pressure later.

Here's how you do it: Call the dealership finance manager and ask about these products and services. They may be of value to you, but just know that the price is often negotiable and you don't have to buy them when you buy the car, unless you intended to fold their price into the purchase contract.

Step 6: Review the Deal and Check for Dealer Financing

Now that you have a price quote for the car, your big question is probably whether it's competitive. It's important to keep in mind that an average price paid is exactly that. Some people have paid more and others paid less. Some shoppers are only happy if they grind their way to a rock-bottom price. But for most shoppers, that usually isn't worth the hassle and frustration. If your price quote is above the average, it's not necessarily reason to walk away from a deal.

Here's why:

A car's price isn't the only factor that determines a good car deal. You also should look at the interest rate, the loan term and the value of your trade-in, if that's part of your deal. There are even some intangibles, such as how the salesperson and the dealership treat you, and the time you save in the shopping process. Those are all factors in a good deal. In fact, at this point in the process, you may be able to improve parts of it.

In Step Two, you got pre-approved for financing. Now that you're close to purchase, there's a chance that you can get a better interest rate at the dealership.

To see if that's possible, let the dealership run a credit report and assess your interest rate. Or, if you know your credit score, tell the finance manager what it is and the rate for which you'd qualify. You can give your information to the finance manager over the phone. Some dealerships have credit applications on their websites and you can fill one out. If the interest rate is lower than the one in your pre-approved loan, go for it. If not, you already have a good loan locked in.

Step 7: Close the Deal

If the price, financing and fees look right, it's time to say yes to the deal. From here, you can proceed in one of two ways: buy at the dealership or have the car and paperwork delivered to your home. Most people tend to wrap up the sale at the dealership. Once you've agreed on a price, the salesperson will take you to the finance and insurance office. Here, you'll sign the contract and purchase any of the additional products we discussed earlier, such as an extended warranty. The alternative is to make the sale contingent on having your new car delivered to your home or office. This is a great time saver and allows you to close the deal in a relaxed environment. Regardless of where you finalize the deal, review the contract carefully and make sure the numbers match the out-the-door breakdown. Be sure there are no additional charges or fees. A good finance manager will explain each form and what it means. Don't hurry. Buying a car is a serious commitment. And remember: There is no cooling-off period. Once you sign the contract, the car is yours.

Step 8: Take Delivery

Whether you take delivery of your car at the dealership or at your home, it should be clean. The gas tank should be full. Give the car a final walk around, checking for any dents or scratches that might have occurred during transport. Finally, let the salesperson give you a tour of your new car. This includes showing you how to pair your smartphone via Bluetooth and demonstrating other important features and safety devices. All this is in the owner's manual, but let's face it, very few people ever read that book, which can be hundreds of pages long. If you don't have time for a complete demonstration when you sign the contract, set up an appointment a week or so later. With the amount of technology that comes in most new cars, that walkthrough is important and very useful. You'll learn tricks and shortcuts you might not find on your own.

6.5 Renting an Car

When it comes to documentation, each car rental agency has a policy that may differ from other companies. Before booking your car rental, call or email the rental agency and request a list of required documents in writing. Many car rental agencies charge hidden fees for secondary drivers, out-of-state trips, mileage overages, or a myriad of other state or government surcharges. Check the bottom line before you sign. There are a few required documents that must be presented when renting a car. These documents include, a valid driver's license, an active credit card and car insurance.

Driver's License: A state-issued driver's license is required to rent a car in the United States. Not only does a license ensure that you are a legal driver, but it doubles as proof of age. It is commonly assumed that you have to be at least 25 years old to rent a car, but this is not the case. In the U.S., the minimum car rental age is 21. Drivers aged 21 to 24 will incur a rental agency fee. Some car rental agencies will require a driver's license from the same state as the rental location.

Active Credit Card: Even if you have a car reservation and driver's license in hand, you may be turned away for not having an active credit card that matches the name on your driver's license. Most car rental agencies will not accept debit cards, even with a credit card logo such as Visa, American Express or Mastercard. Active credit cards in the driver's name are essential because the agency puts the card on hold for insurance purposes. If your secondary driver has a credit card that matches his driver's license, consider adding him as the primary driver to solve this problem.

Car Insurance: Car rental companies will offer you auto insurance, which is optional, but strongly encouraged if your personal auto or homeowner's insurance policy does not cover rental cars. If you are renting a car for business purposes, check with your employer before buying the optional coverage. If you opt out of insurance and you are not covered on your personal or employer's policy, you will be financially responsible for any damage to the rental car.

Chapter 6 Summary

Buying instead of renting a home needs to make sense financially. You can use many amortization calculators or online see how many years it will take before the cost of buying equals the cost of renting. Homeownership also comes with somewhat less-predictable costs that occur only once or at irregular intervals. If you're a first-time homebuyer, your new home is probably larger than your previous space. That means you need to buy furniture and fixtures, even if you owned some or all of the furnishings in your rental. If you're a repeat buyer, furnishing isn't quite so costly. Regardless, your furnishing expenses are likely to vary in accordance with your budget. The time value of money calculations has many applications. When it comes to purchasing a home there are many applications of the time value of money procedure that can be utilized. Amortization is the systematic process of paying the principal along with interest as stated in a contract. In real estate the most common type of loan is an amortized loan. When it comes to documentation required to rent a car, each car rental agency has a policy that may differ from other companies. Before booking your car rental, call or email the rental agency and request a list of required documents in writing.

Chapter 6 Key Words

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fixed rate mortgage	71
mortgage	69

Chapter 6 Problems

Q6.1.

A cost associated with home buying would be:

- A. renter's insurance.
- B. the security deposit.
- C. annual appreciation of the property.
- D. property taxes.
- E. interest lost on the security deposit.

Q6.2.

Renting would be most appropriate for people who:

- A. want to reduce their taxes.
- B. have difficulty establishing credit.
- C. have limited funds currently available.
- D. enjoy remodeling their residence.
- E. desire the financial benefits of increased equity.

Q6.3.

Brenda Williams plans to rent instead of buy her housing. What advantage of renting will Brenda encounter?

- A. tax advantages
- B. lower initial costs
- C. community pride
- D. financial benefits
- E. home improvement flexibility

Q6.4.

A conventional mortgage usually involves:

- A. a variable interest rate.
- B. a government guarantee.
- C. a balloon payment.
- D. equal payments.
- E. a payment cap.

Q6.5.

Which of the following is an example of a conventional mortgage?

- A. an FHA mortgage
- B. a buy down
- C. a fixed rate mortgage
- D. a shared appreciation mortgage
- E. a home equity loan

Q6.6.

A VA-guaranteed loan program provides assistance to:

- A. military veterans.
- B. recent college graduates.
- C. low-income homebuyers.
- D. government employees.
- E. the elderly.

Q6.7.

A short-term mortgage with a very large final payment is called a _____ mortgage.

- A. balloon
- B. graduated payment
- C. growing equity
- D. shared appreciation
- E. negative amortization

Q6.8.

Which of the following expenses is paid from an escrow account?

- A. title insurance
- B. property insurance
- C. points
- D. loan application fee
- E. real estate agent's commission

Q6.9.

The purpose of an appraisal is to:

- A. estimate the current value of a home.
- B. reduce the amount paid for property taxes.
- C. qualify for a reduced mortgage rate.
- D. eliminate the need for home insurance.

Q6.10.

The appraised value of your home is:

- A. The value of your home used to calculate property taxes
- B. The estimated current value of your home in the market
- C. The price you pay for your home
- D. The amount of money the buyer pays when they make an offer on a home
- E. The amount of a down payment

Q6.11.

Earnest money is:

- A. The value of your home used to calculate property taxes
- B. The estimated current value of your home in the market
- C. The price you pay for your home
- D. The amount of money the buyer deposits when they make an offer on a home
- E. The cost of home insurance

Q6.12.

What is the disadvantage to buying a home?

- A. The value of your house may increase
- B. Eventually you will be able to live payment-free
- C. The value of your house may decrease
- D. You will gain equity by paying down your mortgage

Q6.13.

One disadvantage to renting is _____.

- A. You are able to move easily
- B. Its low initial cost
- C. You gain equity as you pay
- D. You do not gain any equity in the rented property

Q6.14.

What mortgage type has an interest rate adjusted every year, so that monthly payments are subject to change every year for the entire 30-year loan term?

- A. 5 year balloon mortgage
- B. 1 year adjustable-rate mortgage
- C. 7 year balloon mortgage
- D. 1 in 30 adjustable-rate mortgage

Q6.15.

What is a mortgage?

- A. The legal document used to allow a lender to use real property as collateral
- B. The difference between what is owned vs. what is owed
- C. The transfer of a lease agreement to a new tenant
- D. All of the choices are incorrect

