

LESSON 10

CONSUMER CREDIT: BUY NOW, PAY LATER, AND MORE

INTRODUCTION

The word credit comes from the Latin word *creditus* meaning *entrusted*. Credit means that someone will lend you money and give you time to pay it back, usually with interest. Credit allows you to buy now and pay later.

The introduction of credit cards in the economy has influenced the way consumers purchase goods and services. In 1993, Americans charged more than \$350 billion on their credit cards and paid \$36 billion in interest charges.¹ Despite the widespread use of credit cards, many consumers do not fully understand the terms, interest rates, and charges on their credit cards.

Each year the number of Americans who use credit cards increases. According to a survey by MasterCard International, 32 percent of high school students and 62 percent of college students had at least one credit card in 1993. The use of a credit card is a loan from the issuer of the card and not used in place of cash. If the amount owed on a credit card is paid in full each month, there is no additional cost for using the credit card. However, if the borrower is unable or unwilling to pay the credit card bill in full, there is an interest or finance charge on the unpaid balance. The effect of the finance charge is the increased cost of goods and services purchased with a charge card.

CONCEPTS

Credit
Consumer credit
Decision making
Opportunity cost
Interest

¹ *Financial Responsibility*, American Express, 1994

(Data compiled from *Nilson Report 563*, January 1994, 6-7, and *Lehman Global Economics*, 1993)

CONTENT STANDARD

Few choices are all-or-nothing propositions; they usually involve trade-offs, that is, getting a little more of one option in exchange for a little less of something else.

OBJECTIVES

- ◆ Determine the costs and benefits of using credit cards.
- ◆ Discuss and analyze the decision-making process when using credit cards.
- ◆ Identify ways and criteria to establish and obtain credit.

LESSON DESCRIPTION

Through group activity, students analyze the costs and benefits of using credit cards to purchase goods and services.

TIME REQUIRED

3 class periods.

MATERIALS

- ★ Copies of Activities 1, 2, 3, 4, and 5
- Transparencies of Visuals 1, 2, 3, and 4

PROCEDURE

1. Divide students into cooperative learning groups. Explain that the purpose of the lesson is to learn the costs and benefits of using credit cards. Display Visual 1 and distribute Activity 1, Credit Card Fact Sheet.
2. Ask each group to share new information learned from the reading. List and discuss responses on the board. Ask students, "Why are more people using credit cards and paying monthly finance charges when that increases the price of the goods and services they buy?" Write student hypotheses on chart paper for future reference. (These hypotheses could include convenience, emergency, immediate benefit, defer cost of goods.)
3. Explain: (1) opportunity cost of purchasing goods and services with credit cards. (The opportunity cost is the value of whatever is given up

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when you purchase an item with a credit card; the use of future income; and whatever else could have been bought with the interest payment.); (2) the collective cost of using credit. (If you continue to purchase goods or services with a credit card without paying the unpaid balance each month, the finance charge is computed on the total unpaid balance. This can increase the cost of the items purchased.); and (3) the use of credit cards for purchasing consumable and durable goods. (Generally, using credit cards to purchase living expenses such as clothing, groceries, gasoline and restaurant meals is not wise if you don't pay off your bill at the end of the month because you will pay more and you may use up the purchase before you repay the loan. However, if you pay off your bill at the end of each month, there is no additional cost for the consumable item. And you can use installment loans to finance large purchases such as automobiles or appliances because the interest rate is generally lower than rates for credit cards.)

4. Ask students, "Why don't people analyze all the cost(s) of using credit before their purchase?" Discuss and list student responses on the board.

5. Distribute Activity 2, Situations, and Activity 3, Planning Your Credit Purchase. Each group will have a situation to analyze. For each situation, the person named has a credit card and pays the minimum required at the end of the month. The credit card has an APR of 18% or 1.5% per month on the unpaid balance. Upon completion of Activity 3 planning matrix, each group will share its purchase decision with the class. To help students complete Activity 3, do one scenario with the class.

6. Display Visual 2, Benefits of Credit Cards, and Visual 3 Costs of Credit Cards. Discuss and give an example of each item on the lists. Summarize the benefits and costs of using credit cards.

7. Tell students the second part of this lesson is on how to obtain credit. Display Visual 3, The 3Cs of Credit. Discuss and explain the 3Cs, the criteria lenders use when issuing credit. These are *capacity*, your ability to pay back a loan; *col-*

lateral, your assets used as a guide to figure out your ability to repay the debt; and *character*, your reputation as a reliable and trustworthy person.

8. Ask, "Why are the 3Cs important?" (They help determine whether the borrower has the ability and willingness to repay the loan.) "How can you best show your ability to satisfy the requirements of the 3Cs?" (*Capacity*, employment, wages earned, monthly payments; *collateral*, assets such as a house, car, or other valuable items that could be sold to repay the debt; *character*, how you repaid other loans, stability, how long you have lived at our present address, rent or own your home).

9. Have groups discuss and list features of various credit cards to compare when shopping for the "best" credit card. (List may include: interest rate, grace period, annual fee or membership fee, credit limit, cash advance, acceptance by merchants, frequent flyer miles, discounts, or gifts).

CLOSURE

To conclude the lesson ask, "Why are more people using credit cards and paying monthly finance charges when the charges increase the effective price of the goods and services? What are the costs and benefits of purchasing goods and services with a credit card?" Refer to the student hypotheses at the beginning of the lesson.

Using A Credit Card

Benefits	Costs
Earlier consumption, use of goods while paying for them	Costs more if unpaid balance is not paid monthly
Convenience	Ties up future income
Use for emergencies	Tempts one to overspend
Establishment of credit history	Reduces comparison shopping if you shop only in stores extending you credit
Identification	Decreases future buying power

OPTIONAL ACTIVITY

1. Distribute Activity 4, Credit Card Usage Survey, for an outside class activity. Each group will survey 5 people representing various age groups to assess cardholder's knowledge of the cost(s) of using credit. The analysis of the survey is to be completed the next class period.

2. Each group will summarize the results of their survey. Discuss the findings. (The findings should reveal credit card use is high; however, most people are unfamiliar with the terms and costs of using their credit cards. Studies have shown that many people who don't pay off their bills every month will say that they do.)

Note: If your school is located in a low socioeconomic area or has a large immigrant population, it may be difficult to find high usage of credit cards due to income or cultural values. Then discuss, why is credit card usage low?

3. Ask, "Why do so many people continue to use credit cards when they do not know the financial and opportunity cost(s) of using them? What are the benefits of using a credit card? What are the costs of using a credit card?" List student responses on the board.

ACTIVITY 1

CREDIT CARD FACT SHEET

Name _____

The word credit originates from the Latin word *creditus* meaning *entrusted*. Credit means that someone will lend you money and give you time to pay it back, usually with *interest* (money paid for the use or borrowing of money). When purchasing goods and services with your credit card, you are getting a loan from the issuer of the credit card. It is not used in place of cash. Consumers use credit cards to buy things they want or need.

A credit card is a plastic card identifying the holder as a participant in a credit plan of a lender. Many stores and companies such as oil companies issue credit cards for use only at their place of business. Banks and other financial institutions issue credit cards, such as Visa or MasterCard, that can be used at any establishment that accepts credit cards.

Cardholders can purchase services, merchandise, or obtain cash advances (loans). Most credit cards are used as open-ended credit accounts or charge accounts, originally designed for the short-run money needs of consumers. These accounts have a credit limit (*the maximum amount you may charge*) and a flexible repayment schedule. The cardholder who pays the entire balance due within the grace period (*a period of time after the due date not subject to late charges*) avoids interest or finance charges. A *late charge* is a payment for not paying the balance owed before the due date. If a card offers a grace period, federal law requires a bill be sent to the cardholder at least 14 days before payment is due. A cardholder can repay any amount equal to or greater than the purchase price to eliminate interest charges.

A wise consumer will pay off credit card bills promptly. If you don't pay it off, you are taking out a loan and it can be very expensive. Would I take out a loan for dinner tonight? Avoid the minimum payment trap. People who pay the mini-

um think they are handling their finances, but it could take them a long time to pay off the bill. Many cardholders maintain balances and the average customer takes more than 15 months to pay for the charges.¹ When a credit card is used responsibly, the cardholder can build a good credit history. If not, it can ruin a person's credit record. A bad credit record is hard to fix and takes many years to correct.

Sixty (60%) percent of all families make credit card purchases. Worldwide, more than 90 million MasterCard, 41 million Discover, and 142 million Visa cards are issued.² Credit cards are issued by local and national businesses as well as banks. With the passage of the Fair Credit and Charge Card Disclosure Act in 1988, credit card issuers must inform consumers before they sign up about: (1) annual percentage rate (APR), (2) how monthly fees are calculated, (3) cost of all fees such as membership, transaction, cash advance and others, and (4) grace period.

Not all plastic cards are credit cards. The use of bank debit cards and smart cards is increasing. The debit card automatically deducts money from checking accounts. The smart card stores valuable information about the consumer on computer chips instead of magnetic strips. This allows businesses access to better information about the consumer so that they can provide personalized service. Some consumers are concerned about privacy issues associated with smart cards and credit cards knowing so much about them.

Credit cards help consumers satisfy their wants and needs, but how does the credit card affect the issuers of cards and businesses that accept purchases made by credit cards? Purchases made by credit cards issued by banks charge merchants a transaction fee. This fee is a percentage of the price of any good or service purchased with a

¹ E. Thomas Garman. (1993). *Consumer Economic Issues in America*. Houston: DAME Publications.

² Ibid.

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ACTIVITY 1 (CONTINUED)

Name _____

credit card. Credit card issuers charge interest on the unpaid balances not paid during the grace period and they may collect an annual fee from cardholders. American Express and other companies issue gold or platinum status credit cards. These cards may have higher annual fees, but include extras such as travel insurance and other benefits.

The prime target for credit companies is the “baby boom” generation. Families headed by younger persons use consumer credit more than families headed by older persons. Higher income groups use credit more than lower income groups. Some companies target a younger market and issue cards to college students. According to a survey by MasterCard International, 32 percent of high school students and 62 percent of college students had at least one credit card in 1993.

ACTIVITY 2
SITUATIONS

Name _____

Directions: For each situation listed below, complete questions on Activity 3, Planning Your Credit Purchase, to help determine the costs and/or benefits of a credit card purchase. In each situation, the person named has a credit card with an APR of 18% or 1.5% per month on the unpaid balance. Each person named also is expected to pay all credit card balances and fees

Situation 1

Jennifer is a senior in high school. Her parents gave her a credit card and told her that she may use the card only in case of an emergency. As she was walking across the Mall, she saw the perfect dress for the senior prom in a store window display. The prom is two weeks away. The tag on the dress was \$125.00. Also on the window was a sign: **One day only, all items 25% off ticket price.** Jennifer's grandmother, a dressmaker, told her if she needed a special outfit, she would be willing to sew it for her. What should Jennifer do?

Situation 2

Tony spends much of each day in his car commuting from home to school and work. His parents gave him a credit card to be used only for emergencies. Recently, the radio in his car went on the blink. He enjoys listening to music on his long drives. He went to the repair shop and was told it would cost \$75.00 to diagnose the problem. To fix the problem, he would have to pay additional costs for labor and parts. The repair person told Tony that his shop had a special sale on a portable CD player for \$150.00. What should Tony do?

Situation 3

Sarah is a college student who had volunteered to drive three members of her debate team to the state debate championship in a city 75 miles away. As they were approaching a small town half way to their destination, they stopped at a fast-food restaurant to get something to eat. When they got back into the car, the car would not start. The girls got out and pushed the car to the gas station next door. Sarah was told her battery was dead and a new one would cost \$80. If the girls pooled all their money, they would have just enough money to purchase the battery. Sarah could have the car jump-started and hope that the battery will recharge itself during the rest of the trip. The service station attendant will accept her credit card. Sarah is responsible for paying all her auto repair bills. What should Sarah do?

Situation 4

Jason is an honors pre-med student at the state university. He is on a very limited budget. Each semester, he charges his tuition and fees. He pays for his books with money in his savings account, which has only \$30 left. One of his professors strongly recommended that he purchase books on an optional reading list that cost \$250 to better prepare him for medical school entrance exams. A high score on the entrance exam may help Jason get a scholarship to attend medical school. What should Jason do?

ACTIVITY 3
PLANNING YOUR CREDIT PURCHASE

Name _____

What decision are you trying to make?	
What goals do you hope to accomplish in making your decision?	
What are the alternatives?	
List the <i>benefits</i> of the purchase with a credit card.	
List the <i>costs</i> of the purchase with a credit card:	
Make a decision <ul style="list-style-type: none">• Which alternative best matches your goal?• What do you gain with each alternative?• What do you give up with each alternative?	

ACTIVITY 3
PLANNING YOUR CREDIT PURCHASE

Name _____

Situation 1

What decision are you trying to make?	<i>Determine the costs and benefits of purchasing a prom dress with a credit card.</i>
What goals do you hope to accomplish in making your decision?	<i>Have a dress for the prom.</i>
What are the alternatives?	<i>Don't buy the dress, look for another dress, ask Grandma to sew a dress.</i>
List the <i>benefits</i> of the purchase with a credit card.	<i>Take advantage of the sale price of the dress, don't have to spend time to look for another dress.</i>
List the <i>costs</i> of the purchase with a credit card:	<i>Cost of the dress plus the finance charge, Grandma's feelings may be hurt.</i>
Make a decision <ul style="list-style-type: none"> • Which alternative best matches your goal? • What do you gain with each alternative? • What do you give up with each alternative? 	

ACTIVITY 4
CREDIT CARD USAGE SURVEY

Name _____

QUESTION	ANSWER
1. a. Do you have a credit card? b. Do you have more than five credit cards?	
2. a. Do you use your credit card once a week? b. Do you use your credit card more than once a week?	
3. a. Do you use your credit card for convenience? b. Do you use your credit card in emergencies? c. Do you use your credit card for identification? d. Do you use your credit card to consolidate debts? e. Do you use your credit card so you can use something before paying for an item? f. Do you use your credit card to establish a credit history?	
4. a. Do you purchase gas with a credit card? b. Do you purchase consumable goods with your credit card? c. Do you purchase durable goods with your credit card?	
5. a. Do you pay off your bill monthly? b. Do you pay the minimum each month? c. Do you pay a set amount each month?	
6. Estimate your monthly cost of using your credit cards.	
7. What is the annual percentage rate of your most used credit card?	
8. What is the annual membership fee of your most used credit card?	
9. What is the late charge on your most used credit card?	
10. What is your monthly credit card costs.	
11. What special benefits does your most used credit card provide?	
12. What is your opportunity cost of using credit cards?	

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ACTIVITY 5

Name _____

Name of Institution	APR	Grace Period	Late Fees	Annual or Membership Fee	Cash Advance	Special Benefits

VISUAL 1

- Americans charged more than \$350 billion on their bank credit cards in 1993.
- Americans paid \$36 billion in credit card interest in 1993.
- The average credit cardholder has more than nine credit and charge cards.
- The typical cardholder who paid finance charges in 1993 spent nearly \$460 in interest.

Source: *Financial Responsibility*, American Express, 1994.

VISUAL 2

BENEFITS OF CREDIT CARDS

- Earlier consumption; use of goods while paying for them
- Convenience
- Use for emergencies
- Establishment of a good credit history
- Consolidation of debts
- Identification

VISUAL 3
COSTS OF CREDIT CARDS

- Costs more if unpaid balance is not paid monthly
- Ties up future income
- Tempts one to overspend
- Reduces comparison shopping if you only shop in stores extending credit
- Decreases future buying power

VISUAL 4
THE 3 CS OF CREDIT

Capacity:

Your ability to pay back a loan

Collateral:

Your assets used as a guide to determine your ability to repay the debt

Character:

Your reputation as a reliable and trustworthy person