

## FINANCIAL SERVICES READING

### Introduction

Before anyone thinks about borrowing money, one rule to remember is to “live within your means.” This rule encourages saving rather than borrowing. Setting aside or saving money for new clothes, a class trip, or concert tickets rather than borrowing or using credit cards is a better way to acquire things you may want. These are considered “extras” and are not considered essential to daily living.

**Loans** are often reserved for the necessities or emergencies of living. There are times when going into **debt** may be required. **Debt** implies that you do not have enough money to pay for an item without the need to borrow money for it. Paying for a college education, repaying medical bills, paying for a car required for transportation, are all examples when debt may be necessary. Many financial services exist that offer **personal loans** to individuals. It is important to know about these financial institutions before applying for a loan.

### Banks

**Banks** are the most common of all lending institutions. Some banks may ask that you have a checking or savings account established before considering making a loan to you. As **lenders**, banks want to know that the borrower will pay back the loan in a timely manner. Banks will ask about **credit history**. This refers to when you may have used a **credit card** or had a previous loan and paid back the money owed within the required time.

If the borrower has no credit history, then the bank has several options to ensure that the loan will be repaid. The bank can ask for a **co-signer**. This is someone who does have a positive credit history and will agree to pay back the loan if the borrower fails to do so. Sometimes parents or other adults will act as a co-signer of a loan. In some cases, the borrower may be asked to put up something of value (often a house or a car) as security for a loan. This security is called **collateral**. If the borrower fails to make payments on the loan, the collateral may be sold, and proceeds from the sale may be used to pay down the unpaid debt. Typically, when asking for a car loan, the bank will use the car as collateral. If the borrower cannot make payments, then the car can be **repossessed** or taken back by the bank as repayment of the loan.

Banks can also charge a higher **interest rate**. Interest rates are the amount of money any lender charges on the amount of money borrowed. It is also called the **annual percentage rate** or **APR**. This allows the bank to make a **profit** from the loan. This percentage rate is determined by the **amount of risk** the bank believes it is taking in granting a loan. Often, the greater the risk, the higher the APR the lender charges.

## Mortgage Companies

**Mortgage companies** operate similarly to banks. These companies only offer loans when borrowers want to buy or refinance houses or buildings. Mortgage companies will first review the **credit history** of the borrower and expect a positive credit history. The interest rate will be determined based upon the borrower's positive credit history and other debts. If the borrower has repaid bills and credit cards in a timely manner, then the interest rate may be lower.

A house or building loan requires a large amount of money. Mortgage companies expect that the house or building will act as the **collateral** for the loan. In case the loan cannot be repaid, the house will be repossessed by the company and possibly resold to a new buyer. Mortgage companies repossess houses, but only as a last resort. Sometimes, mortgage companies will offer borrowers lower monthly mortgage payments or suspend payments for a short time if the borrower is experiencing other financial difficulties.

## Pay Day Loan Stores

If an emergency occurs and money is needed immediately, borrowers often turn to **payday loans**. Payday lenders also have certain requirements for borrowers. Loans are given if the borrower has a job and can pay back the loan with their earnings. Payday loans are given for a very short amount of time. Usually, the loan must be paid back within two weeks or by the time of the borrower's next paycheck. States have different **regulations** or rules for payday loan amounts. The typical loan is \$350 to \$1,000.

Payday lenders charge steep fees or high interest rates. According to the Consumer Federation of America, payday loan interest rates can be as high as anywhere from 100% to 400%. Consider a loan of \$350. By the time of the borrower's next paycheck, the loan amount to be repaid may be as high as an additional \$350 to \$1400 in interest rates.

Despite the high cost, roughly 2.5 million Americans take out a payday loan every year. Why? Many borrowers may have been turned down for a loan by another financial institution. Others may lack knowledge about payday loans. Still others may believe that the financial emergency they face is worth the cost.

## Credit Unions

**Credit unions** offer the same services as banks. The difference is that credit unions are owned by their members, and you must be a member to use their services. Members are usually people who share the same employer, labor union, religious affiliation, or geographic location. For example, there are credit unions for educators and any educator can become a member. Potential members can call local credit unions to discover what the requirements of membership might be and if they qualify.

Many credit unions often provide lower fees and interest rates than banks as a service to their members. For large loans, credit unions will still require houses or cars as collateral. A first-time loan will also require a review of the borrower's credit history to guarantee repayment.

### Credit and Debit Cards

**Credit cards** are issued by large banks or finance companies. Credit cards are very easy to use and are simple to obtain. Many people forget that when they use a credit card, they are taking out a loan with that bank or finance company.

Borrowers fill out an application for a credit card. The issuing bank or company will set an interest rate or APR, a **minimum monthly payment**, and the largest amount that can be borrowed on the card.

Minimum monthly payments can be deceiving. This minimum payment may only address interest charged and fees. Credit card companies are required by law to show borrowers the length of time it will take to pay off their debt with only a minimum monthly payment. It may take years to pay off a debt of a few hundred dollars with only a minimum payment.

**Debit cards** are often confused with credit cards. Debit cards are connected directly to your bank account, and, like writing a check, the funds must be deposited in advance in the account. If you use a debit card to purchase something or pay a bill, the money is drawn immediately from your bank account. Debit cards impose some control over spending since you are actually using your own money. Debit cards typically have few or no fees since you are not borrowing money from any institution. One down side to using a debit card instead of a credit card is that using a debit card does not help build your credit rating. Managing a credit card effectively helps build credit.

A **secured credit card** is used less often than either a credit or a debit card. The consumer must provide a security deposit, which becomes their credit limit. Most credit card companies that provide secured cards require a minimum deposit of \$200. The non-refundable annual fee must be paid in advance. Secured cards can incur interest or the credit card company may charge a service fee, and the bill must be paid monthly. Unlike debit cards, secured credit cards help with building or repairing credit.

### Conclusion

In 2020, Americans owed 1 trillion dollars in credit card debt. The ease of using a credit card can lead to overspending. A good rule of thumb is to maintain a **low debt to income** ratio (DTI). This is represented as a percentage. It is important to keep your debt-to-income ratio below 30%. In other words, what you owe in bills, housing, loan payments, or credit card payments should not exceed more than one-third of your earnings.

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