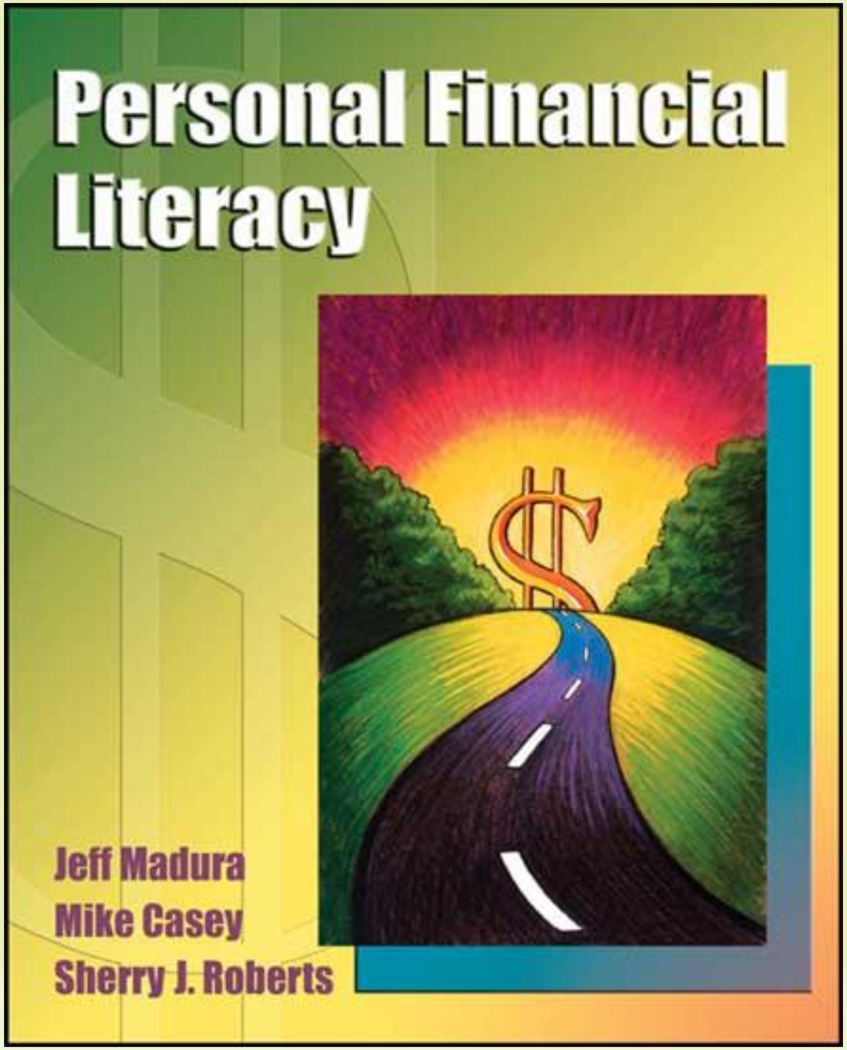
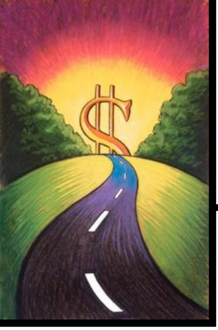
Chapter 10

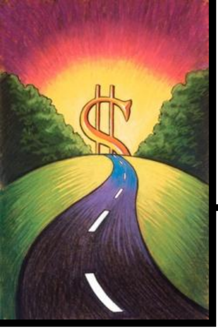
Personal Loans and Purchasing Decisions





Learning Objectives

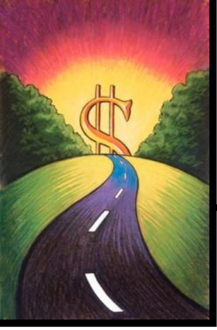
- Describe the key features and qualities of personal loans
- Explain the unique issues and challenges of financing a home
- Explain the unique issues and challenges of financing an education
- Explain the unique issues and challenges of financing a car



Personal Loans

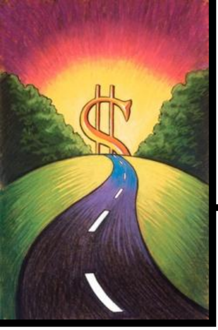
- **Personal loans** are a type of credit that is typically started at the time of purchase for a specific asset (car, boat, etc)
- **Down payment** is the portion of the purchase price that the buyer is required to pay

- People take out personal loans to cover the cost of large purchases
- The loan makes up the difference between the down payment and the total purchase price
- The lender sets up a repayment schedule



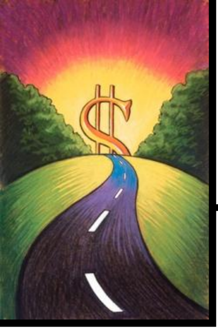
Why Take a Personal Loan?

- The repayment schedule spells out the details (the terms of the loan)
- The terms include:
  - the amount of your payment
  - the interest rate charged
  - the number of months you will need to make payments to repay the entire loan



Why Take a Personal Loan?

- Typical personal loans will have time periods of 24 to 72 months
- A portion of the payment will pay the interest charges
- The rest is applied toward reducing the initial loan amount, which is called the principal



The Personal Loan Process

- Banks, credit unions, and other financial institutions are sources for personal loans
- Major auto companies also make personal loans to people who buy their cars
- The process of taking a personal loan begins with an application
- Take a look at figure 10.1 for an example of a loan application

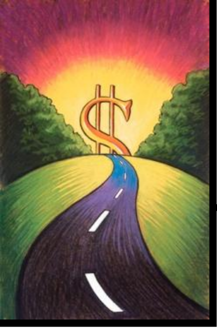


Figure 10.1

Exhibit 10.1 Example of a Loan Application

When you seek a personal loan, you will fill out a detailed form that provides you and the lender with much information.

DCU Digital Federal Credit Union

Loan application Vehicle: ❑ Purchasing ❑ Refinance ❑ RV/Boat ❑ Motorcycle

Loan Amount or monthly payment amount $________ Loan Term________ months

BORROWER

Member #	SS#
Name	Date of Birth
Home Address	
City State Zip	
Home Phone #	Work Phone #
# of Dependents/Ages	
Own / Rent / Board (circle one)	Payment Amount / How Long?
Mortgage/Landlord Name	
Employer Name	Date of Hire
Previous Employer	From / To
Checking Account Institution	

CO-BORROWER/COSIGNER

Member #	SS#
Name	Date of Birth
Home Address	
City	State Zip
Home Phone #	Work Phone #
# of Dependents/Ages	
Employer Name	Date of Hire

M730A (3/2000)

Monthly Gross Income (please attach verification of income). Alimony, child support, or separate maintenance income need not be revealed if you do not wish to have it considered as a basis for repaying this obligation.

	Gross Income	Overtime	Other
Borrower	$	$	$
Co-Borrower	$	$	$

Are you obligated to pay alimony, child support, separate maintenance? If yes, amount $__________per__________

SIGNATURES REQUIRED BELOW

Subject to Digital Federal Credit Union (DCU) Loan Underwriting Guidelines.

BY SIGNING THIS APPLICATION YOU AGREE TO THE FOLLOWING: You agree that we may obtain and use consumer credit reports and exchange credit and employment information in connection with this application and any update, renewal, or extension of credit we may extend to you. You agree, upon approval of this loan, that you will ensure DCU is properly listed as lienholder on the vehicle title as: Digital Federal Credit Union, 141 Parker Street, Maynard, MA 01754. You agree that your account will be subject to the terms and conditions of all applicable Loan Agreements and Disclosure Statements. You agree that a photocopy or facsimile of this application shall be as binding as the original. You understand that we will retain this application whether or not it is approved. Everything you have stated in this application is correct.

Borrower's Signature Date

Co-Borrower's/Cosigner's Signature Date

CREDIT LIFE/DISABILITY INSURANCE

❑ I am interested in obtaining Credit Life and/or Disability Insurance. Please send me more information.

ELECTRONIC PAYMENT METHOD

By selecting one of the two electronic payment methods below, you agree to the following as applicable:

DCU Initiated Automatic Transfer: You authorize us to initiate a transfer of sufficient funds from the DCU account indicated to pay all amounts due monthly. The transfers will be made as indicated below. You agree you are responsible for maintaining a sufficient balance to cover the amount of the payment and that the funds will be available to transfer as of the start of business on the scheduled transfer date. We will only transfer from the available balance in the account you have designated. If there are insufficient funds, the available funds will be transferred but your payment may be considered late.

Member Initiated Loan Payment Via PC Branch or Easy Touch Telephone Teller: You agree to initiate and complete one or more loan payment transactions via either the "Account Transfer" or "Automatic Transfer" PC Branch option or the "Loan Payment Transaction" Easy Touch Telephone Teller option each month on or before the loan payment due date. You understand that you will not receive a coupon book or monthly bill. You accept responsibility and agree that you will have paid no less than the Monthly Payment Due to your loan by 5:00 p.m. on the payment due date each month.

PLEASE SELECT ONE OF THE FOLLOWING:

❑ **DCU Initiated Automatic Transfer**

Frequency:

☐ Weekly (Friday) ☐ Monthly (On the payment due date or business day closest to but not before)

Transfer From:

☐ DCU Primary Savings ☐ DCU Checking

Member #______________, Account #______________

❑ **Member Initiated PC Branch or Easy Touch Telephone Teller**

❑ **Coupon Book(non-Electronic)**

You understand that direct deposit and use of an Electronic Payment Method is voluntary and is not a factor in whether the loan will be granted. However, both are required to obtain the reduced interest rate.

We reserve the right to terminate this payment method and adjust the annual percentage rate if the privilege is abused. Termination will not affect prior transactions nor your responsibility to repay the entire amount.

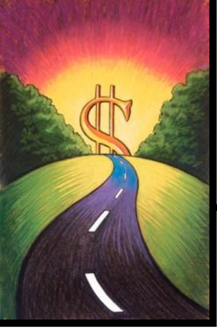
Borrower's Signature Date

Co-Borrower's/Cosigner's Signature Date

Internal Use Only

Member #______________, Loan#______________

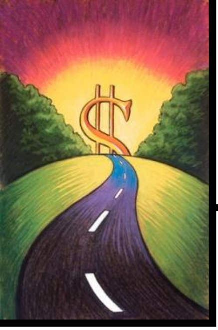
Processed By #__________, Date___/___/___



The Personal Loan Process

- **Cosigner** is someone who agrees to sign the loan document and to repay the loan if the other individual stops making payments

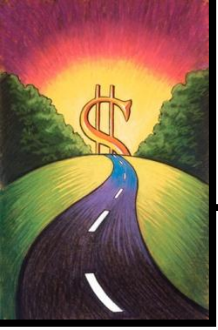
- Loan applications require you to provide information to the lender
- The lender will decide if you will be able to pay back the loan
- The lender will contact the credit bureaus and access your credit score



Loan Contract

- **Maturity date** is the date at which the loan will be completely repaid

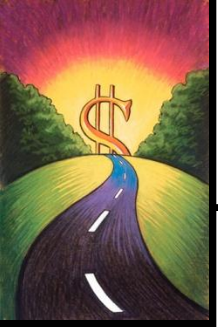
- You may be approved or unapproved after you apply for a loan
- If approved for a loan, you will sign a legal contract agreeing to the terms
- The contract will specify the following:
  - the dollar amount of the loan
  - the interest rate to be charged
  - The loan repayment schedule



Loan Contract

- Interest rate charges on personal loans are reported as the **annual percentage rate (APR)**

- Lenders are required to make sure you understand the interest rate you are being charged
- THE APR factors in all the costs of financing
- Borrowers know exactly what they are paying and can make informed decisions
- Look at figure 10.2 to see how other finance costs can effectively increase the interest rate



Math for Personal Finance

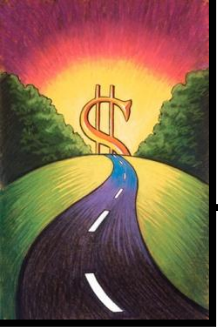
- Assume Kayce's loan was for $5,000 and that she will make 48 monthly payments of $117.42 to repay the loan.
- How much total interest will she pay over the life of the loan?

Math for Personal Finance

- Solution: Kayce will pay a total of $117.42 x 48 months = $5,636.16 for the bike. The price of the bike is $5,000; therefore, the interest is equal to $5,636.16 - $5,000 = $636.16.

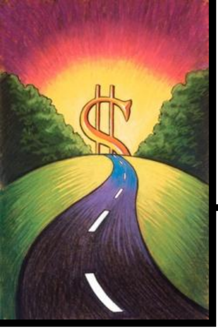
Check Your Financial IQ

- What is the usual purpose of a personal loan?



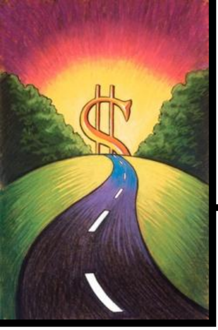
Check Your Financial IQ

- Personal loans make possible the purchase of large ticket items for which most people do not have ready cash on hand



Financing a Home

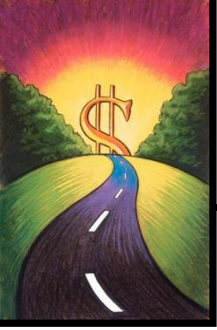
- The biggest single purchase most people make is buying a home
- You will most likely finance the purchase with a loan
- Know the unique issues surrounding the purchase of a home
- It can play a big role in your financial life



Mortgage Loans

- **Mortgage** is the common term for the type of loan people take to obtain a home.

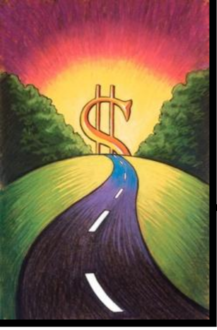
- A mortgage is a legal instrument by which the home becomes collateral for the loan
- Mortgages come in two basic forms:
  - fixed rate
  - adjustable rate



Mortgage Loans

- A **fixed rate mortgage** means the interest rate remains the same for the life of the loan.
- An **adjustable rate mortgage (ARM)** is one where the rate may go up or down over time

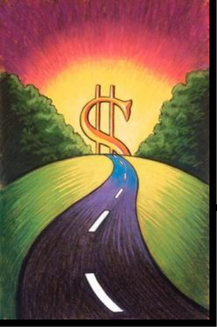
- A fixed rate mortgage means the payment will never go up or down
- With an ARM, the rate change occurs as some preset time—for example, after a year
- The amount and direction of the rate changes depends on changes in the economy



Mortgage Loans

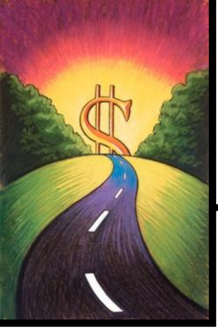
- **Teaser rate** is an extremely low interest rate for a short period of time that is used as a deal sweetener

- ARMs have a starting rate that is often lower fixed rate mortgages (teaser rate)
- People also choose ARMs because they believe interest rates will go down in the foreseeable future
- ARMs may appeal to someone who moves frequently because of job transfers.



Mortgage Loans

- People take mortgages for long periods of time—sometimes 30 years or more
- The monthly mortgage payment may be the largest bill you will have to pay
- The consequences of defaulting on a mortgage can be huge



Buying versus Renting a Home

- Consider the following questions when trying to decide if you should rent or buy:
  - How long do you plan to live in the area?
  - Do you have money saved for a down payment?
  - What is the price of homes relative to the price of rent in the area? (see Figure 10.3)
  - Are houses increasing in value or decreasing in value in the area?
  - Do you have enough knowledge of the area to buy?
  - How much are typical security deposits in the area?

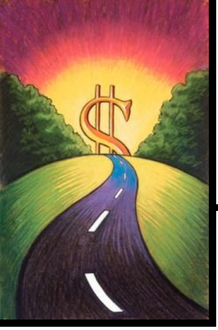
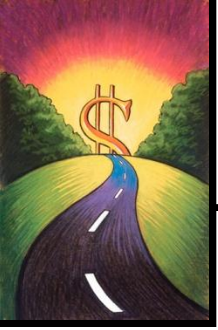


Figure 10.3

Exhibit 10.3 Effect of Homeowning and Renting on Net Worth:

When deciding whether to own or rent, you must consider not only how much you can afford each month in payments, but also how those payments may affect your net worth.

	Marcos	Sonia
Housing Expense	$1,500 (Rent per month)	$1,500 (Mortgage per month)
Annual Federal Tax Benefit	$0	$350 (assuming 28% tax bracket × $1,250 in interest)
Effect on Net Worth	–$1,500	–$900 ($1,500 in payment – $250 increase in equity – $350 tax benefit)



The Importance of Homeowners and Renters Insurance

- **Policy riders** are additional coverage

- Homeowners insurance provides insurance protection for a house in the event of some kind of property damage
- Homeowner policies vary greatly in the types of perils that are covered (See figure 10.4)
- You can also add numerous additional coverage (policy riders)

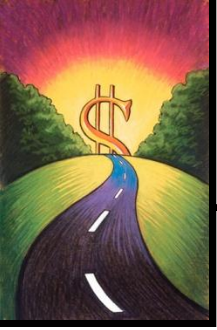


Figure 10.4

Exhibit 10.4 **Types of Perils Protected by Homeowner's (HO) Insurance Policies**

Homeowners and renters insurance can provide invaluable protection against loss. Different policies, however, cover different things.

HO-1: Protects against fire, lightning, explosions, hail, riots, vehicles, aircraft, smoke, vandalism, theft, malicious mischief, glass breakage.

HO-2: Protects against the events identified in HO-1, along with falling objects, the weight of ice, snow, or sleet, the collapse of buildings, overflow of water or steam, power surges, and the explosion of steam or hot-water systems, frozen plumbing, heating units, air-conditioning systems, and domestic appliances.

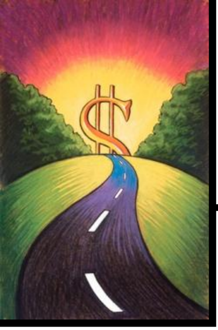
HO-3: Protects the home and any other structures on the property against all events except those that are specifically excluded by the homeowner's policy. The events that are typically not covered by this insurance are earthquakes, floods, termites, war, and nuclear accidents. It may be possible to obtain additional insurance to protect against floods or earthquakes. This policy also protects personal assets against the events that are listed in HO-2.

HO-4: Renter's insurance. Protects personal assets from events such as theft, fire, vandalism, and smoke.

HO-5: Protects the home, other structures on the property, and personal assets against all events except those that are excluded by the specific homeowner's policy. This policy provides coverage of the home similar to that provided by HO-3, but slightly more coverage of personal assets.

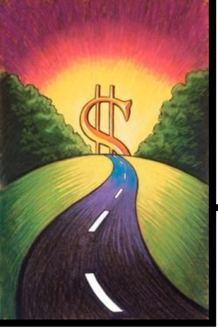
HO-6: Condominium owner's insurance. Protects personal assets from events such as theft, fire, vandalism, and smoke (review the specific policy to determine which events are covered).

HO-8: Protects the home from the same events identified in HO-1, except that it is based on repairs or cash values, not replacement costs.



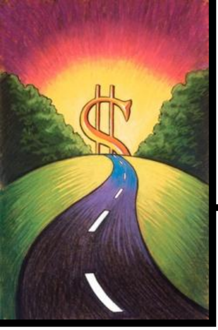
The Importance of Homeowners and Renters Insurance

- Lenders require homeowners to purchase enough insurance to cover the amount of the mortgage on the home
- Homeowners insurance is an important component of your financial plan because it protects your assets
- With each mortgage payment, you build equity in your home and add to your net worth



The Importance of Homeowners and Renters Insurance

- Many people do not realize that their possessions are not protected when they rent
- You can purchase renters insurance that will protect you
- Renters insurance can cover your living expenses if the property you rent is being repaired as the result of some covered event



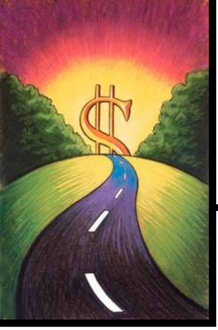
Math for Personal Finance

- Brian purchased renters insurance with a $200 deductible. Recently a fire destroyed his apartment complex and he lost all his possessions—at least $7,000 worth.
- If his insurance coverage was limited to $5,000, how much will he receive from the insurance company?

- Solution: The $200 deductible means he was self-insured for the first $200 in damage so he would receive $5,000 - $200 = $4,800.

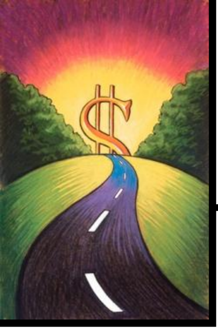
Check Your Financial IQ

- By what means do most people finance the purchase of a home?



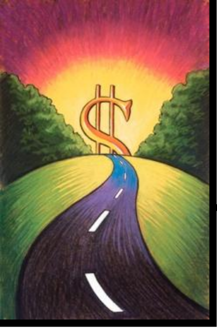
Check Your Financial IQ

- Most people finance their home with a mortgage.



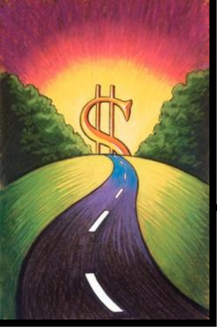
Financing Your Education

- Education and training for a successful career will require borrowing money
- Student loans are another type of personal loan
- These loans finance the expense of going to college or trade schools
- Student loans allow the borrower to obtain money for education bills
- They also allow delaying payments on the borrowed money until after graduation



Financing Your Education

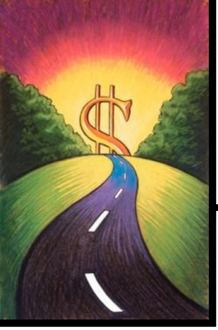
- Federal student loans are the largest source of student loans
- These loans are guaranteed by the federal government and have the best terms
- The government acts as the cosigner on these loans and pledges to repay them if the borrower defaults
- Federal Stafford loans and Federal Perkins loans are two primary education loans made to students.



Federal Stafford Loans

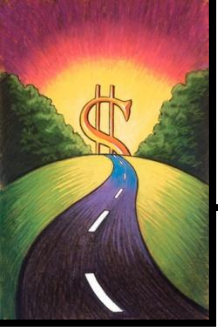
- **Federal Stafford loans** are the most common type of federal education loans.

- Federal Stafford loans come in two forms:
  - Subsidized
  - unsubsidized



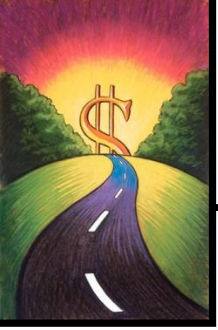
Federal Stafford Loans

- Subsidized Stafford loans are need-based
- Applicants must show a certain level of financial need in order to qualify
- Interest charges do not build up on these loans while the student is in school
- Subsidized Stafford loans also have a six-month grace period after the student leaves school
- During this time interest does not accrue and payments do not have to be made



Federal Stafford Loans

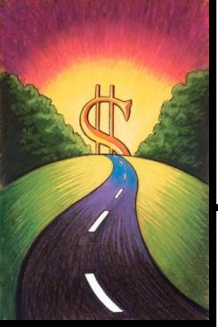
- Unsubsidized Stafford loans are not need-based
- Interest accrues on these loans while you are in school
- Recipients do not have to make monthly payments until leaving school
- Both types of Stafford loans are backed by the government and neither one requires a credit check
- Both types have limits on the annual and total amounts you can borrow



Federal Perkins Loans

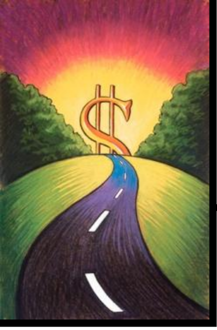
- **Federal Perkins loans** are loans for students with “exceptional” financial need

- Federal Perkins loans carry a lower interest rate
- These loans offer a longer grace period before students have to begin repayment
- These loans go to students coming from extreme poverty



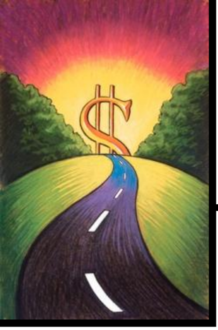
The Reality of Student Loans

- Both Perkins and Stafford loans are still loans and need to be repaid
- Student loans are a useful financial aid, but students should use them with caution
- Parents can to borrow from many sources to finance a college education
- These loans have varying interest rates, repayment schedules, and maturities
- You can find out more information about student loans by going to www.salliemae.com



Math for Personal Finance

- Landi took out a total of $8,000 in subsidized Stafford loans for her four-year college education.
- How much interest that accrued during her four years of college will she have to repay assuming a market rate of 5 percent?

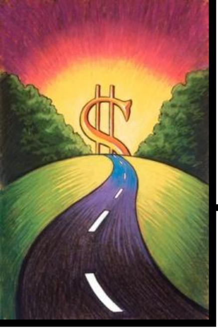


Math for Personal Finance

- Solution: The loan is a subsidized loan meaning the federal government pays the interest. Landi will not be liable for any interest that accrued while she was in school.

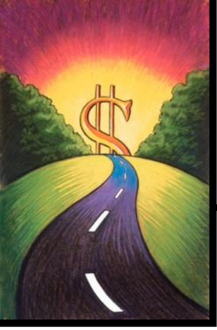
Check Your Financial IQ

- Why are student loans different from other kinds of personal loans?



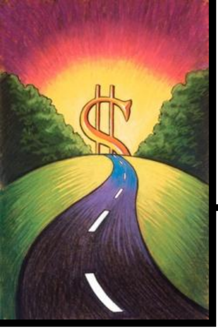
Check Your Financial IQ

- In general, they allow recipients to delay repayment of the loan until after the student graduates



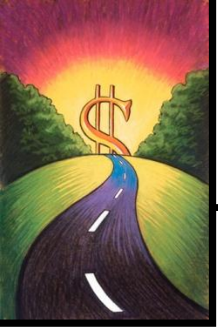
Financing Your Car

- A car is another major expense for people
- People finance car purchases with loans from the car dealer, from a bank, or other lending institution
- Car loans typically run from three to six years for new cars
- Longer loan periods generally mean lower payments
- But, the borrower will pay more in interest over the life of the loan



Financing Your Car

- Used cars are a good option for many people,
- The amount of the loan is typically restricted by the market value of the vehicle
- This value can be determined by Kelley Blue Book or some other reputable source
- The Internet is a great source for used vehicles
- Buyers should research a car’s history prior to purchasing



Leasing versus Buying a Car

- **A lease** is essentially a long-term rental agreement
- Leasing vehicles has become popular in the past several years
- Leasing requires only a small down payment—or none at all
- Lease payments for a new car are generally lower than loan payments for that same car
- At the end of the lease, you return the vehicle to the dealer

Leasing versus Buying a Car

- When you lease a car, you do not own the car
- It can never be listed as one of your assets
- You are liable for any damage to it
- There are often penalties for ending the lease early
- Look at Figure 10.5 for a comparison of these advantages and disadvantages

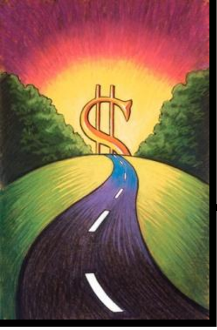


Figure 10.5

Exhibit 10.5 Comparison of the Cost of Purchasing versus Leasing

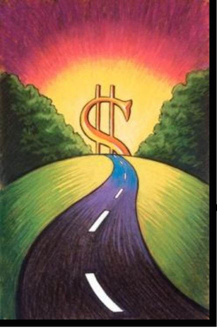
Leasing and purchasing a car each have their benefits and drawbacks, but you can make a good comparison of the actual costs of each option.

Cost of Purchasing the Car	Cost
1. Down payment	$1,000
2. Down payment of $1,000 results in forgone interest income:	
Forgone Interest	
Income per Year = Down Payment × Annual Interest Rate	
= $1,000 × .04 = $40	
Forgone Interest over Four Years = $40 × 4 = $160	160
3. Total monthly payments are:	
Total Monthly Payments = Monthly Payment × Number of Months	
= $412 × 48 = $19,776	19,776
Total	$20,936
Minus: Expected amount to be received when car is sold in four years	– 10,000
Total cost	$10,936

Cost of Leasing the Car for Four Years	
1. Security deposit of $800 results in forgone interest income (although she will receive her deposit back in four years):	
Forgone Interest	
Income per Year = Down Payment × Annual Interest Rate	
= $800 × .04 = $32	
Forgone Interest over Four Years = $32 × 4 = $128	$128
2. Total monthly payments are:	
Total Monthly Payments = Monthly Payment × Number of Months	
= $300 × 48 = $14,400	14,400
Total cost	$14,528

The Importance of Car Insurance

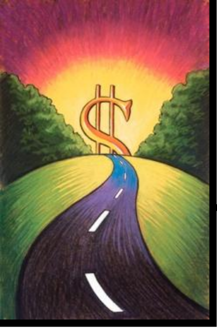
- You are required to maintain adequate insurance on your car
- Lenders require that you keep sufficient auto insurance to protect their investment
- Many states also require you to maintain automobile insurance



The Importance of Car Insurance

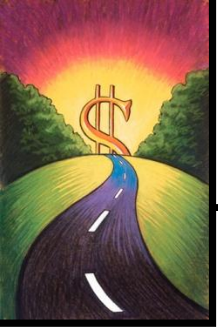
- **Liability coverage** insurance that covers you against any damage you do to other people or their property

- Auto insurance covers you against the loss of your property—your car
- The two primary liability components are property damage liability and bodily injury liability
- The property damage liability will cover repairs to their vehicle if you are at fault
- Bodily injury liability covers the costs you may be responsible for if you are at fault in an accident



The Importance of Car Insurance

- Insurance can be very expensive for young drivers with limited experience
- Your credit rating can impact the amount you pay for vehicle insurance
- The value of your car and where you live can also impact your insurance premium
- Shop around when you buy car insurance

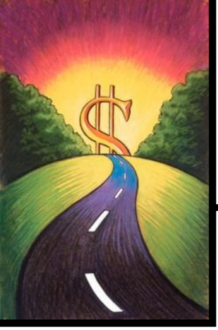


Check Your Financial IQ

- What are two major options for paying for a new car?

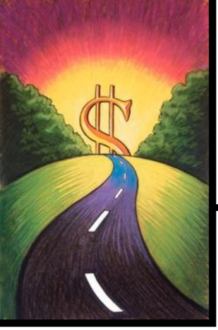
Check Your Financial IQ

- You can buy or lease the vehicle.



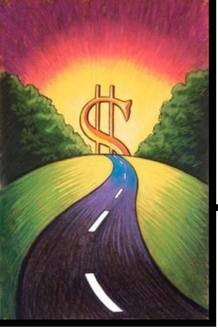
Summary

- Loans allow people to buy things and pay for them over time
- People take out personal loans for large purchases
- These loans are available from a variety of sources including:
  - banks
  - credit unions
  - other financial institutions
- Loans also come in many forms such as:
  - secured loans
  - unsecured loans.



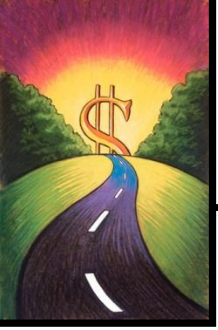
Summary

- Determine how much you can afford when purchasing a home
- If you purchase a home, you will get a loan called a mortgage
- Mortgages come in two basic forms: fixed rate and adjustable rate
- You will also get homeowners insurance
- Renters should purchase renters insurance coverage on their personal belongings



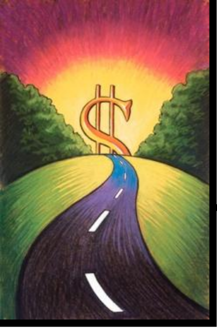
Summary

- Student loans are common personal loans used to finance education
- Federal student loans are the largest source of student loans
- They are guaranteed by the federal government and have the best terms
- Student loans must be repaid and should be taken with great care



Summary

- Financing a car for purchase is a widely used option
- some people find leasing to be an attractive alternative
- Each option has benefits and drawbacks
- In all cases, car insurance is a must



Key Terms and Vocabulary

- Adjustable rate mortgage
- **Annual percentage rate**
- **Collateral**
- **Cosigner**
- Default
- **Down payment**
- Federal Perkins loan
- Federal Stafford loan
- Fixed rate mortgage
- **Home equity loan**
- **lease**
- Liability coverage
- Line of credit
- Maturity date
- **Mortgage**
- **Personal loan**
- **Policy rider**
- **Secured loan**
- Subprime mortgage
- Teaser rate
- **Unsecured loan**

Websites

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- Studentaid.ed.gov
- www.staffordloan.com/
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- www.salliemae.com
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- www.autotrader.com
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