C O N S U M E R S E R I E S

FINANCE

Credit: What Are Your Choices? no. 9.140

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Quick Facts...

Shopping for credit can save you hundreds of dollars.

If you have good credit and shop for the best loans, you have the most choices for how much you want to pay for interest.

Interest rates for payday loans may exceed 500 percent.

Colorado State University Cooperative Extension

Putting Knowledge to Work

The marketplace offers goods and services at competitive prices. Many people are good comparison shoppers when it comes to food or gas, but ignore the shopping opportunities for credit.

For example, if you are in the market for a washer and dryer, how many sources of credit might finance the purchase for you? Would they all charge the same rates of interest or have the same terms? Before answering these questions, read the following information that describes the three basic types of credit and the major sources offering credit.

Types of Credit

Consumer loans. A consumer borrows an amount of money from a person or company regularly in the business of making loans, such as a credit union, bank or savings and loan institution. A consumer loan may be either secured by a product such as an automobile or furniture or unsecured based solely on the borrower's signature. The loan may be repaid in installment payments or as one lump sum – principal and interest. Consumer loans, however, are generally paid in regular installments.

When property is pledged for a secured loan, the property may be repossessed if payments are not made. Auto loans are examples of secured loans. Unsecured loans have no security and are made to people who have good credit ratings, often customers of the lending institution where they do business. Rates may be higher on unsecured loans because there is no property to be claimed if the loan is not repaid.

Credit sales. The consumer buys goods or services and credit is arranged by the seller of the product. In most cases, the merchandise is used as security for the loan. Credit sales are frequently arranged for furniture and auto purchases and paid in regular installments.

Credit cards are offered by retail stores, credit unions and banks. Finance charges are added each month whenever there is an outstanding account balance.

Sources of Credit

Credit unions lend only to members, however, most people in a geographical area can become members. Credit unions offer consumer loans, credit cards, debit cards, and sometimes even mortgage loans. Rates are usually lower than other lenders because credit unions loan members' money, are eligible for federal tax exemptions, and generally take fewer credit risks.

Commercial banks mainly cater to customers with established credit histories. They offer consumer loans, credit cards, debit cards, and mortgage loans. They may make short term loans to good customers. Banks often require

For the latest information about credit cards and rates, visit:

www.CardTrak.com;

www.bankrate.com;

www.lendingtree.com;

www.credit-search.com.

(Remember that web sites that end in .com are commercial sites and will usually have something to sell).

You should also check the Colorado State University Cooperative Extension Financial Web Resources listing of current web sites that address financial topics: www.ext.colostate.edu/pubs/finance/general.html.

items for security, and vary interest rates according to the type of loan. Their rates may be lower than other lenders because they take fewer risks and have money from customers' savings to lend.

Savings and loan associations select credit-worthy individuals and often require security for loans. Similar to credit unions and commercial banks, savings and loan rates are often lower because they loan depositors' money. Savings and loan associations offer consumer loans, credit cards, and mortgage loans.

Consumer finance companies will lend to some individuals who do not meet credit standards of other lenders. Rates are often higher because they take greater risks and must borrow money to lend to customers. They mainly finance consumer loans.

Retail stores charge interest on monthly revolving accounts. Rates may be higher than lending institutions. Sometimes major purchases may be made on 90-day contracts at lower rates of interest. Retail establishments may offer a store credit card and/or accept most bank credit cards.

Some retail stores that sell merchandise such as furniture, appliances and automobiles may offer credit sale contracts at their places of business. These contracts frequently are sold to a financial institution such as a bank or consumer finance company. Because the interest rates may be higher than other credit sources, before agreeing to these loan terms consumers should investigate the credit terms they can arrange on their own from another source.

Life insurance companies lend the cash value of life insurance policies to policy holders. The rates are less because they take no risk and have no collection costs. Outstanding loans against life insurance policies will be deducted from survivor benefits.

Pawnbrokers loan money on items that are left for security. Interest rates generally are close to the maximum allowed by law. If you can't repay the loan within the specified time period, the pawnshop will sell your items.

Friends and relatives may be willing to make loans. Rates will vary. It is essential to have a written agreement that is considered as binding as any other credit obligation.

Check-cashing stores and payday loans are short-term loans (cash advance) based on your paycheck. Effective annual interest rates may be more than 250 percent.

Payday Loans are a growing market for financial services. These small, short term, very high rate loans go by a variety of names: "payday loans," "cash advance loans," "check advance loans," "post-dated check loans" or "delayed deposit check loans." Typically, a borrower writes a personal check payable to the lender for the amount he wishes to borrow, plus the fee. The loan must be repaid within 40 days. Colorado law limits the lender from renewing the loan (at high interest rates) more than once. If the loan is refinanced a second time, the interest rate can not exceed 36 percent. Fees for payday loans are most often a percentage of the face value of the check or a fee per $100 loaned.. In total, Colorado consumers can be charged over 520 percent on payday loans.

Rent-to-Own is a special situation where people pay little or no down payment to rent furniture, appliances and electronics. When they make the last payment, they own the item.

Instead of stating interest rates for people who pay until they own the merchandise, a total purchase price is given. It is up to the consumer to compute the interest rate. Rent-to-own contracts usually offer low payments plus fees for repair and delivery services. In Colorado, rent-to-own agreements are considered rental agreements and interest rates are not

This section does not apply to payday or rent-to-own loans. It is a general statement comparing interest rates of all loans.

The total interest cost varies greatly according to the interest charges. Here is an example of a $1,000 loan borrowed for one year.

APR	***Total Interest***
9%	*$50.00*
18%	*$100.00*
27%	*$146.00*
250%	*$1,700.00*

capped at consumer loan or credit sale maximums. The rent-to-own business in Colorado is regulated by the Colorado Attorney General's UCCC Administrator www.ago.state.co.us/uccc/uccchome.htm and the federal Uniform Consumer Credit Code.

A rent-to-own customer could end up paying a total that would include annual interest rates of 100 percent on average and possibly as high as 275 percent. If someone used a rent-to-own contract on a 19" television, they could pay $9.99 per week for 78 weeks, a total of $780. They could purchase the same television for $218 at a retail store. Because the rent-to-own contract is not considered credit, the merchandise can be picked up any time a payment is missed, even if there are only 3 payments remaining on a 78-week contract.

Colorado does provide some protection. Late charge payments cannot be more than $5.00 for the month after the payment is 5 days late. Late charges for weekly payments cannot be more than $3.00 for the week after the payment is three days late. There is no penalty for ending the lease agreement, and the lender is not to sell insurance.

Credit Choices

Now back to the question about the washer and dryer purchase – how many sources of credit could be tapped for the credit needed? The correct answer is that most of the sources of credit might be used to purchase a washer and dryer. Table 1 shows the types of credit offered by different credit sources. The interest rates can vary from 0 percent from a friend to more than 250 percent per year from a rent-to-own store.

Table 1. Types of credit offered by different credit sources.

Credit Source	Consumer Loans	Credit Sales	Credit Cards
Credit unions	X		X
Banks	X		X
Savings & loan associations	X		X
Consumer finance companies	X		
Retail stores		X	X
Life insurance companies	X		
Pawnbrokers	X		
Friends and relatives	X		
Check-cashing stores	X		
Payday loans	X		
Rent-to-own stores	X[1]		

[1]Technically, rent-to-own financing is not a loan.

Formula for figuring annual percentage rates.
Total finance charges (including interest and service charges)
÷ half the original price x number of payments ÷ number of years x [1÷ (number of payments + 1)] = APR

Example: *If you purchase a $600 sofa and finance it in equal payments for one year with a finance charge of $75, what is the APR?*

Total finance charges ÷ half the original purchase price (75 ÷ 300 = .25)

x number of payments ÷ number of years (12 ÷ 1 = 12) x [1 ÷ (number of payments 12+ 1)] [(1 ÷ 13 = .077)] =.25 x 12 x .077 = .231
This calculation shows an APR of 23 percent.

Cost of Credit

The federal Truth-in-Lending Act requires lenders to state their interest charges as an annual percentage rate (APR) so that consumers can compare true costs of borrowing. The APR is based on finance charges, amount borrowed, and the repayment schedule. For example, if you borrow $600 with a finance charge of $60 and pay the entire $660 at the end of twelve months, you will be paying an APR of 10 percent. If, on the other hand, you borrow $600 with a $60 finance charge and agree to repay in twelve monthly payments, you do not have the use of the $600 for the entire year. The APR on this loan would be 18.5 percent.

The APR and total finance charges must be clearly stated on all credit contracts. Compare APRs when shopping for credit to determine the most favorable rate of credit.

Interest Rates Differ

The maximum amount of interest that can be charged for financing a product or service depends on the type of credit used. The Colorado Uniform Consumer Credit Code (UCCC) sets the maximum rates for credit cards, consumer loans, and credit sales.

Consumer Loans. The maximum rate that a lending institution can charge for a consumer loan is set by Colorado statute. Maximum interest rates allowable are the same whether the loan is secured or unsecured, set up on an installment plan or repayable in one lump sum, the interest is deducted at the beginning of the loan or added to monthly payments.

Credit Sales. Rates for credit sales are also set by Colorado law and are the same as consumer loans.

Credit Cards. For credit cards the maximum allowable interest charge is 1.75 percent per month or 21 percent per year for credit granted from Colorado-based lenders. Lenders charging the maximum amount must allow consumers to pay for goods and service without interest in 25 days.

Payday Loans. These are also known as post-dated check loans and paycheck advance loans. The top amount that can be borrowed at one time is $500. Lenders may charge 20 percent on the first $300 borrowed and 7.5 percent on amounts from $301 to $500.

Interest Rebates. If you want to pay a loan off early, how would the final interest charge be computed? The amount of interest reduction you would be entitled to is computed by using the Rule of 78. This rule is based on the idea that the creditor is entitled to earn more interest in the early months of the loan when you owe more money. The creditor earns less interest in subsequent months when you owe less money.

Consumer loans/Credit Sales

Lenders can charge 21 percent of the total financed or:

- 36 percent per year on amounts from $0 to $1,000; plus
- 21 percent per year on amounts over $1,000 to $3,000; plus
- 15 percent per year on amounts over $3,000.

This doesn't mean, however, that a lender will only charge 15 percent on a $3,500 loan. When the stairstep rates are computed, the maximum rate could end up being 26.82 percent.

Example: 36 percent on the first $1,000

+ 21 percent on the next $2,000

+ 15 percent on the remaining $500

= 26.82 percent average interest rate

In addition, a lender may charge a maximum finance charge of $25.00.

Summary

Lenders sell credit just as department stores sell clothing. In order to buy the product, which in the case of credit is money, the consumer must pay a fee. Be aware of the cost of credit. By comparing the cost from one lending institution to another you can save yourself hundreds and sometimes thousands of dollars. A credit shopping expedition can be well worth the effort.

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