Name____________________________Period_________________________Date_________________

Cost of Credit

Instructions: Read the article on the cost of credit and then complete the handout, "Clarifying the Cost of Credit."

Credit is a service which must be paid for. If you borrow five dollars from a friend to pay for lunch, it is likely that the amount repaid will be five dollars. However, when credit is extended in the marketplace, the amount you repay will include the initial amount borrowed plus the finance charge, which is the total amount the consumer pays for using credit. Finance charges include interest rates and other applicable costs such as service charges or credit-related fees.

Credit costs consumers money because it costs creditors to loan money. Creditors have to pay for the goods and services they sell. When they let consumers purchase on credit, they either have to borrow money themselves and pay interest, or they must use money on hand which could otherwise have been invested to earn money. Credit accounts cost money to set up and service; costs of administering credit include such expenses as employees, facilities and supplies, equipment and communications. In addition, creditors take risks in extending credit. Not every person who borrows money is willing or able to repay it. Creditors spend a lot of money collecting on past due accounts, and some money is never collected. Collection costs and credit losses not only increase the immediate costs to creditors but also ultimately increase the cost for all credit consumers.

Finance charges paid by consumers will vary. Under the **Truth in Lending Act**, creditors are required to inform consumers in writing of the finance charges and the annual percentage rates on all credit purchases. The **annual percentage rate**, or **APR**, is the cost of credit expressed as a yearly rate. To make it easier for consumers to understand and compare interest rates, lenders are required to report interest in terms of this standard APR.

Total finance charges paid will depend upon the amount financed, the annual percentage rate and the length of the repayment period.

- **Amount financed.** Total interest charges are proportional to the amount financed. The greater the amount financed, the more interest charges will total. For example, for twelve monthly payments over a one-year period at an APR of 12.5%, compare total interest charges on the following amounts:

$500.00	$34.50
$1000.00	$68.99
$3000.00	$206.98

- **Annual percentage rate.** As the annual percentage rate goes up, the total finance charge increases. For example, for twelve monthly payments over a one-year period, compare interest charges on $3,000.00 with varying APR:

10%	$164.97
12.5%	$206.98
15%	$249.30

- **Length of the repayment period**. The longer the repayment period, the higher the finance charges. For example, compare interest charges when $3,000.00 is financed at 12.5% over varying time periods:

One year (twelve monthly payments)	$206.98
Three years (36 monthly payments)	$612.99
Five years (60 monthly payments)	$1,049.63

Because each of the preceding factors helps determine the total cost of credit, you can impact the total finance charge by varying one or more factors. For example, if you can make a down payment of $250.00 on a $1,000.00 purchase, the total amount financed would be $750.00 – a 25% reduction in the amount on which interest will be charged. By shopping around to find a better annual percentage rate of interest, you can cut credit costs. If you can make a larger monthly payment and reduce the length of the loan, for example, from five years to three, the total finance charge will be substantially reduced.

In order to use credit to your advantage, and avoid the pitfalls associated with disadvantages, it is important to understand the costs associated with credit. As a wise credit shopper, you can compare finance charges to find the best deal. Knowing the costs up front will help determine whether a credit buy is affordable or whether it might be better to postpone the purchase or save up to pay cash. If you decide to use credit, there will no surprise when you receive the bill for payment.