Loan Lessons

The Low-Down on Loans, Interest and Keeping Your Head Above Water

Course Objectives – Learn About:

• Different Types of Loans
• How to Qualify for a Loan
• Different Types of Interest

Financial Genius
Financial Education Powered by U.S. Bank

All of us serving you®

usbank.com/financialeducation
Index

Key Types of Lending Agreements .......................... 1

Common Types of Loans .................................. 2

Applying for a Loan ........................................ 3

How Do I Qualify For a Loan? ............................. 4

Who Will Get the Loan? .................................... 5

The Low-Down on Loans ................................... 5

Repaying Student Loans .................................. 7

Credit Cards: The Other Loan ......................... 8

Which Car Loan Is Best for You? ....................... 8

Defining Interest ............................................. 9

Truth in Lending .............................................. 9

Glossary ...................................................... 10

Notes .......................................................... 12
Key Types of Lending Agreements

Revolving Agreement
A consumer pays in full each month or chooses to make a partial payment based on the outstanding balance. Interest charges apply to unpaid balances. As the customer pays down the balance, they can re-borrow up to the approved credit limit without having to re-apply. Department stores, gas and oil companies, and banks typically issue credit cards based on a revolving credit plan.

- Visa®
- MasterCard®
- Discover®
- Department Store
- Gas
- Home Equity Line of Credit

Charge Agreement
A consumer promises to pay the full balance each month, so the borrower does not have to pay interest charges. Charge cards, not credit cards, and charge accounts with local businesses often require repayment on this basis.

- American Express®

Installment Agreement
A consumer signs a contract to repay a fixed amount of credit in equal payments over a specific period of time. Automobiles, furniture and major appliances often are financed this way. Personal loans usually are paid back in installments, too.

- Car Loan
- Home Mortgage Loan
- Home Equity Loan

Key Lending Channels
- Indirect Loans – Borrower gains a loan or financing generally through a retailer who completes all of the documents and then works with a bank or other financial institution to secure the loan.
- Direct Loans – Borrower secures a loan by applying directly with a bank or other financial institution.
Common Types of Loans

**Auto**
- Obtained as either a direct or indirect loan.
- Has a fixed or variable rate of interest. A fixed rate of interest works just the way it sounds. It means that the interest rate will remain the same for the duration of your loan. A variable interest rate means your interest rate could go up and down during the term of your loan.
- Generally maximum term is five years or 60 months.
- Vehicle is used as collateral and may be repossessed in case of default.

**Student**
- Education Loans are funds borrowed from a financial institution or the federal government.
- Has a fixed or variable rate of interest depending on federal or private loan type.
- Standard 10 year repayment on federal loans.

**Home Mortgage**
- Obtained as direct loan through a bank or a financial institution.
- May have fixed or variable rate of interest.
- Generally 15-year or 30-year term.
- Property is used as collateral in case of default.

**Home Equity Loan**
- Money is borrowed on the amount of equity you have in your home. The amount of equity is the value of your property minus the amount you owe.
- Property is used as collateral in case of default.
- Fixed amount of money repayable over a fixed timeframe.
- Home equity loan might be considered if you need a set amount for a specific purpose, such as an addition to your home.

**Home Equity Line of Credit**
- Money is borrowed on the amount of equity you have in your home. The amount of equity is the value of your property minus the amount you owe.
- Form of revolving credit.
- Property is used as collateral in case of default.
- You are approved for a certain amount of credit, much like a credit card.
- Credit limit is set by taking a percentage (say, 75%) of the appraised value of the home and subtracting the balance on the existing mortgage. For example:

  Appraisal of home: $100,000
  Percentage of appraised value: $75,000 ($100,000 x 75%)
  Less mortgage debt of $40,000
  Potential credit line: $35,000
Applying for a Loan

You’re ready to apply for a loan, but where do you start? Here’s what you’ll need to know before you take the plunge.

Applications
If you’re planning on shopping around for various loans, be prepared to fill out applications. Be sure to have vital information like your Social Security Number, permanent home address, employment history, and checking or savings account information (account numbers and balances) on hand to make the process as easy as possible.

Regular source of income
Creditors want to know that you can afford to re-pay the money they’re letting you borrow, so it’s important to have a steady job when applying for credit. Some lenders may ask for proof of employment, such as a pay stub.

Good credit history
If you’ve never applied for a loan before, you likely don’t have a credit history. However, it is always a good idea to check with one of the three major credit reporting agencies before applying for a loan.

Co-signer
For those who don’t have a credit history, you may need to have a co-signer. A co-signer is someone who is willing to accept responsibility for your debt if you aren’t able to pay off the loan.
How Do I Qualify For a Loan?

How much money a lender will let you borrow will be determined, primarily, by your credit score, or FICO score. This score is a three digit number between 300 and 850 that gives lenders a quick glimpse of what kind of credit risk you might be. The higher the number, the better off you are.

How Your Credit Score Is Determined

1. Payment history
How quickly you pay your bills weighs heavily on your overall score. Your credit report will indicate whether you are 30, 60, or 90 days or more late with a payment. A history of late payments will damage your score. On the flip side, by paying your bills consistently on time, you can greatly improve your overall score.

2. Amounts owed
Add up all of your outstanding balances and compare the number to the amount of credit that is available to you. At the same time, you want to make sure that the credit extended to you isn’t out of proportion with your income.

3. Length of credit history
The longer you’ve had credit established, the better you’ll look in the eyes of a lender. Your score is determined by how long you’ve had individual accounts as well as how long it’s been since you’ve used that account. Don’t open multiple new accounts in the hopes of building credit quickly, however. This will reduce the “average account age” and will therefore reduce your score. It’s best to open one account and build upon that credit rather than opening several accounts and spending small amounts of money on each.

4. Amount of new credit
Every time you apply for new credit (credit cards or loans), that inquiry is noted on your credit report. Lenders take note if there have been too many inquiries on your report in a short period of time. When you do apply for new credit (such as a car loan), do so in short period of time. FICO can distinguish between multiple inquiries on a single loan (say, if you’re shopping around for the best rates on that car loan) or multiple lines of credit.

5. Types of credit
Credit cards and installment loans (like car loans or your mortgage) are examples of different types of credit. If you have had no credit, lenders will consider you a higher risk than someone who has managed their credit responsibly.
Who Will Get the Loan?

Read through these scenarios, and use the information on the previous page to decide who is most likely to be approved for the loan, and least likely to get the loan.

- Tim pays his bills on time, but he has $9,500 of debt on a credit card with a $10,000 limit.
- Mary is working on paying off her credit card balance of $2,500. She has paid off $750 of that debt, and she is in otherwise good financial standing.
- Nick normally is very good about making timely payments on his debts. However, this month, he was unable to pay any of his bills.
- Carrie recently applied for an additional credit card. The credit limit is well within her means, and she has a solid credit history.

The Low-Down on Loans

1. Be realistic
   Borrow only what you need, and remember that you must pay back — with interest — whatever you borrow. Consider your earning potential after you graduate. Prepare a budget to see exactly how much you can afford to spend on monthly loan payments.

2. Stay within what is an “acceptable” level of debt
   Your debt-to-income ratio is the measure of how much debt you carry each month (including rent/housing, credit card balances and installment loan payments) to how much money (after taxes) you have coming in. Consider this example:

   Total monthly expenses: $500
   Total monthly after-tax annual income: $2,200
   Debt-to-income ratio: \( \frac{500}{2,200} = 22.7\% \)

   The ideal number is zero. But at the very least you want to keep your debt — including car loans — to 25% or less of your after-tax income.

3. Read your application carefully
   Make sure you understand the terms of your loan. Once you sign the application, you’re committing yourself to a real debt. You’ll have to repay your student loan whether or not you finish school, and you’ll have to pay off the entire balance of your auto loan even if you decide to sell the car for less than you owe.

4. Make extra payments when you can
   Adding even a little extra money to your loan payment can pay big dividends in the long run. How? The more you pay off of your principal (your original loan amount), the less interest you pay.

Answer: Mary is most likely to get approved while Nick is least likely to get approved for the loan.
Going Back to School

As an adult, you may decide to go back to school to earn the degree you’ve always wanted or even to help make a career change. After deciding to return to school, it’s imperative to create a plan to pay for it. Scholarships, grants and federal loans should be the first financial aid options you consider, and for good reason. Scholarships and grants do not have to be paid back and Federal loans may have a lower interest rate than private loans.

If you have unmet needs after considering these resources, a student loan from a bank or other lender can help cover the full cost of a college education.

How to Apply for Federal Loans

To determine the education costs that you and your family are responsible for assuming and the type and amount of federal aid you qualify for, follow the steps below.

Step 1: Complete a federal financial aid application

Obtain and complete a Free Application for Federal Student Aid (FAFSA), which determines how much you and your family must contribute each year for your college education. Since some schools require you to also use their applications, check with your school to ensure that you have all the forms you need.

You can get a FAFSA:
- Online
- From the college you plan to attend
- By calling 800-433-3243

Complete the FAFSA and submit it to the FAFSA processor as soon as possible. A few weeks after submitting your application, you and the schools designated on your application will receive your FAFSA Student Aid Report, which will indicate the amount you are expected to contribute for your college education.

Step 2: Review your financial aid award

Your college financial aid office will use your FAFSA Student Aid Report to create a custom financial aid package for you. This information will be sent to you in an award letter, which will indicate your expected family contribution and the types and amounts of financial aid you qualify for. You will need to let your financial aid office know if you accept or reject the aid offered in the package.

Your award letter may state that you are able to pay a specified amount toward your college education. That does not mean, however, that you have funds available for this purpose. Many people need additional money to meet their expected contribution.

Step 3: If needed, apply for a private loan

Private student loans are credit-based loans that must be certified by your school’s financial aid office. They are offered by banks, schools and education loan organizations, and should be used only when federal loans, grants and other forms of financial aid aren’t enough to cover the full cost of education. Interest rates and fees, if applicable, are determined by the lender.
Federal loans are the largest source of student lending available and offer low fixed-interest rates, flexible repayment and deferment options, interest-rate discounts and more. The completion of the FAFSA is required. You should exhaust federal student loan options before applying for a private loan.

Remember, both federal and private student loans must be repaid even if you don’t finish school or aren’t happy with the education you received.

**Student Loan Tips**

1. Don’t assume that your income makes you ineligible for financial aid. You may be surprised to see what’s available. Apply for every financial aid choice available.
2. Complete and submit a Free Application for Federal Student Aid (FAFSA) early! Most financial aid is awarded on a first-come, first-served basis. You should submit your application in January or February for the fall school year.
3. Call your school’s financial aid office for their application deadlines.
4. Keep a copy of every form you complete.
5. Record the dates on which you submitted forms and note the names of everyone with whom you spoke.
6. Remember to re-apply for financial aid each year.

**Repaying Student Loans**

So you took out loans in order to finance your education, now it’s time to start repaying those loans. It’s important to know the exact total of your student loan debt. The National Student Loan Data System (NSLDS) through the U.S. Department of Education can help you organize your loan information. The NSLDS can also inform you who your loan servicer is. A loan servicer is a company that handles the billing, repayment plan, loan consolidation and other services related to your student loan. Your loan servicer will also be your resource for any questions or concerns you may have. Make sure that your loan servicer always has the most up to date contact information for you on file.

Most student loans are paid back over a period of 10 years – know what your repayment plan is so that you can budget accordingly. You may also want to review all of your repayment options with your loan servicer; federal loans can offer a variety of repayment options based on your individual situation. Student loans affect your credit score so it is important to make your payments on time and to never miss a payment. If you find you are having difficulty making your monthly student loan payments you should contact your loan servicer immediately to discuss your options.
Credit Cards: The Other Loan

1. A credit card is just that — a card that extends a line of credit to the cardholder
When you use your credit card, the issuer is essentially extending a short term loan to you. Pay off your balance each month and you’ll begin to build solid credit; carry a balance month to month on your card and you’ll pay the issuer interest on your balance.

2. Try to pay more than the minimum payment
Pay off as much of your balance as you can, especially on cards with high interest rates. In the end, this will save you money on interest charges.

3. Watch out for fees
Of course, there are the more obvious fees — annual fees, fees incurred for late payments and spending over your credit limit (if you’ve opted in to have over-the-limit transactions processed). In addition, some companies charge fees for “extra” services such as withdrawing cash, ordering a replacement card, using a “convenience check,” requesting an extra account statement, transferring a balance and more. Before you commit to a credit card, carefully read the terms and conditions of your new card so you won’t be surprised by fees.

Which Car Loan Is Best for You?

Okay, you’ve been pinching pennies for months, and you finally have $2,800 saved up for a car. You find a great used car for $10,800. Now all you need is a loan to cover the extra $8,000 and you’re set. Take a look at each one of your loan options, and decide which loan is the best deal for you.

<table>
<thead>
<tr>
<th>Place</th>
<th>Principle</th>
<th># Payments</th>
<th>Interest Rate</th>
<th>Monthly Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dealer</td>
<td>$8,000</td>
<td>42</td>
<td>13.5%</td>
<td>$240.06</td>
</tr>
<tr>
<td>Bank</td>
<td>$8,000</td>
<td>36</td>
<td>6.9%</td>
<td>$246.65</td>
</tr>
<tr>
<td>Finance Company</td>
<td>$8,000</td>
<td>48</td>
<td>18.0%</td>
<td>$235.00</td>
</tr>
</tbody>
</table>

Answer: The bank car loan is the best deal.
Defining Interest

Interest is the amount of money the bank charges for letting you use its money, and can be either variable or fixed. Here’s a quick look at how simple interest works:

- **Variable rate** means the interest rate might change during the loan term, as written in the contract.
- **Fixed rate** means the interest rate stays the same throughout the term of the loan.

Interest on a loan is often referred to as simple interest, and is calculated using three criteria in an easy formula: \( \text{Interest} = \text{Principle} \times \text{Rate} \times \text{Time (in years)}. \)

- **Principle** = the amount borrowed from the bank
- **Rate** = the percent
- **Time** = how many years it will take you to pay back the loan

Truth in Lending

In addition to interest, lenders charge various rates and fees, and the Truth in Lending law requires banks to state charges in a clear and uniform manner so consumers can easily compare prices. Lenders are required to disclose:

- **Amount Financed** – the amount of the loan provided to you.
- **Annual Percentage Rate, or APR** – the cost of your loan expressed as a yearly percentage rate. When shopping for loans, you should compare APRs, not interest rates, since APRs reflect the cost of interest and other finance charges.
- **Finance Charge** – the total dollar amount the loan will cost you. It includes items such as interest, service charges, and loan fees.
- **Total of Payments** – the amount you will have paid after you have made all payments as scheduled.
Glossary

**Annual Percentage Rate (APR)**
A calculation which standardizes rates, points, and other costs of a loan. This rate is likely to be higher than the stated note rate or advertised rate, because it takes into account points and other credit costs, such as loan discounts and origination fees. The APR allows borrowers to compare different types of loans based on the annual cost for each loan.

**Borrower**
An individual who receives funds in the form of a loan with an obligation to repay the principal with interest.

**Co-signer**
Someone who signs a credit agreement along with the borrower who does not receive goods, services or money in return for the obligation. The co-signer is legally obligated to assume responsibility for loan repayment if the borrower doesn’t.

**Collateral**
Anything of value (asset) pledged to a lender until a loan is repaid. Can be seized if the loan is not paid.

**Deposit**
A sum of money (earnest money) given by the borrower to secure a loan.

**Fixed Interest Rate**
An interest rate that does not change during the entire term or life of the loan.

**Gross Monthly Income**
The total monthly income earned before taxes and any benefit deductions.

**Interest Rate**
The percentage of an amount of money that is borrowed and is paid for during a specific period of time outlined in the terms of the loan.

**Loan Balance**
The outstanding balance of a loan not paid in full, excluding any accrued interest.

**Loan Term**
The total number of payments required to pay the loan in full. This is also known as an amortization term.

**Maturity**
The termination or due date on which final payment of a loan must be paid in full.
Payment Schedule
A schedule detailing the amount and due date of payments required to be paid over the life of the loan. The dollar figures represent principal and interest. This schedule does not reflect payment for taxes and insurance.

Pre-qualification
A request by a prospective loan applicant for a preliminary determination of whether the prospective applicant would likely qualify for credit under a lender’s standards, or of the amount of credit for which the prospective applicant likely would qualify. Pre-qualification is generally not a commitment to lend or to borrow.

Term
A period of time (usually months) that a loan must be repaid.