SMART BORROWING TV

SB TV

A Guide to Help You Make Wise Borrowing Decisions

Consumer Education and Training Services (CENTS) is a non profit organization formed in 1995 by bankruptcy and legal service professionals in response to an alarming increase in the number of financially troubled individuals and families. CENTS' mission is to provide education and training to increase the financial literacy skills of consumers.

1200 5th Avenue, Suite 600 • Seattle, WA 98101 • 206-267-7017 • www.centsprogram.com

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The Smart Borrowing curriculum designed by Karl Frunz and Tony Leahy.
Workbook written by Karl Frunz. DVD written and directed by Tony Leahy.

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How to order Smart Borrowing booklets and/or videos:

Call (206)267-7017, email info@centsprogram.com, or visit our website:
www.Centsprogram.com www.centsprogram.com/smartborrowing

PREFACE

Welcome to Smart Borrowing

Smart Borrowing presents unbiased, practical information about the entire process of consumer financing, providing you tools to make the most of your credit opportunities.

First, Smart Borrowing provides an essential review of:

- The language of borrowing
- Budgeting fundamentals
- The demand that debt can have on your income
- The role credit scores play in borrowing

Second, Smart Borrowing presents in-depth examinations of five common lending arenas:

- Credit cards
- Payday Loans
- Auto loans
- Mortgages
- Mortgage refinancing and home equity lines of credit

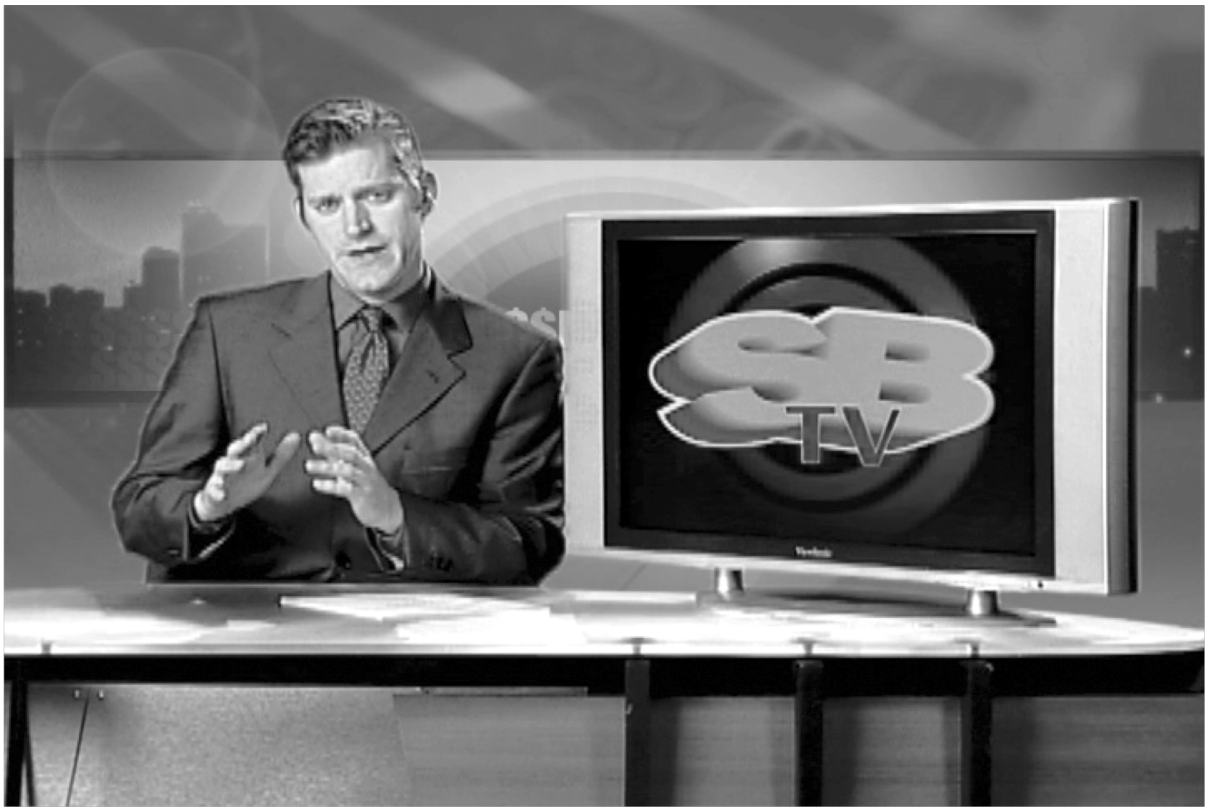
In each of the five chapters, Smart Borrowing examines the following factors:

- The marketplace for each lending arena
- The real-world risks associated with each financial opportunity
- The initial, ongoing and opportunity costs of the debt or financed purchase
- The best practices for selecting, managing and repaying a consumer credit obligation
- Crisis remedies and resources

Smart Borrowing As A Learning Tool

Smart Borrowing is a multimedia curriculum incorporating this booklet and the accompanying video/DVD program. The video and workbook are designed to work together as a coordinated curriculum.

Each chapter of Smart Borrowing can be used as a stand-alone learning module for its specific lending area. However, when examined in its entirety, Smart Borrowing provides a comprehensive guide for all consumers to successfully manage their financial opportunities.



"We here at Smart Borrowing TV will help you make fully informed borrowing decisions."

CENTS

provides financial literacy education and money management training to empower consumers to take control of their finances.

CENTS' GUIDING PRINCIPLES

FOR THE DESIGN AND DEVELOPMENT OF COMMUNITY FINANCIAL EDUCATION:

• TO ENCOURAGE CRITICAL THINKING •

Developing critical thinking skills empowers consumers to negotiate to their best advantage and achieve positive financial results

• TO PROVIDE GUIDELINES •

Circumstances vary—as do needs and wants. Guidelines offer a map in which you'll make your own path

• TO BASE SPENDING AND BORROWING DECISIONS ON NET – NOT GROSS – INCOME •

Reality is the best basis to build from – and understanding your net income is the first step toward effective money management

INTRODUCTION

Today, consumers have more opportunities to borrow money than ever before. In other words, it has never been easier to get over your head in debt. Financial hardships are often unavoidable. However, getting into financial trouble because of a bad borrowing decision *is* something you can guard against—protecting your money, your credit and your well-being.

In 2004, over 1 million Americans filed for bankruptcy.[1] Many times that number struggled to hold their heads above water, while suffering the stress and disappointment of lost opportunity resulting from excessive interest and fees. Smart Borrowing will empower you to control your own financial future by:

- Understanding fundamental facts about budgeting, borrowing and credit
- Identifying, analyzing and comparing the true cost of credit, including initial, ongoing and opportunity costs
- Comprehending the risks for every financial choice
- Recommending best practices for acquiring, managing and repaying debt
- Employing strategies to regain control over borrowing decisions gone bad

Smart Borrowing—Something For Everyone

Smart Borrowing is designed for everyone. For first-time borrowers, Smart Borrowing will be your road map for the first time you enter into the marketplace of consumer financing. For seasoned borrowers, these materials will help you determine whether you are making the best choices possible. For those struggling with financial hardship, Smart Borrowing will provide you with the resources to get back on track.

Making A Fully Informed Decision

Smart Borrowing illustrates the importance of making a fully informed decision. It is easy to identify the benefits of a borrowing choice—that is where the advertisers want you to focus. You must think about the total costs of a borrowing choice and the risks the costs pose to your financial stability. Smart Borrowing choices are not made in a vacuum but rather in the context of your personal financial situation. This means you must be fully aware of your income, monthly budget and financial goals.

INTRODUCTION

Borrowing Thinking Traps

Smart Borrowing will help you avoid thinking traps—those hopeful perspectives like, "It will all work out" or "I'll get a better job soon." Smart Borrowers must make and base their financial choices on the reality of their current situation. That doesn't mean you don't believe in yourself; it means you make decisions based on your actual situation. When circumstances change in your favor, you reap the rewards at that time. That's much better than counting on something in the future and getting into financial trouble if your wish doesn't come true.

Also, if you often say, "I will never be good at managing money" or "I just don't understand money talk," Smart Borrowing provides you with an array of techniques to develop and manage your financial plan.

Never Too Late

No matter your situation, it is never too late to become a Smart Borrower. You can use these principles to plan and prevail in most consumer financial marketplaces. For those struggling with an existing problem, each chapter offers a "Crisis Remedy" checklist to help you regain financial control.

You are on your way to being a Smart Borrower.

The CENTS Program
September 2005

NOTES:
1 Bankruptcy statistic for 2004

STEP ONE

SPEAK THE LANGUAGE OF BORROWING

Do you speak the language of borrowing? Being in control of your borrowing choices starts with understanding a few basic financial terms.

Throughout Smart Borrowing, you will see these terms explained and demonstrated for each lending market. For more information on the language of borrowing, please refer to the glossary in the Summary & Resources section of this workbook.

Principal

Principal is the actual amount of money you owe for an item or items you've purchased through a borrowing commitment. If you charge $800.00 on your credit card, that's the principal balance of the account. If you take out an auto loan for a car that costs $19,000, that's the principal balance you'll be paying off. A Smart Borrower never loses sight of the principal balance—it's the big commitment.

Interest Rate

Interest is the price you pay, beyond the principal balance, for being allowed to pay the principal balance of a loan over time. Interest is stated as a percentage of the principal balance and is usually calculated on an annual basis. Think of interest as the opposite of a sale. At a 15% sale, 15% is taken off your purchase price. On the other hand, a credit card that carries a 15% rate of interest will cost you 15% more per year on the total principal you owe.

Annual Percentage Rate

The Annual Percentage Rate (APR) refers to the total cost of your financing, including interest plus any other charges. Sometimes lenders will advertise a low interest rate to attract borrowers but then add other finance charges, resulting in a much higher overall cost to the consumer. To make sure the consumer is not fooled by such a tactic, lenders are required to add up all the charges and recalculate them in the form of the APR. This is a much more important number than the stated interest rate!

Fees

Fees are payments you make to a lender for its services. Lenders may charge processing fees at the outset of a loan commitment, as well as ongoing fees or penalties. Examples are annual fees and late payment penalties. Any ongoing fees that are not paid in full when accrued will be added to the principal balance, so you will pay interest on those fees as well. A Smart Borrower will always inquire about and monitor the application of fees on her accounts.

Term Of The Loan

The loan term is the length of time and number of payments the lender schedules for you to pay back the principal and interest. Fundamentally, the longer you have to pay off the balance, the more money you will pay in interest. A Smart Borrower must always understand the importance of the loan term to each borrowing choice.

Costs

Costs refer to the money you are out (not including principal) as a result of taking on a debt.

INITIAL COSTS are the total of all the amounts you negotiate and agree to at the time of borrowing. Initial costs include the interest rate and any other finance charges that relate directly to the loan or credit.

ONGOING COSTS represent the ongoing demands of the item you have financed on your monthly net income. For example, when Smart Borrowers finance a car, they consider not only the monthly payments and how long the loan will last, but also mileage, maintenance and insurance. All of these items place a demand on income and must be considered factors in the price of the item.

OPPORTUNITY COST, put simply, is the difference between the choices you make with your money. You cannot spend the same money twice, so once you have spent it, you have lost the opportunity to spend it on something else. Making wise choices allows you to maximize your opportunities over the long term.

YOUR MONEY'S OPPORTUNITIES	
How far could $1,000 go?	
$800.00 spent on a vacation $200.00 charged on a credit card = $1,000.00	$400.00 spent on vacation $300.00 used to pay off debt $300.00 put into savings = $1,000.00

Collateral And Secured Vs. Unsecured Credit

COLLATERAL is an item of property that you pledge as a guarantee in the case of failure to repay a loan. Typically, the collateral will be the item you are financing with the loan, such as a car, house, boat, etc. Sometimes a lender will require collateral even if you are not going to purchase anything with the loan proceeds. In that case, the collateral will consist of anything (and perhaps everything) you own, such as electronics equipment and furniture. If the lender takes collateral for a loan, the loan is **SECURED.** If not, the loan is **UNSECURED.**

If you default on a secured loan, the lender can take, or **REPOSSESS,** the collateral, sell it (or keep it) and apply the proceeds (or value) to the balance you owe. Your balance is then reduced by the proceeds (or value) of the collateral, after adding the costs of repossession. If you still owe a balance after repossession, it is called a **DEFICIENCY.**

STEP TWO BUILD AND MANAGE YOUR BUDGET

What is your capacity to borrow and repay money? The answer depends on what you have left after you have met your basic needs, and it is revealed by building and managing a budget of your personal finances.

A budget is a simple math problem. To get the correct answer, you must use the correct numbers. You start with **NET INCOME**—the amount of money you actually receive at your payday. From that number, you subtract all your **EXPENSES** to be paid from that income—the bills you pay, the services you use, the items you buy. The difference between your income and expenses is your **MARGIN.**

If you do the math and come up with zero remaining—or worse, a negative number—you have **NO MARGIN.** Taking on any additional commitments, like a borrowing choice that requires a regular payment, is a recipe for disaster. If, on the other hand, you have steady net income with money left over after expenses, you have a margin with which to borrow now and repay over time.

NET INCOME
– MINUS –
TOTAL EXPENSES
=
YOUR MARGIN or OPPORTUNITY

Calculate Your Capacity To Borrow

Calculating your margin tells you how many dollars you have after expenses. To determine whether you can reasonably afford a given item, it also helps to know the **RATIO** of the expense to your net income. A ratio is determined by dividing the expense or payment by the amount of your net income. Throughout Smart Borrowing, you will learn the significance of expense-to-income (or loan-to-income) ratios in making prudent decisions.

Weighing the impact of a borrowing decision requires that you build and consistently manage your personal financial budget.

Build Your Monthly Budget

In the "Summary & Resources" section of Smart Borrowing, you'll find a blank template you can use to build your personal monthly budget. The instructions outline the steps for you to:

- Identify the *frequency of your paydays* each month
- Indicate your anticipated *net income* per payday
- List your *expenses by category*
- Do the math to *determine your margin* between income and expenses

Manage Your Monthly Budget

Your budget will be a valuable tool if you commit to collecting, adjusting and managing the categories and numbers. You cannot make a budget once and expect it to be your guide month after month. You must instead manage it daily and be aware of changes that might enhance or limit your financial opportunities.

Planning and managing your budget will allow you to make all of your scheduled payments on time or ahead of time, which is essential to a good credit rating. Then, when you need to borrow, your high credit score will pay big dividends by allowing you to borrow at the best repayment terms.

"The worst way to make a borrowing choice is to assume you can afford it because you were approved for it."

DETERMINE YOUR DEBT-TO-INCOME RATIO

STEP THREE

Do you know your debt-to-income ratio? And does it cause you concern? A debt-to-income ratio is a calculation of how much of your current and future income must be used to cancel (or at least cover) the expenses of your outstanding debts.

Is There "Good" vs. "Bad" Debt?

Debt does not have to be a bad thing—especially if it relates to something of value. Taking a mortgage in order to purchase real estate is a very positive step toward financial empowerment; there is equity (value) that can be gained and tax advantages for the interest you will pay. Taking on student loans in order to improve your career potential is a strong investment in your own future. Those types of debts allow you to acquire the value now and pay off the expense over time. However, items of little or no value shouldn't be paid for by creating a debt.

Frankly, most everything you could purchase with a credit card is NOT heavy on the value scale. Things like clothes, entertainment, travel or meals—though part of the value of your life—are not tangible items that could either:

- Be sold to pay off the acquired debt
- Increase in value over time (though large meals might increase your waistline over time)

A Smart Borrower should always consider the long-term value of a purchase when considering a long-term commitment to paying off the expense.

How Much Is Too Much?

The answer to quantity is a relative matter. But it matters very much.

From your current net income, only so much of your money can go to pay for today, save for tomorrow and cancel the expenses of yesterday–your debts. If you have too much of your money committed to paying off "old" things, how can you move forward to new opportunities? For this reason, guidelines about the ratio/quantity of debt expense are important for every Smart Borrower to understand.

Throughout this workbook, you'll learn how to calculate the ratio of an expense and a debt to your net income. Here is the formula for calculating debt to income, and three examples:

THE AMOUNT OF THE DEBT DIVIDED BY THE AMOUNT OF INCOME = % OR RATIO OF YOUR DEBT TO THE INCOME

	One expense payment as a ratio of monthly net income	Many expense payments as a ratio of monthly net income	Total debts as a ratio of total annual net income
Debt(s)	$450.00 car payment	$450.00 car $205.00 credit card = $655.00	$9,200 car loan $4,100 credit card debt = $13,300.00
DIVIDED BY			
Income	$3,200.00 net monthly income	$3,200.00 net monthly income	$38,400 net annual income
Ratio	**.14 or 14%**	**.2046 or 20.5%**	**.346 or 35%**

For more information on debt-to-income and loan-to-value, please visit the CENTS Program's Web site www.centsprogram.com

STEP FOUR

UNDERSTAND AND PROTECT YOUR FICO® CREDIT SCORE

Do you know your FICO® score? When people say they have "good credit," they are talking about their FICO® score, which is based on a formula derived from their personal financial behaviors. The Fair Isaac Corporation, a company that specializes in the collection and analysis of consumer financial data, devised the FICO® scoring formula. Your FICO® score is the largest single influence on your access to consumer finance and the costs you'll pay. For this reason it is essential that you understand the role of your credit files and the impact your FICO® score has on your borrowing costs.

Credit Files

If you have purchased everything in your life "for cash," have never made any financial commitments and have paid for all services (such as rent or utilities) on time, you probably do not have credit files. Everyone else who has had a credit card, auto loan, student loan, mortgage or installment payment plan, or has had a debt go to collection, should have a credit file in the databases of the following credit reporting companies:

EXPERIAN **EQUIFAX** **TRANSUNION**

(See the "Summary & Resources" section for each company's contact information.)

Your credit files will list the commitments you've made with banks, department stores and public agencies—anyone with whom you've had a relationship to pay off a balance over time. For each financial commitment, your credit report will note facts about the original balance, the length of the borrowing relationship, if you ever paid late, if you exceeded a revolving credit limit and whether the account is still open or has been closed. Generally, your payment records for things like rent or utilities aren't reported to the Credit Reporting Agencies *unless* you fall way behind and the accounts are turned over to a third-party collection firm.

Obtaining A Copy Of Your Credit Files

Thanks to 2004 federal legislation, consumers have the right to obtain one free copy per year of each of their credit files from Experian, Equifax and TransUnion. You can learn more about this program at:

https://www.annualcreditreport.com

Additional copies can be purchased directly from each credit reporting company . See the "Summary & Resources" section for each company's contact information.

FICO® Credit Score

Credit files are the record of your financial behaviors and those records are the ingredients that go into your FICO® credit score. To determine your FICO® score, the Fair Isaac Corporation applies a mathematical formula that considers the factors[1] shown in the accompanying chart to determine your score.

Payment history	35%
Amounts owed	30%
Length of credit history	15%
Credit used	10%
New credit	10%

When you know your FICO® score, you begin with an upper hand in your negotiations with a consumer finance provider. FICO® scores range from 300 to 850 points. *Lenders assign their interest rates in direct relation to YOUR FICO® SCORE.* Thus, protecting and improving your credit score is a top priority for Smart Borrowers.

CONSIDER THIS EXAMPLE OF FICO® SCORES, RATES AND COSTS:[2]

A consumer with a **760 FICO® score** receives a mortgage loan with an interest rate of **5.25%**	A consumer with a **620 FICO® score** receives a mortgage loan with an interest rate of **6.75%**
On a $280,000 home, the monthly mortgage payment would be **$1,546**	On a $280,000 home, the monthly mortgage payment would be **$1,816**
Over the life of a 30-year fixed rate mortgage, the total amount paid in financing would equal **$276,621**	Over the life of a 30-year fixed rate mortgage, the total amount paid in financing would equal **$373,785**

A DIFFERENCE OF $97,164!

In each chapter of this workbook, best practices will be highlighted to help you understand which behaviors affect your score, how to protect your score and how to improve it over time.

Obtaining Your FICO® Credit Score

To obtain the most accurate verification of your FICO® score, consumers should request and purchase the information directly from:

www.myfico.com

CAUTION: *Do not purchase credit scores offered by the Credit Reporting Companies. These are estimates and may differ greatly from the actual scores calculated by the Fair Isaac Corporation.*

NOTES:
http://www.myfico.com/CreditEducation/WhatsInYourScore.aspx
http://www.homestore.com/HomeFinance/Calculators/mortgagepayment.asp?poe=homestore

"We're paying off our credit card debts, including all the interest charged on the debt, and the fees. That's money we could have used on something else."

1

CREDIT CARDS

THE CREDIT CARD MARKET

In 2004, over 5 billion credit card offers were mailed to consumers in the United Sates. Why? Because there are billions of dollars to be earned from consumers and their credit card debts. Since 1997, credit card company profits have increased 163%!

If you already have credit cards in your wallet, you are among the 46% of American consumers who have at least two credit cards at their disposal[1] and owe an average of $9,000 in outstanding credit card debt.[2]

CREDIT CARDS

CREDIT CARDS

In today's world of Internet shopping and "retail therapy," credit cards have become a common item in almost every consumer's wallet or purse. However, easy use leads to rapidly expanding balances, which in turn causes severe financial stress for millions of Americans.

The Real-World Risks Related To Credit Cards:

Credit card debt can cast a looming shadow over your personal finances as you swipe those cards, "saving" money on sale items and "saving" time by dining out. Pay only the minimum payment on your account, and you guarantee the credit card company a long-term income. Let your balances grow, and you commit your future income to pay for yesterday's luncheons, purchases or entertainment. Most important: neglect to manage your credit cards, and you do long-term damage to your credit files and FICO® scores.

In This Chapter, We Will:

- Describe the basics of revolving consumer credit financing
- Expose the deadliest Thinking Traps relating to credit card spending
- Examine the initial costs of credit card financing
- Outline the role and range of Principal, Interest and Fees—P.I.F.
- Highlight a strategy for evaluating and selecting credit cards
- Reveal why making minimum monthly payments is *madness*
- Illustrate how to construct and manage a debt reduction plan
- Explain how to improve your FICO® score by managing revolving credit

The Basics Of Revolving Consumer Credit Financing

Credit cards are the most common form of revolving consumer financing. When approved for a credit card account, you are authorized to make purchases up to a stipulated credit limit—for example, $1500. Unlike other lending products, credit card accounts do not have a term—a specific timeline—in which you must repay the balance. And, that's one of the major dangers of credit card debt: monthly minimum payments make almost no impact to reduce your actual outstanding balance.

Credit card accounts are unsecured debts. However, they are significant contributors to your credit files and FICO® score.

CREDIT CARD ESSENTIAL DOCUMENTS

***ALWAYS* OBTAIN AND KEEP IN YOUR RECORDS:**

TERMS & CONDITIONS DISCLOSURE

Before activating your account, review the agreement details for:

- Annual and other APRs
- Annual fees
- Transaction and penalty fees

CREDIT CARDS

THE DEADLIEST THINKING TRAPS IN CREDIT CARD SPENDING

1. Credit Card Purchases Beyond Your Budget Create Debt

The reality is that credit card purchases beyond your budget create debt. *All* spending must fit into your budget. From one payday to the next, your purchases cannot exceed the cash you have in hand or in your savings—and generally you should not touch what is in your savings. When you charge purchases that cost more than what you can pay in full from your budget, you are creating debt. In fact, you are dedicating your future income to pay for yesterday's purchases and activities.

2. Purchasing And Paying Are Two Very Different Transactions

To avoid the first trap, remember that *purchasing and paying are two very different transactions.* When you purchase anything with a credit card, whether a pair of shoes, a latte, a movie ticket or a tank of gas, your credit card company pays for it. Although you may be able to take the item home (or drink it, watch it or drive to work or school on it), you have not even made a down payment on it! In reality, you have delayed paying for the item, service or article. Unless you pay your credit card balance in full each month, the price of the item will be increased by interest and perhaps fees, which is income to the credit card company. Until your credit card balance is paid in full, you still have not paid for the merchandise that created that debt. In short, you have not paid for the shoes (or latte, movie ticket or tank of gas) until the actual money goes from your resources (income) to the credit card company to pay off, first, the finance charges and, second, the original purchase price.

The Initial Costs Of Credit Card Financing

Your initial costs for credit card financing involve *all* of the following:

PRINCIPAL BALANCE AND OUTSTANDING BALANCE

This is the total of what you have charged. If you pay your balance in full every month, this is all you will pay. If you do not pay the balance in full, your outstanding balance (that is, the principal balance less payments) will be the basis on which interest/finance charges will be calculated. Those charges will be added to your balance the next month and will become part of the principal balance. The larger the balance, the more in interest/finance charges you will pay.

INTEREST RATES AND FINANCE CHARGES—THE APR

For the privilege of delaying payment, *you will pay interest,* and the rates may surprise you. On the same account, you may be charged:

- **A Promotional or Introductory Rate** – a low rate advertised to attract customers. Be careful! These last for a very short period of time, after which they revert to the standard APR. Read the fine print to find out how long the introductory rate lasts and what the standard rate will be later on.

CREDIT CARDS

- **Annual Percentage Rate (APR)** — The standard rate of interest calculated against your balance to determine your monthly finance charge.
- **Penalty Rate** — A higher rate charged if you exceed your credit limit or fail to make regular payments.
- **Cash Advance Rate** — A higher rate charged for withdrawing cash against your balance instead of making direct purchases with your credit card.

Fees

Credit card companies often charge annual fees or other fees to increase their income. Fees do nothing but increase your balance. They do not entitle you to additional services, and they do not improve your credit rating. A Smart Borrower will shop credit card offers to select an account with minimal or no fees.

Strategies For Evaluating And Selecting Credit Cards

With a clear understanding of the costs associated with using credit cards—and a commitment to avoiding the thinking traps about spending—you are well-equipped to consider selecting a credit card.

1. **Decide why you want to use a credit card**

   Will it be a tool for managing your scheduled expenses, meaning those already included in your budget? Do you need a credit card to book travel expenses? *Do not* merely collect credit cards because you have been approved. Too many cards create a risk of over-spending and may damage your FICO® score.

2. **Read the small print**

   Do not focus on the big print announcing the offer. Analyze the little print (in the Terms & Conditions enclosure), detailing the real APR, fees, payment cycle and terms of the offer.

3. **Compare the cost to the credit limit**

   When you receive the credit card, confirm the assigned credit limit. Compare this to any annual fees or service charges associated with obtaining the account. Remember that these fees are *in addition to* the interest rate. Divide the total fees by your credit limit to determine whether the fees are an acceptable percentage of the total limit you have been assigned.

   You may find that you will pay a proportionately high fee for just having the card, even if you do not use it! *Do not hesitate to cancel*—before or after activating—any account that is too costly due to fees. (And cancel in writing!)

BEST PRACTICES FOR SELECTING A CREDIT CARD:

- Determine your purpose for having a credit card
- Read the Terms & Conditions enclosure — understand the total fees associated with the account
- Compare the fees to the actual credit limit amount

CONSUMER PROFILE

Martin was thrilled to be "pre-approved *up to* $4,000." As a college student, he never thought he would be approved for that much money. He completed the simple reply card and sent if off in the next day's mail.

Anxious to get the card, he checked the "Express Processing" box, meaning he would get the credit card with 14 days. He then mailed the card and pinned the offer letter to his calendar on a date about two weeks off. Time could not pass quickly enough.

In less than two weeks, Martin received and ripped into the envelope holding his new card. Thrilled, he decided to celebrate by treating his friends to dinner—for $82. Dinner was great. So were the new clothes he bought for $211. Things were not so great at the campus bookstore, however, where his card—his *new card*—was declined. There had to be something wrong, and indeed there was.

The offer had said, "*up to* $4,000." Assuming he had been approved for $4,000, Martin neglected to confirm his actual credit limit. In reality, Martin was approved for only $500, and it was clearly stated on the letter that came with his card. Even so, he had not charged anywhere near $500. Perplexed, Martin grabbed the promotion letter and started looking for clues. He found the answer right there, in the Terms & Conditions enclosure:

Express Processing fee (optional)	**$49.00**
Annual membership fee	**$99.00**
One-time processing fee	**$59.00**
TOTAL FEES:	**$207.00**

All of those fees had been charged to his new account *even before* the card arrived in Martin's hands. In fact, in his first month, Martin hit the limit after charging only $293!

Martin's initial fees of $207 took up 41% of his $500 available credit limit.

Having already used the card, Martin could not escape the charges by canceling the account. Furthermore, he could not use the card again that month, because his two outings had used up the remainder of his $500 limit.

Credit Card Reward And Rebate Programs

Don't spend dollars to earn pennies

Many credit cards have rebate programs in which you can earn back a percentage of your spending through an annual refund. In general, that sounds like a generous effort to keep customers happy. However, if you're running a balance on a rebate program credit card, the actual result is to encourage your spending and to increase the credit cards profits from monthly finance charges.

Always consider how much you're paying to get any type of rebate or reward. A Smart Borrower should know that "free" isn't free when you're required to spend money to be eligible or active in a program.

CREDIT CARDS

WHY IT IS *MADNESS* TO PAY ONLY THE MINIMUM

Making just the minimum monthly payments means that almost all of your payment goes to finance charges. *Do not* fall into this trap!

Your payment is applied as follows:

First to paying finance charges, here **$35. Second** to reducing your balance — in this case, only **$7.00.**

ASSUMPTIONS:

$2,000.00 Beginning Balance
21% APR Monthly interest rate of 1.75% (21%) 12 = 1.75%
$42.00 Minimum monthly payment required in 1st month

DATE	TRANSACTION	MINIMUM PAYMENT	+ = Accrued – = Paid To FINANCE CHARGES	PAID TO PRINCIPAL	PRINCIPAL BALANCE
JAN 1	**OUTSTANDING BALANCE**				**2,000.00**
JAN 20	**This month's finance charges**		**+ 35.00**		**2,035.00**
JAN 30	**Minimum payment required**	**42.00**			
Minimum payment applied to FIN CHGs and PRIN BAL			**– 35.00**	**–7.00**	**1,993.00**
FEB 20	**This month's finance charges**		**+ 34.88**		**2,027.88**
FEB 30	**Minimum payment required**	**42.00**			
Minimum payment applied to FIN CHGs and PRIN BAL			**– 34.88**	**–7.12**	**1,985.88**
MAR 20	**This month's finance charges**		**+ 34.75**		**2,020.63**
MAR 30	**Minimum payment required**	**42.00**			
Minimum payment applied to FIN CHGs and PRIN BAL			**– 34.75**	**–7.25**	**1,978.63**
APR 20	**This month's finance charges**		**+ 34.62**		**2,013.25**
APR 30	**Minimum payment required**	**42.00**			
Minimum payment applied to FIN CHGs and PRIN BAL			**– 34.62**	**–7.38**	**1,971.25**
MAY 20	**This month's finance charges**		**+ 34.50**		**2,005.75**
MAY 30	**Minimum payment required**	**42.00**			
Minimum payment applied to FIN CHGs and PRIN BAL			**– 34.50**	**–7.50**	**1,963.75**
JUN 20	**This month's finance charges**		**+ 34.37**		**1,998.12**
JUN 30	**Minimum payment required**	**42.00**			
Minimum payment applied to FIN CHGs and PRIN BAL			**– 34.37**	**–7.63**	**1,956.12**
		$ 252.00	**$ 208.12**	**$ 43.88**	**1,956.12**

Question:
If finance charges are income to the credit card company and principal payments reduce your actual, outstanding debt, who is the winner when you make just your minimum payment?

6 MONTHS LATER
~ SIX MINIMUM PAYMENTS LATER ~

Your $42.00 is now being allocated:
$34.37 to finance charges
AND ~ ***WOW!*** ~
$7.63 to the actual debt

Answer: The credit card company.
A $2,000.00 balance at 21% with minimum monthly payments of $42.00 will take *8 years and 8 months to pay off.* During those 8 years and 8 months, you will pay $2,337.81 in interest, *in addition to* the $2,000.00 principal balance.[4]

HOW TO CONSTRUCT AND MANAGE A DEBT REDUCTION PLAN

By creating a concrete debt reduction plan, you are setting the term, thereby reducing the total you pay as well as the amount the credit card company makes off of you in finance charges.

If you compare the last chart with this one, you will see the huge difference between paying only the monthly minimum and making a larger payment. Because everything above the minimum payment goes to principal, you can see how fast the actual balance drops and how little is being lost to interest.

ASSUMPTIONS:
$2,000.00 Beginning Balance
21% APR Monthly interest rate of 1.75% (21%) 12 = 1.75%
$42.00 Minimum monthly payment required in first month

Watch how fast the balance — and finance charges — reduce when you pay MORE THAN the minimum payment!

DATE	TRANSACTION	MINIMUM PAYMENT	+ = Accrued – = Paid To FINANCE CHARGES	PAID TO PRINCIPAL	PRINCIPAL BALANCE
JAN 1	**OUTSTANDING BALANCE**				**2,000.00**
JAN 20	**This month's finance charges**		**+ 35.00**		**2,035.00**
JAN 30	**Minimum payment required**	**42.00**			
	EXTRA paid to principal	**300.00**			
Minimum payment applied to FIN CHGs *and* PRIN BAL			**– 35.00**	**– 307.00**	**1,693.00**
FEB 20	**This month's finance charges**		**+ 29.63**		**1,722.63**
FEB 30	**Minimum payment required**	**40.00**			
	EXTRA paid to principal	**300.00**			
Minimum payment applied to FIN CHGs *and* PRIN BAL			**– 34.88**	**–7.12**	**1,985.88**
MAR 20	**This month's finance charges**		**+ 24.20**		**1,406.83**
MAR 30	**Minimum payment required**	**36.00**			
	EXTRA paid to principal	**300.00**			
Minimum payment applied to FIN CHGs *and* PRIN BAL			**– 24.20**	**–311.80**	**1,070.83**
APR 20	**This month's finance charges**		**+ 18.74**		**1,089.57**
APR 30	**Minimum payment required**	**32.00**			
	EXTRA paid to principal	**300.00**			
Minimum payment applied to FIN CHGs *and* PRIN BAL			**– 18.74**	**–313.26**	**757.57**
MAY 20	**This month's finance charges**		**+ 13.26**		**770.83**
MAY 30	**Minimum payment required**	**28.00**			
	EXTRA paid to principal	**300.00**			
Minimum payment applied to FIN CHGs *and* PRIN BAL			**– 13.26**	**–314.74**	**442.83**
JUN 20	**This month's finance charges**		**+ 7.75**		**450.58**
JUN 30	**Minimum payment required**	**25.00**			
	EXTRA paid to principal	**425.58**			
Minimum payment applied to FIN CHGs *and* PRIN BAL			**– 7.75**	**–442.83**	**0.00**
		$2,128.58	**$128.58**	**$2,000.00**	**$0.00**

ACCOUNT PAID OFF IN 6 MONTHS!

CREDIT CARDS

CONSUMER PROFILE

Bruce and Beverly have a very common story. They are dealing with understanding, managing and getting out from under some serious credit card debt.

Like so many consumers, they began their credit card usage with just one account, but offers kept arriving in the mail—offers of "no annual fees" or "0% APR"—each one sounding better than the last. Their one card was quickly joined by others, allowing Bruce and Beverly to diversify their mounting debt—a little to MasterCard, some to Visa and a goodly amount to an array of department store cards.

Thus, the balances grew, but they ballooned when Bruce lost his job. **"I thought I would find another job quickly, so we charged many of our living expenses," he said.** However, the new job did not come together for several months. By that time, most of the accounts exceeded their limits, and payments were either late or not made at all.

Fortunately, some strict budgeting has put Bruce and Beverly in a much better place. After more than a year and a half of diligent effort, they have cut their total credit card debt in half and are doing everything possible to pay off the remaining balance. **"We think about how much money this has cost us, and how many other ways we could have spent—or saved—that money. But we are doing something about it now, and we are not looking back."**

Manage Credit Cards To Build A Positive FICO® Score

The financial behaviors you demonstrate with your credit card usage funnel directly into your consumer credit files and your FICO® score.

Manage your credit card accounts with care, and always do the following:

- Make all payments on or ahead of their due dates. This component makes up 35% of your FICO® score.
- Try never to exceed 75% of a card's total credit limit. When you run your balances to the limit, your credit score suffers. You are seen as someone who cannot budget or manage within financial limits.
- As illustrated in the previous charts, always pay more than the required minimum payment. If you fall into the trap of paying only the minimum, you will be paying for years to come—even on small balances.
- Do not open and close credit card accounts quickly. A major factor in your FICO® score is the length of time you have managed open accounts.

Be certain to read "Understand and Protect your FICO® Score" in Borrowing Basics.

CREDIT CARDS

Summary

Credit cards are not evil, but they must be used with caution. If used properly, credit cards can help you build a strong credit history and a positive FICO® score. If not, they can hurt your credit and leave you deep in debt.

Succeeding with revolving consumer credit means:

- Reading the small print
- Paying more than the minimum
- Staying well within your credit limit
- Paying on time *every* time
- Managing your debt
- Having a plan to pay it off—the sooner the better
- Living within your means: If your credit card debt is growing, you are spending too much

BEST PRACTICES FOR PROTECTING AND IMPROVING YOUR FICO® CREDIT SCORE:

- Make every monthly credit card payment *on or ahead* of its due date
- Limit the number of credit card applications you submit
- Always consider the *entire debt,* not merely the minimum monthly payment due
- Keep your balance at *less than* 75% of your available credit
- Put a debt reduction plan in action
- Always pay *more* than the minimum monthly payment

CRISIS REMEDY CHECKLIST:

If you are struggling to regain control over your credit card limits, be certain to:

- ✓ Act quickly to communicate with your credit card issuers. Lenders are much more willing to work with you if you confront the challenge and do not make them track you down.
- ✓ Keep your guard up—not all financial relief organizations have your best interests in mind.
- ✓ Ask for reductions in your interest rate or for the option to skip one month's payment, without penalty.
- ✓ Go back to your budget and see whether any other expense can be eliminated to free up funds to help reduce your credit card debt.
- ✓ When you do not have enough to make full payments on all your credit cards, try to maintain as many in good standing as possible. Protect as much of your credit record as possible, instead of letting all the accounts become delinquent.

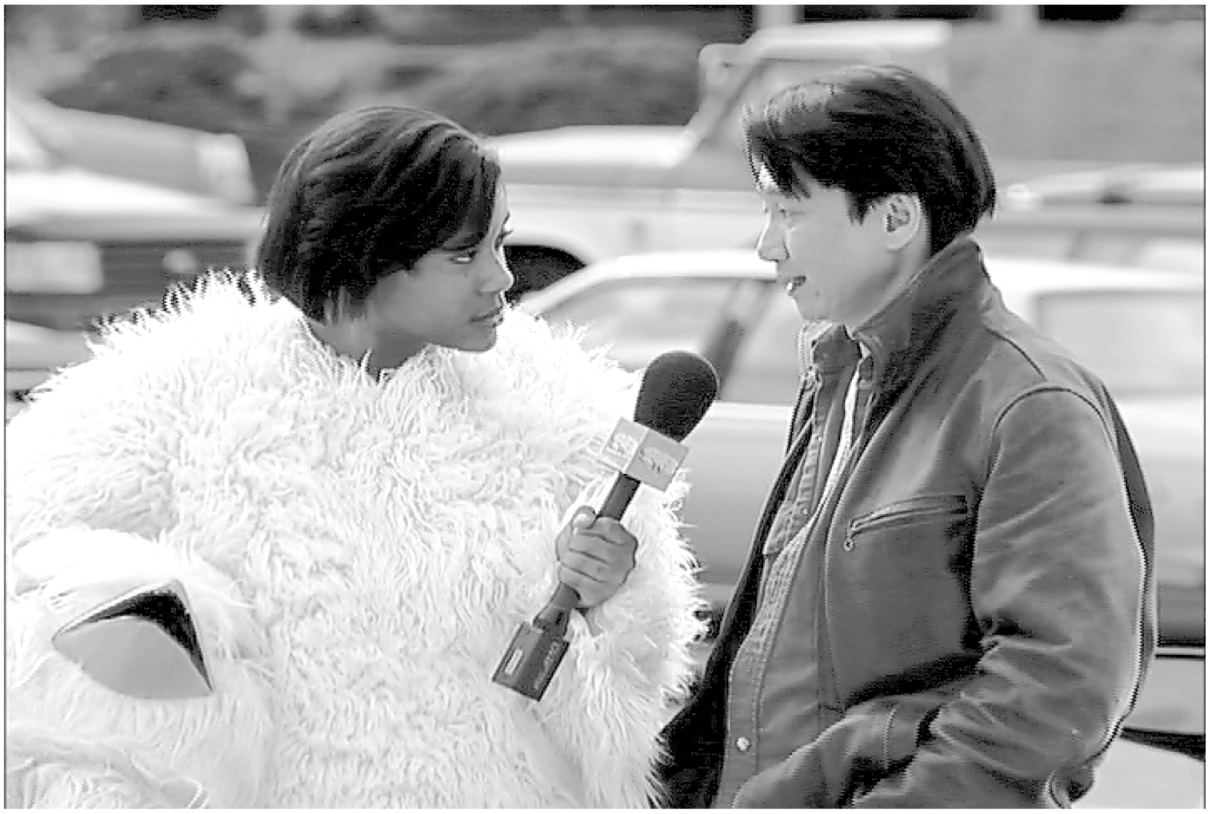
BEWARE OF QUICK FIXES that do not correct your problems and may put you into deeper trouble. For example, avoid using cash advances from one credit card to make payments on another account, and avoid taking a Payday Loan to make your monthly credit card payments.

If you are facing insurmountable challenges, please read "When You have Passed Your Financial Breaking Point," on page 60.

NOTES:

1 Experian, 5-2004; http://www.spotlightonfinance.org/2004/May/product-story1.htm
2 The Motley Fool, June 7, 2004; http://www.fool.com/news/mft/2004/mft04060703.htm?npu=y
3 http://www.bankrate.com/brm/calc/creditcardpay.asp
4 http://www.bankrate.com/brm/calc/minpayment.asp

PAYDAY LOANS



"I'm kind of chicken to get a pay day loan because the fees can really grow quickly."

2

PAYDAY LOANS

THE PAYDAY LOAN MARKET

You are out of cash, your checking account is overdrawn, you have maxed out your credit cards and payday is a week away. You pass a sign that reads:

"GET CASH UNTIL PAYDAY! FAST AND EASY APPROVAL!
NO CREDIT CHECK!
FLEXIBLE PAYMENT OPTIONS AND DISCRETE SERVICE!"

The solution seems very tempting. But is a Payday Loan truly a *solution* or merely a delay to the actual cash crisis you're having?

Payday Loan stores are popping up in every neighborhood and, most recently, have begun to offer their services over the Internet. In 2004, the Payday Loan industry brought in $3.4 billion dollars[1] from desperate consumers, most of whom took out five or more such loans during the year. Payday Loans are fast and easy to get, but the risks are high and the costs are great—and payment terms are not so flexible after all.

PAYDAY LOANS

PAYDAY LOANS

Payday Loan stores are clean and respectable, with convenient hours and locations. Their TV and Internet ads are slick and professional, and their personnel appear supportive. However, convenience comes at a very high cost and may mean disaster for a consumer struggling with a cash crisis.

The Real-World Risks Of Taking A Payday Loan

The reality is that most payday loan customers have come because of an urgent need for cash to cover a necessary expense, such as groceries, gas or rent. Unless the need is truly short-term, caused by an emergency and not by a chronic gap between income and expenses, borrowing to pay for necessities creates far more problems than it solves.

In hard numbers, will you really have—*out of your very next payday*—the money to pay off the entire loan and fee, in addition to the regular expenses that consume the balance of your paycheck? If the answer is no, you may end up in a spiral of fees that gets worse with every extension, until you find yourself in the hands of a collection agency, owing more than you ever dreamed. If this warning seems harsh, read on.

In This Chapter We Will:

- Describe the basics of a Payday Loan
- Examine the costs and term of a Payday Loan
- Consider alternatives to taking a Payday Loan
- Highlight the consequences to your finances and FICO® credit score resulting from an unpaid Payday Loan

The Basics Of A Payday Loan

We use the term "Payday Loan" to refer to an *extremely* short-term, unsecured loan that is provided at an enormously high annual percentage rate of interest.

Payday Loans are most often used—and marketed—as a solution to resolve an immediate cash crisis. To obtain a Payday Loan, you must give the lender a check for the full amount of the loan *plus* a fee. You will get the cash, and the loan company will cash your check on your next payday, typically within 15 days.

The fee is based on the amount borrowed. For additional fees, you may obtain a limited number of short extensions to repay the loan. Failure to pay can cause both short-term and long-term damage to your finances and your FICO® score.

PAYDAY LOANS

THE COSTS OF A PAYDAY LOAN

The Exorbitant Apr Of A Payday Loan

Assume that a borrower requests $300 cash. In exchange, he provides a check for $345—the amount of the loan plus a $45 fee. The date on the check is 15 days into the future. A $45 fee may not offend you at first; after all, it is only 15% of the total loan. However, keep in mind that the loan is due in 15 days, not a year. That is 1% of the total loan amount *per day,* or 365% when expressed as an Annual Percentage Rate (APR) of interest!

On a Payday Loan in the amount of $300	$300
The loan fee is:	$45
The fee as a percentage of the loan is:	15%
Calculated on an annual basis, the APR interest on the loan is:	**365%**

Would you ever consider using a credit card with an **APR of 365%?** How about taking out an auto loan at that amount? *Never!* In fact, Payday Loans carry *the highest interest rates* in the lending industry.

The Term Of The Payday Loan

The friendly Payday Loan store will put cash in your hand, hold your check—for the amount and fee—and deposit it at your next payday. And your next payday better be within 15 days because that's the maximum term of the loan: *two weeks.*

If in two weeks you don't have the cash in your account to pay off the entire loan, costs or consequences are going to occur. You may have to pay loan extension fees.

Consequences Of An Unpaid Payday Loan

Although the original Payday Loan may have only been for a few hundred dollars, the direct and indirect costs of non-repayment may be many times that amount.

Spiraling Extension Fees

When you do not have the money to repay the loan, you may be offered the option to extend, or "roll over" your loan, for another two weeks. You'll pay a new fee—equal to the original loan's fee—and will still owe the same amount of principal. There are two major problems with this option:

- You have only postponed the expense without resolving the problem
- You may get yourself into a destructive spiral of repeated extensions, *without ever paying back the principal* balance of the loan

PAYDAY LOANS

EXTENDING A PAYDAY LOAN: MORE FEES – SAME DEBT

Original Payday Loan amount	Loan fee	Extension fee	The loan has now cost you
$300	**$45**		**$45**
1st extension		**$45**	**$90**
2nd extension		**$45**	**$135**
3rd extension		**$45**	**$180**
4th extension		**$45**	**$225**
5th extension		**$45**	**$270**
TOTAL FEES			
AND YOU *STILL* HAVE NOT PAID BACK THE ORIGINAL $300!			

Further Consequences From An Unpaid Payday Loan

BANK FEE FOR NON-SUFFICIENT FUNDS (NSF) CHECK
If you do not have sufficient funds to cover the post-dated check you wrote and you do not ask for an extension, *or* you have already obtained the maximum number of extensions, your check will bounce and the bank will charge you a fee.

If the check clears your bank and puts you in an overdraft situation, other checks you have written will be returned as NSF, and a fee for each will be added to your growing negative balance.

RETURNED CHECK FEE
The Payday lender will add a large returned check fee to your unpaid loan amount.

DELINQUENCIES AND RETURNED CHECK FEES ON OTHER BILLS
If your rent check bounces, you may face eviction, especially if you have a history of late payments. There will be other consequences specific to any other payments that end up delinquent because of NSF checks.

LOSS OF CHECK-WRITING PRIVILEGES
If your account is negative for too long, you may lose the privilege to write checks.

CHECKS DECLINED
Your bank may report you to TeleCheck,® a check verification service used by most major retailers to alert them of bad check writing risks. If this happens to you, the grocery store may decline your check.

COLLECTION AND NEGATIVE IMPACT ON FICO® SCORE
Ultimately, if the Payday Loan is not repaid, the Payday store will turn your account over to a collection agency and that will impact your FICO® score.

PAYDAY LOANS

ALTERNATIVES TO TAKING A PAYDAY LOAN

If you are facing a short-term cash crisis, consider the following options:

As an alternative to taking a Payday Loan:

- Ask if your employer will give you an advance against your own salary, to be paid by deductions from your next one or two paychecks. This carries no fee.
- Ask about making a payment plan with the company or service you need to pay. Utilities, medical providers, insurance companies and many others should work with you to set up a reasonable installment plan.

Borrowing at a less costly rate:

- Ask a friend or relative to lend you the amount of money that you need—and no more.
- Ask whether your bank or credit union provides short-term loans.
- *Last resort*: Pay the bill or service with a credit card.

CONSUMER PROFILE

After two years in the Army, Jeff finds himself unable to pay for repairs to his car. He needs the car to get back and forth to his job.

Jeff walks into one of the many Payday Loan stores he has seen near the Base. The clerk tells him he can walk out of the store with $300 cash, which is enough to pay for the car repairs. At first ecstatic, Jeff stops short when he realizes that he will be required to pay back the entire $300 plus a $45 fee by his next payday—only two weeks away. As it is, that payday will leave him with only a few dollars in his pocket after paying rent and car insurance. Jeff has learned the hard way what happens when he overdraws his account—$35 per overdraft.

Jeff asks about stretching the term out longer. The clerk explains that the term cannot change. However, when the term is up, he can extend for an additional two weeks by paying *an additional $45*. "Are you telling me, that after four weeks, the loan will cost me $90—and I still won't have paid back the $300?" The clerk responds that this is the price of fast cash with no credit check.

Considering the long-term costs of the loan, not to mention the risk of overdrafts and other associated costs, Jeff concludes that the Payday Loan will cause more problems than it will solve. Jeff desperately wants to keep in touch with his fiancée, but he knows that a big financial deficit is not going to help their relationship. He decides to research other alternatives and suggest to her that they confront this problem together.

PAYDAY LOANS

SUMMARY

Payday Loans provide the most expensive access to cash that the law will allow. Using a Payday Loan will not solve a budget shortfall; it will only delay the problem. Additionally, taking out a payday loan when you truly cannot repay it on time will cost you in repeated loan fees, bank overdraft charges, returned check fees from vendors and possibly other fees, if unpaid accounts are turned over to a collection agency.

If possible, your budget should include a reserve to cover unforeseen expenses. However, if faced with an absolute emergency, *do not* consider a Payday Loan until you have examined all your alternatives, including those contained in the Crisis Remedy Checklist.

CRISIS REMEDY CHECKLIST:

If you are struggling to regain control over your PAYDAY LOAN, be certain to:

- ✓ Act quickly to communicate with your Payday Loan company. Lenders are much more willing to work with you if you confront the challenge and do not make them track you down.
- ✓ Keep your guard up. Realize that lenders act in their own financial best interests— not yours!
- ✓ Ask the Payday Lender to arrange a payment plan at a reasonable rate of interest.
- ✓ If you cannot achieve a reasonable solution with the Payday Lender directly, try negotiating with other lenders or vendors (e.g., utility providers) to free up funds to pay off the outstanding Payday Loan.

BE CAUTIOUS OF QUICK FIXES that do not correct your problems and may put you into deeper trouble, such as using cash advances from your credit cards to pay off your current Payday Loan.

If you are facing insurmountable challenges, please read the "When You have Passed Your Financial Breaking Point" on page 60.

BEST PRACTICES FOR PROTECTING AND IMPROVING YOUR FICO® CREDIT SCORE:

- **Do not ignore the debt**—it can influence your access to banking services and the ability to write checks at retail stores.
- **Work with the payday loan store**—avoid your account being turned over to a third-party collection firm, which will have a negative impact on your FICO® credit score.

NOTES:

1 The Motley Fool, Jan. 31, 2005; http://www.fool.com/news/mft/2005/mft05013101.htm
2 The Motley Fool, Jan. 31, 2005; http://www.fool.com/news/mft/2005/mft05013101.htm
3 http://www.myfico.com/CreditEducation/CreditScores.aspx

3

AUTO LOANS

THE AUTO LOAN MARKET

There once was a day when an automaker made money by selling cars. Now, automakers—both foreign and domestic—are becoming bankers, offering financial services to bolster their profits.[1]

What does that mean for customers? For consumers with great credit, it means great opportunity. For those with less-than-perfect track records, it means huge risk. The warning: In today's marketplace, consumers must be as diligent in negotiating their auto loans as they are in haggling over the price tag of the vehicle.

AUTO LOANS

AUTO LOANS

An auto loan can be your fast track to getting into a new or used car. However, committing to a loan you cannot afford can place you on an even faster track to financial disaster.

The Real-World Risks Of Vehicle Financing

People buy automobiles for very different motives. For some people, a car is a status symbol. For others, a car is a tool used to earn a living. And for others, a car is merely a means of transportation. Regardless of the motives, consumers with auto loans need to be aware that their vehicle can be repossessed if proper payments aren't maintained. A Smart Borrower must be diligent to negotiate an auto financing agreement with the lowest rate and terms. And Smart Borrowers must maintain regular payments in order to protect and improve their FICO® scores.

In This Chapter We Will:

- Describe the basics of auto financing
- Examine the initial costs of an auto loan:
    - The annual percentage rate of interest
    - The term (length) of the loan
    - Prepayment penalties and balloon payments
- Outline the ongoing costs of an auto loan:
    - The components of a P.I.I. auto payment and its ratio to net income
    - The expenses of using and maintaining a vehicle
- Analyze the opportunity cost of auto loans
- Illustrate the impact of FICO® credit stores on auto loans

The Basics Of Auto Financing

An auto loan is an installment loan that is secured by the vehicle being purchased. Auto financing can be obtained from banks, credit unions or directly from auto dealers.

The payments on an auto loan are applied first to interest and then to the principal balance. The annual percentage rate of interest, together with the loan term, will determine the total cost of financing.

Generally, auto loans are written for periods of 24 to 60 months—two to five years.

AUTO FINANCING ESSENTIAL DOCUMENTS

***ALWAYS* OBTAIN AND KEEP THE FOLLOWING:**

RETAIL INSTALLMENT SALE CONTRACT

Before signing, ensure that the agreement details:

- Auto make, model, year & VIN
- Federal Truth-In-Lending disclosures

AUTO LOANS

THE INITIAL COSTS OF AN AUTO LOAN

When you find yourself face-to-face with the finance manager at an auto dealership, the manager may try to convince you to buy a more expensive model by focusing on a low monthly payment or a low APR. *Do not let this happen!* You must always be mindful of each factor that goes into the **TOTAL INITIAL COST** of financing the vehicle, as follows:

Principal — The Amount Financed

To the price of your vehicle, you must add any taxes and license fees. These may be considerable. Unless you pay for these separately, they will be added to the principal of the loan, which is expressed in the loan documents as the "Amount Financed."

Interest — The Annual Percentage Rate (Apr)

As with any other type of financing, the interest rate is the percentage charged on principal balance due at any point. Interest is added to any other upfront charges to determine the Annual Percentage Rate, or APR. Simply put, the higher the APR, the higher the cost of financing. A Smart Borrower will always seek to obtain the lowest APR possible.

The Term (Length) of the Loan

The term of a loan is the number of months over which the loan must be repaid. A longer term may mean a lower monthly payment, but it also means more interest paid to the lender. In order to pay the least amount of interest possible, a Smart Borrower will repay the loan in the shortest time period.

Terms To Avoid

Prepayment Penalties. Since lenders make money only when you are paying interest, some will charge a set period of interest—for example, the first two years—even if you pay the loan off in less than that period. This is called a prepayment penalty. It has no value to the borrower.

Balloon Payments. A balloon payment is one large payment of principal that must be made at the end of the loan term—right when you think you have paid off the commitment. This happens when the monthly payment is so low that it includes little or no principal. An "interest only" loan will always require a balloon payment. A Smart Borrower will *never* accept a sales contract with a balloon payment.

BEST PRACTICES FOR FIRST-TIME AUTO BUYERS:

- Obtain your credit files and FICO® credit score
- Update your budget with your most recent income and all your expenses
- Do your homework: read consumer magazines that provide unbiased surveys about auto prices, reliability and resale values
- Be definite about the type—new or used—and models of car you wish to buy

AUTO LOANS

THE ONGOING COSTS OF AN AUTO LOAN

Making the deal on a car purchase is an achievement. Consistently making the loan payment can be a challenge. The ongoing costs of an auto loan involves monies being paid for:

Principal (P), Interest (I) and Insurance (I)

An amortized payment splits your money between funds going toward principal (the actual debt) and to interest—the finance charges determined by your loan's APR. Interest is always paid off first, and then the remainder of your payment—and any additional funds you pay per month—contributes to repaying the actual principal balance.

However, when you purchase any asset through financing (car, boat or home), you must consider the added cost of insurance. Remember, until you make the final payment on the loan, you're paying to insure the lender's value in the car. For that reason, maintaining your insurance is an essential part of your loan commitment. If you fail to keep proper insurance coverage on the auto, the lender will impose mandatory coverage at rates much higher than you could obtain on your own.

The Ongoing Costs Of Using And Maintaining An Auto

After determining your payment for principal, interest and insurance, do not put away your calculator until you have added the expense of using and maintaining the vehicle. These will vary widely based on your transportation choices (for example, whether you drive everywhere or use public transportation part of the time), the type of vehicle and the licensing requirements in your area. Whether or not you are financing your vehicle, a smart consumer will do the research necessary to make an educated estimate of these expenses:

- Fuel
- Oil and regular maintenance
- Repairs and replacement parts
- Annual license fees and taxes

BEST PRACTICES FOR SELECTING AN AUTO FINANCING:

- Review you're credit history and FICO® score before shopping for an auto loan
- Ask if the lender places prepayment or balloon payments into loans
- Don't provide your personal information to every lender—be selective about whom you allow to obtain your credit files and FICO® score

Debt-To-Income Ratio

Your monthly Principal (P), Interest (I) and Insurance (I) payment must be a rational portion of your budget. A Smart Borrower must always determine the potential debt-to-income ratio—the amount a given payment will demand of monthly net income—before taking on a loan. To calculate your debt-to–income ratio, complete the following formula:

MONTHLY LOAN PAYMENT: P. I. I.	DIVIDED BY MONTHLY NET INCOME	EQUALS % OR RATIO OF DEBT TO INCOME
$497.00	$3150.00	16 %
$635.00		20 %

(Please refer to the "Borrowing Basics" section of Smart Borrowing for more information on how to calculate debt-to-income ratios.)

AUTO LOANS

CONSUMER PROFILE

Cindy is in the market for an auto—and an auto loan. She isn't certain whether a new car is within her grasp or if she'll have to settle for a pre-owned vehicle. Either way, she's looking to finance the majority of the purchase. But she's trying to decide how much she can borrow and for how long.

At the dealership, Cindy test-drives two vehicles: a new car for $18,900, and a pre-owned one for $13,500. Her immediate thought is that the pre-owned car will be her only choice, until the salesperson asks her the following question: "How much can you afford each month?"

Well aware of her budget, Cindy replies that she could only pay $390.00 per month. A few minutes later, the salesperson returns with an amazing offer: Cindy can purchase the new car for only $68.00 more per month than the cost of the pre-owned vehicle. Wow! But then Cindy asks about the term, and the true numbers revealed themselves:

How Term Affects Total Finance Costs

AUTO LOAN	$18,900.00	$13,500.00
APR	6.5%	
MONTHLY PAYMENT	$317.00	$385.00
DIFFERENCE per month	$68.00	
TERM of the loan	60 MONTHS	36 MONTHS
INTEREST PAID in first 12 months of the loan	$1,150.11	$763.00
INTEREST PAID over the life of the loan	$3,208.00	$1,395.00
DIFFERENCE over the life of the loan—principal and interest	**$7,293.00**	

So, $68.00 more a month—over 60 months—turns out to be an additional cost of $7,293.00. At that point, Cindy is sure that the pre-owned vehicle will be her choice, but being a Smart Borrower, she takes the time to consider a few more factors.

Insuring And Using The Vehicle

	NEW CAR	**USED CAR**
Monthly insurance premium	$152.00	$93.00
Gas mileage—fuel costs per month	$110.00	$85.00
Maintenance—potential cost	Full, five-year, 100,000-mile warranty	Two-year warranty of major components

For Cindy, the choice is clear: She'll commit to a 39-month loan at 6.5% with monthly payments of $385.00. She can extend the term and lower her monthly cost but she wants to have that obligation out of her budget as soon as possible. Cindy is planning on buying a home in the next few years and having an excellent payment record on the car loan will only help her FICO® score and her chances for an excellent mortgage. Smart Borrowers need to always be thinking ahead—about their financial plan and credit condition.

AUTO LOANS

THE OPPORTUNITY COST OF AUTO FINANCING

As explained, a Smart Borrower understands that combining APR and the term of the loan determines the full cost of auto financing. Though you may not have much influence over the interest rate you're offered, you do—depending on your budget—have absolute control over the length of the loan. You can negotiate a loan with a very short term, or you can make additional principal payments to a longer-term loan in order to reduce the total cost of the financing.

Consider how much opportunity exists between the following two auto loan terms:

	S t r e t c h the term and pay the costs	
AUTO LOAN	$37,995.00	
APR	7.5 %	
TERM	36 Months	72 months
MONTHLY PAYMENT	$1,181.88	$656.94
INTEREST PAID in the first 12 months of the loan	$2,451.82	$2,672.94
INTEREST PAID over the life of the loan	$4,552.71	**$9,304.52**

So, is there any question why it's in the best interests of Smart Borrowers to repay their auto loans in the shortest time possible? Long-term loans reduce principal balances very slowly and the majority of each payment goes only to paying interest.

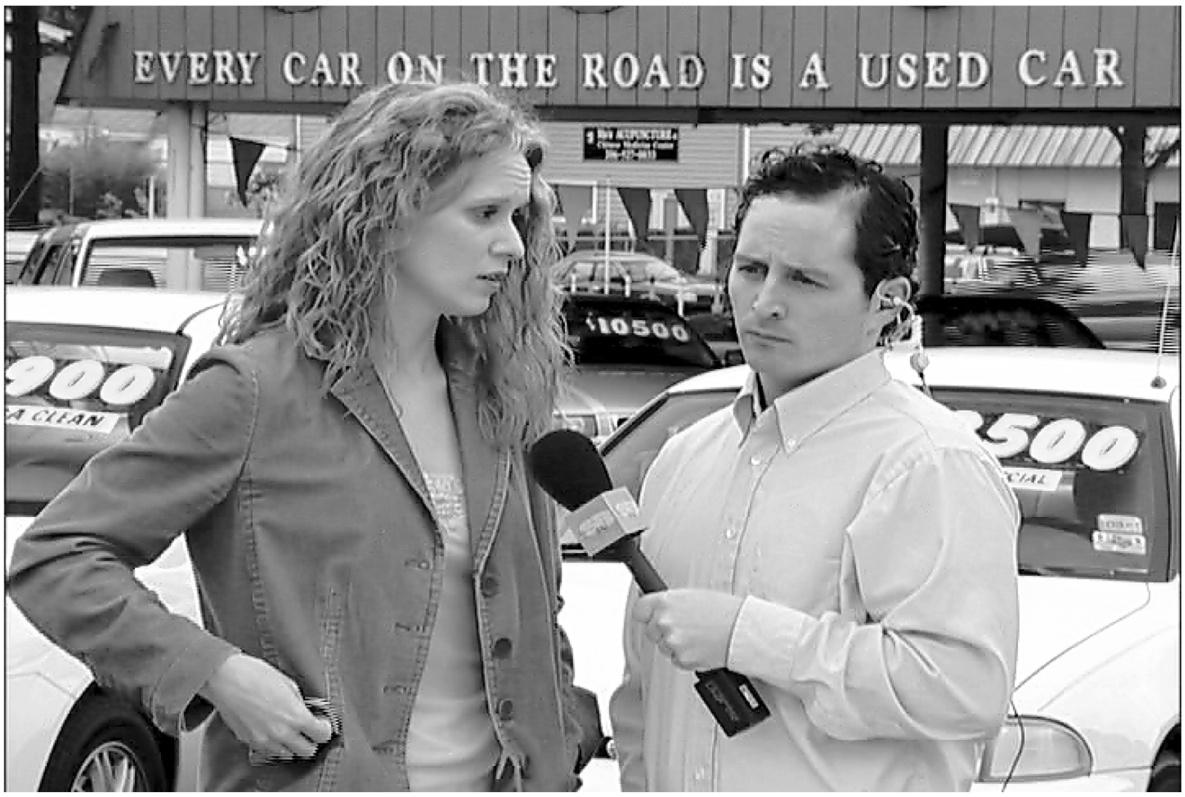
The Impact Of FICO® Scores On Auto Costs

Knowledge, preparation and a healthy degree of caution can help you obtain the best auto loan possible. However, if your basic financial behaviors are having a negative impact on your FICO® score, all the negotiating talents in the world will not get you a better rate. Your FICO® score is the major influence upon the APR you will actually be able to get, as opposed to what is advertised. A Smart Borrower will do everything within her capacity to protect and improve her FICO® score in order to reduce the costs of financing.

Consider how different annual percentage rates (APRs) can affect the cost of financing:

AUTO LOAN	$28,400.00		
TERM OF THE LOAN	48 months		
APR	5%	8%	11%
MONTHLY PAYMENT	$654.03	$694.33	$734.01
INTEREST PAID in the first 12 months of the loan	$1,270.62	$2,045.24	$2,828.48
INTEREST PAID in the 48 months of the loan	$2,983.53	$4,879.70	$6,832.62

AUTO LOANS



"Extending the loan from five to seven years lowers the monthly payment, but increases the total cost of the car."

AUTO LOANS

SUMMARY

The factors that determine the overall cost of a vehicle loan are the price (amount financed), interest (APR) and loan term. To ensure availability of the best APR, protect your FICO® score by diligently paying your bills on time. Next, determine the payment you can reasonably afford and select a vehicle that will allow you to pay the loan in the shortest time possible. In this way, you will reduce the total cost of your financing while keeping your financial opportunities open. Paying on time or even early will in turn enhance your FICO® score, allowing you to obtain favorable terms the next time you need a loan.

BEST PRACTICES FOR PROTECTING AND IMPROVING YOUR FICO® CREDIT SCORE:

- Make every auto loan payment *on or ahead* of the due date
- Add additional payments to principal whenever possible
- When the loan is repaid, request a confirmation letter from the lender stating that the balance is paid in full

CRISIS REMEDY CHECKLIST:

If you are struggling to regain control over your AUTO LOAN, be certain to:

- ✓ Act quickly to communicate with your lender. Lenders are much more willing to work with you if you confront the challenge and do not make them track you down.
- ✓ Keep your guard up—all financial relief organizations do not have your best interests in mind.
- ✓ Ask what the grace period is on your payment due date—having a few more days to make your payment could be a big relief.
- ✓ Ask lenders if they'll accept a partial payment and waive any late or non-payment fees while you get back on track.
- ✓ Consider if there are other expenses you can postpone or renegotiate in order to free up funds to get back on schedule with your loan schedule.
- ✓ If repossession is inevitable, work with the lender to return the vehicle in its best condition so that your outstanding balance due will be the smallest amount possible.

BE CAUTIOUS OF QUICK FIXES that do not correct your problems and may put you into deeper trouble. For example, avoid using cash advances from your credit cards or taking a Payday Loan to make your auto payment.

If you are facing insurmountable challenges, please read the "When You have Passed Your Financial Breaking Point" on page 60.

NOTES:

1 US Banker, June 2004; http://www.us-banker.com/article.html?id=20040601OV9AS818

2 http://www.bankrate.com/brm/auto-loan-calculator.asp

MORTGAGES

"Just like we are shopping for the best house, we're shopping for the best mortgage."

4

MORTGAGES

THE MORTGAGE MARKET

So, you are thinking about getting a mortgage loan and moving out of your apartment into your own home? Congratulations! You are joining the housing revolution. In 2004, 6.1 million homes were sold in the U.S., and the market just keeps expanding. [1]

Mortgage financing is more accessible today than ever before. You can find loan packages through a wide variety of institutions, including banks, credit unions, savings and loans, mortgage companies and mortgage brokerages—and at a wide range of costs. Given the long-term commitment required to finance a home, comparison-shopping is essential. Even after signing on the dotted line, however, a Smart Borrower will continue to monitor and manage the many costs of owning a home.

MORTGAGES

MORTGAGES

Being a homeowner is a major part of the American Dream. The dream can become a nightmare very quickly, however, if the homeowner fails to consider or budget for all associated costs.

The Real-World Risks Of A Mortgage Financing

A home is the largest investment most consumers will ever make, and their mortgage loan is the largest financial commitment they will ever take on. The commitment means dedicating a fixed portion of one's monthly budget to one purpose over a very long period of time, generally from 15 to 30 years. Failure to keep up with the costs of a mortgage will jeopardize your investment and waste your efforts. For these reasons, you must carefully consider all the costs of your mortgage and how they will fit into your immediate budget and financial plan.

In This Chapter We Will:

- Describe the basics of mortgage financing
- Distinguish between "approval" and affordability
- Examine the initial cost of a mortgage—the annual percentage rate of interest
- Identify the ongoing costs of a mortgage:
    - The components of a P.I.T.I. mortgage payment and its ratio to net income
    - The expenses of managing a home
- Analyze the opportunity costs of mortgage financing
- Illustrate the impact FICO® credit stores have on mortgage costs

The Basics Of Mortgage Financing

A mortgage is a long-term loan used to purchase real estate. When you repay a mortgage, you are repaying two parts:

- The principal balance
- The fee for using someone else's money, calculated as a rate of interest

The standard mortgage is a 30-year commitment—that's 12 payments per year, times 30 years, for a total of 360 payments. But in today's world, many consumers will move from one residence to another approximately every seven years. So, the first few years of a mortgage are truly the most important—and the most costly.

MORTGAGE FINANCING ESSENTIAL DOCUMENTS

***AT LEAST 48 HOURS BEFORE CLOSING,* YOU HAVE THE RIGHT TO RECEIVE AND REVIEW:**

GOOD FAITH ESTIMATE OF SETTLEMENT CHARGES

At closing, ensure that you receive and keep in your records:

- Federal Truth-In-Lending Statement
- U.S. HUD Settlement Statement
- Copies of all loan documents

MORTGAGES

APPROVAL VS. AFFORDABILITY—A THINKING TRAP

Lending money is a risky business. Before making a loan, the lender will investigate your financial circumstances and issue approval for a limited amount. During the loan approval process, you will be required to provide information and documentation relating to your income, assets and liabilities, as well as allow access to your credit files. Your approved borrowing limit will be based a number of factors, including the following:

1. Credit history as evidenced by your FICO® score—influencing the loan amount, interest rate and term you will be offered
2. Income and stability of employment and other sources of income
3. Debt-to-income ratio—who else you owe and how much, as compared to your income
4. Assets—whether you are coming to the table with or without cash or other resources

From this information, the lender will decide how much to risk on you. However, what the lender *approves* does not determine what you can *afford*. To equate the two is a dangerous trap for borrowers.

The home you buy—and the mortgage and home ownership expenses you will incur—have to fit into your current budget as well as your overall financial plan, lifestyle and goals. Committing to a mortgage payment that has you stretched to your absolute maximum is neither comfortable nor safe. Every budget must contain a cushion to cover future setbacks as well as valued activities and opportunities.

"House-proud" signifies accomplishment and self-determination. "House-poor," on the other hand, means your finances are so dominated by the mortgage that you have little left for anything else. Rather than you owning the house, it owns you, leaving you feeling trapped and vulnerable.

To avoid these traps, carefully consider the considerations and calculations that will allow you to decide for yourself how much mortgage expense you can afford.

BEST PRACTICES FOR FIRST-TIME HOMEBUYERS:

- Attend at least one free homebuyer seminar offered by a bank or real estate broker in your community
- Obtain your credit files and FICO® credit score
- Update your budget with your most recent income and all your expenses
- Set your own timetable; *do not* get in over your head in response to "act now" or high-pressure tactics

BEST PRACTICES FOR SELECTING A MORTGAGE LENDER OR BROKER:

- Review you're credit history and FICO® score before you begin shopping for a mortgage
- Ask each lender/broker for an outline of fees
- Don't provide your personal information to every lender—be selective about whom you allow to obtain your credit files and FICO® score

MORTGAGES

THE INITIAL COST OF A MORTGAGE

The Annual Percentage Rate of Interest (APR)

With a home seller, you negotiate the purchase price of a house. The price is a one-time amount you pay to acquire the real estate. With a lender, you negotiate the cost of financing, expressed as an annual percentage rate of interest (APR). The interest rate is the factor that determines your cost for using the lender's money to finance the purchase price of your home.

Types Of Mortgages

FIXED RATE MORTGAGE (FRM) — With a fixed rate mortgage, the interest rate will *never change* during the term of the mortgage. A fixed interest rate guarantees that your monthly payment will remain constant throughout the life of the loan.

ADJUSTABLE RATE MORTGAGE (ARM) — With an adjustable rate mortgage, the interest rate *can change* during the term of the mortgage. An adjustable rate is tied to a financial indicator in our economy—such as the Prime Rate of Interest set by the Federal Reserve Bank. When the indicator changes, so to will your monthly mortgage payment. If the indicator goes *down,* your monthly payment will also go down. If the indicator goes *up,* so will your monthly mortgage cost.

Adjustable Rate Mortgages are attractive because they often start out lower than fixed-rate mortgages, and they contain limits as to the rate of increase—or decrease—over a given period and over the life of the loan. On the other hand, ARMs can be a hardship to effective financial management. An ARM makes the most sense if you know you will be selling your home within a very few years, and you are able to make extra payments to principal.

INTEREST-ONLY LOANS AND BALLOON PAYMENTS — Interest-only loans generally have short terms in which the monthly payment is entirely interest. The principal is never reduced by the payments you make. At the end of the loan period, a "balloon payment" of the entire principal comes due at once, requiring the borrower to find another loan to pay it off or extend the interest-only term, usually by paying additional fees. These loans are marketed heavily in periods when homes are rapidly increasing in value. The idea is that the buyer will acquire equity through appreciation rather than reduction in principal. High-risk borrowers are also targets for interest-only lenders. These terms are rarely advantageous to the average consumer and can wreak havoc with financial stability.

The Importance Of The APR

APR dictates cost. In recent years, mortgage interest rates have hit record lows. However, even low APR rates on moderate to expensive homes can add up to be large costs. For that reason, it is extremely important that you strive to achieve the lowest rate possible in order to have the lowest mortgage cost.

MORTGAGES

SMALL DIFFERENCES—BIG IMPACT

On a mortgage of $285,000, a variation of 1 to 2% in the APR makes a huge difference in the cost of a loan, both on a monthly basis and over the life of the loan. On a loan of this size, two percentage points more means $340 additional per month and over $112,000 additional paid over the life of the loan, as shown in the following chart:

ORIGINAL MORTGAGE	**$285,000.00**		
APR	**5%**	**6%**	**7%**
Monthly	$1,529.00	$1,708.00	**$1,896.00**
Interest paid in the first year	$14,154.00	$17,005.00	**$19,858.00**
Interest paid over 30 years	$285,775.00	$330,139.00	**$397,600.00**

Amortization

Amortization is the process of paying off a loan at a stated rate of interest, over a given period of time. An amortization table shows how much of each payment is interest, how much is principal and the principal balance remaining after each payment is made. An amortization table is a great tool to illustrate the benefits of lower APRs, shorter terms and/or extra payments to principal.

An amortization table can help you tremendously if you understand:
1) That interest is calculated on the **DIMINISHING PRINCIPAL** balance
2) That interest is the first amount paid to the lender out of each and every monthly payment.

At the start of a mortgage loan, most of each monthly payment goes to pay interest charges. As the loan progresses—and the mortgage balance is diminished—monthly payments become more evenly divided between interest and principal. In the final years of a mortgage, interest becomes a smaller component and the majority of each payment is applied to the outstanding principal balance.

Example: A 30-year mortgage of $250,000 (at 6% APR), with monthly payments of $1499		
Payment	**Dollars paid to interest** (income to the lender)	**Dollars applied to principal balance** (your equity)
#1 $1,499.00	$1,250.00	$249.00
#90 $1,499.00	$1,111.00	$388.00
#180 $1,499.00	$891.00	$608.00
#222 $1,499.00	$750.00	$749.00
#270 $1,499.00	$547.00	$952.00
#360 $1,499.00	$7.00	$1,491.00

Making extra payments to principal reduces the outstanding balance and the portion of each payment that is taken for finance charges—the lender's income. Smart Borrowers can build equity and more quickly reduce their outstanding principal mortgage debt by making twice-monthly payments or adding extra payments to principal.

MORTGAGES

THE ONGOING COSTS OF A MORTGAGE — PART ONE: The "PITI" Payment and its Ratio to Net Income

A mortgage is a large commitment, not only in dollars but also in scope. So far, we have discussed the payment you must make to the lender. However, the lender is only one of three entities you must pay in order to keep your mortgage in good standing. The three portions of a complete mortgage commitment are:

Principal (P) and Interest (I)
As described above, this is your monthly payment of interest and principal due to the lender.

Property Tax (T)
In most communities, homeowners pay a tax based on the value of their home. Paying property taxes in full and on time is part of a borrower's commitment to keep her mortgage in good standing, and failure to pay the tax is considered a default on the loan and can result in foreclosure, either by the taxing authority or the lender.

Homeowners Insurance (I)
Lenders require borrowers to obtain and pay for homeowners insurance in an amount equal to the full value of the real estate. In the event the home is damaged or destroyed by fire or other disaster, the insurance proceeds can be used to repair the home to restore its value, or to pay off the mortgage.

Escrow
Lenders frequently offer escrow services that collect and forward your insurance and property tax payments, allowing you to make just one PITI payment. If the lender does not provide this service, then it is the borrower's responsibility to make certain that all payments are made on or ahead of their due dates.

WARNING:
When budgeting for your mortgage payment, be sure to include the PITI payment in your calculations. If you are using online mortgage calculators, most will include only the principal and interest.
Be sure to leave room for the additional tax and insurance requirements as well.

Loan-To-Income Ratio—A 40% Guideline

Most lenders considering how much money to lend you will look at the ratio of your monthly debt obligations to your monthly income. A Smart Borrower will employ a similar test to help decide whether a major purchase—such as a home—is affordable.

Housing debt to income should include *at least* the four expenses that make up PITI. As a general guideline, CENTS recommends keeping your PITI costs at less than 40% of your monthly net income. Remember, PITI are just the basics: you need to keep in your budget of the other needs and wants to live a good life in your new home.

You may very well find lenders who will approve you for a greater debt load. However, you are far better off keeping your debts within a comfortable range and within your control.

MORTGAGES

CONSUMER PROFILE

Steve and Sally have been approved for $250,000. They're thrilled to know they can buy a home for so much money. But they also wonder if they can afford that much mortgage cost on what they're currently earning. Together, Steve and Sally examine the approval offer they received.

Their mortgage broker has offered them the following:

- Approval of a 30-year, fixed interest rate mortgage up to $250,000
- A 5.5% APR
- A 1% broker's commission (fee) paid at closing: $250,000 x .01 = $2,500.00

The commission and the closing expenses aren't a major concern for Steve and Sally. They'll be able to pay all the escrow, title and fees at closing with the $6,000 they've saved. So they focus on constructing an estimate of their full mortgage payment that includes Principal (**P**), Interest (**I**), Property Taxes (**T**) and Homeowners Insurance (**I**):

Ratio of PITI mortgage cost to net income

Mortgage value	**$250,000.00**
APR	**5.5%**
Monthly **Principal and Interest** mortgage payment	**$1,419.00**
Monthly **Property Tax** payment	**$200.00**
Monthly **Homeowners Insurance** payment	**$100.00**
TOTAL for a full PITI mortgage payment	**$1,719.00**
Monthly **Net Income**	**$4,150.00**
RATIO: PITI mortgage as a % of net income	**42%**

If Steve and Sally use their entire approval amount and buy a house costing $250,000, their full PITI mortgage payment will demand 42% of their net monthly income.

Knowing that prices for homes in their area vary greatly, the couple examines what their ratio of mortgage costs would be if they spent less than their approval amount.

Mortgage value	**$250,000. 00**	**$225,000. 00**	**$190,000. 00**
APR	**5½ %**		
Principal and interest	**$1,419.00**	**$1,277.00**	**$1,124.00**
Property Tax	**$200.00**	**$175.00**	**$150.00**
Homeowners Insurance	**$100.00**	**$90.00**	**$80.00**
TOTAL PITI payment	**$1,719.00**	**$1,542.00**	**$1,354.00**
Net Income	**$4,150.00**		
RATIO: PITI mortgage as a % of net income	**42%**	**37%**	**32%**

Seeing the numbers on paper gave Steve and Sally a much better understanding of how much home they wanted to afford. At 42%, what would happen if there was a big—or even a little—interruption in their income? As their first home, they could easily make the PITI mortgage payment at 32% of their net income and still have money left over to buy things for the home—like a washer and dryer set.

MORTGAGES

RISKS

Your mortgage commitment is under the scrutiny of three entities: your lender, your insurer and the property tax authority. The three entities communicate and track every move you do or do not make. For example:

1. **If you do not make your principal and interest payment, you are in default.**
   - If you do not make your payment on time, your lender will charge a late fee. Late fees can be steep, and they build up fast.
   - Although most lenders will work with you to resolve a temporary setback, unresolved defaults or a pattern of late or missed payments will result in foreclosure. This means that the lender takes your house, and you lose your investment.
2. **If you do not pay your homeowners insurance:**
   - The insurance company will terminate your policy, and
   - The lender will impose its own mandatory insurance—at amazingly high rates—and attach the premium as an additional cost to your P *and* I payment.
3. **If you do not pay your property taxes:**
   - The county or state will impose penalties and interest and may eventually take action to levy against the property.
   - The lender may pay the property taxes and add the amount as an additional cost to your P *and* I payment.

Smart Borrowers know that falling behind on any part of their PITI mortgage payment will have serious negative impacts on their finances, credit and equity investment in the home.

The Ongoing Costs Of A Mortgage—Part Two: Home Management Expenses

Once you have determined how much your potential PITI mortgage payment will be, you are halfway to fully understanding the total costs of a mortgage. The remaining costs relate to the expenses you must bear as a homeowner that you did not necessarily have as a renter. The following chart illustrates the type of expenses that are common for renters vs. homeowners:

EXPENSE	COST FOR A RENTER?	COST FOR A HOMEOWNER?	CONSIDER
Electricity	YES	YES	Consumption in a home is generally higher than in an apartment
Heating Fuel	NO	YES	If you do not have electric heat, you will pay a high cost for oil, gas or other heating fuel
Water	SOMETIMES	YES	This charge is sometimes passed onto a renter but is always a cost for a homeowner
Sewer *and* Garbage	NO	YES	A regular cost for a homeowner
Public utilities	NO	YES	Part of a homeowner's obligation to help support public services such as storm drains or public lighting
Cable TV	SOMETIMES	OPTIONAL	A choice—not a need—that comes with an invoice to pay every month
Property *and* yard maintenance	NO	YES	Variable but very necessary to maintain the value of a home
Major repairs	NO	YES	A reserve expense that *must* be figured into a homeowner's budget

MORTGAGES

Smart Borrowers have to consider how much their *total* costs will be for mortgage, taxes and insurance, as well as utilities and maintenance. The risks associated with falling behind on these costs can be as serious in the long term as missing mortgage payments.

Risks

Being stretched too far to meet your total mortgage and home management expenses is a dangerous position. If you don't have financial reserves built into your budget, even the smallest unforeseen expense or repair can cause negative impacts on your finances, credit and—ultimately—your investment in the home.

The Opportunity Cost Of Mortgage Financing

Money spent is money gone—forever. The difference between what you *can* borrow vs. what you *do* borrow is your opportunity cost. Because your home is also an investment, it is not unreasonable to get the most that you can afford, especially if housing costs are going up and your income prospects are stable and increasing.

Interest is the highest opportunity cost in your mortgage package. As illustrated above, you can reduce your costs and increase your opportunities by 1) obtaining a lower APR, and 2) reducing your loan term, either by taking a shorter mortgage or making extra principal payments. In this way, you will release more of your hard-earned money for other goals, such as your children's college education or your own retirement.

Consider how much opportunity exists in the gap between the following two mortgage loans:

	HOUSE/ MORTGAGE	HOUSE/ MORTGAGE	DIFFERENCE EQUALS AN OPPORTUNITY OF
COST	$319,000.00	$294,000.00	**$ 25,000.00**
APR		5.75%	
MONTHLY	$1,861.00	$1,715.00	**$146.00**
Interest paid in the 1st year	$18,265.00	$16,806.00	**$1,459.00**
Interest paid in 5 years	$88,607.00	$81,663.00	**$6,944.00**
Interest paid over 30 years	$351,176.00	$323,856.00	**$27,320.00**

The Impact Of The Fico® Score On Mortgage Costs

Your FICO® score is by far the most important influence upon the APR you will achieve. Knowledge, preparation and a healthy degree of caution can help you obtain the best mortgage possible. However, if your basic financial behaviors are negatively impacting your FICO® score, all the negotiating talents in the world will not get you a better rate. Smart Borrowers will do everything within their capacity to protect and improve their FICO® score in order to reduce mortgage costs.

MORTGAGES

Consider the *big* difference between a few APR points:

	Consumer with a strong FICO® score	Consumer with a damaged FICO® score
MORTGAGE AMOUNT	$310,000.00	
APR per FICO® score	5.5%	8.5%
MONTHLY P *and* I	$1,760.00	$2,383.00
Interest paid in the 1st year	$16,946.00	$26,260.00
Interest paid in 5 years	$82,236.00	$129,037.00
Interest paid over 30 years	$323,650.00	$548,107.00

Summary

Obtaining a mortgage to buy a home is a process that takes commitment, effort and a clear understanding of your personal financial capability. Unscrupulous lenders will appear to work magic with numbers to "get you into a house"—but for how long? As a Smart Borrower, you must be committed to learning everything you can about the housing and mortgage markets in your community. Success comes when you find a mortgage that fits your budget and financial plan.

BEST PRACTICES FOR PROTECTING AND IMPROVING YOUR FICO® CREDIT SCORE:

- Make every mortgage payment on or ahead of its due date
- Limit the number of credit applications you submit
- Consider closing zero balance, revolving credit accounts

CRISIS REMEDY CHECKLIST:

If you are struggling to regain control over your MORTGAGE LOAN, be certain to:

- ✓ Act quickly to communicate with your mortgage lender. Lenders are much more willing to work with you if you confront the challenge and do not make them track you down.
- ✓ Be wary of so-called financial relief companies that offer to help you cure defaults or negotiate with your lender. Assume that such organizations have their own financial interests in mind—not yours. All will cost you; some will scam you.
- ✓ When in doubt, seek advice and resources from community nonprofit agencies, such as legal clinics or your local bar association.
- ✓ If your payment obligation includes both principal and interest, ask the lender if you can just make interest payments until you regain control.
- ✓ Inquire whether you can make partial payments in order to keep the loan from going into foreclosure.

BE CAUTIOUS OF QUICK FIXES that do not correct your problems and may put you into deeper trouble. For example, avoid using cash advances from your credit cards or taking a Payday Loan to make your mortgage payment.

If you are facing insurmountable challenges, please read the "When You have Passed Your Financial Breaking Point" on page 60.

NOTES:

1 Realtor Magazine Online, June 1, 2004; http://realtor.org/rmomag.nsf/pages/economyjune04

2 www.bankrate.com

3 http://www.homestore.com/HomeFinance/Calculators/mortgagepayment.asp?poe=homestore

5

MORTGAGE REFINANCING

THE REFINANCING MARKET

So, you are thinking about getting a mortgage loan and moving out of your apartment into your own home? Congratulations! You are joining the housing revolution. In 2004, 6.1 million homes were sold in the U.S., and the market just keeps expanding. [1]

Mortgage financing is more accessible today than ever before. You can find loan packages through a wide variety of institutions, including banks, credit unions, savings and loans, mortgage companies and mortgage brokerages—and at a wide range of costs. Given the long-term commitment required to finance a home, comparison-shopping is essential. Even after signing on the dotted line, however, a Smart Borrower will continue to monitor and manage the many costs of owning a home.

MORTGAGE REFINANCING

MORTGAGE REFINANCING

A mortgage is the largest single financial commitment that most consumers will ever take on. A home is so much more than a shelter, a residence or a retreat: it is usually the major asset for an individual or family. For that reason, you must use extreme caution when considering mortgage refinancing or an equity line of credit.

The Real-World Risks Of Mortgage Refinancing And Home Equity Lines Of Credit

Advertisers are eager to get you to refinance your existing mortgage or add a second mortgage. In essence, they are suggesting that you treat your home equity as a resource to buy more things or pay off existing debt. This is risky business, unless you consider *all of the costs* associated with the transaction and compare them with your existing costs.

In This Chapter We Will:

- Describe the basics of mortgage refinancing
- Examine the costs of refinancing for purposes of consolidating debt
- Discuss the uses and misuses of second mortgages and home equity lines of credit

The Basics Of Mortgage Refinancing

You have been in your house for one year, and you have made every mortgage payment on or ahead of time. Interest rates are slightly lower than when you first financed your home, and your income is a little higher. Should you refinance your existing mortgage to get that lower interest rate?

Refinancing is not a simple renegotiation of your loan terms. Refinancing means obtaining a new mortgage to pay off the existing one. You will pay—again—all the same fees and costs you paid with your initial loan, including closing and escrow costs, title insurance, document preparation, etc. You may be able to avoid some costs by going through the same lender, but even then you will charged a fee, whether a flat fee or a percentage of the loan. If you do not have the savings to pay the costs up front, you may be able to add them to the loan principal.

MORTGAGE REFINANCING ESSENTIAL DOCUMENTS

AT LEAST 48 HOURS BEFORE CLOSING, YOU HAVE THE RIGHT TO RECEIVE AND REVIEW:

GOOD FAITH ESTIMATE OF SETTLEMENT CHARGES

At closing, ensure that you receive and keep in your records:

- Federal Truth-In-Lending Statement
- U.S. HUD Settlement Statement
- Copies of all loan documents

MORTGAGE REFINANCING

CONSUMER PROFILE

Rick has a mortgage balance of $220,000, with a 7% APR. He has been offered a refinancing loan at 6.75% with a 1% fee paid to the lender at closing.

- What will Rick save in interest over the life of the loan?
- How much will the refinance cost in actual dollars?

Refinancing his mortgage at the rate of 6.75% will reduce Rick's overall interest payments as follows:

Interest rate / Loan balance	7% APR	6.75% APR
	At these rates, Rick's monthly mortgage payments would be:	
LOAN $220,000	$1,463.00	$1,426.00
Interest savings per month:	$37.00	
	At these rates, in the next 12 months, Rick would pay in interest:	
LOAN $220,000	$15,329.00	$14,778.00
Interest savings in 12 months:	$551.00	
	At these rates, over the 30 year life of the loan, Rick would pay in interest	
LOAN $220,000	$306,918	$293,691
Interest savings over 30 years:	$13,227.00	

The 1% fee and closing expenses will cost Rick:

FEE or EXPENSE	COSTS	TOTAL COSTS
1% Lender's fee: 220,000 x .01 =	$2,200.00	
1.5%* estimate for closing expenses: Escrow services, title insurance, state and county taxes	$3,300.00	
	TOTAL:	**$5,500.00**

What is Rick's cost-to-savings exchange if he pays the costs upfront?
If Rick does not pay the refinancing costs in cash, it will take *10 years* of interest rate savings to recoup the cost of the refinance transaction. Is it worth it? Probably not.

Year	.25% interest rate savings will equal	Total savings
1	551.00	551.00
2	553.00	1,104.00
3	553.00	1,657.00
4	555.00	2,212.00
5	555.00	2,767.00
6	556.00	3,323.00
7	555.00	3,878.00
8	554.00	4,432.00
9	552.00	4,984.00
10	550.00	**$5,534.00**

BEST PRACTICES FOR SELECTING A MORTGAGE REFINANCE LENDER:

- Determine if the new interest rate is fixed or adjustable
- Identify all the fees and/or expenses that will be taken at closing

MORTGAGE REFINANCING

FACTORS BEARING ON YOUR DECISION TO REFINANCE

A Smart Borrower must consider these factors before launching into a mortgage refinancing:

• What type of interest rate is the new loan—fixed or adjustable?
If you move from a fixed to an adjustable rate mortgage, you face the very real risk of increased monthly payments due to market changes in the Annual Percentage Rate of the loan. In Rick's case, consider how the following interest adjustments—increases—would raise his monthly mortgage payment.

AT 6.75 %	UP .5% TO 7.25% =	AND UP .5% MORE TO 7.75% =
$1,426.00	$1,500.00	$1,576.00
Little changes in APR can cost BIG dollars	$74.00 per month	$150.00 per month

• How long do you intend to stay in the house?
Refinancing is justified only if you will be staying long enough to recoup the costs. As shown in our Consumer Profile, it will take Rick 10 years to recoup the $5,500 cost of his refinance. If he intends to sell his house within that time, the refinance will not have saved him any money.

• What impact will the costs have on your annual federal income taxes?
Mortgage interest and certain other costs are tax deductible and therefore reduce a person's federal income tax obligation. The tax consequences of borrowing are not addressed in this book, and borrowers are encouraged to seek professional advice on that issue.

• Do your current circumstances allow you to refinance with a shorter-term loan?
If your existing mortgage has a 30-year term, but you can now afford a higher payment, consider refinancing into a 15-year loan. Shortening the term may qualify you for an even lower rate. A lower rate, added to the reduced interest resulting from paying off the principal more quickly, will result in substantial savings.

Refinancing To Consolidate Debt

Refinancing your mortgage to obtain a lower APR can be evaluated by examining the exchange between cost and savings, both as to your monthly payment and overall loan cost. Unless you refinance at a shorter term, your housing debt-to-income ratio should not increase as a result of the refinance.

A much different result occurs when you refinance in order to borrow more money for the purpose of 1) financing new purchases or home improvements, or 2) consolidating existing debt. Either way, you must perform the same cost/savings analysis, with the understanding that *you will be increasing your housing debt-to-income ratio.* Additionally, by adding principal to a long-term mortgage loan, you substantially increase the interest you pay on the mortgage. Although this may be less than the interest on your other debt, you must not fool yourself into thinking the cost is insignificant.

MORTGAGE REFINANCING

If you can afford the increased payment, refinancing to cover new purchases, make home improvements or send your children to college involves value judgments that we will not cover here. Suffice it to say you must assess the costs and make sure that your new mortgage is within your budget and returns value to you.

If you are struggling to pay down substantial credit card debt at typically high interest, you may want to pay all your credit cards off with a single loan bearing a lower interest rate. If you are considering refinancing your home to do so, you must understand that ***the only possible justification for invading your home equity to consolidate existing debt is if doing so results in a meaningful and sustained reduction in your overall debt-to-income ratio.*** Do not consolidate your debt simply to allow you to pay your bills with "one simple payment." Consider loan consolidation as a one-time fix for a financial setback. If, after refinancing, you continue to incur your other debts, your overall debt-to-income ratio may suddenly get out of hand.

CONSUMER PROFILE

James and Christina want to consolidate their debts. Their current mortgage stands at $298,000, but the market value of the home has reached $335,000. They are considering a debt consolidation refinancing in order to cash out $30,000 in equity and pay off *all* their other bills: credit cards, one auto loan and a student loan.

Their mortgage broker offers them the following:

- Approve their new mortgage for the current market value of $335,000
- Write their new loan with a 5.5% APR, .75% higher than their current rate
- Get them $30,000 of cash back at closing—after paying their current loan and all closing fees

Though James and Christina want to simplify their finances down to one payment per month, they are concerned about how the new loan amount—at a higher APR—will elevate their ratio of mortgage cost to their net income. First, James and Christina calculate the impact of their mortgage payment for principal (**P**) and interest (**I**):

RATIO OF P&I MORTGAGE COST TO NET INCOME

Mortgage—current vs. refinanced	**$298,000**	**$335,000**
APR	**4.75%**	**5.5%**
Monthly **Principal & Interest** mortgage payment	**$1,554.00**	**$1,902.00**
Monthly net income	**$4,850.00**	
RATIO: P&I mortgage as a % of net income	**32%**	**39%**

Second, the couple adds in the other mortgage requirements of property taxes (**T**) and homeowners insurance (**I**):

RATIO OF PITI MORTGAGE COST TO NET INCOME

Mortgage value	**$298,000**	**$335,000**
Monthly **Principal & Interest** mortgage payment	**$1,554.00**	**$1,902.00**
Property taxes paid monthly	**$110.00**	**$110.00**
Insurance (based on mortgage value	**$100.00**	**$125.00**
TOTAL FOR PITI:	**$1,764.00**	**$2,137.00**
Monthly net income	**$4,850.00**	
RATIO: PITI mortgage as a % of net income	**36%**	**44%**

What if something unforeseen occurred, like an illness, a layoff or a major repair to the house? If they cash out all their equity, they would have nowhere to turn in an emergency except to their credit cards. And at a demand of 44% of their current net income, how could James afford to work part-time and pursue his graduate degree?

MORTGAGE REFINANCING RISKS

A Smart Borrower realizes the significance of her debt-to-income ratios, knows how to make the calculation and keeps all ratios within a safe range.

- If your housing debt-to-income ratio is manageable, but your car payment puts you beyond a reasonable range for your overall debt, defaulting on your vehicle loan will cause you to lose the car but not your house.
- By refinancing your house to consolidate the two payments, you increase the risk that you will default on your home loan. The result? You may keep the car but lose your home.
- As long as your debts are separate, you have flexibility in how you pay them off. In the case of the car, if you cannot maintain the payments you can cut it loose or at least devise a manageable solution. Every non-housing debt you tie to your mortgage is like an additional passenger in a boat: too many passengers, and your boat will capsize.

Another major risk is that you fall into the **THINKING TRAP** that your old debts have been paid off. In fact, they have not been paid off; they have just taken a different form. If you perceive yourself as being free of credit card debt, you will be tempted to start using those cards again for a little purchase here and there, or even for "emergencies." This danger is very real.

Never forget that in refinancing your home, you may have decreased your overall debt-to-income ratio, but you have increased the ratio as to your housing debt. After sacrificing your home equity to consolidate debt, you must be vigilant to avoid incurring new balances on the accounts you just paid off. Once again, a Smart Borrower will never lose sight of the all-important debt-to-income ratio.

HOME EQUITY LINES OF CREDIT

A Home Equity Line of Credit (HELOC) is a revolving account with terms that are very similar to those of a credit card. Like a credit card, you can use the account for purchases or cash advances up to your credit limit; and you can pay the balance in full each month or carry a balance that will accrue finance charges based on the APR of the loan.

The crucial difference is that a credit card is unsecured, while a HELOC is secured by the equity in your home, usually in the form of a second (or third) mortgage. HELOCs have high initial costs that include fees for opening and accessing the account, as well as a relatively high APR.

You must make the payments on both your first mortgage and your HELOC on time each month in order to keep your home investment safe. Thus, your HELOC debt must be included when calculating your housing debt-to-income ratio. A high ratio puts you at risk of default, giving the lender the right to foreclose its mortgage.

How does a Smart Borrower assess the costs and potential savings of a HELOC? The following Consumer Profile will make it quite clear:

HOME EQUITY LINES OF CREDIT

CONSUMER PROFILE

Marie has acquired $24,000 of equity in her home. She purchased the home two years ago at $187,000. Between the payments she's made and the market appreciation, the house is now appraised at a value of $211,000.

Marie's bank has sent her several offers to open a home equity line of credit. The brochures have all said that she can get cash for her equity to pay off high interest credit card or car loans. Or, that she can use the money for something fun . . . like a cruise or a trip. But, being a Smart Borrower, Marie asks two essential questions:

- What are the costs?
- What are the savings?

COSTS

Marie asked her banker and discovers that the HELOC has the following costs:

- Account set-up fee **$299.00**
- Annual fee **$199.00**
- Cash advance fee (each time she takes money from the account) **$35.00**
- A **19.5%** annual percentage rate of interest

Thus, though it's *her equity*, converting it to cash will cost Marie some big money.

IN THE FIRST YEAR	Marie will pay fees equal to	If she takes 7 cash advances in the year	If she averages a balance of $15,000 in the HELOC, her finance charges will equal
	$498.00	$245.00	$2,925.00
TOTAL	$3,668.00		

SAVINGS

Although the idea of using the HELOC money for a trip was very tempting, Marie wants to use the funds to pay off her auto loan and two credit cards. Understanding the costs (as seen above), Marie examined what her savings might be by comparing the current rates/fees on her accounts to the HELOC costs.

DEBT	BALANCE	ANNUAL APR	ANNUAL FEES	TOTAL
Auto loan	$8,500.00	7.5% = $548.51	$0.00	$548.51
1st credit card	$4,200.00	21% = $882.00	$0.00	$882.00
2nd credit card	$2,300.00	11.9% = $273.70	$49.00	$322.70
MARIE'S COSTS FOR 1 YEAR:		$1,704.21	$49.00	$1,753.21
THE HELOC COSTS FOR 1 YEAR:				$3,668.00
SAVINGS? NO. MARIE WOULD HAVE A NET LOSS OF:				- $1,914.79

The idea of having only one bill to pay—instead of four—has a great appeal to Marie. However, being a Smart Borrower, she took the time to ask direct questions and did the math to determine the actual savings. In this case, using a HELOC had no savings for Marie: it would actually cost her an additional $1900.00!

HOME EQUITY LINES OF CREDIT

SUMMARY

HELOCs bear all the risks of credit cards and refinancing mortgages combined. Ease of access combined with relatively high limits and high APRs mean that balances can spin out of control, with payments that rapidly outpace manageable debt-to-income ratios. The risk is clear: In very short order, you can lose your home.

Owning a home is a huge financial responsibility, with great investment potential. A Smart Borrower will protect her investment by weighing every choice that might impact the equity, security and stability in the place she calls home.

BEST PRACTICES FOR PROTECTING AND IMPROVING YOUR FICO® CREDIT SCORE:

- Consider closing credit card accounts that were paid off with home equity capital
- Make every payment *on or ahead* of its due date
- Keep the balance of your HELOC at less that 75% of the available credit limit

CRISIS REMEDY CHECKLIST:

If you are struggling to regain control over your HOME EQUITY LINE OF CREDIT, be certain to:

- ✓ Act quickly to communicate with your financing company. Lenders are much more willing to work with you if you confront the challenge and do not make them track you down.
- ✓ Keep your guard up—all financial relief organizations do not have your best interests in mind.
- ✓ If you were making combined principal and interest payments, ask the lender if you can just make interest payments until you are back in control.
- ✓ Inquire if partial payments can be made in order to keep the equity line active, avoiding the account being turned over to a third-party collection agency and harming your credit record.
- ✓ Consider if there are other expenses you can cancel or renegotiate in order to free up funds to get back on schedule with your HELOC.

BE CAUTIOUS OF QUICK FIXES that do not correct your problems and may put you into deeper trouble. For example, avoid using cash advances from your credit cards or taking a Payday Loan to make your HELOC payments

If you are facing insurmountable challenges, please read the "When You have Passed Your Financial Breaking Point" on page 60.

NOTES:
1 http://www.spotlightonfinance.org/issues/December03/Stories/story8.htm
A 1.5% estimate for closing costs is used here for illustration purposes only; consult with brokers or escrow companies in your area to inquire as to cost estimates.

SUMMARY

THE SMART BORROWING PROCESS

CONGRATULATIONS! You've just completed your first study of the Smart Borrowing process. We hope you'll keep these materials close by, as your "go-to" reference on consumer financing. Also, we hope that you'll apply these skills to every borrowing decision, so you'll always achieve viable and valuable financial commitments.

Moving forward, keep in mind that the Smart Borrowing process is based on a critical examination of risks, costs and opportunities related to your personal financial situation. Always employ these skills to avoid detrimental borrowing decisions.

Furthermore, be conscious to follow best practices that reinforce good financial behaviors and positively impact your FICO® credit score.

Remember, as an educated and empowered consumer—able to manage and maximize your opportunities—you are building with concrete for a solid future.

We hope you will continue to be an active learner, an aggressive negotiator and a confident consumer.

The CENTS Program

A SMART BORROWER WILL ALWAYS:

- ✓ Keep in mind the borrowing basics:
  - Speak the language (p. 8)
  - Manage a budget (p. 10)
  - Know your debt ratio (p. 12)
  - Protect your score (p. 13)
- ✓ Analyze *all* the costs of a borrowing decision:
  - Initial—interest and fees
  - Ongoing—demand on income
  - Opportunity—where else the money could have gone
- ✓ Be aware of real-world risks
- ✓ Avoid borrowing thinking traps (p. 7)
- ✓ Use critical thinking
- ✓ Keep your financial plan in mind

AND, IF A CRISIS OCCURS:

- ✓ Communicate
- ✓ Seek out resources
- ✓ Don't give up

WHEN YOU'VE PASSED YOUR FINANCIAL BREAKING POINT

This section is intended to support and mentor those consumers who have passed their personal financial breaking point. The following is a concise strategy you can use to map your way out of even the most difficult of financial situations.

Quickly face the challenge

Dealing with financial stress is emotionally draining and can impact every other aspect of your life. For those reasons, we encourage you to quickly face the challenge and communicate with your creditors/lenders. It will always be easier if you open the dialogue about your difficulty as opposed to them trying to track you down.

Don't drop your guard

Be aware that many financial relief organizations don't have your best interests as their first goal. Ask critical questions of any organization that offers to take control and solve your financial problems. (See the next page, "What a Smart Borrower must know about Credit Counseling.")

Seek out unbiased professional advice

Legal clinics and bar associations (listed in the white pages of most phone directories) can provide free or low-cost professional advice as to you legitimate rights and responsibilities regarding consumer finance.

Bankruptcy

Bankruptcy can be a good recourse for consumers who have passed their financial breaking point. However, study this option with great care for it will have a long-term impact on your credit record and not all your debts will be forgiven.

You may have gotten into deep financial trouble because of a bad borrowing choice or from some event completely out of your control. But managing your way out of the problem is completely in your hands. As a Smart Borrower, you need to use your critical thinking skills, consider all the risks and costs of any move and keep all options in view of your true financial capability.

Be resilient and don't give up!

The CENTS Program

RESOURCES

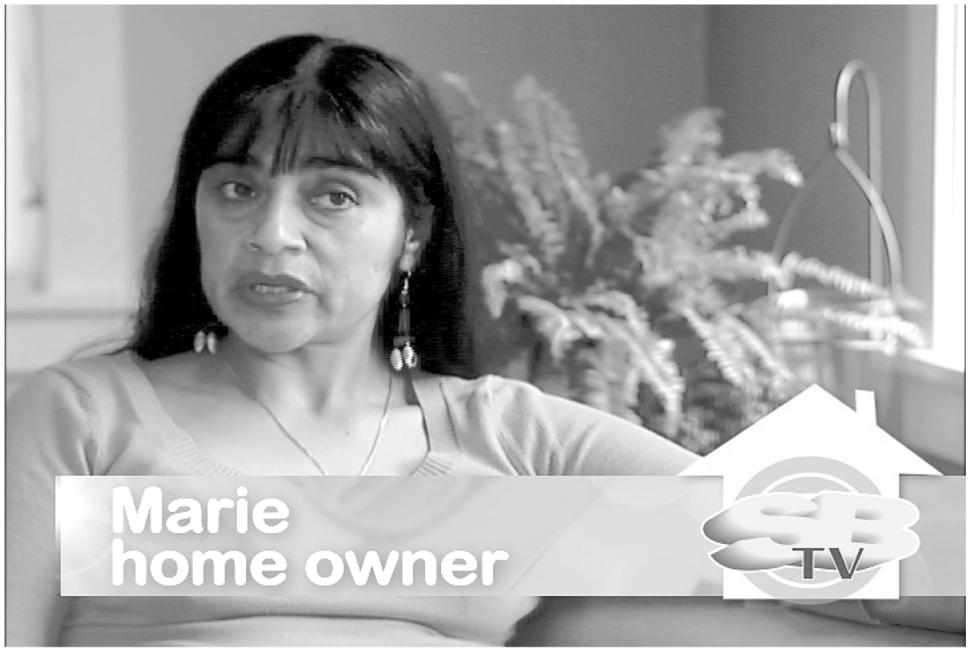
REGARDING SMART BORROWING
206-267-7017 1200 5th Avenue – Suite 600 Seattle, WA. 98101 www.centsprogram.com/smartborrowing
CONSUMER CREDIT REPORTING AGENCIES
888-397-3742 www.experian.com
800-685-1111 www.equifax.com
800-888-4213 www.transunion.com
CONSUMER CREDIT FICO® SCORES
800-342-6726 www.myfico.com
PUBLICATIONS AND CONSUMER INFORMATION
Consumer Response Center 877-382-4357 Federal Trade Commission CRC-240 Washington, D.C. 20580 www.ftc.gov/ftc/consumer.htm
800-372-8303 (Within Washington State) 360-902-8700 Department of Financial Institutions P. O. Box 41200 Olympia, WA. 98504 www.dfi.wa.gov **Check with the Department of Financial Institutions in your state.**
FREE FINANCIAL CALCULATORS
www.bankrate.com/brm/rate/calc_home.asp
www.financial-calculator.com

GLOSSARY

ANNUAL PERCENTAGE RATE (APR)	Most often expressed as a percentage (%), APR is the quantity of interest that will be charged against your loan or debt balance.
BAIT AND SWITCH	The process by which a consumer is drawn to a lender because of a particular (usually very desirable) opportunity, but is pushed toward another product, service or rate that is more profitable to the lender.
BALANCE TRANSFER	The process of moving a financial commitment/ balance from one account to another.
BALLOON PAYMENT	A large principal payment built into the end of a loan term or repayment schedule.
CASH ADVANCE	The transaction of accessing cash from a credit card or home equity line of credit. The amount will appear as an increase in the balance due on the account. Cash advances may involve a fee or cost being added to the account balance.
FEE	An amount charged for a process or transaction performed—such as the processing of a loan application or for a cash advance from a credit card or home equity line of credit.
HOME EQUITY LINE OF CREDIT (HELOC)	A revolving consumer credit account that is secured by the equity value of a home.
INSTALLMENT DEBT	An amount that is lent as a single disbursement and then repaid over a specific period of time (its term) with regular payments. Examples of installment debt are mortgages, car loans and student loans.
INTEREST RATE	An interest rate is the quantity multiplied against your loan or debt balance to determine the finance charges for a given period—day, month or year.
INTRODUCTORY RATE	An APR/interest rate that is only available for a specific period of time—perhaps 3 to 6 months. Once the introductory period has expired, regular rates will be applied to any outstanding balance on the account.
MORTGAGE	A long-term, secured loan used for the purchase of real estate.
MORTGAGE LOAN CLOSING	The process by which a mortgage is signed and disbursed for the purchase of real estate. A mortgage loan closing usually involves the fee-based services of an escrow and/or title company.
PREPAYMENT PENALTY	This is a clause in a loan—specifying a minimum terms of payments—that guarantees the lender a given amount of interest income from the borrower, if the loan is paid off ahead of schedule.

GLOSSARY

REFINANCING	The process by which a consumer exchanges the terms of one loan in favor on a new loan with more desirable rates and/or terms
REVOLVING DEBT	An open-ended opportunity defined by a maximum limit of funds that can be borrowed at any given time. The balance of a revolving account can be paid in full each billing period or a partial (minimum) payment can be made. Examples of revolving debt are credit cards or home equity lines of credit.
SECURED DEBT	A debt that is tied to something tangible that could—in the worst case—be taken by the lender to pay off the borrowed funds. Examples of secured debts are car loans, mortgages and home equity lines of credit.
TERM OF A LOAN	The period of time in which an installment loan is to be fully repaid, usually identified by a number of payments and/or months.
UNSECURED DEBT	A commitment that has no direct link to a tangible item that could be sold to pay off the debt. Credit cards are examples of unsecured debt because they are only guaranteed by the consumer's commitment to repay any charges made.
2ND MORTGAGE	A secondary mortgage taken by consumers based on the equity value of their real estate.



"It's really important to understand your loan."

HOW TO BUILD AND MANAGE YOUR MONTHLY BUDGET

In the "Borrowing Basics" section of Smart Borrowing, we stated:

NET INCOME
– MINUS –
TOTAL EXPENSES
=
YOUR MARGIN
or OPPORTUNITY

Budgeting is a process that requires dedication. When you first begin, you may need to work over your budget for a few minutes each day, making certain you're identifying *all* your expenses. Later, you'll be able to "check in" on your budget each week as you pay bills and allocate money for the expenses you've decided to make. And eventually, your budget will become a record of your financial progress as you look back over months of successfully paying everything *on or ahead of time.*

In this section, we'll walk you through the steps of building and managing a monthly budget. You'll learn how to:

1. Identify the frequency and net income amount(s) of your paydays
2. List and arrange your expenses by due dates
3. Manage the math for each income column in order to achieve successful cash flow

In addition, this section contains the following:

- A list of expense categories/items you can add into your budget
- Two CENTS Program Monthly Budget Templates that you can photocopy and use in managing your finances

For more help with budgeting,
visit the cents program web site at
WWW.CENTSPROGRAM.COM

BUILD YOUR BUDGET

1st

Start with your NET INCOME – how often and how much:

Determine how many times money will come into your household—from everyone who is contributing—in a given month. Sometimes employers issue paychecks on specific dates, like the 5th and 20th. In other situations, your payday may be the same—for example, every other Tuesday—but the date will float as the calendar shifts each month. Grab a calendar and identify the exact dates of all the paydays.

Once you've determined the quantity of paydays for the month you're approaching, divide the third column on your CENTS Program Monthly Budget Template into the correct number of columns.

EXAMPLE: In a family of two incomes, one person is paid the last day of each month. The other is paid every other Tuesday. For July 2005, they'll need three income columns.

FOR THE MONTH OF JULY 2005				
NET INCOME	**PAYDAY(S)**	Tue. 7-5	Tue. 7-19	Fri. 7-29
	NET AMOUNT(S)			

Indicate below each payday the anticipated NET INCOME you should receive. *Be realistic*: If you have slight variations in your net income per paycheck, use the least amount possible as your budget number.

NET INCOME	**PAYDAY(S)**	Tue. 7-5	Tue. 7-19	Fri. 7-29
	NET AMOUNT(S)	**$1,350.00**	**$1,350.00**	**$2,670.00**

2nd

List all your EXPENSES – to whom and when the payment is due:

List *all* your expenses *and* their payment due dates. Your expenses will be unique to your lifestyle, needs and circumstances. But remember, anything you regularly spend money on is an expense.

HOUSING UTILITIES & SERVICES				
Housing Payment	**5th**			
Electricity	**10th**			
Telephone	**16th**			
TRANSPORTATION/VEHICLE, INSURANCE & MAINTENANCE				
Vehicle Payment	**7th**			
Gas & Oil	**Weekly**			
Car Insurance	**28TH**			
Visa Credit Card	**21ST**			

EXAMPLE: You can organize your list however you'd like—by category, by order of due dates. It is most important to be very detailed about the range of expenses drawn from your income.

Payment due dates are *critical*. Paying *on or ahead of due dates* is how you'll avoid late fees and build the best possible FICO® score.

MANAGE YOUR BUDGET

3rd

Do The Math—Net Income Minus Expenses *For Each Payday*:

No matter how many times you may get paid during any month, the math for each payday column *must* result in either zero or—better—a positive number. When income minus expenses equals a negative number in a payday column, it's a clear indication that you're overspending or overextended.

As stated above, *paying on or ahead of due dates is critically important*.

NET INCOME	PAYDAY(S)	Tue. 7-5
	NET AMOUNT(S)	$1,350.00
EXPENSE FOR	PAYMENT DUE ON OR BEFORE DATE OF:	
Savings—Self-Financing Funds		100.00
Food/Groceries	Weekly	75.00
Housing Payment	5TH	745.00
Electricity	10TH	
Telephone	16TH	
Vehicle Payment	7th	420.00
Gas And Oil	Weekly	25.00
Car Insurance	28th	
Visa Card Bill	21st	
Dining Out	Weekly	125.00
Student Loan	14th	
	TOTAL:	- $140.00

EXAMPLE: FIRST ATTEMPT

In the first attempt to outline a budget, our couple ended up with a negative number in their first income column.

NOT ACCEPTABLE

They can remedy the problem by means of:

- **Splitting large payments across two paychecks. For example, the $745.00 housing payment**
- **Inquire about moving payment due dates. For example, the auto loan payment could be moved to the end of the month**
- **Consider decreasing optional expenses like dining out**

EXAMPLE:
SECOND ATTEMPT

In the couple's second attempt, by merely splitting the housing payment between two pay periods (the 30th and the first Tuesday) and reducing their optional expense for dining out:

Instead of a deficit of $140.00, they have a clear margin of $282.50.

VERY ACCEPTABLE

DON'T GET DISCOURAGED!
Budgeting is a skill that takes effort and time to master.

NET INCOME	PAYDAY(S)	Tue. 7-5	
	NET AMOUNT(S)	$1,350.00	
EXPENSE FOR	PAYMENT DUE ON OR BEFORE DATE OF:		
Savings—Self-Financing Funds		100.00	
Food/Groceries	Weekly	75.00	
Housing Payment	5th	372.50*	372.50
Electricity	10th		
Telephone	16th		
Vehicle Payment	7th	420.00	
Gas And Oil	Weekly	25.00	
Car Insurance	28th		
Visa Card Bill	21st		
Dining Out	Weekly	75.00	
Student Loan	14th		
	TOTAL:	$282.50	

**$372.50 taken from the previous month's payday on the 30th*

LIST OF POTENTIAL EXPENSES IN YOUR BUDGET

The categories of budget expenses can range from the essential, such as housing costs, to the ultimately esoteric, such as first-edition comic books.

Remember, if an expense places a consistent demand on your income, *you need to figure it into your monthly budget.*

SAVING FOR
Emergency Fund / Retirement / Child's College Fund / Vacation

BASIC NEEDS:	**DEBTS—COMMITMENTS:**
Food/groceries	CREDIT CARDS, such as: VISA,® MasterCard,® Discover,® American Express®
Prescription drugs	
Clothing	
AT HOME:	Department store credit cards
Housing costs (rent or mortgage)	Gas company credit cards
Electricity	Tax debts
Natural Gas	Student Loan(s)
Water	Personal debts
Sewer, garbage and yard waste	Debts to third party (collection) agencies
Telephone (land line and/or cell)	**LIFE AND LIVING:**
Internet service	Home furnishings
Cable TV	Dining out
Yard maintenance	Entertainment
Household repairs	Personal grooming (haircuts)
Cleaning supplies	Hobbies
TRANSPORTATION:	Health needs
Vehicle(s) loan payment	Exercise and/or sports activities
Gas and oil	Job related expenses
Routine maintenance	Charitable contributions
Parking	Licensing fees
Bus/transit pass	Pet expenses
INSURANCE:	**FAMILY:**
Life insurance	Child care expenses
Homeowners' *or* renters' insurance	School supplies and clothes
Medical / Dental insurance	Activity and program fees
Vehicle(s) insurance	Travel and excursions

For more help with budgeting, visit the CENTS Program Web site

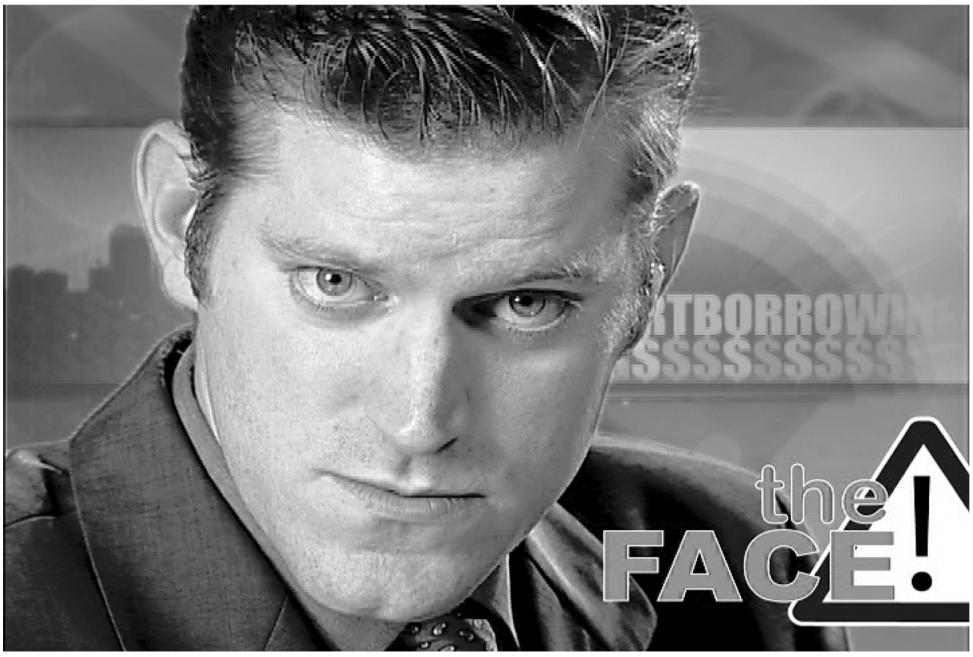
www.centsprogram.com

MONTHLY BUDGET

Consumer Education And Training Services

FOR THE MONTH OF:		
NET INCOME	PAYDAY(S)	
	NET AMOUNT(S)	
EXPENSE FOR	PAYMENT DUE ON OR BEFORE DATE OF:	
Savings—Self-Financing Funds		
Food/Groceries		
HOUSING UTILITIES & SERVICES		
Housing Payment		
Electricity		
Natural Gas		
Telephone		
Internet Service		
Cable Tv		
TRANSPORTAION/VEHICLE, INSURANCE & MAINTENANCE		
Vehicle Payment		
Gas & Oil		
Auto Insurance		
Maintenance		
Cleaning		
Parking		
PAYMENTS ON INSTALLMENT AND/OR REVOLVING DEBTS:		
Auto Loan		
Debt:		
Debt:		
Debt:		
Debt:		
Student Loan(S)		
HOUSEHOLD AND LIFESTYLE EXPENSES:		
Life Insurance		
Medical Insurance		
Perscription Drugs		
Child Care		
Entertainment		
Clothes		
Income Minus Expenses Per Payday(s)		

PHOTOCOPY CENTS MONTHLY BUDGET TEMPLATE



"The FACE says to make copies of these budget templates."

MONTHLY BUDGET

Consumer Education And Training Services

FOR THE MONTH OF:		
NET INCOME	PAYDAY(S)	
	NET AMOUNT(S)	
EXPENSE FOR	PAYMENT DUE ON OR BEFORE DATE OF:	
Savings—Self-Financing Funds		
Food/Groceries		
HOUSING UTILITIES & SERVICES		
Housing Payment		
TRANSPORTATION/VEHICLE, INSURANCE & MAINTENANCE		
PAYMENTS ON INSTALLMENT AND/OR REVOLVING DEBTS:		
HOUSEHOLD AND LIFESTYLE EXPENSES:		
Income Minus Expenses Per Payday(s)		

Consumer Education And Training Services

CENTS
1200 5th Avenue, Suite 600
Seattle, WA. 98101
(206) 267-7017
www.centsprogram.com/smartborrowing