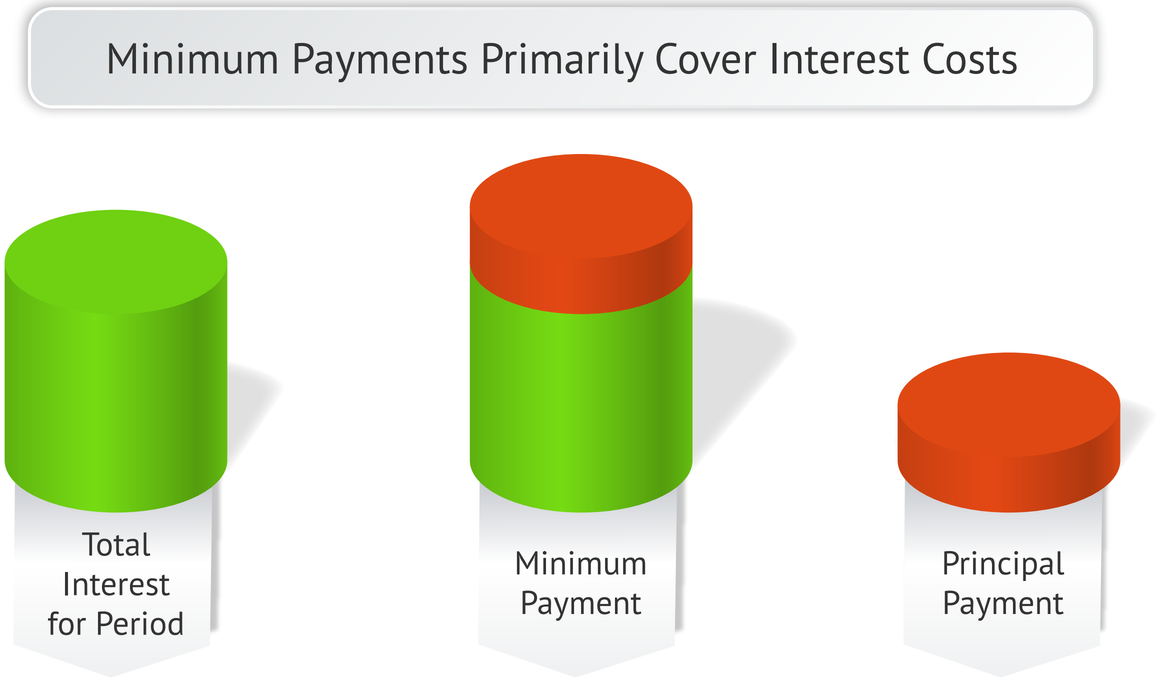
Promotional Rates

Credit card companies often offer promotional interest rates – sometimes as low as 0% – for a specified period of time when you first open the card. Be wary of these promotions. First, if you decide to transfer balances from other cards to take advantage of the lower interest, be aware that there may be transfer fees. Make sure the transfer fees are less than what you'll save in interest.

Second, pay close attention to the date when the promotional period expires. If you have a balance on the card when the promotion runs out, all the interest debt from the promotional period will capitalize on the principal balance. That can cost you a lot in additional interest.

Minimum Payment

People have a common misperception that it's okay to pay just the minimum payment calculated for you by the credit card company. But this amount is the bare minimum that, if paid, will keep your account active. It's barely high enough to pay the interest charges, let alone ever actually retiring the debt. If you pay only the minimum payment, you could end up paying $1,000 for a pair of new shoes. Your debt will last a lot longer than the shoes.



Compounding Interest

When you use a credit card, you also have to figure in the concept of compounding interest. If you carry a balance on the card – just like with any loan – you end up paying "interest on the interest." That is, when a debt compounds, any unpaid interest is added to the principal balance. You then pay interest not only on the principal, but also on the interest that was added (compounded) onto your principal.

Consider the following simple example: you open a credit card with a 24% interest rate and an introductory option to make no payments for 12 months, and the interest compounds monthly. You use the card to buy a new laptop computer for $1,000. At the end of the first month, the interest is $1,000 X .02 (1 month at 24%/year interest) = $20. That makes your new principal balance $1,000 + $20 = $1,020.

Then the second month, your interest compounds again: $1,020 X .02 = $20.40. See how the figure goes up? You're paying interest not only on the original principal of $1,000, but also on the $20 interest you accrued in the first month. Your new principal balance is $1,020 + $20.40 = $1,040.40. In the third month, your interest compounds again: $1,040.40 X .02 = $20.81. Your new principal balance is $1,061.21. And so on. If we continued calculating all the way to the end of Month 12 and then you paid off the balance, the total amount would be $1,243.37.

Other inputs allow you to get more accurate compounding interest calculations, such as when interest compounds (at the beginning or end of the period), whether you pay more than your fixed payments, and how frequently the debt compounds. Many compounding interest calculation tools are available online through a simple search.

Conclusion

Credit card debt can be a huge pitfall for many people. But when can credit cards work in your favor? When you're smart about controlling your credit card spending. If you pay off your balance in full every month, you will never pay a penny in interest on a credit card. That means you should never charge more in a given month than you can afford to repay the next month. If you have emergency funds set aside, you can help protect yourself from having to pay the typically high interest rates associated with carrying a credit card balance month to month. Using a credit card with care and good judgment can help you build a good credit rating and move closer to your financial objectives.

Activity:

Review the Terms on Your Credit Cards

This activity leads you to gather the relevant terms and information about your current credit cards, compare those terms with other credit card offers, and decide whether obtaining a new card and transferring your balance would be beneficial to your personal financial situation.

Activity: Review the Terms on Your Credit Cards

1) Information on Your Existing Cards

Gather information about your existing credit cards and enter the information into the “Existing Cards” column below.

2) Shop for New Opportunities

Do a quick search online or just check the mounds of junk mail you’ve received at home for multitudes of credit card offers.

Don’t just look at the advertised, promotional rate. Those rates are almost always temporary. Check the full terms to determine the non-promotional rate that will be charged after the promotional period.

Especially note any balance transfer fees in the card’s terms and conditions. Sometimes the transfer fee is charged as a percentage of the total debt you transfer; other times it’s a flat rate.

Enter the information for the card offers you want to compare into the “Compare Cards” column below.

3) Compare and Transfer

Compare your current card’s rates, terms, promotions, and rewards with those offered on the cards that you gathered from your search online or the mail pile.

If your current rates are generally higher than what you see for the recently discovered cards, contact your credit card company, inform them of your research, and ask them to match or beat the rates on the ones you shopped.

If you are not satisfied with your current card company’s response to your request, you can begin the process of applying for one of the new cards you shopped previously and, if approved, transfer the debt from the old card to the new card.

Transferring a balance does NOT relieve you from the credit card debt. You are simply moving debt from one spot to another. But if the fee to transfer is less than the savings you gain in interest or the benefits you gain from rewards, then the transfer is worth the trouble.

Activity: Review the Terms on Your Credit Cards

Existing Cards

- Credit Card Name ____________________
- Current Interest Rate _______%
- Is this a Promotional Rate? ◯ Yes ◯ No

If Yes, List the Date the Rate Will Change

_____/_____/_____

If Yes, What the New Rate Will Be _______%

- Balance Transfer Fee (If Applicable)

____

- Bonuses or Incentives that are Useful to You (e.g. 2% cash back on gas purchases)

____

- Credit Card Name ____________________
- Current Interest Rate _______%
- Is this a Promotional Rate? ◯ Yes ◯ No

If Yes, List the Date the Rate Will Change

_____/_____/_____

If Yes, What the New Rate Will Be _______%

- Balance Transfer Fee (If Applicable)

____

- Bonuses or Incentives that are Useful to You (e.g. 2% cash back on gas purchases)

____

Comparison Cards

- Credit Card Name ____________________
- Current Interest Rate _______%
- Is this a Promotional Rate? ◯ Yes ◯ No

If Yes, List the Date the Rate Will Change

_____/_____/_____

If Yes, What the New Rate Will Be _______%

- Balance Transfer Fee (If Applicable)

____

- Bonuses or Incentives that are Useful to You (e.g. 2% cash back on gas purchases)

____

- Credit Card Name ____________________
- Current Interest Rate _______%
- Is this a Promotional Rate? ◯ Yes ◯ No

If Yes, List the Date the Rate Will Change

_____/_____/_____

If Yes, What the New Rate Will Be _______%

- Balance Transfer Fee (If Applicable)

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- Bonuses or Incentives that are Useful to You (e.g. 2% cash back on gas purchases)

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Activity: Review the Terms on Your Credit Cards

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- Is this a Promotional Rate? ◯ Yes ◯ No

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Comparison Cards

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- Is this a Promotional Rate? ◯ Yes ◯ No

If Yes, List the Date the Rate Will Change

_____/_____/_____

If Yes, What the New Rate Will Be ________%

- Balance Transfer Fee (If Applicable)

____

- Bonuses or Incentives that are Useful to You (e.g. 2% cash back on gas purchases)

____

Quiz:

Credit Cards 101

Quiz

1. With a credit card, the faster you pay off the balance, the less money you will pay to the lender overall.

   a) True
   b) False

2. There are no other benefits of using a credit card apart from the money it lends you.

   a) True
   b) False

3. Using a credit card with care and good judgment can help you build a good credit rating and move closer to your financial objectives.

   a) True
   b) False

4. Your emergency fund should equal a minimum of at least ____ months' worth of your current monthly bills.

   a) 2
   b) 4
   c) 6
   d) 8

5. Before transferring an existing credit card balance to a new card, it might be a good idea to contact your current credit card company and see if they will match or better the interest rate offered on the new card.

   a) True
   b) False

6. A few months ago, Allison's credit card balance was $1,500. Instead of just paying off the minimum balance every month, she worked extra shifts at her job and, today, she was able to pay off her entire credit card balance. Why did Allison go through so much trouble to pay off her credit card?

   a) Because otherwise, she would have had to pay income tax on her credit card balance.
   b) Because otherwise, she would have had to pay compounded interest for a long time.
   c) Because otherwise, she would have had to cancel her credit card.
   d) Because otherwise, the credit card company would have seized her savings account.

7. Which of the following individuals' credit card use habits could benefit them over time? More than one answer may be correct.

   a) Teddy uses his credit card to purchase gas and groceries, and pays off the total balance at the end of each month.
   b) Meredith uses her credit card to pay her family's utility bills, and carries about half the card's balance over to the next month.
   c) James and his partner used their credit card to purchase a new computer, and paid the balance in full during the 0% promotional rate period.
   d) Edie uses her credit card as her emergency fund.

8. Hefty compounding credit card interests are the main reason behind credit card debt.

   a) True
   b) False

Automobile Financing - Loan & Lease Options

Many variables go into the terms of an automobile loan. In this topic, you will be introduced to the various loan and lease options, understand what lenders look at to qualify you for a car loan, and weigh the options against your short- and long-term financial goals.

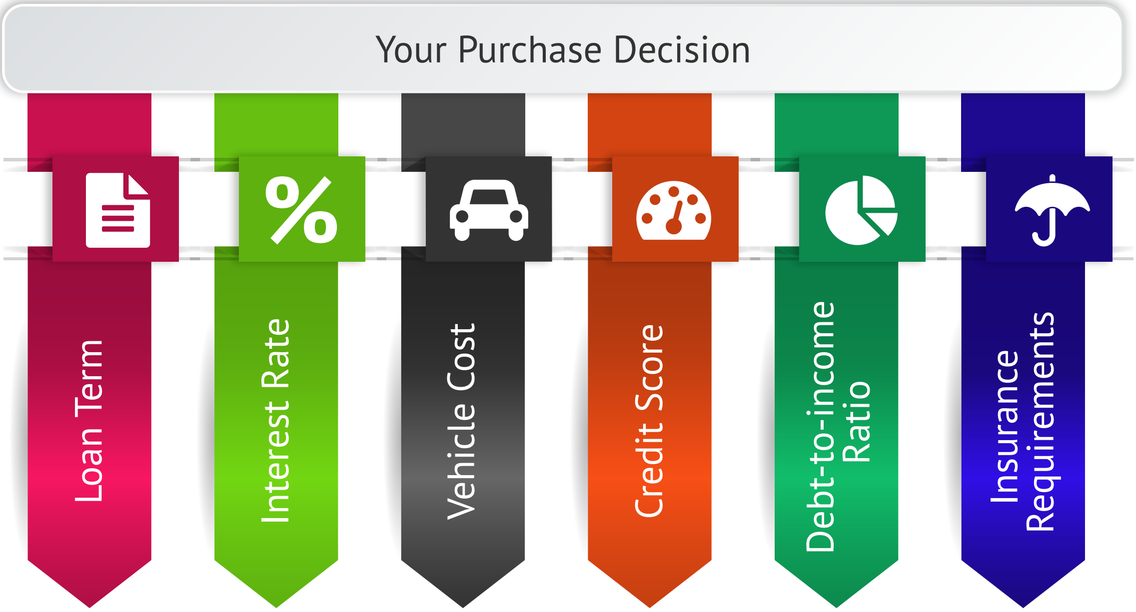
Time Investment
1.5 hours

National Financial Educators Council

Automobile Financing - Loan & Lease Options
Loans & Debt

Automobile Financing - Loan & Lease Options

Choosing the right car loan could potentially save you thousands of dollars. For that reason, it's important to understand the ins and outs of what to look for when entering into a car loan agreement. That way, you can carefully weigh your choices and avoid ending up in a situation where you owe more than the vehicle is actually worth or with a vehicle you can't afford.



Car loans are available under a variety of different terms, ranging from one to eight years in length. In general, longer loan terms correspond with lower payments; but you will end up paying more in interest over those long terms.

Applying for a car loan is typically not too difficult. In fact, it's part of the sales process when you finance through a dealership. Just as with anything involving significant sums of cash, the effort you put in at the early stages of the loan process will more than pay off down the line by helping you avoid undesirable loan repayment situations and maintain a solid credit score.

Decide on Your Desired Loan Term Length

Assuming that you do not have any major red flags in your credit history, you will have to decide what kind of loan you want. The bulk of loan options typically come in durations of between three to five years, although other term options are possible.

While shorter-term loans come attached to higher monthly principal payments, longer loans will end up costing you more in interest as a consequence of the longer payment term. Salespeople will always try to get your monthly payment into the range you can achieve. By simply increasing the loan term, they can make a monthly payment seem more feasible; but remember that it will cost you more in total. In addition, when you enter into long-term loans, you run the risk of becoming "upside down" on the loan – owing more than the vehicle is worth.

Interest Rates

Like any loan, you will have to pay back not only the principal amount of the loan, but also interest on the principal balance. Your interest rate is determined by the level of risk you pose based on your credit score, credit history, and debt-to-income ratio. If they perceive a high risk that you won't pay the money back, they will charge more interest to offset that risk.

The loan term also makes a difference in the interest rate: usually, the shorter the loan term, the lower the interest rate will be. And interest rates can vary widely depending on the type of lender – whether a bank, credit union, private lender, or the car dealership. Highly-qualified customers (e.g. credit scores above 720) might be offered a rate as low as 2-3%, whereas customers with poor credit (e.g. credit scores of 500-589) might have to pay as high as 25%. Most states have "usury limit" laws that mandate the maximum interest rate a lender can charge, but those limits differ state-by-state.

Gain Pre-approval

Once you have an idea about the kind of loan you are looking for, the next step is to gain pre-approval from a financial institution that could serve as the lender for your auto loan. By applying for pre-approval with a financial institution before you speak with the salesperson, you will know what kind and amount of loan is available to you based on your financial situation. Pre-approval allows you to compare that offer with the offers the dealership will make, and potentially increases your leverage during negotiation.

Assuming that you qualify for an auto loan, you will be given terms of "pre-approval" that contain the maximum amount of money for which the financial institution will provide a loan. Pre-approval is limited in duration, often giving you up to 60 days to purchase a vehicle under the terms of the offer.

It should be noted that you are free to select a vehicle that costs less than the maximum amount indicated in the pre-approval. In that case, you will simply pay back the correspondingly lower sum of money over the life of the loan.

Buy Your Car (and Finalize Your Loan)

With pre-approval in hand, you will already know the price range of vehicles from which you can choose. You simply have to decide what kind of car you want, given the options available. However, just because you were approved for a certain amount doesn't mean you should use that full amount. Consider the vehicle's costs in your budget and find a price that works within your short- and long-term goals. If you feel like you are "stretching" your budget just to get the car you want, you may want to reconsider.

After you select the car you would like to buy, dealers may also offer loan terms of their own. Feel free to compare them with the terms of the pre-approval, but be careful not to get talked into the superficial appeal of lower monthly payments by taking a longer-term loan. The cost of the vehicle, the term of the loan, and the interest rate are all separate items open for negotiation. Dealers purposefully simplify these items into a single "monthly payment" figure to help them make a sale.

What Car Lenders Consider

When you apply for a car loan, lenders want to be confident that you have the means to repay the loan according to the agreed-upon terms. Toward that end, lenders look at several key factors when deciding whether you qualify for a loan:

Your Credit Score

The better your credit score, the lower interest rate you will be offered on a car loan. Lower interest translates into lower monthly payments.

Your Debt-to-Income Ratio

Lenders evaluate your income compared to any outstanding debts that you may have accrued. This statistic is captured in your debt-to-income ratio. Those who secure the best loan terms will usually have a stable employment history along with low debt.

Available Capital

The more cash you can put down up front, the less you'll need to borrow over the duration of the loan. A large down payment is a good way to more easily qualify for a loan and is recommended to whatever extent possible given your situation.

The Pitfalls of Winding up “Upside-down”

In lender jargon, an “upside-down” or “underwater” car loan refers to a situation in which the amount you still owe on the loan is greater than the resale value of the car. For instance, imagine that you purchase a new car for $20,000 on a seven-year loan. After paying loan installments for three years, you still owe a total of $12,687 for the remaining four years of the loan duration.

What if you decide that you’d like to trade in your current car with that $12,687 remaining in loan repayments and put the proceeds towards the purchase of a new vehicle, only to find out that the value of your car is now only $9,000? That means you actually owe $3,687 more than the car is worth!

Upside-down on a Car Loan

You now have negative equity in your current vehicle. You will either have to continue making the payments as scheduled, or just eat the loss in equity in addition to making the down payment for the new car. Neither situation is appealing, which makes being “upside-down” no fun at all and something to be avoided if at all possible.

For example, you might have been able to take out just a three-year loan. In that case, you would own the car completely after only three years of monthly payments. While this situation would have required making higher monthly payments than in the seven-year loan option, the shorter term provides built-in discipline to ensure that you can actually afford the contract you're signing.

Getting Right-side-up Again

If you do find yourself stuck in an upside-down loan, it is more important than ever to carefully review each of the options still available to you.

The first thing to consider is paying down the negative equity in one lump sum. Repayment requires that you have capacity to absorb the one-time hit to your savings account, so you should take stock of the total negative equity tied up in the underwater loan as well as the total assets you have at your disposal for the purpose of paying it down.

If it is not feasible to just eat the negative equity, it may be worthwhile to attempt to renegotiate your loan terms. For instance, your lender might be amenable to a situation where you pay higher principal on each of your loan installments in return for a reduction in the loan duration. In that case, you conceivably could manage to catch up with your vehicle's ongoing depreciation and get out from under the negative equity.

Finally, depending on your financial situation and credit history, it might be possible to take out a new loan at a more appealing interest rate. If refinancing seems like a good option, it is probably best to avoid the allure of low monthly payments on loans of an extended duration – that's what caused your upside-down situation in the first place. Instead, try to pay off any loans as quickly as possible.

Avoiding the "Upside-down" Trap Altogether

Continuing the example from before, imagine that you had only taken out a three-year loan. In that case, you would own the car completely after making three years' worth of larger payment installments. Then, at the conclusion of the three years, the entire $9,000 value of your car would be available for you to use as a down payment on another vehicle.

The key to avoiding an "upside-down" loan is not to fall into the trap of buying a car with a long-term loan structure that you can't really afford. If you couldn't afford the payments under the shorter three-year loan term, that might be an indication that you should not take out a longer-term loan just to nominally reduce the monthly payments.

After all, there is a situation far worse even than having negative equity: when you can't make your car payments at all.

Beware the Repo!

So what happens if you can't keep up with your car payments?

If you miss several months of car payments, the lender will contract with a repossession ("repo") company. The repo company will come and take the car back, usually on the back of a tow truck. Not only do you lose the car, but you lose all the money you paid in loan payments and your initial down payment as well.

And that's not even the end of it. If your car is repossessed as a consequence of failing to make loan payments, your credit history will also be seriously damaged. As a result, it will be much more difficult to qualify for another car loan in the future.

Insurance Requirements under Car Loans

Every car owner must also buy insurance for the vehicle. In the case that your car is entirely paid for, it is possible to insure your car at only the minimum level required by state law. Most states at minimum require liability insurance, which pays for any damages that you cause to others while driving.

When you take on a car loan, however, the lender will also impose its own insurance requirements. These requirements usually mandate that you carry a more comprehensive suite of insurance policies representing what is known as "full coverage." Lenders want to protect themselves from significant losses in the event the car becomes damaged.

Full Coverage

"Full coverage" is a term commonly used to denote holding three different kinds of car insurance at the same time: liability, collision, and comprehensive insurance.

As mentioned before, liability insurance is used only to cover damages that you cause; not any damages to your own vehicle. Collision insurance takes care of any necessary repairs resulting from a collision. Comprehensive insurance kicks in where collision insurance leaves off, paying for damages caused by anything else – as long as it is covered in the fine print of the policy contract. Such covered incidents may include damages from fire, theft, vandalism, animals, or inclement weather.

Since full coverage insurance can cost up to three times the minimum required coverage, it pays to look around for the best deal. You should start this process early, at the same time that you are shopping for your car and auto loan. As always, a clean driving record helps in your search to get the best insurance rates on the market.

Leasing

For most individuals, leasing a vehicle is not the best choice. But for a select few individuals with unique circumstances, or for small business owners, leasing may be a financially viable option. While it's true that you won't build equity in the car while making the necessary loan payments, you will also avoid the possibility of winding up with an upside-down loan and the associated negative equity. This same risk can be mitigated by accurately budgeting your vehicle costs and keeping the loan term of purchased vehicles to a few years, so the benefits of leasing typically can be found through other means.

Leases usually have lower monthly payments, which can make them seem more attractive. However, when you lease a vehicle it is essentially a long-term rental. You must return the vehicle to the dealership at the end of the lease.

Many lease contracts have an option that will allow you to buy the vehicle from the dealership at the end of the lease. Again, for most individuals, lease buyback is not a wise financial decision. You would have just paid 2-4 years' worth of lease payments, and then immediately sign up for another 3-6 years of additional payments when you finance the loan for the leased vehicle's purchase.

With all that said, financing a leased vehicle functions similar to purchasing a vehicle. As you may already be aware, as you add mileage to a vehicle and as its age increases, its value goes down. Therefore, driving the leased vehicle over a period of time is akin to "spending" the vehicle's value. You and the dealer come to an agreement as to how much the vehicle is worth and how much of that value you will "spend" during your lease agreement. You then finance that amount and agree to make monthly payments to the dealer.

There are many factors to take into consideration when deciding whether to purchase or lease a vehicle, such as how much you drive and the length of time you plan to own the car. If you plan to drive the car into the ground, securing an auto loan for purchase may be the better option. But at least give the idea of leasing a moment of thought to see if it might be more suitable for you.

Conclusion

Most people are likely to finance a vehicle at some point in their lives. The thought of getting a new car can trigger feelings of excitement and pride. However, there are many factors involved in an auto loan, and not all loans are created equal. Before you become convinced to make a decision that takes you off course toward your financial goals, it's important to consider all the details of the loan agreement and the additional costs of owning a vehicle. This topic has sought to lay out the options for purchasing a vehicle, so you can make decisions that best align with your long-range personal finance plan.