



LouisianaBankers

EDUCATION COUNCIL

*Simply Banking*  
*Student Version*

## Introduction

The Louisiana Bankers Education Council (LBEC) is the educational outreach division of the Louisiana Bankers Association (LBA). The mission of this group of middle management bankers is to promote financial education among bankers and students throughout Louisiana. Providing banking study guides to Louisiana high school students has been part of the LBEC outreach program for many years.

*Simply Banking* was developed by the 2003 Council and updated by the 2009 Council to present the basics about banking to high school students and adult learning groups. Increasing the financial literacy of young consumers is a primary concern for bankers, who are interested in serving customers of all ages.

**Thank you to all those who took part in preparing *Simply Banking*:**

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# Louisiana Young Bankers

## *Simply Banking*

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## THE HISTORY OF BANKING

Banking has come a long way since it began in the 1700's. The banking community has evolved into the system we know today by many acts of the government. Banking plays a big part in any economy. Banks help people start businesses and help people buy things they cannot afford to pay cash for, like houses and cars. When banks first opened in the 1700's, there were only state banks (banks governed by state constitutions). In 1791, the first national bank was opened and it was called The First Bank of the United States. The national banks are governed by the federal government.

### **1863: National Bank Act**

One of the first banking acts passed came in 1863, the National Bank Act, is still in effect today. The act produced major changes in the banking systems. The act was needed because banks were unsafe and the government had no control over the banking system.

The National Bank Act of 1863 did the following things for the banking community:

1. Established the office of Comptroller of the Currency (which is still used today).  
The Comptroller of the Currency had to approve any bank before opening.
2. Established the national bank note – the predecessor to today's "dollar" bill.
3. Established reserve requirements which forced banks to keep cash in reserve.  
Banks could not lend out 100% of deposits.

### **1913: Federal Reserve Act**

In 1913, the Federal Reserve Act was passed. The act established 12 Federal Reserve districts. The 12 Federal Reserve districts were placed throughout the United States and checks from all banks must go through this system. This helped reduce the time it took to collect cash from checks. The act established local control of reserve requirements, and established that bank notes did not have to be backed by government securities.

### **Glass-Steagall Act of 1933 and Federal Deposit Insurance Act of 1935**

During the depression in the 1930's, the Banking Acts of 1933 and 1935 were passed with the following results:

1. Commercial Banks could not pay interest on checking accounts.
2. The Federal Reserve could set the maximum interest rate on time deposits.
3. Investment banks could not take deposits and commercial banks could not participate in investments.
4. Authorized the Federal Deposit Insurance Corporation (FDIC) to set standards for operations and examinations of banks to reduce bank failures and set standards to protect deposits.



## **1980: DIDMCA**

The Depository Institution Deregulation and Monetary Control Act (DIDMCA) was passed in 1980 for deregulation of the banking industry. A number of banks in the 1970's failed. This act lifted the legal ceiling on the interest rates that banks could pay on deposits. The deregulation promoted competition between financial institutions. The act also extended Federal Reserve requirements to commercial banks. Finally, the act raised the FDIC insurance, which protects customer's deposits, from \$40,000 to \$100,000. Currently, there is legislation pending that could raise the insured deposits again.

## **1989: Financial Institutions Reform, Recovery and Enforcement Act (FIRREA)**

This act reformed and consolidated the federal deposit insurance system to restore the public's confidence in the savings and loan industry.

## **1999: Gramm-Leach-Bliley Act**

In 1999, the Gramm-Leach-Bliley act was passed, which gave bank holding companies the opportunity to invest in non-banking companies. Before the Gramm-Leach-Bliley act, bank holding companies could only invest in banks, but once the act was passed it gave bank holding companies the freedom to invest in non-banking companies.

There are many other acts and regulations that affect the banking industry. The few listed here give an overview of the evolution of the system.

## **The Federal Reserve System**

The Federal Reserve is the central bank for the United States. The Federal Reserve came about in the The Federal Reserve Act of 1913, to help with issues that were unresolved in the banking industry. The system has 12 Federal Reserve Bank Cities. These cities are: Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco. Louisiana is split between two different Federal Reserve districts. South Louisiana is a member of the Atlanta district and north Louisiana is a member of the Dallas district. Each member bank in the district owns stock in the Federal Reserve Bank. Although the banks own stock in the system, they do not have a vote on the decisions that are made by the Federal Reserve.

Seven members rule the Federal Reserve System, which make up the Board of Governors. The President of the United States appoints each member of the Board of Governors for a 14-year term. Terms expire every two years, spreading appointments out among different presidents. The Board of Governors is a very powerful group. The decisions that the board makes affect the whole United States economy.



The Federal Reserve is responsible for the following:

1. Clearing checks.
2. Setting interest (discount) rates on loans the Federal Reserve makes to banks.
3. Holding and setting reserve balances.
4. Furnishing coins and currency.
5. Transferring funds from one bank to another.

When a check from bank A is deposited in bank B, the Federal Reserve is the vehicle that bank B would use to collect the cash from bank A. This is a way of ensuring bank B that they can collect the money from bank A.

The Federal Reserve uses the interest (discount) rate to affect borrowing. If the Federal Reserve is trying to increase the money supply, they reduce the interest (discount) rate and encourage borrowing. If they are trying to decrease the money supply, they increase the interest (discount) rate and discourage borrowing.

When banks receive deposits, they can only lend a portion of the money out and must keep a portion of the money in reserve. This money is kept at the Federal Reserve. The Federal Reserve also can adjust the amount required to be kept in reserve as it sees fit.

The Federal Reserve furnishes new coins and currency for banks. Shipments are made to banks at regular intervals to take old money (that will be destroyed) out of circulation and to make new money available to customers. This insures that currency and coins are replaced regularly.

If a customer of bank A needs to pay someone at bank B they can transfer money from one bank to the other. The Federal Reserve is the way that the money would be transferred from one bank to the other.

The Federal Reserve is the central bank for the United States. The Federal Reserve System fills many voids that were in the banking industry before the Federal Reserve Act of 1913 was passed. The Federal Reserve System helps banks and also assists the customers of the banks. The Federal Reserve System helps make the United States banking system one of the strongest in the world.



## **BANK PRODUCTS**

### **Savings Accounts**

A savings account is a type of banking account that allows you to deposit money and earn interest. It has no stated maturity and funds can be deposited and withdrawn at will. Interest is money that is paid to you by the banking institution for the use of your money. One of the biggest advantages of a savings account is that the bank will pay you for keeping your money with them. Another advantage is that your money is in a safe place. If you leave your money at home, you may lose it, spend it or forget where you put it. By having your money in a savings account you can take time to plan and to spend it wisely. You can take money to your banking institution and deposit it or withdraw it at any time. Savings accounts are insured by the FDIC up to a maximum per customer.

### **Certificate of Deposit**

Another way to save is with a Certificate of Deposit (CD). A CD will usually pay more interest than a savings account. The difference in a savings account and a CD is that you have to deposit a minimum amount of money into a CD for a set period of time. This time frame can be anywhere from 30 days to 5 years or more. Once the money is deposited into the CD the money cannot be withdrawn until the set time is up (maturity date). On the maturity date, the bank will pay you your money along with the interest earned. If funds are withdrawn before the maturity date then penalties will be applied, which vary by bank.

### **Checking Accounts**

One of the most popular services provided by a bank is a checking account. A check is a small piece of paper printed with the account holder's name, address, account number and the banking institution on it. We write checks to pay our bills or to purchase items without carrying a large amount of money. The check cannot be for more than the amount of money in the account. When the check is cashed, the bank takes the money out of the owner's account. Checks are safer to send through the mail than cash. Once a deposit of money is made into a checking account, it can be taken out by writing a check or using an automated teller machine or by a draft from a company to pay bills. See Checking Account section for more detail.

### **Interest Bearing Checking Accounts**

Interest bearing checking accounts pay you interest for retaining a minimum balance on the account and not using more than a maximum number of transactions. The interest rate and minimum balance varies with each institution. An interest bearing checking account can be used for the same purpose as a non-interest bearing checking account.



## **Money Orders**

A money order is an order for the payment of an amount of money, usually issued and payable at a bank or post office. People typically use money orders if they do not or cannot have a checking account. Money orders are safer to send through the mail than cash. A fee is paid for each money order at the time of purchase.

## **Cashiers Checks**

A cashiers check is also known as an official check. The cashiers check is issued by a customer and bought at the bank. The customer pays for the cashiers check when they buy it. Because a cashiers check is an official bank check, many companies require that customers pay with a cashiers check. Banks often use cashiers checks to pay their own obligations. These checks may also be sold to customers who require an official check of the bank.

## **Certified checks**

A certified check is the bank's promise to pay. A certified check is a customer's check that the bank has stamped with the word CERTIFIED and added a signature. Through certification of a check, the bank guarantees that sufficient funds have been set aside from the customer's account to pay the check.

## **Travelers checks**

Travelers checks are sold by banks in different denominations for the convenience of people who do not wish to carry cash. These checks can be used as cash. Funds can be recovered if lost or stolen. There is usually a fee to purchase, but the "checks" are able to be used around the world.

## **Safe Deposit Box**

A safe deposit box is a secured container that is rented to customers for safe keeping of personal valuables. Each box is kept in a heavy steel cabinet. Customers who rent safe deposit boxes are issued a key to the box and the bank manager retains a key. When a customer wants to get into their box at the bank both keys must be used. The use of two keys is for added protection. Items in a Safe Deposit Box are not insured by the bank.

## **ATM**

Automated Teller Machines (ATM) are electronic machines that dispense cash, take deposits, transfer deposits or give account balances to the account holder. They may be located inside, outside or apart from the bank. ATMs allow 24 hour access to the funds in your account. Customers have a personal identification number (PIN) based debit or ATM card to be used in the ATM. Some PIN based credit cards can be used in the ATM to access cash.



## **Debit Card**

A card issued by a bank to allow customers access to funds in their checking account electronically. It allows a customer to withdraw funds from a deposit account. It acts like a check. Debit cards are usually branded with MasterCard or VISA and are accepted worldwide

## **Wires**

Wire transfer funds are electronically moved from one bank to another and/or from account to account, upon a customer's instruction. Typically, there are fees associated with wires.

## **Internet or Online Banking**

The Internet allows customers, especially those who enjoy the convenience of banking from the privacy of their own homes, the option of completing their banking from a computer. Customers can view their accounts, make transfers between bank accounts, pay bills and even receive their monthly statements. Strict regulations help keep information secure.

## **Automated Clearing House (ACH)**

ACH allows the electronic transfer of bank items such as deposits and withdrawals to and from bank accounts. This nationwide electronic network has been used since the mid 1970s.



## Investment Products

**Mutual Funds** pool money from lots of small investors to invest in a large portfolio of stocks and bonds with many investments. To be successful in mutual fund investing you must be patient and use the fund as a long-term investment. Mutual funds come in many varieties. A mutual fund is also known as an open-end investment company, meaning that there is a continuous offering of new shares and redemption of outstanding shares.

**Stocks** are shares of ownership in a company purchased by investors. The value of the stock is related to how well the company is doing. As a shareholder you may receive dividends. This means you are paid part of the company's profit each year.

**Bonds** are basically a loan to a company. Bonds pay a fixed amount of interest every year until they mature, at which time the amount of the bond may be cashed in.

## Retirement Accounts

**401K** retirement plans are offered by employers. A certain percentage of your salary can be deducted from your paycheck before taxes, and placed into an investment of your choice. Often your employer will match a percentage of the money you put in. You cannot cash in your investment until retirement age without paying a penalty.

**IRA or Individual Retirement Accounts** let you save for retirement and the savings is typically tax-deductible. One advantage of an IRA over 401K is the additional freedom. With a 401K you choose from your employer's plans and the money is automatically deducted from your paycheck. With an IRA you invest when you want, with whom you want. You cannot cash in your investment until age 59 1/2 without paying a penalty. There are annual limits of IRA deposits that can be tax deductible and the tax deductibility depends on your other retirement plans you may have with your employer. There are various types of IRAs including, traditional, ROTH and education.

## Loan Products

Banks may offer several types of loans for many different purposes. Some of the basic types of loans include: installment, revolving and mortgage loans.

**Installment Loans** are loans in which a lump sum of money is issued to the borrower for a specific purpose and repaid over a specified period of time, including: auto loans, personal loans and student loans.

**Revolving Loans**, the borrower has the ability to borrow up to a certain dollar amount on an ongoing basis. As the balances of revolving loans are repaid, the borrower may continue to borrow up to the set dollar amount. A Credit Card is an example of Revolving Loan.



**Home Loans or Mortgage Loans** are installment loans used to purchase houses and land. Repayment of home loans is generally longer than that of an installment loan, typically, 15 to 30 years. There are a variety of home loan types depending upon the specific need of the home owner/purchaser. See Loans and Credit sections for more detail.

## **Insurance Products**

Banks may offer several types of insurance in conjunction with loans to protect yourself, your family, and your investment. These types of insurance are Credit Life, Property and Casualty, and Accident and Health insurance.

**Credit Life Insurance:** This is an optional insurance that is purchased through your bank when you take out a loan. This insurance will payoff your loan in the event that the insured borrower should die. Upon receipt of written proof of death, the insurance will pay the amount required to payoff the debt.

**Property and Casualty Insurance:** This insurance is required by the bank to protect the items for which you are borrowing money. This insurance is taken out as a separate policy to protect your home or vehicle from any damages they may receive. If you do not take out your own policy, the bank has the right to buy an insurance policy for your loan.

**Accident and Health Insurance:** This is optional insurance that is purchased through your bank when you take out a loan. This insurance will cover your payments in the event that you are sick or injured and out of work for more than 30 days. Upon written proof from your doctor, the insurance will pay the amount of your monthly note until you return to work.

## CHECKING ACCOUNTS

### Opening

Opening a checking account is easy at the bank of your choice. The person who opens your account is typically called a New Accounts Representative or a Customer Service Representative. You will generally be asked for a picture ID such as a driver's license. You will need to provide the new accounts representative with your Social Security Card and Number. You will need an initial deposit when opening your account; the amount varies by bank. The bank will then perform an account verification to identify your history of using checking accounts. The system that is used keeps track of other checking accounts you have had in the past. It reports things like checks you may have written on other checking accounts you had, when you didn't have money in that account. If you have a history of writing checks on accounts with no money, the bank might not be willing to open an account for you. The bank will also perform an identification check in an effort to prevent identity theft. The bank will compare your name to a globally provided list, provided by the government. After verification is complete you will sign a signature card, which is used to verify your signature on checks and withdrawals in the future. Signing the signature card means you accept the fees, terms and conditions of the account.

At the time of opening an account, you will receive temporary checks to use until the checks that you have ordered with your name, address, and preprinted account number come in the mail. The checks that you order from the bank will cost money. The price varies by the type of checks you buy. You may also apply for an ATM card or Debit card. Congratulations, you have just opened your checking account!

### Maintaining

It is your responsibility to maintain your checking account after it is opened. You will receive a check register with your checks and deposit slips. As deposits are made and checks are written, each transaction needs to be recorded in the check register. (Turn to the check register on page # in your book). Let's go over each column in the check register.

1. **CHECK NUMBER:** If you are writing a check, the check number goes here. Otherwise, leave it blank.
2. **DATE:** Record the date you wrote the check, made a deposit or withdrawal, or recorded a service fee.
3. **DESCRIPTION OF TRANSACTION:** Record information to which you made the check payable, the deposit or withdrawal source (such as ATM, debit card, direct deposit. Direct deposit is when your payroll check is sent directly to the bank from your employer through electronic means).



4. **PAYMENT/DEBIT (-):** Record the amount of checks written, ATM withdrawals, automatic withdrawals, or debit card transaction. Money coming out of your account is recorded here.
5. **FEE:** Record any fees charged, such as a monthly maintenance fee or an ATM fee.
6. **DEPOSIT/CREDIT (+):** Record any deposits or automatic deposits made to your account.
7. **BALANCE:** In this column, add any deposits or credits and subtract any fees and payments or debits to your account.

### Check Writing

Now that we have opened a checking account, we are going to learn how to use money from our checking account. Remember a check is a written contract between you and your bank. When you write a check, you are asking the bank to take money from your account and give it to someone else. The first step before writing a check is to make sure you have enough money in your account. It is against the law to issue a check when there is not enough money in your account to cover the check. This is called issuing a NSF (non-sufficient funds) check. Depending on the amount of the NSF check, this may be a felony, which would give you a criminal record. How do you keep this from happening? It is important to record every transaction in your check register and reconcile your checkbook regularly, so you know the balance you show is correct. Write our opening deposit of \$50.00 in the register now.

Let's write a check. You are buying groceries and the price is \$32.25. First you need to look in your register to see if you have enough money to write a check for the groceries. If you do then you can proceed writing the check. (Turn to your sample checks in the back of this chapter) To write your checks, you will need to fill in:

1. The date
2. The Pay to the Order line. This is where you write the name of the person or company to whom you are writing the check.
3. The dollar amount of the check in numbers such as \$32.25 in our example.
4. The dollar amount of the check in words such as Thirty-two and 25/100. After writing the check, draw a line to the end. This prevents anyone from adding an additional amount after what you have written.
5. The memo section. This is where you can write a description of why the check was written.
6. The signature line.



Checks also have other information on them.

7. Your name and address. Your phone number is sometimes included.
8. The check number. This number is used to identify each check written.
9. Codes for the state where the bank is located and the regional Federal Reserve Bank that will handle the check.
10. Your bank's name and branch.
11. Routing numbers. The bank's computer identification numbers and your account number.

If you make a mistake writing your check, write the word 'VOID' across the check and tear-up the check. You need to record the check in your check register. Write your check and enter the information in your register at this time. You need to enter all withdrawals from your account such as ATM and Debit Cards.

### **Depositing Into Your Checking Account**

We are going to add money to our account by depositing money into the account. (Turn to the deposit slip at the back of this chapter) You are going to deposit \$30.00 cash and a \$15.00 check.

1. Write in the date.
2. In the currency section write \$30.00
3. In the check section write \$15.00, if you had more than one check you would put the total of all checks here, with the listing on the back.
4. Add up the total of cash and checks and write in the net deposit section \$45.00
5. You need to write this transaction in your check register.

### **Balancing Your Account**

As you write checks and make deposits, you have been entering the transactions in the register. At the end of the statement period you will get a bank statement that you will have to balance against. It is important to balance your register with the bank statement so you can make sure you did not forget to enter a transaction or that the bank didn't make a mistake. This will keep you from writing the NSF checks that were previously talked about. When you get your bank statement, there will probably be a difference in the balance that the bank shows and the register balance that you have because of checking account statement dates or fees, etc. When we find the differences in these balances it is called reconciling your account or balancing. Most bank statements will have instruction on balancing your statement, and we will practice balancing our account.

We started our account with \$50.00 and wrote a check for \$32.25. We also had a deposit of \$45.00, so we show a balance of \$62.75. Our bank statement shows a balance of \$10.75, which is different from our register balance; let's find the difference. On the back of the statement, write in the bank balance of \$10.75. We don't have an outstanding check (checks we have written but are not on the bank statement). If we did, we would subtract them from the bank total. Add any deposits that are outstanding. In our case we have one - - our \$45.00 deposit. We now have a reconciled balance of \$55.75, which still does not balance our register, but remember there is a bank fee of \$7.00 for this account. We need to enter this into our register and then we will have a register and account that equals or balances.

## **Fees**

When you open your account you will get information from the bank listing all of the possible fees that you may incur using your checking account. You need to be aware of these fees and to register them into your check register in order to balance your checkbook.

When you open your account, the bank may give or offer you overdraft privileges. In the event your account balance drops below zero, the bank will automatically cover your overdraft up to a pre-determined limit, usually based on account type. Be aware that there is a fee for this service you must be completely aware of the amount of fees that could be assessed to your account.

Congratulations, you now have the knowledge to open and maintain a checking account!



## **SAVINGS ACCOUNTS**

Saving money is planning ahead for a person's future. As students, you may not realize how important it is to have savings. What will you use as a down payment when you are ready to buy a car? Savings is your personal insurance on all of life's "what ifs" and on your retirement. Savings can pave the way for you to have the things you want and need in the future to reach your goals.

Once you are ready to start to saving, familiarize yourself with the different types of savings. What best fits your needs? Institutions vary on interest rates paid on savings accounts, and interest can be calculated in different ways.

The Truth in Savings Act created Regulation DD which requires that account information be given to you disclosing interest rates, interest computation methods, and balances on which payments will be based in uniform terms. Using uniform terms helps customers compare account benefits from one type of account or bank to another.

### **Certificates of Deposit**

Certificates of deposit (CD's) can be issued in varying amounts for varied lengths of time. Some CD's have a fixed interest rate for the life of the CD. Others have an interest rate that can be adjusted. Usually, higher interest rates are paid on CD's that have a longer maturity date. Banks may charge a penalty if money is withdrawn from the certificate of deposit before the maturity date.

### **Regular Savings Accounts**

The regular savings account is probably the most common type of savings. There is usually a minimum balance required to open a savings account. Some banks may also set limitations on the number of withdrawals allowed within a given period without paying a penalty. If there is no activity on an account for a certain length of time, some banks may begin charging dormant account fees.

### **Club Accounts**

Some banks offer checking accounts that have other services tied to them; such as, insurance products, discounts on trips, rental cars, etc., lost key service and many other such items. Typically, the club account holders pay a fixed monthly fee for the checking account along with the additional services.

### **Investment Accounts**

Many banks offer brokerage accounts. These accounts invest in products that are housed in the stock market and not in the bank. The accounts are not insured by the Federal Deposit Insurance Corporation. This type account gives the customer choices of investment in addition to the bank accounts.



## **Interest Bearing Checking Accounts**

Interest bearing checking accounts are becoming popular alternatives for consumers. These accounts allow consumers to earn interest on their deposits while maintaining the convenience of writing checks. Financial institutions often require consumers to maintain a minimum balance in this type of account.

## **IRA Accounts**

Individual Retirement Accounts (IRA) are accounts where customers can save for retirement. There are limits on the amount a customer can put in this account each year. The account may be tax deductible depending on other retirement benefits the customer has. Early withdrawal penalties may be assessed if money is withdrawn from the account before reaching age 59 ½ because the money is designated for retirement purposes.

## **Compound Interest**

Compounding is when the interest that you earned on your account is added to the principal of your account. Interest earned from this point forward will be calculated on this new higher balance. There are different ways in which interest can be compounded on your account and each way will have a different effect on your annual percentage rate.

## **Federal Deposit Insurance Corporation (FDIC)**

The FDIC promotes public confidence in the United States financial system by insuring deposits in banks and thrift institutions for a maximum amount. The FDIC was created in 1933 as a result of the wide spread failure of financial institutions during the late 1920s and early 1930s. Since the creation of the FDIC, no depositor at a FDIC-insured institution has lost a single penny of insured funds as a result of a failure.

## LOANS

A loan is when a bank lends money to a person, and the person pays it back over time with interest. Loans are used to purchase high cost items or services that a person cannot afford to pay for all at once. Loans are usually needed to purchase items such as automobiles, homes and boats, or to pay for services such as school tuition and home improvements.

To qualify as a bank, the bank is legally required to make commercial loans. Banks issue loans as a benefit to customers. In order to issue loans, banks must raise deposits. Banks try to keep an equal balance between loans and deposits.

The loan process starts when a person has a need for money. The person contacts a bank and inquires about borrowing the money. The person must first fill out a loan application, which usually consists of questions such as the amount and purpose of loan as well as information such as monthly income, job history, monthly bills, and assets owned. Merely applying for a loan does not guarantee approval for a loan. Banks use the application to determine if the loan requested is reasonable for the purpose of the loan, and to judge the ability of the customer to repay the loan.

In addition to the loan application, the bank will order a credit report on the person or persons applying for the loan. As you will learn in the credit section of this study guide, your personal credit history is one of the most important items banks examine in the credit approval process. Your credit report lists your current loan obligations and shows the bank how you have handled your loan responsibilities in the past.

The information the bank obtains from your application and credit report helps to determine if you qualify for the loan. In reviewing this information the bank looks for five basic things, which is sometimes referred to as the “**Five Cs of Credit**”.

**Character:** Character is a very important factor banks use to consider a loan request. Your character is evaluated by looking at how you have handled you money and loans in the past. Your Credit Report is the primary tool banks use to determine your character. A good credit history showing payments made on time usually tells the bank that a person is a good credit risk.

**Capacity:** Your capacity is the measure a bank uses to determine if a person has the ability to repay the loan as agreed. A person’s monthly income and expenses are items banks look at in measuring a person’s capacity.

**Capital:** Capital is the money or assets a person owns or has access to. A person with limited capital may be required to provide a **co-signer** on the loan. In the event a person does not repay the loan as agreed, the bank may call upon the co-signer to repay the loan.



**Collateral:** Collateral is some form of security or assets that are pledged to the loan and can be used in case the borrower does not repay the loan. An example of collateral is a title to a car. If a person does not repay the loan as agreed, the bank may take possession of (or repossess) the collateral and sell it to pay on the loan.

**Conditions:** Conditions include what is happening that may affect the borrower's ability to repay the loan in the future. The key questions are what can go wrong, from job changes to illness and accidents to family status changes, and how this may affect the repayment of the loan.

After your loan application and credit report are reviewed, the bank then determines the worthiness of the loan you are requesting. At this point the bank will then approve or decline the loan.

## **Types of Loans**

Banks offer many different types of loans, which may be used for a variety of purposes. You may remember some of them from the bank products section you studied earlier. Most banks offer these three basic types of loans:

### **Installment Loans**

For an installment loan, a lump sum of money is issued to the borrower for a specific purpose and repaid over a specified period of time. Installment loans may be secured (collateral is pledged to the bank) or unsecured (no collateral) and typically have a fixed interest rate for the term (time or length) of the loan. The following are examples of installment loans:

- Auto Loan (secured by automobile)
- Personal Loan (usually unsecured loans such as Student Loans)

### **Revolving Loans**

With a revolving loan, the borrower has the ability to borrow up to a certain dollar amount on an ongoing basis. As the balances of revolving loans are repaid, the borrower may continue to borrow up to the set dollar amount. Like installment loans, revolving loans may also be secured or unsecured. A credit card is an example of revolving loan.

### **Home Loans or Mortgage Loans**

Home Loans are installment loans used to purchase homes. The collateral for these loans is the home being purchased. Repayment of home loans is generally longer than that of an installment loan. Typical repayment periods range from 15 to 30 years. Several types of home loans may be offered, depending upon the specific need of the home owner/purchaser.

Some examples of home loans include:

- Home Purchase
- Home Equity Loans  
Home Equity loans are issued to homeowners and are collateralized by the equity in their home. Home Equity is defined as follows:  
$$\frac{\text{Value of Home} - \text{Debt on Home (how much you still owe on home loan)}}{\text{Home Equity Amount}}$$
- Home Loan Refinance  
Home Owners will sometimes refinance (obtain a new loan to payoff an existing loan) their home. The primary reason for refinance is to lower the interest rate on the loan.

### **Loan Payments**

Monthly loan payments are affected by three main factors or variables related to the loan: original balance, interest rate, and term. The original balance of the loan is simply the amount of money borrowed at the loan's inception. The interest rate is determined by the bank and/or negotiated by the borrower (see loan pricing below). The term of the loan is the length of time over which the payments will be made. The loan's term is typically related to the purpose of or collateral securing it. For instance, a new car loan might be repaid with 60 equal monthly installments. This term is roughly equal to the useful life of the automobile. However, since a used car has a useful life less than a new one, the term for a used car loan may be only 36 months. Alternatively, a person's home has a much longer useful life than their automobile; therefore, home loans typically have terms of 15 to 30 years.

### **Loan Pricing – Interest Rates**

A loan is an investment a bank makes with the expectation of receiving income. Banks make money from interest charged on loans, among other things. The amount of interest the bank charges depends on a number of factors or types of risk including: the risk associated with the loan, the amount of time taken to repay the loan (or term), the cost of funds being loaned, and other rates available in alternative investments. These factors are discussed here in more detail:

## **Credit Risk**

Higher rates of interest are charged for loans that have a historically higher rate of non-payment than for those that have a better track record. Typically, loans with greater perceived risk require a greater return on investment for a bank to be willing to loan the money to the borrower. In other words, the higher the risk that the customer will not pay back the entire loan, the higher the interest rate charged for that type of loan. This type of risk is called credit risk.

## **Interest Rate Risk and Cost of Funds Being Loaned**

The length of time it takes to repay a loan affects the interest rate because banks never know what will happen to the interest rate they have to pay for the money they use to make loans. Interest rates change continually. They may be higher or lower on any given day. The longer it takes to repay a loan, the greater the risk the bank will not be able to re-invest their money at a more attractive (higher) interest rate if rates should rise. This risk is compounded by the fact that most bank depositors do not invest in long-term deposit products. Therefore, the cost to the bank of funds used to make loans is very important when establishing interest rates for loans. This is called interest rate risk.

## **Rates Available in Alternative Investments**

Federal, state, and local government bonds are investment alternatives available to banks (another way for banks to make money). Since most of these investments have less perceived risk (U.S. Government bonds are said to have no risk), banks must earn a rate higher than those available with these investments to make it worthwhile to make a loan. Therefore, these rates act as a floor for loan rates with similar maturities.

## **YOUR CREDIT and YOUR CREDIT REPORT**

When you apply for a loan at a bank, the bank will have you fill out a loan application to find out what you do for a living, how much money you make, and to ask for a list of your other creditors. Usually, the next thing a bank will do is download your credit report from a credit bureau (credit reporting agency). Your credit report is a history of how well you have repaid your debts in the past. Your credit report may be the most important factor the bank will use to decide if they should loan you money.

### **Your Credit Report**

Credit reports contain four main types of information: personal identification, public records, account payment history, and inquiries. Credit reporting agencies collect the information from their lender-customers who share information from loan applications and current accounts. Banks and other lenders use this information to make lending decisions, so it is important that you understand how your behavior can affect your credit report.

#### **Personal Identification**

Personal information included in your credit report may include: your name, Social Security number, current address and how long you have lived there, former address, current job and how long you have been employed, former job, and spouse. Lenders want to make loans to stable people who stay in one place and at one job long enough ( 2 years or more) to pay off their debts.

#### **Public Records**

Credit reports show public record information like collection accounts, bankruptcies, foreclosures, tax liens, and civil judgments. These are collected from court records, as well as from lenders. Most information stays in your credit report for 7 years; however, Chapter 7 Bankruptcy stays for 10 years. You can see why your current credit behavior can have such a long-term effect on your credit history!

#### **Account Payment History**

Your credit report shows how well you are repaying your credit card debt and how much you owe. It shows all of your loans from banks and your repayment history. It also shows your record on loans from car dealerships and other finance companies. Past due bills like electricity, phone, doctor or cable bills are included, as well. In summary, your report shows how much you have borrowed and if you were ever late paying it back. It shows each time you get behind on payments, and how far behind you were each time. It shows each debt, and whether you paid it back in full, or if you still owe the money.



## **Inquiries**

Credit reports also show who has requested and received your credit report. Each time you apply for credit, the lender will make an inquiry or request to see your credit report. This information is important to creditors, who want to know how much other credit you have. If you apply for too much credit in a short period of time (within just a few months), lenders might be afraid that you cannot afford all of that credit and may decline your application for a loan.

## **Establishing A Good Credit History**

### **What is Good Credit?**

Banks want to loan money to people with steady jobs, with enough income to repay all of their debts, and with good credit. So what is good credit? A good credit report shows that you are repaying all of your debts on time every month. Your credit gets better each month you pay your credit cards and bank loans on time. It gets better with each bank loan you borrow and pay back over time.

For example, someone who has paid all bills on new credit cards in full for the first six months has some good credit. Someone who has had credit cards for seven years and has never missed a payment has better credit. To explain further, someone who borrowed \$1,000 from a bank and paid it back on time every month for one year to pay it off has a good start on establishing some good credit. Someone who has borrowed and paid back several loans of \$4,000 for a four-wheeler, \$15,000 for a boat, and \$23,000 for a car on time during the last 8 years has better credit. A numbering system, called credit scoring, may also be used to determine your credit risk.

Does good credit mean I can never miss making a payment on time? The answer is no. Banks know different things happen in people's lives that can make money tight at times. The most important thing you can do is when you see money is tight, and you might have trouble making a bank or credit card payment on time, is to call your creditor right away. They usually will work with you, and might be able to help keep your credit history clean. It is very impressive; however, if your report shows you were never late. It shows how serious you take your obligations of debt to others. If you are applying for a new loan, and your credit report shows you were a little late a few times over the last few years, be prepared to explain each situation. Understand though, being late all the time is a different issue.



## **Debt-to-Income Ratio?**

How much debt can you afford? Remember that banks want you to have enough income to repay all of your debts. That means that you could have a perfect payback record on your credit report, but your report might show you owe so much money to so many different creditors that your current income might not allow you to borrow any more money until you pay down some of your debt.

Lenders calculate your debt-to-income ratio to compare how much money you make with how much debt you already have. You can divide the dollar amount of your total debts by your income to get this ratio (percent of your income spent on debt). Typically, banks would like you to have no more than a 36% debt-to-income ratio, including your home mortgage. This ratio is different for different banks and for different types of loans. If you do not have a mortgage, the total debt-to-income ratio for personal revolving credit (cards) and other installment loans may need to be under 20% (including the new credit for which you are applying) to be approved.

## **No Credit?**

What if I have no credit? No credit is okay; everyone with credit today started in the same spot. To start building a good credit history, you might get a credit card and pay it on time every month. You might take out a small loan at a bank, and pay it back on time every month. In the beginning, an easy way to start is to borrow a little money, but use that money as collateral. For example, borrow \$500, and put in a savings account and let the bank hold the money for collateral. When you have paid your loan back in full, you get the \$500 and you have established a good credit history.

Another easy way to borrow money at a bank might be with a co-signer. This is when you borrow money, but someone with good credit also signs the loan with you. They promise to pay if you cannot, so the bank feels better, but you also get the good credit on your credit report when you pay it back on time.

It is good advice to get to know a banker, and develop a relationship over the years borrowing money from him/her. It will help to have someone who knows you and your family's financial needs. Also, if you need credit, do not apply to every bank or credit card company in the world at the same time. It is okay to shop around for the best deal, but decide on one (or two) you would like to do business with and only officially apply for credit with them. Remember, your report shows who has downloaded your credit file. It may appear that you are trying to get too many loans or cards at the same time. If banks or credit card companies see you have applied for credit all over the place at once, it may make them nervous and unsure about approving your loan.



## Why?

Why do I need good credit? Unless you make enough money to buy everything you ever need with cash, including cars and houses, you need good credit. Many companies check credit histories before opening accounts with you. Take every bill seriously and pay it on time. Many young people think it is no big deal to be a little late on a small credit card bill or not to pay the last payment on the cell phone bill since the service was changed months ago. What they do not realize is that, if they are not responsible enough to pay those back, how will a bank believe they are responsible enough to pay back a much larger loan for a vacation, boat, truck, or house? Good credit is an asset that can help you throughout your life since it follows you wherever you go, and bad credit will cause difficulties at every turn. Begin establishing good credit when you are young, and make sure to protect it throughout your lifetime.



## CARDS

In today's financial world there are many tools made available to assist with consumer spending. If used correctly these tools can be a great benefit to consumers and merchants. The instruments that we will be discussing in this section are credit cards, debit cards, and ATM cards.

### Credit Cards

A credit card can be described as a plastic card authorizing the account holder to charge purchases, or borrow money, against a pre-approved credit line. Banks, thrift institutions, retailers, gasoline companies, and other credit grantors issue credit cards. Credit cards are generally accepted all over the world.

You may have heard a lot of negative information concerning credit cards and their usage, but the fact is that if used wisely, credit cards can be one of the most important financial tools that you will ever use. Credit cards can be carried instead of cash on vacations, to purchase major goods, for emergencies, on business trips, and in many other situations. The most important thing about using credit cards is to remember how much you spend so you can be prepared for the bill when it arrives.

Credit card companies have several different means of earning profits. The most significant profit earner for credit card companies is the interest customers are charged for the use of their cards as money. These interest rates can range from 8.0% to 25%, depending on the customer and the company. Other income producers for credit card companies include fees charged for late payments (\$29.00), over-limit fees (\$29.00), cash advances (1% of advance) and transfer balances (1% of balance transferred). In recent years, credit card companies have reported that 25 % of their net profit came from fees.

Credit cards can be a great tool for consumers. They can be used for a quick supply of cash, for purchases, to hold reservations, and for many other occasions. Wise consumers do their homework to compare costs and terms before choosing a card and then use self-discipline to use them properly.



## **Debit Cards**

A debit card is a plastic card issued by a bank that allows a customer to withdraw funds from a deposit account. These withdrawals usually come in the form of purchases made by the consumer. Purchases made with debit cards are withdrawn directly from a customer's checking or saving account, like writing a check. In fact, debit cards are sometimes referred to as a check cards or a cash cards. A debit card usually carries a Visa or a MasterCard logo just like a credit card, which allows customers to use the card in many locations throughout the World. Debit cards are slowly taking the place of the "old handwritten check". When a customer makes a purchase with his debit card, the funds are taken directly from either his checking or savings account. That is why it is so important that every transaction be logged into your registry so that the account can always be balanced. Your debit card may also be your ATM card.

## **ATM Cards**

An Automatic Teller Machine (ATM) card is a plastic card issued to customers by banks to allow access to their deposit accounts during and after normal business hours. An ATM card may also be used to withdraw funds through another financial institution's Automated Teller Machine as long as it is on the same network.

ATM cards allow consumers to travel without carrying excessive amounts of cash. Networks such as Gulfnet, Cirrus, and Pulse link Automated Teller Machines. The linkage of these machines allows customers to access their accounts from all over the world for a nominal fee. These usage fees can range from \$1 to \$10, depending on the transaction. It is important to remember that both the bank supplying the ATM and the bank that holds your deposit account charges these fees. ATM's and ATM cards have revolutionized the banking industry allowing the convenience of banking at any hour of the day in any city throughout the world.



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