

# Understanding debt and consumer credit



## Learner guide

Personal finance skills

**Pre-employment skills**

# **Understanding debt and consumer credit**

Version 1.1



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### Understanding debt and consumer credit

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# Contents

What is credit? .....	1
Advantages and disadvantages of using credit .....	3
Activity 1 .....	5
Types of credit .....	6
Credit provider requirements .....	9
Activity 2 .....	10
The cost of using credit .....	11
Minimising the cost of credit .....	13
Activity 3 .....	15
Using credit wisely .....	16
Minimising fees .....	17
Activity 4 .....	19
Your credit rating and history .....	20
Activity 5 .....	21
What you have learnt .....	22
Check your learning .....	23
Answers .....	24
Answers to activities.....	24
Answers to check your learning.....	26



# What is credit?

Credit means borrowing money to pay for something now and repaying that money over time. You are borrowing money when you:

- use a credit card or store card
- pay for goods in instalments
- have an overdraft on your bank account
- take out a personal, car or home loan.

Once you borrow money from a credit provider, you have a debt. The debt is made up of several parts.

Capital	The amount you borrowed to start with
Interest	The percentage that is added to the debt regularly (e.g. each month)
Fees and charges	The other costs charged by the credit provider
Balance	The total amount that you owe

When you use credit, you have to pay back more money than you borrowed. This is called interest. Credit providers charge interest in return for lending you money. The amount of interest you pay is called the 'interest rate' and is usually shown as a percentage. For example, if you borrow \$1,000 at an interest rate of 10 per cent over one year, you will have to pay back \$1,100 by the end of the year.

The interest rate you will be charged depends on:

- who lends you the money
- what you're borrowing money for
- how much money you borrow
- your personal credit rating.

Don't confuse the terms 'debt' and 'debit'. Although they look similar, their meanings are different. A debit is when your own money leaves your account to pay for goods or services. Examples are using your EFTPOS card (cheque or savings) to pay in a shop. Debit transactions use only the money you have in your account.

If you only use the money you have to buy things and don't use a credit card or loan, then you do not have any debt.



# Advantages and disadvantages of using credit

Many Australians use credit to help them buy expensive items such as houses, cars and computers. A large loan will take a long time to pay back, but it can be a good investment. For example, you can use your car to get to work or live in your house while you pay your loan off.

Sometimes people use credit to buy everyday items such as groceries, or treats such as holidays. This can be a problem if they can't pay off the debt quickly; for example, if you are still paying off a two-week holiday you took two years ago.

It is estimated that the average Australian household owes \$250,000 (source: [www.finder.com.au/australias-personal-debt-reported-as-highest-in-the-world](http://www.finder.com.au/australias-personal-debt-reported-as-highest-in-the-world)). The average credit card holder has a debt of \$4,000 on which they are paying \$700 a year in interest (source: [www.moneysmart.gov.au/borrowing-and-credit/credit-cards/credit-card-debt-clock](http://www.moneysmart.gov.au/borrowing-and-credit/credit-cards/credit-card-debt-clock)).

Household debt has an effect on the Australian economy because the more money Australians owe, the less they have to spend. When spending slows, this affects businesses and employment. If people lose their jobs, they might not be able to pay back their debt.

There are advantages and disadvantages to using credit. Some of these are listed in the table below.

Advantages of credit	Disadvantages of credit
Ease of purchase – buy now, pay later	Makes it easy to spend money you don't have
Gives access to certain items and services, e.g. hotel booking, security deposit for renting a car	Increases the cost of a purchase (unless you are able to pay off the debt during an interest-free period)
Allows you to invest in significant items such as a house or car	Easy to incur fees for late payments, not meeting minimum repayments, etc.
Helpful in an emergency if you don't have savings	Late or missed repayments can affect your credit rating, making it difficult to get credit in the future
Establishes a credit rating, which you will need if you want to take out a larger loan	If you're always paying off debt, it makes it difficult to save money

## Story

Anna is a student with a part-time job in a supermarket. She wants to buy a new laptop for \$2,000 to use in her course. Anna has \$500 in savings and can put aside \$100 a month for repayments.



## Activity 1

Read the story again and then answer these questions.

1. What methods of payment could Anna consider to purchase her laptop?

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2. What advice would you give Anna about paying for her laptop and why?

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[Click to complete Activity 1](#)

## Types of credit

There are many types of credit available. These include:

- credit cards
- store cards
- store loans
- consumer leases
- overdrafts
- personal loans
- payday loans
- low-interest and no-interest loans
- car loans
- mortgage loans.

Credit type	What it is	What you need to know
Credit card	A line of credit up to a certain limit with strict repayment terms	<ul style="list-style-type: none"> <li>• Most common form of credit</li> <li>• Has an annual fee</li> <li>• Minimum monthly payment required</li> <li>• Easy to incur fees or penalties for late or incorrect payment</li> </ul>
Store card	A credit card that can only be used in the issuing store	<ul style="list-style-type: none"> <li>• Has an annual fee</li> <li>• Minimum monthly payment required</li> <li>• Easy to incur fees or penalties for late or incorrect payment</li> </ul>
Store loan	'Buy now, pay later' loan, which allows you to buy goods now and pay them off in instalments or at the end of an interest-free period	<ul style="list-style-type: none"> <li>• Once the interest-free period runs out, you will have to pay a high rate of interest if you can't settle the debt</li> <li>• May have monthly fees</li> </ul>

Credit type	What it is	What you need to know
Consumer lease	A contract in which you agree to rent an appliance, car, computer or other major item for a certain period	<ul style="list-style-type: none"> <li>You may pay more than it would have cost to buy it outright (see <a href="http://aspirelr.link/rent-buy-calculator">http://aspirelr.link/rent-buy-calculator</a>)</li> <li>Can quickly turn into a debt if you miss payments or incur late fees</li> <li>You don't necessarily own the item at the end of the lease</li> <li>You may have to pay out the full amount of the contract, even if you no longer need the item or it is stolen or damaged</li> </ul>
Overdraft	A line of credit on your bank account	<ul style="list-style-type: none"> <li>Useful if you need money for an emergency</li> <li>Fees and interest can be high</li> </ul>
Personal loan	An unsecured loan that can be used for a variety of purposes such as holidays, renovations or paying off other debt	<ul style="list-style-type: none"> <li>Interest rates are similar to credit cards</li> <li>Paid off over a certain period of time (usually one to five years)</li> </ul>
Payday loan	A short-term, high-cost loan for amounts up to \$2000 that is easy to get approved for	<ul style="list-style-type: none"> <li>Fees and charges are extremely high</li> <li>Payday lenders have been fined for irresponsible lending practices</li> </ul>
Low-interest or no-interest loan	A small loan offered for essential items by a non-profit organisation	<ul style="list-style-type: none"> <li>Available to low-income earners and pension card holders</li> <li>Can be used for appliances, medical/dental treatment, education expenses, etc.</li> <li>Sometimes called 'microfinance'</li> </ul>

Credit type	What it is	What you need to know
Car loan	A loan to buy a car, in which the car is held as security by the credit provider	<ul style="list-style-type: none"><li>• The car can be repossessed by the credit provider if repayments aren't made</li><li>• The comparison rate can be used to compare loan options</li></ul>
Mortgage loan	A secured loan used to buy a property or business, in which the property is held as security by the credit provider	<ul style="list-style-type: none"><li>• Paid off over many years</li><li>• Involves set-up/application fees and legal costs</li><li>• Offered with fixed and variable interest rates</li><li>• A larger deposit may get you a better interest rate</li></ul>



## Credit provider requirements

When a credit provider agrees to lend you money, they want to make sure you can pay it back. They will want to know how much you earn, what assets (valuable items) you own and whether you have other debts.

The credit provider may also ask for a further promise that you can pay back what you owe.

Security	<ul style="list-style-type: none"> <li>• For car loans and mortgages, your car or house acts as 'security'.</li> <li>• This means the credit provider can take your car or house if you don't keep up with your repayments.</li> <li>• The credit provider will sell the item to get their money back.</li> </ul>
Guarantor	<ul style="list-style-type: none"> <li>• The credit provider asks you to find someone to guarantee the loan if they think you might struggle to make your repayments.</li> <li>• Your parents or partner can agree to guarantee your loan.</li> <li>• This is a very serious commitment. The guarantor will have to make the repayments if you can't.</li> </ul>

Borrowing money is a serious commitment. If you can't pay back a loan, financial institutions will take legal action to get the money back. Before getting any kind of credit, you need to understand the true cost of the loan and make sure you can afford the repayments.

The MoneySmart website, <http://aspirelr.link/money-smart>, is a good place to start learning about financial matters.

## Story

Anna is looking at the laptop she wants to buy in a local store. She notices a sign that says: '12 months interest free. No deposit! No interest! Monthly payments'. Anna is excited – she could get her \$2,000 laptop straight away. She has \$500 in savings and can afford \$100 a month in repayments.

## Activity 2

Read the story again and then answer these questions.

1. Would Anna be able to pay for the laptop within 12 months? Explain your answer.

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2. What costs will Anna have if she uses this form of credit?

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[Click to complete Activity 2](#)

## The cost of using credit

The cost of using credit is more than just paying interest. There are also fees and charges, such as set-up fees or penalties for late payment. The table below shows the fees and charges for various credit types. You will need to find out what the fees and charges are if you are planning to use credit.

Fee type	Credit card	Store card	Overdraft	Personal loan	Car loan	Home loan
Establishment/application fee				X	X	X
Annual fee	X	X				
Late payment fee	X	X		X	X	
Balance transfer fee	X					
Over limit fee	X	X				
Cash advance fee	X					
Early repayment fee				X		
Monthly fee			X	X	X	
Balloon payment					X	
Valuation fee						X
Legal costs						X
Settlement costs						X
Discharge fee						X

You might have decided which form of credit is the best for your circumstances, but how do you decide which credit offer is the best for you? You can start by making a table; use each column to compare the costs and fees. You can research offers yourself by getting information from each credit provider or you can use a comparison website. Comparison websites let you compare products side by side, which can be helpful, but they don't include every credit provider.

A comparison rate is a way of comparing the total cost (interest, fees and charges) of one loan to another. It is given for personal, car and home loans.

Do your research properly to ensure you find the best offer for your circumstances. Be sure to use a credit or loan calculator to make sure you can afford the repayments. If you missed one, would you be able to afford the additional charges?



## Minimising the cost of credit

Many people are attracted to the idea of interest-free credit because they think it won't cost them anything. However, most interest-free offers still have costs that you can't avoid, like an annual fee. Some credit providers charge application and monthly service fees, followed by high interest rates if you haven't paid off your loan during the interest-free period.

If you're considering a personal loan or mortgage, you will need to understand the difference between fixed and variable interest rates. A credit provider will usually offer both.

The advantages and disadvantages of fixed and variable interest rates are summarised in the table below.

Interest rate	Advantages	Disadvantages
Fixed interest rates	<ul style="list-style-type: none"> <li>• Repayments stay the same over the term of the fixed payment.</li> <li>• Makes budgeting easier.</li> <li>• Easier to know if you can afford repayments.</li> </ul>	<ul style="list-style-type: none"> <li>• Usually higher than variable interest rates.</li> <li>• You cannot benefit from a drop in variable interest rates.</li> <li>• If the loan changes to a variable interest rate, the new repayments could be higher.</li> </ul>
Variable interest rates	<ul style="list-style-type: none"> <li>• Usually lower than fixed interest rates.</li> <li>• You will benefit if the interest rate is lowered.</li> </ul>	<ul style="list-style-type: none"> <li>• Harder to budget because your repayments may go up without much notice.</li> <li>• Interest rate increases could make your repayments unaffordable.</li> </ul>

Fixed rates are usually offered for a certain period, such as five years. A loan may have a fixed rate at the start of the term, changing to a variable rate after a specified time.

If you research your credit options carefully, you may be able to find an option that has little or no cost if you make all your repayments on time. In this situation, credit can work for you.

Alternatively, you may decide that a loan allows you to take advantage of sales or invest in items that make the cost of the credit worthwhile. With research and careful comparisons you can ensure you're not paying more for credit than you have to.

## Story

Anna decides to buy the laptop using credit so she can have it straight away. Her course runs for three years and she needs the laptop to complete her assignments.

Anna has never borrowed money before, so needs some help deciding which credit option will work for her.

## Activity 3

Read the story again and then answer these questions.

1. Is a credit card a good option for Anna? Explain your answer.

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2. Is a store loan a good option for Anna? Explain your answer.

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3. Is a consumer lease a good option for Anna? Explain your answer.

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4. Is a payday loan a good option for Anna? Explain your answer.

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[Click to complete Activity 3](#)

## Using credit wisely

The first thing you should ask yourself when considering credit is, 'Will I be able to pay the money back?' You will need to know:

- how much you can pay back
- how long it will take you
- what the cost of the credit is.

For example, you want to buy a new tablet for \$1,200. You can afford to repay \$100 a month. Research your credit options and work out what is the best for you. An example is provided below.

Details	Standard credit card	Interest-free offer
Interest rate	11.99%	0% for 2 years, then 29.49%
Fees	No annual fee \$10 late payment fee	\$25 establishment fee \$4.95 monthly service fee
Time taken to repay	13 months	13 months
Total amount paid	\$1,271	\$1,242.95

If you are not sure about whether you can afford to use credit, you should get independent advice before committing to anything. The National Debt Helpline offers free financial counselling. See <http://aspirelr.link/national-debt-helpline> or call 1800 007 007.



## Minimising fees

You can minimise the fees you pay to use credit if you research credit options and choose the one that works best for you.

Making payments on time and paying as much as you can off the amount owing are two simple strategies to reduce the cost of accessing credit. Even a few extra dollars a month on top of your regular repayments will help reduce the interest.

Remember that all fees – such as those for late payments or exceeding your credit limit – are added to the total amount owing and that you pay interest on that total.

Credit will only work in your favour when you're able to:

- avoid penalty fees
- afford the cost of the credit
- make the repayments on time.

You must make the minimum payment on your credit card each month. Your statement will tell you what that amount is. If your payment is less than the minimum amount, it will be classed as a late payment, which attracts a fee as well as a note on your credit report.

If your payment is more than 60 days overdue and the amount is more than \$150, you will be said to have defaulted on your payment – this will stay on your credit report for up to five years. Having notes and defaults on your credit report will make it hard for you to obtain credit in the future.



One other thing to be aware of is credit card fraud. These guidelines will help you keep your credit card safe:

- Do not give out your credit card details over the phone to 'cold callers' (salespeople who call you from a company you do not know).
- Always use secure websites for internet shopping – they will have a padlock in the address bar or the address will start with 'https'.
- Do not use public computers for online shopping or banking.
- Keep your PIN and passwords secret. Don't use the same password for everything. Make sure passwords can't be easily guessed.
- Check your statements for purchases that you don't recognise. Contact your credit provider straight away if you notice anything unusual.

Financial institutions will reimburse you for fraudulent use of your credit card, as long as you let them know as soon as it happens. But if you accidentally let someone see your PIN or password, or have granted someone access to your computer, then reimbursement is unlikely. Remember to keep your banking details safe and secret.

## Story

To buy her laptop, Anna has applied for a credit card, which requires a minimum payment of 2 per cent of the balance per month. Her application has been approved and she's waiting for the card to arrive, when her boss says her hours at the supermarket have been cut.

Now Anna is worried – this means she will have less money and might only be able to pay \$25 a month towards her laptop. She doesn't know whether she should go ahead with the purchase or not.

## Activity 4

Read the story again and then answer these questions.

1. What could Anna do to help her make the right choice?

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2. What advice would you give Anna and why?

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[Click to complete Activity 4](#)

# Your credit rating and history

A credit rating is a five-point scale that credit providers use to determine how risky it is to lend you money. Your credit rating can be excellent, very good, good, average or below average.

The rating is based on a score generated from your credit file, which contains:

- information about you, such as your age and address
- the type of credit providers you have used
- the amount of money you have borrowed
- the number of credit applications and enquiries you have made
- any unpaid or overdue loans or credit
- any history of insolvency or bankruptcy.

In Australia, there are four credit-reporting agencies: Equifax, Dun and Bradstreet, Experian and Tasmanian Collection Service. These agencies collect and sell credit information on individuals and companies to help credit providers make lending decisions. You can obtain a free copy of your credit report once a year from one of the credit reporting agencies.

Having late payments or defaults on your credit history can prevent you from obtaining credit in the future. Falling behind on your credit card payments, even if you only owe a small amount, could also affect you in the future. A poor credit record might prevent you from getting a car loan or mean that you're required to pay a higher interest rate on your mortgage. This is because people with a poor credit record are considered a higher risk by lenders. That's why it's always important to consider whether you can repay a loan before you enter into a credit agreement.

If you get into trouble with repayments, contact your credit provider straight away. You should also get advice from a financial counsellor, which is available free via the National Debt Helpline.

## Story

Anna decides to buy the laptop using her credit card. She puts the full \$2,000 on the card and decides to use her savings to meet the monthly repayments. She hopes her work hours will increase or that she will find a new job before her savings are gone.

Unfortunately Anna's hours are cut further and she can now spare only \$10 a month. She misses a payment and notices a late payment fee on her credit card. She makes a payment of \$10, but gets another late fee because this is less than the minimum repayment required.

Anna starts to panic when she realises that the fees are higher than the amount she can pay each month.

## Activity 5

Read the story again and then answer these questions.

1. What should Anna do?

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2. How is this likely to affect Anna's credit report?

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[Click to complete Activity 5](#)

## What you have learnt

Put a ✓ in the box when you have understood these things.

- Credit means borrowing money to pay for something now and repaying that money over time.
- Interest is what credit providers charge you in return for lending you money.
- Types of credit include credit cards, overdrafts, personal loans and mortgages.
- A secured loan is money borrowed against a valuable item, such as a car or house, which can be taken by the credit provider if repayments are not made.
- A guarantor is someone who will be responsible for paying back your loan if you can't make the repayments.
- There is a range of fees associated with accessing credit.
- It is important to know how much each credit option will cost you, and find one that best meets your needs and budget.
- Credit providers use your credit report to decide whether they will loan you money. You can get a free copy of your credit report to learn about your credit history and rating.

## Check your learning

Decide whether each of the following statements is true or false.

1. Household debt does not have any effect on the Australian economy.
2. Debit and debt mean the same thing.
3. One advantage of credit is being able to spend more than you can afford.
4. A family member can guarantee your loan.
5. Interest is the only cost of credit.
6. Fixed interest rates are usually higher than variable interest rates.
7. Variable interest rates could make your repayments unaffordable.
8. You should not use public computers for online shopping or banking.
9. Credit providers use your credit rating to determine how risky it is to lend you money.
10. You will be charged for requesting a copy of your credit report.

[Click to complete](#)

# Answers

## Answers to activities

### Activity 1

#### Answer to Question 1

Answers could include saving until she reaches \$2,000, paying on a credit card or store card, taking out a loan or borrowing money from her family.

#### Answer to Question 2

Saving the money will ensure Anna doesn't have any debt or worries about paying off the laptop. Using a credit card, store card or loan will allow Anna to have the laptop straight away, and she can pay it off fairly quickly without paying much interest.

### Activity 2

#### Answer to Question 1

No. If Anna uses her savings (\$500), she will owe \$1,500. If she pays off \$100 a month, she will still owe \$300 at the end of 12 months.

#### Answer to Question 2

Anna will have to pay interest on the balance owing (\$300) after 12 months. She might also have to pay a set-up fee and monthly fees.

### Activity 3

#### Answer to Question 1

A credit card could be a good option for Anna because it's easy to use and has the least fees if she keeps up her repayments, but she needs to research interest rates and other credit card costs.

#### Answer to Question 2

This is not a good option for Anna because she would not be able to pay back the loan in the interest-free period.

**Answer to Question 3**

This is not a good option for Anna because she won't own the laptop at the end of the lease. She needs the laptop to finish her course.

**Answer to Question 4**

This is not a good option for Anna because she won't be able to repay the loan quickly and the costs are very high.

**Activity 4****Answer to Question 1**

Anna could talk to her credit provider or call the National Debt Helpline before she buys the laptop to ask for advice. Anna needs to work out what her repayments would be and whether she can still afford them.

**Answer to Question 2**

It is not a smart decision for Anna to buy the laptop using the credit card. Even if she uses her savings, she will have to pay at least 2 per cent of the balance every month, which will be \$30 to start with. She has only \$25 to spare because her hours have been cut. She needs to wait until she has more hours or another job that allows her to afford the repayments.

**Activity 5****Answer to Question 1**

Anna should ring her credit provider and explain her situation. She should also contact the National Debt Helpline for counselling. She could look at her budget and see if she can save any more money, work extra hours to earn money or sell something to raise money to pay off her credit card. Anna could also talk to her family and see if they can help.

**Answer to Question 2**

Missed and late payments will appear on Anna's credit report. This may make it harder for her to get credit in the future.

## Answers to check your learning

1. False. Household debt does have an effect on the Australian economy.
2. False. Debit means when money leaves your account to pay for goods or services. Debt is when you owe someone money.
3. False. You should never spend more than you can afford.
4. True. You can ask a family member to guarantee your loan.
5. False. You must also pay the balance and any fees and charges.
6. True. Fixed interest rates are usually higher than variable interest rates.
7. True. Variable interest rates could make your repayments unaffordable.
8. True. You should never use public computers for online shopping or banking.
9. True. Credit providers will check your credit rating when deciding whether to lend you money.
10. False. You can obtain a free copy of your credit report once a year from credit reporting agencies.