



Kiplinger Financial Services' COMMON CENTS MATTERS

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TEACHING CHILDREN ABOUT MONEY (Part 3 of 3)

In *Teaching Children about Money, Parts 1 and 2*, we outlined the five steps in financial planning, the impact your career choice can have on your financial future, budgeting, and saving and investing. In this edition, we will discuss credit and insurance.

CREDIT: BUY NOW, PAY LATER

Credit means that someone is willing to loan you money in exchange for your promise to pay it back, usually with interest (the amount you pay to use someone else's money). The interest rates are quoted as an annual percentage rate (APR). The APR is the amount it costs you a year to use credit. In addition to interest, there may be other costs of using credit, such as annual fees, finance charges and origination fees (the cost to set up the loan). The longer the loan term (how long the loan lasts) and the higher the APR, the higher cost of using credit.

THE BENEFITS OF USING CREDIT – If you use credit responsibly, there are potential benefits.

- Access to cash in an emergency, for example if your car breaks down and you need a tow.
- The ability to use your purchase now, i.e., purchasing a car or a home.
- Safety and convenience – You do not have to carry around large sums of cash in general or when traveling. Many purchases can be made over the phone or on the Internet.
- Incentives – Many credit card companies offer rewards based on purchases.

SOURCES OF CREDIT –

- *Credit cards* are often used to make purchases and to get cash when you want it. There is no loan term with credit cards which means you need to pay the outstanding balance for purchases made every month or it will cost you in finance charges which are as high as 20%. The best strategy is to pay your balance in full each month avoiding interest charges altogether. Some credit card companies charge an annual fee; therefore, look for cards with no annual fee. All cards come with a credit limit, which is the

amount you can charge. Once you have reached the limit, you cannot make new purchases.

- *Installment loans* are used for large purchases such as a vehicle or an appliance. There is typically a monthly payment due until the loan is paid off. Interest rates on installment loans are generally lower than credit card rates.
- *Student loans* are available at banks, credits unions, and through the federal government. Some programs allow you to delay making payments until you finish your education, based on your income level.
- *Mortgages* are often needed when purchasing a home. It works much like an installment loan, except the length of the mortgage extends over a longer period of time, typically 15 to 30 years. Interest rates are usually lower than installment loans and the interest amount paid each year is deductible on your income tax return if you are able to itemize your deductions.

CREDIT CONSIDERATIONS – With the abundance of credit available, it is prudent to evaluate if credit is the tool to use in making a purchase and examine the costs involved. As a general rule of thumb, all your loan payments including credit cards, car loans, etc. (excluding a mortgage) should not exceed 15%-20% of your take-home pay. Most mortgage lenders use about 33% of your take-home pay in setting limits in the amount to be borrowed to purchase a home. In shopping for credit offers, review the APR, the length of the loan, annual or up-front fees, prepayment penalties, minimum payment amounts, the amount of income needed to qualify for credit, additional fees for late payments, bounced checks, etc.

CREDIT REPORTS – A credit report is a record of your credit history. When you apply for a loan, credit lenders will review your credit report to evaluate how well you have managed credit in the past. In addition, some employers check credit reports when making hiring decisions. You establish a positive credit report by making deposits on a regular basis to your

savings accounts, not bouncing checks when using your checking account and always paying your bills on time.

It is important to realize that when you sign the application for a loan or credit card, you are legally obligated to abide by what is written in the agreement. If you fail to uphold the agreement, lenders may take legal action against you, or any co-signer, to recover what they can. Please note also that you have rights as a consumer with lenders. For example, with certain types of credit, you are permitted to cancel the credit agreement within three business days (assuming you return the money borrowed). In addition, if your credit card is lost or stolen and someone unauthorized uses it, your responsibility to pay is limited to \$50.

INSURANCE: YOUR PROTECTION

Insurance is purchased to protect against a large financial loss. In exchange for a payment, the premium, you are protected against the chance of a large financial setback. Insurance helps people manage big financial risks.

INSURANCE BASICS – Most people pass on the risk of financial loss to someone else, the insurance companies. Let us take a look at some key insurance information.

- *Insurance Premiums* are the payments you make to the insurance company in exchange for its promise to pay for the potential cost of a loss.
- *A deductible* is the amount of loss you pay out of your own pocket before the insurance company reimburses you. The higher your deductible, the lower the insurance premium will be.
- *Coverage limit* is the maximum amount the insurance company will pay. The insurance premiums increase as the coverage limits increase.

TYPES OF AUTO INSURANCE COVERAGE

- *Liability coverage* pays for bodily injury to other people and damage to property as well as legal bills if someone sues you.
- *Medical payments* cover medical expenses for you, your family members and anyone riding with you in your car.
- *Uninsured motorist coverage* is needed if an uninsured motorist injures you or damages your car, your insurance company will help. If you do not have enough coverage on your policy to pay your bills, this coverage will also help out.
- *Underinsured motorist* is similar to uninsured motorist protection, in that you effectively own a policy on yourself that protects you in case another motorist does not have enough coverage.

- *Collision coverage* pays to repair your car if it is damaged in an accident by running into another vehicle or an object, such as a tree.
- *Other than collision* protects you from everything except a collision, such as damage caused by vandalism, theft, hail, flood, etc.

OTHER FACTORS THAT AFFECT THE COST OF A POLICY ARE:

- *Age* - The younger you are, the higher the premium,
- *Gender* - Males under the age of 25 have significantly higher accident rates and thus pay higher premiums,
- *Marital status* - Single rates are higher than married rates due to higher incident of accidents,
- *Type of car* - Sports cars and car models that are frequently stolen have higher premium rates,
- *Cost of repairs* – Foreign cars cost more to repair, and thus usually have higher premiums,
- *Mileage* – The less you drive, the lower the premium,
- *Driving record* – Drivers without traffic violations and accidents have lower premiums than drivers with multiple traffic violations and accidents.

OTHER INSURANCE NEEDS – As you get older your life may warrant other types of insurance to protect you and your family from catastrophic financial loss.

- *Health insurance* pays medical bills in case you or your family members become sick or injured. The cost of health insurance is usually less expensive if you can join a group policy which is what many employers offer their employees. Many policies cover full-time students, up to age 23. After that time, you are no longer covered on the adult family member's health insurance and are on your own.
- *Homeowners insurance* protects your home against damage from fire, flood, theft, etc.
- *Renter's insurance* protects your material possessions and not the building you rent in case of damage or loss.
- *Property insurance* is similar to renter's insurance except it is for the homeowner. It protects the material possessions in your home, such as appliances, furniture, computer equipment, stereo, etc.
- *Life insurance* protects people who depend on you financially in the event of your untimely death. For example, when you are married and have children, if you die unexpectedly, your children will have financial needs such as food, clothing, housing costs, etc. If you are single and you provide financial support to another family member, that family member will still have financial needs in the

- future. Life insurance comes generally in two forms, term and whole life. Term is often more affordable and offers pure insurance protection. Whole life offers protection and builds up a savings account.
- *Disability insurance* pays you approximately 60%-70% of your full-time wages should you become sick or physically unable to work for a long period of time. Some employers offer disability insurance as an employee benefit.
- *Liability insurance* is offered by most insurers as an enhancement of coverage to a homeowner's policy, called an "umbrella" policy. This coverage is relatively inexpensive and protects you from legal fees and large court settlements if you are sued.

In *Teaching Your Children about Money*, our hope is to encourage parents, grandparents, teachers, etc. to make financial training a priority and to be consistent in their instruction and their example. The National Endowment for Financial Education Teen Resource Bureau provides a helpful website, <http://www.ntrbonline.org> providing young people a fun way to learn about their finances. Jump\$tart Coalition for Personal Financial Literacy also has a list of websites under links under the resource dropdown menu, <http://www.jumpstartcoalition.org>.

In addition to the above websites, you may want to visit Kiplinger Financial Services' website, <http://www.kiplan.com> which has been recently updated to include our newsletters, information about our firm such as services we provide, workshops, our philosophy and values, other resource links, etc.