# Credit Basics

## Advanced Level

*Your present self impacts your future self.* **When borrowing, you are spending future income.**

You have used **credit** if you receive money, goods or services in exchange for your promise to pay back a definite sum of money at a future date. Credit involves borrowing. Credit availability depends in large part on whether lenders trust that you will pay back the loan as agreed. Lenders consider you more creditworthy as they gain confidence that you will pay back loans. Sources of credit include but are not limited to depository institutions, private mortgage companies, finance companies, automobile dealerships, credit card companies, retail stores, insurance agents, payday loan companies and pawn shops.

## Using Credit Responsibly

*You are responsible for yourself.*

When you borrow, you are spending future income. You pay back a loan by making regular payments (usually monthly) over time. The lender also typically expects you to pay back interest in addition to the amount borrowed.

For example: Toby was approved for a $10,000 loan at an 8% interest rate to purchase a used automobile. The loan terms require him to make monthly payments of $313.36 for the next three years (36 months) to pay back the loan. In addition to paying back the original $10,000 borrowed, Toby will also be paying a total of $1,280.96 in interest. So, the total amount repaid over the 36 months will be $11,280.96.

Credit is an effective financial tool when managed responsibly. But, not managing your credit wisely and over-obligating your future income can lead to a decrease in your future quality of life and negative financial well-being.

**The amount owed for credit is a liability on the Statement of Financial Position and decreases total net worth (assets – liabilities)**

Net Worth = Total Assets − Total Liabilities

| Statement of Financial Position | |
|---|---|
| **Liabilities** | |
| Home mortgage balance | |
| Installment loan balance for automobile | |
| Student loan balance | |
| Credit card balance | |
| Money owed to others | |
| Other: | |
| **Total Liabilities** | $ |
| **Net Worth = Total Assets - Total Liabilities** | $ |

Before you borrow, carefully evaluate the reason(s) for using credit. Are you going to apply for credit to pay for higher education, purchase a home or buy a new car? Borrowing to pay for higher education is a way you can invest in your human capital. This investment may pay off in the future with a better job and higher wages. Similarly, borrowing for a new home or a new car can make sense by securing more comfortable housing or more reliable transportation. But, you should think through any purchase that requires you to borrow.


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Do you have the option of using your savings or maybe dipping into an investment account as an alternative to borrowing? You may discover one or both of these options are better suited for you. Examine possible penalties for withdrawing funds from your investment account. Those potential penalties may sway your decision.

Remember that a loan is a legal contract. Once you enter into this contract you are required to make payments in the future according to the agreement. Take a look at the impact that your loan payments will have on your budget. Can you manage this monthly payment along with your other financial responsibilities? Financial experts recommend that the total amount borrowed (excluding any mortgage loans) should be less than 20% of your annual net income. Your monthly loan payments (including payments for auto loans, education loans, credit card payments, but excluding any mortgage payments) should not be more than 10% of your monthly net income. Keeping the total amount of credit owed within these limits is a part of using credit responsibly.

***Why should individuals limit their total amount of debt?***

## Types of Credit

There are two types of credit:

- **Closed-end credit** (also known as installment credit) is a loan which you must repay in a specified number of equal monthly payments. Examples of closed-end credit include automobile loans, mortgages, and education loans.
- **Open-end credit** (also known as revolving credit) is extended as a line of credit established in advance, so you do not have to apply for credit each time credit is desired. Credit cards are the most common type of open-end credit. A unique feature of open-end credit is that you can pay the loan balance in a single payment or a series of equal or unequal monthly payments. Your lender will typically require a specified minimum monthly payment towards your outstanding balance.

***How will you use credit responsibly?***


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The following table outlines examples of different types of credit and the most common sources for each type:

| Type of Credit | Example | Other Information | Most Common Sources of Credit |
|---|---|---|---|
| Closed-end credit | Mortgage loans | Includes home equity loans | Depository institutions<br>Private mortgage companies |
| | Automobile loans | | Depository institutions<br>Automobile dealerships |
| | Personal loans | | Depository institutions |
| | Education (student) loans | | Government and depository institutions |
| Open-end credit | Credit cards | There are many different types:<br>▪ Secured<br>▪ Retail store | Depository institutions<br>Credit card companies<br>Retail stores |
| Alternative | Payday loans | ▪ A short-term loan that provides immediate cash by securing a borrower's written check or receiving authorization for automatic withdrawal from the borrower's depository institution account.<br>▪ For example, James writes a check for $350 to the payday lender. The lender gives James $290 in cash and keeps $60 for fees. The lender holds the check until the agreed upon date, usually the borrower's payday before cashing it.<br>▪ Also known as cash advance loans | Payday lenders |
| | Rent-to Own | ▪ Tangible items such as furniture, electronics or household appliances are leased with the condition that the item will be owned by the renter if the term of rent is completed. The cumulative end amount a consumer pays to lease an item is typically much higher than if the consumer bought the item from the onset. | Rent to Own retail stores |
| | Pawn loans | ▪ A loan based on the value of personal property. The personal property is held until the borrower repays the loan, including any fees. If the owner fails to repay the loan the lender keeps the item. | Pawn shops |
| | Title loans | ▪ The borrower gives the lender his/her automobile title in exchange for a set amount of cash. The lender holds the title until the loan is repaid. If the loan is not repaid as agreed, the lender keeps title to the item. | Title loan companies |
| | Refund anticipation loans | ▪ Short-term cash advance secured by a taxpayer's expected tax refund. If the tax refund is less than expected, the borrower owes the lender the difference. | Varies |


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# How to Obtain Credit

### *Shopping for Credit*

As with the purchase of any good or service, it pays to shop for credit. Comparing offers across different lenders provides you with the opportunity to find the best credit terms to fit your needs. Consider the following:

- Interest rate – What is the annual interest rate?
- Fees – Are there fees associated with the application process and/or the use of the credit? Are there any fees for repaying the loan early?
- Missed or late payment – What does the credit contract indicate are consequences of missed or late payments?
- Default – What is the consequence of not paying back in full the borrowed amount?

Credit scoring models recognize that a person may want to shop around to find the best credit terms for them. Therefore, multiple inquires for the same type of loan, like a mortgage or automobile loan, are counted as a single inquiry if conducted within any 14-day period. This minimizes or eliminates any impact on a credit score.

### *Applying for Credit*

The exact process to obtaining credit varies depending on the lender and type of credit. However, most lenders require two steps:

1. Credit application: A **credit application** is a form requesting information about the applicant (you). Depending upon the lender, credit applications may be completed in person or online. Credit applications usually ask for the following categories of information, but specific questions will depend on the type of credit and the lender:

    a. Personal information: Name, address, social security number, etc.

    b. Amount of credit requested: The lender will ask how much you want to borrow, and may also ask how long you need to pay it back and how you intend to use the loan.

    c. Information regarding your ability to repay the loan: Lenders will probably ask about your income, and may require proof. They will also want to know of any additional debt.

2. Credit history check: Most lenders will check your credit history by obtaining a copy of your credit report and/or credit score to determine how likely you are to repay the credit (your credit worthiness). Alternative lenders such as payday and title loans commonly advertise credit approval with no credit history check. However, the trade-off to no credit history check is often higher interest rates and fees.

**To obtain credit if you are under the age of 18, you must have an adult co-signer. If you are between the ages of 18 -21, to obtain a credit card you must have a co-signer or proof of sufficient income to make payments. Make sure co-signers understand that they are equally responsible for the credit, and that it will appear on their credit report as well.**

*You are responsible for your present self and future self.*

You are responsible for understanding your responsibilities as a borrower, including the terms of a credit contract. Before signing a credit contract, shop around for the best credit terms for you and consider the future implications of paying back the amount borrowed.


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