How can I use credit responsibly?

Chapter 27
Credit

Chapter Objectives

After studying this chapter, you will be able to

- **discuss** the advantages and disadvantages of using credit.
- **describe** four major types of credit.
- **list** ways to begin building a credit history.
- **describe** a person whom creditors would view as a good credit risk.
- **explain** the importance of a good credit rating.
- **list** ways to protect yourself from identity theft.

Key Terms

credit line
collateral
assets
cosigner
credit bureau
credit rating
credit agreement
identity theft

Key Concepts

- There are both advantages and disadvantages to using credit.
- There are four major types of credit.
- People with good credit ratings are viewed as good credit risks.
- You can protect yourself from identity theft.

Common Uses of Credit

Billboards and store windows are covered with signs that say, "Buy now, pay later!" Newspaper ads read, "Easy credit terms with no down payment!" Radio and TV commercials advertise offers for "one-day credit approval." These are familiar slogans. They encourage people to buy on credit. They make buying easy—sometimes too easy. They don't mention the fact that credit ends up making items cost more.

Credit can be good. It can help people buy homes, cars, and furniture. It can help people live more comfortably.

Credit, however, can be dangerous. It becomes dangerous when it is overused or abused. It can cause financial problems when people can't make the payments they owe. In some cases, financial problems may lead to other problems. They may cause family arguments. They may also cause stress, which can affect health.

Credit used wisely can enrich your lifestyle. Credit used poorly can create major problems. You need to know when and how to use credit.

Advantages of Credit

When used properly, credit has the following advantages:

- Credit is a convenience. You can shop and travel without the worry of carrying large amounts of cash, 27-1.
- Credit allows you to use goods and services while paying for them. Saving enough money to buy expensive items can be difficult. Credit helps you buy such items and pay for them over a period of time.
- Credit helps you meet financial emergencies. Unexpected costs due to sicknesses, accidents, and repairs can be handled through credit.

Disadvantages of Credit

Credit has some drawbacks, especially if it is overused. The following disadvantages of credit can become problems if credit is used unwisely:

- Credit encourages impulse buying. You might buy more than you need. You may overspend and have trouble repaying.

Making a Difference

Investigate how you can use a credit card to make a microloan. *Microloans* are small loans that help people in need start businesses and end the cycle of poverty. Visit **www.kiva.org** for more information. Write a report about the steps involved in the process of lending and repaying these kinds of loans.

27-1
People often use credit cards while traveling to avoid the need to carry a lot of cash.

- Credit can get you into serious debt. Many people lose items purchased with credit if they can't make the payments. The items are repossessed or taken back by the sellers.
- Credit makes the cost of goods and services higher. It is usually cheaper to pay cash than to use credit.
- Credit ties up your future income. Any raises you get may need to be used to pay off past credit charges.

When to Use Credit

You should always think carefully before using credit to make a purchase. Ask yourself the following questions: Can you do without the item now? Will you have problems paying back the debt? Are you already spending more than 20 percent of your take-home pay on installment debt? If you answer "yes" to these questions, try to avoid more credit at this time. It is likely that you cannot handle any more payments. Credit should work for you, not against you.

Your Reading

How can credit affect your lifestyle?

Types of Credit

As a consumer, you should be aware of the following types of credit available to you:

- charge accounts
- credit cards
- installment credit
- loans

Charge Accounts

A charge account is the oldest type of credit offered by business to consumers. Usually no down payment is required nor is any interest charged. The consumer agrees to pay at a later date. If the consumer does not pay by the assigned date, a fee is usually added to the amount owed. An example of a business offering this type of credit is a utility company that provides natural gas or electricity.

Credit Cards

credit line
The maximum amount that can be charged on a credit card.

Banks, stores, and many other types of companies issue credit cards. See 27-2. When you apply for one, the issuer sets a maximum amount you can charge, called a ***credit line***. This amount is based on how much you earn and your ability to repay. For example, your maximum credit line may be $2,000. You can make any number of purchases as long as the total does not exceed $2,000.

Once a month, you receive a bill. You can pay the entire bill by the due date, which involves no added interest. The other option is to make monthly installment payments. You then have to pay interest on the unpaid balance.

Installment Credit

Many expensive household items, such as computers and refrigerators, are purchased with installment credit plans. In such a plan, you agree to make set payments over a given period of time. For this convenience, you pay the going interest rate plus any service charges. If you fail to make payments, the company can repossess the goods.

27-2
Department stores issue credit cards for consumers to use when buying clothing and household purchases.

Loans

Banks and other lending institutions offer credit in the form of loans. People take out loans to borrow money to pay for the following types of expenses:

- cars
- homes
- further education
- outstanding bills
- home improvements
- start-up expenses for a business
- vacations

The important point to remember about loans is that you have to pay back what you borrow plus interest. You can get a signature loan, which is a loan backed by your signature or promise to repay. Many loans, however, require you to put up collateral before you get the money. ***Collateral*** is something of value held by a lending institution in case you fail to repay. For instance, a bank may hold the title for your car until you have repaid your car loan. See 27-3.

When you need a loan, find out more about the different types of loans available to you. The interest charged and the repayment terms can vary considerably.

Community Connections

Find out the cost of a home and a car you would like to own. Refer to homes from local real estate brochures and the local newspaper. Cut out pictures or descriptions of your "dream" purchases and write a paragraph explaining how you plan to pay for the items.

collateral
Something of value held by a lending institution in case a loan is not repaid.

Your Reading

What are the four types of credit?

27-3
Any car you purchase does not legally belong to you until you have paid for it completely. The creditor keeps the title as collateral.

How to Obtain Credit

If you have never used credit, you have no credit history. If this is the case, you need to begin building a credit history. The following suggestions may help you:

- Establish a steady work record.
- Pay all bills promptly.
- Open a savings account and a checking account, and use them. This shows creditors that you can handle money.
- If your place of employment has a credit union, join it. Credit unions make loans available to their members at lower interest rates than some sources of credit.
- If you drive, apply for a gasoline credit card. Make occasional gas purchases on the card. Make sure you pay the total due on time.
- Purchase an item in a local department store using a lay-away plan. Make payments on time to develop a good credit record.
- Apply for a local department store credit card. Use the card for items you need. Stay within your budget plan.

Creditors Look for Good Credit Risks

Creditors want to issue credit to people whom they feel are good credit risks. These are people who repay their debt. Therefore, creditors look for certain traits in people, 27-4. From a creditor's point of view, a good credit risk is a person who has the following traits:

- is honest
- has a job with a steady income
- made regular payments on past loan or credit purchases
- lived in the same community for a few years
- has assets

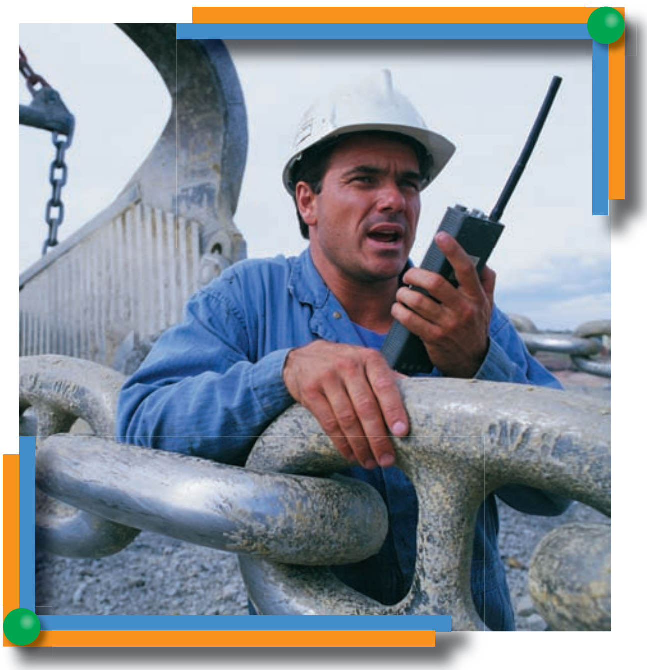
Assets are valuable possessions you own, such as a house or a car. Assets also include money you have in bank accounts and the value of stocks and bonds you own.

assets
The valuable possessions a person owns, such as a house or a car.

Getting a First Loan

As a minor, it is difficult to borrow money. Generally, a person must be at least 18 years old. Even then, it may be difficult to borrow without a cosigner. A ***cosigner*** signs the loan agreement with the person who is borrowing the money. The cosigner must have a good credit history and guarantee

cosigner
A person who signs a loan with a borrower and is held responsible if the borrower does not pay back the loan.



27-4
Most creditors consider steady employment a requirement for someone who wants to obtain credit.

repayment of the loan. In the event the borrower does not make the payments, the cosigner must make them.

You might need to ask a relative or friend to cosign your first loan. Be sure you make your payments. Before you sign for a loan, figure out whether you can afford to pay it back. It would be unfair to the cosigner if you failed to live up to your responsibility. It could also damage your ability to obtain credit in the future.

Credit Applications

Before credit is granted to anyone, the person's job history, credit history, and ability to repay are checked. When you apply for a credit card or loan, you must fill out a credit application. You will be asked to give the following information:

- name, address, and previous addresses
- current and former employers, including their addresses
- current job title (or military rank), salary, and number of years employed
- sources of additional income
- name of a close relative who is not living at your address
- existing sources of credit, including credit card accounts and loans
- all financial accounts, their account numbers, and the names and addresses of the financial institutions

Credit Bureaus and Credit Ratings

credit bureau
An organization that gathers financial information on individuals for businesses to use as a credit reference.

Complete all credit applications honestly. The information on your applications will be checked by ***credit bureaus***. Businesses depend on credit bureaus to gather financial information on individuals. Businesses make their decisions to grant or deny credit based on information in reports from credit bureaus.

Don't lie or try to hide information. If you give false information, you run the risk of being denied credit. Credit bureaus keep track of all your loans and lines of credit. They not only know how much credit you already have, they also know if you repay your debts on time.

A credit bureau reports your credit rating. Your ***credit rating*** is an estimate of how likely you are to pay your bills on time. The rating is based on past records of your credit behavior. Your credit rating reflects your level of risk. The more credit cards you have, the lower your credit rating will be. This is because creditors view the cards as potential debts.

If you handle credit well and pay your bills on time, you will have a good credit rating. However, if you abuse credit and fail to repay your debts, you will have a bad credit rating. If you have a bad credit rating, you may have trouble getting credit in the future. Creditors often do not lend money to people who have a history of not paying their bills. If they do lend money, it is at a higher rate. Credit ratings are also used to determine car insurance rates and car and home loan interest rates. If you have a poor credit rating, you will pay more. Work hard to protect your credit rating. Use credit wisely. Don't abuse it.

There may be times when you may not be able to make loan payments. If that happens, call your creditors and tell them the facts. Be honest. You may have lost your job. You may be very ill. Special arrangements could be made until your situation improves. When it does improve, make every effort to meet your obligations.

It is wise to check your credit report periodically to ensure that all the information is accurate. The FACT Act (Fair and Accurate Credit Transaction Act) entitles each U.S. resident to one free copy of his or her credit report from each credit-reporting agency once every 12 months.

credit rating
An estimate of how likely a person is to pay bills on time based on past records.

Community Connections

Invite a representative from the credit department of a local retailer to talk to the class about how to fill out a credit form, establish credit, and develop a good credit history. Ask the guest how his or her company judges a person as a "good credit risk." Prepare in advance the questions you want answered.

Examine All Credit Agreements

Always read a credit agreement before you sign it. A ***credit agreement*** is a contract. It legally binds the lender and the borrower to the credit terms defined. It is important for you to read and understand what you are signing. Some common credit terms you might encounter on credit agreements are listed in 27-5.

Don't be rushed into signing a credit agreement. Study the agreement before you sign it. Never sign a credit agreement that has blanks. Make sure that all numbers are correct. Don't overlook the finance charges.

credit agreement
A written contract that legally binds a lender and a borrower to specific credit terms.

27-5
Before you sign a credit agreement, know what these terms mean.

Credit Terms

- **Annual fee:** A flat, yearly charge similar to a membership fee. (Many companies offer "no annual fee" cards, and lenders who do charge annual fees are often willing to waive them to keep your business.)
- **Finance charge:** The dollar amount you pay to use credit. (In addition to interest costs, this may include other charges such as cash advance fees, which are charged against your card when you borrow cash from the lender. You generally pay higher interest on cash advances than on purchases.)
- **Annual percentage rate (APR):** The yearly percentage rate of the finance charge.
- **Grace period:** A time period, usually about 25 days, during which you can pay your credit card bill without paying a finance charge. (Under most credit card plans, the grace period only applies if you pay your balance in full each month. It does not apply if you carry a balance forward. Also, the grace period does not apply to cash advances.)
- **Fixed rate:** A fixed annual percentage rate of the finance charge.
- **Variable rate:** Prime rate (which varies) plus an added percentage. (For instance, your rate may be the prime rate plus 5.9 percent.)
- **Introductory rate:** A temporary, lower APR that usually lasts for about six months before converting to the normal fixed or variable rate.

Your Reading

Why is a good credit rating important?

Ask questions if you are not sure of something in the agreement. You could also seek advice from someone knowledgeable in money matters. If you are in doubt, you should write *no*. When you are satisfied with the contract, sign it. Then be sure to live up to the agreement.

identity theft
Theft that occurs when someone uses your personal information, such as your name, social security number, or credit card number without your permission to commit fraud or other crimes.

Identity Theft

Protecting your credit may be more important than establishing credit. ***Identity theft*** occurs when someone uses your personal information, such as your name, social security number, or credit card number, without your permission to commit fraud or other crimes. An identity thief may rent an apartment, obtain a credit card, or establish a telephone account in your name. You may not find out about the theft until you review your credit report or a credit card statement and notice charges you didn't make—or until you are contacted by a debt collector. Some identity theft victims can resolve their problems quickly, while others spend a great deal of time and money trying to repair damage to their name and credit records. Some people who are victims of identity theft may lose out on job opportunities, or be denied loans for education, housing, or cars because of negative information on their credit reports. In some cases, they may even be arrested for crimes they did not commit.

Tips for protecting yourself from identity theft are listed in 27-6. If your identity is stolen or compromised, file a police report, notify creditors, and monitor financial records.

Your Reading

What is identity theft and how can it affect you?

Protect Yourself from Identity Theft

- Be aware if someone is looking over your shoulder when you are using an ATM or making store purchases.
- Don't leave your receipt behind at the ATM. This could make you vulnerable to fraud.
- Never give your credit card number over the phone unless you initiated the call. Avoid giving your card number out over a cordless phone. Radio scanners can eavesdrop on conversations on cordless phones.
- Make certain you get your card back after you make a purchase. A good way to do this is to leave your wallet open in your hand until you have the card back.
- Always keep a list of your credit cards, credit card numbers, and credit card company numbers in case your card is lost or stolen.
- Shred bank and credit statements and credit card offers before throwing them away. Don't mail checks from your home mailbox. Drop them off at the post office. Also, have new checks delivered to your bank, not your home.
- Obtain your credit reports and scores. Make sure you recognize all the account information listed.
- Close out unused credit cards. Cutting them up is not enough.
- Avoid giving out your social security number. It is the prime target of identity thieves. Never put your social security number on your checks or your credit receipts.
- Install a firewall and buy virus-protection software. If you dispose of a computer, remove data with a disk wipe utility program.
- Don't use the same password for all your accounts. Avoid using easily identifiable words or numbers.

27-6 These tips can help to protect you from being a victim of identity theft.

Chapter 27

Summary

Credit is easily available in today's society. Used wisely, it can be helpful. If abused, it can be dangerous. Always think carefully before using credit. Be sure you will be able to pay for it later.

Four major types of credit are charge accounts, credit cards, installment credit, and loans. Before using them, you should understand how they work. Know what costs and responsibilities are involved.

Although you may not need credit now, you should start thinking about building a credit history. Learn about credit applications, ratings, and agreements. Become familiar with the different types of credit and credit terms.

Avoid becoming a victim of identity theft. An identity thief can steal information to obtain credit in your name. There are ways to protect yourself from identity theft.

Reviewing Key Concepts

1. List three advantages of credit.
2. List four disadvantages of credit.
3. True or false. A charge account usually involves a large down payment and a high interest rate.
4. When you receive a monthly credit card bill, what are your two options?
5. True or false. To buy something using an installment credit plan, a person agrees to make set payments over a given period of time.
6. Why might a lending institution ask for collateral before making a loan?
7. Name three ways to begin building a credit history.
8. Describe five traits of a person who is a good credit risk.
9. What risk does the cosigner of a loan take?
10. What should you do if your identity has been stolen or compromised?

Building Academic Skills

1. **Speaking, Listening.** Debate whether credit causes impulse buying.
2. **Speaking.** Imagine you are a loan officer at a bank in charge of writing a description of the type of borrowers to whom you would lend money. Describe the assets and qualifications you would expect of potential borrowers before you would recommend that the bank would grant them a loan.
3. **Writing.** Thomas Jefferson has been quoted as saying, "Never spend your money before you have it." Write a paragraph about what you think this means and a second paragraph on what you think would be in Thomas Jefferson's wallet today if he were living.

Building Career Knowledge and Skills

1. Investigate the costs and interest rates of three different credit cards. Use the information to prepare a comparison chart.
2. Agree or disagree with this statement: Credit companies should not issue credit cards to students. Prepare a report that explains your position.
3. Research what is involved in using an installment credit plan to buy a computer. What steps do you need to take? How much interest would you pay? What is the final cost of the computer with the added cost of the interest?
4. Research what types of information are used to calculate a person's credit rating/score.

Building Technology Skills

1. Use the following Web sites to investigate how high of a credit line you would be allowed: **calcbuilder.com/cgi-bin/calcs/HEL1.cgi/financenter**, **federalreserve.gov/pubs/HomeLine**, and **compassweb.com/personal/calculators**. Share examples you used on the Web site and what you learned about credit lines.
2. Use a spreadsheet program to document the results of a credit survey you conduct with five adults living in different households. Find out what form of payment people used to make the following five purchases: the primary car of the household, clothes washer, refrigerator, television set, and CD player. Eliminate actual names from the survey.
3. Conduct online research on the topic of good credit risks. Report your findings in a report. Share three sentences to summarize what you learned.

Building Workplace Skills

Working with three or four of your classmates, find the least expensive way to buy a new car, financing it for four years. (As a class, choose one category to explore, such as a two-door compact or a sports utility vehicle.) Check the cost of the car through local dealers versus sources available on the Internet. Check at least five different credit sources. Prepare a written report indicating where your team would buy the car, at what cost, and with what type of financing. What are the monthly payments? What is the cost of financing? Are there any special costs involved? What is the total cost of the new car with all the related costs added? Present your conclusions to the class.