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Credit – Financial Planning Series

Michigan State University Extension Service

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Credit

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The good news is—we can have the stereo, furniture and car right now and pay later.

The bad news is—we are legally obligated to pay even if our income is decreased, misfortune comes our way, or we have overestimated how much we can afford.

Credit is a good news/bad news situation. Used wisely, credit can help us build net worth. Used badly, credit can be the cause of great distress and possibly financial disaster.

\$ *The Three C's of Credit*

People who don't have credit sometimes find it hard to establish. Credit worthiness will be evaluated before you are granted credit. Credit worthiness is determined by your character, capital and capacity.

Character is your willingness to repay. If you have borrowed money before, the way you repaid your obligations will affect your next attempt to borrow. If you paid everything as agreed, then you should have no problem obtaining credit.

Capital is determined by your financial resources or collateral. Do you own a car, house or other property? The item you use for collateral must be surrendered to repay a loan if cash repayment is not made. For example, the car is collateral when obtaining a car loan.

Capacity takes into account your income and current financial commitments, how long you have been working and the stability of your income. Some creditors rate information on a scale. Where your data fits on the scale will determine your credit worthiness.

\$ *Building a Credit Record*

To build credit worthiness, start gradually. Open a savings and/or checking account to establish yourself at a financial institution. Try to make regular deposits into your savings account and don't overdraw your checking account. Your business with a financial institution will affect your credibility with them. Once you are established, apply for a small loan. By repaying the money you borrowed as agreed, you are on your way to establishing a good credit record.

Other sources of credit include retail store and bank credit cards. A retail store credit card is usually much easier to obtain than bank credit cards. Therefore, you may be able to obtain a retail store credit card even if you don't have an extensive credit history.

\$ *Types of Credit*

Shopping for credit is as important as shopping for the items you purchase or how you use the money you borrow. There are several factors that you need to explore before you can make your choice: the type of credit, contract agreements and all costs involved.

Basically there are two types of credit: sales and cash. Sales credit purchases goods or services. These credit agreements are usually made with department stores, furniture stores, appliance stores and car dealers. With a sales credit agreement there are three basic ways to pay for the goods purchased.

A regular 30-day account allows you to take the item with you and pay for it within 10 to 30 days after the billing date. There are usually no finance charges with this type of account unless payments are not made on time. The most common services that use this billing form are utility and telephone companies.

A revolving or open end account allows you to make repeated purchases up to a predetermined limit. You can pay the balance in full at the end of the billing period, with no interest charges, or you can pay a minimum amount that the creditor specifies. You can pay any amount between the minimum and the total balance due, but you must pay the minimum.

If you do not pay the account in full each month, an interest charge is calculated on your average daily

balance. The average daily balance is determined by dividing the sum of the balances outstanding for each day in the billing period by the number of days in the billing period. The finance charge is then applied to that amount. Bank cards, most department store and gas credit cards use this method.

The last form of sales credit is the installment or closed agreement. You agree to a contract for a specific item purchased, such as a car, furniture or appliances. A new contract will be written for each additional purchase. The payment amount and length of the repayment period will be pre-determined at the time of purchase. The finance charge will vary depending on the amount of purchase, the amount borrowed and the length of the repayment period.

\$ *Cash Credit*

Credit loans involving cash are usually made by commercial banks, savings and loan associations, credit unions, finance companies, life insurance companies or a cash advance through your bank credit card. The cost of borrowing money will depend on how much you borrow, the length of the repayment period, and the source of the loan.

\$ *The Credit Contract*

All credit, even revolving store credit, involves a signed contract. Be sure you understand everything in the contract before you sign it. Some questions you might ask before you sign a contract are:

- Do the payments fit into your budget?
- Can you make the payments for the length of time agreed upon?

It may be better to keep your monthly payments smaller for a longer period of time than pay out more money than you can afford each month. Although extending your payments costs more in interest, you can pay off the debt sooner if money is available. If you agree to make large payments and money becomes tight, you could find yourself in a difficult situation.

What are the consequences if you default on the agreement? What will you lose? When an installment contract is not paid by the terms agreed, the creditor can repossess the collateral. You would lose not only the item, but also any money that you have already paid. You may even owe additional money. Read the fine print before you sign a contract to avoid situations you can't handle.

\$ *Your Credit Limit*

When you receive a credit card, you will be granted a credit limit. This is the total amount that you can charge. You may continue charging goods or services to your account until you have reached your credit limit. You must make monthly payments of at least the minimum amount required. You may find that your credit limit is higher than you can comfortably repay. Don't let the limit fool you into spending more than you should.

\$ *Credit Costs*

Credit is like food or vacuum cleaners. You buy it. Therefore, you should "shop" for it. To find the best value, understand how much it costs, what you get for your money and compare different agreements. For example, repayment terms can vary from creditor to creditor. The creditor determines these variables, but you can find credit to suit your needs and situation on terms you can live with—if you shop around.

One credit cost is an annual fee. Many financial institutions charge an annual fee of \$20 or more for a bank credit card. To avoid surprises, be sure you understand if there are fees involved.

Another cost is the interest charged on the amount you borrow. The best way to compare interest charges is to look for the Annual Percentage Rate (APR). In Michigan, the highest annual interest rate allowed by law is 20.4 percent for store credit cards and 18 percent for bank credit cards. Out-of-state financial institutions can advertise their bank credit cards in Michigan. The 18 percent limit only affects those financial institutions that operate in Michigan. The out-of-state institutions may charge more, or they may also charge less.

Advertisements may claim you can get a bank card without a prior credit history. These cards will usually have a higher annual fee and the highest interest rate allowed. This protects the financial institution from higher risk customers.

\$ *Your Credit History*

Information on your credit worthiness is kept in a file at a credit bureau. The credit bureau does not determine whether or not you will be granted credit. Its purpose is to collect information and provide it to creditors. It is the creditor's decision whether or not to give you credit. It is important that you keep your credit file in good standing and correct any misinformation. Because both good and bad information is recorded in your credit file, it is important for both partners to handle a joint account responsibly.

Don't apply for too many credit cards at once. Applications, as well as denials of credit, are kept in your credit file at a local credit bureau. If you are denied credit, find out why. You can then attempt to change the situation and reapply.

Credit histories are important to have in both of your names. The Equal Credit Opportunity Act requires that information must be reported in both names when credit is joint. When you apply for credit, list both names on the application if you want joint credit. When filling out an application as a married couple use first and last names, not Mrs. John Smith but Carol Smith. It is also a good idea to have credit in your own name, if you have income. This will establish your credit worthiness using only the resources that you bring to the partnership. A woman who marries and changes her name needs to be sure that her credit file is updated. Provide updated information to both your creditors and the credit bureau.

\$ *Checking Your Credit File*

The Fair Credit Reporting Act of 1971 allows you to see your credit file at no charge if you contact the credit bureau within 30 days of being denied credit. Even if you have not been denied credit, it is wise to occasionally check your credit file to be sure there are no errors. There will be a small charge in this situation.

If you find an error and a creditor cannot verify the information, it must be deleted from your file. If this misinformation has been reported to creditors within the last six months, they must be notified of the deletion. If you have a disagreement with information from a creditor, you can write a statement of 100 words or less that will be included in your file.

\$ *Preventing Credit Problems*

Credit problems can occur due to a decrease in income, loss of income or going from two incomes to one. Problems can also come from taking on too much credit at once. To prevent problems, a general rule is to limit minimum monthly payments and installment payments to 20 percent of your monthly net income. It is even better to have no more than 15 to 17 percent as your target maximum.

If you own several credit cards, it can be easy to charge more than you can handle. There are danger signals of too much credit. They include:

- Total monthly payments keep increasing
- You are at or near your credit limit
- You can only make minimum payments
- You extend payments
- You use savings to pay bills
- You work overtime to make ends meet.

Before taking on new credit obligations, add up your current monthly payments to be sure that you do not overextend yourself.

There may be times when you cannot meet your credit obligations. If this happens contact the creditor, explain your situation and try to work out a new agreement. But don't ignore the problem. Think through your use of credit, control it and let it add to your financial lifestyle.

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