Section 3 | Managing Credit

3 Managing Credit

NaTasha, the Cradle, and Credit Cards

NaTasha was a capable student throughout high school. Although she wasn't sure that her high school had prepared her well for college, attending college was her goal, and her teachers encouraged her. NaTasha graduated from high school on time and was planning to begin college the next fall. Then she made some choices that changed her life. She became pregnant over the summer after high school and had the baby the next winter. She postponed college because of the baby. In the meanwhile, the father, her boyfriend from high school, left town.

NaTasha had opened three credit-card accounts soon after she had turned 18 and graduated from high school. She and the baby needed a lot of things. She charged many of the purchases using the credit cards. She paid the minimum amount stated on the card bill. That seemed fine. No one had ever told her anything different. No one ever said anything about how to handle credit cards in school. Soon Natasha noticed that the credit card bills were getting bigger and bigger. Even the minimum payments seemed large. She started to miss payments. She knew this was mistake, but she didn't see any way out. Then collection agencies got after her, calling her at odd hours and threatening her with legal action. But NaTasha could do little. She had no savings, no home, and almost no furniture. She felt paralyzed by fear.

Many, many people have had experiences like Natasha's. Credit problems are among the leading causes of stress, family break-ups, and suicides.

What is credit?

Let's start from the beginning and identify some of the information that could have helped NaTasha.

Credit allows individuals to obtain the use of money that they do not have. Obtaining credit means convincing someone else (a lender) to provide a loan in return for a promise to pay it back, plus an additional charge called interest. Many people use credit, obtaining loans to buy cars, homes, and major appliances, to improve their homes, to pay for college education, and so forth.

Credit decisions can be difficult ones. Like all difficult decisions, credit decisions involve examining the advantages and disadvantages facing the individual making the choice. The hard part, of course, is figuring out if the advantages of using credit outweigh the disadvantages.

Credit is from heaven

There are two important things to know about credit. It can work for you or it can work against you.

What is the bright side to using credit? Credit can help people acquire valuable assets — a home, for example, or an education. Assets are goods or services that usually retain or increase their value. Ordinarily, owning a home or obtaining a post-secondary education is considered an asset. Credit can help people lead happier lives by obtaining the things they wish to have now while paying for them later. Credit also can help people in an emergency — to pay for the unexpected tire repair or visit to the clinic.

Credit is from hell

There is also a dark side to using credit. Ask NaTasha. Mistakes in using too much credit in relation to your income can be hard to recover from. Many new graduates from vocational school or college, for example, spend a lot of the income from their first jobs repaying large credit-card debts they have rolled up while in school. These repayments mean they have to spend a lot of their current income on previous purchases, leaving less money to buy things they currently want. Misusing credit — missing payments or defaulting on loans — can have many negative consequences including the inability to get credit later or having money deducted from your pay check to be applied against delinquent loans.

Common forms of credit

Figure 3.1 describes the types of credit people use and the lenders who provide credit. It also explains the advantages and disadvantages of various forms of credit.

The information shown in Figure 3.1 suggests several ways in which credit can help people. Look at home mortgages, for example. Owing a home offers several advantages, since homes often increase in value and interest paid on home loans is tax-deductible. But buying a home involves a big financial commitment, and few families could afford to buy a home if they had to come up with the cash all at once.

Credit card loans also offer advantages. They are convenient and easy to use. They can be great in an emergency. And it's nearly impossible to travel without credit cards. But credit card loans can pose serious problems. They come with relatively high interest rates. Some people may borrow more against their credit cards than they should, given their income levels.

Figure 3.1: Forms of Credit

Type of Credit	Lender	Advantages	Disadvantages
Home mortgage	• Commercial bank • Savings and loan • Credit union	• Homes often increase in value. • Interest rates for mortgages are relatively low. • The interest paid is tax-deductible.	• Mortgages are long-term commitments. • Obtaining a home loan involves extensive credit checks.
Car loans	• Commercial bank • Savings and loan • Credit union • Consumer finance company	• Cars can make it easier to work and earn an income	• Cars lose their value relatively quickly. The car you purchase on credit may have little value when the last payment is made.
College loans	• Commercial bank • Savings and loan • Credit union	• A college education is usually a good investment. • Interest rates can be relatively low.	• Students sometimes borrow more than necessary. • New graduates can face difficulty in repaying large loans.
Personal loans	• Commercial bank • Savings and loan • Credit union • Consumer finance company	• Personal loans allow individuals to purchase something today and pay for it later.	• Personal loans have relatively high interest rates. • Some young people may burrow more than they should, given their income levels.
Credit cards	• Commercial bank • Savings and loan • Department Stores • Oil companies • Consumer finance company • Other financial institutions, e.g., American Express	• Credit cards are convenient to use and useful in an emergency. • Credit cards bills provide a record of charges.	• Credit cards come with relatively high interest rates. • Some people may borrow more than they should, given their income levels.

3 Managing Credit

How credit works

Financial institutions (banks, savings and loan associations, credit unions, consumer finance companies) hold money that they are willing to lend. The owners of financial institutions are not charities. They expect to be compensated when they make a loan. This compensation is called interest. Interest is the price a borrower pays to a lender for use of the lender's deposits. Interest is the reward lenders receive for allowing others to use their deposits.

Both sides usually benefit in a credit transaction. Borrowers are able to purchase something that may be of value today and perhaps in the future. Lenders are repaid the money they loaned, plus interest. It can be a win-win deal!

An important factor in determining the rate of the interest to be charged is the amount of confidence the lender has that the amount of the loan plus interest will be repaid in the agreed-upon time. Higher risk loans — loans where it is uncertain that the borrower can repay — usually come with higher interest rates. Lower risk loans — loans where it seems evident that the borrower can repay — usually come with lower interest rates.

Loans for an intangible thing like a vacation are likely to cost more in interest than a loan for a tangible item like a home. Loans that are backed by other assets (your car, for example) are likely to have lower interest rates than loans that are not backed by other assets. An asset used to back a loan is called collateral.

How to get credit

To obtain credit, you need to contact a financial institution and complete a loan application. Ordinarily, a loan application asks for the following information:

- Name
- Address
- Length of time at the address
- Employment record
- Other loans
- Credit card accounts
- Savings account
- Checking account

Lenders, as we said, are not charities. Banks, for example, have many ways to use the money deposited in their accounts. They can build new buildings or buy stocks and bonds. Or they can make loans to people. When they make loans, they expect to have the amount repaid with interest. As a result, financial institutions tend to look for certain qualities in loan applicants. These qualities are called the Three Cs of Credit. They are:

- ***Character:*** Will the applicant be responsible and repay the money as agreed?
- ***Capacity:*** Does the applicant have enough income to comfortably make payments on the loan amount requested?
- ***Collateral:*** Will the loan be secured, or guaranteed, by collateral that can be used to repay the debt in case the borrower defaults on the loan?

Debit cards

People sometimes think that all those plastic cards in their wallets and purses are the same. They are not. For example, there are big differences between debit cards and credit cards.

Debit cards look like credit cards, but they work differently. Debit cards are nearly the same as cash. Many merchants accept debit cards. When you use the debit card the charge is immediately withdrawn, by electronic notation, from your checking account. You do not receive a bill later. There is no loan involved, so you do not pay interest.

Debit cards provide a convenient way to pay for things. In using debit cards, however, you need to remember two things. First, you must keep track of the debit card payments. Many people record these payments immediately in their check register so they will not forget. Second, there is no "grace period" as there is when using a credit card. Payment is immediate and certain.

Credit cards

Using a credit card really means you are taking out a loan. When you buy something on a credit card, you promise to pay back the charges on your account plus a payment for interest and fees.

Many institutions offer credit cards, including banks, department stores, savings and loans, credit unions, oil companies, finance companies, auto companies, telephone companies, and even national football teams. Typically, borrowers can charge up to a certain amount either through buying goods and services or through cash advances. A statement is mailed to the card holder each month showing the charges, the total owed, the minimum to pay, and the finance charge.

Most cards charge a fixed interest rate. Many charge an annual fee for the card. Most credit cards offer a grace period (usually 30 days) that allows you to avoid paying interest on the balance if the balance is paid in full.

Here are some tips for using a credit card successfully:

- Have only one card.
- Pay off the monthly balance.
- Shop for a card with a low interest rate.
- Shop for a card with no annual fee or a low fee.
- Use your card for such things as travel and emergency purchases.
- Use credit-card records to keep track of your spending.
- Avoid using your credit card for minor purchases.

Credit reports

An important step toward obtaining credit at low rates of interest is building and maintaining a good credit history. A good credit history can often make the difference between getting a loan or being turned down, or between paying a high rate of interest or a low rate. In addition, potential employers and landlords will often check an applicant's credit history before making a decision about offering a job or a renting an apartment.

Credit histories are described in credit reports. A credit report is a record of an individual's personal credit history. It is one good indicator of an applicant's character and whether he or she will repay borrowed money as agreed. A credit report will tell, in detail, how much the person has borrowed, from whom, and whether the bills have been paid on time.

Three agencies issue credit reports. They are:

- Equifax (800) 685-1111 or equifax.com
- Esperian (888) 397-3742 or experian.com
- Trans Union (800) 888-4213 or transunion.com

Companies like these regularly collect information on millions of consumers. They obtain information from a variety of sources including stores, credit-card companies, banks, mortgage companies, and medical providers.

Reading a credit report

Credit reports contain four types of information:

1. Identifying information: This includes your Social Security number, address, date of birth, and so forth.
2. Credit history: This includes a list of your accounts with creditors.
3. Inquiries: This lists the agencies that have requested your credit information. The list might include institutions checking your credit application. It could also include inquiries from landlords and employers.
4. Public record information: This includes any collection accounts, bankruptcies, late payments for child support, and so forth.

While credit reports include lot information about you, they don't include everything. Credit reports do not include checking and savings account balances, your income, or purchases made with cash or check. Much personal information is not included — e.g., your medical history, race, gender, religion, national origin, or driving record.

Credit reports often use specific terminology.
Here are some common definitions:

- ***Tax lien:*** A claim against property filed by the government for unpaid taxes.
- ***Judgment:*** A court order placing a lien on a debtor's property as security for a debt owed to a creditor.
- ***Collection account:*** A past-due account that has been referred to a collection agency.
- ***Bankruptcy:*** A legal agreement that can legally release a person from repaying debt.

For an example of a credit report, see Figure 3.2.

Figure 3.2: A Credit Report

EQUIFAX
CREDIT REPORT

Personal Data

John Q. Public		
2351 N. 85th Ave.	Social Security Number:	022-22-222
Phoenix, AZ 85037	Date of Birth:	1/11/1960

Previous Address(es):
133 Third Avenue
Phoenix, AZ 85037

Employment History

Cedant Hospitality FR	Location: Phoenix, AZ	Employment Date: 2/1/1989	Verified Date: 1/3/2001

Previous Employment(s):

SOFTWARE Support Hospitality Branch	Location: Atlanta, GA	Employment Date: 01/3/2001	Verified Date: 01/3/2001

Public Records

No bankruptcies on file
No liens on file
No judgements on file
No garnishments on file
No secured loans on file
No marital statuses on file
No financial counseling on file
No financial counseling on file
No foreclosures on file
No non-responsibility entries on file

Collection Accounts

No collections on file

Figure 3.2 (cont.)

Credit Information

Company Name	Acct No. & Whose Account	Date Opened	Last Activity	Type of Acct. & Status	High Credit	Items as of Reported Terms	Date Balance	Past Due	Date Reported
Americredit Financial Services	40404XXX JOINT Acct.	03/1999	03/2000	Installment REPOSSESSION	$16933	$430	$9077	$128	2/2000
Prior Paying History 30 days past due 07 times; 60 days past due 05 times; 90+ days past due 03 times INVOLUNTARY REPOSSESSION AUTO									
Capital One	412174147128XXXX INDIVIDUAL Acct.	10/1997	01/2001	Revolving PAYS AS AGREED	$777	15	$514		01/2001
Prior Paying History 30 days past due 02 times; 60 days past due 01 times; 90+ days past due 00 times CREDIT CARD									
Desert FCU Schools	423325003406XXXX INDIVIDUAL Acct.	07/1997	06/1998	Revolving PAYS AS AGREED	$500	$0			07/1999
Prior Paying History 30 days past due 02 times; 60 days past due 00 times; 90+ days past due 00 times ACCOUNT PAID CLOSED ACCOUNT									
Helig-Meyers Company	7360300XXXX INDIVIDUAL Acct.	03/1998	07/1999	Revolving PAYS AS AGREED	$1000	$0			07/1999
Prior Paying History 30 days past due 02 times; 60 days past due 01 times; 90+ days past due 00 times CREDIT CARD AMOUNT IN H/C COLUMN IS CREDIT LIMIT									
SEARS	806050211XXXX	08/1998	07/1999	Revolving PAYS AS AGREED	$720	$0			07/1999
Prior Paying History CHARGED AMOUNT IN H/C COLUMN IS CREDIT LIMIT									
WELLS FARGO	503830276150XXXX	11/1996	12/2000	Installment PAYS AS AGREED	$17146		$401	$4058	12/2000
Prior Paying History AUTO									

FIGURE 3.2 (CONT.)

Credit Inquiries

Companies that Requested your Credit File

04/29/2001	EFX Credit Profile Online
06/30/2001	Automotive
06/16/2000	AR-Associates National Bank
01/18/2000	Desert Schools Federal C.U.
01/15/2000	Desert Schools Federal C.U.
07/02/1999	Time Life, Inc.

THE FOLLOWING INQUIRIES ARE NOT REPORTED TO BUSINESSES:

PRM – This is a promotional inquiry in which only your name and address were given to a credit grantor so you could be solicited with an offer such as a credit card. (PRM inquiries remain on file for 12 months.)

AM or AR – These inquiries indicate a periodic review of your credit history by one of your creditors (AM and AR inquiries remain on file for 12 months.)

EQUIFAX, ACIS or UPDATE – These inquiries indicate Equifax's activity in response to your contact with us for either a copy of your credit file or a request for research.

PRM, AM, AR, INQ, EQUIFAX, ACIS and UPDATE inquiries do not show on credit files that businesses receive, only on copies provided to you.

Your confirmation number is 10999333931. Please keep this number in your records for future communication with us.

Equifax Consumer Services, Inc.

ANSWER THE FOLLOWING QUESTIONS:

1. Whose credit report is this?
2. When did Mr. Public open his Capital One account?
3. When did he last use his Capital One account?
4. What is the credit limit on his Capital One account?
5. How many total times has Mr. Public been 30 days overdue? 60 days overdue? 90 days overdue?
6. Has he had any accounts turned over to a collection agency?
7. Has he ever had a repossession? Explain
8. Does he have any public record items that might be of interest to a potential lender?
9. How would you evaluate Mr. Public's credit report?

CREDIT SCORES

A credit score is a number lenders use to help them decide whether to make a loan to an individual. Fair, Isaac and Company develops the most widely used scores. They are commonly knows as FICO scores. FICO scores range from 300 to 850. High scores are good. The scores are calculated based on data from your credit history.

According to FICO, here are the typical "weights" assigned to the different parts of a credit history (as you can see, payment history and amounts owed are the most important factors):

- ***Types of credit in use*** counts for about 10 percent.
- ***New credit*** counts for about 10 percent.
- ***Length of credit history*** counts for about 15 percent.
- ***Amounts owed*** counts for about 30 percent.
- ***Payment history*** counts for about 35 percent.

You can obtain your score by contacting the companies (Equifax, Experian, or Transunion) listed nearby. Fees charged to obtain your credit report and your credit score vary from $9.00 to $15.00. Under the Fair Credit Reporting Act, you can get a free copy of your credit report if you are denied credit. Six states (Colorado, Georgia, Maryland, Massachusetts, New Jersey, and Vermont) make credit reports available to their residents.

Ways to improve your credit score

A credit score is a "snapshot" of your creditworthiness at one point in time. Your score changes as new information is added to your credit report. Scores change as behavior changes. Credit problems from the past may diminish as time passes and behaviors like missing payments decrease.

There are ways to improve your credit score. The best way to get your credit score up is to pay down your credit-card balance. Here are other possibilities:

- Pay bills on time. Missed payments and collections have a major impact on lowering your score. The more your payments are made on time, the better your score.
- Keep balances low on credit cards and other "revolving credit." The most effective way to improve your score in this area is to pay down balances.
- Apply for new accounts only when necessary. Don't open new accounts just to show that you can handle them.
- Check your credit reports for accuracy. Mistakes can occur.

Mistakes in credit reports

Unfortunately, credit reports sometimes include mistakes. For example, a credit report for one person named Robert E. Johnson might contain information about someone else named Robert E. Johnson. Or a credit report might incorrectly list paid accounts as unpaid. The law provides individuals with a means of requesting and reviewing their credit report and having mistakes corrected. Although it may take time and patience to correct such errors, it is an important step to take before you apply for a loan.

Here is a sample of a letter to write to correct a mistake in your credit report.

Credit Bureau Name [Date]
Complaint Department
Address
City, State Zip code

Dear Credit Bureau:

I am disputing [describe the entry] on my credit report.

This entry is mistaken because . . . [explain the error: For example, "The lien filed on 00/00/00 is inaccurate. No such lien was ever filed against me. Similarly, the collection agency account filed on 00/00/00 is also in error. I have never missed a payment on this loan. I have never been notified by a collection agency."]

I request that you investigate these entries and, if they cannot be verified, please remove them from my credit report.

If the entry is removed, I request that you make notifications according to section 611(d) of the Fair Credit Reporting Act.

Sincerely,

[Give your full name]

[Enclose a complete copy of your credit report]

Recovering from bad credit

Are you having serious financial problems? What might be the signs?

- Do you pay one company one month and then pay another company the next?
- Do you frequently receive overdue notices?
- Have you reached the limit on your credit cards?
- Do you pay only the minimum on your credit-card balances?
- Do you sometimes write bad checks?
- Do you use your credit to pay for everyday purchases like food or rent because you have run out of cash?

If you have any of these problems, the worst thing you can do is ignore them. Refusing to pay your bills won't make them go away. Matters will only get worse. The sooner you deal with the problem with your creditors, the sooner you can get yourself on the path to recovery.

Correcting a financial problem will take time. You will need to be patient. Financial problems are a lot like an unwanted pregnancy. It seemed to happen fast and with little effort. The consequences, however, are long-term, and dealing with them will involve sacrifice.

Here are some steps to consider.

1. Reduce your spending. The first rule when you find yourself in a financial hole is to stop digging. Reduce your spending now. Consider ways to bring your spending into line with your income. Stop eating out—even at cheap fast-food places. Move in with family. Sell your car. Find ways to have some money at the end of your pay period.
2. Contact the lender. Most lenders would rather help you reschedule your payments than take back the property or call in a collection agency. See what can be worked out.
3. Other things being equal, it might be wisest to pay off the loan with the highest interest rate first.
4. You might want to contact the local chapter of Consumer Credit Counseling Service. Call 800-388-2227 to find the telephone number of an office near you. Somebody there can help you work out a family budget and a repayment plan. This is a private, not-for-profit organization. They offer their services free or charge low fees.

The last resort

Have you seen the ads on TV by a lawyer telling how he or she can help you get out of debt and get a fresh start? Just call and, for a fee, this friendly person can help you to file bankruptcy. They make it sound like taking a walk in the park. But filing bankruptcy is not a walk in the park. It is your financial last resort. If you must make use of it, do so knowing that the consequences will be with you for years.

There are two types of bankruptcy: Chapter 13 and Chapter 7.

Chapter 13

- This is the most common form of bankruptcy.
- The debtor keeps property and makes regular payments on debts after filing.
- To qualify for Chapter 13, you must have regular income.
- You file a petition to the court explaining your repayment plan, your income, assets, debts, and a budget.
- The judge appoints a trustee who works with you and your creditors to agree on a plan.
- Creditors cannot bother you as long as you make the agreed-upon payments.
- A Chapter 13 bankruptcy remains on your credit report for seven years after it is discharged.

Chapter 7

- All assets are turned over to the bankruptcy court.
- The law allows the debtor to maintain a limited amount of home equity, life insurance, tools, and so forth.
- The court distributes the assets or holds an auction to pay whatever can be raised to the creditors.
- Once the bankruptcy is discharged, the debtor is under no obligation to pay the debts.
- A Chapter 7 bankruptcy remains on your credit report for 10 years after it is discharged.

The secret to establishing good credit

The secret to building a good credit history is, of course, no secret at all. It is simple common sense. It begins with living below your means. This is how most people who are financially successful get started. They live below their means. They get in the habit of saving. They notice how savings can increase. They save up an emergency fund. Then they begin saving to acquire valuable assets like an education or a home. Over the years, they work to improve their income and their assets. Many actually retire wealthy.

Specific ways to establish and keep good credit include:

- Pay bills on time.
- Keep balances low on credit cards.
- Apply for new accounts only when necessary.
- Check credit reports for accuracy.
- Never borrow more than you can comfortably pay back.
- Borrow only the amount you need.
- Contact lenders immediately if you expect to have a payment problem.
- Report lost or stolen credit cards immediately
- Never give your credit-card number over the phone unless you initiated the call.

3 Managing Credit