



# CREDIT 101

EXTENSION   
UtahStateUniversity

Change  
\$ Makes  
Sense™

**Where are you now? Where do you want to be?** *Fill in these blanks:*

In my current credit situation, this is where I am right now: \_\_\_\_\_

\_\_\_\_\_

In my future credit situation, this is where I want to be: \_\_\_\_\_

\_\_\_\_\_

Things I will do to get there: \_\_\_\_\_

\_\_\_\_\_

## **Credit Crunch:**

The average household credit card balance for low to moderate income families was \$7,145 in 2012.<sup>1</sup>

# INTRODUCTION

The purpose of this presentation is to introduce the basics of credit. Credit is a very broad topic. In this presentation we will focus on:

1. What is credit?
2. Benefits and dangers of credit.
3. Obtaining credit: The 4 C's of obtaining personal credit.
4. What is a credit history?
5. Understanding a credit score.
6. Why good credit is important.

This workbook will follow along with the Credit 101 presentation.

## WHAT IS CREDIT?

Merriam Webster Dictionary defines credit as **“The provision of money, goods, or services with the expectation of future payment.”**<sup>2</sup>

This means anytime we are asking for something in advance, before we pay for it, we are asking for credit. Credit is designed to simplify how we use goods or services.

What would heating our home be like without credit? Can you imagine the gas company installing a slot on your furnace to insert quarters as you use heat? Instead, they allow us to use gas all month and then send us a bill. Likewise, if we had to purchase a home with cash, very few families could become homeowners.

**Question:** Look at the definition of credit. What kinds of transactions would count as being extended, or offered, credit?

Mark which transactions below would qualify as being credit.

- |   |   |  |
|---|---|--|
| <input type="checkbox"/> Obtaining a credit card          | <input type="checkbox"/> A gas card with no limit   | <input type="checkbox"/> Overdraft account     |
| <input type="checkbox"/> In-house financing for furniture | <input type="checkbox"/> A rent to own washer/dryer | <input type="checkbox"/> An auto loan          |
| <input type="checkbox"/> Opening a checking account       | <input type="checkbox"/> Using your Visa debit card | <input type="checkbox"/> Getting a Pell Grant  |
| <input type="checkbox"/> Getting a student loan           | <input type="checkbox"/> Leasing a car              | <input type="checkbox"/> A cell phone contract |
| <input type="checkbox"/> Opening gas utilities            | <input type="checkbox"/> Home equity loan           | <input type="checkbox"/> Cashing a check       |
| <input type="checkbox"/> Borrowing \$10 from a friend     | <input type="checkbox"/> Mortgage                   | <input type="checkbox"/> Using a money order   |

## Types of Credit

In general we can group credit in four broad categories<sup>3</sup>:

- A. Service Credit - Service credit includes heat, water, phones, and other utilities. We use the service and then are billed at a future date for the amount we used.
- B. Installment Loans - These are loans for a specific amount of money that are repaid in a set timeframe. Examples include car loans and mortgages.
- C. Revolving Loans - A revolving loan has a specific credit limit, but you can borrow from that pool of funds at any time. The account can stay open indefinitely. Most credit cards and some home equity lines of credit are revolving loans.
- D. Open Loans - Open loans have no maximum. You can charge what you need, as you need it. However, an open loan must be paid in full each month. Some business credit cards and diners' cards are open loans. Many forms of service credit are also open; your heat bill doesn't have a maximum, you simply pay for what you use.

**What types of credit do you use?**

## BENEFITS AND DANGERS OF CREDIT

### Benefits of Wise Credit Use

#### 1. Convenience

- A. Using a credit card, over cash, may be convenient. You pay one bill and it creates a record of your spending. You can also use it to pay many bills online, at any time, even outside of business hours.
- B. Credit allows use of utilities and similar services in a reasonable way. Imagine having to put quarters into your furnace or kitchen sink to pay for utilities as you use them.

#### 2. Access to large purchases

- A. How many people would own a home if they had to save the entire purchase price? How many people would go to college if they were required to pay for tuition up front?
- B. We can borrow for mortgages, education, automobiles, improvements on our homes, and similar purchases. Obtaining an education may allow for increased future income. Purchasing, and eventually paying off, a home can help you save on future housing expenses.

### 3. Specific benefits related to credit cards

- A. Access to services. Some services, such as renting a car or reserving a hotel room, may require a credit card.
- B. With credit cards we have limited liability if the card is stolen and we report it in a timely manner. Debit cards do not have the same protections<sup>4</sup>.
- C. Some credit cards have additional benefits. They may provide incentives in the form of cash back on purchases, Sky Miles, or similar rewards.

### 4. Wise credit use can improve your score. Using credit wisely, not overspending, modest borrowing, and paying bills on time can improve your credit score. A good credit score can help you obtain:

- A. Housing: Many landlords check the credit of applicants. Mortgage lenders will use your credit score to qualify you for a loan and to determine the interest rate of the loan.
- B. Insurance: Good credit scores will save you money on insurance for your home and automobiles.
- C. Employment: Many employers check credit scores of new applicants.
- D. New credit: Good credit scores will allow you to obtain new credit with favorable terms. This includes credit cards, personal loans, and service credit for utilities.

## Dangers of Using Credit Poorly

### 1. Convenience

- A. Using a credit card builds up debt. In addition, we can choose not to repay the balance in full each month, making a minimum payment instead. A debit card can offer many of the same conveniences in making payments, going cashless, and recording spending, without going into debt.
- B. Utilities and phone services offer convenience but can be difficult to monitor. Most of us don't look at our electricity use part way through the month to see if we are using more than normal. At the end of the month the bill is due regardless.

### 2. Access to large purchases

- A. Large loans represent a significant long-term liability. It can be tempting to buy more of a home or car than is necessary because we can afford the payments now. We should carefully consider large purchases that require credit.
- B. Borrowing large sums can impact future opportunities. As monthly debt obligations increase, our ability to save and work toward retirement is reduced.

### 3. Specific drawbacks of a credit card.

- A. Studies show that the average person spends more with credit cards than they do with cash. Credit cards don't limit our spending habits in the same way as carrying cash does; this may result in spending more than we can pay off at the end of the month<sup>5</sup>.

- B. If a credit card is not paid in full each month, we must pay interest on the remaining balance. The average interest rate on credit cards is 12.83%. The average jumps to 27.88% if we miss a payment<sup>6</sup>.
- C. The cost of failing to pay the balance in full each month will often exceed the value of rewards on credit cards.

#### 4. Poor credit use can impact us in many ways.

- A. Lower credit scores. Low credit scores can cause us to be denied new credit, have higher interest rates on loans, be denied housing, be passed over for employment, or pay higher deposits on utilities.
- B. Collections and judgments. Missing payments may lead to accounts going to collections. This is also true of service credit for utilities.
- C. Crushing debt. Failing to manage credit can lead to increasing levels of debt and potential bankruptcy. High levels of debt also negatively impact health<sup>6</sup> and lead to higher levels of stress<sup>8</sup>.

## OBTAINING CREDIT:

### The 4 C's of Applying for Consumer Credit

When you are applying for credit, there are some specific things lenders may consider when evaluating your application. These attributes can be summarized as the 4 C's of consumer credit: capacity, character, collateral, and capital (Dennis, n.d).

#### Capacity

Merriam Webster defines capacity as: "the maximum amount or number that can be contained or accommodated." For the purpose of credit, this maximum amount relates to your ability to repay the loan. This is usually determined by comparing your monthly income to your monthly debt obligations. This information is usually disclosed on your credit application.

**Capacity Tip:** The less debt you have relative to your income, the more comfortable a potential lender will be in offering you additional credit.

#### Character

Merriam Webster defines character as: "moral excellence and firmness." For getting a loan, this excellence and firmness is referring to how consistent you are in paying your debts. The lender wants to see that when you borrow, you pay that debt as agreed and in a timely manner. They check this by pulling a credit report and looking at your credit (FICO) score. A high credit score shows you prioritize honoring credit agreements.

**Character Tip:** If you are applying at a local bank or credit union, your character might also be measured by your relationship with that agency. For example, having a saving and checking account at a credit union might make it easier to be approved for an auto loan through them.

## Collateral

Merriam Webster defines collateral as: “of, relating to, or being collateral used as security, as for payment of a debt or performance of a contract.” The key here is security. Collateral is what backs up the loan. For a car or home, the home or car act as collateral for the loan; if we don't pay the loan they can take them away! A secured credit card has savings that are set aside as collateral.

**Collateral Tip:** A down payment can also be a form of collateral. When you pay a significant portion of a large ticket item, such as a home or car, you have additional incentive to make your monthly payments.

## Capital

Merriam Webster defines capital as: “a store of useful assets or advantages.” In the context of getting a loan, capital may refer to cash reserves or material possessions. When a lender sees you have many assets, the lender can assume that the debt could be paid or resolved with your assets if needed. For large loans, you may disclose assets, such as stock holdings or savings, as part of the application.

**Capital Tip:** If a lender can see you have cash reserves in savings, the lender knows you are more likely to be able to continue making payments if you have emergency expenses or your income is reduced.

# WHAT IS A CREDIT HISTORY?

## Reading and Understanding Your Credit History

Information about how we use credit is gathered by the national credit bureaus. The three primary credit bureaus are Equifax, Experian, and Transunion. They gather details about where you live, who you work for, the credit accounts you have, and who you have requested credit from. This information is compiled into your credit report, or credit history.

Once you have your credit report, it is important to be able to read and understand it. A study by the Federal Trade Commission (FTC) on credit reports found that one in five consumers had errors with at least one of the three credit bureaus. More than 10% of those who disputed the errors had an immediate increase in their credit score. Those increases were higher than 25 points for 29% of those consumers. Fixing errors in your credit report will help you acquire new loans at fair prices, obtain housing, and obtain utilities.

Checking your credit history is also important to avoid identity theft. The FTC has reported ID theft as the top complaint for the last 12 years in a row. Monitoring your credit history can help you identify credit lines that have been opened without your consent.

If you have a family member with a similar or the same name, you need to be especially thorough in ensuring that your credit history is correct. Often someone who is named after a parent or grandparent will find items from the two credit histories mixed together.

The information on your credit report will be organized into different sections. Different credit bureaus may not organize things in the exact same way, so it is important to understand what information you are looking for.

## **Credit Summary**

The summary section will generally provide a good snapshot of your report. It will list the total number of mortgage, installment, revolving, and other loans. It may also show how many accounts have balances, maximum credit limits, debt to credit ratio, and similar categories. This section may also include totals for your inquiries and negative accounts.

## **Personal Information**

This section will include information on your name, variations of your name that you have used when acquiring credit, your social security number, address, and work history. It may also include alerts on your account, a consumer statement (if you have submitted one) and information on disputing errors, your rights under the Fair Credit Reporting Act, and what to do if you suspect identity theft.

## **Account History**

These are specific details on each account. Important pieces of information include who issued the credit, when the account was opened, the loan terms, current balance, and if it is past due. It will also show your payment history, indicating if you pay on time. If you have ever been 30, 60, or 90 days late in making your payments it will indicate that here.

Some credit bureaus will break this section into open accounts, closed accounts, or even negative accounts. They may also further break it up by account type, such as mortgage loans, installment loans, and revolving loans.

## **Public Records**

This section details court actions against you. This will include bankruptcies, collections, and judgments. It will show when they originated, how much they are for, if they are paid, and similar details. Any records in this section hurt your credit. Even if a collection or judgment is paid, it will still stay on your report for 7 years. Bankruptcies can remain for up to 10 years.

## **Credit Inquiries**

This section shows who has looked at your credit history. It may include businesses looking to send you promotional offers, inquiries from those you applied for credit from, and reviews from those you already have a loan with. Two kinds of inquiries will be listed. Hard inquiries are requests from companies you have tried to obtain new credit from. Too many of these will negatively impact your credit score. Soft requests are credit requests that don't impact your score. They include companies you already have credit with and those wishing to provide you with promotional and pre-approved credit offers.

## **Credit History Tips**

1. Your free credit report does not come with your credit score. If you want your credit score, purchase it directly from [www.myfico.com](http://www.myfico.com).
2. Contest inaccurate information directly with the credit bureau. Check to ensure that it has been removed from all three of the credit reporting agencies.
3. Keep a file that details your efforts to get inaccurate information changed or removed.
4. Make use of your free annual credit report each year. The first time you pull your credit history it is recommended you pull all three reports. After you have removed mistakes, consider stretching your free credit reports out over the course of a year, pulling one from a different bureau every four months. This can help you monitor your history for problems and ID theft all year.

For more information on understanding your credit, check out Al Bingham's book "The road to 850" (2nd ed.). Layton, UT: CP Publishing

# UNDERSTANDING A CREDIT SCORE

Have you ever applied and been denied credit when applying for a loan or received a higher interest rate than you expected? Lenders may look at many things when determining if they will issue credit, including your assets, income, relationship with the lender, length of employment, and your credit score. Most of these criteria are fairly straightforward, but how is your credit score determined?

## What is a credit score?

Your credit score can be compared to earning a grade in school. A grade in school summarizes your understanding of a particular subject by how well you completed assignments and tests. Your credit score is a summary of information regarding how you use credit; it includes things like the amount you have borrowed, what types of loans you have, and if you make payments on time. This information is gathered by national credit reporting agencies. There are three main agencies: Transunion, Equifax, and Experian. This information is used to generate a credit score. Most lenders use a particular score known as a FICO score. The score tries to predict the likelihood you will default on a new loan.

Transunion, Equifax, and Experian have their own internal scores that they use as well. This is important, because these other types of scores are not widely used to determine if you qualify for loans. If you purchase a score directly from a credit reporting agency, it will not be the score you want. The only way to make sure you have a FICO score is to obtain the score directly from FICO at [myfico.com](http://myfico.com)

## What does FICO mean?

FICO stands for the Fair Isaac Corporation. Fair Isaac developed a formula that takes the information from the credit reporting agencies and gives it a score. The FICO score ranges from 300 to 850 points. Your score is a snapshot of your history on any given day.

While you have the right to view your credit history, you do not have the right to see your score. You must pay FICO to see your score. Ordering your score directly from FICO will not hurt your credit score.

## Who Can Check Your Score?

It is important to understand who has access to your credit score. There are two broad categories of people that can access your credit: lenders and people you give permission.

**Lenders** - There are a few different reasons that lenders may have access to your credit score. Any lender that you have an existing loan with has a right to access your credit score. If you have a car loan, credit card, or mortgage, those lenders have a right to see if your credit situation has changed.

The second group of lenders is those that you request credit from. If you are trying to acquire a new loan, that lender has the right to see if you pay your existing obligations.

Finally, potential lenders may have limited access to your credit report to determine if they want to send you promotional offers.

**Those You Give Permission** - The second category of people who have access to your credit score is those you give permission to. There may be a variety of reasons you would give permission to have your credit checked.

*Employment:* More employers are checking credit scores as part of their background checks on potential employees. Poor credit could potentially take away a chance for a job.

*Housing:* If you are renting, many landlords will require a credit score before signing a contract. In addition, regardless if you are renting or buying, most utility companies will require a credit check to acquire services. This could include heat, electricity, city services, phones, or even Internet.

*Other services:* Other services, like cable companies, memberships, and even dating websites, may pull credit. Make sure you ask before you join.

Don't Want Unsolicited Offers? You can opt out of credit offers for 5 years by calling 1 888 5OPTOUT (1 888 567 8688)

How do you know if your credit is being checked? Always be sure to read the fine print. If the application asks for your birth date and your social security number, chances are they are pulling your credit.

## WHY GOOD CREDIT IS IMPORTANT

### Good credit scores are not just for loans anymore.

When we think of credit scores, we often associate that with applying for new credit cards, car loans, or mortgages. Some people assume that if they already have a car or house loan they don't need good credit. While initially credit scores were only used to apply for credit, your credit score is now used in a variety of situations.

**Loans** - Poor credit may result in being denied new credit. It can hamper your ability to get loans for cars, homes, education, credit cards, and even checking and overdraft accounts. Sometimes we can get a loan with poor credit, but usually we have to pay higher fees or interest rates.

**Rentals** - Renting an apartment, a hotel room for the night, or an automobile all may require access to credit.

**Employment** - A study by Demos found that 1 in 10 unemployed individuals have been denied work based on poor credit.

**Insurance Rates** - Those with poor credit may pay up to 200% higher premiums than those with good credit.

Loan Amount	Interest Rate	Monthly Payment	Total interest paid over 30 years
\$150,000	2%	\$554.43	\$49,594.57
\$150,000	5%	\$805.23	\$139,885.28
\$150,000	10%	\$1,316.36	\$323,883.14

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## ACTIVITY-CREDIT SCENARIOS

1. John is traveling for work when his “check engine light” comes on. He pulls over to check things out and finds that the car will no longer start. He uses what cash he has to get towed to a local mechanic who tells John the car needs another \$200 in repairs.

Risks:

Benefits:

Credit Alternatives:

**2. Jane has had her eye on a new computer for a while. This week the model she wants is on sale for 25% off. She does not have the cash to buy it right now. If she waits to buy the computer it will cost considerably more, or she can use her credit card to pick up the computer now.**

Risks:

Benefits:

Credit Alternatives:

**3. John started his own business repairing electronics. Business has been slow, but a customer brought in a plasma TV that needs some work. John doesn't have the tools to make the repair, but figures if he purchases them on credit this one repair would repay one-fourth of the cost right away.**

Risks:

Benefits:

Credit Alternatives:

**4. John hates carrying cash around. When he goes out to eat for lunch, he prefers to just pull out his credit card to make the purchase.**

Risks:

Benefits:

Credit Alternatives:

**5. Jane is making a purchase online. She has never shopped with this online retailer before and is deciding if she wants to use her credit or debit card to make the purchase.**

Risks:

Benefits:

Credit Alternatives:

6. John has gone back to school at a technical college. He doesn't have the money for his textbooks and is considering using a credit card to buy the books he needs.

Risks:

Benefits:

Credit Alternatives:

**What criteria (or rules) can we make regarding when it is appropriate to use credit?**

**What alternatives do we have to using credit?**

## CREDIT CRUNCH STATISTICS

One in 10 job seekers was denied employment based on credit.<sup>1</sup>

Those with bad credit may pay up to 200% more in insurance costs.<sup>2</sup>

The average FICO score (September 2013) for the U.S. was 639 pts. The average FICO score for Utah was 646 (out of 850).<sup>3</sup>

Two people both buy a \$150,000 home; one with a 3% interest rate, the other with a 10% interest rate. Over 30 years the one with a 10% rate will pay \$240,000 more in interest than the one with a 3% rate.<sup>4</sup>

One in five consumers had errors with at least one credit bureau.<sup>5</sup>

85 percent of college students didn't know what their credit score was in spring 2012.<sup>6</sup>

Average household credit card debt from those who carry a balance is \$7,145.<sup>7</sup>

76% of adults over the age of 18 have a credit card.<sup>8</sup>

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