UNIT 3 – 1

The Three C's of Credit

Credit has become a vital part of our economy. The average American household with credit cards holds nine credit card accounts. According to the Consumer Federation of America, a typical teenager spends several thousand dollars a year on cars, clothes, food, and entertainment. This amounts to nearly $80 billion annually nationwide. Included in all of this spending, more than 40 percent of American teenagers use their parents' credit cards and 55% of students age 16-22 have their own credit card.

The average American household with at least one credit card has nearly $9,200 in credit card debt. According to the www.themint.org website, college student debt is also on the rise. The site sponsored by the National Council on Economic Education states that 78% of college students have credit cards with 32% of these students having four or more credit cards. The average debt of these students is $2,748. An astounding 25% of college students owe more than $3,000 in credit card debt. The National Credit Research Association's research (http://www.crfonline.org/) indicates that college students owe almost half of the nation's $285 billion credit card debt! The typical American cardholder has at least *nine* different credit cards.

With all of this credit being used by consumers, what are the factors that creditors are using to determine who gets the credit and who does not? How does credit card debt influence the pathways to home ownership? How can you maintain a good level of debt and assets? What are the top things you should know about credit and debt management?

Case Study Application

In this lesson, we will be examining the role of credit in determining one's pathway to home ownership. As we go along, we will examine the following case study which introduces us to a credit situation that many of us have or will face.

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CASE STUDY: ANDREW'S CREDIT CRUNCH

Andrew is a full-time college student and works part-time at the local pizzeria for a little more than minimum wage. Lately, Andrew has been receiving advertisements for credit card applications and information for credit applications in the mail. He knows that he needs to start building his credit so that he can purchase a home in the future, but he is confused by all of the applications and does not know where to begin.

Types of Credit

Many types of credit are available to consumers in the United States today. Credit can be individual (based on one person's assets, income, and credit history), or joint (based on the assets, income, and credit history of both applicants). The types of credit available to American consumers include retail, mortgage, and service credit. All of the types of credit we have today have been designed to make it easier for the customer to buy a product.

For example, in the 1950s, expensive restaurants wanted a better way for customers to pay for their dinners, so they invented the credit card to make this possible. Restaurant customers used these first credit cards to meet their needs, but eventually the cards became more and more important. With the increases in online shopping, a credit card has become something that is valued by consumers for its ease of use and security. A credit card today can be used to purchase almost everything, including college tuition! Credit cards are big business and they are EVERYWHERE!

There are definite advantages to using credit. With a credit card, you are able to buy needed items now. You don't have to carry cash. The credit card purchase creates a record of your purchases. It is often more convenient than writing a check and it allows you to consolidate your bills into one payment. Some credit card companies offer satisfaction guarantees on your purchases.

Disadvantages of using credit include the interest charged for using the account. The credit account may require additional fees such as an annual fee, balance transfer fees, and overdraft fees. If you don't carefully track your spending, you may lose track of how much you have spent and overspend. Credit also increases impulse buying.

There are a number of different *types* of credit. For example, there is ***retail credit***, credit that is used to buy goods and services from retail stores. This type of credit includes:

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Installment Credit—used to purchase a single item such as a car, jewelry, furniture, medical expenses, education, etc. The credit must be repaid in a specific time and the payments are the same each month.

Open Charge Credit—the balance of this credit must be paid at the end of the billing period (usually 30 days).

Revolving Credit—account that has a limit on the amount of money that can be spent (credit limit); the monthly amount paid depends on the total amount owed and the finance/interest charges due each month.

In addition to the above, there is ***mortgage credit*** which is used to buy a house and involves a complex application process. Finally, there is ***service credit*** which is used for utility payments such as water, electricity, and telephone. This is called service credit because the consumer is billed after services are received.

When shopping for a credit card, think about the best use of that card. How do you plan to use it? A good practice is to pay the bill in full each month so that you will avoid the interest charges. If you repay the bill over time with smaller payments, the actual amount that you pay for the items charged will be the cost plus the interest charges—leading to the items costing more than you originally paid. You should consider how widely the card is accepted and what services and features are available for the card.

You should never borrow more than 20% of you yearly net income. If you net income, or money after taxes, is $1,000 a month, then your net income in one year is:

12 x $1,000= $12,000

Calculate 20% of your annual net income to find your safe debt load:

$12,000 x 20% = $2,400.

Therefore, you should never have more than $2,400 of outstanding debt. This debt does not include housing debt. It is other debt such as car loans, credit cards, and student loans. Another consideration is that of your monthly payments. You should not exceed more than 10% of your monthly net income. If your monthly take-home pay is $1,000 a month:

$1,000 x 10%= $100

Your total monthly debt should not be more than $100 per month. Again, housing payments are not included in this 10%, but other debts such as credit cards, student loans, and car loans should be considered.

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When looking for a credit card, you will want to look at such things as the **annual percentage rate**. This is a measure of the annual cost of credit. This rate can be computed using different methods—daily, monthly, annually. Therefore, the terms of the rate and its computation should be studied carefully. Another component to examine is that of the **grace period**. The grace period is the time in which the borrower can pay off all new purchases without incurring finance charges. The finance charges are the fees charged when a borrower receives cash against a line of credit and is paid in addition to the interest rate. It includes annual membership, late payments, charges for exceeding the credit limit and cash advance charges.

Another consideration should be the **average daily balance**. The interest paid on the credit card is figured on the balance in your account on each day of the billing cycle. Then the creditor uses these amounts and divides by the number of days in the billing cycle. You should also inquire as to the annual fees and transaction fees associated with the card. Is there an annual fee just to have the card? What fees will you be charged if you go over your limit, transfer balances, or have a late payment? Finally, you will want to examine the rewards offered by the card. Does the card offer cash back, reward points, airline travel, discount coupons, etc.?

To get a better idea of the extent to which credit is available today, use Activity Sheet 3-1 to examine the different kinds of credit that are available. Then, review Andrew's case study from this lesson and answer the following questions:

- If Andrew gets a credit card, what type of credit will he be getting?
- Given other factors such as Andrew's age and occupation, do you think a credit card at this time of life is a good idea? Why or Why not?

Examining the C's of Credit

The study of credit, like any other topic, involves its own set of terms, definitions, and concepts. For example, when it comes to actually applying for credit, the "three C's" of credit – capital, capacity, and character – are crucial. [1] Specifically:

- ***Capital*** is savings and assets that can be used as collateral for loans. Collateral is a security or guarantee that can be collected in the event that a loan or credit is not paid. What property do you own that can secure the loan? Do you have a savings account? Do you have investments?

[1] Although some financial advising sources consider other C's of credit such as the conditions of the borrower and overall economy and collateral or assets secured to the debt, we will only focus our analysis on the traditional three C's.

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- ***Capacity*** is your present and future ability to meet financial obligations. This is determined by answering questions such as: Do you have a steady job? What is your salary? How long have you worked at your present job? What is your prior job history? How much do you already owe? What are your living expenses? How many dependents do you have?

- ***Character*** refers to your trustworthiness. For example, have bills been paid promptly? Is the credit record good? Do you appear to be willing to repay? How long have you lived at your current address? How long have you been at your present job? Can you provide character references? Have you used credit before?

The ***creditor***—a person or firm that extends credit by loaning money, by selling property or goods on credit, or by furnishing credit cards— tries to determine if an applicant is creditworthy, or a good risk. Because credit is a form of trust between the creditor and the borrower, the creditor wants to select the most creditworthy applicants.

In order to determine a borrower's creditworthiness, the ***credit history***, or the official record of the way a person uses credit and repays debt is critical. This information is found in a ***credit report***—the official record of how bills have been paid; how much money is owed and to whom; financial stability; current and past residential addresses, employment status, and payment history. It does not include income, bank balances, or personal details such as ethnicity, religion, gender, political preferences, medical history, or other information that does not relate to credit. The creditor will also look at your income and expenses. How much do you earn and how much are your regular expenses such as rent, utilities, food and other ongoing debts. Also, the creditor will examine your assets that can serve as collateral. They will look for bank accounts and other items of value such as investments or property that you may own.

Take a few moments to answer the questions on Activity Sheet 3-2 regarding your own C's of credit. Then, review Andrew's credit crunch case study to answer the following questions:

- What are Andrew's C's of credit (capital, capacity, and character)?

- What are steps that Andrew should take now to ensure that he is creditworthy later on?

Using Credit Wisely

Careful use of credit can lead to a strong credit history that will help when purchasing a home. The information about your credit remains on your report for seven years; therefore, it is important to use credit very wisely. Seven years can be a very long time!

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According to Money Magazine and other financial advising sources there are key ideas when using credit. There is good debt and bad debt. Borrowing money to pay for a house or college is usually a good idea if you can afford to pay it back. In contrast, using a credit card to pay for things that are consumed quickly such as coffee, meals, gadgets, handbags, and vacations can be bad debt if you cannot pay your bill in full each month. If you only pay the minimum amount due each month, you are likely to fall into a debt trap! The minimum payment will barely cover the interest you owe without even touching the principal. You could end up spending thousands more than what you originally charged.

To use your credit wisely, be sure to read the credit contract carefully. Don't rush into signing the card until you have thoroughly read the conditions and contract for the credit. Be sure you know the penalties if you miss payments or go over your limit. When using credit, be sure you figure out the total price. How much will that designer handbag actually cost if you buy it today and pay off the credit in incremental payments over the next 12 months? Be sure to make the largest payments possible—it is always best to pay the debts in full each month.

Remember, it pays to shop around to find the best deal on credit, especially on credit cards. Look at various sources for the best credit offer. Be sure to read and understand the contract for the credit. The fine print is especially important, as a number of additional fees will drive up the cost of credit. For example, a recent credit card offer charges 3% of the amount of a cash advance, but not less than $10. There is no upper limit to the charge. Late payment fees, over-the-credit-limit fees, return payment fees, and return check fees are $29 *each*—so it pays to not abuse the terms of the credit card. Be sure that you know what the penalties and other chargers will be.

Take a few moments to review Andrew's credit crunch case study to answer the following questions:

- What recommendations can you make for Andrew's credit crunch?
- What are types of good debt that he should consider?
- What debt should he avoid incurring?

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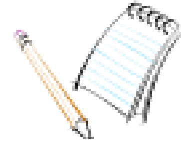
Activity Sheet 3-1: Credit is Everywhere



Directions: For a period of a week, collect sample credit offers from the Internet, direct mail, grocery store circulars, newspapers, magazines, and other sources to complete this activity. Then examine the different credit offers you collected and answer the following questions:

- What types of credit were most often advertised? What method of advertising did you find most effective? Least effective?

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- Which offers had the best deals concerning the factors of grace periods, fees, cash advance charges, and minimum payments?

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- What generalizations can you make about the types of credit offered and the interest rates charged?

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- What advice could you offer to other consumers regarding the types of credit available?

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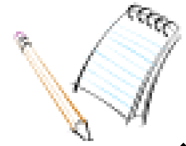
Activity Sheet 3-2: Examining the C's of Credit



Directions: Remember that credit is a form of trust between the borrower and the lender, and that the creditor will almost always try to determine if an applicant is creditworthy. So, for this activity you are going to analyze your creditworthiness by examining your own three C's of credit: capital, capacity, and character of credit applications.

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1. What type of **capital** or assets do you have that could be considered in a loan or credit application (house, car, savings account, or other financial resources)? ____

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2. What is your **capacity** that could be considered in the application? (your ability to repay the debt; will your present income stay the same or increase in the future?) ____

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3. Examine your **character**/credit history (Are bills paid on time? Are there previous defaults on credit? Etc.). How will these factors into the loan officer's consideration of your application? ________________________

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4. Do you think that someone else's evaluation of your three C's of credit would match the descriptions you listed above? Why or why not? ______

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