Learning Objectives

After completing this chapter, you’ll be able to:

1. **Describe** the nature of credit.

2. **Explain** the advantages and disadvantages of using credit.

continued
Learning Objectives

After completing this chapter, you’ll be able to:

3. **Name** the places where you can get credit.

4. **List** the three main types of charge accounts.

continued
Chapter 25

Key Words
credit
creditor
debtor
interest
consumer credit
commercial credit

Introduction to Business, What Is Credit?
continued
Key Words

credit rating
charge account
revolving account
installment loans
Why It’s Important

You’ll probably use credit some day. When you do, it will be helpful to know what credit is and the types of credit you can use.
Credit is an agreement to get money, goods, or services now in exchange for a promise to pay in the future.
Credit: The Promise to Pay

The one who lends money or provides credit is called the creditor.

The one who borrows money or uses credit is called the debtor.
What is the difference between a **creditor** and a **debtor**?

A. The **creditor** borrows the money and the **debtor** loans the money.

B. The **debtor** borrows the money and the **creditor** loans the money.
Credit: The Promise to Pay

Creditors charge a fee for using their money, which is called **interest**.
Credit: The Promise to Pay

The amount of **interest** is based on three factors:

- **Interest Rate**
- **Time** of the loan
- **Amount of the loan - Principal**

\[ I = P \times R \times T \]
Credit: The Promise to Pay

It’s important to shop around for credit because creditors may charge different rates.

<table>
<thead>
<tr>
<th></th>
<th>Harris Bank</th>
<th>Cary Bank</th>
<th>Great Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Auto Loan</strong></td>
<td>3%</td>
<td>3.5%</td>
<td>6%</td>
</tr>
<tr>
<td><strong>Home Loan</strong></td>
<td>5.2%</td>
<td>5.5%</td>
<td>4%</td>
</tr>
<tr>
<td><strong>Personal Loan</strong></td>
<td>6%</td>
<td>6%</td>
<td>6.5%</td>
</tr>
<tr>
<td><strong>Home Equity</strong></td>
<td>7%</td>
<td>6%</td>
<td>5%</td>
</tr>
</tbody>
</table>

A *lower rate* means *lower cost* (interest) to you.
Credit: The Promise to Pay

Interest rates change daily.

<table>
<thead>
<tr>
<th></th>
<th>Harris Bank</th>
<th>Cary Bank</th>
<th>Great Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Loan</td>
<td>3.7%</td>
<td>3.5%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Home Loan</td>
<td>6.2%</td>
<td>5.38%</td>
<td>4.98%</td>
</tr>
<tr>
<td>Personal Loan</td>
<td>8.5%</td>
<td>8.3%</td>
<td>8.4%</td>
</tr>
<tr>
<td>Home Equity</td>
<td>9.3%</td>
<td>8.7%</td>
<td>7.65%</td>
</tr>
</tbody>
</table>

The day you finalize your loan you should lock in your rate IF you applied for a fixed rate loan.
Credit: The Promise to Pay

Variable rate loan changes on a periodic (monthly, yearly) basis.

<table>
<thead>
<tr>
<th>Loan Type</th>
<th>Harris Bank</th>
<th>Cary Bank</th>
<th>Great Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Loan</td>
<td>3.3%</td>
<td>3.2%</td>
<td>3.3%</td>
</tr>
<tr>
<td>Home Loan</td>
<td>5.8%</td>
<td>5.3%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Personal Loan</td>
<td>9%</td>
<td>9.2%</td>
<td>9.4%</td>
</tr>
<tr>
<td>Home Equity</td>
<td>8.68%</td>
<td>8.54%</td>
<td>7.73%</td>
</tr>
</tbody>
</table>

If the rate of your loan goes down, you get the lower rate until the next change. If the rate of your loan goes up, you get the higher rate until the next change.
The interest rate of a variable rate loan will always be the same.

A. True
B. False
Who Uses Credit?

The type of credit used by **people** for personal reasons is called **consumer credit**.
Who Uses Credit?

Credit used by a **business** is called **commercial credit**.

When businesses borrow money, they often pass along the cost of credit to consumers by charging higher prices on their products.
Commercial credit is the type of credit you will need to get an auto loan.

A. True
B. False
Who Uses Credit?

The federal government uses credit to pay for many of the services and programs it provides to its citizens.

National Debt
Who Uses Credit?

State and local governments use credit to pay for such things as highways, public housing, stadiums, and water systems.
Advantages of Credit

The main advantage of credit is that it’s convenient.

Credit is especially useful in an emergency.
Advantages of Credit

Without credit, there are some things you can’t buy.
Advantages of Credit

If you don't like to carry large amounts of cash with you or if a company doesn't accept cash purchases (for example most airlines, hotels, and car rental agencies), putting purchases on a credit card can make buying things easier.
Advantages of Credit

It helps establish a credit history.

Using credit wisely establishes a good **credit rating**. A credit rating is a measure of a person's ability and willingness to pay debts on time.
Advantages of Credit

A good **credit rating** tells other lenders that you are a responsible borrower and a good credit risk.

A good **credit rating** leads to a guaranteed loan at a **low interest rate**.
Advantages of Credit

You can take advantage of sales.

Some stores offer special sales for credit card customers only.
Advantages of Credit

Credit helps you keep track of your spending.
Advantages of Credit

Credit contributes to the growth of our economy.

More people are able to spend money now and pay in the future.
Which of the following is not an advantage of using credit?

A. Establish a credit history
B. Convenient
C. Buy now, pay later
D. Pay interest
Disadvantages of Credit

The more items you charge and the longer you take to pay off your credit cards, the more you pay in interest.
Disadvantages of Credit

You may be discouraged from comparison shopping thus paying higher prices for items.
Disadvantages of Credit

Credit contracts (rules) may be difficult to understand.
Disadvantages of Credit

Overuse leads to a poor credit rating.
Disadvantages of Credit

Your future income is tied up repaying previous debts.
Disadvantages of Credit

Late or missed payments lower your credit rating, which will make it difficult for you to get credit in the future.
Which of the following is not a disadvantage of using credit?

A. Overuse leads to a poor credit rating.
B. Convenient
C. Buy things you can’t afford
D. Future income is tied up to pay credit debt
Do you know how to use credit wisely?

Write down the letter that best describes your answer to these questions.

1. I pay any bills I have when they are due _____.
   a. always   b. most of the time   c. sometimes

2. If I need more money for my expenses, I ____ borrow it.
   a. never   b. sometimes   c. often

3. If I want to see a copy of my credit report, I can contact _____.
   a. a credit reporting agency
   b. a bank
   c. the principal at my school

4. If I default (don’t pay) on a loan, it will stay on my credit report for _____.
   a. 7 years   b. 2 years   c. 6 years

5. If I have serious problems, I should _____.
   a. contact my creditors to explain the problem
   b. contact only the most persistent creditors
   c. not contact my creditors and hope they will forget about me

6. I can begin building a good rating by _____.
   a. opening a savings account and making regular monthly deposits
   b. paying most of my bills on time
   c. opening a checking account and bounce checks

**Scoring:** Give yourself 3 points for each “a,” 2 points for each “b,” and 1 point for each “c.” Add up the number of points.

- 6–9 points = learn more about credit before you’re in debt
- 10–13 = you’re off to a good start; be sure you know about the pitfalls of opening a credit account
- 14–18 = you know a lot about credit and use it wisely

**Source:** How to Be Credit Smart (Washington, DC, Consumer Education Foundation, 1994).
How did you do?
5. Identify the different types of credit.
Types of Credit

**Short-term** loans last for one year or less.

**Medium-term** loans last for one to five years.

**Long-term** loans last longer than five years.
Types of Credit
Introduction to Business, What Is Credit?
Charge Accounts

One of the most common types of short-term and medium-term credit is the charge account.
Charge Accounts

The three main types of charge accounts are:

• Regular
• Revolving
• Budget
Regular Charge Accounts

If the bill is paid on time, you don’t have to pay interest.

If you don’t pay the entire bill, interest is charged on the amount that hasn’t been paid.
A *revolving account* allows you to borrow or charge up to a certain amount of money and pay back a part of the total each month.

Interest is charged on the unpaid amount.

House payment
$1500.00 per month
Budget Charge Accounts

Budget charge accounts let you pay for costly items in equal payments spread out over a period of time.

Each payment includes part of the total due on the item plus interest.

$300
Which of the following is **not** a type of charge account?

A. Budget  
B. Convenient  
C. Regular  
D. Revolving
Credit Cards

Credit cards are like charge accounts but some can be used in many different places.
Credit Cards

Some credit cards have **annual fees**, which might range from $25 to $80.

Credit card companies earn money from the interest they charge. Interest rates vary.
Credit Cards

The three basic types of credit cards are:

- Single-purpose
- Multipurpose
- Travel and entertainment
Single-Purpose Cards

Single-purpose cards can only be used to buy goods or services at the business that issued the card.
Seller-Provided Credit

Many stores provide credit for their customers.

One of the reasons they provide such credit is to make it easier for consumers to buy their products.
Multipurpose Cards

Multipurpose cards are also called bank credit cards because banks issue them.

Multipurpose cards work like a revolving charge account.
3% Rule

Single-Purpose Card
3% of transaction remains with the seller (store).

Multipurpose Card
3% of transaction goes to the multipurpose card company.

You purchase an item for $100.00. You use a multipurpose credit card. The multipurpose credit card company ONLY pays the store $97.00. The store loses $3.00.
Chapter 25

Introduction to Business, What Is Credit?
Travel and Entertainment Cards

Travel and entertainment cards usually work like regular charge accounts.

You must pay the full amount due each month. NO INTEREST. You will have an annual fee.
If you are looking for a credit card that can be used at many different places, you should apply for which of the following cards?

A. Single Purpose
B. Multi Purpose
C. Travel and Entertainment
D. All of the above

[Bar chart showing: A: 2, B: 17, C: 0, D: 0]
No matter what your age is, credit card companies hound you to sign up and spend. Before you accept a company’s offer, carefully consider your options. Look at the comparative chart on the left.

If you wanted to get a credit card, which one would you consider? Why?

### Table: Comparison of Credit Cards

<table>
<thead>
<tr>
<th>Credit Card A</th>
<th>Credit Card B</th>
</tr>
</thead>
<tbody>
<tr>
<td>No annual fee</td>
<td>No annual fee</td>
</tr>
<tr>
<td>Offers a fixed 8.90 percent APR (for the first 6 months of purchases; then 15.49 percent)</td>
<td>An interest-free grace period of at least 25 days (if you pay your entire monthly balance)</td>
</tr>
<tr>
<td>Eligible for 14 round-trip e-tickets</td>
<td>A free customized credit card</td>
</tr>
<tr>
<td>Eligible for calling card (free 10 minutes per month for 1 year)</td>
<td>Accepted at more than 18 million locations</td>
</tr>
<tr>
<td>Customer service available 24 hours a day</td>
<td>Toll free customer service 24 hours a day</td>
</tr>
</tbody>
</table>
Single Payment Loan

The debtor pays back this type of loan in one payment, including interest (at the end of the loan period).
Chapter 25

Introduction to Business, What Is Credit?
Installment Loan

Installment loans are loans repaid in regular payments over a period of time.

The debtor makes equal monthly payments, which cover the amount of the loan and the interest.
What is the difference between a single payment loan and an installment loan?

A. A single payment loan is paid in 1 payment.
B. An installment loan is paid in equal payments.
C. Both A&B
Chapter 25

Introduction to Business, What Is Credit?
A **mortgage** loan is a form of an **installment loan** only it is written for a long period, such as 15 to 30 years.

**House Payment:** $2300 *per month for 30 year*
Mortgage Loan

Some loans require **collateral**, which is something of value the bank can take if you don’t make the required loan payments.
Chapter 25

Introduction to Business, What Is Credit?
Personal Loans

Banks or other financial institutions may offer you a personal loan. You can use this money for **personal reasons**.

This is an **unsecured loan**, so therefore the interest rate will be higher than for a secured loan.
Chapter 25

Introduction to Business, What Is Credit?
Automobile Loans

Banks or other financial institutions may offer you a **automobile loan**. This is a **secured loan**, so therefore the interest rate will be lower than for an unsecured loan.
Chapter 25

Introduction to Business, What Is Credit?
Banks or other financial institutions may offer you a **home improvement (equity) loan**. This is a **secured loan**, so therefore the interest rate will be lower than for an unsecured loan.

You do not have to use the money borrowed to improve your loan. Some people use it to pay for college expenses, because the interest rate is cheaper than a student loan.
Where do you borrow money from?

1. Banks
2. Savings and Loans
3. Credit Unions
4. Finance Companies
5. Payday Advance
6. Pawnshops
Banks and Other Financial Institutions

Financial institutions, such as banks, savings and loans, and credit unions offer many types of loans.
Banks and Other Financial Institutions

Financial institutions, such as banks and credit unions usually have the lowest rates on their loans, but they place more demands on the borrower.

For example, they’ll only lend money to people with good credit ratings.
Consumer Finance Companies

Consumer finance companies specialize in loans to people who might not be able to get credit elsewhere.
Consumer Finance Companies

The interest on a loan from a consumer finance company is higher than the cost of a loan from other sources since this loan involves a greater risk.
Payroll Advance Services

If you don’t have any savings and an unexpected expense occurs, you might look for a short-term loan until payday.
“Borrow Until Payday” Loan

A payday loan is made without a credit check, but you must have proof of a checking account and employment.
Payroll Advance Services

You write a check to them for $300 that they can cash on your next pay day (1 week) and they give you $250 today.
“Borrow Until Payday” Loan

Some businesses provide very short-term loans, usually for 5 to 14 days.

The interest on this kind of loan is especially high.
Pawnshop Loan

A pawnshop loan is based on the value of something you own.

Generally, the interest of this type of loan is very high.
If you have good credit and want a low interest loan you should apply at which of the following places?

A. Bank
B. Payday advance
C. Pawnshop
D. American General Finance
Types of Credit

Charge Accounts
- Regular
- Revolving
- Budget

Credit Cards
- Single-purpose
- Multipurpose
- Travel and entertainment

Institutional Loans
- Single payment
- Installment
- Mortgage

Seller Provided Credit

Consumer Finance Companies

Payroll Advance Services
Match the Loan with the potential Interest Worksheet.