

Module 2 Managing Credit

# Learning Objectives

* Check their credit score and report
* Describe two types of credit
* Discuss advantages and disadvantages of credit and credit cards
* Calculate the effective interest rate for revolving credit

# Credit Scores

Individual consumers, as well as businesses, have a **credit score**. These scores range from 300-850 and indicate to lenders the risk or how likely borrowers are to repay a loan promptly. There are several types of credit scores. FICO credit scores from the Fair Isaac Corporation are one typical example introduced in 1989 (Credit, 2012). The exact formula is proprietary, and it is not publicly disclosed, but it is generally accepted that credit scores are based on five components: payment history, amounts owed, credit age, new credit, and consumer credit mix. Payment history describes the consumer’s ability to pay their bills consistently on time. Defaulting on debt has an adverse effect on your credit score. The credit available is affected by income and by how much you already owe. Credit age is the number of years you managed credit properly, paying more attention to the most recent years. The category of new credit often causes confusion. Did you know that canceling a credit card for an unused account can lower the credit rating? It seems responsible to cancel an unused account; however, it shortens credit history and decreases diversity in account types.Consumer credit mix takes diversity between amortized loans and revolving credit into consideration. Amortized loans have a repayment schedule that calls for the same amount of payment each time, with each payment being a mix of principal and interest. Mortgage, car, and student loans are usually amortized. In contrast to amortized loans, revolving credit agreements do not specify a fixed repayment amount; rather, the lender states a minimum payment that is required each time, while the borrower can pay any amount that is equal to or greater than the required minimum. Demographics like age, gender, religion, and address are not included in a person’s credit score.

Do you know your credit score? The rest of this module will make more sense if you do. Experian, Equifax, and Transunion offer free or low-cost credit scores with reports. They offer various forms of credit monitoring for a fee. However, the three entities are required by federal law to provide your score once each year for free and to correct mistakes found in your report. This site <https://www.annualcreditreport.com> allows you to order a report from all three agencies. Beware of fake websites that try to emulate this site. Hackers would love for you to enter your information into their site. Each company uses a slightly different formula and produces a different score.

Credit scores determine if the lender will say yes to the borrower, and scores often set the interest rate for the borrowed funds. The higher the credit score, the lower the interest rate is potentially. Stanger (2019) lists the parameters for score categories in the table below.

|  |  |
| --- | --- |
| **Description of Credit History** | **Score Range** |
| Exceptional | 800+ |
| Very Good | 740-799 |
| Good | 670-739 |
| Fair | 580-669 |
| Poor | 579 and below |

No more than 1% of borrowers whose credit is described as Exceptional become delinquent on their loans. Approximately 21% of Americans belong to this group (Papandrea, 2024). In contrast, the 12% of Americans whose credit is described as Poor have 60% probability of default. This group most likely will be denied loans or charged high interest rates, fees, or both, to compensate for high lender risk.

Good news! There are ways to improve your score over time. For consumers with lower descriptors than desired, it is possible to change your credit score for the better. Besides what seems obvious: to pay on time, here are a few other suggestions that may increase your score. First, try to lower your credit utilization ratio. **Credit utilization** is the ratio of total debt balances (such as the amounts you owe on the credit card) to the total allowed credit limit**.** For example, if you have a $1000 limit and you have a balance of $300, that is 30% credit utilization. A good goal to strive for may be to reduce or keep your credit utilization below 30%. There are two tactics you may use to achieve low utilization of a credit limit. The first method is to pay the outstanding balance. To accomplish this, you may try making payments twice a month rather than once a month, as required, and whenever possible, pay more than the minimum required payment. The second method is to request a credit limit increase. The purpose of asking for an increase is to show lower credit utilization and not to spend more. Of course, you can also combine these two tactics.

For those credit newbies, those consumers in their late teens and early twenties, you have several options for building or improving credit scores. One method is to become an authorized user on someone else’s account, preferably on a family member’s or friend’s account that has a history of good credit and pays attention to it. It may seem strange, but the account holder is not required to let you use a card or know the account number. Another option is to get a secured credit card. A **secured credit card** account requires payment upfront, and then it is used like a normal credit card. The third option is to have rent and utility payments added to your credit report. VantageScore from Transunion allows rent to be reflected in your credit report, and Experian Boost from Experian can show utility payments. FICO scores do not show these.

# Types of Consumer Credit

# Amortized Loans

Consumers build assets by using long-term loans with consistent payments to purchase goods and services that cost thousands of dollars, which they cannot purchase outright with a single payment. Purchasing homes and vehicles are common examples of amortized loans. Student loans that pay for higher educational expenses for bachelor's or master's degrees are usually amortized loans. Students should seek scholarships, grants, or a combination to defray educational expenses before using student loans. Amortized loans can also be used to purchase discretionary items such as boats, recreational vehicles, or even elective medical services.

Payments for these loans are designed to have a consistent payment schedule where each payment contains a mix of money that pays down principal and interest simultaneously. The breakdown between the principal and interest is different each month. In effect, the borrower pays interest on the entire remaining amount of principal in each payment. Since the principal amount is the highest immediately after the purchase, the interest amount at that time is also the highest. As a result, at the start of the loan payment series, the interest portion of the payment is the highest, and it dominates the principal portion. As the principal is gradually paid off, the amount of interest declines, which leaves more room for the principal payment. Towards the end of the payment series, closer to the loan “maturity” (full repayment date), the payment consists primarily of the remaining principal and a small amount of interest. This type of debt is long-lasting. Three to five-year vehicle loans and 15-to-30-year home loans are common.

# Credit and Credit Cards

Revolving credit and credit cards are used in the short term to purchase goods or services, delay payments, and finance living expenses. Examples of credit card use can include financing a new couch, repairing the plumbing, or even purchasing groceries or clothing. Credit can be used as a cash management tool or to finance personal consumption. The benefits of credit and card cards are convenience, security over carrying cash, and its universal acceptance around the globe.

**Installment credit** (aka amortized loans) is typically issued by a single vendor for a specific item. For example, suppose that Mark just bought a house and realizes that he needs a lawn mower for yard maintenance. He stops at the Super Lawn Center to purchase a new mower. Coincidently, the store is having a sale. Advertising for no money down or 0% interest for some number of months is intended to lure the consumer and make the object for purchase appear affordable. The store, the Super Lawn Center, screens the applicate and extends credit to make the sale. The store also assumes the risk of nonpayment or the default risk. Mark is paying for the lawnmower in monthly installments. The payments that Mark makes are the same each month and include both payments for the lawnmower (principal) and interest. This is a common way to pay for appliances, furniture, electronics, and other household items.

Retailers often partner with finance companies to sell customers revolving credit and installment payments simultaneously. In the case above, Mark may agree to an installment purchase by opening revolving credit. Mark agrees to open a Super Lawn Center Visa and pay $240 for 12 months at no interest. He can use the credit card for other purchases that have an interest rate of 23%. When Mark buys other items on the same card, he now has revolving credit. If Mark defaults on the payments during the 12 months at no interest, the lender can then charge Mark interest, fees, or both.

**Revolving credit** is typically issued for multiple vendors for a certain limit to delay payment. Consumers are issued a credit card or charge card to utilize this revolving credit. There are two types of revolving credit. In some instances, most often for consumers with poor or short credit history, the card balance must be paid in full for each credit cycle. Many cards offer a **grace period** between the time of the credit purchase and the time of payment (assuming a zero balance). When you pay your card balance off in full each month, you can think of it as using someone else’s money to make purchases. Using revolving credit in this manner is using the credit card as a cash management tool.

Alternatively, in another best-known and most common case, credit card companies allow consumers to pay some minimum amount each month, depending on the current balance on the card. As long as a borrower pays at least the minimum amount on time, then they will not be charged a penalty. As mentioned above, the downside of paying no more than a minimum amount is that this strategy may accumulate larger balances, which would result in a higher credit utilization ratio and a lower credit score. In addition, any unpaid balance is, of course, subject to further interest charges.

The credit card industry became possible with the emergence of technology. It has revolutionized modern spending. If it is not used as a money management tool, then it is easy to forget that it is borrowing with costs, costs that are driven by the risk of failure to repay the cash advanced to the consumer. What happens when the consumer does not pay the monthly balance in full? When the consumer only pays only the required much lower minimum payment, the credit card is used to extend credit as a means of financing a purchase. This is when interest starts to accrue. Extremely expensive interest!

Credit cards can be compared based on their **annual percentage rate (APR),** which they are required by law to disclose. The APR can be deceiving because it does not represent the actual interest consumers pay since credit card companies calculate interest with daily compounding. The rate that consumers pay is the **effective interest rate**. The effective interest rate formula is

, where *i* is the effective interest rate in decimal form, APR is the annual percentage rate and *m* is the compounding period.

For example, when the APR is 20% and . The consumer who assumes a compounding period of one year, hence the word *annual* in APR, might think the effect interest rate is the same as the APR.

In comparison, when the compounding period is changed to 365 (daily) the effective interest rate is different.

The effective interest rate the consumer pays is 22.13%. The difference is more than 2%, which may not seem like much initially, but over time with large credit card balances, it can be substantial.

Understanding how interest is calculated will help consumers make conscious decisions and manage credit card debt. It is common for the advertised APR to be more than 20 percent. Before using credit cards to finance a purchase or service, the consumer should calculate product totals or use the effective interest rate to find the additional (hidden) cost they will add to the purchase.

It is important to weigh the advantages and disadvantages when using credit cards. Can you take advantage of the pros of using credit cards and reasonably manage the cons?

|  |  |
| --- | --- |
| **Pros for using Credit Cards** | **Cons for using Credit Cards** |
| Convenience  Security against stolen cash  Universally accepted  Less transaction costs  Record of transactions  Cash management tool | Impulse purchasing  Expensive interest charges  Risk of fraud  Risk of identity theft  Overwhelming debt |

Consumers should shop around and compare credit card offers and promotional deals. What credit limit is being offered? What is the consumer liability for fraud? Is there an annual fee for just having the card? Credit card companies compete by offering promotions that include consumer rewards in the form of cash back, reward “points” for spending. Will those rewards be used? It does not make sense to pay 23% interest for a 3% cash back. What are the fees for cash advances, overdue payments, or extending credit?

The purpose of the credit card dictates the card of choice. For example, if you pay off the balance each month then you may not be concerned about a high APR, but more concerned about the annual fee to have the card. If you pay interest on the balance, then APR becomes a more important feature than others.

# Modern Loan Sharking

The Hollywood version of loan sharking depicts the lender causing or threatening to cause harm to the borrower for repayment. Physically harm to others is illegal. Modern day loan sharking looks different than Hollywood’s version and can operate within the legal limits of the law. Modern, legal loan sharking should be suspected with any offer of instant cash. Consumers can get instant cash for pawning objects or payday loans. Lenders may offer cash for short term pawns by using property, including vehicles, as collateral. **Payday loans** offer cash advances until the next payday. Schemes arise annually tied with offers to provide the consumer with an early tax refund. These types of “cash now” loans usually involve charging exorbitant interest rates to desperate consumers. The one-time issue “fees” charged on these short-term loans, propel the effective annualized rates into shocking heights, from 200% to 800%. The credit can quickly multiply and becomes more difficult to pay, translating into vicious debt cycles. Since these predatory lenders target lower-income economic groups, with minimal financial education, they contribute to further deterioration of the consumers’ living standards.

# What Happens When You Cannot Pay?

Be proactive in resolving problems when you cannot consistently pay on time or at all. The best defense is to revisit the budget and make realistic goals for yourself. Include debt payments in the budget if possible. Call creditors, explain your situation and see if they can work with you to renegotiate payments, lower the APR, remove fees, etc. Credit counselors can help with budgeting, consolidating debt, or serving as an intermediary to lenders. Professional credit consultants that offer debt consolidation may be internally motivated to favorably argue for debt consolidation from creditors. Debt consolidation can offer lower interest rates, streamline payments, and plan to become debt free. However, consolidation may also offer more credit, when what you are looking for is realistic credit that is manageable, not necessarily higher debt limits. The absolute last resort is bankruptcy. Seek professional legal and financial advice when filing for bankruptcy. Bankruptcy and federal and state laws that apply to both lenders and borrowers are beyond the scope of this module.

# Quiz Questions

1. An Exceptional credit score is above what value?
   1. 800 \* answer
   2. 750
   3. 700
   4. 600
2. What is the effective interest rate for a credit card with 23% APR?
   1. 23%
   2. 24.1%
   3. 25.8% \* answer
   4. 26.2%
3. Julie buys a new $3000, bedroom suite for her apartment at the Bedroom Store. She pays $600 down and makes monthly payments of $225 to the store for 12 months using her new Bedroom Store card. What type of credit is this?
4. Installment credit \*answer
5. Revolving credit
6. Open credit
7. None of these
8. Julie buys a new $3000, bedroom suite for her apartment at the Bedroom Store. She pays $600 down and makes monthly payments of $225 to the store for 12 months using her new Bedroom Store card. What is the APR for her card?
   1. 0.125 %
   2. 3 %
   3. 11 %
   4. 12.5 % \*answer
9. Disadvantages of credit cards include which of the following?
   1. Convenience
   2. Impulse spending \*answer
   3. Worldwide acceptance
   4. Records of transactions

# Assignments

1. Check your credit score and report. This will not be collected or shared with classmates as it is confidential information. However, you may be asked to provide the last date on which you checked your score.
2. Suppose you need a new dishwasher, and you have found the perfect one for $1200. Find two credit cards that offer different promotions. Since you are starting your profession you have no emergency fund, and you decide to opt for a credit card. Your financial goal is to pay the dishwasher off in a year or less.

Determine which one is the better deal and explain why.

1. Select a master’s program to attend such as UNG’s MAT program. Students may select a different master's program related to an educational field of study they might pursue. Estimate the expenses for one semester at full time student status. Use the estimated expenses and the current federal student loan intertest rates from [Current Federal Student Loan Interest Rates](https://cri.studentaid.gov/content/currentfederalstudentloaninterestrates) to determine the loan's interest if paid over 5 years or 10 years.

# Vocabulary

**Credit score**- A number between 300-900 indicates how likely the borrowers are to repay the leader.

**Credit utilization**- A proportion of the borrower’s credit balance to their credit limit.

**Secured credit card**- A credit card where payment is made before spending occurs.

**Installment credit**- A one-time credit that is paid for by scheduled, consistent, regular payments.

**Revolving credit**- A flexible account for spending approved for a specific amount or limit.

**Grace period-** The time between the time of the credit purchase and the time of payment.

**APR**-An annual percentage rate of interest for an account given to the lender.

**Payday loans**- A loan that provides instant cash in exchange for repayment upon the borrower's next payday.

## References

Credit. (2012, October). What does FICO stand for? and what is a FICO score? Retrieved from <https://www.credit.com/credit-scores/what-does-fico-stand-for-and-what-is-a-fico-credit-score/>

Papandrea, D., Shepard, D. (Ed.). (2024, May). Average credit score in the US: FICO and VantageScore breakdown. Lending Tree. Retrieved from <https://www.lendingtree.com/credit-repair/credit-score-stats-page/#:~:text=71.3%25%20of%20Americans%20have%20a%20FICO%20Score%20of,exceptional%20FICO%20credit%20score%20of%20800%20or%20above>.

Stanger, T. (2019, April). What’s a good credit score? There are ways to improve it. Consumer Reports. Retrieved from <https://www.consumerreports.org/banking-credit/what-is-a-good-credit-score/>

Adaptation of Personal Finance. **Provided by**: Saylor Academy. **Located at**: <https://saylordotorg.github.io/text_personal-finance>. **License**: [*CC BY-NC-SA: Attribution-NonCommercial-ShareAlike*](https://creativecommons.org/licenses/by-nc-sa/4.0/)