What Is Credit?

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

Credit decisions can be difficult. 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 whether the advantages of using credit outweigh the disadvantages.

There is a bright side to using credit. Credit can help people acquire assets. Assets are goods or services that usually retain or increase in value. Ordinarily, a home or post-secondary education is considered an asset. Credit can help people lead happier lives by helping them to obtain the goods and services they wish to have while paying for them. Credit also can help people in an emergency.

There is also a dark side to using credit. Mistakes in using too much credit in relation to your income can be hard ones from which to recover. Many new college graduates, for example, spend a lot of the income from their first jobs repaying large credit card debts they have rolled up while in college. 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—has many negative consequences including the inability to get credit later for major purchases, such as homes and cars.

Financial institutions (commercial banks, savings and loans, credit unions, and consumer finance companies) hold money that they, in turn, loan out to others. The owners of financial institutions 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 in a credit transaction almost always benefit. Borrowers are able to purchase something that may be of value today and perhaps in the future. Lenders are repaid the money that was loaned, plus interest.

An important factor in determining the rate of 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 result in higher interest rates.

Lower risk loans—loans where it seems evident that the borrower can repay—usually result in lower interest rates.

A loan for an intangible, like a vacation, is 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) 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.*

Questions

1. What is credit?

2. What is the bright side of using credit?

3. What is the dark side of using credit?

4. What institutions are sources of credit?

5. What is interest?

6. Who most often wins in a credit transaction?

7. How does risk influence the rate of interest?

8. What is collateral?

Common Forms of Credit

Directions: Study the chart below and answer the questions that follow.

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 today that boat or vacation they want.	• Personal loans have relatively high interest rates. • Some young people may borrow more than their income should allow.
CREDIT CARDS	• Commercial bank • Savings and loan • Department store • Oil companies • Other financial institutions, e.g., American Express	• Credit cards are convenient to use and useful in an emergency. • Credit cards provide a record of charges.	• Credit cards have relatively high interest rates. • Some young people may borrow more than their income should allow.

Questions

1. What are the advantages of home loans and college loans compared to credit card and personal loans?

2. What are the disadvantages of credit card and college loans?