What Is Credit?
By Mark Schug

If people waited until they had saved up enough cash to pay in full for all of their purchases, most of them would have a lower standard of living. Having access to credit allows people to acquire goods and services that they otherwise could not yet afford. But credit, when used foolishly, can cause serious financial problems from which it might be very difficult to recover.

Through most of our history, credit was a personal, face-to-face arrangement. A 19th century farmer might purchase seed supplies in the spring "on account" from the local mercantile store. The account would be repaid after the fall harvest. Credit of this sort was essential for many farms and businesses to operate.

Consumers could also get credit at the local mercantile store. The development of consumer credit, however, accelerated during the 1920s. Mass production of automobiles, washing machines, home lighting with electricity, refrigerators, vacuum cleaners, inside flush toilets, central heating systems, and radios increased Americans' standard of living.

Simultaneously, car companies, banks, and finance companies responded to consumer demand and made credit more widely available to average consumers. You no longer had to be wealthy to afford to own a home, car, or refrigerator. It seemed that nearly everyone could "buy now, pay later." Rather than saving up cash to buy a consumer durable—like a new Chevrolet with the latest innovations such as a heater, windshield wipers, and an automatic starter—a consumer could make a down payment on the car, take immediate possession of it, and pay for it in monthly installments. Since the 1920s, many new forms of credit have developed to meet the changing desires of consumers. Today's consumers face a wide array of credit alternatives that were unavailable to earlier generations of Americans.

The Role of Financial Institutions

Financial institutions like retail banks, savings and loans, and credit unions provide important financial services for their customers or members. The most important service provided by financial institutions is performing their role as "middlemen," or financial intermediaries. *Common Sense Economics* discusses the role played by middlemen to reduce transaction costs.

How do financial institutions act as middlemen or intermediaries? They reduce transaction costs by connecting lenders and borrowers.

People who use financial institutions are interested in improving their own economic well-being. They wish to deposit their savings in bank savings and checking accounts that they know are safe. They may also wish to earn a return on their savings by placing them in investment accounts. Having a relationship with a financial institution also provides convenient access to credit.

Banks and other financial institutions channel these savings into the economy. They connect these deposits to others who can put them to productive uses. Banks, for example, provide loans to borrowers to buy homes and cars. They also provide loans to businesses that, in turn, can now expand their operations, hire more workers, and produce the goods and services desired by consumers.

People who use financial institutions actually are helping others even though that is not their intention since they are simply acting out of self-interest. They only mean to help themselves. Savings buried in the back yard or stuffed into a mattress cannot help anyone—including the saver—given the high risk of loss in such saving arrangements, as well as the opportunity cost of interest forgone (that is, money in your mattress doesn't earn interest). However, when people deposit their savings in financial institutions, these institutions connect these savings to others. They are released into the economy to help other households and businesses. That is, financial institutions are guided to serve others by the incentives they face.

Here are the major types of financial institutions:

Retail banks: These are depositary institutions that work directly with consumers, as opposed to other banks or corporations. Often, these are large banks that offer services through their local branches. They offer many financial services such as checking accounts, savings accounts, home loans, credit cards, certificates of deposit, safe deposit boxes, and so forth. Retail banks are private, profit-seeking businesses. They earn revenue by paying lower interest on deposits and charging a higher interest on loans. They also charge fees for services.

Savings and loans: Savings and loans—often called thrifts—operate much like retail banks. They offer loans of various types. They specialize, however, in making loans for homes. They are private, profit-seeking institutions that are often locally owned. Savings and loans give primary attention to single-family residences.

Credit unions: These are also depositary institutions but they work a little differently because they are organized as not-for-profit cooperatives. Like retail banks, credit unions provide financial services to their members including savings accounts, checking accounts, and loans. To join a credit union, a person must ordinarily belong to a participating group or organization, such as a college alumni association or a labor union, or live in a particular geographic region. When people deposit savings in a credit union, they become a member and are considered partial owners.

Consumer finance company: These private, for-profit institutions specialize in providing loans to people or businesses that may have encountered difficulties in obtaining credit from a retail bank or a credit union. A consumer finance company generally charges higher interest rates than a retail bank or credit union.

The Basics of Using Credit

The essential feature of credit is that it allows individuals to obtain the use of money that they do not have. Obtaining credit means convincing someone else (a lender) to provide a loan in return for a promise to pay it back at a certain time or on a certain schedule, plus an additional charge called interest. The interest charged is usually a percentage of what you borrowed. Borrowing more will mean you pay more in interest.

People use credit for many reasons: obtaining loans to buy cars, homes, major appliances, to improve their homes, to pay for college education, and so forth.

Credit decisions can be difficult ones. Like all choices, credit decisions involve examining the additional costs and benefits facing the individual making the choice. The hard part, of course, is figuring out if the advantages of using credit outweigh the disadvantages.

There are two important things to know about credit. It can work for you or it can work against you.

Credit Is from Heaven

What are the benefits to using credit? Credit can help people acquire valuable assets—a home, for example, or an education. Assets are goods or services that usually retain or increase their value. Ordinarily, owning a home or obtaining a post-secondary education is considered an asset. Credit can help people lead happier lives by obtaining the things they wish to have now while paying for them over time. Credit also can help people in an emergency—to pay for the unexpected tire repair or visit to the clinic.

Credit Is from Hell

There is also a dark side to using credit. Almost certainly, you know people that are having trouble with credit card debt. It can be difficult to recover from the mistake of using too much credit in relation to your income. For example, many new college graduates spend a lot of the income from their first jobs repaying large credit card debt or student loan debt they have rolled up while in school. 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 like having a decent place to live and owning a dependable car. Misusing credit—missing payments or defaulting on loans—can have many negative consequences including the inability to attain credit later, or having money deducted from your paycheck to be applied against delinquent loans.

Common Forms of Credit

Exhibit 1 describes the types of credit people use and the lenders who provide credit. It also explains the advantages and disadvantages of various forms of credit. The information shown in Exhibit 1 suggests several ways in which credit can help people. Look at home mortgages, for example. Owning a home offers several advantages, since homes often increase in value and interest paid on home loans is tax-deductible. But buying a home involves a big financial commitment, and few families could afford to buy a home if they had to come up with the cash all at once. Moreover, homeowners—unlike renters—have to handle the costs for property taxes, repairs, insurance, and improvements.

Credit card loans also offer advantages. They are convenient and easy to use. They can be great in an emergency. Furthermore, it is nearly impossible to travel without credit cards. But credit card loans can pose serious problems. They come with relatively high interest rates. Some people may borrow more against their cards than they should, given their income levels.

Exhibit 1: Common Forms of Credit

Type of Credit: Car loan

Lenders are: Retail banks, Savings and loan, Credit unions, and Consumer finance companies

Advantages:	**Disadvantages:**
• Car ownership can make it more convenient to work and earn an income. • Cars are assets and retain value.	• New cars lose their value quickly. • Cars come with expenses for maintenance, fuel, insurance, and repairs.

Type of Credit: Home mortgage

Lenders are: Retail banks, Savings and loan, and Credit unions

Advantages:	**Disadvantages:**
• Homes are assets and may increase in value over time. • Interest rates are often low. • Interest paid is tax deductible.	• New cars lose their value quickly. • Cars come with expenses for maintenance, fuel, insurance, and repairs.

Type of Credit: College loans

Lenders are: Retail banks, Savings and loan, and Credit unions

Advantages:	**Disadvantages:**
• Post-secondary education is usually a good investment. • Interest rates tend to be low.	• Students may borrow more than is necessary. • New graduates can face difficulty in repaying large loans.

Type of Credit: Personal loans

Lenders are: Retail banks, Savings and loan, Credit unions, and Consumer finance companies

Advantages:	**Disadvantages:**
• Personal loans allow an individual to purchase luxury items such as a boat, jet ski, or	• Personal loans come with relatively high interest rates. • Most personal loans are not

a hot tub now but pay for it later.	assets that retain value over time. • Some people borrow more than they should, given their level of income.

Type of Credit: Credit cards

Lenders are: Retail bank, Savings and loan, Department stores, Oil companies, Consumer finance company, and Other financial institutions such as American Express or Visa.

Advantages:	**Disadvantages:**
• Credit cards are convenient to use and useful in an emergency. • Credit card bills provide a record of charges that can be useful in tracking expenses.	• Credit cards come with relatively high interest rates. • Some people borrow more than they should, given their level of income.

How Credit Works

Financial institutions (banks, savings and loan associations, credit unions, and consumer finance companies) hold money that they are willing to lend. Most often, these funds come from deposits made by savers. The owners of financial institutions are not charities. Financial institutions are private, profit-seeking businesses. They expect to be compensated when they make a loan. As we saw, this compensation is called interest. Interest is the price a borrower pays to a lender for use of the lender's deposits. Interest is also the reward lenders receive for allowing others to use their deposits. The Annual Percentage Rate (APR) is the cost of credit figured on an annual basis. The APR provides a standard way for comparing interest rates.

Both sides usually benefit in a credit transaction. Borrowers are able to purchase items that may be of value today and perhaps in the future. Lenders are repaid the money they loaned, plus interest. It can be a win-win deal!

An important factor in determining the rate of the 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 made when it is uncertain that the borrower can repay—usually come with higher interest rates. Lower risk loans—loans the borrower is almost certain to repay—usually come with lower interest rates.

Loans for an intangible thing like a vacation are 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, for example) 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.

Because lenders are not charities, they face incentives to seek the most profitable uses of their money, deciding among investments, real estate projects, and loans to consumers like you. When they make consumer loans, they expect to have the amount repaid—with interest most of the time—and they work to control losses when they are not paid back. As a result, financial institutions tend to look for certain qualities in loan applicants. These qualities are called the "Three Cs of Credit." They are:

- **Character:** Will the applicant be responsible and repay the money as agreed? Financial institutions are looking for customers with good financial reputations—people who take financial responsibilities seriously and are timely in fulfilling obligations. An applicant's credit score is frequently used as evidence of character. Applicants with high credit scores are likely to be offered better deals than applicants with low credit scores. Lower character (in this financial sense) is signaled by foreclosures, bankruptcies, repossessions, and debts referred to debt collection agencies.

- **Capacity:** Does the applicant have enough income to comfortably make payments on the loan amount requested? Lenders will wish to know about the applicant's current expenses and other assets or savings with which to repay the loan if income is unavailable. The main idea of "capacity" is to learn whether the applicant will realistically be able to honor the obligation and repay the debt.
- **Collateral:** Will the loan be secured, or guaranteed, by collateral that can be used to repay the debt in case the borrower defaults on the loan? Collateral might include equity in a home, a car, or some other asset. A large down payment on a home partially financed with a mortgage is considered part of the appellant's collateral.

Debit Cards

People sometimes think that all those plastic cards in their wallets and purses are the same. They are not. For example, there are big differences between debit cards and credit cards.

Debit cards look like credit cards, but they work differently. Debit cards are nearly the same as cash. When you use a debit card, the charge is immediately withdrawn from your checking account via an electronic transaction. You do not receive a bill later. There is no loan involved, so you do not pay interest.

Debit cards provide a convenient way to pay for things. In using debit cards, however, you need to remember two things. First, you must keep track of the debit card payments. Many people record these payments immediately in their check register or check their account online so they will not forget or lose track of their spending. Second, there is no "grace period" as there is when using a credit card. Payment is immediate and certain. The funds must be in your account.

Credit Cards

Using a credit card really means you are taking out a loan. When you buy something on a credit card, you promise to pay back the charges on your account plus a payment for interest and fees. Credit card loans are revolving credit plans. You have access to a fixed amount of money, called your credit limit. Once you repay any of the money you have spent, you can borrow that amount all over again. A statement is mailed or sent online to the card holder each month showing the charges, the total owed, the minimum to pay, and the finance charge.

Many institutions put their names on credit cards, including banks, department stores, airline companies, savings and loan companies, credit unions, oil companies, finance companies, automobile companies, telephone companies, and even national football and baseball teams.

Most credit card companies charge a fixed interest rate. Many charge an annual fee for the card. Most credit cards offer a grace period (usually 30 days) that allows you to avoid paying interest on the balance if the balance is paid in full.

Here is an example: What you borrow, or what you spend, is called the principal. For the privilege of using the principal, you pay the credit card issuer a finance charge, which is the interest that accumulates on any unpaid balance. If you have a balance of $600 on a card with an annual interest rate of 18 percent, your monthly finance charge will be $9. It is calculated by multiplying a month's worth of interest—1.5 percent—times the balance. Every credit card company has to disclose the interest rate it charges on the balance you carry, and different cards charge different rates so it's worth shopping around.

Here are some tips for using a credit card successfully:

- Have only two or three cards.
- Pay off the total balance due each month.
- Shop for a card with a low interest rate.
- Shop for a card with no annual fee, or a low fee.
- Use your card for such things as travel and emergency purchases.
- Use credit card statements to keep track of spending.
- Notify the credit card issuer immediately if the card is lost or stolen.
- Never give your credit card numbers or expiration dates to businesses you do not know, whether it is by phone or online.
- Notify your card issuer if you will be traveling out of the country.
- Report any questionable charges to the card issuer.
- Keep an eye on your card when using it for a transaction. Make sure you get it back when you leave.

Applying for a Loan

A loan usually involves a greater sum of money than you can typically borrow with a credit card. Therefore the process of applying for a loan is more complex than applying for a credit card.

When you apply for a loan, the bank or other financial institution will review your credit report and credit score, and you will have to provide additional information including:

- **Employment:** You will be asked to list the name of your employer as well as your salary. You will be asked to provide a record of payroll statements. Lenders may contact your employer to verify the information you provide.
- **Savings and credit accounts:** You will be asked to provide information about all of your assets and liabilities,

such as bank accounts, credit card accounts, and investment accounts. Lenders like to have a full picture of any assets you might have available to help you repay your new loan as well as your existing loans.

- **References:** You might be asked to give the names of a contact at work or a professional such as your lawyer who can recommend you as a candidate for the loan.

A Word about Alternative Financial Services

In addition to mainstream financial services, there are alternative forms of credit. No doubt you have noticed that in nearly every strip mall in America—small towns and large urban centers alike—there are stores offering financial services such as check cashing, payday loans, pawn shops, and rent-to-own items.

Many individuals have discovered advantages in using alternative financial services. Here are three reasons why: First, these outlets offer financial services that people find useful. Many banks, for example, do not offer short-term loans for small amounts of cash. And people often find it convenient to use check-cashing services, money orders, and wire transfers. Second, the outlets that offer these services tend to be conveniently located. In some neighborhoods there are more check-cashing outlets than grocery stores. Obviously, these outlets are responding to demand in local communities for the services they provide. Third, these outlets provide quick services with a minimum of hassle. Cash may be provided quickly, with few questions asked and few papers to sign.

There are several disadvantages, however, to using alternative financial services. Payday loans provide an example. Payday loans are small loans made by a short-term lender to individuals—usually for $300 to $500. The key advantage is that such loans may be helpful to people facing a short-term financial emergency—an unexpected moving expense, a medical expense, a car repair bill, and so forth. While banks often do not offer loans for less than $1,000, short-term lenders do.

These loans are usually very expensive. Let's consider their costs from a couple of different angles. Suppose the fee for a two-week $100 loan is $33. If you convert that fee to an annual percentage rate, it comes to 858 percent.[1] That is a terribly high rate. Think of the opportunity costs of taking out such a loan—all the other things that could be done with the money that is instead paid as interest.

The annual percentage rate may not mean much to some, so let's consider the cost in another way. The main disadvantage of payday loans is that many people do not pay them back on time. If a person is a little short of cash before the end of one pay period, it is easy to imagine that he or she will be short of cash during the next pay period. When the borrower cannot pay off the loan, the loan is renewed or "rolled over." This means taking out another loan to pay off the first loan. Or the loan agreement may specify that an interest payment will be required to extend the first loan if it is not paid off on time. Either way, it is expensive. Imagine that a person takes out a payday loan for $200 for two weeks at a fee of $40.00. If this loan is refinanced four times, the cost increases dramatically. In fact, in the course of four renewals, the borrower will wind up paying approximately $400 ($200 in interest) to borrow $200 for just 10 weeks.

Mainstream financial institutions such as retail banks, savings and loan associations, and credit unions offer many advantages over the check-cashing outlets and providers of payday loans. Most importantly, banks offer a safe place to keep money. The federal government insures deposits in banks. In contrast, holding cash savings at home is very risky. Cash can be easily lost or stolen. Banks and similar institutions offer several other advantages as well. They enable bank customers to accumulate savings, develop a credit history, keep records, and use various financial services at comparatively low rates. It makes sense to deal with mainstream financial institutions as your individual situation permits.

Concluding Thought

Credit is a double-edged sword. Wise use of credit can expand opportunities, but unwise use can lead to disastrous results. Smart decision-makers will manage their affairs so they will not have to use credit under unfavorable circumstances.

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[1] To calculate 858 percent: $\frac{\$33}{\$100} = 33\% \approx 0.33 \rightarrow 0.33 \times 26 = 8.58 = 858\%$.