Lesson 16.2

Types and Sources of Credit

Goals
- **List and describe the kinds of credit available.**
- **Describe and compare sources of credit.**

KINDS OF CREDIT

You will likely use several forms of credit throughout your life. Different types of credit are designed to meet different consumer needs.

Open-Ended Credit

Credit card accounts are open-ended forms of credit. **Open-ended credit** is an agreement to lend the borrower an amount up to a stated limit and to allow borrowing up to that limit again, whenever the balance falls below the limit. The borrower usually has a choice of repaying the entire balance within 30 days or repaying it over a number of months or years. Open-ended credit can be used again and again, as long as the balance owed does not exceed the limit.

Open 30-Day Accounts

In an open *30-day credit agreement*, a consumer promises to pay the full balance owed each month. Travel-and-entertainment cards, such as American Express and Diner's Club, are examples of 30-day open-ended credit agreements. On all charges, the balance must be paid in full when the bill is received. There is no credit extended beyond the 30-day billing cycle. In some cases, the billing cycle may be less than 30 days. A 25-day billing period is common. These cards are widely accepted nationwide and overseas, usually have high or no credit limits, and provide instant purchasing power.

Revolving Credit Accounts

In a *revolving credit agreement*, a consumer has the option each month of paying in full or making payments at least as high as the stated minimum. The minimum payment is based on the amount of balance due. Most all-purpose credit cards, such as Visa, MasterCard, and Discover, are revolving credit agreements. Retail store cards, such as department store and gasoline company cards, are also based on revolving credit. Figure 16-1 shows a credit card statement for a revolving credit account.

Credit Card Terms

Credit card companies keep a record of transactions made on your account, and bill you at the end of each month for all purchases. If you pay off the total each month, you probably can avoid a finance charge. But remember—a credit card is a form of borrowing. It usually involves interest and other charges as well. Before selecting a credit card, learn which credit terms and conditions apply. Each affects the overall cost of the credit you will be using. Be sure to compare the following terms:

1. *Annual Percentage Rate.* The **annual percentage rate (APR)** is the cost of credit expressed as a yearly percentage. The Truth-in-Lending law requires lenders to include all loan costs in the APR. As a result, you can compare the APR of different lenders to find the best deal. The APR must be disclosed to you when you open the account and must be noted on each monthly bill you receive. Usually the APR is a variable rate, and it can be very high on credit cards.
2. *Free Period.* A free period—also called a *grace period*—allows you to avoid the interest charge by paying your current balance in full before the due date shown on your billing statement. If there is no free period of 10 to 25 days, the card issuer will impose an interest charge from the date you use your credit card or from the date each credit card transaction is posted to your account.
3. *Annual Fees.* Many credit card issuers charge an annual fee. The fee can range from $15 to $35 or more, and you must pay it whether or not you use the card.
4. *Transaction Fees and Late Fees.* A credit card also may involve other types of costs. For example, if you use an access check or pay by phone, or if you go over your limit or make your payment late, you are likely to be charged a fee.
5. *Method of Calculating the Finance Charge.* If your plan has no free period, or if you expect to pay for purchases over time, it is important to know how the card issuer will calculate your finance charge. This charge will vary, depending upon the method the card issuer used to figure your balance. The method used can make a difference, sometimes a big difference, in how much finance charge you will pay. Examples of how finance charges based on identical APRs can differ are explained in Chapter 18.

MONTHLY CREDIT CARD STATEMENT

figure 16-1

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Account Number	Payment Due Date	New Balance	Minimum Payment Due	Indicate Amount Paid
779 19 9171	05/24/--	$244.61	$20.00	

07734270420000244610000200004 70

ADDRESS CHANGE

ELIZABETH SANCHEZ
3410 MAIN STREET
VANCOUVER WA 98684-0129

ADDRESS

CITY/STATE/ZIP

(AREA CODE) PHONE 5008440

Please return this portion with your payment. Detach here ▼

Account Number		Page
779 19 9171	To avoid additional **FINANCE CHARGES** being applied to your current purchases on next month's statement, pay the new balance on this statement in full by the due date.	1 of 1

Date	Store	Reference	Description	Charges	Payments Or Credits
3/28	021	108475936	SPECIAL CARE TREATMENT COSMETICS	60.00	
4/07	021	108476335	COSMETICS CLEANSERS, TONERS, MOISTURIZERS	80.00	
4/12	311	071070078	PAYMENT-THANK YOU		189.16
4/24	097		FINANCE CHARGE	4.61	

ANNIVERSARY TO DATE PURCHASES $1,853.39
ANNIVERSARY TO DATE DIVIDEND $5.96
YOU WILL EARN A 1% DIVIDEND ON MCADAMS PURCHASES
MADE PRIOR TO YOUR NEXT BILLING.
DIVIDEND WILL BE CREDITED ON YOUR JUNE 19-- STATEMENT.

Previous Balance	+ New Charges	– Payments Or Credits	Average Daily Balance (For Finance Charge Only)	+ FINANCE CHARGE (50¢ Minimum)	+ Late Payment Fee	= New Balance
289.16	140.00	189.16	307.19	4.61		244.61

Billing Date This Month	Payment Due Date	**PERIODIC RATE**	**ANNUAL PERCENTAGE RATE**	Credit Line	Amount Past Due	Minimum Payment Due
04/24/--	05/24/--	1.50	18.00	2,000		20.00

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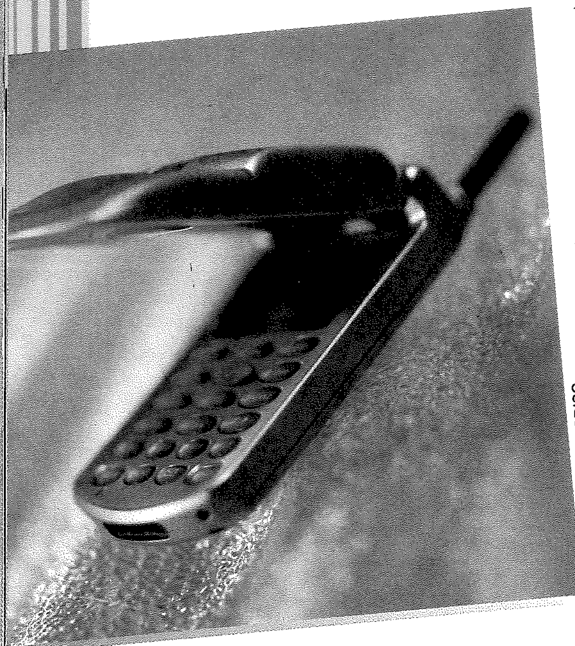
Payments or credits received after payment due date will appear on next month's statement. For customer service inquiries, please call 1-800-555-6200. **AMOUNTS DUE HEREUNDER MAY BE ASSIGNED. NOTICE: SEE REVERSE SIDE FOR IMPORTANT INFORMATION.**

Closed-End Credit

To pay for very expensive items, such as cars, furniture, or major appliances, consumers often use closed-end credit. **Closed-end credit** is a loan for a specific amount that must be repaid, in full, including all finance charges, by a stated due date. Unlike open-end credit, closed-end agreements do not allow continuous borrowing or varying payment amounts. The borrower takes out a closed-end loan for a particular amount and then repays it with fixed payments, or *installments,* that include principal and interest. As a result, closed-end credit is sometimes called an *installment loan.*

The contract for closed-end credit tells, among other things, the amount loaned, the total finance charge, and the amount of each payment. Usually a down payment is required, and the product purchased with the loan becomes collateral to assure repayment.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What kinds of businesses expect payment in full by a certain time limit?

Service Credit

Almost everyone uses some type of **service credit,** which is an agreement to have a service performed now and pay for it later. Your telephone and utility services are provided for a month in advance; then you are billed. Many businesses—including doctors, lawyers, hospitals, dry cleaners, and repair shops—extend service credit. Terms are set by individual businesses. Some of these creditors do not impose finance charges on unpaid account balances, but they do expect regular payments to be made until the bill is paid in full. Others, such as utility and telephone companies, expect payment in full within a time limit. However, they usually offer a budget plan as well, which allows you to average bills to get lower monthly payments.

SOURCES OF CREDIT

Credit is a service consumers buy. As with other things you buy, it pays to shop around to get the best deal.

Retail Stores

Retail stores are stores that sell directly to consumers, such as department stores, restaurants, and most service businesses. Many retail stores offer their own credit cards. These cards are accepted only at those stores. Store credit customers often receive discounts, advance notice of sales, and other privileges not offered to cash customers. Most retail stores also accept credit cards issued by major credit card companies. Accepting credit cards helps retail stores attract customers, because people like to shop where they can buy on credit.

Credit Card Companies

You may receive credit offers directly from credit card issuers, such as Visa, MasterCard, American Express, and Discover. These all-purpose cards are generally accepted nationwide and even internationally. You can also get an all-purpose credit card through your financial institution or from various organizations. *Affinity cards* are credit cards sponsored by professional organizations, college alumni associations, and some members of the travel industry. An affinity card issuer often donates a portion of the annual fees or charges to the sponsoring organization, or qualifies you for free travel or other bonuses. Although these cards may show the name of the organization, they are actually issued and serviced by a credit card company.

When you have an all-purpose credit card, you have an automatic line of credit up to the limit of the card. A *cash advance* is money borrowed against the credit card limit. In other words, you are taking out a cash loan from your line of credit rather than making a purchase with it. You can access this money at a teller machine, at a customer service desk in your bank, or by writing an *access check* against the credit card account. Access checks look just like regular checks. They are supplied by the credit card company and, when written, are treated like a purchase. You must then pay back the cash advance in the same way that you pay for credit card purchases.

Banks and Credit Unions

In addition to offering credit cards, commercial banks and credit unions make closed-end loans to individuals and companies. They loan money to consumers for specific purchases, such as a home, car, or vacation. Interest on closed-end loans tends to be lower than on credit cards.

Credit unions make loans to their members only. Interest rates are generally lower than those charged by banks because credit unions are nonprofit and are organized for the benefit of members. Credit unions are more willing to make loans because the members who are borrowing also have a stake in the success of the credit union.

VIEWPOINTS

Some consumers are loyal to particular financial institutions, such as their banks, and obtain credit services from those institutions even if the rates and fees are higher than elsewhere. Other consumers shop around and may switch back and forth if they find better deals.

Think Critically: What advantages do you see to establishing an exclusive relationship with one financial institution? Are there disadvantages? What advantages are there to always shopping around? Are there disadvantages?

Finance Companies

Often called small loan companies, *finance companies* usually charge high interest rates for the use of their money. The reason for the high rates is that finance companies are willing to take risks that banks and credit unions will not take. In many cases, people who are turned down by banks and credit unions can get loans at finance companies. Finance companies are second only to banks in the volume of credit extended.

There are two types of finance companies. A *consumer finance company* makes mostly consumer loans to customers buying consumer durables. Consumer durables are items expected to last several years, such as an automobile, refrigerator, or stereo. (Non-durable goods, such as food products, are consumed in a few days or months.) Well-known consumer finance companies include Household Finance and Beneficial Finance.

The second type of company is the manufacturer-related *sales finance company* that makes loans through authorized representatives. For example, General Motors Acceptance Corporation (GMAC) finances General Motors automobile dealers and their customers. Both types of finance companies borrow money from banks and lend it to consumers at higher rates.

Finance companies take more risks than banks. Therefore, they must be more careful to protect their loans. If you do not make your payments when due, you can expect a call from someone at the finance company, who will ask for an explanation. The company will stay in constant contact with you until you make your payments as agreed. You can expect phone calls, letters, and even personal visits if you deviate even slightly from the agreed-upon payment schedule.

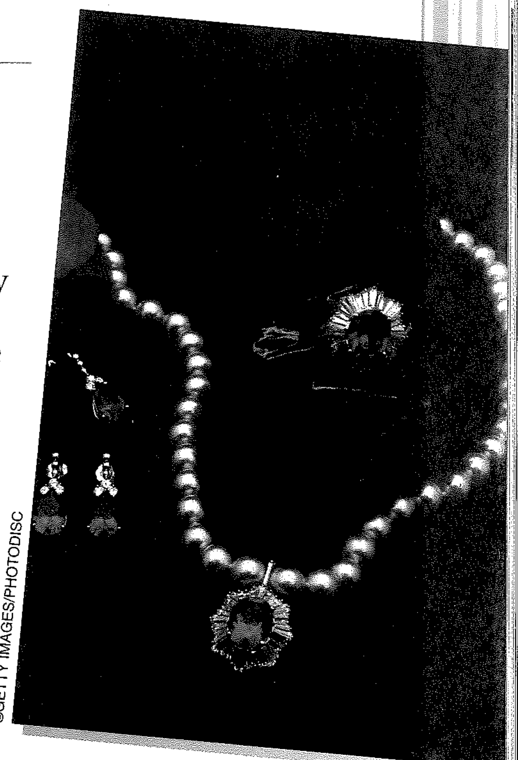
High interest rates are another form of protection for the finance company. The Uniform Small-Loan Law in most states permits loans of up to $5,000 and allows interest rates of up to 42 percent a year. The growth of finance companies is the result of efforts to eliminate **loan sharks**—unlicensed lenders who charge illegally high interest rates. Nevertheless, it is difficult to eliminate such practices, which take advantage of the poorest members of society who can least afford to pay.

Usury laws set maximum interest rates that may be charged for loans. In states where usury laws exist, finance companies charge the maximum. Where no usury laws exist, finance companies charge as much as the customer is willing to pay. When an emergency or other extreme need arises, consumers often feel forced to pay these higher rates to get the money they need.

Pawnbrokers

A **pawnbroker** is a legal business that makes high-interest loans based on the value of personal possessions pledged as collateral. Possessions that are readily salable (such as guns, cameras, jewelry, radios, TVs, and coins) are usually acceptable collateral. The customer brings in an item of value to be appraised. The pawnbroker then makes a loan for considerably less than the appraised value of the item. Some pawnshops give only 10 to 25 percent of the value of the article. Most give no more than 50 or 60 percent.

For example, if you have a ring appraised at $500, you could probably borrow between $50 and $250 with the ring as collateral. You would turn the ring over to the pawnbroker and receive a receipt and a certain length of time—from two weeks to six months—to redeem the ring by paying back the loan plus interest. If you do not pay back the loan and claim the ring, the pawnbroker will sell it in the pawnshop and keep the proceeds. Property taken in by a pawnbroker is considered collateral for the loan because it is something of value that may be sold if you fail to pay off the loan.



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What do pawnbrokers usually accept as collateral? Why?

Private Lenders

The most common source of cash loans is the private lender. Private lenders include your parents, other relatives, friends, and so on. Private lenders may or may not charge interest.

Other Sources of Consumer Credit

Life insurance policies can be used as an alternate source of consumer credit. As some life insurance policies build cash value, policyholders can borrow at low interest rates against the value of their policy. The loan does not have to be repaid, but interest will be charged; and the amount of the loan will reduce the value of the life insurance policy. (See the section on life insurance in Chapter 27.)

If you have a certificate of deposit with a financial institution, you can borrow money against the certificate. The certificate is used as collateral, and the interest rate charged is usually only 2 to 5 percent above the interest rate you are receiving on the certificate. If you cash in the certificate before maturity, you incur a penalty. If you borrow money using the certificate as collateral, you get a moderate rate of interest on the loan, and the certificate retains its full value.

Check Your Understanding

1. What is a revolving credit agreement?
2. Why should you get a bank loan rather than a loan from a finance company?