PEAK FINANCIAL ACTIVITY 4b:
Intro to Credit and Types of Credit *(see answers on the last page)*

The definition of credit is: money granted by a lender to a borrower, who defers payment of the debt.

In exchange for the loan, the lender gets the money back with payments that include interest. The interest rate, length of time (term), and the frequency of payments are called the "terms of the loan."

There are different kinds of loans: mortgage, revolving credit, consumer loans, unsecured loans, secured loans, etc. There are different kinds of interest; simple, deferred, amortized, rule of 78, etc.

A loan can be used for a specific purpose, such as to purchase real estate. It can also be used for no specific purpose, such as a credit card, although a credit card cannot typically be used to purchase real estate. A credit card often is limited to consumer purchases that include food, clothing, airline tickets, Internet purchases, etc. There are exceptions, however. Generally a credit card has few limits on how it can be used by the borrower.

Your credit is a sign of your character. A credit report contains historical information about how you have handled your obligations in the past. It provides answers to the important question: do you pay your debts as agreed?

If the answer to that question is no, then don't expect lenders to offer you credit. If the answer to that question is yes, you can rest assured that lenders will compete to offer you loans.

The nature of your credit rating is to demonstrate your trustworthiness to a lender. Observing competence and character over time it the only way to develop trust. Without a historical report of how you have behaved toward your obligations in the past, a lender must make a leap of faith to offer credit. Few lenders will take such a leap without adequately compensating themselves. Without a credit report that demonstrates your trustworthiness, a lender is not likely to offer favorable credit terms or may not offer credit at all.

Types of Credit

Credit Card
A credit card is an unsecured, revolving line of credit. A bank issues a credit card either directly or indirectly. If you apply and are approved for a credit card at a department store, it is really a bank that evaluates your credit report and decides whether or not to extend a line of credit. Based upon the perceived quality of your credit, the bank will also decide what kind of interest rate to give you.

A credit card is approved primarily because of a high credit score. A high credit score meets the bank's requirements. A credit score above 700 shows a lender that you can use credit cards and manage them well.

As long as an applicant has a high credit score, credit card companies are happy to offer lines of credit at an average of 16% interest to the people in the habit of making the minimum payments.

Secured Loan
Secured debt means that the loan is tied to a specific material item. If you default on the loan, the item can be repossessed. Examples are real estate, automobiles, and boats.

Just because a bank or finance company takes the item back does not release you from financial responsibility. The item can be sold below what is owed on it, and you can find yourself with a Deficiency Judgment.

Unsecured Loan
Lenders are required to adhere to certain standards when making unsecured loans. Unsecured loans are not as common as secured lines of credit. To be approved for an unsecured line of credit, a lender will have guidelines they will follow to determine if you are a good risk.

When asking for an unsecured line of credit, however, expect lenders to want to tie the loan to collateral whenever possible. Collateral might be a car, your home, or investments the lender can seize if you default on the loan.

Student Loans
Student loans are different nature from other types of credit. The student doesn't need a credit history. As long as the student has not defaulted on any prior student loans, most students can get a new student loan even if the prior credit history is poor.

Student loans cannot be bankrupted. Defaulting on a student loan may result in your wages being garnished or other proactive debt recovery steps. The proceeds of a student loan are intended for tuition, school fees, and to purchase books. In reality, some students use the proceeds to live on while attending school or other purposes such as transportation.

A student loan can have subsidized interest if the student qualifies for financial aid. Otherwise, the loan is unsubsidized. Payments for student loans are typically deferred until a student has been out of school for a stated period of time.

Para-Credit

Para-Credit are things like your electric bill, cell phone bill, cable bill, payment plan for taxes or back taxes, child support payments, payment plan for unpaid medical bills, payment plan for unpaid judgments or liens, etc. In short, any regular recurring amount you are paying for services or paying past due amounts can be documented as showing an on-time payment history.

The current credit scoring model does not give consumers "credit" for paying rent, electric, water, newspaper, child support, telephone, insurance on time.

Personal Loan

You've probably made a personal loan to a friend. Someone might ask to borrow a few dollars or you ask for the price of a movie ticket when out with friends. "I'll pay you on Tuesday, after I get paid." These are typically short term, interest free loans made out of "love and consideration."

Payday Loans

Payday loans have become a national concern. These firms that offer them have been referred to as loan sharks in disguise. It's a form of a secured loan since it is a loan against your future earnings. Companies offering payday loans claim they charge only flat fees. Government agencies compute the "fees" as interest and claim the APR (Annual Percentage Rate) exceeds all states' legal limits for interest, with interest payback exceeding 400 percent!

Try this example: You need $100 to make it to your next paycheck. You go to a payday loan storefront. They are happy to take your personal check and hold it for two weeks (deferring the deposit) for the low, low price of $15. That means when you return to pay off the payday loan, you'll pay them $115. You decide to ask them to wait for another two more weeks, rolling it over. They are glad to oblige for another $15 fee. When you arrive to pay off your loan one month later, you will pay them $130.

If you had gone to a bank or had asked for an advance on a credit card for the same 30 day period, you might have balked at the APR (as high as 30% in some cases). The fact is, however, that even at a 30% APR, you would have paid less than $5.00 for the use of the $100 for 30 days from these sources.

If you calculate the APR using the $30 fees charged by the payday loan company, the APR is approximately 360 percent.

Which was the better deal? The bank, obviously. Many people get into a vicious cycle of rolling over payday loans for additional fees. This results in exorbitant interest and a relationship not unlike that of an addict and his drug dealer.

The best way to avoid the trap of payday loans is to establish a budget that works and keep your bank account balanced regularly. North Star will guide you through the process of establishing a budget that works toward your stated goal and bypass any need for payday loans.

If you find yourself in trouble with payday loans, do anything you can to earn the money you need to pay them off and then stay away from them. Payday loans will establish a vicious cycle that will keep you circling a financial drain.

If you repay a payday loan on time it is not generally reported to your credit report. If you are late or default on a payday loan, it will show up as a bad check.

---

1. What are the number of payments, the payment amount, the interest rate, and the frequency of payments called?

- ☐ **Extended Purposes**
- ☐ **The terms**
- ☐ **Consumer Purchases**
- ☐ **None of the above**

2. Match the letters with the right loan type:

A. Credit card	____Consumer Line of Credit
B. Mortgage	____Unsecured Debt
C. Loan from parents	____Secured Debt
D. 6 months same as cash	____Personal Loan
E. Bank note	____Revolving Debt

3. Check all the types of credit you currently use:

- [ ] **Credit card**
- [ ] **Secured loan**
- [ ] **Unsecured loan**
- [ ] **Personal loan**
- [ ] **Para credit**
- [ ] **Student loan**
- [ ] **Payday loan**

4. Choose the purpose for which a credit card CANNOT be used:

- ○ **Dinner out**
- ○ **Down payment for a home loan**
- ○ **Back to school clothes**
- ○ **Tickets to a movie**

ANSWERS to questions (DON'T PEEK!)

1.) The "terms"
2.) _D__Consumer Line of Credit
_E__Unsecured Debt
_B__Secured Debt
_C__Personal Loan
_A__Revolving Debt
4.) Down payment for a home loan