It Is More Than Just "Money I Don't Have"

All You Need To Know About:

<u>Credit</u>

You Can Make it Work
<u>FOR YOU!</u>

Ask or email abechler@Springfieldrescuemission.org for a copy!

Why You Need Credit

If I walked up to you today and asked to borrow $200, would you give it to me? You don't know me next to nobody. Now say you have a friend who you have let borrow money from you several times, of varying amounts, over many years. He's always paid you back, on time, and even a little bit more for helping him out in a pinch. He walks up to you and ask you for $200, you doing it? You probably wouldn't hesitate because he has proved himself time and time again.

See, the bank doesn't know you either. How then are they supposed to determine your trustworthiness and make the decision to give you money? Introducing the **Credit Score.** This is like your best friend in the above scenario. Your credit score, your buddy, walks with you wherever you go, through the years, and has your back when it comes to telling the bankers all about your trustworthiness.

You need credit for:

- Major purchases (house, car, appliances)
- Emergencies (medical bills, car repairs, vet bills)
- Utilities (electric, water, internet)
- Employment (some companies check your credit to see your responsibility)
- Housing (landlords will check your credit in order to rent from them)

In all major areas of life, credit seems to play some role. You can run from it, you can try to even hide from your debts, but eventually it will catch back up to you. Forward and facing the reality of the situation is the only way to go. Don't live with the fear and anxiety of when you are finally ready for that next step in your life but you know when credit gets involved, it won't come back good. Stop being scared and read the following document about beginning your credit journey. It may seem complex at first but the more you practice, the more you will understand, and you will be able to learn more new knowledge.

Credit is defined as the power to buy now with the promise of paying later. In the same since, credit unlocks the ability to do things now that you otherwise would have to take years to save up for. Begin to learn more by taking the next step…turning the page.

Different Types of Credit

There are three (3) main types of credit that are most important for you to know and understand as you begin your credit journey. These are: **R**evolving, **O**pen, and **I**nstallment credit. To remember these try thinking **ROI**; Return On Investment as they say in the business world.

Revolving Credit

Revolving credit means that you are able to borrow funds from the account on a repeated, on-going basis.

Revolving Credit also has three (3) main types:

1. Credit Cards
2. Personal Lines (PLOC)
3. Home Equity Lines (HELOC)

Credit Cards are you being entrusted to borrow up to the maximum on that card and pay it back, on a revolving basis. As it may sound, that is fairly risky for a business to take on. Because of this, interest rates on credit cards tend to run higher than the other types of credit we will talk about.

Let's say you hit a curb, dent your rim, and pop your tire one day. The repairs will cost $500. This is a pretty hefty bill to come your way out-of-the-blue. However only being $500, it seems inconvenient to go through a loan process. Perhaps you get paid soon and you may be able to afford this unexpected expense but you need more time; time that you obviously don't have. You also may have to pay up-front costs such as a tow truck; this is where credit cards come in handy. Additionally, technology can fail. It always seems to fail right at the time you need it not to the most. There is an old adage that goes "rather have it and not need, then need it and not have it." This can't be more true for credit cards. Debit cards can fail and for some transactions, like renting cars or hotel rooms, you may need a credit card specifically in order to pay. These types of services also can place holds that can range from $100 to $500+ on your card temporarily incase you cause any serious damages. Many facilities such as sports venues are going cashless so there is no way for you to pay but card. So for all you cash-lovers out there, you can not escape the changing times.

Personal **L**ines **O**f **C**redit or **PLOC** are used to pay for expenses of $1,000 or more generally and *most* of the time is a credit you prepare to take on in advance. Things like medical bills, debt consolidation, home improvement, and major purchases like weddings, vacations, and funerals. They usually offer higher lines of credit, allow continuous withdraws of the money, and lower interest rates. This can boost your overall credit utilization rate and is beneficial in showing the creditors your ability to pay off higher amounts of debt, for different things, continuously.

Take that same example from above and apply it here. Now say they find out upon further inspection that your drive shaft got snapped. That's going to be another $1,200, so your total bill is nearing $2k. This may be a good opportunity to explore PLOC. This is an *unsecured loan* meaning the bank does not have any asset to pay for the loan as collateral – like a house, car, savings, etc. We will talk more about *secured loans* under the *Installment Credit* section. Unlike your credit card with a 20%+ interest rate and a low limit, PLOC offers the ability to take care of even emergency costs for lower affordable rates. If you work with a community bank or credit union for this type of credit, it may be even more beneficial and funds could be in your account as soon as the end of the business day that you call.

Open Credit

Open credit can involve a number of different things depending on your living and financial situation. Electricity, water, and gas are the most common for individuals if they have a house or are renting an apartment depending on the lease agreement and what is included or not. Internet can be Open credit and believe it or not some people still have cable, now replaced by streaming services, which both are examples as well.

Even if you have been doing this credit stuff for a while or if you are just starting out your credit journey, be sure to look into if your phone bill, internet protection provider, landlord, or just about any other services you make monthly payments on is reporting on your credit. If not, get a history of payments and ask them for a letter. You can then provide that proof to the three (3) credit bureaus and boost your credit. Always double-check the requirements from the bureaus in order to do this. We will talk more about the bureaus in depth in the next section. Having multiple types of *credit history* – that is paid-off-credit – in each category (ROI), can open up a world of opportunities for you in the future. Keep reading to find out more!

Installment Credit

Once you have mastered *revolving* and *open credit* you can look into *installment credit*. With this type of credit, you will receive a lump-sum (all at once) amount of money to make a large purchase. Then you will pay the loan off in monthly intervals, installments, at a set amount per month which will not change.

It is important that we think of our credit journey as a progression. This what creditors call *credit worthiness* or your merit to entrust you with money and new larger amounts of it. If you have no credit or just one credit card, you ***can not*** just jump from there to any of the types of *installment loans* below. The caveat to this is *student loans* which has different rules and factors. Take this process step by step though and you will see the fruit of it. Master and show your *credit worthiness* through *revolving* and *open* credit first, then determine your next steps.

Types of installment credit include:

1. Personal Loans
2. Auto Loans
3. Mortgages
4. Student Loans

Personal Loans are distinctly different than Personal Lines of Credit (PLOC). Depending on what you are paying off, you may have one or the other. For debt consolidation purposes, opening a PLOC over a personal loan could be beneficial as it would decrease your revolving utilization rapidly and add to your existing total credit in that section. Personal loans on the other hand can be taken out for many more reasons than debt consolidation. Note: if you do choose to pay debt with a *personal loan* or PLOC you may be required and have to show proof of paying down the debt as stated in your loan application. Besides debt, *personal loans* can be used to pay for car upgrades and repairs, moving, a wedding, home improvements, and much more. If it is above or around $5,000 this may be a good option for you.

We talked about *unsecured* loans earlier, now we will discuss *secured loans;* namely auto loans and mortgages as they are the most common and easiest to understand. Both are widely *fixed rate loans* meaning that you will pay a certain amount per month with a set interest rate that will not change over the life of the loan.

An *auto loan* will most likely be your next biggest credit move. There are a handful of things you need to remember as you are purchasing a car. First and foremost, it is not an *investment*. Meaning that nothing you do to the car will increase its value enough to make your money back on it. You will definitely want a downpayment. It is suggested that you pay 20% of the price of the vehicle if it is new and 10% used. Remember that you do not just pay for the price of the car but also sales tax and every year, excise/property tax on its current value. Other on-going expenses include insurance, gas, and maintenance/repairs. It can be however an *investment* in yourself to get you to your next step.

Moving on to mortgages, you will need to show that you have had, and have paid-off, 3 to 5 lines of credit in the last 10 years. They will want to see your credit history and how it has fluctuated, your income steadiness, how much debt you owe now compared to your income (known as debt-to-income ratio or DTI), and that you have enough saved, after the down payment, to afford to live in the house and pay the mortgage month over month. Shoot for a 20% downpayment but it is not required. This can unlock better savings and lower payments. If 20% is not likely, shoot for 10%. Some lenders will only ask for 3% to 5%. **BUT** just because you *can* does not mean you *should.* It is entirely not suggested to take out any installment loan, but especially a mortgage, with nothing down to start. Other factors that may work in your favor are assets – which again can be savings/investing accounts, cars, boats, jewelry, and other items of value. The banks thought is that, if you absolutely need to, you could sell it for money to pay for the mortgage. Their other thought is they could seize it themselves if need be and sell it in order to pay the loan. Be careful of doing this, know your stipulations, and always have enough to take a hard hit (like a job loss) and still be able to make timely payments; suggested 3 to 6 months' worth for a mortgage.

HELOC that I referred to in the first section and business loans are sometimes *variable* rate *loans*, meaning that the interest rate on the loan will change with the market. HELOC offers a *secured loan*, against your house, on the remaining balance of it. This is roped into your mortgage, increasing it slightly. People do this commonly for home improvement purposes with the goal of increasing their homes value in the long run.

What Creditors Are Looking At

<u>The Three (3) Credit Bureaus</u>

There are three (3) credit bureaus: Equifax, Experian, and Transunion. These are companies who keep track of all the debts, payments, etc. through the life of your credit history and gives you a number between 300 and 850 based primarily your ability to borrow, manage, and pay back loans on time. Since there are three (3) different companies, you will have three (3) separate scores that vary slightly but all will generally be around the same number. It is important you look at what is being reported and that it is accurate frequently; humans and technology alike can and will make mistakes!

<u>The Five (5) Factors</u>

There are five (5) factors that are weighted differently, that the three (3) credit bureaus will use to determine the score as discussed above. These factors are:

1. Payment History (35%)
2. Amount of Current Debt (30%)
3. Length of Credit History (15%)
4. Credit Mix (10%)
5. New Credit (10%)

Let's think from the creditors perspective real quick in terms of applying for a new loan:

If you have a poor history of paying your debts, should they trust you will pay theirs? If you have a lot of debt now, will this make it hard to pay other debts and maintain your everyday life? If you are new to credit, they don't have much to go off of to know you are trustworthy! We will discuss more about *credit mix* in the next section but if you're a shopaholic with a lot of cards for retail outlets (this includes Home Depot and Lowes gentleman), should they trust that you won't buy more than you can afford with their money? Lastly, if you just opened a bunch of new cards or other loans, what does that look like? Looks like you're in financial trouble to me. If you're needing money because you don't have it, how can they trust you can afford this one with their money at risk? They can't! For those of you who do not understand, we will cover each of the above in more plain language.

Payment History is important and the largest weighted factor at 35% because it is essentially a summary of your entire life of your credit. If you can make frequent, on-time payments you will be golden.

Amount of Current Debt holds the second highest weight at 30%. One or two people (if co-signed or two-income home) can only afford up to so much. Taking into account your pay, creditors try to make a reasonable judgement on how much more you can handle.

Length of Credit History is as simple as it sounds. If you have a long, well paid, and varying credit history that shows you are responsible in managing what has been entrusted to you, you are more likely to have access to more!

Credit Mix can be made up of two (2) parts: *overall* mix and *credit card* mix. Your *overall* mix refers to the three (3) topics we have covered (ROI). As we now know, there are multiple types within each; this is also taken into account. Large debts for a house for instance may seem alarming initially but it is normal to have this kind of debt. Creditors know this is on a fixed interest and payment cycle, so they take this into account. If your overall mix in history is only credit cards, then of course your credit card mix will play the largest factor. Your *credit card* mix is made up of the different companies your cards are through. We will share all the different types in the next section but think to yourself: if they have a bunch of retail and travel cards, which are expensive in nature, should I trust them with new money as well?

New Credit plays a lower but important factor in the makeup of your score. Included in this is time between credit applications and those new-to-credit. People open new credit because they are expecting some larger expense that, if they pay for by debit, they may not have enough for other expenses. Whatever the expense and whatever the reasoning, they open cards to cover this. Now, imagine someone doing this multiple times in the same month or over consecutive months. You might think they are quite a spender right? The banks think this too. You’re again a risk of maxing them out and it is through *credit history* you demonstrate your ability to not do this. If you’re new to credit, just know its not personal; it is part of the process. Make it a challenge to show the creditors just how good you can be at paying AND managing your available funds.

Credit Cards

Visa, Master Card, American Express or Discover?

There are four (4) main types of Credit Cards, most of which you probably have heard of.; Visa, Master Card, American Express, and Discover. So what's the difference? Visa and Master Card are *processors* whereas American Express and Discover are both *processors* and *issuers.* You can get a physical card from American Express or Discover and have a virtual account through them. Can't say you have ever heard of logging into a Visa or Master Card account have ya? They don't exist, that is because they just process payments for other companies. You will notice a majority of banks and retailers use Visa as their processor for their cards. Visa is by far the most accepted card around the world. Master Card is not as much so but has gained popularity in the United States becoming more commonly accepted. American Express has built themselves as a well-managed, fairly money healthy clientele, that has built its reputation around the world and continues to grow in being accepted. Discover is widely popular and accepted around the United States. However, they must partner with companies themselves and typically charge higher processing fees. Because of this, small local business, Costco, and a large majority of countries outside of the U.S. do not accept them.

Secured/Credit-Builder, Rewards, Retail, Gas, or Travel

If you're new to credit OR are rebuilding it, then a **Secured Credit Card** or **Credit Builder Account** might be right for you. Remember, as discussed earlier, *secured* means it is backed by something. So what might this mean *secured credit card*? This means you're going to give them the money up front. They typically will put this into a savings for you that, for as long as the loan is active, you will not be able to take out from. Say this amount is $200. They will then set an amount per month with you to have you pay until you pay of $200. You are then awarded your $400, have built credit, and a new revolving credit of an amount set by your bank. Credit Builder accounts are generally the same concept. Pay on time, save, and be rewarded for your trustworthiness. Almost every bank has some way for their customers to begin their credit. Again, community banks and credit unions usually tend to be more personable and understanding. If you are just starting your credit journey and know you will be near their branches in the long-term then begin to build your creditor/client relationship now for when you go for an auto or home loan.

Gas Cards are specifically designed to be used on, you guessed it, gas. Because gas is relatively cheap, a singular product, and does not require too often use, these cards can help someone who is new to credit or is rebuilding it. Remember, thinking from the creditors perspective, if they can limit what you are able to do with the card or offer less perks, then it is less risky on their end and they me be more open in giving you a shot at credit.

Rewards Credit Cards are the most common type of card. If your credit card comes from a bank directly and does not have an additional brand on it, it most likely is a *rewards credit card*. These cards perks are specifically designed around rewarding purchases made with the card, commonly at specific places or on specific products. Instead of rewarding purchases to one specific brand, like Costco, heavily if you had a Costco Credit Card, these cards reward general, every day purchases in lower amounts. This can be groceries, gas, and much more.

Travel Cards are like *reward credit cards* but have a travel-focused system of perks and rewards. If you are a frequent flyer, especially one near a hub of a certain airline, definitely check out if their card is right for you. You can get free bags, upgrades, and even free flights. Cards like these also have extensive hotel and rental car perks that you are able to gain points on. Many partner with these companies to automatically upgrade these card users to higher status levels, unlocking a host of discounts and saved value.

Just about every major retailer is in the **Retail Credit Card** game. They have expensive items and want people to buy them. This is the way the bureau and new lenders are thinking while reviewing your report for a new credit application – whether you're spending a lot or not. If you have, you will use is there mentality. So, if you have a lot of retail cards they may be more cautious to lend to you.