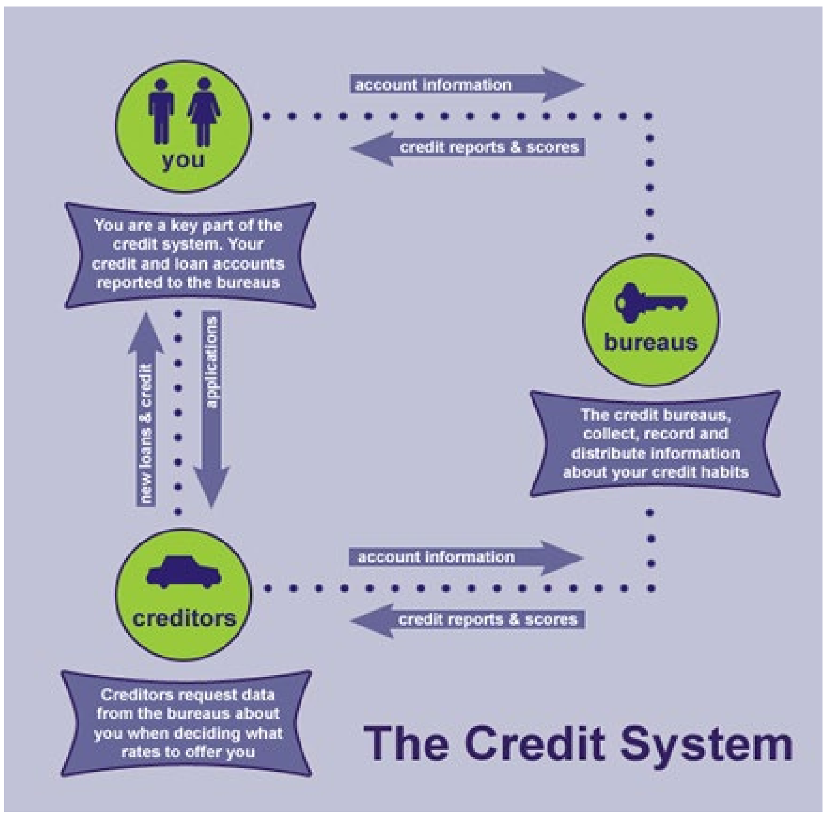
WORKSHOP 6

Understanding Credit

How Credit Works: The credit reporting system is made up of three main players: consumers, credit bureaus, and financial companies. Information about your credit card and loan accounts is reported electronically to the three national credit bureaus by each of your creditors every 30 days. These bureaus -- TransUnion, Equifax, and Experian -- collect and store your credit information for future reference.



The three national credit bureaus do not share information with each other. Because of this, your credit reports from TransUnion, Equifax, and Experian can contain significantly different information about you. It is important to monitor all three reports since you can never be sure which one will be used when you apply for a new account, loan, line of credit, etc.[74]

[74] Original material from Peerlink National Technical Assistance Center.

Credit Reports & Credit Scores

A credit report is an accumulation of information about how you pay your credit bills, how you repay loans, how much credit you have available, what your monthly debts are, and other types of information that can help a potential lender decide whether you are a good credit risk or a bad credit risk.

Businesses such as auto lenders, banks, credit card companies, and insurance agencies use your credit reports from the three credit bureaus to determine if you are a risky customer. The lower the risk, the lower the interest rates you will have to pay. They also use this information to send you pre-approved offers in the mail.

Under federal law, Americans have access to a free credit report from each of the credit bureaus every 12 months. You can access your free credit report online at AnnualCreditReport.com. Accessing your credit report can be a good way to keep track of any loans and debts you may have, and can be a good practice for monitoring your accounts for fraudulent activity. You can access all three free reports at once, or request them separately to monitor your accounts throughout the year. After you use up your three free reports, you can request reports from the bureaus for a fee.

Many, but not all, creditors will report your account information to the credit bureaus. While businesses are legally required to report accurate information, there is no law that says they have to report at all. While nearly every major creditor reports to all three bureaus, smaller lenders and banks may not send your monthly account information to all or any of the credit bureaus.

Along with your credit card and loan account records, your name, address, employer, and recent applications are recorded in your credit files. Public records such as bankruptcies, tax liens, and judgments can also appear on your reports. Information about your income, race, checking accounts, gender, age, religion, or health is *not* included on your credit report. Most information expires from your credit reports after 7-10 years. If there is something inaccurate on your credit reports, you can file a dispute to have it removed from your record.

It's important to keep the information on your credit reports positive and accurate. The data in your credit files is used to calculate your **credit score.** This three digit score is a numerical representation indicating how risky a borrower you are from a lender's perspective. Your credit score number reflects your credit risk level, with a higher number indicating lower risk. It is generated through statistical models using elements from your credit report.

A higher credit score (700+) will get you the best deals on big purchases. For example, your credit report and credit score impact the deals and interest rates you will receive when you buy a home, finance a car, rent an apartment, apply for a job, buy insurance, purchase a cell phone, or open a new credit card.

The best way to have "healthy" credit is to have a few credit cards and loans that you pay on time every month. Making late payments or maxing out credit limits can negatively impact your credit report and credit score and make it difficult to apply for a loan or make a big purchase.[75] Being on top of your bill payments, including credit card payments, can be an empowering financial practice.

Your credit score depends on the information in your credit reports. Your score is not physically stored as part of your credit history on the credit file. Rather, it is typically generated at the time a lender requests your credit report, and is then included with the report that will be viewed by the creditor.

Your credit score changes as the elements in your credit report change. For example, payment updates or a new account can cause your score to fluctuate. Additionally, many different credit scores are used in the financial services industry, and your score may be different from lender to lender or loan type to loan type (car loan vs. mortgage loan). It all depends on the type of credit scoring model that is used.

You can create an account with Credit Karma on their website or app to access your credit score for free anytime, anywhere. Visit https://www.creditkarma.com/free-credit-score to learn more.

FAQs about Credit Scores[76]

Why are credit scores used?

Before credit scores, lenders looked over each applicant's credit report to determine whether to grant credit. In this system, a lender might deny credit based on a subjective judgment that a consumer already held too much debt, or had too many recent late payments. Not only was this

[75] Natalie Issa. "How do Credit Scores Work?" *Credit.com,* April 18, 2019. https://www.credit.com/credit-reports/how-credit-works/
[76] Original material from Peerlink National Technical Assistance Center.

time consuming, but human judgment was prone to mistakes and bias. Credit scores help lenders assess risk more fairly because they are consistent and objective. Consumers also benefit from this method, because your credit score only reflects your likelihood to repay debt *responsibly*, based on your past credit history and current credit status.

Who uses credit scores and how are they used?

Banks, credit card companies, auto dealers, retail stores and most other lenders that issue credit or loans use credit scores to quickly summarize a consumer's credit history, saving the need to manually review an applicant's credit report and provide a better, faster risk decision.

Although many additional factors are used in determining risk, such as an applicant's income vs. the size of the loan, a credit score is a leading indicator of an individual's basic creditworthiness. Some landlords ask for credit scores during the rental application process, so building and maintaining good credit can be important not only for banking and getting loans but also in finding housing.

What information impacts your credit score?

The information that impacts a credit score varies depending on the score being used. Generally, credit scores are affected by elements in your credit report, such as:

- Number and severity of late payments
- Type, number, and age of accounts
- Total debt
- Recent inquiries

Credit bureau-based scores cannot use demographics prohibited under the Equal Credit Opportunity Act, such as race, color, religion, national origin, gender, age, marital status, receipt of public assistance, or exercise of rights under the Consumer Credit Protection Act. Scores used by individual lenders may use such elements as income, occupation and type of residence in determining their own custom credit score.[77]

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[77] "Credit Score FAQs." *Experian.* https://www.experian.com/blogs/ask-experian/credit-education/faqs/credit-score-faqs/

Facts about Credit

Credit limit: A credit card company sets limits on how much you can charge on your card. This limit is based on your ability to handle debt.

Paying only the minimum monthly payment: Is a bad idea. After you subtract the minimum payment from your balance, finance charges will be added to your remaining balance. These charges add up month after month. The minimum payment is the LEAST amount you can pay to keep the card active. If you pay less, your card will be deactivated (turned off).

Grace period: If you pay your bill in full during the grace period, you won't have to pay a finance charge on purchases for that bill. A grace period is usually about 25 days.

Late fees: If you don't pay your bill by the due date (the date your grace period expires), you will be charged a late fee. These can be as high as $35! Because paying late can be costly, get yourself organized to pay on time. Write yourself reminders or sign up for automatic payments to avoid these fees.

Interest rates: Remember that when you use your credit card, you are borrowing money, so you will be charged interest whenever you do not pay your bill in full. With a credit card, you are paying for convenience. Credit card interest rates can be as high as 18% or 24% depending on your credit history. The best way to avoid interest rates is to pay your credit card bill in full and on-time.

"Secured" credit cards: Some banks and credit card companies offer secured credit cards to people with a poor credit history or no credit history at all. Secured cards can be the best option for your first credit card. The card is "secured" with a cash balance, such as a savings account. Your savings account acts like collateral for a loan -- if you charge over your limit, the bank will take the balance. Other secured credit cards require you to pay a cash balance, usually equal to your line of credit. The financial institution will take this money if you do not pay your bill. You can get these funds back when you close your account in good standing or when you upgrade to a regular credit card. Secured cards may charge higher interest rates but they offer the convenience of using a credit card while you build a good credit history.[78]

[78] "Best Secured Credit Cards of February 2022." *NerdWallet.* Feb 18, 2022. https://www.nerdwallet.com/best/credit-cards/secured

If your Credit Card is Lost or Stolen:

You must notify your credit card company as soon as you know your card has been lost, stolen, or used without your permission. If you do, you will be responsible for only the first $50 of unauthorized charges. Sometimes thieves don't need the actual credit card – they can use your money simply by stealing your credit card number. Always know where your card is and keep all of your receipts.[79]

> **Note:** Debit cards do not offer the same protection as credit cards, though some credit card companies offer debit cards with similar protection. With debit cards, the money is immediately taken out of your account. If you do not report a false charge or charges within 60 days of receiving your bank statement, you could be held responsible for the false charges. Be sure you understand the details when you sign up for a debit card.

Interest Rates

There are two basic types of interest: the interest you pay (mortgage, loans, debts) and the interest you earn (retirement, investment, and savings accounts). Because using credit is a form of borrowing money (like a loan), you will be required to pay interest whenever you do not pay your credit card bill in-full.

Credit card interest rates can vary widely, usually from as low as 0% (introductory rate) to as high as 36%. Your credit history, banking history, income, and your credit score are all used by a bank or credit union to calculate your likelihood of making good on payments. Generally, the lower the perceived risk to the bank, the lower your interest rate will be. Interest rates on loans are calculated the same way.[80]

The best practice for avoiding paying credit card interest, which can add up significantly over time, is to pay your credit card bill in-full. If that is not possible, try to pay as much over your credit card minimum payment as you can. Even just $10 more each month can reduce your credit card interest and enable you to pay off the balance faster.

[79] Original material from Peerlink National Technical Assistance Center.
[80] Original material from Peerlink National Technical Assistance Center.

The Pros & Cons of Credit

Benefits:

- **Security:** Credit cards can be safer than carrying cash. Unlike cash, if you report your card lost or stolen, the card will be canceled, rendering it unusable.
- **No-Interest Grace Period:** Grace periods allow you to float money. If you pay the amount in full before the payment due date, you can essentially 'borrow' money interest-free. However, if you are late with the payment, you will be charged a penalty and your interest rate will likely rise.
- **Rewards & Rebates:** You can use credit cards that offer rewards or rebates. Some credit card companies are affiliated with airlines, allowing you to earn airline miles that, eventually, can be redeemed for free airfare or upgrades on travel. Other companies offer cash back awards. Keep in mind that these schemes can only work in your favor if you pay off the balance most, or all, months to keep your interest down to a minimum.
- **Online Management:** Similar to internet banking, credit card companies have websites and apps where you can check your credit balance and interest rates, and make payments easily and securely. You can also enroll in auto-pay so you never miss a payment.

Drawbacks:

- **Credit Limit Can Be Too High:** Credit card companies often extend credit limits far above a reasonable amount compared to a person's income. This can leave a person in debt and it may take years to pay it down.
- **Too Easy to Buy Now, Pay Later:** Having a credit card can make it too easy to make a purchase now rather than waiting until you have the money saved for that purchase. If you make too many of these decisions, your debt to the credit card company could increase to thousands of dollars.
- **Identity Theft:** Using credit cards can increase your chances of becoming a victim of identity theft. It is important that you stay vigilant with your credit card receipts, only give your credit card number to trusted sites when making internet purchases, and scrutinize your monthly bill for any transactions that do not look right.

Developing Healthy Credit Habits

To build and maintain good credit:

1. Pay your credit bills on time.
2. Do not accumulate too much credit debt. If it starts to add up, **stop** using your credit card until you have paid off that debt.
3. Monitor your credit reports to look for errors and to avoid identity theft.

How much credit is too much?

Acquiring a lot of credit can add up quickly and be hard to pay off. Here are some signs that a person's credit card debts are accumulating and becoming difficult to manage:

- You pay only the minimum amount due on your credit cards each month.
- You buy so much on credit that the amount you owe from one month to the next never goes down.
- You take out new loans or get new credit cards to pay off old ones.
- You have to skip some payments.
- You are borrowing to pay for regular expenses like groceries because you do not have cash.
- You are frequently late making your monthly payments.
- You must rely on extra income from overtime work to make ends meet.
- You must use savings to pay current bills.
- You have more than 20% of your take-home pay committed to credit payments other than your home mortgage.
- You have lost track of how much you owe.
- You put off essential medical or dental work because you cannot afford it.

If you answer yes to more than two or three signs, you may need to work on trimming your debt load.[81]

[81] Melinda Opperman. "10 Warning Signs You Have Debt Problems." *Credit.org*. https://credit.org/blog/10-warning-signs-of-a-debt-problem/

Steps to Paying Down Credit Cards

Although the following steps to paying down your credit cards are simple, they will require a firm commitment on your part:

1. Stop using your credit card(s).
2. Pay off the card with the highest interest first.
3. Pay more than the minimum due.

To calculate how long it would pay down your credit card(s) and what you will pay on interest over time, visit: http://www.calculatorweb.com/calculators/creditcardcalc.shtml

Best Credit Cards for Building or Rebuilding Credit:

- **Best for Building Credit:** Petal 2 “Cash Back, No Fees” Visa Credit Card
    - No credit history required, no fees – great beginner card
- **Best Secured Card:** Discover it Secured Credit Card
    - You put down a deposit and that is your credit limit, after eight months you can transition to an unsecured card and get your deposit back
- **Best Low Deposit:** Capital One Secured MasterCard
    - No annual fees, low security deposit options, and you can get a higher credit limit after making your first 5 monthly payments on time
- **Best for International Applicants:** Deserve Digital First Card
    - No annual fee or security deposit, no prior credit history needed
- **Best for Students:** Discover it Student Cash Back
    - Cash back perks and a welcome bonus, student-centric benefits
- **Best for Average Credit**: Capital One Platinum Credit Card
    - No annual fee, travel benefits, good for building existing credit[82]

Note: We are not advertising any of these credit cards. One should keep in mind the pros and cons of opening up a new line of credit. Credit cards can be an important and helpful financial tool, but they must be handled responsibly so as not to increase debt.

[82] Alexandria White. “The best credit cards for building credit of 2021.” *NBC Select,* April 27, 2021. https://www.cnbc.com/select/the-best-credit-cards-for-building-credit/

Understanding Loans

A **loan** is a type of debt. In a loan, the borrower borrows an initial amount of money, called the *principal*, from the lender, and is obligated to pay back an equal amount of money to the lender at a later time. Typically, the money is paid back in regular *installments*, or partial repayments.

A loan is generally provided at a cost, referred to as **interest**, on the debt. In a legal loan, each of these obligations and restrictions is enforced by *loan contract*, which can also place the borrower under additional restrictions known as *loan covenants.*

Financial institutions use the same tools for calculating risk and interest rates for borrowers as they use for credit card offers.

Reasons for Taking out a Loan:

Debt consolidation: If you have multiple debts at high interest rates, it might work to your advantage to pull all of your debts together under one lower-interest loan.

Making large purchases: Because of the large amount of money involved, buying a home or car is often done through a loan.

Attending school: Many students use federal loans to attend college, trade school, or graduate school.

Additional reasons: Starting or expanding a business, making home improvements, planning a wedding, travel.[83]

> **Note:** Loan debts can be just as difficult as credit cards to pay down and any debt that has become overwhelming can become the source of a great deal of anxiety and stress. Later in this course, we will develop tools to address personal debts and create a person-centered plan to pay off debts.

[83] Original material from Peerlink National Technical Assistance Center.

Pros & Cons of Taking out a Loan:

Benefits:

- A loan gives you the ability to buy something now (like a home or a car) that you could not otherwise afford.
- A small business loan or student loan can help you grow professionally and build your *human capital*.
- A single, low-interest loan can help you pay off several debts faster and can save you a great deal of money in interest.

Drawbacks:

- You **will** pay interest. Over time, you will end up paying more than if you had paid for your purchase in-full.
- If you have an unexpected change in your income, you may have difficulties making the payments on the loan.

Understanding Loan Contracts:

It can be useful to have a good understanding of the terms used in loan contracts. The following are some commonly used terms:

Principal: The amount you borrow.

Term: The length of the loan (how long you have to pay it off).

Interest: The charge from the lender for using their money. This is usually expressed as a yearly rate, called the annual percentage rate (APR).

A fixed rate of interest: The interest rate charged on the outstanding loan balance will remain the same for a set amount of time (usually the entire duration of the loan). Fixed interest rates offer greater control over your finances because the repayment amount will always be the same for the fixed interest period.

The fixed interest rate and the time period it applies to *must* be stipulated in the contract. Generally you will not be able to make more than the agreed-upon repayments (i.e. pay the loan off more quickly). Check the loan contract for any conditions that apply.

A variable or floating interest rate: The interest charged on the outstanding loan balance increases or decreases based on changes to the market interest rate, which is usually set to a benchmark (such as the federal funds rate).

Variable interest rates can be beneficial when the market rate is low, and harmful when the rate is high. When the market interest rate declines, a variable interest rate will decline as well, reducing your loan payment. However, when the market interest rates rise, the interest on your loan will also increase and you'll have to pay more.[84]

A split interest rate: You may be able to choose to split the type of interest rate that applies to a loan. This occurs in two ways:

1. A fixed interest rate applies for a set amount of time. When that time elapses, the rate can be changed to a variable interest rate
2. Part of the amount borrowed has a fixed interest rate applied and the remaining amount has a variable interest rate applied.

The total amount you pay to the lender will depend on the amount you borrow, the interest rate charged, and the length of time that you borrow the money for (the term of the loan). Lenders will usually calculate interest charges on a daily basis. These interest charges are usually added to your loan account each month.

[84] Matt Lee. "Fixed and Variable Rate Loans: Which is Better?" *Investopedia,* April 23, 2021. https://www.investopedia.com/ask/answers/07/fixed-variable.asp

Calculating Interest Rates:

It is important to keep in mind that the amount you ultimately pay on a loan may be very different from the base amount, depending on the interest rate attached to the loan. Below are three examples of $10,000 loans with different interest rates. Notice how a slight increase in the rate of interest leads to a very different loan amount.

Interest rate	Potential annual loan interest	Actual total interest	Actual total loan and interest
9.0%	$900.00	$4500.00	$14,500.00
12.0%	$1200.00	$6000.00	$16,000.00
15.0%	$1500.00	$7500.00	$17,500.00

To get an accurate calculation of interest rates on your loan, visit:

https://www.bankrate.com/calculators/mortgages/loan-calculator.aspx

Before taking out a loan, ask yourself these questions:

- Do I really need this now? Is this something that can wait while I save more money?
- What will the payments be? Are they affordable now?
- How long will it take me to pay the loan off?
- If my income drops or I have an unexpected financial emergency, will I still be able to make the payments?
- How much money will I have left after payments for my other bills?[85]

[85] Original material from Peerlink National Technical Assistance Center.

Predatory Lending

Predatory Lending: Any lending practices that enforce deceptive, unfair, and/or abusive loan terms on borrowers. These loans benefit the lender by 1) having high fees and interest rates, 2) taking away the borrower's equity, or 3) putting a borrower in a more expensive and lower credit-rated loan. Federal agencies use the term "predatory lending" as a catch-all for numerous illegal activities in the loan industry.

Predatory lenders take advantage of a borrower's lack of financial knowledge. Lenders may be accused of tricking a borrower into believing that an interest rate is lower than it actually is, or that the borrower's ability to pay is greater than it actually is.[86]

Predatory lending typically occurs on loans backed by some kind of collateral, such as a car or a house, so that if the borrower defaults on the loan, the lender can repossess or foreclose their assets and sell them for profit. People with poor credit scores, low-income families, BIPOC borrowers, elderly folks, military service members, and people in financial crisis are disproportionately targeted by predatory lenders.[87]

Warning Signs of Predatory Lending:

- There are excessive fees attached to the loan.
- The lender tries to convince you to take out a loan greater than what you can afford to pay back.
- The lender tries to make an expensive loan look as inexpensive as possible.
- The lender promises you one type of loan but gives you a different one.
- The lender links your loan to your assets, like your home, instead of your income.
- The lender increases the price of your loan at the end of the loan term (a balloon payment) without disclosing it up front.
- The lender makes promises of frequent refinancing as needed.
- The lender charges extra high interest rates to low-income neighborhoods, where finding a bank to borrow from often can be difficult.

[86] Adam Hayes. "Predatory Lending." *Investopedia*, February 27, 2021. https://www.investopedia.com/terms/p/predatory_lending.asp
[87] Amy Livingston. "How to Spot & Avoid Predatory Lending (& What to Do If You're a Victim)." *Money Crashers*, March 5, 2019. https://www.moneycrashers.com/spot-avoid-predatory-lending-victim/

Types of Loans that Could Become Predatory:[88]

- **Payday Loans:** Also known as Deferred Deposit Service, payday loans are loans against paychecks. You must be employed and have a checking account to get this type of loan. Typically, you give the lender a post-dated check for the amount you wish to borrow, plus a fee. The length of the loan is usually around two weeks. On the agreed-upon date to pay back the loan, you either bring cash to the lender or let them deposit your post-dated check.
- **Pawn Shop Loans:** These loans are secured by a piece of property. Interest rates range from 2% to 25% per month, depending on which State you live in. Loan periods range from 30 days to 90 days, depending on the State. The collateral is sold if the interest or loan amount is not paid in the specified period.
- **Title Loans:** These loans are secured by your car's title. The lender determines how much you can borrow based on your car's value. Typically, car title loans range from $250 to $1,000, but can go as high as $10,000. The duration of these loans is often 30 days. If you fail to make loan payments – even just one – the lender can repossess your vehicle.
- **High-L-TV (Loan to Value) Home Equity Loans:** Loans secured by the equity in your home but oblige you to pay more than your equity is worth. Some home equity lenders allow you to create a loan-to-value ratio of as much as 125%, which is risky because houses rarely sell for more than their fair market value.
- **Advance-Fee Loans**. The companies that offer this service do not directly lend money. Rather, they find lenders who will make a loan or issue another type of credit. While they claim high success rates, even for individuals who have poor credit histories, their fees can be very high. These companies should **never** require you to pay application, appraisal, or credit report fees before identifying a lender and completing the application.

Note: The interest rates and fees attached to most of these loans are much higher than those offered through conventional lenders (i.e. banks or credit unions). However, these loans generally make it quicker to qualify and obtain much-needed cash, so these types of lenders can often be the first choice for people experiencing a financial crisis. If you're undergoing financial stress and need a quick loan, it is important to understand the warning signs of predatory lending and review loan contracts *thoroughly* before signing them.

[88] Original material from Peerlink National Technical Assistance Center.

How to Avoid Predatory Loans:

1. Know what you *can* afford and shop around for loans. Calculate your debt-to-income ratio (monthly debt payments divided by your income). Your new loan should not push your DTI over 36%. Make sure all the lenders you are considering are licensed.
2. Ask lenders lots of questions. Ask whether your monthly payments will change at any point, whether there are payment penalties or fees, etc.
3. Identify any red flags, such as signing a waiver or contracts with blank spaces, and back out of the loan.

How to Fight Back Against Predatory Lenders:

1. Report the lender. File a complaint with the Consumer Financial Protection Bureau (CFPB) at and your State's banking office.
2. Use your Right to Recession, which allows you to cancel your loan within 3 days of signing it. If you never received a Notice of Recession from your lender, the entire loan may be invalid and you m ay be able to rescind the agreement within 3 years of signing it.
3. Sue the predatory lender. If your loan agreement violates federal or state law, you may have the option to file a civil lawsuit.
4. Refinance the loan. To escape the predatory loan, you can refinance it with another lender.
5. For more information and resources, visit:

   https://www.moneycrashers.com/spot-avoid-predatory-lending-victim/

"Money often costs too much."

Ralph Waldo Emerson

WORKSHOP 6: SUMMARY

In this section, we learned about credit: how it works, common terms, and what credit reports and credit scores are and why they are used.

We also learned what to do if your credit card is lost or stolen, some pros and cons of credit, how credit card interest rates work, and how to develop healthy credit habits.

Then, we explored how much credit is *too much* and the steps a person can take to pay down their credit card(s). We also learned about a few different beginner credit card options for building or rebuilding credit.

Next, we learned about loans. We discussed why people take out loans and their pros and cons. We also learned about some common terms used in loan contracts and how to calculate the interest rate on a loan.

Finally, we explored the definition of predatory lending and the warning signs of those types of loans. We learned some ways to avoid these loans and what to do if you are already engaged in a loan that is predatory.

How can the topics I learned in this section be helpful for me?

Topic	N/A	How this will be helpful to me:
How credit works; credit reports and credit scores		
Facts about credit		
Pros and cons of credit		
Interest rates (credit)		
How much credit is too much?		
Steps to paying down credit cards		
Pros and cons of taking out a loan		
Understanding loan contracts		
Interest rates (loans)		
Predatory lending		

WORKSHOP 7

DEBT & TOOLS TO GET OUT OF IT