Give Credit Where Credit Is Due

Credit and Its Importance

Set some limits

It’s interest-ing

Cash or convenience?
When a restaurant needs a large amount of food and supplies to cater a wedding, how does it obtain these products without paying cash for them? How can an individual purchase a new home when s/he has only a small amount of money in the bank? How can you buy a television or a refrigerator without having the purchase price on hand? The answer to all of these questions is by using credit.

Describe types of credit extended to businesses and to consumers.

Explain the reasons for extending credit.

Credit is the arrangement by which businesses or individuals can purchase a good or service now and pay for it later. Businesses use credit to obtain goods and services to sell, and consumers use credit to purchase those goods and services.

Just my type
Credit users are responsible for finding out what kinds of credit are available to them and who offers credit. There are many different types of credit. Let’s take a look at a few of the most common types.

Revolving credit accounts. Under a revolving credit account system, the maximum amount of money that the credit user can owe (also known as the credit limit) is set at the time the credit account is opened. For example, if a customer opened an account with a credit limit of $500, the customer could charge purchases up to that total amount. The customer could then pay off the entire amount at the end of the month or make payments over a period of time. If the customer chooses to pay over a period of time, s/he might be required to pay a minimum amount at the end of each month. The unpaid portion would then be subject to finance charges. Whenever the balance on the account reaches the customer’s credit limit, no further purchases can be charged to the account until some payment has been made.

Installment credit accounts. These accounts are designed to handle one total amount of credit, which is paid in installments within a certain time period. The credit user makes a down payment and signs an agreement to pay monthly installments until the total is paid. Customers usually pay finance charges for the privilege of using this kind of credit.

Installment credit is commonly used to purchase large, expensive items such as furniture or cars. The title, or legal ownership document, for an item purchased on installment credit is made out in the name of the credit user. However, the seller has a lien, or claim, on the title until all installment payments have been made. In most cases, the lender will hold the title until payment is complete. If for any reason the credit user does not pay, the seller can repossess, or take back, the good.
**Regular credit accounts.** Regular credit accounts are sometimes called open accounts because they allow credit users to buy at any time during a set period, usually 30 days. At the end of that time, the person or business is expected to pay the entire amount that is due for the purchases made during the period. Unlike a revolving credit account, there may or may not be a credit limit. Businesses that use regular credit to make purchases are often given a slightly longer time period in which to pay. They may also be given a discount if they meet certain payment requirements, such as a 3% discount for payment within 10 days.

**Budget credit accounts.** Budget accounts are usually a form of short-term credit. They are often set up for 60- or 90-day periods with a payment due every 30 days. Most budget accounts do not charge interest if the customer makes payments on time. For example, furniture or appliance retailers will often advertise “90 days same as cash,” meaning that customers can purchase goods on credit with the same advantages as they would have with cash purchases—immediate delivery and no additional charges to pay. However, if a customer does not pay the amount in full by the end of the 90 days, s/he will be subject to finance charges applying to the entire time period.

**Bank credit cards.** Credit cards offered through or by banks are very popular with credit users. They can be used to purchase a variety of goods and services. The most widely used bank cards are Visa, MasterCard, American Express, and Discover. Credit users can obtain them in a number of different ways. Here are just a few examples:

- **U.S. Bank customers** can choose from about 20 different Visa cards, each with unique features and rewards (such as airline or shopping perks).
- **Small-business owners** can go online to compare benefits and apply for corporate MasterCards. They may receive cash back when they make business purchases on these cards.
- **Business or personal travelers** who frequent Hilton Hotels can apply for a Hilton Honors American Express card.
- **Individuals** can respond to mail solicitation to receive pre-approved Discover cards.

All of these cards are considered bank cards because cardholders’ charges are handled by banks. When a customer makes a purchase with a bank card, the customer presents the card to the business and signs a charge slip for the purchase. The business sends the charge slip to the bank for payment. The bank deducts a fee for its services, usually a small percentage of the amount of the sale, and pays the business the remainder. Once a month, the bank bills the customer for all purchases charged to the customer’s bank-card account during the billing period. Credit users can choose to pay the entire balance each month or to pay a minimum amount with finance charges over a period of time.

**Travel and entertainment cards.** Some credit cards have traditionally been used in restaurants, clubs, and hotels, especially by travelers who do not wish to carry very much cash. The most well-known of these types of cards is a Diners Club International card. As a matter of fact, when the Diners Club issued its first 200 cards in 1950, they were the first independently issued credit cards in the world.

To qualify for this type of credit card, individuals and businesses must have excellent credit ratings, and they must pay annual fees. Qualifying businesses can obtain these cards in the names of individual employees for their use in business travel and entertaining. Customers are billed on a monthly basis, and they must pay the full amount that is due each month. The system for using the cards is the same as that for using bank cards.

**Service credit.** When you own or rent a place to live or to operate your business, you use utilities such as electricity, water, gas, sewer services, trash removal, etc. You may pay for these services at the end of each month or perhaps at the end of each quarter. Sometimes, the utility provider will charge you an estimated amount for the services used each month, and then send an adjusted bill at the end of the quarter or at the end of six months. No matter what the payment plan is, you are using utilities before you pay for them. This is a type of credit known as service credit.
Secured loans. In a secured, or collateral, loan, the borrower pledges to the lender some valuable possession as collateral, or security, to guarantee that the loan will be repaid. If the borrower does not repay the loan, the item used as collateral will then belong to the lender. Among the items that are often used as collateral are real estate, stocks and bonds, personal property such as machinery or cars, and the cash value of life insurance.

Unsecured loans. An unsecured loan, also known as a signature loan, is an amount of money borrowed by an individual or a business simply by signing a promissory note, a written promise to repay the loan. In this type of loan, the borrower is not required to put up collateral. Unsecured loans are usually made for shorter periods of time than secured loans and only to individuals or businesses with excellent credit ratings. Interest rates on unsecured loans may be slightly higher than those on secured loans because of the higher risk of loss to the lender.

Straight from the source

There are many different sources of credit. Whether borrowers are seeking credit for themselves as individuals or for their businesses, they should compare the options available to them. A few sources of credit to consider are:

Commercial banks. Full-service banks offer a variety of credit services, including secured and unsecured loans, installment credit, and bank credit cards.

Savings and loan associations. Savings and loan associations began as home loan institutions. Today, they make loans similar to those made by commercial banks, but many of their loans are still for real-estate purchases.

Credit unions. Credit unions are cooperative financial institutions that are owned by their members. These institutions usually have some requirement for membership, such as working for a certain company, belonging to a certain labor union, or living in a certain geographic area. Similar to banks, they provide savings accounts and credit services. They usually offer their members small loans, installment credit, and low interest rates.

Sales finance companies. These lenders offer credit through retailers such as car dealerships. When a borrower buys a car on credit, the car dealer then sells the borrower’s contract to the sales finance company for cash. The borrower then makes payments to the sales finance company, which retains a legal interest in the car until all payments are completed.

Other businesses. Businesses offer credit to ultimate consumers, but manufacturers, wholesalers, and retailers also use credit to purchase raw materials, supplies, stock, or products from other businesses. When one business extends credit to another business, the credit usually covers a longer period of time than would be granted to ultimate consumers. The credit period may vary from 30 to 120 days.

Count the costs

Using credit can add to the total cost of goods and services. Some of these costs are more obvious than others. Let’s consider some of the costs businesses and individuals pay for using credit.

Annual fees. Some credit-card providers require users to pay an annual fee for the privilege of using their cards. These fees vary from card to card, depending on the services supplied by the credit-card company. For example, American Express charges $95 per year for its Preferred Rewards Green Card and $450 per year for its Platinum Card. Each card comes with certain perks, such as assistance with making reservations and buying gifts.

Not advertised on its web site, American Express also offers the Centurion Card (known as the “black card”) by invitation only. Centurion Card holders must charge an annual amount of at least $250,000 and pay an annual fee of $2,500, in addition to a one-time initiation fee of $5,000.
Finance charges. These are the interest charges on accounts that are not paid in full at the end of each payment period. Expressed in percentages, these charges average around 14% per month on the unpaid balance. These costs are expressed as an annual percentage rate (APR) so that it is easier for credit users to compare the costs of various credit plans. In general, interest on credit cards is higher than interest on installment credit or bank loans.

Higher prices. Businesses that offer credit usually charge higher prices for their goods and services than those that do not. The business must cover the expense of operating the credit system and paying the bank's fees. It must also protect itself against loss from credit customers who do not pay for their purchases. Some businesses require purchases of a certain dollar amount (at least $5, for instance) for customers to be able to use credit cards. Occasionally, you will visit a small business that will offer you a discount for paying cash instead of using your credit card. Both of these measures are attempts to cut down on the costs associated with offering credit.

Interest rates. Interest is the fee the lender charges the borrower for the use of the money. Interest rates go up and down according to the supply of and demand for money. The amount of interest is calculated by multiplying the amount of money being borrowed (the principal), times the interest rate, times the length of time for which the loan is made. The length of time borrowers use to pay off loans plays an important role in determining the costs of credit. The faster a loan is repaid, the less the interest charged.

Look at the difference between the cost of using credit over a one-year period and a four-year period to pay off a loan of $4,000 with an interest rate of 8.3%. As you can see, the difference in cost to the borrower between a one-year loan and a four-year loan is $996.

<table>
<thead>
<tr>
<th>Time</th>
<th>Monthly Payment</th>
<th>Interest</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year</td>
<td>$361.00</td>
<td>$332.00</td>
<td>$4,332.00</td>
</tr>
<tr>
<td>2 years</td>
<td>194.00</td>
<td>656.00</td>
<td>4,656.00</td>
</tr>
<tr>
<td>3 years</td>
<td>139.00</td>
<td>1,004.00</td>
<td>5,004.00</td>
</tr>
<tr>
<td>4 years</td>
<td>111.00</td>
<td>1,328.00</td>
<td>5,328.00</td>
</tr>
</tbody>
</table>

Summary
Credit is the arrangement by which businesses or individuals can purchase a good or service now and pay for it later. Businesses use credit to obtain goods and services to sell, and consumers use credit to purchase those goods and services. There are many types of credit, including revolving credit accounts, installment credit accounts, regular credit accounts, budget credit accounts, bank credit cards, travel and entertainment cards, service credit, and secured and unsecured loans. Sources of credit include banks, savings and loan associations, credit unions, sales finance companies, and other businesses. Costs of using credit include annual fees, finance charges, higher prices, and interest rates.

Debt is a big problem for Americans. Over 40 percent of American families spend more than they earn each year, and an average household carries $8,000 in credit-card debt at any given time. Some people say that the credit-card companies’ unethical actions are to blame. These companies bombard people with offers for available credit, reel them in, and then, due to interest and finance charges, individuals are “on the hook” for years trying to pay off their debts. Other people say that those who are in debt are to blame. It's everyone's responsibility to manage her/his own finances wisely and not to charge purchases that can’t be paid off. What do you think?
Now that you have learned about the basic types of credit and how they work, are you wondering why businesses offer credit? It’s easy to see that running a credit system involves a certain amount of time, effort, and expense. Let’s find out why businesses decide to offer credit, what the benefits of credit are to businesses and consumers, and what laws regulate the way in which credit is handled.

Reasons for offering credit

There are several very important reasons for businesses’ offering credit. Among those reasons are:

**To be competitive.** Businesses must compete with each other for scarce customer dollars. If two businesses offer similar products, one of those businesses may decide to offer credit as an added attraction. Being able to buy now and pay later is often the deciding factor in the customer’s choice of which company to do business with.

Interest rates can also be used in competition. To gain a competitive edge, a bank may offer a lower interest on home loans than its competitors.

**To gain new customers.** All businesses lose customers from time to time due to factors such as relocation, illness or death, or loss of employment. Therefore, to be successful, businesses must continually attract new customers. One way to do this is by offering credit. For example, even an established business with many customers can offer customers instant credit when it opens a new location.

**To encourage customers to buy.** Credit encourages customers to buy more freely. Credit customers like being able to buy without worrying about whether they have the cash on hand to pay for their purchases. They may buy impulse items that catch their attention in the store, larger quantities, or more expensive models when they know these purchases can be put on a credit account. A customer who needs a new dishwasher, for instance, may buy a larger model with many more features than s/he had intended to purchase if the dishwasher can be paid for over a period of time. The business profits from the sale and from the interest it earns on the customer’s credit account.

**To foster customer loyalty.** While gaining new customers is important, keeping current customers is critical. Offering credit gives the business many opportunities to satisfy customers and gain their loyalty. Some of the ways businesses use credit to foster customer loyalty include notifying credit customers of sales before the sales are announced to the general public, extending the payment period at heavy buying times such as back-to-school or Christmas, and printing thank-you messages for prompt payment on credit statements.

**To use as a marketing-information tool.** Credit records provide a business with valuable information about its credit customers. The records show who the customers are, what they have bought, and when they made their purchases. One way a business can use this information is to plan promotions. A car-maintenance provider can send coupons toward an oil change to its credit customers, based on the last time they came in for service.

A business can also use credit records to target a particular market. All recent purchasers of cribs, for example, are a ready-made market for infants’ and children’s wear, along with many other baby products.

In addition, credit records can help identify problem areas by showing where sales have declined. This information lets the business know it needs to make changes in its product mix. If sales of a certain style of jeans are declining, the business may need to reduce its inventory of that style.
Benefits of obtaining credit

Some of the benefits of using credit are that businesses and consumers can:

- **Purchase expensive items.** For most of us, it would be difficult to pay cash for large, expensive items such as cars, homes, delivery vans, and heavy equipment. Let’s say a business wants to expand its product lines and facilities. The business may have $250,000 in cash but can use credit to fund the remaining cost of the $1,000,000 it needs.

- **Take advantage of its convenience.** Credit allows businesses and consumers to pay for several different purchases at one time with a single payment. It is not only more convenient but safer to carry credit cards than to carry a sizable amount of cash. Credit also provides the convenience of ordering by telephone or over the Internet.

- **Purchase emergency items.** Being able to buy items needed in an emergency situation can be an advantage of credit. Bob owns and operates a pet shop. One day, the hot-water heater breaks, and water floods the shop floor. Bob can use credit to pay for a new hot-water heater because he does not have enough cash on hand to pay for one right now.

- **Maintain appropriate inventory levels.** If a business finds itself short of inventory, it may use credit to buy more. The supply of inventory may run low at a time when the funds of the business must be used for other purposes. The business can replenish its inventory by ordering on credit.

- **Have cash available.** Businesses that buy on credit also “buy time.” In other words, they may be able to sell some or all of the goods purchased on credit before their credit payment is due. The business’s cash is then available for other purposes during this time.

- **Establish a credit rating.** When individuals or businesses buy on credit and pay bills promptly, they establish good credit ratings. A good **credit rating** has become so necessary that some people open credit accounts even when they have cash on hand. They buy on credit and pay their accounts promptly so that they can establish a good credit rating and a reputation for dependability. If they need more credit at a later time, it will be much easier for them to obtain it because of their good credit rating.

- **Save money.** Credit customers are often given more opportunities to save money on purchases than cash customers. Businesses may receive discounts on their purchases for paying their credit accounts promptly. Retail credit customers usually receive periodic discounts or advance notice of special sales. This allows them to save by buying at reduced prices even when they are short on cash.
Legislation affecting credit

All businesses and consumers should be familiar with the laws that regulate credit. They should understand what businesses are allowed to do, what they are not allowed to do, what their rights are, and what customers’ rights are. Businesses must comply with legislation at the state and federal levels.

**State laws.** Every state in the United States has varying laws governing credit. The Uniform Commercial Credit Code (UCCC) gives states a model to follow in writing their own sets of credit laws. The UCCC provides rules covering all areas of credit, including credit terms, interest rates, and credit insurance. In addition, most states have enacted Retail Installment Sales Acts (RISA) to regulate installment sales of personal property.

**Federal laws.** There are several important federal laws concerning credit. These include:

- **The Truth-in-Lending Act.** This law is also called the Consumer Credit Protection Act. Its main purposes are to protect consumers who use credit and to make it easier for them to compare the terms of different credit systems. This law specifies what information the business is required to give the customer in each of the different kinds of credit systems.

- **The Equal Credit Opportunity Act.** The main purpose of this law is to make the granting of credit fair by prohibiting the denial of credit based on the applicant's gender, race, age, marital status, or national origin. If a credit application is rejected, the rejection must be made in writing, and the applicant is entitled to know the specific reason for the refusal.

- **The Fair Credit Billing Act.** This law requires credit-extending businesses to respond within 30 days to any customer's complaint or inquiry about a billing error. The business has 90 days in which to explain or correct the error or misunderstanding.

- **The Fair Credit Reporting Act.** This law gives consumers the right to inspect the files of their credit history at any credit agency and to have any mistakes corrected. Credit agencies handle a great deal of information, and errors can easily occur. Since credit is often granted or refused on the basis of credit agency information, it is very important to consumers to know what is in these files and to make sure they are kept up to date.

**Summary**

Businesses offer credit to stay competitive, to gain new customers, to encourage customers to buy, to foster customer loyalty, and to use as a marketing-information tool. Benefits of obtaining credit include the ability to purchase expensive items, to take advantage of convenience, to purchase emergency items, to maintain inventory levels, to have cash available, to establish a credit rating, and to save money. Credit is regulated by a number of state and federal laws.

1. Why do businesses offer credit?
2. What are the benefits of obtaining credit?
3. What are some laws that govern the granting of credit?