# Understanding Credit

Establishing credit, and using it responsibly, is an important component of personal finance. Credit enables you to make a purchase without using cash. Credit can be used because you don't want to extinguish your savings, help bridge the gap until your next paycheck, or to make a large purchase that you wouldn't have access to funds, such as when you buy a car or home.

## The 5 Cs of Credit

Every time a financial institution lends money, there is a risk that the borrower will not repay the loan. To help mitigate risk, lenders consider five key areas, commonly referred to as the 5 Cs of Credit.

Character refers to the individual's history of repaying debt. Lenders typically rely on an applicant's credit report and score to measure character. Refer to the section *How Your Credit Score Impacts Your Loan* below.

Capacity is the ability to repay the loan, based on the individual's current salary and total payments. A Debt-to-Income Ratio (DTI) calculates the percentage of an individual's income required to pay expenses each month.

Capital is the amount of money the individual currently possesses. This helps to determine if the applicant has available funds to cover a down payment or closing costs on a home, or has reserve cash to repay a loan.

Collateral is an asset which can be used to help secure a loan. For example, the borrower's car would be collateral for an auto loan. At the time of the loan, the financial institution places a hold, or lien, against the car's title, which would allow them to legally take the car in the event the borrower defaults, or does not repay, the loan.

Conditions are the term, rate, due date, purpose, and other requirements of the loan.

## How Your Credit Score Impacts Your Loan

Lenders commonly use an individual's credit score as an indicator of their creditworthiness, or how safe it would be to lend that person money. Credit scores are calculated based on information found on the individual's credit report, generated by three major credit bureaus: Experian, Equifax, and Trans Union. The Fair Issac Corporation (FICO) is widely considered the industry standard in calculating an individual's score. Scores from each of the three credit bureaus can vary from the others.

Credit scores fall between a range of 300-850. The higher the score, the more creditworthy an individual. Lenders typically reward borrowers who have higher credit scores with better rates, ability to borrow more money, and lower restrictions. Borrowers with lower credit scores tend to pay more for credit. Financial institutions refer to the policy of assigning interest rates based on an individual's credit score as risk-based pricing.

The following is a guide to how lenders view scores:

| **Credit** | Rating | Details |
|---|---|---|
| under 580 | Poor | Lenders typically view scores under 580 as a substantial credit risk |
| 580 - 669 | Fair | This score is below the national average. Lenders may approve loans at a higher interest rate with stricter conditions. |
| 670 - 739 | Good | This score is within the national average. Lenders will typically approve loans with less restrictions. |
| 740 - 799 | Very Good | This score is above the national average. Lenders will typically offer their best rates to borrowers with these scores. |
| 800 and above | Exceptional | This score is well above the national average and indicates very little risk to lenders. |

An individual with a credit score of 700 is likely to pay a higher interest rate, and higher monthly payment, for the same loan as someone with a score of 750.

**Real Life Impact**

Kayla and Frank both apply for a $20,000 car loan for 60 months. Kayla has a 750 credit score, while Frank's score is 690.

Kayla's rate is **3.24%** for a monthly payment of **$361.51**
Frank's rate is **5.75%** for a monthly payment of **$384.34**

At the end of the loan, Frank would have paid **$1,370** more in interest than Kayla for the same amount and term.

## Credit Score Factors

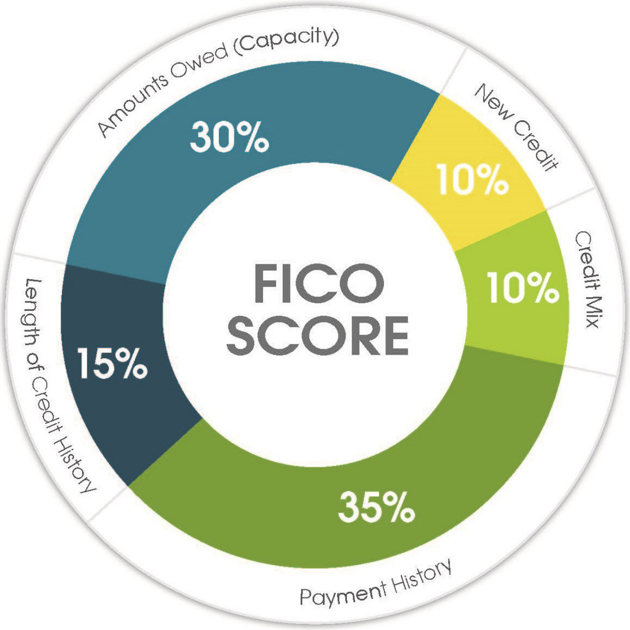
35% - Payment History

30% - Amounts Owed

15% - Length of Credit History

10% - Length of Credit

10% - Credit Mix




## Tips to Build and Boost Your Credit

Now that you have an understanding of how your credit score impacts your ability to get a loan, and the amount you will pay, here are tips to build and boost your credit:

- Pay on Time. On time payments show dependability and will start boosting your score.
- Utilize Credit. The best way to demonstrate you can pay on time is by utilizing credit. Consider paying monthly bills such as cell phone, cable, or gym membership with your credit card and then pay the balance at the end of the month. An exception would be if the company charges a convenience fee to pay with a credit card.
- Keep Spending in Check. While utilizing credit is important, don't get in over your head. Approximately 30% of your credit score is based on the ratio of your outstanding debt compared to total debt available to use, and a good ratio is under 30%. This means if the total limits of your credit cards combined is $10,000, you want to have a total balance of less than $3,000.
- Respect Your Obligations. Not happy with your cell phone service? Better leave on good terms. Disregarding the last bill will result in the company reporting to a collections agency, which will do big damage to your credit. Failing to pay utility payments, medical bills, and even parking tickets will all likely result in a collections hit on your credit.
- Consider a Secured Loan. Individuals looking to build or repair their credit may want to consider a secured credit card. With this loan, the amount of your credit line is secured in a savings account as collateral. Since the risk to the lender is low, it is easier to get approved and start building credit with on-time payments.
- Check for Errors. Occasionally, something which appears on your credit report doesn't belong to you, or information may be inaccurately reported. Individuals should check their credit report on a regular basis to ensure everything is correct. You can request one free report per year from each of the three credit bureaus. View and download online at www.annualcreditreport.com.

**Horizon Tip:** Instead of ordering credit reports from all three bureaus at once, spread it out, and order one every four months.

## Using Credit Responsible

It is easy to overspend using a credit card. The allure of buying something now and paying for it later may result in you paying much more than you would expect over the long-haul. According to a 2020 survey, about half of all Americans carry credit card debt, with nearly 40% saying they cannot afford to pay more than the minimum payment.*

Here are tips to follow to use credit responsibly:

- Keep to a budget. Credit cards are a convenient way to pay and come in handy when you need to make a purchase Tuesday, but don't get paid until Friday. Plus, many cards offer rewards like cash back or travel benefits each time you use them. Just make sure you budget for those purchases and are able to pay off most, if not all, of the balance each month.
- If you carry a balance, find a low rate card. Credit card balances can escalate pretty quickly when rates exceed 20%. If you require additional time to pay off the balance, look for a card that offers rates below 10%.
- Reward-based Cards that offer cash back, points, or other perks are a great option if you pay off your balance each month.
- Pay more than the minimum balance. If you do have to carry a balance, make sure to pay as much as you can each month. Paying just the minimum balance is like running on a treadmill; lots of effort without getting anywhere.

  Assume you have a credit card balance of $2,000 at an Annual Percentage Rate (APR) of 18%, with a minimum payment of just 2% of the balance. If you paid just the minimum payment it would take you almost 30 years, and nearly $5,000 in interest, to pay off the card!
- Know the terms. That store card that offers you an extra 10% off the purchase price may also carry an extremely high 24% interest rate. Cards that offer no interest financing for 12 or 18 months will likely charge all of that interest back on the card if you don't pay off the balance by the end of the promotional period. Reward-based cards may charge an annual fee which offsets the rewards earned throughout the year.
- Monitor Your Score. As your score increases, you may be eligible for better interest rates that will lower your monthly payment.

** Source: https://www.cnbc.com/2020/05/04/almost-half-of-america-now-carrying-credit-card-debt-and-more-of-it.html*

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