Planning: Use of Credit

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PLANNING: 

use of John Doe's credit
WHAT IS CREDIT?

Intelligent use of credit may mean the difference between success and failure. An understanding of the place of credit in your life can help you get the goods and services you need and many of those you want. Credit may be a tool or a trap.

Credit is a transaction which enables you to get goods and services now with the agreement to pay in the future. Credit is a temporary substitute for cash: it alters the time when you can spend your income. Money for an item purchased on credit is saved after the purchase rather than before.

WHEN IS CREDIT USED?

Before considering the use of credit, you will need to make a complete analysis of your financial situation. Have you taken into consideration your present and future needs? Do you know what you want from life? Is your spending based upon what's important to you and your family? What resources do you have—income, credit, property, labor and management resources of the family, and opportunities provided by the community (financial, educational, recreational, religious).

There are times when it is wise to borrow money, for instance: to buy stock and equipment needed to help increase income; to pay for education or training which will give the family members greater earning power; to make needed improvements for comfort and happiness of the family; and to meet serious emergencies.

It is not easy to judge whether to use credit. When we desire something very much we can usually convince ourselves that we must have it right away.

To help evaluate whether to use credit, consider the following:
Will the immediate satisfaction from this credit mean fewer opportunities and satisfactions later?
Is your income regular enough to allow taking on this obligation, within the time limit?
Will you be in a better position or will the new obligation take too large a part of the next years' income, thus depriving the family of necessities?
Is the credit being used for an emergency, for comfort, for necessities, or for luxury?
How large is the down payment?
How often, how long and what size payments need to be met?
What interest rate will have to be paid (see page 7)?
What happens in case of default in payment? Are there repossession charges?
Will you get a refund if early payment is made?
What property is required for collateral?
Do the services of having credit justify the cost?
Would it be better to wait and pay cash? (Saving ahead to pay cash would mean getting interest on money in a savings account as well as eliminating charges for credit.)
Where will the money be obtained?

KINDS OF CREDIT

There are two kinds of credit: production credit and personal credit.

Production credit is for business purposes. It is used to increase the working capital—such as buying land, buildings, machinery, equipment, stock, livestock, etc. This credit is available through bank loans, National Farm Loan Associations, Production Credit Associations, and certain store accounts.

Personal credit is called "consumers" credit. This is used:
To obtain goods and services for personal and family living.
To meet emergencies.
For convenience: it enables you to pay bills periodically, and take advantage of special opportunities.
To pay off old debts.
Usually in small amounts rather than large amounts as is commonly necessary for production credit.
To increase personal satisfaction rather than to make money.

The answers to the questions on the blank you fill out when you apply for credit help the lending agency decide
whether you meet the three C’s of credit.
Capacity—can you pay as agreed? What is your past, present, and potential income?
Character—will you pay as agreed? Are you honest, dependable, willing to cooperate?
Collateral—what are you worth? What property can you offer as security?

KINDS OF CONSUMERS’ (PERSONAL) CREDIT

Charge Account
This is the most common and simplest form of credit.

Advantages:
No notes, written contracts or other written promises to pay.
Convenient for buying every day needs. Do not need to carry money when shopping, pay in one lump sum later.
Saves time—phone order and have it delivered.
Enables you to take advantage of sales.
Establishes credit rating which is helpful in applying for credit elsewhere when you change residence.
Easier to return unsatisfactory goods, since no change of money takes place.
Monthly statements from the store give itemized list of purchases. This helps in keeping records and can be filed for future reference.
The store is usually more prompt in replacing, repairing or “making right” a purchase made.

Disadvantages:
Charge accounts lead to careless and needless buying.
Encourages the spending of “maybe” income.
Goods may cost more at stores where charge accounts are allowed or encouraged because of additional bookkeeping.
Many stores are charging additional interest for the use of credit.
Uncollected charge accounts increase the cost of the service to the customers who pay their bills.

Installment Credit
The use of installment credit:
Involves a formal legal contract.
Usually requires a down payment, then specified payments at stated times in the future.
Runs from a few months to several years.

Advantages:
You may use the goods while paying for them but if you fail to live up to the contract the seller can take the merchandise away from you.
Forced “savings” for those who can’t discipline themselves to save and buy with cash at a lower cost.
Raises the standard of living. Helps young people to get started.

Disadvantages:
Encourages over-spending for goods and services not needed. Goods are usually higher priced.
A dealer can repossess the item if payments are not met on time.
The cost is higher because of bookkeeping involved each time payment is made, plus insurance coverage on purchase.
Cost of investigating a prospective buyer.
Charges to cover loss to the store of returned, used, and partially paid-for goods.
Encourages high-pressure selling.
Often compels too drastic economies, causing you to deny yourself necessities in order to meet payments.

Loans
Loans provide you with cash which in turn enables you to buy goods and services. The borrowed money is paid back later—in one lump sum or, more usually, in several smaller amounts. Loans involve the use of legal contracts. The repayment includes the sum borrowed plus interest. Sometimes collateral is required. Interest rates may be very high—especially on small loans.

Banks as a rule make personal loans. Most of them follow the discount policy: they withhold the charge for the loan from the total amount. For example, if you borrow $100 at 6 per cent, you will sign a note for $100, but will receive $94 in cash. Additional charges for investigation, late payment or service fee may be added.

Credit unions are voluntary cooperative savings and loan associations. They are organized within definite groups. They are operated by the members for the service of members. They may be state or federal chartered.

Life insurance policies—A loan may be made on the loan value of the policy at a definite rate of interest, which is usually stated in a table in the policy. A loan may be made directly from the life insurance company or from a bank using the life insurance policy as collateral. Some
times banks will lend at a lower rate of interest than the insurance company.

**Personal-finance companies**—These companies often lend on the borrower’s promise to pay rather than his assets; therefore, greater risk and expense are involved. Due to the greater risk, the interest rate is considerably higher. However, this is governed by “Small Loans Law.” South Dakota—(1953) Small Loan Law permits a maximum of 3 per cent on sums up to $300 and \( \frac{3}{4} \) per cent on sums up to $2,500 per month of the unpaid principal.

*Note:* On a yearly basis this would be 36 per cent on sums up to $300 and 9 per cent on sums up to $2,500.

It is always to your advantage to borrow through legally established lending agencies with good reputations. Illegal lenders (who do not obtain a license from the state) charge from 12 per cent to 700 per cent for small loans.

### COST OF CREDIT

Credit is not free. It is cheaper to pay with cash. But often the convenience of buying on time is worth a reasonable additional charge. When an emergency occurs it is sometimes necessary to use some form of credit. It is wise to establish a good credit reputation.

When you use credit you pay for:
- The amount of money borrowed.
- The length of time it is borrowed.
- The risk assumed by the creditor.
- The creditor’s extra charges.

**Shop for credit.** The chief consideration when getting credit is the cost. Not all lenders make the same charges or offer the same terms.

Many times it is not easy to determine the exact cost of credit.

Interest rate may be charged:
- On the total amount of the loan for the entire period of time.
- On the unpaid balance after each payment is made.

All interest paid in advance (discounted loan).

Suppose you are interested in a radio priced at $125 in cash. But on the installment plan you could buy it for $10 down and $10 per month for 12 months. You are told the rate on the unpaid $115 would be 6 per cent. This sounds reasonable enough. Six per cent of $115 is $6.90. This is the carrying charge, or Dollar Cost—what you pay in addition to cash price for the credit privilege. This places the
radio cost at $131.90. But remember the debt decreases every time you make a $10 monthly payment so you have use of the full $115 only the first month. This is roughly equivalent to an average of one-half the original unpaid balance, or $57.50. If you paid 6 per cent interest on only the unpaid balances each month, you would pay about $3.63. This is about half the $6.90 you actually pay, so you are really paying about 12 per cent interest instead of 6 per cent.

How to figure "real" interest

Suppose you want to buy a home freezer and will have to borrow $100. The store will carry the balance of $100 for a year with 12 monthly payments of $9.42.

Here is how to figure the actual annual interest rate:

\[
\text{total financing charge} = \frac{1}{2} \times \text{original loan} \times \frac{\text{No. payments}}{\text{No. years}} \times \frac{1}{\text{No. of payments} + 1}
\]

Example: $9.42 \times 12 \text{ months} = $113.04

\[
\text{Original amount of loan} = 100.00
\]

Total financing charge = $13.04

\[
\frac{13.04}{50.00} \times \frac{12}{1} \times \frac{1}{13} = \text{about 0.24 or an annual interest rate of 24 per cent}
\]

GOOD CREDIT IS AN ASSET

Keep your credit good by:
Guarding your signature. Read and know what you are signing before you sign—especially the fine print. Be sure all blanks are filled before you sign.
Buy no more than you can pay for within the time limit.
Pay the debt on or before date due—or arrange for renewals.

Beware of the Seller Who—

Tries to rush you.
Refuses to give you a contract.
Asks you to sign before all blanks are filled in.
Answers evasively about penalties for late payments, refunds, etc.
Requires you to pay insurance but does not give you a policy.
Quotes a per cent charge which is not a true per cent charge of the actual unpaid balance.
Who adds a new contract to an old, instead of giving you a separate contract for each purpose.
Demands the right to attach or garnishee your wages.
Requires you to sign a “receipt” for a “free trial” which turns out to be a binding contract.

Who lures you with certain merchandise and then insists on selling you something else.

Approaches you confidentially with “imported,” “stolen” goods or “special bargains.”