PURDUE EXTENSION | Consumer Science

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What is Credit?

David Evans, PhD, Purdue Extension Specialist in Family Resource Management

Schane Coker, Financial Counselor, Armed Forces Services Corporation

Andi Long, Honors student in the Department of Consumer Science at Purdue University

Defining Credit

The word "credit" has several meanings. An advisor suggests that a student register for three more credits in order to graduate. Credits at the end of a movie show who helped in the creation of the film. A credit to your bank account is always a nice surprise. In short, credit is a good thing.

Your financial credit (i.e., financial reputation) is a tool used by lenders, insurers, landlords, and even employers to quickly assess whether trusting you is going to be worth the risk. If your credit is good, you potentially pose less of a threat.

Think of credit as a rating system for an app on your smartphone. The more stars and positive comments about the app, the more likely you are to "take the risk" of downloading it on to your device. Lenders and others who wish to do business with you will check to see if you have good credit. Then they check your history for any negative behaviors — for example, not paying bills on time, taking out too many loans, or "maxing out" your credit cards (i.e., spending ALL of the available money in your account).

Says Who?

It was necessary for a third party, an outside, unbiased player, to create a system in which information from our behavior as borrowers (e.g., how many loans we have and how much money we have borrowed) could be recorded and analyzed in a way that would create a level playing field on which borrowers and lenders could exchange information. The lender records information about the behavior of its borrowers and sends it to the third party. The three third-party credit bureaus are Equifax, Experian, and TransUnion.

The information is then analyzed and recorded, which generates a score that is used by the lender to determine whether it is wise to engage in a financial relationship with the borrower. This pattern of information exchange is repeated as often as the borrowers engages in the act of using money from the lender, paying it back, or simply opening a new account.

Building Credit

Opening a credit account and making payments on time is the most effective way to build good credit. To be considered current and in good status, be sure that you are paying at least the required minimum monthly payment.

You can still make overpayments to the account, or pay it off early. But if you miss a payment, or do not make the full payment amount, your good standing will be negatively affected. The following types of credit lines can be used to establish or re-establish credit (NCUA, 2017):

1. Secured credit card: You supply a financial institute with a finite amount of money (e.g., $500). The financial institution will then issue you a credit card with that same limit. The $500 is held as collateral while you use the credit card for everyday purchases. The goal is for you to charge on this credit card and then pay off the balance when the bill comes due. That will build a healthy credit trade line (or account) on your credit report.*
2. Pledge Share Loan: This type of product is specific to credit unions. It is identical to the secured credit card. Instead of being issued an active credit line, you are given a closed end, installment loan (such as a car loan) without being issued any funds. Additionally, you may or may not need to give your financial institution a finite amount of money (i.e., $500).
3. Become a joint owner of someone else's credit account. But before you sign any documents, you want to make sure the following criteria is met (CUNA, 2017):

   A. You are a joint owner of a credit account in good standing: Simply put, if you're wanting to build your credit, you want to be a joint owner on a credit account that is in good standing and will continue to grow as either one of you makes payments.

   B. Someone is making the monthly minimum payments: Being a joint owner means that BOTH of you are responsible for the repayment of the loan. That is, both of your credit scores will be affected positively or negatively by how the account is managed.

   C. The primary owner of the credit account dictates what happens: The primary holder can decide to close the account after the balance is paid, or can decide that he or she doesn't want anyone else on the account and sign you off as a secondary owner.

Bibliography

Secured credit cards. National Credit Union Association. https://www.ncua.gov/Pages/default.aspx

Account ownership. Credit Union National Association. https://www.cuna.org/

Notes: * If for some reason you neglect to make a payment on your credit card, the collateral is utilized to make that missing payment. At that point, the credit card is frozen until you compensate the amount deducted from the collateral. Depending on your payment history with the financial institution, you may be eligible to apply to have the collateral released to you and maintain the credit line, which will act as any type of credit card.

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