

# Establishing Credit

## Introduction

Remember the fable of the boy who cried wolf? The shepherd boy made up so many stories about seeing a wolf in the pasture that when he actually did see one, no one in the village believed him or answered his cries for help. If he had been honest and trustworthy in the beginning, his story would have been accepted when he was in real trouble.

This fable also says something about what is needed in order to establish a good credit history. People who borrow money and don't return it, or who are consistently late in making payments on loans, will have a bad credit record. They will not be trusted because of their past history and will have trouble getting loans or credit cards in the future. More important, being turned down for credit can have unfortunate consequences: perhaps no college financial aid, or no new car, no house, furniture, or even an mp3 player or computer.

This lesson will help you understand the importance of establishing a good credit history. By being a responsible borrower in small things, you can develop good habits that lead to a favorable credit record. Then, when you are older, you will avoid problems when applying for a loan for big-ticket items, such as a car or a house.

## Vocabulary

**Collateral:** Property or other valuables used as security to guarantee the repayment of a loan. The lender can claim collateral if the borrower fails to repay.

**Credit bureau:** A firm that collects borrowers' credit histories.

**Credit report:** A history of a borrower's use of credit. You should get a copy of your credit report once a year to ensure there are no mistakes.

**Credit score:** A score used to evaluate a borrower's credit worthiness and likelihood to repay a loan. Credit scores are based primarily on a borrower's payment history and the amount owed. Other factors used in determining credit scores include how long you have had each account, the mix of types of credit used (credit cards and loans) and factors related to any new credit account that has recently been opened.

**Debt to income ratio:** A measurement of how much of your income is being spent on debt. Many financial advisors suggest that you keep debt levels below 15 percent of your net income and that debt levels of 20 percent of your net income are dangerously high. This limit does not include mortgage payments.

# Completed Loan Application and Credit Report - Applicant 1

## Loan Application, Part A

Loan amount requested: \$10,000      Length of loan: 4 years  
 Monthly payment: \$240      Reason for loan: Buy a used car

### Personal Information:

(A) Applicant's name: James Paul Anderson      Date of birth: 9-2-82

(S) Spouse's name: Judith Rice Anderson      Date of birth: 9-29-83

Marital status (please mark one):  single  married

Address: 704 Houser Street      Social security #: (A) 002-92-8976

City: Leslietown      (S) 202-35-7653

State: VA      Zip: 24523

Phone: (703) 927-0909

Dependents:	Relationship:	Age:
<u>Sean Stuart Anderson</u>	<u>son</u>	<u>6 mos.</u>

Education (record only your highest level of education attained):

(A) High school diploma      (S) High school diploma

Employment (list only the current jobs held by you or your spouse):

(A) Construction laborer      (S) Homemaker  
Building Contractors, Inc.

Household gross annual employment income: \$40,800

Approximate net annual employment income: \$34,350

Other income: none

Monthly net income: \$2,863

Do you:  own  rent  live with others?

Monthly mortgage or rent expense: \$655

Adapted from *Personal Finance Economics, 6-8: Money in the Middle*  
 ©Council for Economic Education, New York, NY, 1996.

### Loan Application, Part B

**Current Loans Outstanding** (List the lender, loan type, balance owed, monthly payment, and remaining period of loan):

1) Seventh Bank	Personal loan	\$1,960	\$180	11 mos.
2) You Buy It Now	TV/furniture	\$2,000	\$ 90	32 mos.

**Credit cards** (List the name of the lender, type of card, current balance outstanding, typical monthly payment):

1) Seventh Bank	VIDA Card	\$2,500	\$62
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**References** (You must list in the designated order: your current employer, previous employer, and nearest relative not living with you):

1) Samantha Sternwell	Building Contractors, Inc	(703) 927-7623
2) Jason Briddet	Skyscrapers, Incorporated	(703) 937-8354
3) Martha S. Anderson	Leslietown, VA	(703) 927-0098

**Purpose of loan:** We would like to buy a newer car. Our current car is not reliable and needs repair. We would like to borrow \$10,000 for four years and think we could afford a monthly payment of \$240.

### Credit Report

James P. and Judith Anderson

Financial Information	Item	Balance/Value
Checking accounts(s):	Seventh Bank	\$3,000
Savings accounts(s):	Seventh Bank	\$2,000
Investments:	none	
Real estate:	none	

#### Reference Information

- Landlord: Always pay rent on time. Excellent tenant. Good neighbor to others in building.
- Seventh Bank: New customer but timely with payments. They took out a personal loan last month, have had their credit card for six months, and have been paying the minimum on their balance each month.
- You Buy It Now: Recently opened their account. Timely payments so far.

# Completed Loan Application and Credit Report - Applicant 2

## Loan Application, Part A

Loan amount requested: \$38,000      Length of loan: 5 years  
 Monthly payment: \$773.00      Reason for loan: Buy a sporty new car

### Personal Information:

(A) Applicant's name: Joey Deligh      Date of birth: 1-5-80  
 (S) Spouse's name: \_\_\_\_\_      Date of birth: \_\_\_\_\_

Marital status (please mark one):  single     married

Address: 9191 Edgemare Drive      Social security #: (A) 778-90-6732

City: Leslietown      (S) \_\_\_\_\_

State: VA      Zip: 24523

Phone: (703) 927-1112

Dependents:	Relationship:	Age:
<u>none</u>	_____	_____

### Education (record only your highest level of education attained):

(A) Bachelor of Science in Marketing (S)  
University of Leslietown

### Employment (list only the current jobs held by you or your spouse):

(A) Advertising Executive (S)  
Billboards Galore

Household gross annual employment income: \$91,100

Approximate net annual employment income: \$64,320

Other income: \$ 2,000

Monthly net income: \$ 5,527

Do you:  own     rent     live with others?

Monthly mortgage or rent expense: \$1,054

### Loan Application, Part B

**Current Loans Outstanding** (List the lender, loan type, balance owed, monthly payment, and remaining period of loan):

1) Sixth Bank _____	Personal business _____	\$ 9,000 _____	\$500 _____	57 mos. _____
2) Sixth Bank _____	Auto _____	\$ 286 _____	\$290 _____	1 mos. _____
3) Wildcat Lenders _____	Education _____	\$19,500 _____	\$348 _____	67 mos. _____

**Credit cards** (List the name of the lender, type of card, current balance outstanding, typical monthly payment):

1) Sixth Bank _____	VIDA Card _____	\$8,500 _____	\$125 _____
2) Sixth Bank _____	Charge-It-Meter _____	\$5,000 _____	\$ 75 _____

**References** (You must list in the designated order: your current employer, previous employer, and nearest relative not living with you):

1) Hayward Stephens _____	Billboard Galore _____	(803) 937-9998 _____
2) No previous employer _____	_____	_____
3) Ronald Deligh _____	Winston, CA _____	(909) 843-1121 _____

**Purpose of loan:** I would like to buy a new car. I am about to pay off my current car and don't want it anymore. If I borrow \$38,000 for five years, my payment would be \$733 per month and I could get a sporty new car.

### Credit Report

Joey Deligh

<b>Financial Information</b>	<b>Item</b>	<b>Balance/Value</b>
Checking accounts(s):	Sixth Bank	\$ 600
Savings accounts(s):	Sixth Bank	\$ 1,200
Investments:	IMF Mutual Funds	\$ 6,000
Real estate:	9191 Edgemare Dr.	\$12,000*

\*Value of home less than what is owed on its mortgage.

#### Reference Information

Mortgage Holder:	Frequently late making payments. Currently behind one monthly mortgage payment.
Sixth Bank:	Has two outstanding loans and two credit cards with our bank. Has been late with payments in the past. Currently up to date with both loan payments. However, credit cards are at their maximum credit limit and he has been paying the minimum payment on balance owed.
Wildcat Lenders:	Always pays on time.
Ronald Deligh (father):	Is willing to co-sign on a loan.

# Completed Loan Application and Credit Report - Applicant 3

## Loan Application, Part A

Loan amount requested: \$25,000 Length of loan: 7 years  
 Monthly payment: \$340.00 Reason for loan: Buy a boat

### Personal Information:

(A) Applicant's name: Claudette Ransdia Date of birth: 12-08-63

(S) Spouse's name: Landon H. Ransdia Date of birth: 8-01-64

Marital status (please mark one):  single  married

Address: 5608 Uptown Street Social security #: (A) 209-96-1746

City: Leslietown (S) 207-33-7330

State: VA Zip: 24533

Phone: (703) 937-1990

Dependents:	Relationship:	Age:
<u>S. Olivia Ransdia</u>	<u>daughter</u>	<u>16</u>
<u>John S. Ransdia</u>	<u>son</u>	<u>13</u>
<u>Erin E. Ransdia</u>	<u>daughter</u>	<u>12</u>

### Education (record only your highest level of education attained):

(A) Juris Doctor (S) Master of Arts in Education  
James Madison University University of Wyoming

### Employment (list only the current jobs held by you or your spouse):

(A) Attorney (S) Teacher  
Jones, Barnett, & Cline Leslie County Middle School  
Attorneys at Law

Household gross annual employment income: \$168,000

Approximate net annual employment income: \$118,332

Other income: \$ 2,000

Monthly net income: \$ 10,028

Do you:  own  rent  live with others?

Monthly mortgage or rent expense: \$1,500

**Loan Application, Part B**

**Current Loans Outstanding** (List the lender, loan type, balance owed, monthly payment, and remaining period of loan):

1) Leslietown Bank	<u>Auto</u>	<u>\$ 4,300</u>	<u>\$145</u>	<u>33 mos.</u>
2) Leslietown Bank	<u>Auto</u>	<u>\$ 8,000</u>	<u>\$247</u>	<u>38 mos.</u>
3) Leslietown Bank	<u>College</u>	<u>\$21,000</u>	<u>\$293</u>	<u>93 mos.</u>
4) Leslietown Bank	<u>Motor Home</u>	<u>\$26,000</u>	<u>\$587</u>	<u>57 mos.</u>

**Credit cards** (List the name of the lender, type of card, current balance outstanding, typical monthly payment):

1) Leslietown Bank	<u>VIDA Card</u>	<u>\$250</u>	<u>in full</u>
2) Leslietown Bank	<u>Charge-It-Meter</u>	<u>\$750</u>	<u>in full</u>
3) AmeriPlan Bank	<u>Explorers</u>	<u>\$6,750</u>	<u>\$1,000</u>

**References** (You must list in the designated order: your current employer, previous employer, and nearest relative not living with you):

1) (A) Reginald Jones	<u>Jones, Barnette &amp; Cline</u>	<u>(703) 591-4325</u>
	<u>Attorneys at Law</u>	
1) (S) Janis Franken	<u>Leslie County Schools</u>	<u>(703) 927-4443</u>
2) No previous employer	<u></u>	<u></u>
3) Mia Ransdia	<u>Band, KY</u>	<u>(502) 224-2224</u>

**Purpose of loan:** We would like to buy a boat. We vacation every summer at the lake and the kids like to water ski. We would like to borrow \$25,000 for seven years and think we could afford the monthly paymeny of \$340.

**Credit Report**

Landon H. and Claudette Ransdia

<b>Financial Information</b>	<b>Item</b>	<b>Balance/Value</b>
Checking accounts(s):	Leslietown Bank	\$ 2,500
Savings accounts(s):	Leslietown Bank	\$ 1,000
	AmeriPlan Fund	\$ 4,000
Investments:	AmeriPlan Fund	\$22,000
	Digitiec Corp. Stock	\$16,000
Real estate:	5608 Uptown St.	\$67,000*

\*Value of home less than what is owed on its mortgage.

**Reference Information**

Mortgage Holder:	Always pays mortgage on time. We have been doing business with the couple for 20 years.
Leslietown Bank:	Currently, we have four loans and two credit cards with the applicants. Have never been late with a payment in 20 years.
AmeriPlan Bank:	Monthly credit card balance fluctuates between \$8,000 and \$0 each year. Highest balances in late summer and the lowest in early spring.

# Completed Loan Application and Credit Report - Applicant 4

## Loan Application, Part A

Loan amount requested: \$12,000 Length of loan: 5 years  
 Monthly payment: \$239.00 Reason for loan: Purchase a motor home

### Personal Information:

(A) Applicant's name: Mr. Rhett Willis Date of birth: 11-14-65

(S) Spouse's name: \_\_\_\_\_ Date of birth: \_\_\_\_\_

Marital status (please mark one):  single  married

Address: 14 Town Street Social security #: (A) 402-48-3278

City: Leslietown (S) \_\_\_\_\_

State: VA Zip: 40533

Phone: (883) 927-3345

### Dependents:

Mary Jo Willis

### Relationship:

daughter\*

### Age:

11

Melanie Willis

daughter\*

9

\*Mr. Willis's daughters live with their mother, who receives \$450 in child support each month from their dad.

### Education (record only your highest level of education attained):

(A) Associate's Degree (S) \_\_\_\_\_

Leslietown Community College

### Employment (list only the current jobs held by you or your spouse):

(A) General Electrician (S) \_\_\_\_\_

Self-employed

Household gross annual employment income: \$48,000

Approximate net annual employment income: \$38,076

Other income: \$ 10

Monthly net income: \$ 3,174

Do you:  own  rent  live with others?

Monthly mortgage or rent expense: \$871



### Loan Application, Part B

**Current Loans Outstanding** (List the lender, loan type, balance owed, monthly payment, and remaining period of loan):

1) Leslietown Bank      Auto      \$ 9,000      \$250      60 mos.

**Credit cards** (List the name of the lender, type of card, current balance outstanding, typical monthly payment):

1) Our Town Bank      VIDA Card      \$2,000      \$55

**Purpose of loan:** I would like to buy a used motor home which is priced at \$12,000. I think I can pay \$239 a month over 5 years for the motor home.

### Credit Report

Mr. Rhett Willis

Financial Information	Item	Balance/Value
Checking accounts(s):	Sixth Bank	\$1,250
	Sixth Bank	\$2,900
Savings accounts(s):	Sixth Bank	\$600
Investments:	none	
Real estate:	none	

#### Reference Information

Landlord:	Mr. Willis has been a tenant for four years. He always pays his rent, although he has been late a couple times in the last six months.
Our Town Bank:	Long-standing customer. Credit cards have outstanding balances, but he has made payments on them in a timely fashion.
Leslietown Bank:	Always pays auto loan on a timely basis.
Clarence Mims:	Mr. Willis was a faithful and dedicated employee for 15 years before he resigned six months ago to start his own business. He buys equipment and supplies from us and always pays on time.
Thomas Willis (father):	Cannot co-sign on a loan. He is elderly and has a limited, fixed income.

NAME: \_\_\_\_\_ CLASS PERIOD: \_\_\_\_\_

# Applicant Summary Sheet

What does the loan application and credit report tell you about the following:

A. The applicant's character: \_\_\_\_\_

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B. The applicant's capacity: \_\_\_\_\_

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C. The applicant's collateral: \_\_\_\_\_

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D. Percent of income currently spent on debt (other than mortgage payments)? \_\_\_\_\_

(Hint: debt payments of 15 percent of net income are usually manageable; debt payments of 20 percent or more can be dangerously high.)

E. Percent of income spent on debt if you include the new loan payment? \_\_\_\_\_

Would you lend money to this applicant? Yes \_\_\_ No \_\_\_

Explain why or why not: \_\_\_\_\_

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## Character Counts (So Do Capacity, Collateral, and Credit Scores)

**Character:** You may be a fine, upstanding citizen, but if you want to borrow money, you are going to have to prove it to lenders. When you are being evaluated for a loan, the lender will review your credit history as shown on your credit report. Your credit report is a detailing of the credit you are currently being granted, the credit you have been granted in the past, and how well you maintained that credit. The lender will review your credit report and credit history, watching for the following:

- Your bill-paying history: who has extended you credit in the past and your record of paying your debts on time.
- Your history of managing other finances, such as a checking account.
- Your identification and employment information, including your income, whether or not you own a home, how long you have lived at your current residence, and how long you have been at your current job.
- Your public record information, such as bankruptcies, foreclosures, and tax liens.

Young people seeking to borrow money often will discover one little problem with demonstrating their character: they can't get credit without a credit history, and they can't get a credit history without someone offering them credit. Okay, it's actually a big problem. However, there are ways to solve it. A person can begin to build a credit history in the following ways:

- Open a checking or savings account. Maintaining a checking or savings account in a responsible manner indicates stability and good money-management habits. Don't bounce a check!
- Establish a department store credit card. Department stores may allow you to open an account with a low credit limit.
- Obtain a small starter loan or credit card. Consider using a savings account as collateral for a small loan at a bank. Or ask your bank officer for a "starter" credit card, which has a low credit limit or can be secured by the cash in a savings account. Borrow only what you can comfortably repay. If you obtain a credit card, pay the entire balance on time, each month!
- Have your utilities and phone billed in your name. Paying your bills on time is an indication that you are creditworthy.
- Get a co-signer for a loan. Ask a friend or family member to co-sign a loan for you. Be sure to pay the loan off as agreed. If you don't pay, your co-signer will have to pay.

**Capacity:** The lender will want to know if the borrower can afford to repay the loan. To make this determination, the lender will review the following:

- Income from all sources—to make sure the borrower has enough income to make the payments.

- Other assets, such as investments and money in savings accounts that can be liquidated if necessary to make a payment.
- Current debts: Many financial advisors consider 20 percent of your take-home pay, or net monthly income, to be the maximum you should spend on consumer debt. (This amount does not include mortgage payments.) A limit of 15 percent of net monthly income is a safer level of debt.
- Net worth (the difference between everything you own and everything you owe).

**Collateral:** Perhaps you've heard the complaint that banks only give loans to people who don't need them. In other words, some loan applicants are told they can't get a loan because they have no assets (things of value). Their response? "If I had assets, I wouldn't need a loan!" This is an exaggeration. Lenders want to know that borrowers have something of value—collateral—that could be sold to repay the loan just in case the borrower defaults (doesn't repay). The lender will review the following:

- The fair market value of the collateral (a car, a house).
- Insurance on collateral—to repair or replace it if it is damaged.

Often the collateral for a loan is the item for which the borrower took out the loan. For instance, if you borrow money to purchase a car, the lender will use the car as collateral. If you don't make your payments, the lender will take possession of the car. You must carry insurance on the car in case it is damaged. That way, if the car is damaged, your insurance will pay for the repair, and the value of the collateral (the repaired car) is maintained. Even if the car is damaged beyond repair, the insurance company will pay the value of the car, and the lender will not lose the loan money.

Lenders request information regarding the three "Cs" (character, capacity, and collateral) to determine the level of risk they will be assuming by lending money to the applicant. Risk is uncertainty of repayment. The higher the risk, the higher the interest rate. Keep in mind that, if the borrower fails to repay the loan, the lender's profits will be reduced. A person with a very poor credit history may only be able to get credit at a very high rate of interest.

**Credit Scores:** Lenders also use credit scores to make decisions about loans. Credit scores are based on credit histories. Credit reporting agencies summarize the information they have in their report of your credit history by scoring it, using a statistical model. Your credit score serves as another measure of your credit risk. One commonly used model (FICO) was developed by Fair, Isaac and Company, Inc. FICO scores range between 350 and 850—the higher the number, the better the score and the more likely the borrower will be granted a loan at a low interest rate. Credit scores are also used by insurance agencies and employers to make decisions. A very good place to get your credit report is the Annual Credit Report web site: [www.annualcreditreport.com](http://www.annualcreditreport.com).

NAME: \_\_\_\_\_ CLASS PERIOD: \_\_\_\_\_

## Using Your Evaluation Skills

You are the loan officer for Sixth Bank in Leslietown. You have received a completed loan application from one of your customers, Rhett Willis. Evaluate the loan application for Rhett Willis found in Exercise 16.1D. Then complete the following:

What does the application from Rhett Willis tell you about the following:

A. His character? \_\_\_\_\_

B. His capacity? \_\_\_\_\_

C. His collateral? \_\_\_\_\_

D. Percent of income currently spent on debt? \_\_\_\_\_

(Hint: debt payments of 15 percent of net income are usually manageable; debt payments of 20 percent or more can be dangerously high.)

E. Percent of income spent on debt with new loan payment? \_\_\_\_\_

Would you lend money to this individual?      Yes \_\_\_\_\_ No \_\_\_\_\_

Explain why or why not:

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