Types and Sources of Consumer Credit - Part 1: Types of Credit

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Not many years ago a prospective borrower's credit alternatives were limited, in terms of both the kinds of loans that were available and the types of lenders which were actively making those loans. Today there are many different types of consumer credit that are available from a wide variety of sources. Some loan agreements specify equal monthly or annual payments, while others require a large single payment of both principal and interest. Some loans require nothing more than a borrower's promise to pay (in other words, a note); others necessitate that the borrower pledge certain assets as collateral to guarantee repayment of the loan.

Consumer credit can be divided into two broad categories: installment credit and noninstallment credit. **Installment credit**, also called *closed-end credit*, includes loans that require the borrower to repay the principal mount in equal periodic payments, usually monthly. A loan to purchase an automobile is one example of installment credit. It's also a popular method of financing other high-end appliances and electronics, such as refrigerators, washing machines or computers. The lender will ordinarily retain the title to the property (if one exists) until the loan is paid completely. These fixed-payment loans typically provide the borrower with very little repayment flexibility.

Noninstallment credit, which essentially includes all forms of consumer credit other than fixed-payment loans, is comprised of single-payment loans and loans that permit the borrower to make irregular payments and to borrow additional funds without submitting a new credit application. This latter type of loan is also known as *revolving-* or *open-end credit*.

Single-payment loans (or term loans) require the repayment on a specified date of the entire amount that was borrowed. Term loans may demand periodic interest payments, but more often than not require the accumulated interest to be paid at the same time that the loan's principal is due.

Open-end credit allows the borrower to draw out additional funds as they're needed, so long as the total outstanding loan balance doesn't exceed a predetermined limit, known as the credit limit or line of credit. *Charge accounts* (such as Sears and J.C. Penny) and *credit card accounts* (like MasterCard and Visa) are the most common examples of open-end credit. These types of accounts permit a continuous source of credit. The borrower reduces the debt by making payments and can also add to it by borrowing, or charging, addition amounts without having to reapply for credit. Generally, open-end credit accounts allow irregular or partial payments to be made subject to a predetermined periodic minimum amount established by the lender. This minimum may be a stipulated dollar amount or a percentage of the outstanding balance.

A ***personal line of credit*** allows the borrower to draw out funds as needed, generally by the use of special checks supplied by the lender. The checks can be used to pay for goods and services or deposited into the borrower's checking account. The line of credit permits the borrower to obtain and repay funds at his or her convenience, subject to the line's maximum amount. Interest charges are based on the amount of the outstanding balance and the length of time the funds remain unpaid.

Home equity loans use the equity (the market value of a property less any outstanding loans against it) of a borrower's home as collateral and can be structured either as a line of credit (*HELOC*) or as an installment loan (*HEL*). They are convenient forms of borrowing money at a very competitive interest rate.

Travel and entertainment (T&E) accounts, offered by American Express, Diners Club and other financial services companies, provide credit for a specified period (generally thirty days), at which time the entire outstanding balance must be paid in full. They do not permit partial-payment of their bills, and they're generally accepted by fewer merchants when compared with Visa or MasterCard. T&L companies also tend to be more selective regarding the applicants who are approved to receive their credit cards.

Thirty-day accounts permit customers to defer payment for purchases made by up to thirty days without incurring interest charges; the full amount, however, must be paid by the due date. *Service credit*, which is offered by utility companies, doctors, and other suppliers of services, allow customers to make payment fifteen to thirty days following the date that the service is provided, with no interest charges being accrued.

In Part 1 of *Types and Sources of Consumer Credit*, the numerous kinds of credit accounts available to potential borrowers was examined. This article will attempt to expound upon the various types of credit sources, or lenders, which make the use of credit possible for the borrowing public.

Lenders vary in the qualifications which they require of borrowers, the interest rates and fees that they charge, and the types and lengths of loans that they'll make. Being acquainted with the characteristics and requirements of a diversity of credit sources will ultimately help borrowers to better determine which lenders are more likely to provide the type of financing that they need.

+ 1 ***Commercial banks*** generally offer a greater variety of credit than do other lenders. Banks can offer credit cards, lines of credit, term loans and installment loans, both on a secured or an unsecured basis. Most will make loans for cars, boats, home purchases, taking a vacation, paying off another loan, investing in a business, paying taxes, or a myriad of other reasons. As a general rule, they tend to be rather selective, choosing to make loans to individuals and businesses with established credit histories.

2 At one time ***savings & loan*** *associations* were restricted to making residential real estate loans. Federal deregulation led to numerous speculative and risky lending practices, which precipitated the massive S&L failures of the late 1980s. The associations which survived gravitated back to a concentration on residential and commercial real estate lending. Most of the larger S&Ls operate in a manner which is identical to that of commercial banks.

+ 3 ***Credit unions*** are cooperative associations that accept savings from and make loans to member individuals. People who qualify for membership (normally by way of a job or organizational affiliation) must purchase a credit union *share* in order to activate their membership status and participate in the financial services which are offered. Credit unions operate in much the same way that commercial banks do, offering most types of consumer credit. Their rates may be found to be slightly lower, however, due in part to usually lower overhead costs. Maximum loan amounts may also not be as quite as large as those of commercial banks or S&Ls.

— 4 ***Consumer finance companies*** concentrate on making installment loans and second mortgages. Consolidation loans are popular among customers of this credit source. Finance companies are generally more willing to make relatively small loans that commercial banks and S&Ls frequently avoid. These lenders are more likely to approve loans for applicants with bad or no credit histories; however, the interest rates that they charge are considerably higher. The worse an individual's credit file, the greater amount of collateral that a finance company may require before it approves a loan. High interest rates and fees make this a credit source to be wary of.

+ – 5 ***Sales finance companies*** are formed to lend money to customers of an affiliated company. For example, Ford Motor Credit Company acts as a credit source to car buyers at Ford dealerships. Sales finance companies periodically offer borrowers particularly attractive interest rates or financing offers in order to stimulate business at the affiliated company. Without this special financing, loans from this credit source, while likely being convenient, will probably be somewhat more expensive than similar loans from commercial banks or credit unions.

6 ***Life insurance companies*** are a source of credit for certain policyholders who own policies that include a savings component, or *cash value*. Life insurance loans carry relatively low interest rates compared to the rates of comparable loans from other lending institutions. Borrowers should be aware that utilizing this source of financing actually involves borrowing one's own money, and any loan amount that is outstanding at the time of the insured's death is deducted from the policy's death benefit.

7 ***Brokerage** firms* are a source of credit for investors who have securities on deposit in a *margin account*. The maximum that can be borrowed depends upon the market value of the securities owned and the percentage of this value that the brokerage firm will lend. The borrower may be required to put up additional collateral if the value of the securities in the account declines. Money borrowed against securities is not limited to investment needs, but can be used for any purpose.

8 ***Pawnbrokers*** offer short-term, single-payment loans secured by personal property which is left in the possession of the lender. The pawnbroker can sell the property in the event that the loan and accumulated interest isn't repaid on the due date. Although providing quick access to cash for individuals with bad credit and no alternative source of funding, this credit source tends to be quite expensive because of the extremely high interest rates charged.

Credit Card Types

There are so many different types of charge and credit cards, how you find the card that is right for you? Begin by thinking about how you are likely to use credit and then comparing the types of charge cards and credit cards available. Some of them offer excellent value, while others may cost more to use but provide special services you may find helpful. The best approach is to carefully research card rates, fees and benefits—perhaps even creating a chart for easy comparison.

Charge cards provide you with the convenience of purchasing power based on your agreement to pay the full amount of the charges due each month, so there is no finance charge. The American Express Card for Students (the green Card) is an example of a charge card.

Credit cards provide you with a revolving loan—or credit limit—based on your agreement to pay at least the minimum amount due on the amount of credit you use by the payment date. A finance charge is applied to the outstanding balance—the amount you do not pay by the due date. For example, if you purchase $200 in one month and you pay the minimum amount due of $15, you will pay a finance charge on the outstanding balance the next month. The American Express Credit Card for Students (the blue Card) is an example of a credit card.

You can avoid paying finance charges by paying your balance in full—that is, paying off the outstanding revolving loan balance. However, revolving credit cards give you the flexibility of making minimum payments when that is most convenient for you. The cost of this convenience is the finance charge.

Typically, credit cards have a revolving credit limit. That means that as soon as you pay for credit you

Single or limited-purpose credit cards are credit cards that can be used only in a specific store or group of stores, or for a specific purpose. The JCPenney Regular Charge Card and the Radio Shack Answer Plus are examples. Some people prefer to have separate credit accounts, such as a gasoline credit card, a credit card at a chain or specialty store, plus other cards.

have used, it becomes available again. For example, if you had a credit limit of $500, then spent $100, your available credit would be $400 until you repaid the outstanding $100, when your available credit would be $500 again.

General-purpose credit cards are credit cards that can be used to pay for just about anything, any where from clothes at department stores to meals at restaurantsas well as to get cash advances. American Express, Visa, MasterCard and Discover cards are examples. Many people prefer a general-purpose card because they can use it in many different establishments. Another advantage of using this type of card is that it combines many different types of expenses in a single bill, making

Premium cards such as Platinum or Gold Cards are charge or credit cards that offer additional benefits such as travel upgrades, special insurance or exclusive seating for concerts. Generally, premium cards require a substantial income and an excellent credit history, offer a higher credit limit, and may charge higher fees. To find out if you qualify for one of these cards, call the company's toll-free number to learn about application requirements and costs. Apply only if you fulfill the application requirements, and if the card provides you with benefits and services you believe to be worthwhile.

Affinity credit cards are associated with specific organizations and offered to people affiliated with those organizations. Generally, an affinity credit card is co-sponsored by the organization it is associated with, and the organization receives a percentage of the sales or profits generated by the card. The Penn State MBNA Visa Card is an example. Rates, fees and benefits of affinity cards vary widely, and may make these cards more expensive to use than similar, non-affiliated cards. People who use them generally do so to help support an organization or cause they care about.

Co-branded credit cards are co-sponsored by two companies and have benefits and rewards designed specifically for their joint customers. For example, the American Express Delta SkyMiles Card is a co-branded credit card for people who travel frequently on Delta Airlines that offers Cardmembers exclusive travel discounts and other benefits. Other popular co-branded cards are available to owners or prospective owners of automobiles, investors in mutual funds and credit union members.

Secured cards are credit cards guaranteed by a bank account or deposit made by the applicant. The credit limit is based on the amount of deposit and may be the same amount or larger. Secured credit cards are useful to establish or improve a credit record, particularly if someone has never had credit or has a poor credit history. The APR on a secured credit card is usually higher than on an unsecured credit card. Application and processing fees may also be required. Interest may or may not be paid on your deposit.

Stored-value or "smart" cards look like credit cards but are actually prepaid cards. A stored-value card has a set value which decreases as the card is used. For example, a $10 phone card is programmed to provide $10 worth of service. When the card value is depleted, you buy another card.

Smart cards are more flexible because they contain an integrated microship that can be programmed to provide information codes as well as financial information. The prepaid value of a smart card decreases as you use the card but can be increased by paying for additional value. Many colleges issue smart cards that give students access to food services, vending, photocopying, laundry, telephone and other purchases as well as access to the library, laboratories and other secured areas on campus.

Debit cards look like credit cards and can be used in many places where a credit card is used. The difference between a credit card and a debit card is that a debit card accesses the money in your bank or investment account to pay for purchases. The payment amount is transferred from your account to the merchant's account the same day—you do not have a "float" of a few days between the time of purchase and payment collection. An advantage of a debit card is that you can't spend money you don't have—you don't create debt—because you aren't buying on credit; you are paying with funds in your bank or investment account. A disadvantage is that debit cards are not subject to many of the consumer legal rights that apply to credit cards regarding returns, resolution of errors, fraud or other issues.

ATM cards are used to get cash and complete other transactions at a bank machine or automatic teller machine (ATM). Many ATM cards can be used in selected computer networks, such as Cirrus, HONOR, NYCE and STAR. For example, your ATM may work in any bank, supermarket or other store that is part of the Cirrus network.

ATM cards are increasingly being used as debit cards as well. Like all debit cards, the money for these purchases is transferred out of your account within that day's business cycle. If you aren't sure if your ATM card is also a debit card, you can call the Customer Service number on the back of your card and ask the representative.