How to Establish, Use, and Protect Your Credit

How to Establish, Use, and Protect Your Credit

What you need to know

Good credit is valuable. Having the ability to borrow funds allows us to buy things we would otherwise have to save for years to afford: homes, cars, a college education. Credit is an important financial tool, but it can also be dangerous, leading people into debt far beyond their ability to repay. That is why learning how to use credit wisely is one of the most valuable financial skills anyone can learn.

What Lenders Look For

Before creditors lend money, they need to be assured that the funds will be repaid. In other words, is the prospective borrower creditworthy? To find out, they ask for various types of information:*

Income & Expenses

Lenders will look at what you earn and your regular expenses, such as rent, utilities, food, and other ongoing items. The amount left tells them whether you can afford to take on additional debt.

Assets

Do you have assets that can serve as collateral? Lenders will look for things like bank accounts, insurance, and valuable items such as a house, if you own one.

Credit History

How do you manage debt? If you have credit cards or have borrowed money before, you have a history that shows prospective lenders whether you are creditworthy by revealing details about the amount of debt you already have, how many credit cards you have, and whether you make payments on time.

**Creditors obtain much of this information from your credit report, a computerized profile of your borrowing, charging, and repayment activities. For information on credit reports, see "Your Credit Report," a Federal Reserve Bank of San Francisco brochure.*

It's easy to qualify for credit if you have a good credit history, but what if you have never used credit before? This is a common problem for people who just started working, those who work in the home, people who always pay in cash, and those who do not have assets or accounts in their own names. For them, the first step is to establish a credit history.

How to Establish Credit

Begin by opening individual savings and checking accounts in your name. Over time, your deposits, withdrawals, and transfers will demonstrate that you can handle money responsibly.

Applying for a loan is another option, but be aware that this method of establishing a credit history will cost, since loans require the payment of interest.

You could take out a bank loan secured by the funds you have on deposit or by items you own, such as a car. You could also ask a friend or relative who has good credit to cosign a loan, which means that he or she shares liability for the loan with you.

You could also apply for department store and gasoline credit cards, which generally are easier to obtain than major credit cards. Before you apply for any credit, however, make sure you understand the terms. For example, how long is the grace period or the time you have to pay the current balance in full before finance charges are added? Is there an annual fee or other fees associated with the credit? If you believe that you will carry a balance, you need to know how finance charges are calculated.

Patience is important in this process. It takes time to establish credit and build a record of consistency in making payments to demonstrate your creditworthiness. And it is much better to go slowly and develop a strong credit record than to apply for too many credit cards or a loan that is larger than you can handle.

Start slowly, be cautious, keep track of your overall debt, and pay on time. Most importantly, remember that credit actually represents real money and has to be repaid with interest.

Protecting Credit

Once you have obtained credit, it is necessary to protect it. This means being careful with your credit, debit, and ATM cards, as well as your account and personal identification numbers (PIN).

Carry only the cards you expect to use, and keep the others in a safe place. Maintain a list of account and telephone numbers of the companies that issued your cards. Then, if the cards are lost or stolen, you can notify the companies quickly. If your notification is received before the cards are used, you have no legal responsibility for the bills; if it is received after the cards are used, your legal responsibility is $50 for each card.

Be cautious about giving anyone your account numbers, especially over the telephone when someone calls you. Save sales receipts to compare with your bill, and when you discard documents with account numbers on them, be certain that the numbers can't be read.

If you disagree with an item on a bill, you are responsible for notifying the creditor in writing within 60 days of receiving the bill. You should include your name, account number, the item you believe is in error, and the reasons why.

Common Reasons for Denying Credit

Among the most common reasons people are turned down when they apply for credit are:

- Too little time in current job or at current residence.
- Too much outstanding debt.
- Unreasonable purpose for requesting credit.
- Cosigner cannot take on additional debt liability.
- Errors on applicant's credit report.**
- Strict creditor's standards.

*** For information on correcting credit report errors, see "Your Credit Report," a brochure published by the Federal Reserve Bank of San Francisco.*

In general, creditworthiness must be determined on the basis of criteria that relate to your ability and willingness to repay debt. You cannot be denied credit based on your sex, marital status, race, religion, national origin, age, or dependence on income from public assistance.

If you are denied credit, the creditor must provide you with a written statement of the action and your rights, as well as the reason for denial or how to request the reason. For information on the laws applying to credit, see "Your Credit Rights," a Federal Reserve Bank of San Francisco brochure.

Improving Poor Credit

If you have fallen behind in your payments, begin immediately to repair your credit record. Here's how:

- *Face up to the problem.* Recognize that you are overextended, and contact your creditors to see if they will set up a new payment schedule that you can maintain. In any case, don't ignore your bills.
- *Immediately stop purchasing with credit.* Take your credit cards out of your wallet. Store them in a spot that is hard to reach, or even cut them up.
- *Consider consolidating debts.* You may find it easier to make a single payment rather than several. You might also get a lower interest rate that will make it easier to keep up with payments. Remember that debt consolidation is not a cure-all. You have to learn to control your spending to avoid future debt.
- *Contact a credit counseling organization.* You can obtain referrals for organizations in your area through the National Foundation for Consumer Credit, (800) 388-2227.
- *Don't expect miracles.* Don't believe companies that promise to fix a poor credit rating quickly and painlessly for a fee. As long as it is accurate and timely, negative information cannot be removed from your credit record. The only way to improve a credit record is to let time pass and establish a record of on-time payment.

Divorce and Credit

Aside from its non-financial effects, divorce can cause problems with your credit record. The end of a marriage does not erase the debts you and your former spouse took on as a couple. Even if your former spouse is ordered by the court to pay debts from the marriage, you can become liable if they are not paid. Here are a few suggestions to protect your financial standing:

- Decide how to divide or dispose of property. If necessary, you can use a mediator to work through this with your former spouse.
- Close or separate joint accounts. Decide with your former spouse who will be responsible for paying bills, and notify your creditors of your divorce.
- Establish independent credit, if you do not already have it.
- Make sure bills are paid.

Paying Off a Loan Early

If you are applying for a loan and think you may want to pay it off before it has run its full term, you should be aware that lenders have several methods of calculating interest. The method they use affects the amount you will owe if you decide to pay off early. Since lenders are not required to disclose which method they use, you may have to ask. Here is a brief description of the most common interest-calculation methods.

Rule of 78

This method uses tables based on a mathematical formula to determine how much interest you have paid at any point during a loan. It requires that you pay more interest at the beginning of a loan when you have the use of more of the money and that you pay less interest as the debt is reduced. Since all of your payments are the same in amount, the amount of your payment that is going toward the principal increases while the amount going toward interest decreases. State law may mandate the use of the Rule of 78.

Generally, the longer the term of a loan and the higher the interest rate, the less favorable the Rule of 78 is to borrowers who wish to pay off early. However, for loans of less than five years and with interest lower than 15 percent, the payoff calculated by the Rule of 78 is similar to that calculated with the actuarial method, described below.

Actuarial Method

This method is most often used for mortgages and other loans in which a periodic rate is applied to a declining balance. It does not take into consideration whether a payment is made before or after the due date. Late payments are subject to a flat penalty, but interest does not continue to accrue.

Daily Simple Interest

In this method, a daily periodic rate is applied to an outstanding balance. Therefore, borrowers benefit by reducing the outstanding balance through early payments or lump-sum payments, both of which reduce the balance and the interest due. Under a simple interest system, late payers will end up owing more.

For More Information

The Federal Reserve Bank of San Francisco has several other consumer brochures. These brochures are posted on our web site at: http://www.frbsf.org.

Learn about . . .

- ***Bank Products***
- ***Credit and Charge Cards***
- ***Frauds and Scams***
- ***Your Credit Rights***
- ***Private Mortgage Insurance (PMI)***
- ***Your Credit Report***
- ***Plastic Fraud***

Questions or comments about these brochures can be sent to:

Federal Reserve Bank of San Francisco
Public Information/Publications
P.O. Box 7702, MS 1110
San Francisco, CA 94120-7702
http://www.frbsf.org
(415) 974-2163 or
e-mail us at: pubs.sf@sf.frb.org

Questions and concerns about credit agencies and credit practices can be directed to:

Federal Trade Commission
Consumer Response Center - FCRA
600 Pennsylvania Avenue, NW
Washington, D.C. 20580
http://www.ftc.gov
(877) FTC-HELP

For information on organizations that help with credit counseling, contact:

National Foundation for Consumer Credit
8611 Second Avenue
Silver Spring, MD 20910
http://www.nfcc.org
(800) 388-2227