

## ESTABLISHING A CREDIT HISTORY

When you say you want credit, you are probably asking for payment terms on a purchase.

You are seeking to purchase goods or services today and forego all or a portion of the payment until a later date. You may or may not be bound by a payment plan. You may or may not be required to pay a percentage of the purchase price up front (down payment). You may or may not pay a fee (interest) in exchange for the privilege of buying now and paying later. In all cases, you are making a purchase and being trusted to make final payment at some time in the future.

### What is credit? Why is credit so important?

#### Credit provides you with financial flexibility and security

There are many reasons why you may seek credit. Here are a few examples:

- You move into your first apartment and don't want to sleep on the floor while you are saving up money to buy a bed. You need credit.
- Your blind date orders the lobster, champagne, and a chocolate dessert. You only brought \$40 cash. You need credit.
- You are traveling in another country with no access to your bank account and unexpectedly find a painting that will look great in your living room. You need credit.
- You are traveling through Big City, USA, when your car engine dies. You didn't anticipate such an emergency. You need credit.
- You can't live through the summer without a kidney-shaped swimming pool just like the one the neighbors got, but your savings are tied up in certificates of deposit that won't mature for another six months. By that time, it will be winter. You need credit.
- The local piggery is running a promotion on hindquarters of pork, a free barrel of scrapple and 2% financing to qualified buyers. You figure your money is making 3% in the bank. You can take the credit and net a gain of 1%. You need credit.

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Whether you're unable to make immediate payment, can't get access to your cash, are faced with unexpected circumstances or simply recognize the time value of money, credit allows you to obtain goods and services today that you will not have to pay for until a later date. Used responsibly, credit can help you improve the quality of your life, overcome financial obstacles and emergencies, and even (on rare occasions) save you money.

### **What does it mean to establish credit?**

#### **Establishing credit means establishing your reputation as a good credit risk**

When you make a purchase on credit, you are being trusted to make final payment at some time in the future. If you pay as agreed, the lender will likely want to do business with you again. If you don't pay as agreed, the lender will likely be less willing to extend credit in the future or will charge you a higher interest rate. As time goes by, you establish a reputation. If you have paid your bills, it will be said that you are a good credit risk, that you have good credit or that you have a good credit rating. This will enable you to obtain more credit from other lenders, in greater amounts.

If, however, you have not paid your bills or have consistently paid them late, it will be said that you have negative credit. You will develop a reputation as a bad credit risk. Lenders and collection agencies will label you as a no-pay, a slow-pay, a get-me-done, a deadbeat or just plain bogus. It will become increasingly difficult to get credit, even when you need it for an emergency.

#### **Lenders rely on credit reports to determine your reputation for creditworthiness**

Usually, lenders rely on information provided by credit-reporting agencies at some stage of the credit-granting process. These agencies collect data about credit transactions and attempt to keep accurate records on all borrowers in a particular area. There are at least three major providers of such information in the United States. For a fee, and with your permission, a lender can obtain a copy of your credit report and evaluate your reputation for creditworthiness (a limited amount of information can be gathered without your permission).

A typical credit report contains information about you, your address, your job and your income. Most importantly, it contains a history of your experience with lenders. It typically includes details about who you obtained credit from, how much you borrowed, when you obtained it, when you paid it back, whether you were late, how often you were late, whether there is any outstanding balance, whether any collection actions were taken and whether or not you filed for bankruptcy.

#### **Convenient access to credit is available only if you have established a favorable credit report**

If you want convenient access to credit, it is almost necessary to have a favorable credit history on file with a major credit-reporting agency. Lenders typically ask you to fill out a credit application when you are seeking credit (it is usually in the fine print of this application that you grant permission for them to obtain your credit report). However, information set forth in your credit application is likely to be seriously considered only if it is consistent with information obtained from a credit-reporting agency or verified independently (an inconvenient and time-consuming process).

Without a credit report, lenders have nothing to go on. It is easy for a lender to deny you credit when you have no credit history. Without a record of your credit experience, a potential lender deems you a mystery. The lender knows nothing about you or your reputation for creditworthiness. It may be easier for a lender to deny credit than to take

a risk or conduct an independent investigation. If you cannot get a credit application approved, then you won't be able to establish credit.

### **How do you get credit?**

#### **Get an income**

If you want to establish credit, you need a regular source of income. The income can be derived from a job, trust fund dividends, an allowance from your parents, government benefits, alimony, investment dividends or any other source. What is important is that you have some kind of continuing and predictable cash flow. Without regular income, you cannot demonstrate an ability to make regular payments. Establishing a regular source of income is your first step.

#### **Request credit from a lender who reports to a credit bureau**

All your efforts to establish a credit rating will be wasted if your lender does not report repayment information to a recognized credit-reporting agency. Lenders are not required to report. Ask about their policy before you apply for credit. If the lender reports, then ask for a credit application.

#### **Think small at first**

By thinking small, you limit the lender's exposure. Exposure is the lender's total potential loss. If you have never obtained credit before, do not make your first request a personal loan for \$40,000 with no collateral. This maximizes the lender's exposure. The lender might be willing to extend you credit but not if big money is at stake. Try applying for a small loan, perhaps \$500, and pay it off promptly. Then apply for another loan, perhaps a larger one. Eventually, you will have a solid credit relationship with that lender, and the credit activity will be reflected on your credit report.

#### **Choose a credit card with a low credit limit**

While thinking small, you may explore the chances of getting a credit card with a low credit limit. Major credit card companies frequently offer small lines of credit to groups such as college students or credit union members. If you are a student, look for applications in the back of campus magazines or in the school's bookstore. Check with your credit union. Your status as a group member may be enough to get you a card. Get it, use it and pay it off promptly. The activity will be reported to a reporting agency.

#### **Apply for a retail store charge card**

If you don't belong to a special group, try the local mall. Many retail stores issue charge cards, which are similar to credit cards, but can only be used at the issuing store. Most major retailers will offer charge cards to first-time borrowers. Ask for an application at the cash register or customer service counter. The interest rates are usually high and credit limits low for first-time borrowers, but if you use the card and pay your bills promptly, you will establish a credit rating. Furthermore, the store may sell your name and address to other retailers, who will mail you invitations to apply for their charge cards.

**Tip:** Most retailers offer a gift or discount for your first purchase on a new card.

#### **Make a large retail purchase and ask for credit terms**

Many retail stores offer credit terms for high-ticket purchases. If you are planning to make a large purchase from a retail store, use the opportunity to establish credit. Major appliance stores, furniture stores, video/stereo stores, computer retailers, home improvement outlets and jewelry stores (to name a few) will extend credit to first-time borrowers for the sole purpose of closing the sale. You can even find zero-interest deals

when shopping in competitive markets for high-ticket merchandise, such as jewelry. Check your local paper or listen to radio advertisements for special deals.

**Caution:** Many of the so-called zero-interest financing deals require that you pay off the entire balance by a certain date. If you fail, you must pay interest on the outstanding balance, retroactively from the date of purchase. Make sure you understand the risks before signing on.

### **Obtain a gas card**

Most major petroleum companies offer gas cards to first-time credit seekers. These can be used to purchase gas and services at any of the company's stations. The credit limit is low and the balance must be paid in full every month. Ask for a card at your favorite gas station, or check popular magazines devoted to travel, vacation, automobiles or business for applications and toll-free numbers.

### **Apply for an overdraft line of credit on your checking account**

Another way to start small is with your own bank account. Most consumer banks will provide a line of credit attached to your checking account. It is often called an overdraft account because it is designed to cover bounced checks.

Here is how it works. You have a checking account. You apply for, and are granted, an overdraft line of credit in the amount of \$500. Your checking account balance is \$40. You write a check for \$75. When the check is presented to the bank for collection, the bank does not return it for insufficient funds. Instead, it credits your checking account in the amount of \$100. Now you have a balance of \$140 in your account. The bank can honor the \$75 check, leaving you with \$65 in the account. The bank bills you monthly for the \$100. You can repay the \$100 all at once, or make minimum monthly payments. You will be charged interest and perhaps a service fee. Although it may not look like a loan, it is. Activity on these accounts is regularly reported by many banks.

### **Join a health club**

Many clubs that require annual membership fees can arrange financing. If you are planning to join a club, take the opportunity to establish credit. The club is probably not extending credit itself. It is probably working with a local bank or finance company that is willing to be permissive about approving club members' applications for credit. Find out who is extending the credit and whether they report payment activity.

### **Get help from someone with a good credit rating**

Reducing exposure is one way to make lenders more comfortable with your credit application. Reducing risk is another. Risk is the degree of likelihood that a loss will result. You can minimize the risk to a lender by providing a comaker, cosigner, or guarantor for your loan.

You may be able to reduce risk by having a parent or other relative cosign on a loan or credit card for you (most lenders require the cosigner to be related in some way). Cosigners should be aware that they are liable for any unpaid balances and that credit activity will be reported on their credit report, as well as yours. Generally, if your cosigner has a good credit rating, lenders will be satisfied that risk is minimized and will extend credit. You may be able to borrow enough for a car or even a home.

**Caution:** If you are getting help from parents to establish credit using a credit card account, make sure you are a joint cardholder and not just an authorized user. If you are merely listed on their account as an authorized user, then you are not legally liable for the debts. Using the card will not help you to acquire a credit history because it will not be included on your credit report.

### **Get the government to guarantee your loan**

If you are a full-time student at an institution for higher learning, you probably qualify for one or more government-guaranteed loans. Most government-guaranteed student loans are available even if you do not have a credit history. Lenders are willing to extend enormous amounts of credit under these plans because the government agrees to repay the loan if you don't.

**Caution:** Your failure to pay will be reported to the credit bureaus, and the federal government will pursue you for the unpaid balance.

**Caution:** It takes a long time to establish a credit history with student loans. If you are a freshman in college, your first-year loans may not become due and payable until six or nine months after you graduate. Until you start making payments on the loan, account activity will not be reported to a credit bureau. It could take years to establish a credit record in this manner.

### **Secure your credit with collateral**

When you secure credit, you give the lender collateral to back your loan. The risk is reduced for the lender. If you do not pay, the lender can use the value of the collateral to satisfy the debt. Collateral can be anything of value, but usually takes the form of cars or real estate. If you have something of value, but no credit rating, you may be able to acquire credit by offering to post your valuables as collateral.

**Caution:** Many large banks sell their secured loans to investors and cannot customize loan documents if unco nventional collateral is involved.

### **Get a secured credit card**

Many credit issuers offer secured credit cards. A secured credit card provides you with an open line of credit secured by a cash deposit. These types of cards typically come with a high interest rate. Here is how a secured credit card works. You give the credit card issuer a cash deposit. The credit issuer gives you a credit card with a credit limit equal to the cash deposit. You can charge up to the credit limit using the card, and then make monthly payments on the balance. If you fail to make the payments, the credit card issuer uses your cash deposit to cover the unpaid balance. If you make your payments as agreed, you will eventually establish credit and qualify for an unsecured credit card. The secured credit card issuer will return your deposit, less any unpaid balance due, when you cancel the account.

### **Make large down payments**

If you have not established credit, you can still obtain financing for major purchases (such as a new car) if you can afford to make a large down payment. A large down payment reduces the lender's exposure by reducing the loan amount. With a smaller outstanding balance, there is less at stake for the lender. The large down payment also makes your monthly payments lower and shows the lender that you are committed to making the purchase. Even if you have no credit history, you should be able to get financing for a reasonably priced car if you are willing to make a down payment of 20 to 50% of the purchase price. You will also need income sufficient to make monthly payments on the balance.

### **Consider insuring your credit**

Some automobile dealerships can arrange financing for people with no credit history by using repossession insurance. Here is how repossession insurance works. You make a standard down payment and agree to make payments on the balance of the purchase price. You also agree to pay premiums to an insurance company that will cover the lender's

loss if you fail to make payments and the car is repossessed. Repossession insurance (sometimes referred to as repo-insurance) is expensive, but it is one way to obtain a loan and begin establishing credit.

### **Increase your credit validation score**

Some lenders use scoring methods to determine your creditworthiness. They examine your credit application and, using a scoring sheet, determine a score that corresponds to the information you provide. If your score is over a certain number, you get a loan. The scoring system is based on statistics and historical data. Different lenders use different systems, and the points may change. The following list is a sampling of questions that could appear on a credit validation scoring sheet:

- a. Does the applicant have a checking account? 3 points
- b. Does the applicant have a savings account? 3 points
- c. How old is the applicant?

Under 20	0 points
20 to 30	2 points
30 to 40	3 points
41 and over	5 points

- d. Is there a phone in the applicant's house?

Listed?	5 points
Unlisted	2 points

- e. Does the applicant own a home?

If so	5 points
Rent unfurnished	3 points
Rent furnished	1 points

- f. How long has the applicant lived at his or her present address?

More than two years?	3 points
More than five years?	5 points

- g. Does the applicant have adequate income?

Yes	3 points
No	0 points

h. How long has the applicant been receiving income from his or her present source of income?

More than two years	3 points
More than five years	5 points

i. Applicant's education?

High School Graduate	2 points
College Degree	3 points
Masters degree	4 points
Pequivalent	5 points

j. Ratio of expenses to income?

Over 95%	0 points
90-95%	1 point
80-90%	2 points
Below 80%	3 points

These questions are only samples. Different lenders use different factors and assign varying levels of importance to each. However, once you have a general idea of what lenders are looking for, you may be able to manipulate some of the factors to maximize your potential score, get a loan, and begin to establish a credit rating. For example, according to this sample, you can increase your credit validation score by 11 points if you just obtain a telephone number and open a joint checking and savings account.

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