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Who Gives Credit and How Do They Decide

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Consumer credit includes both traditional and non-traditional sources. There are criteria for each source that lenders use to decide whether to give credit or not. This publication provides a description of available credit sources, and an explanation of what lenders look for before extending credit.

Sources of Credit for Consumers

Consumers may find credit available from the following sources:

- **Retailers** may give credit accounts and issue credit cards. Such credit may be from local, regional, or national retailers such as Dillard's, Target, or Sears.
- **Financial institutions** such as banks, credit unions, and savings and loans offer loans, lines of credit, and credit cards. Banks and savings and loans give credit to average and better credit risk people. Credit unions loan only to their members. Because credit unions are nonprofit, loan rates often are lower than from other financial institutions.
- **Finance companies** usually require collateral for installment loans and second mortgages. Interest rates usually are higher than those offered by financial institutions because they borrow from commercial banks to get the money needed for their loans. National finance companies include businesses such as Household Finance Corporation and Beneficial Finance Corporation.
- **Sales finance companies** such as General Motors Acceptance Corporation offer collateral loans only, and are tied to the seller. Loans may include lower special promotion interest rates. Some sales finance companies specialize in mail or loans over the phone, advertise via television, and may charge higher interest rates than other financial institutions. Cosigners may be required.
- **Pawnshops** are lenders offering a single payment loan for a short time (generally one to two months) based on the value of the item left for collateral. If the borrower fails to repay the amount due plus interest and reclaim the property by the due date, the pawnshop owner sells the item that was left as collateral.
- **Rent-to-own retailers** provide a way to buy something with little or no down payment. The item is rented for a specified time before it is owned by the renter. Late payments will result in the item being seized with no payback of what has already been paid in rent. The actual cost of rent-to-own items usually is very high because of the length of the loan.
- Besides cashing checks for people who do not have traditional accounts at financial institutions, **check cashing businesses** also give cash for a check and may hold the check for a week or more before cashing it, thus extending credit to the consumer. The fees for such services often are 20 percent or more of the amount cashed.
- **Rapid refund services** loan money based on the amount of a future income tax refund. The borrower also pays a fee for this service so the full tax refund is not received.
- **Life insurance companies** allow policyholders to borrow against the cash value of life insurance policies if the policy has cash value. Usually these loans have a low interest rate but you reduce the amount of death benefit coverage by the amount of any unpaid loan.
- **Friends and relatives** may be the only source of funds for very risky borrowers, those with no credit history, or without a reliable job. Any loans to friends or relatives should be business-like. The borrower should sign a written statement stating the amount borrowed, and the terms of repayment including the payment amounts, repayment schedule, and any interest.

How Do Lenders Decide

Before loaning money, formal lenders often use the five "C's" to determine whether they will extend credit to someone:

- *Character* is your honesty and past reliability in paying your bills on time. Late payments show on your credit report. Stability also is an aspect of character. Owning vs. renting housing, living at the same address for a number of years, and years of employment are considered signs of stability.

- *Capital* is a measure of financial net worth and the value of what is owned. Lenders look for more owned than owed but may not consider the primary mortgage as a debt since the house is collateral.
- *Capacity* is income available to repay the lender. Having a good income, the same job for a number of years, and not having many debts suggests strong financial capacity.
- *Collateral* is property or something of value pledged to guarantee repayment of a loan. If the loan is not repaid, the lender takes possession of the collateral. Lenders are more willing to loan money to people who have collateral in some form.
- *Conditions* including general and local economic conditions affect the ability to get credit. When there is a short money supply, it is harder to borrow money. When the local economy is tight, it's also harder to get credit.

You may need a *cosigner* if you don't meet the lender's criteria for getting a loan (character, capital, capacity, collateral, and conditions). A cosigner is someone who agrees to pay the loan if you fail to repay it. Cosigners must meet the lender's criteria.

If you cosign a loan for someone else, be sure you're willing to repay the debt. Be aware that a cosigned loan will affect your ability to get credit since the cosigned loan will be included on your credit record also.

Credit can no longer be denied solely on the basis of sex, race, marital status, national origin, age, or source of income.

Keys to Wise Credit Use

1. Live within your means. Don't use credit to buy what you can't afford.
2. Keep track of how much debt you owe in total, not just the monthly payments.
3. Do your homework. Shop around for the type of loan that fits your needs. Be sure to read all of the fine print before signing the credit contract.
4. Compare different sources for credit by looking at the annual percentage rate of interest (APR) charged, down payment amount required, length of loan or number of payments, other fees and penalties charged, monthly payment amount, and total amount to be repaid. Also note the cash amount of the loan and any special circumstances.

Resource

Garman, E. T. & Forgue, R. E. (2006). Personal finance (8th ed.). Boston MA: Houghton Mifflin Co.

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Index: Financial Management
Credit and Debt
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