Finance and Economics

EXTENSION UtahStateUniversity

extension.usu.edu

May 2014 Finance&Economics/Credit/2014-01pr

Different Types of Credit and How They Impact You

Lucas Martin, Extension Assistant Professor, and
Margie Memmott, Extension Associate Professor

What Is Credit?

Merriam Webster Dictionary defines credit as "The provision of money, goods, or services with the expectation of future payment." This means anytime something is provided in advance, before it is paid for, credit is being extended. Some credit is designed to simplify how goods or services are used. What would heating a home be like without credit? Imagine the frustration that could come from the gas company installing a slot on the furnace to insert quarters to pay for gas as it is used. Instead, they allow customers to use gas all month and then send them a bill. Likewise, if households had to purchase a home with cash, very few families could become homeowners.

Chances are, credit is a part of everyday life for most families. They might use credit for many things. Credit cards, buying a car or home, heat, water, phone and other utilities, furniture loans, student loans, and overdraft accounts are examples of credit.

In general, credit can be grouped into four broad categories: service, installment, revolving, and open credit (NYC Department of Consumer Affairs, 2013). The next section will look at each category or type of credit, identify examples, and examine why each is important. Some examples of credit may fit into more than one category.

Service Credit

Service credit is credit extended in the form of services, like utilities. Examples of service credit include heat, electricity, water, phones, and similar services.

Why is service credit important? Most families use service credit every day. Service credit is often one of the first forms of credit acquired by individuals starting out on their own. While service credit providers use credit scores to initially qualify customers for an account, most utility companies don't report on-time payments to the national credit bureaus. This does not mean it is acceptable to make late payments. Failure to pay on time can result in late fees and delinquent accounts. If a utility account goes to collections, it will be reported to the credit bureaus, hurting the customer's credit score and potentially giving future service credit providers a reason to deny applications or charge higher deposit fees.

Installment Credit

Installment credit is a loan for a specific amount of money that is repaid on a set timeframe. Examples of installment credit include car loans, mortgages, student loans, a loan for furniture, and most payday and check cashing loans.

Why is installment credit important? Installment loans give you access to many important goods. It is not uncommon for people to need to use an installment loan when making large purchases such as a car, home, or for education. Using most types of installment loans wisely can help improve your credit score. Paying installment loans on time will have a positive impact on credit scores.

It is important to realize that not all installment loans are of equal benefit. Some smaller organizations may not report on-time loan payments to the credit bureaus, meaning they won't help build credit scores! Where loans are obtained can also make a big difference. Even if you make on-time payments for payday loans and check cashing loans, just having them show up on a credit history will lower the credit score! Where possible, avoid borrowing from these types of institutions. When shopping for furniture or vehicles, avoid in-house financing as a general rule of thumb. If considering in-house financing, ask if the dealer or merchant partners with a bank or credit union to provide the loan. A loan from a bank or credit union is better for credit scores than one from a merchant or finance company.

Revolving Credit

A revolving loan has a specific credit limit; however, this credit limit can be reused as the loan is repaid. Most revolving accounts can stay open indefinitely. Examples of revolving credit include most credit cards, overdraft accounts, and home equity lines of credit.

Why are revolving loans important? Wise credit card use can potentially have a greater long term positive impact on a credit score than any other credit type. To use a credit card wisely, make a purchase at least once a month, pay at least the minimum payment on time each month, limit the amount borrowed on the card to less than 30% of the card's maximum amount, and keep the account for as long as possible (Bingham, 2011). While only the minimum payment is required, paying the account in full each month will keep the balance low and save the card user money by not having to pay interest fees. The longer the card has been open and in good standing, the greater the benefit to credit scores. Having two to three credit cards that are used wisely can greatly improve a credit score over time.

Credit cards can also be detrimental to a credit score if used poorly. Having too many credit cards, missing payments, and borrowing a large portion of the credit limit can hurt the credit score (Bingham, 2011). Research shows that consumers with credit cards often spend more than consumers using cash, in some cases paying up to 100% more for purchases (Prelec & Simester, 2001). The interest rates on credit cards are often very high; this means when credit card users choose to make minimum payments instead of paying the balance in full each month, they could end up paying much more for goods and services than they might realize.

Open Credit

Open loans have no maximum. Users can charge what they need, as they need it. However, an open loan must be paid in full each month. Examples of open loans include many business credit cards and diner cards. Utilities can also be thought of as open loans. For example, utility customers use as much water as they need, and at the end of the month they are billed for their total usage with the entire balance due the next bill.

Why is open credit important? Open credit cards, such as diner cards and business cards, will show on a credit report. Using them responsibly and paying the balance in full each month can have a positive impact on credit scores. Open credit in the form of utilities is also important. Failure to pay utilities in full each month can bring negative consequences. Utility companies may place a limit on trouble accounts, shut off services if the potential bill exceeds a specific amount, charge late fees, interrupt services on unpaid accounts, and deny services in the future as a result of bad credit scores or poor payment history.

Additional Credit Tips

- Use all types of credit wisely to improve credit scores and access to future credit. Pay all bills on time, keep balances low, and avoid having too many credit lines open at once. Good credit scores can also help secure employment, housing, and low interest rates on future credit.
- Limit the number of revolving accounts. Having more than two or three credit cards can reduce a credit score. Credit cards from national banks will have a greater impact than cards from credit unions, businesses, and merchants.
- Contact creditors if problems arise. Always contact a creditor if a payment cannot be made on time. Creditors are more likely to help customers who are proactive and let them know about problems.

- Avoid over borrowing. It can be tempting to obtain a loan for the largest house or nicest car. The larger the loan, the more the borrower pays in interest over time. Large loans can also impact an individual's ability to get new credit.
- Some borrowers have a hard time using credit cards responsibly. If individuals cannot consistently pay off their entire balance each month, they should consider making changes to the way they spend. Leaving the credit cards at home and only using them to pay a steady bill, like a utility bill, can be a good use of credit without the temptation to spend more than can be repaid on the next bill.

References

Bingham, A. (2011). *The road to 850* (2nd ed.). Layton, UT: CP Publishing

Federal Trade Commission (2012). *Consumer information: Utility services*. Retrieved from https://www.consumer.ftc.gov/articles/0220-utility-services.

NYC Department of Consumer Affairs (2013). *Debt /credit help-Credit basics.* Retrieved from http://www.nyc.gov/html/ofe/html/help/3types.shtml.

Merriam Webster Dictionary (n.d.). *Credit*. Retrieved from http://www.merriam-webster.com/dictionary/credit.

Prelec, D., & Simester, D. (2001). Always leave home without it: A further investigation of the credit-card effect on willingness to pay. *Marketing Letters* 12:1, 5-12.

This publication is issued in furtherance of Cooperative Extension work, acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, Kenneth L. White, Vice President for Extension and Agriculture, Utah State University.