



# ***Managing Money***

***Types of Credit:  
What Are Your  
Choices?***

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## **Types of Credit: What Are Your Choices?**

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The marketplace offers goods and services at competitive prices. Many people are good comparison shoppers when it comes to food or gas, but ignore the shopping opportunities for credit. Shopping for credit can save you money if you have good credit and shop for the best loans.

For example, if you are in the market for a washer and dryer, how many sources of credit might finance the purchase for you? Would they all charge the same rates of interest or have the same terms? Before answering these questions, read the following information that describes the three basic types of credit and the major sources offering credit.

### **Types of Credit**

**Consumer loans.** A consumer borrows an amount of money from a person or company regularly in the business of making loans, such as a credit union, bank or savings and loan institution. A consumer loan may be either secured by a product such as an automobile or furniture or unsecured based solely on the borrower's signature. The loan may be repaid in installment payments or as one lump sum—principal and interest. Consumer loans, however, are generally paid in regular installments.

When property is pledged for a secured loan, the property may be repossessed if payments are not made. Auto loans are examples of secured loans. Unsecured loans have no security and are made to people who have good credit ratings, often customers of the lending institution where

they do business. Interest rates may be higher on unsecured loans because there is no property to be claimed if the loan is not repaid.

**Credit sales.** The consumer buys goods or services and credit is arranged by the seller of the product. In most cases, the merchandise is used as security for the loan. Credit sales are frequently arranged for furniture and auto purchases and paid in regular installments.

**Credit cards** are offered by retail stores, credit unions, and banks. Finance charges are added each month whenever there is an outstanding account balance. See the section on Credit Cards for information on choosing the credit card that works best for you.

### **Sources of Credit**

**Credit Unions** lend only to members, however, most people in a geographical area can become members. Credit unions offer consumer loans, credit cards, debit cards, and sometimes even mortgage loans. Rates are usually lower than other lenders because credit unions loan members' money, are eligible for federal tax exemptions, and generally take fewer credit risks.

**Commercial banks** mainly cater to customers with established credit histories. They offer consumer loans, credit cards, debit cards, and mortgage loans. They may make short-term loans to good customers. Banks often require items for security, and interest rates may vary according to

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the type of loan. Their rates may be lower than other lenders because they take fewer risks and have money from customers' savings to lend.

**Savings and loan associations** select credit-worthy individuals and often require security for loans. Similar to credit unions and commercial banks, savings and loan rates are often lower because they loan depositors' money. Savings and loan associations offer consumer loans, credit cards, and mortgage loans.

**Consumer finance companies** will lend to some individuals who do not meet credit standards of other lenders. Interest rates are often higher because they take greater risks and must borrow money to lend to customers. They mainly finance consumer loans.

**Retail stores** charge interest on monthly revolving accounts. Rates may be higher than lending institutions. Sometimes major purchases may be made on 90-day contracts at lower rates of interest. Retail establishments may offer a store credit card and/or accept most bank credit cards.

Some retail stores that sell merchandise such as furniture, appliances, and automobiles may offer credit sale contracts at their places of business. These contracts frequently are sold to a financial institution such as a bank or consumer finance company. The interest rates for these loans may be higher than other credit sources. Consumers should investigate the credit terms they can arrange on their own from another source before agreeing to these loan terms.

**Life insurance companies** lend the cash value of life insurance policies to policy holders. The rates are less because they take no risk and have no collection costs. Outstanding loans against life insurance policies will be deducted from survivor benefits.

**Pawnbrokers** loan money on items that are left for security. Interest rates generally are close to

the maximum allowed by law. If you can't repay the loan within the specified time period, the pawnshop will sell your items.

**Friends and relatives** may be willing to make loans. Interest rates will vary. It is essential to have a written agreement that is considered as binding as any other credit obligation.

**Check-cashing stores and payday loans** are short-term loans (cash advance) based on your paycheck. Effective annual interest rates may be more than 250 percent.

**Payday Loans** are a growing market for financial services. These small, short-term, very high rate loans go by a variety of names: payday loans, cash advance loans, check advance loans, post-dated check loans, or delayed deposit check loans. Typically, a borrower writes a personal check payable to the lender for the amount he wishes to borrow, plus the fee. Fees for payday loans are most often a percentage of the face value of the check or a fee per \$100 loaned. The fees are typically around \$20 per \$100 borrowed, which figures out to be a 521 percent annual interest rate.

With a payday loan, both the lender and the borrower know that sufficient funds to cover the check are not available when the check is tendered. The check casher agrees to hold the check until the consumer's next payday, usually up to two weeks. At that point, the consumer can either redeem the check with cash or a money order, permit the check to be deposited, or renew the loan by paying another fee. Payday lenders charge additional fees to rollover the loan. Payday lending thrives because of peoples' desperation. A typical customer might need to borrow \$200. The fee would be around \$40 for a two-week loan. At the end of the two weeks, if the borrower doesn't have \$200 to make the check good, another \$200 must be borrowed, at a cost of another \$40.

The borrower thus begins a downward spiral of rolling over very high-cost loans, because the alternative is unaffordable. To pay off the loan could take the whole monthly income. If the loan is not paid off or rolled over, the borrower could be criminally prosecuted for writing a bad check.

Use of a personal check makes collection very easy for a payday lender. Use of the criminal process gives payday lenders a collection tool that no other creditor has.

**Rent to own** is a special situation where people pay little or no down payment to rent furniture, appliances, and electronics. When they make the last payment, they own the item. Instead of stating an interest rate for people who pay until they own the merchandise, a total purchase price is given. It is up to the consumer to compute the interest rate. Rent-to-own contracts usually offer low payments plus fees for repair and delivery services. The rent-to-own industry says it does not offer credit and is not governed by most state credit laws.

A rent-to-own customer could pay a total that would include annual interest rates of 100 percent on average and possibly as high as 275 percent. If someone used a rent-to-own contract on a 19-inch television, they could pay \$9.99 per week for 78 weeks, a total of \$780. They could purchase the same television for \$218 at a retail store. Because the rent-to-own contract is not considered credit, the merchandise can be picked up any time a payment is missed, even if there are only 3 payments remaining on a 78-week contract.

### Credit Choices

Now back to the question about the washer and dryer purchase—how many sources of credit could be tapped for the credit needed? The correct answer is that most of the sources of credit might be used to purchase a washer and dryer. Table 1 shows the types of credit offered

by different credit sources. The interest rates can vary from 0 percent from a friend to more than 250 percent per year from a rent-to-own store. The total interest cost of borrowing money varies greatly according to the interest charges.

**Table 1.** Types of credit offered by different credit sources.

Credit Source	Consumer Loans	Credit Sales	Credit Cards
Credit unions	X		X
Banks	X		X
Savings & loan associations	X		X
Consumer finance companies	X		
Retail stores		X	X
Life insurance companies	X		
Pawnbrokers	X		
Friends and relatives	X		
Check-cashing stores	X		
Payday loans	X		
Rent-to-own stores*	X		

\*Technically, rent-to-own financing is not a loan.

The Decision, Decisions Work Sheet can be used to compare the costs of rent-to-own, using credit, or paying cash.

### Cost of Credit

The federal Truth-in-Lending Act requires lenders to state their interest charges as an annual percentage rate (APR) so that consumers can compare true costs of borrowing. The APR is based on finance charges, amount borrowed, and the repayment schedule. For example, if you borrow \$600 with a finance charge of \$60 and pay the entire \$660 at the end of twelve months, you will be paying an APR of 10 percent. If, on the other hand, you borrow \$600 with a

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\$60 finance charge and agree to repay in twelve monthly payments, you do not have the use of the \$600 for the entire year. The APR on this loan would be 18.5 percent.

The APR and total finance charges must be clearly stated on all credit contracts. Compare APRs when shopping for credit to determine the most favorable rate of credit.

## Decisions, Decisions Work Sheet

### Save First, Buy Later? Rent-to-Own? Buy on Credit?

John and Mary want to get a color television with a remote control in time for Christmas. What should they do? Should they buy the TV on credit? Go to a rent-to-own store? Maybe they should wait until next Christmas and save the money each week to pay cash for a new TV. First, they must decide if they have a real *need* for the television, or if they just *want* a new TV. Many people are attracted by the rent to own stores, because they can satisfy their wants immediately. If you are thinking about making a major purchase, it is necessary to weigh the pros and cons of each choice. Included here is a list of the options people have in making such a decision. Review them carefully. Then, when you are faced with this type of buying decision, you will be better prepared for the purchase.

Since rent-to-own stores have become very popular, here are some questions you will want to ask about their contracts before making a purchase.

- What is the total cost? Multiply payment amount times the number of payments.
- Does the company guarantee the item being rented is new?
- Can the customer buy the item outright at a reduced price at some point during the contract, or do they have to make all of the contracted payments to become the owner?
- Even though the company may provide repairs at no charge, does it also provide a substitute at no extra charge or stop payments during the repair period?
- Does the company require a large “balloon payment” at the end of the contract? Can the rent-to-own (RTO) contract be reinstated without the customer losing the investment up to that point?

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*This resource is one in a series on **Managing Money** which include:*

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**Making your Money Work:**

Determining What Is Important to You  
Where Are You Now? (Net Worth Statement)  
Stop Spending Leaks  
Developing a Spending Plan

**Using Credit:**

What Is Credit and How Much Credit Can I Afford?  
Types of Credit: What Are Your Choices?  
Credit Cards  
Credit Reports

**Building Savings:**

Ways to Save  
How Your Money Can Grow  
Where to Save  
Investment Options

**Selecting Financial Institutions:**

Selecting a Financial Institution  
Checking Accounts  
Savings Accounts

**Creating a Record System:**

Keeping Records in Order  
Where to Keep Records

**Determining Readiness:**

Financial Readiness  
Benefits and Challenges

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