Chapter 25
The Basics of Credit

Chapter Objectives
After completing this chapter, you will be able to:

Section 25.1 Credit Essentials
• Define credit and indicate three factors that affect the interest that is paid.
• Name different groups in our economy who use credit.
• Identify three advantages and disadvantages of using credit.

Section 25.2 Types of Credit
• Name the places where you can get credit, and list the three different types of credit cards.

Ask
The Basics of Credit: The Advantages of Debt

Q: When is it worth going into debt for better liquidity?

A: Liquidity is simply the ease with which an asset can be bought, sold, or turned into cash. For example, suppose you need to buy a car. You have $20,000 saved that you could use to buy the car outright. However, after a little investigating, you realize that putting $10,000 toward the car, borrowing the remaining $10,000 for the car, and investing $10,000 in stocks might actually be a more profitable approach. If the interest rate on the loan is lower than the rate of increase on the stocks, going into some debt might be a good idea. Furthermore, since stocks can be more easily liquidated than a car, they allow you to access your money more quickly in case of an emergency.

Mathematics You’ve decided to buy that car. You’re trying to choose whether to spend all of your savings on the car or to pay for part of the cost of the car now, take out a loan to pay the rest, and invest the rest of your savings. The interest rate on the loan will be 9.25% while the rate of increase on the investment is likely to be about 13.5%. What is the difference between these two rates?

CONCEPT Subtracting Decimals When subtracting decimals, write the numbers vertically, lining up the numbers by place value (the decimal points will also be lined up). If necessary, add zeros as place holders in the decimal places that do not have values, then subtract as you usually would. Do not forget to place a decimal point in the correct place in your answer.
The Importance of Good Credit

Paying your bills on time and keeping your total debt low will improve your credit rating. What does a good credit rating tell lenders?
Section 25.1

**Credit Essentials**

**Reading Guide**

**Before You Read**
Think about the skills you need to obtain credit and to use it wisely.

**Read to Learn**
- Define credit and indicate three factors that affect the interest that is paid.
- Name different groups in our economy who use credit.
- Identify three advantages and disadvantages of using credit.

**The Main Idea**
Credit allows borrowers to purchase items that they otherwise could not afford. Consumers, businesses, and governments all borrow money. There are advantages and disadvantages to using credit.

**Key Concepts**
- Credit: The Promise to Pay
- Who Uses Credit?
- The Pros and Cons of Using Credit

**Vocabulary**
**Key Terms**
- credit
- creditor
- debtor
- interest
- consumer credit
- commercial credit
- credit rating

**Academic Vocabulary**
You will find these words in your reading and on your tests. Make sure you know their meanings.
- military
- contributes
- constantly
- committed

**Graphic Organizer**
In a graphic such as the one shown, list some advantages of using credit in the PROS column and some disadvantages in the CONS column as you read.

<table>
<thead>
<tr>
<th>PROS</th>
<th>CONS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Go to the *Introduction to Business* Online Learning Center through glencoe.com for a printable graphic organizer.

**Academic Standards**

**English Language Arts**
- **NCTE 1** Read texts to acquire new information

**Mathematics**
- **Number and Operations** Understand meanings of operations and how they relate to one another
Credit: The Promise to Pay

Buying an item now and paying for it later can be an easy and convenient way to make a purchase. Consumers use credit to buy all kinds of goods and services. Credit is an agreement to obtain money, goods, or services now in exchange for a promise to pay in the future. When buying on credit, you are delaying the payment for an item.

A creditor lends money or provides credit. A debtor borrows money or uses credit. Credit is based on the creditor’s confidence that the debtor can and will repay the debt. Creditors charge a fee for using their money, which is called interest. The amount of interest to be paid is based on three factors. One is the interest rate, which is a percentage of the total amount borrowed. Interest rates vary from one provider to the next. Another factor is the length of time of the loan. The longer you take to pay it off, the more interest you will have to pay. The other factor is the amount of the loan. The larger the amount, the more interest that will be charged.

Identify On what three factors is the amount of interest based?

Who Uses Credit?

Many people use credit. To a great extent it has replaced money as a means of making purchases. Credit is used practically everywhere. Many people use credit to pay for CDs, meals at restaurants, or even higher education.

The type of credit used by people for personal reasons is called consumer credit. Businesses often use credit for the same reasons that consumers do. Manufacturers borrow money to buy

ETHICS in Business

Credit Cards

- Critical Reading Life is full of important decisions. Think about the kinds of decisions that you make as you read the question below.

You work in the promotions department of a credit card company. The company instructs you to set up a booth on college campuses in an attempt to get incoming freshmen to sign up for a card. You are told to offer a pre-approved line of credit with a higher-than-average interest rate. Your manager also recommends giving a bunch of free promotional gifts to attract students to your booth.

- Decision Making Would the fact that the majority of people you will be soliciting have limited, if any, disposable income affect your actions? Explain your answer.
raw materials, new machinery, factories, or trucks. Some borrow money to buy goods that they later resell. Credit used by businesses is called **commercial credit**. When businesses borrow money, however, they often pass along the cost of interest to consumers by charging higher prices.

The federal government uses credit to pay for many of the services and programs it provides to its citizens. For example, during World War II, the federal government used credit to finance **military** spending. State and local governments use credit to pay for things such as highways, public housing, stadiums, and water systems.

### The Pros and Cons of Using Credit

Credit is so common in today’s society that most people choose to use it. To use credit effectively, the consumer must know its advantages and disadvantages.

#### Advantages of Credit

An important advantage of credit is that it is convenient. You can shop and travel without carrying large amounts of cash. Instead of saving for an expensive item, such as a car, you can buy the car on credit and use it right away. Credit is especially useful in an emergency. If your car breaks down and you do not have cash to fix it, you can use credit.
Buying on credit enables people to establish a credit rating. A credit rating is a measure of a person’s ability and willingness to pay debts on time. A good credit rating tells other lenders that you are a responsible borrower and a good credit risk. Credit also helps consumers keep track of their spending. Whenever you buy something on credit, it goes on your credit card bill so you have a record of your expenses.

Finally, credit contributes to the growth of our economy. Credit allows consumers to buy more goods and services. Since so many consumers make credit purchases, businesses must hire more workers and produce more goods to keep up with the demand.

Finding the Finance Charge

If you borrow money and do not pay it back right away, you will probably have to pay a finance charge. What is the finance charge that you would pay if you borrowed $100 for 18 months at an APR of 9 percent?

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Finding the Finance Charge

If you borrow money and do not pay it back right away, you will probably have to pay a finance charge. What is the finance charge that you would pay if you borrowed $100 for 18 months at an APR of 9 percent?

Disadvantages of Credit

Since credit is so convenient to use, it can also be easy to misuse. With credit, it is tempting for people to buy things that they cannot afford or do not need. Advertisements and salespeople constantly urge consumers to buy more things. You might find it hard to resist sales or offers for more credit. Easy purchasing power should not encourage unnecessary purchases.

Items also cost more when you use credit instead of cash because of the interest. The more items you charge and the longer you take to pay off credit card debt, the more you pay in interest. Another disadvantage is that using credit means that you have committed some of your future income since the debt must be repaid. Figure 25.1 shows the way total interest payments increase with higher interest rates and longer payment terms.
As credit card bills pile up, you might have trouble paying them. After a while, you may reach your credit limit, the point where you cannot charge any more. Late or missed payments lower your credit rating, which can make it difficult to get credit in the future. Always remember when you use credit that it is not money you own, it is money you owe.

**Factors to Consider Before Using Credit** Imagine that you have conducted research on the Internet regarding the possibility of financing (or getting money for) a used vehicle. Before you decide to finance a major purchase by using credit, you should consider the following points:

- Do you have the cash you need for the down payment?
- Do you want to use your savings instead of credit?
- Can you afford the item?
- Could you use the credit in some better way?
- Could you put off buying the item for a while?
- What are the costs of using credit?

As previously mentioned, one of the main factors to consider is that when you buy something on credit, you agree to pay a fee that a creditor may add to the purchase price. If you do not pay your credit card bill in full every month, you will be charged interest on the unpaid balance. Interest essentially increases the original price of the item you purchased.

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### Section 25.1

**Review Key Concepts**

1. What is credit?
2. What is the difference between commercial and consumer credit?
3. Why is it important to have a good credit rating?

### Academic Skills

4. **Mathematics** You have an unpaid balance of $100 on a credit card and plan to pay off the balance in 12 months. Your credit card company charges you 9% interest per year. You transfer the balance to a card that charges only 7% per year and plan to pay off the balance in 6 months. Use the table in Figure 25.1 to calculate the difference in the total charge for interest.

**Reading Tables** To read a table, first locate the headings for the row and column requested. Reading across the row and down the column will let you compare data.

**Math** For math help, go to the Math Appendix.

Go to the Introduction to Business Online Learning Center through glencoe.com to check your answers.
Types of Credit

Read to Learn

- Name the places where you can get credit, and list the three different types of credit cards.

The Main Idea

There are many different types of credit plans, including charge accounts, credit cards, single payment loans, installment loans, and mortgage loans. There are also many different sources for credit.

Key Concept

- Sources of Credit

Vocabulary

Key Terms

charge account  collateral
installment loans

Academic Vocabulary

You will find these words in your reading and on your tests. Make sure you know their meanings.

available  annual  range  options

Graphic Organizer

In a table like the one below, write definitions for the different sources of credit.

<table>
<thead>
<tr>
<th>Sources of Credit</th>
<th>Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charge account</td>
<td></td>
</tr>
<tr>
<td>Credit card</td>
<td></td>
</tr>
<tr>
<td>Banks/financial institutions</td>
<td></td>
</tr>
<tr>
<td>Seller-provided credit</td>
<td></td>
</tr>
<tr>
<td>Consumer finance company</td>
<td></td>
</tr>
<tr>
<td>Payroll advance service</td>
<td></td>
</tr>
</tbody>
</table>

Go to the Introduction to Business Online Learning Center through glencoe.com for a printable graphic organizer.

Academic Standards

English Language Arts

NCTE 1 Read texts to acquire new information
NCTE 5 Use different writing process elements to communicate effectively
NCTE 7 Conduct research and gather, evaluate, and synthesize data to communicate discoveries

Science

Content Standard F Students should develop an understanding of science and technology in local, national, and global challenges
Sources of Credit

Credit is available from many different sources. These sources provide different types of loans for varying lengths of time. Loans can be short-term (one year or less), medium-term (one to five years), or long-term (more than five years). The risk a creditor takes in lending money or selling on credit is the most important factor in determining the cost of credit.

Charge Accounts

A charge account is credit provided by a store or company for customers to buy its products. Customers who have charge accounts at a store can use their credit to buy now and pay later. When the bill arrives in the mail, the customer can pay part of the total amount owed or the entire amount.

Credit Cards

Credit cards are like charge accounts, but some can be used in many different places. Those issued by banks, for example, can be used in different stores, including companies that sell

Big Plastic’s Online Challenger

Gary Marino is giving e-shoppers an alternative to credit cards—and his Bill Me Later® service is catching on. Is it an idea too good to survive?

Gary Marino knows more than most people about how difficult it is to create a new way for consumers to pay for goods and services.

A self-described “credit card geek” who worked for decades at Citicorp and then First USA, he watched various efforts fail over the years. “The last one that succeeded was the Discover® card in the mid-1980s, and they had to spend tens of billions to build their brand over the last 20 years.” Indeed, other than PayPal®, which is used mostly for transactions between individuals on eBay®, most consumers still make their purchases the old-fashioned way: with cash, checks, or plastic when shopping online.

But Marino is making progress at creating another option. He runs a 150-person outfit called I4 Commerce, whose Bill Me Later payment system is catching on with online merchants and shoppers.

Case Study Go to the Introduction to Business Online Learning Center through glencoe.com for the BusinessWeek Reader Case Study.

Active Learning

Online payments are booming, but giving money to an unknown credit company is a major issue for consumers. Research the benefits offered by Bill Me Later. With a classmate, write a 60-second commercial for the company that is designed to calm customers’ fears. Film your commercial and show it to the class.
on the Internet. Some of the cards have **annual** fees, which can **range** from $25 to $80. Credit card companies earn money from the interest they charge as well as from annual fees and penalties.

There are three basic types of credit cards: single-purpose, multipurpose, and travel and entertainment.

**Single-Purpose Cards** Single-purpose cards can be used to buy goods or services only at the business that issued the card. Each month cardholders receive a statement listing all the purchases they made in the last 30 days. They can pay part of the amount owed or the entire amount. Interest is charged on the unpaid balance. Credit cards issued by oil companies and department stores, such as Shell® and Macy's®, are examples of single-purpose credit cards.

**Multipurpose Cards** Multipurpose cards are also called bank credit cards because banks issue them. Multipurpose cards work the way single-purpose cards do. Consumers can pay them off or pay only part of the bill, with interest due on the unpaid balance. These cards may be used at many different stores, restaurants, and other businesses all over the world. MasterCard and VISA are multipurpose cards.

**Travel and Entertainment Cards** These cards work a little differently than the others. Holders of travel and entertainment cards must pay the full amount due each month. Cards such as American Express® and Diners Club® are examples. They are accepted

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**Standard Formats**

Did you ever wonder why all credit cards are the same size? The International Organization for Standardization developed a standard that defines the format for credit cards. It specifies a size of 3.370 × 2.125 inches for bank cards. **Why do you think it is necessary to formally define the size of a credit card?**

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**Smart Cards**

More and more credit cards around the world have computer chips embedded in the plastic. The information in the chip can be read when waved in front of a special reader. Smart cards first became popular in Europe and Asia as stored-value cards. They could be purchased to pay for calls in phone booths or fees on toll roads. Increasingly, chips are showing up in credit cards everywhere. The chips can hold more than 100 times as much information as the magnetic strip on a standard card, which increases security for consumers using them. MasterCard, Visa, and American Express each offer a version of these smart cards.

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**Go to the Introduction to Business Online Learning Center through glencoe.com for links to Web sites where you can find out more about smart cards. What are some of the positives and negatives associated with their use?**
worldwide for expenses connected with travel, business, and entertainment, such as restaurant and hotel bills, car rentals, and airline tickets. They often have an annual fee, which is higher than the fee for a multipurpose card.

Banks and Other Financial Institutions

Financial institutions such as banks, savings and loans, and credit unions offer many types of loans. However, they tend to place many demands on the borrower, which can make it more difficult to get a loan. For example, these financial institutions only want to lend money to people with good credit ratings. Many credit unions only lend money to credit union members and employees in a certain business or field (such as a teachers credit union).

**Single-Payment Loan** As the name suggests, the debtor pays back this type of loan in one payment, including interest (at the end of the loan period). Many farmers secure single-payment loans in the spring to pay for their seed and fertilizer. They pay back the loan in the fall, after they harvest their crops.

**Installment Loan** Student loans, car loans, and home improvement loans are types of **installment loans**, or loans repaid in regular payments over a period of time. The debtor receives the loan money for a certain period, such as two years. Over that period, the debtor makes equal monthly payments, which cover the loan and interest.

**Mortgage Loan** A mortgage loan is a form of an installment loan, only it is written for a long period, such as 15 to 30 years. It is used to purchase real estate, such as a home. Over the period of the loan, the debtor makes monthly payments. The home serves as collateral, which is something of value the bank can take if a borrower does not make the required loan payments.

**Borrow Until Payday** There are businesses that specialize in providing “borrow until payday” loans, which are loans borrowed against an upcoming paycheck. **Why should you avoid using such loans?**

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**Analyze** What type of collateral does the bank receive when you take out a mortgage loan?
Seller-Provided Credit

Many stores provide credit for their customers. Clothing, furniture, and appliance stores as well as car dealerships are among those that offer credit to customers.

Consumer Finance Companies

Consumer finance companies specialize in loans to people who might not be able to get credit elsewhere. Loans from consumer finance companies cost more because there is greater risk involved.

Other Types of Loans

For people who have difficulty getting a loan, there are other options, although they are the most costly. Payday advance services offer short-term loans until payday. However, they charge high fees and interest. A pawnshop loan is based on the value of something you own that is left with a pawnbroker as security against money borrowed. You can later buy back your item. “Borrow until payday” loans are short-term, usually for 5 to 14 days. The cost of this kind of loan is especially high.

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Section 25.2

Review Key Concepts
1. Discuss the different sources of credit.
2. How is a multipurpose credit card different from a travel and entertainment card?
3. Which types of loans usually cost the most?

Academic Skills
4. **English Language Arts** Work with three or four other students to research the kinds of consumer credit used in at least two countries. Are there banks there? Are there places where you cannot use credit cards? Prepare a group presentation to present your findings.

5. **English Language Arts** Tina found a coat she liked at a department store, but it cost $20 more than she had. She did not have any credit cards and decided to leave. As she approached the exit, an employee offered her instant credit if she would apply for a store credit card. Tina signed up for the card and charged the coat. Write a sentence or two explaining various ways in which the store will benefit from extending credit to Tina.

Go to the [Introduction to Business Online Learning Center through glencoe.com](http://www.glencoe.com) to check your answers.
**Section 25.1 Summary**

**Credit Essentials** Credit is an agreement to get money, goods, or services now by promising to pay later. Creditors charge a fee (interest) for using their money. Consumers, businesses, and the government use credit extensively. Consumers find that credit is convenient, useful in an emergency, and helps to establish a credit rating and to keep track of one’s spending. It also contributes to the growth of the economy. However, it costs more to buy items on credit, commits future income, can lead to overspending, and if handled improperly, may lower your credit rating.

**Section 25.2 Summary**

**Types of Credit** There are many different types of credit, including charge accounts, credit cards, single-payment loans, installment loans, mortgage loans, seller-provided credit, pawnshop loans, and “borrow until payday” loans. Loans are given by banks, credit unions, and savings and loan associations. Other financial firms specialize in specific loans (such as credit cards), and businesses that sell goods and services also offer credit. Businesses such as consumer finance companies offer loans to people who have difficulty obtaining one. However, these loans are usually costly.

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**Vocabulary Review**

1. On a sheet of paper, use each of these key terms and academic vocabulary terms in a sentence.

   - **Key Terms**
     - credit
     - creditor
     - debtor
     - interest
     - consumer credit
   - **Commercial Credit**
     - charge account
     - installment loans
     - collateral

   - **Academic Vocabulary**
     - military
     - available
     - contributes
     - annual
     - constantly
     - range
     - committed
     - options

**Review Key Concepts**

2. Define credit and indicate three factors that affect the interest that is paid.
3. Name different groups in our economy who use credit.
4. Identify three advantages and disadvantages of using credit.
5. Name the places where you can get credit, and list the three different types of credit cards.
Critical Thinking

6. Describe two situations in which cash is more convenient than credit. Then describe two situations in which credit is better to use than cash.

7. Why is it important to take care of your credit rating?

8. Why do credit card companies try so hard to persuade you to use their card?

9. If people use credit, does that mean they have money problems? Explain.

10. How do businesses use credit to help sell their products?

11. Imagine that you have a good credit rating and you want to buy a new car. Which would be the best place to get a loan for it, a bank, a consumer finance company, or a pawn shop?

12. Some people use a credit card and never pay any interest. How can that be?

13. Suppose you would like to pay for a course to improve your job skills, a new computer, and a new TV. You do not have enough cash, so you consider taking out a loan to buy at least one of them. Which one would be the best use of credit? Which would be the least wise use of it?

Write About It

14. Write at least two paragraphs either for or against this statement: “People should be charged the same interest rate, regardless of their credit rating.”

15. Your friend wants to buy a ring for $400 using a credit card. He would pay 2% of the price each month, which would be $8. He would have to make payments for 95 months. Calculate the total cost of the purchase with interest. Write a letter to him about your opinion of the deal.

16. Write a short essay on whether you think it is fair or unfair for people to have to pay so much in interest on payday loans.

17. Research credit cards that offer rewards. Describe in writing the nature of the rewards you can get if you use them.

18. Write an e-mail to your teacher discussing how you will start to develop your credit rating.

19. Write a paragraph either agreeing or disagreeing with the following statement: “Businesses that charge high interest rates should be banned from the marketplace.”

Business Ethics

Borrowing from an Employer

21. You have an emergency, and you ask your employer for a loan. She gives you $100. You sign a form indicating that you received the loan and will start repaying it next month. However, you quit the job the following week. Your former manager calls and asks whether you are going to pay back the loan. You indicate that since you are a minor, the contract is voidable, meaning that you do not have to abide by it. Is it a good idea to avoid the contract?
Chapter 25  Review and Activities

Applying Academics to Business

English Language Arts

22. What is the difference in the meanings of the words *debt* and *debit*? List some synonyms and antonyms for each and use each in a sentence.

Mathematics

23. The Fair Isaac Corporation® (FICO) rates consumer credit worthiness according to a scale that ranges from 350 to 900 points. A good score is often considered to be 600 or greater. Banks or other companies may not give credit to those with scores below 600. List whether the following people are likely to receive credit.

<table>
<thead>
<tr>
<th>Name</th>
<th>Credit Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sam</td>
<td>300</td>
</tr>
<tr>
<td>Jill</td>
<td>590</td>
</tr>
<tr>
<td>Tina</td>
<td>480</td>
</tr>
<tr>
<td>Guillermo</td>
<td>600</td>
</tr>
</tbody>
</table>

CONCEPT  Reading a Chart  Read down the column and across the row to the right to find information in a chart.

English Language Arts

24. Find newspaper and magazine articles and advertisements that demonstrate uses of credit by consumers, businesses, and governments. Write a paragraph explaining who benefits most from these examples of credit.

Mathematics

25. Research credit and the cost of credit from a variety of institutions, such as those listed below. Convert the rates to decimals, and use a number line to rank them in order from the lowest interest rate to the highest.

- consumer finance company
- revolving charge account
- travel and entertainment credit card
- credit union
- commercial bank

CONCEPT  Number Line  Positive decimals closer to zero on a number line are less than decimals closer to 1.

Active Learning

Analyze Advertisements

26. During the next two weeks, save all the advertisements and junk mail that try to persuade you and your family to apply for a credit card. Keep a log of the promotional offers. Conduct a mini-survey among your family and friends, and find out whether they would choose one of the cards based on the advertising material that has been sent to your home.

Business in the Real World

Comparing Credit Cards

27. Obtain a credit card application from two different retail stores or gas stations. Form groups. Compare the applications, listing similarities and differences. Be sure to examine the interest rates and repayment procedures. Then create a table using word-processing or spreadsheet software. Discuss your findings with the class.
Role Play

ADVICE ON USING CREDIT

28. Interview a consumer credit counselor or a financial adviser at a bank, asking the following questions:
   a. What are the major consumer credit problems and their causes?
   b. What is their advice for using credit?
   c. Is a person’s credit rating very important? Why or why not?

COOL Business CAREERS

FIND YOUR DREAM JOB

29. Go to the Introduction to Business Online Learning Center through glencoe.com for a link to the Occupational Outlook Handbook Web site. Click on the “OOH Search/A-Z Index” link and enter the job category “bill and account collectors.” Then write a one-page report about this area of occupation. Conclude your report with a list of things you could do now to prepare yourself to pursue the occupation.

SHOP AROUND FOR A CAR

30. Situation You are a consumer advocate for a local news station. You are asked to prepare a news segment advising consumers on buying a car.

Activity Prepare a presentation that advocates that people shop around for credit when buying a car.

Evaluation You will be evaluated on how well you meet the following performance indicators:
   • Show how consumers can save by reviewing different car loans.
   • Answer questions from the newscaster(s) and/or consumers about buying a car.
   • Use credit terminology correctly.
   • Organize ideas in a logical sequence.
   • Project your voice, and use correct English.

Standardized Test Practice

Directions Choose the letter of the best answer. Write the letter for the answer on a separate piece of paper.

1. $15\frac{1}{2}$% of [ ] = $403
   A $6,246.5
   B $60.45
   C $26.00
   D $2,600

TEST-TAKING TIP To control the stress of test taking, approach exams with a positive attitude. View the exam as an opportunity to show how much you have studied and to receive a reward for the studying you have done.

READING Go to the Introduction to Business Online Learning Center through glencoe.com for a list of outside reading suggestions.