What is credit?

Credit has various meanings. In the context of money, it involves a consumer's ability to pay someone back when money is borrowed. Typically, this includes the cost of an item plus interest.

There are three major credit bureaus: Equifax, Experian, and TransUnion. They collect data and determine a credit score based on important characteristics of the borrower. The credit scoring models are different at each credit bureau.

Let's take a look at four types of credit:

- **Revolving credit**. A credit limit is given to an individual. They can make charges up to that limit. Each month the balance is carried forward and the individual makes a payment.

- **Charge cards**. Many charge cards are a form of revolving credit, but others require that the total balance be paid off every month. Therefore, it is difficult for all credit cards to be classified as revolving credit.

- **Service credit.** This category of credit is typically with service providers. Think of your cell service, internet, or cable provider. Your family has an agreement in place that they will pay the provider each month for a service that is performed.

- **Installment credit.** With this type of credit, a creditor loans you a certain amount of money. You agree to repay that amount monthly until the item is paid for. The monthly payment includes the interest and is for a certain number of months or years. A loan for a vehicle or a mortgage for a house is two types of installment credit.

What does it mean to have good credit? Credit is a lot more than just borrowing money. A lender must know that you will pay them back on time. Think of credit as your reputation. Can you be trusted to pay the agreed upon amount every month? So, if you are purchasing a car, the lender will likely pay more attention to your payment history. It's very important to have good credit – and maintain it. Credit scores range from 300-850. The higher the number the better!

Sources: Equifax, Experian, TransUnion, and Investopedia

There are 4 C's of credit. They are collateral, character, capacity, and capital. Sometimes a fifth "C" is added representing conditions. We'll concentrate on the four main ones.

- **Character.** Think about this as your reputation or track record for repaying loans. This information appears on your credit report which includes how many times you have borrowed money in the past, whether it was repaid on time, if you have declared bankruptcy, or been reported to a collector.

- **Capacity**. This is a measurement of an individual's ability to repay a loan by comparing it to other debts the borrower owes.

- **Capital.** This term refers to how much money, or capital, the person can contribute to the purchase price. For example, on larger purchases, individuals are usually required to put money, called a "down payment," against the loan. This reduces the amount you will owe for that item. A higher down payment by the individual helps reduce the overall risk of the loan for the lender. A benefit of a higher down payment also means the individual will not have to pay back as much in interest.

- **Collateral.** This is something of value that the lender hangs on to until the loan is repaid. If the borrower defaults, or doesn't pay the money back, then the lender can repossess the collateral. As an example, when a bank loans money for a car, they keep possession of the title which represents who owns the vehicle. Once the loan is paid off, the bank releases the title to the individual.

What is interest? It's the cost of credit and is usually expressed as a percent. Interest applies to almost any form of borrowing. The lower the interest rate, the less money you have to pay back. Credit cards typically have a higher interest rate than loans, such as a car or mortgage. However, the amount of money involved in a loan is usually higher than what someone purchases on a credit card. Interest rates can fluctuate so it is important to read the fine print and know the facts before you enter into any sort of agreement. A credit card company may offer you a lower interest rate as a special incentive to start using their card. But if you miss a payment, that interest rate may skyrocket!

Sources: Equifax, Experian, TransUnion, and Investopedia