

# How Do Credit Cards and Loans Work?

Carla Mooney



**GUIDE TO FINANCIAL RESPONSIBILITY**

# CONTENTS

|   |           |
|---|-----------|
| <b>Introduction</b>                       | <b>4</b>  |
| The World of Credit                       |           |
| <b>Chapter One</b>                        | <b>7</b>  |
| Using a Credit Card                       |           |
| <b>Chapter Two</b>                        | <b>15</b> |
| Taking Out a Loan                         |           |
| <b>Chapter Three</b>                      | <b>22</b> |
| The Costs of Borrowing: Interest and Fees |           |
| <b>Chapter Four</b>                       | <b>30</b> |
| Credit History                            |           |
| <b>Chapter Five</b>                       | <b>38</b> |
| Borrowing for College                     |           |
| <b>Chapter Six</b>                        | <b>46</b> |
| Credit Card Fraud and Identity Theft      |           |
| <b>Source Notes</b>                       | <b>55</b> |
| <b>Glossary</b>                           | <b>58</b> |
| <b>For More Information</b>               | <b>59</b> |
| <b>Index</b>                              | <b>61</b> |
| <b>Picture Credits</b>                    | <b>64</b> |

## Using a Credit Card

Credit cards are a convenient way to pay when you don't have money in your wallet. Most places, from gas stations to grocery stores, accept credit cards for payment. If you shop online, credit cards are an easy way to pay. And credit cards are also an excellent way to build a credit history.

### What Is a Credit Card?

A credit card is an instant-loan tool issued by a financial institution, usually a bank, that allows individuals to borrow money from that institution. When people use a credit card, they buy on credit, which means they borrow money to buy something now and promise to pay the borrowed money back later with interest. The credit card's repayment terms differ by institution.

Although credit cards and debit cards look almost the same, and both can be used to make purchases in many places, there are some essential differences between the two cards. Debit cards allow you to spend money that is already in the bank. When you pay with a debit card at the store, the payment immediately comes out of your bank account. You must be careful not to spend more than you have in the bank.

In contrast, a credit card allows you to make purchases by borrowing money from the financial institution that issued the card. You can use credit cards to pay for purchases even if you do not have the money in your bank account. Therefore, using a debit card is a “buy now, pay now” transaction, while using a credit card is a “buy now, pay later” transaction.

**“A credit card represents a loan. You’re not using your money—you’re using the credit card issuer’s money. You have a limit that you can borrow up to, set by the card issuer.”<sup>7</sup>**

—Debbie Schwartz, financial services executive

It’s important to understand that a credit card is not free money. “A credit card represents a loan. You’re not using your money—you’re using the credit card issuer’s money. You have a limit that you can borrow up to, set by the card issuer,”<sup>7</sup> says financial services executive Debbie Schwartz. And Schwartz warns that borrowing money comes with a cost—interest. “Teens and young adults need to under-

stand that interest is an extra charge for borrowing money. You can borrow a portion of your available balance and then repay it. If you don’t pay off your credit card balance when the bill is due, you’ll be charged interest. The bigger the balance you carry, the more you’ll pay in interest,”<sup>8</sup> she says.

## **Benefits of Credit Cards**

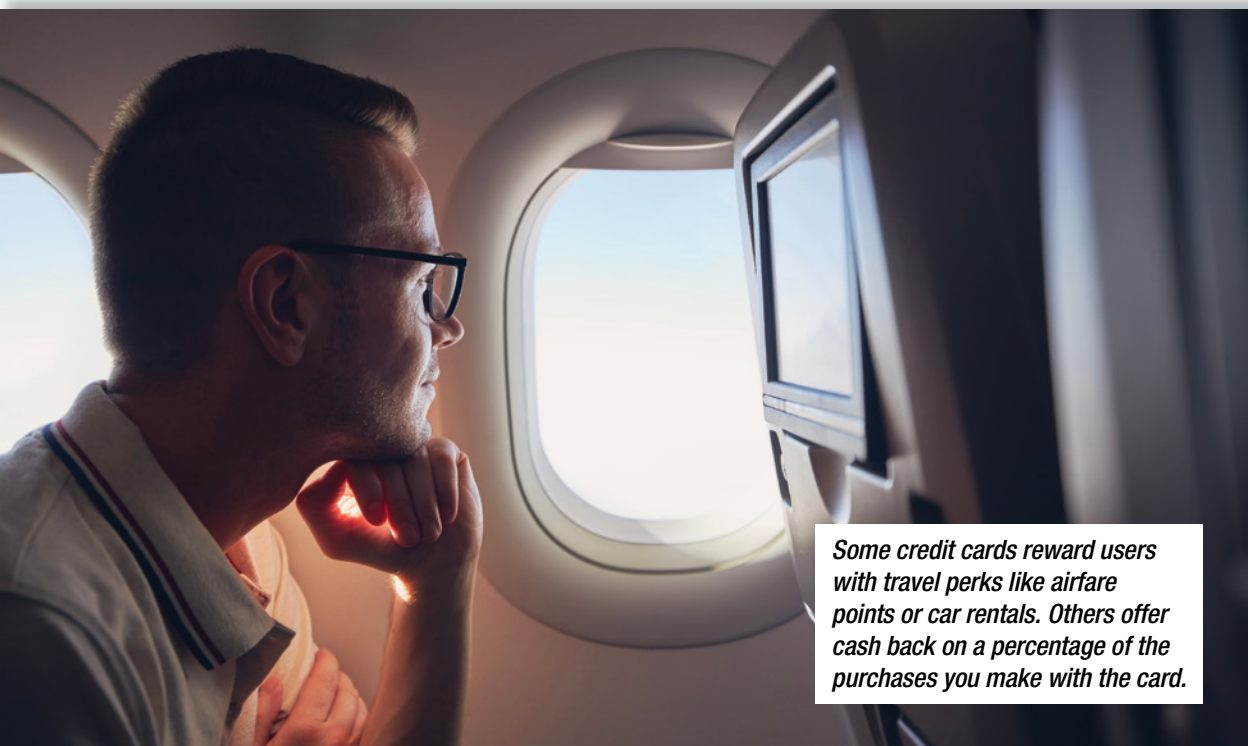
Credit cards can be valuable for achieving financial goals when used responsibly. First, credit cards help you build a credit history and show future creditors that you are responsible with your credit and pay bills on time. This will translate into a credit score, which you will need in order to rent an apartment, get a car loan, get a mortgage, and more. “Without a good credit score, you might end up paying much higher interest rates on car loans and mortgages—if you can even get those loans at all. In some states, your credit score might affect your car insurance premium, and there are some landlords that run credit checks before they’ll let you into an apartment,”<sup>9</sup> says Schwartz. Spending under the card’s spending limit and paying off the balance on time every month will help you build a strong credit history.

Many credit cards also offer rewards programs or perks for users just for buying everyday items. Some credit cards reward you with travel perks like airline miles or hotel discounts. Others offer cash back as a percentage of what you charge on the card. Some cards award points you can redeem for magazine sub-

scriptions, gift cards, and more. Savvy users can choose a credit card that gives the rewards they are most interested in earning.

Using a credit card for purchases can also add an extra layer of security and protection. Some credit cards provide additional warranties or insurance on purchased items beyond what a store or brand offers. Other credit cards protect users against fraud. For example, if you use a credit card to buy a T-shirt online but the online merchant never delivers it and refuses to refund your money, you can report it to the credit card company and dispute the charge. You won't have to pay for the disputed item most of the time. Also, if someone makes a fraudulent charge on a credit card, most credit card companies will help the user fight it and won't make them pay the unauthorized charges.

Convenience is another benefit of credit cards. There was a time when people routinely carried cash in their wallets, but times have changed. Many people, especially young people, depend more on noncash payment methods like Venmo or debit cards. But not all businesses accept these forms of payment. Credit cards, on the other hand, are accepted almost everywhere. "A credit card allows you to make purchases without carrying around



*Some credit cards reward users with travel perks like airfare points or car rentals. Others offer cash back on a percentage of the purchases you make with the card.*

**“A credit card allows you to make purchases without carrying around cash.”<sup>10</sup>**

—Lee Baker, president of Apex Financial Services

cash,”<sup>10</sup> says Lee Baker, president of Apex Financial Services. Lauren Chin, a college student at the Maryland Institute College of Art, uses a credit card for its convenience. “[Credit cards] are convenient for online purchases or for times when I don’t have cash on me,”<sup>11</sup> says Chin.

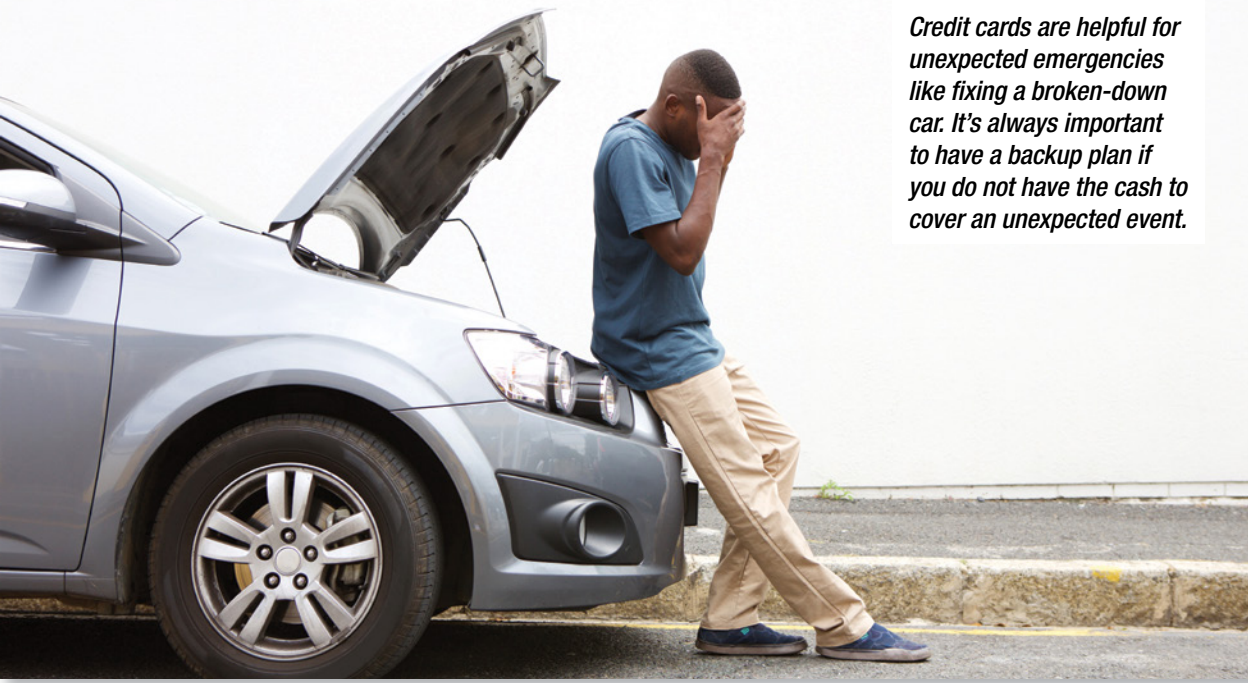
Credit cards are also helpful for unexpected emergencies. “[Credit cards] definitely come in handy when there is an emergency that goes beyond your available cash. Imagine, if you will, you’re taking a trip and run into car trouble. Having a credit card can allow you to get your vehicle repaired and pay off the expense later,”<sup>12</sup> says Lee.

## **Potential Pitfalls**

When credit cards are not used responsibly, users can cause significant harm to their financial future. One of the biggest risks is building debt that a user is unprepared to repay. It is easy to use a credit card to pay for something, even if you do not have the money to buy it now. It’s easy for many people to convince themselves that they are not spending real money when swiping a credit card. And they won’t have to pay it back until the bill ar-

## **Other Paths to Credit**

If you are not ready or able to get a student credit card, there are other ways to access credit. Students can apply to be an authorized user on another person’s credit card, usually a parent’s or guardian’s card. As long as the student and the primary cardholder use the card responsibly, both will build good credit histories. Another way to build credit is to apply for and use a secured credit card. These credit cards require cardholders to put down a security deposit, usually equal to the credit limit. The deposit is collateral for the lender in case these cardholders do not pay their bill. Secured cards often have bonus tools to help beginners manage credit responsibly, and many institutions allow users to transition to traditional, unsecured cards after demonstrating good financial habits. At that point, the initial deposit is typically returned. The deposit will also be returned if a user chooses to close the account.



*Credit cards are helpful for unexpected emergencies like fixing a broken-down car. It's always important to have a backup plan if you do not have the cash to cover an unexpected event.*

rives. “You know that you’ll have to pay the bill eventually, but the promise of small minimum payments can make purchases seem like bargains,”<sup>13</sup> says Michele Cagan, a certified public accountant. Without careful planning, you could wind up with a credit card bill that is much higher than you expect or can repay. Carrying high balances on multiple credit cards worsens the problem, making it challenging to keep up with monthly payments.

When a person uses a credit card, the bank gives the person a short-term loan. To loan money, the bank charges interest and fees. The higher the interest and fees, the more it will cost if the balance is not paid off in full each month. In 2022 the average credit card interest rate was 20.4 percent, according to Federal Reserve data. For many people who get in trouble with credit card debt, high interest and fees can significantly add to what they owe the bank.

For example, when you carry a balance on a credit card, the bank charges interest on that amount of money. The following month, if the interest is not paid, it is added to the outstanding balance, and now the bank charges interest on the balance and the interest owed. In this way, the amount to be repaid can skyrocket

# SOURCE NOTES

## Introduction: The World of Credit

1. Halle Newman, “My Experience of Getting My First Student Credit Card—and Which Credit Card I Want Next,” *The Points Guy* (blog), June 29, 2022. <https://thepointsguy.com>.
2. Newman, “My Experience of Getting My First Student Credit Card.”
3. Newman, “My Experience of Getting My First Student Credit Card.”
4. Quoted in Alex Gailey, “This 32-Year-Old Paid Off \$7,000 of Credit Card Debt in 7 Months. Here’s What She Learned,” *Time*, September 27, 2021. <https://time.com>.
5. Quoted in Gailey, “This 32-Year-Old Paid Off \$7,000 of Credit Card Debt in 7 Months.”
6. Quoted in Sienna Wrenn, “Why Credit Is a Powerful Financial Tool,” *The Balance*, June 20, 2022. [www.thebalancemoney.com](http://www.thebalancemoney.com).

## Chapter One: Using a Credit Card

7. Debbie Schwartz, “5 Important Credit Card Lessons for Teens and Young Adults,” *Sallie Mae*, October 12, 2022. [www.salliemae.com](http://www.salliemae.com).
8. Schwartz, “5 Important Credit Card Lessons for Teens and Young Adults.”
9. Schwartz, “5 Important Credit Card Lessons for Teens and Young Adults.”
10. Quoted in Sophie Jin, “What College Students Need to Know About Credit Cards,” *CNBC*, September 15, 2022. [www.cnbc.com](http://www.cnbc.com).
11. Quoted in Jin, “What College Students Need to Know About Credit Cards.”
12. Quoted in Jin, “What College Students Need to Know About Credit Cards.”
13. Quoted in Erin Hurd, “Does Using a Credit Card Make You Spend More Money?,” *NerdWallet*, October 14, 2022. [www.nerdwallet.com](http://www.nerdwallet.com).
14. Quoted in Jin, “What College Students Need to Know About Credit Cards.”
15. Quoted in Jin, “What College Students Need to Know About Credit Cards.”
16. Quoted in Jasmin Suknanan, “Here Are 5 Pieces of Credit Card Advice That Financial Advisors Are Giving Their Clients in 2021,” *CNBC*, September 9, 2022. [www.cnbc.com](http://www.cnbc.com).
17. Hurd, “Does Using a Credit Card Make You Spend More Money?”

# GLOSSARY

**collateral:** Something of value that a borrower promises as security for a loan.

**credit history:** A record that shows how a person has handled credit in the past and indicates the person's ability to repay debt in the future.

**credit score:** A numerical rating that measures a person's loan risk.

**creditworthiness:** How likely a borrower is to repay borrowed funds.

**fixed interest:** An interest rate that stays the same for the life of a loan.

**fraud:** A deception intended to result in financial gain.

**identity theft:** The act of stealing personal information for financial gain.

**interest:** The fee borrowers pay to lenders for borrowing money.

**loan:** Money borrowed from a bank or other financial institution.

**principal:** The original amount borrowed from a lender.

**secured loan:** A loan that is backed by collateral.

**term:** The life of a loan.

**unsecured loan:** A loan that is not backed by collateral.

**variable interest:** An interest rate that moves up and down with a benchmark rate.

# FOR MORE INFORMATION

## Books

Alexis Burling, *Managing Debt*. Minneapolis, MN: ABDO, 2020.

Kevin Hayes, *Financial Literacy Information for Teens*. Detroit, MI: Omnigraphics, 2021.

Stuart A. Kallen, *Managing Credit and Debt*. San Diego, CA: ReferencePoint, 2021.

Xina M. Uhl and Ann Byers, *Getting a Credit Card*. New York: Rosen, 2020.

Virginia Vitzthum, *Money Matters for Teens: Advice on Spending and Saving, Managing Income, and Paying for College*. New York: Sky Pony, 2022.

## Internet Sources

Chris Muller, "Credit Card Basics—a Guide for Teens," *Money Under 30*, September 14, 2022. [www.moneyunder30.com](http://www.moneyunder30.com).

NerdWallet, "Student Loan Repayment Options: Find the Best Plan for You," August 26, 2022. [www.nerdwallet.com](http://www.nerdwallet.com).

NerdWallet, "What Is a Credit Score, and What Are the Credit Score Ranges?," December 2, 2022. [www.nerdwallet.com](http://www.nerdwallet.com).

One Main Financial, "How Teenagers and Young Adults Can Establish a Healthy Credit Score," April 7, 2022. [www.onemainfinancial.com](http://www.onemainfinancial.com).

Debbie Schwartz, "5 Important Credit Card Lessons for Teens and Young Adults," *Sallie Mae*, October 12, 2022. [www.sallie-mae.com](http://www.sallie-mae.com).

## Websites

### Consumer Financial Protection Bureau

[www.consumerfinance.gov](http://www.consumerfinance.gov)

The Consumer Financial Protection Bureau is a federal agency that ensures consumers are treated fairly by banks and other financial institutions. Its website has a consumer education section with several topics that include loans, credit cards, and fraud.

# INDEX

*Note: Boldface page numbers indicate illustrations.*

- annual percentage rate (APR), 22
- avalanche repayment method, 12
  
- Baker, Lee, 9–10
- bankruptcy, 29, 30
- Barkley-Denney, Whitney, 22–23
- Bureau of Labor Statistics, 45
- Butler, Jason, 36–37
  
- Cagan, Michele, 11
- car loans, 18, 21
- cash-back/rewards programs, 8–9
- Castellano, Rick, 39, 41
- Center for Responsible Lending, 23
- Chartier, Dee, 27
- Chin, Lauren, 10
- collateral, 10, 17, 18, 20, 30
- college
  - financial aid for, 39–41
  - high cost of, 38, 40
  - work-study programs, 39–41
  - See also* student loans
- College Board, 38
- College Scholarship Service (CSS), 39
- compound interest, 25–26
  
- Consumer Financial Protection Bureau, 59–60
- credit
  - establishing, 34
  - ways to access, 10
- credit bureaus, 31
- credit card fraud, 47–49
  - actions to take for
    - suspected, 51–52
  - protecting against, 49–51
  - spotting, 49
- credit cards, 7–8
  - benefits of, 8–9
  - carrying balances on, 11–12
  - choosing best, 12–14
  - closing accounts for,
    - downsides of, 35–36
  - getting best rate on, 26–29
  - interest on, 25–26
  - repayment methods for, 12
  - with zero percent interest, 27
- credit counseling, 33
- credit history
  - improving, 36–37
  - lack of, 35–36
- credit score, 31–32
  - calculating, 32–33
  
- Davis, Paul, 50, 51
- debit cards, 7
- debt
  - credit card, 10–11
  - interest as cost of, 22
  - loans as type of, 15
  - managing, 12, 21