

The Financial Way of Thinking

A Guide to Taking Control of Your Personal Credit and Finances

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Section I

Personal Credit

Chapter 1: What You Need to Know Before You Borrow

What You Need to Know Before You Borrow.

An investment in knowledge always pays the best interest.

-- Benjamin Franklin

In the same way that a well-built house requires a solid foundation on which to rest, it is important that you understand the basics of the world of credit before you borrow - or borrow again if you already have an established credit history. By taking into account what it is that creditors will be looking at you can better position yourself for both the short and long term. Remember, the action of borrowing is not done once the loan is completed. Rather, the loan is ongoing for the life of the loan. And even when it is long paid off it will continue to tell future creditors something about you for many years to come.

You will do well, therefore, to think of the world of credit as you do life itself: as an ongoing process. Until we die, our lives are never complete or finished. We have to work at improving them throughout our existence. And along the way, we are often met with twists and challenges that we did not anticipate. Those who succeed do so because they understand the nature of the world, that happiness is found in the *persistent* pursuit of excellence. As T.S. Eliot observed, "There are no lost causes because there are no gained causes." Our work is never truly finished.

And so it is with the world of credit. Understanding the basics is equally, if not more, important in the long-run as it is in the short-run. What you do throughout the life of the loan is as informative to lenders as the amount of the loan itself, for example. The key to accomplishing your financial goals lies in knowing what the norms or conditions of accomplishment are. Put another way, it is understanding others' expectations for you, knowing what it is that lenders are going to look at when determining your credit worthiness.

The number and kind of total factors that are considered in determining credit worthiness varies among lenders. Everything from income and assets to your employment and credit history are considered. That said, there are four general factors or principles that incorporate what most lenders review. We will refer to them as the "Four C's of the World of Credit": Character, Capability, Capacity, and Credit Score.

Character

More than anything, creditors want to know your character. That is, they want to know something about your nature or disposition. *Who you are* is not so much your name, the kind of residence you have, or the city you live in - although this is, no doubt, important information that will be required of you. Rather, your "credit character" is determined by what, if anything, you have done in the world of credit through the present. It's not what you can say about yourself that matters but what your past actions say about you.

Things you will need to consider in the area of **character** include answers to the following questions:

- Do you have a checking and/or savings account? How long has it been established? What do your activities in these regards look like? Do you have a history of bouncing checks, for example?
- What is your payment history? Do you pay your bills on time? Do you always pay your bills on time or are there instances where you did not? If so, why?
- Do you currently have any credit cards? Have you had any credit cards in the past that are now closed accounts? If so, who closed them and why?
- Do you have any other lines of credit at this time? If so, how much? How much credit have you applied for in the past? What was approved and disapproved and why?

- Do you make minimum, partial, or full payments each month? Do you make monthly payments or are there instances where you did not? If so, why? Did you default on any of your credit cards or were any open accounts closed for you by the creditor in question? If so, how recently?

When reviewing your character, lenders want to know what actions you have demonstrated to date. Take some time now to collect all of the data you have in this regard and begin to build a file on yourself. Note any trends you see (on-time payments, late payments, full or partial payments, etc.) and try to get an idea of the picture that others will have of you when looking at the same information.

Capability

"Remember the root-beer principles of borrowing," often counseled a college professor of mine. "Borrowers must be A&W," he would say referring of course to the famed producer of root-beer.

What this learned individual was attempting to draw the attention of his students to, is the very idea that every potential borrower must be able AND willing to borrow. If both criteria - ability and willingness - are not met, a loan application will not be approved.

For most consumers, lack of willingness is usually not an issue. The primary issue in this instance is most often ability and that is precisely what a creditor is going to look at in determining whether or not to approve your application. While one's ability to borrow is determined by a variety of factors there is probably no larger consideration than the capability of paying the loan in question. Simply stated, lenders want to know whether or not you have the means of repaying the loan plus interest.

Things you will need to consider in the area of **capability** include answers to the following questions:

- What is your current monthly or annual income?
- What are your current monthly expenditures? How much of your monthly spending reflects needs? How much of your monthly spending reflects wants? How much discretionary income do you have?
- Do you have any additional sources of income such as second jobs, investments, or other assets that deliver a regular dividend or payment of some kind?
- Do you have hard assets (e.g., a car, personal belongings, home, etc.) that can be used as collateral against the loan, if needed? Do you have soft assets that can be liquefied if needed?
- Do you have a spouse with an income and/or similar assets who can serve as a co-applicant with you? Or do you know someone who is willing to guarantee the loan on your behalf should you fail to make the payments yourself?

Remember, you may be very willing to borrow but the key question for you is, "Can you borrow?" This is what lenders want to know and this is what they will look at when considering your "credit capability."

Capacity

"What is capacity?" you ask. In short, it is the difference between the amount of the total line of credit you are considering (any current lines of credit plus that for which you are applying), minus the actual amount of the credit line you are using.

Let's say, for example, that you currently have a total credit line of \$15,000 via three credit cards and a personal signature loan at your local credit union. Let's assume further that of the \$15,000 available, you have used \$8,500 for various expenditures. That leaves you with a net credit line balance of \$6,500. Stated another way, you have used about 57% of the total line of credit available to you. This is what lenders mean by capacity.

Things you will need to consider in the area of **capacity** include answers to the following questions:

- How much total credit do you currently have?
- How does your total line of available credit compare to your income, savings, and other assets?
- Should you be approved for a new loan, what will your new capacity rate be?
- Do you have a history of maximizing your available lines of credit?
- Have you recently applied for any other loans or lines of credit? If so, how much? What are the re-payment terms and the interest rates in question?

Credit Score

There are few, if any, more mysterious or frustrating subjects for the average consumer today than a credit score. Even though it has caught the attention of the American media and consumers nationwide, especially with respect to identity theft, credit scores remain one of the more intimidating and shadowy topics of the day.

Simply stated, a credit score is your financial identity, your "financial DNA" or "credit report card" as some experts have referred to it. Your credit score tells the financial world everything that it wants to know about you. If you learn nothing else from this text, it is hoped that this will be the one thing. Your financial well-being is absolutely dependent upon your credit score: Achieve and maintain a strong and healthy one and all will generally be well. Earn a poor and withering one and life will very likely become more difficult and challenging than you may have imagined.

We will delve into the topic of credit scores in both a deeper and broader way later (see chapter 2). For now, the things you will need to

consider in the area of your **credit score** include answers to the following questions:

- What does your lending track record say about you? How have you behaved in the past?
- What does your credit activity look like over the last eight to twelve months? What does it look like over the last five to six years?
- What is your debt-to-income ratio? What will your debt-to-income ratio become if the new loan you are applying for is approved?
- How many inquiries does your report show? Who is making these inquiries and why?

Communication

At the outset of this chapter, I drew attention to what we refer to as the "Four C's" of personal credit: Character, Capability, Capacity, and Credit Score. To this I would add a fifth and significant "C", a kind-of at-large advisor: Communication.

Granted, the benefits of communication seem obvious enough. Yet, so many individuals put themselves into a position of severe weakness and limitation by failing to communicate or to communicate effectively and efficiently.

You will do yourself a tremendous favor if you make effective and efficient communication a habit. Let your current creditors know if you are experiencing problems of some kind (e.g., the loss of an income). While few persons like bad news, no one likes indifference, especially those who loan you money and expect regular, on-time payments. You could possess all the concern in the world for a given challenge but if you fail to communicate that concern - and more importantly, your proposed plan for overcoming it - the message you are sending to your creditor is one of indifference or lack of concern, the very opposite of what you think and feel.

Furthermore, if you find something in error - on your credit report, a billing statement, or a bank statement - contact the relevant party or parties and find out what the process for remedying it is. Do not leave it to chance or "later, when I have more time" because when that time finally arrives it may already be too late. The damage may already be done.

For example, even though you may resolve a lost payment in the mail with a particular lender, they may have already reported what they thought was a missed payment to the credit reporting agencies. Now, instead of merely correcting the situation with your lender, you will have to undertake the time consuming, and often daunting, task of correcting your credit report. And if you are applying for a loan of some kind during this same period, it is very likely that potential creditors reviewed your report and gave you a lower credit score than you might have gotten otherwise, all because of inaccurate information on your credit report.

Things you will need to consider in the area of **communication** include answers to the following questions:

- Are there any situations or circumstances that will adversely affect my ability to pay my current bills or lines of credit? If so, what and whom (which lenders) will be affected?
- Do my credit reports accurately reflect my credit history? Have I communicated any errors that are on my reports to the credit reporting agencies? Have I contacted the lender/s in question to make them aware of the error?
- Have I communicated my plan for rectifying the problems at hand to my creditors?
- Does my spouse know about the errors on my credit reports? Have they checked their respective reports to see how they compare?
- Have I notified the co-applicant on my loan about the problems I am currently facing? Do they understand the potential circumstances? Did I communicate my plan for overcoming this challenge?

Wrap-up

In summary, there are several important principles that are essential to the achievement of lasting financial freedom. Character, capability, capacity, and credit score are four factors that cannot be avoided if you want to succeed. They are like four pillars or foundation stones upon which your entire personal credit and finance edifice must rest. And to them, we add the undying benefits of effective and efficient communication without which the rest are meaningless. The choice before you is not one of wisdom over communication or vice-versa. Rather, it is the choice of wisdom and communication together or the lack thereof. Choose the former and a happy - though perhaps, hard-earned - life awaits you.