The AFC® Learning System

AFC Reading Sample

AFCPE®

Educate the Client about Uses of Credit

The financial counselor will educate the client about the uses of **credit,** defined as follows: A financial arrangement where goods, services, or money are provided in exchange for an agreement to repay in the future.

Credit represents a contractual agreement where a borrower receives something of value now and agrees to repay the lender over time, typically with interest. Credit may enable individuals or businesses to make purchases beyond their immediate financial capacity.

Before approving a loan, to assess credit risk, an individual's application goes through **underwriting,** defined as: The process by which financial institutions assess the risk of insuring or lending to a person or entity, determining terms and eligibility. Some additional related terms are:

- **Risk:** Uncertainty associated with a situation or event that could result in a loss or negative outcome or a gain or positive outcome.
- **Credit history:** A continuing record of how an individual has managed debt over time, including payment behavior and amounts owed.
- **Collateral:** An asset pledged by a borrower to secure a loan, which can be claimed by the lender if the borrower fails to repay.

Lenders evaluate various things during underwriting:

- Credit history and score
- Income and employment stability
- Debt-to-income ratio
- Value of collateral and down payment amount (if applicable)

This risk assessment helps lenders determine whether to approve credit applications, how much to lend, and at what interest rate. Effective underwriting balances the lender's need to minimize defaults with providing access to credit for qualified borrowers, ultimately determining who receives financing and on what terms.

Pros of Credit Use

When managed properly, credit serves as a powerful financial tool. Educate the client about some of the pros of credit use.

- **Convenience:** Credit cards are often preferred to cash and allow the client to consolidate multiple purchases into one payment.

- **Building a credit profile:** Maintaining low credit utilization (below 30%), paying balances in full each month, and making on-time payments builds a positive credit history.

- **Emergency preparedness:** Credit provides options during emergencies and unexpected financial needs.
- **Building net worth:** Strategic borrowing like mortgages, business loans, and student loans can have long-term payoffs that increase the client's overall wealth.
- **Improved terms for future borrowing:** Healthy credit practices lead to better terms when the client needs to borrow in the future.
- **Interest-free opportunities:** Lenders sometimes offer interest-free credit term offers for strategic purchases.

Note that another pro of using credit can be found if the client commits to paying off the credit card balance within the grace period of that credit card. The client will not owe interest if this method is used consistently.

Cons of Credit Use

When advising clients about the cons of credit practices, a financial counselor can be both instructional and supportive. Credit use can affect many aspects of the client's financial life. Overextending or not paying back credit can lead to several consequences, including:

- Higher interest rates on loans and credit cards
- Difficulty getting approved for apartments or rental homes
- Higher insurance premiums
- Required security deposits for some utilities
- Limited access to financial products and services

When counseling clients about credit histories, emphasize that having no credit history is generally preferable to having negative credit. No credit history simply means lenders lack information about the client's financial behavior, while negative credit demonstrates a pattern of financial missteps that causes lenders to view them as a risk. Building a positive credit profile from scratch is typically easier and faster than repairing damaged credit, as negative items like late payments, collections, or bankruptcies can remain on credit reports for seven years.

- **Collections:** The process by which creditors attempt to recover outstanding debts from borrowers.
- **Bankruptcy:** A legal process through which individuals or entities unable to meet their debt obligations can seek relief from some or all of their debts.

With no credit, a client starts with a clean slate; with a low credit score, the client must overcome a documented history of problems that make lenders hesitant to extend financing or likely to charge significantly higher interest rates when they do.

Educate the Client on Criteria to Obtain Credit

When a client applies for credit, they will complete an application form or interview detailing their financial situation and payment history to help assess their likelihood to repay debts. Some relevant terms are:

- **Credit application:** A formal request submitted to a lender that provides financial and personal information used to evaluate a borrower's creditworthiness.
- **Credit report:** A statement of a consumer's credit activity, compiled by a credit bureau.
- **Credit bureau:** A company that gathers and maintains consumer credit data, providing reports that lenders use to assess credit risk.
- **Credit score:** A numerical value, usually ranging from 300 to 850, that represents a person's credit risk based on their financial history.

The lender retrieves the applicant's credit report from one or more credit bureaus, commonly the three major ones (Equifax, Experian, and TransUnion), though specialized bureaus also exist. These companies gather and maintain credit information on consumers. After retrieving the applicant's credit report, the lender obtains the applicant's credit score.

Finally, the lender evaluates all this information—the application, credit report, and credit score—to make their decision based on the applicant's demonstrated history of using credit and repaying debts.

The Five Cs of Credit

The Five Cs of Credit is defined as follows: A framework used by lenders to assess a borrower's creditworthiness, focusing on five areas: character, capacity to repay, collateral, capital, and current conditions.

Many lenders refer to these in determining creditworthiness:

- **Capacity:** An evaluation of a borrower's ability to repay a loan, typically based on income, expenses, and existing debt.

- **Capital:** The total value of a person's financial assets, including money and property. This evaluates overall financial stability through net worth, assets, and any down payments the person contributes toward purchases.

- **Character:** A factor in lending that considers a person's credit history and reliability in repaying debts.

- **Collateral:** An asset pledged by a borrower to secure a loan, which can be claimed by the lender if the borrower fails to repay.
- **Conditions:** Specific requirements or terms outlined in a loan agreement or contract that must be met by one or more parties, such as timelines, documentation, or actions needed for approval, funding, or enforcement.

A lender might base a decision to loan money on other factors besides a borrower's credit report and credit score. These factors include income, length of residence, and/or employment. These are just a few of the factors that can affect whether or not a borrower will get approved for a loan.

About AFCPE: The Association for Financial Counseling and Planning Education® (AFCPE®) is dedicated to certifying, educating, and supporting financial professionals to serve as qualified motivators of change for individuals pursuing their life goals, regardless of their financial history. The Accredited Financial Counselor® (AFC®) credential is accredited by The National Commission for Certifying Agencies (NCCA). Please visit www.afcpe.org for more information.