

Real World Graduation: Question 58: Credit

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Question 58

Credit is a situation in which a person or institution lends money to another person or institution upon a written promise to repay the loan. The loan is usually repaid at an agreed-upon interest rate. This additional amount paid by the borrower to the lender is the fee to the lender for the use of his (or the lending institution's) money. In other words, the lender gives his capital temporarily to the borrower; the borrower repays the amount borrowed plus a certain percentage per year at a certain rate. The additional amount repaid is income to the lender for the borrower's use of his capital.

Normally individuals borrow from banks or credit card companies, but not every person is allowed to borrow the same amount. Some people are allowed to borrow more than others. Why do banks and credit card companies give credit unequally?

- a) Most banks prefer to deal with people they know, and are more likely to be more liberal in the amount of credit they give - in other words, those who know bankers and those who work at credit card companies have an advantage.
- b) People who are given less credit are victims of some bias or prejudice by the banks and credit card companies; in fact offering different credit levels is a violation of the Fair Lending Act.
- c) Banks and credit card companies give credit based on what is necessary to maintain their lifestyle. Therefore, wealthy people are given more credit than the middle class people, and middle class people are given more credit than poor people because the wealthy have more day-to-day needs than the middle class, and the middle class likewise has greater need than the poor.
- d) Banks and credit card companies prefer to give more credit to those who are desperate, because they can squeeze a higher interest rate out of them.
- e) Some combination of the above, depending on state regulations

Answer to Question 58

This is a trick question. All of the answers provided are wrong because neither banks nor credit card companies "give credit". Credit is something each individual has (or not). Your creditworthiness is based on the lenders' estimate of the risk taken by the lender when lending you money. In other words, the issue is whether or not you are able and willing to repay the loan. If the lender has reason to believe that you will fail to repay, then you are considered a higher risk than someone else, and your credit is low compared to another person. If you have a steady income and pay your bills on time, the risk of lending to you is low and your creditworthiness is high. In both cases, the amount of credit you have depends on your situation and your past behavior, along with normal market forces, since credit is like any other commodity. Remember that you, as the individual, possess a certain amount of credit; it is not "given" to you by banks, credit card companies, or another person. The amount of money you can borrow and upon what terms is a consequence of your creditworthiness.