Credit basics

Credit is another term for borrowed money. Used effectively, credit offers some real benefits. Credit can help you achieve your financial goals. However, it's important to use credit responsibly. If credit gets out of control, there can be serious consequences for your financial health – it can have adverse effects on your relationships and put your financial goals out of reach. Managing your credit carefully will ensure it's something that works for you, rather than becomes a burden.

What is credit?

Credit is borrowed money that allows you – the borrower – to buy goods or services now, but pay for them later.

In Australia, businesses that typically provide credit include banks, building societies, credit unions, finance companies, friendly societies, payday lenders, and retail stores or government bodies that offer credit.

When you borrow money you enter into a "credit contract". Personal loans, credit cards, a personal overdraft on your bank account, home loans, and store cards all involve some type of credit contract. A credit contract is legally binding and sets out the terms and conditions of the credit provided, including the cost of the credit – the price you pay for being able to make use of the borrowed money. Costs may include interest and fees.

Under the terms of a credit contract, you and your credit provider have certain responsibilities. For example, you must pay back the borrowed money within a certain period of time and according to the terms and conditions of the contract. Your credit provider must give you important information about the credit facility, such as a full explanation of the terms and conditions, and any fees that may apply.

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Why use credit?

Credit can be a convenient way to buy goods and services without having to pay the whole price upfront. Buying on credit means you pay over an extended period of time – making it possible to buy larger items that you generally can't afford to pay for immediately.

For example, a personal loan can make it possible to purchase a car, and then pay it off in instalments over a few years. A home loan makes home ownership possible for many Australians, as most people would simply never have the money to pay the full amount for their home upfront.

As well as making it possible to defer payment, some forms of credit offer a convenient way to manage day-to-day expenses. For example, credit cards give you the ability to shop over the phone or via the Internet 24/7. Paying by credit card also means you don't have to carry around large amounts of cash for your day-to-day purchases.

Tip: Before applying for a credit product

Ask yourself the following questions:

- Can you afford it?
- Do you really need the item you're trying to purchase?
- How much is the item going to cost you over time, once you add interest and fees to be paid for the loan?
- Are there alternatives, such as saving up for the item and purchasing it later, or purchasing it gradually through a lay-by arrangement?
- Is your credit history in good shape?
- Which type of credit is best suited for your situation?
- Who is the credit provider – are you confident they'll uphold your rights and their responsibilities?
- Will you need to take out any other products in association with this credit? For example, is the credit provider recommending you to take out consumer credit insurance with your loan?

The costs of credit

Borrowed money comes at a price, in the form of interest, fees, or both.

The cost of a credit arrangement will depend on a number of factors, including:

- the type of credit
- the amount you borrow
- the type of provider offering the credit
- the time you'll take to repay the debt, and
- whether the credit is secured or unsecured.

Generally, the more you borrow and the longer you take to pay it off, the more interest you'll pay.

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WHAT IS INTEREST?

Interest is the amount you pay to the credit provider for the use of their money. Interest is calculated as a percentage of the amount you still owe, and is usually payable at regular intervals over time.

The type of interest can vary depending on the credit product and the credit provider. For example, personal loans may be described as fixed rate or variable rate loans, while credit cards may offer interest-free days or ongoing interest.

Fixed rate loans

Fixed rate loans mean the interest rate is set for the life of the loan. Your repayment amount and frequency are usually set at the beginning of your term. With such loans, you may have to pay an early repayment fee if you make additional repayments along the way or if you pay out your loan earlier than the agreed term.
Repayments for fixed rate loans are easy to include in your budget because you'll always know what your repayments will be. As the interest rate is fixed, you're protected from increases in interest rates, but you won't get any benefit if interest rates fall.

You may be able to get a fixed rate loan which is 'interest only', meaning that the principal is repayable at the end of the loan and you make only interest payments during the term of the loan.

Variable rate loans

Variable rate loans have interest rates that are subject to change. Such changes may occur at the credit provider's discretion, or in line with changes in market rates. Generally, if market rates go up, so too will the repayments on your loan, while if market rates come down, your repayments will fall.

With most variable rate loans you can choose the frequency of your repayments to be included in your credit contract. For example, you might choose to make a repayment weekly, fortnightly or monthly. You may also have the freedom to make additional payments at any time, or increase the amount of your regular repayment.

Variable interest rates typically apply to personal overdrafts and credit cards.

What are fees?

In addition to interest, other fees typically apply to credit contracts, such as annual fees on credit cards, or administration fees on personal loans, or establishment and/or exit fees on home loans.

The credit provider must tell you before you enter into the credit contract what fees and charges (to the extent they are known at the time), and interest rates apply, and when they'll apply.

It's vital to be aware of any fees (as well as interest rates) before entering into a credit contract.

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The table below summarises some of the fees that typically apply to credit products. The exact amount of the fees will vary depending on the credit product and the credit provider.

Common credit fees and charges		
Fee	**When it may apply**	**Who charges the fee**
Administration fee (also known as account keeping fee)	An ongoing fee that may be charged on some personal loans at regular intervals – such as monthly or yearly, depending on the loan and the credit provider.	Some credit providers
Annual fee	Most credit cards have an annual fee.	Some credit providers
Application fee	May be charged when applying for a loan, and may be payable even if your application is unsuccessful.	Some credit providers
Cash advance fee	Usually applied when obtaining cash on your credit card – it may be charged as a percentage of the total amount advanced.	Some credit providers
Dishonour fee	May be charged if you've tried to make a payment with a direct debit, and the payment was declined because you've exceeded your credit limit (if paying with a credit card) or had insufficient funds in your account (if paying from a bank account).	Some credit providers
Exit fee	May apply if you pay out a personal loan or home loan earlier than the agreed term of the loan. An exit fee can have up to three components – an adjustment to cover the loss to the lender if you terminate a fixed rate loan early, a deferred establishment fee if the original establishment fee for the loan was discounted and you've held the loan for a short period (usually about 3 - 4 years) and an administration fee to cover the lender's costs of processing the termination which could include a fee to discharge any mortgage.	Some credit providers
Establishment fee	A one-off fee that may apply when you take out a personal loan or other form of loan, but can be deferred and waived after borrowers have had a mortgage for 3 - 4 years.	Some credit providers
Foreign exchange fee	A fee that is charged on transactions made overseas on your credit card. The fee covers the cost of converting the transaction from foreign currency back into Australia dollars.	Some credit providers
Government taxes and charges	Government taxes (such as stamp duty) or registration fees (such as mortgage registration) may apply to some credit arrangements (such as home loans) depending on the State or Territory you live in.	Federal and State Governments (where applicable)
Credit card surcharges	Some merchants or retailers may charge a fee when you pay for goods or services with your credit card. Merchants and retailers are required by law to tell you if a fee applies for credit card transactions, and how much that fee is.	Some merchants and retailers
Overdrawn account fee	If you exceed the limit on your overdraft or credit card, you may incur an overdrawn account fee.	Some credit providers
Overdue payment fee (also known as late payment fee)	May apply if you miss a payment on your credit card or a repayment on a personal loan.	Some credit providers
Reward program fee	Many of the credit cards that offer reward programs for card holders charge an annual reward program fee (this is in addition to the annual fee for the credit card itself). You may also have to pay an annual fee to another service provider to be a member of their program (e.g. a frequent flyer program).	Some credit providers

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Tip: Keeping fees and interest low on your credit product

- Read the pre-contractual disclosures carefully so you understand the circumstances when additional fees may be payable.
- Avoid late payment fees on loans and credit cards by always paying your bills and instalments by the due date.
- Avoid overdrawn account or dishonour fees on overdrafts and credit cards by staying within your credit limit and making sure you've got enough money in your account to cover your expenses and direct debits.
- Try to pay more than just the minimum payment due on your credit card.
- If your credit card offers interest-free days, avoid all interest charges by always paying your bill in full by the due date, not just the minimum payment.
- Try to avoid costly methods of accessing money, such as obtaining cash through a cash advance on your credit card.
- Limit yourself to one credit card – not only will your credit situation be easier to manage, you'll also avoid doubling up on annual fees.

For more information about obtaining and managing credit, refer to 'Smarter Banking: Make credit work for you' booklet at the ABA website www.bankers.asn.au.

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