

# Credit: A Double-Edged Sword

FROM FINANCIAL SLAVERY TO BUILDING WEALTH

Give the true gift of wealth to your children and  
they will reap the benefits for a lifetime!

Written by  
G.W. Lawrence  
Lattice Hardwick

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# Credit: A Double-Edged Sword

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# CREDIT: A DOUBLE-EDGED SWORD

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# CHAPTER 3

## HOW LENDING WORKS



# HOW LENDING WORKS

In order to understand how credit can work in your life, you must first understand how lending works from the perspective of the creditor or lender.

Have you ever loaned money to a person?

Has anyone ever asked you to lend him or her money? When they do, what thoughts cross your mind?

**How do you loan money?**

What questions do you think about before lending money to someone?

1. \_\_\_\_\_
2. \_\_\_\_\_
3. \_\_\_\_\_
4. \_\_\_\_\_
5. \_\_\_\_\_

What reasons would stop you from lending someone money?

1. \_\_\_\_\_
2. \_\_\_\_\_
3. \_\_\_\_\_
4. \_\_\_\_\_
5. \_\_\_\_\_

What personal details and characteristics would make you confident that a person would repay the money you loaned them and on the date you requested your money to be returned.?

1. \_\_\_\_\_
2. \_\_\_\_\_
3. \_\_\_\_\_
4. \_\_\_\_\_
5. \_\_\_\_\_

The same thought process you use to lend money personally is practically the same process banks or creditors use to lend money. Questions begin to develop concerning the repayment of the money, the use of the money, and the absence of the money. Do they have a job? Do they already owe money? Have they repaid loans properly in the past? Do they have a stable residence and job? The difference is that the creditors do not know you personally, so they look at your financial history or your credit report.

***When a bank lends someone money,  
they are actually extending Credit to that person***

So, let's turn the table around. Imagine that you are the bank offering credit to someone. Remember, as the bank, you do not know the person applying for the loan and you expect to make a fair profit. The only way you know them is by their credit report, which shows you how they manage their money and how they pay their bills. So, what would you do if you were asked to lend money to someone you did not know, and the only document you had was a loan request or an application.

As the banker, you must answer these basic questions:

- ❖ How do you know they will repay the loan?
  - Do they make enough money to make the monthly payments?
  - Do they have a checking account?
  
- ❖ Have they repaid their debts in a timely manner?
  - Do they have a record of completely paying off other debt?
  - Whom have they received loans from before and why?
  - How long was the term of those debts?
  
- ❖ How have they handled money in the past?
  - Are there any problems in their repaying someone else?
  - What other bills do they have?
  - Do they have any poor spending habits?

- ❖ Do they make enough money?
  - Where do they work and how long have they been employed in the same line of work
  - What kind of job do they have?
  - How much do they earn?
  - How much debt do they currently have?
  
- ❖ On a scale of 1 to 10, 10 being best case, at what level do you think they will repay you? How much risk is involved?
  - What is their credit score?
  - What patterns or habits does their credit history show?
  
- ❖ How much will you charge them?
  - What is a fair amount to charge for the loan according to the risk involved and the length of time they want to keep the money? (the higher the risk and the longer it takes to repay the loan, the more you charge (i.e. interest rate).
  - **FYI:** Remember the longer it takes for a borrower to repay the loan to the bank, the longer the bank does not have the money to loan to someone else. **Time is money**, when credit is involved.
  
- ❖ To measure the risk, you must learn as much as you can about the borrower.

In your role as a banker, you begin the loan process, where you receive hundreds of applications every day from people looking for a loan. Remember, lending money is how you earn your living; so, you want to lend money, but you don't want to lose money. There are huge risks involved as well as huge profits. The key is to know how to eliminate the risks and maximize the profits.

**Banking example:** Let say that Dennard is going to deposit \$100 into his savings account and the bank agrees to pay him \$1 for every \$100 that Dennard deposits. This transaction places Dennard in the position of an investor. The bank can take the \$100 Dennard deposited into his account and loan it to

Michelle. Michelle agrees to pay \$10 to the bank for every \$100 the bank will loan her. After this transaction, the bank then becomes an investor. The bank makes \$9 between both transactions. This is the most basic method of how banks make money. They “borrow” the money (from Dennard) and then “lend” it (to Michelle).



What dangers could there be if you were offering credit to individuals on a regular basis?

- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_

***Whenever you borrow money from a lender, you are losing money. Be sure your purpose for borrowing gives you more than you are losing on the loan.***

Now you have a basic understanding of how credit and lending works. Take a moment to think how credit can work in a positive way for you.

- Business loans
- School loans
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_

Now, let's look at how money automatically adjusts and multiplies without any effort from you.

**Compound Interest... continued in book**