In this unit, you will:

- Learn what credit is
- Compare the advantages and disadvantages of using credit
- Outline the process of applying for credit
- Examine what a credit history is and why it is important
- Learn how to manage credit responsibly
- Explore the consequences of excessive debt and how to correct it
- Learn what to do about an inaccurate credit report

UNIT FOUR

Good Debt, Bad Debt: Using Credit Wisely

Say you dream of buying a $15,000 car. Even if you saved $200 a month and put it in a savings account where it earned 3 percent interest, it would still take you seven years to save what you needed to buy the car. Seven years is a long time for most people to wait for wheels!

But there is a way you can get that car sooner—by taking out a loan. You'll still have to save some money for a down payment on the car, but you'll end up getting the keys much faster than having to save the whole amount. Of course, as you'll soon see, you'll have to pay extra for this privilege.

Car loans, school loans, installment loans, and credit cards are all based on the use of credit. And like any other tool to manage your finances, you can use credit wisely, or you can use it poorly. While some types of credit work better in certain situations than others, they all follow the same basic pattern: buy what you want now and pay for it later. This may sound like a tempting deal, but it comes with a price. In this unit, you will learn about ways to manage your use of credit wisely.

What Do You Think?

1. Nearly ____% of teens owe money to either a person or company, with an average debt of $____.

2. About ____% of teens ages 16–18 already have more than $1,000 in debt.

3. ____% of teens say they understand how credit card interest and fees work.

4. ____% of teens say they know how to establish good credit.

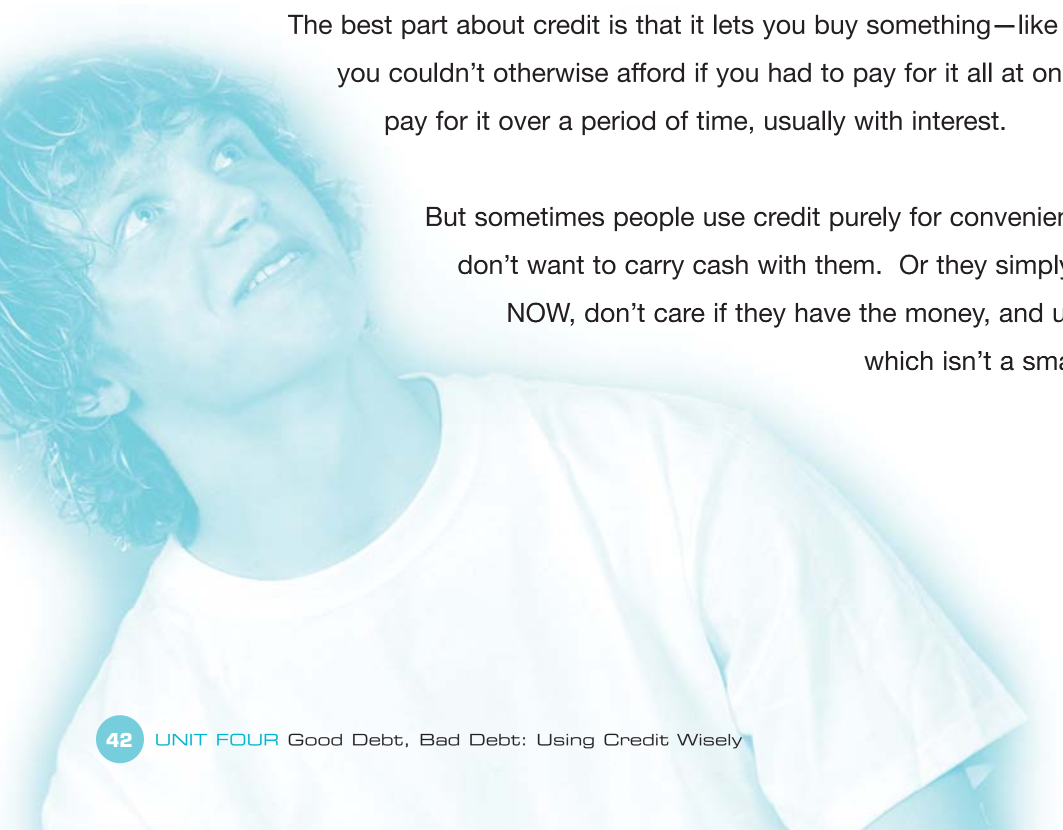
Source: "Teens and Money," Charles Schwab Foundation, April 2006

What Is Credit?

Credit can be a valuable addition to your financial tool box if you use it carefully and sensibly. ***Credit*** means someone is willing to loan you money—called ***principal***—in exchange for your promise to repay it, usually with interest. ***Interest*** is the amount you pay to use someone else's money. So the higher the interest rate, the higher the total amount you pay to buy something on credit.

The best part about credit is that it lets you buy something—like a car or a year of college tuition—you couldn't otherwise afford if you had to pay for it all at once. You get to buy the item now but pay for it over a period of time, usually with interest.

But sometimes people use credit purely for convenience. They have the money but don't want to carry cash with them. Or they simply decide they want something NOW, don't care if they have the money, and use credit for immediate satisfaction, which isn't a smart use.



Common Types of Credit

Type of Credit	Institution	Features
Credit Card	Banks, credit unions, stores, and gas stations	Some types of cards can be used just about anywhere, some only at a specific place. No payoff deadline. Monthly minimum payments vary, based on the balance. Usually has the highest rate of these four types of credit.
Installment Loan	Banks, credit unions, auto dealers, and other financial institutions	Typically used for large purchases such as a car or an appliance. Loan term can vary from a few months to many years. Monthly payment amounts are often set for the life of the loan. Usually has a lower interest rate than a credit card.
Student Loan	Banks, credit unions, and the federal government	Used for tuition and other college expenses. Depending on your income level, some loan programs let you delay making payments until you graduate. Loan term is usually up to 10 years, depending on the amount borrowed. Monthly payment amounts are usually set annually, when interest rates are adjusted. Usually has a lower interest rate than an installment loan. May provide an income tax break on interest paid to the lender.
Mortgage	Banks and credit unions	Used specifically for a loan to purchase a home. Usually repaid over 15–30 years. Monthly payments may be set for the life of the loan, or changed more frequently, depending on the type of interest rate. Usually has a lower interest rate than an installment loan. May provide an income tax break on interest paid to the lender.

TRY IT!

Exercise 4A:
What Info Do You Need for a Loan?

What information do you think is needed to get a loan?

Review several samples of loan applications to see what information you need when you apply for a loan.

The Cost of Using Credit

As mentioned earlier, using credit comes with a price. And the biggest part of that price is usually the interest rate, so it definitely pays to shop around. Advertisers like to focus on the size of the monthly payment—"Buy it now for only $19 a month!" But that doesn't tell you what you'll *really* pay for the item. So savvy shoppers know to first read the fine print of a credit card or loan application, then compare several options before making a final choice. Doing so can make a big difference in the total cost of an item.

The key credit feature to compare among credit offers is the ***annual percentage rate (APR),*** which tells you the cost of the loan per year as a percentage of the amount borrowed. The law requires that all lenders calculate the APR exactly the same way, so this is the best number to use for apple-to-apple comparisons. The APR also incorporates some of the costs of obtaining that loan, giving you a truer estimate of your total cost to borrow money than by the interest rate alone.

Sometimes you'll see a low introductory interest rate advertised on a credit offer. These "teaser" rates usually expire in a few months, then increase—a lot. It's important to read the fine print of a loan application to find out what you're getting into.

So what else should you be looking for when you pull out your magnifying glass? Other factors tied to the cost of using credit include:

Annual Fee. Usually charged by credit card companies, the ***annual fee*** is a yearly charge you pay for the privilege of using credit.

Credit Limit. The ***credit limit*** is the maximum amount of credit a lender will extend to a customer.

Finance Charge. Usually seen on credit card statements, a ***finance charge*** represents the actual dollar cost of using credit to maintain a balance.

Origination Fee. Usually associated with home loans, the ***origination fee*** is a charge for setting up the loan.

Loan Term. Usually applied to installment, student, and mortgage loans, the ***loan term*** is the length of time you have to pay off the loan. The longer the loan term, the lower your monthly payment. But the cost of using the credit increases because you're paying interest over a longer period of time.

Grace Period. The ***grace period*** is the length of time you have before you start accumulating interest. If you plan to pay off your balance each month, make sure to get a credit card with a grace period of 25 or more days so you can avoid paying interest on your purchases.

Now while we know you have every intention of handling your credit responsibly, everyone makes a mistake every once in a while. So there are two more fees you should look at. For credit cards, there is usually an ***over-the-limit fee*** for spending more than your credit limit. And for all types of credit, a ***late fee*** is obviously a penalty for making a payment after the due date. Know how much a late fee is and how soon after the due date it will be charged.

But a late fee may not be the only penalty for making late payments. A growing number of credit card companies are including something called a ***universal default*** clause in their agreements. This means they can hike up your interest rate if you make just one late payment—even if that late payment is made to a different creditor for a different type of payment. In fact, the late payment doesn't even have to be for a big payment like your car loan. It could be for a phone bill you overlooked during a move or a forgotten magazine subscription. Again, read the fine print so you know what's in store if you do slip up.

While we've talked about the actual financial costs of using credit, you also should consider how they affect your financial plan. Yes, getting a car loan instead of saving the entire amount first means you can attain that financial goal a lot sooner. But you have to remember to build the cost of repayment into your spending plan.

Of course, there are opportunity costs to using credit as well. Making a loan payment each month means you have less to spend in other areas or save toward other financial goals. Also, the interest you pay for something bought on credit is money that could have been spent in other ways. This doesn't mean it's bad to buy something on credit—just be fully aware of all the potential costs before you do so.

TRY IT!

Exercise 4B:
Scavenger Hunt for Credit

Look for at least three print ads that advertise credit. Use the *Common Types of Credit* chart on page 43 as a reference to classify the type of credit featured in the ads. Identify the terms and costs of each credit offer.

YOU CAN DO IT!

Assignment 4-1:
5 FAQs About Credit

Brainstorm general questions people might frequently ask about credit. Write these questions and their respective answers as a 5 Frequently Asked Questions (FAQs) list that might appear on a creditor's Web site.

Credit: The Good and the Bad

Before you can decide whether credit is a good choice for you, it's important to know all the rewards and risks of using it.

On the rewards side, credit offers:

Convenience. It's often easier and safer to have a credit card or get a loan rather than carry around a large amount of cash. And it's much more convenient to use a credit card for travel expenses and buying items on the Internet.

Protection. Buying items with a credit card can make it easier to get a refund if there's a problem with an item you purchased. Also, some cards offer buyer protection—a type of insurance for items you buy with a credit card in the event you find them damaged after purchase. This protection also may apply to items mistakenly charged to your account.

Emergencies. With a credit card, you always have a way to pay for emergency expenses. If your car breaks down on a Sunday morning, you're going to get back on the road much faster if you charge the repairs than if you try to find a nearby bank from which to get money.

Opportunity to Build Credit. Using credit responsibly is simply the best way to build your credit history (which is defined later in this unit). It makes it easier to get more credit when you need it later.

Quicker Gratification. Credit allows you to buy and use an expensive item, such as a car or house, while you're paying for it instead of postponing your purchase until you have enough saved. For many people, it's the only way they can afford to own a house or car.

Special Offers. Sometimes you can take advantage of special offers, such as a reduced interest rate for a limited time, or even deals to buy now and make no payments until next year. These offers decrease the short-term costs of using credit. (But always know when and what happens when the deals expire.)

Bonuses. Some types of credit also offer bonus points such as frequent-flyer miles or cash rebates for every dollar you spend. But credit card holders often pay for these perks through higher interest rates or annual fees. Savvy credit users carefully read the card's terms and weigh the value of the bonus features against potentially higher costs.

So now you've heard all the great things about using credit, let's consider the potential risks:

Interest. As you learned earlier, interest is the amount you pay for using credit. This automatically makes the item more expensive than if you had just paid for it with cash.

Overspending. People often use credit to live beyond their means—buying items they simply can't afford. As time goes on and the amount they owe grows, it gets harder and harder to pay down the balance.

Debt. The amounts you borrow add up to what is called your ***debt,*** or the entire amount of money you owe to lenders. These lenders have legal claims against your future income should you not be able to repay a debt. And if you take on too much debt, it can completely derail your financial plan—and your future.

Identity Theft. Identity theft occurs when someone uses your personal information without your permission to commit fraud or other crimes. Each time you give out your credit card or Social Security number, you're at risk for someone stealing that information to run up debts in your name. We'll discuss identity theft in great depth in Unit 5.

TRY IT!

Exercise 4C: Rewards and Risks of Credit

What are your perceptions about credit? What do you think are the rewards of using it? What are the risks? What else is interesting about credit?

Rewards:________________________________

____

Risks:__________________________________

____

Just Interesting:__________________________

____

6 Questions to Ask When You Compare Credit

1. What's the interest rate for purchases?
2. How long is the loan for?
3. What's my minimum monthly payment?
4. What's the grace period?
5. What extra fees and penalties may be charged?
6. Which is the best deal for me?

Exercise 4D:

On the Go—
Getting Wheels

TRY IT!

If you want to borrow money to buy a car, the first question you have to answer is how much will the car cost? Imagine that you are buying a used Honda Civic. Calculate the total cost of buying the car with the features that you want. Is the loan a good deal?

Assignment 4-2:

Compare Phone Plans

YOU CAN DO IT!

Gather information on at least two local phone plans provided by different companies. Compare the terms of each plan, and consider the advantages and disadvantages of each plan.

Are You Worthy?

Some day, you'll start receiving credit card and loan offers in the mail. But whether you decide to apply for one of those or seek out credit from another source, you'll usually need to have several things on hand:

- Social Security number
- Driver's license number
- Date of birth
- Address and phone number
- Name of employer
- Monthly income amount
- Total monthly payments on other debts
- Amount of monthly rent or mortgage payment

Once you apply, the first thing a lender does is decide if you're creditworthy. This is critical to the lender's next decision regarding if and how much to lend you. What all lenders look for is often referred to as the 4 C's.

The 4 C's of Credit

Collateral. This is an asset of value that lenders can take from you if you don't repay the loan as promised. When you put up collateral for a loan—typically for a home mortgage or car loan—it may be referred to as a "secured" loan.

Capital. Lenders take comfort in knowing that you have personal items of value. In the event you don't pay your bills, lenders will want to know if you have items they can sell to repay the loan. Typical items they look for are an investment account and, in some states, your home.

Capacity. Lenders' chief concern is whether you are able to repay a loan. So key factors of creditworthiness are your income and employment history. A pattern of rising income and steady employment gives lenders more confidence. Of course, if you already have a lot of debt or have an uneven work history, lenders will question whether you are able to make your payments.

Character. Finally, lenders want to know if you're trustworthy. One way they measure this is by looking at your credit record. A history of paying bills on time shows them that you are responsible with your finances.

TRY IT!

Exercise 4E:
Apply for a Loan

Fill out the sample loan application. What information on the application reveals your collateral? Capital? Capacity? Character?

Application

Name		Social Security Number
Birth Date	Home Phone	Work Phone
Current Address		
Own or Rent?	Length of Time at Address	
Mortgage or Rent Paid To	Monthly Payment	Monthly Payment
Employment Income $______________per month	Start Date	Employer Phone Number
Name and Address of Employer		
Other Income $______________per month	Source of Other Income	
References/Other Creditors	Account Number	City and State
Requested Loan Amount $______________	Purpose of Loan	
Date	Signature	

YOU CAN DO IT!

Assignment 4-3:

My 4 C's of Credit

Think about your own creditworthiness. Identify specific evidence to show how you meet any or all of the 4 C's of Credit.

Keeping Score With Your Credit

On average, today's consumer has a total of 13 credit obligations on record at a credit bureau. – "Average Credit Statistics," www.myFICO.com.

Just as your report card tracks your success in school, a credit report tracks your success in managing money responsibly. Right now, you may be more concerned about the grades on your report card, but your current financial habits can carry over and affect your ability to get credit as an adult. That's because your credit history will follow you for the rest of your life.

A ***credit report*** is simply a record of your personal financial transactions, or ***credit history.*** Lenders look at it to see how well you've managed credit in the past. Your credit report tells lenders any credit you have, loan amounts you've received, your credit card balances and limits, and whether you paid your bills on time or not at all. In short, it's your credit report card for the past seven to 10 years.

While your personal financial transactions on your credit report detail your current and past borrowing history, a ***credit score*** is a number that reflects your creditworthiness, based on the 4 C's. When you apply for credit, lenders want to know what risk they take in lending you money. Your credit score gives them an idea of your creditworthiness at the moment in time when they check it. And your score changes over time as your financial situation changes.

So who looks at your credit report? Credit reporting agencies, also known as credit bureaus, sell credit report information to businesses that are interested in finding out your creditworthiness. For example, lenders will purchase and review your credit report anytime you apply for a credit card or loan. When you apply to rent an apartment or buy a cell phone, someone will probably review your credit report. And you may be surprised to learn that employers often look at your credit report during the hiring process. So building a good credit history can smooth the way in many areas of your financial life.

The Titans of Credit

There are three main credit reporting agencies in the United States: Equifax, Experian, and TransUnion. By law, people are entitled to a free copy of their credit report from each of these companies once every 12 months. It is against federal law for anyone to obtain another person's credit report without that person's permission.

The most popular credit score is the FICO score. The score ranges from about 300 to 850, with the higher score reflecting a lower risk for the lender. In general, a credit score of 680 or above is considered good.

Fortunately, building a good credit history just takes discipline:

- Always pay your bills on time. That's the single best way you can show creditors that you'll be responsible with their money.
- If you have a savings account, it's good to make additional regular deposits, no matter how small. Lenders like to see a consistent savings pattern.
- Be choosy about your credit cards and loans. Apply only for the ones you really need, and keep them for a long time.
- Surprisingly, it's better for your credit score to maintain a low balance on one card and pay it off each month than to have no balance at all.

On the flip side, there are a number of ways you can hurt your credit history and credit score:

- Making late payments. **Even just one missed payment can affect your credit report.**
- Writing checks when you don't have enough money in your account to cover them. (This is often called "bouncing" checks.)
- Having a lot of credit cards and loans. If lenders think you have too much credit available to you, they may perceive you as a risky customer.
- Maintaining high balances on your credit cards and loans. Especially with credit cards, lenders are leery of lending you more money if your balances are too close to your credit limit.
- Changing credit cards frequently. Lenders like to see credit card holders maintain long-term relationships with credit card companies. Your score may decrease a little if you're always switching to cards with a good introductory offer.

You're probably wondering—does it *really* matter what my credit score is? ***It matters a lot.*** Of course, the worst-case scenario when you have a bad credit score is not getting approved to borrow the money you need, not being able to rent an apartment, or not getting a job. Yes, people with bad credit can still get approved sometimes—but they pay a lot more for the privilege. People with low credit scores usually have to make higher down payments or pay higher interest rates. And remember, on big-ticket items, even 1 percent more in interest can have a huge effect on your budgeted fixed expenses.

Think of good credit as another important reserve to have. Just as it's good to have savings for unexpected expenses, a good credit score means you can always borrow money if the need arises.

Your Rights When Your Credit Report Is Wrong

The law requires that credit bureaus provide information about your credit history correctly, completely, and confidentially. You have the right to see everything in your report and, most of the time, who reported the information. Part of being a savvy consumer is regularly reviewing your credit report to make sure it is accurate and that there hasn't been any fraudulent use of your identity.

As discussed earlier, you are entitled to a free credit report every year, so there's no excuse for not monitoring your credit report at least annually.

If you do find something inaccurate on your report, don't panic. Simply contact a credit reporting agency, and ask a representative to investigate the information. By law, the agency must research the questionable item and correct or delete anything that's incorrect.

If that doesn't resolve your issue, you also have the right to attach a short statement to your credit report. You may want to describe the situation along with any facts that support your claim so the lender can take that information into account.

Finally, credit bureaus must delete unfavorable information that is more than seven years old. They also must remove information on any bankruptcy that is more than 10 years old. So even if you do go through a bad time, it won't be on your record permanently.

Assignment 4-4:

Please Correct My Credit Report

Imagine you recently discovered that your credit report is inaccurate. Write a letter to one of the credit reporting agencies to request that your credit report be corrected.

Getting Your Piece of the Credit Pie

It can be tough to get credit on your own when you're still in school. One way to get started is by asking a parent or another trusted adult to co-sign a credit card application or car loan for you. This means your co-signer is equally responsible for paying the debt. But if you don't pay the bill, it also means your co-signer is on the hook—legally and financially. Other ways to get started with credit include:

- Ask the place where you have your savings or checking account for a credit card application. Because you already have a track record there, it may be more likely to approve your application.
- Apply for a credit card from a store, which is often easier to get than the major bankcards.
- You could also apply for a secured credit card. Basically, you deposit money in an account and can make charges against that amount. Of course, if you don't make your payments, the lender can simply take this money.
- If you're renting a place with some of your friends, make sure to get at least one of the utility bills in your name and pay it on time.

Your first credit card may have a low credit limit on it, but that's okay. As you prove you're able to handle the credit sensibly, lenders are usually willing to offer you more credit over time.

TRY IT!

Exercise 4F:

What's the Rating?

Evaluate Carmen's credit application. Would you approve this loan request? If so, what terms would you offer?

Application		
Name *Carmen Vasquez*		Social Security Number *000-11-2222*
Birth Date *11/24/91*	Home Phone *888-555-1111*	Work Phone
Current Address *12 Money Street, Penny Town, CO 81111*		
Own or Rent? *Live with parents*	Length of Time at Address *Entire life*	
Mortgage or Rent Paid To	Monthly Payment	Monthly Payment
Employment Income $ *500* per month	Start Date *January 15, 20XX*	Employer Phone Number *888-555-2222*
Name and Address of Employer *Susie's Gift and Card Shop* *123 Main Street, Penny Town, CO 81111*		
Other Income $ *50–$100* per month	Source of Other Income *Childcare as requested*	
References/Other Creditors *Colorado State Bank*	Account Number *Checking account #123-45-678*	City and State *Penny Town, CO 81111*
Requested Loan Amount $ *3,000*	Purpose of Loan *Purchase car*	
Date	Signature	

Be a Savvy Credit User

- About 40% of credit card holders carry individual balances of less than $1,000, while about 15% individually carry total card balances of more than $10,000.
- Forty-eight percent of consumers individually carry less than $5,000 of debt (not including mortgage loans).
- The typical consumer has about $19,000 total credit available on credit cards. More than half of all people with credit cards are using less than 30% of the total credit limit.

– "Average Credit Statistics," www.myFICO.com.

Now that you've gotten the scoop on credit reports and how they can affect your future, the importance of using and managing credit wisely should be a no-brainer. Good credit is crucial to achieving your financial goals. So take steps to avoid mismanaging credit. Shop around so you don't end up paying higher interest rates than you need to. Put purchases that you're not going to pay off right away on the card with the lowest interest rate. Don't fill your wallet with credit cards for every store you frequent—a multi-purpose bankcard will usually offer a lower interest rate while keeping your wallet trim.

Taking out a high-interest loan to buy dinner sounds silly, doesn't it? But credit card holders who don't pay their bills in full each month do exactly that when they buy household items or restaurant meals. Remember, if you don't have the money to pay for an item now, you probably won't have it after the credit card bill arrives.

?

Did You Know?

If charging that $1,000 computer seems like a good idea, think again. Let's say you buy the computer on a card with an 18% interest rate. If you make minimum payments of $30 per month, it will take you 3.9 years to pay it off—and you'll end up paying a total of $1,396!

Again, you should always pay your bills on time. But if unexpected circumstances mean you must be late on a payment, call your creditor, who may be willing to make alternative arrangements that won't leave a mark on your credit rating.

Of course, the most common way people mismanage credit is to overspend. Using credit can be smart for large purchases that you'll have for a long time. But too often, people fall into the trap of charging a lot of little purchases as well. It may be convenient, but as you know from your earlier work on budgets, small purchases can add up quickly. If you must charge small things, put them on a card you pay off every month. Otherwise, those small charges may balloon into big debts—with monthly payments you can no longer afford.

It's always easier to get into debt than to get out of it. That's because as your debt payments grow, so do the fixed expenses in your budget. Then you have fewer dollars to pay for variable expenses and to save for other financial goals. So, if you're not careful, you may end up charging more to make up for the shortfall. This will get you further into debt and increase next month's minimum payment.

Of course, there are many good reasons for using credit, if they align with your financial goals. To figure out if that's the case, let's revisit the decision-making process we discussed in Unit 1.

1. **Identify your goal.** What is it that you want to buy with credit?
2. **Gather information.** What are the terms of the credit offer you're considering? What is the interest rate? How long will it take you to pay it off? What will the minimum payment be? What will be the extra cost of using credit?
3. **Examine alternatives.** If you decide to save for the purchase instead, how long will that take? How much would you have to save each month? Could you invest the money to reach your goal sooner?
4. **Analyze outcomes.** Do you really need the item right now or can it wait? How will both options affect your budget and saving for other financial goals?
5. **Make a decision.** Decide whether or not credit is the best option for you.
6. **Evaluate results.** Look at the impact that making the purchase on credit instead of saving for it has had on your budget and other financial goals. Would you make the same decision if you had to do it all over again?

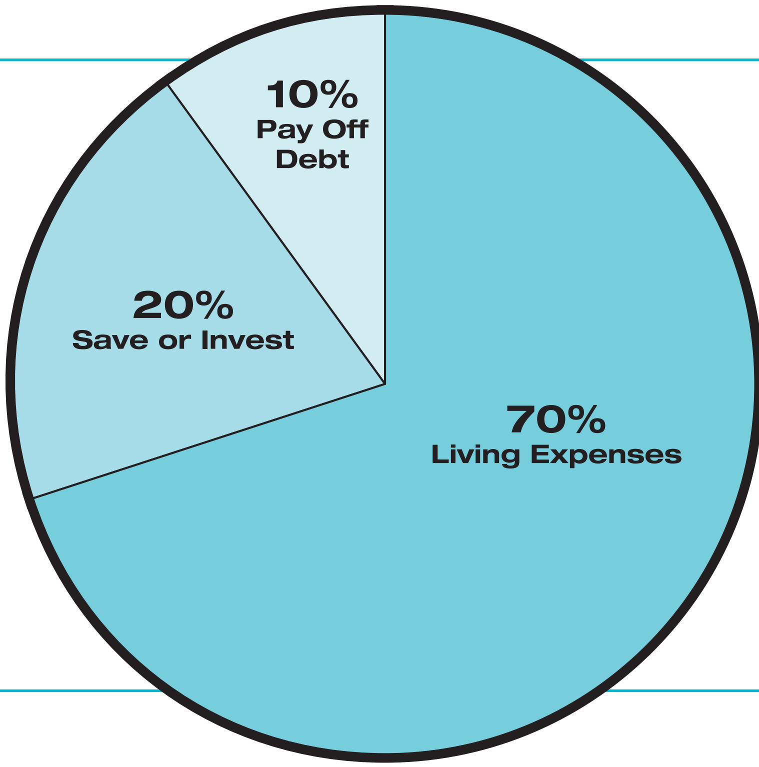


Figure 4-1: 70–20–10 Rule

Overall, a good way to keep debt in check is to follow the 70–20–10 Rule. Spend 70 percent of your income on living expenses such as rent, food, and gasoline. Save or invest 20 percent of your income for financial goals and emergency expenses. Spend 10 percent on debt payments for items such as credit cards and car and school loans.

Pitfalls to Avoid With Credit

Look Out!

- The higher the interest rate and the longer the loan term, the higher the cost of credit. To pay less interest and pay off your balance sooner, pay more than the minimum payment amount.
- Making minimum payments raises the cost of whatever you bought in the first place, and can take a very long time to pay off.
- Charging small, everyday purchases will come back to haunt you if you don't pay your credit card balance off every month.
- Having too much available credit or debt for your income level will make you look risky to a lender.

How to Avoid the Pitfalls

- Always read the fine print of a credit card or loan application before you sign on the dotted line.
- To avoid the higher interest rates of credit cards, consider a loan for large purchases.
- Be choosy about your credit, and don't apply for more than you actually need.
- Pay as much as you can every month. Even an extra $10 will reduce your balance much faster than the minimum payment.
- Pay a bill at least a week before it's due or, even better, as soon as it comes in.
- Arrange for automatic payments for your monthly bills so you don't get burned by any late payments.
- Get into a saving mode so you rarely need credit or loans for your purchases.

Credit-Related Record Keeping

Make sure to keep in your financial files:

- Terms of agreement—a document that accompanies your loan application defining the rights and responsibilities of the borrower and creditor. You may receive an occasional flyer with your bill notifying you of a change in terms.
- Receipts, so you can promptly compare charges when your bills arrive.
- Monthly statements for at least a year; tax-related items, such as your tax return, for seven years.
- A list of your credit card numbers and the telephone number of each card issuer so you can quickly notify it if your cards are lost or stolen.

The Dark Cloud of Debt

Having a lot of debt can take a tremendous toll on you. It certainly makes it harder to achieve your financial goals because you're spending more and more of your income on debt payments. After a while, it can seem like there's just no hope of ever having enough money to keep up with your bills. And of course, struggles to pay your bills will probably show up negatively on your credit report, affecting your future ability to borrow money.

Living under a dark cloud of debt can affect other areas of your life as well. The stress of worrying about paying your bills can affect your health—not to mention the strain of not having enough money if serious medical problems do arise. Excessive debt can also affect your relationships. Don't you find it annoying if a friend or family member is always short on cash? And people often resent those who keep asking to borrow money. Then when marriage comes into the picture, in some states debt becomes a spouse's responsibility too. That can create a huge source of tension between couples. Finally, people over their heads in debt often try to hide their trouble, which only further erodes trust between loved ones.

If you ever feel like you need to reduce your amount of debt, there is a way out.

1. Put away the plastic, and stop adding to your debt. Start living entirely on a cash basis again.
2. Make a personal commitment to repay all your debts. After all, they are *your* debts.
3. Find out exactly how bad it is—how much do you really owe?
4. Create a repayment plan that you can stick with.

There are two popular methods people use to tackle debt. One is to take any additional money you may have available and use it to pay off the debt with the smallest balance first. After you repay that balance, apply the same payment amount to the card or loan with the next smallest balance and continue the process until all debts are paid off. This method can be very rewarding because you see progress quickly.

The other popular method is to concentrate first on repaying the debt with the highest interest rate. This method will save you more in interest charges over time, but progress will be harder to see. Either method works, as long as you're patient and persistent.

Unfortunately, debt can sometimes completely overwhelm responsible people. Illness, divorce, business losses, and other events beyond their control can bring them to the point where they can no longer make even minimum payments. And they fall further and further behind as compounding interest on their debt grows.

If this is ever your situation, the best first step is to contact your creditors immediately and tell them your situation. Creditors want to be repaid, so most will try to work with you. Also, it costs them money to send your debt to a collection agency, so they'd rather avoid that if you seem committed to repaying the debt in full.

If your creditors don't seem willing to work with you, another option is to seek help from an organization such as the Association of Independent Consumer Credit Counseling Agencies (AICCCA). This organization's Web site (www.aiccca.org) has a search engine you can use to locate a registered nonprofit credit counseling agency in your zip code. The agency you locate can contact your creditors and help you work out a budget and repayment plan that you can afford. But you should know that going this route may affect your credit rating—so don't choose this lightly.

Of course, sometimes it's too late for even a counseling service to help. In that case, the last resort is bankruptcy.

Bankruptcy

The road of last resort when someone gets too deeply into debt is bankruptcy. ***Bankruptcy*** is a legal process to get out of debt when you can no longer make all your required payments. There are two types of bankruptcy:

- ***Chapter 7*** effectively allows you to erase most of your debt. To qualify, you typically must be unemployed or have a very low income. You must also undergo financial counseling as part of the process.

- ***Chapter 13*** allows you to repay many of your debts over a period of time, usually no more than five years. A court typically oversees the repayment plan to make sure that you do.

Note that not all debts will be erased by bankruptcy. Some common types that aren't usually erased include student loans, child support and alimony, and any penalties and fines for crimes a person committed. Also, because of the growing rate of bankruptcy abuse, Congress changed the bankruptcy law in 2005. It is now much harder to declare Chapter 7 bankruptcy.

Going bankrupt is a very serious action to take because it can stay on your credit record for up to 10 years. Bankruptcy makes it much harder and more expensive to buy a house or get other types of credit during that time. It's also very costly to everyone else, because lenders usually end up raising rates on all of their loans and services available to the public to cover their losses.

Many people have to file for bankruptcy because of unforeseen and unavoidable misfortune. For people in this situation, bankruptcy provides a "clean slate" and a chance to rebuild their lives. But for many others, bankruptcy is the result of irresponsible borrowing by people who simply decided to default on their obligations.

The Law and Order of Debt

You do have a responsibility to repay your debts. After all, you agreed to repay the money borrowed plus interest, on time, when you signed the credit application. If you fail to keep your part of the bargain, lenders may take legal action against you to recover what they can.

But you also have rights that lenders must respect. The Truth in Lending Act requires that lenders tell you in writing the true interest rate and total finance charge before you sign a credit application. Lenders also must be truthful and not mislead you with their advertisements.

You also have the right, with certain types of credit, to cancel an agreement with a lender within three days—assuming you return the money borrowed. And if you're ever turned down for a loan or credit card, the lender must tell you the specific reason for the denial as well as the name and address of the credit reporting agency that provided the information.

Another law, the Fair Debt Collection Practices Act (FDCPA), protects you from harassment by creditors. If your creditor hires a collection agency to get you to repay a debt, its debt collector is not allowed to:

- Use abusive language with you.
- Call at unreasonable hours (before 8 a.m. and after 9 p.m.) or an excessive number of times.
- Threaten to notify your employer or friends that you haven't paid your bills.
- Attempt to collect more than what you owe.
- Send you misleading letters that appear to be from a government agency or a court of law.

If a collection agency does any of these things, consumers can sue the collector in state or federal court. Consumers can also report a debt collector problem to the state Attorney General's office and the Federal Trade Commission (FTC).

TRY IT!

Exercise 4G:

What Are the Priorities?

Using the credit information below, prioritize the order of the debts to be paid.

____ A car loan with a balance of $6,000, monthly payments of $250, and an interest rate of 8.9%.

____ A bank credit card with a balance of $800, minimum monthly payments of $20, and an interest rate of 19.5%.

____ A student loan with a balance of $30,000, monthly payments of $175, and an interest rate of 6%.

____ A store credit card with a balance of $2,300, minimum monthly payments of $70, and an interest rate of 15.9%.

____ A credit union credit card with a balance of $3,500, minimum monthly payments of $110, and an interest rate of 12%.

TRY IT!

Exercise 4H:

Rights and Responsibilities of Using Credit

Any time you use credit, you enter into a contract with the creditor or lender. Read a loan contract to examine your rights and responsibilities of using credit. Use the chart below to list at least three rights and three responsibilities of consumers who use this type of credit.

Rights of Using Credit	Responsibilities of Using Credit

Assessment 4-1: My Plan to Handle Credit

Assess your own credit history. Reflect on ways to improve your credit rating in the next few years. Also, identify strategies for managing your credit.

Adding It Up

Credit—if you use it wisely—can be a valuable tool in your financial tool box. And understanding the value of credit really comes down to just four things:

1. **Know the real cost of debt.** The same item will cost more in the end if you buy it on credit instead of with cash. So choose the credit option carefully.
2. **Don't use credit to live beyond your means.** If you can't pay for an item in a reasonable amount of time, you shouldn't be borrowing money to buy it.
3. **It's all about the details.** The fine print is your friend when you're comparing credit options. Uncover the details of what an option may truly cost you in interest, fees, and other penalties.
4. **Pay as much as you can, as early as you can.** This will help you reduce your overall finance charges, avoid penalties, and keep your credit report in good standing.

For more tips, tools, and articles about credit, visit hsfpp.nefe.org.

Unit Assessment 4-1: My Plan to Handle Credit

Refer to your response for **Assignment 4-3, My 4 C's of Credit,** to think about how your current situation might affect your ability to obtain and use credit over the next five years. Use what you learned in Unit 4 to select strategies you will use to handle credit and manage debt in the next few years.

Competency:
Select strategies to use in handling credit and managing debt.

Directions:

- ☐ Preview the Required Criteria to plan for your assessment.
- ☐ Refer to your credit history analysis completed for **Assignment 4-3, My 4 C's of Credit.** State the potential consequences over the next five years if you were to maintain your current credit history. Consider your ability to obtain future credit. Also explain how your financial goals will be affected.
- ☐ Explain at least two strategies you can employ now to help you establish good credit habits.
- ☐ Describe at least two additional strategies you can use in the near future to establish good credit habits.

Required Criteria	Status
1. You predict the consequences of maintaining your credit history over the next five years including your ability to obtain credit	complete not complete
2. You predict how your financial goals will be affected by your existing credit history	complete not complete
3. You detail at least two strategies that you can implement now to build a good credit history	complete not complete
4. You detail at least two strategies that you can implement sometime in the next five years to build a good credit history	complete not complete
5. Your strategies are realistic for your current and near-future situation	complete not complete
6. You explain how your strategies to manage credit are in line with your financial goals	complete not complete
7. You use correct spelling, grammar, and punctuation	complete not complete

Feedback:

Score _______/50 **Name** ________________________________ **Date** ____________