



FINANCE

Credit: Getting Started and Staying on Track

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Quick Facts...

The average U.S. family has 14 credit cards maintaining an average balance of \$8,000.

Almost one-half of American families don't pay their entire credit card balances each month. The average balance due is \$8,940 at 18.9 percent interest.

Almost half of American families report difficulty paying their minimum monthly payments. If they miss a payment, the average late fee is \$35 per card.

Credit card debt usually has a higher interest rate than ordinary installment debt. Monthly credit card interest rates may be as high as 29.49 percent.

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Credit is a big resource for most consumers. It allows you to cover expected and even unexpected expenses in a simple and convenient way. A good credit history that reflects on-time payments can pave the way for financing major purchases such as automobiles or homes. At the same time, if credit is used as a way to live beyond your means, you can find yourself in a financial crisis or experience health, work and family problems.

Consumer debt is big business. In 2003, total consumer debt exceeded \$1.97 trillion.

Advantages

- It eliminates the need to carry large sums of cash.
- Sometimes the only way to survive an emergency such as unemployment, auto repairs or unexpected medical expenses is to borrow from a creditor.
- For people who find it difficult to save for purchases, credit payments may be considered a form of forced savings.
- It is often difficult to make hotel or car rental reservations without using a credit card. It may be difficult to cash checks away from home, and credit cards are accepted widely.
- Some credit cards offer extra incentives such as airline frequent flyer miles and rebates on car purchases.
- Credit card bills summarize all of your purchases and simplify your record keeping.

Disadvantages

- There's the tendency to spend more money when charging items rather than just paying cash. Recently, a study showed that people would pay twice as much for an item when using a credit card compared to paying cash.
- Finance charges add to the price of goods and services. Many people don't realize that a large portion of an already tight income goes to paying off monthly interest charges.
- Psychologically, people can find themselves caught in the buy-now, pay-later cycle.

Qualifying for Credit

Credit grantors consider the following before approving a loan application: the ability to pay (income and savings); the willingness to borrow money; and the record of fulfilling former credit obligations (your credit history). The goal of every consumer should be to use credit as

inexpensively as possible. That goal can be achieved by paying off credit card balances each month and making loan payments on time.

Companies use various methods to determine if a consumer qualifies for credit. Credit scoring systems assign points to applicant characteristics. Called a FICO or credit score, you are scored according to how long you have held your present job, the number of years you have lived in your present home, and whether you have previously borrowed money. No single item is important by itself, but total points will determine if your application gets approved.

If you establish a good credit history, you will be looked upon favorably by lenders when you want to make large purchases such as a car or home. If you have no credit history, you may be turned down or be forced to pay a higher interest rate. Many young people have found credit unobtainable because they have no record showing credit worthiness. Having an established credit history will speed the application process. Credit laws protect consumers from unreasonable denial of credit, but it still takes consumer effort to establish and maintain a good credit report.

How Much Credit Can You Afford?

Calculate your debt ratio by analyzing how much of your net monthly income is going towards paying debts (this does not include a home mortgage). You can figure this by dividing your total monthly debt payments by your net monthly income. This gives you an indication of how much of each month's take home pay is spent on loan payments. If the debt ratio is less than 15 percent, you are doing fine with credit. If it is between 15 and 20 percent, you are on the verge of having too much debt. If it's over 20 percent, you are in dangerous territory. (See Table 1.)

If someone has a debt load that leaves no room for additional credit purchases, increased prices for food or perhaps an unexpected emergency can put the whole balance out of whack. Excessive credit commitments keep people from exercising flexibility when they need to adapt to changing situations.

As you consider using credit, ask yourself two questions: Do I have limited flexibility for future decisions because I am locked into long-term credit obligations? If I need an emergency loan, am I too heavily committed to get it? If your answers are "yes," your best bet is to decide how you can get rid of some of your debt.

A good strategy when you have paid off a loan is to use the amount of the payment to pay off your next highest interest loan.

After you've paid off your debts, use your loan payments for investments. You will be amazed at how quickly your savings will grow. As they build, you can tap into your savings to pay for large purchases and unexpected expenses instead of using credit.

Your First Credit Card

Credit is not an advantage when consumers use it to stretch their income. The Federal Reserve reports that 58 percent of households using credit cards pay interest charges each month. The lesson is not to avoid credit, but to learn to use it so it that it works for you. Here are some tips on how you can prepare for handling credit responsibly.

- Credit card companies market to college students because they expect to have their business years after graduation. When students arrive on campus, credit card companies are very aggressive about signing them up with incentives such as free t-shirts and other gifts.

Table 1. Sawyer Jackson is newly out of school and has the following credit obligations:

Debt	Monthly pymt	# of pymts	Balance
School loans	\$125	47	\$5,000
Car	190	36	\$6,000
Stereo	70	12	\$800
	\$385	95	\$11,800

Net monthly income = \$1,667

Total monthly payments (\$385) ÷ Net monthly income (\$1,667) = 23 percent

Using the debt ratio calculation, how much credit can Jackson afford? The recommended maximum is 20 percent, which for Jackson would mean monthly payments of \$333. But Jackson's debt ratio shows that 23 percent of his monthly income is committed to paying off debt. This level is a warning sign for Jackson not to take on any additional debt.

If Jackson continues to pay his debts at the rate of \$385/month, it will take him 2.5 years to pay it all off.

Useful Web sites:

Several useful Internet sites for additional information are:

- www.consumer-action.org
- www.credit-search.com
- www.lendingtree.com
- www.collegeparents.org
- www.studentcredit.com
- www.cardweb.com
- www.bankrate.com
- www.ext.colostate.edu/PUBS/COLUMNYM/yymenu.html

(Remember that Web sites ending in .com are commercial sites and will usually have something to sell.)

- If used carefully, students who use credit cards can build a positive credit history and have a source of payment for emergencies. But credit cards are very seductive and without thinking about it, students can reach their credit limits without a source of income to pay off the debt. The average college graduate leaves school with \$18,900 in student loan(s).
- Because some credit cards have annual fees and high interest rates, using credit to your advantage means finding a credit card with the lowest possible costs. Ignore ads offering low interest rates for an introductory period of time.
- Most cards offer an interest-free period if you pay your balance in full within a certain period of time. But, if you forget to mail your check on time or carry over ANY balance—even a dollar—you'll forfeit the grace period and pay interest on all of your new purchases plus the outstanding balance.
- Pay your balance in full each month, and say no to cash advances. Credit card issuers love customers who pay the minimum monthly payment, typically only 2.5 percent of the balance. If you charge up to your maximum credit level of say \$500 and make the minimum payment, at 18 percent interest, it will take seven years to pay off the balance (with no additional purchases), and you will have paid \$365 in interest - almost as much as the \$500 you charged at the beginning.

In recent years, the amount of the required monthly minimum payment has dropped. That may seem to make it easier to keep up with your credit card bills however this is costly. Smaller minimum payments extend the life of the debt and result in much larger interest payments to the credit card company. In fact, for some consumers, making only the minimum payment means they will never pay off the balance owed.

Sometimes, credit card issuers may even let you charge more than your credit limit. Then they'll charge you a fee because you exceeded that limit. It's up to you to be aware of your available credit if you want to avoid a fee. Be aware that you may also pay fees for late payments.

Cash advances from your credit card can be quite costly too. Interest is charged from the date of the cash advance and you usually pay a special cash advance fee. Let's say you take a cash advance of \$300 and are charged the average fee of \$10.00. At the same time, you'll pay interest (about 18.5 percent depending upon the card). If you pay the advance in full 25 days after taking out the advance, you will have paid an approximate interest rate of 34 percent for the advance. Legal? Yes. Smart? Maybe not.

If you feel you are having difficulties managing your credit there are a number of resources to get help. You can call the National Foundation for Consumer Credit (1-800-388-2227), InCharge Institute of America (1-888-394-3687), Myvesta (1-800-680-3328) or Money Management International (1-888-762-2271). You can visit The America Consumer Credit Counseling Web site at www.consumercredit.com.

Strategies for Using Credit to Your Benefit

- Spend time shopping for credit just as you would shop for a car or a stereo system. It can save you thousands of dollars.
- Don't exceed 20 percent of your monthly income in consumer debt payments. Think of having to work five days and getting paid for only four which is the same as owing 20 percent of what you earn.

- If you are afraid you'll use your credit card too much, put it in a block of ice in the freezer so it's not readily available. Also, limit the number of cards that you have.
- Use a debit card instead of a credit card if your tendency is to spend without control.
- Always pay off your credit card balance each month. If you must maintain a balance, use a credit card with a low interest rate.
- Review your credit report once a year and correct any inaccurate information. Colorado law requires credit bureaus to send you a free credit report once a year if you request one. Unfavorable credit can stay on your report for seven years or more.
- Promise yourself never to use the cash advance feature on credit cards – the interest rate could exceed 30 percent with fees.

Credit is an asset that is just as important as stocks or gold.

Consumers with good credit can often negotiate better loan rates for major purchases such as cars and furniture. A good credit history also makes it much easier to get a home mortgage. Credit histories are often checked when individuals inquire about renting and purchasing insurance or even applying for a job. Poor credit is a danger signal that may indicate you are an undesirable tenant or customer.

Good credit is a lifelong asset to be used for convenience and emergencies.

For a copy of your credit report, call:

- Equifax (800) 685-1111,
- Experian (888) 397-3742, or
- TransUnion (800) 916-8800.