

# Credit, Credit Cards & Good Debt vs. Bad Debt

## Chapter

# 4

### Objectives

At the end of this section, you will be able to:

1. Understand loan basics, such as interest, term, and prepayment
2. Define and calculate the cost of borrowing
3. Identify good debt vs. bad debt
4. Identify features and evaluate credit card offers
5. Understand your credit rights as a consumer

In addition to the objectives above, this section will define the following **Key Terms**:

borrower/debtor

lender/creditor

principal

installments

interest

annual percentage rate (APR)

fixed rate

variable rate

credit report

credit limit

available credit

Federal Trade Commission (FTC)

Equal Credit Opportunity Act (ECOA)

Fair Credit Reporting Act (FCRA)

amount owed factor

debt

issuer

effective annual rate (EAR)

periodic rate

billing cycle

average daily balance

minimum payment

annual fee

finance charge

good debt

bad debt

federal student loan

FAFSA

payday loan

title loan

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## Mindset

The option to use borrowed money for major purchases provides consumers with convenience and purchasing power. However, over-borrowing or improper use of debt can put a buyer's financial health at risk. Improper use of credit can have a detrimental impact on individuals as well as national and global economies. Understanding how to use credit wisely and recognizing common mistakes that create credit mishaps is critical to controlling your personal finances.

Before taking on credit—borrowing money—consider these questions:

- Are you sure you will be able to repay the money?
- How long will it take you to repay the money?
- How much will it cost you to borrow money?
- What will you do if you can't pay the loan?
- How will borrowing the money impact your credit report?
- Will others be impacted if you do not repay the loan (e.g., a co-signer)?

Credit is the ability to borrow money. This chapter will take a detailed look at how credit is reported, your consumer rights related to credit, the use of credit cards as a specific form of credit, and the difference between good debt and bad debt.

## Credit

There are at least two parties involved in any credit transaction. They are the **borrower/debtor**—the person or company that receives or borrows money, and the **lender/creditor**—the person or company providing the money to the borrower. The amount of money borrowed is called the **principal**, and it is repaid at some point in the future or over a period of time in installments. **Installments** are partial payments made over a period of time.

### The Cost of Credit

The fee that companies charge for extending credit is called **interest**, and it is usually expressed as an annual percentage. The term **annual percentage rate (APR)** represents the total yearly cost of a loan including insurance, any origination fee (points), or other costs related to the loan. The APR is expressed as a percentage. It is important to understand what is included in your quoted payment.

The following chart shows the difference between the interest rate offered in an advertisement for home mortgages and the related APRs for those mortgages:

	Rate	APR
30-Year Fixed	2.750	3.061
15-Year Fixed	2.250	2.646
7-Year ARM	1.875	3.037
5-Year ARM	1.500	3.089
FHA Rates	Rate	APR
30-Year Fixed	3.250	3.890
15-Year Fixed	2.750	3.141

The interest rate for borrowing can be either fixed or variable. A **fixed rate** remains the same over the life of the loan. A **variable rate** fluctuates with the current market rate and may change over time. As the interest rate increases, so does the loan payment.

#### QUICK TIP

Interest on money you borrow is calculated similarly to interest you earn.

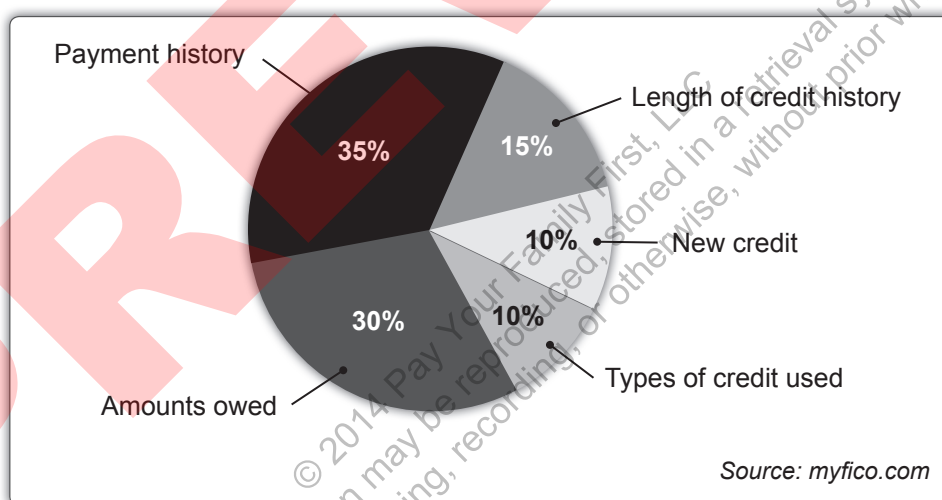
## Exercise

When would it be beneficial to have a fixed-rate loan?

What is the annual interest charge on a loan amount of \$7,000 with an interest rate of 8%?

## Reporting Credit

A credit score, along with detailed information regarding how the score was determined, is found on a credit report. A **credit report** is a detailed report of a person's credit history. These reports are prepared by credit monitoring agencies Experian, TransUnion, and Equifax. These agencies sell your credit reports to companies who use it as a tool to evaluate whether to grant you credit, insurance, employment, or even housing. In addition, your credit report is used by lenders to establish interest rates and **credit limits**—the maximum amount you can borrow.



A credit report will show whether you pay your bills and if you pay them on time. It will also reveal if you've ever filed bankruptcy, where you've been employed, where you live, how often you have applied for new credit, and whether you've ever been sued. In addition, a credit report will provide a comparison of how much money you owe to how much credit you have. The difference between your credit limit and the current amount you owe is called **available credit**.

## Exercise

Jean owes money on the following credit accounts with associated credit limits. Complete the chart with her available credit for each account.

Account	Amount Owed	Credit Limit	Available Credit
Stylish 1 Department Store	\$ 102.29	\$ 300.00	
Modern Home Improvement Store	\$ -	\$ 2,500.00	
Overdraft Protection	\$ 76.01	\$ 500.00	
Major Credit Card 1	\$ 2,945.20	\$ 5,000.00	

What is Jean's total credit allowance on all accounts?

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What is Jean's total available credit?

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What percent of Jean's total credit is still available?

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Information on a credit report is typically updated every 30 days. However, not every creditor will report to all three agencies, so you may find different information about your credit on each report. This is also why you may have a different credit score from each of the agencies. It is recommended that you review all three reports every 6 to 12 months.

Although a report from one agency may have information about an account that another agency's report doesn't have, you will find the same six components on reports from each of the three agencies:

- Identifying information: Name, address, birthday, social security number
- Employment information: Reported by you or your creditors
- Consumer statement: Written statements or information you have submitted to be on record on your reports (e.g., a reason you did not pay a debt)
- Account information: Broken down by account type and including your payment history
- Public records: This could be tax liens or judgments or anything else you might owe that would be on public record
- Inquiries: Broken down between public (seen by anyone who pulls your report) and non-public (seen only by you when you pull your report)

## Exercise

Sample Credit Report

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### Identifying Information

The information found in this report is acquired by what is reported from different sources including creditors, yourself and other sources. You might find that information reported from other sources appears differently leading to variations such as social security number, address, name, etc. Your social security number that was provided to obtain this report will not show due to our efforts to protect your privacy and avoid fraud. Our system identifies who you are through the Name identification number and Address identification number that appears on this report. A Geographic Code is used on this report for every address. This identifies the census tract, state, county, block ground and the Metropolitan Statistical Area associated with each address on record.

Names:

SALLY SIMPSON

Name identification number: 15621

Address : 1234 MAIN STREET

ANYTOWN, NY 90001-9999

Address identification number:

025591142

Type of Residence: Multifamily

**Identifying Info:** Name, address, birthday, Social Security Number.

Social Security number variations:

999999999

Address : 1255 SOMEWHERE DRIVE

ANYTOWN, MD 90002-7777

Address identification number :

015522343

Type of Residence: Single family

Year of birth:

1981

Spouse or co-applicant:

JOHN

Address : 555 NEW ROAD

ANYTOWN, MD 90003-5555

Address identification number: 0-122344-21-8511

0170129301

Type of Residence: Home

### Employment Information

FACTORY USA

Telephone numbers:

(555) 555 5555 Residential

**Employment Info:** reported to you by creditors.

### Consumer Statement

No general personal statements appear on your report.

### Important Message from ABC Credit

Due to certain laws, we are unable to share medical information such as physical, mental or behavioral health conditions. This data is not information normally collected. It is possible it will show under the name of the party providing the data (i.e. "Heart Center") that reports your payment history. Those names will appear in your report, but reports furnished to others will reference only as MEDICAL PAYMENT DATA. These reports containing medical data are disclosed if requested by you.

**Consumer Statement:** Written statements or information you have submitted to be on record on your reports (i.e. a reason you did not pay a debt).

ABC Credit's report is comprised of information gathered about you from public records, reliable sources and your creditors. Your credit history gathered by ABC Credit is made available to entities allowed by law such as employers and creditors looking to extend you credit. The decision to grant or deny credit is made solely by the grantor of credit, not ABC Credit.

If you find that you are not in agreement with the information provided in this report, file a dispute.

## Potentially Negative Items

### Public Records

Information provided in your report is carefully reviewed by credit grantors. The information found in your report is connected with some public records, such as bankruptcy, along with your credit items.

#### STATE REVENUE DEPARTMENT

Address:  
555 Main St.  
HOUSTON, TX 10000

Identification Number:  
1

Plaintiff:  
DEPARTMENT OF REVENUE

Status :  
Civil claim paid.

Status Details:  
This item was verified and updated in  
Jul 2012.

Date Filed: 02/01/2012  
Date Resolved: 05/14/2012  
Claim Amount: \$500  
Liability Amount : NA

Responsibility:  
INDIVIDUAL

**Public Records:** This could be tax liens or judgements or anything else that you would owe that would be on public record.

### Credit Items

Please note that for privacy and your protection, the last few digits of your account numbers do not display in this report.

#### FIRST MONEY BANKS

Address:  
100 CENTER RD  
HOUSTON, TX 10000  
(888) 888-8888  
Status: Paid/Past due 60 days.

Account Number:  
9999999 ...

#### ACCOUNT INFORMATION

Date Opened: 11/2010  
Reported Since: 12/2010  
Date of Status: 07/2012  
Type: Installment  
Terms: 12 Months  
Monthly Payment: \$0  
Last Reported: 07/2012  
Responsibility: Individual

Credit Limit/Original Amount:  
\$1,523  
High Balance: NA  
Recent Balance: \$0 as of 07/2012  
Recent Payment: \$0

**Account Information:** Broken down by account type, including payment history.

Account History:  
60 days as of 10-2011  
30 days as of 11-2011

**COLLECTION COMPANY INC.**

Address: PO BOX 555  
ANYTOWN, PA 10000  
(555) 555-5555  
Account Number: 0123456789 ..  
Original Creditor: CELL SERVICE USA  
Status: Collection account. \$195 past due as of 1-2009.

Date Opened: 01/2009  
Type: Installment  
Reported Since: 02/2009  
Terms: NA  
Date of Status: 04/2009  
Monthly Payment: \$0  
Credit Limit/Original Amount: \$195  
High Balance: NA  
Recent Balance: \$195 as of 07/2009  
Recent Payment: \$0  
Last Reported: 07/2009  
Responsibility: Individual

Your statement: ITEM DISPUTED BY CONSUMER

Account History:  
Collection as of 4-2009

**Accounts in Good Standing****ELECTRONICS PLUS INC.**

Address: 1559 MAIN ST.  
ANY TOWN, MD 90001  
(555) 555-5555  
Account Number: 12345678998 ..  
Status: Open

Date Opened: 01/2008  
Type: Installment  
Reported Since: 01/2008  
Terms: 36 Months  
Date of Status: 04/2009  
Monthly Payment: \$315  
Credit Limit/Original Amount: \$13,465  
High Balance: NA  
Recent Balance: \$8,452 as of 04/2009  
Recent Payment: \$0  
Last Reported: 04/2009  
Responsibility: Individual

**GENERAL CREDIT**

Address: PO BOX 1111  
NEW YORK, NY10000  
Account Number: 654321 ..  
Status: Closed/Never late.  
Date Opened: 04/2007  
Type: Revolving  
Reported Since: 04/2007  
Terms: 1 Months  
Date of Status: 08/2008  
Monthly Payment: \$0  
Credit Limit/Original Amount: NA  
High Balance: \$5,331  
Recent Balance: \$0 /paid as of 08/2008  
Recent Payment: \$0  
Last Reported: 08/2008  
Responsibility: Individual

Your statement:  
Account closed at consumer's request

## Request Inquiries for Your Credit History

### Requests Viewed By Others

Remember, your credit history is made available to current and prospective creditors along with employers as allowed by law. Personal information about you may be made available to those whose companies have products that may provide an interest to you.

Below is a list of all those who have requested such information pertaining to actions that involve you, for example, completion of a credit application or the transfer of an account to a collection agency, application for a home loan or insurance. Creditors may review these requests when evaluating your credit worthiness during their review process.

#### USA REALTY CO

Address:  
2000 S. Main Blvd 1000  
(555) 555-5555

Date of Request:  
05/12/2009

Comments:

Real estate loan on behalf of 3903 MERCHANTS EXPRESS M. This inquiry is scheduled to continue on record until 5-2010.

#### AMERICA ONE BANK

Address:  
PO BOX 1001  
ANYTOWN NY 10000  
(555) 555-5555

Date of Request:  
03/22/2008

Comments:

Permissible purpose. This inquiry is scheduled to continue on record until 3-2010.

#### WESTERN FUNDING INC

Address:  
155 MAIN ST. STE 1001  
NASHVILLE CA 10000  
(559) 555-5555

Date of Request:  
02/24/2007

Comments:

Permissible purpose. This inquiry is scheduled to continue on record until 2-2010.

### Requests Viewed Only By You

Below is a list of those who have a permissible purpose by law and have recently requested in the past to view your information. These requests may not have been initiated by you. You may not recognize each source provided below as a result. Information is only provided to those who have a permissible purpose such as:

- existing creditors to monitor your credit activity (most recent requests appear);
- creditors who wish to offer you a pre approved credit offer;
- an employer wanting to offer employment;
- a potential investor attempting to assess risks of current obligations;
- experian or other agencies reporting credit to process your report.

These requests are only reported to you giving you a record of activities. Information contained in this portion of the report is not seen by other creditors wishing to evaluate your credit worthiness.

#### ABC BANK

Address:  
1 MAIN CIRCLE ST  
BUFFALO NY 14203

Date of Request:  
08/10/2008

#### MYTOWN BANK

Address:  
PO BOX 1525  
UPTOWN NY 10000  
(555) 555-5555

Date of Request:  
09/03/2008

#### LOCAL DATA CENTER

Address:  
1000 S MAIN BLVD  
INTOWN TX 1000J (555) 555-5555

Date of Request:  
04/ 12/2007

**Inquiries:**  
Broken down between public (seen by anyone who pulls your report) and non-public (seen only by you when you pull your report).

Based on this sample credit report, answer the following questions:

1. What is the current address for Sally Simpson? \_\_\_\_\_
2. How many accounts on this report are currently open? \_\_\_\_\_
3. How many accounts on this report are currently closed? \_\_\_\_\_
4. Are there any negative events or delinquent accounts on this report? \_\_\_\_\_
5. How many public inquiries are there? \_\_\_\_\_
6. How many private inquiries are there? \_\_\_\_\_

Has it been longer than 6 to 12 months since you have reviewed your credit reports and checked your score? If so, it is time to request your reports.

### Exercise

My Credit Score:

TransUnion \_\_\_\_\_

Equifax: \_\_\_\_\_

Experian \_\_\_\_\_

How do you feel about your credit score? Are there opportunities to improve your score? Based on what you have already learned about how it is determined, what are three ways you can improve your credit score?

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### Consumer Credit Rights

The **Federal Trade Commission (FTC)**, an independent agency of the U.S. government created for consumer protection, enforces the credit laws that protect your right to get, use, and maintain credit. Although the laws enforced by the FTC do not guarantee that everyone will receive credit, they protect consumer rights by requiring businesses to give everyone a fair and equal opportunity to get credit and to resolve disputes over credit errors.

### The **Equal Credit Opportunity Act (ECOA)**

prohibits credit discrimination as a result of sex, age, religion, marital status, national origin, or receipt of government assistance by the applicant.

Consumers are also protected by the federal **Fair Credit Reporting Act (FCRA)**, which advocates for the accuracy and privacy of information collected by credit reporting companies. Under the FCRA, consumers have rights related to the following:

- Free copies of your credit report annually: Each of the three reporting agencies is required to provide one free copy of your credit report every 12 months containing all information in your file at the time requested.
- Free copies of your credit report for application denials: If you are denied an application for credit, employment, or insurance or if a company takes other adverse action against you, you have a right to receive a copy of your credit report if you request your report within 60 days of receiving notification of the action.
- Free report when seeking employment: You are entitled to a free report each year if you are unemployed and plan to look for employment within 60 days or if you're on welfare, if you have been a victim of identity theft, or if your report contains other inaccurate information due to fraudulent activity.

#### QUICK TIP

Some companies may ask for information related to your gender, age marital status, national origin or whether you've received public assistance—but they may not base a decision to grant you credit on any of these factors.

#### QUICK TIP

If you have exhausted your opportunities to get a free credit report, a reporting company may charge you up to \$9.50 for another copy.

Additionally, consumers are entitled to the following rights under FCRA:

- Right to know who has requested your credit report within the last 12 months
- Right to know what credit agency was contacted if you were denied an application
- Right to dispute information on your credit report that you believe to be inaccurate
- Right to add a summary explanation to your credit report if you dispute information and it is not satisfactorily resolved. This statement would appear in the Consumer Statements section of your credit report. You may also ask the agency to provide your statement to companies who have recently received your report, although they may charge a fee to do so.

## Correcting False Information on Your Credit Report

The law allows you to request, at no charge, an investigation of information on your file that you believe is incorrect or incomplete. If you find that information on your report is incorrect, follow the necessary steps to correct the information:

1. Tell the credit reporting agency in writing that you believe the information is not accurate. A sample dispute letter is provided on the next page. Be sure to include the following and send your letter and documentation with certified delivery.
  - Details about each item you are disputing (e.g., each late payment)
  - Copies of support documentation (e.g., a receipt)
  - Request for items in question to be removed from your report
2. After 30 days, confirm that the agency has forwarded all your provided information to the company that reported the incorrect information.
3. Ask about results of the investigation. Did the reporting company agree that it reported incorrectly?
4. If the answer to Step 3 is yes, confirm the company in error notified the credit reporting agency of the necessary correction.
5. Request the results in writing. The credit reporting agency is required to send you a free copy of your updated report.
6. Ask the credit reporting agency to send notices of all corrections to anyone who has pulled your credit report in the last six months.
7. If the company claims that your report is correct:
  - Contact the vendor directly to see if you can resolve the issue yourself.
  - Consult a debt counselor who may be able to assist you.
  - If serious enough, you may want to consult with an attorney.
  - Submit a consumer statement to be included on your report regarding the information you believe to be incorrect.
  - Accept the results and start focusing on other ways to improve your credit.

### Exercise

Based on the information related to fair credit reporting and consumer protection, under which of the following circumstances can you request a free copy of your credit report? Mark with an X.

\_\_\_\_\_ You are granted credit but at a rate that is higher than you would like.

\_\_\_\_\_ You forget your wallet at a restaurant and learn that someone has been charging purchases to your credit card.

- \_\_\_\_\_ You are downsized from your job and plan to live off your savings for three months before looking for another job.
- \_\_\_\_\_ Your application for car insurance is denied.
- \_\_\_\_\_ It has been over a year since you received a free credit report.
- \_\_\_\_\_ You have just learned that your available credit has been reduced on one of your credit cards.

### Sample Dispute Letter

Date  
Your Name  
Your Address  
City, State, Zip Code  
Your Phone Number

Complaint Department  
Name of Company  
Address  
City, State, Zip Code

Dear Sir or Madam:

I am writing to dispute the following information in my file. The items I dispute are also circled on the attached copy of the report I received.

This item [identify item(s) disputed by name of source, such as creditors or tax court, and identify type of item, such as credit account, judgment, etc.] is [inaccurate or incomplete] because [describe what is inaccurate or incomplete and why]. I am requesting that the item be deleted [or request another specific change] to correct the information.

Enclosed are copies of [describe any enclosed documentation, such as payment records, court documents] supporting my position. Please investigate [this/these] matter(s) and [delete or correct] the disputed item(s) as soon as possible.

Sincerely,  
Your name

Enclosures: (List what you are enclosing.)

source: [www.fico.com](http://www.fico.com)

## Exercise

Bethany pulled her credit report and noticed that her credit card company reported a late payment. When looking back at her payment confirmations, she verified that her payments were always made on time. Bethany has a printed copy of her payment confirmations for the last 3 years.

Based on Bethany's situation, does she have the ability to change the late payment reporting?

\_\_\_\_\_ Yes

\_\_\_\_\_ No

**Using the space provided, write a dispute letter for Bethany.**

**Bethany's Dispute Letter:**

Once Bethany sends her dispute letter, follow-through and perseverance will be the key for her requests to be granted. Staying informed of her rights and following the recommended procedures for disputing false information will give her a better chance of having information corrected.

Additional information related to the ECOA and FCRA and additional consumer rights is available on the Federal Trade Commission's website at [www.igrad.com/t/FTC](http://www.igrad.com/t/FTC).

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### How Long Does Information Stay on my Credit Report?

A credit report is like a snapshot of your credit history at a point in time. Your credit history is continuously accumulating. The older a negative event becomes on your report, the less negative impact it will likely have. Even though a negative event still appears on your credit report, your score will go up as more time passes since the event occurred.

The length of time information appears on your credit report will depend on the type of information. For example, a bankruptcy may remain on your credit report for up to 10 years which is longer than the 7 years referenced for a late payment. More importantly, a bankruptcy will impact your ability to borrow money much more severely than making some late payments. This is because a bankruptcy shows that you “walked” away from debt making your creditor lose money.... as opposed to a few late payments where you are still attempting to pay your creditors.

Late payments = 7 years

Inquiries = 2 years

Foreclosures = 7 years

Collections = 7 years for most, depending on the age of the debt being collected

Public Records = 7 years for most, unpaid tax liens can remain indefinitely

Bankruptcies = 7 years for Chapter 13; 10 years for Chapter 7

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### Tips to Increase Your Credit Score:

1. Improve your debt-to-credit limit ratios (the amount owed factor).
2. Ask for higher credit limits on your accounts, but don't borrow against it.
3. Pay down over-the-limit accounts until they are within the approved limit.
4. Pay down accounts until your balance is less than 30% of your available limit.
5. Be on inquiry alert—if a company checks your credit by pulling a credit report, it may create an inquiry that lowers your score (the new credit factor).
6. If you haven't had credit very long, don't open too many new accounts (length of history factor).

7. Shop for new credit within a short period of time—FICO knows the difference between a consumer looking for several types of new credit versus shopping around for one type (like the best car loan or mortgage) if it is done in a focused period of time (where it will count as only one inquiry).
8. Don't close accounts once paid off; as it may hurt you more than help you.

For more information on credit, how your score is calculated, and how you can improve your credit, visit [www.igrad.com/t/MyFico](http://www.igrad.com/t/MyFico).

## Credit Cards

At any given time, there are numerous types of credit available to consumers. When you choose to borrow money to finance a purchase, you take on debt. **Debt** is an amount of money one person or entity owes to another. This includes home mortgage loans, leases, credit cards, college loans, lines of credit, and personal loans. Although credit cards may be one of the most accessible ways to borrow and their flexibility is attractive, they can also become destructive to an individual's financial well-being if not used with discretion.

In this section, we will refer to a bank or company that issues a card to a consumer as the credit card **issuer**.

Consumers have the ability to use credit offered by credit card companies to make purchases, transfer balances (pay off amounts owed to other creditors), and take cash advances (use available credit to receive cash).

### MONEY MYTH

**MYTH** The more credit cards you apply for, the better your credit rating.

**TRUTH** Submitting multiple applications for credit will most likely result in multiple inquiries on your report. A high number of inquiries can actually decrease your credit score.

### Credit Card Interest

Credit card interest is just one of the ways issuers generate revenue. The interest you pay on your balance is their income. Each credit card issuer will set the interest rate for individual customers based largely on the customer's credit report and score. In fact, credit cards even have different interest rates based on how the card is used. In the example below, Kory found this out the hard way.

***Credit buying is much like being drunk.  
The buzz happens immediately, and it gives you a lift.  
The hangover comes the day after.***

— Dr. Joyce Brothers

## CASE STUDY: Kory's Lesson



Kory received his first credit card three months ago—a card advertised specifically for students. The offer provided an introductory rate of 0% for six months that would increase to 14% after the promotional period. Around the same time Kory was working fewer hours to study for finals, so he was short on cash when it came time to pay his bills. He took a cash advance on his credit card to cover his expenses.

Kory was not looking at his statements closely and had been making only the minimum payment. When his third statement came in he noticed that he was being charged 24.99% interest. Kory called the customer service line to ask for a refund. He got a rude awakening when they explained that cash advances are charged at a higher rate than purchases and did not qualify under the introductory offer.

As Kory found out, it is important to read the fine print on credit card offers to understand the charges and rules related to using the card. Kory might have made a different choice if he had known he was going to pay 24.99% interest on this cash advance.

Credit card interest is expressed and quoted as an annual percentage rate. However, it can be misleading because while banks quote interest rates based on an annual rate, they frequently calculate your debt on a daily compounded interest basis. This means the amount you pay in interest will not equal exactly what your annual rate is. When compounding is taken into consideration, annual percentage rate is expressed as the **effective annual rate (EAR)**.

$$EAR = (1 + APR/n)^n - 1$$

The calculation for EAR is  $EAR = (1 + APR/n)^n - 1$  where “n” equals the number of compounding periods. For example, for a credit card with a 14% interest rate that compounds monthly, the one year EAR would be  $(1 + .14/12)^{12} - 1$ , or 14.93%. Compounded daily, the one year EAR is  $(1 + .14/365)^{365} - 1$  or 15.02%. Because most U.S. credit cards compound interest daily, knowing the EAR is important to comparing credit cards with different compounding practices and understanding the true cost of credit.

To determine interest owed when compounding daily, we must first convert the annual rate to a daily rate. We do this by taking the annual rate and dividing it by 365 days.

### Exercise

What is Kory's daily rate for cash advances? \_\_\_\_\_

Kory's daily rate will be referred to as the periodic rate on his credit card statement. A **periodic rate** is the interest rate expressed in relation to a certain amount of time. When interest is compounded monthly, the periodic rate is the annual rate converted to a monthly rate (annual rate divided by 12 months). In Kory's example, credit card interest is compounded daily, so the periodic rate determines the cost of credit each day.

When calculating interest, many credit card companies will also use the average daily balance in the billing cycle. The **billing cycle** is the number of days between billings—usually 30 days for credit cards. The **average daily balance** is the average amount of money owed during a billing cycle. It is calculated by adding each day's balance and then dividing by the number of days in the billing cycle. Both the average daily balance and the number of days in the billing cycle will be disclosed on your credit card statement.

$$\text{Interest} = \text{Average Daily Balance} \times \text{Periodic Rate} \times \text{Number of Days in Billing Cycle}$$

#### Exercise

If Kory's average daily balance after his first credit card statements was \$500, what was his daily interest charge? \_\_\_\_\_

What is Kory's effective annual rate (ERA) since his interest is compounding daily? \_\_\_\_\_

In Kory's case, even at a high rate his interest fee is manageable. But what happens when the balance is greater and the interest rate is higher?

#### CASE STUDY: David & Dahlia's Dive



David and Dahlia recently purchased a home. They used their major credit card to purchase flooring and other household needs and have accumulated \$10,000 in credit card debt. They have been making payments of \$150 for the last two months and are considering ways to accommodate a larger monthly payment in their budget so that they are able to pay it off sooner. Their annual percentage rate is 16.99% and interest accrues after their first billing cycle. They have 30 days in their billing cycle.

At the end of their first billing cycle, David and Dahlia make their first payment of \$150. Assuming their average daily balance was \$9,850 after they made their first payment, how much was the interest charge for their second billing cycle? \_\_\_\_\_

How much of their principal balance did David and Dahlia pay off with their \$150 payment in month two? \_\_\_\_\_

It would take Dahlia and David over 16 years to repay their remaining \$9,850 in credit card debt making payments of \$150 per month, and they will pay over \$18,000 in interest. They are smart to look for ways to pay it off faster. The larger the monthly payment they can make, the faster they will reduce their principal balance. This means they will pay less interest over the life of their debt. By adding another \$50 a month to their payment beginning with their first billing cycle, David and Dahlia will pay their credit card off over 10 years faster and they will save over \$11,000 in interest charges.

### Making the Minimum Payment

A **minimum payment** is the least amount an issuer will allow a borrower to pay each billing cycle on a credit card balance. The minimum amount required to be paid will vary but most often it ranges from 2-5% of the balance owed.

#### Exercise

What would David and Dahlia's minimum payment be if their credit card issuer required a minimum payment of 3% each month?

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Understanding how your minimum payment will be calculated is important because it will help you determine how much of your monthly budget you will be required to allocate for repayment of your credit card. In the case of Dahlia and David, the amount they were paying on their card would not have covered the minimum amount due. What if they do not have the room in their budget to make a \$300 payment each month? They will need to find ways to increase their monthly income or reduce their other expenses. This information should be gathered and considered before diving into credit card debt.

In cases with extremely high interest rates, making the minimum payment may not be enough to cover interest. Let's say that David and Dahlia used their retail credit card from the local home improvement store rather than their major credit card to purchase \$10,000 in flooring and other supplies. Their interest rate for this card is 27% with a 30-day billing cycle and a 2% minimum payment.

After their first billing cycle, Dahlia and David paid their minimum payment of \$200 and their interest began to accrue on the remaining \$9,800.

## Exercise

What will their new minimum payment be after their first billing cycle?

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How much interest will they be charged in the next 30 days?

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What will happen if David and Dahlia pay only the minimum payment on their second credit card statement?

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Using the credit card payment calculator [www.igrad.com/resources/?credit-card-payment-calculator](http://www.igrad.com/resources/?credit-card-payment-calculator), determine how long it will take David and Dahlia to pay off this \$9,800 debt at the interest rate of 27% and a minimum payment of \$200.

\_\_\_\_\_ (Interesting answer?)

Now calculate how long it will take David and Dahlia to pay the \$9,800 debt at the interest rate of 27% if they increase their minimum payment to \$300.

\_\_\_\_\_

Explain the difference: \_\_\_\_\_

As the last example illustrates, making the minimum payment required by the credit card company may provide more flexibility for cash, but it is not necessarily the best decision. In this case, it actually caused the credit card balance to go up—not down! This will cause minimum payments to increase over time, thereby eating away at the initial flexibility.

High interest rates and minimum payments are just one of the pitfalls that consumers often fall into when taking on credit card debt. However, there are many other things to be aware of for your own financial well-being and protection.

Tips for Credit Card Use:

1. Be wary of promotional or introductory rates. Many cards start out with low rates but eventually move up to higher rates. Make sure you know when the higher rate begins.
2. Be wary of companies offering free gifts in return for filling out a credit card offer.

3. Always read the fine print.
4. When paying only the minimum payment on your monthly credit card bill, it can take months—or years—to pay off the balance. If you charge \$1,000 at 18.5% interest and pay only the minimum payment (2%) each month, it will take 8 years and cost you \$927 in interest to pay back the \$1,000!
5. Never give your card number over the phone or Internet unless you initiated the communication and you know you are dealing with a reputable company.
6. Always carefully review your credit card statements to make sure there are no unauthorized charges.

#### MONEY MYTH

**MYTH** I need to carry a balance due on my credit card so I can improve my credit rating.

**TRUTH** It is the amount of credit that you have available (unused) that is important. Pay your balance off each month before the payment due date and it will improve your credit score because you will maintain a higher level of available credit.

### Credit Card Fees

In addition to interest, credit card companies may also charge a variety of fees. In fact, one issuer may offer several different cards, each with its own set of fees. Below is a list of fees issuers commonly charge:

**Annual fee:** This is a fee that is assessed on a yearly basis for the privilege of using the card.

**Over-the-limit fee:** When you spend more money than the issuer provides in credit, they will charge a fee for going over your limit.

**Transfer fee:** If you transfer balances from one card to another, companies will most likely charge a small percentage of the amount transferred as a fee.

**Paper statement fee:** A company may charge a fee for choosing to receive paper statements rather than electronic statements.

All of these charges combined with interest will be your total **finance charge** on your billing statement.

Because not all credit cards are the same, it is critical to understand the offer(s) you are receiving and to get all of the pertinent information to determine what use of each card will cost. Without doing this, you and your budget are at the mercy of your credit card company.

## Good Debt vs Bad Debt

As we learned in the previous section, not all credit offers are created equal. The truth is, not all uses of credit are equal either. Although it may seem counterintuitive, it is possible to have good debt just as it is possible to have bad debt. The determining factor is how the debt is being used.

**Good debt:** Debt that is used to purchase assets or results in increased revenue

**Bad debt:** Debt that increases expenses without a corresponding financial benefit

### Exercise

What are three examples of good and bad debt?

#### Good Debt

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#### Bad Debt

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Examples of good debt include real estate loans on rental properties, business loans, and college loans. Examples of bad debt include retail credit card debt, car loans, and payday or title loans.

You may be asking yourself, “How can a car loan be a bad debt? I need my car!” By definition, a car loan on a vehicle used for personal use creates no financial benefit. Having said that, your car loan could become a good debt if you are using your car for business purposes to generate revenue.

### College Loans

In general, the higher the level of completed education an individual has, the greater the person’s earning potential. In addition, there is a positive correlation between higher education levels and the ability to find employment opportunities. Information related to average earnings for an individual, based on their education completed, is available through various sources online.

## Exercise

Using your favorite search engine, do your own research related to income.

What is the average income for a high school graduate? \_\_\_\_\_

What is the average income for a college graduate with a Bachelor's degree? \_\_\_\_\_

What is the average income for a college graduate with a Master's degree? \_\_\_\_\_

An investment in a college degree is likely to pay for itself in the long run. Over the course of a lifetime, educated workers are likely to see a return on the investment of a college education amounting to hundreds of thousands of dollars. In order to better determine what that return will be, it is essential to understand the cost of borrowing for college, especially as tuition costs continue to rise.

### The rising cost of college

Average estimated undergraduate budgets for full-time students, 2011-12

	PUBLIC TWO- YEAR	PUBLIC FOUR- YEAR IN-STATE	PRIVATE FOUR- YEAR
Tuition & fees	\$2,963	\$8,244	\$28,500
Room & board, books, etc	\$12,323	\$13,203	\$13,724
Total expenses	\$15,286	\$21,447	\$42,224

SOURCE: COLLEGE BOARD

Source: College Board ([http://money.cnn.com/2011/10/26/pf/college/college\\_tuition\\_cost/index.htm](http://money.cnn.com/2011/10/26/pf/college/college_tuition_cost/index.htm))

College loans are made available by both government programs and private banks. They may come with either fixed or variable interest rates, depending on the loan program.

**Federal student loans** are loans offered through government funding and are characterized by low interest rates and flexible repayment plans. In order to get access to federal funding, students must complete a Free Application for Federal Student Aid (FAFSA). The **FAFSA** is the application by which students apply for federal loans, grants, and work study funding provided

by the government. FAFSA forms can be completed online at [www.igrad.com/t/FAFSA](http://www.igrad.com/t/FAFSA). Examples of federal student loans include Perkins and Stafford Loans for students and PLUS loans for parents. Each type of loan has its own features and benefits.

**Private student loans** are offered to students and parents by private lenders, such as banks, credit unions, and schools. Loan limits and interest rates are usually higher than for federal loans. Personal loans, such as loans using a home or other real estate as collateral, may also be used. These loans may make sense if financial aid and other resources don't cover all college expenses.

No matter what type of loan you consider, it is important to look at the big picture. What amount will you need to borrow to cover your years of education?

## Payday and Title Loans

While some loans, including student loans, are offered at low interest rates and may result in increased income over time, payday and title loans do the exact opposite. Both payday and title loans are considered bad debt because of their high fees and should be avoided.

A **payday loan**, also called a **payday advance**, is a small, short-term loan that is secured by a customer's next paycheck. There are few qualification requirements for payday loans—most lenders ask only for a check stub as proof that a potential customer holds a job and has future income with which they can repay the loan.

Interest rates for payday loans can exceed 350%-400%, making it easy to fall into a cycle of recurring payday loan debt. Borrowers who are unable to repay their loans often roll the entire amount, including the interest they were charged, into a new loan.

### QUICK TIP

Payday loan companies typically charge \$15 for each \$100 borrowed for a two-week period. This means if you borrow \$200 for two weeks, you would pay \$30 in fees. That amounts to a daily interest rate of 1.07%.

### Exercise

Ella needs new tires for her car and doesn't have the cash to pay for them. She goes to the closest payday loan store and shows her most recent pay stub. They lend her \$500 for two weeks at a cost of \$75.

Two weeks go by and Ella has other bills she did not expect and is unable to repay her payday loan. The lender charges her another \$75 for two more weeks to repay.

How much does Ella owe on her \$500 loan at the end of the four weeks?

A **title loan** is a short-term loan that is secured by a customer's car title. To qualify for a title loan, borrowers must own their car and a credit check is seldom performed. Lenders make the decision to loan based on the value and condition of the applicant's car.

Interest rates on title loans can range from 36% to over 100%, and the loan term and payment schedule for repaying a loan will vary. However, borrowers are required to pay at least the interest due with each payment. In the event that a borrower is unable to repay a loan, he or she may roll the loan over into a new loan; interest must be paid for each payment due, and there are government regulations related to how many times a loan may be rolled over. If at the end of the payment term the borrower is unable to repay the loan, the lender has the right to take possession of the car and sell it to recoup the title loan amount due.

Payday and title loans have extremely high interest rates and are difficult to pay back for those who are most likely to seek them out. Lenders target low-income individuals with low credit scores and limited access to other forms of credit.

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### Exercise

Matt borrowed \$1,000 in the form of a title loan with an interest rate of 100%. His loan required that he repay the principal with interest at the end of 30 days. Although Matt intended to make payments throughout the month, unexpected bills kept coming up. He couldn't catch a break and finally after the loan was rolled over for another 2 months, Matt took out a payday advance to pay off the title loan.

How much interest did Matt accrue during the first 30 days of this title loan?

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Matt paid his interest every 30 days on his title loan. How much interest did he pay in total?

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Assuming that the payday advance charged 15% interest every 2 weeks, how much interest would Matt accrue in 30 days?

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Matt fell into a common cycle related to payday and title loans. Because of the high cost of interest associated with these loans, it is often difficult to pay down the principal balance because such high amounts are paid in interest.

Payday and title loans offer convenience and a quick solution for individuals who may not have better options for receiving credit. The examples in this section show how bad debt can be very bad for your financial health.

## Conclusion

Having the ability to use credit increases access to large items that otherwise may be unaffordable to many people. How long would you need to save in order to purchase a car or a home outright? What about that new set of living room furniture? While there is something to be said for saving money over time and making these purchases outright, most people opt for the convenience of being able to get what they need now and finance it over time.

While most types of loans may have similar features (minimum payments, interest rates or APR, repayment term), not all borrowers will receive the same terms. Lenders will use information found on a borrower's credit report to determine whether to lend money. In addition, this same information will be used to assign an interest rate. When considering using credit for your next big purchase, keep in mind that not all types of credit are the same. There is such thing as good debt and bad debt. You may find opportunities to leverage money provided by someone else to purchase assets or generate revenue.

Whether considering good or bad debt, the ultimate impact of borrowing will be determined by the terms of the debt you take on. Is your credit score an asset or a liability? Does it save you money by qualifying you for the best interest rates or do creditors look at your credit score and see you as a risk? If the latter applies to you, your credit is probably costing you money in the long run and you may benefit from doing a detailed review to see what you can improve right away.

### Additional Resources

Don't forget that we have made additional articles, videos, and interactive tools available for your use online. You can find them at [www.igrad.com/t/StudentGuide](http://www.igrad.com/t/StudentGuide)