Introduces teenagers to the basic concepts of managing money. They will learn how to live within a budget, open and use bank accounts, manage credit and debt, pay for a college education, and more. Includes tips, glossary and practical examples.

Cash, Credit and Your Finances: The Teen Years

CASH, CREDIT, AND YOUR FINANCES: THE TEEN YEARS

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CHAPTER 3:
CREDIT AND DEBT

Throughout this country, businesses and people are moving toward a cashless society. People are using bank cards, debit cards, credit cards, electronic banking, and Internet-based services to manage their finances.

Now that you're establishing yourself financially, you may want to move into this world, too. The key is establishing credit and learning how to manage credit and debt. In this chapter, I'll help you understand credit and debt and tell you what you can do to manage both.

ESTABLISHING CREDIT

As you enter the financial world, you'll need to establish your own credit. *Credit* is when you purchase something now and don't pay for it until later. The issuer of the credit extends a certain dollar amount of credit to you (the amount of a loan, or *credit limit*), and you are expected to repay that amount according to the terms of your agreement.

As you go through life and want to make major purchases, such as a car or a house, you'll find that your credit report and credit score, which reflect your use of the credit extended to you, are the keys to your finances. If you use credit well, you may get more favorable loan terms; if you do not use credit well, it may be difficult to get loans at all.

Important tip: Before making a decision to buy or do something, take time to make an informed decision; avoid impulse buying. Think about whether you really need the item, or just want it. Using your purchasing power carefully and selectively may keep you from over-extending yourself into excessive debt.

You establish your credit by handling money well. This includes paying bills on time, using your credit cards wisely, and paying back your loans (including student loans) on schedule. Managing your credit cards may be one of the most important things you can do to build credit. Debit cards do not appear on your credit report.

So, how do you establish credit? You must borrow money and then pay it back on time. Many people start out with a credit card; others might take out a small personal loan. If you start with a credit card, you will be given a limit or maximum; you cannot charge over that limit. Then you make a purchase with your credit card, and receive a bill in the mail. You will be expected to pay this bill. The bill will state a minimum amount that must be paid; you may pay the minimum, more than the minimum, or the full amount that you charged. As long as you pay the minimum by the due date, you will be considered in good standing.

The credit card company reports the balance on your account, your payment, and other information to the *credit reporting agencies*. This is the information that appears on your credit report. After a minimum of six months, the credit reporting agencies will rate your credit-worthiness by giving you a credit score (see ‘Your Credit Score,’ below).

If you choose to establish your credit with a loan, the process is a bit different. You apply to a bank or another lender for a loan, such as a student loan or car loan. The bank may ask you to get a co-signer, because you have not yet established your credit-worthiness. The bank may also ask you to get a co-signer, such as a parent or grandparent, if you are still underage. Then the bank evaluates your loan application to determine whether you are a good credit risk. If the loan is approved, you will be given the loan amount (called the *principal*) to use. This loan will come with a predetermined rate of interest, monthly payment (usually a combination of principal and interest), and length. You will be expected to make your monthly payments over the length of the loan. Your lender will report to the credit reporting agencies whether you make your payments on time. It is essential in establishing your credit to make all of your payments on time. If you are late in even one payment, it will be reflected in your credit-worthiness and your credit score.

CREDIT CARDS

Since credit cards are so important for building credit, you'll want to get one as soon as you can. How do you do this? You start by applying for a secured credit card, which is associated with a savings account. If you have $500 in a savings account that is associated with a secured credit card, you will get a credit card with a $500 limit. You will be able to charge up to your limit.

Every month, you will receive a statement/bill that shows the amount you owe, the items you purchased (called *charges*), any items you returned (credits), the payment you made (a credit), and the minimum amount due by a specified date. All of this information is important to you.

First, you need to make sure that all of the information on the monthly statement is correct. You do this by comparing your receipts to the entries on your statement. If you find a transaction on your statement that you consider incorrect, you must immediately follow the procedure set out by the card issuer for questioning and resolving the problem.

Then, you must make sure that your payment is made before the due date. Depending on the type of card you have, the payment may be the entire amount charged or a portion of that amount. At the very least, you must make the minimum payment specified. The bank must receive your payment before the due date; if you're mailing the payment, you'll need to allow a few days for it to get to the bank. Making your payments on time will establish your credit in a positive way. Remember that, with a secured credit card, the issuer is holding your savings account and can use that money to cover your bill, if you don't make your payments on time.

Credit card billing and payments take into account a *grace period*, which is defined in the terms that apply to the card. The grace period is the time from when you charge to when the bill is due. If you have no balance at the start of the billing cycle and pay the full amount on your current bill by the due date, you are paying your bill within the grace period, and no interest or finance charges will appear on your next bill.

Important Tip: If you do not receive your monthly statement for whatever reason, you are still responsible for paying on time. It's a good idea to be aware of when your credit card payments are due, and be prepared to call the issuer to ask for a copy of the statement. You are not excused from making a payment, simply because you did not receive your statement.

Once your basic credit is established, you can apply for further credit cards at any bank, financial institutions, stores, or companies offering them. Banks issue either MasterCard or Visa credit cards. Individual stores and companies – department stores, gas stations, specialized stores and so forth – all offer credit cards to customers. Financial companies, such as Discover and American Express offer credit cards too.

MasterCard and Visa credit cards are widely accepted. American Express and Discover credit cards are also widely accepted, but some stores accept only certain credit cards. You should check with the merchant before you get to the checkout counter to find out whether your card will be accepted. Cards from individual stores are accepted only at those stores; you cannot use a Home Depot credit card at Sears, for example. When you go shopping, each store may offer you its own credit card; the store may even go as far as offering you an advantage for getting that card, such as 10% off all of you purchases that day.

Important Tip: If is not a good idea to apply for every credit card offered to you; choose wisely, compare terms, and know what you are getting into. Think about how often you would make purchases in that store. Will having the credit card encourage you to purchase more then you need or can afford?

Peter decided to go to a local bank and ask for a credit card. He was very surprised when they told him he had to have a savings account with the bank first. "Where am I going to get the money to open a savings account?" he thought. So Peter asked his parents to get him a card by putting him on their credit card account. "I promise I'll pay you back every month," he said. But Peter had already borrowed some money from his mother, and there were no signs she'd get it back. Peter's parents told him they'd get him a credit card after he learned how to stick to a budget. Peter wanted the credit card NOW, though. Some of his friends had gotten credit cards through a nearby big box retailer, so Peter approached them, and was successful. With credit card in hand, Peter bought a new watch for his girlfriend, some new clothes and DVDs for himself, and a cool cell phone as a birthday present for his brother. And then the first bill came. Peter could barely make the minimum payment. He couldn't pay anything on his second bill or the third bill. A month later, the store cut him off and reported him to the credit reporting agencies as a nonpayer. "Now where am I going to get a new credit card?" he wondered.

Credit Card Fees and Terms

How should you determine which credit cards to apply for? You need to evaluate the pluses and minuses of each card. The first thing to look at is the fees associated with the card. Typically, credit card issuers charge several major kinds of fees. The first is an *annual fee* (sometimes called a *membership fee*), which you are charged every year simply for having that credit card. The second is the interest rate you are charged if you do not pay your credit card balance off in full by the due date. You may also be charged fees if you make a late payment (that is, your payment does not reach the issuer by the due date), exceed your credit limit, or pay with a check that is not honored by your bank (due to insufficient funds). Credit card issuers make money from collecting the annual fee, the interest on unpaid balances, and the fees assessed if you violate the terms of the agreement. Many of these fees can be avoided if you pay attention to your finances.

For your first credit card, I suggest that you apply for one without an annual fee and with the lowest possible interest rate. Note that your interest rate can change without notice if you have chosen a variable rate credit card or if you do not comply with the terms of your agreement. Making a late payment or no payment at all can raise your interest rate substantially. You will also fall into *universal default*; this means that anyone extending you credit or services will see that you did not pay on time, so they too will raise your interest rate or change other terms in your agreement with them.

Your monthly bill shows your balance, which includes your purchases for that month, plus any unpaid balance from previous months and the amount of interest you are being charged. The bill also lists a minimum payment; you must pay at least the minimum due. If you pay less than the full amount, you will be charged interest on the remaining balance, even if you pay the minimum amount due.

Credit card issuers tell you how they calculate the interest payment. Some use the *average daily balance method*, in which the average amount you owe on each day is multiplied by the interest rate. Some use a *two-cycle billing average method*, under which they calculate your average amount owed over two billing cycles and multiply that amount by the interest rate. For example, suppose you paid your balance off in full last month, but didn't this month. The balances from both months would be combined and divided by two to come up with the two-month average. I recommend that you stay away from credit cards that use this method of calculating the interest payment.

Some credit cards offer rewards, either on a range of products and services or on specific items. The rewards can be cash back to you, free items, or credit toward certain items, such as airline miles or charitable donations to an entity you choose. Reward cards typically charge both an annual fee and a higher interest rate, since you are getting a reward for using the card. You must read and understand the terms and agreements attached to rewards cards to make sure you get the benefits you deserve.

Using Your Credit Card Wisely

When you have a credit card, you need to be responsible with your finances. This means making charges you can afford, and not charging more than you can afford. It also means avoiding all the extra fees for violating the terms of your agreement. These fees can make the amount you owe even higher and could put you over your credit limit.

Yes, it's very easy to use a credit card – you simply pull it out and hand it to the clerk; you do not have to show identification, as you would if you paid by check. The downside is that you can charge much more than you can afford to pay back. Credit is something you will need throughout your life, and if you get into trouble by accumulating too much debt and having trouble paying your bills, you can suffer severe consequences. For example, the interest on your unpaid balances will keep accumulating to the point where the interest takes up so much of your income, you can't reduce the balance. Even worse, your account could go into collection (that is, a third party would try to collect the debt), and you would be reported to the three credit reporting agencies as a nonpayer.

There are other problems to be aware of. If your credit card is lost or stolen, it is your responsibility to contact your credit card issuer as soon as possible. You typically have 24 hours to call the issuer to limit your liability to the first $50.00 of unauthorized charges. If you take too long to call, or fail to call at all, you could be responsible for all of the charges. Know at all times what credit cards you are carrying in your wallet, and know where your wallet is. Make sure you keep the paperwork that comes with your new credit card, so you know what telephone number to call to alert the issuer.

Another problem is when an unauthorized charge appears on your bill. The first step is to call the credit card issuer to ask for details of the transaction. Sometimes stores and vendors use a different name (such as the name of their parent company), so you just might not recognize a legitimate charge. If you still don't recognize the charge, you can dispute it. Your credit card issuer will ask you to complete a dispute affidavit and return it to them. The issuer will put the disputed charge 'on hold' until the charge is resolved. The issuer will serve as the intermediary between you and the company that says you made the transaction until the matter is resolved. This is one reason to keep your receipts, keep good records, and compare your receipts to your credit card statements each month – you'll be better able to find errors on your credit card statement.

MANAGING CREDIT

Since it is so important to establish good credit, you will have to pay attention to managing your credit. You can do this by monitoring your credit report, correcting any incorrect information, and doing what you can to raise your credit score.

Your Credit Report

The first step in managing your credit is to check your *credit report* each year. You can order a free credit report from **www.AnnualCreditReport.com**. You are entitled to receive one free copy of your credit report from each of the three credit reporting agencies (Experian, Equifax, and TransUnion) each year.

When you receive the report, take the time to understand the information on it and what the information says about you. Does all of the information apply to you? Is it all accurate? If you find inaccurate information, you need to get it corrected. When you receive the credit report, you will also receive instructions on how to dispute inaccurate information.

Important tip: If you are disputing information on a credit report, remember that the bad information could be showing up on the reports issued by each of the three credit reporting agencies. You might have to dispute the same item three separate times (once with each agency) to clear your record.

Correcting or Disputing Inaccurate Information. Suppose the credit report indicates that you made a late payment, but you believe the payment was on time. You may be asked to make copies of your credit card statement and a cancelled check or bank statement that shows the payment was made on time. You would submit this information to the credit reporting agency, so they can investigate the dispute and resolve it in your favor.

What if you find an account listed on your credit report that is not yours? It's impossible to prove that an account is NOT yours, so you would have to ask the credit reporting agency to investigate and to compare your personal information with the paperwork the account issuer has on file. It is possible the account issuer confused you with someone else. This is very common when a family gives a son the same name as the father (such as John Smith, John Smith, Jr., and John Smith III).

Because I'm in the mortgage business, I see many credit reports, and I would estimate that half of them contain at least one error. Correcting the error can make the difference between getting what you want financially and being denied credit or offered less-than-favorable terms. So make sure that you correct any errors on your credit report by following the instructions.

An investigation by a credit reporting agency into a dispute can have one of three outcomes:

1. You have proof that an error has been made, and the dispute is resolved in your favor.
2. You don't have proof and are relying on the entity making the charge or issuing the credit to have the information; this dispute may not be resolved in your favor.

3. The credit reporting agency does not get a response from the entity making the charge or issuing the credit, and it is up to the agency to make the decision.

The credit reporting agency typically takes 30 days to resolve any dispute. When you are working with an agency, make sure you keep copies of all of the paperwork you send them, along with their responses.

If you think you are a victim of identity theft, see 'Preventing Identity Theft' in Chapter 1 for information on handling this problem.

Your Credit Score

One of the most important lessons to learn from this book is how important it is to know and understand your credit score. A *credit score* is a three-digit number used throughout the financial industry to determine a person's creditworthiness. A company called Fair Isaac and Company (FICO) developed the standard formula used by the three credit reporting agencies to assign a credit score to each person's credit report.

Credit scores range from a low of 350 to a high of 850. The average creditscore is 720. Lenders often look for a score of 760 or higher.

Your credit score is an extremely important number. Your credit score determines whether you will get the credit you are applying for and what the interest rate will be. Your credit score may be used by landlords to determine whether to rent an apartment to you. Potential employers may check your credit score to help decide whether to hire you for that job opening. Car dealerships will certainly check your credit score before deciding whether to give you a car loan and what interest rate to charge.

So, how do you get and maintain a high credit score?

Under the FICO formula, your credit score is determined by the following five factors:

1. 35% of your score comes from your payment history. How do you pay your bills: On time? Late? Not at all?

2. 30% of your score takes into account the total amount you owe in relation to your credit limits, that is, how much you've already borrowed in relation to how much money you could borrow. The amount you've already borrowed should be less than 50% of what you could borrow.

   For example, suppose you have two credit cards, each with a credit limit of $1,000.00. The total amount you could borrow would be $2,000.00. If you already owe $500.00 on one card and $250.00 on another card, the total amount you've already borrowed is $750.00. Therefore, you already owe $750.00 against a credit limit of $2,000.00, or 37.5% of your credit limit.

3. 15% of your score comes from the length of your credit history. The longer you have a credit card, for example, the more history you accumulate, and the better sense a borrower gets of how you handle money. If you've just gotten your first credit card, a borrower might not be able to tell how good a payer you would be.
4. 10% of your score is based on how many new accounts you've opened and recent credit applications you've made. Any time you authorize someone to review your credit report for the purpose of extending credit, your credit score is reduced by a few points. So, if you apply for a number of new credit cards and open a number of

new accounts over a short period, your credit score could be lowered.

5. 10% of your score is based on your credit mix, that is, how much of your credit is secured and how much is unsecured. *Secured credit* is based on something of value to support the loan. A car loan, for example, is secured by the title of your car. A credit card can be either *secured* or *unsecured credit*.

Now that you know how a credit score is calculated, you can easily see how to establish and maintain a high score: Pay your bills on time. Don't spend up to your credit limits all the time. Manage your use of credit over time. Don't open too many credit card accounts. In other words, managing your finances well generally will help you manage your credit well.

Important tip: Keeping your credit score as high as possible will benefit you in all aspects of your financial life. Your score affects everything from getting a credit card, to renting an apartment, to the amount you will pay to insure your car, to being offered a job you really want…and more.

MANAGING DEBT

If you can manage and pay for your debt, all is well. If you can't, bad things happen quickly. It's hard to get out of debt if you have charged the maximum amounts on all of your credit cards and are close to your credit limits. This is a negative factor on your credit report and will lower your credit score. (See the section on 'Credit Scores', above.) This in turn, makes it much more difficult to get another credit card.

Suppose you have accumulated a lot of debt and need to reduce it. What do you do? The first step is to make a list of all of your credit cards and any other types of debt, including the name of the credit issuer, the minimum payment amount, the total balance owed, the interest rate, and the credit limit. The second step is to make sure that you make at least the minimum payment to each credit issuer every month before the due date. The third step is to pay more than the minimum amount to credit issuers when your balance is over your credit limit and you are being charged additional fees. When you bring your balance under the limit, the fees will be reduced.

When all of your credit account balances are under their limits, start making extra payments to the credit issuer charging the highest amount of interest. Use any extra money you have and add it to the minimum payment until this balance is paid off in full. Then start paying extra money to the credit issuer charging the second highest rate of interest. Continue to do this until all of your credit accounts are paid in full.

Paying down debt will require that you budget carefully (see the section on 'Budgeting' in Chapter 1 for more information) and that you watch your day-to-day spending. You may have to put in more hours at your job, get a second job, or get a higher-paying job. You will have to watch every penny that you spend to see where you can come up with the extra funds. This can be very difficult for you, but the rewards down the road make it more than worthwhile.

When you are carrying too much debt, you will find it very hard or impossible to get new credit. If you do get new credit, the interest rate will be extremely high. Credit card interest rates tend to fluctuate and can be as low as around 8% for people with excellent credit to as high as 30% for people with not-so-good credit.

If you are carrying a credit card balance of $5,000 at an 18% interest rate, it will take you over 18 years to pay off the loan if you only pay the minimum amount due with each statement. Clearly, making sure you keep your interest rates as low as possible and making more than the minimum payment will help you keep your debt manageable.

Important tip: If you accumulate too much debt, you may not be able to make the purchases you want. If you spend up to your limit on your credit cards, the money won’t be available to purchase the new iPod, for example. Also, utilities and some services may check your credit score before allowing you to sign up. This is especially true for some telephone and communications services. So make sure that you keep your debt to a level you can easily handle.

BORROWING FROM OR LENDING TO A FRIEND

Borrowing from or lending to a friend can be tricky. Let’s say you have a friend who wants to borrow $20.00 from you. You do lend him the money, with the understanding that he will pay you back in two weeks when he gets paid. In two weeks, the friend does pay you back. All is well. But what happens if the friend can’t pay you back, or simply doesn’t pay you back in two weeks? Not only will you be out your $20.00, but you could also lose a friend. I suggest you think hard about lending money to friends.

Let’s look at the other side: Suppose you want to borrow money from a friend. You need to be absolutely sure that you can pay this person back when you say you will. If you ever watch the court shows on television, you'll see a lot of cases about someone borrowing money from a friend or family member and not paying it back. The two parties end up in court, and usually the relationship is broken. Is losing your relationship with a friend worth borrowing the money?

If you do choose to borrow or lend, I suggest that you put it in writing. You should write out an agreement, so that everyone is clear about all the terms. Here's a possible agreement:

I, John Smith, am borrowing $100.00 from George Jones for football tickets and will repay the loan by paying $20.00 per week starting on January 5, 2009, and making a total of five payments over the next five weeks.

This agreement states the amount of the loan, the terms of repayment, and the timing of repayment. Both you and the person borrowing or lending the money should sign the agreement and you should each have a copy.

If you lend money to a friend and he defaults on repayment, you will have to make a decision. Perhaps you have extra money and are willing to convert the loan into a gift. Or perhaps you could extend the loan by allowing your friend to repay it later. But you should be prepared for the possibility that your friend will not repay the loan, and you will have to decide whether you will take any further action.

Summary:
Establishing credit means handling money well, including paying bills on time, using credit cards wisely, and paying back loans.

Credit cards are available through banks, financial companies, and stores. Before taking out a credit card, make sure you understand the fees and terms attached to it.

To manage your credit effectively, check your credit report every year, correct any inaccurate information on it, and monitor your credit score. If you do accumulate debt, set a schedule for paying it off.

To get your **Implementation Checklist & Resources Guide**s, please go to **www.CashCreditandYourFinances.com/Guides** to download your free copies.

Introduces teenagers to the basic concepts of managing money. They will learn how to live within a budget, open and use bank accounts, manage credit and debt, pay for a college education, and more. Includes tips, glossary and practical examples.

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