Financial Literacy Basics: How to Manage Debt

Sometimes it seems as if everywhere you look, someone wants your money. Maybe you get past-due notices from a credit card company, or warnings about paying your student loan on time. You might be afraid to even look at your mail in case you missed a payment on something last month. If you have bills to pay, you might feel worried about what could happen if you fall behind.

Managing debt can be easier if you understand the meaning of debt and know how to keep it under control. If you have debt, you can make a plan to get rid of it and free yourself from that worry!

What Is Debt?

Debt is money that's owed, and **credit** is money given for use. The person who owes a debt is known as the **debtor** or **borrower**. The person (or company or financial institution) that gives credit is the **creditor**. Examples of debts are money owed on credit cards, car loans, mortgages, and student loans. These are personal debts.

Loans are usually for a certain time, such as several years. The loan agreement includes how many payments the debtor will make, how often, and how much interest will be charged. **Interest** is what the debtor pays to use someone else's money. The debtor pays the interest and the original loan, or **principal**, to the lender. Interest is usually a percentage of the principal. It might be high, especially if the debtor is considered a high risk. This could be because the lender suspects the debtor may have trouble repaying the loan or if the debtor has poor credit.

Credit card debt is a loan, but it has a rolling (open-ended) repayment date. The lender decides how much credit to provide, and the debtor can charge up to the limit. The lender may also increase the limit.

Interest

Each payment you make on a loan includes money toward repayment of the loan as well as interest. In simple terms, if you borrow $100 (the principal) at 10

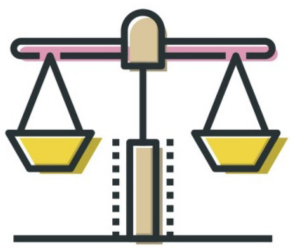
percent interest and agree to make ten monthly payments, you will pay $11 a month, and the lender will collect $110 by the end of the loan term. You paid the lender $10 in exchange for borrowing $100. The lender charges this interest, known as **simple interest** because it is based only on the principal amount, not only because you are borrowing the money, but also to cover the cost of collecting it, such as paying employees to process payments.

Interest on credit cards is called **compound interest**. Compound interest is interest calculated against the principal amount—then interest is also added to the principal and then interest is charged on the combined amount. In essence, it's interest on interest. For example, if your principal is $100 and you are charged 20% interest semi-annually, at six months, you are charged 20% interest on your principal, which means your principal is now $120. At the next six month interval, you are charged 20% interest on $120, which will be $24, so your principal is now $144. With compound interest, you end up paying much more than the principal.

This type of interest may be compounded, or added, at different intervals. For example, it may be compounded annually, semi-annually, or monthly. The number of intervals depends on the loan agreement. The more often interest is compounded, the more money you will pay.

Collateral

Debt can be **secured**, or backed by something of value. This is called **collateral**. Debt can also be **unsecured**. A mortgage is backed by the value of the property you are using it to buy, so it is secured debt. Credit card debt is unsecured, because nothing of value is backing it. Secured debt usually involves lower interest rates, because if you fail to make your payments, the creditor can take possession of the collateral.



Good Debt and Bad Debt

Good debt, such as a mortgage or loans for education, can benefit the debtor. Good debt is an investment. It may increase in value or increase your value.

Bad debt is debt used to acquire things that do not create long-term income and lose their value quickly. Debt that carries a high interest rate is also bad debt. The value of debt can

GOOD DEBT vs. BAD DEBT

GOOD DEBT

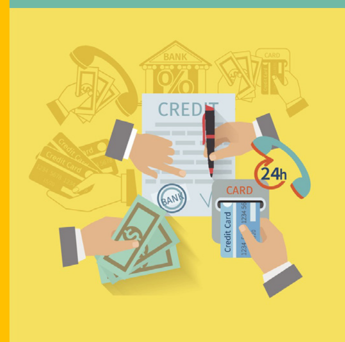
Good debt is an investment. It may increase in value or increase your value.

- Student Loans
- Mortgages
- Business Loans

BAD DEBT

Bad debt has higher interest rates or is used to purchase items that lose their value quickly.

- Credit Card Debt
- Car Loans
- Consumer Loans



be evaluated by looking at its potential to benefit you in the future.

People with college degrees often earn more, so your potential future income could be greater if you take a college loan. These loans also usually have lower interest rates. For these reasons, student loans are usually good debt.

Mortgages used to buy a home are also usually considered good debt. They typically have lower interest rates than other kinds of debt and the monthly payments are usually low. Mortgage interest is tax deductible. And the value of a home usually increases over time.

A **home equity loan** is a loan based on the value of your house. For example, if your house is worth $100,000 and you only owe $50,000 on the mortgage, you have $50,000 of equity in the house. A home equity loan uses