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 amount of 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 that limit. The lender may also increase the limit.

Interest

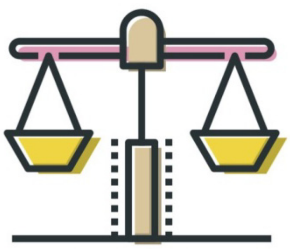
Each payment you make on a loan includes money toward repayment of the loan as well as interest. For example, if you borrow $100 (the principal) at 10 percent interest and agree to make ten monthly payments, you will pay $11 a month, and the lender will collect $110 by the end of the loan term. You paid the lender $10 in exchange for borrowing $100. The lender charges this interest, known as **simple interest** 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 first against the principal amount—then again on the combined amount of principal and interest. 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

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

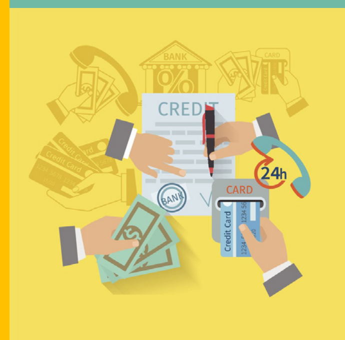
- Student Loans
- Mortgages
- Business Loans

vs.

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

this equity as collateral. Home equity loans are often good debt, because the interest rates are lower than other kinds of debt. Before getting a home equity loan, however, consider the consequences of failing to make the payments. You could lose the house.

Auto loans may also qualify as good debt. If transportation allows you to earn more, you win. To make the most of the investment, however, the buyer should pay as much as possible at the start, and borrow as little as possible.

Examples of bad debt include credit card debt and cash advance or payday loans. Using a credit card to purchase things you want but can't afford increases your debt but does not provide long-term value. Credit cards usually have higher interest rates.

Payday or cash advance loans also increase your debt without benefiting you. A borrower writes a personal check to the lender and pays a fee for use of the money, but the borrower must pay it back with interest and the fee when he or she gets a paycheck. The interest rates on these loans may be 300 percent annually, and fees for missing payments can be crippling.

How Much Debt Is Too Much?

Even if you have a high income, you might have too much debt to keep up with your loan payments, or you might be paying a great deal in interest. To see if you have too much debt, you can calculate your **debt-to-income (DTI) ratio**. This is a comparison of your monthly debt and earnings. DTI is the percentage of your income before taxes, or gross monthly income, that you use to pay debt.

If your DTI is too high, you should examine your habits and experiences. Maybe you had to rely on credit cards for a while because you were unemployed. Or maybe you were sick and have large medical bills to pay.

You may have to examine your spending habits, such as restaurant dining, impulse buying, and shopping for unnecessary items. You can find free apps to help you keep track of every penny you spend. You can also create a budget to help you see how much you owe and find ways to save. A budget can help you pay down debt.

CALCULATE YOUR DTI

To calculate your DTI, add your monthly payments. This includes mortgage or rent (and insurance and property taxes if you pay them), minimum monthly credit card payments, loans including student and auto, and other debts. Don't count other expenses including gas, groceries, utilities, and taxes.

Divide this debt total by your gross monthly income. This is the amount of money you are paid before taxes are taken out of it. The DTI is the percentage of your gross income needed to cover debt.

Lenders often look at DTI—a lower number means you are less risky. Many finance experts say that DTI should be no greater than 36 percent.

For example:

Mortgage	$1,000		+
Auto loan	$280		+
Credit card payments	$220		+
Monthly debt total:	=	$1,500	
Monthly gross income:		$3,900	

$1,500 divided by $3,900 = 38 percent DTI

HOW TO MAKE A BUDGET

The first step is to track all of your spending for a month. Write down everything you buy and all the bills you pay. Also keep track of all your monthly income. This may include wages, tips, and any money you regularly get, such as a gift from a relative. If your wages change from month to month, look at paychecks from several months and find the average.

You can find free tools and links to help you manage money at www.360financialliteracy.org/Calculators and www.mymoney.gov/tools/Pages/tools.aspx. You can also simply write your budget in a notebook or use the budget worksheet on page 7. For more information about managing a budget, you can get further details in another volume in this series, *Financial Literacy Basics: How to Make and Stick to a Budget*.

Divide your expenses into needs and wants. Your needs will include **fixed expenses**, such as rent or a mortgage payment (including property tax), insurance, child care, and loan payments; and **variable expenses**, which change from month to month. Variable expenses include groceries, health expenses, transportation, and necessary clothing. Wants include entertainment, such as restaurant meals and movies, as well as unneeded clothing.

Subtract your monthly expenses from your monthly earnings. If you have money left over, you can save it or use it to pay off debt. If your expenses are greater than your earnings, however, you need to find ways to cut expenses or earn more money to cover them.

Start by looking at your wants, and see if you can eliminate spending there. You may be able to reduce needs as well, such as saving on groceries, finding a better rate for utilities or cell phones, or getting rid of a vehicle if you can use public transportation instead.

Look at your spending habits. How and when did you spend your money all month? If you bought a coffee or snack every day, you can brew your own at home and buy snacks in bulk to cut costs.

Any way you can save money on expenses can help you pay off debt.

BUDGET WORKSHEET

Month/Year: ______________________

Monthly Income

	Wages	
	Tips	
	Other Income	
	TOTAL MONTHLY INCOME	

Monthly Expenses

HOUSING	Mortgage/Rent	
	Utilities (Electricity/Water)	
	Credit Cards	
	Insurance (Homeowner's, Renters, etc.)	
	Loan Payments	
	Other Housing Expenses (Cable, Internet, etc.)	
FOOD	Groceries/Household Supplies	
	Restaurant and Other Food	
TRANSPORTATION	Public Transportation	
	Vehicle Loan	
	Gas for Personal Vehicle	
	Parking, Tolls, etc.	
	Maintenance & Supplies (oil, etc.)	
	Vehicle Insurance	
HEALTH	Health Insurance	
	Medicine/Prescriptions	
	Other (Dental, Vision, Copays)	
PERSONAL	Childcare or Support	
	Other Family Support	
	Laundry	
	Clothing, Shoes, etc.	
	Charitable Gifts, Donations, etc.	
	Entertainment (Movies, etc.)	
	Other (Haircuts, etc.)	
DEBT & FINANCE	Debt (Credit Cards, etc.)	
	Student Loans or Other Debts	
	Fees (Bank, Credit Card, Debit)	
	Prepaid Cards, Phone Cards, etc.	
MISCELLANEOUS EXPENSES	Supplies (School, etc)	
	Pet Care	
	Other	
	TOTAL MONTHLY EXPENSES	

TOTAL MONTHLY INCOME	
- TOTAL MONTHLY EXPENSES	
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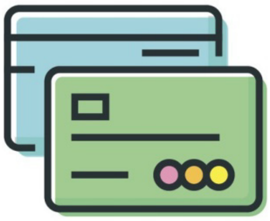


Credit Cards, Charge Cards & Debit Cards

What's the difference? Here's information on how these types of cards differ, and what to look for when applying for a credit card.

- **Credit card**: You can use a credit card to buy things and pay for them over time. But remember, buying with credit is a loan, you have to pay the money back. And some issuers charge an annual fee for their cards. Some credit card issuers also provide "courtesy" checks to their customers. You can use these checks in place of your card, but they're not a gift, they're also a loan that you must pay back. And if you don't pay your bill on time or in full when it is due, you will owe a finance charge, which is the dollar amount you pay to use credit. The finance charge depends in part on your outstanding balance and the annual percentage rate (APR).

- **Charge card**: If you use a charge card, you must pay the balance in full each time you get your statement.

- **Debit card**: This card allows you to make purchases in real-time by accessing the money in your checking or savings account electronically.

When applying for credit cards, it's important to shop around. Fees, interest rates, finance charges, and benefits can vary greatly. And, in some cases, credit cards might seem like great deals until you read the fine print and disclosures. When you're trying to find the credit card that's right for you, look at the following:

- **Annual percentage rate (APR)**: The APR is a measure of the cost of credit, expressed as a yearly interest rate. It must be disclosed before your account can be activated, and it must appear on your account statements. The card issuer also must disclose the "periodic rate," which is the rate applied to your outstanding balance to figure the finance charge for each billing period.

  Some credit card plans allow the issuer to change your APR when interest rates or other economic indicators, called indexes, change. Because the rate change is linked to the index's performance, these plans are called "variable rate" programs. Rate changes raise or lower the finance charge on your account. If you're considering a variable rate

card, the issuer also must tell you that the rate may change and how the rate is determined.

Before you become obligated on the account, you also must receive information about any limits on how much and how often your rate may change.

- **Grace period**: The grace period is the number of days you have to pay your bill in full without triggering a finance charge. For example, the credit card company may say that you have 25 days from the statement date, provided you paid your previous balance in full by the due date. The statement date is on the bill.

  The grace period usually applies only to new purchases. Most credit cards do not give a grace period for cash advances and balance transfers. Instead, interest charges start right away. If your card includes a grace period, the issuer must mail your bill at least 14 days before the due date so you'll have enough time to pay.

- **Annual fees**: Many issuers charge annual membership or participation fees. Some card issuers assess the fee in monthly installments.

- **Transaction fees and other charges**: Some issuers charge a fee if you use the card to get a cash advance, make a late payment, or exceed your credit limit. Some charge a monthly fee regardless if you use the card or not.

- **Customer service**: Customer service is something most people don't consider, or appreciate, until there's a problem. Look for a 24-hour toll-free telephone number.

- **Unauthorized charges**: If your credit card is used without your permission, you can be held responsible for up to $50 per card. If you report a lost card before it is used, you can't be held responsible for any unauthorized charges. To minimize your liability, report the loss as soon as possible. Some issuers have 24-hour toll-free telephone numbers to accept emergency information. It's a good idea to follow-up with a letter to the issuer. Include your account number, the date you noticed your card missing, and the date you reported the loss. Keep a record, in a safe place separate from your cards, of your account numbers, expiration dates, and the telephone numbers of each card issuer so you can report a loss quickly.

Pay Credit Card Bills on Time

It's important to pay your credit card bill on time. If you don't, you'll pay late fees and additional finance charges. Late payments to your credit card issuer will also lower your credit score.

When you make a payment, your card issuer generally must credit your account the day they receive it, but there are exceptions.

To help avoid additional charges, follow your issuer's payment instructions. Sending your payment to the wrong address, even if the payment is received and accepted at some other office of the issuer, could delay crediting your account for up to five days. If you pay by mail and misplace your payment envelope, look for the payment address on your billing statement or call the issuer for the correct address for payments.

If you pay your bill online, set up a reminder a week or so before the bill is due to be sure you pay on time and to the proper electronic address. Set up a return electronic notice showing the company received your online payment. No matter what method you use, check your billing statement to be sure you have the right due date and location for each account.

Automatic debiting to your bank account can be a convenient way to pay bills, but there are factors to consider. For example, the amount due each month could vary, and you would need sufficient funds in your bank account to pay it. Otherwise, you could overdraw your account, be charged for insufficient funds, and damage your credit rating. Under federal law, you can't be required to use automatic debits from your bank account to repay an extension of credit.

Prepaid Cards

If you're just starting out and want to build your credit history, or maybe you don't want to have any debt to start with, you might consider using prepaid credit cards.

Unlike a debit card, that withdraws money from your bank account, a prepaid card requires you to load money onto the card before you can use it for purchases.

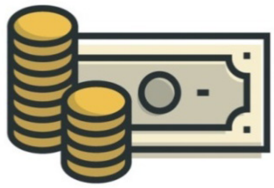
Some benefits of a prepaid credit card:

- You can get a prepaid credit card without any credit history requirements.
- Possible cash-back incentives.
- No late fees or worries about exceeding your credit limit. But, keep in mind that your purchases are limited to the amount you have loaded onto the card.

If you are getting a prepaid credit card to build your credit history, make sure that the card you select builds credit by reporting to the credit bureaus. If your card does not report to the credit bureaus it will do nothing to help build your credit.

A prepaid credit card might sound like a good solution, but there can be drawbacks. Consider these points before using a prepaid card:

- Beware of hidden fees. Some cards charge activation fees, fees to load funds, more fees to call customer service and other fees for balance inquiries. Your money might be spent on fees rather than purchases.
- Prepaid cards don't have the same consumer protections that credit cards offer. If you purchase something online and it arrives damaged, you would have better protections if you purchased with a credit card.

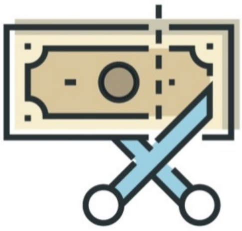


Rewards Cards

You might be tempted to take advantage of credit cards that offer rewards like airline miles or cash back.

Before you apply, be sure to read the fine print. Some reward cards charge higher interest rates than other cards to offset the rewards that they pay out. Some may charge an annual fee as well.

If you pay your balance in full every month, rewards cards can be a good way to earn airline miles or get cash back. If you cannot pay your balance in full every month, a credit card with a lower interest rate would save you money in the long run.



Take Steps to Reduce Debt

Once you have made your budget and know how much you earn and spend, here are some ways to pay down or reduce your debt.

- Make a list of monthly debts, including student and car loans, credit cards, and mortgage.

- Make a monthly budget to determine how much you can afford to pay towards your debt. You'll want to pay as much as you can to bring down your debt.

- Continue to pay all your debts, because if you miss payments, you may be charged fees and even higher interest rates.

- Pay as much as you can on the debt with the highest interest rate. To help you do this, pay the minimum amounts due on other debts.

- After you pay your highest interest debt off, move on to the debt with the next-highest interest rate and pay that down. Keep paying as much as you can each month towards brining your debt down.

- Move down the line until you have paid off your debts.

- Use the debt snowball method. Order your debts by size, regardless of interest rate. Pay off the smallest debt while making minimum payments on the rest of your debts. That way, you have a smaller, more achievable goal that you can celebrate sooner. That might give you the incentive to keep paying off your debt. As you pay off each card, close it or stop using it, so you're not incurring new debt.

- Avoid using credit cards for new purchases. Put your credit cards away until you have paid off your debt. If you continue to add new charges to your credit card debt, it is unlikely that you will pay it off.

- If you get a raise, increase your savings instead of increasing your spending.

- Don't use all of your savings to pay off debt. You'll want to keep a small amount of savings on hand in the event of an unforeseen emergency. Savings will prevent you from having to charge these emergencies to your credit card.