

Financial Literacy 101

Fact Sheet: Credit and Debt

Understanding Credit

From buying a pack of gum to financing a car or home, people use credit every day. Credit offers a way for us to get the things we want without having to carry cash, and it allows us to buy things we might not be able to afford all at once, like a home or college education.

What is credit? Credit is simply a promise that you will repay the money you borrow. The lender, who could be a bank, store, or credit card company, charges interest for the use of the money.

Your Credit Report and Credit Score

Remember when your teachers threatened to include your misbehavior on your “permanent record”? Your credit report doesn’t keep track of detentions, but it does track information about you and your financial history. This information is also summarized into a number called your credit score.

Your credit report is available to lenders, landlords, and even employers. A bad credit history means it will be harder to get a car loan or a home mortgage, and your loans will be more expensive since you’ll have to pay higher interest rates. For example, having to pay just one extra percentage point on an average home mortgage because of shaky credit could cost nearly \$75,000 dollars over the course of the loan. Plus, if you need private loans for school, you will also be charged a higher rate. We’ve even heard of people being turned down for a job because of a poor credit report.

To maintain a good credit score...

- **Pay Your Bills on Time** – Be diligent about paying any bills on time, including your phone, utilities, cable, student loan and credit card. After 30 days, your account could be considered delinquent and your credit could be damaged.
- **Manage Your Credit Cards** – Responsible use of a credit card will help to build your credit record. That means no late payments and no high card balances. Remember, having more than one card will not help and may even hurt your credit score. More than one card makes it much easier to get into serious trouble with debt.
- **Review Your Credit Report Periodically** – The only way to find errors on your credit report is to see it. Don’t pay a fee or give away sensitive personal information to get a look at your credit report. You can get a free credit report once per year at AnnualCreditReport.com.

Items on your credit history last seven years or more, so keep in mind that this month’s missed payment may haunt you for years.



Students and Credit Cards

Credit cards can be a source of financial hardship for students and recent grads. The average college student graduates with nearly \$4,000 in credit card debt, in addition to nearly \$18,000 in student loans.

Like anything, credit cards can be used for sound and unsound reasons – for example, using credit for a financial emergency like a car repair far away from home would be a reasonable use of credit. But using credit cards when you’re short on cash for clothes, dinners out, or entertainment can be a dangerous game. As a general rule, if you can eat, drink or wear an item, it’s usually not a good use of credit. Use a debit card or cash for everyday purchases.

The Minimum Payment Trap

Credit cards are simple, right? You charge stuff and pay it off - what’s so complicated about that? Besides the fact that you can quickly charge more than you could easily repay, credit card companies also charge interest and fees (the average late fee is now \$34).

Here’s a good example of how interest works. Say you’ve charged a total of \$2,000 and then stop making new charges. If your card has a typical interest rate of 19% and a typical minimum repayment policy of 2% of your balance per month, it will take you more than 22 years to pay off the card and the total cost will be \$7,000 – if you make just the minimum payment.

How is that possible? Even though you pay off 2% per month, the amount you owe grows every day because of interest - your 2% mainly pays the interest and a fraction of the original \$2,000.

If it’s not possible to pay off your entire balance each month, pay as much as you can. Most debt counselors recommend paying at least twice the minimum payment. That way, you will pay off part of the debt, not just interest.

Problem with debt? See our Debt fact sheet.

Visit the Resources area of FinancialLiteracy101.org for more information.