MANAGING CREDIT 101

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The sponsoring editor for this book was Michelle Mielke, the editing supervisor was Loni Bienek, the designer was Amy Schmidt.

The Importance of Credit

Credit is an essential part of our lives when it comes to purchasing. The following practical information will help you better understand credit and how it works. We hope it helps you evaluate your own credit situation and know what steps are needed for establishing a healthy credit profile.

What is credit?

Credit can be a valuable addition to your financial tool box if you use it carefully and sensibly. Credit means someone is willing to loan you money - called principal - in exchange for your promise to repay it, usually with interest. Interest is the amount you pay to use someone else's money. So the higher the interest rate, the higher the total amount you pay to buy something on credit.

The best part about credit is that it lets you buy something - like a car or a home - you couldn't otherwise afford if you had to pay for it all at once. You get to buy the item now but pay for it over a period of time, usually with interest.

Sometimes people use credit purely for convenience. They have the money but don't want to carry cash with them. Or they simply decide they want something NOW, don't care if they have the money, and use credit for immediate satisfaction, which isn't a smart use.

Understanding the Value of Credit

1. **Know the real cost of debt.** The same item will cost more in the end if you buy it on credit instead of with cash. So choose the credit option carefully.

2. **Don't use credit to live beyond your means.** If you can't pay for an item in a reasonable amount of time, you shouldn't be borrowing money to buy it.

3. **It's all about the details.** The fine print is your friend when you're comparing credit options. Uncover the details of what an option may truly cost you in interest, fees, and other penalties.

4. **Pay as much as you can, as early as you can.** This will help you reduce your overall finance charges, avoid penalties, and keep your credit report in good standing.

Common Types of Credit

Type of Credit	Features
Credit Card	Some types of cards can be used virtually anywhere, some only at a specific place. No payoff deadline. Monthly minimum payments vary, based on balance. Usually has the highest rate of these common types of credit.
Installment Loan	Typically used for large purchases such as a car or an appliance. Loan term can vary from a few months to many years. Monthly payment amounts are often set for the life of the loan. Usually has a lower interest rate than a credit card.
Mortgage	Used specifically for a loan to purchase a home. Usually repaid over 15-30 years. Monthly payments may be set for the life of the loan, or changed more frequently, depending on the type of loan. Usually has a lower interest rate than an installment loan. May provide an income tax break on interest paid to the lender.

What information will you need to apply for a loan?

- Social Security number
- Driver's license number
- Date of birth
- Address and phone number
- Name of employer
- Two references
- Monthly income amount
- Total monthly payments on other debts
- Amount of monthly rent or mortgage payments

Avoiding Debt and Credit Problems

How much debt is too much debt?

Debt isn't necessarily bad, but too much debt is. Add up what you pay monthly on your car loans, student loans, credit card, personal loans, and your mortgage. Now divide that number by the amount of your gross monthly earnings. Your debt should generally not exceed 40% of your gross pay.

> "Be cautious when using cash advances and read the fine print in the agreement, particularly since they usually carry higher interest rates."

"Good Debt" vs "Bad Debt"

Yes, there is such a thing as good debt. That's debt that can provide a financial pay off. Borrowing to buy or remodel a home, pay for a child's education, advance your own career skills, or buy a car for getting to work can provide long-term financial benefits.

Bad debt is when you borrow for things that don't provide financial benefits or that don't last as long as the loan. This includes borrowing for vacations, clothing, furniture, or dining out.

When Does Debt Consolidation Make Sense?

When done right, debt consolidation can help you accelerate the rate at which you get out of debt, lower the amount of interest you have to pay to your creditors, and improve your credit rating. However, to achieve these potential debt-consolidation benefits, the following criteria need to apply:

- The interest rate on the new debt is lower than the rates on the debts you consolidate.
- You lower the total amount of money you have to pay on your debts each month.
- You don't trade fixed-rate debt for variable-rate debt.
- You pay off the new debt as quickly as you can.
- You commit to not taking on any additional debt until you pay off the debt you consolidated.

Which is the best deal for me?

When you are shopping around for a loan, use the worksheet below to compare details.

1 Name of Financial Institution ______________ ______________ ______________

2 What is the interest rate? ______________ ______________ ______________

3 Will I be charged any extra fees or penalties? ______________ ______________ ______________

4 What is my monthly payment? ______________ ______________ ______________

5 How many months long is the loan? ______________ ______________ ______________

Understanding Your Credit Report and Credit Score

What is a Credit Report?

Once you have applied for a loan, the first thing a lender does is decide if you are creditworthy. This can be determined by pulling your credit report. Your credit report tells lenders any credit you already have, loan amounts you've received, your credit card balances and limits, and whether you pay your bills on time. The information in the credit report can go back as far as 10 years.

What is a credit score?

A credit score is a snapshot of your credit risk picture at a particular point in time. The higher your score, the lower the risk to lenders. Most lenders will look at your credit score when evaluating your loan application. Knowing your score puts you one step ahead when you apply for a mortgage, loan or other credit. Scores range from a low of 300 to a high of 850.

Rating	Score
Excellent:	750 and up
Good:	720 - 749
Fair:	660 - 719
Uncertain:	620 - 659
Poor:	619 or lower

How is my score calculated?

1. 35% is based on your payment history.
   - Number of accounts paid on time
   - Delinquent accounts - current pay history is more important than past pay history
   - Negative public records or collections
2. 30% is based on capacity.
   - Percent of revolving credit available
3. 15% is based on the length of credit history.
4. 10% is based on new credit.
   - Number of accounts recently opened
   - Number of recent inquiries
5. 10% is based on the types of credit used.
   - Total number of accounts
   - Types of accounts (installment vs. revolving)

What will hurt my score?

- Missing payments (it will take two years to restore credit with one late payment)
- Maxing out credit cards
- Closing out credit cards (this lowers available credit)
- Shopping for credit excessively
- Opening up several new accounts in a short time frame
- Having more revolving loans in relation to installment loans
- Borrowing from finance companies
- Bankruptcy

What doesn't affect my score?

- Debt ratio (debt to income)
- Income
- Length of residence
- Length of employment
- Race, color, religion, national origin
- Gender, marital status, age

How can I improve my score?

- Get a copy of your credit report and review it carefully. Correct any errors.
- Pay your bills on time (old late payments will become less significant over time).
- Pay down credit card debt.
- Do not close credit cards because available credit will decrease.
- Slow down on opening new accounts and don't open accounts you don't intend to use.
- Contact creditors as soon as you know you will have a problem paying bills on time and try to work out a payment arrangement.
- Work towards developing an ongoing record of paying on time.
- Moving revolving debt to installment debt.

Be Careful With 0% Financing Offers

"No interest and no payments for three full years!" You've probably seen the ads on TV for 0% financing on furniture, carpeting, appliances or other products. Be very careful with offers like this and be sure to read the fine print:

Interest is waiting. The one thing that stores don't mention is that if you don't pay off your purchase completely before the promotional period is up, the interest that would've accrued during the promotional period will be added to the loan immediately, usually at a rate of 20% or more.

They may not remind you to pay. Some merchants don't send out a monthly statement so it is up to you to remember to pay.

Payments may not go where you want them to. If the line of credit can be used for other purchases – for example, the store issues you a branded Visa – they may apply your payments to those purchases first. If you must take out this type of financing, do not use the card for anything else.

Your credit score will be affected. Since this is a loan, it will appear on your credit report. If you plan on any big purchases, like a home or car, then you might want to hold off on using this type of financing.

Understanding Credit Cards

What are the APRs?

A single credit card may have several APRs:

- One APR for purchases, another for cash advances, and yet another for balance transfers. The APRs for cash advances and balance transfers are often higher than the APRs for purchases.
- A penalty APR. The APR may increase if you are late making your payments. For example, your card agreement may say, "If your payment arrives more than ten days late two times within a six-month period, the penalty rate will apply."
- An introductory APR. A different rate will apply after the introductory rate expires.

Fixed vs. variable APR

Some credit cards are fixed rate, meaning the APR doesn't change, or at least doesn't change often. Even the APR on a fixed rate credit card can change over time; however, the credit card company must tell you before increasing a fixed APR.

Other credit cards are variable rate, meaning the APR changes from time to time. The rate is usually tied to another interest rate, such as the prime rate or the Treasury bill rate. If the other rate changes, the rate on your card may change too.

How long is the 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 given 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.

What are the fees?

Most credit cards charge fees under certain circumstances:

- Annual fee (sometimes billed monthly). Charged for having the card.
- Cash advance fee. Charged when you use the card for a cash advance; may be a flat fee or a percentage of the cash advance.
- Balance transfer fee. Charged when you transfer a balance from another credit card.
- Late payment fee. Charged if your payment is received after the due date.
- Over-the-credit-limit fee. Charged if you go over your credit limit.

Checklist for Comparing Credit Cards

When choosing a credit card, think about how you will use the credit card. Do you expect to pay your monthly bill in full? Carry over a balance from month to month? Get cash advances? Use this checklist to find the best credit card that will work for you.

	Card A	Card B	Card C
What are the APRs?			
For purchases?	____________	____________	____________
For cash advances?	____________	____________	____________
For balance transfers?	____________	____________	____________
If you pay late?	____________	____________	____________
What type of interest does the card have?			
Fixed/variable/tiered?	____________	____________	____________
How long is the grace period?			
If you carry over a balance?	____________	____________	____________
If you pay off the balance each month?	____________	____________	____________
For cash advances?	____________	____________	____________
What are the fees?			
Annual	____________	____________	____________
Cash advance	____________	____________	____________
Late-payment	____________	____________	____________
Over-the-credit limit	____________	____________	____________
Other fees	____________	____________	____________
How much is the credit limit?	____________	____________	____________
Does the card offer other features?			
Rebates	____________	____________	____________
Frequent flier miles	____________	____________	____________
Insurance	____________	____________	____________
Other	____________	____________	____________

Establishing Credit History

- Open a checking and savings account at your financial institution
- Apply for a small limit financial institution credit card - pay on time
- Apply for a gas card - pay off monthly
- Budget, track expenses and save

Tips for Using Credit Wisely

- Charge small amounts - pay on time
- Pay in full if possible
- Avoid the minimum payment trap
- Don't max out credit cards
- Avoid late or over the limit fees
- Avoid using cash advances
- Don't co-sign loans for your friends
- Don't open several new credit cards at once

Warning Signs of Too Much Debt

- Only making the minimum payments
- At or near your credit limit on cards
- Don't know how much you owe
- Use cash advances to pay other bills
- Denied credit
- Lie to spouse or family about spending

Bankruptcy as a Last Resort

The road of last resort when someone gets too deep into debt is bankruptcy. Bankruptcy is a legal process to get out of debt when you can no longer make all your required payments.

Filing for bankruptcy can put a "stay" on your credit report for up to 10 years. In other words, for 10 years, creditors will know you filed for bankruptcy and you may have a much tougher time qualifying for future credit such as a mortgage or a car loan. If you do qualify for credit, it usually will be at higher interest rates.

If you can't pay your bills, write a letter or call each of your creditors and tell them you would like to meet with them to develop a spending plan to show how much money you need to live and a repayment plan to show how much you can pay each creditor each month. Some may refer you to a credit counseling agency for help. One reputable credit agency is the Consumer Credit Counseling Service (1-800-388-CCCS).

Bankruptcy is the last resort option and should be considered carefully before filing.

Warning: Credit Repair Companies

You may have seen advertisements in newspapers, on TV and on the Internet claiming:

- "Credit Problems? No Problem!"
- "We can erase your bad credit - 100% guaranteed."
- "Create a new credit identity - legally."
- "Remove bankruptcies, judgments, liens and bad loans from your credit file forever!"

Do yourself a favor and save some money, too. Don't believe these statements. Only time, a conscious effort and a personal debt repayment plan will improve your credit report and score.

The Scam

Everyday, companies nationwide appeal to consumers with poor credit histories. They promise, for a fee, to clean up your credit report so you can get a car loan, a home mortgage, insurance or even a job. The truth is, they can't deliver. After you pay them hundreds or thousands of dollars in fees, these companies do nothing to improve your credit report; most simply vanish with your money.

If you decide to respond to a credit repair offer, look for these tell-tale signs of a scam:

- They want you to pay for credit repair services before they provide any services.
- They do not tell you your legal rights and what you can do for yourself for free.
- They recommend that you not contact a credit reporting company directly.
- They suggest that you try to invent a "new" credit identity - and then, a new credit report - by applying for an Employer Identification Number to use instead of your Social Security number.
- They advise you to dispute all information in your credit report or take any action that seems illegal, like creating a new credit identity. If you follow illegal advice and commit fraud, you may be subject to prosecution.

You could be charged and prosecuted for mail or wire fraud if you use the mail or telephone to apply for credit and provide false information. It's a federal crime to lie on a loan or credit application, to misrepresent your Social Security number, and to obtain an Employer Identification Number from the Internal Revenue Service under false pretenses. Under the Credit Repair Organizations Act, credit repair companies cannot require you to pay until they have completed the services they have promised.

The Truth

No one can legally remove accurate and timely negative information from a credit report. The law allows you to ask for an investigation of information in your file that you can dispute as inaccurate or incomplete. There is no charge for this. Everything a credit repair clinic can do for you legally, you can do for yourself at little or no cost.

The Credit Repair Organizations Act

By law, credit repair organizations must give you a copy of the "Consumer Credit File Rights Under State and Federal Law" before you sign a contract. They also must give you a written contract that spells out your rights and obligations. Read these documents before you sign anything. The law contains specific protections for you. For example, a credit repair company cannot:

- Make false claims about their services
- Charge you until they have completed the promised services
- Perform any services until they have your signature on a written contract and have completed a three-day waiting period. During this time, you can cancel the contract without paying any fees.

Your contract must specify:

- The payment terms for services, including their total cost.
- A detailed description of the services to be performed.
- How long it will take to achieve the results.
- Any guarantees they offer.
- The company's name and business address.

Have you been victimized? Many states have laws regulating credit repair companies. State law enforcement officials may be helpful if you've lost money to credit repair scams.

If you've had a problem with a credit repair company, don't be embarrassed to report it. While you may fear that contacting the government will only make your problems worse, remember that laws are in place to protect you. Contact your local consumer affairs office or your state Attorney General.

Calculate Your Debt To Income Ratio

Your debt to income ratio is an important number to be acquainted with. It tells you how your monthly debt payments compare to your monthly income. A high debt ratio might indicate that your monthly expenses are becoming unmanageable. It also might discourage lenders from loaning you any more money. Use the table below to determine whether your debt ratio is acceptable or too high.

Gross Monthly Income	
Salary/Wages	
Social Security	
Military Pay	
Pension/Retirement Income	
Investment Interest	
Alimony/Child Support	
Rental Income	
Unemployment	
Food Stamps	
Royalties	
Business Income	
Other	
Other	
Total Monthly Income	$

Outstanding Monthly Debt Payments	
Mortgage/Rent	
Credit Cards (Minimum Payments)	
Student Loan Payments	
Automobile Payments	
Recreational Vehicle Payments	
Other Loan Payments	
Other Loan Payments	
Other	
Total Monthly Debt	$

Calculated Debt to Income Ratio

Total Monthly Debt Payment		Total Gross Monthly Income		Total Debt to Income Ratio
$	÷	$	=	%

* **We suggest this be under 40%**

Total Debt to Income Ratio. The total debt to income ratio is a personal finance measure that compares an individual's debt payments to the gross income he or she generates. This measure is important in the lending industry as it gives lenders an idea of a borrower's ability to repay the loan. The higher the ratio, the more burden there is on the individual to make payments on his or her debts. If the ratio is too high, the individual will have a hard time obtaining other forms of financing. On average, a good total debt to income ratio is under 40%.

Annual fee - a yearly fee charged for administering your credit cards. Many credit card companies charge an annual fee.

Annual percentage rate (APR) - a rate that reflects the actual annual cost of a loan, incorporating the loan interest rate, private mortgage insurance, points, and fees.

Annual percentage yield (APY) - the amount of interest earned on a deposit account (checking, savings, money markets, CDs, IRAs), including the effect of interest compounding, expressed as a yearly percentage and assuming funds remain in the account for at least one year.

Amortization schedule - a schedule that shows the portions of each payment that are applied to interest and to principal. It also shows the loan balance remaining after each payment.

Application fee or document fee - most lenders charge an application or document fee to process your paper work. Make sure you shop around for the best deal.

Auto payment - you can set your payments to be made automatically every month from your account.

Bankruptcy - a federal court proceeding in which a debtor who owes more than his or her assets can relieve the debts by transferring the assets to a trustee.

Collateral - the property you provide as security against a secured loan (e.g. house, car).

Co-signer - a person who signs and assumes joint liability with another person for repayment of a debt.

Credit limit - the maximum amount of credit that a bank or financial institution will extend for use.

Credit report - a report of an individual's credit history prepared by a credit bureau and used by a lender to determine a loan applicant's creditworthiness.

Credit reporting agencies - you can obtain a free credit report from the following agencies: *Experian.com, Equifax.com, or Transunion.com.*

Debt-to-Income Ratio - the ratio of a borrower's monthly debt payments to his or her monthly gross income. Lenders use this ratio to assist them in determining how much to lend.

Delinquency - failure to make loan payments on time.

Finance charge - the charges that include all of the interest expected to be earned over the life of a loan, in addition to the service charges, mortgage insurance premiums and certain other charges related to a loan.

Grace period - a specified period after the regular due date of a loan payment during which no late charge or other penalty is assessed.

Installment loan - a type of loan that is paid in periodic and equal-sized payments, such as an auto loan.

Interest - the cost for borrowing money.

Late fee - a penalty fee for not making your payment on time.

Lien holder - the company or individual that has a lien on property.

Liabilities - a person's financial obligations. Liabilities include long-term and short-term debt, as well as any other amounts that are owed to others.

Loan term - the period granted for loan repayment.

Line of credit - a pre-established amount of credit extended to a borrower by a lender that the borrower can draw against as needed.

Mortgage - a legal document that pledges a property to the lender as security for payment of a debt.

Over the limit fee - a fee imposed to you for spending more than the credit limit on your credit card.

Principal - the amount originally borrowed. Also that amount of the monthly loan payment that reduces the outstanding balance of a loan.

Principal and interest - the total amount needed to pay on a loan each month.

Revolving loan - a type of loan that does not have a fixed number of payments. As you pay the balance, the funds once again become available for use.

Signature loan - a loan requiring no collateral.

Title - evidence of a person's right to possession ownership of a property.

Variable rate - an interest rate that may fluctuate during the term of the loan, line of credit or deposit account according to the changes in an index rate, such as the prime rate.

Notes

Managing Credit 101

The majority of the
information contained in
this book is from NEFE
(National Endowment
For Financial Education).
However, some of the
information is based on
the opinions of Capital
Credit Union.

Revised: 2/09