



AVOIDING THE

# Debt Trap

What Young Adults Need To Know

a program of  
The National Association of Retail Collection Attorneys

# What We'll Talk About:

Budgeting for Beginners

How does Credit Work?

It's all in the Math – The True Cost of Credit

Smart vs. Expensive Uses of Credit

The Benefits of Good Credit

The Burdens of Bad Credit

What to do if you get behind

Protecting your Credit

# Budgeting for Beginners

## Why do I care about Budgeting?

- Money only comes from 3 places
  - What you earn
  - What you have saved or been given
  - What someone will lend you
- Debt only comes from 3 places
  - Current Consumption
  - Past Obligations
  - Future Savings





# Budgeting for Beginners

## Typical Young Adult Budget

Monthly Earnings: \$1,200

Monthly Expenses:

– Rent \$400

– Food \$400

– Entertainment \$100

– Transportation  
\$200

– Other \$100

Total \$1,200

Savings \$500



# Budgeting for Beginners

## Typical Middle Age Budget

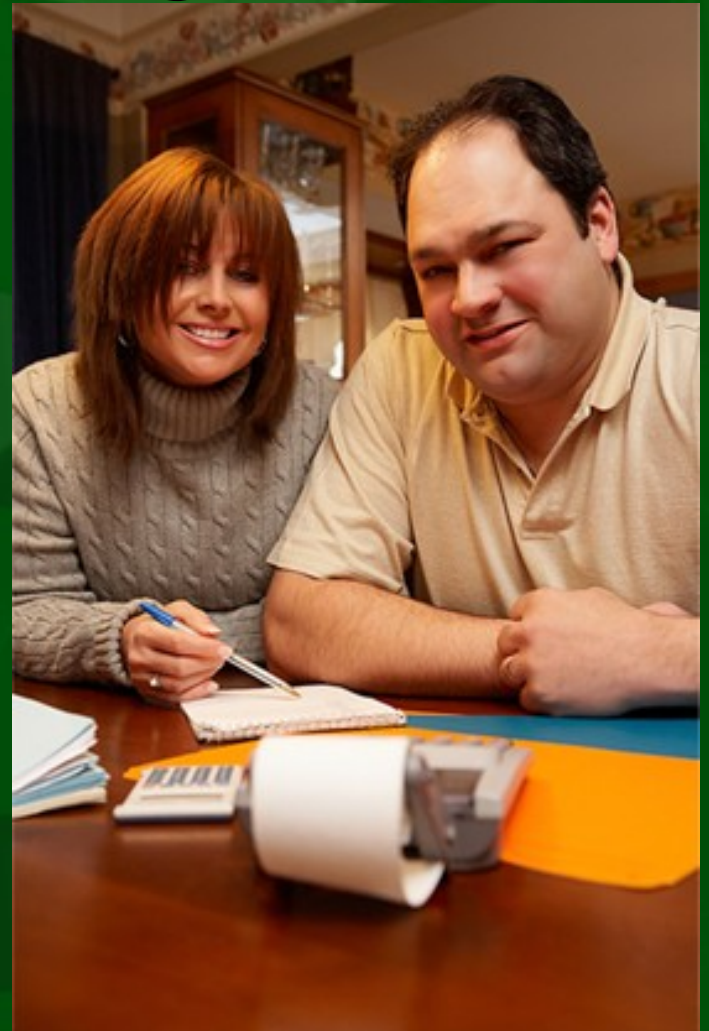
Monthly Earnings: \$4,000

Monthly Expenses:

– Rent/Mortgage	\$1,500
– Utilities	\$400
– Food	\$800
– Transportation	\$400
– Debt Payments	\$500
– Other	\$150
– Savings	<u>\$250</u>
Total	\$4,000

Savings

\$5,000



# Budgeting for Beginners

## Typical Retiree Budget

Social Security \$1,500

Retirement Savings \$500

Total \$2,000

Expenses:

- Taxes & Insurance for Home \$500

- Food \$600

- Travel/Transportation \$400

- Debt Payments \$200

- Other \$300

Total \$2,000

Savings \$2,000



# How does Credit Work? Credit Back Then

*“Buy it new, wear it out,  
pay with cash or do without”*

Signature loans –  
Small Loan Companies

Rent to Own

Mortgage Lending –  
15 years, 20% down



# How does Credit Work?

## Credit Today

**REPLACED BY**

Electronic Financial  
Transactions tied  
to Credit

**REPLACED BY**

Open-end Revolving  
Lines of Credit

**REPLACED BY**

Leasing



# How does Credit Work?

## How Does Credit Work Today?



### Terminology:

- Auto Finance
  - Purchase Price
  - Down Payment
  - Rebates
  - Add ons
    - Credit Life
    - Credit Disability
    - Extended Warranty

# How does Credit Work?

## How Does Credit Work Today?

### **Terminology (cont.)**

- Revolving Line of Credit (Credit Card)
  - Charge Now, Pay When Billed
  - Credit Limit
  - Grace Period
  - “Fixed Rate”
  - Teaser Rate
  - Default Interest Rate
  - Universal Default
  - Rejection of Change in Terms

# How does Credit Work?

## Alternative Finance Options

### **PAYDAY LOANS**

High Fee, Short term borrowing

### **PAWN SHOP**

Sell \$300 item for \$75

Buy back for \$150

After 60 days, they own it

### **RENT TO OWN**

Weekly Rental, no future obligation, eventual ownership, available to those w/ poor credit.

- \$1,000 couch, \$25/week  
36 months = \$3,600 final cost

# It's all in the Math – The True Cost of Credit

## The Miracle of Compounding Interest

Interest for past period is added to the basis for

calculating interest for next period:

**Year 1:**  $\$100 @ 10\% + \$10 = \$110$

**Year 2:**  $\$110 @ 10\% + \$11 = \$121$

**Year 3:**  $\$121 @ 10\% + \$12 = \$133$

**Year 4:**  $\$133 @ 10\% + \$13 = \$146$

**Year 5:**  $\$146 @ 10\% + \$15 = \$161$

**Vs. Simple Interest = \$150**



# It's all in the Math - The True Cost of Credit

## Credit Math

**\$10,000 20 years @ 10%**

Simple Interest = \$30,000

Monthly Compound Interest = \$73,280

Daily Compound Interest = \$73,870

### Earning vs. Paying



I invested \$10,000  
and now I have  
**\$73,870**



I spent \$10,000  
but had to pay **\$73,870**

# It's all in the Math - The True Cost of Credit

## Compare the Cost of Credit

### Loan 1

- \$10,000 / 36 months
- 5.5% interest
- \$500 origination fee
- \$317.06 Monthly pmt
- \$11,414.16 Total Cost

### Loan 2

- \$10,000 / 36 months
- 7% interest
- No origination fee
- \$308.77 Monthly pmt
- \$11,115.72 Total Cost

**Lower interest rate does not  
always result in lower total cost**

# Smart vs. Expensive Uses of Credit

## Wise Use of Credit

### Purchase Washer & Dryer for Home:

Assumptions: Cost of Washer/Dryer: \$1,000 / Value of time (hourly) \$0.00

	<b>Laundromat</b>	<b>Home</b>
Cost per load	\$4	\$0
Soap	Same	Same
Electricity	\$0	\$1
Water	\$0	\$0.50
Time wasted (hours)	3	0
Drive cost (per trip)	\$5	\$0
Depreciation	\$0	\$100

### LOADS PER WEEK

	<b>1</b>	<b>2</b>	<b>4</b>	<b>6</b>	<b>10</b>
<b>Net Annual Savings</b>	<b>\$225</b>	<b>\$300</b>	<b>\$450</b>	<b>\$600</b>	<b>\$900</b>
<b>Rate of Return</b>	<b>18%</b>	<b>27%</b>	<b>44%</b>	<b>59%</b>	<b>90%</b>
<b>Rate of Return, Time = \$1/hr.</b>	<b>36%</b>	<b>44%</b>	<b>59%</b>	<b>75%</b>	<b>105%</b>

# Smart vs. Expensive Uses of Credit

## Other Wise Uses of Credit



### **Purchase**

Home • Car • Durable Goods

### **Finance Education**

### **Emergencies**

### **Home Renovations**

### **Refinance Higher Cost Credit**



# Smart vs. Expensive Uses of Credit

## Potentially Expensive Uses of Credit

- Charging Dinner & Entertainment
- Charging daily expenses
- Charging luxury purchases
- Paying one card with another (“Surfing”)
- Speculating or gambling

Smart vs. Expensive Uses of Credit  
What If You Bought ...  
A New Surround System.



TOTAL \$2,000.00

## Smart vs. Expensive Uses of Credit

*And what if you use your credit card to buy the system*

*and you make monthly payments of **\$300**?*

*Assume you never miss a payment and the annual percentage rate on your card is **8%**.*

**What will the system end up costing you?**

**How long will it take you to pay for it?**

## Smart vs. Expensive Uses of Credit

**Your total cost will be**

**\$2052.00**

**It will take you**

**SEVEN MONTHS**

**to pay for it**



## Smart vs. Expensive Uses of Credit

- Now, instead of an 8% rate of interest , assume that, because of your poor credit rating , you must pay interest at the rate of **24.9%**.
- Also assume that you pay only the **MINIMUM MONTHLY PAYMENT** of \$45 per month (2.25% of the balance).

How long will it take  
you to pay for it?

What will the system  
end up costing you?

## Smart vs. Expensive Uses of Credit

Your total cost will be  
**\$5,595.84!**

It will take you  
**Nearly  
125 Months!**  
(over ten years)  
to pay for it



# Smart vs. Expensive Uses of Credit

## Your choices:

- Pay \$2,000 cash
- Pay \$2,052 over seven months
- Pay \$5,595 over ten years



# The Benefits of Good Credit

## What are the Benefits of Good Credit?



- Lower cost to borrow money
- Larger amounts available to borrow
- Many more credit options available
- Satisfy security clearance checks
- Satisfy employment background checks
- Insurance rates may be lower
- Easier access to credit in emergencies



# The Burdens of Bad Credit

## What are the Consequences of Bad Credit?



- Higher cost to borrow money
- Less money available to borrow
- Many less credit options available
- Unable to get security clearances
- Denied employment in some positions
- Insurance rates may be higher
- Difficult to access credit in emergencies

# Credit Tips

## How to Establish Credit

- Using a checking account or debit card instead of a credit card
- Pay bills in full and on time
- Do not have many open credit card accounts
- Do not have a balance on your credit card exceeding more than 20-30% of your credit limit

# What is a Credit Bureau Report?

- Voluntary Association of Merchants & Credit Grantors
- Each member submits information on its customers to the Bureau
- Each member has access to the information submitted by other members
- Bureau may obtain information from other sources: *Court records, property records, motor vehicle records, etc.*
- Information from all sources are collected into one report for each person
- 3 largest Consumer Credit Bureaus: TransUnion, Experian, Equifax

# Credit Bureau Reports

- Look back 7 to 15 years depending on basis for request.
- Shows the information last reported by the creditor to the bureau.
- May not show information of credit history with non-members.
- Consumers may request a copy of their credit bureau report once each year or if a creditor notifies you that they have denied you credit based on your credit report.
- Any inaccurate listing may be disputed by a consumer, triggering a re-investigation process.

**[www.annualcreditreport.com](http://www.annualcreditreport.com)**



# FICO Credit Scores

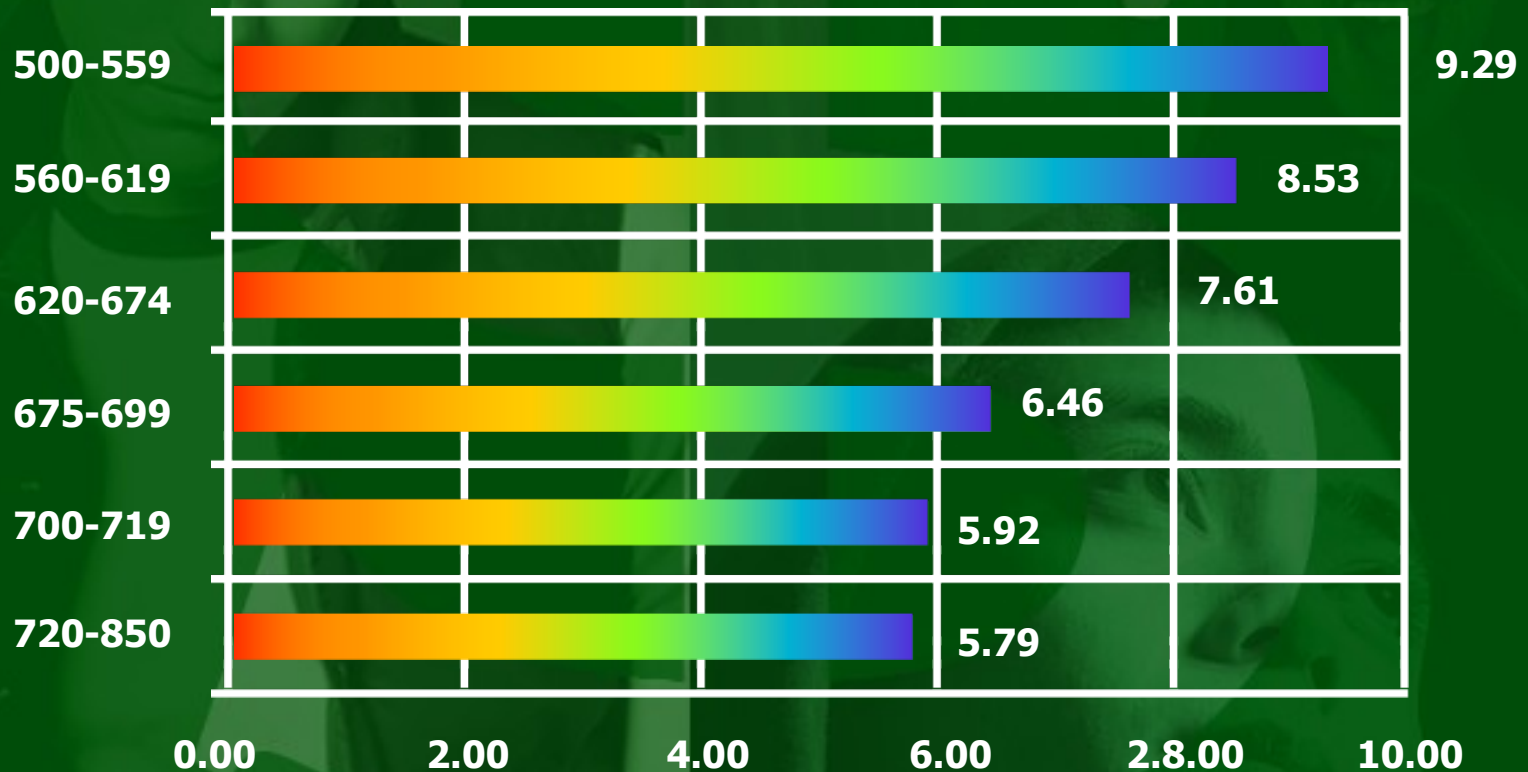
- Determined by Fair ISSAC Corporation
- Analyzes data from credit report to determine a comparative score to compare your future likelihood to repay consumer credit advances
- Determined by past use of credit as recorded by the 3 credit reporting agencies
- Consumer credit score typically a 3-digit number between 300-850, 850 being the best
- Lenders purchase the score to evaluate creditworthiness

# FICO Credit Scores (cont.)

Used by lenders to determine your credit risk / interest rate

**Lower FICO score = higher interest**

**Scores >700 = lower interest**



Average interest rate for a \$200,000 30-year, fixed-rate mortgage on August 5, 2005, based on credit scores nationwide

## FICO Credit Scores (cont.)

- Also used by lenders:
  - To approve your credit application
  - To increase your credit limit
  - To determine treatment if you make a very late payment

FICO Scores are **not** part of your credit report. Learn more and obtain your scores; visit:

[www.myfico.com](http://www.myfico.com)

# Young Adults

- People under age 25 are fastest growing group of bankruptcy filers
- One out of five young adult households are in debt hardship (over 40% of income goes to debt payments each month)
- In last decade, youngest adults (18-24) saw credit card debt increase 104%
- Graduating college students average \$20,402 of debt-- \$3,262 on credit cards
- Individuals seeking credit counseling have average annual salary of \$29,425; average debt excluding mortgage or rent of \$23,184



# Test Your Financial Knowledge



**TRUE**

**FALSE**

# Test Your Financial Knowledge

## True or False?

All credit cards charge the same annual percentage rate of interest on the balance you owe.

**FALSE**

- Different banks charge different rates. Other important terms vary also, such as annual fees, late fees, grace period.
- Check out this website for a comparison of terms:
  - [www.cardtrak.com](http://www.cardtrak.com).
  - [www.bankrate.com](http://www.bankrate.com)

# Test Your Financial Knowledge

## True or False?

The Annual Percentage Rate (APR) on a credit card can be changed at any time by the credit card issuer.

The APR on your credit card can be changed AT ANY TIME by the credit card issuer.



**TRUE**

Change may take place as soon as the beginning of the next billing period.

You may reject the change and payoff the account under the old terms, but may not also make future charges to the account.

Rejection of the change must be made in writing and often sent to a specified address.



## TERMS & CONDITIONS

**Authorization:** When you sign and return the form for this credit card offer from Bank USA, N.A. ("we", or "us"), you agree to the following:

Trans Union Corp., P.O. Box 97328, Jackson, MS 39288.

If we receive this form after the expiration date on the front, or the name and address on the front differ from the information you submit to us, we

**5. As described in the Cardmember Agreement, we reserve the right to change the terms of your account (including the APRs) at any time, for any reason, in addition to APR increases that may occur for failure to comply with the terms of your account.**

- promotional APRs) before balances with higher APRs.
4. Claims and disputes are subject to arbitration.
  5. As described in the Cardmember Agreement, we reserve the right to change the terms of your account (including the APRs) at any time, for any reason, in addition to APR increases that may occur for failure to comply with the terms of your account.

### Notice About this Pre-Approved Offer:

You have been "Pre-Approved" for this offer on the basis of criteria contained on your credit report.

Before we finally approve you for a credit card, we will review your credit report and the information you provide with your form to confirm that you continue to meet these criteria and the other predetermined criteria for this offer. Based on this review, you may not receive a card or you may receive a card with a credit line as low as \$500. It is possible that certain applicants directly applying for a credit card from us, now or in the future, could obtain cards on the same terms or on more favorable terms than the terms available through this offer.

You have the right to notify credit bureaus not to use your credit report in connection with any credit or insurance transaction you do not initiate.

To exercise this right, please call 1-888-567-8688 or write to the credit bureau(s) listed below:

Equifax Options, P.O. Box 740123, Atlanta, GA 30374-0123,

Experian Target Marketing, P.O. Box 919, Allen, TX 75013,

before we grant you credit, or we have actual knowledge of the adverse obligation. All obligations on this account will be incurred in the interest of your marriage or family. You understand that we may be required to give notice of this account to your spouse. Married Wisconsin residents must furnish their (the applicant's) name and social security number as well as the name and address of their spouse to Cardmember Service at P.O. Box 15218, Wilmington, DE 19850-5218.

**Affiliate Information Sharing:** Bank USA, N.A. is part of We and our affiliates may share information about you among affiliates in order to offer products and services of interest to you. If you would prefer that we do not share information from your application, credit bureaus or third parties, please call us at 1-888-868-8618. For more information about our information handling policies, visit us on the web at: <http://www.bankusa.com/privacypolicy>.

If you omit any information on the form, we may deny your request for an account.

We cannot process the form if the mailing address has been changed to a foreign address.

Return your offer in the envelope provided or mail to: Cardmember Service, P.O. Box 15201, Wilmington, DE 19850-5201.

We comply with Section 326 of the USA PATRIOT Act. This law mandates that we verify certain information about you while processing your account application.



# Is That Fair??

Understand what an open end revolving line of credit account

“Credit Card”) **is**, and what it **is not**:

The bank gives you access to credit to make purchases at most merchants.

You agree to pay the charged amounts off as soon as you are billed.

If you don't pay off the balance in full, you agree to pay the bank the finance charge in the current agreement.

You may always reject a change in the account terms by contacting the bank to terminate the account.

If you reject a change in terms you cannot use the card and must pay the account bank according to the terms prior to the proposed change.

It is NOT an agreement to lend you money forever at the rate first agreed to.

# Test Your Financial Knowledge

## True or False?

If you pay your credit card balance in full each month, it doesn't matter what rate of interest the bank charges on your credit card.

**TRUE**

- Since you only pay interest on the unpaid amount each month, you *never pay any interest charge if you pay the entire debt.*
- Exception: Some cash advances incur finance charges immediately

# Test Your Financial Knowledge True or False?

You pay no interest on a debit card purchase.

**TRUE**

- A debit card works just like a check. Your ATM card is probably a debit card.



# Test Your Financial Knowledge

## True or False?

There is a credit report for everyone over the age of 18.

**FALSE**

- There is a credit report only for those who have established a credit history.
- Having **no** credit history can also have adverse consequences.



# Test Your Financial Knowledge

## True or False?

If you are late making a few payments on your credit card, the interest rate you pay may increase sharply.

- For example, on one Platinum VISA card, the rate jumps from 4.9% to 24% if you pay late or miss even one payment. Late charges also accrue.

**TRUE**

# Test Your Financial Knowledge

## True or False?

If you miss just one or two payments on your credit card, it won't hurt your credit rating.

**FALSE**

- That negative information can legally remain on your report for **7 - 15 years.**

# Test Your Financial Knowledge

## True or False?

If you apply for a car loan, the lender will probably review your credit report.

**TRUE**

- People who lend you money will almost always review your credit report. If your credit is poor you may be unable to get a loan or your interest rate will be higher.
- You may receive free copies of your credit report each year.

# Test Your Financial Knowledge

## True or False?

When you apply to rent an apartment, your prospective landlord may review your credit report.

**TRUE**

- Because you are promising to make future payments a landlord would want to know your past payment history.
- Many landlords belong to Associations that retrieve and report information to the credit bureaus for them.



# Test Your Financial Knowledge

## True or False?

When you apply for a job, your prospective employer may review your credit report.



**TRUE**

- A prospective employer can review your credit report if you give written authorization.
- More employers are asking to see credit reports.
- What happens if you refuse to let employers see report?

# Test Your Financial Knowledge

## True or False?

Bouncing just one check won't cause you credit problems.

**FALSE**

- If you bounce a check your bank may put your name in ChexSystems. You could be “blacklisted” by financial institutions for up to 5 years - this means you cannot use a checking account at many stores.

# Test Your Financial Knowledge

## True or False?

The average college student owes several thousand dollars in credit card debt today.

**TRUE**

- Credit card debt is rising rapidly among young adults.
- Don't fall into the trap of spending money you don't have.
- Doing so may result in you having to file bankruptcy.

# What if you get behind?

- Budgets only work when everything goes as planned.
- Job loss, illness & change in living situation most common reasons people get behind.
- **EVERYONE** gets behind in their finances at one time or another.



# What to do if you get behind

## DO

- Adjust your budget
- Contact creditors
- Come up with a realistic plan
- Stick to your plan
- Look for ways to increase income or limit expenses

## DON'T

- Ignore the problem and hope that it will go away.
- Try to maintain your old habits/budget
- Get upset or embarrassed

# Ignoring your creditors when you get behind

- Telephone calls/letters from the creditor
- Telephone calls/letters from a collection agency
- Communication from an attorney
- Filing of a lawsuit
- Issuance of Judgment

## Ignoring your creditors when you get behind (cont.)

- Involuntary enforcement remedies
  - Wage Garnishment
  - Bank Account Seizure
  - Property Lien - Foreclosure
  - Vehicle seizure
  - Mandatory Court Appearances

# Tips for protecting your credit

- ✓ Make a budget and compare it to your actual experience monthly
- ✓ Pay your regular bills in full and on time
- ✓ Always know your current credit balances
- ✓ Review your credit report from each Bureau each year
- ✓ Contact your credit cards every now and then to ask them to lower your rates



# Tips for protecting your credit (cont.)

- ✓ Contact and work with creditors if you get behind – Don't avoid them – It will only make it more expensive
- ✓ Keep creditors and the post office notified of address changes
- ✓ Research credit options closely when financing a home, car or other large purchase to compute the total cost of credit.
- ✓ Keep an eye out for opportunities to refinance your existing credit obligations
- ✓ “Buy it new, wear it out, pay with cash or do without”



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# Questions?

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