



Managing Money

***What Is Credit
and How Much
Credit Can I
Afford?***

Managing Money:

What Is Credit and How Much Credit Can I Afford?

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Consumer credit is a way of using future income to buy the goods and services you want today. When used wisely, credit can be a valuable financial tool. But, when it is used carelessly, credit can cause serious financial problems. Make being smart with credit a habit. Some tips for building good credit include: paying your bills on time; paying at least the minimum amount required; keeping credit card balances low; and establishing credit if you currently have none.

It also is important to know how to avoid credit problems. Can you recognize the credit danger signals? Take a few minutes to read these statements. Check all that apply to you.

- ___ 1. Don't save money.
- ___ 2. Always out of money before payday.
- ___ 3. New monthly credit card charges are more than the monthly credit card payments that you make.
- ___ 4. Longer time needed to pay account balance.
- ___ 5. Juggling payments to creditors.
- ___ 6. Borrowing to pay fixed costs, such as insurance.
- ___ 7. Credit card cash advances used to pay everyday expenses.
- ___ 8. Receive creditors' calls and letters demanding payment of overdue bills.
- ___ 9. Unsure of how much you owe.

- ___ 10. Always late in paying bills.

Now, total up the number of blanks you have checked. One check signals caution. Two checks suggest trouble is brewing. Three or more checks indicate that you should be very concerned and need to take some steps now to help correct the problem.

Advantages/Disadvantages of Credit

Borrowing money isn't good or bad in itself. It just depends on how you use it. When you use credit, what you actually are doing is paying to borrow someone else's money. It's up to you to pay back what you have borrowed by a certain date at a specified cost to you; usually the amount borrowed plus interest charges.

Advantages

- Interest costs for some kinds of purchases may be deducted if you itemize deductions on your tax return. These include interest on a home mortgage, home equity loans and some educational loans. Check with your tax preparer.
- During inflationary times, you repay a debt with cheaper dollars.
- It is possible to buy some goods at a lower price now than in the future.
- Credit cards are convenient to use and safer than carrying large amounts of cash.

Managing Money: What Is Credit and How Much Credit Can I Afford?

- Credit allows you to buy items you can't afford to pay for immediately.

Disadvantages

- You may be easily tempted to buy more than you really need because it's so simple to say, "charge it."
- Instead of comparison shopping for the best price, you shop at the store where you have credit.
- Buying on credit can be habit-forming and can add up to 20 percent or more to the cost of goods and services.
- Because you did not repay quickly, you actually end up paying more for an item you bought on sale than you would have paid when it was the regular price. Think about what you may have to give up later to pay for what you are getting now on credit. If you buy the stereo on credit now, what will you have to give up repaying the loan later? If you take a student loan, will your increase in income cover the cost of repaying the loan? Is it worth it to use credit?

Credit is Not Free

The cost of credit depends on whom you borrow from, your credit history, how much you borrow and how long you take to repay the money you borrowed. Credit costs will vary from lender to lender. Before you borrow, compare the costs at several places. The information in the section on Types of Credit can be used to help you choose the best place to get credit. Annual Percentage Rate (APR) can be used to compare costs. The higher the APR and the longer it takes to repay, the higher the total cost. At a given interest rate, borrowing a smaller amount of money will result in a lower overall credit cost to you. So, a larger down payment lowers the total amount you will have to pay in finance charges.

The longer you take to repay your debt, the more you will pay. Don't just look at how much

you have to repay each month. Look at the total amount of money you will repay. Be sure you know the cost of credit. Try to take the shortest repayment period you can, and make the highest monthly payments you can afford safely. Although repaying the debt in the shortest time frame will save money in interest charges, make sure that you leave enough money to cover current expenses. You do not want to create a situation in which you are stretching your cash flow too thin in order to repay a debt quickly.

Credit Worthiness

Your credit history shows your ability and willingness to repay a debt. It is measured by your record of paying bills. It is determined by how prompt and reliable you have been in making past credit payments. A good credit history helps you qualify for future credit and also may help you get credit at a lower cost. You can check your credit report through the three major credit reporting services. The section on Credit Reports provides information on how to request your credit report and what the information on your credit report says about your credit history.

You also should know that credit histories are used by insurance companies not only to decide whether to cover you, but also to decide whether to renew your coverage. In addition, insurance companies use this information to determine how much to charge for the coverage. Employers often can use your credit history to check you out before you are hired or to decide whether to give you a promotion. Landlords also check it to decide whether or not to rent to you. Your eligibility for a mortgage loan and the interest rate you will be charged is based on your credit report. So it's very important to keep a good credit history.

Can I Afford to Buy This on Credit?

Let's say you really want a new refrigerator but you don't have the money for it. What do you do? Do you borrow the money? Or, do you wait until you

can save some money and buy it later? Consider these basic guidelines when thinking about borrowing money.

- Use the 15-20 percent rule. Your total debt load (except for your mortgage payment) should not exceed 15-20 percent of your monthly after-tax income. Caution! This maximum may still be too high for some families, such as those with an uncertain job future, a low income, high rent, or a high mortgage payment.
- Use the Credit Signal Light Work sheet to help you. Write down how much money you bring home monthly. Multiply the amount by .20 for the maximum amount of credit you can afford. Compare this to your current monthly payments. Now decide—can you really afford to purchase that new refrigerator?
- How much credit you use is really a personal decision, but do look at your needs realistically. Credit is just one part of your spending plan. Consider carefully before obligating any of your future income. If you promise all your money to credit repayment, you won't have any money to "live" on.

Avoid Credit Card Blues

It is all too easy to make purchases when you just have to pull out the "plastic." Easy that is, until all of the monthly bills arrive. Many families use credit to make ends meet and then find it hard, if not impossible, to make all the monthly payments. That's when the "credit card blues" set in. If you have trouble just meeting your monthly payments, let it be a warning to you to cut back on credit use. If you have a hard time avoiding impulse buying, leave the credit cards at home. Keeping track of what you charge will help keep you out of trouble. One suggestion to help keep track is to use a separate check register to record credit card charges. Those purchases can add up at the end of the month without you realizing it.

Finding ways to reduce spending is hard for many families, but not impossible. Everyone in the family should be included in the cutbacks. The more involved family members are in planning ways to reduce spending, the more committed they will be to succeed. It also is a good lesson for your children to learn early in life.

Getting Out of Trouble

The best way to handle debts is to avoid them in the first place. But we all know that is very difficult to do for the majority of families. If you checked two or more of the statements at the beginning of this section, it's time for you to act and do something to better manage your debt load. Use the How Much Do You Owe Work Sheet to help you give you a complete picture of your debt.

- Make sure you know who you owe and how much you owe them. List each creditor (loan company, bank, department store or family member), the total balance owed, the date the monthly payment is due, the number of payments left, the amount of the monthly payment, the due date, and any amount that is past due. Total the balance owed. Next, total your monthly payments.
- Look for ways you might increase your income or decrease your spending. Try to free up some income so you can make your payments. You might want to read the section on spending leaks for tips on reducing spending.
- Do not use any more credit until you are in better financial shape. Try hiding those credit cards so you won't be tempted to use them. You may even need to cut them up! That is exactly what some budget counselors make their clients do before payments are adjusted.
- If you see you will not be able to make your payments, by all means, contact your creditors. Do not ignore them! If you don't contact them about your financial difficulties and don't

Managing Money: What Is Credit and How Much Credit Can I Afford?

make scheduled payments, your account may be turned over to an independent collection agency. However, many creditors, if they know the facts about your financial problems and are convinced of your intent to pay, may agree to defer payments or refinance the debt to reduce the size of your monthly payments. Many are willing to make some arrangement with you. To be helpful, creditors must know of your problems before your payments are overdue. Avoiding them is the worst thing you can do. Above all, be sure to keep your word. If creditors are willing to help you out, be sure you follow through as you say you will. Only make promises that you are sure you can keep.

- If you don't think you can figure out how to manage your debt on your own, you may want to contact a credit counseling service for some help. Classes on rebuilding your credit also could be a source of help.

Be Credit Wise

Credit can be a friend or a foe. It can be an asset or a liability.

If you abuse the privilege, it can ruin future plans. As your family's money manager, you have the responsibility to use credit wisely. If you find your debts have piled up and you feel as if you are out of control, develop a plan to help solve the problem. Getting out of debt takes a lot of work and self-discipline. It can't be done overnight, but it can be done!

Credit Signal Light Work Sheet

Total monthly take-home pay = \$ _____

Total monthly non-mortgage debt owed = \$ _____

10 percent of take-home pay = \$ _____

20 percent of take-home pay = \$ _____

RED STOP!

Monthly credit Payments take 20 percent or more of take-home pay.
STOP! Avoid more credit.

YELLOW!

Monthly credit payments take 15 percent of take-home pay.
CAUTION! Control new credit use.

GREEN

Monthly credit payments take 10-15 percent of take-home pay.
Proceed carefully!

*This resource is one in a series on **Managing Money** which include:*

Making your Money Work:

Determining What Is Important to You
Where Are You Now? (Net Worth Statement)
Stop Spending Leaks
Developing a Spending Plan

Using Credit:

What Is Credit and How Much Credit Can I Afford?
Types of Credit: What Are Your Choices?
Credit Cards
Credit Reports

Building Savings:

Ways to Save
How Your Money Can Grow
Where to Save
Investment Options

Selecting Financial Institutions:

Selecting a Financial Institution
Checking Accounts
Savings Accounts

Creating a Record System:

Keeping Records in Order
Where to Keep Records

Determining Readiness:

Financial Readiness
Benefits and Challenges

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