

Seeking **Good Credit**— And Keeping It

Katie Fraser

“Buy now and pay later.” “Interest free.” “No credit checks.” These are words that we all see every day—on television, in newspapers, and in store windows. They reflect the fact that credit has become almost universally available. We are all able to buy something today and pay for it tomorrow, in a month, or in a year. It is hard to imagine a world without credit and its corollary, debt.

Young people often have their first brush with credit when they leave home to start work or enter college. According to Nellie Mae, a subsidiary of college student loan company Sallie Mae, more than 83 percent of undergraduate students have at least one credit card. The average student credit card balance is \$2,347. Graduating students have an average of \$20,402 in combined education loan and credit card balances. Sixteen percent—more than \$3,000—of that debt is from credit cards.

It is important to teach students about credit early, before they turn 18 and become eligible to sign up for credit cards in their own name. Credit poses risks for the unwary, and many young people get burned. They may pay high annual percentage rates and fees, or borrow more than they can comfortably repay. It is far too easy for young people to learn about managing credit the hard way—by being unable to pay bills on time and damaging their credit record. And a bad credit record has real consequences—not only does it affect the ability to get loans, but it can also be a factor in renting an apartment or even getting a job. Teaching high school students about how to use credit responsibly can help young people man-

age their credit—and their debt—after they leave school and move on to college or the workplace.

Credit has become crucial to our personal economy and to our national economy. With that in mind, this article seeks to answer some of the most common questions about credit so that you can educate young people about how to get good credit, and keep it.

Credit Basics

What is Credit?

Credit is an arrangement by which you borrow money to buy something of value now, and repay the lender at some later date. For example, credit lets you purchase a pair of shoes today and pay for them next month. Credit enables you to make more substantial purchases too: you can buy a car tomorrow, and pay the lender back over the course of several years.

However, there are costs associated with an extension of credit. People do not give you money or sell you products on a deferred payment basis for free. When you obtain credit, you will need to repay the amount you borrowed and an additional amount called interest. Interest compensates the creditor for the costs and risks of extending credit.

What is Debt?

Debt is the amount you borrowed, plus interest. Debt is a consequence of credit. However, it is worth noting that levels of credit and debt are not always equal. For example, if you used credit to purchase a home five years ago and its market value increased, then you have earned extra credit. If you sell the home, you will be able to repay your debt and have money to spare. But if you used credit to purchase a new car a year ago, its market value will have decreased. If you sell the car, you may not be able to repay all of the debt.

Are There Different Types of Consumer Credit?

Yes, there are three basic types of consumer credit:

- **Noninstallment credit** requires consumers to pay their balance in full every month. Travel-and-entertainment cards, such as American Express and Diners Club cards, typically operate this way.
- **Installment credit** requires consumers to repay the amount owed in multiple installments over a fixed period of time. Automobile credit and personal loans are common examples of this type of credit.



Brian Nolan, who has a web page asking for donations to pay off his credit card and student loan debt so he can go to paramedic school, sits next to his computer at his home in Woodland Hills, California, on January 31, 2003. He was more than \$40,000 in debt when he posted his site.

(AP Photo/
Jill Connelly)

- **Revolving credit** allows consumers to draw upon a line of credit, pay off the balance, the minimum monthly payment, or any amount in between, and then use the credit again. Most common credit cards, such as MasterCard and Visa, as well as store credit cards, are examples of revolving credit.

Who is the Creditor and Who is the Debtor?

A person who extends you credit is called a creditor. Creditors include, for example, banks, department stores and other retail sellers, credit card issuers, and finance companies. Recipients of credit are called debtors because they owe a debt to their creditors.

Why do People use Credit?

Many people use credit because it enables them to make large purchases that they could not otherwise afford. For example, most people cannot afford to pay in cash for a new home. But many people can afford to pay a deposit and monthly mortgage payments for the next 20 or

30 years. As long as you continue to make mortgage payments on time, you own your home, and it is yours to live in, remodel, or sell. If you cannot pay off the loan, the mortgage lender may repossess your home and sell it to cover the debt.

People also use credit to purchase things that they could afford to pay for with cash. Why do people use credit this way? Sometimes people use credit for convenience—if you don't have any cash on you, you can use credit instead. Some people use credit to help them keep track of what they are spending, and to receive reward points and other incentives from credit card companies. And many people use credit because they are trying to establish a solid *credit record*.

What is a Credit Record and Why is it Important?

Your credit record is simply your history of credit use. If you have paid your credit card bills and utilities on time, you will probably have a good credit record. If you have skipped bills, your credit record will reflect that. Your credit record also

includes information on where you live, how you pay your bills, and whether you have been sued, arrested, or have filed for bankruptcy.

There are three nationwide consumer reporting companies that keep consumer credit records. A federal law called the *Fair Credit Reporting Act* (FCRA) requires each consumer reporting agency to provide you with a free copy of your credit report, at your request, once every 12 months. That means you can get a free credit report three times per year. It is a good idea to apply for a free copy of your credit report on a regular basis. It gives you a good sense of how your actions can affect your credit report. It's also an excellent way to ensure that you have not become a victim of identity theft (see sidebar).

The nationwide consumer reporting companies sell the information in your credit report to creditors, insurers, employers, and other businesses that use it to evaluate your applications for credit, insurance, employment, or renting a home. Without a credit card, it is difficult to rent a car or get a good car

insurance policy. You could get turned down for an apartment when a potential landlord checks your credit history and finds nothing there. Or you could be asked to pay a large deposit before moving in. For these reasons, it is important to create and maintain a good record.

What is a Credit Score?

A credit score is a number that reflects your credit record. Several pieces of information go into a credit score, including your payment history, length of credit history, types of credit used (a mix of credit cards and other loans is good) and debt (aim to use no more than 35 percent of the credit available—known as the credit limit—on your cards). Income is not a factor. Credit scores range from 300–800. If you have paid bills late, your credit score will be low. If you have always paid bills on time, your credit score will be higher.

When lenders are trying to decide whether to lend you money—for example, to buy a car—they will look at your credit score. If you have a good credit score, then you will represent less of a risk to

the lender, and a lender is more likely to lend you money and charge you lower interest rates.

Starting Out

How do I Establish a Credit Record?

The best way to establish a credit record is to use a major credit card, stay within your credit limit, and pay the bills on time, every time.

How do I Get my First Credit Card?

You may have noticed a Catch-22 to credit reports. You need a good credit record to apply for credit; but you won't have a credit record, if you don't have credit. There are a couple of ways that young people can get their first credit cards:

- Parents can add a child to their own credit cards as an authorized user on the account. The authorized user receives a credit card in his or her own name, and can use the credit card to make purchases. The parent remains financially responsible for the account, but the information about credit card

use is reported on both the parent's and the child's credit record. If the parent makes payments on time, this good payment history will be reported on both the parent's credit record and the child's credit record. The child will be able to build a solid credit record and can apply for credit in his or her own name after turning 18.

- After a young person turns 18, he or she can apply for a secured card instead of a credit card. The secured card looks like a regular credit card. However, it works like a debit card—you can only run up charges that are covered by your savings. So, if you have savings of \$200, you can run up \$200 on your secured card. The good news is that if you use a secured card for a few months and do not go over the limit, you will establish a good credit record, and will be able to apply for a real credit card.

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- You can build a credit record by applying for limited credit from a large, local department store, and using it. Department stores may be willing to give you a charge card even if you have little or no credit record.

Credit card issuers are likely to give credit cards to college students. Credit card issuers realize that parents can be counted on to bail out students who run up balances or fall behind in payments. And students tend to be loyal to their first credit cards—they will keep on charging on those cards long after graduation.

What Kind of Terms Should I Look for When I Apply for a Credit Card?

Remember, credit is not free—you usually have to pay interest and other charges on money you borrow. The yearly fees associated with credit are often expressed in the form of an Annual Percentage Rate, or APR. The lower the APR, the less interest you will pay on the balance you owe. According to Bankrate.com, interest rates on most student credit cards range

from 10-18 percent. Interest rates on the low end of the scale are probably variable, so you can expect them to rise. It can be best to go for a slightly higher fixed rate for the sake of predictability. Bear in mind that some cards will increase the APR if you make late payments, and will charge a higher rate for cash advances.

The charges you pay are not only affected by the APR. Many credit cards have a grace period, which means that you will pay no interest on what you borrow for 20 days or more after you charge it. If your card has a grace period and you pay off the balance on your credit card at the end of every month, you will probably never pay any interest—in effect, you get an interest free loan every month. This is a smart, cost-effective way to use a credit card. Try to avoid credit cards that offer no grace period, even if they have a lower APR.

Some cards will charge penalties if you go over the credit limit, make late payments, or pay less than the minimum payment each month. Charges can be high—up to \$25 per month. Try to avoid cards that charge penalties—they can

RESOURCES

Myvesta has an online exhibit about the history of credit and debt at myvesta.org/history/history_creditcard.htm.

The Bankrate.com website, at www.bankrate.com, has a section on “College Finance” with information for college students on credit cards, student loans, and other money-management issues for young people.

The Nellie Mae website provides some statistics on student debt, and tips for students on how to manage credit wisely: www.nelliemae.com/library/cc_companies.html.



You can apply for one free credit report a year from each of the three Consumer Reporting agencies: TransUnion is at www.transunion.com; Experian is at www.experian.com; and Equifax is at www.equifax.com.

The Young Money website, at www.youngmoney.com/credit_debt, provides useful information for young people on credit and how to manage it.

The Federal Trade Commission provides information for consumers about credit, including information on your legal rights, at www.ftc.gov/bcp/conline/edcams/credit/index.html.

Liberty Under Law: Empowering Youth, Assuring Democracy

Law Day is May 1, 2007

Celebrated each year since 1958, Law Day is, in the words of President Dwight D. Eisenhower, “a day of national dedication to the principles of government under law.” The 2007 theme, *Liberty Under Law: Empowering Youth, Assuring Democracy*, invites us to listen to the voices of youth and consider how the law can better serve their needs and interests.



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result in sky-rocketing credit card balances.

Many credit cards also charge an annual fee, of up to \$75 or so. If you are looking for a no-frills, low-rate card offer with no special rewards program, you should be able to find a card that does not have an annual fee.

A federal law called the Truth in Lending Act obliges lenders to give you information about the APR and other charges associated with credit before you sign on the dotted line. Remember that interest rates and other credit costs vary, and comparison shopping is possible. You should shop for credit as carefully as you shop for the best deal on a car or television set.

If I'm Short on Cash, Should I Take out a Student Loan Instead of Using a Credit Card?

Student loans are a relatively cheap form of credit for students. There are several different types of student loans, including federally subsidized Stafford loans. Most student loans offer a low, fixed-interest rate to students, and you may be able to defer payments until after you finish college. This can make student loans cheaper than credit cards.

These advantages, however, also make it easy to overspend. Remember that student loans are not free money. After you graduate, you will have to pay the money back. In fact, you cannot even escape student loans by declaring bankruptcy. The debts you incur as a student will follow you for a long time.

The Consequences of Credit Abuse

Remember that credit has a consequence: debt. If you use credit responsibly, you will be able to pay back all or part of the debt you owe on credit cards every month. If you abuse credit—if you spend money faster than you can afford to repay it—then your debt will start to escalate.

What will Happen if I Can't Pay my Credit Card Bills?

If you miss a credit card payment or make late payments, your credit card issuer may increase the interest rates on your card and levy penalty fees. If you miss several payments, your bank may cancel the card and ask for immediate payment in full. You may start receiving phone calls from debt collectors, who have the right to seize your property and sell it in order to pay your debt.

If you can't pay your bills, you may want to approach one or more of your creditors and try to reduce or defer your monthly payments without having to pay a penalty. Simply be honest: explain your cash flow problem and ask your creditors if they can help you get back on your feet. If they say no, you may want to contact a credit counseling agency and ask for help in balancing your budget and advice about whether you should consolidate your debt. You may also need to consider bankruptcy.

What is Bankruptcy?

During the early 1800s, you could get tossed in debtor's prison for failing to repay your debts. You were imprisoned until you paid your debts and the cost of your imprisonment. Some people were imprisoned for years. Today there is another option: bankruptcy.

Bankruptcy is a legal process through which people and businesses can seek to obtain a fresh start when they are in such financial difficulty that they cannot repay their debts. There are two types of bankruptcy. If you file for *Chapter 7* bankruptcy, a court will eliminate most of your debts. In return, you will need to *liquidate* your assets. This means you

AVOIDING ID THEFT

Identity theft occurs when one person uses the personal information of another person to commit fraud or theft. In many cases, identity theft involves someone using your Social Security number to apply for credit cards in your name. The thief then runs up credit card bills, which go unpaid, damaging your credit record. It can take months and piles of paperwork to clear your name and escape liability for unpaid bills after you have been a victim of identity theft. Students experience identity theft at the same rate as the general population—about one in thirty students will be a victim of ID theft.

You can take several steps to reduce the chance that you will be a victim of identity theft:

- Guard your personal information. Do not leave your wallet or private information lying around your dorm. Ensure that all credit card bills are mailed to a secure mail box, and shred them after you check them. Use U.S. Mail Boxes for outgoing mail.
- Shop carefully. Use secured sites (indicated by "https") for online shopping. If you receive an email from your bank or any other institution asking you to submit your account information, phone the company to check that the email is genuine.
- Opt out of preapproved credit card offers. There's nothing illegal about these offers. You get them because a consumer reporting company has given your name to companies that solicit new credit card accounts from people with solid credit records. However, preapproved credit card offers do contain sensitive personal information and can put you at increased risk of ID theft if other people have access to your mail. You can opt out of receiving them by calling 1-888-5-OPTOUT or by visiting www.optoutpre-screen.com. The telephone number and website are operated by the major consumer reporting companies.
- Keep track of your finances. Make sure you check your credit card bills to ensure you recognize all the charges. Take advantage of your right to three, free credit reports every year, and check them carefully.

TEACHING ACTIVITY

Planning a Budget

Before your students begin to build good credit, they must have a good understanding of how they earn and spend their money. The best way for them to do this is to track their income and expenses for a period of time. The information they gain can then be used to develop a budget—a plan they can follow to keep their spending in control.

Getting Started

The amount you spend can change from week to week—you might go out to a movie with friends one weekend, but stay at home the next. To get a good sense of how income and expenses average out over time, this activity will ask your students to track their finances for four weeks.

Ask your students to get a small notebook that they can carry with them over the course of this activity. They will use this notebook to record their income and expenses from week to week.

Discuss with students the definitions of the following terms:

Income. Income is the amount of money you receive from any source—an after-school job, an allowance, interest on money deposited in a bank, a holiday or birthday gift from a relative, etc. The total amount of all money you receive is called gross income. Net income is the amount of money actually available to you—if you have a job, for example, expenses such as federal or state income tax may be deducted from your paycheck before you receive it.

Expenses. Expenses are the amounts of money you spend. Fixed expenses are those that you regularly pay, such as a rent or a mortgage payment on a residence or a monthly fee for cell-phone or internet service. Variable expenses change from week to week or month to month. Examples are purchases of clothing or entertainment expenses.

Tracking Income and Expenses

Ask students to record their income and expenses in their notebooks, which they should try to keep with them throughout the four weeks of the activity. For income entries, ask students to note the source of the income (e.g., after-school job, baby-sitting, weekly allowance, gifts) and to record net income only (this may be an issue if students have an after-school or weekend job from which taxes are withheld). For expense items, ask students to note whether the expense is “fixed” or “variable” (see definitions above). Emphasize that students should record all money they receive as income and everything they spend (even small purchases can quickly add up if they are made every day).

At the end of each week, ask the students to record their notebook entries on a two-column chart (one column for income and one for expenses). Have the students total the two columns and calculate how much their income exceeds their expenses or

their expenses exceed their income. Also ask students to circle or highlight any income or expense items that were unexpected or unusual. Students should save their weekly reports—they will need them to complete the activity.

Developing a Budget

At the end of the fourth week, ask the students to calculate their total income and expenses for the four weeks. Ask them to calculate how much they earned and spent each week on average (i.e., total income and expenses divided by four). Then ask students to analyze their reports by answering the following questions:

1. Did your income exceed your expenses for the four-week period? What was the average weekly difference between income and expenses?
2. Did you have unusual income or expenses during the four-week period? What impact did these items have on your reports?
3. Do you have any significant expenses during the year (e.g., new “back to school” clothes, holiday gifts, etc.) that weren’t included in your four weekly reports?
4. If you had expenses in excess of income, are there any “non-essential” expenses you could have avoided to keep your expenses at, or below, your income?

After students finish their analysis of their reports, ask them to develop a weekly (or monthly) budget that they can follow over the coming year. The budget should detail their anticipated income for the period, their anticipated fixed expenses, and their anticipated variable expenses. Encourage students to develop subcategories for income (job wages, allowance money, etc.) and expenses (clothing, entertainment, school supplies, etc.) so they can keep a close eye on where their money is coming from and how it is being spent.

When developing their budgets, students should keep in mind the following points:

1. Use the information gathered during the four weeks to plan your expected income and expenses. If you need to reduce your expenses, focus first on expenses you noted as “variable.” Also consider which of your fixed expenses might be non-essential or could be reduced (for example, eliminating optional features on a cellphone plan).
2. If you thought of any significant expenses that will occur during the coming year but were not reflected on your weekly reports, think of how much you would need to set aside each week (or month) to pay those expenses.
3. Try to budget to save at least 5 percent of your income—this is a great habit to start early on.
4. Use your budget to keep track of your expenses over the coming year. Living within a budget is a skill you will need for the rest of your life.

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have to give up most of your assets so that they can be sold in order to repay your creditors. A Chapter 7 bankruptcy will be recorded on your credit record for up to 10 years. It can be difficult or impossible to get credit during that time.

If you file for a *Chapter 13* bankruptcy, your debts will not be eliminated. Instead, you will need to pay off all or a percentage of your debts over five years. The advantage of Chapter 13 is that the court does not require you to liquidate your assets—you can keep your home, for example, if you stay up to date on payments. The disadvantage is that you will be locked in to paying your creditors every single month for up to five years. Chapter 13 bankruptcies are recorded on your credit record for seven years.


Can I Choose to File for Bankruptcy under Chapter 7 or Chapter 13?

It used to be the case that you could decide which kind of bankruptcy to file for. The majority of people filed under Chapter 7 and eliminated their debts. However, in 2005, Congress passed the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*. Under the act, you may only file for Chapter 7 bankruptcy if you earn less than the median income in your state. As a result of the act, more people are filing for Chapter 13 bankruptcy, and have to pay off their debts over an extended period of time.

How Can I Avoid Getting Deep in Debt?

- Take credit seriously. Remember, credit is not free money—you will have to repay it.
- Learn to manage your money. One of the best ways to start managing your money wisely is to map out a budget. Work out how much income you have per month, and what expenses you have. Make sure you budget to save a small amount each

month—saving is a good habit to get into. If you find you are regularly going over your budget, try and work out why that is. Write down everything you spend in a week—on transport, food, clothes, entertainment and so on. You will be surprised at how much you spend, and where your money goes. Once you work out why you are over budget, you can take action to cut down on your spending.

- Don't take on more credit than you can handle. Start out by using just one card, and pay it off completely every month. If your goal is establishing a solid credit record, you should be sure to pay your credit card bills on time. If you can't pay off the card in full every month, you may be getting too deep into debt.
- Use credit cards sparingly, and avoid using credit cards instead of cash.
- Avoid cash advances. They may seem like a good idea, but you will pay a high interest rate on cash advances from the moment you make the withdrawal.
- Don't overlook credit cards available from credit unions on college campuses. These cards tend to have more consumer-friendly rates and fees. 

KATIE FRASER was program manager and editor for the ABA Division for Public Education, based in Chicago, through December 2007. She is now living in Australia.

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